



Quarterly Financial Report  
December 31, 2009 and 2008



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This discussion and analysis of the financial performance of Pennsylvania Higher Education Assistance Agency (“PHEAA”) is required supplementary information. It introduces the basic financial statements and provides an analytical overview of our financial activities. Please read it in conjunction with the financial statements that follow this discussion.

## **About PHEAA**

Our mission is to improve higher education opportunities for Pennsylvanians. We are a public corporation and government instrumentality created by the Pennsylvania General Assembly. We serve students and schools nationally through our state grant, guaranty, servicing, and financial aid processing systems. We have developed ways to reduce the financial burdens on students and borrowers, while streamlining delivery systems for schools and lenders.

Our Keystone family of student loan programs is one way that has helped make higher education more affordable. The Keystone family of loans, which includes Stafford and PLUS loan programs, has helped reduce the cost of student loan borrowing, and it has increased efficiency, flexibility and lender choice within the financial aid community.

The Pennsylvania State Grant Program is the third largest state grant program in the nation. We administer the program on behalf of the Commonwealth of Pennsylvania each year, without taxpayer support. Our business earnings fund the administration of this program ensuring that every appropriated dollar goes directly to students.

Our debt management professionals; our use of technology; and our website, YouCanDealWithIt.com, have reduced financial risk for our customers and ensured that funds remain accessible to all students. Our cohort default rate for fiscal year 2007 (the most recently published rate from the U.S. Department of Education (ED)) was 5.5%, which ranks below the national industry average of 6.7%.

We guarantee Federal Stafford, PLUS and consolidation loans enabling students to continue their pursuit of higher education. As of December 31, 2009, the original principal outstanding balance of student loans guaranteed was \$51.3 billion.

On June 17, 2009, ED selected us as one of four servicers to service a portion of the nation’s growing federally owned student loan portfolio. FedLoan Servicing (FLS), a division within PHEAA, is responsible for the servicing of the federal student loans. On August 26, 2009, we successfully completed the acceptance and validation process for the initial phase of the Title IV Servicing Management contract and the federal government approved us to begin servicing Title IV FFEL Program loans for ED.

We save schools administrative costs through our advanced financial aid delivery products and services, such as our OneLINK<sup>SM</sup> Loan Guaranty System. OneLink is a real-time financial aid processing system that provides schools with loan guaranty, origination, and servicing functionality, allowing them control of the financial aid delivery process.

## **Public Service Benefits**

To serve Pennsylvanians effectively, we operate both inside and outside Pennsylvania. Instead of using taxpayer money to support our administration, we administer state programs at no cost to taxpayers to ensure that every appropriated dollar goes directly to students and their families.

The following table highlights the public service benefits and the operating expenses incurred by us for those programs.

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
<b>Self-funded</b>				
Costs of operating state and federal governmental programs	\$ 3,296	3,750	\$ 6,974	7,457
Keystone loan program origination fees and benefits paid on behalf of borrowers	150	693	167	1,263
Federal default fees paid on behalf of borrowers	1	4,386	53	15,295
Funding and support of The Pennsylvania Higher Education Foundation, Inc.	(50)	127	59	234
Other public service activities and outreach	228	1,571	778	2,791
	<b>3,625</b>	<b>10,527</b>	<b>8,031</b>	<b>27,040</b>
<b>Financial support funded by our business partners</b>				
Keystone loan program origination fees and benefits paid on behalf of borrowers	7	176	11	446
	\$ 3,632	10,703	\$ 8,042	27,486

We administer various grant programs to help students pursuing higher education. The most significant programs are funded by the Commonwealth of Pennsylvania and are as follows:

- The State Grant Program provides full-time students grants up to \$4,120 based upon financial need.
- The Institutional Assistance Grants Program provides grants to independent postsecondary education institutions to make sure both public and independent postsecondary institutions are viable in the Commonwealth.
- The Matching Funds Program provides financial assistance to higher education institutions to assist them in capturing federal funds that require a state or local match as part of the federal grant award.
- The New Economy Technology Scholarship Program provides financial assistance grants up to \$3,000 to students enrolled in a postsecondary science or technology program approved by the Pennsylvania Department of Education.
- The Pennsylvania National Guard Education Assistance Program (EAP) is for members of the Pennsylvania National Guard. This program provides tuition assistance for students who enter into a service commitment with the Pennsylvania National Guard, typically for a period of six years. The maximum EAP award for full-time students is the lesser of the actual tuition charged for the full-time course of study, or 100% of the tuition charged to a Pennsylvania resident at a state-owned university.
- The Postsecondary Educational Gratuities Program (PEGP) assists birth or adoptive children of Pennsylvania police officers, firefighters, rescue and ambulance squad members, corrections employees and National Guard members who died in the line of duty since January 1, 1976. The program also includes the birth and adoptive children of Pennsylvania sheriffs, deputy sheriffs and certain other individuals who were on federal or state active military duty who died in the line of duty since September 11, 2001. The PEGP covers all institutional charges for tuition, fees, room and board not covered by other grants and scholarships.

We support The Pennsylvania Higher Education Foundation, Inc., ("PHEF") which is a tax-exempt organization that supports postsecondary education. PHEF created the Nursing Education Grant Program and disbursed \$10.3 million of grants during its most recent fiscal year ended May 31, 2009.

Finally, we fund other public service and outreach initiatives to ensure students are aware of the financial aid opportunities available to them and to avert student loan defaults.

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### *Changes in Federal Laws and Public Service Initiatives*

Changes in federal laws and the decline of the credit and financial markets adversely affected our operations and our ability to continue to fund public service initiatives. Presented below is a recap of the changes in federal laws and the changes made to public service initiatives.

On September 27, 2007, President Bush signed the College Cost Reduction and Access Act ("Act") into law. This Act was generally effective on October 1, 2007 and caused, or will cause, the following reductions in operating revenue.

- For Stafford and Consolidation loans first disbursed on or after October 1, 2007, special allowance payments to us are 0.4% lower.
- For PLUS loans first disbursed on or after October 1, 2007, special allowance payments to us are 0.7% lower.
- For all loans first disbursed on or after October 1, 2007, lender origination fees paid to ED increased from 0.5% to 1.0%.
- Effective October 1, 2007, retention of collections on defaulted loans decreased from 23% to 16%.
- Effective October 1, 2007, the account maintenance fee received from ED for outstanding loan guarantees decreased from 0.1% to 0.06%.
- Effective October 1, 2007, the exceptional performer section was eliminated from the law.
- Effective October 1, 2012, lender insurance for loans first disbursed on or after October 1, 2012 will decrease from 97% to 95%.
- Effective July 1, 2010, the Parent Loan for Undergraduate Students (PLUS) program will be converted to an auction.

On October 19, 2007, because of the passage of the Act, the board of directors adopted a resolution reducing the supplement to the State Grant Program to \$35 million and eliminating funding of the Workforce Advancement Grant for Education and other financial aid programs for the fiscal year ending June 30, 2009. On April 24, 2008, due to the capital and financial market developments, the board of directors adopted a resolution to eliminate the funding of the State Grant Supplement Program and other financial aid programs.

On January 24, 2008, the board of directors adopted a resolution discontinuing annual cash donations to the Pennsylvania Higher Education Foundation (PHEF), and reducing the amount provided for ongoing operational support to \$300 thousand annually through May 31, 2012 and thereafter until further action of the board. On April 23, 2009, the board of directors repealed a portion of the January 24, 2008 resolution that directs PHEAA not to exceed \$300 thousand annually in operational support.

On April 24, 2008, management announced a workforce optimization program to better support our changing business needs and to realize greater efficiencies. The program, open to all non-union employees, allowed participants to receive a one-time cash payout, which was calculated based upon salary and longevity, for voluntarily departing the Agency. The last day employees could elect to participate in the program was June 23, 2008. The program resulted in staffing reductions of 264 employees.

On May 7, 2008, President Bush signed H.R. 5715, titled "Ensuring Continued Access to Student Loans Act of 2008," (ECASLA) into law. ECASLA was in response to concern that the credit market conditions could disrupt federal student loan availability. The law gives ED temporary authority to purchase federally backed student loans made by private lenders, effectively providing a secondary market for the loans. ED created the following four separate loan purchase arrangements under ECASLA:

- **Put Option** – The Put Option gives lenders the option to sell Federal Family Education Loan (FFEL) issued during the 2008-09 academic year. This option expired on September 30, 2009. Lenders have until September 30, 2010 to sell the loans made for the 2009-10 academic year. The put option allows, but does not require, lenders to "put" (sell) loans to ED by a certain date at a predetermined price. Private contractors hired by ED service loans sold under the put option.

- **Short-term purchase program** – This program is different from the put option program, because it applies only to academic year 2007-08 loans, instead of 2008-09 and 2009-10 and it limited the weekly loan sales to \$500 million (the put option has no limit). ED requires that the average loan value within any package of loans sold by a lender be at least \$3,000. ED paid lenders 97% of outstanding principal (including accrued but unpaid interest) for each sold loan. This percentage matches the default guarantee rate the government provides on FFEL loans.
- **Loan financing arrangement – participation interest program** - This program allows lenders to secure temporary financing from the federal government for loans issued in academic years 2008-09 and 2009-10. Lenders make FFEL loans to borrowers and then pool the loans. The pooled loans are then temporarily sold to a bank that has agreed to act as a custodian. ED purchases a 100% ownership interest in the loan principal held by the custodian. Lenders continue to service the loans and can make new loans with the sale proceeds. Each quarter, lenders make interest payments to and receive subsidies from ED under the financing arrangement.
- **Asset-backed commercial paper conduit program** – The conduit program applies to loans issued between October 1, 2003 and July 1, 2009, making it the only purchase program for loans made before the 2007-08 academic year. Asset-backed commercial paper conduits are used in private capital markets to finance assets and receivables such as mortgages, credit card payments and loans. The conduit borrows funds by issuing commercial paper. Investors buy the commercial paper and collect interest and the conduit uses the borrowed funds to buy a pool of assets. Income from these assets is used to pay interest on the commercial paper. ED is acting as buyer-of-last-resort for loans financed through private conduits. ED has committed to purchase the underlying FFEL loans in the event that a conduit cannot refinance maturing commercial paper. Under the arrangement, ED will purchase FFEL loans issued after May 1, 2008 for 100% of outstanding principal and accrued interest. Loans issued earlier than May 1, 2008 will be paid out at 97% of unpaid principal plus accrued interest.

On August 14, 2008, President Bush signed into law H.R. 4137, the Higher Education Opportunity Act. This law continues Congress's efforts to make college more affordable and accessible by enacting the following:

- Holds colleges and universities accountable by requiring greater disclosure in costs
- Protects students from aggressive marketing practices by lenders
- Simplifies the federal student aid application process
- Allows students to receive Pell Grant scholarship aid year round
- Increases college aid and support for veterans and military families
- Expands loan forgiveness program
- Amends Truth in Lending Act to prevent unfair and deceptive lending practices

On October 7, 2008, President Bush signed into law H.R. 6889, which amends H.R. 5715 above. H.R. 6889 does the following:

- Amends the Higher Education Act of 1965;
- Extends by one year, from July 2009 to July 2010, the Secretary of Education's authority to purchase, or enter into forward commitments to purchase, FFELP loans from lenders upon the determination that there is an inadequate availability of loan capital to meet the demand for such loans.
- Extends by one year, from June 30, 2009 to June 30, 2010, the authority of institutions of higher education (IHEs), to participate in the FFEL lender-of-last-resort program for borrowers otherwise unable to obtain such loans; thereby requiring guaranty agencies serving as lenders-of-last-resort to make FFELs to student and parent borrowers of such IHEs, until such date, regardless of their ability to otherwise obtain such loans.

## Operations

Our operations involve originating, purchasing, selling, guaranteeing, and servicing student loans that generally operate under FFELP, although we also originate, purchase, and service loans that are not part of FFELP. FFELP is the federal program that allows undergraduate or graduate students at eligible postsecondary schools to obtain low-cost loans.

Currently, there are four types of FFELP loans:

- Subsidized Stafford – the federal government pays the interest on these loans while the student is in school, during the grace period, and during deferments.
- Unsubsidized Stafford – the student is responsible for all interest.
- PLUS – this is a supplemental loan to parents and graduate students.
- Consolidation – this allows the borrower to combine Stafford and certain other education-related loans, fix the rate of interest on the loans, and extend the repayment period.

The type of loan and the regulations in effect during the origination of the loan determines the interest rate charged to borrowers. For example, undergraduate borrowers that receive subsidized Stafford loans on or after July 1, 2009 have an interest rate of 5.6%. Graduate borrowers that receive subsidized Stafford loans on or after July 1, 2009 have an interest rate of 6.8%. Undergraduate and graduate borrowers that receive unsubsidized Stafford loans on or after July 1, 2006 have an interest rate of 6.8%. PLUS loans disbursed on or after July 1, 2006 have an interest rate of 8.5%.

In the past, we purchased student loans related to the Health Education Assistance Loan (“HEAL”) Program. Under the HEAL Program, borrowers pay interest at a variable-rate that resets quarterly based upon the 91-day U.S. Treasury Bill plus a spread of up to 3%. The U.S. Department of Health and Human Services determines the actual limit on the interest rate spread for an individual loan.

#### ***Special Interest Subsidy and Special Allowance Payments***

ED compensates lenders participating in the FFELP through a combination of interest benefits and special allowance payments, which we account for these payments as interest revenue. Interest benefits are paid to lenders on behalf of eligible borrowers with subsidized FFELP loans when the loans are in a qualifying status.

Special allowance payments bring a lender's earnings on eligible FFELP loans closer to market rates. ED pays special allowance payments during any quarter in which the special allowance calculation is a positive number. For loans first disbursed on or after April 1, 2006, ED will collect excess interest for quarters in which the interest rate on the loan exceeds the special allowance support level, commonly referred to as negative special allowance. Special allowance rates vary according to date of the loan disbursement, the loan period and the loan status.

The special allowance rates are calculated using the following factors:

- The average of the bond equivalent rates on the quotes of the 3-month financial commercial paper rates for Stafford and PLUS loans first disbursed on or after January 1, 2000, and for Consolidation loans made from applications received by lenders on or after January 1, 2000.
- The average bond equivalent rate of the 91-day Treasury bills for Stafford and PLUS loans first disbursed prior to January 1, 2000 and for Consolidation loans made from applications received by lenders before January 1, 2000.
- A factor prescribed by law for each category of loans. This factor is added to the applicable 91-day Treasury bill or 3-month financial commercial paper rate.

The Federal Government charges an origination fee to help offset the costs of interest, special allowance and reinsurance payments on a FFELP loan. The federal government requires the up-front origination fees to be deducted from the proceeds of student loans and remitted to them. These fees decreased from 1% in 2008 to 0.5% in 2009, and they will continue to decrease to 0% by July 1, 2010.

#### ***Guaranty Activities***

Our major function as a guarantor is to use the Federal Fund to guarantee 97% - 98% of borrower's outstanding loan balance if the borrower fails to pay the loan. Under federal regulations, we must manage the Federal Fund so that there is enough money to pay lenders when their normal collection efforts fail. The federal government reinsures the

Federal Fund, and reinsurance rates vary based upon the default rates of our portfolio of guaranteed loans and the disbursement date of the loan. The following outlines reinsurance rates:

- |  |            |
|--|------------|
| ▪ Disbursed before October 1, 1993                         | 80% – 100% |
| ▪ Disbursed between October 1, 1993 and September 30, 1998 | 78% – 98%  |
| ▪ Disbursed on or after October 1, 1998                    | 75% – 95%  |

ED pays us a loan processing and issuance fee of 0.40% for loans we guarantee; however, new consolidation loans are exempt from this fee. ED also pays us an annual account maintenance fee of 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new guaranteed Stafford and PLUS loans. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. On October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. We discuss the federal default fees paid on behalf of borrowers within the section titled "Changes in Net Assets - Grants and Other Financial Aid Activity".

Once a loan defaults, as a guarantor, we continue to try to collect on the loan and we retain up to 16% of the borrower's payments collected as revenue. The federal government retains the remaining portion of any borrower's payments.

As a guarantor, we have established a loan rehabilitation program for all borrowers with an enforceable promissory note. However, the following circumstances will exclude a borrower from the loan rehabilitation program:

- a judgment has been obtained on the loan;
- default claims were filed on the loan under Sec. 682.412 (Consequences of the failure of a borrower or a student to establish eligibility); and
- the borrower has been convicted of, or has pled *nolo contendere* or guilty to, a crime involving fraud in obtaining Title IV, Higher Education Act program assistance

A borrower must meet the following requirements for us to consider the loan rehabilitated:

- the borrower has made nine of the ten payments required under a monthly repayment agreement;
- nine payments have been received by us within a ten month period; and
- the loan is sold to an eligible lender.

The borrower regains all benefits of the rehabilitation program, including any remaining deferment eligibility, once the above program is completed. For rehabilitation payments, we retain 18.5% of the original principal balance, 100% of the collection costs (capped at 18.5% of principal and accrued interest) and 100% of accrued interest collected as revenue.

Lastly, we earn default aversion fees when servicers involve us as a guarantor to avert potential defaults. The Federal Fund pays the default aversion fee, but if the loan subsequently defaults, we must return the fee to the Federal Fund. Since January 1, 2008, we have not recognized default aversion fee revenue, since we do not expect to collect these amounts from the Federal Fund. We manage the cash flow of the Federal Fund to pay default claims rather than to pay default aversion fees.

### ***Servicing Activities***

We service student loans that we own and we provide third party servicing for student loans owned by others. We also offer remote servicing, which is limited to data processing functions. We service student loans for federal and state agencies, commercial and private lenders throughout the United States. As a servicer, we are responsible for servicing, maintaining custody of, and making collections on student loans.

We use our proprietary COMPASS system for full servicing of student loans for our external clients, as well as, our own clients. Our personnel, lending institutions, academic institutions, and other higher education servicing agencies use COMPASS, which is a mainframe-based decision support tool. Each of our client's data is separated, monitored and secured. As of December 31, 2009, we are servicing under our full-servicing program approximately \$62.7 billion and under our remote servicing operation approximately \$32.3 billion.

Our eCommunications Center provides our borrowers with access to on-line customer servicing including convenient and easy repayment options.

Our Online Account Access customer portal ensures our borrowers' safety and security as they make loan payments, update personal account information, apply for a loan, and receive online customer service. Borrowers also have the option to make their loan payments by phone via our Interactive Voice Response (IVR) telephone payment service.

Our loan origination web refund system provides financial aid professionals with an efficient and secure online automated system to refund student loans. Users may enter the borrower's account number or group the refunds by disbursement date and then review the AES Loan Origination System for loan disbursement.

We have a green initiative, which promotes eBilling to our borrowers encouraging them to eliminate their monthly paper bills. As of December 31, 2009, more than 272 thousand of our borrowers have opted for this green method of loan billing.

### ***Loan Origination and Purchasing***

We issued revenue bonds from 1983 until the present and we used the proceeds from those revenue bonds to make various types of student loans. We also purchased student loans from banks and other lenders from time to time. However, due to an inability to access the credit or financing markets, effective March 7, 2008, we suspended our activities as a lender for any new loans first disbursed on or after that date. In addition, we suspended making purchases under our forward purchase contracts with other lending institutions. As of December 31, 2009, we have student loan purchase commitments of \$163.9 million that we have been unable to fund or settle, and an additional \$7.9 million of student loan purchase commitments through June 30, 2010 and thereafter. All of the purchase commitments are with financial institutions and we continue to work with those institutions to renegotiate the terms and timing of these commitments.

### **Forward-looking Statements**

This financial report contains statements relating to future results. These forward-looking statements relate to, among other things, risk-sharing losses, servicing losses, simulation of changes in interest rates, litigation results, changes in law and regulations, and the adoption of new accounting standards. These forward-looking statements are based on assumptions that involve risks and uncertainties and that are subject to change based on various important factors (some of which are beyond our control). Actual results may differ materially from those expressed or implied as a result of these risks and uncertainties, including, but not limited to, interest rate fluctuations; changes in political and economic conditions; competitive product and pricing pressures within our markets; market fluctuations; the effects of adopting new accounting standards; inflation; technological change; changes in law; changes in fiscal, monetary, regulatory, and tax policies and laws; success in gaining regulatory approvals when required; success in the timely development of new products and services; as well as other risks and uncertainties. Such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

## **Description of the Basic Financial Statements**

The statements of revenues, expenses, and changes in net assets report our revenues and expenses. The statements measure the results of our operations over a period of time.

The statements of net assets include recorded assets and liabilities. Assets are what we own or control, and liabilities are what we owe. Net assets remain after assets are used to satisfy liabilities. These statements report our assets, liabilities and net assets at a point in time.

The statements of cash flows supplement these statements providing relevant information about cash receipts and payments over a period of time.

The notes to the financial statements are an integral part of the financial statements and contain important information necessary to get a complete view of our finances.

We are financed and operated similar to a private business enterprise; therefore, the Commonwealth accounts for us as an enterprise fund. As an enterprise fund, we follow the economic resources measurement focus and accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. While private business enterprises follow the accounting guidance issued by the Financial Accounting Standards Board ("FASB"), we follow the guidance issued by the Governmental Accounting Standards Board ("GASB"). As encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989 to be consistent with the accounting practices of the Commonwealth.

## Condensed Financial Information

### Statements of Revenues, Expenses, and Changes in Net Assets

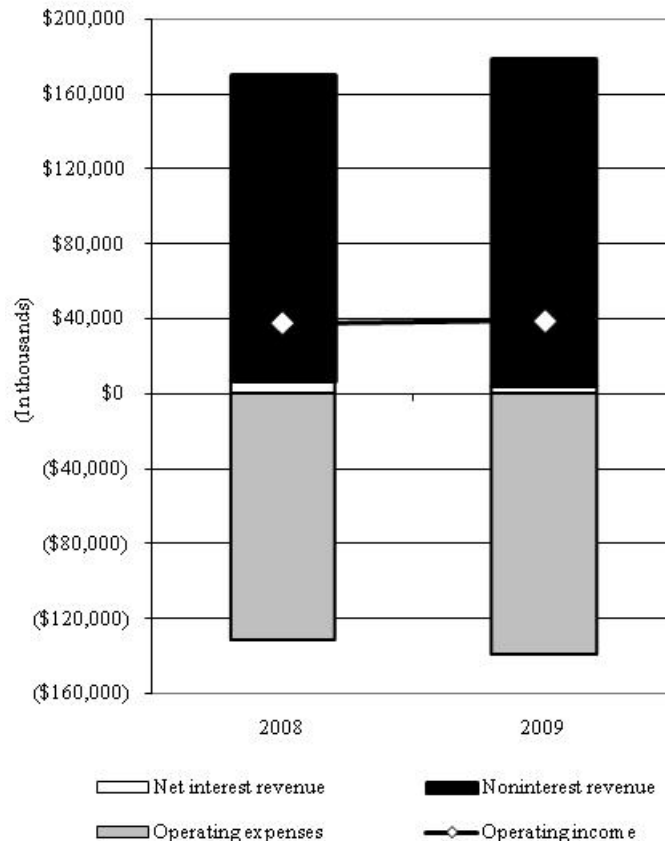
(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
Student loan interest revenue	\$ 48,481	108,223	\$ 100,459	224,401
Investment interest revenue	2,345	1,523	6,329	3,610
Interest expense on student loan financings and notes and bonds payable	(46,507)	(102,201)	(94,375)	(213,103)
Interest expense on capital and other financings	(2,884)	(2,849)	(5,226)	(6,100)
Net interest revenue	1,435	4,696	7,187	8,808
Provision for loan losses	(1,730)	(1,367)	(3,377)	(2,117)
Net interest (expense) revenue after provision for loan losses	(295)	3,329	3,810	6,691
Servicing fees	49,111	42,042	97,063	79,866
Retention of collections on defaulted loans	29,668	28,121	55,758	56,402
Federal fees	9,893	10,452	22,980	22,964
Changes in fair value of residual interest, net	2,129	3,873	2,523	4,894
Loss on student loan sales, net	(3,440)	-	(3,459)	-
Default aversion fees, net of rebates	(26)	(43)	(603)	(1,295)
Other	37	80	56	309
Total noninterest revenue	87,372	84,525	174,318	163,140
Operating revenues	87,077	87,854	178,128	169,831
Operating expenses	(71,624)	(67,186)	(139,389)	(132,107)
Operating income	15,453	20,668	38,739	37,724
Commonwealth of Pennsylvania grants	407,263	181,969	407,659	422,471
Federal grants	3,909	-	5,450	5,716
Grants and other financial aid	(229,624)	(78,428)	(240,349)	(253,392)
Grant funds returned to the Commonwealth of Pennsylvania	(11,284)	(75)	(11,284)	(14,931)
Transfers from (to) Pennsylvania Higher Education Foundation	50	(127)	(59)	(234)
Change in net assets	\$ 185,767	124,007	\$ 200,156	197,354

Statements of Net Assets

(In thousands)	December 31, 2009	June 30, 2009
Cash, cash equivalents, and investments, substantially restricted	\$ 1,018,010	594,808
Student loans receivable, net	10,074,839	11,169,840
Interest income receivable	166,882	197,302
Capital assets, net	61,871	59,783
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	117,535	107,655
Other	155,593	149,103
<b>Total assets</b>	<b>11,594,730</b>	<b>12,278,491</b>
Student loan financings and notes and bonds payable, net	10,406,364	11,361,553
Capital and other financings	258,011	274,855
Amounts related to the Federal Student Loan Reserve Fund	117,535	107,655
Other	215,101	136,865
<b>Total liabilities</b>	<b>10,997,011</b>	<b>11,880,928</b>
<b>Net assets</b>		
Invested in capital assets, net of related debt	(16,284)	(16,424)
Restricted for debt service	277,886	263,489
Restricted for financial aid grant programs	222,942	59,819
Unrestricted	113,175	90,679
<b>Total net assets</b>	<b>\$ 597,719</b>	<b>397,563</b>

## Results of Operations

Six months ended December 31



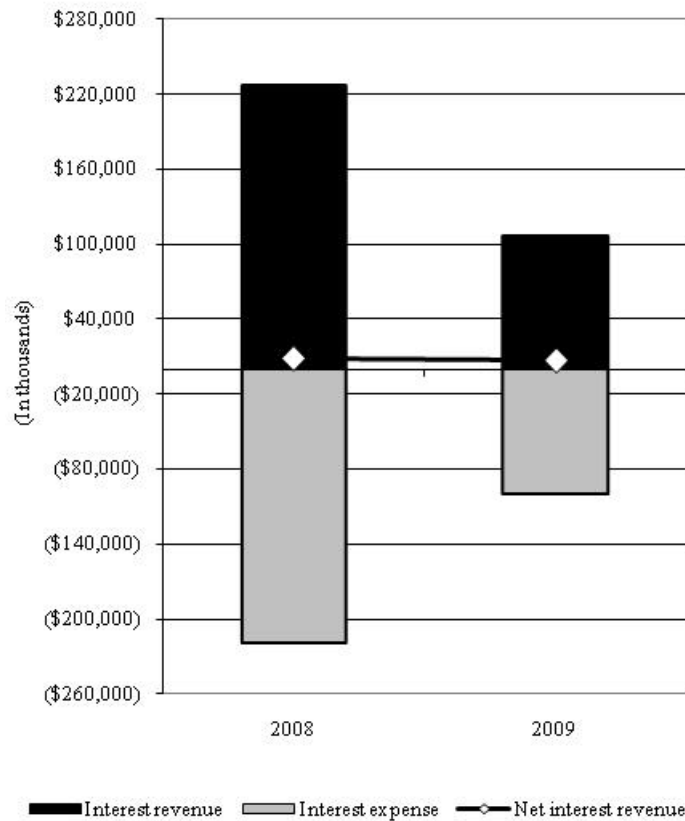
Operating income for the three months ended December 31, 2009 was \$15.5 million, a 25.1% decrease from operating income of \$20.7 million in 2008. Operating revenues were \$87.1 million in 2009, a 0.9% decrease from \$87.9 million in 2008. Net interest expense after provision for loan losses was \$295 thousand in 2009, a 108.9% decrease from net interest revenue after provision for loan losses of \$3.3 million in 2008, which was principally due to stabilizing interest rates. Noninterest revenue was \$87.4 million in 2009, a 3.4% increase from \$84.5 million in 2008, which is due to increases in servicing fees and retention of collections on defaulted loans. Operating expenses were \$71.6 million in 2009, a 6.5% increase from \$67.2 million in 2008.

Operating income for the six months ended December 31, 2009 was \$38.7 million, a 2.7% increase from operating income of \$37.7 million in 2008. Operating revenues were \$178.1 million in 2009, a 4.9% increase from \$169.8 million in 2008. Net interest revenue after provision for loan losses was \$3.8 million in 2009, a 43.3% decrease from net interest revenue after provision for loan losses of \$6.7 million in 2008. Noninterest revenue was \$174.3 million in 2009, a 6.9% increase from \$163.1 million in 2008, which is due to increases in servicing fees. Operating expenses were \$139.4 million in 2009, a 5.5% increase from \$132.1 million in 2008.

A more detailed explanation of the results of operations follows.

**Net Interest Revenue**

Six months ended December 31



Net interest revenue results primarily from the interest rate margin in our portfolio of student loans, although we have investments and debt not related to those student loans, which can also create net interest revenue. For the three months ended December 31, 2009, net interest revenue was \$1.4 million, a 70.2% decrease from net interest revenue of \$4.7 million in 2008.

For the six months ended December 31, 2009, net interest revenue was \$7.2 million, an 18.2% decrease from net interest revenue of \$8.8 million in 2008.

During 2009, the decrease in net interest margin was due to decreasing interest rates on our student loan holdings, which are based upon the 3-month financial commercial paper rate and the 91-day U.S. Treasury Bill rate.

The following table shows the average rates earned on interest earning assets and the average rates paid on interest bearing liabilities.

For the three months ended December 31 (Balances in thousands)	2009		2008	
	Balances	Rate	Balances	Rate
<b>Average interest earning assets</b>				
Student loans receivable, net	\$ 10,699,338	1.81%	11,785,493	3.67%
Investments	776,384	1.21%	493,677	1.23%
	<u>\$ 11,475,722</u>	<u>1.77%</u>	<u>12,279,170</u>	<u>3.58%</u>
<b>Average interest bearing liabilities</b>				
Student loan financings and notes and bonds payable	\$ 11,043,392	1.68%	11,908,199	3.43%
Capital and other financings	263,896	4.37%	240,071	4.75%
	<u>\$ 11,307,288</u>	<u>1.75%</u>	<u>12,148,270</u>	<u>3.46%</u>
Net interest margin		<u>0.02%</u>		<u>0.12%</u>
For the six months ended December 31 (Balances in thousands)	2009		2008	
	Balances	Rate	Balances	Rate
<b>Average interest earning assets</b>				
Student loans receivable, net	\$ 10,886,968	1.85%	11,795,843	3.80%
Investments	703,806	1.80%	484,636	1.49%
	<u>\$ 11,590,774</u>	<u>1.84%</u>	<u>12,280,479</u>	<u>3.71%</u>
<b>Average interest bearing liabilities</b>				
Student loan financings and notes and bonds payable	\$ 11,158,548	1.69%	11,925,919	3.57%
Capital and other financings	266,492	3.92%	239,875	5.09%
	<u>\$ 11,425,040</u>	<u>1.74%</u>	<u>12,165,794</u>	<u>3.60%</u>
Net interest margin		<u>0.10%</u>		<u>0.11%</u>

The following table shows the net interest margin on student loans.

	Three months ended, December 31		Six months ended, December 31	
	2009	2008	2009	2008
Student loan yields	<b>3.04%</b>	4.93%	<b>3.08%</b>	5.07%
Consolidation loan rebate fees	<b>(0.70)</b>	(0.69)	<b>(0.70)</b>	(0.69)
Premium amortization	<b>(0.43)</b>	(0.47)	<b>(0.43)</b>	(0.48)
Lender origination fees	<b>(0.10)</b>	(0.10)	<b>(0.10)</b>	(0.10)
Student loan revenue	<b>1.81%</b>	3.67%	<b>1.85%</b>	3.80%
Cost of funds	<b>(1.68)</b>	(3.43)	<b>(1.69)</b>	(3.57)
Net interest margin on student loans	<b>0.13%</b>	0.24%	<b>0.16%</b>	0.23%

The following rate/volume analysis shows the relative contribution of changes in interest rates and changes in volumes to changes in net interest revenue.

For the three months ended December 31 (in thousands)	Increase (decrease)	Increase (decrease) attributable to change in	
		Rate	Volume
<b>2009 vs. 2008</b>			
Student loan interest revenue	\$ (59,742)	(49,768)	(9,974)
Investment interest revenue	822	(50)	872
	(58,920)	(49,818)	(9,102)
Student loan financings and notes and bonds payable interest expense	(55,694)	(48,272)	(7,422)
Capital and other financings interest expense	35	(248)	283
	(55,659)	(48,520)	(7,139)
	\$ (3,261)	(1,298)	(1,963)

For the six months ended December 31 (in thousands)	Increase (decrease)	Increase (decrease) attributable to change in	
		Rate	Volume
<b>2009 vs. 2008</b>			
Student loan interest revenue	\$ (123,942)	(106,652)	(17,290)
Investment interest revenue	2,719	1,086	1,633
	(121,223)	(105,566)	(15,657)
Student loan financings and notes and bonds payable interest expense	(118,728)	(105,016)	(13,712)
Capital and other financings interest expense	(874)	(1,551)	677
	(119,602)	(106,567)	(13,035)
	\$ (1,621)	1,001	(2,622)

While the amount that we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 4% of the variable-rate loans change based upon changes in the 91-day U.S. Treasury Bill rate, and 96% change based upon changes in the 3-month financial commercial paper rate. The borrowers pay a fixed rate of 5.6% for loans originated on or after July 1, 2009. For the three and six months ended, December 31, 2009 and 2008, the decrease in the student loan earnings is due to decreases in the U.S. Treasury Bill rate and negative special allowance as a result of decreases in the 3-month financial commercial paper rates for loans disbursed on or after April 1, 2006. The borrowers pay rates that are set under a different formula and generally reset annually on July 1.

#### Provision for Loan Losses

Currently, when an FFELP loan defaults, the federal government reimburses the guaranty agency at the following rates:

- 95% of its losses on default claim payments on loans first disbursed on or after October 1, 1998;
- 98% of its losses on default claim payments on loans first disbursed on or after October 1, 1993 and before October 1, 1998; and
- 100% of its losses on default claim payments to lender for loans first disbursed prior to October 1, 1993.

However, the guaranty agency guarantees 97% of the unpaid principal balance plus eligible interest for loans first disbursed on or after July 1, 2006, so the holder of the loan must absorb the remaining 3% not guaranteed as a risk sharing loss on the loan.

The provision for losses represents our estimate of the costs related to the risk sharing on FFELP loans we own and is a weighted average calculation based upon the above reimbursement rates. We report the provision for losses below as "provision for loan losses" within the Statements of Revenues, Expenses and Changes in Net Assets. In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions. We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio.

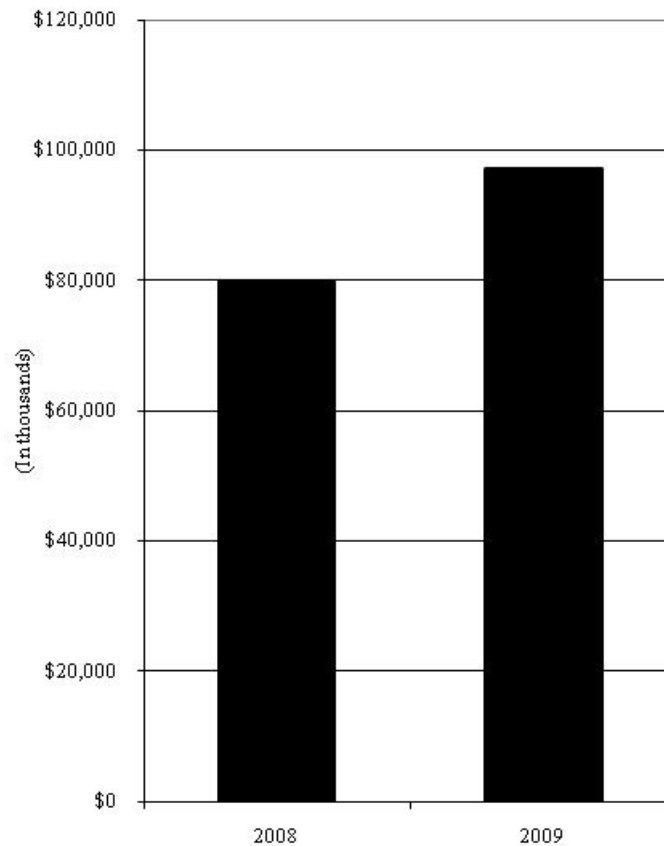
Presented below is an analysis of our allowance for loan losses.

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2009	2008	2009	2008
Balance at beginning of period	\$ 7,371	10,758	\$ 7,315	11,343
Provision for losses	1,730	1,367	3,377	2,117
Charge-offs	(1,730)	(1,838)	(3,321)	(3,173)
Balance at end of period	\$ 7,371	10,287	\$ 7,371	10,287
Allowance as a percentage of ending balance of student loans	0.08%	0.09%	0.08%	0.09%

## Noninterest Revenue

### Servicing Fees

Six months ended December 31



For the three months ended December 31, 2009, servicing fees were \$49.1 million, a 16.9% increase from \$42.0 million in 2008. During 2009, servicing fees increased due to increased volume of loans serviced, deconversion fees and early termination fees for loans put to ED. Loans serviced by us for third party servicing clients averaged \$51.6 billion in 2009, compared to \$48.5 billion in 2008.

For the six months ended December 31, 2009, servicing fees were \$97.1 million, a 21.5% increase from \$79.9 million in 2008. In 2009, servicing fees increased due to increased volume of loans serviced. Loans serviced by us for third party servicing clients averaged \$50.6 billion in 2009, compared to \$47.2 billion in 2008.

We also provide systems for other servicers and guarantors for a fee. For the three months ended December 31, 2009, fees earned from servicing systems amounted to \$3.8 million, an 8.6% increase from \$3.5 million in 2008. For the three months ended December 31, 2009, loans serviced by other servicers using our systems averaged \$32.8 billion, which was a 3.5% decrease from \$34.0 billion in 2008.

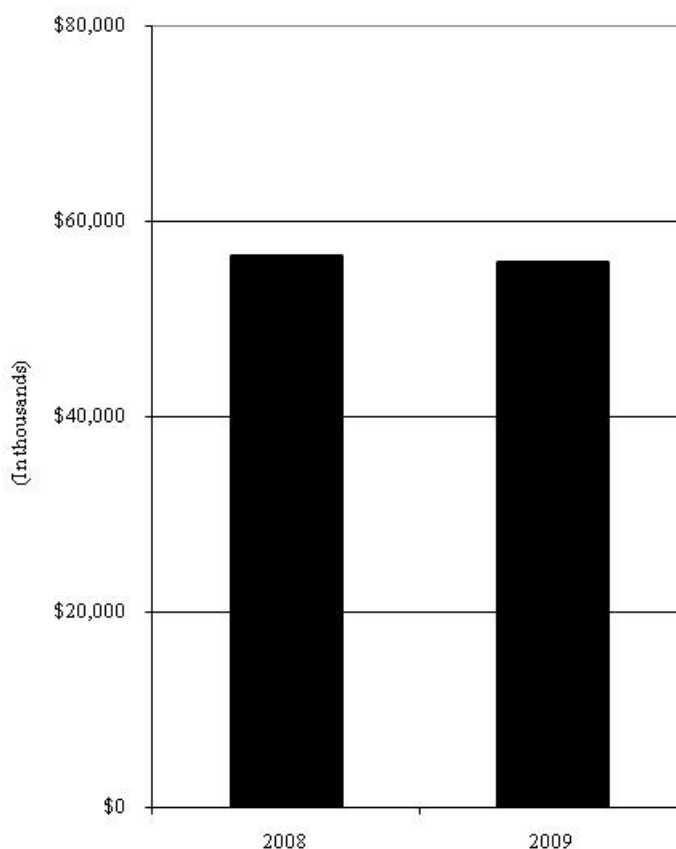
For the six months ended December 31, 2009, fees earned from servicing systems amounted to \$7.6 million, an 8.6% increase from \$7.0 million in 2008. For the six months ended December 31, 2009, loans serviced by other servicers using our systems averaged \$33.1 billion, which was a 1.8% decrease from \$33.7 billion in 2008.

For the three months ended December 31, 2009, fees earned from guaranty systems amounted to \$427 thousand, a 26.0% increase from \$339 thousand in 2008. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

For the six months ended December 31, 2009, fees earned from guaranty systems amounted to \$859 thousand, a 32.8% increase from \$647 thousand in 2008. For the six months ended December 31, 2009, original principal amount outstanding for guarantors using our systems averaged \$4.5 billion, a 7.1% increase from \$4.2 billion in 2008. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

### Retention of Collections on Defaulted Loans

Six months ended December 31



After a loan defaults, as a guarantor, we continue to try to collect on the loan. The federal government allows us to retain up to 16% of the borrower's payments collected as revenue and we remit the remaining amount to the federal government. On October 1, 2007, the College Cost Reduction and Access Act reduced the retention of collections on defaulted loans from 23% to 16%.

As a guarantor, we have established a loan rehabilitation program for all borrowers with an enforceable promissory note for rehabilitating defaulted loans. A loan is considered rehabilitated only after all of the following requirements are met:

- the borrower has made and the guarantor has received nine of the ten payments required under a monthly repayment agreement;
- all nine payments are received within a ten month period that begins with the month in which the first required due date falls and ends with the ninth consecutive calendar month following that month; and
- the loan has been sold to an eligible lender.

After the borrower meets all of the above requirements, the borrower regains all benefits of the program, including any remaining deferment eligibility and is no longer in default status. For rehabilitation payments, we retain 18.5% of the original principal balance, 100% of the collection costs (capped at 18.5% of principal and accrued interest) and 100% of accrued interest collected as revenue.

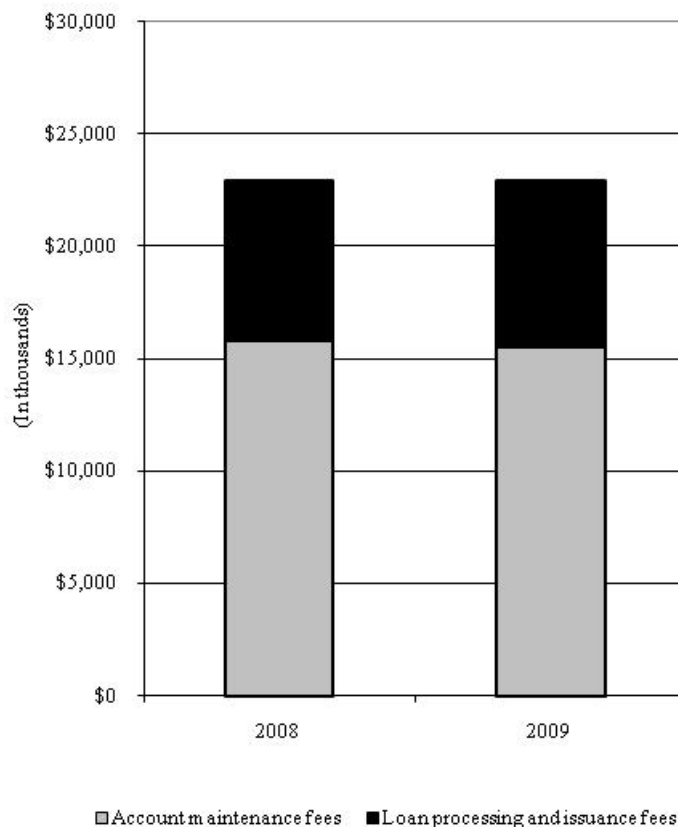
For the three months ended December 31, 2009, retention of collections on defaulted loans was \$29.7 million, a 5.7% increase from \$28.1 million in 2008. For the three months ended December 31, 2009, retention on rehabilitation collections was \$26.7 million, a 31.5% increase from \$20.3 million in 2008.

For the six months ended December 31, 2009, retention of collections on defaulted loans was \$55.8 million, a 1.1% decrease from \$56.4 million in 2008. For the six months ended December 31, 2009, retention on rehabilitation collections was \$45.6 million, a 13.7% increase from \$40.1 million in 2008.

During 2009, the increase in the collections of defaulted loans was attributable to increasing loan defaults and by aggressively pursuing the collection of rehabilitation payments. However, the discounts we gave to eligible lenders who purchased rehabilitation loans from us offset this increase in collections of defaulted loans. Due to the decline in the credit and lending markets in the past and present, we have negotiated contracts with selected eligible lenders to sell rehabilitation loans to them at a discount from the face value of the loan, which has reduced the amount of collections we retain on these loans.

### Federal Fees

Six months ended December 31



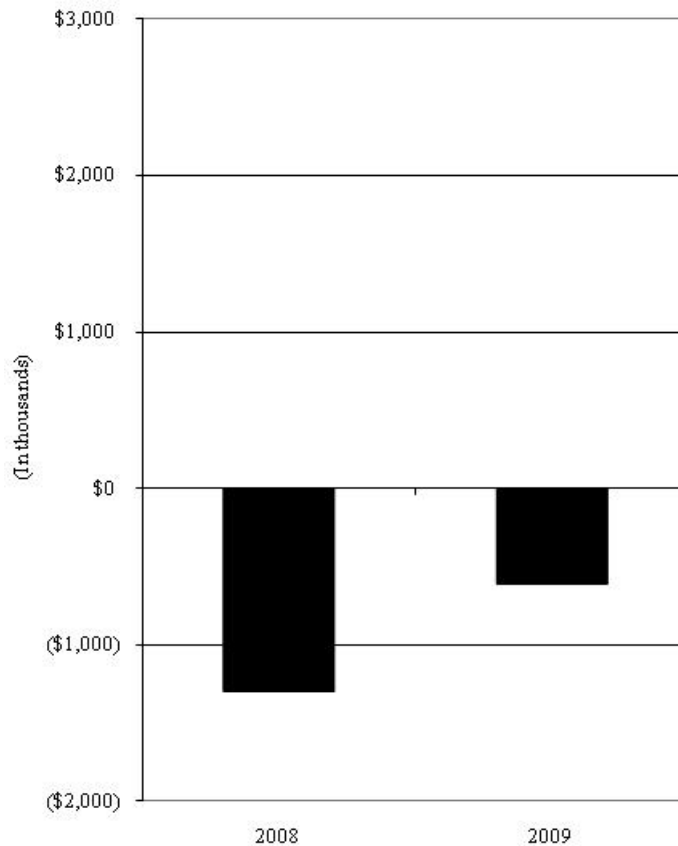
We earn federal fees from operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee of 0.40% on disbursed loans, which we guarantee; however, ED does not pay this fee on new consolidation loans. ED also pays us an annual account maintenance fee that is 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force. Before October 1, 2007, the account maintenance fee received from ED for outstanding loan guarantees was 0.10%.

For the three months ended December 31, 2009, federal fees were \$9.9 million, a 5.7% decrease from \$10.5 million in 2008.

For the six months ended December 31, 2009 and 2008, federal fees were \$23.0 million. At December 31, 2009, the principal outstanding balance of loans guaranteed was \$51.3 billion compared to \$52.3 billion in 2008.

**Default Aversion Fees**

Six months ended December 31



We earn default aversion fees when servicers involve us as guarantors to avert potential defaults and these fees are paid from the Federal Fund. The Federal Fund can only pay the default aversion fee once for a loan and if the loan subsequently defaults, we have to repay the fee to the Federal Fund. Since January 1, 2008, we have not recognized default aversion fee revenue due to the increased doubt about the collectability of the default aversion fees from the Federal Fund.

For the three months ended December 31, 2009, default aversion fees were negative \$26 thousand, a 39.5% increase from a negative \$43 thousand in 2008.

For the six months ended December 31, 2009, default aversion fees were negative \$603 thousand, a 53.6% increase from a negative \$1.3 million in 2008. In 2009, the change in default aversion fees is due to a reduction in the amounts returned to ED due to subsequent loan defaults. We expect default aversion fees to be minimal in the future.

**Change in Fair Value of Residual Interest, net**

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. For transactions qualifying as sales, we retain a residual interest, which is recognized on the statements of net assets as the residual interest in off-balance sheet securitizations. The residual interest is the right to receive cash flows from the student loans in excess of the amounts needed to pay servicing, administration, and other fees, as well as the principal and interest on the bonds backed by the student loans. The residual interest is the present

value of these future expected cash flows. We value the residual interest at the time of sale of the student loans to the trust and at the end of each subsequent quarter and reflect the change in the value in residual interest, net on the statements of revenues, expenses, and changes in net assets.

For the three months ended December 31, 2009, an increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was \$2.1 million compared to an increase of \$3.9 million in 2008.

For the six months ended December 31, 2009, an increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was \$2.5 million compared to an increase of \$4.9 million in 2008. During 2009, the change was due primarily to the decline in the blended effective interest rate.

### Operating Expenses

The following table displays operating expenses in more detail.

(In thousands)	Three months ended, December 31, 2009		Three months ended, December 31, 2008	
Personnel and Benefits	\$ 35,577	49.7%	\$ 36,985	55.0%
Professional services	11,291	15.8%	9,688	14.4%
Mail services	4,940	6.9%	4,421	6.6%
Information technology related expenses	4,890	6.8%	6,298	9.4%
Depreciation	2,597	3.6%	2,947	4.4%
Bank fees	1,383	1.9%	1,862	2.8%
Building and Grounds	1,095	1.5%	951	1.4%
Telephone expenses	879	1.2%	537	0.8%
Printing	535	0.8%	494	0.7%
Servicing liability	366	0.5%	1,789	2.7%
Other	8,071	11.3%	1,214	1.8%
	<b>\$ 71,624</b>	<b>100.0%</b>	<b>\$ 67,186</b>	<b>100.0%</b>

(In thousands)	Six months ended, December 31, 2009		Six months ended, December 31, 2008	
Personnel and Benefits	\$ 70,743	50.8%	\$ 73,847	55.9%
Professional services	21,535	15.4%	17,359	13.1%
Mail services	9,850	7.1%	9,412	7.1%
Information technology related expenses	10,161	7.3%	10,678	8.1%
Depreciation	5,291	3.8%	6,158	4.7%
Bank fees	2,879	2.0%	3,617	2.8%
Building and Grounds	2,056	1.5%	1,908	1.4%
Telephone expenses	1,854	1.3%	1,871	1.4%
Printing	1,228	0.9%	991	0.8%
Servicing liability	927	0.7%	3,739	2.8%
Other	12,865	9.2%	2,527	1.9%
	<b>\$ 139,389</b>	<b>100.0%</b>	<b>\$ 132,107</b>	<b>100.0%</b>

For the three months ended December 31, 2009, operating expenses were \$71.6 million, a 6.5% increase from \$67.2 million in 2008. The increase in 2009 is due to increases in professional services and costs associated with forward purchase contracts.

For the six months ended December 31, 2009, operating expenses were \$139.4 million, a 5.5% increase from \$132.1 million in 2008. The increase in 2009 is due to increases in professional services and costs associated with forward purchase contracts.

***Personnel and Benefits***

The following table displays Personnel and Benefits expenses:

(In thousands)	<b>Three months ended, December 31, 2009</b>		Three months ended, December 31, 2008	
<b>Personnel and Benefits</b>				
Compensation	\$ 25,698	72.2%	\$ 24,863	67.2%
Health care benefits for employees and retirees	5,792	16.3%	8,900	24.1%
Employer's share of Social Security	1,874	5.3%	1,808	4.9%
Independent contractor fees	1,591	4.5%	1,470	4.0%
Retirement contributions	792	2.2%	800	2.1%
Capitalized software development costs	(619)	(1.7%)	(559)	(1.5%)
Other	449	1.2%	(297)	(0.8%)
	<b>\$ 35,577</b>	<b>100.0%</b>	<b>\$ 36,985</b>	<b>100.0%</b>

(In thousands)	<b>Six months ended, December 31, 2009</b>		Six months ended, December 31, 2008	
<b>Personnel and Benefits</b>				
Compensation	\$ 51,432	72.7%	\$ 48,859	66.2%
Health care benefits for employees and retirees	11,565	16.3%	17,828	24.1%
Employer's share of Social Security	3,785	5.4%	3,958	5.4%
Independent contractor fees	3,181	4.5%	2,776	3.7%
Retirement contributions	1,588	2.2%	1,676	2.3%
Capitalized software development costs	(1,719)	(2.4%)	(1,209)	(1.6%)
Other	911	1.3%	(41)	(0.1%)
	<b>\$ 70,743</b>	<b>100.0%</b>	<b>\$ 73,847</b>	<b>100.0%</b>

For the three months ended December 31, 2009, personnel and benefit costs were \$35.6 million, a 3.8% decrease from \$37.0 million in 2008. Included in these costs are healthcare benefits for employees and retirees. For the three months ended December 31, 2009, healthcare benefits for employees and retirees were \$5.8 million, a 34.8% decrease from \$8.9 million in 2008. In 2009, the decrease in healthcare benefits for employees and retirees is due to a change in the estimate of the other post employment benefits liability.

For the six months ended December 31, 2009, personnel and benefit costs were \$70.7 million, a 4.2% decrease from \$73.8 million in 2008. Included in these costs are healthcare benefits for employees and retirees. For the six months ended December 31, 2009, healthcare benefits for employees and retirees were \$11.6 million, a 34.8% decrease from \$17.8 million in 2008. In 2009, the decrease in healthcare benefits for employees and retirees is due to a change in the estimate related to the other post employment benefits liability.

Permanent staff makes up 95.5% of the total personnel and benefits costs. For the three months ended December 31, 2009, permanent staff costs were \$34.6 million, a 4.2% decrease from \$36.1 million in 2008. For the six months ended December 31, 2009, permanent staff costs were \$69.3 million, a 4.1% decrease from \$72.3 million in 2008. The average permanent staff positions filled was 2,214 for the six months ended December 31, 2009, which was a 6.2% increase from the 2,084 average permanent staff positions filled for the six months ended December 31, 2008.

For the three months ended December 31 2009, independent contracting costs were \$1.6 million, a 6.7% increase from \$1.5 million in 2008. For the six months ended December 31 2009, independent contracting costs were \$3.2 million, a 14.3% increase from \$2.8 million in 2008. We generally use independent contractors for specialized services, such as computer programming. Costs vary based upon changes in computer programming initiatives.

For the three months ended December 31, 2009, personnel costs relating to capitalized software development costs were \$619 thousand, a 10.7% increase from \$559 thousand in 2008. For the six months ended December 31, 2009, personnel costs relating to capitalized software development costs were \$1.7 million, a 41.7% increase from \$1.2 million in 2008.

Our workforce consists of union and non-union positions. For union positions, contractual increases are negotiated and generally include periodic step increases of 2.2%, as well as cost of living adjustments.

### *Professional Services*

The following table displays professional services expenses:

(In thousands)	Three months ended, December 31, 2009		Three months ended, December 31, 2008	
<b>Professional Services</b>				
Collection agency fees	\$	<b>8,147</b>	72.2%	\$ 6,235 64.4%
Consulting fees		<b>1,321</b>	<b>11.7%</b>	15 0.2%
Default aversion outsourcing fees		<b>694</b>	<b>6.1%</b>	884 9.1%
Legal fees		<b>569</b>	<b>5.0%</b>	1,630 16.8%
Audit fees		<b>270</b>	<b>2.4%</b>	440 4.5%
Other professional fees		<b>290</b>	<b>2.6%</b>	484 5.0%
	\$	<b>11,291</b>	<b>100.0%</b>	\$ 9,688 100.0%

(In thousands)	Six months ended, December 31, 2009		Six months ended, December 31, 2008	
<b>Professional Services</b>				
Collection agency fees	\$	<b>15,219</b>	<b>70.7%</b>	\$ 11,074 63.8%
Consulting fees		<b>1,624</b>	<b>7.5%</b>	180 1.0%
Default aversion outsourcing fees		<b>1,459</b>	<b>6.8%</b>	1,608 9.3%
Legal fees		<b>1,770</b>	<b>8.2%</b>	2,511 14.5%
Audit fees		<b>619</b>	<b>2.9%</b>	679 3.9%
Other professional fees		<b>844</b>	<b>3.9%</b>	1,307 7.5%
	\$	<b>21,535</b>	<b>100.0%</b>	\$ 17,359 100.0%

### *Collection Agency Fees*

For the three months ended December 31, 2009, collection agency fees were \$8.1 million, a 30.6% increase from \$6.2 million in 2008. For the six months ended December 31, 2009, collection agency fees were \$15.2 million, a

36.9% increase from \$11.1 million in 2008. The increase in collections agency fees during 2009 is due to increased collections on an increasing portfolio of defaulted loans.

### *Provision for Servicing Liability*

We can incur losses on our portfolio of loans and on the portfolio of loans serviced by us for our clients by not meeting servicing regulations. We make estimates of the potential loan losses based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We present the provision for losses below as "servicing liability" within operating expenses. We present an analysis of our allowance for servicing losses in the following table:

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
Balance at beginning of period	\$ 8,828	9,626	\$ 9,115	8,172
Provision for losses	366	1,789	927	3,739
Charge-offs	(174)	(1,458)	(1,022)	(1,954)
Balance at end of period	\$ 9,020	9,957	\$ 9,020	9,957
Allowance as a percentage of ending balance of student loans	0.02%	0.02%	0.02%	0.02%

### **Changes in Net Assets**

The following table shows the changes in net assets for the three and six months ending December 31, 2009 and 2008:

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
Operating income	\$ 15,453	20,668	\$ 38,739	37,724
Commonwealth of Pennsylvania grants	407,263	181,969	407,659	422,471
Federal grants	3,909	-	5,450	5,716
Grants and other financial aid	(229,624)	(78,428)	(240,349)	(253,392)
Grant funds returned to the Commonwealth of Pennsylvania	(11,284)	(75)	(11,284)	(14,931)
Transfers from (to) Pennsylvania Higher Education Foundation	50	(127)	(59)	(234)
Changes in net assets	\$ 185,767	124,007	\$ 200,156	197,354

### *Grants and Other Financial Aid Activity*

For the three months ended December 31, 2009, grants and other financial aid were \$229.6 million, a 192.9% increase from \$78.4 million in 2008. The increase during 2009 was due to the disbursement of Commonwealth funds once the funds were received after the Commonwealth's budget was approved. For the six months ended December 31, 2009, grants and other financial aid were \$240.3 million, a 5.2% decrease from \$253.4 million in 2008. The decrease during 2009 was due to the Commonwealth appropriating fewer funds to the State Grant Program due to the downturn in the economy.

The following table displays self-funded financial aid awarded through our various programs along with state and federally funded programs.

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
<b>Self-funded</b>				
Keystone loan program origination fees and benefits paid on behalf of borrowers	\$ 150	693	\$ 167	1,263
Federal default fees paid on behalf of borrowers	1	4,387	53	15,295
Other	(15)	(485)	669	57
	<b>136</b>	<b>4,595</b>	<b>889</b>	<b>16,615</b>
<b>State and federally funded</b>				
State Grant Program	192,063	28,050	199,224	183,078
Institutional Assistance Grant Program	26,770	37,978	27,072	37,869
Matching Funds Program	8,704	4,069	10,398	10,016
New Economy Technology Scholarship Program	629	1,099	266	1,837
Other	1,322	2,637	2,500	3,977
	<b>229,488</b>	<b>73,833</b>	<b>239,460</b>	<b>236,777</b>
	\$ <b>229,624</b>	<b>78,428</b>	\$ <b>240,349</b>	<b>253,392</b>

For the three months ended December 31, 2009, self-funded financial aid was \$136 thousand, a 97.0% decrease from \$4.6 million in 2008. For the six months ended December 31, 2009, self-funded financial aid was \$889 thousand, a 94.6% decrease from \$16.6 million in 2008. In 2009, the decrease in the self-funded financial aid was due to the suspension of paying the federal default fees on behalf of borrowers on loans guaranteed on or after January 1, 2009.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans are disbursed. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. On October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. For the six months ended December 31, 2009, we paid fees totaling \$53 thousand to the Federal Fund for loans disbursed from July 1, 2009 through December 31, 2009. For the six months ended December 31, 2008, we paid fees totaling \$15.3 million to the Federal Fund for loans disbursed from July 1, 2008 through December 31, 2008.

#### ***Other Changes in Net Assets***

For the three months ended December 31, 2009, Commonwealth of Pennsylvania grants were \$407.3 million, a 123.8% increase from \$182.0 million in 2008. For the six months ended December 31, 2009, Commonwealth of Pennsylvania grants were \$407.7 million, a 3.5% decrease from \$422.5 million in 2008. The decrease during 2009 was due to the Commonwealth appropriating fewer funds to the State Grant Program due to the downturn in the economy.

For the three months ended December 31, 2009, federal grants were \$3.9 million compared to no additional grant funds received in 2008. The increase during 2009 was mainly due to the timing of the funds received from the

Federal government. For the six months ended December 31, 2009, federal grants were \$5.5 million, a 3.5% decrease from \$5.7 million in 2008.

For the three months ended December 31, 2009, we did not donate services to PHEF compared to \$127 thousand of services contributed during 2008. For the six months ended December 31, 2009, we contributed \$59 thousand of services to PHEF compared to \$234 thousand of services contributed during 2008.

### Net Asset Position

As of December 31, 2009, our net asset position was \$597.7 million and most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of \$113.2 million at December 31, 2009. Included in unrestricted net assets is \$47.0 million due from the Federal Fund that will likely be realized over the long term. The most substantial restriction on our net assets relates to restrictions for debt service, which amounted to \$277.9 million. Of that amount, \$275.6 million is related to our student loan notes, bonds and financings. Net assets restricted for financial aid grant programs amounted to \$222.9 million. The deficit in net assets invested in capital assets, net of related debt of \$16.3 million occurred because of differences between the timing of depreciation of the assets and principal payments on the debt.

### Description of Debt Activity and Significant Capital Assets

Our principal funding need is securing capital to fund student loan originations and purchases. Our ability to raise debt could be limited in the future, because under our enabling legislation there is a formula that imposes a debt limit. As of December 31, 2009, our debt limit was \$26.0 billion and our outstanding debt amounted to \$10.7 billion. The following table shows the financing (bond market and financial institutions) of our debt activity.

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
<u>Capital market activity</u>				
Repayment of student loan demand revenue bonds	\$ (1,120,700)	(900)	\$ (1,304,750)	(900)
Proceeds from issuing student loan floating rate notes	457,600	-	457,600	-
Repayment of student loan floating rate notes	(26,290)	(19,965)	(50,531)	(41,989)
<u>Student loan financings</u>				
Proceeds from student loan variable rate funding notes	436,449	-	436,449	-
Repayment of student loan variable rate funding notes	(19,344)	-	(26,623)	-
Repayment of student loan financings	(443,943)	(45,400)	(469,233)	(94,800)
<u>Capital financing activity</u>				
Proceeds from capital financings	-	725	-	4,650
Repayment of capital financings	(2,303)	(2,390)	(3,135)	(3,281)
<u>Other financing activity</u>				
Repayment of lines of credit	(18,000)	(7,035)	(26,000)	(7,035)
Proceeds from term financings	17,505	-	17,505	-
Repayment of term financings	(2,474)	(1,795)	(5,253)	(1,795)

The following table shows our capital assets, net of accumulated depreciation.

(In thousands)	December 31, 2009	June 30, 2009
Land	\$ 2,946	2,946
Buildings and improvements	38,459	39,303
Software development	8,379	8,851
Purchased software	1,518	2,254
Other, principally information technology equipment	10,569	6,429
	\$ 61,871	59,783

The most significant ongoing capital item is software development. Mainly, our software development is customized systems for student financial aid processing that cannot be purchased from third party vendors. For the three months ended December 31, 2009, we capitalized \$619 thousand of software development compared to \$559 thousand in 2008. For the six months ended December 31, 2009, we capitalized \$1.7 million of software development compared to \$1.2 million in 2008.

### Interest Rate Risk Management

Student loans are generally variable-rate assets, so we generally fund them with variable-rate debt.

In the table on the next page, we categorize variable-rate assets and liabilities by reset date and fixed-rate assets and liabilities by their maturity dates. An interest rate gap is the difference between the volumes of assets and liabilities maturing or re-pricing during specific future time intervals. The table includes only those assets and liabilities related to our student loan notes, bonds and financings. However, we have \$446.0 million of cash, cash equivalents and investments and \$93.0 million of student loans, as well as other assets and liabilities, not included in the analysis below, because they do not relate to the student loan revenue bonds.

The gap analysis on the next page reflects rate-sensitive positions at December 31, 2009 and is not necessarily reflective of positions that existed throughout the period.

If a period gap is positive, it means there are more assets than liabilities re-pricing during the period. If interest rates rise in a period with a positive gap, net interest revenue will increase. Conversely, if interest rates fall in a period with a positive gap, net interest revenue will decrease.

The opposite is true when the period gap is negative. This occurs when more liabilities than assets are re-pricing during the period. If interest rates rise in a period with a negative gap, net interest revenue will decrease. If interest rates fall in a period with a negative gap, net interest revenue will increase.

At December 31, 2009 (In thousands)	Interest rate sensitivity period					
	3 months or less	3 months to 6 months	6 months to 1 year	1 to 2 years	2 to 5 years	Over 5 years
<b>Assets</b>						
Student loans	\$ 9,550,730	155,971	215,234	24,935	33,171	1,797
Restricted cash and cash equivalents	571,970	-	-	-	-	-
Other assets	96,311	35,638	8,954	12,602	17,977	30,211
<b>Total assets</b>	<b>10,219,011</b>	<b>191,609</b>	<b>224,188</b>	<b>37,537</b>	<b>51,148</b>	<b>32,008</b>
<b>Liabilities</b>						
Student loan financings and notes and bonds payable	10,177,993	228,371	-	-	-	-
Other liabilities	72,526	613	227	6	119	-
<b>Total liabilities</b>	<b>10,250,519</b>	<b>228,984</b>	<b>227</b>	<b>6</b>	<b>119</b>	<b>-</b>
<b>Net assets</b>						
Restricted for debt service	\$ -	-	-	-	-	275,646
<b>Period gap</b>	<b>\$ (31,508)</b>	<b>(37,375)</b>	<b>223,961</b>	<b>37,531</b>	<b>51,029</b>	<b>(243,638)</b>
<b>Cumulative gap</b>	<b>\$ (31,508)</b>	<b>(68,883)</b>	<b>155,078</b>	<b>192,609</b>	<b>243,638</b>	<b>-</b>
Ratio of interest- sensitive assets to interest-sensitive liabilities and net assets	99.7 %	83.7 %	98761.2 %	625616.7%	42981.5 %	11.6 %
Ratio of cumulative gap to total assets	(0.3) %	(0.6) %	1.4 %	1.8%	2.3 %	- %

### Federal Student Loan Reserve Fund

Under current law, we are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees. Historically ED has calculated this ratio at September 30, which is the close of the federal fiscal year, based upon regulatory reports that we file with ED.

The following table displays our calculation of the ratio on a regulatory basis of accounting, which includes gain contingencies not recognized under generally accepted accounting principles.

(In thousands)	December 31, 2009	September 30, 2009
Generally accepted accounting principles – net assets	\$ (36,412)	(27,017)
Deferred federal default fees	16,044	17,814
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund	6,240	7,143
Gain contingency – collections complement on future default collections	138,389	131,698
Regulatory net assets	\$ 124,261	129,638
Original principal outstanding	\$ 51,266,753	51,820,622
	0.24%	0.25%

For the three months ended December 31, 2009 purchases of defaulted loans were \$344.1 million, which was a 4.3% increase from \$330.0 million in 2008. For the six months ended December 31, 2009 purchases of defaulted loans were \$662.0 million, which was an 8.8% increase from \$608.5 million in 2008. See **Note 5 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education** for more details.

## **Contacting Us**

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Phone – 717 720-2540

Fax – 717 720-3923

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February 12, 2010

	(Unaudited)			
	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
<b><u>Interest revenue</u></b>				
Student loans	\$ 48,481	108,223	\$ 100,459	224,401
Investments	2,345	1,523	6,329	3,610
Total interest revenue	50,826	109,746	106,788	228,011
<b><u>Interest expense</u></b>				
Student loan financings and notes and bonds payable	46,507	102,201	94,375	213,103
Capital and other financings	2,884	2,849	5,226	6,100
Total interest expense	49,391	105,050	99,601	219,203
Net interest revenue	1,435	4,696	7,187	8,808
Provision for loan losses	(1,730)	(1,367)	(3,377)	(2,117)
Net interest (expense) revenue after provision for loan losses	(295)	3,329	3,810	6,691
<b><u>Noninterest revenue</u></b>				
Servicing fees	49,111	42,042	97,063	79,866
Retention of collections on defaulted loans	29,668	28,121	55,758	56,402
Federal fees	9,893	10,452	22,980	22,964
Changes in fair value of residual interest, net	2,129	3,873	2,523	4,894
Loss on student loans sales, net	(3,440)	-	(3,459)	-
Default aversion fees, net of rebates	(26)	(43)	(603)	(1,295)
Other	37	80	56	309
Total noninterest revenue	87,372	84,525	174,318	163,140
Operating revenues	87,077	87,854	178,128	169,831
<b><u>Operating expenses</u></b>				
Personnel	35,577	36,985	70,743	73,847
Professional services	11,291	9,688	21,535	17,359
Mail services	4,940	4,421	9,850	9,412
Information technology related expenses	4,890	6,298	10,161	10,678
Depreciation	2,597	2,947	5,291	6,158
Other	12,329	6,847	21,809	14,653
Total operating expenses	71,624	67,186	139,389	132,107
Operating income	15,453	20,668	38,739	37,724
Commonwealth of Pennsylvania grants	407,263	181,969	407,659	422,471
Federal grants	3,909	-	5,450	5,716
Grants and other financial aid	(229,624)	(78,428)	(240,349)	(253,392)
Grant funds returned to the Commonwealth of Pennsylvania	(11,284)	(75)	(11,284)	(14,931)
Transfers from (to) Pennsylvania Higher Education Foundation	50	(127)	(59)	(234)
Changes in net assets	185,767	124,007	200,156	197,354
Net assets, beginning of period	411,952	417,953	397,563	344,606
Net assets, end of period	\$ 597,719	541,960	\$ 597,719	541,960

See accompanying notes to financial statements.

	(Unaudited) December 31, 2009	June 30, 2009
<b>Assets</b>		
Cash and cash equivalents	\$ 206	29,514
Restricted cash and cash equivalents	578,749	367,096
Restricted cash and cash equivalents – due to customers	80,261	47,185
Investments	78,969	26,971
Restricted investments	279,825	124,042
Residual interest in off-balance sheet securitizations	25,723	23,200
Student loans receivable, net	10,074,839	11,169,840
Interest income receivable	166,882	197,302
Due from Federal Student Loan Reserve Fund, net	46,971	44,504
Capital assets, net	61,871	59,783
Deferred financing costs, net	39,345	42,047
Other assets	43,554	39,352
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	117,535	107,655
<b>Total assets</b>	<b>11,594,730</b>	<b>12,278,491</b>
<b>Liabilities</b>		
Due to customers	80,261	47,185
Accounts payable and accrued expenses	129,782	89,680
Student loans financings and notes and bonds payable, net	10,406,364	11,361,553
Capital and other financings	258,011	274,855
Obligations under capital lease	5,058	-
Amounts related to the Federal Student Loan Reserve Fund	117,535	107,655
<b>Total liabilities</b>	<b>10,997,011</b>	<b>11,880,928</b>
<b>Net assets</b>		
Invested in capital assets, net of related debt	(16,284)	(16,424)
Restricted for debt service	277,886	263,489
Restricted for financial aid grant programs	222,942	59,819
Unrestricted	113,175	90,679
<b>Total net assets</b>	<b>\$ 597,719</b>	<b>397,563</b>

See accompanying notes to financial statements.

	(Unaudited)	
	Six months ended December 31,	
	2009	2008
<b><u>Cash flows from operating activities</u></b>		
Interest received on student loans	\$ 59,099	169,608
Principal received on student loans	602,946	538,186
Student loan originations	(303)	(2,073)
Student loan purchases	(10,721)	(302,243)
Student loan sales, including net gains	570,895	26
Servicing fees	94,810	75,348
Retention of collections on defaulted loans	53,290	61,313
Federal fees	22,196	22,771
Default aversion fees, net of rebate	(2,300)	(229)
Other	(3,403)	309
Payment of operating expenses	(124,719)	(127,553)
Net cash provided by operating activities	<b>1,261,790</b>	435,463
<b><u>Cash flows from noncapital financing activities</u></b>		
Proceeds from the issuance of noncapital debt	911,553	-
Principal paid on noncapital debt	(1,882,390)	(146,519)
Interest paid on student loan financings and notes and bonds payable	(54,973)	(189,611)
Issuance costs	(3,305)	-
Commonwealth of Pennsylvania grants received	407,659	422,471
Federal grants received	5,450	5,716
Grants and financial aid paid	(240,349)	(253,182)
Grant funds returned to the Commonwealth of Pennsylvania	(11,284)	(14,931)
Net cash used for noncapital financing activities	<b>(867,639)</b>	(176,056)
<b><u>Cash flows from capital and related financing activities</u></b>		
Proceeds from issuance of capital debt	-	4,650
Principal paid on capital debt	(3,135)	(3,281)
Interest paid on capital and other financings	(5,067)	(6,060)
Purchases of capital assets and development of software, net of disposals	(2,321)	(612)
Net cash used for capital and related financing activities	<b>(10,523)</b>	(5,303)
<b><u>Cash flows from investing activities</u></b>		
Proceeds from sales and maturities of investments	348,708	219,092
Purchases of investments	(556,489)	(418,200)
Interest received on investments	6,498	3,812
Net cash used for investing activities	<b>(201,283)</b>	(195,296)
Net change in cash and cash equivalents (including restricted cash)	<b>182,345</b>	58,808
Cash and cash equivalents (including restricted cash), beginning of period	<b>396,610</b>	311,914
Cash and cash equivalents (including restricted cash), end of period	<b>\$ 578,955</b>	370,722

(continued)

		(Unaudited)	
		Six months ended, December 31,	
		2009	2008
<b>Reconciliation of operating income to net cash provided by operating activities</b>			
Operating income	\$	<b>38,739</b>	37,724
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation		<b>5,291</b>	6,158
Student loan financings and notes and bonds payable interest		<b>54,973</b>	189,611
Capital and other financings interest		<b>5,067</b>	6,060
Investment interest		<b>(6,498)</b>	(3,812)
Amortization of premium on loan purchases		<b>21,078</b>	28,002
Amortization of loan origination costs		<b>(692)</b>	6,103
Amortization of deferred financing costs		<b>6,007</b>	1,255
Amortization of deferred amount on refundings of student loan demand revenue bonds		<b>1,899</b>	400
Accretion discount on capital and other financings		<b>40</b>	39
Operational support provided to Pennsylvania Higher Education Foundation		<b>(59)</b>	(234)
Changes in assets and liabilities:			
Decrease in interest income receivable		<b>30,420</b>	6,595
Increase in residual interest in off-balance securitizations		<b>(2,523)</b>	(4,894)
Decrease in student loans receivable		<b>1,074,615</b>	141,193
(Increase) decrease in amounts due from Federal Student Loan Reserve Fund		<b>(2,467)</b>	4,913
Increase in other assets		<b>(4,202)</b>	(6,279)
Increase in accounts payable and accrued expenses		<b>40,102</b>	22,629
Total adjustments		<b>1,223,051</b>	397,739
Net cash provided by operating activities	\$	<b>1,261,790</b>	435,463

See accompanying notes to financial statements.

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## **Note 1 – About PHEAA**

### Organization

Pennsylvania Higher Education Assistance Agency (“PHEAA”), doing business as American Education Services (“AES”) and FedLoan Servicing (“FLS”), is a public corporation and government instrumentality created by the Pennsylvania General Assembly on August 7, 1963. Our mission is to improve higher education opportunities for Pennsylvanians.

We are a discretely presented component unit of the Commonwealth of Pennsylvania. That means that our financial information is included in the financial statements of the Commonwealth, but we are not considered part of the primary government.

### Blended Component Unit

We formed the PHEAA Student Loan Foundation, Inc. on August 6, 2002. The foundation is exempt from federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). Its charitable purpose is to carry out student loan securitization transactions for our benefit. The foundation is a blended component unit, because we appoint a majority of the foundation’s board of directors, we can impose our will on the foundation, and it provides services entirely to us. As a blended component unit, we consolidate the transactions of the PHEAA Student Loan Foundation, Inc into our financial statements.

On May 22, 2009, the PHEAA Student Loan Company, LLC (PHEAA SLC) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFELP; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On June 1, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED that was authorized under section 459A of the Higher Education Act (HEA). In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose vehicle (PHEAA SLC). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC, so PHEAA SLC is a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

On November 2, 2009, the PHEAA Student Loan Company II, LLC (PHEAA SLC II) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFELP; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 10, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC II). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC II, so PHEAA SLC II is a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

On November 2, 2009, the PHEAA Student Loan Company III, LLC (PHEAA SLC III) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFELP; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 12, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC III). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC III, so PHEAA SLC III is a blended component unit of the

PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

#### Discretely Presented Component Unit

The Pennsylvania Higher Education Foundation, Inc.

We supported the formation of The Pennsylvania Higher Education Foundation, Inc. (“PHEF”), which is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purposes include, but are not limited to, activities intended to improve or enhance postsecondary education opportunities for students in Pennsylvania and elsewhere. PHEF is a discretely presented component unit, because our Executive Committee appoints a majority of the foundation’s board of directors, we can impose our will on the foundation, but it does not provide services entirely to us. As a discretely presented component unit, we do not consolidate the transactions of PHEF into our financial statements, but we present them in the notes of the annual financial report.

PHEF’s audited financial statements are available on its website – [www.higheredfoundation.org](http://www.higheredfoundation.org).

#### Related Organization

The Higher Education Foundation, Inc.

We also supported the formation of The Higher Education Foundation, Inc. (“HEF”), and it is also tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purpose is exclusively for the benefit of PHEF and the directors of PHEF are directors of HEF. The purpose of HEF’s formation was to assist with fundraising and program administration particularly for projects that may extend beyond Pennsylvania. We cannot impose our will on HEF, there is no financial burden or benefit associated with it; therefore, we do not consolidate the financial transactions of HEF into our financial statements. PHEF prepares consolidated financial statements that include transactions for HEF.

### **Note 2 – Recent Developments**

On October 13, 2009, we determined that the parity ratios associated with our 2001B and 2002 A Series bonds dropped below levels required by the liquidity provider, which resulted in one or more breaches, violations or defaults. Through December 31, 2009, we obtained signed waivers from certain financial institutions for the above breaches, violations or defaults related to our 2001B and 2002 A Series bonds. As of December 31, 2009, the 2001B series bonds remained below the required parity ratio level. On January 29, 2010, we redeemed in full the 2001B, 2002A and 2002B Series bonds.

Because of the above noted events of default, we were unable to issue our annual financial statements within 120 days of our fiscal year end. This event caused a triggering event to occur with a note purchase agreement, which in turn caused cross events of default with certain financial institutions. Through December 31, 2009, we obtained signed waivers from those financial institutions

As documented in **Note 1 – About PHEAA** on November 2, 2009, the PHEAA SLC II and the PHEAA SLC III were formed in the State of Delaware. The purpose of the PHEAA SLC II and III are purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFELP; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 10, 2009 and November 12, 2009, we issued notices of intent to participate in the Loan Purchase Commitment Program with ED.

On December 7, 2009, we transferred \$449.4 million of eligible student loans to the PHEAA SLC II. On December 10, 2009, the PHEAA SLC II entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A

Funding, LLC (Conduit) through which the Conduit purchased the variable funding note at 97% of the collateral value of eligible student loans pledged or \$436.0 million. On that same day, we entered into a \$9.8 million Note Purchase Agreement (NPA) with a financial institution, which is non-recourse debt to us. The financial institution funded the NPA in consideration of the redemption or defeasance of the 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2 bonds that were subject to the asset-backed securities transactions conduit refinancing.

On December 17, 2009 and December 21, 2009, we issued series 2009-1, class A-1, floating rate student loan asset-backed notes and series 2009-2 class A-1 and A-2 floating rate student loan asset-backed notes, respectively. The use of the proceeds for the above issued notes were used (i) to fund initial deposits to a reserve account and to the capitalized interest account (both established under the indenture), (ii) to purchase certain student loans and (iii) to pay costs associated with the issuance of the notes. Furthermore, on the closing date, a portion of the proceeds categorized as "Deposit to Temporary Student Loan Subaccount" were applied to the repayment of certain outstanding indebtedness of PHEAA, which is secured in part by a pledge of student loans through the purchase of student loans. For more details on the new issues see the "Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-1, Class A-1" and the "Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-2" official statements dated December 17, 2009 and December 21, 2009, respectively.

On December 30, 2009, we fully redeemed the following bond issues: 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2.

### **Note 3 – Summary of Significant Accounting Policies**

#### Basis of Presentation and Accounting

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*, our financial statements have been prepared on the basis of the governmental enterprise fund concept, which pertains to financial activities that operate similarly to a private business enterprise. We follow the economic resources measurement focus and accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. While private business enterprises follow the accounting guidance issued by the Financial Accounting Standards Board ("FASB"), we follow the guidance issued by the Governmental Accounting Standards Board ("GASB"). As encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989 to be consistent with the accounting practices of the Commonwealth.

#### Use of Estimates

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that influence the reported assets, liabilities, revenues, and expenses during the reporting periods. Actual results could differ significantly from those estimates.

#### Cash Equivalents

Cash equivalents include investments in money market funds, U.S. government agency funds, and commercial paper with original maturities at acquisition of three months or less, and we report them at fair value.

Cash equivalents also include amounts invested in nonparticipating interest-earning investment contracts that provide a guaranteed return on principal over a specified time. These amounts include investments of bond proceeds that are used to originate or purchase student loans and we report them using a cost-based measure. We report these amounts as cash equivalents, because we may deposit and withdraw cash at any time without prior notice or penalty.

### Restricted Cash and Investments

Restricted cash and investments include cash received from financial institutions pending disbursement for student loans, cash received for the benefit of servicing customers, and cash and investments of bond proceeds held by a trustee and restricted by the provision of the bond indentures and financing agreements. We consider these amounts restricted and they cannot be disbursed for any other purpose.

### Investments

Investments include amounts invested with the State Treasury investment pool, which is a short-term investment portfolio maintained by the Commonwealth of Pennsylvania Treasury Department's Bureau of Cash Management and Investments for the benefit of all Commonwealth funds, and other instruments including securities. We report these amounts at fair value based upon information provided by the Commonwealth of Pennsylvania's Treasury Department.

Investments also include amounts invested in nonparticipating interest-earning investment contracts that provide a guaranteed return on principal over a specified period. These amounts include investments of funds reserved for debt service payments and we report these amounts using a cost-based measure.

### Student Loans Receivable, net

We report student loans in the statement of net assets at their unpaid principal balances net an allowance for potential losses. We defer costs related to loan originations and premiums related to loan purchases and we recognize these costs over the life of the loan, after giving effect to estimated prepayments, as an adjustment of yield. We report the deferred amount as part of the principal balance of student loans.

In the past, we paid all of the up-front federal fees that could be charged to borrowers for loans originated by us. However, on October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. We report the cost of providing these benefits with grants and other financial aid in the Statements of Revenues, Expenses and Changes in Net Assets.

Allowances for potential losses on our student loans can result from deficient servicing, risk sharing on defaults and uninsured loans. These allowances are based upon our ongoing evaluation of the loan portfolios, past and anticipated loss experience and the amount and quality of the loans. We maintain the allowances at a level that we believe is adequate to absorb estimated incurred losses, but our evaluation is inherently subjective and the required allowances may significantly change in the future. We do not write-off uncollectible loans that are not guaranteed or insured as we continue to pursue collection on those loans.

We recognize student loan income as its earned including adjustments for the amortization of costs of loan originations and purchases. The U.S. Secretary of Education provides a special allowance to student loan owners participating in the FFELP. The special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of the 3-month financial commercial paper rate, to the average daily unpaid principal balance and capitalized interest of student loans held by us. We accrued the special allowance as earned or payable. For loans first disbursed prior to January 1, 2000, the 91-day Treasury Bill rate is used rather than the 3-month financial commercial paper rate.

We accrue interest on student loans based upon the actual principal amount outstanding. The U.S. Secretary of Education makes quarterly interest payments on subsidized loans until the student is required, under the provisions of the Higher Education Act, to begin repayment. Repayment must begin generally within six months after the student completes his or her course of study, leaves school, or ceases to carry at least one-half the normal full time academic load as determined by the participating institution.

We report expenses related to risk sharing on defaults in the provision for loan losses, and we include the expenses related to servicing deficiencies in "other" operating expenses.

### Capital Assets

We report capital assets at cost net of depreciation and estimated impairment, if any. We report assets held under capital leases at the present value of minimum lease payments net of amortization. We calculate depreciation based on the straight-line method over the estimated useful life of the asset. We amortize assets held under capital leases and leasehold improvements based on the straight-line method over the shorter of the lease term or the estimated useful life of the asset.

We capitalize purchased computer software if the per unit costs, based on per license fee, is \$10,000 or more. We capitalize improvements or additions to existing software that constitute a capital outlay or increase the value or life of the asset by 25 percent of the original cost or life as a betterment and we record it as an addition of value to the existing asset. We calculate depreciation based on the straight-line method over the estimated useful life of the purchased software.

Software development involves three phases: preliminary project phase, application development phase and post-implementation/operation phase. We expense the cost associated with the preliminary project and the post-implementation/operating phase. We capitalize internal and external costs associated with the application development phase. The capitalization of costs begins when the preliminary project phase is complete and management has implicitly authorized or commits to funding the software project with the intent it will be completed and used to perform its planned functions. Capitalization will cease no later than at the time when substantial testing is complete and the software is ready for its intended purpose or rendered into service. Upgrades and enhancements are modifications to existing internal-use software that result in additional functionality, that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may require a change to all or part of the existing software specifications. We capitalize upgrades and enhancements, as defined above. We report software development at cost net of amortization. We calculate amortization based on the straight-line method over the estimated useful life of the software developed.

We capitalize assets that cost \$10,000 or more; amounts under that threshold are expensed. The following estimated useful lives are used for significant asset categories:

- Buildings and improvements 7 – 40 years
- Furniture, furnishings and equipment 5 – 10 years
- Software (purchased and development) 3 – 5 years

### Deferred Financing Costs

Deferred financing costs consist of underwriting and other costs of issuing financings. We amortize these costs over the term of the financing using the straight-line or effective interest method and these costs are included in interest expense.

### Compensated Absences

Employees earn annual leave based upon years of service and may carry forward up to 45 days of unused annual leave at the end of each calendar year. We pay employees for accumulated annual leave at termination or retirement. Employees earn sick leave and may carry forward up to 300 days of unused sick leave at the end of each calendar year. We pay employees a portion of accumulated sick leave at retirement based upon a formula. We include in accrued expenses on the statements of net assets the estimated amounts payable upon retirement or termination under these arrangements.

### Revenue Recognition

We recognize servicing fees as revenue when we provide the contractual services and when we record the unbilled amounts as accounts receivable. For federal loan processing and issuance fees related to our guaranty function, we recognize revenue as the guaranteed loans are disbursed, and we recognize account maintenance fees throughout the year at rates established by law. We recognize retention of collections on defaulted loans as revenue when we collect the cash on the defaulted loans.

We receive default aversion fees amounting to 1% of the principal and interest of a loan when the lender submits a default preclaim. If the loan later defaults, we must return these fees to the Federal Fund at the time of the loan default. Therefore, the revenue recognized from default aversion fees is net of the amount we estimate that we will have to be return to the Federal Fund. As of January 1, 2008, we have not recognized revenue related to default aversion fees, as we could not assure the ultimate collectability of those loans, so we have not transferred any of these fees from the Federal Fund. However, the Federal Fund continues to recognize the entire default aversion fee returns as an expense when incurred.

### Operating Revenues and Expenses

Operating revenues include net interest revenue earned on student loans and investments and fees earned from providing services. Operating expenses include the costs of providing services and operating all programs. We do not report as a component of operating income the grants we receive and the grants and financial aid we disburse.

### Advertising

We incur advertising expenses to generate additional business and to make sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. As we incur advertising expenses, we expense them. For the three months ended, December 31, 2009 advertising expense was \$7 thousand as compared to \$32 thousand in 2008. For the six months ended, December 31, 2009 advertising expense was \$9 thousand as compared to \$75 thousand in 2008.

### Residual Interest in Off-Balance Sheet Securitizations

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. We do not report in our financial statements the securitized loans, bonds, and related income and expenses, since the securitization does not meet the financial reporting requirements of GASB Statement No. 14 – *The Financial Reporting Entity*. See **Note 10 - Student Loan Securitizations** for more details.

For transactions qualifying as sales according to GASB Statement No. 48 – *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, we retain a residual interest, which we recognize in the Statements of Net Assets as the residual interest in off-balance sheet securitizations. The residual interest is the right to receive cash flows from the student loans in excess of the amounts needed to pay servicing, administration, and other fees, as well as, the principal and interest on the bonds backed by the student loans. The residual interest is the present value of these future expected cash flows. We value the residual interest at the time of

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sale of the student loans to the trust and at the end of each subsequent quarter and we reflect the changes in fair value of residual interest, net on the statements of revenues, expenses, and changes in net assets.

#### Commonwealth of Pennsylvania and Federal Grant Revenues

Commonwealth and federal grants are nonexchange transactions. We use the receipts as a source of funds to disburse grants and financial aid. Our agreements contain restrictions requiring us to spend the money in accordance with the legislation or grant agreement, but generally do not refer to specific time requirements. Accordingly, we recognize the entire amount as revenue when we receive it.

#### Reclassifications

We have reclassified certain prior year amounts to conform to the current year's presentation.

### Correction of Immaterial Errors

During 2009, we identified certain prior period errors related to the reporting of activities in the Statements of Cash Flows in accordance with GASB 9 – *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. We corrected the prior period errors in the Statement of Cash Flows for the six months ended December 31, 2008 as follows:

	As previously reported	Impact of Errors	As Adjusted
<b><u>Cash flows from operating activities:</u></b>			
Principal received on student loans	\$ 543,793	(5,607)	538,186
Student loan originations	(2,035)	(38)	(2,073)
Student loan purchases	(325,508)	23,265	(302,243)
Student loan sales, including net gains	17,646	(17,620)	26
Interest received on investments	3,812	(3,812)	-
Interest paid on student loan financings and notes and bonds payable	(189,611)	189,611	-
Interest paid on capital and other financings	(6,060)	6,060	-
Net cash provided by operating activities	243,604	191,859	435,463
<b><u>Cash flows from noncapital financing activities:</u></b>			
Interest paid on student loan financings and notes and bonds payable	-	(189,611)	(189,611)
Net cash used for noncapital financing activities	13,555	(189,611)	(176,056)
<b><u>Cash flows from capital and related financing activities:</u></b>			
Interest paid on capital and other financings	-	(6,060)	(6,060)
Net cash used for capital and related financing activities	757	(6,060)	(5,303)
<b><u>Cash flows from investing activities:</u></b>			
Interest received on investments	-	3,812	3,812
Net cash used for investing activities	\$ (199,108)	3,812	(195,296)

We assessed the materiality of the above errors in the 2008 quarterly financial statements and determined that those errors are immaterial to the previously reported amounts.

### **Note 4 – New Accounting Pronouncements**

During 2009, the GASB issued Statement No. 55 - *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The objective of this Statement is to incorporate the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the Governmental Accounting Standards Board's (GASB) authoritative literature. The "GAAP hierarchy" consists of the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. The GASB is responsible for establishing GAAP for state and local governments. However, the current GAAP hierarchy is set forth in the American Institute of Certified

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Public Accountants' (AICPA) Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, rather than in the authoritative literature of the GASB.

During 2009, the GASB issued Statement No. 56 – *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*. The objective of this Statement is to incorporate into the Governmental Accounting Standards Board's (GASB) authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements on Auditing Standards. This Statement addresses three issues not included in the authoritative literature that establishes accounting principles—related party transactions, going concern considerations, and subsequent events. The presentation of principles used in the preparation of financial statements is more appropriately included in accounting and financial reporting standards rather than in the auditing literature.

During 2009, the GASB issued Statement No. 57 - *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. The objective of this Statement is to address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers). This Statement amends Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, to permit an agent employer that has an individual-employer OPEB plan with fewer than 100 total plan members to use the alternative measurement method, at its option, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates. This statement is effective for reporting periods after June 15, 2011.

During 2009, the GASB issued Statement No. 58 - *Accounting and Financial Reporting for Chapter 9 Bankruptcies*. The objective of this Statement is to provide accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. It requires governments to remeasure liabilities that are adjusted in bankruptcy when the bankruptcy court confirms (that is, approves) a new payment plan. This statement is effective for reporting periods after June 15, 2009.

#### **Note 5 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education**

As a part of our guaranty operations, we manage the Federal Fund for the ED. We pay claims on defaulted loans out of the Federal Fund, which belongs to the federal government. On the statements of net assets, we report the total assets of the Federal Fund under the caption “Federal Student Loan Reserve Fund assets held for the U.S. Department of Education.” We also report the same amount as a liability on the statements of net assets. Since the Federal Fund has both assets and liabilities, we use a net asset approach in the following tables to report activity in the fund.

The following table shows the changes in net assets held by us for ED in the Federal Fund.

(In thousands)	<b>Three months ended, December 31,</b>		<b>Six months ended, December 31,</b>	
	<b>2009</b>	2008	<b>2009</b>	2008
<b>Additions</b>				
Reinsurance from the U.S. Department of Education	\$ <b>330,678</b>	317,151	\$ <b>636,745</b>	584,559
Collections on defaulted loans	<b>143,609</b>	111,023	<b>264,383</b>	222,816
Federal default fees	<b>2,682</b>	5,573	<b>18,274</b>	17,835
Net (depreciation) appreciation in fair value of investments	<b>(122)</b>	22	<b>(107)</b>	121
<b>Total additions</b>	<b>476,847</b>	433,769	<b>919,295</b>	825,331
<b>Deductions</b>				
Purchases of defaulted loans from lenders	<b>344,115</b>	329,962	<b>662,008</b>	608,543
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections	<b>102,411</b>	79,516	<b>188,493</b>	159,916
Reimbursement to PHEAA for our retention of defaulted loans collections	<b>37,326</b>	28,121	<b>68,967</b>	56,402
Default aversion fees, net	<b>2,387</b>	5,922	<b>7,246</b>	12,520
Other	<b>3</b>	-	<b>3</b>	-
<b>Total deductions</b>	<b>486,242</b>	443,521	<b>926,717</b>	837,381
<b>Net decrease</b>	<b>(9,395)</b>	(9,752)	<b>(7,422)</b>	(12,050)
<b>Net liabilities, beginning of period</b>	<b>(27,017)</b>	(6,790)	<b>(28,990)</b>	(4,492)
<b>Net liabilities, end of period</b>	\$ <b>(36,412)</b>	(16,542)	\$ <b>(36,412)</b>	(16,542)

The following table shows the detail of the net assets held by us for ED in the Federal Fund.

(In thousands)	December 31, 2009	June 30, 2009
<b>Assets</b>		
Cash	\$ 9,962	31,695
Receivable from the U.S. Department of Education	89,725	64,242
Other receivables	17,848	11,718
<b>Total assets</b>	<b>117,535</b>	107,655
<b>Liabilities</b>		
Accounts payable and accrued expenses	3	15
Deferred federal default fees	16,044	10,147
Amounts payable to PHEAA	137,900	126,483
<b>Total liabilities</b>	<b>153,947</b>	136,645
<b>Net liabilities</b>	<b>\$ (36,412)</b>	(28,990)

Under the Higher Education Amendments of 1998, we are to act as a fiduciary in managing the assets of the Federal Fund.

Under current law, we are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees. Historically ED has calculated this ratio at September 30, which is the close of the federal fiscal year, based upon regulatory reports that we file with ED.

During the six months ended December 31, 2009 and 2008, we have managed the cash flow of the Federal Fund in a manner to assure our customers that sufficient funds are available to continue to pay default claims by not transferring default aversion fees that are due to us. In addition to paying default claims, we pay our share of retention on defaulted loan collections from the fund and we could in the future resume paying default aversion fees from the fund.

## Note 6 – Student Loans Receivable

The following table shows our student loan holdings.

(In thousands)	December 31, 2009	June 30, 2009
FFELP:		
Consolidation	\$ 7,042,418	7,315,493
Stafford	2,350,085	3,053,956
PLUS	354,917	425,898
Supplemental Loans for Students	1,772	1,378
	<b>9,749,192</b>	10,796,725
HEAL	148,275	161,415
Privately insured loans	50,300	51,509
Uninsured loans	5,792	6,094
Unamortized premium on loan purchases	108,293	134,905
Unamortized loan origination costs	27,307	33,037
	<b>10,089,159</b>	11,183,685
Allowance for loan losses	<b>(14,320)</b>	(13,845)
	<b>\$ 10,074,839</b>	11,169,840

Under FFELP, 97% of the unpaid principal balances and eligible interest are guaranteed for loans first disbursed on or after July 1, 2006; 98% of the unpaid principal balances and eligible interest are guaranteed for loans first disbursed on or after October 1, 1993 and before July 1, 2006; and 100% of the unpaid principal balances and eligible interest are guaranteed for loans first disbursed before October 1, 1993. FFELP loans are guaranteed through guaranty agencies and reinsured by ED. HEAL loans are guaranteed by the Secretary of the U.S. Department of Health and Human Services. The guarantees for both FFELP and HEAL loans are subject to regulatory requirements related to loan servicing.

In the past, ED designated us as an Exceptional Performer in recognition of meeting certain performance standards set by ED in servicing FFELP loans. Because of this designation, we received 100% reimbursement on all eligible FFELP default claims submitted for reimbursement before July 1, 2006, as we remained in compliance with the required standards, were assessed annually and quarterly through compliance audits. Beginning July 1, 2006 and before October 1, 2007, the reimbursement for student loans serviced by servicers designated as Exceptional Performers decreased from 100% to 99% for all claims filed during that time. The ratification of the College Cost Reduction and Access Act on September 27, 2007 eliminated the Exceptional Performer program, resulting in a decrease in the reimbursement for student loans from 99% to 97% for loans first disbursed on or after July 1, 2006. We report the losses associated with the risk sharing on FFELP loans as “provision for loan losses” on the Statements of Revenues, Expenses and Changes in Net Assets.

Not meeting ED regulations on servicing can also result in losses. We make estimates of the potential losses based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We report the provision for losses related to servicing as “servicing liability” as a component of operating expenses.

We believe the provision for losses below is adequate to cover the inherent losses in the student loan portfolio for the risk sharing on FFELP loans and the servicing of loans. We present an analysis of our allowance for loan losses related to student loans in the following table.

(In thousands)	<b>December 31, 2009</b>	June 30, 2009
Balance at beginning of period	\$ <b>14,505</b>	16,939
Provision for losses	<b>1,607</b>	3,560
Charge-offs	<b>(1,792)</b>	(6,654)
Balance at end of period	\$ <b>14,320</b>	13,845

As of December 31, 2009, we have student loan purchase commitments of \$163.9 million that we have been unable to fund or settle, and an additional \$7.9 million of student loan purchase commitments through June 30, 2010 and thereafter.

**Note 7 – Notes and Bonds Payable and Other Financings**

Activity for notes and bonds payable and other financings as of December 31, 2009 are as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
<b>Student loan financings, demand revenue bonds and auction rate notes:</b>					
Student loan demand revenue bonds and auction rate notes, due 2016-2047, at weighted-average rates of 4.24% at December 31, 2009 and 5.02% at December 31, 2008.	\$ 8,544,250	-	(1,304,750)	7,239,500	-
Student loan floating rate notes, due 2016-2042 at weighted-average rates of 0.30% at December 31, 2009 and 3.94% at December 31, 2008.	1,300,449	457,600	(50,531)	1,707,518	-
Deferred amount on current refunding of student loan demand revenue bonds.	(9,125)	-	1,899	(7,226)	-
Student loan variable rate funding notes, due 2014 at an estimated weighted-average rate of 0.57% at December 31, 2009.	799,960	436,449	(26,623)	1,209,786	-
Student loan financings, due on demand at weighted-average rates of 0.87% at December 31, 2009 and 2.07% at December 31, 2008.	726,019	-	(469,233)	256,786	256,786
	11,361,553	894,049	(1,849,238)	10,406,364	256,786
<b>Capital financings:</b>					
Capital financings, due 2010-2015, at weighted-average rates of 4.87% at December 31, 2009 and 5.88% at December 31, 2008.	76,285	-	(3,135)	73,150	69,168
Unamortized discount on capital acquisition bonds.	(78)	-	26	(52)	-
	\$ 76,207	-	(3,109)	73,098	69,168

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
<b>Other financings:</b>					
Line of credit, due 2010, at weighted-average rates of 2.76% at December 31, 2009 and 4.17% at December 31, 2008.	\$ 72,000	-	(26,000)	46,000	46,000
Term financings, due 2010 - 2030, at weighted-average rates of 5.09% at December 31, 2009 and 2008.	66,410	-	(1,865)	64,545	1,935
Unamortized discount on capital acquisition refunding bonds	(443)	-	14	(429)	-
Term financing, due 2029, at zero percent interest at December 31, 2009.	60,680	17,505	(3,388)	74,797	-
	198,647	17,505	(31,239)	184,913	47,935
	\$ 11,636,407	911,554	(1,883,586)	10,664,375	373,889

The note and bond indentures among other things require us to comply with various covenants. Student loans and investments collateralize all student loan financings, student loan floating rate notes, and student loan demand revenue bonds and auction rate notes. At December 31, 2009, \$10.1 billion of student loan principal and related interest receivable and \$563.5 million of investments and related interest receivable collateralized the \$10.4 billion of student loan financings and notes and bonds payable.

The student loan demand revenue bonds are subject to purchase, at par plus accrued interest. Under the stand-by bond purchase agreements, the trustee is entitled to draw an amount sufficient to pay the purchase price of bonds delivered to it. As of December 31, 2009, there was \$64.7 million of variable-rate demand bonds that were put to the liquidity provider and are classified as bank bond mode with interest rates equal to the prime rate. We have letters of credit that are valid through 2015, which we are required to pay annual commitment fees of 27 basis points for the Variable Rate Demand Bonds (VRDN) and 90 basis points for the Pennsylvania Local Government Investment Trust (PLGIT). At December 31, 2009, total liquidity coverage was \$214 million.

On October 13, 2009, we determined that the parity ratios associated with our 2001B and 2002 A Series bonds dropped below levels required by the liquidity provider, which resulted in one or more breaches, violations or defaults. Through December 31, 2009, we obtained signed waivers from certain financial institutions for the above breaches, violations or defaults related to our 2001 and 2002 A Series bonds. As of December 31, 2009, the 2002A Series bonds remain below the required minimum parity ratio. On January 29, 2010, we redeemed in full the 2001B, 2002A and 2002B Series bonds.

Because of the above noted events of default, we were unable to issue our annual financial statements within 120 days of our fiscal year end. This event caused a triggering event to occur with a note purchase agreement, which in turn caused cross events of default with certain financial institutions. Through December 31, 2009, we obtained signed waivers from those financial institutions.

On December 7, 2009, we transferred \$449.4 million of eligible student loans to the PHEAA SLC II. On December 10, 2009, the PHEAA SLC II entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A Funding, LLC (Conduit) through which the Conduit purchased the variable funding note at 97% of the collateral

value of eligible student loans pledged or \$436.0 million. On that same day, we entered into a \$9.8 million Note Purchase Agreement (NPA) with a financial institution, which is non-recourse debt to us. The financial institution funded the NPA in consideration of the redemption or defeasance of the 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2 bonds that were subject to the asset-backed securities transactions conduit refinancing.

On December 17, 2009 and December 21, 2009, we issued series 2009-1, class A-1, floating rate student loan asset-backed notes and series 2009-2 class A-1 and A-2 floating rate student loan asset-backed notes, respectively. The use of the proceeds for the above issued notes will be used (i) to fund initial deposits to a reserve account and to the capitalized interest account (both established under the indenture), (ii) to purchase certain student loans and (iii) to pay costs associated with the issuance of the notes. Furthermore, on the closing date, a portion of the proceeds categorized as “Deposit to Temporary Student Loan Subaccount” were applied to the repayment of certain outstanding indebtedness of PHEAA, which is secured in part by a pledge of student loans through the purchase of student loans. For more details on the new issues see the “Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-1, Class A-1” and the “Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-2” official statements dated December 17, 2009 and December 21, 2009, respectively.

On December 30, 2009, we fully redeemed the following bond issues: 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2.

Capital financings are collateralized with capital assets. At December 31, 2009, we had \$3.3 million of available credit under capital financing arrangements.

The following table displays the debt service requirements based upon the stated maturities for demand bonds and estimated interest rates for variable-rate debt after considering terms renegotiated after December 31, 2009.

(In thousands) Year of Maturity	Student Loan Notes, Bonds and Financings		Capital and Other Financings	
	Principal	Interest	Principal	Interest
2010	\$ 256,786	171,181	117,103	8,643
2011	-	170,053	3,447	8,390
2012	-	170,053	3,578	3,279
2013	-	170,053	3,088	3,119
2014	1,209,786	170,053	2,220	2,978
2015-2019	241,465	840,569	12,709	13,165
2020-2024	429,990	827,378	16,160	9,757
2025-2029	713,900	794,779	95,422	5,418
2030-2034	-	758,920	4,765	694
2035-2039	1,392,838	742,932	-	-
2040-2044	2,246,250	567,169	-	-
2045-2050	3,922,575	133,392	-	-
	\$ 10,413,590	5,516,532	258,492	55,443

As of December 31, 2009, \$10.4 billion of the student loan notes, bonds and financings are variable-rate debt. \$137.3 million of the variable-rate debt resets based upon auctions every 7 days. \$6.3 billion resets based upon auctions every 28 days. \$748.5 million resets based upon auctions every 35 days. \$1.9 billion is indexed to the 1-

month or 3-month LIBOR, \$86.5 million is indexed to 3-month financial commercial paper, \$1.2 billion is conduit financing and \$64.7 million is in bank bond mode.

Notes and bonds payable, as well as all other debt, are limited obligations payable only from the pledged assets. We have no taxing power, and the Commonwealth is not obligated to pay the principal, redemption price, if any, or interest on any of our debt.

Activity for notes and bonds payable and other financings as of December 31, 2008 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
<b>Student loan demand revenue bonds, floating rate notes and financings:</b>					
Student loan demand revenue bonds and auction rate notes	\$ 9,499,900	-	(900)	9,499,000	-
Deferred amount on current refundings of student loan demand revenue bonds	(9,925)	-	400	(9,525)	-
Student loan floating rate notes	1,388,543	-	(41,989)	1,346,554	-
Student loan financings	1,084,019	-	(94,800)	989,219	989,219
	11,962,537	-	(137,289)	11,825,248	989,219
<b>Capital financings:</b>					
Capital financings	76,766	4,650	(3,281)	78,135	4,591
Unamortized discount on capital acquisition bonds	(129)	-	25	(104)	-
	76,637	4,650	(3,256)	78,031	4,591
<b>Other financings:</b>					
Line of credit	94,035	-	(7,035)	87,000	31,000
Term financings	68,205	-	(1,795)	66,410	1,865
Unamortized discount on capital acquisition refunding bonds	(470)	-	14	(456)	-
	161,770	-	(8,816)	152,954	32,865
	\$ 12,200,944	4,650	(149,361)	12,056,233	1,026,675

## Note 8 – Segment Information

We generally finance student loan portfolios by issuing notes, bonds, and other financings and the earnings are pledged in support of the debt. Because the revenue stream of the student loan portfolios is pledged to support the debt, we are reporting condensed financial information about this segment. The notes, bonds, and other financings related to this segment are limited obligations payable only from the pledged assets.

### Statements of revenues, expenses, and changes in net assets

(In thousands)	Three months ended, December 31,		Six months ended, December 31,	
	2009	2008	2009	2008
Interest revenue	\$ 52,855	114,407	\$ 109,810	237,301
Interest expense	46,507	102,201	94,375	213,103
Net interest revenue	6,348	12,206	15,435	24,198
Provision for loan losses	(1,736)	(1,350)	(3,281)	(2,059)
Net interest revenue after provision for loan losses	4,612	10,856	12,154	22,139
Loss on student loan sales, net	(2,776)	-	(2,795)	-
Total operating revenues	1,836	10,856	9,359	22,139
Operating expenses	15,803	19,050	33,232	37,890
Operating loss	(13,967)	(8,194)	(23,873)	(15,751)
Financial aid	(143)	(556)	(153)	(1,027)
Loss before transfers	(14,110)	(8,750)	(24,026)	(16,778)
Transfers from unrestricted net assets	40,602	7,058	38,824	7,015
Change in net assets	26,492	(1,692)	14,798	(9,763)
Net assets, beginning of period	249,154	244,982	260,848	253,053
Net assets, end of period	\$ 275,646	243,290	\$ 275,646	243,290

### Statement of net assets

(In thousands)	December 31, 2009	June 30, 2009
Restricted cash and cash equivalents	\$ 571,970	360,250
Student loans receivable, net	9,981,838	11,070,568
Other, principally interest income receivable	201,693	235,215
Total assets	10,755,501	11,666,033
Student loan financings and notes and bonds payable, net	10,406,364	11,361,553
Other, principally accrued interest payable	73,491	43,632
Total liabilities	10,479,855	11,405,185
Net assets, restricted for debt service	\$ 275,646	260,848

Statements of cash flows

(In thousands)	Six months ended, December 31,	
	2009	2008
<u>Cash flows from operating activities</u>		
Interest received on student loans	\$ 60,176	169,228
Principal received on student loans	595,195	533,258
Student loan originations	(16)	(1,599)
Student loan purchases	-	(309,805)
Student loan sales, including net gains	567,151	3,816
Payment of operating expenses	(34,602)	(38,780)
Net cash provided by operating activities	<b>1,187,904</b>	356,118
<u>Cash flows from noncapital financing activities</u>		
Proceeds from issuance of noncapital debt	116,816	-
Principal paid on noncapital debt	(1,073,904)	(137,689)
Interest paid on student loan financings and notes and bonds payable	(54,973)	(189,611)
Other	35,366	5,988
Net cash used for noncapital financing activities	<b>(976,695)</b>	(321,312)
<u>Cash flows from investing activities</u>		
Interest received on investments	511	2,462
Net cash provided by investing activities	<b>511</b>	2,462
Net change in restricted cash and cash equivalents	<b>211,720</b>	37,268
Restricted cash and cash equivalents, beginning of period	<b>360,250</b>	296,226
Restricted cash and cash equivalents, end of period	<b>\$ 571,970</b>	333,494

As of December 31, 2009, there were \$64.7 million of variable-rate demand bonds that were put to the liquidity provider and classified as bank bond mode with interest equal to the prime rate. As of January 31, 2010, none of our variable rate demand bonds were put to the liquidity provider and classified as bank bond mode.

There are 15 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 1.000 to 1.960 at December 31, 2009.

During 2009, we suspended the recycling of new loans into all trusts.

The master trust that issued auction rate securities holds \$7.0 billion of debt. The parity ratio for this trust is 1.002 at December 31, 2009 and 0.999 at December 31, 2008. There is no parity ratio requirement for this trust.

**Note 9 – Restrictions on Net Assets**

Net assets restricted for debt service amounted to \$277.9 million at December 31, 2009. Of that amount, \$275.6 million is related to net assets held under various indentures related to financing our student loan portfolios, and the remaining \$2.3 million of net assets restricted for debt service is related to capital and other financings.

The \$222.9 million of net assets restricted for financial aid grant programs results from Commonwealth of Pennsylvania grants and federal grants related to specific programs. Those net assets are restricted until we disburse program-related grants.

Under Commonwealth law, our purpose is to increase higher education opportunities for Pennsylvania residents. Net assets that we report as unrestricted are statutorily restricted to our purpose. The Higher Education Amendments of 1998 also restrict our use of net assets related to FFELP guaranty activities to fulfilling our guaranty responsibilities and other student financial aid related activities selected by us. Because that restriction is consistent with our statutory purpose, we consider net assets related to those activities to be unrestricted.

### Note 10 – Student Loan Securitizations

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. For transactions qualifying as sales, we retain a residual interest and we report it on the statements of net assets as the residual interest in off-balance sheet securitizations. The residual interest is the right to receive cash flows from the student loans in excess of the amounts needed to pay servicing, administration, and other fees, as well as, the principal and interest on the bonds backed by the student loans. The residual interest is the present value of these future expected cash flows. We value the residual interest at the time of sale of the student loans to the trust and at the end of each subsequent quarter and reflect the change in the value in residual interest, net on the statements of revenues, expenses, and changes in net assets.

During the years ended June 30, 2004 and 2005, we sold a total of \$1.2 billion of student loans originated under the Federal Family Education Loan Program to PHEAA Student Loan Trust I, Inc. through the PHEAA Student Loan Foundation, Inc. We retain a 100 percent residual interest in these student loans purchased and held by the PHEAA Student Loan Trust I.

The following table summarizes the present value of our residual interests, along with the significant assumptions used to determine that present value.

(Dollars in thousands)	<b>December 31, 2009</b>	June 30, 2009
Present value of residual interest	\$ <b>25,723</b>	23,200
Weighted average life	<b>10.50 years</b>	11.00 years
Constant prepayment rate	<b>4.0%</b>	4.0%
Residual cash flow discount rate	<b>5.0%</b>	5.1%

When we sell student loan receivables in securitizations of student loans, we enter into a servicing agreement with the securitization trust and earn annual servicing fees from the trust of 0.25% per year on the outstanding balance of consolidation loans and 0.50% per year on the outstanding balance of Stafford and PLUS loans. We also entered into an administration agreement with the trust and we generally earn annual administration fees of 0.25% per year on the outstanding balance of student loans in the trust. For the three months ended December 31, 2009, we earned \$742 thousand compared to \$823 thousand in 2008. For the six months ended December 31, 2009, we earned \$1.5 million compared to \$1.7 million in 2008. We report the amount earned in servicing fees on the statement of revenues, expenses, and changes in net assets.

The PHEAA Student Loan Trust I filed a monthly Form 8-K and an annual Form 10-K with the SEC through November 30, 2005 and those filings are available on the SEC's website at [www.sec.gov](http://www.sec.gov). In December 2005, the PHEAA Student Loan Trust I filed Form 15 with the SEC to provide notice for the suspension of duty to file these reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934.

We present condensed unaudited financial information for the PHEAA Student Loan Trust I in the following table:

(In thousands)	December 31, 2009	June 30, 2009
Assets:		
Cash and cash equivalents	\$ 23,915	27,066
Student loans receivable, net	584,536	616,350
Interest income receivable	5,481	5,803
Other assets	2,732	2,948
Total assets	616,664	652,167
Liabilities:		
Notes payable	\$ 584,528	623,278
Interest payable	2,181	2,047
Other liabilities	4,687	4,146
Total liabilities	591,396	629,471
Net assets	\$ 25,268	22,696

## Note 11 – Risk Management, Contingencies, and Legal Proceedings

### *Risk Management and Contingencies*

We are exposed to various risks of loss, such as theft, damage to and destruction of assets. To handle those risks, we purchase insurance coverage, and there have been no material claims.

Federal programs in which we participate are subject to audit in accordance with the provisions of the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. The provisions of this circular do not limit the authority of ED or other federal audit officials to perform, or contract for, audits and evaluations of federal financial assistance programs. Therefore, our operations in current and prior years are subject to audit. We believe we are in substantial compliance with applicable federal regulations and that any adjustment because of future audits will not be material.

On December 8, 2008, Ollie Green and Company, CPA's, on behalf of ED, Federal Student Aid (FSA), issued a report of their review of PHEAA. The purpose of this review was to determine PHEAA's compliance with the establishment of the federal and operating funds as required by the Higher Education Act of 1965, as amended. The final date for establishing these funds was December 6, 1998 with an October 1, 1998 effective date. On April 21, 2009, FSA assessed PHEAA \$11.2 million based on three findings. On May 20, 2009, PHEAA responded to these findings with ED and as of December 31, 2009, these findings remain open. PHEAA has not accrued the \$11.2 million in the accompanying financial statements, since we believe the loss contingency is not probable and PHEAA intends to appeal the findings pursuant to applicable law.

On June 19, 2008, the Student Loan Revenue Bonds, Senior Subseries P-1 and P-2 and Subordinate Series Q (collectively, the "Bonds") issued by us in the original aggregate principal amount of \$150.0 million were selected for examination by the United States Department of Treasury, Internal Revenue Service (IRS). On April 30, 2009, we received an Information Document Request (Request No. 2) asking to explain (i) the reallocation of student loans to and from the Bonds and (ii) why consolidation loan rebate fees paid to the Treasury reduce the yield on the

student loans. We have responded to the above request on May 28, 2009 and we are waiting on a response from the IRS.

#### *Legal Proceedings*

In 2004, we entered into a settlement agreement with a student loan borrower and his lender regarding the servicing of his student loan debt. As part of the settlement agreement, the borrower's lender directed PHEAA to update the credit reporting associated with the borrower's underlying loans. We requested the requisite updates be made but a national credit reporting agency failed to update the reporting. The borrower/plaintiff filed a new legal action against us and the lender alleging that we violated the Fair Credit Reporting Act. If the plaintiff is successful, the plaintiff may be able to recover attorney's fees and punitive damages. Discovery has closed in this case, and per the trial court's local rules, the parties are awaiting permission to file motions for summary judgment. We will continue to vigorously contest all of the allegations set forth in the amended complaint and third-party complaint filed against us by the borrower's lender. We intend to file a motion for summary judgment and we believe based on the completion of discovery that the plaintiff may prevail on certain counts of the amended complaint. As of December 31, 2009, it is difficult to estimate our potential liability on this complaint due to the speculative nature of the alleged damages.

In August 2008, we entered into a Memorandum of Understanding with a FFEL student loan guarantor documenting our agreement to reprocess on behalf of impacted lenders all federal special allowance payments and interest subsidies on student loans that were submitted for payment to the ED during a period of time when the student loans were not reflected as guaranteed in the records of the above guarantor. We have recently learned that approximately 317 additional loans that were submitted to the above guarantor were also not reflected as guaranteed in the records of the above guarantor. As such, we continue to work with the guarantor on the documentation of the guarantee of these loans.

A guarantor has returned several FFEL default claims submitted to it by us, because of consolidation loans allegedly including loan amounts either never requested to be included in the consolidation loan, or loans that the borrowers allegedly expressly requested not to be included in the consolidation. As of December 31, 2009, it is difficult to estimate our potential liability and we are currently investigating the number of consolidation loans affected.

On September 2, 2009, a civil complaint originally filed in 2007 under the Federal False Claims Act, was unsealed that seeks the return of an alleged \$1.0 billion in student loan subsidies paid by ED to ten student loan holders. We were named in the civil complaint as one of the ten co-defendants. On December 1, 2009, the U.S. District Court of the Eastern District of Virginia dismissed this case against PHEAA.

Lastly, we are involved in various legal matters in the normal course of business. Considering available information, we do not believe that resolution of any such matters will have a material impact on the financial statements.