PHEAA
Creating Access to Education

Pennsylvania Higher Education Assistance Agency

Financial Statements

Years ended June 30, 2001 and 2000

PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY
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KPMG

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Independent Auditors' Report

The Board of Directors
Pennsylvania Higher Education Assistance Agency:

We have audited the accompanying balance sheets of Pennsylvania Higher Education Assistance Agency as of June 30, 2001 and 2000, and the related statements of income and retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pennsylvania Higher Education Assistance Agency as of June 30, 2001 and 2000, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the financial statements, the Agency adopted GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* during the year ended June 30, 2001.

KPMG LLP

September 12, 2001

PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

Balance Sheets

At June 30 (In thousands)		2001	2000
Assets			
Cash (note 4)	$	**7,861**	1,486
Accounts receivable, net (note 7)		**9,982**	11,583
Receivable from U.S. Department of Education		**5,730**	16,621
Interest income receivable (note 7)		**84,934**	74,483
Investments (notes 4, 7 and 8)		**572,762**	494,998
Assets held for U.S. Department of Education		**257,330**	272,702
Student loans receivable, net (notes 5 and 7)		**2,668,934**	2,403,527
Operational assets, net (notes 6, 7, and 8)		**79,440**	76,475
Deferred financing costs, net		**19,302**	14,174
Prepaid expenses and other assets		**2,754**	2,941
Total assets	$	**3,709,029**	3,368,990
Liabilities and retained earnings			
Accounts payable and accrued expenses	$	**42,825**	49,001
Accrued interest payable		**25,962**	29,418
Payable to U.S. Department of Education:			
Operating funds		**-**	1,274
Amounts related to Federal Student Loan Reserve Fund (note 3)		**257,330**	272,702
Total payable to U.S. Department of Education		**257,330**	273,976
Notes and bonds payable (note 7)		**3,106,217**	2,775,299
Obligation under capital lease (note 8)		**50,830**	51,930
Total liabilities		**3,483,164**	3,179,624
Retained earnings, substantially restricted (note 11)		**225,865**	189,366
Total liabilities and retained earnings	$	**3,709,029**	3,368,990

See accompanying notes to financial statements.

PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY
Statements of Income and Retained Earnings

For the years ended June 30 (In thousands)		2001	2000
Operating revenues			
Interest income	$	**247,836**	192,879
Premium on the sale of student loans		**5,724**	2,909
Collections on defaulted loans		**-**	114,929
PHEAA's share of collections on defaulted loans		**34,924**	-
Federal fees		**28,793**	28,399
Default aversion fees		**7,387**	6,501
Servicing fees (note 10)		**65,717**	68,002
Other		**254**	252
Total operating revenues		**390,635**	413,871
Operating expenses			
Interest expense and related costs		**177,741**	144,867
Reimbursement to U.S. Department of Education for federal share of defaulted loan collections		**-**	86,520
General and administrative		**154,557**	134,632
Total operating expenses		**332,298**	366,019
Operating income		**58,337**	47,852
Transfers in from the Commonwealth of Pennsylvania		**387,894**	352,474
Federal grants		**4,435**	3,453
Grants and other financial aid		**(394,167)**	(342,842)
Transfer of undisbursed SciTech and Technology Scholarship Program funds to the Commonwealth of Pennsylvania		**(20,000)**	-
Net income		**36,499**	60,937
Transfer out of guaranty reserves (note 3)		**-**	(23,643)
Retained earnings at beginning of year as previously reported		**158,175**	147,654
Adjustment for the cumulative effect on prior years of adopting the new accounting standard for voluntary nonexchange transactions (note 1)		**31,191**	4,418
Retained earnings at beginning of year as adjusted		**189,366**	152,072
Retained earnings at end of year	$	**225,865**	189,366

See accompanying notes to financial statements.

PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY
Statements of Cash Flows

For the years ended June 30 (In thousands)		2001	2000
Cash flows from operating activities			
Operating income	$	**58,337**	47,852
Adjustments to reconcile operating income to net cash used for operating activities:			
Depreciation and amortization		**11,635**	12,990
Amortization of deferred financing costs		**1,398**	1,665
Decreases (increases) in assets and increases (decreases) in liabilities:			
Accounts receivable		**1,601**	1,620
Receivable from U.S. Department of Education		**10,891**	(14,311)
Interest income receivable		**(10,451)**	(10,516)
Student loans receivable		**(265,407)**	(568,802)
Prepaid expenses and other assets		**(6,339)**	(3,468)
Accounts payable and accrued expenses		**(6,176)**	7,394
Accrued interest payable		**(3,456)**	7,690
Payable to U.S. Department of Education		**(1,274)**	(16,113)
Total adjustments		**(267,578)**	(581,851)
Net cash used for operations		**(209,241)**	(533,999)
Cash flows from noncapital financing activities			
Proceeds from issuance of notes and bonds payable		**841,783**	549,991
Principal paid on notes and bonds payable		**(504,598)**	(65,672)
Transfers in from the Commonwealth of Pennsylvania		**387,894**	352,474
Federal grants		**4,435**	3,453
Grants and other financial aid		**(394,167)**	(342,842)
Transfer of undisbursed SciTech and Technology Scholarship Program funds to the Commonwealth of Pennsylvania		**(20,000)**	-
Transfer of guaranty reserves		**-**	8,484
Net cash provided by noncapital financing activities		**315,347**	505,888
Cash flows from capital and related financing activities			
Proceeds from issuance of notes and bonds payable		**1,228**	85,864
Principal paid on notes and bonds payable and obligation under capital lease		**(8,595)**	(10,119)
Acquisition of capital assets		**(14,600)**	(12,700)
Net cash used provided by (used for) capital and related financing activities		**(21,967)**	63,045
Cash flows from investing activities			
Purchases of investments		**(5,512,724)**	(3,777,544)
Proceeds from sale and maturities of investments		**5,434,960**	3,732,749
Net cash used for investing activities		**(77,764)**	(44,795)
Net change in cash		**6,375**	(9,861)
Cash at beginning of year		**1,486**	11,347
Cash at end of year	$	**7,861**	1,486

See accompanying notes to financial statements.

(Dollar amounts presented in tables are in thousands)

1. Organization and Summary of Significant Accounting Policies

Organization and Basis of Accounting

The Pennsylvania Higher Education Assistance Agency ("PHEAA" or the "Agency") was created on August 7, 1963. The Agency's purpose is to increase the higher education opportunities of Pennsylvania residents through a variety of programs that provide financial assistance to students and higher education institutions. In addition to disbursing grants and other financial aid in the Commonwealth of Pennsylvania, PHEAA is engaged in the guaranty, origination, purchase and sale, and servicing of student loans, generally under federally sponsored programs.

The Agency is a discretely presented component unit of the Commonwealth of Pennsylvania and is accounted for as an enterprise fund on the accrual basis, in accordance with generally accepted accounting principles. As permitted under Statement No. 20 of the Governmental Accounting Standards Board and to conform to accounting practices of the Commonwealth, the Agency does not follow Financial Accounting Standards Board pronouncements issued after November 30, 1989.

Student Loans

Student loans are carried at their unpaid principal balances and adjusted for unamortized premiums. The Agency recognizes student loan income as earned, including adjustments for the amortization of premiums. The Agency has established allowances for potential losses on its student loan portfolio that can result from deficient servicing, risk-sharing on default payments and on uninsured loans. Such allowances are based upon management's continuing evaluation of portfolios, past and anticipated loss experience, and the amount and quality of loans. The allowances are maintained at a level that management believes is adequate to absorb estimated potential losses. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant changes.

Investments

Investments are carried at fair value based upon values provided by external investment managers.

Operational Assets

Property, plant and equipment are stated at cost. Assets under capital leases are stated at the present value of minimum lease payments. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets. Assets held under capital leases and leasehold improvements are amortized on the straight-line method over the shorter of the lease term or estimated useful life of the asset.

Computer software is stated at cost. Amortization is calculated on the straight-line method over the estimated useful lives of the software modules developed.

The following estimated useful lives are used for significant asset categories:

▪ Buildings	25 – 40 years
▪ Furniture, furnishings and equipment	5 – 10 years
▪ Computer software development	3 – 5 years

Deferred Financing Costs

Deferred financing costs consist primarily of underwriting and other bond issue costs. The costs are amortized over the term of the related bonds using a method that approximates the effective interest method.

Grant Revenues

During the current year, PHEAA adopted GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. Under this statement, transfers in from the Commonwealth of Pennsylvania and federal grants are considered voluntary nonexchange transactions. The Agency uses the receipts as a source of funds for disbursing 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 or reimbursement requirements. Accordingly, under GASB Statement No. 33, the entire amount received is recognized as revenue when received. Prior to adopting GASB Statement No. 33, the Agency only recognized this type of revenue to the extent grants and financial aid were disbursed and any receipts in excess of disbursements were reported as deferred grant revenues in the liability section of the balance sheet. As a result of adopting this statement, net income in 2000 was increased by $26.8 million and July 1, 1999 retained earnings were increased by $4.4 million to reflect amounts received from the

(Dollar amounts presented in tables are in thousands)

Commonwealth of Pennsylvania that previously were reported as deferred revenue. As a result of these adjustments retained earnings as of July 1, 2000 were increased by $31.2 million.

Servicing Fees

Servicing fees are recognized as the contractual services are provided.

Federal Fees

Loan processing and issuance fees related to PHEAA's guaranty function are recognized as the guaranteed loans are disbursed. Portfolio maintenance fees are recognized throughout the year at rates established by law.

Default Aversion Fees

The Agency is eligible to receive default aversion fees amounting to 1% of the principal and interest of a loan when a default preclaim is submitted. These fees are transferred from the Federal Student Loan Reserve Fund (the "Federal Fund"). If the loan subsequently defaults, 1% of the principal and interest of the loan at the time of default must be returned to the Federal Fund. Revenue recognized from default aversion fees is net of the amount that management estimates will have to be returned to the Federal Fund.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, reported amounts of revenues and expenses and other disclosures. Actual results could differ from those estimates.

2. Agency Programs

Federal Family Education Loan Program ("FFELP")

This program enables students enrolled in either undergraduate or graduate studies at eligible post-secondary schools and colleges to obtain low-cost educational loans from participating lending institutions.

Under its guaranty operations, the Agency guarantees principal and interest repayment to lenders if there is death, disability, bankruptcy, default, school closure, or borrower ineligibility providing the lender follows applicable rules and regulations. Under this program the Agency may charge insurance premiums on Stafford and Parent Loans for Undergraduate Students ("PLUS") loans. However, beginning with the 1997-98 academic year, the Agency has not charged premiums.

Under the terms of the loan guarantee program, PHEAA must maintain reserve funds in amounts sufficient to make timely guarantee reimbursements to lenders when the lenders' normal collection efforts fail.

Under the Higher Education Act of 1965, as amended, the Agency has entered into an agreement with the U.S. Department of Education (the "Department") for reinsurance of death, disability, bankruptcy, default, school closure and borrower ineligibility claims paid to lenders. Pursuant to this agreement, PHEAA receives reimbursement of claims paid to lenders, provided that there is compliance with various federal requirements.

Reinsurance rates vary depending upon default rates in the portfolio guaranteed by the Agency and the date the loan was guaranteed as follows:

▪ Before October 1, 1993	80% – 100%
▪ October 1, 1993 through September 30, 1998	78% – 98%
▪ On or after October 1, 1998	75% – 95%

During the years ended June 30, 2001 and 2000, the Agency's default rate was in a range that permitted the maximum reinsurance reimbursement from the Department.

The Agency is permitted to retain up to 24% of collections from borrowers on defaulted student loans for use in the loan program and 18.5% of rehabilitated loans.

As of June 30, 2001, the total original principal amount of outstanding guarantees issued by the Agency approximated $17.0 billion.

Higher Education Amendments of 1998

Under the Higher Education Amendments of 1998, all liquid assets related to PHEAA's FFELP guaranty functions were transferred to the Federal Fund. The Federal Fund is administered by PHEAA, but it is the property of the United States. The Agency is required to deposit into the Federal Fund reinsurance payments, a percentage of collections equal to the complement of reinsurance paid on defaulted loans, and insurance premiums collected from borrowers. The primary use of the Federal Fund is to pay defaulted claims to lenders. The activity of this fund is reported in note 3.

Under the Amendments, the Agency has also established an operating fund. Loan processing and issuance fees, account maintenance fees, and default aversion fees from the Department as well as the Agency's share of collections on defaulted loans are deposited into this fund.

The primary use of the operating fund is to pay the administrative costs of operating the guaranty agency, although the Agency is permitted to use the fund to pay for other student financial aid related activities.

Keystone Loan Programs

Beginning in academic year 1995-96, PHEAA introduced the Keystone Stafford Loan Program operating under the FFEL program referred to above. In academic year 1996-97, PHEAA expanded the program by offering the Keystone Direct Stafford Loan Program, and in academic year 1997-98, PHEAA began offering the Keystone Rewards℠ loan program. Beginning in 2001-02, PHEAA is offering the KeystoneBEST℠ program.

Normally, up-front origination fees charged to borrowers for Stafford loans total 3%. Under Keystone Direct and Keystone Rewards℠, PHEAA pays 1% on behalf of the borrower and the borrower pays the remaining 2%. Under KeystoneBEST℠, in addition to the PHEAA paying the fees described for the Keystone Rewards℠ program, participating lenders may also pay origination fees on behalf of the borrowers. Under Keystone Stafford, which is available to borrowers who have annual family incomes of less than $21,000, PHEAA pays 2% and the borrower pays the remaining 1%. For the years ended 2001 and 2000, the Agency paid fees on behalf of borrowers under the Keystone loan programs of $11.8 million and $11.5 million, respectively. Such benefits to borrowers are reported under grants and other financial aid.

Grants and Other Financial Aid

The Agency administers various Commonwealth, federal and PHEAA grants and other financial aid programs to assist students pursuing higher education. A brief description of the more significant programs follows.

Commonwealth Financial Aid Programs

The Higher Education Grant Program is the primary state student grant program for Pennsylvania residents and provides financial assistance grants to needy students. Additional funding is received from a federal matching grant program, discussed below, and investment earnings. Total transfers from the Commonwealth for this program amounted to $315.5 million and $284.2 million in 2001 and 2000, respectively. Grant disbursements under this program amounted to $321.3 million and $282.3 million in 2001 and 2000, respectively.

The Institutional Assistance Grants Program provides financial assistance to private post-secondary institutions for maintaining enrollments and maximizing educational resources. Grants are disbursed to eligible institutions based upon the number of Higher Education Grant recipients certified as enrolled during the academic year. For the years 2001 and 2000, Institutional Assistance Grants of $1,036 and $1,098, respectively, per eligible student were paid to participating institutions. Total transfers from the Commonwealth for this program amounted to $41.3 million and $39.1 million, respectively, in 2001 and 2000. Grant disbursements under this program amounted to $41.4 million and $35.0 million in 2001 and 2000, respectively.

Other Commonwealth funded programs include the Matching Funds, New Economy Technology Scholarship, Urban and Rural Teacher Loan Forgiveness, Agricultural Loan Forgiveness, Early Childhood Loan Forgiveness, Mann Bond Pickney Hill Scholarship (formerly known as the Equal Opportunity Professional Education Program), and Primary Health Care Loan Forgiveness programs. Total transfers from the Commonwealth for these programs amounted to $31.1 million and $28.9 million in 2001 and 2000, respectively. Financial aid disbursements under these programs amounted to $15.3 million and $10.6 million in 2001 and 2000, respectively.

Federal Financial Aid Programs

Leveraging Educational Assistance Partnership Program Grants supplement the Commonwealth's Higher Education Grant Program discussed above. Total grants from the federal government for this program amounted to $1.6 million in 2001 and $1.4 million in 2000.

(Dollar amounts presented in tables are in thousands)

Other federal programs include Primary Health Care, Robert Byrd Scholarship, Paul Douglas Teachers Scholarship, Christa McAuliffe Fellowship, and Temporary Assistance for Needy Families programs. Total federal grants for these programs amounted to $2.8 million and $2.1 million in 2001 and 2000, respectively. Financial aid disbursements under these programs amounted to $2.6 million and $2.0 million in 2001 and 2000, respectively.

Summary of Grants and Other Financial Aid

		2001	2000
Commonwealth financial aid	$	**378,013**	327,945
Federal financial aid		**4,223**	3,403
PHEAA financial aid		**11,931**	11,494
Total grants and other financial aid	$	**394,167**	342,842

Other Programs

The Agency also participates in the Law Access® program, which is a national loan program designed specifically for law students attending American Bar Association approved institutions. Three loan programs are made available to the borrower: Stafford, which is reinsured by the Department, Law Access® loans ("LAL"), and Bar Examination loans ("BEL"), both of which are not reinsured by the Department. In addition to providing a guarantee of Stafford loans and providing loan servicing, from May 1, 1989 to July 1, 1991, the Agency guaranteed LAL and BEL loans approximating $105.4 million through this program. Under the guaranty agreement, the Agency is responsible for 50% of future defaults for LAL and BEL loans guaranteed during that period. As of June 30, 2001, $18.9 million of principal and interest related to such LAL and BEL loans is outstanding, of which $296 thousand is more than 90 days delinquent.

3. Federal Student Loan Reserve Fund

The net assets administered by PHEAA for the Department as of June 30, 2001 and 2000 and the changes in net assets for the years then ended are presented for information purposes.

Net Assets Administered for the Department in the Federal Fund

At June 30		2001	2000
Assets			
Cash	$	**1,981**	8,416
Receivable from U.S. Department of Education		**23,211**	19,526
Interest income receivable		**756**	1,654
Investments		**211,713**	217,612
Operational assets, net		**19,669**	25,494
Total assets		**257,330**	272,702
Liabilities			
Default claims payable to lenders		**1,175**	1,494
Payable to PHEAA		**-**	10,893
Payable to U.S. Department of Education		**116,119**	116,119
Deferred student loan insurance premiums		**17,570**	24,379
Total liabilities		**134,864**	152,885
Net assets	$	**122,466**	119,817

(Dollar amounts presented in tables are in thousands)

Changes in Net Assets Administered for the Department in the Federal Fund

For the periods ended June 30		2001	2000
Additions			
Interest income	$	7,219	8,625
Reinsurance from the U.S. Department of Education on defaulted loan purchases		220,153	147,152
Supplemental preclaims assistance fees		-	16
Collections on defaulted loans		138,502	1,490
Student loan insurance premiums		6,809	8,142
Usage fees		5,825	-
Total additions		378,508	165,425
Deductions			
Purchases of defaulted loans from lenders		224,190	147,703
Default aversion fees		9,134	10,606
Depreciation		5,825	-
Reimbursement to U.S. Department of Education for federal share of defaulted loan collections		99,948	-
Reimbursement to PHEAA for Agency's share of defaulted loan collections		34,924	-
Portfolio maintenance fee paid on behalf of the U.S. Department of Education		1,838	1,090
Total deductions		375,859	159,399
Net increase		2,649	6,026
Transfer from PHEAA		-	23,643
Net assets administered for the U.S. Department of Education: Beginning of period		119,817	90,148
End of period	$	122,466	119,817

Under the Federal Balanced Budget Act of 1997, the Secretary of Education is required to recall $1 billion in reserve funds held by guaranty agencies. On January 14, 1998, the U.S. Department of Education informed the Agency that PHEAA's share of the recall is $116.1 million. The recall is payable from the Federal Fund and is reported as an amount payable to the U.S. Department of Education in the statement of net assets presented above.

Under the Act, PHEAA was required to establish a restricted escrow account into which 20% of the recall amount is to be deposited annually. As of June 30, 2001, $93.0 million of investments in the Federal Fund are in the restricted escrow account. On September 1, 2002, the total amount in the restricted account is to be transferred to the U.S. Treasury. Until the transfer occurs, amounts deposited in the account are recorded as investments on the statement of net assets administered for the U.S. Department of Education, above.

Under the Higher Education Amendments of 1998, the Agency is to act as a fiduciary in managing the assets of the Federal Fund. Investments of Federal Fund assets are substantially in the State Treasury investment pool.

Additionally, the Amendments required PHEAA to deposit the federal share of all funds in the Federal Fund within 48 hours of receipt. In order to comply with this requirement, the Agency began depositing all collections in the Federal Fund effective July 1, 2000.

Loan insurance premiums are deferred and amortized using the sum-of-the-years digits method over the estimated period of the related costs.

4. Cash and Investments

The following is a summary of the Agency's cash deposits at June 30, 2001 and 2000:

		2001	2000
Carrying value	$	9,842	9,902
Bank balance	$	27,629	26,732
Less insured balance		306	400
Uninsured balance	$	27,323	26,332

Included in the carrying value of cash detailed above is $2.0 million ($8.4 million in 2000) of cash held in the Federal Fund and the remaining $7.8 million ($1.5 million in 2000) is owned by the Agency and reflected as cash on the accompanying financial statements.

Cash amounting to $6.3 million and $1.7 million in 2001 and 2000, respectively, are restricted under bond indentures and financing arrangements.

The insured balance was covered by federal depository insurance and the uninsured balance was collateralized pursuant to an agreement to pledge assets on a pooled basis to secure public deposits. All collateral on deposits is held by the participating financial institution's trust department and is not in the Agency's name.

Generally, the Agency's investments are limited by the Board of Directors to U.S. Treasury bills and notes, federal agency securities, repurchase agreements collateralized by U.S. Treasury obligations, certificates of deposit, high-grade commercial paper, student and/or parent loans, notes issued by the Student Loan Marketing Association, and other investments approved by the Board from time to time. The Agency also invests in an 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. The Agency's investments under certain debt and bond agreements are also further delineated.

(Dollar amounts presented in tables are in thousands)

The Agency's investments are categorized below to give an indication of the level of risk assumed by the Agency at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the Agency or its agent in the Agency's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the broker's or dealer's trust department or agent in the Agency's name. Category 3 includes uninsured and unregistered investments that are either uncollateralized or for which the securities are held by the broker or dealer, or by its trust department or agent but not in the Agency's name.

The term investments, as used above, includes securities underlying repurchase agreements and investment securities.

The following is a summary of investments held by the Agency at June 30, 2001:

	Category 2	Category 3	Carrying Value
Repurchase agreements	$ -	193,778	193,778
U.S. Treasury notes	-	49,964	49,964
G.E. Capital Corporation commercial paper	-	14,800	14,800
Municipal obligations	2,500	-	2,500
	2,500	258,542	261,042
Invested amounts not susceptible to credit risk categorization:			
Treasury investment pool			232,965
Other money market funds			187,258
Prudential investment agreement			45,450
Guaranteed investment contract – AIG Matched Funding Corporation			7,219
Guaranteed investment contract – Trinity Plus Funding Company			8,000
Citibank investment agreement			23,595
Bayerische Investment Agreement			8,000
Berkshire Hathaway investment agreement			10,946
			$ 784,475

The following is a summary of investments held by the Agency at June 30, 2000:

	Category 2	Category 3	Carrying Value
Repurchase agreements	$ -	159,351	159,351
U.S. Treasury notes	-	53,374	53,374
Ford Motor Credit Company commercial paper	-	20,356	20,356
Municipal obligations	3,600	-	3,600
	3,600	233,081	236,681
Invested amounts not susceptible to credit risk categorization:			
Treasury investment pool			230,484
Other money market funds			124,824
Prudential investment agreement			65,227
Guaranteed investment contract – AIG Matched Funding Corporation			22,807
Citibank investment agreement			17,490
MBIA investment agreement			10,000
Berkshire Hathaway investment agreement			5,097
			$ 712,610

Included in the investments detailed above are $211.7 million ($217.6 million in 2000) of investments held in the Federal Fund and the remaining $572.8 million ($495.0 million in 2000) are owned by the Agency and reflected as investments on the accompanying financial statements.

Investments amounting to $545.8 million and $468.2 million in 2001 and 2000, respectively, are restricted under bond indentures and financing arrangements.

Investments carry interest rates from 3.60% to 7.65% at June 30, 2001 (4.63% to 8.36% at June 30, 2000).

5. Student Loans Receivable

As previously discussed under Agency programs, above, PHEAA originates student loans and purchases student loans from lenders. PHEAA's portfolio primarily consists of loans originated under two federally sponsored programs – FFELP and the Health Education Assistance Loan Program ("HEAL"). PHEAA also originates and purchases loans that are privately insured.

There are four categories of FFELP loans: Stafford loans, PLUS loans, Supplemental Loans for Students ("SLS") loans and Consolidation loans. Generally, these loans obligate the borrower to pay interest at a stated fixed rate or an annually reset variable rate that has a cap. However, the yield to holders is subsidized by the federal government to provide a market rate of return. The formula through which the subsidy is determined is referred to as the special allowance formula. Special allowance is paid whenever the average of all of the 91-day Treasury bill auctions in a calendar quarter, plus a spread of between 1.70 and 3.50 percent depending on the loan status and when it was originated, exceed the rate of interest that the borrower is obligated to pay. In low interest rate environments, the rate that the borrower is obligated to pay may exceed the rate determined by the special allowance formula. In those instances the rate paid by the borrower becomes a floor on an otherwise variable asset. The Agency received special allowance payments of $15.8 million and $23.5 million in 2001 and 2000, respectively.

(Dollar amounts presented in tables are in thousands)

Under the HEAL program, borrowers are obligated to pay interest at a quarterly reset variable rate based upon the 91-day Treasury bill plus a spread of up to 3 percent. The actual limit on the spread in effect for an individual loan is based upon the contract in effect with the U.S. Department of Health and Human Services at the time the loan was originated.

Student loans receivable at June 30, 2001 and 2000 consist of the following:

		2001	2000
Stafford	$	**1,757,131**	1,649,615
PLUS		**55,739**	44,901
SLS		**13,271**	12,277
Consolidation loans		**593,693**	465,020
HEAL		**230,584**	216,898
Privately insured loans		**18,516**	14,816
	$	**2,668,934**	2,403,527

FFELP loans are substantially guaranteed by the Agency and reinsured by the Secretary of the U.S. Department of Education. 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.

6. Operational Assets

Operational assets at June 30, 2001 and 2000 consist of the following:

		2001	2000
Land	$	**2,946**	2,946
Buildings		**62,430**	61,968
Furniture, furnishings and equipment		**31,534**	26,185
Computer software development		**39,459**	31,457
		136,369	122,556
Less accumulated depreciation and amortization		**(56,929)**	(46,081)
	$	**79,440**	76,475

Unamortized computer software costs amounted to $18.1 million in 2001 and $15.2 million in 2000. Amortization of capitalized computer software costs amounted to $4.9 million in 2001 and $4.8 million in 2000.

7. Notes and Bonds Payable

Notes and bonds payable at June 30, 2001 and 2000 consist of the following:

		2001	2000
Student loan financing notes payable, due 2001-2007, at weighted average rates of 5.25% and 6.44% at June 30, 2001 and 2000, respectively	$	735,785	765,703
Demand student loan revenue bonds payable, due 2018-2040, at weighted average rates of 3.23% and 5.10% at June 30, 2001 and 2000, respectively		1,711,000	1,046,000
Student loan revenue bonds payable, due 2005-2026, at weighted average rates of 6.71% and 6.48% at June 30, 2001 and 2000, respectively		537,925	834,405
Other notes and bonds payable, due 2001-2031, at weighted average rates of 6.06% and 6.11% at June 30, 2001 and 2000, respectively		101,507	94,493
Other lines of credit, due on demand, at weighted average rates of 6.5% and 6.49% at June 30, 2001 and 2000, respectively		20,000	34,698
	$	**3,106,217**	2,775,299

(Dollar amounts presented in tables are in thousands)

The note and bond indentures among other things require the Agency to comply with various covenants including minimum parity levels as defined, student loan and investment yields, and program expenses.

All student loan financing notes payable, demand student loan revenue bonds payable and student loan revenue bonds payable are collateralized by student loans and investments. At June 30, 2001, $2.68 billion of student loan principal and related interest receivable and $466.2 million of investments collateralized the $2.985 billion of notes and bonds payable.

The demand bonds payable are subject to purchase, at par plus accrued interest, by the Agency on demand of the holder upon seven days prior irrevocable written notice. In the table of stated maturities below, demand bonds are categorized based upon the contractual maturity of the bond. Under the irrevocable letters of credit the trustee is entitled to draw an amount sufficient to pay the purchase price of bonds delivered to it. The letters of credit are valid from 2001 through 2030, and the Agency is required to pay annual commitment fees ranging from 12 to 45 basis points on the stated amount of the letter of credit coverage. At June 30, 2001, total letter of credit coverage was $2.3 billion.

The other notes and bonds payable are collateralized with operational assets. Amounts due under the lines of credit are collateralized with accounts receivable, student loans, and operational assets.

As of June 30, 2001 the Agency had $119.2 million of available credit under student loan financing arrangements, and $26.0 million was available under other lines of credit.

Stated maturities of notes and bonds payable for each of the five years subsequent to June 30, 2001 and through maturity are as follows:

Year of Maturity		Student Loan Financing Notes Payable	Demand Student Loan Revenue Bonds Payable	Student Loan Revenue Bonds Payable	Other Notes and Bonds Payable
2002	$	121,275	-	-	7,145
2003		31,600	-	-	7,211
2004		-	-	-	7,820
2005		547,910	-	17,925	7,907
2006		-	-	-	4,069
2007-2040		35,000	1,711,000	520,000	67,355
	$	735,785	1,711,000	537,925	101,507

Notes and bonds payable, as well as all other debt, are limited obligations of the Agency. PHEAA has no taxing power, and the Commonwealth is not obligated to pay the principal, redemption price, if any, or interest on any of the Agency's debt.

8. Leases

The Agency is obligated under a capital lease for its headquarters building. In connection with this transaction, the Harrisburg Authority issued bonds payable of approximately $52.2 million and entered into an agreement with a third party providing for the lease of the building. The third party has, in turn, entered into a lease agreement with the Agency for the building. Included in the terms of the 25 year lease is an option to purchase the building and land in 2002, or anytime thereafter, or after 25 years to lease the premises for 99 years.

The Agency prepaid a portion of its lease payments and deposited the funds with a trustee. Amounts on deposit with the trustee include $2.1 million invested in the bonds of the Harrisburg Authority described above and $2.1 million invested in a guaranteed investment contract. These funds are included in the caption "investments" in the Federal Fund described in note 3, and are restricted for use as rental payments for the guaranty agency share of the building lease under terms of the agreement.

The gross amount of the building held under the capital lease is $56.8 million and the accumulated amortization is $19.5 million. Amortization of assets held under capital leases is included with depreciation expense.

Future minimum capital lease payments as of June 30, 2001 are:

Year ending:		
2002	$	**6,498**
2003		**52,730**
Total minimum lease payments		**59,228**
Less amount representing interest (at 9.9%)		**(8,398)**
	$	**50,830**

The Agency also leases information technology and other equipment under operating leases expiring during the next two years. In most cases, management expects the leases will be renewed or replaced by other leases in the normal course of business. Future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of June 30, 2001 are $7.7 million in 2002, $7.3 million in 2003, and $3.6 million in 2004.

(Dollar amounts presented in tables are in thousands)

Total rental expense for all operating leases was $3.6 million in 2001 and $3.7 million in 2000.

9. Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

PHEAA contributes to the Commonwealth of Pennsylvania State Employes' Retirement System ("SERS" or the "System"), a cost-sharing multiple-employer defined benefit pension plan established under the provisions of Public Law 858, No. 331. SERS provides retirement, death and disability benefits. Article II of the Commonwealth of Pennsylvania's Constitution assigns the authority to establish and amend the benefit provisions of the plan to the General Assembly.

As a blended component unit of the Commonwealth, the System issues an audited financial report that includes financial statements and required supplementary information for SERS. Audited financial statements for all Commonwealth component units are available from the individual organizations. Interested parties should write Commonwealth of Pennsylvania, State Employes' Retirement System, 30 North Third Street, P.O. Box 1147, Harrisburg, Pennsylvania 17108-1147 to obtain the report.

Funding Policy

Members are required to contribute 5% of their annual covered salary and PHEAA is required to contribute at an actuarially determined rate. During the year ended June 30, 2001, the required employer contribution rate was reduced to 0%. The contribution requirement of members is established and may be amended by the General Assembly. The contribution requirement of the Agency is established and may be amended by the System's board of directors. PHEAA's contributions for the years ended June 30, 2001, 2000 and 1999 were $318 thousand, $1.9 million, and $2.4 million, respectively, equal to the required contributions for each year.

Postemployment Benefits

The Commonwealth also provides certain health care benefits for retired employees meeting specified length-of-service and age requirements. These benefits are provided as a result of negotiated union contracts and through administrative policy. These benefits are provided through insurance companies whose premiums are based on the benefits paid during the fiscal year. The Commonwealth recognizes the cost of providing these benefits as paid, and charges the Agency for a proportionate share of such costs, which amounted to $4.7 million, $3.9 million, and $2.9 million in 2001, 2000 and 1999, respectively.

10. Servicing Fees

The Agency has contracted with customers to provide servicing of student loans as well as computer equipment and programming services. As of June 30, 2001, the Agency was servicing approximately $15.6 billion of loans for customers. An additional $6.6 billion of loans were serviced by customers using the Agency's computer services.

The Agency's servicing agreements, some of which expire in 2001, have contractual terms at inception ranging from three years to life of loan. Under the Agency's servicing agreements, the Agency generally agrees to reimburse customers for any claims, losses, liabilities or expenses that arise out of or relate to the Agency's acts or omissions with respect to services provided under such agreements. A provision for estimated claims under the agreements has been recorded in the financial statements.

Four loan servicing customers provided $34.1 million in servicing fees for the year ended June 30, 2001. No other individual customer provided servicing revenues in excess of 5% of total servicing fees.

11. Retained Earnings Restrictions and Supplemental Information

Retained earnings at June 30, 2001 and 2000 consist of the following:

		2001	2000
Restricted for use in Commonwealth and federal grant programs	$	**37,880**	43,893
Other retained earnings		**187,985**	145,473
	$	**225,865**	189,366

Retained earnings related to other programs include $71.3 million and $53.6 million in 2001 and 2000, respectively, that is temporarily restricted under student loan revenue bond and student loan financing trust indentures.

(Dollar amounts presented in tables are in thousands)

The Higher Education Amendments of 1998 restricts PHEAA's use of retained earnings related to FFELP guaranty activities to fulfilling its guaranty responsibilities and other student financial aid related activities as selected by the Agency. Because the Agency's purpose under Commonwealth law is to increase higher education opportunities for Pennsylvania residents, PHEAA considers such retained earnings to be unrestricted.

The Agency has issued notes and revenue bonds to finance certain student loans in its portfolio. Selected income statement information related to those financings follows.

Years ended June 30		2001	2000
Operating revenues	$	**237,356**	187,754
Operating income		**39,460**	24,779
Grants and other financial aid		**4,681**	4,488
Operating transfers		**(16,166)**	(5,800)
Net income		**18,613**	14,491

Selected balance sheet information related to those financings follows.

At June 30		2001	2000
Student loans receivable	$	**2,599,589**	2,335,008
Total assets		**3,170,121**	2,816,392
Notes and bonds payable		**2,984,710**	2,646,108
Total equity		**158,682**	140,069

12. Contingencies

Federal programs in which the Agency participates 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 the Department or other federal audit officials to perform, or contract for, audits and evaluations of federal financial assistance programs. As a result, the Agency's operations in current and prior years are subject to audit. Management believes it is in substantial compliance with applicable federal regulations and that any adjustment as a result of future audits will not be material.

The Agency is involved in various legal matters in the normal course of business. Considering available information, management does not believe that resolution of any such matters will have a material impact on the financial statements.