PHEAA
Creating Access to Education

## PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

# ANNUAL FINANCIAL REPORT

## JUNE 30, 2002

1200 NORTH SEVENTH STREET, HARRISBURG, PA 17102

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

PHEAA's mission is to improve postsecondary education opportunities for Pennsylvanians. To fulfill our mission we distribute grants; originate, purchase and sell student loans; guarantee student loans; and service student loans. To effectively serve Pennsylvanians, we operate both inside and outside Pennsylvania and are known nationally as American Education Services. As part of our guaranty operations, we manage the Federal Student Loan Reserve Fund (Federal Fund) for the U.S. Department of Education (ED). The Federal Fund is primarily used to pay claims on defaulted loans.

PHEAA's operations involved in originating, purchasing, selling, guaranteeing and servicing student loans generally operate under the Federal Family Education Loan Program (FFELP) although we also originate, purchase and service loans that are privately insured. FFELP is the federal program that allows undergraduate or graduate students at eligible postsecondary schools to get 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.
- Parent Loan for Undergraduate Students (PLUS) – supplemental loans to parents.
- Consolidation – loans that allow borrowers to combine Stafford and certain other education-related loans, fix the rate of interest and extend the repayment period.

The interest rate charged to the borrower varies based upon the type of loan and regulations in effect at the time that the loan was originated.

ED also makes special allowance payments. These payments generally result in the loan yield to the lender being higher than the rate charged to borrowers and the loan yield being variable regardless of whether the rate paid by the borrower is variable or fixed. The amount of special allowance payments also varies based upon the type of loan and regulations in effect at the time that the loan was originated. The minimum special allowance payment rates for loans made on or after October 1, 1980 and financed with proceeds from tax-exempt obligations issued before October 1, 1993 effectively provide an overall minimum return of 9.5% on those loans.

FFELP regulations require up-front origination fees of 3% to be deducted from the proceeds of student loans and remitted to the federal government. PHEAA pays 2% of the 3% for loans originated by us, and 1% for loans serviced by us for other lenders. We also pay an additional 1% for loans originated by us to borrowers with annual family incomes of less than $21,000. Beginning in the 2002-03 academic year, we are paying all of the up-front fees for loans originated by us, regardless of family income. For loans serviced by us for other lenders, we are continuing to pay one of the three up-front origination points. The cost of providing these benefits is reported with grants and other financial aid.

For our guaranty activities, the federal government pays us loan processing and issuance fees when new loans that we guarantee are disbursed. They also pay us portfolio maintenance fees for managing the outstanding portfolio of guaranteed loans.

Our major function as a guarantor is to guarantee principal and interest repayment to lenders 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 default rates of our portfolio of guaranteed loans and based upon the date we guaranteed the loan as follows:

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

Our default rate has always been at a level that allowed us to receive the maximum reinsurance rate. We may charge a guarantee fee of up to 1% when we guarantee a loan; however, we currently do not charge a fee. If we would charge a fee, the proceeds would go into the Federal Fund.

After a loan defaults, we continue to try to collect the amounts and are allowed to retain up to 24% of the amounts collected as revenue. The remaining amount is returned to the federal government.

We also receive default aversion fees as an incentive to help us prevent defaults. These fees are paid from the Federal Fund and must be repaid if the loan defaults in the future.

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 grants up to $3,300 to students 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 New Economy Technology Scholarship Program is intended to create a pool of highly trained workers in science and technology and provides financial assistance up to $3,000 to students enrolled in a postsecondary science or technology program approved by the Pennsylvania Department of Education.

- 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.

We also operate a number of other smaller state and federal grant programs to assist students.

In the past we have also originated and purchased student loans related to another federally sponsored program – the Health Education Assistance Loan (HEAL) Program. Under the HEAL program, borrowers 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.

### Forward-looking statements

This financial report contains statements relating to future results of the Agency that are considered "forward-looking statements." These statements relate to, among other things, risk-sharing losses, servicing losses, simulation of changes in interest rates, litigation results 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 the Agency's control). Actual results may differ materially from those expressed or implied as a result of these risks and uncertainties, including, but not limited to, changes in political and economic conditions; competitive product and pricing pressures within the Agency's 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; interest rate fluctuations; as well as other risks and uncertainties. Such forward-looking statements speak only as of the date on which such statements are made, and the Agency undertakes 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 financial statements of PHEAA are a series of related reports that detail financial information using accounting methods similar to those used by private businesses.

The statement of revenues, expenses and changes in net assets reports all of PHEAA's revenues and expenses. The statement measures the results of the Agency's operations.

The statement of net assets includes all of the Agency's assets and liabilities. Assets are what we own or control, and liabilities are what we owe. Net assets are what is left over after assets are used to satisfy liabilities.

The statement of cash flows supplements these statements providing relevant information about cash receipts and payments for the Agency.

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 PHEAA's finances.

## Condensed financial information

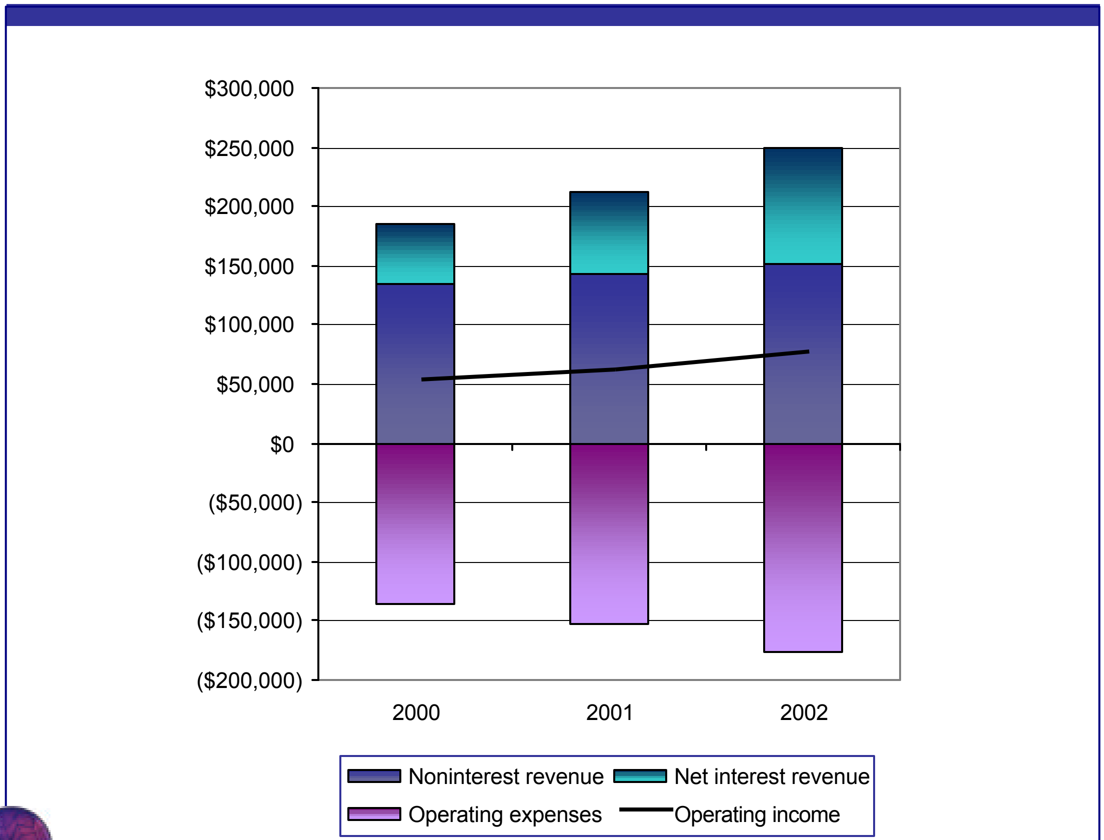
*Statements of revenues, expenses and changes in net assets*

| For the years ended June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Student loan interest revenue | $ | **183,771** | 206,482 |
| Investment interest revenue | | **30,411** | 41,782 |
| Interest expense on student loan financings and bonds payable | | **(105,870)** | (166,234) |
| Interest expense on capital and other financings | | **(13,703)** | (11,507) |
| Net interest revenue | | **94,609** | 70,523 |
| Provision for loan losses | | **3,689** | (1,586) |
| Net interest revenue after provision for loan losses | | **98,298** | 68,937 |
| Servicing fees | | **67,207** | 65,717 |
| Gains on student loan sales, net | | **113** | 5,724 |
| PHEAA's share of collections on defaulted loans | | **43,713** | 34,924 |
| Federal fees | | **31,562** | 28,793 |
| Default aversion fees, net | | **8,705** | 7,387 |
| Other | | **207** | 254 |
| Total noninterest revenue | | **151,507** | 142,799 |
| Operating revenues | | **249,805** | 211,736 |
| Operating expenses | | **(175,628)** | (153,399) |
| Operating income | | **74,177** | 58,337 |
| Commonwealth of Pennsylvania grants | | **411,748** | 387,894 |
| Federal grants | | **6,365** | 4,435 |
| Grants and other financial aid | | **(425,009)** | (394,167) |
| Transfer to Pennsylvania Higher Education Foundation | | **(26,109)** | - |
| Transfer of undisbursed SciTech and Technology Scholarship Program funds to the Commonwealth of Pennsylvania | | **-** | (20,000) |
| Net income | $ | **41,172** | 36,499 |

*Net assets*

| At June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| Student loans receivable, net | $ | **3,222,787** | 2,668,934 |
| Investments | | **510,558** | 569,249 |
| Interest income receivable | | **81,514** | 84,933 |
| Capital assets, net | | **76,076** | 79,439 |
| Federal Student Loan Reserve Fund assets held for the U.S. Department of Education | | **246,819** | 257,330 |
| Other | | **71,127** | 66,835 |
| Total assets | | **4,208,881** | 3,726,720 |
| Student loan financings | | **769,959** | 735,785 |
| Student loan demand revenue bonds | | **2,061,000** | 1,711,000 |
| Student loan revenue bonds, net | | **529,856** | 537,925 |
| Capital financings and other debt | | **249,702** | 172,336 |
| Amounts related to the Federal Student Loan Reserve Fund | | **246,819** | 257,330 |
| Other | | **84,508** | 86,479 |
| Total liabilities | | **3,941,844** | 3,500,855 |
| Net assets | | | |
| Invested in capital assets | | **17,163** | 16,455 |
| Restricted for debt service | | **197,140** | 165,514 |
| Restricted for financial aid | | **51,446** | 37,880 |
| Restricted for default aversion activities | | **10,064** | 7,932 |
| Unrestricted | | **(8,776)** | (1,916) |
| Total net assets | $ | **267,037** | 225,865 |

**Results of operations**
Operating income chart
(In thousands)

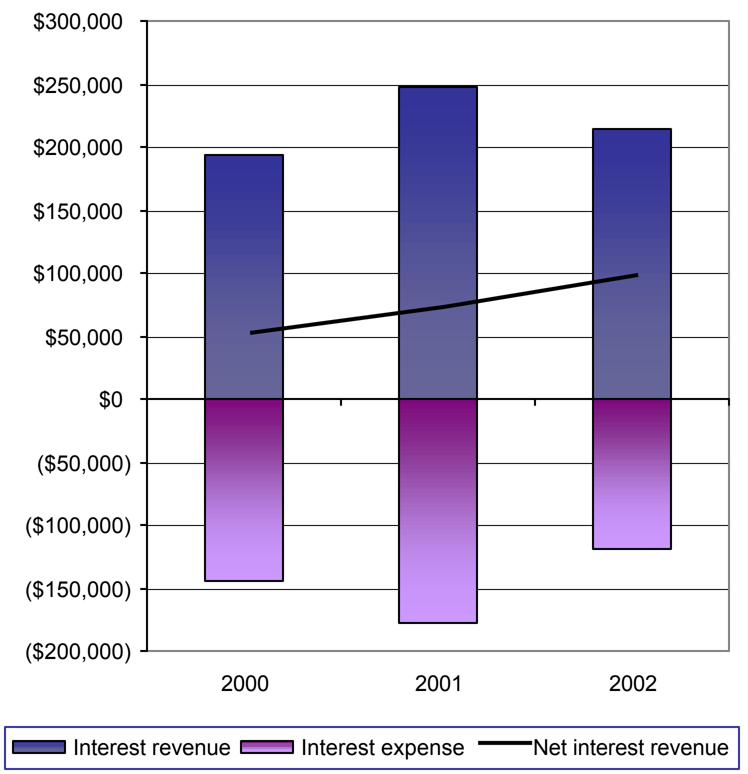



PHEAA's operating income for the year ended June 30, 2002 was $74.2 million, an increase of 27.3% from $58.3 million in 2001. Operating revenues increased 18.0% from $211.7 million in 2001 to $249.8 million in 2002. Net interest revenue after provision for loan losses increased 42.7% from $68.9 million in 2001 to $98.3 million in 2002 because of changes in margins. Noninterest revenue increased 6.1% from $142.8 million in 2001 to $151.5 million in 2002 principally due to increases in PHEAA's share of collections on defaulted loans. Operating expenses increased 14.5% from $153.4 million in 2001 to $175.6 million in 2002 due to increases in personnel and information technology costs.

A more detailed explanation of these items follows.

*Net interest revenue*

Net interest revenue chart
(In thousands)




Net interest revenue is created largely from PHEAA's portfolio of student loans although the Agency has investments and debt that are not related to student loans. For the year ended June 30, 2002, net interest revenue was $94.6 million, an increase of 34.2% or $24.1 million from $70.5 million in 2001. The increase in net interest margin is explained on the following pages.

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

| For the years ended June 30, (balances in thousands) | | 2002 Balances | 2002 Rate | 2001 Balances | 2001 Rate |
|---|---|---|---|---|---|
| **Average interest earning assets** | | | | | |
| Student loans receivable, net | $ | **2,813,821** | **6.53%** | 2,582,253 | 8.00% |
| Investments | | **672,642** | **4.52%** | 555,942 | 7.52% |
| | $ | **3,486,463** | **6.14%** | 3,138,195 | 7.91% |
| **Average interest bearing liabilities** | | | | | |
| Student loan financings | $ | **674,694** | **4.88%** | 770,315 | 6.50% |
| Student loan demand revenue bonds | | **1,892,250** | **2.15%** | 1,427,042 | 4.93% |
| Student loan revenue bonds | | **566,164** | **5.69%** | 719,288 | 6.37% |
| | | **3,133,108** | **3.38%** | 2,916,645 | 5.70% |
| Other debt | | **214,512** | **6.39%** | 106,665 | 10.79% |
| | $ | **3,347,620** | **3.57%** | 3,023,310 | 5.88% |
| Net interest margin | | | **2.57%** | | 2.03% |

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

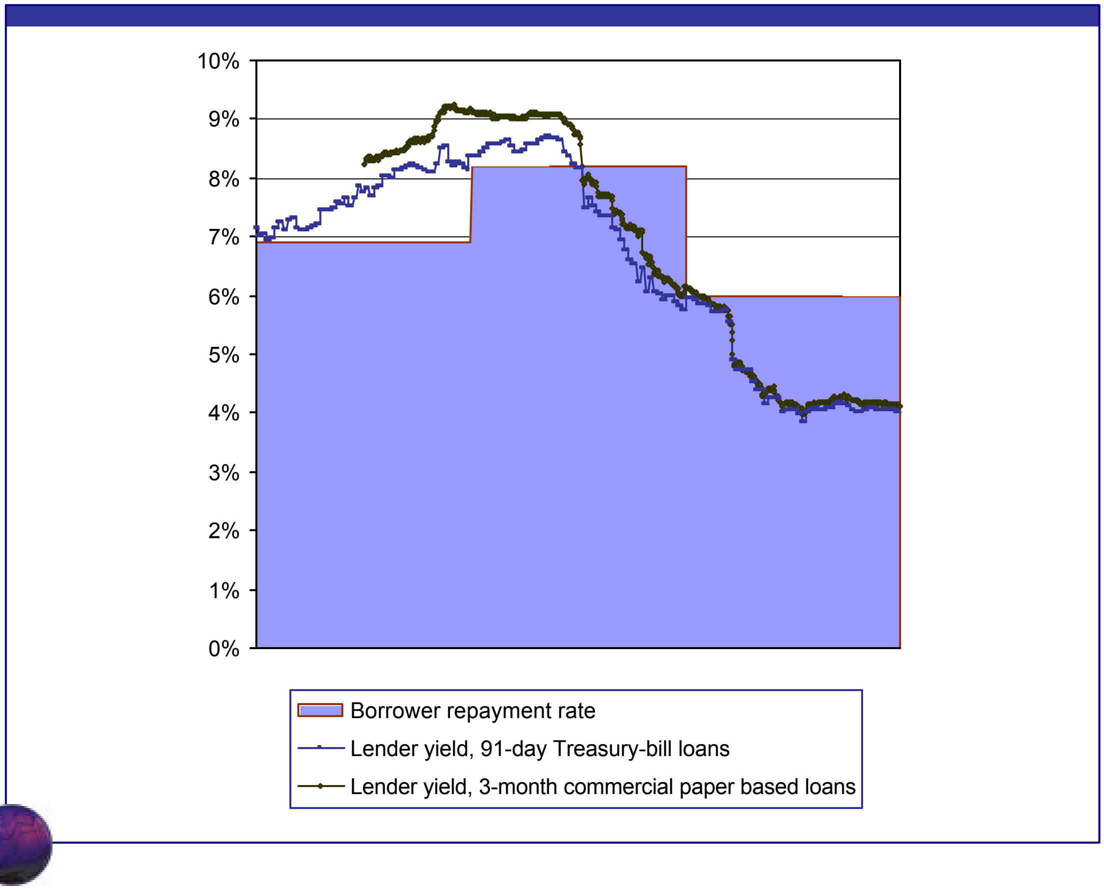
| For the years ended June 30 | 2002 | 2001 |
|---|---|---|
| Student loan yields | **7.07%** | 8.49% |
| Consolidation loan rebate fees | **(0.23)** | (0.20) |
| Lender origination fees | **(0.06)** | (0.06) |
| Premium amortization | **(0.25)** | (0.23) |
| Student loan revenue | **6.53** | 8.00 |
| Cost of funds | **3.38** | 5.70 |
| Net interest margin on student loans | **3.15%** | 2.30% |

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

| (In thousands) | | Increase (decrease) | Increase (decrease) attributable to change in Rate | Volume |
|---|---|---|---|---|
| **2002 vs. 2001** | | | | |
| Student loan interest revenue | $ | (22,711) | (41,228) | 18,517 |
| Investment interest revenue | | (11,371) | (20,142) | 8,771 |
| | | (34,082) | (61,370) | 27,288 |
| Student loan financings and bonds payable interest expense | | (60,364) | (72,701) | 12,337 |
| Capital and other financings interest expense | | 2,196 | (9,439) | 11,635 |
| | | (58,168) | (82,140) | 23,972 |
| | $ | 24,086 | 20,770 | 3,316 |
| **2001 vs. 2000** | | | | |
| Student loan interest revenue | $ | 43,044 | 1,586 | 41,458 |
| Investment interest revenue | | 11,871 | 4,453 | 7,418 |
| | | 54,915 | 6,039 | 48,876 |
| Student loan financings and bonds payable interest expense | | 30,077 | (4,479) | 34,556 |
| Capital and other financings interest expense | | 4,216 | 4,244 | (28) |
| | | 34,293 | (235) | 34,528 |
| | $ | 20,622 | 6,274 | 14,348 |

While the amount that PHEAA earns on student loans involves interpreting and complying with complicated regulations issued by ED, PHEAA's portfolio of student loans are generally variable-rate loans. 71% of the variable-rate loans, including 9.5% floor loans, change based upon changes in the 91-day Treasury bill rate and 29% change based upon changes in 90-day commercial paper. The rates paid by borrowers are set under a different formula and generally reset annually on July 1. As previously mentioned, ED makes special allowance payments that generally result in the loan yield to the lender being higher than the rate paid by the borrower. However, during periods that the borrower rate exceeds the rate that the lender would earn under the special allowance formula, the borrower rate becomes a floor. The following chart displays the lender yield and the borrower rate.

91-day Treasury bill chart
July 1, 1999 through June 30, 2002




For the year ended June 30, 2002, the borrower rate exceeded the lender rate for the entire year resulting in PHEAA earning $15.8 million more than would be expected based upon market conditions. In 2001, the borrower rate exceeded the lender rate for approximately half the year resulting in PHEAA earning $6.3 million more than would be expected based upon market conditions.

Average rates earned and paid by PHEAA can behave differently than market rates for the following additional reasons:

- ED regulations provide for special allowance payments that effectively provide an overall minimum return of 9.5% for student loans made after October 1, 1980 that are financed with tax-exempt debt issued through September 30, 1993. For the year ended June 30, 2002, the average balance of these 9.5% floor loans was $872.1 million, while the average balance was $844.0 million in 2001.

- The Agency has HEAL loans that reset on a one-quarter lag, so the change in market rates is not immediately reflected in the rates earned by PHEAA. For the year ended June 30, 2002, the average balance was $203.7 million, while the average balance was $223.6 million in 2001.

- For borrowings, PHEAA's student loan revenue bonds are fixed-rate bonds so the decline in market interest rates does not result in a decline in interest expense paid by PHEAA. However, during the last two quarters of the year ended June 30, 2002, $312.9 million of bonds were refunded. The effective rate of the refunded bonds decreased from 7.10% to 2.64%.

- Finally, interest rates paid on student loan financings generally are based upon the 91-day Treasury bill; however, the rates are generally reset on a one-quarter lag. Accordingly, the change in market rates is not immediately reflected in the rates paid by PHEAA.

### *Provision for loan losses*

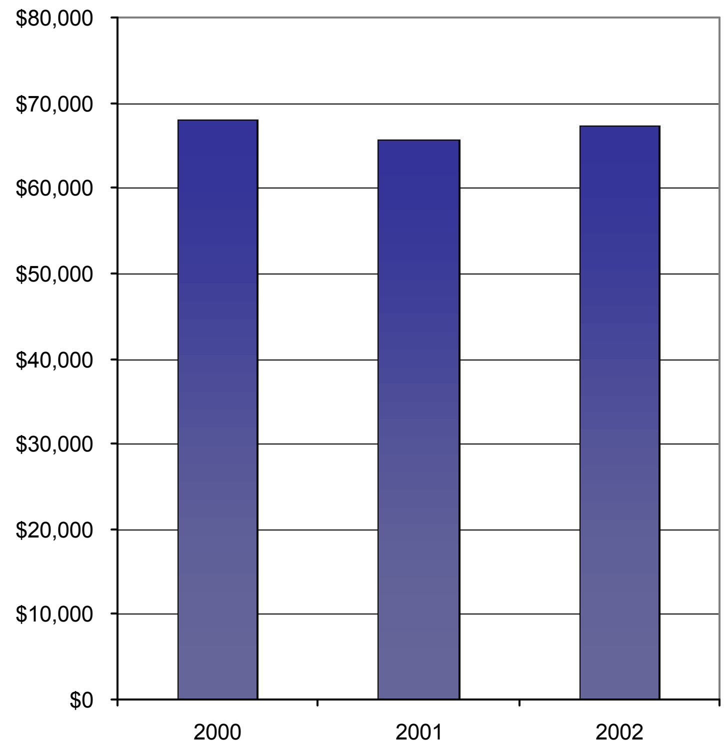
Under FFELP, 98% of principal and interest on student loans is guaranteed. The provision for loan losses represents our estimate of the costs related to the 2% risk sharing on FFELP loans we own.

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. An analysis of PHEAA's allowance for loan losses is presented in the following table.

| For the years ended June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Balance at beginning of period | $ | **5,539** | 4,576 |
| Provision for losses | | **(3,689)** | 1,586 |
| Charge-offs | | **(950)** | (623) |
| Balance at end of period | $ | **900** | 5,539 |
| Allowance as a percentage of ending balance of student loans | | **0.03%** | 0.21% |

*Noninterest revenue*

Servicing fees
Servicing fees chart
(In thousands)

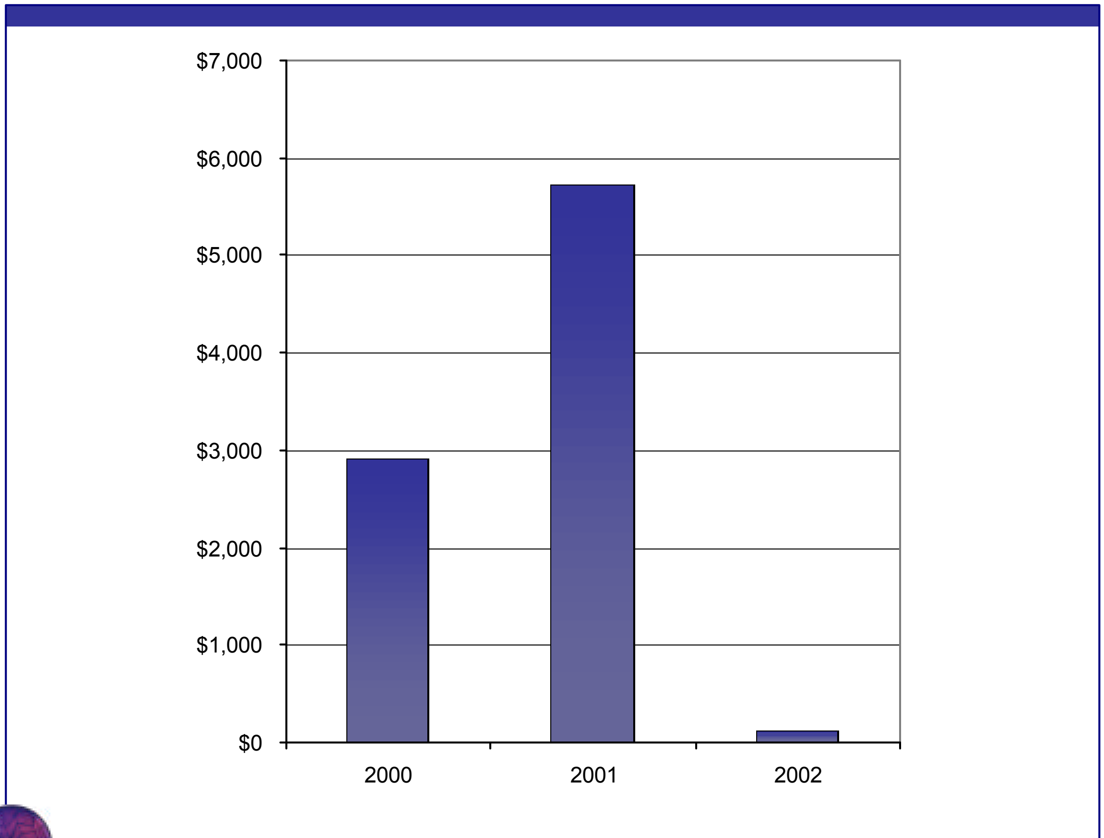



Servicing fees for the year ended June 30, 2002 were $67.2 million, an increase of 2.3% from $65.7 million in 2001. Loans serviced by PHEAA for participating financial institutions averaged $13.8 billion in 2002 and $12.9 billion in 2001.

Fees, as a percentage of the amount of loans being serviced, are decreasing over time. The change in the rate structure is occurring because the gross loan yield earned by participating financial institutions is set by law and has repeatedly been reduced. In order for the federal student loan program to remain viable in Pennsylvania, we have had to reduce per unit servicing costs and reduce fees charged to participating financial institutions.

We also provide systems for other servicers and guarantors for a fee. For the year ended June 30, 2002, fees earned from servicing systems amounted to $5.7 million, an increase of 23.9% from $4.6 million in 2001. Loans serviced by other servicers using our systems averaged $7.7 billion in 2002, an increase of 28.3% from $6.0 billion in 2001. These fees declined as a percentage of loans serviced because of changes in the rate structure discussed above. For the year ended June 30, 2002, fees earned from guaranty systems amounted to $1.7 million, while they were $800 thousand in 2001. Original principal amount outstanding for guarantors using our systems averaged $1.8 billion in 2002. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

Gains on student loan sales
Gains on student loan sales chart
(In thousands)

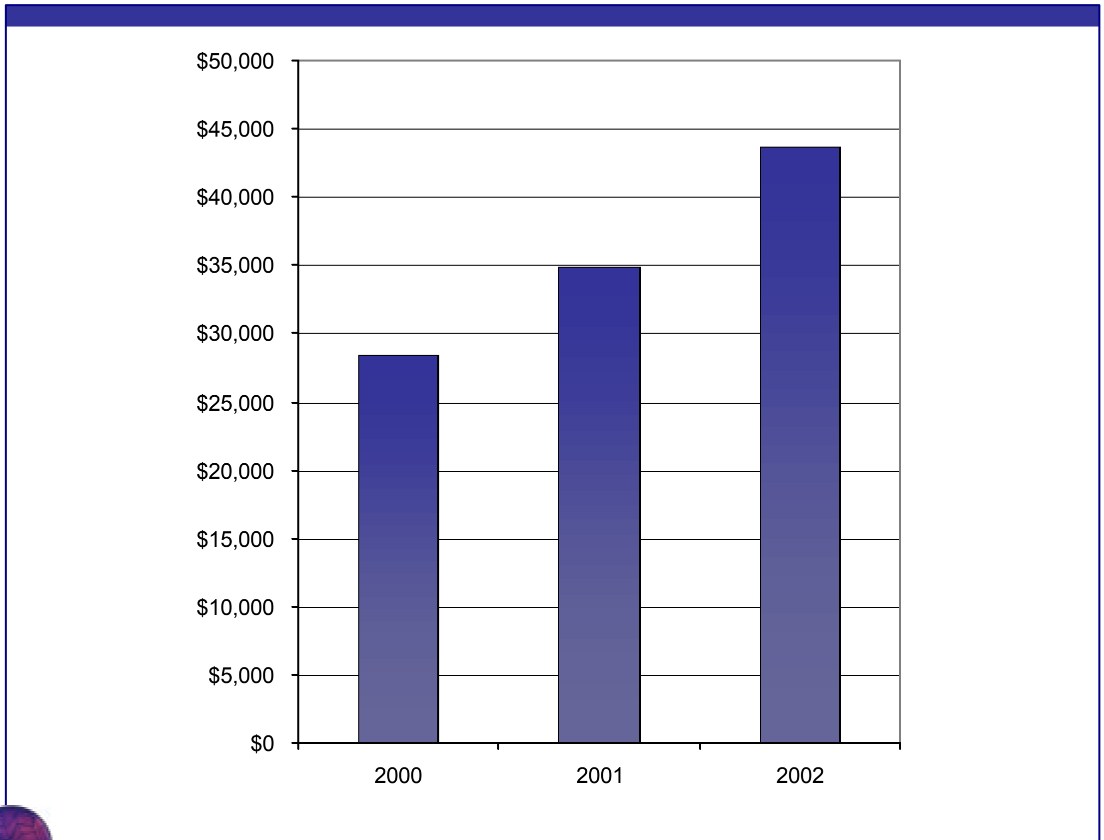



For the year ended June 30, 2002, gains on student loan sales were $113 thousand, compared to net gains of $5.7 million in 2001.

The decrease in gains on student loans sales occurred because of a 38.2% decrease in the volume of loan sales and market forces reducing the value of the loans being sold.

Additionally, we incurred a loss of $453 thousand on one sales transaction for $90.6 million of student loans. In the past, we sold loans for which the borrower was still in school. As part of the sale, we also sold the rights to future loan originations related to those borrowers until the borrower completed school. Due to a processing error, we made the future originations and earned the net interest revenue on those loans for approximately one year. The loan sale that generated the loss related to selling these loans to the financial institution. In order to compensate the financial institution for the loss of net interest revenue that the institution should have earned during the period we owned the loans, the loan sale was completed at face value for the student loans rather than at the premium that student loans typically produce. The loss occurred because we wrote off the unamortized lender origination fees related to the loans at the time of the sale.

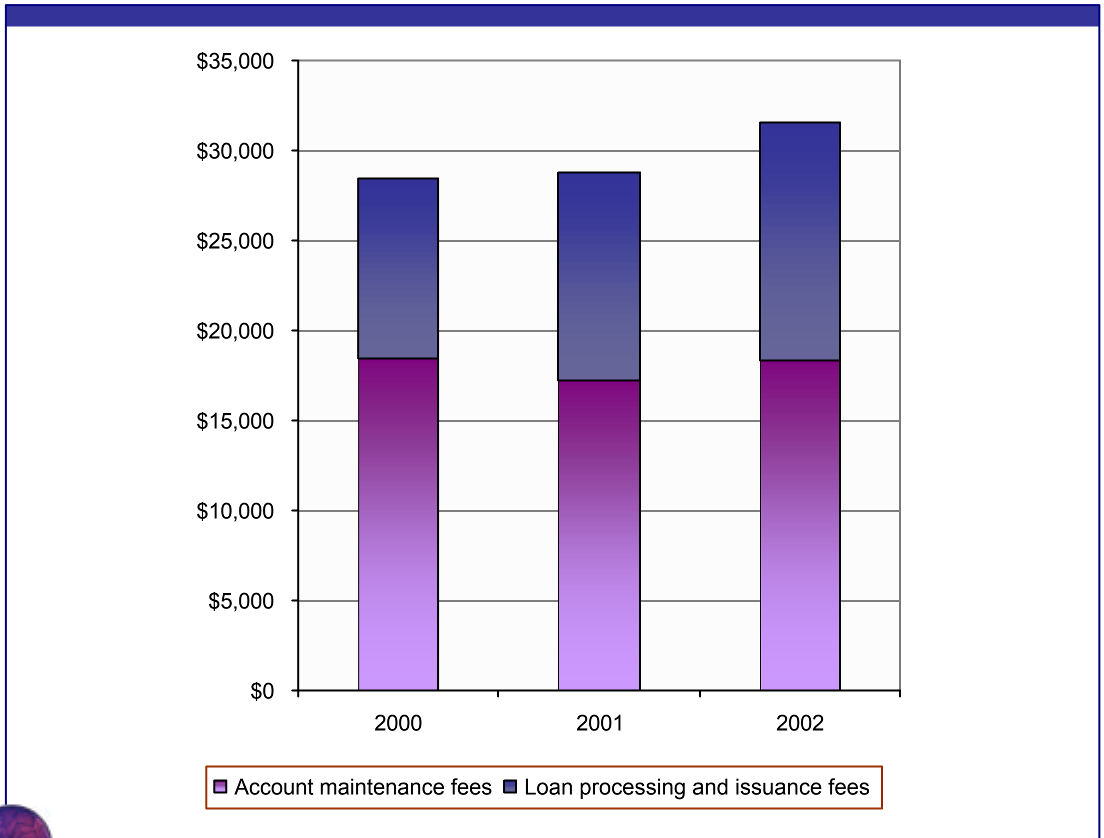
PHEAA's share of collections on defaulted loans
PHEAA's share of collections on defaulted loans chart
(In thousands)




For the year ended June 30, 2002, PHEAA's share of collections on defaulted loans was $43.7 million, a 25.2% increase from $34.9 million in 2001. In addition to increased collection success, the increase is also due to more aggressive promotion of consolidation into the Federal Direct Loan Program as one way for a borrower to repay a defaulted FFELP loan. When a borrower chooses this option, the federal government reimburses our collection costs for these loans and we include that reimbursement in this revenue caption. For the year ended June 30, 2002, these reimbursements were $11.9 million compared to $8.2 million in 2001.

## Federal fees

Federal fees chart
(In thousands)




For the year ended June 30, 2002, federal fees were $31.6 million, an increase of 9.7% from $28.8 million in 2001.

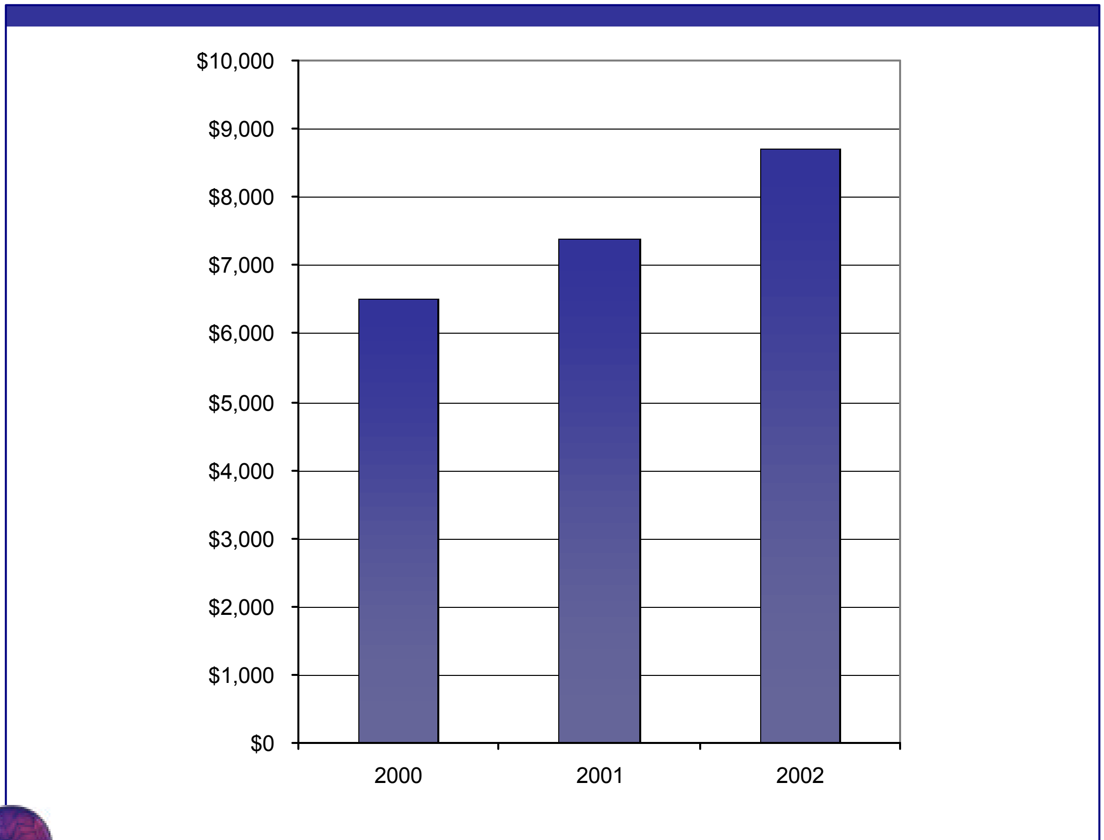
Federal fees are earned by PHEAA for operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee that is 65 basis points for loans that PHEAA guarantees as the loan is disbursed; however, the fee is not paid on new consolidation loans. This fee is scheduled to decrease to 40 basis points on October 1, 2003. The Department also pays PHEAA an annual account maintenance fee that is 10 basis points for the original principal amount of loans guaranteed as long as the guarantee remains in force.

For the year ended June 30, 2002, loan processing and issuance fees were $13.3 million, an increase of 14.7% from $11.6 million in 2001. The Department pays this fee based upon disbursements, which can vary significantly between quarters. Guarantees, a more stable measure of volume over the long term, have increased 8.1% in 2002.

For the year ended June 30, 2002, account maintenance fees were $18.3 million, a 6.4% increase from $17.2 million in 2001.

## Default aversion fees

Default aversion fees chart
(In thousands)

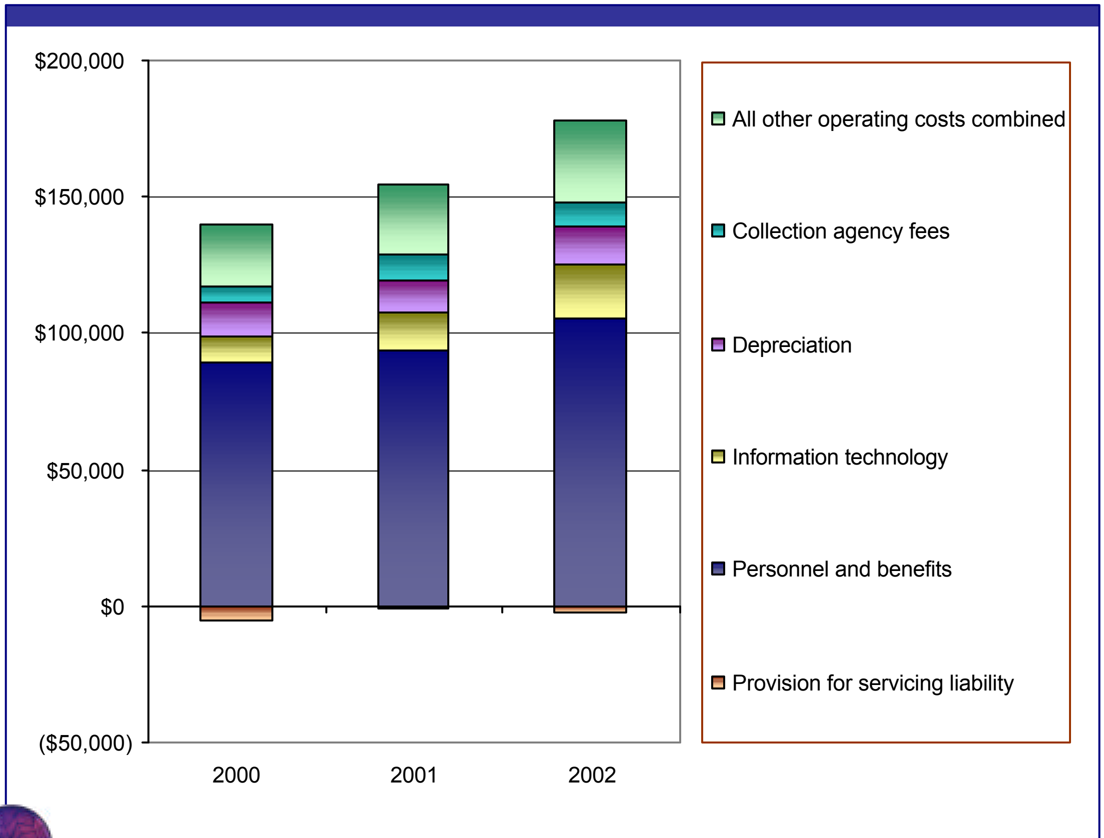



For the year ended June 30, 2002, default aversion fees were $8.7 million, an increase of 17.6% from $7.4 million in 2001.

This fee is earned when servicers involve guarantors to avert potential defaults and is paid from the Federal Fund. If the loan subsequently does default, the amount must be returned to the Federal Fund. The increase is due to increased default aversion activity.

*Operating expenses*

Operating expenses chart
(In thousands)




For the year ended June 30, 2002, operating expenses were $175.6 million, an increase of 14.5% from $153.4 million in 2001. The major reasons for the increase are the increases in personnel and benefits costs and the costs of initiatives related to electronic commerce. A more detailed discussion of costs follows.

## Personnel and benefits

For the year ended June 30, 2002, personnel and benefit costs were $105.6 million, an increase of 12.8% from $93.6 million in 2001.

Permanent staff makes up 84.4% of the total personnel and benefits costs of the Agency. For the year ended June 30, 2002, permanent staff costs were $89.1 million, an increase of 18.0% from $75.5 million in 2001. There were 1,869 permanent staff positions filled at June 30, 2002, an increase of 15.9% from the 1,612 positions filled at June 30, 2001. We have shifted the mix of personnel from contracted staff to permanent staff to reduce turnover and improve customer service.

PHEAA's workforce is unionized. Contractual increases are generally tied to a cost of living increase and annual step increases of 2.2%. While not mandated, PHEAA's management workers typically receive the same percentage cost of living and step increases as union workers.

### Information technology and electronic commerce marketing arrangements

For the year ended June 30, 2002, information technology costs were $19.3 million, a 34.0% increase from $14.4 million in 2001. Services related to electronic commerce increased $2.1 million and $1.4 million of the increase related to new marketing arrangements. Additionally, increased maintenance costs, leases and software licenses all contributed to the overall increase.

### Federal usage fees

During the year ended June 30, 2001, PHEAA was required to start paying usage fees to the Federal Fund to cover the cost of using assets that were purchased or developed with federal funds. We have reached an agreement with ED to pay usage fees equal to depreciation expense on the related asset. For the year ended June 30, 2002, the fees amounted to $6.6 million, compared to $6.5 million in 2001. While the related asset lives vary, generally the assets will be fully depreciated after 2005 and at that point, there will be minimal usage fees. There were no usage fees before the June 30, 2001 fiscal year.

### Provision for servicing liability

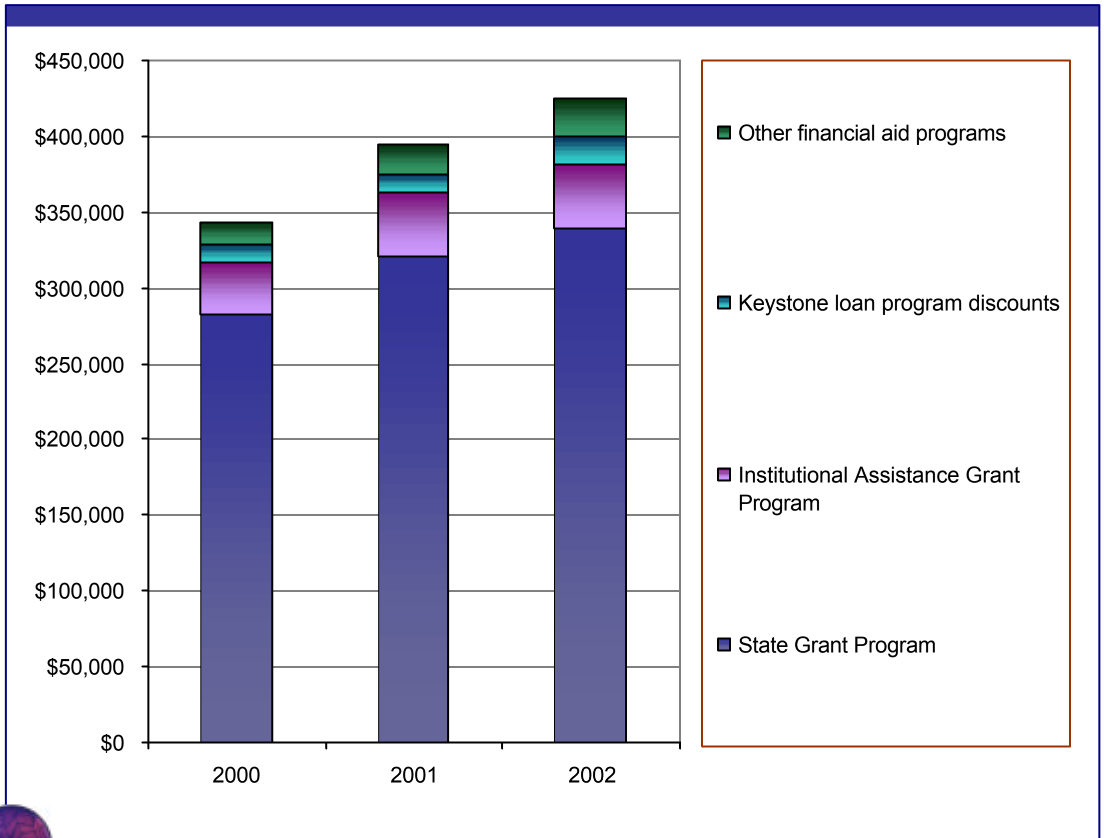
Not meeting ED regulations on servicing can result in losses on the portfolio of loans owned by PHEAA and on the portfolio being serviced for our customers. PHEAA makes estimates of what the potential losses could be based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information and changes in economic conditions.

Currently, the provision for losses is not a significant expense to the Agency. However, since the provision could be significant, an analysis of PHEAA's allowance for servicing losses is presented in the following table:

| For the years ended June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Balance at beginning of period | $ | **14,718** | 16,234 |
| Reduction in allowance | | **(2,670)** | (815) |
| Charge-offs, net | | **(191)** | (701) |
| Balance at end of period | $ | **11,857** | 14,718 |
| Allowance as a percentage of ending balance of student loans | | **0.07%** | 0.09% |

*Financial aid activity*

Financial aid activity chart
(In thousands)




For the year ended June 30, 2002, grants and other financial aid were $425.0 million, a 7.8% increase from $394.2 million in 2001. The following table displays financial aid awarded through PHEAA's various programs.

| For the years ended June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| State Grant Program | $ | **339,220** | 321,332 |
| Institutional Assistance Grant Program | | **42,442** | 41,418 |
| Keystone loan program discounts | | **17,660** | 11,931 |
| Matching Funds Program | | **12,260** | 10,114 |
| New Economy Technology Scholarship Program | | **8,405** | 5,253 |
| Robert Byrd scholarship program | | **1,705** | 1,647 |
| Other | | **3,317** | 2,472 |
| | $ | **425,009** | 394,167 |

Keystone loan program discounts are PHEAA's payment of fees that borrowers typically pay to ED under the federal student loan program. Typically, the borrower is required to pay 3% of the amount borrowed to ED as an up-front origination fee. For all loans PHEAA originates, PHEAA will pay two of the three points. For loans that

PHEAA services for a participating financial institution, PHEAA will pay one of the three points. For loans PHEAA originates for borrowers with family income under $21,000, PHEAA pays all the required points. Beginning July 1, 2003, PHEAA will pay all three of the points for loans that PHEAA originates.

Other than the Keystone loan program discounts, which are funded by PHEAA, Commonwealth of Pennsylvania grants, federal grants and interest on those grants fund the financial aid programs.

For the year ended June 30, 2002, Commonwealth of Pennsylvania grants were $411.7 million, a 6.1% increase from $387.9 million in 2001. For the year ended June 30, 2002, federal grants were $6.4 million, a 45.5% increase from $4.4 million in 2001.

During the year ended June 30, 2002, we transferred $26.1 million to the Pennsylvania Higher Education Foundation. The Board of Directors has authorized an additional $40 million of transfers through June 30, 2006. The authorization is not an obligation and none of this amount has been accrued.

During the year ended June 30, 2001, PHEAA was required to return to the Commonwealth $20 million of undisbursed SciTech and Technology Scholarship Program funds.

## Financial position and liquidity

Most of PHEAA's net assets are restricted or invested in capital assets. The Agency had a deficit in unrestricted funds of $8.8 million at June 30, 2002.

The most substantial restriction on PHEAA's net assets is net assets restricted for debt service, which amounted to $197.1 million. Of that amount, $188.2 million is related to PHEAA's student loan bonds and financings, and $113.4 million could be made available to offset the unrestricted net deficit.

For the year ended June 30, 2002, net cash used for operations was $465.9 million compared to $202.3 million in 2001. Financial reporting standards for government entities require us to report student lending and secondary market activities as operating activities while businesses would report them as investing activities. Eliminating student lending and secondary market activities from operating activities would demonstrate that the remaining operating activities provided cash of $94.8 million in 2002 and $63.2 million in 2001.

### Description of debt activity and significant capital assets

The principal funding need for PHEAA is securing capital to fund student loan originations and purchases. The Agency has a number of sources to raise this capital including access to bond markets and arrangements with banks and the State Treasury. PHEAA's ability to raise debt could be limited in the future because under PHEAA's enabling legislation there is a formula that imposes a debt limit. The limit is $8.8 billion at June 30, 2002. At June 30, 2002, PHEAA's outstanding debt amounted to $3.6 billion. The following table shows the Agency's debt activity.

| For the years ended June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| *Capital market activity* | | | |
| Proceeds from issuing student loan demand revenue bonds | $ | **350,000** | 665,000 |
| Proceeds from issuing student loan revenue refunding bonds | | **312,925** | - |
| Proceeds from issuing capital acquisition refunding bonds | | **76,501** | - |
| Repayment of student loan revenue bonds | | **(312,925)** | (296,480) |
| *Other financings* | | | |
| Net student loan financing activity | | **34,174** | (29,918) |
| Net capital financing activity | | **(4,071)** | (119) |
| Net other financing activity | | **5,552** | (8,679) |

The following table shows the Agency's significant capital assets, net of accumulated depreciation.

| At June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Land | $ | **2,946** | 2,946 |
| Buildings | | **40,745** | 42,930 |
| Software development | | **19,147** | 18,130 |
| Purchased software | | **4,071** | 4,416 |
| Other, principally information technology equipment | | **9,167** | 11,017 |
| | $ | **76,076** | 79,439 |

The most significant ongoing capital item is software development. Our software development is generally related to customized systems for student financial aid processing that cannot be purchased from vendors. For the year ended June 30, 2002, we capitalized $7.5 million of software development compared to $8.0 million in 2001.

### Interest rate risk management

In financing our student loan lending and secondary market operations, we can minimize sensitivity to changing interest rates by matching interest rate characteristics of borrowings to assets to attempt to lock in net interest margin. We generally fund variable-rate loan assets with variable-rate debt and fund fixed-rate assets with fixed-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 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 bonds and financings. As well as other assets and liabilities, PHEAA has $84.4 million of student loans and $183.6 million of investments not included in the analysis. Because of the significance of variable-rate loans that have a 9.5% floor yield, the amount of those loans is separately disclosed. Due to the current interest rate environment, 9.5% floor loans are classified as having an interest rate sensitivity period of over 5 years. During the year ending June 30, 2003, the 91-day Treasury-bill rate would have to reach 11.4% for the 9.5% floor loans to have an interest rate sensitivity period of 3 months or less.

The following gap analysis reflects rate-sensitive positions at June 30, 2002 and is not necessarily reflective of positions that existed throughout the period.

If a period gap is positive, it means that 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 June 30, 2002 (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 |
|---|---|---|---|---|---|---|---|
| *Assets* | | | | | | | |
| Student loans: | | | | | | | |
| 9.5% floor student loans | $ | - | - | - | - | - | 968,352 |
| Other student loans | | 1,836,968 | 180,935 | 111,391 | 5,016 | 16,808 | 18,507 |
| Total student loans | | 1,836,968 | 180,935 | 111,391 | 5,016 | 16,808 | 986,859 |
| Investments | | 300,848 | - | 347 | 4,400 | - | 21,386 |
| Other assets | | 49,247 | 21,768 | 8,597 | 6,489 | 8,211 | 12,204 |
| Total assets | | 2,187,063 | 202,703 | 120,335 | 15,905 | 25,019 | 1,020,449 |
| *Liabilities* | | | | | | | |
| Student loan bonds and financings | | 2,061,000 | 769,959 | - | 304,856 | - | 225,000 |
| Other liabilities | | 11,959 | 6,359 | 151 | 1,975 | 1,997 | - |
| Total liabilities | | 2,072,959 | 776,318 | 151 | 306,831 | 1,997 | 225,000 |
| *Net assets* | | | | | | | |
| Restricted for debt service | $ | - | - | - | - | - | 188,218 |
| Period gap | $ | 114,104 | (573,615) | 120,184 | (290,926) | 23,022 | 607,231 |
| Cumulative gap | $ | 114,104 | (459,511) | (339,327) | (630,253) | (607,231) | - |
| Ratio of interest-sensitive assets to interest-sensitive liabilities | | 105.5% | 26.1% | 79692.1% | 5.2% | 1252.8% | 453.5% |
| Ratio of cumulative gap to total assets | | 3.2% | -12.9% | -9.5% | -17.6% | -17.0% | 0.0% |

Because over the course of a year, PHEAA's debt generally re-prices faster than the assets re-price, decreases in market interest rates will increase net interest revenue while increases in market interest rates will decrease net interest revenue.

The following table shows the simulated impact of a 100 basis point parallel shift downward in interest rates and a 100, 200 and 300 basis point parallel shift upward in interest rates on net interest revenue. A parallel shift means that it would affect both our assets and our debt in the same way at the same time. Given the low interest rate environment, the impact of a 200 or 300 basis point downward shift is not shown in the table below. The analysis was prepared using the levels of assets and liabilities related to our student loan bonds and financings. The impact simulates the effect of rates changing in parallel fashion ratably over the next twelve months.

| | | Movements in interest rates from June 30, 2002 rates | | | |
|---|---|---|---|---|---|
| | | Increase | | | Decrease |
| | | +100 basis points | +200 basis points | +300 basis points | -100 basis points |
| Simulated increase (decrease) on net interest revenue over the next twelve months | $ | (17,766) | (19,724) | (21,682) | (3,399) |

As discussed above, the borrower rate exceeded the lender rate for the entire year resulting in PHEAA earning $15.8 million more than would be expected based upon market conditions. In the scenarios simulating increases in interest rates, eliminating that $15.8 million is the largest factor in the projected reduction of net interest revenue. In the scenario simulating a decrease in interest rates, we project the borrower rate to exceed the lender rate, but not to the extent that it did during the most recent year.

The actual change in net interest revenue compared to results for the year ended June 30, 2002, will also be affected by the decreased interest expense resulting from the current refundings of student loan revenue bonds. That impact, which we expect to be $13.9 million, has not been reflected in the calculations above because it relates to a series of transactions during the year ended June 30, 2002, and not to future changes in interest rates.

### Federal Student Loan Reserve Fund

Under current law, we are required to manage the Federal Fund so that cash and investments are greater than 0.25 percent of the original principal balance of outstanding guarantees.

In making the assessment, we eliminate from consideration the amount of investments that are held in the restricted recall account related to the Federal Balanced Budget Act of 1997 and the amount of investments that will be needed to fund the recall related to the Higher Education Amendments of 1998.

Additionally, we consider receivables and payables because they generally relate to recent default claims and reinsurance and generally will be converted to cash within one month. Finally, we add capital assets because the usage fees we are required to pay will have the effect of converting those assets to cash and investments over the next five years.

The following table demonstrates that we have managed the Federal Fund to exceed the target required by law.

| At June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Cash and investments | $ | **204,670** | 213,694 |
| Adjustments for federal recall of funds: | | | |
| Eliminate investments in restricted recall account related to the Federal Balanced Budget Act of 1997 | | **(116,119)** | (92,896) |
| Eliminate investments that will be transferred to the restricted recall account related to the Federal Balanced Budget Act of 1997 | | **-** | (23,223) |
| Eliminate investment that will need to be used related to the recall of funds in the Higher Education Amendments of 1998 | | **(26,309)** | - |
| | | **(142,428)** | (116,119) |
| Adjustment for timing differences: | | | |
| Add receivable from U.S. Department of Education | | **27,859** | 23,211 |
| Add net capital assets | | **13,948** | 19,669 |
| Other | | **(2,447)** | (419) |
| | | **39,360** | 42,461 |
| Adjusted cash and investments | $ | **101,602** | 140,036 |
| Original principal outstanding | $ | **18,235,496** | 17,025,894 |
| | | **0.56%** | 0.82% |

For the year ended June 30, 2002, purchases of defaulted loans were $279.7 million, an increase of 24.8% from $224.2 million in 2001. The increase for the period occurred primarily due to changes in the timing of filing default claims. The Higher Education Amendments of 1998 required lenders to submit claims to the guarantor 90 days later than under the prior law. As the change was implemented, claim volume decreased in 1999 and 2000. During the year, claim volume in relation to original principal outstanding returned to levels consistent with experience before the change.

**Description of currently known facts, decisions or conditions expected to have a significant effect on net assets or results of operations**

On July 1, 2002, variable interest rates charged to FFELP borrowers decreased 1.93%. As discussed above, under the net interest revenue section, PHEAA earned $15.8 million more than expected during 2002 because the borrower rate exceeded the lender rate for almost the entire year. Since July 1, 2002, the borrower rate has not exceeded the lender rate.

On July 25, 2002, we issued $150 million of student loan revenue refunding bonds. The bonds we issued are tax-exempt variable-rate debt that reset based upon auctions every 35 days and they had an initial rate of 1.40%. The bonds being refunded are tax-exempt fixed-rate debt at a rate of 6.22% and we expect to refund them in September 2002.

The most significant item that will immediately affect future results of operations is the change in short-term interest rates. Since June 30, 2002, rates on 91-day Treasury bills and 3-month commercial paper have remained virtually unchanged. The potential impact of changes in short-term interest rates was discussed in the interest rate risk management section.

### Contacting PHEAA

If you have questions about this report, please contact PHEAA's Financial Management Division at 1200 N. 7th Street, Harrisburg, PA 17102.

Phone – 717 720-2540

Fax – 717 720-3923

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August 30, 2002

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KPMG

30 North Third Street
Suite 200
PO Box 1190
Harrisburg, PA 17108-1190

**Independent Auditors' Report**

The Board of Directors
Pennsylvania Higher Education Assistance Agency:

We have audited the accompanying basic financial statements of the Pennsylvania Higher Education Assistance Agency (PHEAA), a component unit of the Commonwealth of Pennsylvania, as of and for the years ended June 30, 2002 and 2001, as listed in the table of contents. These financial statements are the responsibility of PHEAA'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 net assets of PHEAA as of June 30, 2002 and 2001, and its changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 27 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

As discussed in Note 3 to the basic financial statements, PHEAA adopted the disclosure requirements of Statement No. 34 of the Governmental Accounting Standards Board, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments* as of and for the year ended June 30, 2002.

KPMG LLP

August 30, 2002

KPMG LLP KPMG LLP a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

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FOR THE YEARS ENDED JUNE 30 (IN THOUSANDS)

| | | 2002 | 2001 |
|---|---|---|---|
| *Interest revenue* | | | |
| Student loans | $ | **183,771** | 206,482 |
| Investments | | **30,411** | 41,782 |
| Total interest revenue | | **214,182** | 248,264 |
| *Interest expense* | | | |
| Student loan financings and bonds payable | | **105,870** | 166,234 |
| Capital and other financings | | **13,703** | 11,507 |
| Total interest expense | | **119,573** | 177,741 |
| Net interest revenue | | **94,609** | 70,523 |
| Provision for loan losses | | **3,689** | (1,586) |
| Net interest revenue after provision for loan losses | | **98,298** | 68,937 |
| *Noninterest revenue* | | | |
| Servicing fees | | **67,207** | 65,717 |
| Gains on student loan sales, net | | **113** | 5,724 |
| PHEAA's share of collections on defaulted loans | | **43,713** | 34,924 |
| Federal fees | | **31,562** | 28,793 |
| Default aversion fees, net | | **8,705** | 7,387 |
| Other | | **207** | 254 |
| Total noninterest revenue | | **151,507** | 142,799 |
| Operating revenues | | **249,805** | 211,736 |
| *Operating expenses* | | | |
| Personnel | | **105,585** | 93,564 |
| Information technology related expenses | | **19,298** | 14,427 |
| Other | | **50,745** | 45,408 |
| Total operating expenses | | **175,628** | 153,399 |
| Operating income | | **74,177** | 58,337 |
| Commonwealth of Pennsylvania grants | | **411,748** | 387,894 |
| Federal grants | | **6,365** | 4,435 |
| Grants and other financial aid | | **(425,009)** | (394,167) |
| Transfer to Pennsylvania Higher Education Foundation | | **(26,109)** | - |
| Transfer of undisbursed SciTech and Technology Scholarship Program funds to the Commonwealth of Pennsylvania | | **-** | (20,000) |
| Net income | | **41,172** | 36,499 |
| Net assets, beginning of period | | **225,865** | 189,366 |
| Net assets, end of period | $ | **267,037** | 225,865 |

See accompanying notes to financial statements.

# Statements of Net Assets

## At June 30 (in thousands)

| | | 2002 | 2001 |
|---|---|---|---|
| *Assets* | | | |
| Cash and cash equivalents | $ | **28,829** | 29,067 |
| Investments | | **510,558** | 569,249 |
| Student loans receivable, net | | **3,222,787** | 2,668,934 |
| Accounts receivable, net | | **13,070** | 9,982 |
| Receivable from U.S. Department of Education | | **6,117** | 5,730 |
| Interest income receivable | | **81,514** | 84,933 |
| Prepaid expenses and other assets | | **2,697** | 2,754 |
| Capital assets, net | | **76,076** | 79,439 |
| Deferred financing costs, net | | **20,414** | 19,302 |
| Federal Student Loan Reserve Fund assets held for the U.S. Department of Education | | **246,819** | 257,330 |
| Total assets | | **4,208,881** | 3,726,720 |
| *Liabilities* | | | |
| Accounts payable and accrued expenses | | **65,796** | 60,518 |
| Accrued interest payable | | **18,712** | 25,961 |
| Student loan financings | | **769,959** | 735,785 |
| Student loan demand revenue bonds | | **2,061,000** | 1,711,000 |
| Student loan revenue bonds, net | | **529,856** | 537,925 |
| Capital financings | | **78,876** | 81,733 |
| Other financings | | **121,196** | 39,773 |
| Obligation under capital lease | | **49,630** | 50,830 |
| Amounts related to the Federal Student Loan Reserve Fund | | **246,819** | 257,330 |
| Total liabilities | | **3,941,844** | 3,500,855 |
| *Net assets* | | | |
| Invested in capital assets, net of related debt | | **17,163** | 16,455 |
| Restricted for debt service | | **197,140** | 165,514 |
| Restricted for financial aid | | **51,446** | 37,880 |
| Restricted for default aversion activities | | **10,064** | 7,932 |
| Unrestricted | | **(8,776)** | (1,916) |
| Total net assets | $ | **267,037** | 225,865 |

See accompanying notes to financial statements.

FOR THE YEARS ENDED JUNE 30 (IN THOUSANDS)

| | | 2002 | 2001 |
|---|---|---|---|
| *Cash flows from operating activities* | | | |
| Interest received on student loans | $ | **195,749** | 201,506 |
| Principal received on student loans | | **512,458** | 350,867 |
| Student loan originations | | **(605,746)** | (572,018) |
| Student loan purchases | | **(717,176)** | (448,793) |
| Student loan sales | | **249,779** | 404,458 |
| Interest received on investments | | **32,487** | 41,784 |
| Interest paid on student loan financings and bonds payable | | **(111,996)** | (171,892) |
| Interest paid on capital and other financings | | **(13,066)** | (7,889) |
| Servicing fees | | **64,119** | 67,216 |
| PHEAA's share of collections on defaulted loans | | **43,713** | 34,924 |
| Federal fees | | **31,175** | 29,079 |
| Default aversion fees | | **9,605** | 19,740 |
| Other | | **207** | 254 |
| Payment of operating expenses | | **(157,206)** | (151,499) |
| Net cash used for operations | | **(465,898)** | (202,263) |
| *Cash flows from noncapital financing activities* | | | |
| Proceeds from issuance of noncapital debt | | **934,546** | 824,753 |
| Principal paid on noncapital debt | | **(477,173)** | (494,830) |
| Issuance costs | | **(2,704)** | (6,532) |
| Commonwealth of Pennsylvania grants | | **411,748** | 387,894 |
| Federal grants | | **6,365** | 4,435 |
| Grants and financial aid | | **(425,009)** | (394,167) |
| Transfer to Pennsylvania Higher Education Foundation | | **(26,109)** | - |
| Transfer of undisbursed SciTech and Technology Scholarship Program funds to the Commonwealth of Pennsylvania | | **-** | (20,000) |
| Net cash provided by noncapital financing activities | | **421,664** | 301,553 |
| *Cash flows from capital and related financing activities* | | | |
| Proceeds from issuance of capital debt | | **681** | 4,762 |
| Principal paid on capital debt and obligation under capital lease | | **(4,752)** | (4,881) |
| Purchases of capital assets and development of software, net of disposals | | **(10,624)** | (14,600) |
| Net cash used for capital and related financing activities | | **(14,695)** | (14,719) |
| *Cash flows from investing activities* | | | |
| Proceeds from sales and maturities of investments | | **10,412,963** | 5,812,294 |
| Purchases of investments | | **(10,354,272)** | (5,891,064) |
| Net cash provided by (used for) investing activities | | **58,691** | (78,770) |
| Net change in cash and cash equivalents | | **(238)** | 5,801 |
| Cash and cash equivalents, beginning of period | | **29,067** | 23,266 |
| Cash and cash equivalents, end of period | $ | **28,829** | 29,067 |

(continued)

For the years ended June 30 (in thousands)

| | | 2002 | 2001 |
|---|---|---|---|
| *Reconciliation of operating income to net cash used for operating activities* | | | |
| Operating income | $ | **74,177** | 58,337 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | | |
| Depreciation and amortization | | **13,987** | 11,636 |
| Amortization of deferred financing costs | | **1,592** | 1,404 |
| Amortization of deferred amount on refundings of student loan revenue bonds | | **138** | - |
| Accretion discount on capital and other financings | | **31** | 13 |
| Changes in assets and liabilities: | | | |
| Decrease (increase) in accounts receivable | | **(3,088)** | 1,499 |
| Decrease (increase) in receivable from the U.S. Department of Education | | **(387)** | 10,891 |
| Decrease (increase) in interest income receivable | | **3,419** | (10,450) |
| Decrease (increase) in student loans receivable | | **(553,853)** | (265,306) |
| Decrease (increase) in prepaid expenses | | **57** | 187 |
| Increase (decrease) in accounts payable and accrued expenses | | **5,278** | (7,016) |
| Increase (decrease) in accrued interest payable | | **(7,249)** | (3,458) |
| Total adjustments | | **(540,075)** | (260,600) |
| Net cash used for operating activities | $ | **(465,898)** | (202,263) |

See accompanying notes to financial statements.

## Note 1 – About PHEAA

*Organization*

PHEAA is an independent public corporation created by the Pennsylvania General Assembly on August 7, 1963. Our mission is to improve postsecondary 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.

*Related organizations*

PHEAA appoints all board members of the Pennsylvania Higher Education Foundation and the Higher Education Foundation, but cannot impose its will on the foundations and there is no financial benefit or burden associated with the foundations. The purpose of the foundations is to receive donations to be administered to improve or enhance postsecondary educational opportunities in Pennsylvania and elsewhere. During the year ended June 30, 2002, PHEAA transferred $26.1 million to the Pennsylvania Higher Education Foundation.

## Note 2 – Summary of significant accounting policies

Because we are financed and operated in a manner similar to private business enterprises, we are accounted for as an enterprise fund and 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 allowed by the GASB and to be consistent with the accounting practices of the Commonwealth, we have elected not to follow FASB pronouncements issued after November 30, 1989; however, we do consider FASB guidance for accounting issues that have not been addressed by the GASB.

*Student loans*

Student loans are reported on the statement of net assets at their unpaid principal balances. Costs related to loan originations and loan purchases are deferred and recognized over the life of the loan, after giving effect to estimated prepayments, as an adjustment of yield. The deferred amount is reported as part of the principal balance of student loans. We also reduce the reported value of student loans to reflect expected loan losses.

Student loan income is recognized as earned including adjustments for the amortization of costs of loan originations and purchases.

Allowances for potential losses on our student loans can result from deficient servicing, risk-sharing on defaults and on 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. The allowances are maintained at a level that we believe is adequate to absorb estimated incurred losses, but our evaluation is naturally subjective and the required allowances may significantly change in the future.

Expenses related to risk sharing on defaults are reported in the provision for loan losses, and expenses that relate to servicing deficiencies are included in operating expenses.

*Cash equivalents*

PHEAA considers all liquid debt instruments with original maturities of three months or less to be cash equivalents.

*Investments*

Investments are reported at fair values based upon information provided by external investment managers.

Investment earnings on the statements of revenues, expenses and changes in net assets include earnings on investments in the restricted escrow of the Federal Fund. These earnings are restricted for default reduction activities.

*Capital assets*

Capital assets are reported at cost net of depreciation. Assets held under capital leases are reported at the present value of minimum lease payments net of amortization. Depreciation is calculated on the straight-line method over the estimated useful life of the asset. Assets held under capital leases and leasehold improvements are amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the asset.

Software development is reported at cost net of amortization. Amortization is calculated on the straight-line method over the estimated useful life of the software developed.

PHEAA capitalizes 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 | 25 – 40 years |
| ▪ Furniture, furnishings and equipment | 5 – 10 years |
| ▪ Software development | 3 – 5 years |

*Deferred financing costs*

Deferred financing costs consist of underwriting and other costs of issuing financings. The costs are amortized over the term of the financing using methods that approximate the effective interest method and are included in interest expense.

*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. Grants received and grants and financial aid disbursed are not reported as components of operating income.

*Revenue recognition*

Servicing fees are recognized as the contractual services are provided. For 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. PHEAA's share of collections on defaulted loans is recognized when the cash is collected.

PHEAA receives default aversion fees amounting to 1% of the principal and interest of a loan when the lender submits a default preclaim. These fees are transferred from the Federal Fund. If the loan later defaults, we must return to the Federal Fund 1% of the principal and interest of the loan at the time of the default. Revenue recognized from default aversion fees is net of the amount we estimate will have to be returned to the Federal Fund. For the Federal

Fund the entire default aversion fee is recognized as an expense when the expense is paid. As PHEAA returns amounts when loans default, the amount returned offsets the expense.

*Advertising*

We expense the costs of advertising as costs are incurred. Most advertising expenses are related to making sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. Advertising expenses were $3.2 million in 2002 and $2.0 million in 2001.

*Transfers in from the Commonwealth of Pennsylvania and federal grant revenues*

Transfers in from the 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, the entire amount received is recognized as revenue when we receive it.

*Use of estimates*

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America we must make estimates and assumptions that influence the reported assets, liabilities, revenues and expenses. In the future actual results could be different than our estimates.

## Note 3 – Changes in accounting and new accounting pronouncements

*Financial reporting format*

During the current year, PHEAA adopted GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. Because PHEAA is a special-purpose government and was already reporting under the economic resources measurement focus and accrual basis of accounting, adopting this statement did not result in a change in net assets previously reported. Presenting management's discussion and analysis before the financial statements is the major change caused by this statement.

At the same time we adopted GASB Statement No. 34, we adopted GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. The effect of this statement on PHEAA was to modify disclosures we make regarding debt service requirements and interest rate information for variable-rate debt.

We also adopted new classifications and groupings on the statements of revenues, expenses and changes in net assets and we have adjusted the amounts reported in the prior year to conform to the new classifications.

*Reporting entity*

In May 2002, the GASB issued GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units, an amendment of GASB Statement No. 14*. This statement must be adopted for periods beginning after June 15, 2003. We have analyzed the statement and we do not believe this statement will require the Pennsylvania Higher Education Foundation or the Higher Education Foundation to be reported as component units.

### Note 4 – 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 ED. The Federal Fund is used to pay claims on defaulted loans and 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. Because 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 detail of the net assets held by PHEAA for ED in the Federal Fund.

| At June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| *Assets* | | | |
| Cash and cash equivalents | $ | **4,537** | 1,981 |
| Receivable from the U.S. Department of Education | | **27,859** | 23,211 |
| Interest income receivable | | **342** | 756 |
| Investments | | **200,133** | 211,713 |
| Capital assets, net | | **13,948** | 19,669 |
| Total assets | | **246,819** | 257,330 |
| *Liabilities* | | | |
| Default claims payable to lenders | | **2,789** | 1,175 |
| Payable to U.S. Department of Education | | **142,428** | 116,119 |
| Deferred student loan insurance premiums | | **12,079** | 17,570 |
| Total liabilities | | **157,296** | 134,864 |
| Net assets | $ | **89,523** | 122,466 |

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

| For the years ended June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| *Additions* | | | |
| Reinsurance from the U.S. Department of Education | $ | **272,164** | 220,152 |
| Collections on defaulted loans | | **144,318** | 138,502 |
| Interest income | | **4,046** | 7,708 |
| Student loan insurance premiums | | **5,491** | 6,809 |
| Usage fees | | **6,648** | 6,488 |
| Total additions | | **432,667** | 379,659 |
| *Deductions* | | | |
| Purchases of defaulted loans from lenders | | **279,703** | 224,189 |
| Reimbursement to U.S. Department of Education for federal share of defaulted loans collections | | **97,703** | 99,948 |
| Reimbursement to PHEAA for Agency's share of defaulted loans collections | | **43,713** | 34,924 |
| Recall of reserve funds | | **26,309** | - |
| Default aversion fees, net | | **9,605** | 9,134 |
| Transfers to PHEAA for portfolio maintenance fee not paid by U.S. Department of Education | | **1,549** | 1,838 |
| Depreciation | | **5,711** | 5,825 |
| Other | | **1,317** | 1,152 |
| Total deductions | | **465,610** | 377,010 |
| Net increase (decrease) | | **(32,943)** | 2,649 |
| Net assets, beginning of period | | **122,466** | 119,817 |
| Net assets, end of period | $ | **89,523** | 122,466 |

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, ED 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.

Under the Act, PHEAA was required to establish a restricted escrow account into which 20% of the recall amount was to be deposited annually. At June 30, 2002, $116.1 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.

The Higher Education Amendments of 1998 contain a provision for an additional recall of funds totaling $250 million nationwide. $85 million of the recall is to occur in the federal fiscal year ending September 30, 2002, $82.5 million is to occur in the year ending September 30, 2006 and $82.5 million is to occur in the year ending September 30, 2007. On July 11, 2002, ED informed the Agency that PHEAA's share of the recall is $26.3 million, of which

$8.9 million is due by September 1, 2002. The entire $26.3 million was recorded as a deduction from net assets during the year ended June 30, 2002 and is reported as an amount payable to the U.S. Department of Education.

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

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

### Note 5 – Cash and investments

The following table shows cash deposits managed by PHEAA.

| At June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| PHEAA's cash and cash equivalents | $ | **28,829** | 29,067 |
| Cash in the Federal Fund | | **4,537** | 1,981 |
| Carrying value | $ | **33,366** | 31,048 |
| Bank balance | $ | **29,675** | 45,322 |
| Less insured balance | | **(100)** | (306) |
| Uninsured balance | $ | **29,575** | 45,016 |

At June 30, 2002, $8.1 million of PHEAA's cash was restricted under bond indentures and financing arrangements. At June 30, 2001, that amount was $6.3 million. Additionally, at June 30, 2002, $18.0 million of PHEAA's cash is collections on student loans for our servicing customers. That amount was $18.5 million at June 30, 2001.

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

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 PHEAA or an agent in PHEAA's name holds the securities. We have no investments that meet the definition of Category 1.

Category 2 includes uninsured and unregistered investments for which the broker or dealer's trust department or agent holds the securities in PHEAA'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 table displays a summary of investments managed by PHEAA at June 30, 2002.

| (In thousands) | | Category 2 | Category 3 | Carrying Value |
|---|---|---|---|---|
| Repurchase agreements | $ | - | 40,688 | 40,688 |
| U.S. Treasury notes | | - | 46,702 | 46,702 |
| Citicorp commercial paper | | - | 64,955 | 64,955 |
| UBS commercial paper | | - | 54,986 | 54,986 |
| Atlantis One commercial paper | | - | 43,770 | 43,770 |
| Municipal obligations | | 1,300 | - | 1,300 |
| | $ | 1,300 | 251,101 | 252,401 |
| Invested amounts not susceptible to credit risk categorization: | | | | |
| State Treasury investment pool | | | | 225,587 |
| Other money market funds | | | | 124,584 |
| Guaranteed investment contract – MBIA | | | | 74,392 |
| Guaranteed investment contract – Trinity Plus Funding Company | | | | 17,047 |
| Guaranteed investment contract – AIG Matched Funding Corporation | | | | 6,280 |
| Bayerische investment agreement | | | | 6,000 |
| Guaranteed investment contract – CDC Funding Corporation | | | | 4,400 |
| | | | $ | 710,691 |

At June 30, 2002, $200.1 million of the investments detailed above are in the Federal Fund and the remaining $510.6 million is owned by PHEAA and reflected as investments on the statement of net assets. Of the $510.6 million owned by PHEAA, $327.0 million is restricted under student loan bond indentures and financing arrangements. $602.6 million of the investments mature within one year.

The following table displays a summary of investments managed by PHEAA at June 30, 2001.

| (In thousands) | | Category 2 | Category 3 | Carrying Value |
|---|---|---|---|---|
| Repurchase agreements | $ | - | 190,262 | 190,262 |
| U.S. Treasury notes | | - | 49,964 | 49,964 |
| GE Capital Corporation commercial paper | | - | 14,800 | 14,800 |
| Municipal obligations | | 2,500 | - | 2,500 |
| | $ | 2,500 | 255,026 | 257,526 |
| Invested amounts not susceptible to credit risk categorization: | | | | |
| State Treasury investment pool | | | | 232,968 |
| 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 |
| | | | $ | 780,962 |

At June 30, 2001, $211.7 million of the investments detailed above are in the Federal Fund and the remaining $569.2 million is owned by PHEAA and reflected as investments on the statement of net assets. Of the $569.2 million owned by PHEAA, $466.2 million is restricted under student loan bond indentures and financing arrangements.

Investments carry interest rates from 1.01% to 6.23% at June 30, 2002 and rates from 3.60% to 7.65% at June 30, 2001.

## Note 6 – Student loans receivable

The following table shows PHEAA's student loan holdings.

| At June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| FFELP: | | | |
| Stafford | $ | **2,138,430** | 1,727,256 |
| PLUS | | **100,644** | 55,739 |
| Supplemental Loans for Students | | **10,688** | 13,271 |
| Consolidation | | **723,703** | 593,693 |
| | | **2,973,465** | 2,389,959 |
| HEAL | | **182,214** | 229,607 |
| Privately insured loans | | **12,762** | 6,176 |
| Uninsured loans | | **11,256** | 13,316 |
| Unamortized loan origination costs | | **7,672** | 7,595 |
| Unamortized premium on loan purchases | | **39,678** | 30,795 |
| | | **3,227,047** | 2,677,448 |
| Allowance for loan losses | | **(4,260)** | (8,514) |
| | $ | **3,222,787** | 2,668,934 |

We estimate that payments received on student loans will approximate $600 million during the next year.

Under FFELP, 98% of principal and interest on student loans originated after October 1, 1993 is guaranteed. Loans originated before October 1, 1993 are 100% guaranteed. FFELP loans are guaranteed through the Federal Fund 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.

The provision for loan losses reported in the table below represents our estimate of the costs related to the 2% risk sharing on FFELP loans and losses related to servicing of loans we own. Losses related to servicing are reported as a component of operating expenses. In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions and our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information and changes in economic conditions. We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio.

| For the years ended June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| Balance at beginning of period | $ | **8,514** | 6,998 |
| Provision for losses | | **(3,895)** | 2,487 |
| Charge-offs | | **(359)** | (971) |
| Balance at end of period | $ | **4,260** | 8,514 |

At June 30, 2002, we had commitments to purchase approximately $700 million of student loans.

### Note 7 – Capital assets

Capital asset activity for the year ended June 30, 2002 was as follows.

| (In thousands) | | Beginning Balance | Additions | Retirements | Ending Balance |
|---|---|---|---|---|---|
| Land | $ | 2,946 | - | - | 2,946 |
| Buildings | | 62,430 | 291 | (1) | 62,720 |
| Software development | | 39,459 | 7,515 | - | 46,974 |
| Purchased software | | 6,779 | 1,205 | (255) | 7,729 |
| Other, principally information technology equipment | | 24,754 | 1,842 | (3,724) | 22,872 |
| | | 136,368 | 10,853 | (3,980) | 143,241 |
| Less accumulated depreciation for: | | | | | |
| Buildings | | (19,500) | (2,475) | - | (21,975) |
| Software development | | (21,329) | (6,498) | - | (27,827) |
| Purchased software | | (2,363) | (1,362) | 67 | (3,658) |
| Other, principally information technology equipment | | (13,737) | (3,652) | 3,684 | (13,705) |
| | | (56,929) | (13,987) | 3,751 | (67,165) |
| | $ | 79,439 | (3,134) | (229) | 76,076 |

Capital asset activity for the year ended June 30, 2001 was as follows.

| (In thousands) | | Beginning Balance | Additions | Retirements | Ending Balance |
|---|---|---|---|---|---|
| Land | $ | 2,946 | - | - | 2,946 |
| Buildings | | 61,968 | 462 | - | 62,430 |
| Software development | | 31,457 | 8,002 | - | 39,459 |
| Purchased software | | 3,816 | 2,963 | - | 6,779 |
| Other, principally information technology equipment | | 22,369 | 4,489 | (2,104) | 24,754 |
| | | 122,556 | 15,916 | (2,104) | 136,368 |
| Less accumulated depreciation for: | | | | | |
| Buildings | | (17,063) | (2,437) | - | (19,500) |
| Software development | | (16,469) | (4,860) | - | (21,329) |
| Purchased software | | (1,441) | (922) | - | (2,363) |
| Other, principally information technology equipment | | (11,108) | (3,417) | 788 | (13,737) |
| | | (46,081) | (11,636) | 788 | (56,929) |
| | $ | 76,475 | 4,280 | (1,316) | 79,439 |

### Note 8 – Bonds payable and other financings

Activity for bonds payable and other financings for the year ended June 30, 2002 was as follows.

| (In thousands) | | Beginning Balance | Additions | Reductions | Ending Balance | Amounts Due within One Year |
|---|---|---|---|---|---|---|
| Student loan financings, due 2001-2007 at weighted average rates of 2.33% at June 30, 2002 and 5.25% at June 30, 2001 | $ | 735,785 | 193,974 | (159,800) | 769,959 | 147,049 |
| Student loan demand revenue bonds, due 2018-2040, at weighed average rates of 1.58% at June 30, 2002 and 3.23% at June 30, 2001 | | 1,711,000 | 350,000 | - | 2,061,000 | - |
| Student loan revenue bonds: | | | | | | |
| Student loan revenue bonds, due 2005-2026, at weighted average rates of 4.18% at June 30, 2002 and 6.71% at June 30, 2001 | | 537,925 | 312,925 | (312,925) | 537,925 | - |
| Deferred amount on current refundings of student loan revenue bonds | | - | (8,207) | 138 | (8,069) | - |
| | | 537,925 | 304,718 | (312,787) | 529,856 | - |
| Capital financings: | | | | | | |
| Capital financings, due 2001-2031, at weighted average rates of 5.36% at June 30, 2002 and 6.06% at June 30, 2001 | | 82,154 | 681 | (3,552) | 79,283 | 1,065 |
| Unamortized discount on capital acquisition bonds | | (421) | - | 14 | (407) | - |
| | | 81,733 | 681 | (3,538) | 78,876 | 1,065 |
| Other financings: | | | | | | |
| Term financings, due 2002-2003, at weighted average rates of 5.26% at June 30, 2002 and 5.93% at June 30, 2001 | | 19,773 | 76,501 | (4,448) | 91,826 | 6,309 |
| Unamortized discount on capital acquisition refunding bonds | | - | (647) | 17 | (630) | - |
| Lines of credit, due on demand, at weighted average rates of 3.91% at June 30, 2002 and 6.50% at June 30, 2001 | | 20,000 | 10,000 | - | 30,000 | 30,000 |
| | | 39,773 | 85,854 | (4,431) | 121,196 | 36,309 |
| Obligation under capital lease | | 50,830 | - | (1,200) | 49,630 | 49,630 |
| | $ | 3,157,046 | 935,227 | (481,756) | 3,610,517 | 234,053 |

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.

Student loans and investments collateralize all student loan financings, student loan demand revenue bonds and student loan revenue bonds. At June 30, 2002, $3.2 billion of student loan principal and related interest receivable and $327 million of investments and related interest receivable collateralized the $3.4 billion of notes and bonds payable.

The student loan demand bonds are subject to purchase, at par plus accrued interest, by the Agency on demand of the holder upon seven days prior irrevocable written notice. 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 2002 through 2010, and the Agency is required to pay annual commitment fees ranging from 15 to 33 basis points on the stated amount of the letter of credit coverage. At June 30, 2002, total letter of credit coverage was $1.3 billion.

Capital financings are collateralized with capital assets. Amounts due under the other lines of credit are generally unsecured.

At June 30, 2002, the Agency had $50 million of available credit under student loan financing arrangements, and $16 million was available under other lines of credit.

The following tables display the debt service requirements based upon the stated maturities for demand bonds and current interest rates for variable-rate debt.

| (In thousands) | | Student Loan Bonds and Financings | | Capital and Other Financings and Obligation Under Capital Lease | |
|---|---|---|---|---|---|
| Year of Maturity | | Principal | Interest | Principal | Interest |
| 2003 | $ | 147,049 | 71,402 | 87,004 | 12,386 |
| 2004 | | - | 70,665 | 9,304 | 8,616 |
| 2005 | | 587,910 | 56,672 | 9,467 | 8,037 |
| 2006 | | - | 56,672 | 5,697 | 7,577 |
| 2007 | | 35,000 | 56,510 | 3,652 | 7,291 |
| 2008-2012 | | - | 278,528 | 74,970 | 28,599 |
| 2013-2017 | | 142,925 | 276,540 | 11,120 | 13,626 |
| 2018-2022 | | 546,000 | 220,843 | 13,970 | 10,669 |
| 2023-2027 | | 545,000 | 151,306 | 17,820 | 6,710 |
| 2028-2032 | | 425,000 | 101,215 | 17,735 | 1,790 |
| 2033-2037 | | - | 89,089 | - | - |
| 2038-2042 | | 940,000 | 65,559 | - | - |
| | $ | 3,368,884 | 1,495,001 | 250,739 | 105,301 |

$2.8 billion of the student loan bonds and financings are variable-rate debt. $971 million of the variable-rate debt resets based upon auctions every 7 days. $940.1 million resets based upon auctions every 28 days. $150 million resets based upon auctions every 35 days. $622.9 million is indexed to 91-day Treasury bills and the remaining $147 million is indexed to the 3-month LIBOR.

During 2002, PHEAA issued $312.9 million in student loan revenue bonds at a weighted-average interest rate of 2.64% to current refund $312.9 million of outstanding student loan revenue bonds with a weighted-average interest rate of 7.10%. The current refunding bonds are fixed rate bonds with a mandatory tender on July 1, 2003. At that date, the bonds will be remarketed. We expect to reduce interest payments over the next year by $13.9 million because of the refundings. The current refundings resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $8.2 million. This difference, reported in the accompanying statements of net assets as a deduction from student loan revenue bonds payable, is being charged to student loan financings and bonds payable interest expense ratably over the life of the student loan revenue bonds.

At June 30, 2002, PHEAA had not yet issued $2.3 billion of debt that the Board of Directors has authorized. Since June 30, 2002, PHEAA has issued $310 million of student loan demand revenue bonds. $150 million of the amount issued since June 30, 2002 refunded existing student loan revenue bonds.

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.

Activity for bonds payable and other financings for the year ended June 30, 2001 was as follows.

| (In thousands) | | Beginning Balance | Additions | Reductions | Ending Balance |
|---|---|---|---|---|---|
| Student loan financings | $ | 765,703 | 129,568 | (159,486) | 735,785 |
| Student loan demand revenue bonds | | 1,046,000 | 665,000 | - | 1,711,000 |
| Student loan revenue bonds | | 834,405 | - | (296,480) | 537,925 |
| Capital financings | | 81,173 | 4,762 | (3,781) | 82,154 |
| Unamortized discount on capital acquisition bonds | | (434) | - | 13 | (421) |
| | | 80,739 | 4,762 | (3,768) | 81,733 |
| Other financings: | | | | | |
| Term financings | | 13,754 | 10,185 | (4,166) | 19,773 |
| Lines of credit | | 34,698 | 20,000 | (34,698) | 20,000 |
| | | 48,452 | 30,185 | (38,864) | 39,773 |
| Obligation under capital lease | | 51,930 | - | (1,100) | 50,830 |
| | $ | 2,827,229 | 829,515 | (499,698) | 3,157,046 |

**Note 9 – Leases**

PHEAA's headquarters building is currently financed under a capital lease. As part of the transaction, the Harrisburg Authority issued bonds payable of approximately $52.2 million and entered an agreement with a third party providing for the lease of the building. The third party has, in turn, entered 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 the lease payments and deposited the funds with a trustee. Amounts on deposit with the trustee include $1.3 million invested in the bonds of the Harrisburg Authority described above and $1.2 million invested in a guaranteed investment contract. These funds are included in the caption investments in the Federal Fund, 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 $22 million. Amortization of assets held under capital leases is included with depreciation expense.

PHEAA also leases information technology and other equipment under operating leases expiring during the next three years. In most cases, we expect the leases to be renewed or replaced by other leases in the normal course of business. Total expense for all operating leases was $4.1 million in 2002 and $3.6 million in 2001.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) and future minimum capital lease payments at June 30, 2002 are:

| Year ending June 30 (in thousands) | Capital Leases | Operating leases |
|---|---|---|
| 2003 | $ 51,554 | 4,583 |
| 2004 | - | 3,894 |
| 2005 | - | 806 |
| 2006 | - | 10 |
| Total minimum lease payments | 51,554 | $ 9,293 |
| Less amount representing interest (at 9.9%) | (1,924) | |
| Obligation under capital lease | $ 49,630 | |

**Note 10 – Retirement and other postemployment benefits**

*Retirement Plan*

Plan Description

PHEAA contributes to the Commonwealth of Pennsylvania State Employes' Retirement System (SERS), 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, SERS issues an audited financial report that includes financial statements and required supplementary information. Audited financial statements for all Commonwealth component units are available from the individual organizations. Interested parties should write the 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 to the plan. For most members the contribution rate is 6.25% of annual covered salary. As an employer, PHEAA is required to contribute at an actuarially determined rate. During the year ended June 30, 2002, the required employer contribution rate was 0%. The contribution requirement of members is established by law 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 were $20 thousand for the year ended June 30, 2002; $319 thousand for the year ended June 30, 2001; and $1.9 million for the year ended June 30, 2000. These contributions were 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 through negotiated union contracts and administrative policy. These benefits are administered by 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. These costs amounted to $6.3 million for the year ended June 30, 2002; $4.7 million for the year ended June 30, 2001; and $3.9 million for the year ended June 30, 2000.

**Note 11 – Servicing fees**

The Agency has contracts with customers to provide servicing of student loans as well as computer equipment and programming services. At June 30, 2002, the Agency was servicing approximately $14.3 billion of loans for customers. An additional $7.9 billion of loans were serviced by customers using the Agency's computer services. Other FFELP guarantors were managing $1.8 billion of guarantees using the Agency's computer services.

The Agency's servicing agreements, some of which expire in 2003, have contractual terms at inception ranging from three years to life of loan. Under the Agency's servicing agreements, PHEAA 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 is recorded as a component of operating expenses in the financial statements.

Four loan-servicing customers provided $32.5 million of servicing fees for the year ended June 30, 2002. No other individual customer provided servicing revenues more than 5% of total servicing fees.

## Note 12 – Segment information

PHEAA generally finances student loan portfolios by issuing 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.

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

| For the years ended June 30 (in thousands) | | 2002 | 2001 |
|---|---|---|---|
| Interest revenue | $ | **200,712** | 231,631 |
| Interest expense | | **105,870** | 166,180 |
| Net interest revenue | | **94,842** | 65,451 |
| Noninterest revenue | | **1,459** | 5,724 |
| Total operating revenues | | **96,301** | 71,175 |
| Operating expenses | | **33,122** | 31,716 |
| Operating income | | **63,179** | 39,459 |
| Grants and other financial aid | | **8,702** | 4,681 |
| Net income | | **54,477** | 34,778 |
| Transfers | | **(24,941)** | (16,165) |
| Change in net assets | | **29,536** | 18,613 |
| Net assets, beginning of period | | **158,682** | 140,069 |
| Net assets, end of period | $ | **188,218** | 158,682 |

*Statements of net assets*

| At June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Investments | $ | **326,981** | 466,215 |
| Student loans receivable | | **3,137,977** | 2,599,589 |
| Other, principally interest income receivable | | **106,516** | 106,894 |
| Total assets | | **3,571,474** | 3,172,698 |
| Student loan financings | | **769,959** | 735,785 |
| Student loan demand revenue bonds | | **2,061,000** | 1,711,000 |
| Student loan revenue bonds | | **529,856** | 537,925 |
| Other, principally accrued interest payable | | **22,441** | 29,306 |
| Total liabilities | | **3,383,256** | 3,014,016 |
| Net assets, restricted for debt service | $ | **188,218** | 158,682 |

*Statements of cash flows*

| For the years ended June 30 (in thousands) | | **2002** | 2001 |
|---|---|---|---|
| Interest received on student loans | $ | **186,029** | 198,836 |
| Principal received on student loans | | **464,304** | 415,385 |
| Student loan originations | | **(547,384)** | (629,029) |
| Student loan purchases | | **(706,227)** | (425,513) |
| Student loan sales | | **251,125** | 379,163 |
| Interest received on investments | | **17,841** | 23,600 |
| Interest paid on noncapital debt | | **(111,996)** | (168,244) |
| Payment of operating expenses | | **(32,085)** | (28,887) |
| Net cash used for operations | | **(478,393)** | (234,689) |
| Proceeds from issuance of noncapital debt | | **848,692** | 808,267 |
| Principal paid on noncapital debt | | **(472,725)** | (469,665) |
| Other | | **(35,011)** | (27,353) |
| Net cash provided by noncapital financing activities | | **340,956** | 311,249 |
| Proceeds from sales and maturities of investments | | **9,323,832** | 4,538,727 |
| Purchases of investments | | **(9,184,598)** | (4,612,597) |
| Net cash provided by (used for) investing activities | | **139,234** | (73,870) |
| Net change in cash and cash equivalents | | **1,797** | 2,690 |
| Cash and cash equivalents, beginning of period | | **6,276** | 3,586 |
| Cash and cash equivalents, end of period | $ | **8,073** | 6,276 |

### Note 13 – Restrictions on net assets

As reported on the statements of net assets, there are significant restrictions on PHEAA's net assets. Additionally, the Higher Education Amendments of 1998 restrict PHEAA's use of net assets related to FFELP guaranty activities to fulfilling its guaranty responsibilities and other student financial aid related activities selected by the Agency. However, because the Agency's purpose under Commonwealth law is to increase higher education opportunities for Pennsylvania residents, PHEAA considers such net assets to be unrestricted.

When interpreting the unrestricted deficit it is important to understand that under various indentures related to financing PHEAA's student loan portfolios, we are required to maintain a "parity ratio," a ratio of assets to liabilities, ranging from 1.0 to 1.07. The $188.2 million of accumulated net assets related to these portfolios is reported as restricted for debt service in the statement of net assets; however, at June 30, 2002, $113.4 million is more than is required and could be made available to offset the unrestricted deficit. To receive the funds, PHEAA must satisfy the bond insurer or the provider of the financing that the withdrawal will not impair the ability of PHEAA to meet debt service requirements and maintain the required parity ratio on the underlying financing.

### Note 14 – Risk management and contingencies

PHEAA is exposed to various risks of loss, such as theft, damage to and destruction of assets, etc. To handle those risks, we participate in the Commonwealth's self-insurance program and there have been no material claims.

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 ED or other federal audit officials to perform, or contract for, audits and evaluations of federal financial assistance programs. Therefore, the Agency's operations in current and prior years are subject to audit. We believe PHEAA is in substantial compliance with applicable federal regulations and that any adjustment because of future audits will not be material.

The Agency is 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.