



Annual Financial Report
June 30, 2006 and 2005

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

We are a public corporation and government instrumentality created by the Pennsylvania General Assembly and our mission is to improve higher education opportunities for Pennsylvanians. Doing business as American Education Services, we provide financial aid services serving students, families, schools, lenders, and other student financial aid providers. To fulfill our mission we distribute grants; originate, purchase, and sell student loans; administer the guaranteed student loan program on behalf of the federal government; service student loans; and provide information technology services. To serve Pennsylvanians effectively, we operate both inside and outside Pennsylvania.

Instead of using taxpayer money to support our administration, we manage our business activities to deliver financial aid as well as to provide additional public service benefits.

The following table highlights the public service benefits provided through our programs.

For the years ended June 30 (in thousands)	2006	2005
<u>Self-funded</u>		
Origination fees paid on behalf of borrowers	\$ 31,852	31,048
Guarantee fees waived and paid on behalf of borrowers	31,749	29,040
State Grant Program supplement	25,000	-
Workforce Advancement Grant for Education	9,784	-
Armed Forces Loan Forgiveness Program	3,512	3,876
Academic Excellence Scholarship	2,286	1,143
Hurricane Katrina Emergency Grant Assistance	725	-
Costs of operating state and federal governmental programs	19,512	17,002
Funding and support of The Pennsylvania Higher Education Foundation, Inc.	23,455	2,950
Other public service activities and outreach	13,286	12,382
	161,161	97,441
<u>Financial support funded by our business partners</u>		
Origination fees paid on behalf of borrowers	31,630	28,337
	\$ 192,791	125,778

Under the Keystone family of loan programs, we provide a Keystone Stafford loan for Pennsylvania students with family incomes of less than \$21,000. We pay all three of the federally required origination points and pay the 1% guarantee fee for these students. Additionally we provide a 2% interest rate reduction after 36 consecutive on-time payments.

We also provide a KeystoneBEST loan for other students. For these loans, we also pay all three of the federally required origination points and pay the 1% guarantee fee. We provide a 2% interest rate reduction after 48 consecutive on-time payments.

We supplement the State Grant Program as part of our Grants and Infrastructure for Tomorrow's Students initiative to help meet the needs of Pennsylvanians seeking higher education opportunities. Through the Workforce Advancement Grant for Education program, we provide grants to participating postsecondary institutions to assist Pennsylvania adult students who have demonstrated financial need and are ineligible for a State Grant.

Through the Armed Forces Loan Forgiveness program, we forgive up to \$2,500 of student loan principal to borrowers who served in the armed forces in an active duty status since September 11, 2001.

We have also developed other programs including:

- Academic Excellence Scholarship Award program through which we provide grants of \$1,500 for Pennsylvanians who have both high academic potential and demonstrated financial need.
- Hurricane Katrina Emergency Grant Assistance program through which we provide grants up to \$2,500 for students affected by Hurricane Katrina.
- Nursing Loan Forgiveness for Healthier Futures program through which we forgive up to \$12,500 or 25% of eligible student loan principal over three years of qualifying employment at a participating Pennsylvania healthcare facility or participating Pennsylvania postsecondary educational institution.
- Quality Early Education Loan Forgiveness program through which we forgive up to \$3,300 per year of eligible student loan principal for up to three years for qualified childcare employees.

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 Matching Funds program provides financial assistance to higher education institutions to assist them in capturing federal funds that require a state or local match as part of the federal grant award.
- The New Economy Technology Scholarship Program provides financial assistance grants up to \$3,000 to students enrolled in a postsecondary science or technology program approved by the Pennsylvania Department of Education.

We support The Pennsylvania Higher Education Foundation, Inc., ("PHEF") which is a tax-exempt organization that supports postsecondary education. PHEF created the Nursing Education Grant Program and disbursed \$12.9 million of grants during its most recent fiscal year.

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

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.

Our 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 not part of FFELP. FFELP is the federal program that allows undergraduate or graduate students at eligible postsecondary schools to obtain low-cost loans.

Currently, there are four types of FFELP loans:

- Subsidized Stafford – the federal government pays the interest on these loans while the student is in school, during the grace period, and during deferments.

- Unsubsidized Stafford – the student is responsible for all interest.
- Parent Loan for Undergraduate Students (“PLUS”) – supplemental loans to parents. Beginning July 1, 2006, graduate and professional students will be eligible for PLUS loans certified after June 30, 2006.
- 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 that we account for as interest income. 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. For the year ended June 30, 2006, special allowance payments were \$239.8 million compared to \$183.6 million in 2005.

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 provided an overall minimum return of 9.5% on those loans, which was 2.8% above the average return earned on other student loans during the year ended June 30, 2006 and 4.8% above the average return earned on other student loans during the year ended June 30, 2005. Such loans averaged \$1.6 billion during the year and amounted to \$1.4 billion at June 30, 2006 and \$1.8 billion at June 30, 2005. Effective February 8, 2006, The Deficit Reduction Act of 2005 prohibited the recycling of tax-exempt funds issued before October 1, 1993 into new loans earning the 9.5% minimum return.

FFELP regulations required up-front origination fees of 3% to be deducted from the proceeds of student loans and remitted to the federal government. These fees reduce to 2% effective July 1, 2006 and reduce by an additional 50 basis points every year until they are 0% effective July 1, 2010. We currently pay all of the up-front fees for loans originated by us. For loans serviced by us for other lenders, we pay one of the 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. The federal government also pays us portfolio maintenance fees for managing the outstanding portfolio of guaranteed loans.

Our major function as a guarantor is to use the Federal Fund 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 the loan was disbursed as follows:

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

Our default rate has always been at a level that allowed us to receive the maximum reinsurance rate. In the past, we were permitted to charge a guarantee fee of up to 1% when we guarantee a loan; however, we had not charged a fee in recent years. If we had charged a fee, the proceeds would have gone into the Federal Fund. During the year ended June 30, 2006, we began depositing the fee into the Federal Fund even though we were not assessing it to borrowers. We accounted for the fee we paid on behalf of borrowers in grants and other financial aid. Beginning July 1, 2006,

guarantors are required to deposit a 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans are disbursed. Guarantors are not required to assess the fee to borrowers.

After a loan defaults, we continue to try to collect the amounts and are allowed to retain up to 23% 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 also originate and purchase student loans related to 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 U.S. Treasury Bill plus a spread of up to 3%. 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 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, changes in law and regulations, and the adoption of new accounting standards. These forward-looking statements are based on assumptions that involve risks and uncertainties and that are subject to change based on various important factors (some of which are beyond our control). Actual results may differ materially from those expressed or implied as a result of these risks and uncertainties, including, but not limited to, interest rate fluctuations; changes in political and economic conditions; competitive product and pricing pressures within our markets; market fluctuations; the effects of adopting new accounting standards; inflation; technological change; changes in law; changes in fiscal, monetary, regulatory, and tax policies and laws; success in gaining regulatory approvals when required; success in the timely development of new products and services; as well as other risks and uncertainties. Such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Description of the Basic Financial Statements

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

The statements of net assets include recorded assets and liabilities. Assets are what we own or control, and liabilities are what we owe. Net assets are what are left over after assets are used to satisfy liabilities.

The statements of cash flows supplement these statements providing relevant information about cash receipts and payments.

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

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 encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989 to be consistent with the accounting practices of the Commonwealth.

Condensed Financial Information

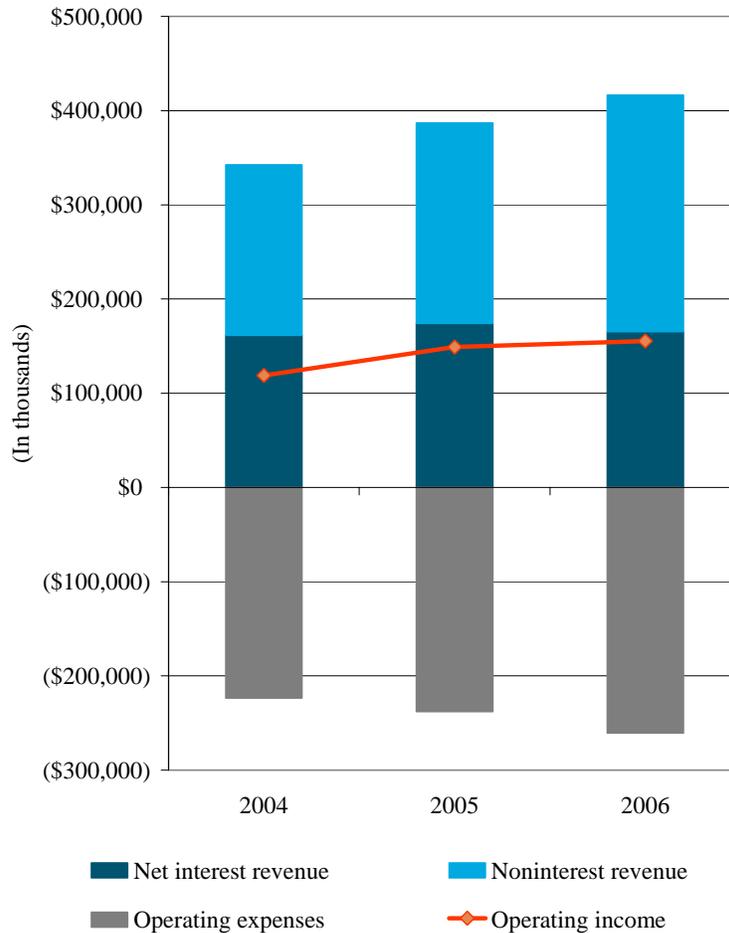
Statements of Revenues, Expenses, and Changes in Net Assets

For the years ended June 30 (in thousands)	2006	2005
Student loan interest revenue	\$ 431,844	296,270
Investment interest revenue	35,126	20,379
Interest expense on student loan financings and bonds payable	(291,751)	(134,231)
Interest expense on capital and other financings	(8,312)	(9,652)
Net interest revenue	166,907	172,766
Reduction in allowance (provision for loan losses)	(1,561)	1,449
Net interest revenue after provision for loan losses	165,346	174,215
Servicing fees	108,355	87,426
Retention of collections on defaulted loans	68,818	63,350
Federal fees	55,631	42,623
Default aversion fees, net	17,574	9,839
Gains on student loan sales including securitizations, net	259	8,964
Other	397	485
Total noninterest revenue	251,034	212,687
Operating revenues	416,380	386,902
Operating expenses	(260,854)	(237,940)
Operating income	155,526	148,962
Commonwealth of Pennsylvania grants	429,250	420,177
Federal grants	8,811	11,124
Grants and other financial aid	(555,187)	(459,284)
Transfer of undisbursed program funds to the Commonwealth of Pennsylvania	(2,237)	-
Transfer of undisbursed program funds to the U.S. Department of Education	(281)	-
Contributions to Pennsylvania Higher Education Foundation	(23,455)	(2,950)
Changes in net assets	\$ 12,427	118,029

Statements of Net Assets

At June 30 (in thousands)	2006	2005
Student loans receivable, net	\$ 9,095,114	5,652,428
Cash, cash equivalents, and investments, substantially restricted	476,581	430,354
Interest income receivable	187,676	115,254
Capital assets, net	76,130	75,460
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	103,283	82,597
Other	127,933	61,536
Total assets	10,066,717	6,417,629
Notes and bonds payable, net	9,189,553	5,698,923
Amounts related to the Federal Student Loan Reserve Fund	103,283	82,597
Other	275,654	150,309
Total liabilities	9,568,490	5,931,829
Net assets		
Invested in capital assets, net of related debt	8,589	5,633
Restricted for debt service	357,628	335,441
Restricted for financial aid grant programs	55,711	75,886
Restricted for default aversion activities	2,326	4,114
Unrestricted	73,973	64,726
Total net assets	\$ 498,227	485,800

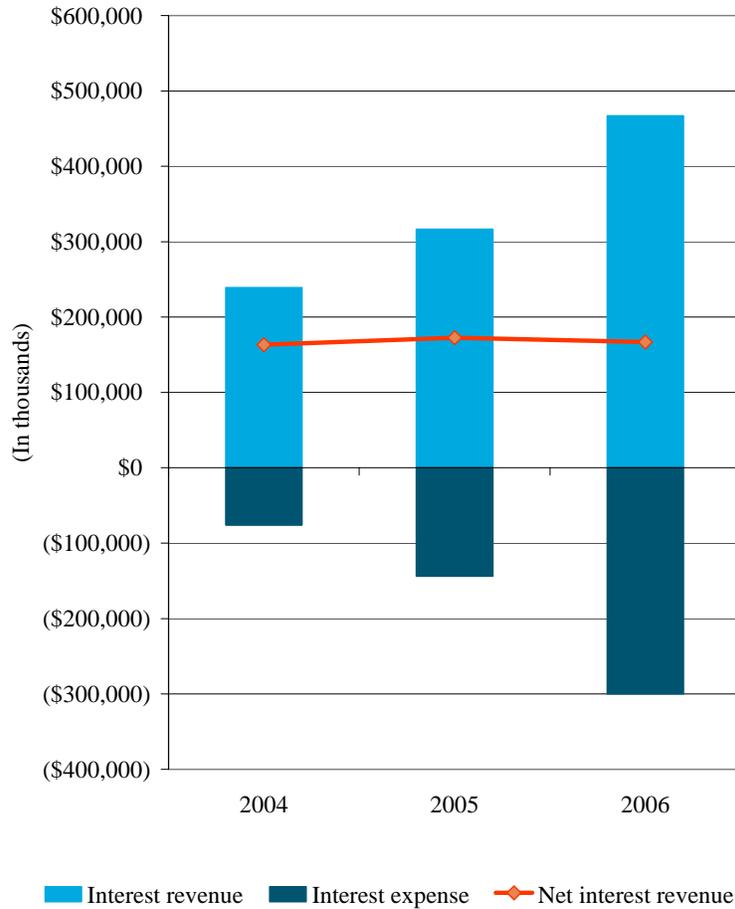
Results of Operations



Operating income for the year ended June 30, 2006 was \$155.5 million, a 4.4% increase from \$149.0 million in 2005. Operating revenues increased 7.6% from \$386.9 million in 2005 to \$416.4 million in 2006. Net interest revenue after provision for loan losses decreased 5.1% from \$174.2 million in 2005 to \$165.3 million in 2006 principally due to changes in interest rates. Noninterest revenue increased 18.0% from \$212.7 million in 2005 to \$251.0 million in 2006 due to increased servicing volume and increased guaranty volume. Operating expenses increased 9.7% from \$237.9 million in 2005 to \$260.9 million in 2006 due primarily to increases in personnel and benefit costs.

A more detailed explanation of these items follows.

Net Interest Revenue



Net interest revenue is created largely from our portfolio of student loans although we have investments and debt that are not related to student loans. For the year ended June 30, 2006, net interest revenue was \$166.9 million, a 3.4% decrease from \$172.8 million in 2005. The changes in net interest margin are 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)	2006		2005	
	Balances	Rate	Balances	Rate
Average interest earning assets				
Student loans receivable, net	\$ 6,837,685	6.32%	5,155,628	5.75%
Investments	801,597	4.38%	703,360	2.90%
	<u>\$ 7,639,282</u>	<u>6.11%</u>	<u>5,858,988</u>	<u>5.40%</u>
Average interest bearing liabilities				
Student loan financings and bonds payable	\$ 6,885,767	4.24%	5,258,134	2.55%
Other debt	151,618	5.48%	181,073	5.33%
	<u>\$ 7,037,385</u>	<u>4.26%</u>	<u>5,439,207</u>	<u>2.65%</u>
Net interest margin		<u>1.85%</u>		<u>2.75%</u>

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

For the years ended June 30	2006	2005
Student loan yields	7.25%	6.52%
Consolidation loan rebate fees	(0.49)	(0.27)
Lender origination fees	(0.07)	(0.06)
Premium amortization	(0.37)	(0.44)
Student loan revenue	<u>6.32</u>	<u>5.75</u>
Cost of funds	<u>4.24</u>	<u>2.55</u>
Net interest margin on student loans	<u>2.08%</u>	<u>3.20%</u>

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
2006 vs. 2005			
Student loan interest revenue	\$ 135,574	38,914	96,660
Investment interest revenue	14,747	11,901	2,846
	<u>150,321</u>	<u>50,815</u>	<u>99,506</u>
Student loan financings and bonds payable interest expense	157,520	115,969	41,551
Capital and other financings interest expense	(1,340)	230	(1,570)
	<u>156,180</u>	<u>116,199</u>	<u>39,981</u>
	\$ (5,859)	(65,384)	59,525
2005 vs. 2004			
Student loan interest revenue	\$ 70,387	30,222	40,165
Investment interest revenue	7,081	1,562	5,519
	<u>77,468</u>	<u>31,784</u>	<u>45,684</u>
Student loan financings and bonds payable interest expense	68,079	55,809	12,270
Capital and other financings interest expense	(189)	382	(571)
	<u>67,890</u>	<u>56,191</u>	<u>11,699</u>
	\$ 9,578	(24,407)	33,985

While the amount that we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 29% of the variable-rate loans, including 9.5% floor loans, change based upon changes in the 91-day U.S. Treasury Bill rate, and 71% 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.

Average rates earned and paid by us can behave differently than market rates for the following 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, 2006, the average balance of these loans was \$1.6 billion, generating \$151.5 million of interest revenue. For the year ended June 30, 2005, the average balance was \$2.0 billion, generating \$187.0 million of interest revenue.

- We have HEAL loans that reset on a one-quarter lag, so the change in market rates is not immediately reflected in the rates we earn. For the year ended June 30, 2006, the average balance was \$297.4 million, while the average balance was \$239.3 million in 2005.
- Finally, interest rates paid on certain student loan financings generally are based upon the 91-day U.S. 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 we pay.

The balance of student loans increased because secondary market loan purchases increased 146.7% from \$1.5 billion in 2005 to \$3.7 billion in 2006. Loan originations also increased 11.9% from \$782.1 million in 2005 to \$874.9 million in 2006.

Provision for Loan Losses

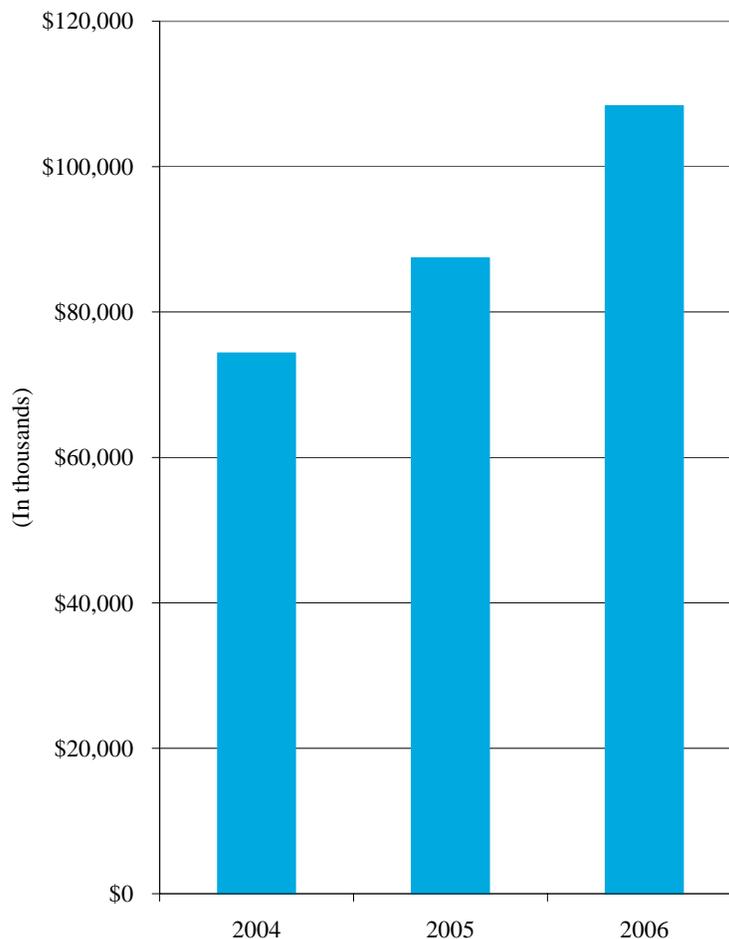
Under FFELP, 98% of principal and interest on student loans originated after October 1, 1993 is guaranteed. On December 1, 2004, we were designated as an Exceptional Performer by ED in recognition of meeting certain performance standards set by ED in servicing FFELP loans. Because of this designation, we received 100% reimbursement on all eligible FFELP default claims submitted for reimbursement before July 1, 2006 because we remained in compliance with the required standards, which are assessed annually and quarterly through compliance audits. Beginning July 1, 2006, the reimbursement for student loans serviced by servicers designated as Exceptional Performers decreased from 100% to 99% for all claims filed after June 30, 2006. The provision for loan losses for the year ended June 30, 2006 represents our estimate of the costs related to the 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 our allowance for loan losses is presented in the following table.

For the years ended June 30 (in thousands)	2006	2005
Balance at beginning of period	\$ -	2,370
Provision for losses (reduction in allowance)	1,561	(1,449)
Charge-offs	(1)	(921)
Balance at end of period	\$ 1,560	-
Allowance as a percentage of ending balance of student loans	0.02%	0.00%

Noninterest Revenue

Servicing Fees

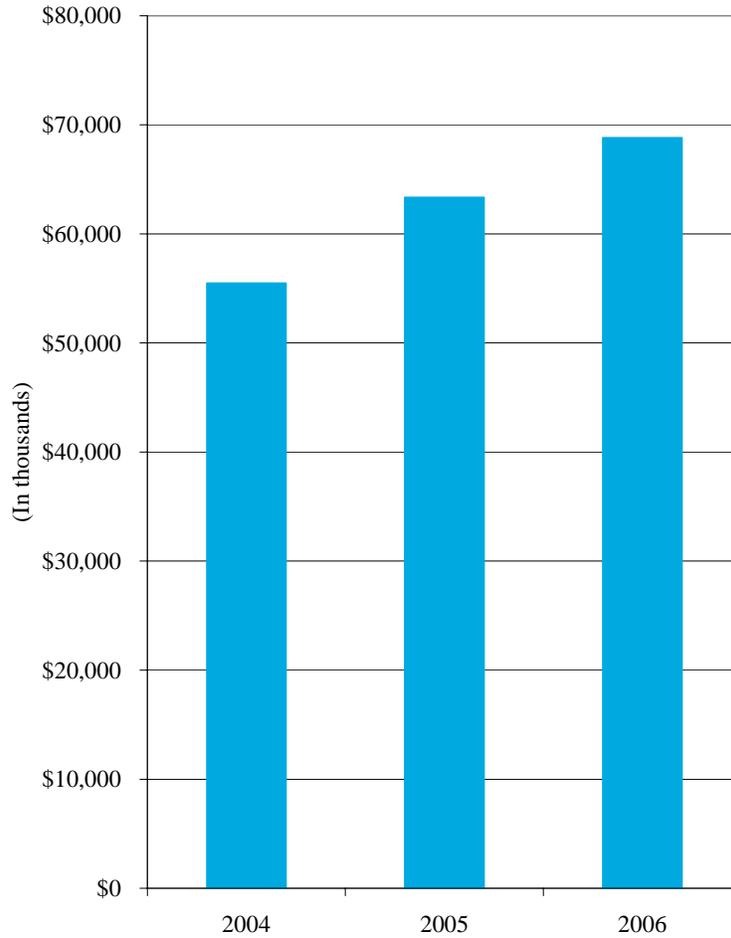


Servicing fees for the year ended June 30, 2006 were \$108.4 million, an increase of 24.0% from \$87.4 million in 2005. Fees increased due to increased volume of loans serviced. Loans serviced by us for participating financial institutions averaged \$32.3 billion in 2006 and \$24.1 billion in 2005.

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.

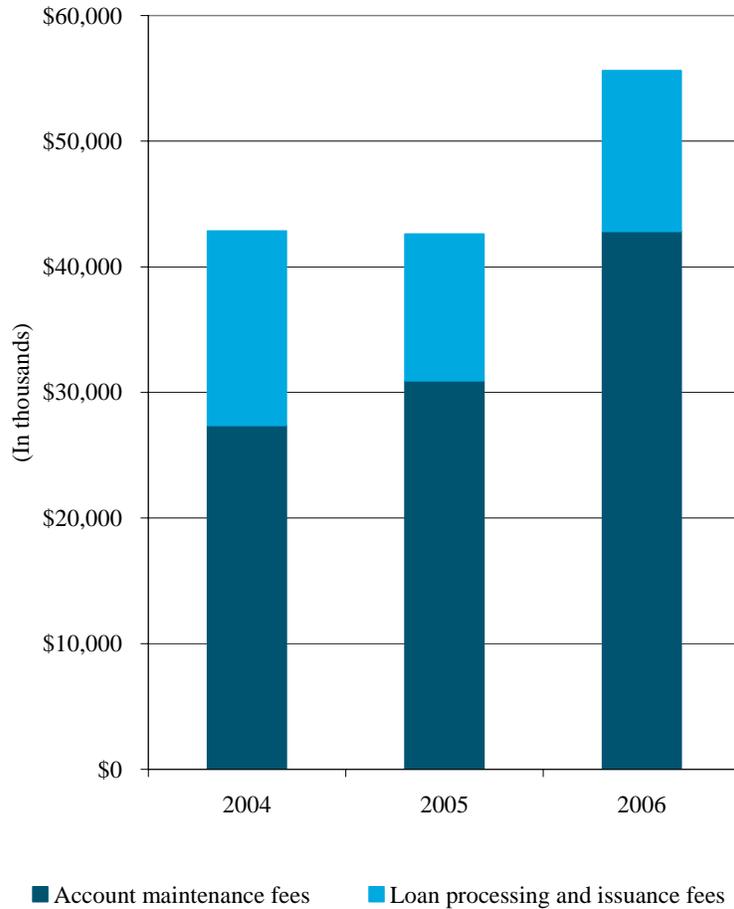
We also provide systems for other servicers and guarantors for a fee. For the year ended June 30, 2006, fees earned from servicing systems amounted to \$9.4 million, an increase of 16.0% from \$8.1 million in 2005. Loans serviced by other servicers using our systems averaged \$15.5 billion in 2006, an increase of 37.2% from \$11.3 billion in 2005. For the year ended June 30, 2006, fees earned from guaranty systems amounted to \$1.2 million, while they were \$1.1 million in 2005. Original principal amount outstanding for guarantors using our systems averaged \$3.4 billion in 2006 and \$2.4 billion in 2005. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

Retention of Collections on Defaulted Loans



For the year ended June 30, 2006, retention of collections on defaulted loans was \$68.8 million, an 8.5% increase from \$63.4 million in 2005. The increase is due to more aggressive pursuit of rehabilitations collections. Retention on rehabilitation collections was \$29.6 million in 2006 and \$23.7 million in 2005.

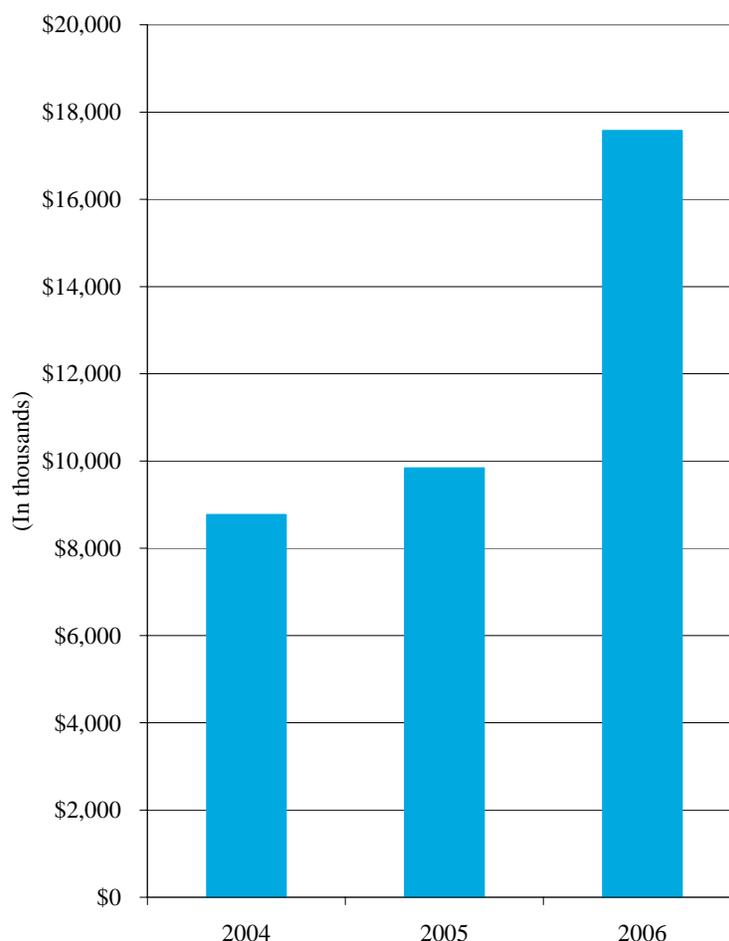
Federal Fees



Federal fees are earned for operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee that is 40 basis points for loans we guarantee as the loan is disbursed; however, the fee is not paid on new consolidation loans. ED also pays us an annual account maintenance fee that is 10 basis points of the original principal amount of loans guaranteed as long as the guarantee remains in force.

For the year ended June 30, 2006, federal fees were \$55.6 million, an increase of 30.5% from \$42.6 million in 2005. The increase occurred due to an increase in the balance of loans guaranteed from \$30.1 billion in 2005 to \$40.8 billion in 2006.

Default Aversion Fees



For the year ended June 30, 2006, default aversion fees were \$17.6 million, an increase of 79.6% from \$9.8 million in 2005. This increase is due to increased preclaim activity on consolidation loans consistent with increased borrower consolidations in prior periods.

This fee is earned when servicers involve guarantors to avert potential defaults and is paid from the Federal Fund. The fee may only be paid once for a loan and if the loan subsequently does default, the amount must be returned to the Federal Fund. We record an accrual for our estimate of such returns.

Gains on student loan sales including securitizations, net

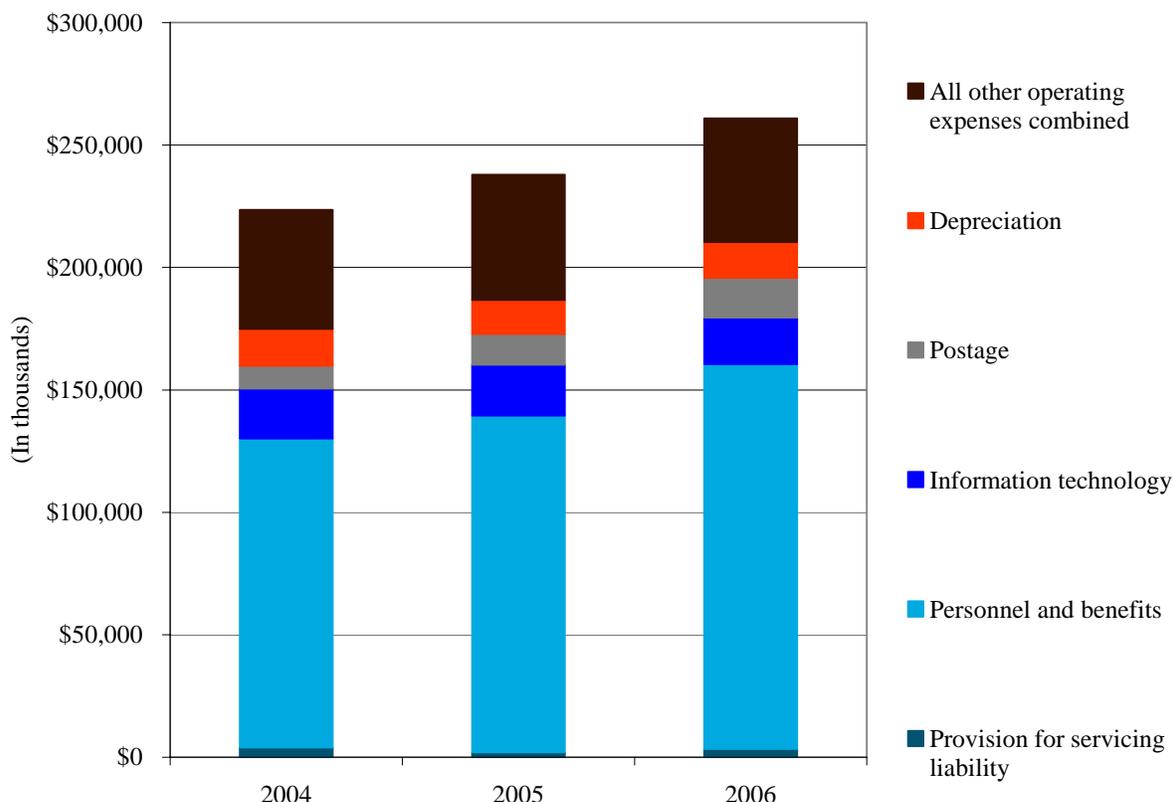
For the year ended June 30, 2006, net gains on student loan sales including securitizations were \$259 thousand, compared to \$9.0 million in 2005.

On April 14, 2005, we securitized \$382.6 million of student loans for a gain of \$6.7 million. On July 14, 2004, we securitized \$388.5 million of student loans for a gain of \$1.9 million. The gains reflect premium received less the write-off of unamortized loan origination costs and unamortized premium on purchased loans related to the loans sold.

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. A residual interest results from the securitization of student loans none of which has been recognized in

the financial statements. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us. This accounting treatment is different from securitization accounting treatment for businesses following FASB guidance, which involves estimating the net present value of expected future cash flows at the time of the securitization.

Operating Expenses



For the year ended June 30, 2006, operating expenses were \$260.9 million, an increase of 9.7% from \$237.9 million in 2005. The major reason for the increase is the increase in personnel and benefit costs. A more detailed discussion of costs follows.

Personnel and Benefits

For the year ended June 30, 2006, personnel and benefit costs were \$157.1 million, an increase of 14.3% from \$137.5 million in 2005. As a result of the increased volume of loans serviced, permanent staff positions increased 14.0% from 2,272 positions filled at June 30, 2005 to 2,589 at June 30, 2006. Included in these costs are healthcare benefits for employees and retirees. For the year ended June 30, 2006, healthcare benefits for employees and retirees were \$29.8 million, an increase of 19.2% from \$25.0 million in 2005.

Personnel costs totaling \$6.7 million in 2006 and \$7.1 million in 2005 related to software development and loan originations that were capitalized.

Permanent staff makes up 92.0% of the total personnel and benefits costs. For the year ended June 30, 2006, permanent staff costs were \$150.7 million, an increase of 19.5% from \$126.1 million in 2005.

For the year ended June 30, 2006, contract staff costs were \$149 thousand, compared to \$2.6 million in 2005.

The increase in permanent staff and the decrease in contract staff is due to a change in employment practices by management.

For the year ended June 30, 2006, independent contracting costs were \$12.9 million, an 18.9% decrease from \$15.9 million in 2005. We generally use independent contractors for specialized services, such as computer programming. Costs vary based upon changes in computer programming initiatives.

Our workforce is unionized. Contractual increases are negotiated and include periodic step increases of 2.2%. While not mandated, our management workers typically receive the same increases as union workers.

Federal Usage Fees

We were required to pay usage fees to the Federal Fund to cover the cost of using assets that were purchased or developed with federal funds. Our agreement with ED was to pay usage fees equal to depreciation expense on the related asset. During the year ended June 30, 2006, we purchased the remaining assets from the Federal Fund for \$4.3 million and we are no longer required to pay usage fees. The fees amounted to \$27 thousand in 2006 and \$3.2 million in 2005.

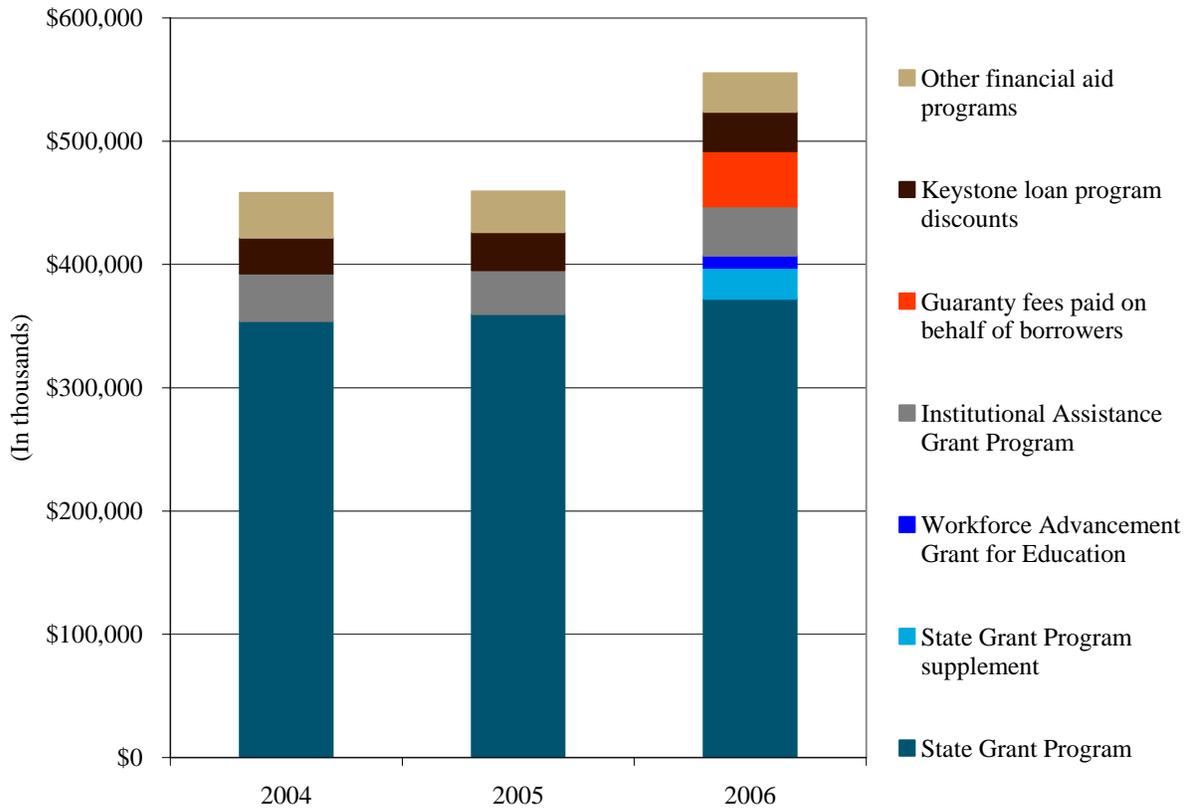
Provision for Servicing Liability

Not meeting ED regulations on servicing can result in losses on the portfolio of loans we own and on the portfolio being serviced for our customers. We make estimates of what the potential losses are based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions.

An analysis of our allowance for servicing losses is presented in the following table:

For the years ended June 30 (in thousands)	2006	2005
Balance at beginning of period	\$ 3,897	3,729
Provision for losses	3,394	1,938
Charge-offs	(851)	(1,770)
Balance at end of period	\$ 6,440	3,897
Allowance as a percentage of ending balance of student loans serviced	0.01%	0.01%

Financial Aid Activity



For the year ended June 30, 2006, grants and other financial aid were \$557.7 million, a 21.4% increase from \$459.3 million in 2005.

The following table displays financial aid awarded through our various programs.

For the years ended June 30 (in thousands)	2006	2005
Self-funded		
Guarantee fees paid on behalf of borrowers	\$ 44,757	-
Keystone loan program origination fees paid on behalf of borrowers	31,852	31,048
State Grant Program supplement	25,000	-
Workforce Advancement Grant for Education	9,784	-
Armed Forces Loan Forgiveness Program	3,512	3,876
Academic Excellence Scholarship	2,286	1,143
Hurricane Katrina Emergency Grant Assistance	725	-
Other	241	216
	118,157	36,283
State and federal funded		
State Grant Program	372,144	359,596
Institutional Assistance Grant Program	40,117	35,603
Matching Funds Program	14,094	15,242
New Economy Technology Scholarship Program	3,396	4,048
Other	7,279	8,512
	437,030	423,001
	\$ 555,187	459,284

Guarantee fees paid on behalf of the borrowers represent our payment of fees to the Federal Fund. Typically, the borrower is required to pay up to 1% of the amount borrowed to us when we guarantee a loan and the proceeds would go into the Federal Fund. For the loans we guarantee, we currently do not charge the fee. For the year ended June 30, 2006, we paid fees totaling \$44.8 million to the Federal Fund for loans guaranteed from October 1, 2004 through June 30, 2006. Guarantee fees related to activity for the year ended June 30, 2006 amounted to \$31.7 million; \$13.1 million of the amount paid related to activity for the period beginning October 1, 2004 through June 30, 2005.

Keystone loan program origination fees paid on behalf of borrowers represent our 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 loans we originate, we pay all three points. For loans we service for a participating financial institution, we pay one of the three points.

For the year ended June 30, 2006, Commonwealth of Pennsylvania grants were \$429.3 million, a 2.2% increase from \$420.2 million in 2005. For the year ended June 30, 2006, federal grants were \$8.8 million, a 20.7% decrease from \$11.1 million in 2005. Federal grants decreased due to the elimination of the Temporary Assistance for Needy Families program and a decrease in the Educational Training Vouchers program grants.

During the year ended June 30, 2006, we donated \$20.0 million and contributed \$3.5 million of services to PHEF. During the year ended June 30, 2005, we contributed \$3.0 million of services. The board of directors has authorized an additional non-contingent \$30 million of donations through June 30, 2009 as well as ongoing operational support. The authorization is not an obligation and none of this amount has been accrued.

Federal Student Loan Reserve Fund

Under current law, we are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees.

Historically, ED has calculated this ratio at September 30, which is the close of the federal fiscal year, and has excluded amounts payable to the U.S. Department of Education related to the recall of reserve funds from this published calculation. These amounts payable are due in two installments, one in September 2006, and one in September 2007.

The following table displays our calculation of the ratio.

At June 30 (in thousands)	2006	2005
Net assets	\$ 26,218	45,341
Adjustment for payable to U.S. Department of Education excluded from the calculation	<u>17,364</u>	<u>17,364</u>
Adjusted net assets	\$ <u>43,582</u>	<u>62,705</u>
Original principal outstanding	\$ <u>40,808,578</u>	<u>30,125,220</u>
	0.11%	0.21%

Based upon our calculation of the ratio, we believe we went below the required ratio during the quarter ended March 31, 2005. Under federal law, we will be required to submit a management plan to ED if we remain under the required level for two consecutive years, and that plan must demonstrate that we will reach the required level within 18 months of submitting the plan. At our request, officials at ED have met with us regarding this issue and we are preparing a plan to submit to ED.

During the year ended June 30, 2006, we took several steps to manage the fund in a manner to assure our customers that sufficient funds are available in the Federal Reserve Fund to continue to pay default claims.

We decided to fund the guaranty fee rather than waive the fee and retroactively funded the fee for guarantees made since October 1, 2004, which was the beginning of the federal fiscal year in which the fund went below the minimum.

In addition to paying default claims, the fund is also used to pay default aversion fees and our share of retention on defaulted loan collections. During the year ended June 30, 2006, we allowed this liability to us to increase.

Finally, PHEAA has a liability for default aversion fee rebate payable to the Federal Reserve Fund. This liability is not recorded as an asset of the fund because generally accepted accounting principles do not allow recognition of gain contingencies. We manage the fund recognizing that these rebates from PHEAA to the Federal Reserve Fund will likely occur over time.

The result of these actions and recognition of the gain contingency is that we are managing the fund above the statutory minimum as follows:

At June 30 (in thousands)	2006
Net assets	\$ 26,218
Adjustment for payable to U.S. Department of Education excluded from the calculation	17,364
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Reserve Fund	11,591
Amounts payable by the Federal Reserve Fund to PHEAA	<u>54,823</u>
Adjusted net assets	\$ <u>109,996</u>
Original principal outstanding	\$ <u>40,808,578</u>
	<u>0.27%</u>

For the year ended June 30, 2006, purchases of defaulted loans were \$494.1 million, an increase of 32.4% from \$373.3 million in 2005. This increase is due to increased defaults of consolidation loans consistent with increased borrower consolidations in prior periods.

Financial Position and Liquidity

Most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of \$74.0 million at June 30, 2006. Included in unrestricted net assets is \$54.8 million due from the Federal Reserve Fund that will likely be realized over the long term. The most substantial restriction on our net assets relates to restrictions for debt service, which amounted to \$357.6 million. Of that amount, \$353.4 million is related to our student loan bonds and financings, and \$62.3 million could be made available. Net assets restricted for financial aid grant programs amounted to \$55.7 million.

Description of Debt Activity and Significant Capital Assets

Our principal funding need is securing capital to fund student loan originations and purchases. We have a number of sources to raise this capital including access to bond markets and arrangements with banks and the State Treasury. Our ability to raise debt could be limited in the future because under our enabling legislation there is a formula that imposes a debt limit. The limit is \$19.1 billion at June 30, 2006. At June 30, 2006, our outstanding debt amounted to \$9.2 billion. The following table shows our debt activity.

For the years ended June 30 (in thousands)	2006	2005
<u>Capital market activity</u>		
Proceeds from issuing student loan demand revenue bonds	\$ 3,050,000	471,000
<u>Other financings</u>		
Net student loan financing activity	395,341	113,300
Net capital financing activity	(2,331)	(3,904)
Net other financing activity	46,749	(37,969)

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

At June 30 (in thousands)	2006	2005
Land	\$ 2,946	2,946
Buildings	41,791	40,026
Software development	16,103	19,283
Purchased software	7,927	5,802
Other, principally information technology equipment	7,363	7,403
	\$ 76,130	75,460

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. We capitalized \$3.6 million of software development in 2006 and \$7.1 million in 2005.

Interest Rate Risk Management

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

In the table on the next page, we categorize variable-rate assets and liabilities by reset date and fixed-rate assets and liabilities by their maturity dates. We adjust the interest rate sensitivity period for variable-rate debt to consider the effect of interest rate swaps. 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, we have \$245.2 million of student loans and \$417.7 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. During the year ending June 30, 2007, the 91-day U.S. Treasury Bill rate will have to reach 8.4% for the 9.5% floor loans to have an interest rate sensitivity period of 3 months or less.

In financing our student loan lending and secondary market operations with variable-rate debt, we increase the sensitivity of net interest margin to changing interest rates to the extent that the 9.5% floor loans have a sensitivity period of greater than 3 months.

The following gap analysis reflects rate-sensitive positions at June 30, 2006 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, 2006 (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	\$ 65,614	66,666	136,558	286,519	691,307	190,223
Other student loans	6,666,060	273,969	362,203	29,219	71,558	10,062
Total student loans	6,731,674	340,635	498,761	315,738	762,865	200,285
Restricted cash and cash equivalents	343,073	-	-	-	-	-
Other assets	135,949	20,451	12,094	9,899	14,302	29,165
Total assets	7,210,696	361,086	510,855	325,637	777,167	229,450
Liabilities						
Student loan bonds and financings						
	7,842,717	757,919	-	-	400,000	-
Other liabilities	50,905	8,097	568	387	907	-
Total liabilities	7,893,622	766,016	568	387	400,907	-
Net assets						
Restricted for debt service	\$ -	-	-	-	-	353,391
Period gap	\$ (682,926)	(404,930)	510,287	325,250	376,260	(123,941)
Cumulative gap	\$ (682,926)	(1,087,856)	(577,569)	(252,319)	123,941	-
Ratio of interest- sensitive assets to interest-sensitive liabilities and net assets	91.3%	47.1%	89939.3%	84143.9%	193.9%	64.9%
Ratio of cumulative gap to total assets	-7.3%	-11.6%	-6.1%	-2.7%	1.3%	0.0%

Because over the course of a year our 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 and 200 basis point parallel shift upward in interest rates and a 100 and 200 basis point parallel shift downward 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. 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.

(In thousands)	Movements in interest rates from June 30, 2006 rates			
	Increase		Decrease	
	+100 basis points	+200 basis points	-100 basis points	-200 basis points
Simulated increase (decrease) on net interest revenue over the next twelve months	\$ (9,047)	(19,790)	8,132	22,561

Description of Currently Known Facts, Decisions or Conditions Expected to have a Significant Effect on Net Assets or Results of Operations

Changes in short-term interest rates will affect future results of operations. As of the date of this report, rates on 91-day U.S. Treasury Bills have decreased 0.44% and rates on 3-month commercial paper have decreased 0.13% from rates at June 30, 2006. The potential impact of changes in short-term interest rates was discussed in the interest rate risk management section.

In June 2003, the board of directors authorized the development of programs to deliver an additional \$25 million of financial aid. As these programs are developed and implemented, net assets will be used to fund the financial aid. Through June 30, 2006, we have provided \$15.2 million of benefits through the Armed Forces Loan Forgiveness Program and \$3.4 million of Academic Excellence Scholarships related to this authorization.

In March 2005, the board of directors adopted a resolution directing that beginning July 1, 2005, an amount up to \$55 million be used to supplement the State Grant Program as part of its Grants and Infrastructure for Tomorrow's Students Initiative. The supplement is to increase \$7.5 million annually for years beginning July 1, 2006 through July 1, 2009 barring an unforeseen economic or regulatory change. These amounts will be used to help meet the needs of Pennsylvanians seeking higher education opportunities and to assist in the implementation of the recommendations of the State Grant Task Force. Through June 30, 2006, we have supplemented the State Grant Program by \$25 million and provided \$9.8 million through the Workforce Advancement Grant for Education program related to this initiative.

On September 14, 2005, the board of directors created a \$2 million Hurricane Katrina Emergency Grant Assistance Initiative for students and families affected by Hurricane Katrina. Through June 30, 2006, we have provided \$725 thousand of grants related to this initiative.

On August 3, 2006, we issued \$225 million of tax-exempt variable-rate student loan demand revenue bonds that reset based upon auctions every 7 days with an initial rate of 3.52%.

On August 10, 2006, we issued \$500 million of taxable variable-rate student loan demand revenue bonds indexed to the 3-month LIBOR with an initial weighted average rate of 5.57%.

Contacting Us

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

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September 21, 2006



KPMG LLP
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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, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of PHEAA's internal control over financial reporting. Accordingly, we express no such opinion. 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, 2006 and 2005, and its changes in net assets and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

The Management's Discussion and Analysis on pages 2 through 25 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquires 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.

KPMG LLP

September 21, 2006

Statements of Revenues, Expenses, and Changes in Net Assets
For the years ended June 30, 2006 and 2005 (in thousands)



	2006	2005
<u>Interest revenue</u>		
Student loans	\$ 431,844	296,270
Investments	35,126	20,379
Total interest revenue	466,970	316,649
<u>Interest expense</u>		
Student loan financings and bonds payable	291,751	134,231
Capital and other financings	8,312	9,652
Total interest expense	300,063	143,883
Net interest revenue	166,907	172,766
Reduction in allowance (provision for loan losses)	(1,561)	1,449
Net interest revenue after provision for loan losses	165,346	174,215
<u>Noninterest revenue</u>		
Servicing fees	108,355	87,426
Retention of collections on defaulted loans	68,818	63,350
Federal fees	55,631	42,623
Default aversion fees, net	17,574	9,839
Gains on student loan sales including securitizations, net	259	8,964
Other	397	485
Total noninterest revenue	251,034	212,687
Operating revenues	416,380	386,902
<u>Operating expenses</u>		
Personnel	157,052	137,480
Information technology related expenses	19,004	20,875
Postage	16,305	12,480
Depreciation	14,632	13,945
Other	53,861	53,160
Total operating expenses	260,854	237,940
Operating income	155,526	148,962
Commonwealth of Pennsylvania grants	429,250	420,177
Federal grants	8,811	11,124
Grants and other financial aid	(555,187)	(459,284)
Transfer of undisbursed program funds to the Commonwealth of Pennsylvania	(2,237)	-
Transfer of undisbursed program funds to the U.S. Department of Education	(281)	-
Contributions to Pennsylvania Higher Education Foundation	(23,455)	(2,950)
Changes in net assets	12,427	118,029
Net assets, beginning of period	485,800	367,771
Net assets, end of period	\$ 498,227	485,800

See accompanying notes to financial statements.

	2006	2005
<u>Assets</u>		
Restricted cash and cash equivalents	\$ 274,292	250,128
Restricted cash and cash equivalents – due to customers	101,464	43,297
Investments	28,372	61,079
Restricted investments	72,453	75,850
Student loans receivable, net	9,095,114	5,652,428
Interest income receivable	187,676	115,254
Due from Federal Student Loan Reserve Fund	54,823	5,831
Capital assets, net	76,130	75,460
Deferred financing costs, net	39,978	27,490
Other assets	33,132	28,215
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	<u>103,283</u>	<u>82,597</u>
Total assets	10,066,717	6,417,629
<u>Liabilities</u>		
Cash overdraft	43,102	29,185
Due to customers	101,464	43,297
Accounts payable and accrued expenses	131,088	77,827
Notes and bonds payable, net	9,189,553	5,698,923
Amounts related to the Federal Student Loan Reserve Fund	<u>103,283</u>	<u>82,597</u>
Total liabilities	9,568,490	5,931,829
<u>Net assets</u>		
Invested in capital assets, net of related debt	8,589	5,633
Restricted for debt service	357,628	335,441
Restricted for financial aid grant programs	55,711	75,886
Restricted for default aversion activities	2,326	4,114
Unrestricted	<u>73,973</u>	<u>64,726</u>
Total net assets	\$ 498,227	485,800

See accompanying notes to financial statements.

Statements of Cash Flows
For the years ended June 30, 2006 and 2005 (in thousands)



	2006	2005
<u>Cash flows from operating activities</u>		
Interest received on student loans	\$ 337,606	254,185
Principal received on student loans	1,017,819	753,839
Student loan originations	(874,879)	(782,130)
Student loan purchases	(3,734,944)	(1,509,321)
Student loan sales, including securitizations and gains (losses)	175,713	798,695
Interest received on investments	32,629	19,991
Interest paid on student loan financings and bonds payable	(274,260)	(122,686)
Interest paid on capital and other financings	(7,940)	(9,276)
Servicing fees	106,148	83,594
Retention of collections on defaulted loans	36,534	63,350
Federal fees	53,885	41,435
Default aversion fees	11,385	12,863
Other	397	485
Payment of operating expenses	(223,366)	(226,035)
Net cash used for operating activities	(3,343,273)	(621,011)
<u>Cash flows from noncapital financing activities</u>		
Proceeds from issuance of noncapital debt	3,855,900	1,289,300
Principal paid on noncapital debt	(363,810)	(742,969)
Issuance costs	(13,942)	(2,428)
Commonwealth of Pennsylvania grants received	429,250	420,177
Federal grants received	8,811	11,124
Grants and financial aid paid	(555,187)	(459,284)
Transfer of undisbursed program funds to the Commonwealth of Pennsylvania	(2,237)	-
Transfer of undisbursed program funds to the U.S. Department of Education	(281)	-
Contributions to Pennsylvania Higher Education Foundation	(23,455)	(2,950)
Cash overdraft	13,917	28,126
Net cash provided by noncapital financing activities	3,348,966	541,096
<u>Cash flows from capital and related financing activities</u>		
Principal paid on capital debt	(2,331)	(3,904)
Purchases of capital assets and development of software, net of disposals	(15,302)	(11,940)
Net cash used for capital and related financing activities	(17,633)	(15,844)
<u>Cash flows from investing activities</u>		
Proceeds from sales and maturities of investments	391,009	359,945
Purchases of investments	(354,905)	(376,643)
Net cash provided by (used for) investing activities	36,104	(16,698)
Net change in restricted cash and cash equivalents	24,164	(112,457)
Restricted cash and cash equivalents, beginning of period	250,128	362,585
Restricted cash and cash equivalents, end of period	\$ 274,292	250,128

(continued)

Statements of Cash Flows
For the years ended June 30, 2006 and 2005 (in thousands)



	2006	2005
Reconciliation of operating income to net cash used for operating activities		
Operating income	\$ 155,526	148,962
Adjustments to reconcile operating income to net cash used for operating activities:		
Depreciation	14,632	13,945
Amortization of premium (discount) on loan purchases	25,939	24,271
Amortization of loan origination costs	5,147	5,493
Amortization of deferred financing costs	1,454	1,190
Amortization of deferred amount on refundings of student loan revenue bonds	799	799
Accretion discount on capital and other financings	72	70
Changes in assets and liabilities:		
Increase in interest income receivable	(72,422)	(18,776)
Decrease in loans held for sale	-	777,000
Increase in student loans receivable	(3,473,772)	(1,580,491)
Increase in amounts due from Federal Student Loan Reserve Fund	(48,992)	(364)
Increase in other assets	(4,917)	(6,353)
Increase in accounts payable and accrued expenses	53,261	13,243
Total adjustments	(3,498,799)	(769,973)
Net cash used for operating activities	\$ (3,343,273)	(621,011)

See accompanying notes to financial statements.

Note 1 – About PHEAA

Organization

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

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

Blended Component Unit

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

Related Organizations

The Pennsylvania Higher Education Foundation, Inc.

We supported the formation of The Pennsylvania Higher Education Foundation, Inc. (“PHEF”), which is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purposes include, but are not limited to, activities intended to improve or enhance postsecondary education opportunities for students in Pennsylvania and elsewhere. Members of our Executive Committee appoint a majority of the board members of PHEF, but we cannot impose our will on it, and there is no financial burden or benefit associated with it. As a related organization, its transactions are not included in our financial statements.

PHEF’s financial statements are available on its website – www.higheredfoundation.org. Condensed financial information for PHEF as of and for its fiscal years that ended May 31 follows.

For the years ended May 31 (in thousands)	2006	2005
Contributions	\$ 19,439	14,248
Income on investments	3,635	1,947
Expenses, including grants of \$12.9 million in 2006 and \$9.1 million in 2005	<u>(17,972)</u>	<u>(11,722)</u>
Increase in net assets	5,102	4,473
Net assets at beginning of year	<u>38,297</u>	<u>33,824</u>
Net assets at end of year	<u>\$ 43,399</u>	<u>38,297</u>



At May 31 (in thousands)	2006	2005
Investments	\$ 39,715	39,588
Office furnishings and equipment, net of accumulated depreciation	91	112
Amounts payable to specific organizations as designated by donors	(583)	(1,103)
Other assets, net of liabilities	4,176	(300)
Net assets	\$ 43,399	38,297

We made cash donations totaling \$20 million to PHEF during the year ended June 30, 2006. We are also authorized to provide operational support to PHEF, which cost \$3.5 million during the year ended June 30, 2006 and \$3.0 million in 2005.

Our board of directors has authorized an additional \$30 million of donations through June 30, 2009 as well as ongoing operational support. The authorization is not an obligation and has not been accrued in our financial statements.

The Higher Education Foundation, Inc.

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

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 encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989 to be consistent with the accounting practices of the Commonwealth.

Student Loans

Student loans are reported on the statement of net assets at their unpaid principal balances. Costs related to loan originations and premiums related to 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 inherent 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 inherent estimated incurred losses, but our evaluation is inherently 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

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

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

Investments

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

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

Restricted Cash and Investments

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

Capital Assets

Capital assets are reported at cost net of depreciation and estimated impairment, if any. 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.

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

- Buildings 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.

Compensated Absences

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

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 and unbilled amounts are recorded as accounts receivable. For federal fees, loan processing and issuance fees related to our guaranty function are recognized as the guaranteed loans are disbursed; portfolio maintenance fees are recognized throughout the year at rates established by law. Retention of collections on defaulted loans is recognized as earned when cash is collected on defaulted loans.

We receive default aversion fees amounting to 1% of the principal and interest of a loan when the lender submits a default preclaim. 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 incurred. As we return amounts when loans default, the amount returned offsets the expense.

Securitization

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. The securitized loans, bonds, and related income and expenses are not reported in our financial statements. A residual interest results from a securitization transaction. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us. This accounting treatment is different from securitization accounting treatment for businesses following FASB guidance, which involves estimating the net present value of expected future cash flows at the time of the securitization.

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 \$7.5 million in 2006 and \$7.3 million in 2005.

Commonwealth of Pennsylvania and Federal Grant Revenues

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

Use of Estimates

To prepare financial statements in conformity with accounting principles that are 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 from our estimates.

Note 3 – New Accounting Pronouncements

In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement must be adopted for periods beginning after December 15, 2006. We anticipate that this statement will change expense recognition and disclosure related to healthcare benefits provided for retirees; however, we have not completed our analysis of the statement, which must be adopted for the year ending June 30, 2008.

In June 2005, the GASB issued GASB Statement No. 47, *Accounting for Termination Benefits*. For termination benefits that affect an employer's obligations for defined benefit other postemployment benefit plan, this statement must be adopted simultaneously with the requirements of GASB Statement No. 45, *Accounting and Financial Reporting for Employers for Postemployment Benefits Other Than Pensions*. For all other termination benefits that are provided as an inducement to hasten the termination of services or as a result of a voluntary early termination or as a consequence of the involuntary early termination of services, this statement must be adopted for periods beginning after June 15, 2005. Historically, we have not offered termination benefits.

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 the U.S. Department of Education (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 changes in net assets held by us for ED in the Federal Fund.

For the years ended June 30 (in thousands)	2006	2005
Additions		
Reinsurance from the U.S. Department of Education	\$ 476,905	363,188
Collections on defaulted loans	208,208	204,676
Net appreciation in fair value of investments	1,521	1,690
Student loan insurance premiums	47,121	2,368
Usage fees	27	3,237
Gain on sale of capital assets	3,324	-
Other	17	5
Total additions	737,123	575,164
Deductions		
Purchases of defaulted loans from lenders	494,077	373,310
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections	135,408	137,432
Reimbursement to us for our retention of defaulted loans collections	68,818	63,350
Default aversion fees, net	28,093	13,376
Depreciation	93	3,231
Transfers to PHEAA for portfolio maintenance fee not paid by U.S. Department of Education	29,757	7,855
Total deductions	756,246	598,554
Net decrease	(19,123)	(23,390)
Net assets, beginning of period	45,341	68,731
Net assets, end of period	\$ 26,218	45,341

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

At June 30 (in thousands)	2006	2005
<u>Assets</u>		
Cash	\$ 2,788	16,538
Receivable from the U.S. Department of Education	59,336	45,286
Other receivables	441	249
Interest income receivable	438	382
Investments	40,280	19,054
Capital assets, net	-	1,088
Total assets	103,283	82,597
<u>Liabilities</u>		
Accounts payable and accrued expenses	4,878	11,697
Payable to U.S. Department of Education	17,364	17,364
Amounts payable to PHEAA	54,823	5,831
Deferred student loan insurance premiums	-	2,364
Total liabilities	77,065	37,256
Net assets	\$ 26,218	45,341

The Higher Education Amendments of 1998 contain a provision for a recall of funds totaling \$250 million nationwide. \$85 million of the recall occurred in the federal fiscal year ended 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 us that the Federal Fund's share of the recall was \$26.3 million, of which \$8.9 million was due and paid by September 1, 2002. The entire \$26.3 million was recorded as a deduction from net assets during the year ended June 30, 2002. \$17.4 million remains as an amount payable to the U.S. Department of Education at June 30, 2006 for the recalls due in 2006 and 2007.

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

Under current law, we are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees.

Historically, ED has calculated this ratio at September 30, which is the close of the federal fiscal year, and has excluded amounts payable to the U.S. Department of Education related to the recall of reserve funds from this calculation. These amounts payable are due in two installments, one in September 2006, and one in September 2007.

Based upon our calculation of the ratio, we believe we went below the required ratio during the federal fiscal year ended September 30, 2005. Under federal law, we will be required to submit a management plan to ED if we remain under the required level for two consecutive years, and that plan must demonstrate that we will reach the required level within 18 months of submitting the plan. At our request, officials at ED have met with us regarding this issue and we are preparing a plan to submit to ED.

During the year ended June 30, 2006, we took several steps to manage the fund in a manner to assure our customers that sufficient funds are available in the Federal Reserve Fund to continue to pay default claims.

We decided to fund the guaranty fee rather than waive the fee and retroactively funded the fee for guarantees made since October 1, 2004, which was the beginning of the federal fiscal year in which the fund went below the minimum.

In addition to paying default claims, the fund is also used to pay default aversion fees and our share of retention on defaulted loan collections. During the year ended June 30, 2006, we allowed this liability to us to increase.

Finally, PHEAA has a liability for default aversion fee rebate payable to the Federal Reserve Fund. This liability is not recorded as an asset of the fund because generally accepted accounting principles do not allow recognition of gain contingencies. We manage the fund recognizing that these rebates from PHEAA to the Federal Reserve Fund will likely occur over time.

The result of these actions and recognition of the gain contingency is that we are managing the fund above the statutory minimum.

Note 5 – Cash and Investments

The following table compares the carrying value of cash and cash equivalents to cash on deposit.

At June 30 (in thousands)	2006	2005
Restricted cash and cash equivalents	\$ 274,292	250,128
Restricted cash and cash equivalents – due to customers	101,464	43,297
Cash overdraft	(43,102)	(29,185)
Carrying value	\$ 332,654	264,240
Cash on deposit, bank balance	\$ 18,799	12,070
Cash equivalents	498,824	386,556
Cash on deposit, bank balance (including cash equivalents)	\$ 517,623	398,626

The following table shows our investments and maturities at June 30, 2006.

(In thousands)	Fair Value	Investment Maturities (in years)		
		Less than 1	1 to 10	More than 10
Cash equivalents				
Money market funds	\$ 167,721	167,721	-	-
Guaranteed investment contracts and agreements	13,593	13,593	-	-
U.S. government agencies	99,959	99,959	-	-
Commercial paper	217,551	217,551	-	-
	498,824	498,824	-	-
Investments				
State Treasury investment pool	28,372	28,372	-	-
Guaranteed investment contracts and agreements	72,453	-	67,400	5,053
	\$ 599,649	527,196	67,400	5,053

Restricted cash and cash equivalents include amounts restricted under bond indentures and financing agreements, which are held by a trustee and managed under the provisions of the agreements. Restricted cash and cash equivalents also include amounts due to customers. The amounts of investments for restricted cash and cash equivalents are different from the balance reported on the statement of net assets because of timing differences between when cash items are recorded and when they clear the financial institution.

Investments in the State Treasury investment pool are investments in 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 governed by the provisions of the State Treasury investment policy.

Other investments are authorized by the board of directors and governed by the "prudent person" rule under our investment policy. Generally, our 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 of directors from time to time. The prudent person rule requires the exercise of judgment, skill, and care under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Deposits and investments have certain risks that have the potential to result in losses, and they are described below.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. We manage our exposure to interest rate risk by structuring our investment portfolio so that investments mature to meet cash requirements for ongoing operations and investing operating funds primarily in shorter-term investments.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. We minimize our credit risk by limiting investments to authorized investments that have a higher credit rating and diversifying the investment portfolio so that potential losses on individual investments will be minimized. This risk is measured by the assignment of a rating by a nationally recognized statistical rating organization. At June 30, 2006, our investments in U.S. government agencies and commercial paper were rated A-1. At June 30, 2006, \$13.6 million of our investments in guaranteed investment contracts and agreements were rated Aaa and \$72.5 million were rated Aa. Our investments in money market funds and the State Treasury investment pool were not rated.

Custodial Credit Risk

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, we would not be able to recover deposits or collateral securities that are in the possession of an outside party. At June 30, 2006, \$18.7 million of our deposits with financial institutions in excess of federal depository insurance limits were uninsured and 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 our name.

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, we would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. Our investment policy does not contain requirements that limit the exposure to custodial credit risk for investments. At June 30, 2006, our investments in the following investment types were held by the same counterparty that was used by us to buy the securities.

(In thousands)	Fair Value
U.S. government agencies	\$ 99,959
Commercial paper	<u>217,551</u>
	<u>\$ 317,510</u>

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of our investment in a single issuer. Our investment policy does not contain requirements that limit the amount that can be invested in any one issuer.

The following table shows investments in any one issuer that represent 5% or more of our total investments at June 30, 2006.

(In thousands)	Issuer	Fair Value
U.S. government agencies	Federal National Mortgage Association	\$ 99,959
Guaranteed investment agreement	MBIA, Inc.	67,400
Commercial paper	Merrill Lynch & Company	30,453

The following table shows our investments and maturities at June 30, 2005.

(In thousands)	Fair Value	Investment Maturities (in years)		
		Less than 1	1 to 10	More than 10
<u>Cash equivalents</u>				
Money market funds	\$ 195,476	195,476	-	-
Guaranteed investment contracts and agreements	31,993	31,993	-	-
U.S. government agencies	105,899	105,899	-	-
Commercial paper	<u>53,188</u>	<u>53,188</u>	-	-
	386,556	386,556	-	-
<u>Investments</u>				
State Treasury investment pool	61,079	61,079	-	-
Guaranteed investment contracts and agreements	<u>75,850</u>	-	<u>70,797</u>	<u>5,053</u>
	<u>\$ 523,485</u>	<u>447,635</u>	<u>70,797</u>	<u>5,053</u>

The Federal Fund had \$40.3 million at June 30, 2006 and \$19.1 million at June 30, 2005 invested in the State Treasury investment pool with a maturity of less than 1 year.

Note 6 – Student Loans Receivable

The following table shows our student loan holdings.

At June 30 (in thousands)	2006	2005
FFELP:		
Stafford	\$ 3,047,722	3,273,277
PLUS	343,130	334,125
Supplemental Loans for Students	4,121	5,467
Consolidation	5,172,644	1,583,727
	8,567,617	5,196,596
HEAL	266,461	328,180
Privately insured loans	46,175	38,712
Uninsured loans	6,479	7,466
Unamortized loan origination costs	24,985	13,238
Unamortized premium on loan purchases	187,373	70,352
	9,099,090	5,654,544
Allowance for loan losses	(3,976)	(2,116)
	\$ 9,095,114	5,652,428

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 represents our estimate of the costs related to the risk sharing on FFELP loans and losses related to servicing of loans we own. On December 1, 2004, we were designated as an Exceptional Performer by ED in recognition of meeting certain performance standards set by ED in servicing FFELP loans. Because of this designation, we received 100% reimbursement on all eligible FFELP default claims submitted for reimbursement before July 1, 2006 because as we remained in compliance with the required standards, which are assessed annually and quarterly through compliance audits. Beginning July 1, 2006, the reimbursement for student loans serviced by servicers designated as Exceptional Performers decreased from 100% to 99% for all claims filed after June 30, 2006. The provision for loan losses for the year ended June 30, 2006 represents our estimate of the costs related to the risk sharing on FFELP loans we own.

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

We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio. An analysis of our allowance for loan losses related to student loans is presented in the following table.

For the years ended June 30 (in thousands)	2006	2005
Balance at beginning of period	\$ 2,116	5,185
Provision for losses (reduction in allowance on servicing and loan losses)	2,429	(960)
Charge-offs	(569)	(2,109)
Balance at end of period	\$ 3,976	2,116

At June 30, 2006, we had commitments to purchase approximately \$1.1 billion of student loans.

Note 7 – Capital Assets

Capital asset activity for the year ended June 30, 2006 was as follows.

(In thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	\$ 2,946	-	-	2,946
Buildings	66,913	3,696	(329)	70,280
Software development	36,059	3,570	(6,330)	33,299
Purchased software	14,501	5,173	(254)	19,420
Other, principally information technology equipment	26,949	3,288	(2,865)	27,372
	147,368	15,727	(9,778)	153,317
Less accumulated depreciation for:				
Buildings	(26,887)	(1,603)	1	(28,489)
Software development	(16,776)	(6,750)	6,330	(17,196)
Purchased software	(8,699)	(2,873)	79	(11,493)
Other, principally information technology equipment	(19,546)	(3,323)	2,860	(20,009)
	(71,908)	(14,549)	9,270	(77,187)
	\$ 75,460	1,178	(508)	76,130

Capital asset activity for the year ended June 30, 2005 was as follows.

(In thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	\$ 2,946	-	-	2,946
Buildings	65,360	1,934	(381)	66,913
Software development	63,028	7,112	(34,081)	36,059
Purchased software	12,689	1,923	(111)	14,501
Other, principally information technology equipment	25,880	1,567	(498)	26,949
	169,903	12,536	(35,071)	147,368
Less accumulated depreciation for:				
Buildings	(25,387)	(1,500)	-	(26,887)
Software development	(43,502)	(7,355)	34,081	(16,776)
Purchased software	(6,712)	(1,987)	-	(8,699)
Other, principally information technology equipment	(16,837)	(3,103)	394	(19,546)
	(92,438)	(13,945)	34,475	(71,908)
	\$ 77,465	(1,409)	(596)	75,460

Note 8 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings for the year ended June 30, 2006 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings, due 2007-2037 at weighted-average rates of 5.19% at June 30, 2006 and 3.29% at June 30, 2005	\$ 841,919	756,000	(360,659)	1,237,260	159,009
Student loan demand revenue bonds: Student loan demand revenue bonds, due 2017-2046, at weighted-average rates of 4.86% at June 30, 2006 and 2.92% at June 30, 2005	4,724,900	3,050,000	-	7,774,900	-
Deferred amount on current refundings of student loan demand revenue bonds	(12,323)	-	799	(11,524)	-
	4,712,577	3,050,000	799	7,763,376	-
Capital financings: Capital financings, due 2007-2011, at weighted-average rates of 6.13% at June 30, 2006 and 6.11% at June 30, 2005	70,096	-	(2,331)	67,765	1,831
Unamortized discount on capital acquisition bonds	(268)	-	45	(223)	-
	69,828	-	(2,286)	67,542	1,831
Other financings: Term financings, due 2007-2031, at weighted-average rates of 5.10% at June 30, 2006 and 5.12% at June 30, 2005	75,150	-	(3,151)	71,999	2,069
Unamortized discount on capital acquisition refunding bonds	(551)	-	27	(524)	-
Lines of credit, due on demand, at weighted-average rates of 6.85% at June 30, 2006	-	49,900	-	49,900	49,900
	74,599	49,900	(3,124)	121,375	51,969
	\$ 5,698,923	3,855,900	(365,270)	9,189,553	212,809

The note and bond indentures among other things require us to comply with various covenants including minimum parity levels as defined.

Student loans and investments collateralize all student loan financings, student loan demand revenue bonds, and student loan revenue bonds. At June 30, 2006, \$9.0 billion of student loan principal and related interest receivable and \$183.1 million of investments and related interest receivable collateralized the \$9.0 billion of notes and bonds payable.

The student loan demand bonds are subject to purchase, at par plus accrued interest, by us 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 2006 through 2015, and we are required to pay annual commitment fees ranging from 10 to 30 basis points on the stated amount of the letter of credit coverage. At June 30, 2006, total letter of credit coverage was \$1.5 billion.

Capital financings are collateralized with capital assets.

At June 30, 2006, we had \$18.1 million of available credit under student loan financing arrangements, and \$55.1 million was available under other lines of credit.

At June 30, 2006, we were out of compliance with a parity calculation related to the \$49.9 million borrowed on the line of credit. The amount was already classified as current, we received a waiver from the financial institution, the amount was repaid after June 30, 2006, and we are now in compliance with the covenant.

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) Year of Maturity	Student Loan Bonds and Financings		Capital and Other Financings	
	Principal	Interest	Principal	Interest
2007	\$ 159,009	435,316	53,800	13,021
2008	698,910	397,205	3,484	7,044
2009	-	397,205	3,385	6,884
2010	-	397,205	3,330	6,729
2011	-	397,205	63,055	4,653
2012-2016	-	1,986,028	10,665	13,626
2017-2021	620,241	1,900,708	13,320	10,669
2022-2026	570,000	1,814,889	16,970	6,710
2027-2031	550,000	1,683,969	21,655	1,790
2032-2036	75,000	1,614,020	-	-
2037-2041	1,529,000	1,455,839	-	-
2042-2046	4,810,000	883,219	-	-
	\$ 9,012,160	13,362,808	189,664	71,126

\$9.0 billion of the student loan bonds and financings are variable-rate debt. \$1.4 billion of the variable-rate debt resets based upon auctions every 7 days. \$5.6 billion resets based upon auctions every 28 days. \$791.0 million resets based upon auctions every 35 days. \$698.9 million is indexed to 91-day U.S. Treasury Bills and the remaining \$538.3 million is indexed to the 3-month LIBOR.

At June 30, 2006, we had not yet issued \$1.7 billion of debt that the board of directors has authorized. On August 3, 2006, we issued \$225 million of variable-rate student loan demand revenue bonds that reset based upon auctions every 7 days with an initial rate of 3.52%. On August 10, 2006, we issued \$500 million of variable-rate student loan demand revenue bonds indexed to the 3-month LIBOR with an initial weighted average rate of 5.57%.

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

Activity for notes and bonds payable and other financings for the year ended June 30, 2005 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance
Student loan financings	\$ 728,619	808,300	(695,000)	841,919
Student loan demand revenue bonds:				
Student loan demand revenue bonds	4,253,900	471,000	-	4,724,900
Deferred amount on current refundings of student loan demand revenue bonds	(13,122)	-	799	(12,323)
	4,240,778	471,000	799	4,712,577
Capital financings:				
Capital financings	74,000	-	(3,904)	70,096
Unamortized discount on capital acquisition bonds	(311)	-	43	(268)
	73,689	-	(3,861)	69,828
Other financings:				
Term financings	81,119	-	(5,969)	75,150
Unamortized discount on capital acquisition refunding bonds	(578)	-	27	(551)
Lines of credit	32,000	10,000	(42,000)	-
	112,541	10,000	(47,942)	74,599
	\$ 5,155,627	1,289,300	(746,004)	5,698,923

Note 9 – Financial Instruments with Off-Balance Sheet Risk

We enter into interest rate swaps to convert variable-rate debt into fixed-rate debt synthetically as part of our interest rate risk management and we enter into basis swaps to lower costs on notes and bonds payable.

The following table summarizes these financial instruments at June 30, 2006.

(In thousands)	Notional Amounts	Effective Dates	Termination Dates	Fair Values
Basis swaps	\$ 400,000	September 15, 2005	September 1, 2020	\$ 5,128
Basis swap	\$ 71,575	March 17, 2006	December 15, 2030	(345)
Interest rate swaps	\$ 200,000	September 30, 2005	October 1, 2010	6,242
Interest rate swaps	\$ 200,000	October 7, 2005	October 1, 2010	5,409
				\$ 16,434

Under the interest rate swaps, we pay the counterparty a fixed rate ranging from 3.095% to 4.703%. Under the basis swaps, we pay the counterparty a variable rate based on The Bond Market Association Municipal Swap Index (“BMA”). For all swaps, we receive a payment from the counterparty based on the London Interbank Offered Rate (“LIBOR”).

We are exposed to credit risk for swaps with a positive fair value. To mitigate the potential for credit risk, for counterparties rated A3 or below by Moody’s or A- or below by Standard & Poors, we generally require collateral posting from the counterparty when the fair value exceeds \$2.5 million. For swaps with a positive fair value, the counterparties were rated A+ or better. For swaps that had a negative fair value, we are not exposed to credit risk. However, should interest rates change and the fair value of the swaps becomes positive, we would be exposed to credit risk in the amount of the derivative’s fair value.

The swaps expose us to basis risk should the relationship between LIBOR and BMA converge. If a change occurs that results in the rates’ moving to convergence, the expected costs savings may not be realized.

We, or the counterparties, may terminate the swap if the other party fails to perform under the terms of the contract. If an early termination occurs, the contracts provide for settlement payment calculations related to the fair values of the contract at the time of termination.

Note 10 – Leases

We lease office space, information technology and other equipment under operating leases expiring during the next seven 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 \$4.5 million in 2006 and \$4.4 million in 2005.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) at June 30, 2006 are:

Year ending June 30 (In thousands)

2007	\$	7,881
2008		5,212
2009		2,980
2010		746
2011		696
2012-2013		1,452
Total minimum lease payments	\$	18,967

Note 11 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

We contribute to the Commonwealth of Pennsylvania State Employees’ 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 Employees' 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, we are required to contribute at an actuarially determined rate. During the year ended June 30, 2006, the required employer contribution rates were 1.9% or 2.37%, depending upon the membership classification of each employee. Beginning July 1, 2006, our contribution rates will be 2.59% or 3.23%. The contribution requirement of members is established by law and may be amended by the General Assembly. The contribution requirement for us is established by the board of directors of SERS. Our contributions were \$2.5 million for the year ended June 30, 2006 and \$1.3 million for the year ended June 30, 2005. 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 \$14.0 million for the year ended June 30, 2006 and \$10.8 million for the year ended June 30, 2005.

Note 12 – Servicing Fees

We have contracts with customers to provide servicing of student loans as well as information technology services. At June 30, 2006, we were servicing approximately \$34.7 billion of loans for customers. Customers using our computer services serviced an additional \$17.6 billion of loans. Other FFELP guarantors were managing \$3.4 billion of guarantees using our computer services.

Our servicing agreements, some of which expire in 2007, have contractual terms at inception ranging from three years to life of loan. Under our servicing agreements, we generally agree to reimburse customers for any claims, losses, liabilities, or expenses that arise out of or relate to our 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.

Five loan-servicing customers provided \$55.2 million of servicing fees for the year ended June 30, 2006. No other individual customer provided servicing revenues more than 5% of total servicing fees.

Note 13 – Segment Information

We generally finance 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)	2006	2005
Interest revenue	\$ 452,584	309,098
Interest expense	292,965	134,231
Net interest revenue	159,619	174,867
Provision for loan losses	(1,537)	-
Net interest revenue after provision for loan losses	158,082	174,867
Gains (losses) on student loan sales including securitizations, net	688	(139)
Total operating revenues	158,770	174,728
Operating expenses	70,418	56,501
Operating income	88,352	118,227
Grants and other financial aid	17,309	17,888
Income before transfers	71,043	100,339
Transfers to unrestricted net assets	(48,208)	(57,995)
Change in net assets	22,835	42,344
Net assets, beginning of period	330,556	288,212
Net assets, end of period	\$ 353,391	330,556

Statements of net assets

At June 30 (in thousands)	2006	2005
Restricted cash and cash equivalents	\$ 343,073	248,331
Student loans receivable	8,849,958	5,527,996
Other, principally interest income receivable	221,860	138,573
Total assets	9,414,891	5,914,900
Notes and bonds payable, net	9,000,636	5,554,496
Other, principally accrued interest payable	60,864	29,848
Total liabilities	9,061,500	5,584,344
Net assets, restricted for debt service	\$ 353,391	330,556

Statements of cash flows

For the years ended June 30 (in thousands)	2006	2005
Interest received on student loans	\$ 333,473	244,366
Principal received on student loans	995,079	739,257
Student loan originations	(873,777)	(781,530)
Student loan purchases	(3,741,916)	(1,448,685)
Student loan sales, including securitizations and gains (losses)	331,073	839,205
Interest received on investments	14,794	7,597
Interest paid on student loan financings and bonds payable	(275,474)	(122,686)
Payment of operating expenses	(54,391)	(55,494)
Net cash used for operating activities	(3,271,139)	(577,970)
Proceeds from issuance of noncapital debt	3,806,000	1,279,300
Principal paid on noncapital debt	(360,659)	(695,000)
Other	(79,460)	(78,312)
Net cash provided by noncapital financing activities	3,365,881	505,988
Net change in restricted cash and cash equivalents	94,742	(71,982)
Restricted cash and cash equivalents, beginning of period	248,331	320,313
Restricted cash and cash equivalents, end of period	\$ 343,073	248,331

Note 14 – Restrictions on Net Assets

Net assets restricted for debt service amounted to \$357.6 million at June 30, 2006. Of that amount, \$353.4 million is related to net assets held under various indentures related to financing our student loan portfolios. Under these indentures, we are required to maintain a parity ratio, a ratio of assets to liabilities, ranging from 1.0 to 1.03. At June 30, 2006, of the \$353.4 million net assets restricted under these indentures, we have \$62.3 million of excess parity that could be made available. However, to release funds from the restriction, we must satisfy the bond insurer or the provider of the financing that the withdrawal will not impair our ability to meet debt service requirements and maintain the required parity ratio on the underlying financing. The remaining \$4.2 million of net assets restricted for debt service is related to capital and other financings.

The \$55.7 million of net assets restricted for financial aid grant programs results from Commonwealth of Pennsylvania grants and federal grants related to specific programs. Those net assets are restricted until we disburse program-related grants.

The \$2.3 million restricted for default aversion activities is restricted under federal law and remains restricted until we incur qualifying expenses.

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

Note 15 – Student Loan Securitizations

When we sell student loan receivables in securitizations of student loans, we enter into a servicing agreement with the securitization trust and earn annual servicing fees from the trust of 50 basis points per year on the outstanding

balance of student loans in the securitization trust. In April 2005, the annual servicing fees from the trust decreased to 25 basis points per year on the outstanding balance of consolidation loans and remained at 50 basis points per year on the outstanding balance of Stafford and PLUS loans. We also enter an administration agreement with the trust and generally earn annual administration fees of 25 basis points per year on the outstanding balance of student loans in the trust. Under these arrangements, we earned \$4.8 million in 2006 and \$5.3 million in 2005. The amount earned is included in servicing fees on the statement of revenues, expenses, and changes in net assets.

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

Condensed financial information for the securitization trust is presented in the following table:

(In thousands)	2006	2005
Principal balance of financed student loans		
Consolidation	\$ 769,723	871,464
Stafford and PLUS	74,428	131,322
	\$ 844,151	1,002,786
Aggregate outstanding principal amount of notes	\$ 909,175	1,075,127

A residual interest results from the securitization of student loans. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us.

Note 16 – Risk Management and Contingencies

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

Federal programs in which we participate are subject to audit in accordance with the provisions of the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. The provisions of this circular do not limit the authority of ED or other federal audit officials to perform, or contract for, audits and evaluations of federal financial assistance programs. Therefore, our operations in current and prior years are subject to audit. We believe we are in substantial compliance with applicable federal regulations and that any adjustment because of future audits will not be material. We have appealed one finding in a Program Review conducted by ED related to our processing of 9.5% floor loans. If we are unsuccessful in our appeal, we estimate that we will have to refund approximately \$10 million of special allowance payments we have received.

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