PHEAA POWERED BY aes

Annual Financial Report
June 30, 2007 and 2006

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)		**2007**	2006
Self-funded			
State Grant Program supplement	$	**59,193**	25,393
Federal default fees paid on behalf of borrowers		**27,845**	-
Guarantee fees paid on behalf of borrowers		**-**	31,749
Keystone loan program origination fees and benefits paid on behalf of borrowers		**27,542**	31,852
Costs of operating state and federal governmental programs		**21,694**	19,512
Workforce Advancement Grant for Education		**8,161**	9,784
Academic Excellence Scholarship		**3,214**	2,286
Armed Forces Loan Forgiveness Program		**3,014**	3,512
Funding and support of The Pennsylvania Higher Education Foundation, Inc.		**13,155**	23,455
Other public service activities and outreach		**15,108**	14,011
		178,926	161,554
Financial support funded by our business partners			
Keystone loan program origination fees and benefits paid on behalf of borrowers		**17,456**	31,734
	$	**196,382**	193,288

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.

We pay the federal default and guarantee fees on behalf of borrowers. Effective 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; however, guarantors are not required to assess the fee to borrowers. Prior to this date, we were permitted to charge a guarantee fee of up to 1% when we guaranteed a loan.

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 also provide a KeystoneBEST and a KeystonePLUS loan for other students. For the KeystoneBEST loans, we pay all of the federally required origination fees on behalf of borrowers. Federally required origination fees decreased from 3% in 2006 to 2% in 2007. For the KeystoneBEST loans, we also provide a 1% graduation credit, a 2% interest rate reduction after 36 consecutive on-time payments, and a 0.25% interest rate reduction for automatic direct debit of payment. For the KeystonePLUS loans, we provide a 1% rebate of the loan amount for the first 24 consecutive on-time payments, an additional 1% rebate after 48 consecutive on-time payments, and a 0.25% interest rate reduction for automatic direct debit of payment.

We administer state and federal governmental programs at no cost to taxpayers to ensure that every appropriated dollar goes directly to students and their families.

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.

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.

- Armed Forces Loan Forgiveness program through which 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.

- 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 $4,500 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 $16.1 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 and graduate students.
- 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 interest subsidy and 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 interest subsidy and 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, 2007, interest subsidy and special allowance payments were $330.9 million compared to $239.8 million in 2006 and $183.6 million in 2005. Interest subsidy and special allowance payments are increasing because of the recent consolidation activity that resulted in many borrowers being charge relatively low, fixed interest rates.

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 1.7% above the average return earned on other student loans during the three months ended September 30, 2006, 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 amounted to $1.3 billion at September 30, 2006, $1.5 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. On January 23, 2007, ED issued Dear Colleague Letter FP-07-01 (DCL FP-07-01) restating the requirements of the statute and regulations that control whether these loans are eligible for special allowance payments at the 9.5% minimum return rate. On January 24, 2007, ED stated that they would pay special allowance payments at the standard rate on these loans until receiving the results of an audit proving that the loans included in the December 31, 2006 billing met the 9.5% billing requirements. On April 25, 2007, ED issued DCL FP-07-06 providing audit requirements with which FFELP lenders must comply to receive special allowance payments at the minimum 9.5% rate. We are currently engaged in the audit process with the ED's auditors to identify those loans that meet the new requirements to receive the 9.5% minimum rate, which could result in additional earnings. Earnings recorded under this provision amounted to $5.7 million for the three months ended September 30, 2006 and we have not recorded any earnings under this provision after September 30, 2006. Earnings under this provision amounted to $42.5 million during the year ended June 30, 2006 and $90.7 million during the year ended June 30, 2005.

FFELP regulations require up-front origination fees to be deducted from the proceeds of student loans and remitted to the federal government. These fees decreased from 3% in 2005 to 2% in 2006 and will decrease 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 fees. 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 guaranteed a loan; however, we had not charged a fee in recent years. Effective 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. The fee we paid on behalf of borrowers is reported in grants and other financial aid.

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 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

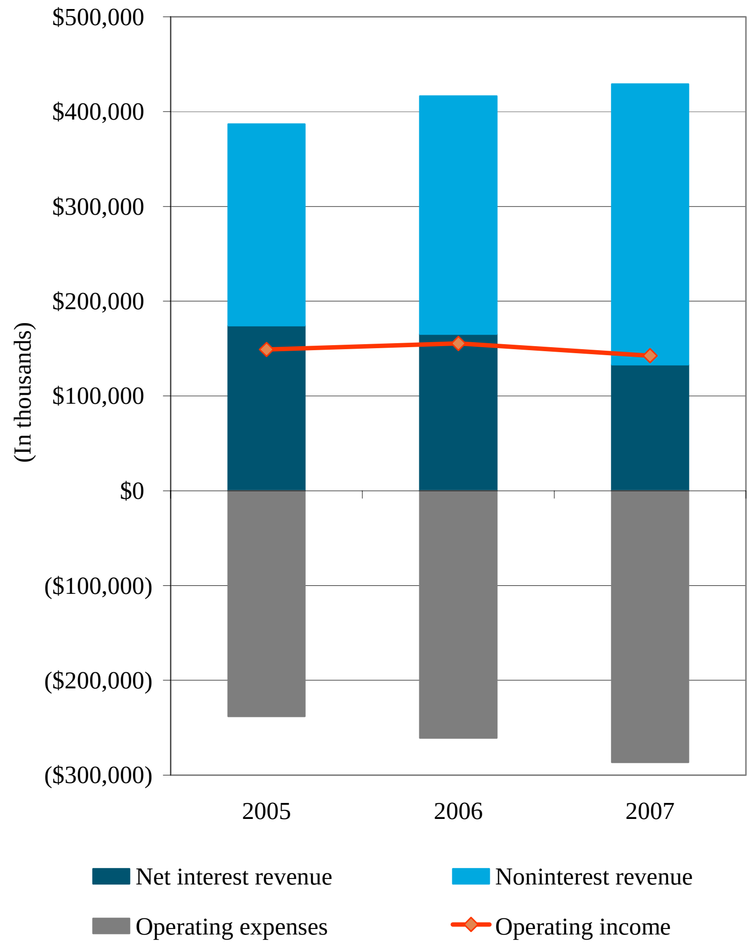
Statements of Revenues, Expenses, and Changes in Net Assets

For the years ended June 30 (in thousands)		**2007**	2006
Student loan interest revenue	$	**636,906**	431,844
Investment interest revenue		**36,348**	35,126
Interest expense on student loan financings and notes and bonds payable		**(527,057)**	(291,751)
Interest expense on capital and other financings		**(10,220)**	(8,312)
Net interest revenue		**135,977**	166,907
Provision for loan losses		**(2,965)**	(1,561)
Net interest revenue after provision for loan losses		**133,012**	165,346
Servicing fees		**113,338**	108,355
Retention of collections on defaulted loans		**82,140**	68,818
Federal fees		**61,895**	55,631
Default aversion fees, net		**27,268**	17,574
Gains on early terminations of financial instruments, net		**11,034**	-
Gains on student loan sales, net		**54**	259
Other		**401**	397
Total noninterest revenue		**296,130**	251,034
Operating revenues		**429,142**	416,380
Operating expenses		**(286,557)**	(260,854)
Operating income		**142,585**	155,526
Commonwealth of Pennsylvania grants		**452,003**	429,250
Federal grants		**8,862**	8,811
Grants and other financial aid		**(617,953)**	(555,187)
Transfer of undisbursed program funds to the Commonwealth of Pennsylvania		**(728)**	(2,237)
Transfer of undisbursed program funds to the U.S. Department of Education		**(71)**	(281)
Contributions to Pennsylvania Higher Education Foundation		**(13,155)**	(23,455)
Changes in net assets	$	**(28,457)**	12,427

Statements of Net Assets

At June 30 (in thousands)		2007	2006
Student loans receivable, net	$	**11,482,091**	9,095,114
Cash, cash equivalents, and investments, substantially restricted		**582,823**	476,581
Interest income receivable		**263,858**	187,676
Capital assets, net		**73,684**	76,130
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**128,430**	103,283
Other		**172,697**	127,933
Total assets		**12,703,583**	10,066,717
Student loans financings and notes and bonds payable, net		**11,597,201**	9,000,636
Capital and other financings		**187,723**	188,917
Amounts related to the Federal Student Loan Reserve Fund		**128,430**	103,283
Other		**320,459**	275,654
Total liabilities		**12,233,813**	9,568,490
Net assets			
Invested in capital assets, net of related debt		**(606)**	8,589
Restricted for debt service		**346,771**	357,628
Restricted for financial aid grant programs		**55,590**	55,711
Restricted for default aversion activities		**2,468**	2,326
Unrestricted		**65,547**	73,973
Total net assets	$	**469,770**	498,227

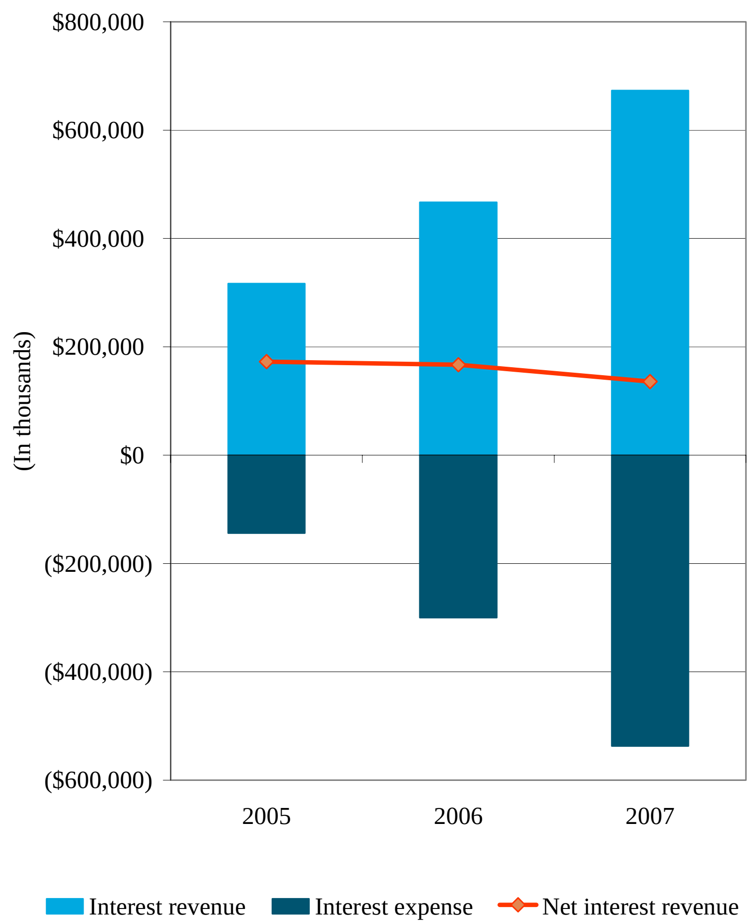
Results of Operations



Operating income for the year ended June 30, 2007 was $142.6 million, an 8.3% decrease from $155.5 million in 2006, which was a 4.4% increase from $149.0 million in 2005. Operating revenues increased 3.0% from $416.4 million in 2006 to $429.1 million 2007. In 2006, operating revenues increased 7.6% from $386.9 million in 2005. Net interest revenue after provision for loan losses decreased 19.5% from $165.3 million in 2006 to $133.0 million in 2007, principally due to the decrease in special allowance payments for 9.5% floor loans after September 30, 2006. In 2006, net interest revenue after provision for loan losses decreased 5.1% from $174.2 million in 2005 principally due to changes in interest rates. Noninterest revenue increased 18.0% from $251.0 million in 2006 to $296.1 million in 2007 due to increased guaranty volume and gains on early terminations of financial instruments. In 2006, noninterest revenue increased 18.0% from $212.7 million in 2005 due to increased servicing volume and increased guaranty volume. Operating expenses increased 9.9% from $260.9 million in 2006 to $286.6 million in 2007 due primarily to increases in personnel and benefit costs. In 2006, operating expenses increased 9.7% from $237.9 million in 2005 also 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, 2007, net interest revenue was $136.0 million, an 18.5% decrease from $166.9 million in 2006. In 2006, net interest revenue decreased 3.4% 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		2007		2006	
(Balances in thousands)		**Balances**	**Rate**	Balances	Rate
Average interest earning assets					
Student loans receivable, net	$	**9,589,991**	**6.64%**	6,837,685	6.32%
Investments		**661,352**	**5.50%**	801,597	4.38%
	$	**10,251,343**	**6.57%**	7,639,282	6.11%
Average interest bearing liabilities					
Student loan financings and notes and bonds payable	$	**9,910,597**	**5.32%**	6,885,767	4.24%
Capital and other financings		**179,464**	**5.69%**	151,618	5.48%
	$	**10,090,061**	**5.32%**	7,037,385	4.26%
Net interest margin			**1.25%**		1.85%

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

For the years ended June 30	**2007**	2006
Student loan yields	**7.97%**	7.25%
Consolidation loan rebate fees	**(0.72)**	(0.49)
Lender origination fees	**(0.09)**	(0.07)
Premium amortization	**(0.52)**	(0.37)
Student loan revenue	**6.64**	6.32
Cost of funds	**5.32**	4.24
Net interest margin on student loans	**1.32%**	2.08%

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
2007 vs. 2006				
Student loan interest revenue	$	205,062	31,236	173,826
Investment interest revenue		1,222	7,368	(6,146)
		206,284	38,604	167,680
Student loan financings and notes and bonds payable interest expense		235,306	107,144	128,162
Capital and other financings interest expense		1,908	381	1,527
		237,214	107,525	129,689
	$	(30,930)	(68,921)	37,991
2006 vs. 2005				
Student loan interest revenue	$	135,574	38,914	96,660
Investment interest revenue		14,747	11,901	2,846
		150,321	50,815	99,506
Student loan financings and notes and bonds payable interest expense		157,520	115,969	41,551
Capital and other financings interest expense		(1,340)	230	(1,570)
		156,180	116,199	39,981
	$	(5,859)	(65,384)	59,525

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. 5% of the variable-rate loans change based upon changes in the 91-day U.S. Treasury Bill rate, and 95% 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. The rate paid by borrowers for loans originated on or after July 1, 2007 is fixed at 6.8%.

Average rates earned and paid by us behave differently than market rates because 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 1.7% above the average return earned on other student loans during the three months ended September 30, 2006, 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 amounted to $1.3 billion at September 30, 2006, $1.5 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. On January 23, 2007, ED issued Dear Colleague Letter FP-07-01 (DCL FP-07-01) restating the requirements of the statute and regulations that control whether these loans are eligible for special allowance payments at the 9.5% minimum return rate. On January 24, 2007, ED stated that they would pay special allowance payments at the standard rate on these loans until receiving the results of an audit proving that the loans included in the December 31, 2006 billing met the 9.5% billing requirements. On April 25, 2007, ED issued DCL FP-07-06 providing audit requirements with which FFELP lenders must comply to receive special allowance payments at the minimum 9.5% rate. We are currently engaged in the audit process with the ED's auditors to identify those loans that meet the new requirements to receive the 9.5% minimum rate, which could result in additional earnings. Earnings recorded under this provision amounted to $5.7 million for the three months ended September 30, 2006 and we have not recorded any earnings under this provision after September 30, 2006. Earnings under this provision amounted to $42.5 million during the year ended June 30, 2006 and $90.7 million during the year ended June 30, 2005.

Provision for Loan Losses

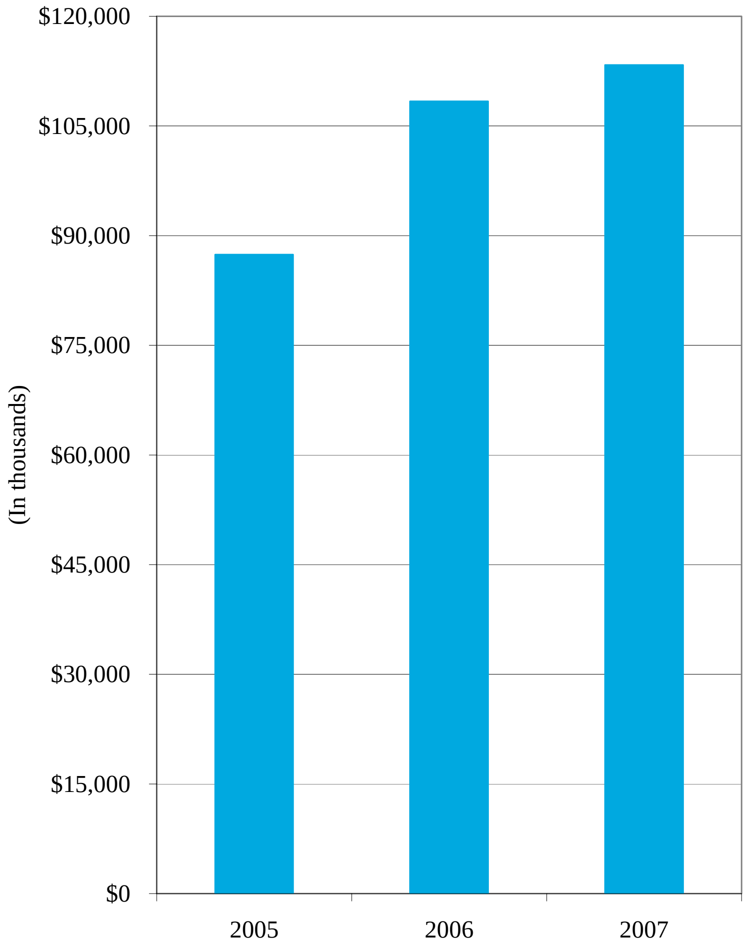
Under FFELP, 98% of principal and interest on student loans originated after October 1, 1993 is guaranteed. On December 1, 2004, we were designated as an Exceptional Performer by ED in recognition of meeting certain performance standards set by ED in servicing FFELP loans. Because of this designation, 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, 2007 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)		**2007**	2006
Balance at beginning of period	$	**1,560**	-
Provision for losses		**2,965**	1,561
Charge-offs		**(1,797)**	(1)
Balance at end of period	$	**2,728**	1,560
Allowance as a percentage of ending balance of student loans		**0.02%**	0.02%

Noninterest Revenue

Servicing Fees



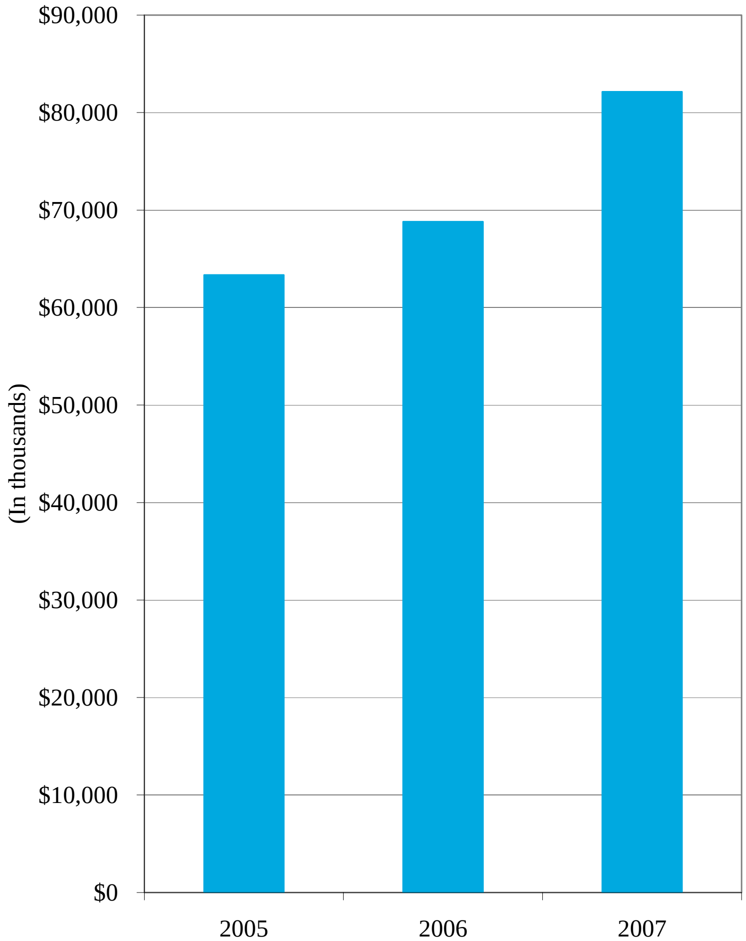
Servicing fees for the year ended June 30, 2007 were $113.3 million, an increase of 4.5% from $108.4 million in 2006. In 2006, servicing fees increased 24.0% from $87.4 million in 2005. Fees increased due to increased volume of loans serviced. Loans serviced by us for participating financial institutions averaged $37.3 billion in 2007, compared to $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, 2007, fees earned from servicing systems amounted to $12.0 million, an increase of 27.7% from $9.4 million in 2006. In 2006, fees earned from servicing systems increased 16.0% from $8.1 million in 2005. Loans serviced by other servicers using our systems averaged $25.1 billion in 2007, an increase of 61.9% from $15.5 billion in 2006, which was an increase of 37.2% from $11.3 billion in 2005. For the years ended June 30, 2007 and 2006, fees earned from guaranty systems amounted to $1.2 million compared to $1.1 million in 2005. Original principal amount outstanding for guarantors using our systems averaged $3.6 billion in 2007, compared to $3.4 billion in 2006 and $2.4 billion in

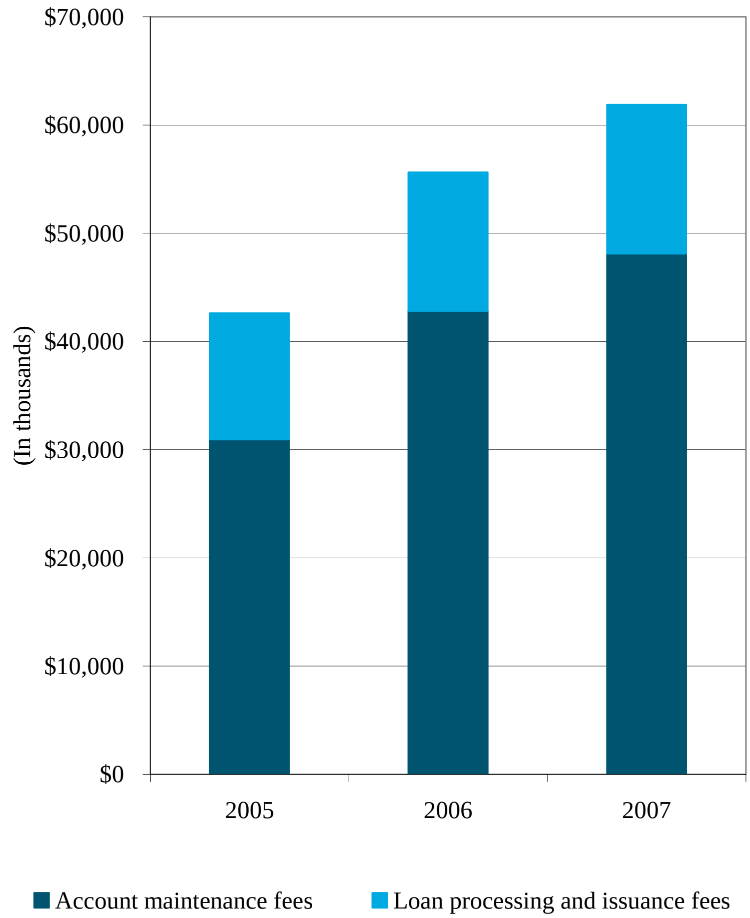
2005. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

Retention of Collections on Defaulted Loans



For the year ended June 30, 2007, retention of collections on defaulted loans was $82.1 million, a 19.3% increase from $68.8 million in 2006. In 2006, retention of collections on defaulted loans increased 8.5% from $63.4 million in 2005. The increase is due to more aggressive pursuit of rehabilitations collections. Retention on rehabilitation collections was $48.5 million in 2007, compared to $29.6 million in 2006 and $23.7 million in 2005. Additionally, the original principal balance of outstanding guarantees increased 16.4% from $40.8 billion at June 30, 2006 to $47.5 billion at June 30, 2007.

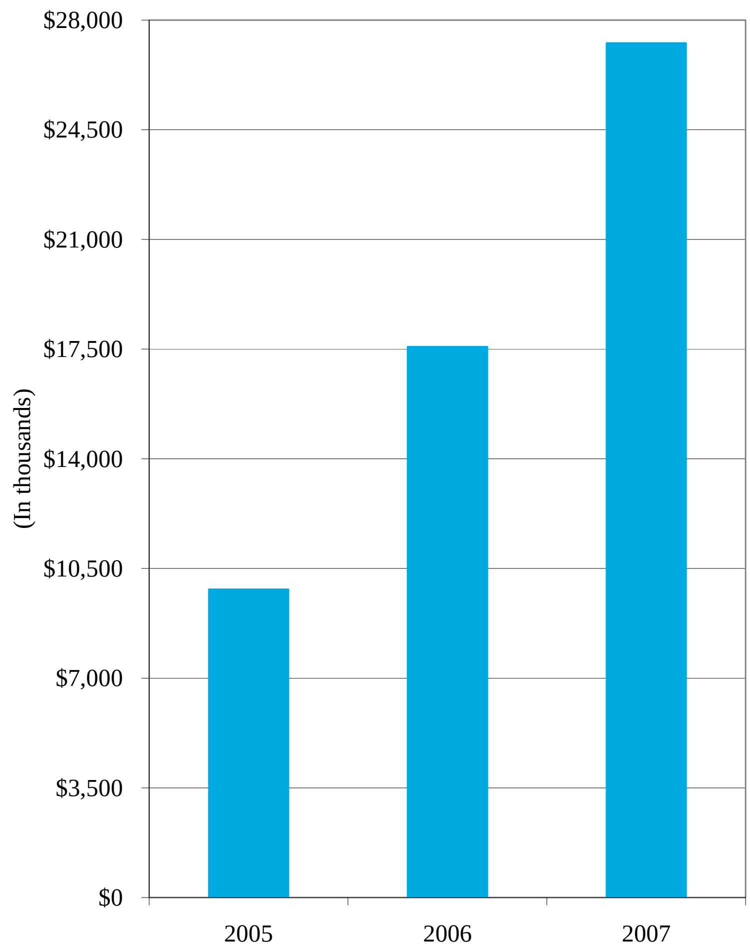
Federal Fees



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, 2007, federal fees were $61.9 million, an increase of 11.3% from $55.6 million in 2006. In 2006, federal fees increased 30.5% from $42.6 million in 2005. The increases occurred due to an increase in the balance of loans guaranteed from $30.1 billion in 2005 to $40.8 billion in 2006 and $47.5 billion in 2007.

Default Aversion Fees



For the year ended June 30, 2007, default aversion fees were $27.3 million, an increase of 55.1% from $17.6 million in 2006. In 2006 default aversion fees increased 79.6% from $9.8 million in 2005. These increases are 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 early terminations of financial instruments, net

For the year ended June 30, 2007, net gains on early terminations of financial instruments were $11.0 million. On March 29, 2007, we terminated basis swaps with notional amounts totaling $471.6 million for net gains of $8.7 million. On March 30, 2007, we terminated interest rate swaps with notional amounts totaling $400.0 million for net gains of $2.3 million.

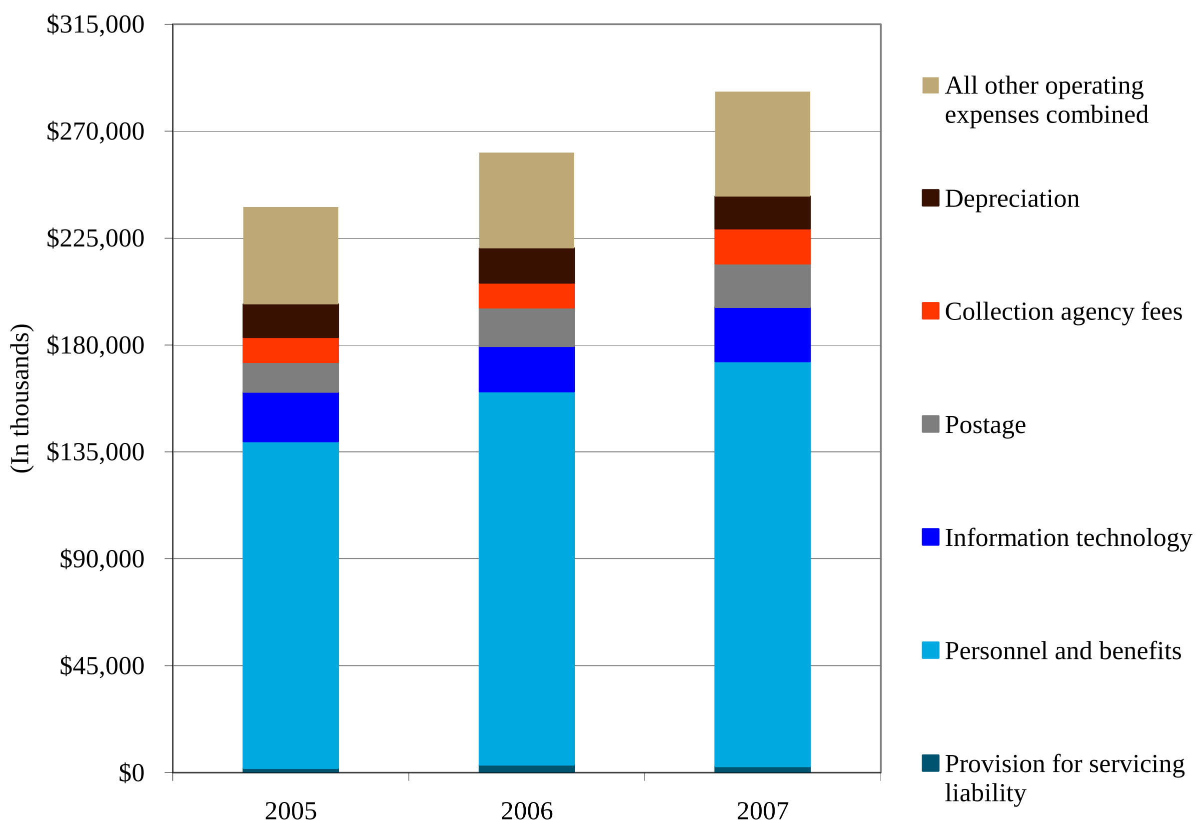
Gains on student loan sales including securitizations, net

For the year ended June 30, 2007, net gains on student loan sales including securitizations were $54 thousand compared to $259 thousand in 2006. In 2005, net gains on student loan sales including securitizations were $9.0 million.

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.

Operating Expenses



For the year ended June 30, 2007, operating expenses were $286.6 million, an increase of 9.9% from $260.9 million in 2006. In 2006, operating expenses increased 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, 2007, personnel and benefit costs were $170.5 million, an increase of 8.5% from $157.1 million in 2006. In 2006, personnel and benefit costs increased 14.3% from $137.5 million in 2005. Included in these costs are healthcare benefits for employees and retirees. For the year ended June 30, 2007, healthcare benefits for employees and retirees were $32.2 million, an increase of 8.1% from $29.8 million in 2006. In 2006, healthcare benefits increased 19.2% from $25.0 million in 2005.

For the year ended June 30, 2007, personnel costs totaling $6.2 million related to software development and loan originations that were capitalized, compared to $6.7 million in 2006. In 2005, personnel costs totaling $7.1 million related to software development and loan origination costs were capitalized.

Permanent staff makes up 95.0% of the total personnel and benefits costs. For the year ended June 30, 2007, permanent staff costs were $167.9 million, an increase of 11.4% from $150.7 million in 2006. In 2006, permanent staff costs increased 19.5% from $126.1 million in 2005. The average permanent staff positions filled were 2,496 for the year ended June 30, 2007, a 4.6% increase from the 2,386 average permanent staff positions filled for the year ended June 30, 2006. For the year ended June 30, 2005, there were 2,052 average permanent staff positions filled. The major reason for costs to increase was the March 13, 2006 conversion from a 37.5 hour work week to a 40 hour work week, effectively resulting in a 6.7% increase in compensation for most employees. Additionally, cost of living and step increases occurred during the year.

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, 2007, independent contracting costs were $8.8 million, a 31.8% decrease from $12.9 million in 2006. In 2006, independent contracting costs decreased 18.9% 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 generally include periodic step increases of 2.2%. While not mandated, our management workers typically receive the same increases as union workers.

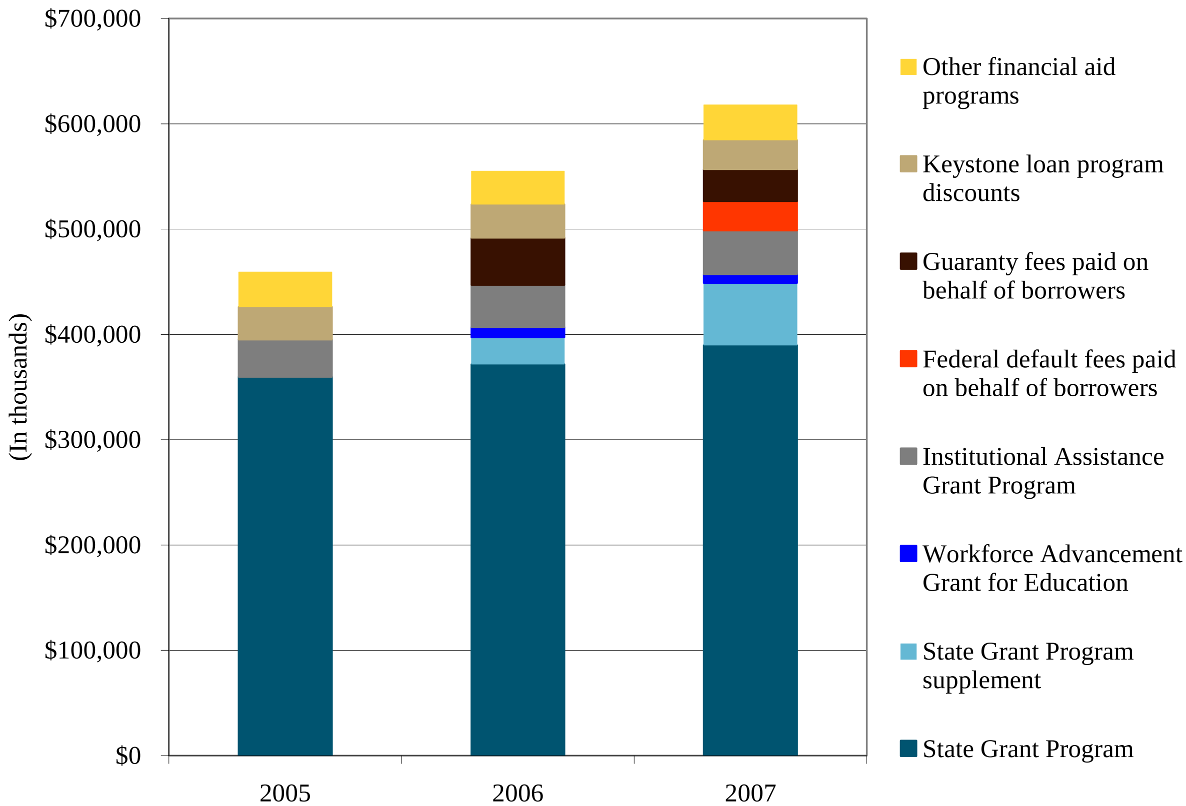
Provision for Servicing Liability

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)		**2007**	2006
Balance at beginning of period	$	**6,440**	3,897
Provision for losses		**2,712**	3,394
Charge-offs		**(815)**	(851)
Balance at end of period	$	**8,337**	6,440
Allowance as a percentage of ending balance of student loans serviced		**0.02%**	0.01%

Financial Aid Activity



For the year ended June 30, 2007, grants and other financial aid were $618.0 million, an 11.3% increase from $555.2 million in 2006. In 2006, grants and other financial aid increased 20.9% 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)		2007	2006
Self-funded			
State Grant Program supplement	$	**59,193**	25,393
Federal default fees paid on behalf of borrowers		**27,845**	-
Guarantee fees paid on behalf of borrowers		**-**	31,749
Guarantee fees paid on behalf of borrowers that were previously waived		**30,600**	13,008
Keystone loan program origination fees and benefits paid on behalf of borrowers		**27,542**	31,852
Workforce Advancement Grant for Education		**8,161**	9,784
Academic Excellence Scholarship		**3,214**	2,286
Armed Forces Loan Forgiveness Program		**3,014**	3,512
Other		**691**	966
		160,260	118,550
State and federal funded			
State Grant Program		**389,745**	371,751
Institutional Assistance Grant Program		**41,501**	40,117
Matching Funds Program		**14,866**	14,094
New Economy Technology Scholarship Program		**2,927**	3,396
Other		**8,654**	7,279
		457,693	436,637
	$	**617,953**	555,187

For the year ended June 30, 2007, self-funded financial aid was $160.3 million, a 35.2% increase from $118.6 million in 2006. In 2005, self-funded financial aid was $36.3 million.

We pay the federal default and guarantee fees on behalf of borrowers. Effective 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; however, guarantors are not required to assess the fee to borrowers. Prior to this date, we were permitted to charge a guarantee fee of up to 1% when we guaranteed a loan. For the loans we guarantee, we currently do not charge the fee. For year ended June 30, 2007, we paid fees totaling $27.8 million to the Federal Fund for loans disbursed from July 1, 2006 through June 30, 2007. For the year ended June 30, 2006, we paid fees totaling $31.7 million to the Federal Fund for loans guaranteed from July 1, 2005 through June 30, 2006.

In order to manage the Federal Fund, in 2006 we made the decision to fund $13.0 million of previously waived fees for loans guaranteed from October 1, 2004 through June 30, 2005. Under the management plan we submitted to ED on April 20, 2007 and ED approved on May 22, 2007, we agreed to deposit the necessary funds to meet the minimum reserve ratio of 0.25% by September 30, 2007. We estimate that we will have to deposit $30.6 million to meet that requirement, which results in us effectively funding a portion of the guaranty fees we have previously waived.

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 also provide a KeystoneBEST and a KeystonePLUS loan for other students. For the KeystoneBEST loans, we pay all of the federally required origination fees on behalf of borrowers. Federally required origination fees decreased from 3% in 2005 to 2% in 2006. For the KeystoneBEST loans, we also provide a 1% graduation credit, a 2% interest rate reduction after 36 consecutive on-time payments, and a 0.25% interest rate reduction for automatic direct debit of payment. For the KeystonePLUS loans, we provide a 1% rebate of the loan amount for the first 24 consecutive on-time payments, an additional 1% rebate after 48 consecutive on-time payments, and a 0.25% interest rate reduction for automatic direct debit of payment.

Other changes in net assets

For the year ended June 30, 2007, Commonwealth of Pennsylvania grants were $452.0 million, a 5.3% increase from $429.3 million in 2006. In 2006, Commonwealth of Pennsylvania grants increased 2.2% from $420.2 million in 2005.

For the year ended June 30, 2007, federal grants were $8.9 million, a 1.1% increase from $8.8 million in 2006. In 2006, federal grants decreased 20.7% from $11.1 million in 2005 due to 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, 2007, we donated $10 million and contributed $3.2 million of services to PHEF. During the year ended June 30, 2006, we donated $20.0 million and contributed $3.5 million of services to PHEF. The board of directors has authorized an additional non-contingent $20 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, based upon regulatory reports that we file with ED.

In anticipation of the regulatory filing at September 30, 2006, ED and several guarantors had discussions concerning the appropriate way to determine compliance with the ratio. Because of those discussions, and to be consistent with the approach that we understand some other guarantors are taking, we included two gain contingencies in our regulatory reporting. These gain contingencies reflect expected future receipts to the fund that we cannot record as assets under generally accepted accounting principles because gain contingencies may not be recognized as assets.

The following table displays our calculation of the ratio.

(In thousands)		**June 30, 2007**	September 30, 2006
Generally accepted accounting principles – net assets	$	**27,826**	23,820
Deferred federal default fee		**6,949**	11,134
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Reserve Fund		**16,344**	13,367
Gain contingency – collections complement on future default collections		**57,529**	38,969
Regulatory net assets	$	**108,648**	87,290
Original principal outstanding	$	**47,453,855**	44,182,198
		0.23%	0.20%

Because we are under the required ratio, we submitted a management plan to ED on April 20, 2007 and ED approved the plan on May 22, 2007.

Under the plan, we agreed to deposit the necessary funds to meet the minimum reserve ratio requirement of 0.25% by September 30, 2007. We estimate that we will have to deposit $30.6 million to meet that requirement. We have recorded that amount in these financial statements as guarantee fees paid on behalf of borrowers under grants and other financial aid because this deposit is necessary due to our past practice of waiving guarantee fees.

During the years ended June 30, 2007 and 2006, we also managed the cash flow of 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.

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 years ended June 30, 2007 and 2006, we allowed this liability to us to increase. As of June 30, 2007, we reduced this liability to us by $30.6 million to reflect our estimate of the deposit necessary to meet the minimum funding requirements as of September 30, 2007. These actions result in us managing the fund above the statutory minimum as detailed in the following table.

(In thousands)		**June 30, 2007**	September 30, 2006
Regulatory net assets	$	**108,648**	87,290
Amounts payable by the Federal Reserve Fund to PHEAA		**84,754**	54,823
Adjusted net assets	$	**193,402**	142,113
Original principal outstanding	$	**47,453,855**	44,182,198
		0.41%	0.32%

For the year ended June 30, 2007, purchases of defaulted loans were $846.2 million, an increase of 71.3% from $494.1 million in 2006. In 2006, purchases of defaulted loans increased 32.4% from $373.3 million in 2005. These increases are 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 $65.5 million at June 30, 2007. Included in unrestricted net assets is $84.8 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 $346.8 million. Of that amount, $343.0 million is related to our student loan notes, bonds and financings, and $34.5 million could be made available. Net assets restricted for financial aid grant programs amounted to $55.6 million. The deficit in net assets invested in capital assets, net of related debt of $606 thousand occurred because of differences between the timing of depreciation of the assets and principal payments on the debt.

We currently have $960.9 million of student loan financings that mature during the year ending June 30, 2008. We intend to extend the financing arrangements or enter into new financings rather than sell student loans to pay the debt when it comes due.

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 $22.6 billion at June 30, 2007. At June 30, 2007, our outstanding debt amounted to $11.8 billion. The following table shows our debt activity.

For the years ended June 30 (in thousands)		2007	2006
Capital market activity			
Proceeds from issuing student loan demand revenue bonds	$	**1,325,000**	3,050,000
Proceeds from issuing student loan floating rate notes		**1,250,000**	400,000
Repayment of student loan floating rate notes		**(82,235)**	(20,659)
Other financings			
Net student loan financing activity		**103,000**	16,000
Net capital financing activity		**6,702**	(2,331)
Net other financing activity		**(7,969)**	46,749

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

At June 30 (in thousands)		2007	2006
Land	$	**2,946**	2,946
Buildings and improvements		**42,225**	41,791
Software development		**13,144**	16,103
Purchased software		**7,058**	7,927
Other, principally information technology equipment		**8,311**	7,363
	$	**73,684**	76,130

The most significant ongoing capital item is software development. Our software development is generally related to customized systems for student financial aid processing that cannot be purchased from vendors. For the year ended June 30, 2007, we capitalized $3.4 million of software development compared to $3.6 million 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. 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 notes, bonds and financings. As well as other assets and liabilities, we have $128.2 million of student loans and $184.6 million of investments not included in the analysis.

The following gap analysis reflects rate-sensitive positions at June 30, 2007 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, 2007 (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	$	10,599,979	232,188	385,498	38,662	89,075	8,463
Restricted cash and cash equivalents		361,127	-	-	-	-	-
Other assets		176,406	36,337	20,485	17,045	23,089	35,451
Total assets		11,137,512	268,525	405,983	55,707	112,164	43,914
Liabilities							
Student loan financings and notes and bonds payable		10,848,282	748,919	-	-	-	-
Other liabilities		73,895	8,135	74	280	1,266	-
Total liabilities		10,922,177	757,054	74	280	1,266	-
Net assets							
Restricted for debt service	$	-	-	-	-	-	342,954
Period gap	$	215,335	(488,529)	405,909	55,427	110,898	(299,040)
Cumulative gap	$	215,335	(273,194)	132,715	188,142	299,040	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		102.0%	35.5%	548625.7%	19895.4%	8859.7%	12.8%
Ratio of cumulative gap to total assets		1.8%	(2.3%)	1.1%	1.6%	2.5%	0.0%

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 notes, bonds and financings. The impact simulates the effect of rates changing in parallel fashion ratably over the next twelve months.

	Movements in interest rates from June 30, 2007 rates			
	Increase		Decrease	
(In thousands)	+100 basis points	+200 basis points	-100 basis points	-200 basis points
Simulated increase (decrease) on net interest revenue over the next twelve months	$ 3,176	6,352	(2,501)	(3,452)

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

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, 2007, we have provided $18.2 million of benefits through the Armed Forces Loan Forgiveness Program and $6.6 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. In November 2006, the board of directors adopted a resolution to extend the supplement for years beginning July 1, 2010 through July 1, 2011. 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, 2007, we have supplemented the State Grant Program by $84.6 million and provided $17.9 million through the Workforce Advancement Grant for Education program related to this initiative.

On July 19, 2007, we issued $400 million of tax-exempt variable-rate student loan demand revenue bonds that reset based upon auctions every 7 days with an initial rate of 3.7%.

Beginning August 13, 2007, disruptions in the capital markets related to subprime mortgages began affecting the pricing of the auction rate debt securities financing our portfolio of student loans. If capital market performance experienced during July 1, 2007 through September 21, 2007 had occurred during the year ended June 30, 2007, we estimate that net interest revenue would have been $22.3 million lower than reported in the accompanying financial statements.

On September 7, 2007, Congress passed the College Cost Reduction and Access Act and the President is expected to sign the Act into law. This Act will generally be effective October 1, 2007 and will cause the following reductions in operating income.

- For Stafford and Consolidation loans first disbursed on or after October 1, 2007, special allowance payments to us will be 0.4% lower.

- For PLUS loans first disbursed on or after October 1, 2007, special allowance payments to us will be 0.7% lower.

- For all loans first disbursed on or after October 1, 2007, lender origination fees paid to ED will increase from 0.5% to 1.0%.

- Effective October 1, 2007, retention of collections on defaulted loans will decrease from 23% to 16%. For the year ended June 30, 2007, retention of collections on defaulted loans amounted to $82.1 million. At the new rate, the amount could have been $57.1 million.

- Effective October 1, 2007, the account maintenance fee received from ED for outstanding loan guarantees will decrease from 0.1% to 0.06%. For the year ended June 30, 2007, account maintenance fees amounted to $48.1 million. At the new rate, the amount would have been $28.9 million.

- Effective October 1, 2007, the exceptional performer section of the law will be eliminated. Because of the exceptional performer section, loans we held were insured at 99%, and the provision for loan losses was $3.0 million for the year ended June 30, 2007. Without the exceptional performer section, loans will be insured at 97%, and the provision for loan losses for the year ended June 30, 2007 would have been $8.9 million.

- Effective October 1, 2012, lender insurance for loans first disbursed on or after October 1, 2012 will decrease from 97% to 95%.

- Effective July 1, 2009, the Parent PLUS program will be converted to an auction.

Contacting Us

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

Phone – 717 720-2540
Fax – 717 720-3923
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September 26, 2007

KPMG

KPMG LLP
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30 North Third Street
PO Box 1190
Harrisburg, PA 17108-1190

Independent Auditors' Report

The Board of Directors
Pennsylvania Higher Education Assistance Agency:

We have audited the accompanying statements of net assets of the Pennsylvania Higher Education Assistance Agency (PHEAA), a component unit of the Commonwealth of Pennsylvania, as of June 30, 2007 and 2006, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of PHEAA as of June 30, 2007 and 2006, 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 28 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 26, 2007

For the years ended June 30, 2007 and 2006 (in thousands)

		2007	2006
Interest revenue			
Student loans	$	**636,906**	431,844
Investments		**36,348**	35,126
Total interest revenue		**673,254**	466,970
Interest expense			
Student loan financings and notes and bonds payable		**527,057**	291,751
Capital and other financings		**10,220**	8,312
Total interest expense		**537,277**	300,063
Net interest revenue		**135,977**	166,907
Provision for loan losses		**(2,965)**	(1,561)
Net interest revenue after provision for loan losses		**133,012**	165,346
Noninterest revenue			
Servicing fees		**113,338**	108,355
Retention of collections on defaulted loans		**82,140**	68,818
Federal fees		**61,895**	55,631
Default aversion fees, net		**27,268**	17,574
Gains on early terminations of financial instruments, net		**11,034**	-
Gains on student loan sales, net		**54**	259
Other		**401**	397
Total noninterest revenue		**296,130**	251,034
Operating revenues		**429,142**	416,380
Operating expenses			
Personnel		**170,468**	157,052
Information technology related expenses		**22,754**	19,004
Postage		**18,306**	16,305
Collection agency fees		**14,751**	10,420
Depreciation		**13,570**	14,632
Other		**46,708**	43,441
Total operating expenses		**286,557**	260,854
Operating income		**142,585**	155,526
Commonwealth of Pennsylvania grants		**452,003**	429,250
Federal grants		**8,862**	8,811
Grants and other financial aid		**(617,953)**	(555,187)
Transfer of undisbursed program funds to the Commonwealth of Pennsylvania		**(728)**	(2,237)
Transfer of undisbursed program funds to the U.S. Department of Education		**(71)**	(281)
Contributions to Pennsylvania Higher Education Foundation		**(13,155)**	(23,455)
Changes in net assets		**(28,457)**	12,427
Net assets, beginning of period		**498,227**	485,800
Net assets, end of period	$	**469,770**	498,227

See accompanying notes to financial statements.

At June 30 (in thousands)

		2007	2006
Assets			
Restricted cash and cash equivalents	$	**365,611**	274,292
Restricted cash and cash equivalents – due to customers		**112,966**	101,464
Investments		**33,573**	28,372
Restricted investments		**70,673**	72,453
Student loans receivable, net		**11,482,091**	9,095,114
Interest income receivable		**263,858**	187,676
Due from Federal Student Loan Reserve Fund		**84,754**	54,823
Capital assets, net		**73,684**	76,130
Deferred financing costs, net		**48,586**	39,978
Other assets		**39,357**	33,132
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**128,430**	103,283
Total assets		**12,703,583**	10,066,717
Liabilities			
Cash overdraft		**35,640**	43,102
Due to customers		**112,966**	101,464
Accounts payable and accrued expenses		**171,853**	131,088
Student loans financings and notes and bonds payable, net		**11,597,201**	9,000,636
Capital and other financings		**187,723**	188,917
Amounts related to the Federal Student Loan Reserve Fund		**128,430**	103,283
Total liabilities		**12,233,813**	9,568,490
Net assets			
Invested in capital assets, net of related debt		**(606)**	8,589
Restricted for debt service		**346,771**	357,628
Restricted for financial aid grant programs		**55,590**	55,711
Restricted for default aversion activities		**2,468**	2,326
Unrestricted		**65,547**	73,973
Total net assets	$	**469,770**	498,227

See accompanying notes to financial statements.

For the years ended June 30, 2007 and 2006 (in thousands)

		2007	2006
Cash flows from operating activities			
Interest received on student loans	$	**520,317**	337,606
Principal received on student loans		**1,272,356**	1,017,819
Student loan originations		**(1,144,937)**	(874,879)
Student loan purchases		**(2,520,105)**	(3,734,944)
Student loan sales, including net gains		**44,595**	175,713
Interest received on investments		**37,890**	32,629
Interest paid on student loan financings and notes and bonds payable		**(505,746)**	(274,260)
Interest paid on capital and other financings		**(9,899)**	(7,940)
Servicing fees		**111,074**	106,148
Retention of collections on defaulted loans		**41,302**	36,534
Federal fees		**58,432**	53,885
Default aversion fees, net of rebate		**13,851**	11,385
Gains on early terminations of financial instruments, net		**11,034**	-
Other		**401**	397
Payment of operating expenses		**(263,856)**	(226,821)
Net cash used for operating activities		**(2,333,291)**	(3,346,728)
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		**3,007,000**	3,855,900
Principal paid on noncapital debt		**(419,204)**	(363,810)
Issuance costs		**(10,594)**	(13,942)
Commonwealth of Pennsylvania grants received		**452,003**	429,250
Federal grants received		**8,862**	8,811
Grants and financial aid paid		**(587,353)**	(555,187)
Grant funds returned to the Commonwealth of Pennsylvania		**(728)**	(2,237)
Grant funds returned to the U.S. Department of Education		**(71)**	(281)
Contributions to Pennsylvania Higher Education Foundation		**(10,000)**	(20,000)
Cash overdraft		**(7,462)**	13,917
Net cash provided by noncapital financing activities		**2,432,453**	3,352,421
Cash flows from capital and related financing activities			
Proceeds from issuance of capital debt		**9,004**	-
Principal paid on capital debt		**(2,302)**	(2,331)
Purchases of capital assets and development of software, net of disposals		**(11,124)**	(15,302)
Net cash used for capital and related financing activities		**(4,422)**	(17,633)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		**389,882**	391,009
Purchases of investments		**(393,303)**	(354,905)
Net cash provided by (used for) investing activities		**(3,421)**	36,104
Net change in restricted cash and cash equivalents		**91,319**	24,164
Restricted cash and cash equivalents, beginning of period		**274,292**	250,128
Restricted cash and cash equivalents, end of period	$	**365,611**	274,292

(continued)

For the years ended June 30, 2007 and 2006 (in thousands)

		2007	2006
Reconciliation of operating income to net cash used for operating activities			
Operating income	$	**142,585**	155,526
Adjustments to reconcile operating income to net cash used for operating activities:			
Depreciation		**13,570**	14,632
Amortization of premium (discount) on loan purchases		**49,403**	25,939
Amortization of loan origination costs		**8,522**	5,147
Amortization of deferred financing costs		**1,986**	1,454
Amortization of deferred amount on refundings of student loan demand revenue bonds		**800**	799
Accretion discount on capital and other financings		**73**	72
Operational support provided to Pennsylvania Higher Education Foundation		**(3,155)**	(3,455)
Changes in assets and liabilities:			
Increase in interest income receivable		**(76,182)**	(72,422)
Increase in student loans receivable		**(2,444,902)**	(3,473,772)
Increase in amounts due from Federal Student Loan Reserve Fund		**(60,531)**	(48,992)
Increase in other assets		**(6,225)**	(4,917)
Increase in accounts payable and accrued expenses		**40,765**	53,261
Total adjustments		**(2,475,876)**	(3,502,254)
Net cash used for operating activities	$	**(2,333,291)**	(3,346,728)

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)		**2007**	2006
Contributions	$	**16,562**	19,439
Income on investments		**6,058**	3,635
Expenses, including grants of $16.1 million in 2007 and $11.7 million in 2006		**(20,061)**	(17,972)
Increase in net assets		**2,559**	5,102
Net assets at beginning of year		**43,399**	38,297
Net assets at end of year	$	**45,958**	43,399

At May 31 (in thousands)		2007	2006
Investments	$	**42,946**	39,715
Office furnishings and equipment, net of accumulated depreciation		**67**	91
Amounts payable to specific organizations as designated by donors		**(196)**	(583)
Other assets, net of liabilities		**3,141**	4,176
Net assets	$	**45,958**	43,399

We made cash donations totaling $10 million to PHEF during the year ended June 30, 2007 and $20 million during the year ended June 30, 2006. We are also authorized to provide operational support to PHEF, which cost $3.2 million during the year ended June 30, 2007 and $3.5 million in 2006.

Our board of directors has authorized an additional $20 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. We currently pay all of the up-front federal fees that could be charged to borrowers for loans originated by us. The cost of providing these benefits is reported with grants and other financial aid. 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 at acquisition 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 and improvements 7 – 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 the straight-line or 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; account 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 the securitization of student loans none of which has been recognized in the financial statements.

Advertising

We expense the costs of advertising as costs are incurred. Advertising expenses are incurred to generate additional business and to make sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. Advertising expenses were $9.7 million in 2007 and $7.5 million in 2006. Included in these expenses are advertising expenses paid on behalf of PHEF totaling $855 thousand in 2007 and $1.3 million in 2006. These amounts are reported as contributions to PHEF.

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.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year's presentation.

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 the year ending June 30, 2008, and our financial statements to date do not reflect these requirements. We anticipate that this statement will change expense recognition and disclosure related to healthcare benefits provided for retirees. We are participating in the Commonwealth of Pennsylvania's actuarial valuation study. To date, we have not received a completed actuarial valuation report from the Commonwealth of Pennsylvania.

In September 2006, the GASB issued GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.* This statement must be adopted for the year ending June 30, 2008, and our financial statements to date do not reflect these requirements. We anticipate that this statement will change recognition of residual interest in the securitization trust from cash basis to accrual basis of accounting.

In June 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. We have not completed our analysis of this statement, which must be adopted for the year ending June 30, 2010.

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)		**2007**	2006
Additions			
Reinsurance from the U.S. Department of Education	$	**812,789**	476,905
Collections on defaulted loans		**276,698**	208,208
Student loan insurance premiums		**58,445**	47,121
Net appreciation in fair value of investments		**2,884**	1,521
Gain on sale of capital assets		**-**	3,324
Usage fees		**-**	27
Other		**619**	17
Total additions		**1,151,435**	737,123
Deductions			
Purchases of defaulted loans from lenders		**846,183**	494,077
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**187,961**	135,408
Reimbursement to PHEAA for our retention of defaulted loans collections		**82,140**	68,818
Default aversion fees, net		**33,543**	28,093
Transfers to PHEAA for portfolio maintenance fee not paid by U.S. Department of Education		**-**	29,757
Depreciation		**-**	93
Total deductions		**1,149,827**	756,246
Net increase (decrease)		**1,608**	(19,123)
Net assets, beginning of period		**26,218**	45,341
Net assets, end of period	$	**27,826**	26,218

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

At June 30 (in thousands)		2007	2006
Assets			
Cash	$	**4,891**	2,788
Receivable from the U.S. Department of Education		**78,741**	59,336
Other receivables		**7,859**	441
Interest income receivable		**409**	438
Investments		**36,530**	40,280
Total assets		**128,430**	103,283
Liabilities			
Accounts payable and accrued expenses		**219**	4,878
Payable to U.S. Department of Education		**8,682**	17,364
Deferred student loan insurance premiums		**6,949**	-
Amounts payable to PHEAA		**84,754**	54,823
Total liabilities		**100,604**	77,065
Net assets	$	**27,826**	26,218

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 occurred in the year ended 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 and $8.7 million was due and paid by September 1, 2006. The entire $26.3 million was recorded as a deduction from net assets during the year ended June 30, 2002. $8.7 million remains as an amount payable to the U.S. Department of Education at June 30, 2007 for the recall due in 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, based upon regulatory reports that we file with ED.

In anticipation of the regulatory filing at September 30, 2006, ED and several guarantors had discussions concerning the appropriate way to determine compliance with the ratio. Because of those discussions, and to be consistent with the approach that we understand some other guarantors are taking, we included two gain contingencies in our regulatory reporting. These gain contingencies reflect expected future receipts to the fund that we cannot record as assets under generally accepted accounting principles because gain contingencies may not be recognized as assets.

Because we are under the required ratio, we submitted a management plan to ED on April 20, 2007 and ED approved the plan on May 22, 2007.

Under the plan, we agreed to deposit the necessary funds to meet the minimum reserve ratio requirement of 0.25% by September 30, 2007. We estimate that we will have to deposit $30.6 million to meet that requirement. We have recorded that amount in these financial statements as guarantee fees paid on behalf of borrowers under grants and other financial aid because this deposit is necessary due to our past practice of waiving guarantee fees.

During the years ended June 30, 2007 and 2006, we also managed the cash flow of 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.

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 years ended June 30, 2007 and 2006, we allowed this liability to us to increase. As of June 30, 2007, we reduced this liability to us by $30.6 million to reflect our estimate of the deposit necessary to meet the minimum funding requirements as of September 30, 2007.

The result of these actions and recognition of the gain contingencies 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)		2007	2006
Restricted cash and cash equivalents	$	**365,611**	274,292
Restricted cash and cash equivalents – due to customers		**112,966**	101,464
Cash overdraft		**(35,640)**	(43,102)
Carrying value	$	**442,937**	332,654
Cash on deposit, bank balance	$	**15,998**	18,799
Cash equivalents		**408,087**	498,824
Cash on deposit, bank balance (including cash equivalents)	$	**424,085**	517,623

The following table shows our investments and maturities at June 30, 2007.

			Investment Maturities (in years)		
(In thousands)		Fair Value	Less than 1	1 to 10	More than 10
Cash equivalents					
Money market funds	$	166,861	166,861	-	-
Guaranteed investment contracts and agreements		143,332	143,332	-	-
U.S. government agencies		11,970	11,970	-	-
Commercial paper		85,924	85,924	-	-
		408,087	408,087	-	-
Investments					
State Treasury investment pool		33,573	33,573	-	-
Guaranteed investment contracts and agreements		70,673	-	65,620	5,053
	$	512,333	441,660	65,620	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 guidelines 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. Government securities, U.S. Government agency securities, Federal instrumentalities sponsored by U.S. agencies, high-grade commercial paper, repurchase agreements collateralized by U.S. Treasury obligations, certificates of deposit, bankers' acceptances eligible for purchase by the Federal Reserve System, and other investments approved by the board of directors from time to time. The prudent person rule requires the contractor shall exercise: the judgment, care, skill, prudence and diligence under the circumstances then prevailing, which persons of prudence, discretion and intelligence, acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims by diversifying the investments of the funds, so as to minimize the risk, considering the probable income as well as the probable safety of their capital.

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, 2007, $90.9 million of our investments in U.S. government agencies and commercial paper were rated A-1+ and $7.0 million was rated A-1. At June 30, 2007, $60.0 million of our investments in guaranteed investment contracts and agreements were rated Aa2, $83.3 million were rated Aaa, and $70.7 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, 2007, $15.9 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, 2007, 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	$	11,970
Commercial paper		85,924
	$	97,894

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, 2007.

(In thousands)	Issuer		Fair Value
Guaranteed investment agreement	MBIA, Inc	$	65,620
Guaranteed investment contracts	Trinity Plus Funding Co.		83,326
Guaranteed investment contracts	IXIS Funding		51,064

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

			Investment Maturities (in years)		
(In thousands)		Fair Value	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

The Federal Fund had $36.5 million at June 30, 2007 and $40.3 million at June 30, 2006 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)		2007	2006
FFELP:			
Consolidation	$	**7,523,624**	5,172,644
Stafford		**3,023,343**	3,047,722
PLUS		**390,840**	343,130
Supplemental Loans for Students		**2,879**	4,121
		10,940,686	8,567,617
HEAL		**221,661**	266,461
Privately insured loans		**51,538**	46,175
Uninsured loans		**6,191**	6,479
Unamortized premium on loan purchases		**225,687**	187,373
Unamortized loan origination costs		**41,984**	24,985
		11,487,747	9,099,090
Allowance for loan losses		**(5,656)**	(3,976)
	$	**11,482,091**	9,095,114

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, 2007 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)		**2007**	2006
Balance at beginning of period	$	**3,976**	2,116
Provision for losses		**3,996**	2,429
Charge-offs		**(2,316)**	(569)
Balance at end of period	$	**5,656**	3,976

At June 30, 2007, we had commitments to purchase approximately $1.2 billion of student loans.

Note 7 – Capital Assets

Capital asset activity for the year ended June 30, 2007 was as follows.

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings and improvements		70,280	2,921	(750)	72,451
Software development		33,299	3,432	(5,235)	31,496
Purchased software		19,420	2,252	(691)	20,981
Other, principally information technology equipment		27,372	4,779	(1,702)	30,449
		153,317	13,384	(8,378)	158,323
Less accumulated depreciation for:					
Buildings and improvements		(28,489)	(1,748)	11	(30,226)
Software development		(17,196)	(6,391)	5,235	(18,352)
Purchased software		(11,493)	(2,722)	292	(13,923)
Other, principally information technology equipment		(20,009)	(2,710)	581	(22,138)
		(77,187)	(13,571)	6,119	(84,639)
	$	76,130	(187)	(2,259)	73,684

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 and improvements		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 and improvements		(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

Note 8 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings for the year ended June 30, 2007 was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings, due on demand at weighted-average rates of 5.67% at June 30, 2007	$	857,919	313,000	(210,000)	960,919	960,919
Student loan floating rate notes, due 2017-2043 at weighted-average rates of 5.45% at June 30, 2007 and 5.19% at June 30, 2006		379,341	1,250,000	(82,235)	1,547,106	-
Student loan demand revenue bonds and auction rate notes:						
Student loan demand revenue bonds and auction rate notes, due 2017-2047, at weighted-average rates of 4.91% at June 30, 2007 and 4.86% at June 30, 2006		7,774,900	1,325,000	-	9,099,900	-
Deferred amount on current refundings of student loan demand revenue bonds		(11,524)	-	800	(10,724)	-
		7,763,376	1,325,000	800	9,089,176	-
Capital financings:						
Capital financings, due 2008-2017, at weighted-average rates of 5.98% at June 30, 2007 and 6.13% at June 30, 2006		67,765	9,004	(2,302)	74,467	3,124
Unamortized discount on capital acquisition bonds		(223)	-	46	(177)	-
		67,542	9,004	(2,256)	74,290	3,124
Other financings:						
Term financings, due 2008-2031, at weighted-average rates of 5.09% at June 30, 2007 and 5.10% at June 30, 2006		71,999	-	(2,069)	69,930	1,725
Unamortized discount on capital acquisition refunding bonds		(524)	-	27	(497)	-
Line of credit, due 2012, at weighted-average rates of 6.32% at June 30, 2007		49,900	119,000	(124,900)	44,000	-
		121,375	119,000	(126,942)	113,433	1,725
	$	9,189,553	3,016,004	(420,633)	11,784,924	965,768

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 floating rate notes, and student loan demand revenue bonds and auction rate notes. At June 30, 2007, $11.6 billion of student loan principal and related interest receivable and $329.3 million of investments and related interest receivable collateralized the $11.6 billion of student loan financings and notes and bonds payable.

The student loan demand revenue bonds are subject to purchase, at par plus accrued interest, 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 2007 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, 2007, total letter of credit coverage was $1.8 billion.

Capital financings are collateralized with capital assets.

At June 30, 2007, we had $399.1 million of available credit under student loan financing arrangements, $2.7 million available credit under capital financings, and $106.0 million available under other lines of credit.

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

(In thousands)		Student Loan Notes, Bonds and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2008	$	960,919	549,457	4,849	10,669
2009		-	531,247	4,997	10,407
2010		-	531,247	4,954	10,141
2011		-	531,247	64,691	7,854
2012		-	531,247	47,225	4,988
2013-2017		398,313	2,644,285	12,156	14,165
2018-2022		891,208	2,452,628	13,970	10,865
2023-2027		674,500	2,307,573	17,820	6,831
2028-2032		425,000	2,167,348	17,735	1,822
2033-2037		1,219,485	2,079,252	-	-
2038-2042		1,306,000	1,700,841	-	-
2043-2047		5,732,500	933,446	-	-
	$	11,607,925	16,959,818	188,397	77,742

$11.6 billion of the student loan notes, bonds and financings are variable-rate debt. $1.7 billion of the variable-rate debt resets based upon auctions every 7 days. $6.7 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, $1.6 billion is indexed to the 3-month LIBOR and the remaining $112.0 million is indexed to the 1-month LIBOR.

At June 30, 2007, we had not yet issued $4.3 billion of debt that the board of directors has authorized. On July 19, 2007, we issued $400 million of tax-exempt variable-rate student loan demand revenue bonds that reset based upon auctions every 7 days with an initial rate of 3.7%.

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, 2006 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance
Student loan financings	$ 841,919	356,000	(340,000)	857,919
Student loan floating rate notes	-	400,000	(20,659)	379,341
Student loan demand revenue bonds and auction rate notes:				
Student loan demand revenue bonds and auction rate notes	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	70,096	-	(2,331)	67,765
Unamortized discount on capital acquisition bonds	(268)	-	45	(223)
	69,828	-	(2,286)	67,542
Other financings:				
Term financings	75,150	-	(3,151)	71,999
Unamortized discount on capital acquisition refunding bonds	(551)	-	27	(524)
Lines of credit	-	49,900	-	49,900
	74,599	49,900	(3,124)	121,375
	$ 5,698,923	3,855,900	(365,270)	9,189,553

Note 9 – Financial Instruments with Off-Balance Sheet Risk

We entered into interest rate swaps to convert variable-rate debt into fixed-rate debt synthetically as part of our interest rate risk management and we entered into basis swaps to lower costs on notes and bonds payable. During the year ended June 30, 2007, we terminated all of these financial instruments. For the year ended June 30, 2007, net gains on early terminations of financial instruments were $11.0 million. These amounts are included in gains on early terminations of financial instruments on the statements of revenues, expenses, and changes in net assets.

The following table summarizes the financial instruments and their net gains for the year ended June 30, 2007.

(In thousands)		Notional Amounts	Effective Dates	Termination Dates		Net Gains
Basis swaps	$	400,000	September 15, 2005	March 29, 2007	$	8,312
Basis swap	$	71,575	March 17, 2006	March 29, 2007		421
Interest rate swaps	$	200,000	September 30, 2005	March 30, 2007		1,504
Interest rate swaps	$	200,000	October 7, 2005	March 30, 2007		797
					$	11,034

Note 10 – Leases

We lease office space, information technology and other equipment under operating leases expiring during the next six 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 $8.7 million in 2007 and $7.4 million in 2006.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) at June 30, 2007 are:

Year ending June 30 (in thousands)		
2008	$	10,341
2009		7,084
2010		4,389
2011		3,396
2012		2,990
2013		736
Total minimum lease payments	$	28,936

Note 11 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

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

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

Funding Policy

Members are required to contribute to the plan. For most members the contribution rate is 6.25% of annual covered salary. As an employer, we are required to contribute at an actuarially determined rate. During the year ended June 30, 2007, the required employer contribution rates were 2.59% or 3.23%, depending upon the membership classification of each employee. Beginning July 1, 2007, our contribution rates will be 2.63% or 3.28%. 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 $3.8 million for the year ended June 30, 2007 and $2.5 million for the year ended June 30, 2006. 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 $14.4 million for the year ended June 30, 2007 and $14.0 million for the year ended June 30, 2006.

Note 12 – Servicing Fees

We have contracts with customers to provide servicing of student loans as well as information technology services. At June 30, 2007, we were servicing approximately $38.3 billion of loans for customers. Customers using our computer services serviced an additional $29.2 billion of loans. Other FFELP guarantors were managing $3.6 billion of guarantees using our computer services.

Our servicing agreements, some of which expire in 2008, 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 $56.6 million of servicing fees for the year ended June 30, 2007. 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 notes, bonds and other financings and the earnings are pledged in support of the debt. Because the revenue stream of the student loan portfolios is pledged to support the debt, we are reporting condensed financial information about this segment.

Statements of revenues, expenses, and changes in net assets

For the years ended June 30 (in thousands)		2007	2006
Interest revenue	$	**672,735**	452,584
Interest expense		**530,200**	292,965
Net interest revenue		**142,535**	159,619
Provision for loan losses		**(2,956)**	(1,537)
Net interest revenue after provision for loan losses		**139,579**	158,082
Gains on student loan sales, net		**101**	688
Total operating revenues		**139,680**	158,770
Operating expenses		**91,769**	70,418
Operating income		**47,911**	88,352
Financial aid		**16,754**	17,309
Income before transfers		**31,157**	71,043
Transfers to unrestricted net assets		**(41,594)**	(48,208)
Change in net assets		**(10,437)**	22,835
Net assets, beginning of period		**353,391**	330,556
Net assets, end of period	$	**342,954**	353,391

Statements of net assets

At June 30 (in thousands)		2007	2006
Restricted cash and cash equivalents	$	**361,127**	343,073
Student loans receivable		**11,353,865**	8,849,958
Other, principally interest income receivable		**308,813**	221,860
Total assets		**12,023,805**	9,414,891
Student loan financings and notes and bonds payable, net		**11,597,201**	9,000,636
Other, principally accrued interest payable		**83,650**	60,864
Total liabilities		**11,680,851**	9,061,500
Net assets, restricted for debt service	$	**342,954**	353,391

Statements of cash flows

For the years ended June 30 (in thousands)		2007	2006
Interest received on student loans	$	**513,660**	333,473
Principal received on student loans		**1,272,140**	995,079
Student loan originations		**(1,143,852)**	(873,777)
Student loan purchases		**(2,736,862)**	(3,741,916)
Student loan sales, including gains (losses)		**162,327**	331,073
Interest received on investments		**20,384**	14,794
Interest paid on student loan financings and notes and bonds payable		**(508,890)**	(275,474)
Payment of operating expenses		**(87,678)**	(54,391)
Net cash used for operating activities		**(2,508,771)**	(3,271,139)
Proceeds from issuance of noncapital debt		**2,888,000**	3,806,000
Principal paid on noncapital debt		**(292,234)**	(360,659)
Other		**(68,941)**	(79,460)
Net cash provided by noncapital financing activities		**2,526,825**	3,365,881
Net change in restricted cash and cash equivalents		**18,054**	94,742
Restricted cash and cash equivalents, beginning of period		**343,073**	248,331
Restricted cash and cash equivalents, end of period	$	**361,127**	343,073

Note 14 – Restrictions on Net Assets

Net assets restricted for debt service amounted to $346.8 million at June 30, 2007. Of that amount, $343.0 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, 2007, of the $343.0 million net assets restricted under these indentures, we have $34.5 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 $3.8 million of net assets restricted for debt service is related to capital and other financings.

The $55.6 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 $2.5 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 25 basis points per year on the outstanding balance of consolidation loans and 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. For the year ended June 30, 2007, we earned $4.0 million, compared to $4.8 million in 2006. 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, filed a monthly Form 8-K and an annual Form 10-K with the SEC through November 30, 2005 and those filings are available on the SEC's website at www.sec.gov. 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)		**2007**	2006
Principal balance of financed student loans			
Consolidation	$	**697,763**	769,723
Stafford and PLUS		**40,713**	74,428
	$	**738,476**	844,151
Aggregate outstanding principal amount of notes	$	**776,206**	909,175

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.

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 and previously recognized as income.

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.

Note 17 – Subsequent Event

On September 7, 2007, Congress passed the College Cost Reduction and Access Act and the President is expected to sign the Act into law. This Act will generally be effective October 1, 2007 and will cause the following reductions in operating income.

- For Stafford and Consolidation loans first disbursed on or after October 1, 2007, special allowance payments to us will be 0.4% lower.
- For PLUS loans first disbursed on or after October 1, 2007, special allowance payments to us will be 0.7% lower.
- For all loans first disbursed on or after October 1, 2007, lender origination fees paid to ED will increase from 0.5% to 1.0%.
- Effective October 1, 2007, retention of collections on defaulted loans will decrease from 23% to 16%.
- Effective October 1, 2007, the account maintenance fee received from ED for outstanding loan guarantees will decrease from 0.1% to 0.06%.
- Effective October 1, 2007, the exceptional performer section of the law will be eliminated.
- Effective October 1, 2012, lender insurance for loans first disbursed on or after October 1, 2012 will decrease from 97% to 95%.
- Effective July 1, 2009, the Parent PLUS program will be converted to an auction.