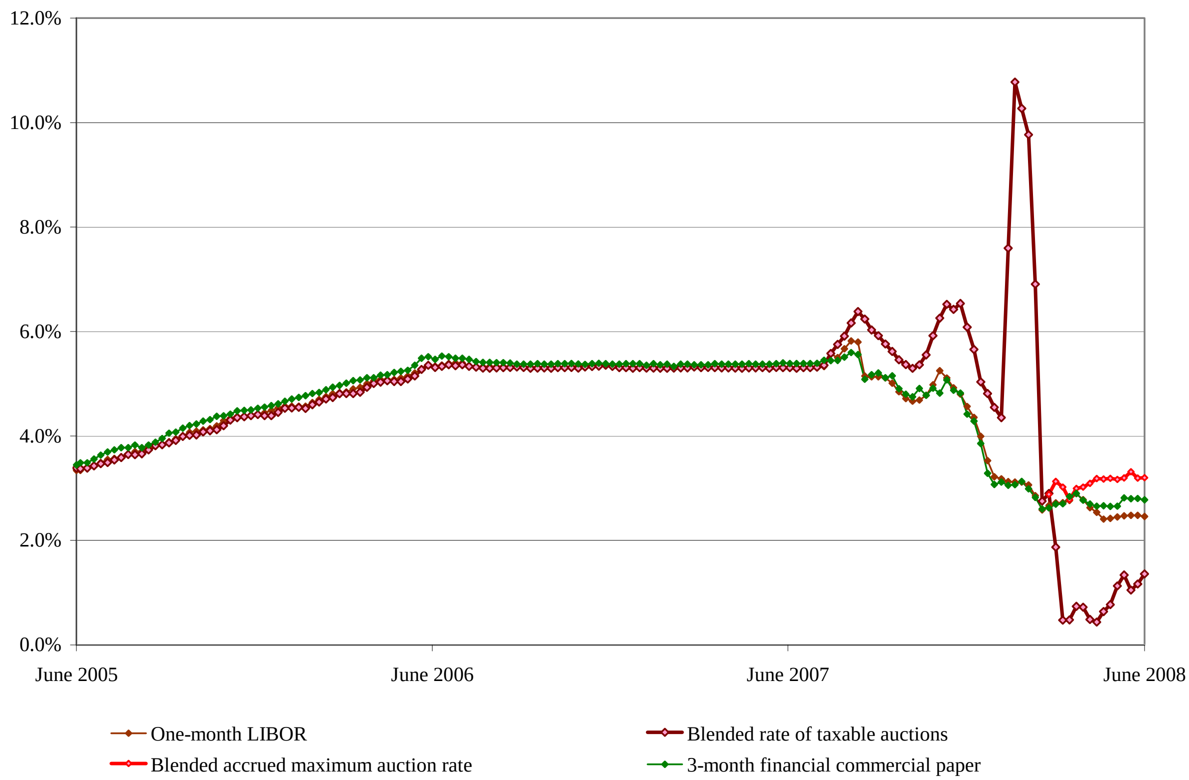
Annual Financial Report
June 30, 2008 and 2007

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.

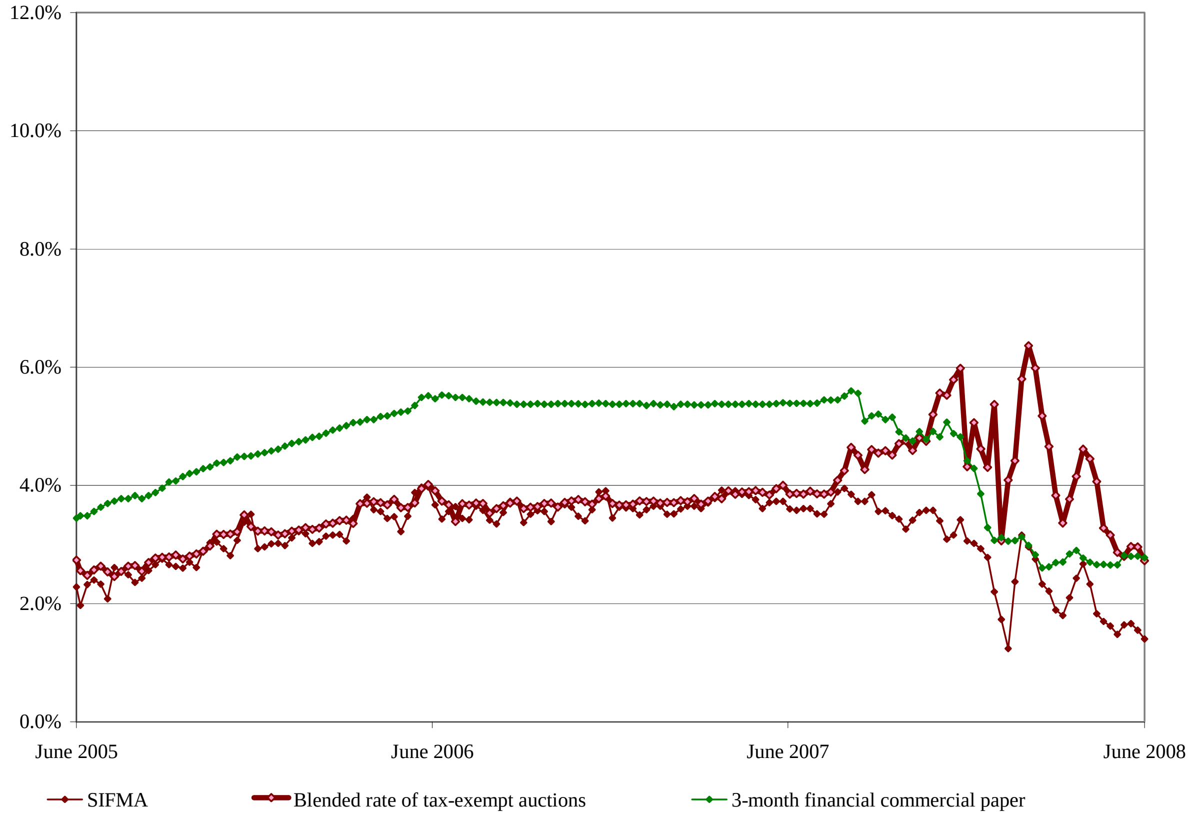
Recent Developments Affecting Profitability and Program Changes and Description of Currently Known Facts, Decisions or Conditions Expected to have a Significant Effect on Net Assets or Results of Operations

In August 2007, disruptions in the capital markets began increasing the cost of $7.4 billion of auction rate debt securities financing our portfolio of student loans. In February 2008, a decline in investor demand in the auction rate market caused auctions to fail. The failure of an auction does not constitute a default on the bonds, and all principal and interest has been paid when due on the outstanding bonds. Upon the occurrence of a failed auction, bondholders are entitled to receive a maximum rate as described in the related auction procedures. The maximum auction rates payable on auction rate securities are based upon bond agreements, and were generally at 91-day treasury-bill rates plus 1.2% or one-month LIBOR rates plus 1% for the one-year period ending on the auction date although there are other formulas for some of the auction rate securities. While we continue to assess the situation, there is no timetable or restructuring plan for these securities at this time.

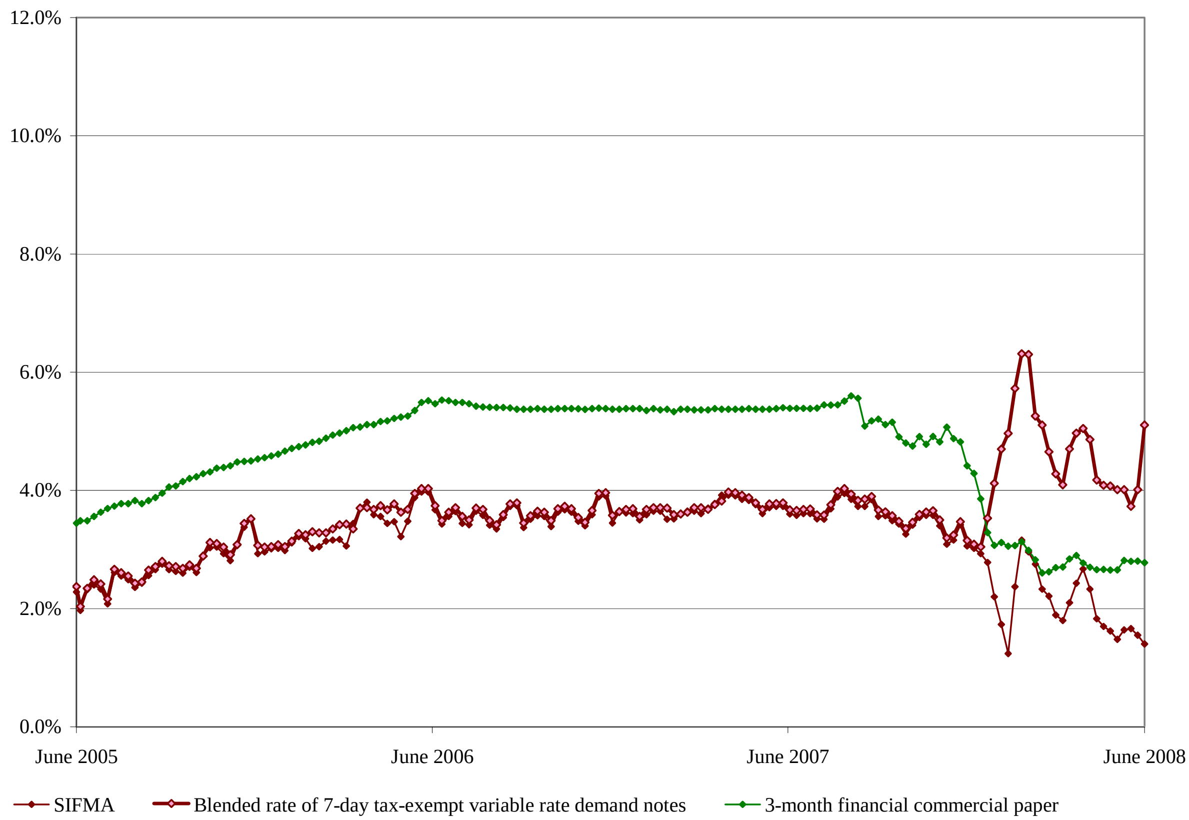
Of our $7.4 billion of auction rate debt, $6.7 billion is taxable. Before August 2007, the blended rate of our taxable auctions tracked one-month LIBOR. The following chart displays one-month LIBOR, the blended rate of taxable auctions, and the blended accrued maximum auction rate since the auctions failed along with the 3-month financial commercial paper rate on which the lender yield for student loans is based. After the auctions failed, during periods in which the calculated rate based upon the one-year look-back period is less than the maximum auction rate payable, we accrued the difference to reflect our expectation that the auctions will continue to fail and the maximum rate will be paid.



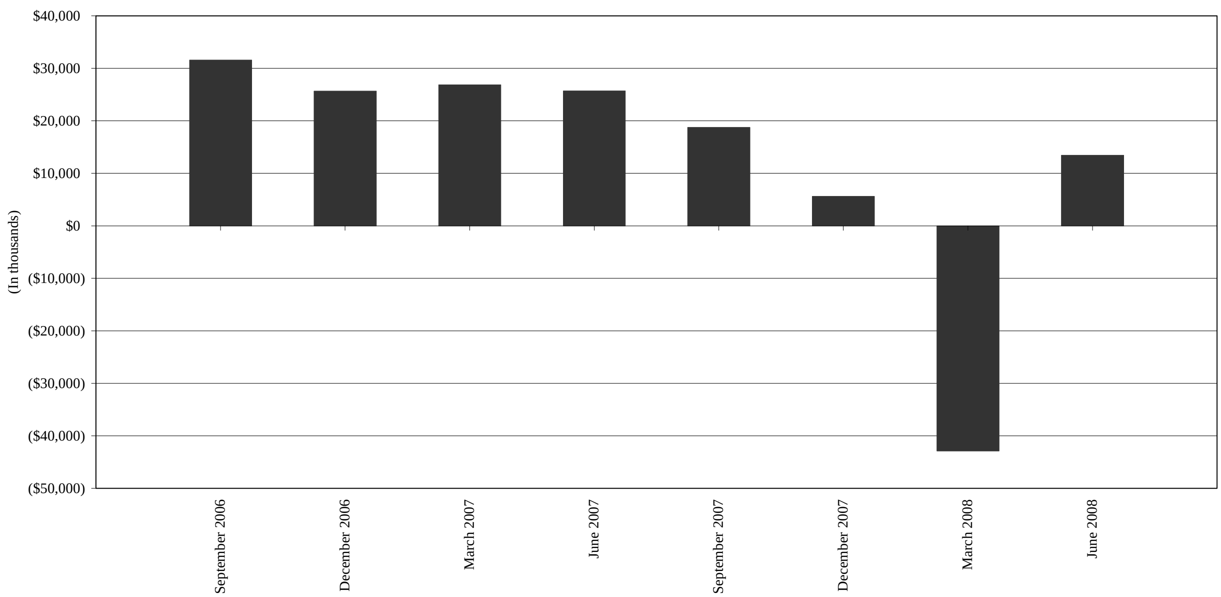
Before August 2007, the remaining $791 million of tax-exempt auction rate debt generally tracked the Securities Industry and Financial Markets Association ("SIFMA") index. The maximum auction rates payable on tax-exempt auction rate securities are based upon bond agreements, and are generally the lesser of a maximum rate of 14% or 175% of the higher of other benchmark rates including the SIFMA index and the AA commercial paper rate multiplied by 65%. The following chart displays the SIFMA index and the blended rate of tax-exempt auctions as well as the 3-month financial commercial paper rate.



In January 2008, a downgrade of Ambac's credit rating and negative market sentiment began increasing the cost of $1.7 billion of our tax-exempt variable-rate demand bonds that Ambac insures. Before January 2008, the interest rates paid on the variable-rate demand bonds tracked the SIFMA index. The following chart displays the SIFMA index and the blended rate of our $2.1 billion of tax-exempt variable-rate demand notes, including the $1.7 billion insured by Ambac.



The combination of these adverse market conditions resulted in increased interest expense while interest revenue on student loans, based upon 3-month financial commercial paper rates, decreased. For the year ended June 30, 2008, net student loan interest expense was $5.1 million, compared to net student loan interest revenue of $109.8 million in 2007, a decrease of $114.9 million. The following chart displays net student loan interest revenue (expense) by quarter for the last two fiscal years.



The net student loan interest expense during the quarter ended March 31, 2008 was caused largely by failed auctions resetting at a maximum rate based upon a twelve-month look-back on the date of the failed auction. As long as the auctions continue to fail and we continue to accrue expense at the maximum rate for each auction period, a one-time transition to the maximum rate, such as the one that occurred in the quarter ended March 31, 2008, should not be necessary in the future.

Because of an inability to access the credit markets or financing markets needed to fund student loans, effective March 7, 2008, we temporarily suspended our activities as a lender for any new loans first disbursed on or after that date. We also have student loan purchase commitments of $885 million that we have been unable to fund, and we are committed to purchase an additional $255 million of student loans through June 30, 2009. Most of the purchase commitments are with financial institutions and we continue to work with those institutions to renegotiate the terms and timing of these commitments.

On April 7, 2008, The Education Resources Institute ("TERI") filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. TERI guaranteed $53.6 million of the private loans we held at June 30, 2008. TERI's bankruptcy filing was an event of default for a $25.0 million financing used to finance a portion of the TERI-guaranteed loans we hold. This event of default was waived by the provider of the financing on May 15, 2008.

Events of default were triggered on a $500 million line of credit facility used to finance federally insured student loans (of which $415.1 million was outstanding at June 30, 2008) due to our inability to fund the student loan purchase commitments referred to above and the occurrence of certain material adverse changes relating to our operations, business, properties, liabilities, financial condition, and prospects taken as a whole. The default caused by the TERI bankruptcy default referred to above, together with other defaults discussed below, also triggered a cross-default provision with respect to this line of credit facility. On September 18, 2008, the lender informed us that no future advances would be permitted on the line. On December 9, 2008, the lender under this facility provided a waiver of previous defaults and forbearance with respect to future defaults relating to our inability to fund the specified loan purchase commitments. To obtain this waiver, we agreed to amend the credit agreement to extend the maturity date on this line to February 3, 2009; increase the collateral coverage from its current level, 101%, to 103%; and increase the interest rate beginning November 1, 2008 from LIBOR plus 0.3% to LIBOR plus 0.75%; among other changes. The lender's remedies are limited solely to the student loans and other assets in trust securing the line of credit.

Similarly, events of default were triggered on a $175 million unsecured line of credit used for operations (of which $94 million was outstanding at June 30, 2008) due to our inability to fund the student loan purchase commitments and the occurrence of the material adverse changes referred to above. The default related to the TERI bankruptcy, together with our defaults under the $500 million secured line of credit facility referred to above, and the $10 million facility referred to below, also triggered a cross-default provision under this line of credit. Effective September 8, 2008, the unsecured line of credit was reduced from $175 million to $94 million. We agreed with the provider of this financing to restructure the debt on December 15, 2008 in exchange for a waiver of past defaults and a conditional forbearance with respect to future defaults relating to our inability to fund the specified student loan purchase commitments. Under the new terms, we will make scheduled payments of the debt to amortize it completely by June 30, 2011, and we granted a security interest in otherwise unencumbered assets to secure this previously unsecured line, among other changes.

Similarly, the events discussed above triggered events of default and cross defaults on a $10 million capital financing line (of which $9.4 million was outstanding at June 30, 2008). On December 2, 2008, the provider of this financing waived the events of default and amended the credit agreement such that defaults under our $500 million secured line of credit and any defaults relating to our future inability to fund the specified student loan purchase commitments would not constitute events of default under this line.

Of the $53.6 million of TERI-guaranteed private loans we hold, $24.2 million are in school and deferment, and $28.3 million are current. Delinquencies are as follows: $418 thousand 31-60 days delinquent, $288 thousand 61-90 days delinquent, $53 thousand 91-120 days delinquent, $78 thousand 121-180 days delinquent, $37 thousand 181-270 days delinquent, $221 thousand in claims filed and awaiting payment, and $21 thousand in rejected claims. We have recorded a $337 thousand provision for loan losses related to these amounts.

As of August 31, 2008, we serviced $580.5 million of loans owned by a Lehman Brothers subsidiary, Campus Door, which has ceased operations. For the year ended June 30, 2008, servicing revenues related to these loans totaled $1.3 million. At September 30, 2008, Campus Door owed us $227 thousand for servicing revenues billed in September 2008. We expect to continue to bill and collect servicing revenues related to this portfolio.

On September 15, 2008, American International Group's credit rating was downgraded. The debt service reserve fund of our capital acquisition refunding bonds held a guaranteed investment contract amounting to $5.1 million with AIG Matched Funding Corporation. On September 17, 2008, AIG informed the trustee that the investment agreement would be terminated and the principal and accrued interest was paid by September 30, 2008.

These events as well as changes in federal law have adversely affected our operations and our ability to continue to fund public service initiatives. A recap of significant public service initiatives, changes in federal law and changes we have taken to react to reduced revenues, including changes in our public service initiatives, follows.

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 was to increase by $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 were to 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, 2008, we have supplemented the State Grant Program by $138.4 million and provided $28.0 million through the Workforce Advancement Grant for Education Program related to this initiative.

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

- For Stafford and Consolidation loans first disbursed on or after October 1, 2007, special allowance payments to us are 0.4% lower.
- For PLUS loans first disbursed on or after October 1, 2007, special allowance payments to us are 0.7% lower.
- For all loans first disbursed on or after October 1, 2007, lender origination fees paid to ED increased from 0.5% to 1.0%.
- Effective October 1, 2007, retention of collections on defaulted loans decreased from 23% to 16%.
- Effective October 1, 2007, the account maintenance fee received from ED for outstanding loan guarantees decreased from 0.1% to 0.06%.
- Effective October 1, 2007, the exceptional performer section of the law was 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.

On October 19, 2007, because of the passage of the Act, the board of directors adopted a resolution reducing the supplement to the State Grant Program to $35 million and eliminating funding of the Workforce Advancement Grant for Education and other financial aid programs for the fiscal year ending June 30, 2009. On April 24, 2008, due to the above-described capital market developments, the board of directors adopted a resolution eliminating funding of the supplement to the State Grant Program and other financial aid programs if the board determines that funding is not available for these programs.

On January 24, 2008, the board of directors adopted a resolution discontinuing annual cash donations to the Pennsylvania Higher Education Foundation (PHEF), and reducing the amount provided for ongoing operational support to $300 thousand annually through May 31, 2012 and thereafter until further action of the board.

On April 24, 2008, management announced a workforce optimization program to better support our changing business needs and to realize greater efficiencies. The program, open to all non-union employees, allowed participants to receive a one-time cash payout, which was calculated based upon salary and longevity, for electing to depart voluntarily from the Agency. The last day employees could elect to participate in the program was June 23, 2008. Based on the participation in the program, this effort is expected to net annual savings of $20 million.

On May 7, 2008, President Bush signed H.R. 5715, titled "Ensuring Continued Access to Student Loans Act of 2008," into law. Among the provisions, the law:

- Increases annual and aggregate Stafford loan limits for loans first disbursed on or after July 1, 2008
- Adds requirements to the Secretary of Education while operating under the Lender of Last Resort ("LLR") program
- Temporarily authorizes the U.S Department of Education ("ED") to purchase Federal Family Education Loan Program ("FFELP") loans originated on or after October 1, 2003; however, ED has chosen to implement a plan which only allows loans originated on or after July 1, 2008 to be purchased.

The plan is to provide lenders with a loan purchase commitment and access to immediate short-term liquidity for new loans originated for the 2008-09 academic year. Lenders will be able to hold and service loans and enter into agreements to sell loans to ED. These participation interests will be priced to yield ED the commercial paper rate plus 50 basis points. We have indicated our intent to participate, however we are not obligated to do so.

On August 8, 2008, we extended through August 7, 2009 a $150 million student loan financing that was due August 8, 2008. At June 30, 2008, $150 million was outstanding on the note. Interest is accrued based on three month LIBOR plus 0.12%, and resets on a weekly basis.

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

- Hold colleges and universities accountable by requiring greater disclosure in costs
- Protect students from aggressive marketing practices by lenders
- Simplify the federal student aid application process
- Allow students to receive Pell Grant scholarship aid year round
- Increase college aid and support for veterans and military families
- Expand loan forgiveness program
- Amend Truth in Lending Act to prevent unfair and deceptive lending practices

On August 28, 2008, we extended through August 28, 2009 a $35 million student loan financing that was due August 31, 2008.

On October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009.

On October 26, 2008, a $500 million student loan financing was reduced to $422 million and the maturity date was extended from December 31, 2008 to July 31, 2009.

Background Information

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 twelve months ended June 30 (in thousands)		2008	2007
Self-funded			
State Grant Program supplement	$	**53,798**	59,193
Federal default fees paid on behalf of borrowers		**36,453**	27,845
Costs of operating state and federal governmental programs		**18,803**	21,694
Keystone loan program origination fees and benefits paid on behalf of borrowers		**18,094**	27,542
Workforce Advancement Grant for Education		**10,071**	8,161
Academic Excellence Scholarship		**4,122**	3,214
Armed Forces Loan Forgiveness Program		**2,729**	3,014
Funding and support of The Pennsylvania Higher Education Foundation, Inc.		**1,906**	13,155
Other public service activities and outreach		**11,878**	15,108
		157,854	178,926
Financial support funded by our business partners			
Keystone loan program origination fees and benefits paid on behalf of borrowers		**19,100**	17,456
	$	**176,954**	196,382

We pay the federal default 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.

Through the 2007-08 academic year, we supplemented the State Grant Program as part of our Grants and Infrastructure for Tomorrow's Students Initiative to help meet the needs of Pennsylvanians seeking higher education opportunities.

Through June 30, 2008, under the Keystone family of loan programs, we provided a Keystone Stafford loan for Pennsylvania students with family incomes of less than $21,000. For Keystone Stafford loans, we paid all the federally required origination and federal default fees on behalf of the borrower. Federally required origination fees decreased from 2% in 2006 to 1.5% in 2007. For Keystone Stafford loans disbursed between July 1, 2007 and October 31, 2007, we provided a 2% interest rate reduction after 36 on-time payments, a 2% graduation credit, a 0.50% credit after 24 on-time payments and a 0.25% interest rate reduction for automatic direct debit of payment. For Keystone Stafford loans disbursed on or after November 1, 2007, we provided a 0.50% interest rate reduction for automatic direct debit of payment. We also provided a KeystoneBEST and a KeystonePLUS loan for other students. For KeystoneBEST loans, we paid all of the federally required origination and federal default fees on behalf of the borrower. For KeystoneBEST loans disbursed between July 1, 2007 and October 31, 2007, we provided a 1% graduation credit, a 2% interest rate reduction after 36 consecutive on-time payments, a 0.50% credit for 24 on-time payments and a 0.25% interest rate reduction for automatic direct debit of payment. For KeystoneBEST loans disbursed on or after November 1, 2007, we provided a 0.25% interest rate reduction for automatic direct debit of payment. For KeystonePLUS loans disbursed between July 1, 2007 and October 31, 2007, we provided 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. For KeystonePLUS loans disbursed on or after November 1, 2007, we provided a 0.60% immediate interest rate reduction, an additional 0.50% rebate after 12 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 provided 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 provided grants of $1,500 for Pennsylvanians who have both high academic potential and demonstrated financial need.
- Armed Forces Loan Forgiveness Program through which we forgave 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 forgave 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 forgave 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 $4,700 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 $15.6 million of grants during its most recent fiscal year ended May 31, 2008.

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 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 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 makes interest subsidy and special allowance payments that we account for as interest revenue. 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, 2008, interest subsidy and special allowance payments were $234.8 million compared to $330.9 million in 2007 and $239.8 million in 2006. In 2008, interest subsidy and special allowance payments decreased primarily due to the decreases in the 3-month financial commercial paper rates. In 2007, interest subsidy and special allowance payments increased because of the increased consolidation activity that resulted in many borrowers being charged 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 and 2.8% above the average return earned on other student loans during the year ended June 30, 2006. Such loans amounted to $1.3 billion at September 30, 2006 and $1.5 billion at June 30, 2006. 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 27, 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 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 for the year ended June 30, 2006.

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 2% in 2006 to 1.5% in 2007 and will decrease by an additional 0.5% every year until they are 0% effective July 1, 2010.

In the past, we purchased student loans related to the Health Education Assistance Loan ("HEAL") Program. Under the HEAL Program, borrowers pay interest at a 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.

For our guaranty activities, ED pays us a loan processing and issuance fee that is 0.40% 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 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force. Before October 1, 2007, the annual account maintenance fee received from ED for outstanding loan guarantees was 0.10%.

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 pay 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 16% of the amounts collected from borrowers as revenue. The remaining amount is returned to the federal government. Before October 1, 2007, retention of collection on defaulted loans was 23%.

We also earn 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. Since January 1, 2008 we have not recognized any default aversion fee revenue, as the amounts owed by the Federal Fund for default aversion fee activity are not expected to be paid.

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

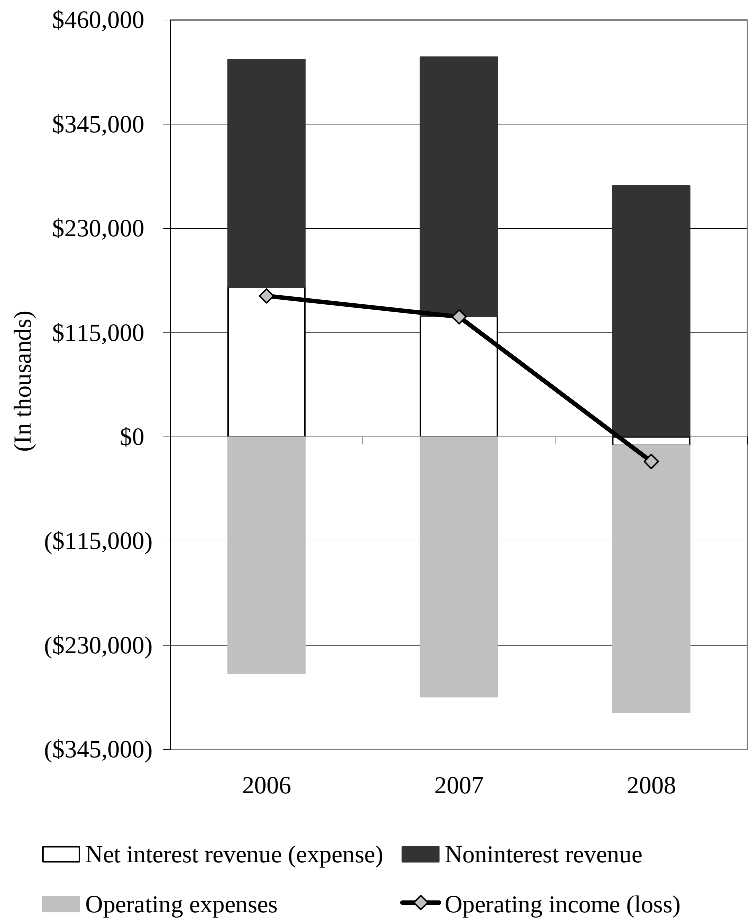
For the years ended June 30 (in thousands)		2008	2007
Student loan interest revenue	$	**615,875**	636,906
Investment interest revenue		**22,412**	36,348
Interest expense on student loan financings and notes and bonds payable		**(620,933)**	(527,057)
Interest expense on capital and other financings		**(13,271)**	(10,220)
Net interest revenue		**4,083**	135,977
Provision for loan losses		**(13,408)**	(2,965)
Net interest revenue (expense) after provision for loan losses		**(9,325)**	133,012
Servicing fees		**131,278**	113,338
Retention of collections on defaulted loans		**93,490**	82,140
Federal fees		**52,306**	61,895
Default aversion fees, net		**15,629**	27,268
Residual interest, net		**(16,408)**	(10,172)
Gains on early terminations of financial instruments, net		**-**	11,034
Gains on student loan sales, net		**365**	54
Other		**320**	401
Total noninterest revenue		**276,980**	285,958
Operating revenues		**267,655**	418,970
Operating expenses		**(294,700)**	(286,557)
Operating income (loss)		**(27,045)**	132,413
Commonwealth of Pennsylvania grants		**452,138**	452,003
Federal grants		**7,982**	8,862
Grants and other financial aid		**(586,371)**	(617,953)
Grant funds returned to the Commonwealth of Pennsylvania		**(2,785)**	(728)
Grant funds returned to the U.S. Department of Education		**-**	(71)
Contributions to Pennsylvania Higher Education Foundation		**(1,906)**	(13,155)
Changes in net assets	$	**(157,987)**	(38,629)

Statements of Net Assets

At June 30 (in thousands)		**2008**	2007
Student loans receivable, net	$	**11,830,205**	11,482,091
Cash, cash equivalents, and investments, substantially restricted		**428,742**	582,823
Interest revenue receivable		**255,837**	263,858
Capital assets, net		**69,137**	73,684
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**139,874**	128,430
Other		**186,266**	205,520
Total assets		**12,910,061**	12,736,406
Student loans financings and notes and bonds payable, net		**11,962,537**	11,597,201
Capital and other financings		**238,407**	187,723
Amounts related to the Federal Student Loan Reserve Fund		**139,874**	128,430
Other		**224,637**	320,459
Total liabilities		**12,565,455**	12,233,813
Net assets			
Invested in capital assets, net of related debt		**(7,500)**	(606)
Restricted for debt service		**256,326**	346,771
Restricted for financial aid grant programs		**40,259**	55,590
Restricted for default aversion activities		**-**	2,468
Unrestricted		**55,521**	98,370
Total net assets	$	**344,606**	502,593

Results of Operations

Years ended June 30

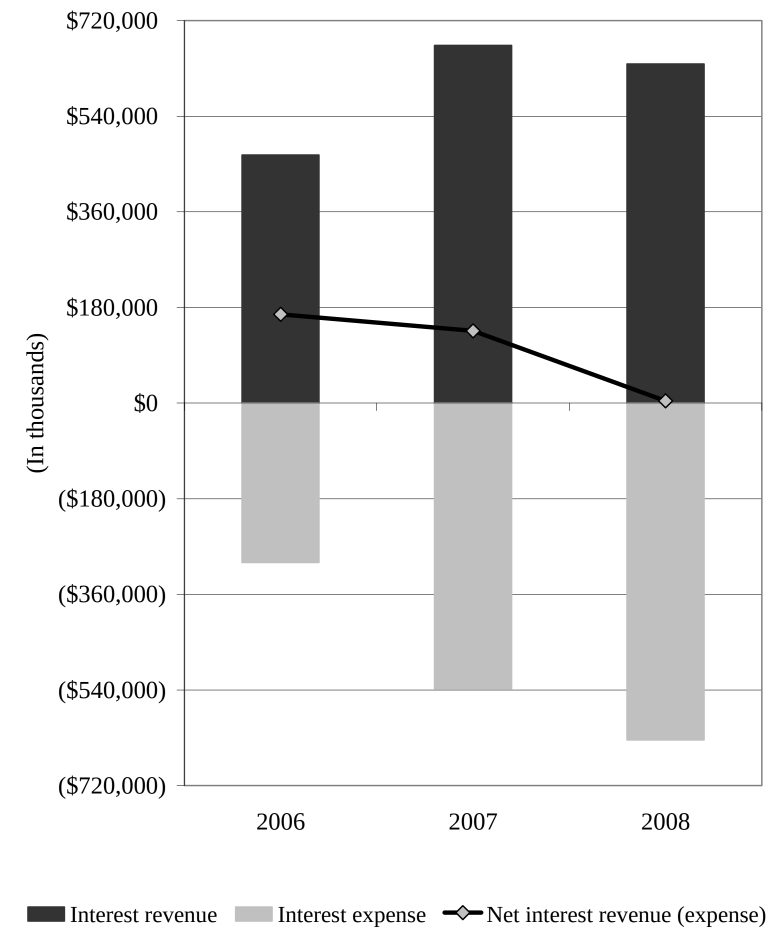


Operating loss for the year ended June 30, 2008 was $27.0 million, a 120.4% decrease from operating income of $132.4 million in 2007, which was a 14.9% decrease from $155.5 million in 2006. Operating revenues decreased 36.1% from $419.0 million in 2007 to $267.7 million in 2008. In 2007, operating revenues increased 0.6% from $416.4 million in 2006. Net interest expense after provision for loan losses was $9.3 million in 2008, a 107.0% decrease from net interest revenue after provision for loan losses of $133.0 million in 2007. The decrease is principally due to decreases in interest rate margins, resulting from the credit market disruptions and increases in the provision for loan losses due to the elimination of the Exceptional Performer program. In 2007, net interest revenue after provision for loan losses decreased 19.5% from $165.3 million in 2006 principally due to the elimination of 9.5% floor earnings after September 30, 2006. Noninterest revenue decreased 3.1% from $286.0 million in 2007 to $277.0 million in 2008 primarily due to decreases in federal fees, default aversion fees, and gains on early terminations of financial instruments. In 2007, noninterest revenue increased 13.9% from $251.0 million in 2006 due to increased guaranty volume and gains on early terminations of financial instruments. Operating expenses increased 2.8% from $286.6 million in 2007 to $294.7 million in 2008 due primarily to increases in collection agency fees and personnel and benefit costs. In 2007, operating expenses increased 9.9% from $260.9 million in 2006 due primarily to increases in personnel and benefit costs.

A more detailed explanation of these items follows.

Net Interest Revenue (Expense)

Years ended June 30



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, 2008, net interest revenue was $4.1 million, a 97.0% decrease from net interest revenue of $136.0 million in 2007, which was an 18.5% decrease from $166.9 million in 2006. The changes in net interest margin are explained below.

In August 2007, disruptions in the capital markets began increasing the cost of $7.4 billion of auction rate debt securities financing our portfolio of student loans. In February 2008, a decline in investor demand in the auction rate debt market caused auctions to fail. The failure of an auction does not constitute a default on the bonds, and all principal and interest has been paid when due on the outstanding bonds. Upon the occurrence of a failed auction, bondholders are entitled to receive a maximum rate as described in the related auction procedures. The maximum auction rates payable on auction rate securities generally were based upon 91-day treasury-bill rates plus 1.2% or one-month LIBOR rates plus 1% for the one-year period ending on the auction date although there are other formulas for some of the auction rate securities. While we continue to assess the situation, there is no timetable or restructuring plan for these securities at this time.

In January 2008, a downgrade of Ambac's credit rating and negative market sentiment began increasing the cost of $1.7 billion of our tax-exempt variable-rate demand notes that Ambac insures. As of June 30, 2008, there were

$893.9 million of variable-rate demand bonds that were put to the liquidity provider and are in bank bond mode with interest rates ranging from federal funds rate plus 1.5% to prime rate plus 2.0%.

At December 15, 2008, there were $1.7 billion of variable-rate demand bonds that were put to the liquidity provider and are in bank bond mode with interest rates ranging from 1-month LIBOR plus 1.75% to prime rate plus 2.0%.

The combination of these adverse market conditions resulted in increased interest expense while earnings on student loan holdings, based upon 3-month financial commercial paper rates, decreased.

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		**2008**		2007	
(Balances in thousands)		**Balances**	**Rate**	Balances	Rate
Average interest earning assets					
Student loans receivable, net	$	**11,709,259**	**5.26%**	9,589,991	6.64%
Investments		**660,063**	**3.40%**	661,352	5.50%
	$	**12,369,322**	**5.16%**	10,251,343	6.57%
Average interest bearing liabilities					
Student loan financings and notes and bonds payable	$	**11,957,802**	**5.19%**	9,910,597	5.32%
Capital and other financings		**220,980**	**6.01%**	179,464	5.69%
	$	**12,178,782**	**5.21%**	10,090,061	5.32%
Net interest margin			**(0.05%)**		1.25%

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

For the years ended June 30	**2008**	2007
Student loan yields	**6.58%**	7.97%
Consolidation loan rebate fees	**(0.70)**	(0.72)
Lender origination fees	**(0.11)**	(0.09)
Premium amortization	**(0.51)**	(0.52)
Student loan revenue	**5.26**	6.64
Cost of funds	**5.19**	5.32
Net interest margin on student loans	**0.07%**	1.32%

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

For the years ended June 30 (in thousands)		Increase (decrease)	Increase (decrease) attributable to change in: Rate	Volume
2008 vs. 2007				
Student loan interest revenue	$	(21,031)	(161,779)	140,748
Investment interest revenue		(13,936)	(13,865)	(71)
		(34,967)	(175,644)	140,677
Student loan financings and notes and bonds payable interest expense		93,876	(14,997)	108,873
Capital and other financings interest expense		3,051	687	2,364
		96,927	(14,310)	111,237
	$	(131,894)	(161,334)	29,440
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

While the amount we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 4% of the variable-rate loans change based upon changes in the 91-day U.S. Treasury Bill rate, and 96% change based upon changes in 3-month financial paper rates. 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, 2006 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 and 2.8% above the average return earned on other student loans during the year ended June 30, 2006. Such loans amounted to $1.3 billion at September 30, 2006 and $1.5 billion at June 30, 2006. 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 27, 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 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.

Provision for Loan Losses

Currently, when a FFELP loan defaults, the federal government guarantees 97% of the principal and interest on student loans originated after October 1, 1993 and the holder of the loan must absorb the remaining 3% not guaranteed as a risk sharing loss on the loan.

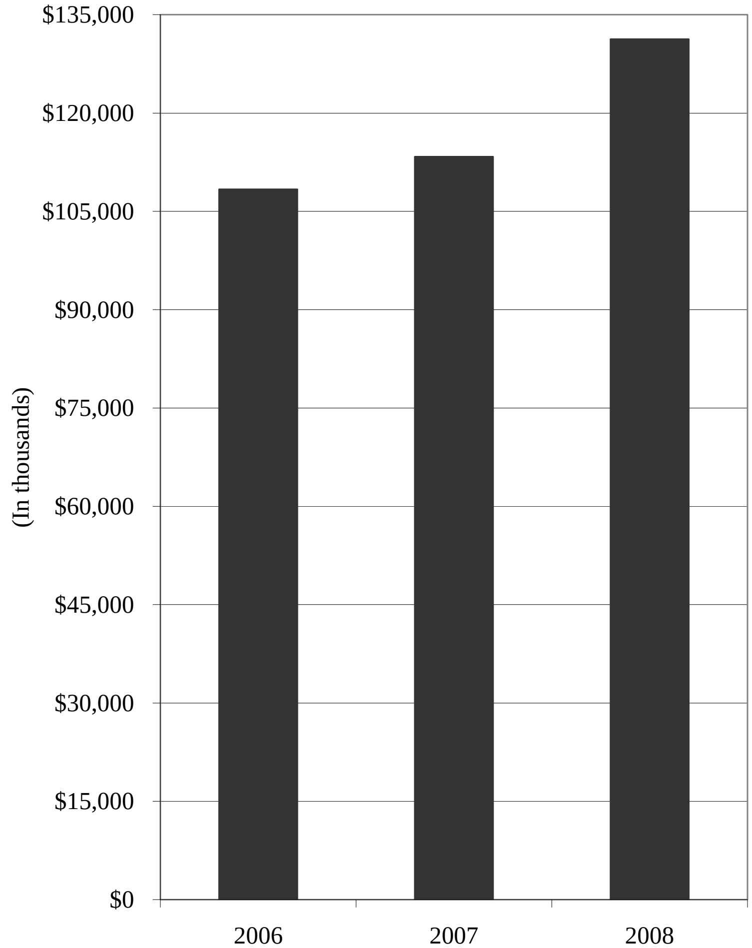
Previously, we were designated as an Exceptional Performer by ED in recognition of meeting certain performance standards set by ED in servicing FFELP loans. Because of this designation, we received 99% reimbursement on all eligible FFELP default claims submitted for reimbursement on or after July 1, 2006 and before October 1, 2007 because we remained in compliance with the required standards, which were assessed annually and quarterly through compliance audits. The ratification of the College Cost Reduction and Access Act on September 27, 2007 eliminated the Exceptional Performer program, resulting in an increase of $7.0 million in the provision for loan losses for the year ended June 30, 2008.

The provision for loan losses 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)		**2008**	2007
Balance at beginning of period	$	**2,728**	1,560
Provision for losses		**13,408**	2,965
Charge-offs		**(4,793)**	(1,797)
Balance at end of period	$	**11,343**	2,728
Allowance as a percentage of ending balance of student loans		**0.10%**	0.03%

Noninterest Revenue

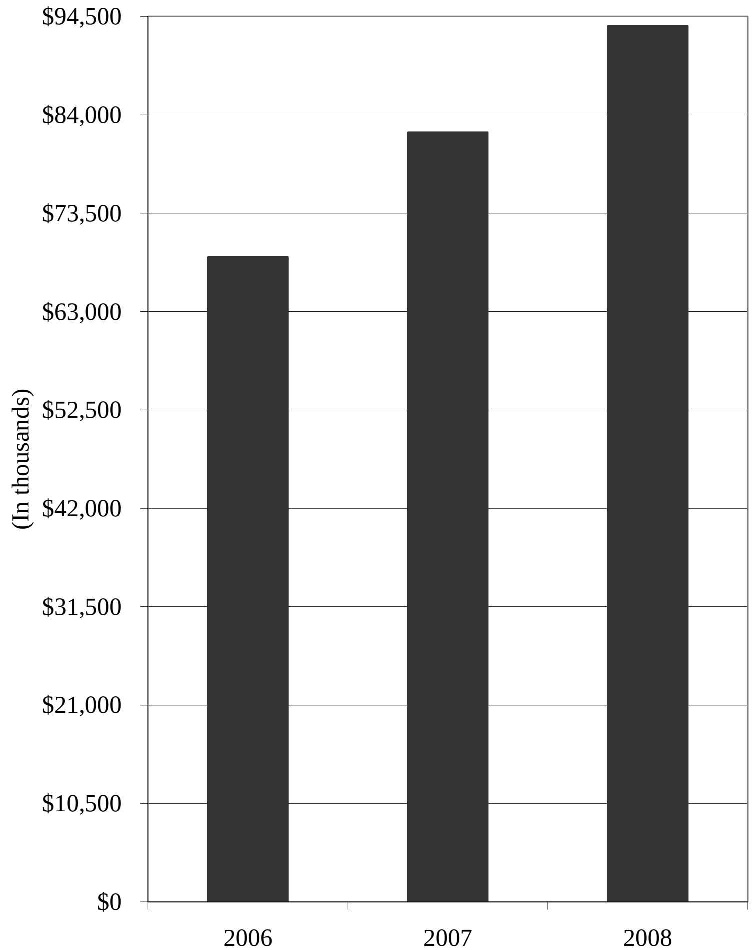
Servicing Fees
Years ended June 30



Servicing fees for the year ended June 30, 2008 were $131.3 million, an increase of 15.9% from $113.3 million in 2007, which was a 4.5% increase from $108.4 million in 2006. Fees increased due to increased volume of loans serviced. Loans serviced by us for participating financial institutions averaged $42.6 billion, compared to $37.3 billion in 2007 and $32.3 billion in 2006.

We also provide systems for other servicers and guarantors for a fee. For the year ended June 30, 2008, fees earned from servicing systems amounted to $13.5 million, an increase of 12.5% from $12.0 million in 2007, which was a 27.7% increase from $9.4 million in 2006. For the year ended June 30, 2008, loans serviced by other servicers using our systems averaged $33.0 billion, an increase of 31.0% from $25.2 billion in 2007, which was an increase of 62.6% from $15.5 billion in 2006. For the year ended June 30, 2008, fees earned from guaranty systems amounted to $1.1 million, compared to $1.2 million in 2007 and 2006. For the year ended June 30, 2008, original principal amount outstanding for guarantors using our systems averaged $3.9 billion, compared to $3.6 billion in 2007 and $3.4 billion in 2006. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

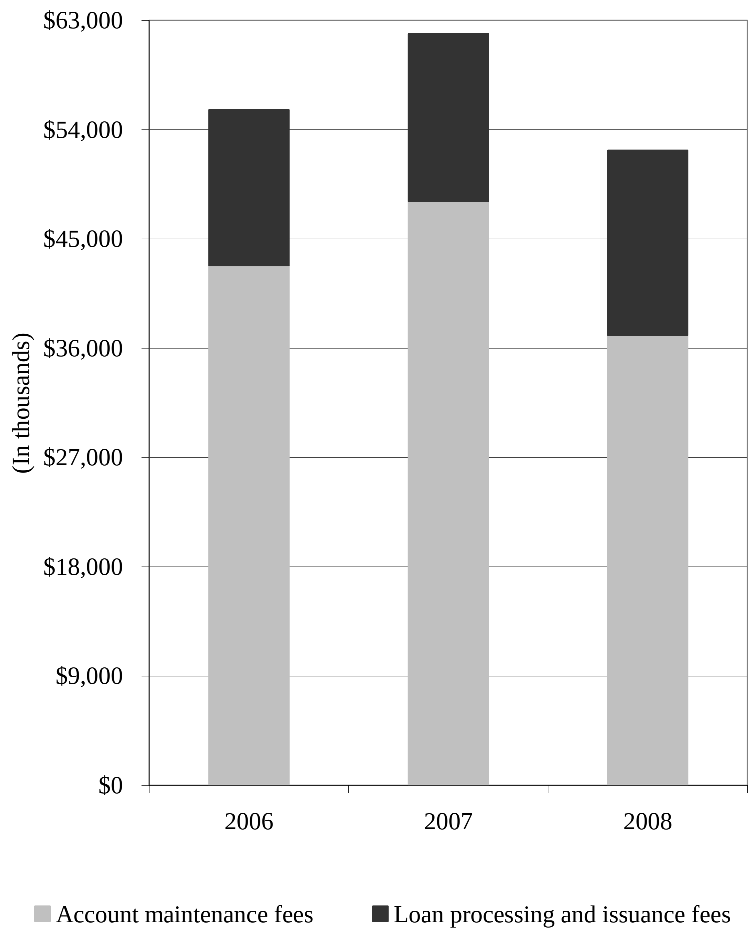
Retention of Collections on Defaulted Loans
Years ended June 30



After a loan defaults, we continue to try to collect the amounts and are allowed to retain up to 16% of the amounts collected from borrowers as revenue. The remaining amount is returned to the federal government. Before October 1, 2007, retention of collections on defaulted loans was 23%.

For the year ended June 30, 2008, retention of collections on defaulted loans was $93.5 million, a 13.9% increase from $82.1 million in 2007. The increase is due to more aggressive pursuit of rehabilitations. In addition, the decrease due to the rate reduction was substantially mitigated by increases in defaulted loan volume. In 2007, retention of collections on defaulted loans increased 19.3% from $68.8 million in 2006 due primarily to more aggressive pursuit of rehabilitation collections. For the year ended June 30, 2008, retention on rehabilitation collections was $59.5 million, an increase of 22.7%, compared to $48.5 million in 2007. In 2007, retention on rehabilitation collections increased 63.9% from $29.6 million in 2006.

Federal Fees
Years ended June 30



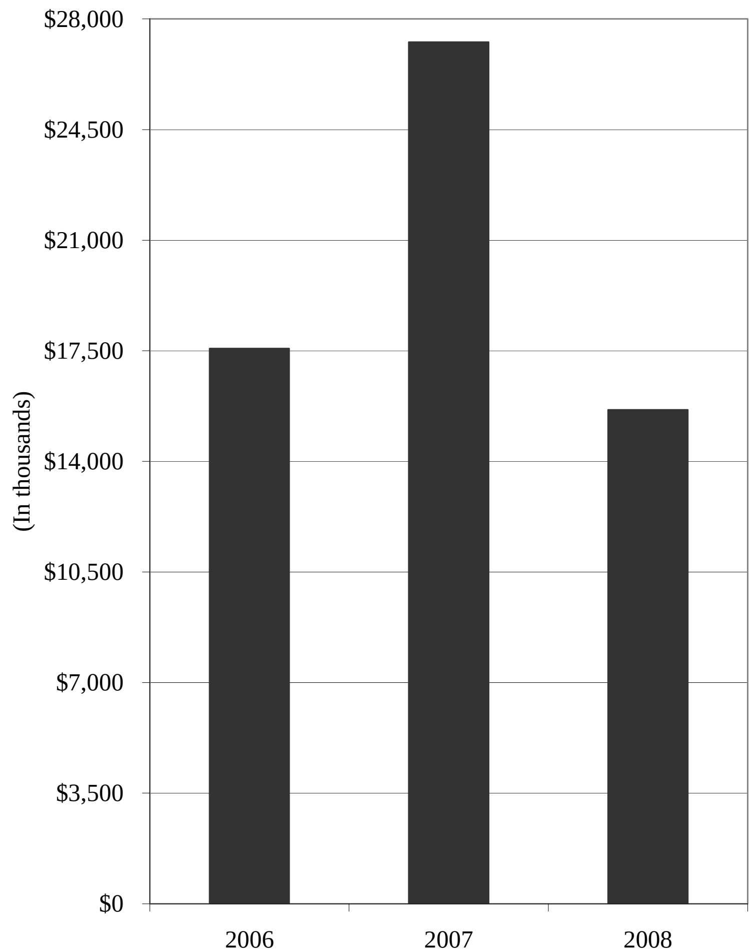
Federal fees are earned from operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee that is 0.40% for loans we guarantee as the loan is disbursed; however, the fee is not paid on new consolidation loans. ED also pays us an annual account maintenance fee that is 0.06%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

For the year ended June 30, 2008, federal fees were $52.3 million, a decrease of 15.5% from $61.9 million in 2007. The decrease occurred due to the reduction in account maintenance fee discussed above.

For the year ended June 30, 2007, federal fees increased 11.3% from $55.6 million in 2006. The increase occurred due to an increase in the balance of loans guaranteed. At June 30, 2007, the balance of loans guaranteed was $47.5 billion, compared to $40.8 billion in 2006.

Default Aversion Fees

Years ended June 30



For the year ended June 30, 2008, default aversion fees were $15.6 million, a decrease of 42.9% from $27.3 million in 2007. These fees are paid from the Federal Fund and the decrease was caused by not recognizing revenue on these amounts since January 1, 2008 due to our assessment of the ultimate collectibility of the amount due from the Federal Fund. In 2007, default aversion fees increased 55.1% from $17.6 million in 2006 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.

Residual interest, net

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. For transactions qualifying as sales, we retain a residual interest, which is recognized on the statements of net assets as the residual interest in off-balance sheet securitizations. The residual interest is the right to receive cash flows from the student loans in excess of the amounts needed to pay servicing, administration, other fees, and the principal and interest on the bonds backed by the student loans. The residual interest is the present value of these future expected cash flows. We value the residual interest at the time of sale of the student loans to the trust and at the end of each subsequent quarter and reflect the change in the value in residual interest earnings, net on the statements of revenues, expenses, and changes in net assets. For the year ended June 30, 2008, decreases in the aggregate carrying value of the residual interest in off-balance sheet securitizations were $16.4 million compared to $10.2 million in 2007. In 2008, the decreases were due primarily to the projected net interest yield being impacted by increases in auction rate debt interest rates as a result of recent failed auctions. In 2007, the decreases were due primarily to increased prepayments for borrower consolidations, which resulted in higher prepayment rates than we had estimated would occur at certain points in the life of the loans.

Operating Expenses

The following table displays operating expenses in more detail.

For the years ended June 30 (in thousands)		2008	2007
Personnel and Benefits			
Compensation	$	**118,084**	120,586
Health care benefits for employees		**19,271**	17,860
Health care benefits for retirees including postemployment benefit expense		**15,662**	14,383
Employer's share of Social Security		**9,001**	8,779
Retirement contributions		**3,841**	3,795
Severance		**4,885**	-
Unemployment compensation		**4,186**	200
COBRA benefits		**1,106**	-
Independent contractor fees		**8,549**	8,832
Capitalized loan origination costs		**(2,114)**	(2,825)
Capitalized software development costs		**(4,835)**	(3,432)
Other		**1,219**	2,290
		178,855	170,468
Information technology related expenses		**22,665**	22,754
Collection agency fees		**21,345**	14,751
Postage		**17,735**	18,306
Depreciation		**13,463**	13,570
Other			
Legal fees		**3,536**	4,494
Auditing fees		**1,427**	1,324
Consulting fees		**1,121**	1,744
Travel and professional development		**968**	1,945
Printing		**3,039**	4,602
Telephone expense		**4,251**	3,276
Office equipment and supplies		**1,606**	2,160
Advertising		**2,934**	11,877
Building and grounds		**4,655**	5,066
Utilities		**1,692**	1,884
Vehicle expense		**153**	171
Building security		**779**	951
Servicing liability		**5,343**	1,544
Trustee fees		**4,496**	4,177
Banking and investment advisory fees		**1,675**	1,524
Donated services to the foundation		**(1,906)**	(3,155)
Other		**4,868**	3,124
		40,637	46,708
	$	**294,700**	286,557

For the year ended June 30, 2008, operating expenses were $294.7 million, an increase of 2.8% from $286.6 million in 2007 due primarily to increases in collection agency fees and personnel and benefit costs. In 2007, operating expenses increased 9.9% from $260.9 million in 2006 due primarily to increases in personnel and benefit costs.

In 2008, one-time costs related to the voluntary workforce reduction amounted to $9.7 million. Additionally, cost reduction activities resulted in reductions in other expenses from $46.7 million in 2007 to $40.6 million in 2008.

A more detailed discussion of certain costs follows.

Personnel and Benefits

For the year ended June 30, 2008, personnel and benefit costs were $178.9 million, an increase of 4.9% from $170.5 million in 2007, which was an 8.5% increase from $157.1 million in 2006. Included in these costs are healthcare benefits for employees and retirees. For the year ended June 30, 2008, healthcare benefits for employees and retirees were $34.9 million, an increase of 8.4% from $32.2 million in 2007, which was an 8.1% increase from $29.8 million in 2006.

For the year ended June 30, 2008, personnel costs totaling $6.9 million related to software development and loan originations were capitalized, compared to $6.3 million in 2007 and $6.7 million in 2006.

Permanent staff makes up 95.4% of the total personnel and benefits costs. For the year ended June 30, 2008, permanent staff costs were $177.3 million, an increase of 5.6% from $167.9 million in 2007, which was an 11.4% increase from $150.7 million in 2006. The average permanent staff positions filled were 2,426 for the year ended June 30, 2008, a 2.8% decrease from the 2,496 average permanent staff positions filled for the year ended June 30, 2007. For the year ended June 30, 2006, there were 2,386 average permanent staff positions filled.

For the year ended June 30, 2008, independent contractor costs were $8.5 million, a 3.4% decrease from $8.8 million in 2007, which was a 31.8% decrease from $12.9 million in 2006. We generally use independent contractors for specialized services, such as computer programming. Costs vary based upon changes in computer programming initiatives.

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

Collection Agency Fees

For the year ended June 30, 2008, collection agency fees were $21.3 million, an increase of 43.9% from $14.8 million in 2007, which was a 42.3% increase from $10.4 million in 2006. The increase is due to increased collections on an increasing portfolio of defaulted loans.

Provision for Servicing Liability

Not meeting servicing regulations 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)		2008	2007
Balance at beginning of period	$	**5,609**	4,880
Provision for losses		**5,343**	1,544
Charge-offs		**(2,780)**	(815)
Balance at end of period	$	**8,172**	5,609
Allowance as a percentage of ending balance of student loans serviced		**0.01%**	0.01%

Financial Aid Activity

For the year ended June 30, 2008, grants and other financial aid were $586.4 million, a 5.1% decrease from $618.0 million in 2007, which was an 11.3% increase from $555.2 million in 2006.

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

For the years ended June 30 (in thousands)		2008	2007
Self-funded			
State Grant Program supplement	$	**53,798**	59,193
Federal default fees paid on behalf of borrowers		**36,453**	27,845
Keystone loan program origination fees and benefits paid on behalf of borrowers		**18,094**	27,542
Workforce Advancement Grant for Education		**10,071**	8,161
Academic Excellence Scholarship		**4,122**	3,214
Armed Forces Loan Forgiveness Program		**2,729**	3,014
Guarantee fees that were previously waived paid on behalf of borrowers		**(1,952)**	30,600
Other		**1,233**	691
		124,548	160,260
State and federal funded			
State Grant Program		**389,262**	389,745
Institutional Assistance Grant Program		**46,740**	41,501
Matching Funds Program		**15,365**	14,866
New Economy Technology Scholarship Program		**2,237**	2,927
Other		**8,219**	8,654
		461,823	457,693
	$	**586,371**	617,953

For the year ended June 30, 2008, self-funded financial aid was $124.5 million, a 22.3% decrease from $160.3 million in 2007. In 2006, self-funded financial aid was $118.6 million.

We pay the federal default 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. For the year ended June 30, 2008, we paid fees totaling $36.5 million to the Federal Fund for loans disbursed from July 1, 2007 through June 30, 2008. For the 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.

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. At September 30, 2007, the deposit necessary to meet the minimum funding requirements was $28.6 million, a $2.0 million decrease from the $30.6 million amount estimated at June 30, 2007. These amounts are reflected in the table above as guarantee fees that were previously waived paid on behalf of borrowers.

We supplemented 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.

Under the Keystone family of loan programs, we provided a Keystone Stafford loan for Pennsylvania students with family incomes of less than $21,000. For Keystone Stafford loans, we paid all the federally required origination and federal default fees on behalf of the borrower. Federally required origination fees decreased from 2% in 2006 to 1.5% in 2007. For Keystone Stafford loans disbursed between July 1, 2007 and October 31, 2007, we provided a 2% interest rate reduction after 36 on-time payments, a 2% graduation credit, a 0.50% credit after 24 on-time payments and a 0.25% interest rate reduction for automatic direct debit of payment. For Keystone Stafford loans disbursed on or after November 1, 2007, we provided a 0.50% interest rate reduction for automatic direct debit of payment. We also provided a KeystoneBEST and a KeystonePLUS loan for other students. For KeystoneBEST loans, we paid all of the federally required origination and federal default fees on behalf of the borrower. For KeystoneBEST loans disbursed between July 1, 2007 and October 31, 2007, we provided a 1% graduation credit, a 2% interest rate reduction after 36 consecutive on-time payments, a 0.50% credit for 24 on-time payments and a 0.25% interest rate reduction for automatic direct debit of payment. For KeystoneBEST loans disbursed on or after November 1, 2007, we provided a 0.25% interest rate reduction for automatic direct debit of payment. For KeystonePLUS loans disbursed between July 1, 2007 and October 31, 2007, we provided 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. For KeystonePLUS loans disbursed on or after November 1, 2007, we provided a 0.60% immediate interest rate reduction, an additional 0.50% rebate after 12 consecutive on-time payments, and a 0.25% interest rate reduction for automatic direct debit of payment.

Through the Workforce Advancement Grant for Education Program, we provided grants to participating postsecondary institutions to assist Pennsylvania adult students who have demonstrated financial need and are ineligible for a State Grant.

Other changes in net assets

For the year ended June 30, 2008, Commonwealth of Pennsylvania grants were $452.1 million, which is less than a 0.1% increase from $452.0 million in 2007. In 2007, Commonwealth of Pennsylvania grants increased 5.3% from $429.3 million in 2006.

For the year ended June 30, 2008, federal grants were $8.0 million, a 10.1% decrease from $8.9 million in 2007, which was a 1.1% increase from $8.8 million in 2006.

During the year ended June 30, 2008, we contributed $1.9 million of services to PHEF. During the year ended June 30, 2007 we donated $10 million and contributed $3.2 million of services to PHEF compared to donations of $20 million and contributions of $3.5 million of services in 2006. The board of directors had authorized an additional non-contingent $20 million of donations through June 30, 2009 as well as ongoing operational support. However, on

January 24, 2008, as a result of our current financial constraints, the board of directors adopted a resolution changing this authorization by discontinuing the annual cash donations and reducing the amount provided for ongoing operational support to $300 thousand annually through May 31, 2012 and thereafter until further action of the board.

Federal Student Loan Reserve Fund

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

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

(In thousands)		**June 30, 2008**	September 30, 2007
Generally accepted accounting principles – net assets	$	**(4,492)**	23,338
Deferred federal default fees		**7,162**	16,583
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund		**19,226**	19,250
Gain contingency – collections complement on future default collections		**93,050**	66,995
Regulatory net assets	$	**114,946**	126,166
Original principal outstanding	$	**50,974,909**	50,320,866
		0.23%	0.25%

Because we were under the required ratio during the federal fiscal years ended September 30, 2005 and September 30, 2006, 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. At September 30, 2007, the deposit necessary to meet the minimum funding requirements was $28.6 million.

Due to the seasonal timing of default fee deposits into the Federal Fund, the fund met the required 0.25% reserve ratio at September 30, 2008.

For the year ended June 30, 2008, purchases of defaulted loans were $1.2 billion, an increase of 41.8% from $846.2 million in 2007, which was a 71.3% increase from $494.1 million in 2006. These increases are due to increased defaults of consolidation loans consistent with increased borrower consolidations in prior periods.

Net Asset Position

Most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of $55.5 million at June 30, 2008. Included in unrestricted net assets is $86.3 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 $256.3 million. Of that amount, $253.1 million is related to our student loan notes, bonds and financings. Net assets restricted for financial aid grant programs amounted to $40.3 million. The deficit in net assets invested in capital assets, net of related debt of $7.5 million occurred because of differences between the timing of depreciation of the assets and principal payments on the debt.

Description of Debt Activity and Significant Capital Assets

Our principal funding need is securing capital to fund student loan originations and purchases. Our ability to raise debt could be limited in the future because under our enabling legislation there is a formula that imposes a debt limit. The limit is $24.6 billion at June 30, 2008. At June 30, 2008, our outstanding debt amounted to $12.2 billion. The following table shows our debt activity.

For the years ended June 30 (in thousands)		2008	2007
Capital market activity			
Proceeds from issuing student loan demand revenue bonds	$	**400,000**	1,325,000
Proceeds from issuing student loan floating rate notes		**-**	1,250,000
Repayment of student loan floating rate notes		**(158,563)**	(82,235)
Other financings			
Net student loan financing activity		**123,100**	103,000
Net capital financing activity		**2,299**	6,702
Net other financing activity		**48,310**	(7,969)

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

At June 30 (in thousands)		2008	2007
Land	$	**2,946**	2,946
Buildings and improvements		**41,151**	42,225
Software development		**11,716**	13,144
Purchased software		**4,883**	7,058
Other, principally information technology equipment		**8,441**	8,311
	$	**69,137**	73,684

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, 2008, we capitalized $4.8 million of software development compared to $3.4 million in 2007 and $3.6 million in 2006.

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 $117.7 million of student loans and $132.5 million of cash, cash equivalents and investments not included in the analysis.

The following gap analysis reflects rate-sensitive positions at June 30, 2008 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.

		Interest rate sensitivity period					
At June 30, 2008 (In thousands)		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	$	10,999,356	198,806	404,187	35,844	64,021	10,269
Restricted cash and cash equivalents		296,226	-	-	-	-	-
Other assets		138,884	46,395	30,330	21,444	26,766	36,056
Total assets		11,434,466	245,201	434,517	57,288	90,787	46,325
Liabilities							
Student loan financings and notes and bonds payable		11,443,618	518,919	-	-	-	-
Other liabilities		84,751	6,855	22	193	1,173	-
Total liabilities		11,528,369	525,774	22	193	1,173	-
Net assets							
Restricted for debt service	$	-	-	-	-	-	253,053
Period gap	$	(93,903)	(280,573)	434,495	57,095	89,614	(206,728)
Cumulative gap	$	(93,903)	(374,476)	60,019	117,114	206,728	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		99.2%	46.6%	1975077.3%	29682.9%	7739.7%	18.3%
Ratio of cumulative gap to total assets		(0.8%)	(3.0%)	0.5%	1.0%	1.7%	0.0%

Typically, we present a table showing the simulated impact of parallel shifts upward and downward on interest rates on net interest revenue. A parallel shift means that the shift would affect both our assets and our debt in the same way at the same time. We have omitted such an analysis because currently our interest revenues and expenses are not moving in parallel and we believe such a disclosure could be misleading.

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
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December 15, 2008

KPMG

KPMG LLP
Suite 200
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, 2008 and 2007, 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, 2008 and 2007, and its changes in net assets and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, disruptions in the capital markets have impacted PHEAA's ability to fund the origination of new student loans and to fulfill its commitments to purchase loans from various financial institutions.

The management's discussion and analysis on pages 2 through 33 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

December 15, 2008

For the years ended June 30 (in thousands)

		2008	2007
Interest revenue			
Student loans	$	**615,875**	636,906
Investments		**22,412**	36,348
Total interest revenue		**638,287**	673,254
Interest expense			
Student loan financings and notes and bonds payable		**620,933**	527,057
Capital and other financings		**13,271**	10,220
Total interest expense		**634,204**	537,277
Net interest revenue		**4,083**	135,977
Provision for loan losses		**(13,408)**	(2,965)
Net interest revenue (expense) after provision for loan losses		**(9,325)**	133,012
Noninterest revenue			
Servicing fees		**131,278**	113,338
Retention of collections on defaulted loans		**93,490**	82,140
Federal fees		**52,306**	61,895
Default aversion fees, net		**15,629**	27,268
Residual interest, net		**(16,408)**	(10,172)
Gains on early terminations of financial instruments, net		**-**	11,034
Gains on student loan sales, net		**365**	54
Other		**320**	401
Total noninterest revenue		**276,980**	285,958
Operating revenues		**267,655**	418,970
Operating expenses			
Personnel		**178,855**	170,468
Information technology related expenses		**22,665**	22,754
Collection agency fees		**21,345**	14,751
Postage		**17,735**	18,306
Depreciation		**13,463**	13,570
Other		**40,637**	46,708
Total operating expenses		**294,700**	286,557
Operating income (loss)		**(27,045)**	132,413
Commonwealth of Pennsylvania grants		**452,138**	452,003
Federal grants		**7,982**	8,862
Grants and other financial aid		**(586,371)**	(617,953)
Grant funds returned to the Commonwealth of Pennsylvania		**(2,785)**	(728)
Grant funds returned to the U.S. Department of Education		**-**	(71)
Contributions to Pennsylvania Higher Education Foundation		**(1,906)**	(13,155)
Changes in net assets		**(157,987)**	(38,629)
Net assets, beginning of period		**502,593**	541,222
Net assets, end of period	$	**344,606**	502,593

See accompanying notes to financial statements.

At June 30 (in thousands)

	2008	2007
Assets		
Cash and cash equivalents	$ **13,388**	-
Restricted cash and cash equivalents	**298,526**	365,611
Restricted cash and cash equivalents – due to customers	**46,334**	112,966
Investments	**-**	33,573
Restricted investments	**70,494**	70,673
Residual interest in off-balance sheet securitizations	**16,415**	32,823
Student loans receivable, net	**11,830,205**	11,482,091
Interest income receivable	**255,837**	263,858
Due from Federal Student Loan Reserve Fund, net	**86,272**	84,754
Capital assets, net	**69,137**	73,684
Deferred financing costs, net	**48,295**	48,586
Other assets	**35,284**	39,357
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	**139,874**	128,430
Total assets	**12,910,061**	12,736,406
Liabilities		
Cash overdraft	**-**	35,640
Due to customers	**46,334**	112,966
Accounts payable and accrued expenses	**178,303**	171,853
Student loans financings and notes and bonds payable, net	**11,962,537**	11,597,201
Capital and other financings	**238,407**	187,723
Amounts related to the Federal Student Loan Reserve Fund	**139,874**	128,430
Total liabilities	**12,565,455**	12,233,813
Net assets		
Invested in capital assets, net of related debt	**(7,500)**	(606)
Restricted for debt service	**256,326**	346,771
Restricted for financial aid grant programs	**40,259**	55,590
Restricted for default aversion activities	**-**	2,468
Unrestricted	**55,521**	98,370
Total net assets	$ **344,606**	502,593

See accompanying notes to financial statements.

For the years ended June 30 (in thousands)

		2008	2007
Cash flows from operating activities			
Interest received on student loans	$	**546,494**	520,317
Principal received on student loans		**1,135,709**	1,272,356
Student loan originations		**(760,536)**	(1,144,937)
Student loan purchases		**(769,775)**	(2,520,105)
Student loan sales, including net gains		**110,119**	44,595
Interest received on investments		**23,377**	37,890
Interest paid on student loan financings and notes and bonds payable		**(595,909)**	(505,746)
Interest paid on capital and other financings		**(12,823)**	(9,899)
Servicing fees		**127,974**	111,074
Retention of collections on defaulted loans		**95,969**	41,302
Federal fees		**58,643**	58,432
Default aversion fees, net of rebate		**8,612**	13,851
Gains on early termination of financial instruments, net		**-**	11,034
Other		**320**	401
Payment of operating expenses		**(292,814)**	(263,856)
Net cash used for operating activities		**(324,640)**	(2,333,291)
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		**1,110,135**	3,007,000
Principal paid on noncapital debt		**(697,288)**	(419,204)
Issuance costs		**(2,411)**	(10,594)
Commonwealth of Pennsylvania grants received		**452,138**	452,003
Federal grants received		**7,982**	8,862
Grants and financial aid paid		**(588,323)**	(587,353)
Grant funds returned to the Commonwealth of Pennsylvania		**(2,785)**	(728)
Grant funds returned to the U.S. Department of Education		**-**	(71)
Contributions to Pennsylvania Higher Education Foundation		**-**	(10,000)
Cash overdraft		**(35,640)**	(7,462)
Net cash provided by noncapital financing activities		**243,808**	2,432,453
Cash flows from capital and related financing activities			
Proceeds from issuance of capital debt		**5,187**	9,004
Principal paid on capital debt		**(2,888)**	(2,302)
Purchases of capital assets and development of software, net of disposals		**(8,916)**	(11,124)
Net cash used for capital and related financing activities		**(6,617)**	(4,422)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		**269,377**	389,882
Purchases of investments		**(235,625)**	(393,303)
Net cash provided by investing activities		**33,752**	(3,421)
Net change in restricted cash and cash equivalents		**(53,697)**	91,319
Cash and cash equivalents (including restricted cash), beginning of period		**365,611**	274,292
Cash and cash equivalents (including restricted cash), end of period	$	**311,914**	365,611

(continued)

For the years ended June 30 (in thousands)

		2008	2007
Reconciliation of operating income to net cash used for operating activities			
Operating income (loss)	$	**(27,045)**	132,413
Adjustments to reconcile operating income to net cash used for operating activities:			
Depreciation		**13,463**	13,570
Amortization of premium (discount) on loan purchases		**59,729**	49,403
Amortization of loan origination costs		**12,427**	8,522
Amortization of deferred financing costs		**2,702**	1,986
Amortization of deferred amount on refundings of student loan demand revenue bonds		**799**	800
Accretion discount on capital and other financings		**75**	73
Operational support provided to Pennsylvania Higher Education Foundation		**(1,906)**	(3,155)
Changes in assets and liabilities:			
Decrease (increase) in interest income receivable		**8,021**	(76,182)
Decrease in residual interest in off-balance sheet securitizations		**16,408**	10,172
Increase in student loans receivable		**(420,270)**	(2,444,902)
Decrease (increase) in amounts due from Federal Student Loan Reserve Fund		**434**	(60,531)
Decrease (increase) in other assets		**4,073**	(6,225)
Increase in accounts payable and accrued expenses		**6,450**	40,765
Total adjustments		**(297,595)**	(2,465,704)
Net cash used for operating activities	$	**(324,640)**	(2,333,291)

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)		**2008**	2007
Contributions	$	**12,844**	16,562
Income on investments		**656**	6,058
Expenses, including grants of $15.6 million in 2008 and $16.1 million in 2007		**(19,047)**	(20,061)
Increase (decrease) in net assets		**(5,547)**	2,559
Net assets at beginning of year		**45,958**	43,399
Net assets at end of year	$	**40,411**	45,958

At May 31 (in thousands)		2008	2007
Investments	$	**38,260**	42,946
Office furnishings and equipment, net of accumulated depreciation		**53**	67
Amounts payable to specific organizations as designated by donors		**(92)**	(196)
Other assets, net of liabilities		**2,190**	3,141
Net assets	$	**40,411**	45,958

During the year ended June 30, 2008, we provided operation support to PHEF, which cost $1.9 million. We made cash donations totaling $10 million to PHEF during the year ended June 30, 2007, in addition to operational support, which cost $3.2 million.

The board of directors had authorized an additional $20 million of donations through June 30, 2009 as well as ongoing operational support. On January 24, 2008, the board of directors adopted a resolution changing this authorization by discontinuing the annual cash donations and reducing the amount provided for ongoing operational support to $300 thousand annually through May 31, 2012 and thereafter until further action of the board.

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 – Recent Developments

As a result of the disruptions in the credit markets during the year ended June 30, 2008, we had a net loss before transfers in our student loan financing segment of $87.1 million compared to net income before transfers in the segment of $31.2 million for the year ended June 30, 2007. The auction-rate debt securities and variable-rate demand bonds financing this activity are limited obligations payable only from student loans and other assets pledged and held in trust. While the financings are non-recourse to the unrestricted assets of PHEAA and non-recourse to the Commonwealth of Pennsylvania, the result of the reduced margin in these financings limits our historic ability to use student loan principal payments received by the trusts to purchase additional loans. Additionally, we were able to transfer $41.6 million of excess funds from the trusts to unrestricted operations in the year ended June 30, 2007, and only $2.8 million in the year ended June 30, 2008. No excess funds are expected to be available in the year ending June 30, 2009.

Because of an inability to access the credit markets or the financing markets needed to fund student loans, effective March 7, 2008, we temporarily suspended our activities as a lender for any new loans first disbursed on or after that date. We also have student loan purchase commitments of $885 million that we have been unable to fund, and we are committed to purchase an additional $255 million of student loans through June 30, 2009. Most of the purchase commitments are with financial institutions and we continue to work with those institutions to renegotiate the terms and timing of these commitments. The loans held by these financial institutions are all serviced and guaranteed (at least at 97%) by PHEAA and are federally reinsured (at least at 95%). Also, as a result of changes in federal law, effective November 1, 2007, we provided notice to the institutions that we would no longer accept additional commitments for loans originated after that date. Until the credit markets begin to function, the only current source of financing available to honor the existing purchase commitments is repayments of student loans in trusts that allow recycling of repayments into new loans. Loan repayments are insufficient to cover all of our existing purchasing commitments.

On April 7, 2008, The Education Resources Institute ("TERI") filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. TERI guaranteed $53.6 million of the private loans we held at June 30, 2008. TERI's bankruptcy filing was an event of default for a $25.0 million financing used to finance a portion of the TERI-guaranteed loans we hold. This event of default was waived by the provider of the financing on May 15, 2008. The financing currently matures on December 31, 2008, and we are negotiating terms to extend the financing. If negotiations are not successful, we have certain alternatives to handle this maturity which are within our control.

Events of default were triggered on a $500 million line of credit facility used to finance federally insured student loans (of which $415.1 million was outstanding at June 30, 2008) due to our inability to fund the student loan purchase commitments referred to above and the occurrence of certain material adverse changes relating to our operations, business, properties, liabilities, financial condition, and prospects taken as a whole. The default caused by the TERI bankruptcy default referred to above, together with other defaults discussed below, also triggered a cross-default provision with respect to this line of credit facility. On September 18, 2008, the lender informed us that no future advances would be permitted on the line. On December 9, 2008, the lender under this facility provided a waiver of previous defaults and forbearance with respect to future defaults relating to our inability to fund the specified loan purchase commitments. To obtain this waiver, we agreed to amend the credit agreement to extend the maturity date on this line to February 3, 2009; increase the collateral coverage from its current level, 101%, to 103%; and increase the interest rate beginning November 1, 2008 from LIBOR plus 0.3% to LIBOR plus 0.75%; among other changes. The lender's remedies are limited solely to the student loans and other assets in trust securing the line of credit.

Similarly, events of default were triggered on a $175 million unsecured line of credit used for operations (of which $94 million was outstanding at June 30, 2008) due to our inability to fund the student loan purchase commitments and the occurrence of the material adverse changes referred to above. The default related to the TERI bankruptcy, together with our defaults under the $500 million secured line of credit facility referred to above, and the $10 million facility referred to below, also triggered a cross-default provision under this line of credit. Effective September 8, 2008, the unsecured line of credit was reduced from $175 million to $94 million. We agreed with the provider of this financing to restructure the debt on December 15, 2008 in exchange for a waiver of past defaults and a conditional forbearance with respect to future defaults relating to our inability to fund the specified student loan purchase commitments. Under the new terms, we will make scheduled payments of the debt to amortize it completely by June 30, 2011, and we granted a security interest in otherwise unencumbered assets to secure this previously unsecured line, among other changes.

Similarly, the events discussed above triggered events of default and cross defaults on a $10 million capital financing line (of which $9.4 million was outstanding at June 30, 2008). On December 2, 2008, the provider of this financing waived the events of default and amended the credit agreement such that defaults under our $500 million secured line of credit and any defaults relating to our future inability to fund the specified student loan purchase commitments would not constitute events of default under this line.

Subsequent to June 30, 2008, we have successfully renegotiated other student loan financings as follows.

On August 8, 2008, we extended through August 7, 2009 a $150 million student loan financing that was due August 8, 2008. At June 30, 2008, $150 million was outstanding on the note. Interest is accrued based on 3-month LIBOR plus 0.12% and resets on a weekly basis.

On August 28, 2008, we extended through August 28, 2009 a $35 million student loan financing that was due August 31, 2008.

On October 27, 2008, a $500 million student loan financing was reduced to $422 million and the maturity date was extended from December 31, 2008 to July 31, 2009.

The events described above, as well as changes in federal law, have adversely affected our operations and our ability to continue to fund public service initiatives. As a result, the board of directors and management have taken steps to reduce discretionary public service funding and reduce operating expenses, including workforce reductions. Self-funded financial aid programs, which are discretionary, were $124.5 million during the year ended June 30, 2008 and are planned to be reduced to approximately $35.9 million for the year ending June 30, 2009.

Note 3 – 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. As of January 1, 2008, no revenue was recognized related to default aversion fees, as the ultimate collectibility of the amounts was not reasonably assured, and no fees were transferred from 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, and the present value of this residual interest 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 $2.9 million in 2008 and $11.9 million in 2007. Included in these expenses are advertising expenses paid on behalf of PHEF totaling $182 thousand in 2008 and $855 thousand in 2007. 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 4 – Restatement of Previously Reported Net Assets

As of and for the year ended June 30, 2008, we adopted GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. The following table reconciles net assets as previously reported, to beginning net assets, as restated, to include the adoption of this new pronouncement.

At June 30 (in thousands)		2007	2006
Net assets as previously reported	$	469,770	498,227
Restatement related to adoption of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*		32,823	42,995
Net assets, as restated	$	502,593	541,222

We believe that the transactions with the PHEAA Student Loan Trust I can continue to be accounted for as a sale under this standard.

Note 5 – New Accounting Pronouncements

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 6 – 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)		2008	2007
Additions			
Reinsurance from the U.S. Department of Education	$	**1,179,005**	812,789
Collections on defaulted loans		**364,628**	276,698
Federal default fees		**34,907**	58,445
Net appreciation in fair value of investments		**1,017**	2,884
Other		**-**	619
Total additions		**1,579,557**	1,151,435
Deductions			
Purchases of defaulted loans from lenders		**1,227,960**	846,183
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**261,971**	187,961
Reimbursement to PHEAA for our retention of defaulted loans collections		**93,490**	82,140
Default aversion fees, net		**28,454**	33,543
Total deductions		**1,611,875**	1,149,827
Net increase (decrease)		**(32,318)**	1,608
Net assets, beginning of period		**27,826**	26,218
Net assets, end of period	$	**(4,492)**	27,826

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

At June 30 (in thousands)		**2008**	2007
Assets			
Cash	$	**11,246**	4,891
Receivable from the U.S. Department of Education		**25,060**	78,741
Other receivables		**8,420**	7,859
Interest income receivable		**250**	409
Investments		**94,898**	36,530
Total assets		**139,874**	128,430
Liabilities			
Accounts payable and accrued expenses		**26,274**	219
Payable to U.S. Department of Education		**956**	8,682
Deferred federal default fees		**7,162**	6,949
Amounts payable to PHEAA		**109,974**	84,754
Total liabilities		**144,366**	100,604
Net assets	$	**(4,492)**	27,826

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.

Because we were under the required ratio during the federal fiscal years ended September 30, 2005 and 2006, 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. At September 30, 2007, the deposit necessary to meet the minimum funding requirements was $28.6 million.

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, 2008 and 2007, we allowed this liability to us to increase. As of September 30, 2007, we reduced this liability to us by $28.6 million to reflect the deposit necessary to meet the minimum funding requirements as of September 30, 2007.

Due to the seasonal timing of default fee deposits into the Federal Fund, the fund met the required 0.25% reserve ratio at September 30, 2008.

Note 7 – Cash and Investments

At June 30 (in thousands)		2008	2007
Cash and cash equivalents	$	**13,388**	-
Restricted cash and cash equivalents		**298,526**	365,611
Restricted cash and cash equivalents – due to customers		**46,334**	112,966
Cash overdraft		**-**	(35,640)
Carrying value	$	**358,248**	442,937
Cash on deposit, bank balance	$	**14,533**	15,998
Cash equivalents		**357,059**	408,087
Cash on deposit, bank balance (including cash equivalents)	$	**371,592**	424,085

The following table shows our investments and maturities at June 30, 2008.

			Investment Maturities (in years)		
(In thousands)		Fair Value	Less than 1	1 to 10	More than 10
<u>Cash equivalents</u>					
Money market funds	$	130,150	130,150	-	-
Guaranteed investment contracts and agreements		169,582	169,582	-	-
Commercial paper		57,327	57,327	-	-
		357,059	357,059	-	-
<u>Investments</u>					
Guaranteed investment contracts and agreements		70,494	-	65,441	5,053
	$	427,553	357,059	65,441	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.

The State Treasury investment pool 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 governed by the provisions of the State Treasury investment policy.

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 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, 2008, all of our investments in commercial paper were rated A-1+. At June 30, 2008, $6.9 million of our investments in guaranteed investment contracts and agreements were rated Aa2, $142.1 million were rated Aaa, $70.5 million were rated Aa, and $20.6 million were rated Aa3. 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, 2008, $14.4 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, 2008, 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
Commercial paper	$ 57,327

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, 2008.

(In thousands)	Issuer		Fair Value
Money market fund	Federated Treasury Obligation	$	102,760
Guaranteed investment agreement	MBIA, Inc		65,441
Guaranteed investment contracts	Trinity Plus Funding Co.		121,206

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

The Federal Fund had $94.9 million at June 30, 2008 and $36.5 million at June 30, 2007 invested in the State Treasury investment pool with a maturity of less than 1 year.

Note 8 – Student Loans Receivable

The following table shows our student loan holdings.

At June 30 (in thousands)		2008	2007
FFELP:			
Consolidation	$	**7,684,432**	7,523,624
Stafford		**3,261,366**	3,023,343
PLUS		**421,498**	390,840
Supplemental Loans for Students		**2,551**	2,879
		11,369,847	10,940,686
HEAL		**188,549**	221,661
Privately insured loans		**53,594**	51,538
Uninsured loans		**6,504**	6,191
Unamortized premium on loan purchases		**183,853**	225,687
Unamortized loan origination costs		**44,797**	41,984
		11,847,144	11,487,747
Allowance for loan losses		**(16,939)**	(5,656)
	$	**11,830,205**	11,482,091

Under FFELP, 97% of principal and interest is 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, as we remained in compliance with the required standards, which are assessed annually and quarterly through compliance audits. Beginning July 1, 2006 and before October 1, 2007, the reimbursement for student loans serviced by servicers designated as Exceptional Performers decreased from 100% to 99% for all claims filed during that time. The ratification of the College Cost Reduction and Access Act on September 27, 2007 eliminated the Exceptional Performer program, resulting in a decrease in the reimbursement for student loans from 99% to 97%.

The provision for loan losses for the year ended June 30, 2008 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)		**2008**	2007
Balance at beginning of period	$	**5,656**	3,976
Provision for losses		**16,776**	3,996
Charge-offs		**(5,493)**	(2,316)
Balance at end of period	$	**16,939**	5,656

Through June 30, 2009, we have student loan purchase commitments of $1.1 billion.

Note 9 – Capital Assets

Capital asset activity for the year ended June 30, 2008 was as follows.

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings and improvements		72,451	776	(23)	73,204
Software development		31,496	4,835	(2,517)	33,814
Purchased software		20,981	441	-	21,422
Other, principally information technology equipment		30,449	3,074	(664)	32,859
		158,323	9,126	(3,204)	164,245
Less accumulated depreciation for:					
Buildings and improvements		(30,226)	(1,850)	23	(32,053)
Software development		(18,352)	(6,263)	2,517	(22,098)
Purchased software		(13,923)	(2,616)	-	(16,539)
Other, principally information technology equipment		(22,138)	(2,735)	455	(24,418)
		(84,639)	(13,464)	2,995	(95,108)
	$	73,684	(4,338)	(209)	69,137

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

Note 10 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings for the year ended June 30, 2008, adjusted for items negotiated after June 30, 2008, is 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 2.96% at June 30, 2008 and 5.67% at June 30, 2007	$	960,919	660,100	(537,000)	1,084,019	505,671
Student loan floating rate notes, due 2016-2038 at weighted-average rates of 2.93% at June 30, 2008 and 5.45% at June 30, 2007		1,547,106	-	(158,563)	1,388,543	-
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 5.33% at June 30, 2008 and 4.91% at June 30, 2007		9,099,900	400,000	-	9,499,900	-
Deferred amount on current refundings of student loan demand revenue bonds		(10,724)	-	799	(9,925)	-
		9,089,176	400,000	799	9,489,975	-
Capital financings:						
Capital financings, due 2008-2019, at weighted-average rates of 5.88% at June 30, 2008 and 5.98% at June 30, 2007		74,467	5,188	(2,889)	76,766	4,213
Unamortized discount on capital acquisition bonds		(177)	-	48	(129)	-
		74,290	5,188	(2,841)	76,637	4,213
Other financings:						
Term financings, due 2008-2030, at weighted-average rates of 5.09% at June 30, 2008 and 2007		69,930	-	(1,725)	68,205	1,795
Unamortized discount on capital acquisition refunding bonds		(497)	-	27	(470)	-
Line of credit, due 2009-11, at weighted-average rates of 5.20% at June 30, 2008 and 6.32% at June 30, 2007		44,000	50,035	-	94,035	22,035
		113,433	50,035	(1,698)	161,770	23,830
	$	11,784,924	1,115,323	(699,302)	12,200,944	533,714

The note and bond indentures among other things require us to comply with various covenants. Student loans and investments collateralize all student loan financings, student loan floating rate notes, and student loan demand revenue bonds and auction rate notes. At June 30, 2008, $12.0 billion of student loan principal and related interest receivable and $283.3 million of investments and related interest receivable collateralized the $12.0 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 banks who hold the bonds 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. As of June 30, 2008, there were $893.9 million of variable-rate demand bonds that were put to the liquidity provider and are in bank bond mode with interest rates ranging from federal funds rate plus 1.5% to prime rate plus 2.0%. The letters of credit are valid from 2007 through 2015, and we are required to pay annual commitment fees ranging from 10 to 32 basis points on the stated amount of the letter of credit coverage. At June 30, 2008, total liquidity coverage was $2.2 billion.

Capital financings are collateralized with capital assets.

At June 30, 2008, we had $589 thousand of available credit under capital financing arrangements.

The following tables display the debt service requirements based upon the stated maturities for demand bonds and estimated interest rates for variable-rate debt after considering terms renegotiated after June 30, 2008.

(In thousands)		Student Loan Notes, Bonds and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2009	$	505,671	362,364	28,043	11,629
2010		578,348	341,180	41,795	10,110
2011		-	339,616	101,548	6,320
2012		-	339,616	4,099	3,310
2013		-	339,616	2,911	3,130
2014-2018		412,488	1,669,697	13,480	13,649
2019-2023		643,970	1,497,963	14,800	10,139
2024-2028		774,500	1,389,243	18,710	5,900
2029-2033		474,500	1,294,491	13,620	1,033
2034-2038		1,719,485	1,210,724	-	-
2039-2043		2,113,500	892,234	-	-
2044-2049		4,750,000	328,174	-	-
	$	11,972,462	10,004,918	239,006	65,220

$12.0 billion of the student loan notes, bonds and financings are variable-rate debt. $2.1 billion of the variable-rate debt resets based upon auctions every 7 days. $6.5 billion resets based upon auctions every 28 days. $791 million resets based upon auctions every 35 days. $1.5 billion is indexed to the 3-month LIBOR, $784 million is indexed to the 1-month LIBOR, and $300 million is indexed to 3-month financial commercial paper.

At June 30, 2008, we had not yet issued $2.1 billion of debt that the board of directors has authorized.

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, 2007 was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings	$	857,919	313,000	(210,000)	960,919	960,919
Student loan floating rate notes		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		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		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		71,999	-	(2,069)	69,930	1,725
Unamortized discount on capital acquisition refunding bonds		(524)	-	27	(497)	-
Line of credit		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

Note 11 – 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 12 – 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 $12.4 million in 2008 and $8.7 million in 2007.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) at June 30, 2008 are:

Year ending June 30 (in thousands)		
2009	$	12,744
2010		6,638
2011		5,455
2012		4,962
2013		2,632
2014		805
Total minimum lease payments	$	33,236

Note 13 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

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

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

Funding Policy

Members are required to contribute to the plan. For most members the contribution rate is 6.25% of annual covered salary. As an employer, we are required to contribute at an actuarially determined rate. During the year ended June 30, 2008, the required employer contribution rates were 2.63% or 3.28%, depending upon the membership classification of each employee. Beginning July 1, 2008, our contribution rates will be 2.64% or 3.29%. 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 years ended June 30, 2008 and 2007. These contributions were equal to the required contributions for each year.

Postemployment Benefits

As of and for the year ended June 30, 2008, we adopted GASB Statement No. 45, *Accounting and Reporting by Employers for Postemployment Benefits Other Than Pensions*.

Plan Description

The Commonwealth of Pennsylvania sponsors the Retired Employees' Health Plan Program (REHP). We participate in the Commonwealth's REHP, a cost sharing, multiple-employer, defined benefit postemployment healthcare plan administered by the Pennsylvania Employees' Benefit Trust Fund (PEBTF), acting as a third-party administrator on behalf of the Commonwealth's Office of Administration. The REHP provides health care and prescription drug plan benefits to eligible Commonwealth of Pennsylvania retirees, and their eligible dependents. The REHP's benefit provisions are established and may be amended by the Commonwealth of Pennsylvania's Office of Administration..

The REHP does not issue stand alone financial statements, however REHP footnote disclosures will be included in the Commonwealth's Comprehensive Annual Financial Report (CAFR) for the year ended June 30, 2008.

Funding Policy

The Commonwealth has committed to fully funding the Annual Required Contribution to the plan. We contribute to the plan at a rate determined each year by the Governor's Budget Office; for the year ended June 30, 2008 the contribution rate was $193 thousand per month. This rate is based on a per retiree cost of $9 thousand annually times the estimated number of retirees enrolled in the REHP. As of June 30, 2008 we have made all required contributions to the REHP as determined by the Governor's Budget Office. The contribution rate effective July 1, 2008 is $215 thousand per month. This current level of funding is subject to future adjustment at the beginning of each fiscal year, based upon projected retiree costs and the number of future retirees. The requirements of GASB Statement 45 were implemented prospectively beginning at July 1, 2007, at which time no liability for other postemployment benefits (OPEB) was recorded.

We pay member contributions, as set by the Governor's Budget Office, to the PEBTF in accordance with terms and conditions of the REHP Participation Agreement and guidelines published in Management Directives and the Master Agreement. Effective July 1, 2005, retiring employees began contributing to the plan, one percent of their final annual salary in twelve monthly installments.

For additional information on the REHP including other postemployment benefit (OPEB) expenses, funded status, funding progress, actuarial accrued liability, and the actuarial assumptions used to determine these amounts for the Commonwealth's REHP, the complete actuarial report is available for review at www.budget.state.pa.us/budget/lib/budget/hay_group_gasb_45_valuation_report.pdf.

Note 14 – Servicing Fees

We have contracts with customers to provide servicing of student loans as well as information technology services. At June 30, 2008, we were servicing approximately $45.2 billion of loans for customers. Customers using our computer services serviced an additional $34.7 billion of loans, and other FFELP guarantors were managing $3.9 billion of guarantees using our computer services.

Our servicing agreements, some of which expire during the fiscal year ending June 30, 2009, 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.

Six loan-servicing customers provided $72.2 million of servicing fees for the year ended June 30, 2008. No other individual customer provided servicing revenues more than 5% of total servicing fees.

Note 15 – Segment Information

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

Statements of revenues, expenses, and changes in net assets

For the years ended June 30 (in thousands)		2008	2007
Interest revenue	$	**653,281**	672,735
Interest expense		**620,878**	530,200
Net interest revenue		**32,403**	142,535
Provision for loan losses		**(13,218)**	(2,956)
Net interest revenue after provision for loan losses		**19,185**	139,579
Gains on student loan sales, net		**375**	101
Total operating revenues		**19,560**	139,680
Operating expenses		**92,981**	91,769
Operating income (loss)		**(73,421)**	47,911
Financial aid		**13,717**	16,754
Income (loss) before transfers		**(87,138)**	31,157
Transfers to unrestricted net assets		**(2,763)**	(41,594)
Change in net assets		**(89,901)**	(10,437)
Net assets, beginning of period		**342,954**	353,391
Net assets, end of period	$	**253,053**	342,954

Statements of net assets

At June 30 (in thousands)		2008	2007
Restricted cash and cash equivalents	$	**296,226**	361,127
Student loans receivable		**11,712,483**	11,353,865
Other, principally interest income receivable		**299,875**	308,813
Total assets		**12,308,584**	12,023,805
Student loan financings and notes and bonds payable, net		**11,962,537**	11,597,201
Other, principally accrued interest payable		**92,994**	83,650
Total liabilities		**12,055,531**	11,680,851
Net assets, restricted for debt service	$	**253,053**	342,954

Statements of cash flows

For the years ended June 30 (in thousands)		2008	2007
Interest received on student loans	$	**545,358**	513,660
Principal received on student loans		**1,129,477**	1,272,140
Student loan originations		**(759,193)**	(1,143,852)
Student loan purchases		**(755,068)**	(2,736,862)
Student loan sales, including net gains		**113,285**	162,327
Interest received on investments		**16,342**	20,384
Interest paid on student loan financings and notes and bonds payable		**(595,854)**	(508,890)
Payment of operating expenses		**(104,893)**	(87,678)
Net cash used for operating activities		**(410,546)**	(2,508,771)
Proceeds from issuance of noncapital debt		**1,060,100**	2,888,000
Principal paid on noncapital debt		**(695,563)**	(292,234)
Other		**(18,892)**	(68,941)
Net cash provided by noncapital financing activities		**345,645**	2,526,825
Net change in restricted cash and cash equivalents		**(64,901)**	18,054
Restricted cash and cash equivalents, beginning of period		**361,127**	343,073
Restricted cash and cash equivalents, end of period	$	**296,226**	361,127

There are 26 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 0.967 to 1.108 at June 30, 2008.

At December 15, 2008, there were $1.7 billion of variable-rate demand bonds that were put to the liquidity provider and are in bank bond mode with interest rates ranging from 1-month LIBOR plus 1.75% to prime rate plus 2.0%.

The following chart displays parity ratios for variable-rate demand bonds.

(Dollars in thousands)

Issue	Debt Outstanding	June 30, 2007	September 30, 2007	December 31, 2007	March 31, 2008	June 30, 2008
1988A	$ 100,000	1.042	1.041	1.042	1.037	1.028
1988B	110,000	1.046	1.049	1.051	1.047	1.041
1988C	75,000	1.055	1.056	1.056	1.053	1.047
1988E	36,000	1.081	1.084	1.091	1.101	1.108
1994A	125,000	1.051	1.053	1.053	1.050	1.044
1995A	125,000	1.057	1.059	1.061	1.057	1.032
1997A	125,000	1.032	1.036	1.039	1.037	1.036
1999A	100,000	1.048	1.047	1.049	1.046	1.032
2000A	100,000	1.047	1.052	1.055	1.055	1.053
2001A	75,000	1.038	1.041	1.045	1.045	1.044
2001B	92,900	1.035	1.037	1.037	1.040	1.039
2002A	170,000	1.032	1.031	1.032	1.037	1.037
2002B	50,000	1.033	1.038	1.041	1.039	1.042
2003A	150,000	1.060	1.065	1.068	1.069	1.065
2006A	225,000	0.977	0.979	0.979	0.974	0.995
2007A	400,000	n/a	0.983	0.983	0.969	0.967

There are no parity requirements for these trusts; however, if parity drops for two consecutive quarters and parity is below 1.02, recycling of new loans into the trusts is suspended.

The master trust that issued auction rate securities holds $7.4 billion of debt. The parity ratio for this trust was 1.004 at June 30, 2007; 1.003 at September 30, 2007; 1.002 at December 31, 2007; 0.995 at March 31, 2008; and 1.001 at June 30, 2008. There is no parity requirement for this trust.

Note 16 – Restrictions on Net Assets

Net assets restricted for debt service amounted to $256.3 million at June 30, 2008. Of that amount, $253.1 million is related to net assets held under various indentures related to financing our student loan portfolios, and the remaining $3.2 million of net assets restricted for debt service is related to capital and other financings.

The $40.3 million of net assets restricted for financial aid grant programs results from Commonwealth of Pennsylvania grants and federal grants related to specific programs. Those net assets are restricted until we disburse program-related grants.

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

Note 17 – Student Loan Securitizations

As of and for the year ended June 30, 2008, we adopted GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.*

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

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

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

(Dollars in thousands)		**June 30, 2008**	June 30, 2007
Present value of residual interest	$	**16,415**	32,823
Weighted average life		**12.0 years**	13.0 years
Conditional prepayment rate		**5.0%**	5.0%
Residual cash flow discount rate		**4.4%**	6.6%

The decrease in the present value of residual interest is due primarily to the projected net interest yield being impacted by increases in auction rate debt interest rates as a result of recent failed auctions and the increased prepayments for borrower consolidations, which resulted in higher prepayment rates than we had estimated would occur at certain points in the life of the loans.

When we sell student loan receivables in securitizations of student loans, we enter into a servicing agreement with the securitization trust and earn annual servicing fees from the trust of 0.25% per year on the outstanding balance of consolidation loans and 0.50% per year on the outstanding balance of Stafford and PLUS loans. We also enter an administration agreement with the trust and generally earn annual administration fees of 0.25% per year on the outstanding balance of student loans in the trust. For the year ended June 30, 2008, we earned $3.6 million, compared to $4.0 million in 2007. The amount earned is included in servicing fees on the statement of revenues, expenses, and changes in net assets.

The PHEAA Student Loan Trust I filed a monthly Form 8-K and an annual Form 10-K with the SEC through November 30, 2005 and those filings are available on the SEC's website at www.sec.gov. 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 unaudited financial information for the PHEAA Student Loan Trust I is presented in the following table:

(In thousands)		June 30, 2008	June 30, 2007
Assets:			
Cash and cash equivalents	$	**29,580**	39,128
Student loans receivable, net		**677,477**	747,834
Interest income receivable		**8,671**	13,623
Other assets		**3,441**	4,001
Total assets		**719,169**	804,586
Liabilities:			
Notes payable	$	**692,977**	776,206
Interest payable		**2,876**	5,438
Other liabilities		**2,932**	1,631
Total liabilities		**698,785**	783,275
Net assets	$	**20,384**	21,311

Note 18 – 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 purchase insurance coverage, and there have been no material claims.

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

We have appealed one finding in a Program Review conducted by ED related to our processing of 9.5% floor loans. On November 19, 2007, the Office of Inspector General of the U.S. Department of Education issued its final audit report titled *Special Allowance Payments to the Pennsylvania Higher Education Assistance Agency for Loans Funded by Tax-Exempt Obligations.* Finding No. 1 of the report questions payments of $14.1 million and duplicates the Program Review finding already under appeal. Finding No. 2 of the report questions payments of $21.3 million. On January 25, 2008, the U.S. Department of Education closed Finding No. 2 by concluding that this finding did not rest on an accurate characterization of DCL 96-L-186 and the statutory and regulatory provisions it interpreted. On August 21, 2008, the U.S. Department of Education adjusted the questioned payments in Finding No. 1 to $11.3 million. Finding No. 1 remains open and the amount of the questioned payment has not been accrued in the accompanying financial statements.

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.