PHEAA POWERED BY aes

Annual Financial Report
June 30, 2009 and 2008

This discussion and analysis of the financial performance of Pennsylvania Higher Education Assistance Agency (PHEAA) 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 and credit markets began increasing the cost of $7.4 billion of auction rate debt securities financing our portfolio of student loans. In January 2008, a downgrade of Ambac Assurance Corporation's (Ambac) 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.

For auction rate securities, investors and potential investors submit orders through a broker-dealer as to the principal amount of notes they wish to buy, hold, or sell at various interest rates. The broker-dealers submit their clients' orders to the auction agent, who then determines the clearing interest rate for the upcoming period. The auction agent or agents reset interest rates on these auction rate securities periodically, every 7 to 35 days. In August 2007, auction rate securities from various issuers failed to receive sufficient order interest from potential investors to clear successfully, resulting in failed auction status. Under normal conditions, brokers-dealers had historically purchased these securities when investor demand was weak. However, since the February 2008, the broker-dealers have been allowing 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 defined by the indenture. The maximum auction rate is an annual interest rate on the securities based on a spread to London Interbank Offered Rate ("LIBOR"), 3-month commercial paper rate, Securities Industry and Financial Markets Association ("SIFMA") index or Kenny Index, or Treasury securities, and these rates are subject to increase if the credit ratings on the bonds are downgraded.

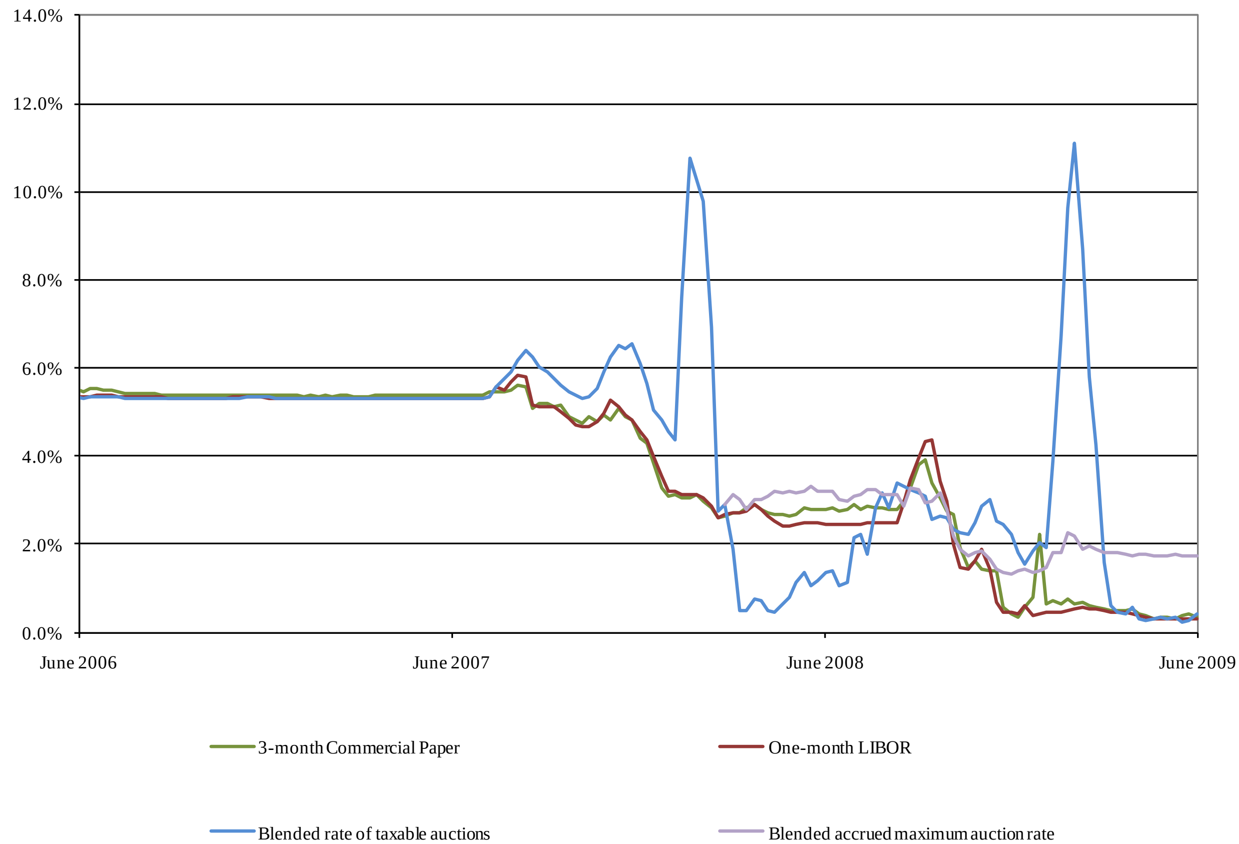
On February 23, 2009, Moody's Investors Services (Moody's) downgraded the bonds within the $7.4 billion auction rate securities from Aaa to A3 and A1 to Baa3. According to Moody's, the rating actions were prompted by the increase of funding costs due to continuing and prolonged dislocation of the auction rate securities market. As most student loan collateral is indexed to the 3-month Financial Commercial Paper rate ("CP rate"), trusts that are funded primarily by auction rate securities have suffered excess spread compression as the yield on the assets has not increased in tandem with the cost of the liabilities.

Due to the aforementioned February 23, 2009 Moody's downgrade of the $7.4 billion auction rate securities, the formula for the maximum auction rates payable increased for some of the failed auction-rate securities. The maximum auction rates payable changed from the 91-day U.S. Treasury Bill rates plus 1.20% or 1.50% to the 91-day U.S. Treasury Bill rates plus 1.50% or 1.75%, and one-month LIBOR rates plus 1% to one-month LIBOR rates plus 1.00% or 2.00% for the one-year period ending on the auction date. However, there are formulas for the maximum auction rates payable that did not change for some of the other auction rate securities. While we continue to assess the situation, there is no timetable or restructuring plan for these securities at this time.

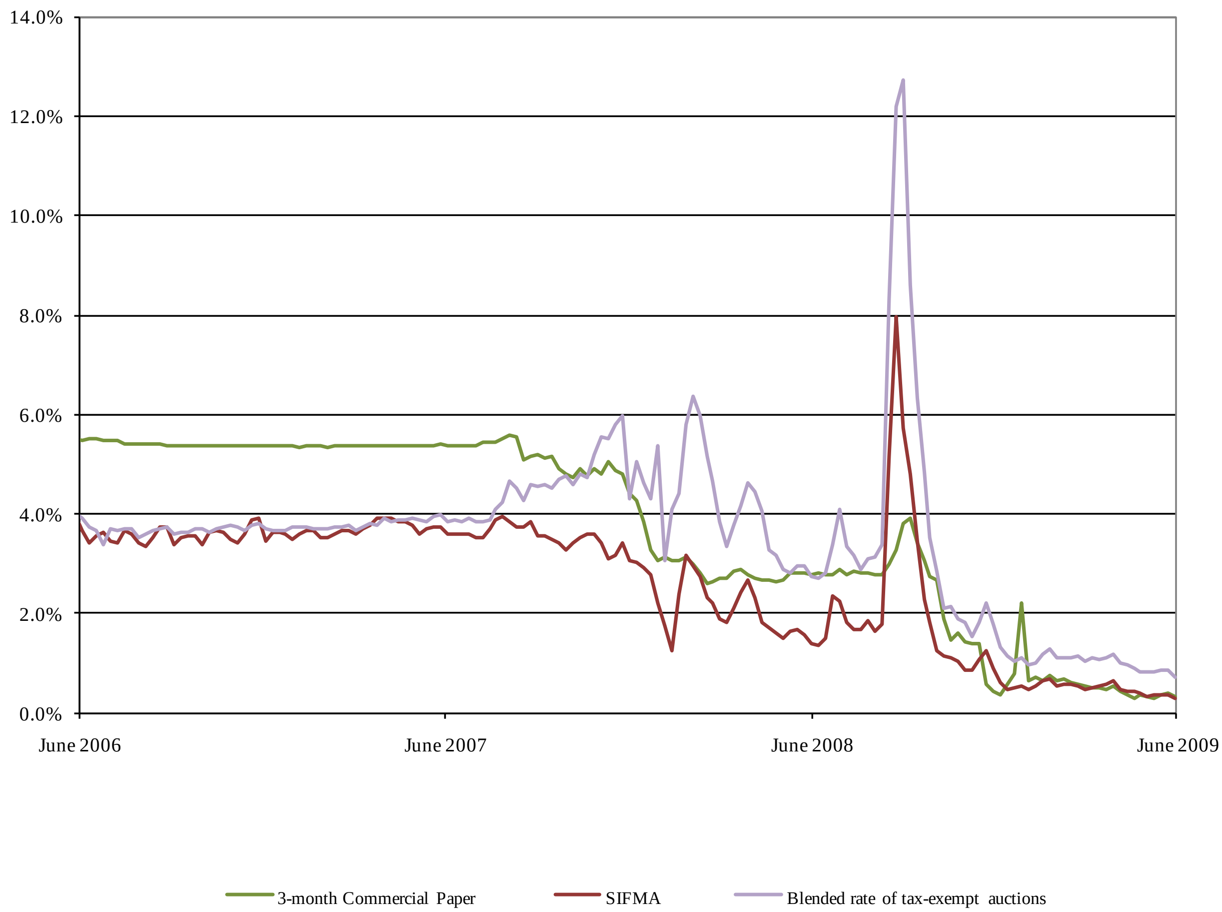
On June 24, 2009, Standard & Poor's Ratings Services downgraded Ambac's financial strength rating to BBB and placed the rating on CreditWatch with negative implications. Ambac provides bond insurance on $1.3 billion of adjustable rate revenue bonds and provides a surety bond for the debt service reserve fund on $7.4 billion of auction rate debt securities.

At June 30, 2009, $3.75 billion of taxable auction rate securities were based upon the 91-day U.S. Treasury Bill rate plus 1.5%; $115 million of taxable auction rate securities were based upon the 91-day U.S. Treasury Bill rate plus 1.75%; $1.4 billion of taxable auction rate securities were based upon the one-month LIBOR plus 1.0%; and $1.3 billion of taxable auction rate securities were based upon the one-month LIBOR plus 2.0%.

Of our $7.4 billion of auction rate debt, $6.6 billion is taxable. Before August 2007, the blended rate of our taxable auctions tracked one-month LIBOR. After the auctions failed, as discussed above, during the 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 would continue to fail and the maximum rate would be paid. The following chart displays the 3-month commercial paper rate on which the lender yield for student loans is based, the one-month LIBOR rate, the blended rate of taxable auctions, and the blended accrued maximum auction rate.



Before August 2007, the remaining $784 million of tax-exempt auction rate debt generally tracked the 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% or 200% of the higher of other benchmark rates including the SIFMA index and the AA commercial paper rate multiplied by 65%. At June 30, 2009, $754.0 million of the senior auction rate securities are payable based upon 175% of the commercial paper rates; and $30.0 million of the subordinate auction rate securities are payable based upon 200% of the commercial paper rates. The following chart displays the SIFMA index and the blended rate of tax-exempt auctions as well as the 3-month commercial paper rate.



In January 2008, Fitch Ratings ("Fitch") downgraded Ambac's credit rating from AAA to AA and negative market sentiment began increasing the cost of $1.8 billion of our tax-exempt variable-rate demand bonds that Ambac insures. In November 2008, Moody's downgraded Financial Security Assurance's (FSA) financial strength rating from Aaa to Aa3 and negative market sentiment began increasing the cost of $312 million of our tax-exempt variable rate demand bonds that FSA insures.

On February 6, 2009, Moody's downgraded $1.8 billion of our variable rate demand bonds. These bonds are guaranteed by Ambac whose financial strength rating was Baa1. According to Moody's, the variable rate demand notes have experienced excess spread compression due to the prolonged and continued market dislocation. Furthermore, almost all of the bonds guaranteed by Ambac were put back to the liquidity banks. At the bank rate, the trusts are expected to generate significant negative excess spread.

On April 3, 2009, Moody's placed $225 million of the variable rate demand bonds on review for possible downgrade. According to Moody's, these bonds have been remarketed successfully, but the interest rates involved have exceeded Moody's original assumptions and led to negative excess spread. Moody's indicated that multi-notch downgrades were likely for the long-term ratings. These variable rate demand bonds were redeemed on June 29, 2009 as part of the Asset-Backed Commercial Paper (ABCP) Conduit Put Program.

On April 13, 2009, Moody's downgraded Ambac's insurance financial strength rating to Ba3 with a developing outlook.

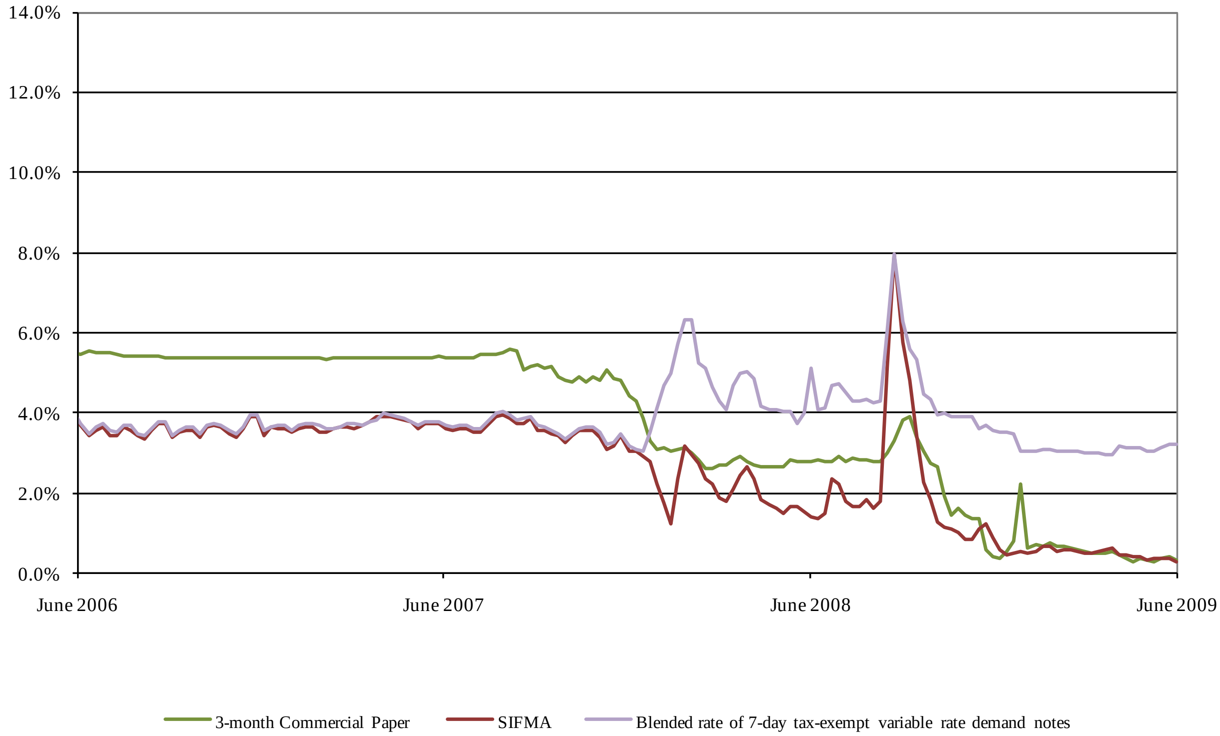
On May 11, 2009, Fitch downgraded FSA's financial strength rating from AAA to AA+ and the long-term rating of FSA Holdings from AA to A. Fitch's downgrade of FSA is based on their view of the residual risks retained by FSA following the transfer of its financial products business to Dexia.

On May 15, 2009, Standard & Poor's Ratings Services corrected its ratings on $306 million of senior secured student loan adjustable-rate revenue refunding bonds by lowering the short-term ratings from A-1+ to A-1. The May 15, 2009 ratings actions reflect the March 6, 2009, lowering of the short-term counterparty credit rating on Lloyds TSB to A-1 from A-1+; and the April 21, 2009, affirmation of their AAA financial strength rating on FSA and the removal of the negative rating from CreditWatch, where it was placed on October 8, 2008. The short-term ratings on the bonds reflect Standard & Poor's opinion of the liquidity providers' ability, as the standby bond purchasers, to pay the purchase price of the bonds when the bondholders tender the bonds.

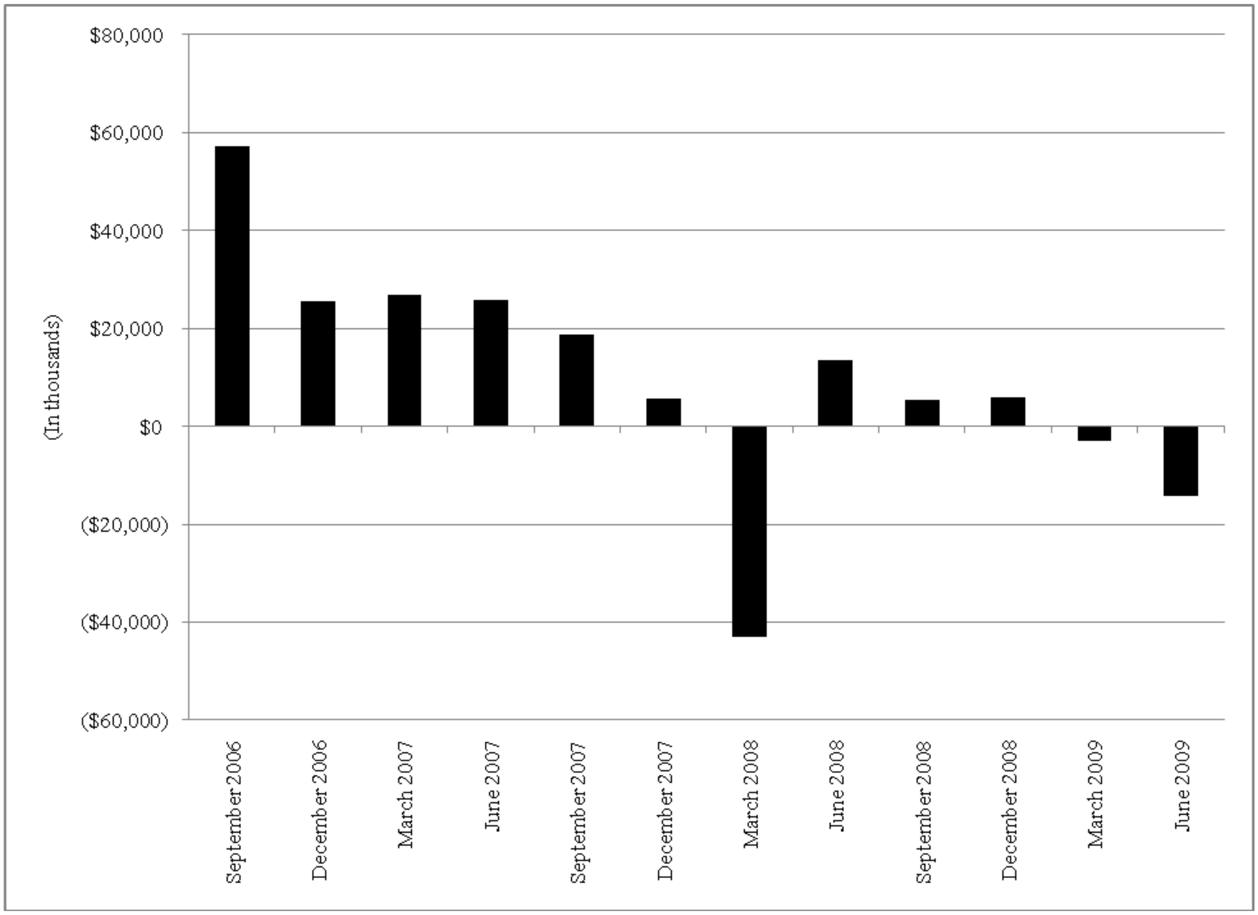
On June 23, 2009, S&P downgraded Ambac's insurance financial strength rating from A to BBB and subsequently on July 28, 2009 from BBB to CC with a developing outlook.

On July 29, 2009, Moody's downgraded Ambac's insurance financial strength rating from Ba3 to Ca2.

Before the January 2008 downgrade of Ambac's credit rating, the interest rates paid on the variable-rate demand bonds tracked the SIFMA index. The following chart displays the SIFMA index, 3-month commercial paper rate and the blended rate of our $1.2 billion of tax-exempt variable-rate demand notes, including the amounts insured by Ambac and FSA.



For the year ended June 30, 2009, net student loan interest expense was $6.1 million, compared to net student loan interest expense of $5.1 million in 2008, a $1.0 million increase in net student loan interest expense. 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 current fiscal year and 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. The net student loan interest expense during the quarters ended March 31, 2009 and June 30, 2009 were caused by the February 23, 2009 ratings downgrade of the auction-rate securities by Moody's, which caused an increase in the maximum auction rate, and by the negative interest rate spreads, respectively.

Because of an inability to access the credit markets or financing markets necessary to fund student loans, effective March 7, 2008, we suspended our activities as a lender for any new loans first disbursed on or after that date. As of June 30, 2009, we have student loan purchase commitments of $573.3 million that we have been unable to fund or settle, and an additional $278.5 million of student loans through June 30, 2010 and thereafter. Subsequent to June 30, 2009, we are in the process of settling $360.5 million of student loan purchase commitments that will result in $3.3 million of additional liabilities. The $3.3 million of additional liabilities are not included in these financial results, but will be a part of the September 30, 2009 quarterly financial results. 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 June 17, 2009, we entered into the Asset-Backed Commercial Paper (ABCP) Conduit Put Program through which we transferred $825.0 million of eligible student loans to PHEAA Student Loan Company (SLC) (100% equity owned by the PHEAA Student Loan Foundation, a blended component unit of PHEAA). PHEAA SLC entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A Funding, LLC (Conduit) through which the Conduit purchased the variable funding note at 97% of the collateral value of eligible student loans pledged or $800.0 million. Of the $800.0 million received from the FNPA, $7.2 million was used to fund a reserve account, pay attorney's fees and other costs associated with the FNPA.

On the same day, we entered into a $60.7 million Note Purchase Agreement (NPA) with lenders, which is non-recourse debt to us. The lenders funded the NPA in consideration for the surrender and release of the insurance policies and the termination of their role as liquidity provider associated with the Series 2007, 2006, 1999 and 1995 variable-rate bonds.

We used the net cash proceeds from the FNPA ($792.8 million), the cash proceeds from the NPA ($60.7 million) and the cash and investments ($46.5 million) from the above trusts to redeem $850 million of the above mentioned bonds and pay down $50.0 million on a line of credit. The $60.7 million of cash proceeds from the NPA were transferred from unrestricted net assets to net assets restricted for debt service and reported in **Note 13 – Segment Information**.

On April 7, 2008, The Education Resources Institute ("TERI") filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. TERI guaranteed $51.5 million of private loans PHEAA held as of June 30, 2009. TERI's bankruptcy filing was an event of default for a $25.0 million financing that was used to finance a portion of the TERI-guaranteed loans we hold, and that event of default was waived by the provider of the financing on May 15, 2008. On December 31, 2008, we renegotiated the terms of the financing, which was extended to December 31, 2009.

During 2008, events of default were triggered on a $500 million line of credit facility used to finance federally insured student loans (of which $303.8 million was outstanding at June 30, 2009) 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 and on September 28, 2008, the line of credit was reduced to $415 million. 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 March 5, 2009; increase the collateral coverage from 101%, to 103.5%; and increase the interest rate beginning November 1, 2008 from LIBOR plus 0.3% to LIBOR plus 0.75%; among other changes. On March 5, 2009, this line of credit was extended to March 20, 2009, and subsequently on March 18, 2009, this line of credit was extended to March 5, 2010. The lender's remedies are limited solely to the student loans and other assets in trust, securing the line of credit.

During 2008, events of default were triggered on a $175 million unsecured line of credit used for operations (of which $72.0 million was outstanding at June 30, 2009) 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 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.

During 2008, the events discussed above triggered events of default and cross defaults on a $10 million capital financing line (of which $7.5 million was outstanding at June 30, 2009). 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.

On July 28, 2009, S&P downgraded Ambac's insurance financial strength rating from BBB to CC. On July 29, 2009, Moody's downgraded Ambac's insurance financial strength rating from Ba3 to Ca2. These recent Ambac downgrades resulted in one or more breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations. Furthermore, these breaches, violations or defaults resulted in defaults under cross-default provisions with certain other financial institutions. Through October 21, 2009, we received signed waivers from certain financial institutions for the above breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations.

On October 13, 2009, we determined that the parity ratios associated with our 2001 and 2002 A series bonds dropped below levels required by the bond insurer, FSA, which resulted in one or more breaches, violations or defaults. As of November 6, 2009, we are in the process of obtaining signed waivers from certain financial institutions for the above breaches, violations or defaults related to our 2001 and 2002 A Series bonds.

Because of the above noted events of default, we were unable to issue our financial statements within 120 days of our fiscal year end. This event caused a triggering event to occur with a note purchase agreement, which in turn caused cross events of default with certain financial institutions. As of November 6, 2009, we are in the process of obtaining signed waivers from those financial institutions.

Of the $51.5 million of TERI-guaranteed private loans we held as of June 30, 2009, $17.5 million were in school and deferment, and $32.6 million were current. Delinquencies were as follows: $274 thousand 31-60 days delinquent, $225 thousand 61-90 days delinquent, $68 thousand 91-120 days delinquent, $184 thousand 121-180 days delinquent, $21 thousand 181-270 days delinquent, $673 thousand in claims filed and awaiting payment, and $19 thousand in rejected claims. We have recorded an $879 thousand provision for loan losses related to these amounts.

As of June 30, 2009, we serviced $708.3 million of loans owned by a Lehman Brothers subsidiary, Campus Door, which has ceased operations. For the year ended June 30, 2009, servicing revenues related to these loans totaled $2.4 million. As of June 30, 2009, Campus Door owed us $226 thousand for servicing revenues billed, but unpaid. As of August 3, 2009, Campus Door owed us $456 thousand for servicing revenues billed, but unpaid. We expect to continue to bill and collect servicing revenues related to this portfolio.

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

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, 2009, we have supplemented the State Grant Program by $138.4 million and provided $27.2 million through the Workforce Advancement Grant for Education Program related to this initiative.

On September 27, 2007, the President signed the College Cost Reduction and Access Act ("Act") into law. 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, 2010, 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.

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 23, 2009, the board of directors repealed the January 24, 2008 resolution that directs PHEAA not to exceed $300 thousand annually in operational support.

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 voluntarily depart from the Agency. The last day employees could elect to participate in the program was June 23, 2008. The program mentioned above resulted in staffing reductions of 264 employees.

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 Department to purchase FFELP loans originated on or after October 1, 2003; however, the Department has chosen to implement a plan which only purchases loans originated on or after July 1, 2008.

The plan provides lenders with a loan purchase commitment and access to immediate short-term liquidity for new loans originated for the 2008-09 academic year. Lenders can hold and service loans and enter into agreements to sell loans to the Department. These participation interests are priced to yield the Department the commercial paper rate plus 50 basis points. We have indicated our intent to participate, however we are not obligated to do so, and we have not done so through June 30, 2009.

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:

- Holds colleges and universities accountable by requiring greater disclosure in costs
- Protects students from aggressive marketing practices by lenders
- Simplifies the federal student aid application process
- Allows students to receive Pell Grant scholarship aid year round
- Increases college aid and support for veterans and military families

- Expands loan forgiveness program
- Amends Truth in Lending Act to prevent unfair and deceptive lending practices

On October 7, 2008, President Bush signed into law H.R. 6889, which amends H.R. 5715 above. H.R. 6889 amends the Higher Education Act of 1965 to extend by one year, from July 2009 to July 2010, the Secretary of Education's authority to purchase, or enter into forward commitments to purchase, Federal Family Education Loans (FFELs) from lenders upon the determination that there is an inadequate availability of loan capital to meet the demand for such loans. Also, H.R. 6889 extends by one year, from June 30, 2009 to June 30, 2010, the authority of institutions of higher education (IHEs), with the Secretary's approval, to participate in the FFEL lender-of-last-resort program for borrowers otherwise unable to obtain such loans; thereby requiring guaranty agencies serving as lenders-of-last-resort to make FFELs to student and parent borrowers of such IHEs, until such date, regardless of their ability to otherwise obtain such loans.

On June 17, 2009, we were selected by ED to service a portion of the nation's growing federally owned student loan portfolio. On August 26, 2009, ED informed us that we successfully completed the acceptance and validation process for the initial phase of the Title IV Servicing Management contract and we had been approved by the federal government to begin servicing Title IV FFEL Program loans for ED.

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 to 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 and the operating expenses we incur for those programs.

For the years ended June 30 (in thousands)		**2009**	2008
Self-funded			
Federal default fees paid on behalf of borrowers	$	**25,880**	36,453
Costs of operating state and federal governmental programs		**13,048**	18,803
Keystone loan program origination fees and benefits paid on behalf of borrowers		**1,750**	18,094
Funding and support of The Pennsylvania Higher Education Foundation, Inc.		**-**	1,906
Armed Forces Loan Forgiveness Program		**31**	2,729
Academic Excellence Scholarship		**(2)**	4,122
State Grant Program supplement		**-**	53,798
Workforce Advancement Grant for Education		**(772)**	10,071
Other public service activities and outreach		**4,770**	11,878
		44,705	157,854
Financial support funded by our business partners			
Keystone loan program origination fees and benefits paid on behalf of borrowers		**565**	19,100
	$	**45,270**	176,954

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, which PHEAA had paid on behalf of borrowers until December 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.

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.

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 the 1% federal default fee on behalf of the borrower. Federally required origination fees of 1.5% were paid on loans originated prior to July 1, 2008. 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 0.5% 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 the entire 1% federal default fee on behalf of the borrower. Federally required origination fees of 1.5% were paid on loans originated prior to July 1, 2008. 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 0.60% immediate interest rate reduction, 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 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 the 2007-08 academic year, we provided grants to participating postsecondary institutions to assist Pennsylvania adult students who have demonstrated financial need and are ineligible for a State Grant through the Workforce Advancement Grant for Education Program

We also developed other programs, which included:

- 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 $4,000 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 $10.3 million of grants during its most recent fiscal year ended May 31, 2009.

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

As part of our guaranty operations, we manage the Federal Student Loan Reserve Fund ("Federal Fund") for the U.S. Department of Education ("ED"). The Federal Fund is used primarily 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 or receives 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's ended June 30, 2009, interest subsidy and special allowance payment revenues were $2.3 million compared to $234.8 million in 2008 and $330.9 million in 2007. In 2009 and 2008, interest subsidy and special allowance payments decreased primarily due to the decreases in the 91-day U.S. Treasury Bill and 3-month financial commercial paper 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. Such loans amounted to $1.3 billion at September 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 engaged with ED's auditors to identify those loans that meet the new requirements to receive the 9.5% minimum rate, and we were notified by ED on January 9, 2009 that the loans identified in the audit process are acceptable to receive special allowance payment at the 9.5% minimum rate.

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.* The report questions payments of $14.1 million and duplicates a Program Review finding which was already under appeal. On August 21, 2008, ED adjusted the above questioned payments to $11.3 million. As of June 30, 2009, the finding has been resolved with an $11.3 million payment due to ED, which will be netted against $5.2 million of additional earnings on the 9.5% minimum rate loans. The net $6.1 million payment has been accrued in the accompanying financial statements and on September 4, 2009, we made the $6.1 million payment to ED to comply with the above finding.

The Federal Government charges an origination fee to help offset the costs of interest, special allowance and reinsurance payments on an FFELP loan. The required up-front origination fees are 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 to 1.0% in 2008, 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 variable-rate that resets quarterly 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 98% - 97% of borrower's outstanding loan balance 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.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans are disbursed. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. The federal default fees paid on behalf of borrowers are reported in grants and other financial aid. 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.

After a loan defaults, we continue to try to collect the amounts and we are allowed to retain up to 16% of the borrower's payments collected as revenue. The remaining amount is returned to the federal government. On October 1, 2007, the College Cost Reduction and Access Act reduced the retention of collections on defaulted loans from 23% to 16%.

As a guarantor, we have established a loan rehabilitation program for all borrowers with an enforceable promissory note for the purpose of rehabilitating defaulted loans, except for loans for which a judgment has been obtained, loans on which a default claims was filed under Sec. 682.412 (Consequences of the failure of a borrower or a student to establish eligibility), and loans on which the borrower has been convicted of, or has pled nolo contendere or guilty to, a crime involving fraud in obtaining Title IV, HEA program assistance, so that the loan may be purchased by an eligible lender and removed from default status. A loan is considered to be rehabilitated only after all of the following requirements are met: (1) the borrower has made and the guarantor has received nine of the ten payments required under a monthly repayment agreement; (2) all nine payments are received within a ten month period that begins with the month in which the first required due date falls and ends with the ninth consecutive calendar month following that month; and (3) the loan has been sold to an eligible lender. After the loan has been rehabilitated, the borrower regains all benefits of the program, including any remaining deferment eligibility. For rehabilitation payments, we retain 18.5% of the original principal balance, 100% of the collection costs (capped at 18.5% of principal and accrued interest) and 100% of accrued interest collected as revenue.

Default aversion fees are earned when servicers involve us as guarantors to avert potential defaults and the fee is paid from the Federal Fund. This fee may only be paid once for a loan and if the loan subsequently defaults, the amount paid to us must be returned to the Federal Fund. Since January 1, 2008, we have not recognized any default aversion fee revenue, as the amounts owed to us by the Federal Fund for default aversion fee activities are not expected to be paid, since we manage the cash flow of the Federal Fund to pay default claims rather than pay out the default aversion fees.

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 over a period of time.

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. These statements report our assets, liabilities and net assets at a point in time.

The statements of cash flows supplement these statements providing relevant information about cash receipts and payments over a period of time.

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

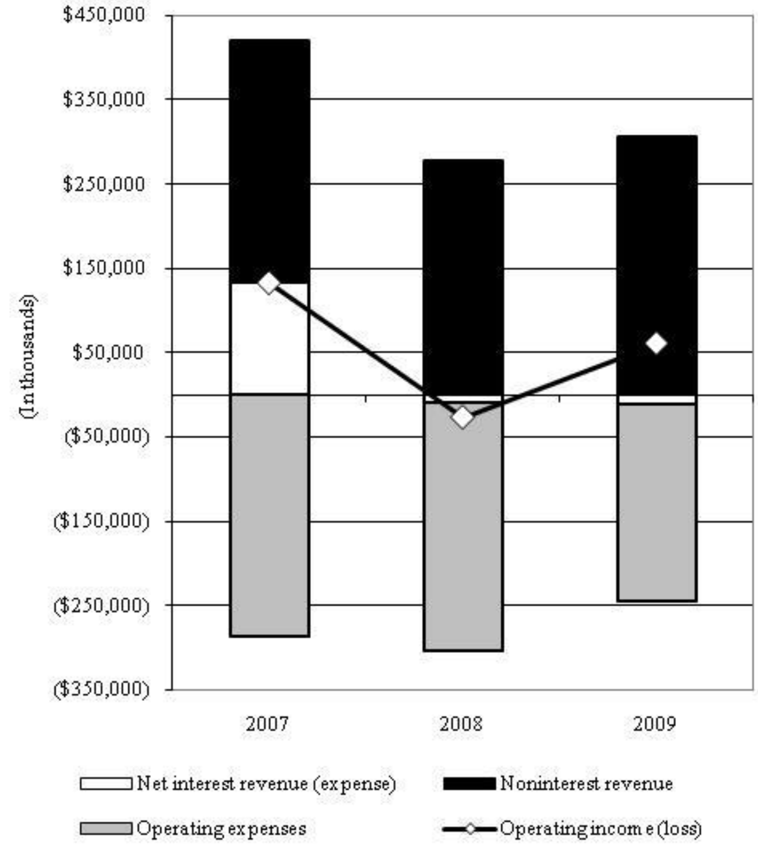
Statements of Revenues, Expenses, and Changes in Net Assets

For the years ended June 30 (in thousands)		2009	2008
Student loan interest revenue	$	344,060	615,875
Investment interest revenue		7,598	22,412
Interest expense on student loan financings and notes and bonds payable		350,113	620,933
Interest expense on capital and other financings		11,431	13,271
Net interest (expense) revenue		(9,886)	4,083
Provision for loan losses		(2,344)	(13,408)
Net interest expense after provision for loan losses		(12,230)	(9,325)
Servicing fees		164,864	131,278
Retention of collections on defaulted loans		110,521	93,490
Federal fees		45,045	52,306
Default aversion fees, net of rebates		(22,031)	15,629
Changes in fair value of residual interest, net		6,784	(16,408)
Gains on student loan sales, net		3	365
Other		358	320
Total noninterest revenue		305,544	276,980
Operating revenues		293,314	267,655
Operating expenses		232,733	294,700
Operating income (loss)		60,581	(27,045)
Commonwealth of Pennsylvania grants		473,461	452,138
Federal grants		8,113	7,982
Grants and other financial aid		(474,953)	(586,371)
Grant funds returned to the Commonwealth of Pennsylvania		(16,802)	(2,785)
Transfers from (to) Pennsylvania Higher Education Foundation		2,557	(1,906)
Changes in net assets	$	52,957	(157,987)

Statements of Net Assets

At June 30 (In thousands)		**2009**	2008
Student loans receivable, net	$	**11,169,840**	11,830,205
Cash, cash equivalents, and investments, substantially restricted		**594,808**	428,742
Interest revenue receivable		**197,302**	255,837
Capital assets, net		**59,783**	69,137
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**107,655**	139,874
Other		**149,103**	186,266
Total assets		**12,278,491**	12,910,061
Student loans financings and notes and bonds payable, net		**11,361,553**	11,962,537
Capital and other financings		**274,855**	238,407
Amounts related to the Federal Student Loan Reserve Fund		**107,655**	139,874
Other		**136,865**	224,637
Total liabilities		**11,880,928**	12,565,455
Net assets			
Invested in capital assets, net of related debt		**(16,424)**	(7,500)
Restricted for debt service		**263,489**	256,326
Restricted for financial aid grant programs		**59,819**	40,259
Unrestricted		**90,679**	55,521
Total net assets	$	**397,563**	344,606

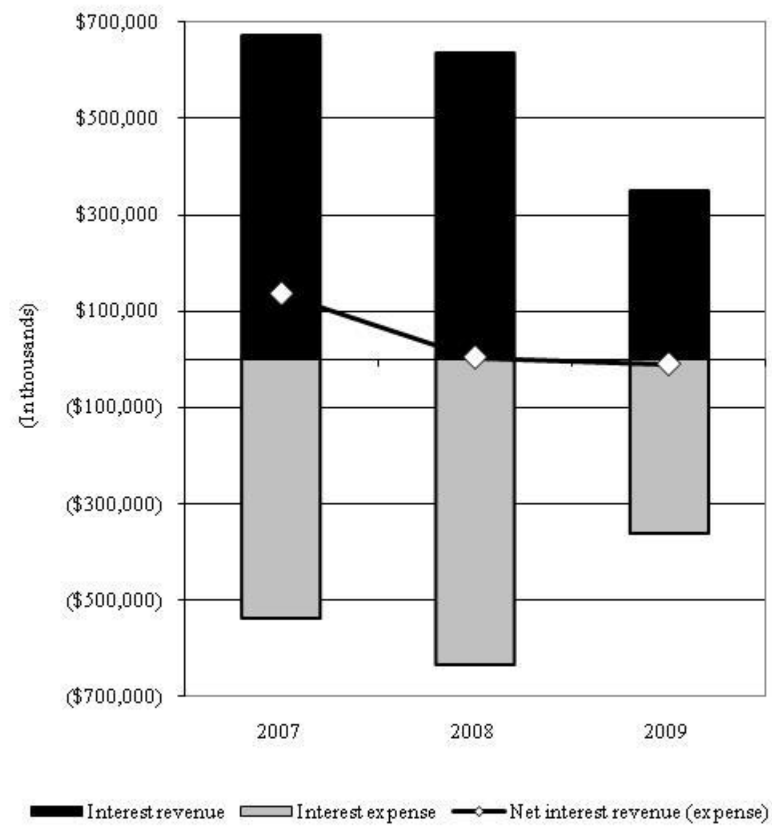
Results of Operations
Years ended June 30



Operating income for the year ended June 30, 2009 was $60.6 million, a 324.4% increase from an operating loss of $27.0 million in 2008, which was a 120.4% decrease from operating income of $132.4 million in 2007. Operating revenues were $293.3 million in 2009, a 9.6% increase from $267.7 million in 2008. In 2008, operating revenues decreased 36.1% from $419.0 million in 2007. Net interest expense after provision for loan losses was $12.2 million in 2009, a 31.2% increase from net interest expense after provision for loan losses of $9.3 million in 2008, which was principally due to stabilizing interest rates. In 2008, net interest expense after provision for loan losses decreased 107.0% from net interest revenue after provision of loan losses of $133.0 million in 2007. Noninterest revenue was $305.5 million in 2009, a 10.3% increase from $277.0 million in 2008, which is due to increases in servicing fees, retention of collections on defaulted loans and residual interest in off-balance sheet securitizations. In 2008, noninterest revenue decreased 3.1% from $286.0 million in 2007. Operating expenses were $232.7 million in 2009, a 21.0% decrease from $294.7 million in 2008, which is primarily due to decreases in personnel and benefit costs. In 2008, operating expenses increased 2.8% from $286.6 million in 2007.

A more detailed explanation of these items follows.

Net Interest Revenue (Expense)
Years ended June 30



Net interest revenue (expense) is generated from the interest rate margin in our portfolio of student loans, although we have investments and debt that are not related to student loans. For the year ended June 30, 2009, net interest expense was $9.9 million, a 341.5% decrease from net interest revenue of $4.1 million in 2008, which was a 97.0% decrease from net interest revenue of $136.0 million in 2007. The changes in net interest margin are due to adverse market conditions, as discussed in previous pages, which resulted in decreased interest rates on our student loan holdings that are based upon the 3-month financial commercial paper rate.

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		2009		2008	
(Balances in thousands)		**Balances**	**Rate**	Balances	Rate
Average interest earning assets					
Student loans receivable, net	$	**11,727,849**	**2.93 %**	11,709,259	5.26 %
Investments		**511,956**	**1.48 %**	660,063	3.40 %
	$	**12,239,805**	**2.87 %**	12,369,322	5.16 %
Average interest bearing liabilities					
Student loan financings and notes and bonds payable	$	**11,867,373**	**2.95 %**	11,957,803	5.19 %
Capital and other financings		**237,089**	**4.82 %**	220,980	6.01 %
	$	**12,104,462**	**2.99 %**	12,178,783	5.21 %
Net interest margin			**(0.12)%**		(0.05)%

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

For the years ended June 30	**2009**	2008
Student loan yields	**4.17 %**	6.58 %
Consolidation loan rebate fees	**(0.68)**	(0.70)
Lender origination fees	**(0.10)**	(0.11)
Premium amortization	**(0.46)**	(0.51)
Student loan revenue	**2.93**	5.26
Cost of funds	**2.95**	5.19
Net interest margin on student loans	**(0.02)%**	0.07 %

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
2009 vs. 2008				
Student loan interest revenue	$	(271,815)	(272,793)	978
Investment interest revenue		(14,814)	(9,785)	(5,029)
		(286,629)	(282,578)	(4,051)
Student loan financings and notes and bonds payable interest expense		(270,820)	(266,124)	(4,696)
Capital and other financings interest expense		(1,840)	(2,807)	967
		(272,660)	(268,931)	(3,729)
	$	(13,969)	(13,647)	(322)
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

While the amount that we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 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 commercial paper rate. 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, 2008 is fixed at 6.0%. Therefore, as interest rates decreased during the years ended June 30, 2009 and 2008, earnings on student loans decreased as well.

Provision for Loan Losses

Currently, when a FFELP loan defaults, the federal government reimburses the guaranty agency for 95% of its losses on default claim payments on loans first disbursed on or after October 1, 1998; 98% of its losses on default claim payments on loans first disbursed on or after October 1, 1993 and before October 1, 1998; and 100% of its losses on default claim payments to lender for loans first disbursed prior to October 1, 1993. The guaranty agency guarantees 97% of the unpaid principal balance for loans first disbursed on or after July 1, 2006, so 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 $10.7 million in the provision for loan losses for the year ended June 30, 2008.

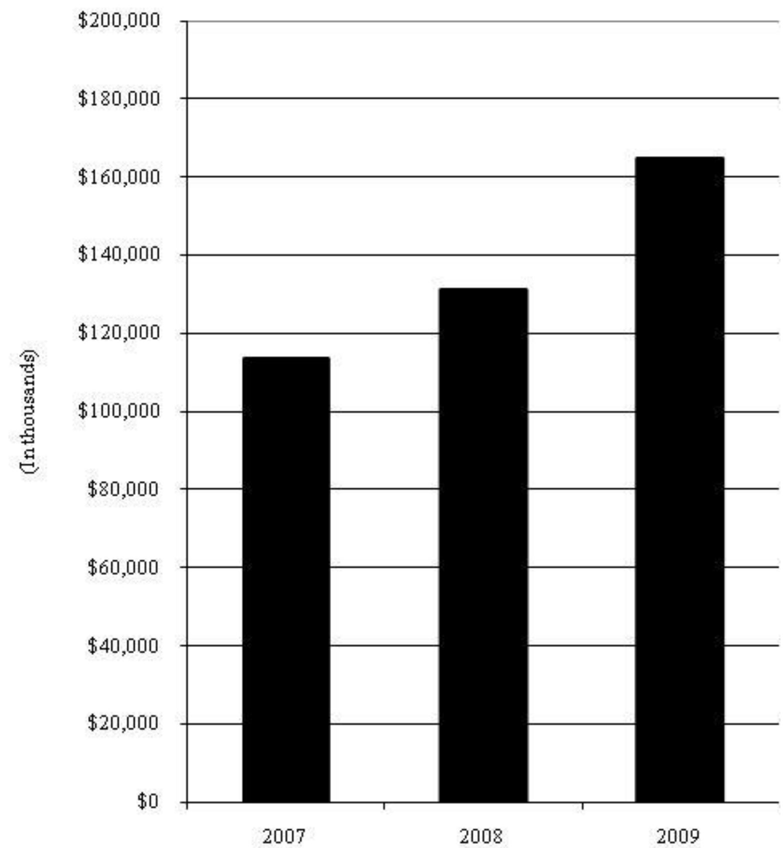
The provision for losses represents our estimate of the costs related to the risk sharing on FFELP loans we own and is a weighted average calculation based upon the above reimbursement rates. The provision for losses below is reported as "provision for loan losses" within the Statements of Revenues, Expenses and Changes in Net Assets. 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)		**2009**	2008
Balance at beginning of period	$	**11,343**	2,728
Provision for losses		**2,344**	13,408
Charge-offs		**(6,372)**	(4,793)
Balance at end of period	$	**7,315**	11,343
Allowance as a percentage of ending balance of student loans		**0.07%**	0.10%

Noninterest Revenue

Servicing Fees

Years ended June 30

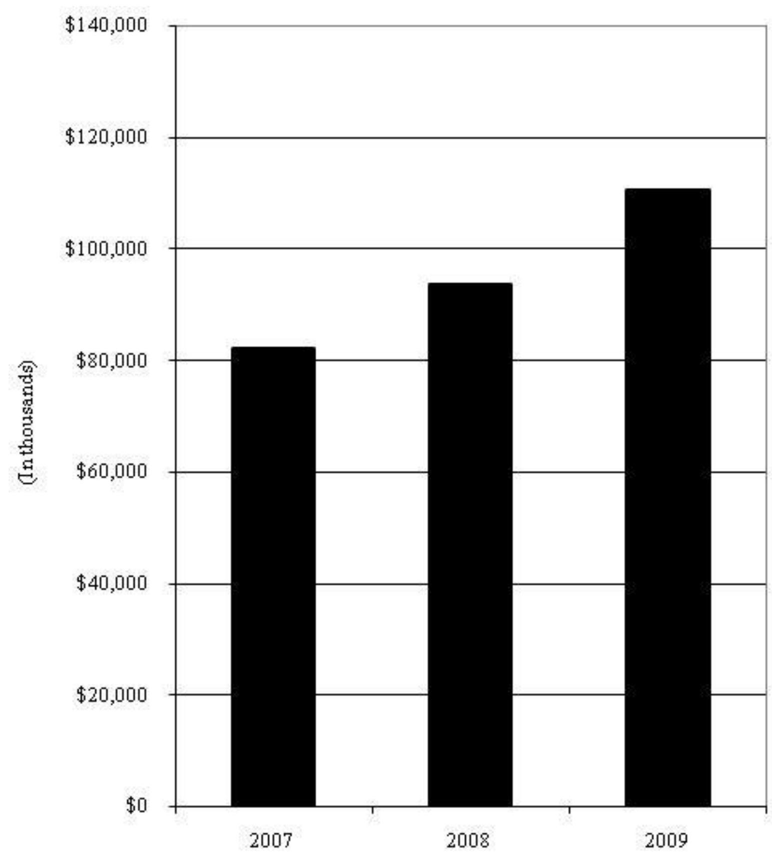


For the year ended June 30, 2009, servicing fees were $164.9 million, a 25.6% increase from $131.3 million in 2008, which was a 15.9% increase from $113.3 million in 2007. In 2009, servicing fees increased due to increased volume of loans serviced. Loans serviced by us for participating financial institutions averaged $48.5 billion in 2009, compared to $42.6 billion in 2008 and $37.3 billion in 2007.

We also provide systems for other servicers and guarantors for a fee. For the year ended June 30, 2009, fees earned from servicing systems amounted to $14.8 million, a 9.6% increase from $13.5 million in 2008, which was an 12.5% increase from $12.0 million in 2007. For the year ended June 30, 2009, loans serviced by other servicers using our systems averaged $34.1 billion, a 3.3% increase from $33.0 billion in 2008, which was a 31.0% increase from $25.2 billion in 2007.

For the year ended June 30, 2009, fees earned from guaranty systems amounted to $1.4 million, a 27.3% increase from $1.1 million in 2008, which was a decrease of 8.3% from $1.2 million in 2007. For the year ended June 30, 2009, original principal amount outstanding for guarantors using our systems averaged $4.3 billion, a 10.3% increase from $3.9 billion in 2008, which was an 8.3% increase from $3.6 billion in 2007. 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



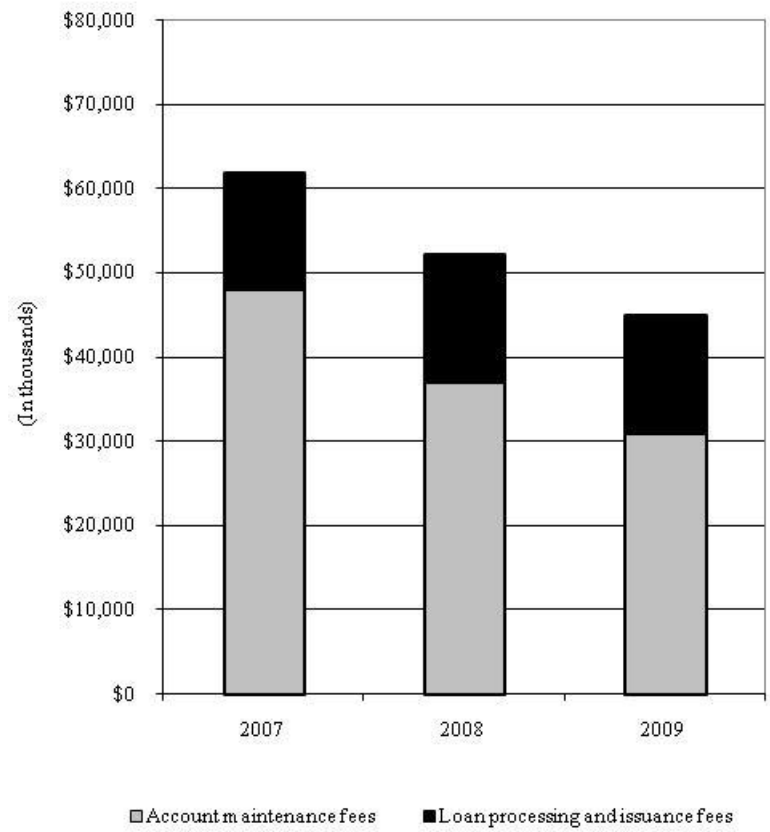
After a loan defaults, we continue to try to collect on the loan and are allowed to retain up to 16% of the borrower's payments collected as revenue. The remaining amount is returned to the federal government. On October 1, 2007, the College Cost Reduction and Access Act reduced the retention of collections on defaulted loans from 23% to 16%.

As a guarantor, we have established a loan rehabilitation program for all borrowers with an enforceable promissory note for the purpose of rehabilitating defaulted loans, so that the loan may be purchased by an eligible lender and removed from default status. A loan is considered to be rehabilitated only after all of the following requirements are met: (1) the borrower has made and the guarantor has received nine of the ten payments required under a monthly repayment agreement; (2) all nine payments are received within a ten month period that begins with the month in which the first required due date falls and ends with the ninth consecutive calendar month following that month; and (3) the loan has been sold to an eligible lender. After the loan has been rehabilitated, the borrower regains all benefits of the program, including any remaining deferment eligibility. For rehabilitation payments, we retain 18.5% of the original principal balance, 100% of the collection costs (capped at 18.5% of principal and accrued interest) and 100% of accrued interest collected as revenue.

For the year ended June 30, 2009, retention of collections on defaulted loans was $110.5 million, an 18.2% increase from $93.5 million in 2008, which was a 13.9% increase from $82.1 million in 2007. In 2009, the increase is due to more aggressive pursuit of rehabilitations. For the year ended June 30, 2009, retention on rehabilitation collections was $83.3 million, a 40.0% increase from $59.5 million in 2008, which was a 22.7% increase from $48.5 million in 2007.

Federal Fees

Years ended June 30

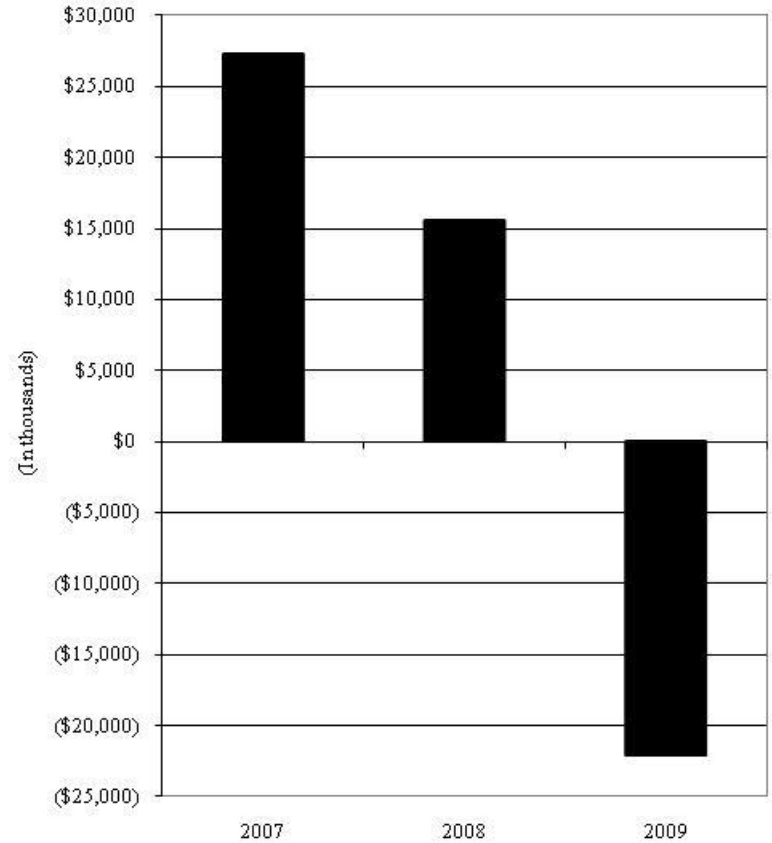


Federal fees are earned from operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee of 0.40% on loans that are disbursed in which we guarantee; however, the fee is not paid on new consolidation loans. ED also pays us an annual account maintenance fee that is 0.06% 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, 2009, federal fees were $45.0 million, a 14.0% decrease from $52.3 million in 2008, which was a 15.5% decrease from $61.9 million in 2007. In 2009, the decrease is due to the lower account maintenance fees discussed above. At June 30, 2009, the balance of loans guaranteed was $51.4 billion, compared to $51.0 billion in 2008.

Default Aversion Fees

Years ended June 30



Default aversion fees are earned when servicers involve us as guarantors to avert potential defaults and are 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. Since January 1, 2008, we have not recognized default aversion fee revenue due to the increased doubt about the collectability of the default aversion fees from the Federal Fund.

For the year ended June 30, 2009, default aversion fees were negative $22.0 million, a decrease of 241.0% from $15.6 million in 2008, which was a 42.9% decrease from $27.3 million in 2007. In 2009, the decrease is due to not recognizing revenue from the default aversion activities since January 1, 2008 and a $20.0 million valuation adjustment to align the default aversion fee receivables to net realizable value.

Change in Fair Value of 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, and other fees, as well as, 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, net on the statements of revenues, expenses, and changes in net assets.

For the year ended June 30, 2009, an increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was $6.8 million compared to decreases of $16.4 million in 2008 and $10.2 million in 2007. In 2009, the increases were due primarily to adjustments in the net present value calculation of the cash flow assumptions and a steadying blended effective interest rate.

Operating Expenses

The following table displays operating expenses in more detail.

For the years ended June 30 (in thousands)		2009	2008
Personnel and Benefits			
Compensation	$	**98,498**	122,969
Health care benefits for employees and retirees		**6,760**	34,933
Employer's share of Social Security		**7,643**	9,001
Independent contractor fees		**5,903**	8,549
Retirement contributions		**3,259**	3,841
Capitalized loan origination costs		**-**	(2,114)
Capitalized software development costs		**(2,591)**	(4,835)
Other		**(30)**	6,511
		119,442	178,855
Professional services:			
Collection agency fees		**22,633**	21,345
Legal fees		**4,990**	3,536
Default aversion outsourcing fees		**3,304**	900
Other professional fees		**2,299**	4,230
Audit fees		**1,159**	1,427
		34,385	31,438
Information technology related expenses		**21,244**	22,665
Mail services		**18,131**	19,077
Depreciation		**11,528**	13,463
Other			
Bank fees		**6,762**	6,498
Building and grounds		**4,180**	4,655
Servicing liability		**3,596**	5,343
Telephone expense		**3,579**	4,251
Printing		**1,816**	3,039
Utilities		**1,413**	1,692
Office equipment and supplies		**1,009**	1,606
Loss on disposal of assets		**653**	-
Travel and business development		**542**	1,174
Building security		**516**	779
Vehicle expense		**70**	153
Advertising expense		**37**	2,720
Donated services to the foundation		**(443)**	(1,906)
Other		**4,273**	(802)
		28,003	29,202
	$	**232,733**	294,700

For the year ended June 30, 2009, operating expenses were $232.7 million, a decrease of 21.0% from $294.7 million in 2008, which was a 2.8% increase from $286.6 million in 2007. The decrease is due primarily to a reduction in personnel and benefit costs. A more detailed discussion of certain costs follows.

Personnel and Benefits

For the year ended June 30, 2009, personnel and benefit costs were $119.4 million, a 33.3% decrease from $178.9 million in 2008, which was a 4.9% increase from $170.5 million in 2007. Included in these costs are healthcare benefits for employees and retirees. For the year ended June 30, 2009, healthcare benefits for employees and retirees were $6.8 million, an 80.5% decrease from $34.9 million in 2008, which was an 8.4% increase from $32.2 million in 2007. In 2009, the $28.1 million decrease in healthcare benefits for employees and retirees is due to a $14.3 million change in estimate related to the other post employment benefits liability. During 2009, the Commonwealth of Pennsylvania provided us additional information relating to the funded status of the Commonwealth's plan, which caused us to reverse $14.3 million of a previously accrued other post employment benefit liability and not to accrue any additional amounts during this fiscal year.

For the year ended June 30, 2009, personnel costs relating to capitalized software development and loan origination costs were $2.6 million, a 62.3% decrease from $6.9 million in 2008, which was a 9.5% increase from $6.3 million in 2007.

Permanent staff makes up 95.2% of the total personnel and benefits costs. For the year ended June 30, 2009, permanent staff costs were $116.1 million, a 34.5% decrease from $177.3 million in 2008, which was a 5.6% increase from $167.9 million in 2007. The average permanent staff positions filled was 2,102 for the year ended June 30, 2009; a 13.3% decrease from the 2,426 average permanent staff positions filled for the year ended June 30, 2008. This was a 2.8% decrease from 2,496 average permanent staff positions filled for the year ended June 30, 2007.

For the year ended June 30 2009, independent contracting costs were $5.9 million, a 30.6% decrease from $8.5 million in 2008, which was a 3.4% decrease from $8.8 million in 2007. 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%, as well as cost of living adjustments.

Professional Services - Collection Agency Fees

For the year ended June 30, 2009, collection agency fees were $22.6 million, a 6.1% increase from $21.3 million in 2008, which was a 43.9% increase from $14.8 million in 2007. The increase in 2009 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 the potential losses that are based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. The provision for losses below is reported as "servicing liability" within other operating expenses. An analysis of our allowance for servicing losses is presented in the following table:

For the years ended June 30 (in thousands)		**2009**	2008
Balance at beginning of period	$	**8,172**	5,609
Provision for losses		**3,596**	5,343
Charge-offs		**(2,653)**	(2,780)
Balance at end of period	$	**9,115**	8,172
Allowance as a percentage of ending balance of student loans		**0.02%**	0.01%

Grants and Other Financial Aid Activity

For the year ended June 30, 2009, grants and other financial aid were $475.0 million, an 18.9% decrease from $586.4 million in 2008, which was a 5.1% decrease from $618.0 million in 2007.

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

For the years ended June 30 (in thousands)		2009	2008
Self-funded			
Federal default fees paid on behalf of borrowers	$	**25,880**	36,453
Keystone loan program origination fees and benefits paid on behalf of borrowers		**1,750**	18,094
Guarantee fees that were previously waived on behalf of borrowers		**210**	(1,952)
Armed Forces Loan Forgiveness Program		**31**	2,729
Workforce Advancement Grant for Education		**(772)**	10,071
Academic Excellence Scholarship		**(2)**	4,122
State Grant Program supplement		**-**	53,798
Other		**755**	1,233
		27,852	124,548
State and federal funded			
State Grant Program		**381,420**	389,262
Institutional Assistance Grant Program		**41,492**	46,740
Matching Funds Program		**13,952**	15,365
New Economy Technology Scholarship Program		**2,956**	2,237
Other		**7,281**	8,219
		447,101	461,823
	$	**474,953**	586,371

For the year ended June 30, 2009, self-funded financial aid was $27.9 million, a 77.6% decrease from $124.5 million in 2008, which was a 22.3% decrease from $160.3 million in 2007. In 2009, the decrease in the self-funded financial aid was related to the reduction of the supplement to the State Grant Program, the elimination of the Workforce Advancement Grant for Education, and the elimination of other financial aid programs.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans are disbursed. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. 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. For the year ended June 30, 2009, we paid fees totaling $25.9 million to the Federal Fund for loans disbursed from July 1, 2008 through June 30, 2009. 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.

We are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees. We were under the required ratio noted above during the federal fiscal years ended September 30, 2005 and September 30, 2006, for which we submitted a management plan to ED on April 20, 2007.

ED approved the plan on May 22, 2007. Under the plan, 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. This decrease is reflected in the table above as "guarantee fees that were previously waived on behalf of borrowers".

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 the 1% federal default fee on behalf of the borrower. Federally required origination fees of 1.5% were paid on loans originated prior to July 1, 2008. 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 0.5% 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 the entire 1% federal default fee on behalf of the borrower. Federally required origination fees of 1.5% were paid on loans originated prior to July 1, 2008. 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 0.60% immediate interest rate reduction, 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 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 the 2007-08 academic year, we provided grants to participating postsecondary institutions to assist Pennsylvania adult students who have demonstrated financial need and are ineligible for a State Grant through the Workforce Advancement Grant for Education Program.

On October 19, 2007, 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, because of the passage of the College Cost Reduction and Access Act on September 27, 2007. On April 24, 2008, due to the decline of the capital markets, the board of directors adopted a resolution eliminating funding of the supplement to the State Grant Program and other financial aid programs.

Other changes in net assets

For the year ended June 30, 2009, Commonwealth of Pennsylvania grants were $473.5 million, a 4.7% increase from $452.1 million in 2008, which was less than a 0.1% increase from $452.0 million in 2007. For the year ended June 30, 2009, federal grants were $8.1 million, a 1.3% increase from $8.0 million in 2008, which was a 10.1% decrease from $8.9 million in 2007.

During the year ended June 30, 2009, PHEF transferred $3.0 million to us that related to loans originated and held by us, but guaranteed by PHEF. During 2009, we donated services of $443 thousand to PHEF compared to $1.9 million in 2008. In 2008, donations totaled $10.0 million of cash and $3.2 million of donated services. The board of directors had authorized an additional non-contingent $20 million of cash donations through June 30, 2009 as well as ongoing operational support. 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. On April 23, 2009, the board of directors repealed the January 24, 2008 resolution that directs PHEAA not to exceed $300 thousand annually in operational support.

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, 2009**	September 30, 2008
Generally accepted accounting principles – net assets	$	**(28,990)**	(6,790)
Deferred federal default fees		**10,147**	16,295
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund		**18,061**	20,593
Gain contingency – collections complement on future default collections		**120,363**	101,172
Regulatory net assets	$	**119,581**	131,270
Original principal outstanding	$	**51,329,067**	52,507,959
		0.23%	0.25 %

For the years ended June 30, 2009 and 2008, purchases of defaulted loans were $1.2 billion, which was a 41.8% increase from $846.2 million in 2007.

Due to the seasonal timing of default fee deposits into the Federal Fund, we expect the fund to meet the required 0.25% reserve ratio at September 30, 2009. However, if we do not meet the required 0.25% reserve ratio at September 30, 2009, we will have to submit and get approval for a management plan by ED.

Net Asset Position

As of June 30, 2009, our net asset position was $397.6 million and most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of $90.7 million at June 30, 2009. Included in unrestricted net assets is $44.5 million due from the Federal 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 $263.5 million. Of that amount, $260.8 million is related to our student loan notes, bonds and financings. Net assets restricted for financial aid grant programs amounted to $59.8 million. The deficit in net assets invested in capital assets, net of related debt of $16.4 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 debt limit is $25.5 billion as of June 30, 2009. As of June 30, 2009, our outstanding debt amounted to $11.6 billion. The following table shows our debt activity.

For the years ended June 30 (in thousands)		2009	2008
Capital market activity			
Proceeds from issuing student loan demand revenue bonds	$	**-**	400,000
Repayment of student loan demand revenue bonds		**(955,650)**	-
Repayment of student loan floating rate notes		**(88,094)**	(158,563)
Other financings			
Net student loan financing activity		**441,960**	123,100
Net capital financing activity		**(480)**	2,299
Net other financing activity		**36,850**	48,310

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

At June 30 (in thousands)		2009	2008
Land	$	**2,946**	2,946
Buildings and improvements		**39,303**	41,151
Software development		**8,851**	11,716
Purchased software		**2,254**	4,883
Other, principally information technology equipment		**6,429**	8,441
	$	**59,783**	69,137

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, 2009, we capitalized $2.6 million of software development compared to $4.8 million in 2008 and $3.4 million in 2007.

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 $234.6 million of cash, cash equivalents and investments and $99.3 million of student loans not included in the analysis.

The following gap analysis reflects rate-sensitive positions at June 30, 2009 and is not necessarily reflective of positions that existed throughout the period.

If a period gap is positive, it means 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, 2009 (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	$	10,503,362	170,221	322,049	29,101	42,225	3,609
Restricted cash and cash equivalents		360,250	-	-	-	-	-
Other assets		95,897	44,506	26,318	16,592	21,256	30,648
Total assets		10,959,509	214,727	348,367	45,693	63,481	34,257
Liabilities							
Student loan financings and notes and bonds payable		11,079,334	282,219	-	-	-	-
Other liabilities		39,823	3,178	-	263	369	-
Total liabilities		11,119,157	285,397	-	263	369	-
Net assets							
Restricted for debt service	$	-	-	-	-	-	260,848
Period gap	$	(159,648)	(70,670)	348,367	45,430	63,112	(226,591)
Cumulative gap	$	(159,648)	(230,318)	118,049	163,479	226,591	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		98.6 %	75.2 %	- %	17373.8%	17203.5%	13.1%
Ratio of cumulative gap to total assets		(1.4)%	(2.0)%	1.0 %	1.4 %	1.9 %	- %

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.

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November 6, 2009

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, 2009 and 2008, 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 net assets of PHEAA as of June 30, 2009 and 2008, and the changes in its 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 37 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

November 6, 2009

(In thousands)

		2009	2008
Interest revenue			
Student loans	$	**344,060**	615,875
Investments		**7,598**	22,412
Total interest revenue		**351,658**	638,287
Interest expense			
Student loan financings and notes and bonds payable		**350,113**	620,933
Capital and other financings		**11,431**	13,271
Total interest expense		**361,544**	634,204
Net interest (expense) revenue		**(9,886)**	4,083
Provision for loan losses		**(2,344)**	(13,408)
Net interest expense after provision for loan losses		**(12,230)**	(9,325)
Noninterest revenue			
Servicing fees		**164,864**	131,278
Retention of collections on defaulted loans		**110,521**	93,490
Federal fees		**45,045**	52,306
Default aversion fees, net of rebates		**(22,031)**	15,629
Changes in fair value of residual interest, net		**6,784**	(16,408)
Gains on student loan sales, net		**3**	365
Other		**358**	320
Total noninterest revenue		**305,544**	276,980
Operating revenues		**293,314**	267,655
Operating expenses			
Personnel		**119,442**	178,855
Professional services		**34,385**	31,438
Information technology related expenses		**21,244**	22,665
Mail services		**18,131**	19,077
Depreciation		**11,528**	13,463
Other		**28,003**	29,202
Total operating expenses		**232,733**	294,700
Operating income (loss)		**60,581**	(27,045)
Commonwealth of Pennsylvania grants		**473,461**	452,138
Federal grants		**8,113**	7,982
Grants and other financial aid		**(474,953)**	(586,371)
Grant funds returned to the Commonwealth of Pennsylvania		**(16,802)**	(2,785)
Transfers from (to) Pennsylvania Higher Education Foundation		**2,557**	(1,906)
Changes in net assets		**52,957**	(157,987)
Net assets, beginning of period		**344,606**	502,593
Net assets, end of period	$	**397,563**	344,606

See accompanying notes to financial statements.

(In thousands)

		2009	2008
Assets			
Cash and cash equivalents	$	**29,514**	13,388
Restricted cash and cash equivalents		**367,096**	298,526
Restricted cash and cash equivalents – due to customers		**47,185**	46,334
Investments		**26,971**	-
Restricted investments		**124,042**	70,494
Residual interest in off-balance sheet securitizations		**23,200**	16,415
Student loans receivable, net		**11,169,840**	11,830,205
Interest income receivable		**197,302**	255,837
Due from Federal Student Loan Reserve Fund, net		**44,504**	86,272
Capital assets, net		**59,783**	69,137
Deferred financing costs, net		**42,047**	48,295
Other assets		**39,352**	35,284
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**107,655**	139,874
Total assets		**12,278,491**	12,910,061
Liabilities			
Due to customers		**47,185**	46,334
Accounts payable and accrued expenses		**89,680**	178,303
Student loans financings and notes and bonds payable, net		**11,361,553**	11,962,537
Capital and other financings		**274,855**	238,407
Amounts related to the Federal Student Loan Reserve Fund		**107,655**	139,874
Total liabilities		**11,880,928**	12,565,455
Net assets			
Invested in capital assets, net of related debt		**(16,424)**	(7,500)
Restricted for debt service		**263,489**	256,326
Restricted for financial aid grant programs		**59,819**	40,259
Unrestricted		**90,679**	55,521
Total net assets	$	**397,563**	344,606

See accompanying notes to financial statements.

(In thousands)

		2009	2008
Cash flows from operating activities			
Interest received on student loans	$	285,871	546,494
Principal received on student loans		1,135,324	1,135,709
Student loan originations		(2,927)	(760,536)
Student loan purchases		(349,248)	(760,546)
Student loan sales, including net gains		(9,213)	100,890
Servicing fees		158,923	127,974
Retention of collections on defaulted loans		121,826	95,969
Federal fees		46,419	58,643
Default aversion fees, net of rebate		8,986	8,612
Other		358	320
Payment of operating expenses		(261,477)	(292,814)
Net cash provided by operating activities		1,134,842	260,715
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		860,640	1,110,135
Principal paid on noncapital debt		(1,425,574)	(697,288)
Interest paid on student loan financings and notes and bonds payable		(391,004)	(595,909)
Issuance costs		(861)	(2,411)
Commonwealth of Pennsylvania grants received		473,461	452,138
Federal grants received		8,113	7,982
Grants and financial aid paid		(474,743)	(588,323)
Grant funds returned to the Commonwealth of Pennsylvania		(16,802)	(2,785)
Transfers from Pennsylvania Higher Education Foundation		3,000	-
Cash overdraft		-	(35,640)
Net cash used for noncapital financing activities		(963,770)	(352,101)
Cash flows from capital and related financing activities			
Proceeds from issuance of capital debt		4,650	5,187
Principal paid on capital debt		(5,130)	(2,888)
Interest paid on capital and other financings		(11,220)	(12,823)
Purchases of capital assets and development of software, net of disposals		(2,174)	(8,916)
Net cash used for capital and related financing activities		(13,874)	(19,440)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		531,494	269,377
Purchases of investments		(612,013)	(235,625)
Interest received on investments		8,017	23,377
Net cash (used for) provided by investing activities		(72,502)	57,129
Net change in cash and cash equivalents (including restricted cash)		84,696	(53,697)
Cash and cash equivalents (including restricted cash), beginning of period		311,914	365,611
Cash and cash equivalents (including restricted cash), end of period	$	396,610	311,914

(continued)

(In thousands)

		2009	2008
Reconciliation of operating income to net cash provided by operating activities			
Operating income (loss)	$	**60,581**	(27,045)
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation		**11,528**	13,463
Student loan financings and notes and bonds payable interest		**391,004**	595,909
Capital and other financings interest		**11,220**	12,823
Investment interest		**(8,017)**	(23,377)
Amortization of premium on loan purchases		**54,235**	59,729
Amortization of loan origination costs		**11,761**	12,427
Amortization of deferred financing costs		**7,109**	2,702
Amortization of deferred amount on refundings of student loan demand revenue bonds		**799**	799
Accretion discount on capital and other financings		**79**	75
Operational support provided to Pennsylvania Higher Education Foundation		**(443)**	(1,906)
Changes in assets and liabilities:			
Decrease in interest income receivable		**58,535**	8,021
(Increase) decrease in residual interest in off-balance securitizations		**(6,785)**	16,408
Decrease (increase) in student loans receivable		**594,369**	(420,270)
Decrease in amounts due from Federal Student Loan Reserve Fund		**41,558**	434
(Increase) decrease in other assets		**(4,068)**	4,073
(Decrease) increase in accounts payable and accrued expenses		**(88,623)**	6,450
Total adjustments		**1,074,261**	287,760
Net cash provided by operating activities	$	**1,134,842**	260,715

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.

On May 22, 2009, PHEAA SLC was formed as an LLC in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFELP; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On June 1, 2009, we issued a notice of intent to participate in the Asset Backed Commercial Paper (ABCP) Conduit Program with ED. In order to participate in the ABCP Conduit Program, we created an individual bankruptcy remote special purpose vehicle (PHEAA SLC). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC, so PHEAA SLC is considered a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

Discretely Presented Component Unit

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. PHEF is a discretely presented component unit, because our Executive Committee appoints a majority of the foundation's board of directors, we can impose our will on the foundation, but it does not provide services entirely to us. As a discretely presented component unit, its transactions are not consolidated in our financial statements, but they are presented in the notes of the annual financial report.

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

For the years ended May 31 (in thousands)		**2009**	2008
Contributions	$	**512**	12,844
Loss (income) on investments		**(1,186)**	656
Loss from write off of contributions receivable		**(1,500)**	-
Expenses, including grants of $17.6 million in 2009 and $15.6 million in 2008		**(19,953)**	(19,047)
Decrease in net assets		**(22,127)**	(5,547)
Net assets at beginning of year		**40,411**	45,958
Net assets at end of year	$	**18,284**	40,411

At May 31 (in thousands)		**2009**	2008
Investments	$	**21,659**	38,260
Office furnishings and equipment, net of accumulated depreciation		**46**	53
Amounts payable to specific organizations as designated by donors		**(92)**	(92)
Other assets, net of liabilities		**(3,329)**	2,190
Net assets	$	**18,284**	40,411

Related Organization

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. 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 years ended June 30, 2009 and 2008, we had net losses before transfers in our student loan financing segment. During the year ended June 30, 2009, we had a net loss before transfers of $60.1 million compared to a net loss before transfers of $87.1 million in 2008. The auction-rate debt securities and variable-rate demand bonds that finance the activities of our revenue bond segment are limited obligations payable only from the student loans and other assets pledged and held in trust. While the financings are non-recourse to our unrestricted net assets 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. During the year ended June 30, 2009, we transferred $67.9 million of funds, of which $60.7 million was related to a note purchase agreement for the ABCP Conduit Put Program, from unrestricted operations to the trusts as compared to transferring $2.8 million of excess funds from the trusts to unrestricted operations during the year ended June 30, 2008. See **Note 13 – Segment Information** for more details.

Because of an inability to access the credit or financing markets needed to fund student loans, effective March 7, 2008, we suspended our activities as a lender for any new loans first disbursed on or after that date. As of June 30, 2009, we have student loan purchase commitments of $573.3 million that we have been unable to fund or settle, and an additional $278.5 million of student loan purchase commitments through June 30, 2010 and thereafter. Subsequent to June 30, 2009, we are in the process of settling $360.5 million of student loan purchase commitments that will result in $3.3 million of additional liabilities. The $3.3 million of additional liabilities are not included in these financial results. 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 us 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.

On June 17, 2009, we entered into the Asset-Backed Commercial Paper (ABCP) Conduit Put Program with ED and as a result we transferred $825.0 million of eligible student loans to PHEAA Student Loan Company (SLC) (100% equity owned by PHEAA Student Loan Foundation, a blended component unit of PHEAA). PHEAA SLC entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A Funding, LLC (Conduit), who purchased the variable funding note at 97% of the collateral value of eligible student loans pledged or $800.0 million. Of the $800.0 million received from the FNPA, $7.2 million was used to fund a reserve account, pay attorney's fees and other costs associated with the FNPA.

On the same day, we entered into a $60.7 million Note Purchase Agreement (NPA) with lenders, which is non-recourse debt to us. The lenders funded the NPA in consideration for the surrender and release of the insurance policies and the termination of their role as liquidity provider associated with the Series 2007A, 2006A, 1999A and 1995A variable-rate bonds.

We used the net cash proceeds from the FNPA ($792.8 million), the cash proceeds from the NPA ($60.7 million) and the cash and investments ($46.5 million) from the above trusts to redeem $850.0 million of the above mentioned bonds and pay down $50.0 million of a line of credit.

On April 7, 2008, The Education Resources Institute ("TERI") filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. TERI guaranteed $51.5 million of private loans PHEAA held as of June 30, 2009. TERI's bankruptcy filing was an event of default for a $25.0 million financing that was used to finance a portion of the TERI-guaranteed loans we hold, and that event of default was waived by the provider of the financing on May 15, 2008. On December 31, 2008, we renegotiated the terms of the financing, which was extended to December 31, 2009.

During 2008, events of default were triggered on a $500 million line of credit facility used to finance federally insured student loans (of which $303.8 million was outstanding at June 30, 2009) 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 and on September 28, 2008, the line of credit was reduced to $415 million. 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 March 5, 2009; increase the collateral coverage from 101%, to 103.5%; and increase the interest rate beginning November 1, 2008 from LIBOR plus 0.3% to LIBOR plus 0.75%; among other changes. On March 5, 2009, this line of credit was extended to March 20, 2009, and subsequently on March 18, 2009, this line of credit was extended to March 5, 2010. The lender's remedies are limited solely to the student loans and other assets in trust, securing the line of credit.

During 2008, events of default were triggered on a $175 million unsecured line of credit used for operations (of which $72.0 million was outstanding at June 30, 2009) 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 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.

During 2008, the events discussed above triggered events of default and cross defaults on a $10 million capital financing line (of which $7.5 million was outstanding at June 30, 2009). 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.

On July 28, 2009, S&P downgraded Ambac’s insurance financial strength rating from BBB to CC. On July 29, 2009, Moody’s downgraded Ambac’s insurance financial strength rating from Ba3 to Ca2. These recent Ambac downgrades resulted in one or more breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations. Furthermore, these breaches, violations or defaults resulted in defaults under cross-default provisions with certain other financial institutions. Through October 21, 2009, we received signed waivers from certain financial institutions for the above breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations.

On October 13, 2009, we determined that the parity ratios associated with our 2001 and 2002 A series bonds dropped below levels required by the bond insurer, FSA, which resulted in one or more breaches, violations or defaults. As of November 6, 2009, we are in the process of obtaining signed waivers from certain financial institutions for the above breaches, violations or defaults related to our 2001 and 2002 A Series bonds.

Because of the above noted events of default, we were unable to issue our financial statements within 120 days of our fiscal year end. This event caused a triggering event to occur with a note purchase agreement, which in turn caused cross events of default with certain financial institutions. As of November 6, 2009, we are in the process of obtaining signed waivers from those financial institutions.

We have successfully renegotiated other student loan financings, including a $234.4 million student loan financing, which the maturity date was extended from December 31, 2008 to July 31, 2009. On July 31, 2009, we extended the $234.4 million of student loan financing to July 31, 2010.

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 $27.9 million during the year ended June 30, 2009 and $124.5 million during the year ended June 30, 2008. Operating expenses were $232.7 million during the year ended June 30, 2009 and $294.7 million during the year ended June 30, 2008.

Subsequent to June 30, 2009, we have successfully renegotiated other student loan financings as follows.

On August 7, 2009, we extended through August 6, 2010 a $135.0 million student loan financing that was due August 7, 2009. At June 30, 2009, $140 million was outstanding on the note.

On August 28, 2009, we extended through August 25, 2010 a $24.9 million student loan financing that was due on August 28, 2009. At June 30, 2009, $26.5 million was outstanding on the note.

Note 3 – Summary of Significant Accounting Policies

Basis of Presentation and Accounting

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended by Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*, our financial statements have been prepared on the basis of the governmental enterprise fund concept, which pertains to financial activities that operate similarly to a private business enterprise. We 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.

Use of Estimates

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that influence the reported assets, liabilities, revenues, and expenses during the reporting periods. Actual results could differ significantly from those estimates.

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 they 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. These amounts are reported as cash equivalents, because we may deposit and withdraw cash at any time without prior notice or penalty.

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.

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, and other instruments including securities. These amounts are reported at fair value based upon information provided by the Commonwealth of Pennsylvania's 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.

Student Loans Receivable, net

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

In the past, we paid all of the up-front federal fees that could be charged to borrowers for loans originated by us. However, 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. The cost of providing these benefits is reported with grants and other financial aid in the Statements of Revenues, Expenses and Changes in Net Assets.

Allowances for potential losses on our student loans can result from deficient servicing, risk sharing on defaults and 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. We do not write-off uncollectible loans that are not guaranteed or insured as we continue to pursue collection on those loans.

Student loan income is recognized as earned including adjustments for the amortization of costs of loan originations and purchases. The U.S. Secretary of Education provides a special allowance to student loan owners participating in the FFELP. The special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of the 3-month financial commercial paper rate, to the average daily unpaid principal balance and capitalized interest of student loans held by us. The special allowance is accrued as earned or payable. For loans first disbursed prior to January 1, 2000, the 91-day Treasury bill rate is used rather than the 3-month financial commercial paper rate.

Interest on student loans is accrued based upon the actual principal amount outstanding. The U.S. Secretary of Education makes quarterly interest payments on subsidized loans until the student is required, under the provisions of the Higher Education Act, to begin repayment. Repayment must begin generally within six months after the student completes his or her course of study, leaves school, or ceases to carry at least one-half the normal full time academic load as determined by the participating institution.

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 other operating expenses.

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.

Purchased computer software is capitalized if the per unit costs, based on per license fee, is $10,000 or more. Improvements or additions to existing software that constitute a capital outlay or increase the value or life of the asset by 25 percent of the original cost or life is capitalized as a betterment and recorded as an addition of value to the existing asset. Depreciation is calculated on the straight-line method over the estimated useful life of the purchased software.

Software development involves three phases: preliminary project phase, application development phase and post-implementation/operation phase. The cost associated with the preliminary project and the post-implementation/operating phase is expensed as incurred. Internal and external costs associated with the application development phase are capitalized. The capitalization of costs begins when the preliminary project phase is complete and management has implicitly authorized or commits to funding the software project with the intent it will be completed and used to perform its planned functions. Capitalization will cease no later than the time at which substantial testing is complete and the software is ready for its intended purpose or rendered into service. Upgrades and enhancements are modifications to existing internal-use software that result in additional functionality, that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may require a change to all or part of the existing software specifications. Upgrades and enhancements, as defined above, are capitalized. 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 (purchased and 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.

Revenue Recognition

Servicing fees are recognized as the contractual services are provided and unbilled amounts are recorded as accounts receivable. For federal, loan processing and issuance fees related to our guaranty function, revenue is 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 collectability 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.

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.

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 $37 thousand in 2009 and $2.9 million in 2008. Included in these expenses are advertising expenses paid on behalf of PHEF totaling zero in 2009 and $182 thousand in 2008. The amounts in 2008 are reported as contributions to PHEF.

Residual Interest in Off-Balance Sheet Securitizations

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, since the securitization does not meet the financial reporting requirements of GASB Statement No. 14 – *The Financial Reporting Entity*. See **Note 15** for more details on Student Loan Securitizations. For transactions qualifying as sales according to GASB Statement No. 48 – *Sales and Pledges of Receivables and Future Revenues and intra-Entity Transfers of Assets and Future Revenues*, we retain a residual interest, which is recognized in 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, and other fees, as well as, 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, net on the statements of revenues, expenses, and changes in net assets.

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.

Correction of Immaterial Errors

During 2009, we identified certain prior period errors related to the reporting of activities in the Statements of Cash Flows in accordance with GASB 9 – *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. We corrected the prior period errors in the Statement of Cash Flows for the year ended June 30, 2008 as follows:

		As previously reported	Impact of Errors	As Adjusted
Cash flows from operating activities:				
Student loan purchases	$	(769,775)	9,229	(760,546)
Student loan sales, including net gains		110,119	(9,229)	100,890
Interest received on investments		23,377	(23,377)	-
Interest paid on student loan financings and notes and bonds payable		(595,909)	595,909	-
Interest paid on capital and other financings		(12,823)	12,823	-
Net cash (used for) provided by operating activities		(324,640)	585,355	260,715
Cash flows from noncapital financing activities:				
Interest paid on student loan financings and notes and bonds payable		-	(595,909)	(595,909)
Net cash provided by(used for) noncapital financing activities		243,808	(595,909)	(352,101)
Cash flows from capital and related financing activities:				
Interest paid on capital and other financings		-	(12,823)	(12,823)
Net cash used for capital and related financing activities		(6,617)	(12,823)	(19,440)
Cash flows from investing activities:				
Interest received on investments		-	23,377	23,377
Net cash provided by investing activities	$	33,752	23,377	57,129

We assessed the materiality of the above errors in the 2008 audited financial statements and determined that those errors are immaterial to the previously reported amounts.

Note 4 – New Accounting Pronouncements

In June 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* has created questions as to whether and when intangible assets should be considered capital assets for financial reporting purposes. An absence of sufficiently specific authoritative guidance that addresses these questions has resulted in inconsistencies in the accounting and financial reporting of intangible assets among state and local governments, particularly in the areas of recognition, initial measurement, and amortization. The objective of GASB Statement No. 51 is to establish accounting and financial reporting requirements for intangible assets to reduce these inconsistencies, thereby enhancing the comparability of the accounting and financial reporting of such assets among state and local governments. As of June 30, 2009, we have not completed our analysis of this statement, which must be adopted for the year ending June 30, 2010.

In 2009, the GASB issued Statement No. 55 - *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The objective of this Statement is to incorporate the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the Governmental Accounting Standards Board's (GASB) authoritative literature. The “GAAP hierarchy” consists of the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. The GASB is responsible for establishing GAAP for state and local governments. However, the current GAAP hierarchy is set forth in the American Institute of Certified Public Accountants' (AICPA) Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, rather than in the authoritative literature of the GASB.

In 2009, the GASB issued Statement No. 56 – *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*. The objective of this Statement is to incorporate into the Governmental Accounting Standards Board's (GASB) authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements on Auditing Standards. This Statement addresses three issues not included in the authoritative literature that establishes accounting principles—related party transactions, going concern considerations, and subsequent events. The presentation of principles used in the preparation of financial statements is more appropriately included in accounting and financial reporting standards rather than in the auditing literature.

Note 5 – 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 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. Since 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)		**2009**	2008
Additions			
Reinsurance from the U.S. Department of Education	$	**1,182,631**	1,179,005
Collections on defaulted loans		**468,508**	364,628
Federal default fees		**34,342**	34,907
Net appreciation in fair value of investments		**137**	1,017
Total additions		**1,685,618**	1,579,557
Deductions			
Purchases of defaulted loans from lenders		**1,231,032**	1,227,960
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**338,734**	261,971
Reimbursement to PHEAA for our retention of defaulted loans collections		**117,087**	93,490
Default aversion fees, net		**23,263**	28,454
Total deductions		**1,710,116**	1,611,875
Net decrease		**(24,498)**	(32,318)
Net (liabilities) assets , beginning of period		**(4,492)**	27,826
Net (liabilities) assets , end of period	$	**(28,990)**	(4,492)

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

At June 30 (in thousands)		2009	2008
Assets			
Cash	$	**31,695**	11,246
Receivable from the U.S. Department of Education		**64,242**	25,060
Other receivables		**11,718**	8,420
Interest income receivable		**-**	250
Investments		**-**	94,898
Total assets		**107,655**	139,874
Liabilities			
Accounts payable and accrued expenses		**15**	26,274
Payable to U.S. Department of Education		**-**	956
Deferred federal default fees		**10,147**	7,162
Amounts payable to PHEAA		**126,483**	109,974
Total liabilities		**136,645**	144,366
Net assets	$	**(28,990)**	(4,492)

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.

During the years ended June 30, 2009 and 2008, we have managed the cash flow of the fund in a manner to assure our customers that sufficient funds are available in the Federal Fund to continue to pay default claims by not transferring default aversion fees that are due to us. 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, 2009 and 2008, we allowed this liability to us to increase.

Note 6 – Cash and Investments

The following table shows the carrying value of cash and cash equivalents and restricted cash and cash equivalents, and the cash on deposit at June 30, 2009 and 2008.

At June 30 (in thousands)		**2009**	2008
Cash and cash equivalents	$	**29,514**	13,388
Restricted cash and cash equivalents		**367,096**	298,526
Restricted cash and cash equivalents – due to customers		**47,185**	46,334
Carrying value	$	**443,795**	358,248
Cash on deposit, bank balance	$	**15,841**	14,533
Cash equivalents		**457,627**	357,059
Cash on deposit, bank balance (including cash equivalents)	$	**473,468**	371,592

The following table shows our investments and maturities at June 30, 2009.

			Investment Maturities (in years)		
(In thousands)		Fair Value	Less than 1	1 to 10	More than 10
Cash equivalents					
Money market funds	$	245,681	245,681	-	-
Guaranteed investment contracts and agreements		156,313	156,313	-	-
Commercial paper		55,633	55,633	-	-
	$	457,627	457,627	-	-
Investments					
State Treasury investment pool		87,544	87,544	-	-
Guaranteed investment contracts and agreements		63,469	-	63,469	-
	$	151,013	87,544	63,469	-
	$	608,640	545,171	63,469	-

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.

We manage our portfolio in such a manner that assures that funds are available as needed to meet the immediate and/or future operating requirements. This is accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands. At maturity or liquidation, such monies shall be reinvested according to our investment guidelines and the "prudent person" rule described above.

Deposits and investments have certain risks that have the potential to result in losses, and those risks 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, 2009, all of our investments in commercial paper were rated A-1 and higher. At June 30, 2009, $122.8 million of our investments in guaranteed investment contracts and agreements were rated Aa2, $33.5 million were rated Aaa and $63.5 million were rated at BB. At June 30, 2009, $52.8 million of our investments in money market funds were rated AAAm. At June 30, 2009, $192.9 million of our money market funds and $87.5 million invested in 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, 2009, $15.7 million of our deposits with financial institutions in excess of the 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 are held by the participating financial institution's trust department and are 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, 2009, 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	$	55,633

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, 2009.

(In thousands)	Issuer		Fair Value
Money market fund	Federated Treasury Obligation	$	186,599
Money market fund	PFM Prime Money Market		48,116
Guaranteed investment agreement	Trinity Plus Funding Co.		122,846
Guaranteed investment contracts	MBIA, Inc		63,469

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

(In thousands)		Fair Value	Investment Maturities (in years) Less than 1	1 to 10	More than 10
Cash equivalents					
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	-	-
Investments					
Guaranteed investment contracts and agreements		70,494	-	65,441	5,053
	$	427,553	357,059	65,441	5,053

At June 30, 2009, we had $87.5 million invested in the State Treasury investment pool with a maturity of less than 1 year as compared to negative $3.5 million at June 30, 2008, which we reclassified to accounts payable. At June 30, 2009, the Federal Fund had zero invested in the State Treasury investment pool with a maturity of less than 1 year as compared to $94.9 million at June 30, 2008.

Note 7 – Student Loans Receivable

The following table shows our student loan holdings.

At June 30 (in thousands)		**2009**	2008
FFELP:			
Consolidation	$	**7,315,493**	7,684,432
Stafford		**3,053,956**	3,261,366
PLUS		**425,898**	421,498
Supplemental Loans for Students		**1,378**	2,551
		10,796,725	11,369,847
HEAL		**161,415**	188,549
Privately insured loans		**51,509**	53,594
Uninsured loans		**6,094**	6,504
Unamortized premium on loan purchases		**134,905**	183,853
Unamortized loan origination costs		**33,037**	44,797
		11,183,685	11,847,144
Allowance for loan losses		**(13,845)**	(16,939)
	$	**11,169,840**	11,830,205

Under FFELP, 97% of the unpaid principal balance for loans first disbursed on or after July 1, 2006 are guaranteed; 98% of the unpaid principal balance for loans first disbursed on or after October 1, 1993 and before July 1, 2006 are guaranteed; and 100% of the unpaid principal balance for loans first disbursed before October 1, 1993 are 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.

In the past, 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 were 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% for loans first disbursed on or after July 1, 2006. The losses associated with the risk sharing on FFELP loans are reported as “provision for loan losses” on the Statements of Revenues, Expenses and Changes in Net Assets.

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

We believe the provision for losses below is adequate to cover the inherent losses in the student loan portfolio for the risk sharing on FFELP loans and the servicing of loans. 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)		**2009**	2008
Balance at beginning of period	$	**16,939**	5,656
Provision for losses		**3,560**	16,776
Charge-offs		**(6,654)**	(5,493)
Balance at end of period	$	**13,845**	16,939

As of June 30, 2009, we have student loan purchase commitments of $573.3 million that we have been unable to fund or settle, and an additional $278.5 million of student loan purchase commitments through June 30, 2010 and thereafter. Subsequent to June 30, 2009, we are in the process of settling $360.5 million of student loan purchase commitments that will result in $3.3 million of additional liabilities. The $3.3 million of additional liabilities are not included in these financial results.

Note 8 – Capital Assets

Capital asset activity for the year ended June 30, 2009 was as follows:

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings and improvements		73,204	-	-	73,204
Software development		33,814	2,591	(7,447)	28,958
Purchased software		21,422	-	(886)	20,536
Other, principally information technology equipment		32,859	236	(271)	32,824
		164,245	2,827	(8,604)	158,468
Less accumulated depreciation for:					
Buildings and improvements		(32,053)	(1,848)	-	(33,901)
Software development		(22,098)	(5,456)	7,447	(20,107)
Purchased software		(16,539)	(1,976)	233	(18,282)
Other, principally information technology equipment		(24,418)	(2,248)	271	(26,395)
		(95,108)	(11,528)	7,951	(98,685)
	$	69,137	(8,701)	(653)	59,783

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)	(2,734)	454	(24,418)
		(84,639)	(13,463)	2,994	(95,108)
	$	73,684	(4,337)	(210)	69,137

Depreciation expense for the years ended June 30, 2009 and 2008 was $11.5 million and $13.5 million, respectively.

Note 9 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings for the year ended June 30, 2009, adjusted for items negotiated after June 30, 2009, are as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings, demand revenue bonds and auction rate notes:					
Student loan variable rate funding note, due 2014 at an estimated weighted-average rate of 0.74% at June 30, 2009.	$ -	799,960	-	799,960	-
Student loan financings, due on demand at weighted-average rates of 1.08% at June 30, 2009 and 2.96% at June 30, 2008.	1,084,019	-	(358,000)	726,019	726,019
Student loan floating rate notes, due 2016-2042 at weighted-average rates of 1.22% at June 30, 2009 and 2.93% at June 30, 2008.	1,388,543	-	(88,094)	1,300,449	-
Student loan demand revenue bonds and auction rate notes, due 2016-2047, at weighted-average rates of 2.93% at June 30, 2009 and 5.33% at June 30, 2008.	9,499,900	-	(955,650)	8,544,250	-
Deferred amount on current refunding of student loan demand revenue bonds.	(9,925)	-	800	(9,125)	-
	11,962,537	799,960	(1,400,944)	11,361,553	726,019
Capital financings:					
Capital financings, due 2009-2016, at weighted-average rates of 5.29% at June 30, 2009 and 5.88% at June 30, 2008.	76,766	4,650	(5,130)	76,286	10,382
Unamortized discount on capital acquisition bonds.	(129)	-	51	(78)	-
	$ 76,637	4,650	(5,079)	76,208	10,382

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Other financings:						
Term financings, due 2009 - 2030, at weighted-average rates of 5.09% at June 30, 2009 and 2008.	$	68,205	-	(1,795)	66,410	1,865
Unamortized discount on capital acquisition refunding bonds		(470)	-	27	(443)	-
Term financing, due 2029, at zero percent interest at June 30, 2009.		-	60,680	-	60,680	-
Line of credit, due 2009-2011, at weighted-average rates of 2.82% at June 30, 2009 and 5.20% at June 30, 2008.		94,035	-	(22,035)	72,000	72,000
		161,770	60,680	(23,803)	198,647	73,865
	$	12,200,944	865,290	(1,429,826)	11,636,408	810,266

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, 2009, $11.0 billion of student loan principal and related interest receivable and $342.5 million of investments and related interest receivable collateralized the $11.3 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, 2009, there was $1.2 billion of variable-rate demand bonds that were put to the liquidity provider and are classified as bank bond mode with interest rates ranging from 1-month LIBOR plus 1.75% to prime rate plus 2.0%. The letters of credit are valid from 2009 through 2015. We are required to pay annual commitment fees ranging from 10 to 32 basis points for the Variable Rate Demand Bonds (VRDN) and 90 basis points for the Pennsylvania Local Government Investment Trust (PLGIT). At June 30, 2009, total liquidity coverage was $1.3 billion.

Capital financings are collateralized with capital assets. At June 30, 2009, we had $2.5 million of available credit under capital financing arrangements.

On June 17, 2009, we entered into the ABCP Conduit Put Program in which PHEAA SLC entered into an $800.0 million variable funding note purchase agreement, at an estimated weighted-average interest rate of 0.74%, with Straight-A Funding, LLC. The variable funding note purchase agreement is collateralized by the student loans that were transferred from us to PHEAA SLC. On the same day, we entered into a $60.7 million note purchase agreement, at zero percent interest, with lenders in consideration for the surrender and release of the insurance policies and the termination of their role as liquidity provider associated with the Series 2007A, 2006A, 1999A and 1995A variable-rate bonds. Since the note purchase agreement has a zero percent interest rate, the associated adjusted available distributions will directly reduce the principal balance of the $60.7 million note. The $60.7 million note purchase agreement is non-recourse debt to us and to the Commonwealth.

On July 28, 2009, S&P downgraded Ambac's insurance financial strength rating from BBB to CC. On July 29, 2009, Moody's downgraded Ambac's insurance financial strength rating from Ba3 to Ca2. These recent Ambac downgrades resulted in one or more breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations. Furthermore, these breaches, violations or defaults resulted in defaults under cross-default provisions with certain other financial institutions. Through October 21, 2009, we received signed waivers from certain financial institutions for the above breaches, violations or defaults relating to our Ambac insured 1997A and 2003A series, non-recourse obligations.

On October 13, 2009, we determined that the parity ratios associated with our 2001 and 2002 A series bonds dropped below levels required by the bond insurer, FSA, which resulted in one or more breaches, violations or defaults. As of November 6, 2009, we are in the process of obtaining signed waivers from certain financial institutions for the above breaches, violations or defaults related to our 2001 and 2002 A Series bonds.

Because of the above noted events of default, we were unable to issue our financial statements within 120 days of our fiscal year end. This event caused a triggering event to occur with a note purchase agreement, which in turn caused cross-default provisions with certain financial institutions. As of November 6, 2009, we are in the process of obtaining signed waivers from those financial institutions.

Since we did not obtain signed waivers for the above events of default, we classified the associated debt as due within one year in the above debt schedule.

The following table displays 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, 2009.

(In thousands)		Student Loan Notes, Bonds and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2010	$	726,019	157,158	84,247	9,633
2011		-	154,663	64,537	7,365
2012		-	154,663	3,503	5,096
2013		-	154,663	3,804	3,190
2014		-	154,663	2,125	3,031
2015-2019		580,744	726,298	12,145	13,464
2020-2024		370,620	634,903	15,390	10,134
2025-2029		1,486,960	545,941	80,325	5,900
2030-2034		313,500	502,464	9,300	1,033
2035-2039		1,429,485	465,426	-	-
2040-2044		2,053,500	344,477	-	-
2045-2050		4,409,850	96,078	-	-
	$	11,370,678	4,091,397	275,376	58,846

$11.4 billion of the student loan notes, bonds and financings are variable-rate debt. $8.8 million of the variable-rate debt resets based upon auctions every 7 days. $6.6 billion resets based upon auctions every 28 days. $784 million resets based upon auctions every 35 days. $2.7 billion is indexed to the 1-month or 3-month LIBOR, $113 million is indexed to 3-month financial commercial paper and $1.2 billion is in bank bond mode.

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, 2008 was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings	$	960,919	660,100	(537,000)	1,084,019	505,671
Student loan floating rate notes		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		9,099,900	400,000	-	9,499,900	-
Deferred amount on current refundings of student loan demand revenue bonds		(10,724)	-	799	(9,925)	-
		11,597,201	1,060,100	(694,764)	11,962,537	505,671
Capital financings:						
Capital financings		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		69,930	-	(1,725)	68,205	1,795
Unamortized discount on capital acquisition refunding bonds		(497)	-	27	(470)	-
Line of credit		44,000	50,035	-	94,035	22,035
		113,433	50,035	(1,698)	161,770	23,830
	$	11,784,924	1,115,323	(699,303)	12,200,944	533,714

Note 10 – Leases

We lease office space, information technology and other equipment under operating leases expiring during the next six years. In most cases, we expect the leases to be renewed or replaced by other leases in the normal course of business. Total expense for all operating leases was $11.5 million in 2009 and $12.4 million in 2008.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) at June 30, 2009 are:

Year ending June 30 (in thousands)		
2010	$	10,202
2011		5,414
2012		5,147
2013		2,761
2014 and thereafter		994
Total minimum lease payments	$	24,518

Note 11 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

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

As a fiduciary fund 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 and selected fiduciary funds 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 years ended June 30, 2009 and 2008, the required employer contribution rate was 3.29% and 3.28%, respectively. Beginning July 1, 2009, our contribution rates will be 3.15%. 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 $3.3 million and $3.8 million for the years ended June 30, 2009 and 2008, respectively. These contributions were equal to the required contributions for each year.

Postemployment Benefits

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

Plan Description

The Commonwealth of Pennsylvania sponsors the Retired Employees' Health Plan Program (REHP). We participate in the Commonwealth's REHP, a single-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 note disclosures will be included in the Commonwealth's Comprehensive Annual Financial Report (CAFR) for the year ended June 30, 2009.

Funding Policy

We contribute to the plan at a rate determined each year by the Governor's Budget Office; for the year ended June 30, 2009 the contribution rate was $215 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, 2009, we have made all required contributions to the REHP as determined by the Governor's Budget Office. The contribution rate effective

July 1, 2009 is $202 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.

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, plan members with membership dates after June 30, 2004 contribute between 0.5% and 2.0% 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 (Financial Reports – Special Reports – "Actuarial Valuation of the Commonwealth's Post-Retirement Medical Plan (Released May 2008)).

Note 12 – Servicing Fees

We have contracts with customers to provide servicing of student loans as well as information technology services. At June 30, 2009, we were servicing approximately $48.4 billion of loans for customers. Customers using our computer services serviced an additional $33.7 billion of loans, and other FFELP guarantors were managing $4.4 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 $83.9 million of servicing fees for the year ended June 30, 2009. No other individual customer provided servicing revenues more than 5% of total servicing fees.

Note 13 – Segment Information

We generally finance student loan portfolios by issuing notes, bonds, and other financings and the earnings are pledged in support of the debt. Because the revenue stream of the student loan portfolios is pledged to support the debt, we are reporting condensed financial information about this segment. 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)		**2009**	2008
Interest revenue	$	**367,715**	653,281
Interest expense		**350,113**	620,878
Net interest revenue		**17,602**	32,403
Provision for loan losses		**(2,338)**	(13,218)
Net interest revenue after provision for loan losses		**15,264**	19,185
Gains on student loan sales, net		**3**	375
Total operating revenues		**15,267**	19,560
Operating expenses		**74,009**	92,981
Operating loss		**(58,742)**	(73,421)
Financial aid		**(1,405)**	(13,717)
Loss before transfers		**(60,147)**	(87,138)
Transfers from (to) unrestricted net assets		**67,942**	(2,763)
Change in net assets		**7,795**	(89,901)
Net assets, beginning of period		**253,053**	342,954
Net assets, end of period	$	**260,848**	253,053

Statement of net assets

At June 30 (in thousands)		**2009**	2008
Restricted cash and cash equivalents	$	**360,250**	296,226
Student loans receivable		**11,070,568**	11,712,483
Other, principally interest income receivable		**235,215**	299,875
Total assets		**11,666,033**	12,308,584
Student loan financings and notes and bonds payable, net		**11,361,553**	11,962,537
Other, principally accrued interest payable		**43,632**	92,994
Total liabilities		**11,405,185**	12,055,531
Net assets, restricted for debt service	$	**260,848**	253,053

Statements of cash flows

For the years ended June 30 (in thousands)		2009	2008
Cash flows from operating activities			
Interest received on student loans	$	**285,259**	545,358
Principal received on student loans		**1,117,395**	1,129,477
Student loan originations		**(1,584)**	(759,193)
Student loan purchases		**(347,470)**	(755,068)
Student loan sales, including net gains		**9,097**	113,285
Payment of operating expenses		**(74,724)**	(104,893)
Net cash provided by operating activities		**987,973**	168,966
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		**799,962**	1,060,100
Principal paid on noncapital debt		**(1,401,744)**	(695,563)
Interest paid on student loan financings and notes and bonds payable		**(391,006)**	(595,854)
Other		**65,676**	(18,892)
Net cash used for noncapital financing activities		**(927,112)**	(250,209)
Cash flows from investing activities			
Interest received on investments		**3,163**	16,342
Net cash provided by investing activities		**3,163**	16,342
Net change in restricted cash and cash equivalents		**64,024**	(64,901)
Restricted cash and cash equivalents, beginning of period		**296,226**	361,127
Restricted cash and cash equivalents, end of period	$	**360,250**	296,226

There are 30 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 0.988 to 1.129 at June 30, 2009.

As of August 31, 2009, there were $1.1 billion of variable-rate demand bonds that were put to the liquidity provider and are classified as 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.

Debt Issue	Outstanding	June 30, 2009	June 30, 2008
1988A	$ 99,900	0.988	1.028
1988B	104,300	1.027	1.041
1988C	70,400	1.041	1.047
1988E	33,400	1.102	1.108
1994A	125,000	1.001	1.044
1997A	117,500	1.023	1.036
2000A	94,200	1.049	1.053
2001A	74,600	1.027	1.044
2001B	90,400	1.041	1.039
2002A	165,900	1.047	1.037
2002B	50,000	1.129	1.042
2003A	145,200	1.061	1.065

If the parity ratio drops for two consecutive quarters and the parity is below 1.02, the recycling of new loans into the trusts is suspended. As of June 30, 2009, the recycling of new loans into all trusts has been suspended.

The master trust that issued auction rate securities holds $7.4 billion of debt. The parity ratio for this trust is 1.001 at June 30, 2009 and 2008. There is no parity requirement for this trust.

Note 14 – Restrictions on Net Assets

Net assets restricted for debt service amounted to $263.5 million at June 30, 2009. Of that amount, $260.8 million is related to net assets held under various indentures related to financing our student loan portfolios, and the remaining $2.7 million of net assets restricted for debt service is related to capital and other financings.

The $59.8 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 15 – Student Loan Securitizations

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, and other fees, as well as, 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, 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 the 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, 2009**	June 30, 2008
Present value of residual interest	$	**23,200**	16,415
Weighted average life		**11.00 years**	12.00 years
Constant prepayment rate		**4.0%**	5.0%
Residual cash flow discount rate		**5.1%**	4.4%

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 entered into 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, 2009, we earned $3.3 million, compared to $3.6 million in 2008 and $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, 2009**	June 30, 2008
Assets:			
Cash and cash equivalents	$	**27,066**	29,580
Student loans receivable, net		**616,350**	677,477
Interest income receivable		**5,803**	8,671
Other assets		**2,948**	3,441
Total assets		**652,167**	719,169
Liabilities:			
Notes payable	$	**623,278**	692,977
Interest payable		**2,047**	2,876
Other liabilities		**4,146**	2,932
Total liabilities		**629,471**	698,785
Net assets	$	**22,696**	20,384

Note 16 – Risk Management, Contingencies, and Legal Proceedings

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.

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 engaged with ED's auditors to identify those loans that meet the new requirements to receive the 9.5% minimum rate, and we were notified by ED on January 9, 2009 that the loans identified in the audit process are acceptable to receive special allowance at the 9.5% minimum rate. We estimated and recorded $5.2 million of additional earnings on these loans for the period October 1, 2006 through June 30, 2009.

On November 19, 2007, the Office of Inspector General of the ED 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 a Program Review finding which was already under appeal. On August 21, 2008, ED adjusted the questioned payments in Finding No. 1 to $11.3 million. As of June 30, 2009, the finding has been resolved with an $11.3 million payment due to ED, which will be netted against the $5.2 million of additional earnings on the 9.5% minimum rate loans noted above. The net $6.1 million payment has been accrued in the accompanying financial statements and on September 4, 2009, we made the $6.1 million payment to ED to comply with the above finding.

On December 8, 2008, Ollie Green and Company, CPA's, on behalf of ED, Federal Student Aid (FSA), issued a report of their review of PHEAA. The purpose of this review was to determine PHEAA's compliance with the establishment of the federal and operating funds as required by the Higher Education Act of 1965, as amended. The final date for establishing these funds was December 6, 1998 with an October 1, 1998 effective date. On April 21, 2009, FSA assessed us $11.2 million based on three findings. On May 20, 2009, PHEAA appealed these findings with ED and as of June 30, 2009, these findings remain open. PHEAA has not accrued the $11.2 million in the accompanying financial statements, since the loss contingency was not probable and the amount of the loss was not reasonably estimated.

On June 19, 2008, the Student Loan Revenue Bonds, Senior Subseries P-1 and P-2 and Subordinate Series Q (collectively, the "Bonds") issued by us in the original aggregate principal amount of $150.0 million were selected for examination by the United States Department of Treasury, Internal Revenue Service (IRS). On April 30, 2009, we received an Information Document Request (Request No. 2) asking to explain (i) the reallocation of student loans to and from the Bonds and (ii) why consolidation loan rebate fees paid to the Treasury reduce the yield on the student loans. We have responded to the above request as of June 30, 2009 and we are waiting on a response from the IRS.

Legal Proceedings

In 2004, we entered into a settlement agreement with a student loan borrower and his lender regarding the servicing of his student loan debt. As part of the settlement agreement, the borrower's lender directed us to update the credit reporting associated with the borrower's underlying loans. We requested the requisite updates be made but a national credit reporting agency failed to update the reporting. The plaintiff filed a new legal action against us and the lender alleging that we violated the Fair Credit Reporting Act. If the plaintiff is successful, the plaintiff may be able to recover attorney's fees and punitive damages. Discovery has closed in this case, and per the trial court's local rules, the parties are waiting permission to file motions for summary judgment. We will continue to vigorously contest all of the allegations set forth in the amended complaint and third-party complaint filed against us by the borrower's lender. We intend to file a motion for summary judgment and we believe based on the completion of discovery that the plaintiff may prevail on certain counts of the amended complaint. As of June 30, 2009, it is difficult to estimate our potential liability on this complaint due to the speculative nature of the alleged damages.

In August 2008, we entered into a Memorandum of Understanding with a FFEL student loan guarantor documenting our agreement to reprocess on behalf of impacted lenders all federal special allowance payments and interest subsidies on student loans that were submitted for payment to the ED during a period of time when the student loans were not reflected as guaranteed in the records of the above guarantor. We have recently learned that approximately 317 additional loans that were submitted to the above guarantor were also not reflected as guaranteed in the records of the above guarantor. As such, we continue to work with the guarantor on the documentation of the guarantee of these loans. As of June 30, 2009, we believe that the special allowance payments and interest on these 317 additional loans may have to be reimbursed to the lender, but it is difficult to estimate our potential liability on this issue.

A guarantor has returned several FFEL default claims submitted to it by us, because of consolidation loans allegedly including loan amounts either never requested to be included in the consolidation loan, or loans that the borrowers allegedly expressly requested not to be included in the consolidation. As of June 30, 2009, it is difficult to estimate our potential liability and we are currently investigating the number of consolidation loans affected.

On September 2, 2009, a civil complaint was unsealed by a federal judge in the Eastern District of Virginia. The civil complaint, originally filed in 2007 under the Federal False Claims Act, seeks the return of an alleged $1.0 billion in student loan subsidies paid by ED to ten student loan holders. We were named in the civil complaint as one of the ten co-defendants. At this time, it is difficult to estimate our potential liability on this issue and we will vigorously defend against this action.

Lastly, 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.