Annual Financial Report
June 30, 2010 and 2009

PHEAA conducts its student loan servicing operations commercially as American Education Services and for federally-owned loans as FedLoan Servicing.

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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.

About PHEAA

Our mission is to improve higher education opportunities for Pennsylvanians. We are a public corporation and government instrumentality created by the Pennsylvania General Assembly. We serve students and schools nationally through our state grant, guaranty, servicing, and financial aid processing systems.

We administer the Pennsylvania State Grant program on behalf of the Commonwealth of Pennsylvania each year, without taxpayer support. Our business earnings fund the administration of this program ensuring that every appropriated dollar goes directly to students.

Our debt management professionals; our use of technology; and our website, YouCanDealWithIt.com, have reduced financial risk for our customers and ensured that funds remain accessible to all students. Our cohort default rate for fiscal year 2007 [the most recently published rate from the U.S. Department of Education (ED)] was 5.5%, which ranks below the national industry average of 6.7%.

We guarantee Federal Stafford, PLUS and consolidation loans, which were originated before July 1, 2010, enabling students to continue their pursuit of higher education. As of June 30, 2010, the outstanding principal balance of student loans guaranteed was $49.3 billion.

We service student loans that we own and for third parties through our Commercial Servicing, Remote Servicing and FedLoan Servicing lines of business.

On July 13, 2010, Governor Rendell signed into law legislation to restructure our Board of Directors. The new legislation was based on a 2009 PHEAA Board resolution that called upon the General Assembly to restructure the Board of Directors to provide additional leadership expertise in an increasingly complex financial environment. Previously, members of the General Assembly filled 16 of 20 board seats and the Governor appointed four individuals. The new legislation will reduce the number of legislators serving on the board to 12. The four legislative caucuses will appoint the four new seats with private-sector professionals with backgrounds relative to higher education finance. In addition, the new legislation will reduce the board members terms from six years to four years.

Public Service Benefits

To serve Pennsylvanians effectively, we operate both inside and outside Pennsylvania. The following table highlights the public service benefits and the operating expenses incurred by us.

For the years ended June 30 (in thousands)		**2010**	2009
Self-funded			
Costs of operating state and federal governmental programs	$	**13,618**	13,048
Keystone loan program origination fees and benefits paid on behalf of borrowers		**357**	1,750
Support of the Pennsylvania Higher Education Foundation, Inc.		**119**	443
Federal default fees paid on behalf of borrowers		**39**	25,880
Other public service activities and outreach		**1,081**	4,027
		15,214	45,148
Financial support funded by our business partners			
Keystone loan program origination fees and benefits paid on behalf of borrowers		**167**	565
	$	**15,381**	45,713

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 Pennsylvania State Grant Program is the largest of the Commonwealth supported student aid programs with approximately 185 thousand recipients projected for 2010 - 2011 academic year. The estimated maximum State Grant Program award will be $3,541 for the 2010 - 2011 academic year. During academic year 2009 - 2010, the maximum State Grant Program award was $4,120.
- The Institutional Assistance Grants Program provides grants to non-profit 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. It also provides matching grants to scholarship awards made by selected non-profit foundations.
- The New Economy Technology Scholarship Program provides financial assistance grants up to $3,000 to students enrolled in a postsecondary science, technology, and allied health programs approved by the Pennsylvania Department of Education.
- The Pennsylvania National Guard Education Assistance Program (EAP) is for members of the Pennsylvania National Guard. This program provides tuition assistance for students who enter into a service commitment with the Pennsylvania National Guard, typically for a period of six years. The maximum EAP award for full-time students is the lesser of the actual tuition charged for the full-time course of study, or 100% of the tuition charged to a Pennsylvania resident at a state-owned university.
- The Postsecondary Educational Gratuity Program (PEGP) assists birth or adoptive children of Pennsylvania police officers, firefighters, rescue and ambulance squad members, corrections employees and National Guard members who died in the line of duty since January 1, 1976. The program also includes the birth and adoptive children of Pennsylvania sheriffs, deputy sheriffs and certain other individuals who were on federal or state active military duty who died in the line of duty since September 11, 2001. The PEGP covers all institutional charges for tuition, fees, room and board not covered by other grants and scholarships.

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 $7.0 million in grants during its most recent fiscal year ended May 31, 2010 as compared to $10.3 million during 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.

Changes in Federal Laws

Changes in federal laws and the decline of the credit and financial markets adversely affected our operations and our ability to continue to fund public service initiatives. Presented below is a recap of the changes in federal laws.

On May 7, 2008, President Bush signed H.R. 5715, titled "Ensuring Continued Access to Student Loans Act of 2008," (ECASLA) into law. ECASLA was in response to concern that the credit market conditions could disrupt federal student loan availability. The law gives ED temporary authority to purchase federally backed student loans made by private lenders, effectively providing a secondary market for the loans. ED created the following four separate loan purchase arrangements under ECASLA:

- **PUT Option** – The PUT option gives lenders the option to sell Federal Family Education Loans (FFEL) issued during the 2008-09 academic year. This option expired on September 30, 2009. Lenders have until September 30, 2010, to sell the loans made for the 2009-10 academic year. The PUT option allows, but does not require, lenders to "PUT" (sell) loans to ED by a certain date at a predetermined price. ED hired private contractors, including PHEAA, to service loans sold under the PUT option.
- **Short-term purchase program** – This program is different from the PUT option program, because it applies only to academic year 2007-08 loans, instead of 2008-09, and 2009-10 and it limited the weekly loan sales to $500 million (the PUT option has no limit). ED requires that the average loan value within any package of loans sold by a lender be at least $3,000. ED paid lenders 97% of outstanding principal (including accrued but unpaid interest) for each sold loan. This percentage matches the default guarantee rate the government provides on FFEL program loans.
- **Loan financing arrangement – participation interest program** - This program allows lenders to secure temporary financing from the federal government for loans issued in academic years 2008-09 and 2009-10. Lenders make FFEL program loans to borrowers and then pool the loans. The pooled loans are then temporarily sold to a bank that has agreed to act as a custodian. ED purchases a 100% ownership interest in the loan principal held by the custodian. Lenders continue to service the loans and can make new loans with the sale proceeds. Each quarter, lenders make interest payments to and receive subsidies from ED under the financing arrangement.
- **Asset-backed commercial paper conduit program** – The conduit program applies to loans issued between October 1, 2003, and July 1, 2009, making it the only purchase program for loans made before the 2007-08 academic year. Asset-backed commercial paper conduits are used in private capital markets to finance assets and receivables such as mortgages, credit card payments and loans. The conduit borrows funds by issuing commercial paper. Investors buy the commercial paper and collect interest and the conduit uses the borrowed funds to buy a pool of assets. Income from these assets is used to pay interest on the commercial paper. ED is acting as buyer-of-last-resort for loans financed through private conduits. ED has committed to purchase the underlying FFEL program loans in the event that a conduit cannot refinance maturing commercial paper. Under the arrangement, ED will purchase FFEL program loans issued after May 1, 2008, for 100% of outstanding principal and accrued interest. Loans issued earlier than May 1, 2008, will be paid out at 97% of unpaid principal plus accrued interest.

On August 14, 2008, President Bush signed into law H.R. 4137, the Higher Education Opportunity Act. This law continues 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; and
- 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. H.R. 6889 does the following:

- Amends the Higher Education Act of 1965;
- Extends by one year, from July 2009 to July 2010, the Secretary of Education's authority to purchase, or enter into forward commitments to purchase, FFEL program loans from lenders upon the determination that there is an inadequate availability of loan capital to meet the demand for such loans; and
- Extends by one year, from June 30, 2009 to June 30, 2010, the authority of institutions of higher education (IHEs), 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 FFEL program loans to student and parent borrowers of such IHEs, until such date, regardless of their ability to otherwise obtain such loans.

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act (H.R. 4872). Attached to H.R. 4872 was the Student Aid and Fiscal Responsibility Act (SAFRA) and it does the following:

- Increases the maximum annual Pell Grant scholarship to $5,500 in 2010 and $5,975 by 2017;
- Invests $750 million to bolster college access and completion support for students;
- Makes federal loans more affordable for borrowers to repay by investing $1.5 billion to strengthen an Income-Based Repayment program and lowers the monthly cap on student loans payments from 15% to 10% of adjusted income after July 1, 2014, and forgives the remaining balances after 20 years of repayment;
- Invests $2.5 billion in historically black colleges and universities and minority-serving institutions;
- Invests $2.0 billion in a competitive grant program for community colleges;
- Terminates the authority to make loans under the FFEL program after June 30, 2010;
- Limits special allowance payments to lenders under the FFEL program to loans first disbursed before July1, 2010;
- Converts all new federal student lending to the William D. Ford (Direct Loan) program beginning July 1, 2010; and
- Only private contractors from the United States will service the loans originated under the Direct Loan program.

Operations

Our operations involve originating, purchasing, selling, guaranteeing, and servicing student loans that were originated under the FFEL, prior to July 1, 2010, and alternative loan programs. On June 30, 2010, we started servicing student loans under the Direct Loan program. The FFEL and the Direct Loan programs are federal programs that allow undergraduate or graduate students at eligible postsecondary schools to obtain loans.

Currently, there are four types of loans under the FFEL and the Direct Loan programs:

- 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;
- PLUS – This is a supplemental loan to parents and graduate students; and
- Consolidation – This allows the borrower to combine Stafford and certain other education-related loans, fix the rate of interest on the loans, and extend the repayment period.

The Direct Loan program was enacted in 1993 under the Student Loan Reform Act of 1993, part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66). The federal government established the Direct Loan program in order to streamline the student loan delivery system and achieve cost savings. Under the Direct Loan program, the federal government serves as the banker and makes loans to students and their families using federal funds from the U.S. Treasury. Schools may serve as a direct loan originator or an ED contractor may originate the loans. Third party contractors perform loan servicing and collections of the Direct Loans.

As indicated above, President Obama signed into law H.R. 4872 on March 30, 2010. Attached to H.R. 4872 was the SAFRA, which terminates our authority to make or guarantee new loans under the FFEL program after June 30, 2010. All new Stafford, PLUS, and Consolidation student loans will be made under the Direct Loan program on July 1, 2010. The elimination of the FFEL program will have an impact on our operations and profitability over time by, among other things, reducing our interest revenues as a result of our inability to add new FFEL program loans to our portfolio and it will reduce our guarantee fees as a result of reduced FFEL program loan servicing and origination volume. However, the additional servicing revenue generated from the Direct Loan contract with ED will help offset the reduction in revenue mentioned above.

Special Interest Subsidy and Special Allowance Payments

ED compensates lenders participating in the FFEL program through a combination of interest benefits and special allowance payments that are accounted for as interest revenue. Interest benefits are paid to lenders on behalf of eligible borrowers with subsidized FFEL program loans when the loans are in a qualifying status.

Special allowance payments bring a lender's earnings on eligible FFEL program loans closer to market rates. ED pays special allowance payments during any quarter in which the special allowance calculation is a positive number. For loans first disbursed between April 1, 2006 and June 30, 2010, ED will collect excess interest for quarters in which the interest rate on the loan exceeds the special allowance support level, commonly referred to as negative special allowance. Special allowance rates vary according to the date of the loan disbursement, the loan period and the loan status.

The special allowance rates are calculated using the following factors:

- The average of the bond equivalent rates on the quotes of the 3-month financial commercial paper rates for Stafford and PLUS loans first disbursed on or after January 1, 2000, and for Consolidation loans made from applications received by lenders on or after January 1, 2000;
- The average bond equivalent rate of the 91-day Treasury bills for Stafford and PLUS loans first disbursed prior to January 1, 2000, and for Consolidation loans made from applications received by lenders before January 1, 2000; and
- A factor prescribed by law for each category of loans. This factor is added to or subtracted from the applicable 91-day Treasury bill or 3-month financial commercial paper rate.

The federal government charges an origination fee to help offset the costs of interest, special allowance and reinsurance payments on a FFEL program loan. For subsidized and unsubsidized Stafford loans, the lender may pay the origination fee on behalf of the borrower, or deduct it from the borrower's student loan proceeds. These fees decreased from 0.5% in 2009 to zero in 2010. For PLUS loans, the federal government requires the up-front origination fees to be deducted from the proceeds of student loans and remitted to them. These fees were 3.0% for 2009 and 2010.

Guaranty Activities

The implementation of SAFRA terminated our authority to make or guarantee new loans under the FFEL program after June 30, 2010. All new Stafford, Plus and Consolidation student loans will be made under the Direct Loan program starting on July 1, 2010.

We use the Federal Student Loan Reserve Fund (Federal Fund) to guarantee 97% to 100% of the 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 and a borrower defaults. The federal government reinsures the Federal Fund, and reinsurance rates vary based upon the default rates of our portfolio of guaranteed loans and the disbursement date of the loan. The following outlines reinsurance rates, which are based on the following loan disbursement dates;

▪ Before October 1, 1993	80% – 100%
▪ Between October 1, 1993 and September 30, 1998	78% – 98%

- Between October 1, 1998 and June 30, 2010 75% – 95%

ED pays us an annual account maintenance fee of 0.06% of the outstanding principal amount of loans guaranteed, as long as the guarantee remains in force. Prior to the implementation of SAFRA, we received a loan processing and issuance fee of 0.40% for new loan guarantees.

Loans guaranteed between July 1, 2006 and June 30, 2010, 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 guaranteed Stafford and PLUS loans. 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. We discuss the federal default fees paid on behalf of borrowers within the section titled "**Changes in Net Assets - *Grants and Other Financial Aid Activity***".

Once a loan defaults, as a guarantor, we continue to try to collect on the loan and we retain up to 16% of the borrower's payments collected as revenue. The federal government retains the remaining portion of any borrower's payments.

As a guarantor, we have established a loan rehabilitation program for all borrowers with an enforceable promissory note. However, the following circumstances will exclude a borrower from the loan rehabilitation program:

- A judgment has been obtained on the loan;
- Default claims were filed on the loan under Sec. 682.412 (Consequences of the failure of a borrower or a student to establish eligibility); and
- The borrower has been convicted of, or has pled *nolo contendere* or guilty to, a crime involving fraud in obtaining Title IV, Higher Education Act program assistance

A borrower must meet the following requirements for us to consider the loan rehabilitated:

- The borrower has made nine of the ten payments required under a monthly repayment agreement;
- Nine payments have been received by us within a ten month period; and
- The loan is sold to an eligible lender.

The borrower regains all benefits of the rehabilitation program, including any remaining deferment eligibility, once the above program requirements are met. 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.

We earn default aversion fees when servicers involve us as a guarantor to avert potential defaults. The Federal Fund pays the default aversion fee, but if the loan subsequently defaults, we must return the fee to the Federal Fund. Since January 1, 2008, we have not recognized default aversion fee revenue, as we cannot assure the ultimate collectability of this revenue due to the financial condition of the Federal Fund. We manage the cash flow of the Federal Fund to pay default claims rather than to pay default aversion fees.

Servicing Activities

We service student loans that we own and for third parties through our Commercial Servicing and FedLoan Servicing (FLS) lines of business. We service student loans for federal and state agencies and commercial and private lenders throughout the United States. As a servicer, we are responsible for maintaining and making collections on student loans. We also provide systems for other servicers and guarantors to use, which is limited to data processing functions, through our Remote Servicing line of business.

We use our proprietary COMPASS system for servicing student loans for our external clients, as well as our own portfolio. Our personnel, lending institutions, academic institutions, and other higher education servicing agencies use COMPASS, which is a mainframe-based decision support tool. As of June 30, 2010, we are servicing approximately $57.4 billion in student loans under our Commercial Servicing line of business, which excludes loans serviced for ED, and approximately $32.3 billion in student loans under our Remote Servicing line of business. As of June 30, 2009, we serviced approximately $59.5 billion in student loans under our Commercial Servicing line of business, and approximately $33.7 billion in student loans under our Remote Servicing line of business.

During 2009, ED selected us as one of four servicers to service a portion of the nation's growing federally-owned student loan portfolio. FLS, a division within PHEAA, is responsible for servicing the federal student loans. We began servicing loans for ED in September 2009. For the year ended June 30, 2010, we recognized $11.7 million of revenue and as of June 30, 2010, we serviced approximately $13.6 billion of loans under this servicing contract.

Our eCommunications Center provides our borrowers with access to on-line customer servicing, including convenient and easy repayment options.

Our Online Account Access customer portal ensures our borrowers' safety and security as they make loan payments, update personal account information, apply for a loan, and receive online customer service. Borrowers also have the option to make their loan payments by phone via our Interactive Voice Response (IVR) telephone payment service.

Our loan origination web refund system provides financial aid professionals with an efficient and secure online automated system to refund student loans. Users may enter the borrower's account number or group the refunds by disbursement date and then review the system for loan refund information.

Our green initiative includes the promotion of eBilling to our borrowers by encouraging them to eliminate their monthly paper bills. As of June 30, 2010, more than 345 thousand of our borrowers have opted for this green method of loan billing.

Loan Origination and Purchasing

We issued revenue bonds from 1983 until the present and we used the proceeds from those revenue bonds to make various types of student loans. We also purchased student loans from banks and other lenders from time to time. We suspended our activities as an FFEL lender for any new loans first disbursed on or after March 7, 2008. In addition, we suspended making purchases under our forward purchase contracts with other lending institutions. As of June 30, 2010, we have student loan purchase commitments of $91.9 million that we have been unable to fund or settle. All 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.

SAFRA terminated our authority to originate or guarantee new loans under the FFEL program after June 30, 2010. All new Stafford, Plus and Consolidation student loans will originate under the Direct Loan program on July 1, 2010.

Forward-looking Statements

This financial report contains statements relating to future results. These forward-looking statements relate to, among other things, risk-sharing losses, servicing losses, simulation of changes in interest rates, litigation results, changes in laws 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 remain 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.

We are financed and operated similar 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.

Condensed Financial Information

Statements of Revenues, Expenses, and Changes in Net Assets

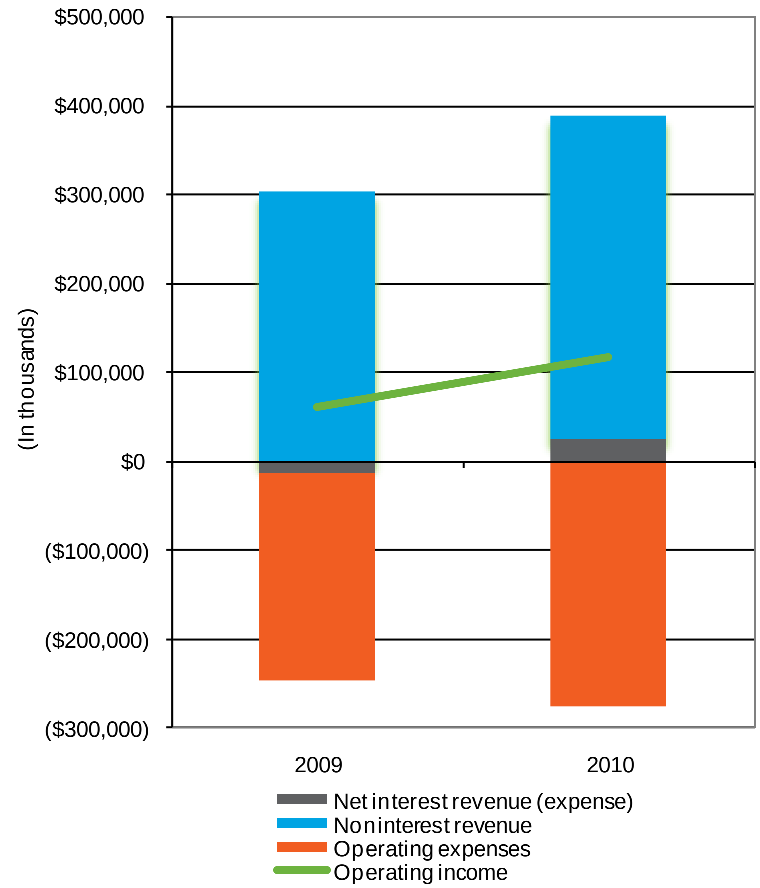
For the years ended June 30 (in thousands)		2010	2009
Student loan interest revenue	$	**189,181**	344,060
Investment interest revenue		**8,205**	7,598
Interest expense on student loan financings and notes and bonds payable		**(155,824)**	(350,113)
Interest expense on capital and other financings		**(9,455)**	(11,431)
Net interest revenue (expense)		**32,107**	(9,886)
Provision for loan losses		**(5,544)**	(2,344)
Net interest revenue (expense) after provision for loan losses		**26,563**	(12,230)
Servicing fees		**192,730**	164,864
Retention of collections on defaulted loans, net		**127,163**	110,521
Federal fees		**44,953**	45,045
Changes in fair value of residual interest, net		**5,175**	6,784
(Loss) gain on student loan sales, net		**(4,054)**	3
Default aversion fees, net of rebates		**(1,766)**	(22,031)
Other		**155**	358
Total noninterest revenue		**364,356**	305,544
Operating revenues		**390,919**	293,314
Operating expenses		**(274,759)**	(232,733)
Operating income		**116,160**	60,581
Commonwealth of Pennsylvania grants		**455,497**	473,461
Federal grants		**7,186**	8,113
Grants and other financial aid		**(465,557)**	(474,953)
Grant funds returned to the Commonwealth of Pennsylvania		**(12,284)**	(16,802)
Transfers (to) from the Pennsylvania Higher Education Foundation		**(119)**	2,557
Change in net assets	$	**100,883**	52,957

Statements of Net Assets

As of June 30 (in thousands)		**2010**	2009
Cash, cash equivalents, and investments, substantially restricted	$	**716,848**	594,808
Student loans receivable, net		**9,564,054**	11,169,840
Interest income receivable		**157,002**	197,302
Capital assets, net		**56,494**	59,783
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**101,622**	107,655
Other		**147,305**	149,103
Total assets		**10,743,325**	12,278,491
Student loan financings and notes and bonds payable, net		**9,739,200**	11,361,553
Capital and other financings		**224,098**	274,855
Amounts related to the Federal Student Loan Reserve Fund		**101,622**	107,655
Other		**179,959**	136,865
Total liabilities		**10,244,879**	11,880,928
Net assets			
Invested in capital assets, net of related debt		**(9,103)**	(16,424)
Restricted for debt service		**247,407**	263,489
Restricted for financial aid grant programs		**44,883**	59,819
Unrestricted		**215,259**	90,679
Total net assets	$	**498,446**	397,563

Results of Operations

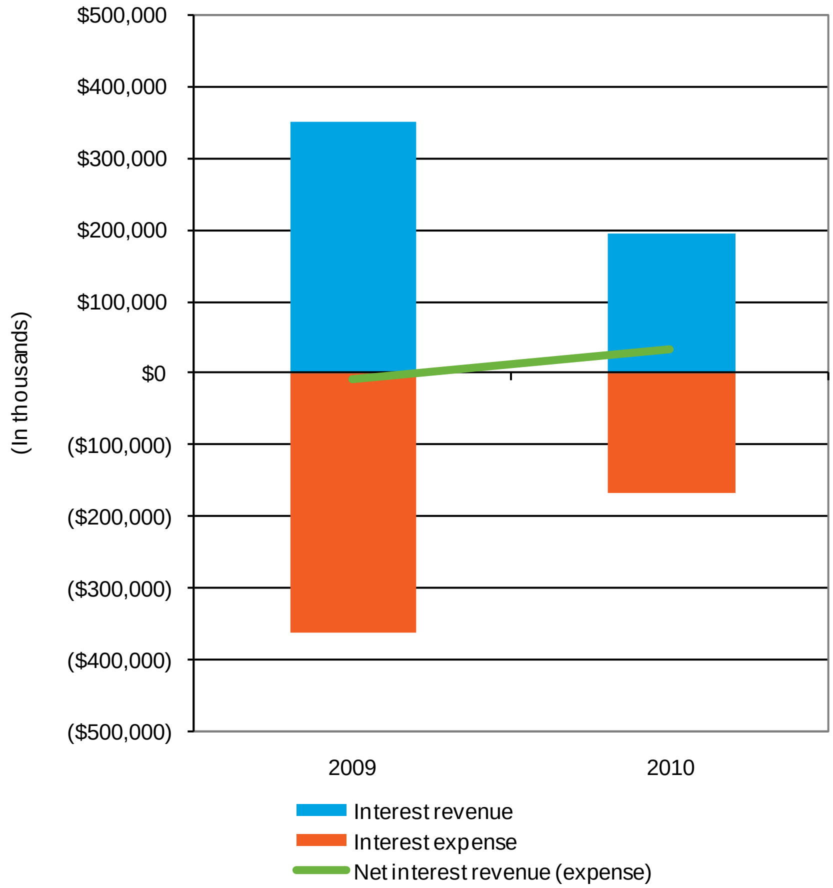
Years ended June 30



Operating income for the year ended June 30, 2010, was $116.2 million, a 91.7% increase from operating income of $60.6 million in 2009. Operating revenues were $390.9 million in 2010, a 33.3% increase from $293.3 million in 2009. Net interest revenue after provision for loan losses was $26.6 million in 2010, an increase from net interest expense after provision for loan losses of $12.2 million in 2009. Noninterest revenue was $364.4 million in 2010, a 19.3% increase from $305.5 million in 2009. Operating expenses were $274.8 million in 2010, an 18.1% increase from $232.7 million in 2009.

A more detailed explanation of the results of operations follows.

Net Interest Revenue
Years ended June 30



Net interest revenue results primarily from the interest rate margin in our portfolio of student loans, although we have investments and debt not related to those student loans that can also create net interest revenue.

For the year ended June 30, 2010, net interest revenue was $32.1 million, an increase from net interest expense of $9.9 million in 2009. During 2010, the increase in net interest margin was due to lower interest rates on our student loan holdings due to the debt refinancings during 2009 and 2010. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details on our student loan holdings and weighted-average interest rates.

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

For the years ended June 30 (Balances in thousands)		**2010** **Balances**	**Rate**	2009 Balances	Rate
Average interest earning assets					
Student loans receivable, net	$	**10,442,061**	**1.81%**	11,727,849	2.93%
Investments		**719,068**	**1.14%**	511,956	1.48%
	$	**11,161,129**	**1.77%**	12,239,805	2.87%
Average interest bearing liabilities					
Student loan financings and notes and bonds payable	$	**11,051,910**	**1.41%**	11,867,373	2.95%
Capital and other financings		**255,718**	**3.70%**	237,089	4.82%
	$	**11,307,628**	**1.46%**	12,104,462	2.99%
Net interest margin			**0.31%**		(0.12)%

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

For the years ended June 30	**2010**	2009
Student loan yields	**3.05%**	4.17%
Consolidation loan rebate fees	**(0.72)**	(0.68)
Premium amortization	**(0.43)**	(0.46)
Lender origination fees	**(0.09)**	(0.10)
Student loan revenue	**1.81%**	2.93%
Cost of funds	**(1.41)**	(2.95)
Net interest margin on student loans	**0.40%**	(0.02)%

The following rate and 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	Increase (decrease) attributable to change in Volume
2010 vs. 2009				
Student loan interest revenue	$	(154,879)	(117,158)	(37,721)
Investment interest revenue		607	(2,467)	3,074
		(154,272)	(119,625)	(34,647)
Student loan financings and notes and bonds payable interest expense		(194,289)	(170,231)	(24,058)
Capital and other financings interest expense		(1,976)	(2,874)	898
		(196,265)	(173,105)	(23,160)
	$	41,993	53,480	(11,487)

Although, the amounts we earn on student loans involve interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. As of June 30, 2010, 3% of the variable-rate loans change based upon changes in the 91-day U.S. Treasury Bill rate, and 97% change based upon changes in the 3-month financial commercial paper rate. The borrowers pay rates that are set under a different formula and generally reset annually on July 1. Undergraduate borrowers pay a fixed rate of 5.6% for subsidized Stafford loans originated between July 1, 2009 and July 1, 2010.

For the years ended June 30, 2010 and 2009, the decrease in the student loan revenue is due to decreases in the U.S. Treasury Bill rates, and negative special allowance as a result of decreases in the 3-month financial commercial paper rates for loans disbursed between April 1, 2006 and June 30, 2010.

Interest Rate Risk Management

Student loans are generally variable-rate assets, so we generally fund them 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 the 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. However, we have $398.8 million of cash, cash equivalents and investments and $55.9 million of student loans, as well as other assets and liabilities, not included in the analysis below, because they do not relate to the student loan revenue bonds.

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.

The gap analysis on the next page reflects rate-sensitive positions as of June 30, 2010, and is not necessarily reflective of positions that existed throughout the period.

As of June 30, 2010 (in thousands)		Interest rate sensitivity period: 3 months or less	3 months to 6 months	6 months to 1 year	1 to 2 years	2 to 5 years	Over 5 years
Assets							
Student loans	$	9,165,121	142,290	161,148	19,149	19,714	695
Restricted cash and cash equivalents		318,010	-	-	-	-	-
Other assets		97,055	26,547	13,954	10,859	16,376	27,034
Total assets		9,580,186	168,837	175,102	30,008	36,090	27,729
Liabilities							
Student loan financings and notes and bonds payable		9,595,200	144,000	-	-	-	-
Other liabilities		31,144	592	-	-	-	-
Total liabilities		9,626,344	144,592	-	-	-	-
Net assets							
Restricted for debt service	$	-	-	-	-	-	247,016
Period gap	$	(46,158)	24,245	175,102	30,008	36,090	(219,287)
Cumulative gap	$	(46,158)	(21,913)	153,189	183,197	219,287	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		99.5 %	116.8 %	-	-	-	11.2 %
Ratio of cumulative gap to total assets		(0.5) %	(0.2) %	1.5 %	1.8%	2.2 %	- %

Allowance for Loan Losses – FFEL Program Loans

The allowance for loan losses – FFEL program loans represents our estimate of the costs related to the risk sharing on FFEL program loans only. This allowance does not include the risk associated with non-FFEL program loans, such as private, uninsured, HEAL and TERI guaranteed loans. These allowances along with allowance for losses on FFEL program loans are included in the section titled "Allowance for loan losses" in **Note 6 – Student Loans Receivable, net**. The allowance for loan losses – FFEL program loans is a weighted average calculation based upon the following guarantee rates:

- 100% of the unpaid principal balance of each loan disbursed before October 1, 1993;
- Not more than 98% of the unpaid principal balance of each loan disbursed on or after October 1, 1993 and before July 1, 2006; and
- Not more than 97% of the unpaid principal balance of each loan disbursed between July 1, 2006 and June 30, 2010.

We report the "provision for losses" in the table below 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 allowance for loan losses presented below is adequate to cover the inherent losses in our student loan portfolio.

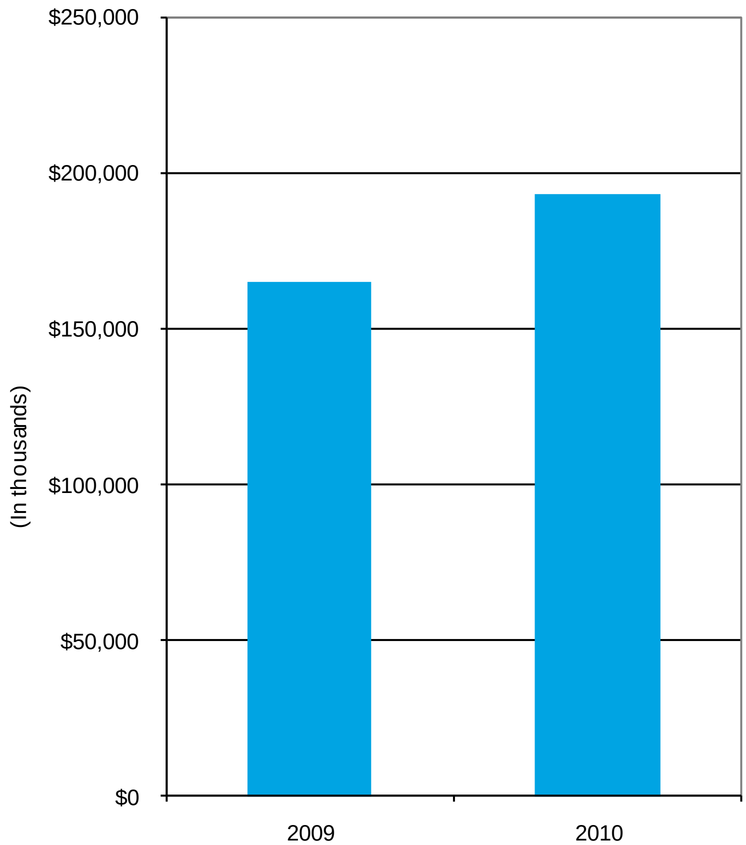
As of June 30 (in thousands)		**2010**	2009
Balance at beginning of period	$	**7,315**	11,343
Provision for losses		**5,544**	2,344
Charge-offs		**(6,169)**	(6,372)
Balance at end of period	$	**6,690**	7,315
Ending balance of student loans	$	**9,278,825**	10,796,725
Allowance as a percentage of ending balance of student loans		**0.07%**	0.07%

Delinquencies have the potential to adversely impact earnings through increased servicing, collection costs and charge-offs. The table below presents our student loan delinquency trends, but does not include those student loans categorized as in-litigation, uninsured, credit balances, and unamortized costs.

As of June 30 (in thousands)	**2010**		2009	
Loans in-school/in-grace	$ **406,263**		$ 921,320	
Loans in deferment and forbearance:				
Deferment	**1,278,696**		1,697,118	
Forbearance	**1,353,960**		1,432,042	
Total loans in-school/in-grace, and deferment and forbearance	$ **3,038,919**		$ 4,050,480	
Loans in repayment:				
Current	$ **5,674,368**	**88.4%**	$ 6,156,234	88.5%
31 – 60 days	**266,581**	**4.2%**	258,580	3.7%
61 – 90 days	**135,536**	**2.1%**	137,470	2.0%
91 – 120 days	**82,146**	**1.3%**	90,436	1.3%
121 – 180 days	**116,956**	**1.8%**	123,164	1.8%
181 – 270 days	**99,085**	**1.5%**	123,379	1.8%
271 days or greater	**29,888**	**0.5%**	47,247	0.6%
Claims filed but not paid	**12,755**	**0.2%**	17,638	0.3%
Total loans in repayment	$ **6,417,315**	**100.0%**	$ 6,954,148	100.0%

Noninterest Revenue

Servicing Fees
Years ended June 30



We earn servicing fee revenue by servicing student loans owned by third parties. We categorize revenue earned from loans owned by financial institutions and secondary markets as "Commercial Servicing"; whereas, we categorize revenue earned from loans owned by ED as "FedLoan Servicing" (FLS). We began servicing loans for ED during September 2009. We also categorize revenue earned from providing systems for other servicers and guarantors to use as "Remote Servicing".

For the year ended June 30, 2010, total servicing fees were $192.7 million, a 16.9% increase from $164.9 million in 2009. In 2010, servicing fees increased due to increased volume of loans serviced, deconversion fees and early termination fees for loans PUT to ED. Loans serviced by us for third party servicing clients averaged $54.7 billion in 2010 compared to $48.6 billion in 2009.

For the year ended June 30, 2010, servicing fees related to Commercial Servicing were $163.1 million, a 9.9% increase from $148.4 million in 2009. Loans serviced by us for Commercial Servicing averaged $48.9 billion in 2010 compared to $48.6 billion in 2009.

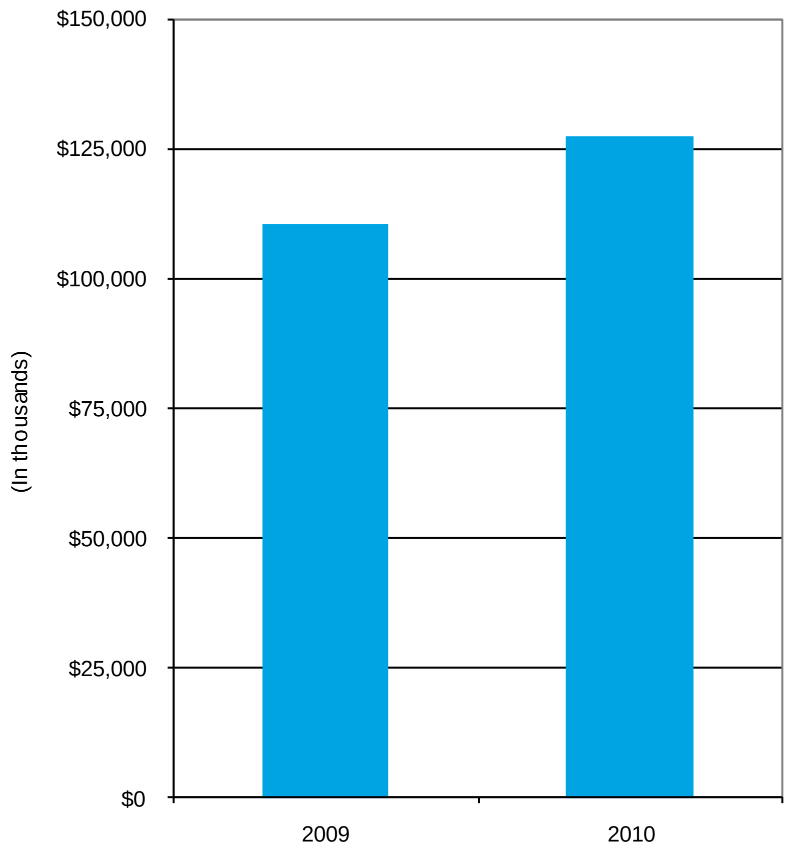
For the year ended June 30, 2010, servicing fees related to FLS were $11.7 million compared to zero in 2009. Loans serviced by us for FLS averaged $5.8 billion in 2010 compared to zero in 2009.

For the year ended June 30, 2010, fees earned from the servicing system amounted to $16.2 million, a 9.5% increase from $14.8 million in 2009. For the year ended June 30, 2010, loans serviced by other servicers using our systems averaged $32.8 billion, a 4.1% decrease from $34.2 billion in 2009.

For the year ended June 30, 2010, fees earned from the guaranty system amounted to $1.7 million, a 21.4% increase from $1.4 million in 2009. For the year ended June 30, 2010, the original principal amount outstanding for guarantors using our systems averaged $4.4 billion, a 2.3% increase from $4.3 billion in 2009. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

Retention of Collections on Defaulted Loans, net

Years ended June 30



If a borrower fails to pay their loan, as a guarantor, we guarantee 97% - 100% of the borrower's outstanding loan balance, depending on the disbursement date of the borrower's loan. The federal government reinsures the guarantor based upon default rates of our portfolio of guaranteed loans and the disbursement date of the loan.

We continue to try to collect on the defaulted loan and we earn revenue on the collection of defaulted loans. The federal government allows us to retain up to 16% of the borrower's payments collected as revenue and we remit the remaining amount to the federal government. 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.

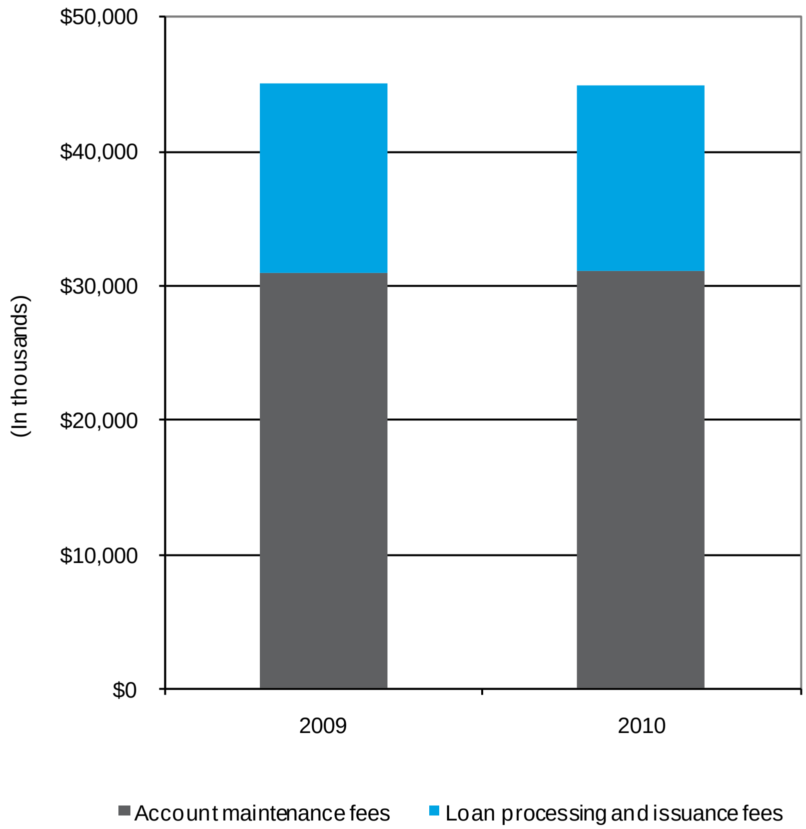
For the year ended June 30, 2010, the net retention of collections on defaulted loans was $127.2 million, a 15.1% increase from $110.5 million in 2009.

For the year ended June 30, 2010, the gross retention of collections on defaulted loans was $158.4 million, a 35.3% increase from $117.1 million in 2009. The increase in the collections of defaulted loans was attributable to increasing loan defaults and by aggressively pursuing the collection of rehabilitation payments.

Since April 2009, we have offered discounts to eligible lenders for purchasing rehabilitation loans from us. The discounts offered to eligible lenders reduce the amount of collections we retain on these loans; however, the increases in default and rehabilitation loans have more than offset the discounts offered. For the year ended June 30, 2010, the discount on rehabilitation collections was $31.2 million, an increase from $6.6 million in 2009.

Federal Fees

Years ended June 30

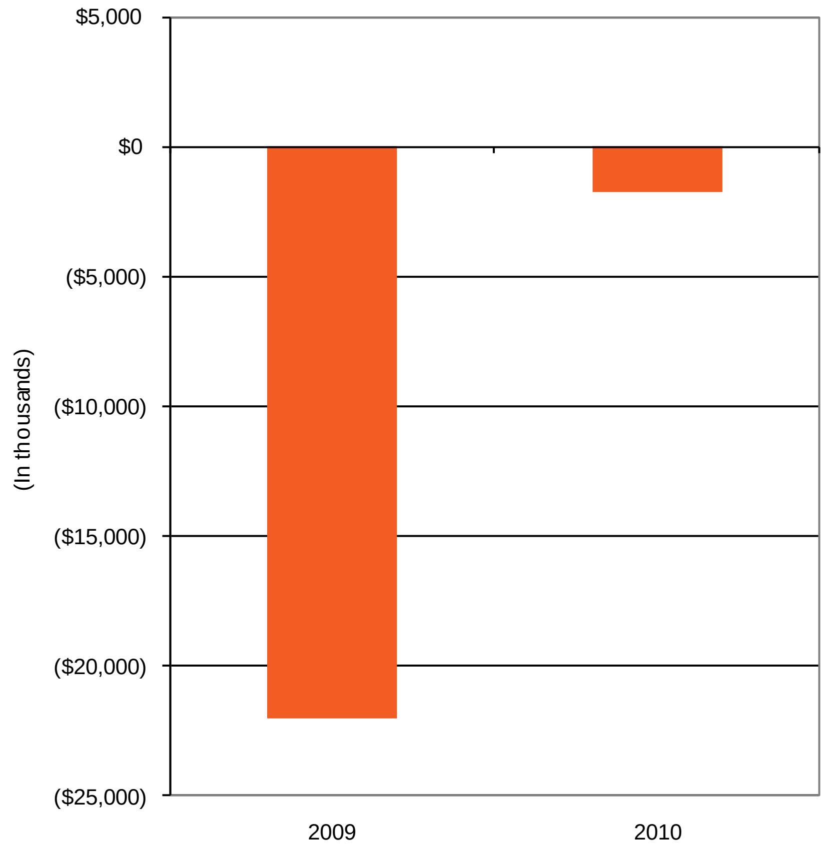


We earn federal fees from operating the guaranty agency. Under current law, ED pays us an annual account maintenance fee that is 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force. In addition, ED pays us a loan processing and issuance fee of 0.40% on disbursed loans, which we guarantee; however, ED does not pay this fee on new consolidation loans. Effective July 1, 2010, the loan processing and issuing fees will be substantially reduced due to the implementation of SAFRA.

For the years ended June 30, 2010 and 2009, federal fees were $45.0 million. As of June 30, 2010, the principal outstanding balance of loans guaranteed was $49.3 billion compared to $51.3 billion in 2009.

Default Aversion Fees, net

Years ended June 30



We earn default aversion fees when servicers involve us as guarantors to avert potential defaults and these fees are paid from the Federal Fund. The Federal Fund can only pay the default aversion fee once for a loan and if the loan subsequently defaults, we have to repay the fee to the Federal Fund. Since January 1, 2009, 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, 2010, default aversion fees were negative $1.8 million compared to a negative $22.0 million in 2009. The change in default aversion fees is due to a $20.0 million valuation adjustment during 2009 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, 2010, the increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was $5.2 million compared to an increase of $6.8 million in 2009. During 2010, the change was due primarily to the decline in the blended effective interest rate used to discount future cash flows.

Operating Expenses

The following table displays operating expenses. We have categorized operating expenses such as bank fees, building and grounds, telephone, and servicing liability as "other".

For the years ended June 30 (in thousands)		**2010**			2009	
Personnel and Benefits	$	**143,164**	**52.1%**	$	119,442	51.3%
Professional services		**44,012**	**16.0%**		34,385	14.8%
Information technology related expenses		**22,086**	**8.0%**		21,244	9.1%
Mail services		**20,792**	**7.6%**		18,131	7.8%
Depreciation		**10,122**	**3.7%**		11,528	5.0%
Other		**34,583**	**12.6%**		28,003	12.0%
	$	**274,759**	**100.0%**	$	232,733	100.0%

For the year ended June 30, 2010, operating expenses were $274.8 million, an 18.1% increase from $232.7 million in 2009. The increase in 2010 is mainly due to increases in personnel and benefits, professional services and costs associated with forward purchase contracts.

In the following section, we discuss changes in personnel and benefits, professional services and the provision for servicing liabilities included in other operating expenses.

Personnel and Benefits

The following table displays Personnel and Benefits expenses:

For the years ended June 30 (in thousands)		**2010**			2009	
Personnel and Benefits						
Compensation	$	**103,581**	**72.4%**	$	98,791	82.7%
Health care benefits for employees and retirees		**22,933**	**16.0%**		6,760	5.7%
Employer’s share of Social Security		**7,602**	**5.3%**		7,643	6.4%
Independent contractor fees		**7,217**	**5.0%**		5,903	4.9%
Retirement contributions		**3,249**	**2.3%**		3,259	2.7%
Capitalized software development costs		**(3,470)**	**(2.4%)**		(2,591)	(2.2%)
Other		**2,052**	**1.4%**		(323)	(0.2%)
	$	**143,164**	**100.0%**	$	119,442	100.0%

For the year ended June 30, 2010, personnel and benefit costs were $143.2 million, a 19.9% increase from $119.4 million in 2009. The changes in personnel and benefit costs are discussed below.

For the year ended June 30, 2010, healthcare benefits for employees and retirees were $22.9 million, an increase from $6.8 million in 2009. In 2010, the increase in healthcare benefits for employees and retirees is due to a change in the estimate related to the other post employment benefits liability that was recorded during 2009.

For the year ended June 30 2010, independent contracting costs were $7.2 million, a 22.0% increase from $5.9 million in 2009. We generally use independent contractors for specialized services, such as computer programming, and the costs vary based upon changes in computer programming initiatives.

For the year ended June 30, 2010, capitalized software development costs were $3.5 million, a 34.6% increase from $2.6 million in 2009.

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

The following table displays professional services expenses:

For the years ended June 30 (in thousands)		**2010**			2009	
Professional Services						
Collection agency fees	$	**29,953**	**68.1%**	$	22,633	65.8%
Legal fees		**5,986**	**13.6%**		4,990	14.5%
Default aversion outsourcing fees		**3,308**	**7.5%**		3,304	9.6%
Consulting fees		**1,764**	**4.0%**		494	1.4%
Audit fees		**1,306**	**3.0%**		1,159	3.4%
Other professional fees		**1,695**	**3.8%**		1,805	5.3%
	$	**44,012**	**100.0%**	$	34,385	100.0%

For the year ended June 30, 2010, collection agency fees were $30.0 million, a 32.7% increase from $22.6 million in 2009. The increase in collections agency fees during 2010 is due to aggressive collections on an increasing portfolio of defaulted loans.

For the year ended June 30, 2010, legal fees were $6.0 million, a 20.0% increase from $5.0 million in 2009. For the year ended June 30, 2010, consulting fees were $1.8 million, an increase from $494 thousand in 2009. The increase in legal and consulting fees is due to the debt refinancing activities and the creation of the PHEAA Student Loan Company II and III during December 2009 and January 2010.

Other Operating Expenses - Provision for Servicing Liability

We can incur losses on our portfolio of loans and on the portfolio of loans serviced by us for our clients by not meeting servicing regulations. We make estimates of the potential loan losses based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We present the provision for losses below as "servicing liability" within other operating expenses.

For the years ended June 30 (in thousands)		**2010**	2009
Balance at beginning of period	$	**9,115**	8,172
Provision for losses		**2,653**	3,596
Charge-offs		**(1,293)**	(2,653)
Balance at end of period	$	**10,475**	9,115
Ending balance of student loans serviced	$	**57,357,126**	59,455,487
Allowance as a percentage of ending balance of student loans		**0.02%**	0.02%

Changes in Net Assets

The following table shows the changes in net assets:

For the years ended June 30 (in thousands)		2010	2009
Operating income	$	**116,160**	60,581
Commonwealth of Pennsylvania grants		**455,497**	473,461
Federal grants		**7,186**	8,113
Grants and other financial aid		**(465,557)**	(474,953)
Grant funds returned to the Commonwealth of Pennsylvania		**(12,284)**	(16,802)
Transfers (to) from the Pennsylvania Higher Education Foundation		**(119)**	2,557
Changes in net assets	$	**100,883**	52,957

Grants and Other Financial Aid Activity

For the year ended June 30, 2010, grants and other financial aid were $465.6 million, a 2.0% decrease from $475.0 million in 2009. The following table displays self-funded financial aid awarded through our various programs along with state and federally funded programs.

For the years ended June 30 (in thousands)		2010	2009
Self-funded			
Keystone loan program origination fees and benefits paid on behalf of borrowers	$	**357**	1,750
Federal default fees paid on behalf of borrowers		**39**	25,880
Other		**(336)**	222
		60	27,852
State and federally funded			
State Grant Program		**411,784**	381,420
Institutional Assistance Grant Program		**27,526**	41,492
Matching Funds Program		**13,657**	13,952
New Economy Technology Scholarship Program		**3,354**	2,956
Other		**9,176**	7,281
		465,497	447,101
	$	**465,557**	474,953

Loans guaranteed between July 1, 2006 and June 30, 2010, were subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors were required to deposit the 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans were disbursed. The guarantor could assess the federal default fee to the lender, if so; the lender could 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. We suspended paying the federal default fee on behalf of borrowers for loans guaranteed between January 1, 2009 and June 30, 2010.

For the year ended June 30, 2010, self-funded financial aid was $60 thousand, a decrease from $27.9 million in 2009. In 2010, the decrease in the self-funded financial aid was due to the suspension of paying the federal default fees on behalf of borrowers on loans guaranteed on or after January 1, 2009.

For the year ended June 30, 2010, we paid fees totaling $39 thousand to the Federal Fund for loans disbursed from July 1, 2009 through June 30, 2010. 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.

Other Changes in Net Assets

For the year ended June 30, 2010, Commonwealth of Pennsylvania grants were $455.5 million, a 3.8% decrease from $473.5 million in 2009. The decrease during 2010 was due to the Commonwealth appropriating fewer funds to the State Grant Program due to the downturn in the economy.

For the year ended June 30, 2010, federal grants were $7.2 million, an 11.1% decrease from $8.1 million in 2009. The decrease during 2010 was mainly due to the timing of the funds received from the federal government.

For the year ended June 30, 2010, we contributed $119 thousand of services to PHEF compared to $443 thousand of services contributed during 2009. 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.

Debt Activity and Capital Assets

Student Loan Financings and Notes and Bonds Payable

The following table shows the changes in student loan financings and notes and bonds payable:

As of June 30 (in thousands)		**2010**	2009
Student loan financings	$	**3,078,517**	2,826,428
Student loan demand revenue bonds		**6,660,683**	8,535,125
Student loan financings and notes and bonds payable	$	**9,739,200**	11,361,553

As of June 30, 2010, student loan financings were $3.1 billion, a 10.7% increase from $2.8 billion in 2009. The increase during 2010 is due to the issuance of the 2009-1 and 2009-2, Class A-1, floating rate notes during December 2009. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details.

As of June 30, 2010, student loan demand revenue bonds were $6.7 billion, a 21.1% decrease from $8.5 billion in 2009. The decrease during 2010 is due to the debt financings that took place during December 2009 and January 2010. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details.

Capital and Other Financings

The following table shows the changes in capital and other financings:

As of June 30 (in thousands)		**2010**	2009
Capital financings	$	**61,093**	76,207
Other financings		**163,005**	198,648
Capital and other financings	$	**224,098**	274,855

As of June 30, 2010, capital financings were $61.1 million, a 19.8% decrease from $76.2 million in 2009. The decrease in 2010 is due to early repayment of various tax-exempt lines of credit and the scheduled payments on the capital acquisition bonds. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details.

As of June 30, 2010, other financings were $163.0 million, a 17.9% decrease from $198.6 million in 2009. The decrease in 2001 is due to the scheduled payments on a revolving line of credit and various debt financings. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details.

Debt Activity Financing

Due to the continued disruptions in the credit and financing markets, our principal funding need is securing capital to fund student loan purchases. Our enabling legislation imposes a debt limit. As of June 30, 2010, our debt limit was \$26.1 billion and our outstanding debt amounted to \$10.0 billion. As of June 30, 2009, our debt limit was \$25.5 billion and our outstanding debt amounted to \$11.6 billion.

The following table shows the financing (bond market and financial institutions) of our debt activity.

For the years ended June 30 (in thousands)		**2010**	2009
Capital market activity			
Repayment of student loan demand revenue bonds	$	**(1,170,800)**	(888,100)
Repayment of student loan auction rate security bonds		**(700,050)**	(67,550)
Proceeds from issuing student loan floating rate notes		**457,600**	-
Repayment of student loan floating rate notes		**(140,017)**	(88,094)
Student loan financings			
Proceeds from student loan variable rate funding notes		**619,355**	799,960
Repayment of student loan variable rate funding notes		**(102,830)**	-
Repayment of student loan financings		**(582,019)**	(358,000)
Capital financing activity			
Proceeds from capital financings		**-**	4,650
Repayment of capital financings		**(15,166)**	(5,130)
Other financing activity			
Repayment of lines of credit		**(46,000)**	(22,035)
Proceeds from term financings		**26,174**	60,680
Repayment of term financings		**(15,845)**	(1,795)

Capital Assets

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

As of June 30 (in thousands)		**2010**	2009
Land	$	**2,946**	2,946
Buildings and improvements		**33,908**	39,303
Software development		**8,211**	8,851
Purchased software		**826**	2,254
Other, principally information technology equipment		**10,603**	6,429
	$	**56,494**	59,783

The most significant ongoing capital item is software development. Mainly, our software development is customized systems for student financial aid processing that cannot be purchased from third party vendors. For the year ended June 30, 2010, we capitalized \$3.5 million of software development compared to \$2.6 million in 2009.

Net Asset Position

As of June 30, 2010, our net asset position was \$498.4 million. We have unrestricted net assets of \$215.3 million. Included in unrestricted net assets is \$32.5 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 $247.4 million. Of that amount, $247.0 million is related to our student loan notes, bonds and financings. Net assets restricted for financial aid grant programs amounted to $44.9 million. The deficit in net assets invested in capital assets, net of related debt of $9.1 million occurred because of differences between the timing of depreciation of the assets and principal payments on the debt.

As of June 30, 2009, our net asset position was $397.6 million. We have unrestricted net assets of $90.7 million. 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.

Federal Student Loan Reserve Fund

As a part of our guaranty operations, we manage the Federal Fund for the ED. We pay claims on defaulted loans out of the Federal Fund, which belongs to the federal government. The following table shows the changes in net assets in the Federal Fund.

For the years ended June 30 (in thousands)		**2010**	2009
Additions			
Reinsurance from the U.S. Department of Education	$	**1,239,030**	1,182,631
Collections on defaulted loans		**603,624**	468,508
Federal default fees		**34,016**	34,342
Net (depreciation) appreciation in fair value of investments		**(84)**	137
Total additions		**1,876,586**	1,685,618
Deductions			
Purchases of defaulted loans from lenders		**1,287,533**	1,231,032
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**429,550**	338,734
Reimbursement to PHEAA for our retention of defaulted loans collections		**158,404**	117,087
Default aversion fees, net		**18,285**	23,263
Total deductions		**1,893,772**	1,710,116
Net decrease		**(17,186)**	(24,498)
Net liabilities, beginning of period		**(28,990)**	(4,492)
Net liabilities, end of period	$	**(46,176)**	(28,990)

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

Because we were under the required ratio during the federal fiscal years ended September 30, 2005 and 2006, we submitted a management plan to ED on April 20, 2007 and ED approved the plan on May 22, 2007. The management plan included the option of foregoing the transfer of default aversion fees from the Federal Reserve Fund (FRF) to the Agency Operating Funds (AOF).

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 and adjustments agreed to in the management plan mentioned above.

(In thousands)		**June 30, 2010**	September 30, 2009
Generally accepted accounting principles – net assets	$	**(46,176)**	(27,017)
Deferred federal default fees		**2,870**	17,814
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund		**5,604**	7,143
Gain contingency – collections complement on future default collections		**150,905**	131,698
Default aversion fees payable to PHEAA, but not transferred from the Federal Reserve Fund		**103,768**	85,224
Regulatory net assets	$	**216,971**	214,862
Original principal outstanding	$	**49,311,598**	51,820,622
		0.44%	0.41%

For the year ended June 30, 2010, purchases of defaulted loans were $1.3 billion, which was an 8.3% increase from $1.2 billion in 2009. See **Note 4 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education** for more details.

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Contacting Us

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

Phone – 717 720-2540
Fax – 717 720-3923
Email – finmgt@pheaa.org

September 22, 2010

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, 2010 and 2009, 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 the 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 the PHEAA as of June 30, 2010 and 2009, and the changes in its net assets and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

The management's discussion and analysis on pages 2 through 30 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 inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

September 22, 2010

(In thousands)

		2010	2009
Interest revenue			
Student loans	$	**189,181**	344,060
Investments		**8,205**	7,598
Total interest revenue		**197,386**	351,658
Interest expense			
Student loan financings and notes and bonds payable		**155,824**	350,113
Capital and other financings		**9,455**	11,431
Total interest expense		**165,279**	361,544
Net interest revenue (expense)		**32,107**	(9,886)
Provision for loan losses		**(5,544)**	(2,344)
Net interest revenue (expense) after provision for loan losses		**26,563**	(12,230)
Noninterest revenue			
Servicing fees		**192,730**	164,864
Retention of collections on defaulted loans, net		**127,163**	110,521
Federal fees		**44,953**	45,045
Changes in fair value of residual interest, net		**5,175**	6,784
(Loss) gain on student loans sales, net		**(4,054)**	3
Default aversion fees, net of rebates		**(1,766)**	(22,031)
Other		**155**	358
Total noninterest revenue		**364,356**	305,544
Operating revenues		**390,919**	293,314
Operating expenses			
Personnel		**143,164**	119,442
Professional services		**44,012**	34,385
Information technology related expenses		**22,086**	21,244
Mail services		**20,792**	18,131
Depreciation		**10,122**	11,528
Other		**34,583**	28,003
Total operating expenses		**274,759**	232,733
Operating income		**116,160**	60,581
Commonwealth of Pennsylvania grants		**455,497**	473,461
Federal grants		**7,186**	8,113
Grants and other financial aid		**(465,557)**	(474,953)
Grant funds returned to the Commonwealth of Pennsylvania		**(12,284)**	(16,802)
Transfers (to) from the Pennsylvania Higher Education Foundation		**(119)**	2,557
Changes in net assets		**100,883**	52,957
Net assets, beginning of period		**397,563**	344,606
Net assets, end of period	$	**498,446**	397,563

See accompanying notes to financial statements.

Statements of Net Assets
As of June 30
(In thousands)

		2010	2009
Assets			
Cash and cash equivalents	$	**27,443**	29,514
Restricted cash and cash equivalents		**324,713**	367,096
Restricted cash and cash equivalents – due to customers		**78,794**	47,185
Investments		**182,429**	26,971
Restricted investments		**103,469**	124,042
Residual interest in off-balance sheet securitizations		**28,375**	23,200
Student loans receivable, net		**9,564,054**	11,169,840
Interest income receivable		**157,002**	197,302
Due from Federal Student Loan Reserve Fund, net		**32,475**	44,504
Capital assets, net		**56,494**	59,783
Deferred financing costs, net		**38,230**	42,047
Other assets		**48,225**	39,352
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**101,622**	107,655
Total assets		**10,743,325**	12,278,491
Liabilities			
Due to customers		**78,794**	47,185
Accounts payable and accrued expenses		**96,661**	89,680
Student loans financings and notes and bonds payable, net		**9,739,200**	11,361,553
Capital and other financings		**224,098**	274,855
Obligations under capital lease		**4,504**	-
Amounts related to the Federal Student Loan Reserve Fund		**101,622**	107,655
Total liabilities		**10,244,879**	11,880,928
Net assets			
Invested in capital assets, net of related debt		**(9,103)**	(16,424)
Restricted for debt service		**247,407**	263,489
Restricted for financial aid grant programs		**44,883**	59,819
Unrestricted		**215,259**	90,679
Total net assets	$	**498,446**	397,563

See accompanying notes to financial statements.

(In thousands)

		2010	2009
Cash flows from operating activities			
Interest received on student loans	$	**96,634**	285,871
Principal received on student loans		**1,131,277**	1,135,324
Student loan originations		**(340)**	(2,927)
Student loan purchases		**(23,226)**	(349,248)
Student loan sales, including net gains		**622,124**	(9,213)
Servicing fees		**186,258**	158,923
Retention of collections on defaulted loans		**139,192**	121,826
Federal fees		**45,012**	46,419
Default aversion fees, net of rebate		**(1,064)**	8,986
Other		**(3,899)**	358
Payment of operating expenses		**(249,242)**	(261,477)
Net cash provided by operating activities		**1,942,726**	1,134,842
Cash flows from noncapital financing activities			
Proceeds from the issuance of noncapital debt		**1,103,129**	860,640
Principal paid on noncapital debt		**(2,757,561)**	(1,425,574)
Interest paid on student loan financings and notes and bonds payable		**(165,699)**	(391,004)
Issuance costs		**1,254**	(861)
Commonwealth of Pennsylvania grants received		**455,497**	473,461
Federal grants received		**7,186**	8,113
Grants and financial aid paid		**(465,557)**	(474,743)
Grant funds returned to the Commonwealth of Pennsylvania		**(12,284)**	(16,802)
Transfers from the Pennsylvania Higher Education Foundation		**-**	3,000
Net cash used for noncapital financing activities		**(1,834,035)**	(963,770)
Cash flows from capital and related financing activities			
Proceeds from issuance of capital debt		**-**	4,650
Principal paid on capital debt		**(15,166)**	(5,130)
Interest paid on capital and other financings		**(9,150)**	(11,220)
Purchases of capital assets and development of software, net of disposals		**(2,329)**	(2,174)
Net cash used for capital and related financing activities		**(26,645)**	(13,874)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		**665,527**	531,494
Purchases of investments		**(800,412)**	(612,013)
Interest received on investments		**8,385**	8,017
Net cash used for investing activities		**(126,500)**	(72,502)
Net change in cash and cash equivalents (including restricted cash)		**(44,454)**	84,696
Cash and cash equivalents (including restricted cash), beginning of period		**396,610**	311,914
Cash and cash equivalents (including restricted cash), end of period	$	**352,156**	396,610

(continued)

(In thousands)

		2010	2009
Reconciliation of operating income to net cash provided by operating activities			
Operating income	$	**116,160**	60,581
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation		**10,122**	11,528
Student loan financings and notes and bonds payable interest		**165,699**	391,004
Capital and other financings interest		**9,150**	11,220
Investment interest		**(8,385)**	(8,017)
Amortization of premium on loan purchases		**42,116**	54,235
Amortization of loan origination costs		**(1,288)**	11,761
Amortization of deferred financing costs		**2,563**	7,109
Amortization of deferred amount on refundings of student loan demand revenue bonds		**(3,592)**	799
Accretion discount on capital and other financings		**80**	79
Transfers to the Pennsylvania Higher Education Foundation		**(119)**	(443)
Changes in assets and liabilities:			
Decrease in interest income receivable		**40,300**	58,535
Increase in residual interest in off-balance securitizations		**(5,175)**	(6,785)
Decrease in student loans receivable		**1,564,958**	594,369
Decrease in amounts due from Federal Student Loan Reserve Fund		**12,029**	41,558
Increase in other assets		**(8,873)**	(4,068)
Increase (decrease) in accounts payable and accrued expenses		**6,981**	(88,623)
Total adjustments		**1,826,566**	1,074,261
Net cash provided by operating activities	$	**1,942,726**	1,134,842

Noncash investing, capital and financing activities

We entered into $4.5 million of capital leases on various pieces of information technology equipment for the fiscal year ended June 30, 2010. See **Note 9 - Leases** for more details.

See accompanying notes to financial statements.

Note 1 – About PHEAA

Organization

Pennsylvania Higher Education Assistance Agency ("PHEAA"), doing business as American Education Services ("AES") and FedLoan Servicing ("FLS"), 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.

The Commonwealth of Pennsylvania (Commonwealth) presents our financial information as a discretely presented component unit in their Combined Annual Financial Report (CAFR). We are a discretely presented component unit of the Commonwealth due to the nature and significance of our relationship with the Commonwealth. The exclusion of this relationship would cause their financial statements to be misleading.

Blended Component Unit

We formed the 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, we can impose our will on the foundation, and it provides services entirely to us. As a blended component unit, we consolidate the transactions of the PHEAA Student Loan Foundation, Inc. into our financial statements.

On May 22, 2009, the PHEAA Student Loan Company, LLC (PHEAA SLC) was formed 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 FFEL program; 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 Loan Purchase Commitment Program with ED that was authorized under section 459A of the Higher Education Act (HEA). In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC, so PHEAA SLC is 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.

On November 2, 2009, the PHEAA Student Loan Company II, LLC (PHEAA SLC II) was formed 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 FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 10, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC II). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC II, so PHEAA SLC II is 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.

On November 2, 2009, the PHEAA Student Loan Company III, LLC (PHEAA SLC III) was formed 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 FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 12, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC III). The PHEAA

Student Loan Foundation is the sole equity member of PHEAA SLC III, so PHEAA SLC III is 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, we do not consolidate the transactions of PHEF into our financial statements, but we present them in the notes of the annual financial report.

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

As of May 31 (in thousands)		**2010**	2009
Assets:			
Cash	$	**70**	316
Short-term investments		**178**	277
Prepaid expenses		**-**	4
Contributions receivable, net		**1,000**	2,300
Long-term investments		**7,529**	21,382
Office furnishings and equipment, net of accumulated depreciation		**41**	46
Total assets		**8,818**	24,325
Liabilities and net assets			
Liabilities			
Accrued expenses		**330**	312
Grants payable		**601**	5,637
Amounts payable to specific organizations as designated by donors		**-**	92
Total liabilities		**931**	6,041
Net assets			
Unrestricted		**401**	375
Temporarily restricted		**7,486**	17,909
Total net assets		**7,887**	18,284
Total liabilities and net assets at end of year	$	**8,818**	24,325

For the years ended May 31 (in thousands)		2010	2009
Changes in unrestricted net assets:			
Revenues:			
Donated services	$	**179**	395
Income on long-term investments		**17**	44
Gain on sale of fixed assets		**11**	-
Net unrealized and realized gains (losses) on long-term investments		**(2)**	7
Total revenues		**205**	446
Net assets released from restrictions		**10,734**	19,558
Increase in unrestricted net assets		**10,939**	20,004
Expenses:			
Program services:			
Nursing Education Initiative			
Grants		**10,302**	17,631
Other program services		**113**	1,237
Total program services		**10,415**	18,868
Management and general		**484**	811
Fundraising		**14**	274
Total expenses		**10,913**	19,953
Net change in unrestricted net assets		**26**	51
Changes in temporarily restricted net assets:			
Contributions		**-**	117
Income on short-term investments		**1**	4
Income on long-term investments		**365**	856
Net unrealized and realized losses on long-term investments		**(55)**	(2,097)
Bad debt expense		**-**	(1,500)
Net assets released from restriction		**(10,734)**	(19,558)
Decrease in temporarily restricted net assets		**(10,423)**	(22,178)
Decrease in net assets		**(10,397)**	(22,127)
Net assets at beginning of year		**18,284**	40,411
Net assets at end of year	$	**7,887**	18,284

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. The purpose of HEF’s formation was 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; therefore, we do not consolidate the financial transactions of HEF into our financial statements. PHEF prepares consolidated financial statements that include transactions for HEF. Effective November 17, 2009, the Board of Directors voted to dissolve HEF.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation and Accounting

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 we report them 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 we report them using a cost-based measure. We report these amounts 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. We consider these amounts restricted and they 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. We report these amounts 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 we report these amounts using a cost-based measure.

Student Loans Receivable, net

We report student loans in the statement of net assets at their unpaid principal balances net an allowance for potential losses. We defer costs related to loan originations and premiums related to loan purchases and we recognize these costs over the life of the loan, after giving effect to estimated prepayments, as an adjustment of yield. We report the deferred amount as part of the principal balance of student loans.

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. We maintain the allowances at a level that we believe is adequate to absorb 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.

We report expenses related to risk sharing on defaults in the provision for loan losses, and we include the expenses related to servicing deficiencies in “other” operating expenses.

Capital Assets

We report capital assets at cost net of depreciation and estimated impairment, if any. We report assets held under capital leases at the present value of minimum lease payments net of amortization. We calculate depreciation based on the straight-line method over the estimated useful life of the asset. We amortize assets held under capital leases and leasehold improvements based on the straight-line method over the shorter of the lease term or the estimated useful life of the asset.

We capitalize purchased computer software if the per unit costs, based on per license fee, is $10,000 or more. We capitalize improvements or additions to existing software that constitute a capital outlay or increase the value or life of the asset by 25% of the original cost or life as a betterment and we record it as an addition of value to the existing asset. We calculate depreciation based 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. We expense the cost associated with the preliminary project and the post-implementation/operating phase. We capitalize internal and external costs associated with the application development phase. 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 at the time when 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. We capitalize upgrades and enhancements, as defined above. We report software development at cost net of amortization. We calculate amortization based 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. We amortize these costs over the term of the financing using the straight-line or effective interest method and these costs 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. We pay employees 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. We pay employees a portion of accumulated sick leave at retirement based upon a formula. We include in accrued expenses on the statements of net assets the estimated amounts payable upon retirement or termination under these arrangements.

Revenue Recognition

We recognize servicing fees as revenue when we provide the contractual services and when we record the unbilled amounts as accounts receivable. For federal loan processing and issuance fees related to our guaranty function, we recognize revenue as the guaranteed loans are disbursed, and we recognize account maintenance fees throughout the year at rates established by law. We recognize retention of collections on defaulted loans as revenue when we collect the cash on the 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. If the loan later defaults, we must return these fees to the Federal Fund at the time of the loan default. Since January 1, 2008, we have not recognized revenue related to default aversion fees, as we could not assure the ultimate collectability of this revenue due to the financial condition of the Federal Fund. However, the Federal Fund continues to recognize the entire default aversion fees as an expense when incurred.

We recognize student loan income as it is 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 FFEL program. 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. We accrued the special allowance 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.

We accrue interest on student loans 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 nine 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.

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. We do not report as a component of operating income the grants we receive and the grants and financial aid we disburse.

Advertising

We incur advertising expenses to generate additional business and to make sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. As we incur advertising expenses, we expense them. For the years ended June 30, 2010 and 2009, advertising expense was $37 thousand.

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. We do not report in our financial statements the securitized loans, bonds, and related income and expenses, since the securitization does not meet the financial reporting requirements of a component unit. See **Note 14 - Student Loan Securitizations** for more details.

For transactions qualifying as sales, we retain a residual interest, which we recognize 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 we reflect the changes in fair value of 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, we recognize the entire amount as revenue when we receive it.

Reclassifications

We have reclassified certain prior year amounts to conform to the current year's presentation.

Note 3 – New Accounting Pronouncements

During 2009, the GASB issued Statement No. 57 - *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. The objective of this Statement is to address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers). This Statement amends Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, to permit an agent employer that has an individual-employer OPEB plan with fewer than 100 total plan members to use the alternative measurement method, at its option, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates. This Statement is effective for reporting periods after June 15, 2011.

During 2010, the GASB issued Statement No. 59 – *Financial Instruments Omnibus*. The objective of this Statement is to update and improve the existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. This Statement is effective for reporting periods beginning after June 15, 2010.

Note 4 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education

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

As of June 30 (in thousands)		2010	2009
Assets			
Cash	$	**24,634**	31,695
Receivable from the U.S. Department of Education		**73,373**	64,242
Other receivables		**3,615**	11,718
Total assets		**101,622**	107,655
Liabilities			
Accounts payable and accrued expenses		**6,962**	15
Payable to the U.S. Department of Education		**1,723**	-
Deferred federal default fees		**2,870**	10,147
Amounts payable to PHEAA		**136,243**	126,483
Total liabilities		**147,798**	136,645
Net liabilities	$	**(46,176)**	(28,990)

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, 2010 and 2009, we have managed the cash flow of the Federal Fund in a manner to assure our customers that sufficient funds are available to continue to pay default claims by not transferring default aversion fees that are due to us. In addition to paying default claims, we pay our share of retention on defaulted loan collections from the fund.

Note 5 – 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.

As of June 30 (in thousands)		**2010**	2009
Cash and cash equivalents	$	**27,443**	29,514
Restricted cash and cash equivalents		**324,713**	367,096
Restricted cash and cash equivalents – due to customers		**78,794**	47,185
Carrying value	$	**430,950**	443,795
Cash on deposit, bank balance	$	**45,633**	15,841
Cash equivalents		**416,605**	457,627
Cash on deposit, bank balance (including cash equivalents)	$	**462,238**	473,468

The following table shows our investments and maturities as of June 30, 2010.

			Investment Maturities (in years)		
(In thousands)		Fair Value	Less than 1	1 to 10	More than 10
Cash equivalents					
Money market funds	$	254,996	254,996	-	-
Guaranteed investment contracts and agreements		125,026	125,026	-	-
Commercial paper		36,583	36,583	-	-
	$	416,605	416,605	-	-
Investments					
State Treasury investment pool	$	224,468	224,468	-	-
Guaranteed investment contracts and agreements		61,430	61,430	-	-
		285,898	285,898	-	-
	$	702,503	702,503	-	-

The following table shows our investments and maturities as of 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. As of June 30, 2010, we had $224.5 million invested in the State Treasury investment pool with a maturity of less than 1 year as compared to $87.5 million as of June 30, 2009.

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 in the following section.

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.

As of June 30, 2010, all of our investments in commercial paper were rated A-1 and higher. As of June 30, 2010, $125.0 million of our investments in guaranteed investment contracts and agreements were rated Aa2 and $61.4 million were rated B-. As of June 30, 2010, $75.8 million of our investments in money market funds were rated AAAm. As of June 30, 2010, $179.2 million of our money market funds and $224.5 million invested in the State Treasury investment pool were not rated.

As of June 30, 2009, all of our investments in commercial paper were rated A-1 and higher. As of 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 BB. As of June 30, 2009, $52.8 million of our investments in money market funds were rated AAAm. As of 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. As of June 30, 2010, $45.4 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. As of June 30, 2009, $15.6 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.

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 as of June 30, 2010.

(In thousands)	Issuer		Fair Value
Money market fund	Federated Fund Cash Manager	$	141,322
Money market fund	PFM Prime Money Market		75,413
Guaranteed investment agreement	Trinity Plus Funding Co.		125,026
Guaranteed investment contracts	MBIA, Inc		61,430

The following table shows investments in any one issuer that represent 5% or more of our total investments as of 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

Note 6 – Student Loans Receivable, net

The following table shows our student loan holdings.

As of June 30 (in thousands)		2010	2009
FFEL:			
Consolidation	$	**6,773,238**	7,315,493
Stafford		**2,176,939**	3,053,956
PLUS		**327,047**	425,898
Supplemental Loans for Students		**1,601**	1,378
		9,278,825	10,796,725
HEAL		**135,894**	161,415
Privately insured loans		**48,610**	51,509
Uninsured loans		**7,135**	6,094
Unamortized premium on loan purchases		**87,255**	134,905
Unamortized loan origination costs		**22,630**	33,037
		9,580,349	11,183,685
Allowance for loan losses		**(16,295)**	(13,845)
Student loans receivable, net	$	**9,564,054**	11,169,840

Allowance for loan losses

We estimated and established an allowance for loan losses based upon our continuing evaluation of our student loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We maintain the allowances for loan losses at a level that is adequate to absorb 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. In the next section, we report the "provision for losses" as "provision for loan losses" and as "other operating expenses" in the Statements of Revenues, Expenses, and Changes in Net Assets.

We present an analysis of our allowance for loan losses related to student loans in the following table.

As of June 30 (in thousands)		2010	2009
Balance at beginning of period	$	**13,845**	16,939
Provision for losses		**5,544**	2,344
Provision for losses – other operating expenses		**3,367**	1,216
Charge-offs		**(6,461)**	(6,654)
Balance at end of period	$	**16,295**	13,845

Note 7 – Capital Assets

Capital asset activity for the year ended June 30, 2010 was as follows:

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings and improvements		73,204	93	(7,068)	66,229
Software development		28,958	3,470	(15,187)	17,241
Purchased software		20,536	61	(4,496)	16,101
Other, principally information technology equipment		32,824	6,957	(1,717)	38,064
		158,468	10,581	(28,468)	140,581
Less accumulated depreciation for:					
Buildings and improvements		(33,901)	(1,759)	3,339	(32,321)
Software development		(20,107)	(4,110)	15,187	(9,030)
Purchased software		(18,282)	(1,476)	4,483	(15,275)
Other, principally information technology equipment		(26,395)	(2,777)	1,711	(27,461)
		(98,685)	(10,122)	24,720	(84,087)
	$	59,783	459	(3,748)	56,494

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

Depreciation expense for the years ended June 30, 2010 and 2009 was $10.1 million and $11.5 million, respectively.

Note 8 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings as of June 30, 2010 are as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan auction rate bonds, floating rate notes, demand revenue bonds, variable rate notes and financings:						
Student loan auction rate security bonds, due 2022 - 2047, at weighted-average rates of 1.28% as of June 30, 2010 and 1.16% as of June 30, 2009.	$	7,395,950	-	(700,050)	6,695,900	-
Deferred amount on current refunding of student loan auction rate security bonds.		(2,544)	-	204	(2,340)	-
Student loan floating rate notes, due 2016 - 2038, at weighted-average rates of 0.62% as of June 30, 2010 and 1.21% as of June 30, 2009.		1,277,949	457,600	(140,017)	1,595,532	-
Deferred amount on current refundings of student loan floating rate notes.		-	(5,006)	310	(4,696)	
Student loan demand revenue bonds, due 2016 - 2033, at weighted average rates of zero as of June 30, 2010 and 3.76% as of June 30, 2009.		1,170,800	-	(1,170,800)	-	-
Deferred amount on current refunding of student loan demand revenue bonds.		(6,581)	-	6,581	-	-
Student loan variable rate funding notes, due 2014 - 2015, at an estimated weighted-average rate of 0.63% as of June 30, 2010 and 0.74% as of June 30, 2009.		799,960	619,355	(102,830)	1,316,485	-
Deferred amount on current refunding of student loan variable rate funding notes.		-	(6,421)	740	(5,681)	
Student loan financings, due on demand at weighted-average rates of 1.07% as of June 30, 2010 and 1.08% as of June 30, 2009.		726,019	-	(582,019)	144,000	144,000
	$	11,361,553	1,065,528	(2,687,881)	9,739,200	144,000

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Capital financings:						
Capital acquisition bonds, due 2010 at weighted-average rates of 6.25% as of June 30, 2010 and 5.29% as of June 30, 2009.	$	76,286	-	(15,166)	61,120	61,120
Unamortized discount on capital acquisition bonds.		(78)	-	53	(25)	-
		76,208	-	(15,113)	61,095	61,120
Other financings:						
Line of credit, due 2010, at weighted-average rates of 2.76% as of June 30, 2010 and 2.82% as of June 30, 2009.		72,000	-	(46,000)	26,000	26,000
Capital acquisition refunding bonds, due 2010 - 2030, at weighted-average rates of 5.09% as of June 30, 2010 and 2009.		66,410	-	(1,865)	64,545	1,935
Unamortized discount on capital acquisition refunding bonds		(443)	-	27	(416)	-
Term financing, due 2029 - 2030, at zero percent interest as of June 30, 2010.		60,680	26,174	(13,980)	72,874	-
		198,647	26,174	(61,818)	163,003	27,935
	$	11,636,408	1,091,702	(2,764,812)	9,963,298	233,055

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. As of June 30, 2010, $9.7 billion of student loan principal and related interest receivable and $297.6 million of cash equivalents and related interest receivable collateralized the $10.0 billion of student loan financings and notes and bonds payable.

The student loan auction rate security bonds, floating rate notes, demand revenue bonds, variable rate funding notes and other term financings are non-recourse obligations to our unrestricted net assets and to the Commonwealth.

Student loan auction rate bonds, floating rate notes, demand revenue bonds, variable rate notes and financings

During 2009 and 2010, disruptions in the credit and financing markets continued to exist, which caused us to refinance certain student loan revenue bonds. Below is a discussion of the refinancing that took place during December 2009 and January 2010.

On December 10, 2009, we transferred $450.3 million of eligible student loans to the PHEAA SLC II. On December 9, 2009, we entered into a $2.3 million Certificate Purchase Agreement (CPA) with a financial institution. We issued a Class R certificate to the financial institution for the cash contribution mentioned above. The Class R certificate represents a residual interest in a portion of the trust estate that remains after the 2009-2 floating rate student loan asset-backed notes are paid in full. We used the proceeds mentioned above from the CPA to refinance a portion of the 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2 revenue bonds. We reported the CPA as a term financing and included it as an addition under "other financings" in the table above.

On December 10, 2009, the PHEAA SLC II 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 $436.4 million. On that same day, we entered into a $9.8 million Note Purchase Agreement (NPA) with a financial institution, which is non-recourse debt to us. The financial institution funded the NPA in consideration of the redemption or defeasance of the 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2 bonds that were subject to the asset-backed securities transactions conduit refinancing. We reported the NPA as a term financing and included it as an addition under "other financings" in the table above.

On December 10, 2009, we entered into a $4.5 million CPA with a financial institution. We issued a Class R certificate to the financial institution for the cash contribution mentioned above. The Class R certificate represents a residual interest in a portion of the trust estate that remains after the 2009-1 floating rate student loan asset-backed notes are paid in full. We used the proceeds mentioned above from the CPA to refinance a portion of the 2001 Series B, 2002 Series A and 2002 Series B revenue bonds. We reported the CPA as a term financing and included it as an addition under "other financings" in the table above.

On December 17, 2009 and December 21, 2009, we issued $188.8 million of series 2009-1, class A-1, floating rate student loan asset-backed notes and $268.8 million of series 2009-2 class A-1 and A-2 floating rate student loan asset-backed notes, respectively. The use of the proceeds for the above issued notes will be used (i) to fund initial deposits to a reserve account and to the capitalized interest account (both established under the indenture), (ii) to purchase certain student loans and (iii) to pay costs associated with the issuance of the notes. Furthermore, on the closing date, a portion of the proceeds categorized as "Deposit to Temporary Student Loan Subaccount" were applied to the repayment of certain outstanding indebtedness of PHEAA, which is secured in part by a pledge of student loans through the purchase of student loans. For more details on the new issues see the "Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-1, Class A-1" and the "Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-2" official statements dated December 17, 2009 and December 21, 2009, respectively.

On December 30, 2009, we fully redeemed the following bond issues: 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2.

On January 19, 2010, we entered into an $8.7 million NPA with a financial institution, whereas the financial institution purchased the NPA in consideration for the redemption of the remaining 2001 Series B, 2002 Series A and 2002 Series B revenue bonds. We reported the NPA as a term financing and included it as an addition under "other financings" in the table above.

On January 29, 2010, we made an intra-entity transfer of $188.6 million of principal and interest of student loans to the PHEAA SLC III. Previously, we entered into a variable FNPA with the Conduit through which the Conduit would purchase the variable FNPA at 97% of the collateral value of eligible student loans pledged or $182.9 million. On January 29, 2010, we received $182.9 million from the FNPA of which we used $1.6 million of the proceeds to fund a reserve account, pay attorney's fees and other costs associated with the FNPA.

On that same day, we used the $181.3 million of net proceeds from the FNPA and the $8.7 million of proceeds from the NPA to redeem the remaining portion of the 2001 Series B, 2002 Series A and 2002 Series B revenue bonds.

On July 30, 2010, we extended the maturity date on $144.0 million of student loan financings to July 31, 2011.

Capital financings

Capital financings are collateralized with capital assets. During the year ended June 30, 2010, we paid off $13.7 million of tax-exempt lines of credit prior to maturity.

Other financings

As part of a mandatory reduction of revolving credit commitment with a financial institution, we reduced our line of credit by $46.0 million during the year ended June 30, 2010. On August 16, 2010, we paid off the remaining $26.0 million of a revolving line of credit prior to maturity.

Debt service requirements

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, 2010.

(In thousands)		Student Loan Notes, Bonds and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2011	$	144,000	103,919	89,055	7,823
2012		-	103,792	1,965	5,340
2013		-	103,792	2,040	3,133
2014		730,210	103,767	2,125	3,031
2015		586,274	97,466	2,220	2,924
2016-2020		113,428	476,643	12,709	12,858
2021-2025		423,390	468,817	16,160	9,368
2026-2030		557,559	454,903	93,500	4,922
2031-2035		-	428,991	4,765	459
2036-2040		1,348,456	409,284	-	-
2041-2045		2,131,850	289,499	-	-
2046-2050		3,716,750	40,561	-	-
	$	9,751,917	3,081,434	224,539	49,858

As of June 30, 2010, $9.7 billion of the $10.0 billion of the student loan notes, bonds and financings are variable-rate debt. $6.0 billion resets based upon auctions every 28 days. $711.0 million resets based upon auctions every 35 days. $1.7 billion is indexed to the 1-month or 3-month LIBOR, $22.0 million is indexed to 3-month financial commercial paper, and $1.3 billion is conduit financing.

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 as of June 30, 2009 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan auction rate security bonds, demand revenue bonds, floating rate notes, financings and variable rate funding notes:					
Student loan auction rate security bonds	$ 7,463,500	-	(67,550)	7,395,950	-
Deferred amount on current refundings of student loan auction rate security bonds	(2,747)	-	203	(2,544)	-
Student loan demand revenue bonds	2,058,900	-	(888,100)	1,170,800	-
Deferred amount on current refundings of student loan demand revenue bonds	(7,178)	-	597	(6,581)	-
Student loan floating rate notes	1,366,043	-	(88,094)	1,277,949	-
Student loan financings	1,084,019	-	(358,000)	726,019	726,019
Student loan variable rate funding notes	-	799,960	-	799,960	-
	11,962,537	799,960	(1,400,944)	11,361,553	726,019
Capital financings:					
Capital acquisition bonds	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
Other financings:					
Line of credit	94,035	-	(22,035)	72,000	72,000
Capital acquisition refunding bonds	68,205	-	(1,795)	66,410	1,865
Unamortized discount on capital acquisition refunding bonds	(470)	-	27	(443)	-
Term financings	-	60,680	-	60,680	-
	161,770	60,680	(23,803)	198,647	73,865
	$ 12,200,944	865,290	(1,429,826)	11,636,408	810,266

Note 9 – Leases

Operating Lease

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 $10.5 million in 2010 and $11.5 million in 2009.

During March 2010, we sold a building for $4.7 million and simultaneously entered into an agreement to lease back the first floor of the building. The sale leaseback met the requirements of an operating lease.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) as of June 30, 2010 are:

(In thousands)		
2011	$	11,254
2012		6,941
2013		4,559
2014		1,203
2015 and thereafter		449
Total minimum lease payments	$	24,406

Capital Lease

We entered into capital leases on various pieces of information technology equipment. As of June 30, 2010, our obligations under capital leases were $4.5 million compared to zero for 2009.

Note 10 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

We contribute to the Commonwealth of Pennsylvania State Employees' Retirement System ("SERS"). SERS was established under the provisions of Public Law 858, No. 331. SERS is the administrator of a cost-sharing multiple-employer defined benefit retirement plan established by the Commonwealth to provide pension benefits for employees of state government and certain independent agencies. SERS is a component unit of the Commonwealth and is included in the Commonwealth's financial report as a pension trust fund.

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 provision of the plan to the General Assembly.

Employees who retire at age 60 with three years of service or with 35 years of service if under age 60, are entitled to a normal annual retirement benefit. Most members of SERS, and all state employees hired after June 30, 2001 are Class AA members. The multiplier for Class AA is 1.25, which translates into an annual benefit of 2.5% of the member's highest three-year average salary times years of service. Most members vest with five years of credited service.

As a pension trust fund of the Commonwealth, SERS issues an audited comprehensive annual financial report (CAFR) that includes financial statements and required supplementary information. The SERS CAFR is available on-line at www.sers.state.pa.us, select "Publications" and select "CAFR – Comprehensive Annual Financial Reports". Written requests for the SERS CAFR should be directed to the following address: State Employees' Retirement System, 30 North Third Street, Suite 150, Harrisburg, Pennsylvania 17101-1716.

Funding Policy

The board of directors of SERS establishes our contribution requirements. Members are required to contribute to the plan and most member contribution rates are set at 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, 2010 and 2009, the required employer contribution rate was 3.15% and 3.29%, respectively. Effective July 1, 2010, our contribution rate will be 4.11% for fiscal year 2010-11. SERS projects the employer contribution rates will increase to 8.00% for fiscal year 2011-12; and the projected contribution rates are to rise and remain above 20% of payroll through fiscal year 2031-32. For the year ended June 30, 2010 and 2009, our contributions were $3.2 million and $3.3 million, respectively and these contributions were equal to the required contributions set by SERS.

Postemployment Benefits

Plan Description

The Commonwealth of Pennsylvania (Commonwealth) 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 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 CAFR for the year ended June 30, 2010.

Funding Policy

We contribute to the plan at a rate determined each year by the Office of Administration. For the year ended June 30, 2010, the contribution rate was $202 thousand per month or $2.4 million annually. This rate was based on a per retiree cost of $10 thousand annually times the estimated number of PHEAA retirees enrolled in the REHP. As of June 30, 2010, we have made all required contributions to the REHP as determined by the Office of Administration. For the year ended June 30, 2009, the contribution rate was $215 thousand per month or $2.6 million annually. This rate was based on a per retiree cost of $9 thousand annually times the estimated number of PHEAA retirees enrolled in REHP. Effective July 1, 2010, our contribution rate will be $250 thousand per month or $3.0 million annually. This current level of funding is subject to future adjustments at the beginning of each fiscal year, based upon projected retiree costs and the number of future retirees.

Employees who retire on or after July 1, 2007, and elect REHP coverage are required to contribute to the cost of coverage. The annual retiree contribution rate is a percentage of the employee's final annual gross salary at the time of retirement equal to the active employee contribution rate in effect on the date of retirement and is payable monthly at the rate of one-twelfth of the annual retiree contribution rate.

Allocated Other Postemployment Benefit (OPEB) Obligation

The net OPEB obligation is the cumulative difference between the annual OPEB cost and the employer's contributions to a plan. The Commonwealth has an actuarial valuation performed on their Post-Retirement Medical Plan in order to provide an estimate of the actuarial accrued liability and the annual required contribution (ARC).

As of June 30, 2010, the Commonwealth's REHP OPEB obligation was $648.0 million, which was an increase from $313.0 million for 2009. The Commonwealth allocates the REHP OPEB obligation based on the ratio of projected payroll by employees in each department supporting the Commonwealth's business activity or component unit or organization, to the total projected payroll for all employees of the Commonwealth as referenced in the October 2009 actuarial valuation. Based on the payroll formula mentioned above, as of June 30, 2010, the Commonwealth determined our allocated share of the REHP OPEB obligation is $17.6 million, which is an increase from $8.5 million for 2009. These amounts have not been recorded in the accompanying financial statements, since the Commonwealth is ultimately responsible for the funding of the REHP OPEB obligation. However, as stated under the "Funding Policy" section above, the Office of Administration determines our required contribution rate to the REHP that is based on an annual per retiree cost times the estimated number of PHEAA retirees enrolled in the REHP. For the year ended June 30, 2010, our required contribution was $2.4 million, which was a decrease from $2.6 million for the year ended June 30, 2009.

For additional information on the REHP including the Commonwealth's total OPEB expenses, funded status, funding progress, actuarial accrued liability, and the actuarial assumptions used to determine these amounts for the Commonwealth's REHP, a complete actuarial report is available for review at www.budget.state.pa.us (select Financial Reports and under the heading "Special Reports" select "Actuarial Valuation of the Commonwealth's Post-Retirement Medical Plan (October 2009)).

Note 11 – Servicing Fees

We service student loans that we own and for third parties through our Commercial Servicing and FedLoan Servicing (FLS) lines of business. We also offer Remote Servicing, which is limited to data processing functions. We service student loans for federal and state agencies, commercial and private lenders throughout the United States. As a servicer, we are responsible for servicing, maintaining custody of, and making collections on student loans.

For the year ended June 30, 2010, servicing revenues were $192.7 million, which was a 16.9% increase from $164.9 million for 2009. As of June 30, 2010, we were servicing an average of $54.7 billion of loans for customers, which was a 13.0% increase from $48.4 billion in 2009. As of June 30, 2010, customers using our computer services serviced an average $32.8 billion of loans, which was a 4.1% decrease from $34.2 billion in 2009. For the year ended June 30, 2010, other FFELP guarantors were managing on average $4.4 billion of guarantees using our computer services, which was a 2.3% increase from $4.3 billion in 2009.

Our servicing agreements, some of which expired during the fiscal year ended June 30, 2010, 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.

For the year ended June 30, 2010, five loan-servicing customers provided $85.4 million of servicing fees. For the year ended June 30, 2009, six loan-servicing customers provided $83.9 million of servicing fees. No other individual customer provided servicing revenues more than 5% of total servicing fees for the years ended June 30, 2010 and 2009.

Note 12 – Segment Information

We generally finance student loan portfolios by issuing notes, bonds, and other financings and we pledge the earnings to support the debt. Because we pledge the revenue stream of the student loan portfolios 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)		**2010**	2009
Interest revenue	$	**206,339**	367,715
Interest expense		**155,824**	350,113
Net interest revenue		**50,515**	17,602
Provision for loan losses		**(5,335)**	(2,338)
Net interest revenue after provision for loan losses		**45,180**	15,264
(Loss) gain on student loan sales, net		**(3,390)**	3
Total operating revenues		**41,790**	15,267
Operating expenses		**61,073**	74,009
Operating loss		**(19,283)**	(58,742)
Financial aid		**(179)**	(1,405)
Loss before transfers		**(19,462)**	(60,147)
Transfers from unrestricted net assets		**5,630**	67,942
Change in net assets		**(13,832)**	7,795
Net assets, beginning of period		**260,848**	253,053
Net assets, end of period	$	**247,016**	260,848

Statement of Net Assets

As of June 30 (in thousands)		**2010**	2009
Restricted cash and cash equivalents	$	**318,010**	360,250
Student loans receivable, net		**9,508,117**	11,070,568
Other, principally interest income receivable		**191,825**	235,215
Total assets		**10,017,952**	11,666,033
Student loan financings and notes and bonds payable, net		**9,739,200**	11,361,553
Other, principally accrued interest payable		**31,736**	43,632
Total liabilities		**9,770,936**	11,405,185
Net assets, restricted for debt service	$	**247,016**	260,848

Statements of Cash Flows

For the years ended June 30 (in thousands)		2010	2009
Cash flows from operating activities			
Interest received on student loans	$	**98,288**	285,259
Principal received on student loans		**1,145,688**	1,117,395
Student loan originations		**(10)**	(1,584)
Student loan purchases		**(37,603)**	(347,470)
Student loan sales, including net gains		**592,461**	9,097
Payment of operating expenses		**(63,951)**	(74,724)
Net cash provided by operating activities		**1,734,873**	987,973
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		**1,076,954**	799,962
Principal paid on noncapital debt		**(2,695,716)**	(1,401,744)
Interest paid on student loan financings and notes and bonds payable		**(165,699)**	(391,006)
Other		**6,706**	65,676
Net cash used for noncapital financing activities		**(1,777,755)**	(927,112)
Cash flows from investing activities			
Interest received on investments		**642**	3,163
Net cash provided by investing activities		**642**	3,163
Net change in restricted cash and cash equivalents		**(42,240)**	64,024
Restricted cash and cash equivalents, beginning of period		**360,250**	296,226
Restricted cash and cash equivalents, end of period	$	**318,010**	360,250

During 2009, we suspended the recycling of new loans into all trusts.

There are 10 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 1.002 to 1.063 as of June 30, 2010. Four of the trusts have a minimum parity ratio requirement and as of June 30, 2010, the trusts complied with the minimum parity ratio requirement.

The master trust that issued auction rate securities holds $6.7 billion of debt. The parity ratio for this trust is 1.002 as of June 30, 2010 and 1.001 as of June 30, 2009. There is no parity ratio requirement for this trust.

Note 13 – Restrictions on Net Assets

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 FFEL 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.

As of June 30, 2010, net assets restricted for debt service amounted to $247.4 million. Of that amount, $247.0 million is related to net assets held under various indentures related to financing our student loan portfolios, and the remaining $400 thousand is related to capital and other financings.

As of June 30, 2009, net assets restricted for debt service amounted to $263.5 million. 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 is related to capital and other financings.

As of June 30, 2010, $44.9 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. As of June 30, 2009, $59.8 million of net assets were restricted for financial aid grant programs.

Note 14 – 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 and we report it 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.

As of June 30 (dollars in thousands)		**2010**	2009
Present value of residual interest	$	**28,375**	23,200
Weighted average life		**10.00 years**	11.00 years
Constant prepayment rate		**4.0%**	4.0%
Residual cash flow discount rate		**4.8%**	5.1%

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 we 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, 2010, we earned $2.9 million of administration fees as compared to $3.3 million in 2009. We report the amount earned in servicing fees on the statements of revenues, expenses, and changes in net assets.

We present condensed unaudited financial information for the PHEAA Student Loan Trust I in the following table:

As of June 30 (in thousands)		2010	2009
Assets:			
Cash and cash equivalents	$	**23,839**	27,066
Student loans receivable, net		**553,006**	616,350
Interest income receivable		**4,918**	5,803
Other assets		**2,515**	2,948
Total assets		**584,278**	652,167
Liabilities:			
Notes payable	$	**548,778**	623,278
Interest payable		**1,973**	2,047
Other liabilities		**5,212**	4,146
Total liabilities		**555,963**	629,471
Net assets	$	**28,315**	22,696

Note 15 – 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. 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.

Due to our inability to access the credit and/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, 2010, we have student loan purchase commitments of $91.9 million that we have been unable to fund or settle. Most of the student loan purchase commitments are with financial institutions and we continue to work with those financial institutions to resolve the outstanding commitments.

On December 8, 2008, an independent accounting firm, on behalf of ED, Federal Student Aid (FSA), issued a report of their review of the 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 PHEAA $11.2 million based on three of the four original findings. On May 20, 2009, PHEAA responded to these findings assessed by ED. PHEAA timely appealed the findings on March 9, 2010. On April 16, 2010, PHEAA's notification from ED indicated that they would not pursue two of the four original findings. However, ED indicated that the remaining two findings remained open pending PHEAA's appeal. On June 24, 2010, ED provided notice that the remaining two findings and program review may now be considered closed. There were no amounts assessed against PHEAA.

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 (IDR) (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. On May 28, 2009, we responded to Request No. 2. On April 23, 2010, we received an IDR (Request No. 3) asking (i) to provide statements/documents to reconstruct the 2002 Series original loan allocation for settlement purposes and (ii) to provide an update on the status report for the 2002 bonds (i.e. outstanding, retired, refunded, etc.). On May 7, 2010, we responded to Request No. 3. On May 13, 2010, we received an amendment to Request No. 3, which requested a revised detailed investment report and/or revised rebate report for the 2002 Series revenue bonds. The IRS set a response date of June 4, 2010 for the information requested in the Request No. 3 (Amended). On June 2, 2010, the IRS stated we should disregard the response date of Request No. 3(Amended) until final resolution guidelines were issued. As of June 30, 2010, it is difficult to estimate our potential liability with 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 PHEAA 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 borrower/plaintiff filed a new legal action against us and the lender alleging that we violated the Fair Credit Reporting Act. On August 25, 2010, at a court-ordered settlement conference in this matter and in the presence of the presiding judge, the parties reached an oral agreement on a tentative settlement in this matter. Upon execution of the settlement agreement, this matter will be closed. We consider the above settlement to be immaterial and we have not accrued for it in the accompanying June 30, 2010 financial statements.

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.

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, 2010, it is difficult to estimate our potential liability and we are currently investigating the number of consolidation loans affected.

On August 26, 2009, PHEAA was served with a copy of a First Amended Complaint in the matter of *Jon H. Oberg v. Nelnet, Inc., et al.*, Civil No. 1:07-cv-960, pending in the United States District Court for the Eastern District of Virginia. This is a Federal False Claims Act case filed by a former employee of the United States Department of Education. The matter was originally filed under seal in 2007, and the plaintiff was not permitted to serve the defendants until August 2009. The Department of Education elected not to intervene in the prosecution of the action. In short, the plaintiff alleged that PHEAA and the other named defendants illegally submitted claims for 9.5% floor loan special allowance payments in violation of applicable law and regulatory guidance. Separately, PHEAA resolved a program review finding with the United States Department of Education regarding a discrete portion of its 9.5% floor loan portfolio and received through requisite audits by the United States Department of Education’s independent auditing firm approval to continue billing its 1st and 2nd generation 9.5% floor loans.

As for the lawsuit, on December 1, 2009, the trial court granted PHEAA's request to dismiss the lawsuit as to PHEAA. Thereafter, the plaintiff's attorney advised that he may appeal this decision once the lawsuit resolved as to the additional defendants. To date, the lawsuit against the additional defendants continues.

On November 30, 2009, St. Joseph's Hospital School of Nursing, Inc. ("St. Joseph's") filed a Statement of Claim before the Board of Claims of the Commonwealth of Pennsylvania. Previously, PHEAA had acted as a lender under an Interim Nursing School Loan Program for students attending St. Joseph's, but lending activities were suspended in October 2008. St. Joseph's alleged that PHEAA, through its President and Chief Executive Officer, members of its Executive Team, and persons allegedly acting on behalf of PHEAA Board Members, made various representations and agreements to renew its lending activities for the students of St. Joseph's beyond October 2008. According to St. Joseph's, when PHEAA allegedly breached its promises, St. Joseph's was forced to advance funds directly to its students. St. Joseph's seeks damages under both breach of contract and promissory estoppel theories for the amount of funds St. Joseph's advanced to the students as a result of PHEAA's decision to not make additional loans.

On January 28, 2010, St. Joseph's filed an Amended Statement of Claim, which essentially restated its position as noted above. On April 6, 2010, the Board of Claims voluntarily issued an Order stating that it lacked subject matter jurisdiction to hear the case, and transferred the matter to the Commonwealth Court of Pennsylvania for additional adjudication. Discovery is ongoing and we will continue to defend against this action. As of June 30, 2010, it is difficult to estimate our potential liability on this complaint due to the speculative nature of the damages.

On April 8, 2010, PHEAA was served with an amended complaint naming it as a defendant in the case captioned "The Education Loan Zone, LLC v. SunTrust Bank, et. al.", pending in the United States District Court for the District of Maryland (CCB-CV-09-993). This civil action involves a commercial dispute between SunTrust Bank and its marketing subcontractor, The Education Loan Zone, LLC (TELZ). PHEAA, SunTrust Bank, and TELZ entered into a three party agreement governing SunTrust's sourcing of alternative student loan applications to TELZ for PHEAA's origination and servicing of SunTrust's alternative student loan products. The amended complaint filed by TELZ against PHEAA is comprised of two causes of action: breach of contract and tortious interference with the contractual relationship between TELZ and SunTrust Bank. On June 7, 2008, we filed our answer, affirmative defenses and counterclaim against TELZ. On June 8, 2008, we filed a third party complaint against NextStudent, a subcontractor of TELZ. On August 5, 2010, the parties signed and executed a global release and settlement agreement. On August 6, 2010, the court signed an order of dismissal with prejudice. There was no assessment or apportionment of liability against PHEAA, nor any payment by PHEAA. This matter is closed.

A lender for which we originate and service alternative loans has preliminarily identified certain alleged origination irregularities to which the lender attributes a provisional rejection of the guarantee on certain alternative loans. We do not agree that the origination was in any way inconsistent with the lender's documented requirements. We continue to investigate the lender's concerns and work toward an amicable resolution of this issue. At this time, it is difficult to estimate our potential liability on this issue.

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.