Annual Financial Report
June 30, 2011 and 2010

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

This discussion and analysis of the financial performance of the 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 (Commonwealth) 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 2009 was 6.0%, which was below the national industry average of 8.8%. Our cohort default rate for fiscal year 2008 was 5.7%, which was below the national industry average of 7.0%.

We guarantee Federal Stafford, PLUS and consolidation loans, which were originated before July 1, 2010. As of June 30, 2011, the original principal balance outstanding of student loans guaranteed was $45.1 billion as compared to $49.3 billion as of June 30, 2010.

We service student loans that we own and loans owned by third parties through our Commercial Servicing, Remote Servicing and FedLoan Servicing (FLS) lines of business. Our Commercial Servicing line of business services alternative and Federal Family Education Loan (FFEL) program loans. Our Remote Servicing line of business provides our system to other servicers to use. Our FLS line of business services federally owned FFEL and William D. Ford (Direct Loan) program loans.

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)		**2011**	2010
Self-funded			
Costs of operating state and federal governmental programs	$	**12,698**	13,618
Keystone loan program origination fees and benefits paid on behalf of borrowers		**871**	357
Support of the Pennsylvania Higher Education Foundation, Inc.		**113**	119
Other public service activities and outreach		**1,038**	1,120
		14,720	15,214
Financial support funded by our business partners			
Keystone loan program origination fees and benefits paid on behalf of borrowers		**105**	167
	$	**14,825**	15,381

We administer various programs to help students pursue higher education with the most significant Commonwealth programs as follows:

- The Pennsylvania State Grant Program is the largest of the Commonwealth supported student aid programs with approximately 190 thousand recipients for the 2010 - 2011 award year. The maximum State Grant Program award was $3,541 for the 2010 - 2011 award year. During the 2009 - 2010 award year, the maximum State Grant Program award was $4,120.

  For the 2011 – 2012 award year, Governor Corbett's appropriation recommendation for the Pennsylvania State Grant Program was $380.9 million. On April 28, 2011, the Board of Directors approved an estimated maximum award of $3,853, which will allow approximately 175 thousand recipients to be eligible for the Pennsylvania State Grant Program for the 2011 – 2012 academic year.

  On June 16, 2011, the Board of Directors announced the approval of a $50 million public service contribution to the Commonwealth, which the Commonwealth will use to supplement the Pennsylvania State Grant program. Our business earnings funded this contribution and is in addition to the $10 million that we incur annually to administer the Pennsylvania State Grant Program at no cost to taxpayers. This contribution will increase the award amounts and the number of recipients for the 2011 - 12 award year. The maximum Pennsylvania State Grant award will increase from $3,853 to $4,348. In addition, the contribution will benefit community college students by moving the annual Pennsylvania State Grant program application deadline for non-renewal students from May 1 to August 1, which is expected to provide awards to approximately 33,000 students.

  On June 30, 2011, Governor Corbett signed into law the general appropriations bill for the 2011 - 12 fiscal year. The final appropriation for the Pennsylvania State Grant Program was $380.9 million for the 2011-12 award year.

- The Institutional Assistance Grants (IAG) Program serves as an integral part of the Commonwealth's commitment to the development and preservation of a planned system of postsecondary education. The IAG program goals are fulfilled through formula grants, which help non-profit independent, postsecondary institutions to maintain enrollment levels and stabilize costs.

- 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 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 for students attending public colleges and universities in Pennsylvania.

We founded the Pennsylvania Higher Education Foundation, Inc., ("PHEF") which is a tax-exempt organization that supports postsecondary education. PHEF disbursed $7.4 million in grants during its most recent fiscal year ended May 31, 2011, as compared to $10.3 million during 2010. PHEF created the Nursing Education Grant Program and disbursed $5.2 million in grants under this program during its most recent fiscal year ended May 31, 2011, as compared to $7.0 million during 2010.

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.

Operations

Our primary operations involve guaranteeing, servicing, and loan origination and purchasing.

Guaranty Activities

We guarantee at least 97% of the principal and accrued interest on Stafford, PLUS, SLS and Consolidation loans made by a lender prior to July 1, 2010, in which the lender is party to a guarantee agreement with us.

We have a federal reinsurance agreement and a supplemental guarantee agreement with ED in which ED will reimburse us for at least 75%, and as much as 100%, of amounts expended resulting from defaulted loans, depending on the default rate for that fiscal year and the year that the loans were guaranteed. In addition, we have agreements with ED in which ED will reimburse us for 100% of the amounts expended by us resulting from the bankruptcy, death or disability of the borrower.

We manage the Federal Student Loan Reserve Fund (Federal Fund) for ED, so there is enough money to pay lenders when their normal collection efforts fail and a borrower defaults on a student loan. ED 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%

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.

Once the borrower meets the above program requirements, the borrower regains all benefits of the loan program, including any remaining deferment eligibility.

Servicing Activities

We service student loans that we own and loans owned by third parties through our Commercial Servicing and FLS lines of business. We also provide systems for other servicers and guarantors to use, which are limited to data processing functions, through our Remote Servicing line of business. Furthermore, as a servicer, we are responsible for maintaining and pursuing collections on student loans.

Our Commercial Servicing line of business services student loans that were originated under the FFEL program, prior to July 1, 2010, and various alternative loan programs. Our FLS line of business services student loans that were originated under the Direct Loan program and the FFEL program, which are now owned by the Department of Education. The FFEL and the Direct Loan programs are federal programs that allow undergraduate or graduate students at eligible postsecondary schools to obtain loans.

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.

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 converted all new federal student lending to the Direct Loan program beginning July 1, 2010.

The Direct Loan program was originally 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.

Loan Origination and Purchasing

SAFRA terminated our authority to originate new loans under the FFEL program after June 30, 2010. All new Stafford, PLUS and Consolidation student loans are originated under the Direct Loan program.

In the past, we issued revenue bonds and used the proceeds to make various types of student loans. We also purchased student loans from banks and other lenders. We suspended our activities as a FFEL program lender for any new loans first disbursed on or after March 7, 2008. However, we continue to earn interest subsidies and special allowance payments based on the types of student loans held within our portfolio.

ED makes interest subsidy payments to holders of qualifying FFEL program loans under the Higher Education Act of 1965, as amended, on subsidized Stafford loans while the student is a qualified student, during a grace period and during periods of deferment. ED pays the interest subsidy payments based on the amount of interest accruing on the unpaid balance, prior to the commencement of repayment or during the deferment period. We record the interest subsidy payments as "Student Loan Interest Revenue".

ED makes special allowance payments to holders of qualifying insured loans and guaranteed loans, subject to certain requirements under the Higher Education Act of 1965, as amended. ED makes the 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. We record the special allowance payments as "Student Loan Interest Revenue".

Special allowance rates vary according to the date of the loan disbursement, the loan period and the loan status. ED calculates the special allowance rates 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.

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

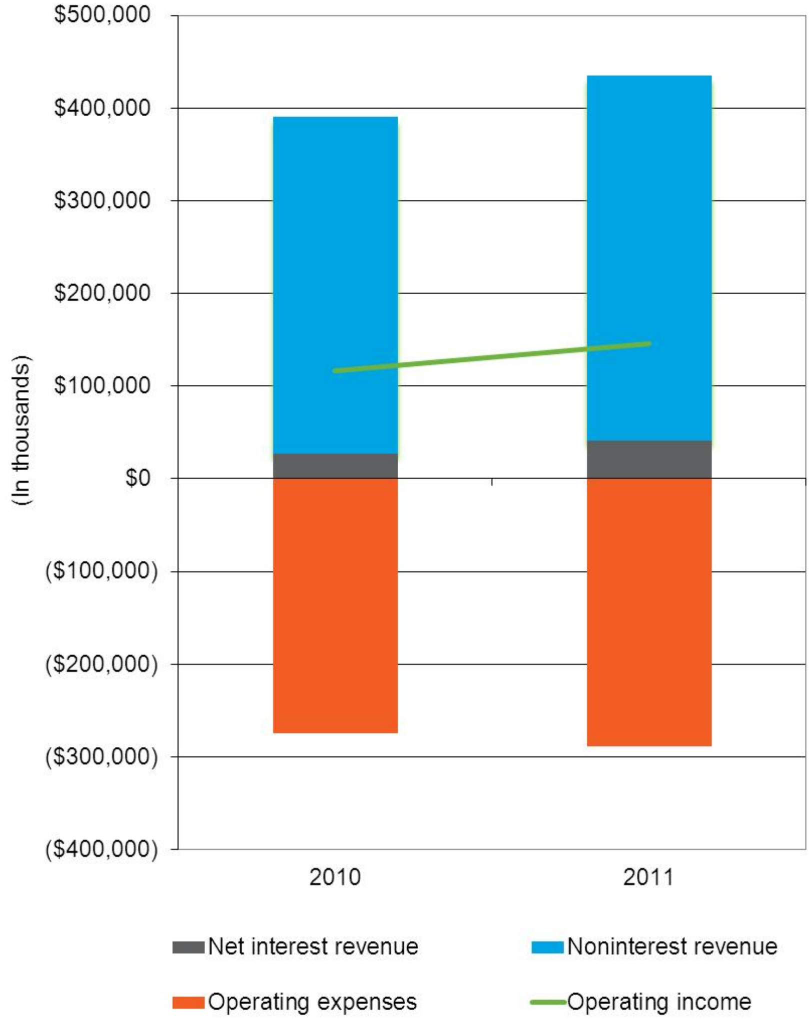
For the years ended June 30 (in thousands)		2011	2010
Student loan interest revenue	$	**165,968**	189,181
Investment interest revenue		**10,095**	8,205
Interest expense on student loan financings and notes and bonds payable		**(125,543)**	(155,824)
Interest expense on capital and other financings		**(5,060)**	(9,455)
Net interest revenue		**45,460**	32,107
Provision for loan losses		**(4,575)**	(8,911)
Net interest revenue after provision for loan losses		**40,885**	23,196
Servicing fees		**219,764**	192,730
Retention of collections on defaulted loans, net		**148,842**	127,163
Federal fees		**28,347**	44,953
Changes in fair value of residual interest, net		**(3,344)**	5,175
Loss on student loan sales, net		**(1,557)**	(4,054)
Default aversion fees, net		**(1,207)**	(1,766)
(Loss) gain on sale of fixed assets		**(539)**	72
Other		**171**	83
Total noninterest revenue		**390,477**	364,356
Operating revenues		**431,362**	387,552
Operating expenses		**(288,399)**	(271,392)
Operating income		**142,963**	116,160
Commonwealth of Pennsylvania grants		**450,661**	455,497
Federal grants		**8,444**	7,186
Grants and other financial aid		**(426,853)**	(465,557)
Grant funds returned to the Commonwealth of Pennsylvania		**(944)**	(12,284)
Grant funds returned to the federal government		**(116)**	-
Transfers to the Pennsylvania Higher Education Foundation		**(113)**	(119)
Change in net assets	$	**174,042**	100,883

Statements of Net Assets

As of June 30 (in thousands)		**2011**	2010
Cash, cash equivalents, and investments, substantially restricted	$	**805,492**	716,848
Student loans receivable, net		**8,557,527**	9,564,054
Interest income receivable		**129,649**	157,002
Capital assets, net		**53,592**	56,494
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**65,848**	101,622
Other		**138,607**	147,305
Total assets		**9,750,715**	10,743,325
Student loan financings and notes and bonds payable, net		**8,726,497**	9,739,200
Capital and other financings, net		**127,682**	224,098
Amounts related to the Federal Student Loan Reserve Fund		**65,848**	101,622
Other		**158,200**	179,959
Total liabilities		**9,078,227**	10,244,879
Net assets			
Invested in capital assets, net of related debt		**53,228**	(9,103)
Restricted for debt service		**219,410**	247,407
Restricted for financial aid grant programs		**80,013**	44,883
Unrestricted		**319,837**	215,259
Total net assets	$	**672,488**	498,446

Results of Operations

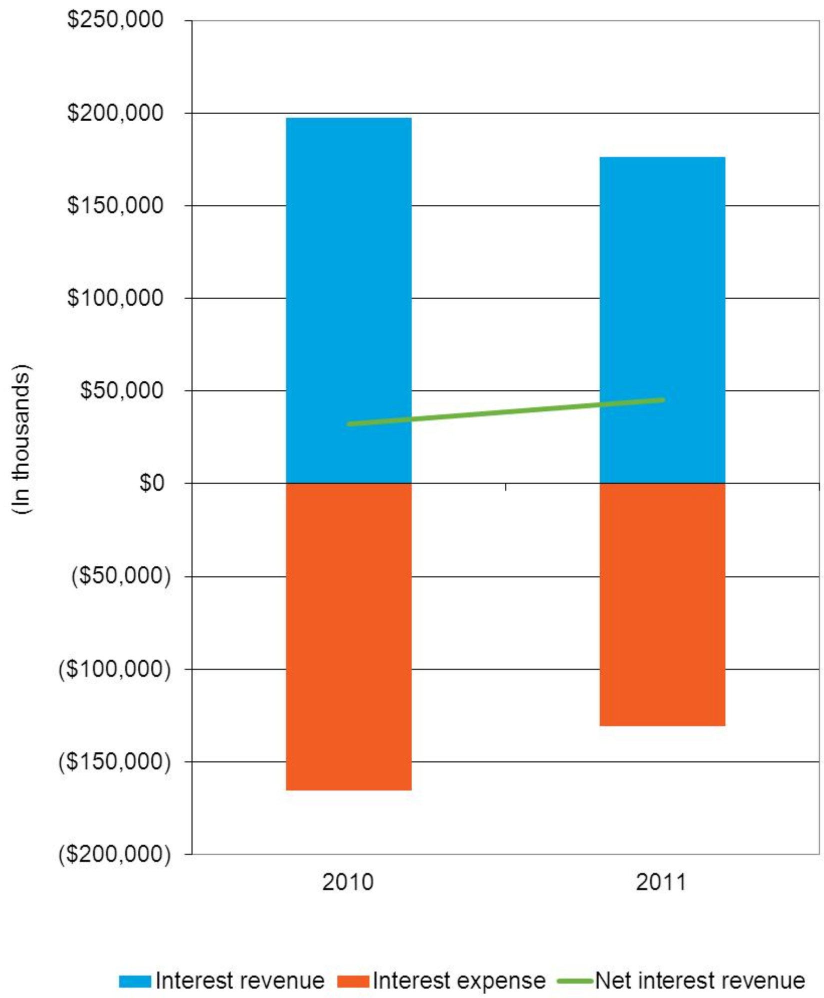
Years ended June 30



Operating income for the year ended June 30, 2011, was $143.0 million, a 23.1% increase from operating income of $116.2 million in 2010. Operating revenues were $431.4 million in 2011, an 11.3% increase from $387.6 million in 2010. Net interest revenue after provision for loan losses was $40.9 million in 2011, a 76.3% increase from net interest revenue after provision for loan losses of $23.2 million in 2010. Noninterest revenue was $390.5 million in 2011, a 7.2% increase from $364.4 million in 2010. Operating expenses were $288.4 million in 2011, a 6.3% increase from $271.4 million in 2010.

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, 2011, net interest revenue was $45.5 million, a 41.7% increase from net interest revenue of $32.1 million in 2010. During 2011, the increase in net interest revenue was due to lower interest rates on our student loan holdings as a result of various debt restructurings.

A more detailed explanation of the change in our net interest revenue follows.

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)		2011 Balances	2011 Rate	2010 Balances	2010 Rate
Average interest earning assets					
Student loans receivable, net	$	**9,232,934**	**1.80%**	10,442,061	1.81%
Investments		**711,888**	**1.42%**	719,068	1.14%
	$	**9,944,822**	**1.77%**	11,161,129	1.77%
Average interest bearing liabilities					
Student loan financings and notes and bonds payable, net	$	**9,542,333**	**1.32%**	11,051,910	1.41%
Capital and other financings, net		**182,807**	**2.77%**	255,718	3.70%
	$	**9,725,140**	**1.34%**	11,307,628	1.46%
Net interest margin			**0.43%**		0.31%

The decrease in our average interest bearing liabilities was due to scheduled debt payments on our student loan financings and notes and bonds payable. In addition, decreases in our capital and other financings was due to management exercising a $61.1 million call option on our Capital Acquisition Series 2000A bonds on December 15, 2010, as well as a $26.0 million reduction of a line of credit prior to maturity. 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 net interest margin on student loans.

For the years ended June 30	2011	2010
Student loan yields	**3.02%**	3.05%
Consolidation loan rebate fees	**(0.75)**	(0.72)
Premium amortization	**(0.38)**	(0.43)
Lender origination fees	**(0.09)**	(0.09)
Student loan revenue	**1.80%**	1.81%
Cost of funds	**(1.32)**	(1.41)
Net interest margin on student loans	**0.48%**	0.40%

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
2011 vs. 2010				
Student loan interest revenue	$	(23,213)	(1,307)	(21,906)
Investment interest revenue		1,890	1,972	(82)
		(21,323)	665	(21,988)
Student loan financings and notes and bonds payable interest expense		(30,281)	(8,997)	(21,284)
Capital and other financings interest expense		(4,395)	(1,699)	(2,696)
		(34,676)	(10,696)	(23,980)
Net interest revenue	$	13,353	11,361	1,992

Although, the amounts we earn on student loans involve interpreting and complying with complicated regulations issued by ED, our portfolio of student loans consists of variable-rate loans. As of June 30, 2011, 3% of the variable-rate loans change is based upon changes in the 91-day U.S. Treasury Bill rate, and 97% of the variable-rate loans change is based upon changes in the 3-month financial commercial paper rate.

For the years ended June 30, 2011 and 2010, the decrease in the student loan interest revenue was due to a decreasing student loan portfolio 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.

For the years ended June 30, 2011 and 2010, the decrease in the student loan financings and notes and bonds payable interest expense was due to a decline in the ending balance of the student loan financings and notes and bonds payable as a result of scheduled debt payments, as well as various debt refinancings that took place during December 2009 and January 2010. For more details on our debt financing activity, see the debt financing activity table within the section titled "Debt Activity and Capital Assets" of the MD&A.

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, as of June 30, 2011, we have $510.4 million of cash, cash equivalents and investments and $40.3 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 that follows reflects rate-sensitive positions as of June 30, 2011, and is not necessarily reflective of positions that existed throughout the period.

		Interest rate sensitivity period					
As of June 30, 2011 (in thousands)		3 months or less	3 months to 6 months	6 months to 1 year	1 to 2 years	2 to 5 years	Over 5 years
Assets							
Restricted cash and cash equivalents	$	295,054	-	-	-	-	-
Student loans		8,243,524	116,519	129,537	15,592	11,560	520
Other assets		78,076	23,466	11,632	9,044	14,031	25,306
Total assets		8,616,654	139,985	141,169	24,636	25,591	25,826
Liabilities							
Student loan financings and notes and bonds payable		8,590,697	135,800	-	-	-	-
Other liabilities		27,520	434	-	-	-	-
Total liabilities		8,618,217	136,234	-	-	-	-
Net assets							
Restricted for debt service	$	-	-	-	-	-	219,410
Period gap	$	(1,563)	3,751	141,169	24,636	25,591	(193,584)
Cumulative gap	$	(1,563)	2,188	143,357	167,993	193,584	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		100.0 %	102.8 %	-	-	-	11.8 %
Ratio of cumulative gap to total assets		- %	- %	1.6 %	1.9%	2.2 %	- %

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							
Restricted cash and cash equivalents	$	318,010	-	-	-	-	-
Student loans		9,165,121	142,290	161,148	19,149	19,714	695
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. We record a provision for loan losses on "FFEL program loans" as follows:

- FFEL program loans - The allowance for loan losses represents our estimate of the costs related to the risk sharing on the FFEL program loans and it 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 on or after that July 1, 2006.

This allowance along with the allowance for loan losses-other program loans are included in the section titled "Allowance for loan losses" in **Note 6 – Student Loans Receivable, net**.

In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions. When a student loan defaults, the guarantor reimburses the lender based on the disbursement date of the student loan. We record a charge-off for the difference between the ending balance of the student loan and the guarantee rate discussed above.

We report the "provision for losses", in the following table, as part of the "provision for loan losses" within the Statements of Revenues, Expenses, and Changes in Net Assets. As of June 30, 2011, we believe the allowance for loan losses is adequate to cover the inherent losses on our FFEL student loan portfolio.

As of June 30 (in thousands)		**2011**	2010
Balance at beginning of period	$	**6,690**	7,315
Provision for losses		**2,705**	5,544
Charge-offs		**(4,404)**	(6,169)
Balance at end of period	$	**4,991**	6,690
Ending balance of FFEL student loans	$	**8,344,721**	9,278,825
Allowance as a percentage of ending balance of student loans		**0.06%**	0.07%

Other Program Loans

The allowance for loan losses – other program loans represents our estimate of the risk associated with non-FFEL program loans, such as private and cure loans. We record a provision for loan losses on "other program loans" as follows:

- Private loans – We record a provision for loan losses on private loans when the student loan delinquency status is no longer current and/or in-litigation. Included with private loans are TERI guaranteed loans. For TERI guaranteed loans, we record a provision for loan losses on 100% of the loan balances that have a payment delinquency status of 121 days and greater, and those loans classified as "claims filed but not paid".

- Cure loans – We consider a loan to be in "cure" status when a due diligence violation has occurred on a PHEAA owned loan and the servicer is attempting correct or "cure" the loan. When a student loan enters a cure status, there is a possibility that the student loan could lose its guaranty status in the event that the borrower defaults on the student loan. If the borrower defaults on the student loan while in cure status, the guarantor will not reimburse us as the lender for the outstanding principal and interest of the loan. A loan can become incurable after three years of unsuccessfully trying to cure the loan, if a loan does not pay-off within the defined terms (i.e. 120 months for a 10 year Stafford loan), or due to an origination error. We record a provision for loan losses on any loans that have been in a cure status for greater than 24 months, and any loans considered incurable.

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**.

We report the "provision for losses", in the following table, as part of the "provision for loan losses" within the Statements of Revenues, Expenses, and Changes in Net Assets.

As of June 30 (in thousands)		**2011**	2010
Balance at beginning of period	$	**9,605**	6,530
Provision for losses		**1,870**	3,367
Charge-offs		**-**	(292)
Balance at end of period	$	**11,475**	9,605
Ending balance of non-FFEL student loans	$	**162,642**	191,638
Allowance as a percentage of ending balance of student loans		**7.06%**	5.01%

As of June 30, 2011, we believe the allowance for loan losses is adequate to cover the inherent losses on our non-FFEL student loan portfolio.

Delinquencies have the potential to adversely affect earnings through increased servicing fees, collection costs and charge-offs. The June 30, 2011, table below presents our student loan delinquency trends on FFEL and non-FFEL student loans, but does not include $12.2 million of student loans categorized as in-litigation, $9.6 million of student loans categorized as uninsured and $196 thousand of student loans with credit balances.

As of June 30, 2011 (in thousands)		**FFEL**			**Non-FFEL**			**Total**	
Loans in-school/in-grace	$	**193,083**		$	**3,103**		$	**196,186**	
Loans in deferment and forbearance:									
Deferment		**1,136,590**			**4,824**			**1,141,414**	
Forbearance		**1,121,170**			**1,982**			**1,123,152**	
Total loans in-school/in-grace, and deferment and forbearance	$	**2,450,843**		$	**9,909**		$	**2,460,752**	
Loans in repayment:									
Current	$	**5,214,668**	**88.6%**	$	**136,869**	**94.3%**	$	**5,351,537**	**88.7%**
31 – 60 days		**236,150**	**4.0%**		**2,988**	**2.0%**		**239,138**	**4.0%**
61 – 90 days		**125,850**	**2.1%**		**1,207**	**0.8%**		**127,057**	**2.1%**
91 – 120 days		**74,048**	**1.2%**		**596**	**0.4%**		**74,644**	**1.2%**
121 – 180 days		**102,231**	**1.7%**		**413**	**0.3%**		**102,644**	**1.7%**
181 – 270 days		**91,715**	**1.6%**		**44**	**0.1%**		**91,759**	**1.5%**
271 days or greater		**27,695**	**0.5%**		**267**	**0.2%**		**27,962**	**0.5%**
Claims filed but not paid		**15,279**	**0.3%**		**2,751**	**1.9%**		**18,030**	**0.3%**
Total loans in repayment	$	**5,887,636**	**100.0%**	$	**145,135**	**100.0%**	$	**6,032,771**	**100.0%**

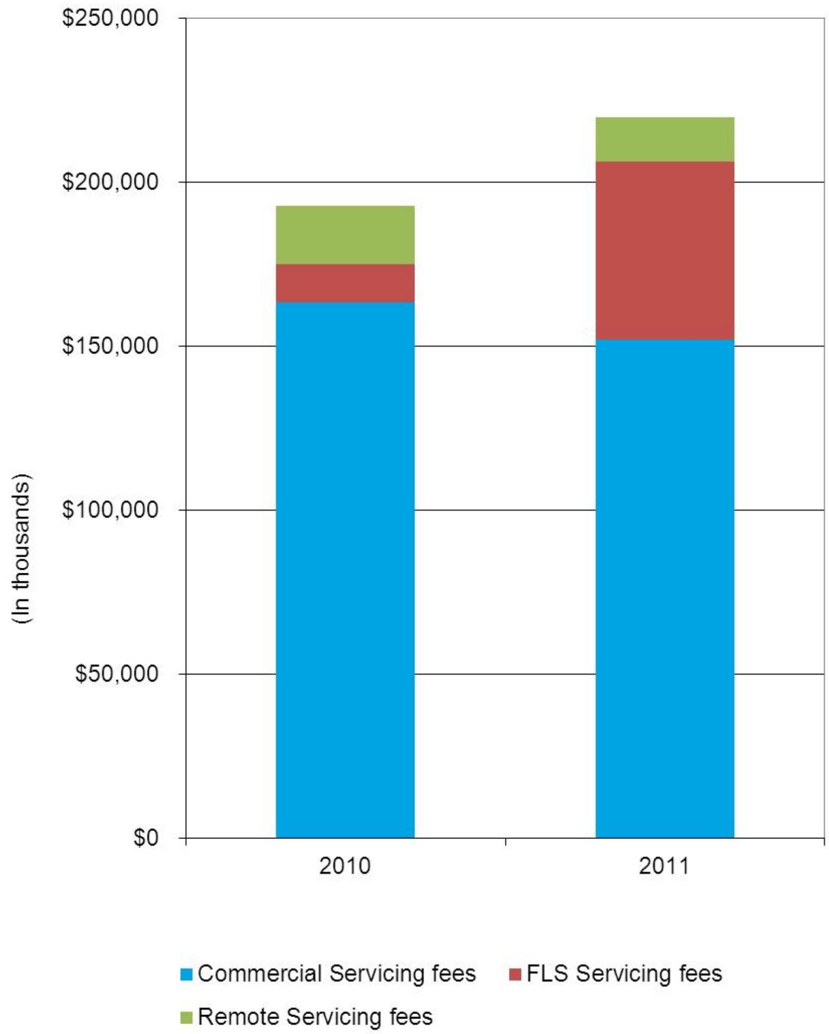
The June 30, 2010, table below presents our student loan delinquency trends on FFEL and non-FFEL student loans, but does not include $13.2 million of student loans categorized as in-litigation, $8.8 million of student loans categorized as uninsured and $302 thousand of student loans with credit balances.

As of June 30, 2010 (in thousands)	FFEL		Non-FFEL		Total	
Loans in-school/in-grace	$ 399,635		$ 6,628		$ 406,263	
Loans in deferment and forbearance:						
Deferment	1,273,620		5,076		1,278,696	
Forbearance	1,350,998		2,963		1,353,961	
Total loans in-school/in-grace, and deferment and forbearance	$ 3,024,253		$ 14,667		$ 3,038,920	
Loans in repayment:						
Current	$ 5,515,364	88.3%	$ 159,004	94.6%	$ 5,674,368	88.4%
31 – 60 days	263,196	4.2%	3,384	2.0%	266,580	4.2%
61 – 90 days	133,648	2.1%	1,887	1.1%	135,535	2.1%
91 – 120 days	81,312	1.3%	835	0.5%	82,147	1.3%
121 – 180 days	116,042	1.8%	914	0.6%	116,956	1.8%
181 – 270 days	98,949	1.6%	136	0.1%	99,085	1.5%
271 days or greater	29,652	0.5%	236	0.1%	29,888	0.5%
Claims filed but not paid	11,131	0.2%	1,624	1.0%	12,755	0.2%
Total loans in repayment	$ 6,249,294	100.0%	$ 168,020	100.0%	$ 6,417,314	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 "FLS Servicing". We also categorize revenue earned from providing systems for other servicers and guarantors to use as "Remote Servicing".

Total Servicing Fees

For the year ended June 30, 2011, total servicing fees were $219.8 million, a 14.1% increase from $192.7 million in 2010. In 2011, servicing fees increased due to increased volume of loans serviced and deconversion fees. Loans serviced on our systems for clients were $118.3 billion as of June 30, 2011, compared to $93.8 billion in 2010.

Commercial Servicing Fees

For the year ended June 30, 2011, servicing fees related to Commercial Servicing were $150.8 million, a 7.5% decrease from $163.1 million in 2010. The decrease in Commercial Servicing fees is due to loan origination fees, deconversion fees and early termination fees on loans sold to ED that were earned during 2010, which were not earned in 2011. As of June 30, 2011, the Commercial Servicing portfolio of loans was $50.2 billion in 2011 compared to $47.9 billion in 2010.

FLS Servicing Fees

For the year ended June 30, 2011, servicing fees related to FLS were $54.0 million, an increase from $11.7 million in 2010. The increase in FLS servicing fees is due to an increase in the portfolio of loans serviced by us for ED, which were $47.5 billion as of June 30, 2011, compared to $13.6 billion in 2010.

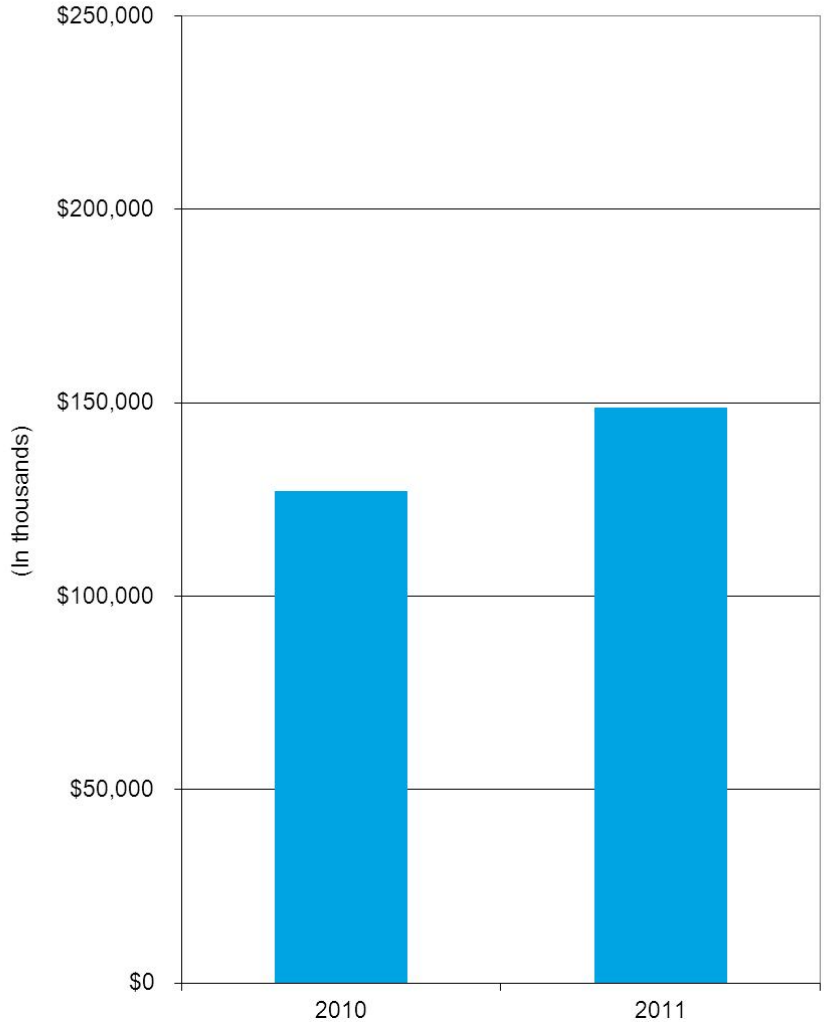
We expect FLS servicing fees to continue to increase as the Direct Loan program continues to expand. We compete for Direct Loan servicing from ED with three other servicing companies. The Direct Loan servicing allocations are awarded annually based on our performance on five different servicing metrics: defaulted borrower count, defaulted borrower dollar amount, a survey of borrowers, a survey of schools and a survey of federal personnel.

Remote Servicing Fees

For the year ended June 30, 2011, servicing fees related to Remote Servicing were $15.0 million, a 16.2% decrease from $17.9 million in 2010. The decrease in Remote Servicing fees is due to fewer loans held on our system for remote clients, which were $20.5 billion as of June 30, 2011, compared to $32.3 billion in 2010. However, revenues earned from providing a federal loan servicing system to potential not-for-profit federal loan servicing providers partially offset this decrease in revenue.

We expect Remote Servicing fees to continue to decrease due to the implementation of SAFRA. Effective July 1, 2010, all government guaranteed student loans are originated under the Direct Loan program.

Retention of Collections on Defaulted Loans, net
Years ended June 30



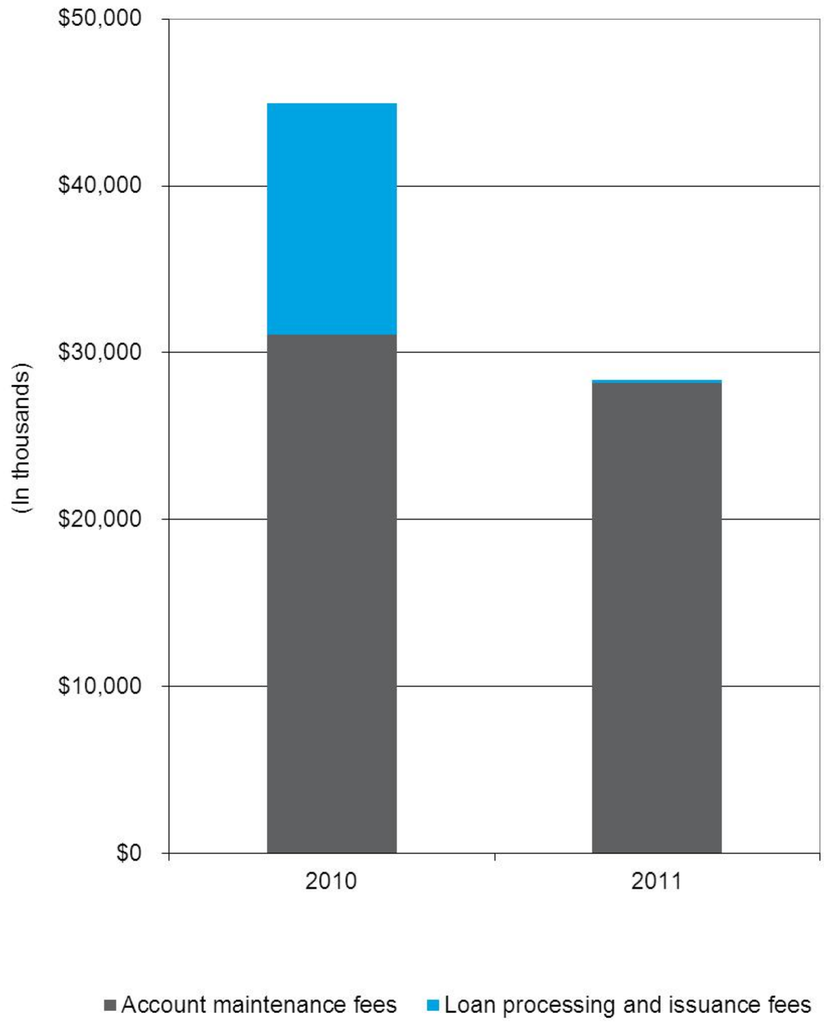
As a guarantor, we guarantee 97% - 100% of the borrower's outstanding loan balance depending on the disbursement date of the borrower's loan. The federal government reinsures the guarantor based upon default rates of the portfolio of guaranteed loans and the disbursement date of the loan.

After a loan defaults, we continue to try to collect on the 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, 2011, the net retention of collections on defaulted loans was $148.8 million, a 17.0% increase from $127.2 million in 2010. The increase in the collections on defaulted loans was mainly due to the increase in the collection of rehabilitation loans, garnishments and default collection loan payments.

We have offered discounts to eligible lenders for purchasing rehabilitation loans. These discounts reduce the amount of collections we retain on these loans; however, increases in loan defaults and collections on rehabilitation loans have more than offset the discounts offered. For the year ended June 30, 2011, the discount on rehabilitation collections was $34.1 million, a 9.3% increase from $31.2 million in 2010.

Federal Fees
Years ended June 30



We earn account maintenance and loan processing and issuance fees, which we classify as federal fees, from operating the guaranty agency. ED pays us an annual account maintenance fee that is 0.06% of the original principal amount of outstanding 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, SAFRA terminated the origination of student loans under the FFEL program and federal student loans are originated under the Direct Loan program. The loan processing and issuing fees we earn were substantially reduced due to the implementation of SAFRA.

For the year ended June 30, 2011, federal fees were $28.3 million, a 37.1% decrease from $45.0 million in 2010. The decrease in federal fees is mainly due to the reduction of the loan processing and issuance fees, because of the implementation of SAFRA. For the year ended June 30, 2011, loan processing and issuance fees were $155 thousand as compared to $13.9 million in 2010. As of June 30, 2011, the original principal balance of outstanding loans guaranteed was $45.1 billion, an 8.5% decrease from $49.3 billion in 2010.

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 recorded 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 more details on the student loan securitizations, see **Note 14 – Student Loan Securitizations**.

For the year ended June 30, 2011, the decrease in the aggregate carrying value of the residual interest in off-balance sheet securitizations was $3.3 million compared to an increase of $5.2 million in 2010.

Operating Expenses

The following table displays our major categories of operating expenses for the years ended June 30, 2011 and 2010. We have categorized operating expenses, such as bank fees, building and grounds, telephone, servicing liability and costs to settle student loan purchase commitments as "other". Costs to settle student loan purchase commitments were $7.3 million for the year ended June 30, 2011, compared to $12.3 million in 2010.

For the years ended June 30 (in thousands)		**2011**			2010	
Personnel and benefits	$	**143,967**	**49.9%**	$	143,164	52.8%
Professional services		**51,617**	**17.9%**		44,012	16.2%
Mail services		**25,878**	**9.0%**		20,792	7.7%
Information technology related expenses		**25,195**	**8.7%**		22,086	8.1%
Depreciation		**8,537**	**3.0%**		10,122	3.7%
Other		**33,205**	**11.5%**		31,216	11.5%
	$	**288,399**	**100.0%**	$	271,392	100.0%

For the year ended June 30, 2011, operating expenses were $288.4 million, a 6.3% increase from $271.4 million in 2010. 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)		**2011**			2010	
Personnel and Benefits						
Compensation	$	**106,911**	**74.3%**	$	103,581	72.4%
Health care benefits for employees and retirees		**18,406**	**12.8%**		22,933	16.0%
Employer's share of Social Security		**7,895**	**5.5%**		7,602	5.3%
Independent contractor fees		**7,572**	**5.2%**		7,217	5.0%
Retirement contributions		**4,366**	**3.0%**		3,249	2.3%
Capitalized software development costs		**(2,082)**	**(1.4%)**		(3,470)	(2.4%)
Other		**899**	**0.6%**		2,052	1.4%
	$	**143,967**	**100.0%**	$	143,164	100.0%

For the year ended June 30, 2011, personnel and benefits costs were $144.0 million, a 0.6% increase from $143.2 million in 2010. The changes in personnel and benefit costs are discussed below.

For the year ended June 30, 2011, compensation costs were $106.9 million, a 3.2% increase from $103.6 million in 2010. The increase in compensation costs during 2011 was due to increased personnel and the periodic step increases for the union workforce. As of June 30, 2011, our personnel headcount was 2,595, a 7.0% increase from 2,426 in 2010. The increase in personnel headcount was mainly due to increases in our FedLoan Servicing department. Our workforce consists of union and non-union positions. For the union positions, the negotiated contractual obligations generally include periodic step increases of 2.2% as well as cost of living adjustments.

For the year ended June 30, 2011, healthcare benefits for employees and retirees were $18.4 million, a 19.7% decrease from $22.9 million in 2010. The decrease in healthcare benefits for employees and retirees during 2011 was mainly due to a decrease in healthcare costs, resulting from changes in the employer contribution rates required by the Commonwealth's Office of Administration.

Professional Services

The following table displays Professional Services expenses:

For the year ended June 30 (in thousands)		**2011**			2010	
Professional Services						
Collection agency fees	$	**39,117**	**75.8%**	$	29,953	68.1%
Legal fees		**5,547**	**10.7%**		5,986	13.6%
Default aversion outsourcing fees		**3,896**	**7.5%**		3,308	7.5%
Audit fees		**1,540**	**3.0%**		1,306	3.0%
Consulting fees		**331**	**0.6%**		1,764	4.0%
Other professional fees		**1,186**	**2.4%**		1,695	3.8%
	$	**51,617**	**100.0%**	$	44,012	100.0%

For the year ended June 30, 2011, professional services were $51.6 million, a 17.3% increase from $44.0 million in 2010. A discussion on the changes in personnel and benefit costs follows.

For the year ended June 30, 2011, collection agency fees were $39.1 million, a 30.3% increase from $30.0 million in 2010. The increase in collection agency fees during 2011 was due to an increase in the collection of rehabilitation, garnishment and default collection loan payments. See "**Retention of Collections on Defaulted Loans, net**" for more details.

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 (excluding the federally owned FFEL and Direct Loan program loans) 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 record charge-offs for liabilities associated with servicing student loans for our clients. We present in the following table the provision for losses as "servicing liability" within other operating expenses.

For the years ended June 30 (in thousands)		**2011**	2010
Balance at beginning of period	$	**2,513**	3,464
Provision for losses		**1,130**	49
Charge-offs		**(623)**	(1,000)
Balance at end of period	$	**3,020**	2,513

Changes in Net Assets

The following table shows the changes in net assets:

For the years ended June 30 (in thousands)		**2011**	2010
Operating income	$	**142,963**	116,160
Commonwealth of Pennsylvania grants		**450,661**	455,497
Federal grants		**8,444**	7,186
Grants and other financial aid		**(426,853)**	(465,557)
Grant funds returned to the Commonwealth of Pennsylvania		**(944)**	(12,284)
Grant funds returned to the federal government		**(116)**	-
Transfers to the Pennsylvania Higher Education Foundation		**(113)**	(119)
Changes in net assets	$	**174,042**	100,883

Commonwealth of Pennsylvania Grants

For the year ended June 30, 2011, Commonwealth of Pennsylvania grants were $450.7 million, a 1.1% decrease from $455.5 million in 2010. The decrease during 2011 was due to the Commonwealth allocating fewer funds for the Pennsylvania State Grant program.

Federal Grants

For the year ended June 30, 2011, federal grants were $8.4 million, a 16.7% increase from $7.2 million in 2010. The increase during 2011 was mainly due to the timing of the funds received from the federal government.

On April 14, 2011, the United States Congress passed a continuing resolution to fund the operations of the federal government through the end of the 2011 fiscal year, which ends on September 30, 2011. As part of the continuing resolution, there were a number of changes to the funding provided for federal student aid programs for the 2011 – 2012 fiscal year. One of those changes was to the Federal Robert C. Byrd Honors Scholarship program, from which the federal government eliminated $42.0 million in funding. As of June 30, 2011, we received $1.6 million of federal grant proceeds from the Robert C. Byrd Honors Scholarship program compared to $1.5 million in 2010.We administer this program in conjunction with the Pennsylvania Department of Education.

Grants and Other Financial Aid Activity

For the year ended June 30, 2011, grants and other financial aid were $426.9 million, an 8.3% decrease from $465.6 million in 2010. An explanation of the changes within "Grants and Other Financial Aid Activity" is documented below along with a table that 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)		2011	2010
Self-funded			
Keystone loan program origination fees and benefits paid on behalf of borrowers	$	**871**	357
Other		**(11)**	(297)
Total self-funded		**860**	60
State and federally funded			
State Grant Program		**361,039**	411,784
Institutional Assistance Grant Program		**30,118**	27,526
Matching Funds Program		**12,505**	13,657
New Economy Technology Scholarship Program		**2,206**	3,354
Other		**20,125**	9,176
Total state and federally funded		**425,993**	465,497
Total grants and other financial aid	$	**426,853**	465,557

For the year ended June 30, 2011, self-funded financial aid was $860 thousand, an increase from $60 thousand in 2010. In 2011, the increase in self-funded financial aid was due to offering Keystone Best borrowers an interest rate reduction of 0.50% if they had their payments withdrawn from their accounts through "direct debit".

For the year ended June 30, 2011, state and federally funded financial aid was $426.0 million, an 8.5% decrease from $465.5 million in 2010. In 2011, the decrease in state and federally funded financial aid was mainly due to the decrease in appropriations for the State Grant program.

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)		2011	2010
Student loan financings and notes and bonds payable	$	**8,726,497**	9,739,200

As of June 30, 2011, student loan financings and notes and bonds payable were $8.7 billion, a 10.3% decrease from $9.7 billion in 2010. The decrease during 2011 was due to the repayment of various types of student loan bonds and notes. See the "capital market activity" and the "student loan financings" sections within the "**Debt Activity**" table below for more details.

Capital and Other Financings

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

As of June 30 (in thousands)		**2011**	2010
Capital financings	$	**-**	**61,093**
Other financings		**127,682**	**163,005**
Capital and other financings	$	**127,682**	**224,098**

As of June 30, 2011, capital and other financings were $127.7 million, a 43.0% decrease from $224.1 million in 2010. The decrease during 2011 was due to management exercising a call option on $61.1 million of principal and $1.8 million of accrued interest of Capital Acquisition Series 2000A bonds on December 15, 2010, the repayment of $26.0 million of a revolving line of credit prior to maturity and the repayment of various term and other financings. See the "capital financing activity" and the "other financing activity" sections within the "**Debt Activity**" table below for more details.

Debt Activity

Our enabling legislation imposes a debt limit. As of June 30, 2011, our debt limit was $26.1 billion and our outstanding debt amounted to $8.9 billion. As of June 30, 2010, our debt limit was $26.1 billion and our outstanding debt amounted to $10.0 billion.

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

For the years ended June 30 (in thousands)		**2011**	2010
<u>Capital market activity</u>			
Proceeds from issuing student loan floating rate notes	$	**-**	457,600
Repayment of student loan demand revenue bonds		**-**	(1,170,800)
Repayment of student loan auction rate security bonds		**(641,425)**	(700,050)
Repayment of student loan floating rate note		**(176,708)**	(140,017)
<u>Student loan financings</u>			
Proceeds from student loan variable rate funding notes		**-**	619,355
Repayment of student loan variable rate funding notes		**(188,841)**	(102,830)
Repayment of student loan financings		**(8,200)**	(582,019)
<u>Capital financing activity</u>			
Repayment of capital financings		**(61,120)**	(15,166)
Repayment of capital lease obligations		**(4,140)**	(942)
<u>Other financing activity</u>			
Proceeds of term and other financings		**-**	26,174
Repayment of lines of credit		**(26,000)**	(46,000)
Repayment of term and other financings		**(9,350)**	(15,845)

See **Note 8 – Notes and Bonds Payable and Other Financings** for more details on our debt activity financings.

Capital Assets

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

As of June 30 (in thousands)		2011	2010
Land	$	**2,946**	2,946
Buildings and improvements		**32,954**	33,908
Software development		**6,750**	8,211
Purchased software		**2,697**	826
Other, principally information technology equipment		**8,245**	10,603
	$	**53,592**	56,494

Net Asset Position

As of June 30 (in thousands)		2011	2010
Invested in capital assets, net of related debt	$	**53,228**	(9,103)
Restricted for debt service		**219,410**	247,407
Restricted for financial aid grant programs		**80,013**	44,883
Unrestricted		**319,837**	215,259
	$	**672,488**	498,446

As of June 30, 2011, we had net assets invested in capital assets, net of related debt of $53.2 million as compared to a negative $9.1 million in 2010. The increase in net assets invested in capital assets, net of related debt, was due to us exercising a call option on $61.1 million of principal and $1.8 million of accrued interest of Capital Acquisition Series 2000A bonds on December 15, 2010. See **Note 8 – Notes and Bonds Payable and Other Financings** for more details.

As of June 30, 2011, we had net assets restricted for debt service, which are related to our student loan notes, bonds and financings, of $219.4 million, an 11.3% decrease from $247.4 million in 2010. The decrease in net assets restricted for debt service was mainly due to transfers to net assets invested in capital assets and unrestricted net assets. The transfers to net assets invested in capital assets were for mandatory debt service payments. The transfers to unrestricted net assets were for mandatory distributions from the various floating rate notes and the conduits to PHEAA. See **Note 12 – Segment Information** for more details.

As of June 30, 2011, we had net assets restricted for financial aid grant programs of $80.0 million, a 78.6% increase from $44.8 million 2010. The increase in net assets restricted for financial aid grant programs was due to undisbursed grant proceeds.

As of June 30, 2011, we had unrestricted net assets of $319.8 million, a 48.5% increase from $215.3 million 2010. The increase in unrestricted net assets was due to unrestricted operating income of $79.0 million and transfers from net assets restricted for debt service of $25.5 million for mandatory debt service payments and distributions from various trusts.

Federal Student Loan Reserve Fund

As a part of our guaranty operations, we manage the Federal Fund for 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)		2011	2010
Additions			
Reinsurance from the U.S. Department of Education	$	**1,205,108**	1,239,030
Collections on defaulted loans		**680,517**	603,624
Federal default fees		**378**	34,016
Net appreciation (depreciation) in fair value of investments		**35**	(84)
Other		**208**	-
Total additions		**1,886,246**	1,876,586
Deductions			
Purchases of defaulted loans from lenders		**1,249,578**	1,287,533
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**479,943**	429,550
Reimbursement to PHEAA for our retention of defaulted loans collections		**182,961**	158,404
Default aversion fees, net		**20,113**	18,285
Total deductions		**1,932,595**	1,893,772
Net decrease		**(46,349)**	(17,186)
Net liabilities, beginning of period		**(46,176)**	(28,990)
Net liabilities, end of period	$	**(92,525)**	(46,176)

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 Fund to the Agency Operating Fund (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, 2011**	September 30, 2010
Generally accepted accounting principles – net assets	$	**(92,525)**	(58,203)
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund		**3,804**	4,753
Gain contingency – collections complement on future default collections		**169,845**	155,208
Default aversion fees payable to PHEAA, but not transferred from the Federal Reserve Fund		**126,888**	110,231
Regulatory net assets	$	**208,012**	211,989
Original principal outstanding	$	**45,094,081**	47,885,509
		0.46%	0.44%

For the year ended June 30, 2011, purchases of defaulted loans were $1.2 billion, which was a 7.7% decrease from $1.3 billion in 2010. See **Note 4 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education** for more details.

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 21, 2011

KPMG

KPMG LLP
Suite 1000
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 (the Agency), a component unit of the Commonwealth of Pennsylvania, as of June 30, 2011 and 2010, 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 Agency'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 Agency'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 Agency as of June 30, 2011 and 2010, 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 21, 2011

(In thousands)

		2011	2010
Interest revenue			
Student loans	$	165,968	189,181
Investments		10,095	8,205
Total interest revenue		176,063	197,386
Interest expense			
Student loan financings and notes and bonds payable		125,543	155,824
Capital and other financings		5,060	9,455
Total interest expense		130,603	165,279
Net interest revenue		45,460	32,107
Provision for loan losses		(4,575)	(8,911)
Net interest revenue after provision for loan losses		40,885	23,196
Noninterest revenue			
Servicing fees		219,764	192,730
Retention of collections on defaulted loans, net		148,842	127,163
Federal fees		28,347	44,953
Changes in fair value of residual interest, net		(3,344)	5,175
Loss on student loans sales, net		(1,557)	(4,054)
Default aversion fees, net		(1,207)	(1,766)
(Loss) gain on sale of fixed assets		(539)	72
Other		171	83
Total noninterest revenue		390,477	364,356
Operating revenues		431,362	387,552
Operating expenses			
Personnel and benefits		143,967	143,164
Professional services		51,617	44,012
Mail services		25,878	20,792
Information technology related expenses		25,195	22,086
Depreciation		8,537	10,122
Other		33,205	31,216
Total operating expenses		288,399	271,392
Operating income		142,963	116,160
Commonwealth of Pennsylvania grants		450,661	455,497
Federal grants		8,444	7,186
Grants and other financial aid		(426,853)	(465,557)
Grant funds returned to the Commonwealth of Pennsylvania		(944)	(12,284)
Grant funds returned to the federal government		(116)	-
Transfers to the Pennsylvania Higher Education Foundation		(113)	(119)
Changes in net assets		174,042	100,883
Net assets, beginning of period		498,446	397,563
Net assets, end of period	$	672,488	498,446

See accompanying notes to financial statements.

(In thousands)

		2011	2010
Assets			
Cash and cash equivalents	$	**27,913**	27,443
Restricted cash and cash equivalents		**301,159**	324,713
Restricted cash and cash equivalents – due to customers		**65,990**	78,794
Investments		**333,023**	182,429
Restricted investments		**77,407**	103,469
Residual interest in off-balance sheet securitizations		**25,031**	28,375
Student loans receivable, net		**8,557,527**	9,564,054
Interest income receivable		**129,649**	157,002
Due from Federal Student Loan Reserve Fund, net		**28,313**	32,475
Capital assets, net		**53,592**	56,494
Deferred financing costs, net		**35,368**	38,230
Other assets		**49,895**	48,225
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**65,848**	101,622
Total assets		**9,750,715**	10,743,325
Liabilities			
Due to customers		**65,990**	78,794
Accounts payable and accrued expenses		**92,210**	101,165
Student loans financings and notes and bonds payable, net		**8,726,497**	9,739,200
Capital and other financings, net		**127,682**	224,098
Amounts related to the Federal Student Loan Reserve Fund		**65,848**	101,622
Total liabilities		**9,078,227**	10,244,879
Net assets			
Invested in capital assets, net of related debt		**53,228**	(9,103)
Restricted for debt service		**219,410**	247,407
Restricted for financial aid grant programs		**80,013**	44,883
Unrestricted		**319,837**	215,259
Total net assets	$	**672,488**	498,446

See accompanying notes to financial statements.

Statements of Cash Flows
For the years ended June 30
(In thousands)

		2011	2010
Cash flows from operating activities			
Interest received on student loans	$	**76,039**	96,634
Principal received on student loans		**1,075,297**	1,131,277
Student loan originations		**(323)**	(340)
Student loan purchases		**(17,830)**	(23,226)
Student loan sales, including net gains and losses		**60,042**	622,124
Servicing fees		**214,685**	186,258
Retention of collections on defaulted loans		**153,004**	139,192
Federal fees		**29,683**	45,012
Default aversion fees, net of rebate		**375**	(1,064)
Other		**(1,925)**	(3,899)
Payment of operating expenses		**(279,382)**	(249,242)
Net cash provided by operating activities		**1,309,665**	1,942,726
Cash flows from noncapital financing activities			
Proceeds from the issuance of noncapital debt		**-**	1,103,129
Principal paid on noncapital debt		**(1,050,524)**	(2,757,561)
Interest paid on student loan financings and notes and bonds payable		**(125,934)**	(165,699)
Issuance costs		**2,708**	1,254
Commonwealth of Pennsylvania grants received		**450,661**	455,497
Federal grants received		**8,444**	7,186
Grants and financial aid paid		**(426,853)**	(465,557)
Grant funds returned to the Commonwealth of Pennsylvania		**(944)**	(12,284)
Grant funds returned to the federal government		**(116)**	-
Net cash used for noncapital financing activities		**(1,142,558)**	(1,834,035)
Cash flows from capital and related financing activities			
Principal paid on capital debt and capital lease obligations		**(65,260)**	(15,166)
Interest paid on capital and other financings		**(5,027)**	(9,150)
Purchases of capital assets and development of software, net of disposals		**(5,635)**	(2,329)
Net cash used for capital and related financing activities		**(75,922)**	(26,645)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		**1,040,703**	665,527
Purchases of investments		**(1,165,235)**	(800,412)
Interest received on investments		**10,263**	8,385
Net cash used for investing activities		**(114,269)**	(126,500)
Net change in cash and cash equivalents (including restricted cash)		**(23,084)**	(44,454)
Cash and cash equivalents (including restricted cash), beginning of period		**352,156**	396,610
Cash and cash equivalents (including restricted cash), end of period	$	**329,072**	352,156

(continued)

(In thousands)

		2011	2010
Reconciliation of operating income to net cash provided by operating activities			
Operating income	$	**142,963**	116,160
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation		**8,537**	10,122
Student loan financings and notes and bonds payable interest		**125,934**	165,699
Capital and other financings interest		**5,027**	9,150
Investment interest		**(10,263)**	(8,385)
Amortization of premium on loan purchases		**35,187**	42,116
Amortization of loan origination costs		**(1,557)**	(1,288)
Amortization of deferred financing costs		**154**	2,563
Amortization of deferred amount on refundings of student loan revenue bonds		**2,472**	(3,592)
Accretion discount on capital and other financings		**54**	80
Transfers to the Pennsylvania Higher Education Foundation		**(113)**	(119)
Changes in assets and liabilities:			
Decrease in interest income receivable		**27,353**	40,300
Decrease (increase) in residual interest in off-balance securitizations		**3,344**	(5,175)
Decrease in student loans receivable		**972,897**	1,564,958
Decrease in amounts due from Federal Student Loan Reserve Fund		**4,162**	12,029
Increase in other assets		**(1,670)**	(8,873)
(Decrease) increase in accounts payable and accrued expenses		**(4,816)**	6,981
Total adjustments		**1,166,702**	1,826,566
Net cash provided by operating activities	$	**1,309,665**	1,942,726

See accompanying notes to financial statements.

Note 1 – About PHEAA

Organization

The 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. ("Foundation") 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 Foundation into our financial statements.

We formed the PHEAA Student Loan Company, LLC (PHEAA SLC) on May 22, 2009, 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 the FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. We created the PHEAA SLC in order to participate in the Loan Purchase Commitment Program with ED. The Foundation is the sole equity member of PHEAA SLC, so PHEAA SLC is a blended component unit of the Foundation and its transactions are consolidated in the financial statements of the Foundation.

We formed the PHEAA Student Loan Company II, LLC (PHEAA SLC II) on November 2, 2009, 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 the FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. We created the PHEAA SLC II in order to participate in the Loan Purchase Commitment Program with ED. The Foundation is the sole equity member of PHEAA SLC II, so PHEAA SLC II is a blended component unit of the Foundation and its transactions are consolidated in the financial statements of the Foundation.

We formed the PHEAA Student Loan Company III, LLC (PHEAA SLC III) on November 2, 2009, 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 the FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. We created the PHEAA SLC III in order to participate in the Loan Purchase Commitment Program with ED. The Foundation is the sole equity member of PHEAA SLC III, so PHEAA SLC III is a blended component unit of the Foundation and its transactions are consolidated in the financial statements of the Foundation.

On April 7, 2011, the Foundation entered into a trust agreement with a financial institution, which created the PHEAA Student Loan Trust 2011-1 (the 2011-1 Trust), a statutory trust. The 2011-1 Trust was formed under the laws of the State of Delaware and its principal purpose is to securitize student loans and related assets, and to acquire student loans from the Foundation and issue promissory notes secured by a pledge of such assets. The 2011-

1 Trust provides services entirely to the Foundation and it has a financial benefit/burden relationship with the Foundation, and us, so the 2011-1 Trust is a blended component unit and its transactions are consolidated in the financial statements of the 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 PHEF's board of directors, we can impose our will on the PHEF, 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)		**2011**	2010
Assets:			
Cash	$	**201**	70
Short-term investments		**178**	178
Contributions receivable, net		**-**	1,000
Long-term investments		**905**	7,529
Office furnishings and equipment, net of accumulated depreciation		**36**	41
Total assets		**1,320**	8,818
Liabilities and net assets			
Liabilities			
Accrued expenses		**40**	330
Grants payable		**601**	601
Total liabilities		**641**	931
Net assets			
Unrestricted		**406**	401
Temporarily restricted		**273**	7,486
Total net assets		**679**	7,887
Total liabilities and net assets	$	**1,320**	8,818

For the years ended May 31 (in thousands)		2011	2010
Changes in unrestricted net assets:			
Revenues:			
Donated services	$	**124**	179
Income on long-term investments		**7**	17
Net unrealized and realized losses on long-term investments		**(2)**	(2)
Gain on sale of fixed assets		**-**	11
Total revenues		**129**	205
Net assets released from restrictions		**7,643**	10,734
Increase in unrestricted net assets		**7,772**	10,939
Expenses:			
Program services:			
Nursing Education Initiative			
Grants		**7,447**	10,302
Other program services		**78**	113
Total program services		**7,525**	10,415
Management and general		**238**	484
Fundraising		**4**	14
Total expenses		**7,767**	10,913
Net change in unrestricted net assets		**5**	26
Changes in temporarily restricted net assets:			
Contributions		**400**	-
Income on short-term investments		**2**	1
Income on long-term investments		**66**	365
Net unrealized and realized losses on long-term investments		**(38)**	(55)
Net assets released from restriction		**(7,643)**	(10,734)
Decrease in temporarily restricted net assets		**(7,213)**	(10,423)
Decrease in net assets		**(7,208)**	(10,397)
Net assets at beginning of year		**7,887**	18,284
Net assets at end of year	$	**679**	7,887

The PHEAA Student Loan Trust I

On January 15, 2003, the Foundation entered into a trust agreement with a financial institution, which created the PHEAA Student Loan Trust I (the Trust), a statutory trust. The Trust was formed under the laws of the State of Delaware and its principal purpose is to securitize student loans and related assets, and to acquire student loans from the Foundation and issue promissory notes secured by a pledge of such assets.

During the years ended June 30, 2004 and 2005, we sold a total of $1.2 billion of student loans originated under the FFELP to the Trust through the Foundation. We retain a 100 percent residual interest in these student loans purchased and held by the Trust.

We do not consolidate the transactions of the Trust into our financial statements, since the Trust is legally separate and fiscally independent. However, we do present information on the residual interest we retain, as mentioned above, in **Note 14 – Student Loan Securitizations**.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation and Accounting

We prepare our financial statements based on 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. We record revenues when earned and expenses 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 and net asset value based upon information provided by the Commonwealth of Pennsylvania's Treasury Department.

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 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

Student loan income

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 on loans first disbursed prior to June 30, 2010. 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 accrue 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 of 1965, as amended, to begin repayment. Repayment must begin generally within six months after the student completes his or her course of study, leaves school, or ceases to carry at least one-half the normal full time academic load as determined by the participating institution.

Servicing fees

We earn servicing fee revenue by servicing student loans owned by third parties. We recognize servicing fees when we provide the contractual services and we record the unbilled amounts as accounts receivable. 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 the Department of Education (ED) as “FLS Servicing”. We also categorize revenue earned from providing systems for other servicers and guarantors to use as “Remote Servicing”.

Retention of Collections on Defaulted Loans

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 the portfolio of guaranteed loans and the disbursement date of the loan.

After a loan defaults, we continue to try to collect on the 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.

Federal Fees

We earn account maintenance and loan processing and issuance fees, which we classify as federal fees, from operating the guaranty agency. ED pays us an annual account maintenance fee that is 0.06% of the original principal amount of outstanding 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, SAFRA terminated the origination of student loans under the FFEL program and all government guaranteed student loans are originated under the Direct Loan program. The loan processing and issuing fees we earn were substantially reduced due to the implementation of SAFRA.

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.

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 the 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 2010, the GASB issued Statement No. 61 – *The Financial Reporting Entity: Omnibus an amendment of GASB Statements No. 14 and No. 34*. The objective of this Statement is to improve financial reporting for a governmental financial reporting entity. The requirements of Statement No. 14, *The Financial Reporting Entity,* and the related financial reporting requirements of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, were amended to better meet user needs and to address reporting entity issues that have arisen since the issuance of those Statements. This Statement is effective for reporting periods beginning after June 15, 2012. Currently, we are evaluating the impact of this Statement on our financial statements.

During 2010, the GASB issued Statement No. 62 - *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The objective of this Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements: 1. Financial Accounting Standards Board (FASB) Statements and Interpretations; 2. Accounting Principles Board Opinions; 3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure. Hereinafter, these pronouncements collectively are referred to as the "FASB and AICPA pronouncements." This Statement is effective for reporting periods beginning after December 15, 2011. Currently, we are evaluating the impact of this Statement on our financial statements.

During 2011, the GASB issued Statement No. 63 - *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The objective of this Statement is to provide financial reporting guidance for deferred outflows of resources and deferred inflows of resources. GASB Concepts Statement No. 4 - *Elements of Financial Statements* introduced and defined deferred outflows and inflows of resources. Previous financial reporting standards did not include guidance for reporting those financial statement elements, which are distinct from assets and liabilities. This Statement amends the net asset reporting requirements in GASB Statement No. 34 - *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* and other pronouncements by incorporating deferred outflows and inflows of resources into the definitions of the required components of the residual measure and by renaming that measure as net position, rather than net assets. This Statement is effective for reporting periods beginning after December 15, 2011. Currently, we are evaluating the impact of this Statement on our financial statements.

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)		**2011**	2010
Assets			
Cash	$	**2,506**	24,634
Receivable from the U.S. Department of Education		**63,140**	73,373
Other receivables		**202**	3,615
Total assets		**65,848**	101,622
Liabilities			
Accounts payable and accrued expenses		**18**	6,962
Payable to the U.S. Department of Education		**3,154**	1,723
Deferred federal default fees		**-**	2,870
Amounts payable to PHEAA		**155,201**	136,243
Total liabilities		**158,373**	147,798
Net liabilities	$	**(92,525)**	(46,176)

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, 2011 and 2010, 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 Federal Fund.

Note 5 – Cash and Investments

The following table shows the carrying value of cash and cash equivalents (unrestricted and restricted), investments (unrestricted and restricted), and the cash on deposit.

As of June 30 (in thousands)		2011	2010
Cash and cash equivalents	$	**27,913**	27,443
Restricted cash and cash equivalents		**301,159**	324,713
Restricted cash and cash equivalents – due to customers		**65,990**	78,794
Investments		**333,023**	182,429
Restricted Investments		**77,407**	103,469
Carrying value	$	**805,492**	716,848
Cash on deposit, bank balance	$	**63,799**	45,633
Cash equivalents		**342,144**	416,605
Investments and restricted investments		**410,430**	285,898
Cash on deposit, bank balance (including cash equivalents and investments)	$	**816,373**	748,136

The following table shows the fair value and maturities of our cash equivalents and investments as of June 30, 2011.

			Maturities (in years)		
(In thousands)		Fair Value	Less than 1	1 to 10	More than 10
Cash equivalents					
Money market funds	$	193,303	193,303	-	-
Guaranteed investment contracts and agreements		123,756	123,756	-	-
Commercial paper		25,085	25,085	-	-
	$	342,144	342,144	-	-
Investments					
State Treasury investment pool	$	410,430	410,430	-	-
Total cash equivalents and investments	$	752,574	752,574	-	-

The following table shows the fair value and maturities of our cash equivalents and investments as of June 30, 2010.

			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 board of directors authorized the investments guidelines and we govern our investments by using the "prudent person" rule under our investment policy. Generally, our investments are limited 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.

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 Commonwealth of Pennsylvania Treasury Department's Bureau of Cash Management and Investments maintain the State Treasury investment pool for the benefit of all Commonwealth funds, which is governed by the provisions of the State Treasury investment policy. The Treasury Department created separate pools within the Commonwealth Investment Program (CIP), each with its own distinctive investment strategies, goals, and holdings that reflect the differing needs of Commonwealth funds for income, cash flows, and investment risk tolerance.

Pool 99 is a liquid vehicle within the CIP, which consists of short-term fixed income and cash and provides a high degree of liquidity and security but only modest returns. Pool 99 is organized similarly to a money market fund, with an expectation of a stable net asset value of $1 per share. The value of a share in Pool 99 is calculated daily, incorporating all realized and unrealized gains and losses, and any cash returned from investments. All gains and losses are distributed to participants monthly to re-set the value to $1 per share. Pool 99's performance is benchmarked to the yield on the three-month Treasury bills rate. As of June 30, 2011, our investments in Pool 99 were $306.8 million compared to $184.1 million in 2010.

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, 2011, all of our investments in commercial paper were rated A-1 and higher. As of June 30, 2011, all of our investments in guaranteed investment contracts and agreements were rated Aa2. As of June 30, 2011, $28.9 million of our investments in money market funds were rated AAAm, $158.8 million were rated Aaa and $5.6 million were not rated. As of June 30, 2011, $410.4 million invested in the State Treasury investment pool were not rated.

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 and $179.2 million were not rated. As of June 30, 2010, $224.5 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, 2011, $63.5 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.

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.

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, 2011.

(In thousands)	Issuer		Fair Value
Money market fund	Federated Fund Cash Manager	$	125,873
Guaranteed investment agreement	Trinity Plus Funding Co.		123,756

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 Treasury Obligation	$	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

Note 6 – Student Loans Receivable, net

The following table shows our student loan holdings.

As of June 30 (in thousands)		**2011**	2010
FFEL:			
Consolidation	$	**6,222,920**	6,773,238
Stafford		**1,854,648**	2,176,939
PLUS		**265,913**	327,047
Supplemental Loans for Students		**1,240**	1,601
		8,344,721	9,278,825
HEAL		**110,818**	135,894
Privately insured loans		**45,265**	48,610
Uninsured loans		**6,559**	7,135
Unamortized premium on loan purchases		**52,069**	87,255
Unamortized loan origination costs		**14,561**	22,630
		8,573,993	9,580,349
Allowance for loan losses		**(16,466)**	(16,295)
Student loans receivable, net	$	**8,557,527**	9,564,054

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.

When a student loan defaults, the guarantor reimburses the lender based on the disbursement date of the student loan. We record a charge-off for the difference between the ending balance of the student loan and the reinsurance rate. In the following table, we report the "provision for losses – FFEL program loans" and the "provision for losses - other program loans" as the "provision for loan losses" 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)		**2011**	2010
Balance at beginning of period	$	**16,295**	13,845
Provision for losses – FFEL program loans		**2,705**	5,544
Provision for losses – other program loans		**1,870**	3,367
Charge-offs		**(4,404)**	(6,461)
Balance at end of period	$	**16,466**	16,295

Note 7 – Capital Assets

Capital asset activity for the year ended June 30, 2011 was as follows:

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings and improvements		66,229	644	-	66,873
Software development		17,241	2,085	(3,331)	15,995
Purchased software		16,101	2,862	(200)	18,763
Other, principally information technology equipment		38,064	3,372	(4,670)	36,766
		140,581	8,963	(8,201)	141,343
Less accumulated depreciation for:					
Buildings and improvements		(32,321)	(1,598)	-	(33,919)
Software development		(9,030)	(3,502)	3,287	(9,245)
Purchased software		(15,275)	(989)	198	(16,066)
Other, principally information technology equipment		(27,461)	(2,404)	1,344	(28,521)
		(84,087)	(8,493)	4,829	(87,751)
	$	56,494	470	(3,372)	53,592

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

Depreciation expense for the years ended June 30, 2011 and 2010 was $8.5 million and $10.1 million, respectively.

Note 8 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings as of June 30, 2011, was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan auction rate bonds, floating rate notes, variable rate notes and financings:						
Student loan auction rate security bonds, due 2022 - 2047, at weighted-average rates of 1.12% as of June 30, 2011 and 1.28% as of June 30, 2010.	$	6,695,900	-	(641,425)	6,054,475	-
Deferred amount on current refunding of student loan auction rate security bonds.		(2,340)	-	203	(2,137)	-
Student loan floating rate notes, due 2016 - 2038, at weighted-average rates of 0.57% as of June 30, 2011 and 0.62% as of June 30, 2010.		1,595,532	-	(176,708)	1,418,824	-
Deferred amount on current refundings of student loan floating rate notes.		(4,696)	-	683	(4,013)	-
Student loan variable rate funding notes, due 2014 - 2015, at an estimated weighted-average rate of 0.75% as of June 30, 2011 and 0.63% as of June 30, 2010.		1,316,485	-	(188,841)	1,127,644	-
Deferred amount on current refunding of student loan variable rate funding notes.		(5,681)	-	1,585	(4,096)	-
Student loan financings, due on demand at weighted-average rates of 0.78% as of June 30, 2011 and 1.07% as of June 30, 2010.		144,000	-	(8,200)	135,800	135,800
	$	9,739,200	-	(1,012,703)	8,726,497	135,800

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Capital financings:						
Capital acquisition bonds	$	61,120	-	(61,120)	-	-
Unamortized discount on capital acquisition bonds.		(25)	-	25	-	-
		61,095	-	(61,095)	-	-
Other financings:						
Term financings, due 2029 – 2030, at zero percent interest as of June 30, 2011 and 2010.		72,874	-	(7,415)	65,459	-
Capital acquisition refunding bonds, due 2011 - 2030, at weighted- average rates of 5.09% as of June 30, 2011 and 2010.		64,545	-	(1,935)	62,610	1,965
Unamortized discount on capital acquisition refunding bonds		(416)	-	29	(387)	-
Line of credit		26,000	-	(26,000)	-	-
		163,003	-	(35,321)	127,682	1,965
	$	9,963,298	-	(1,109,119)	8,854,179	137,765

The note and bond indentures, among other things, require us to comply with various covenants. Student loans and investments collateralize all student loan auction rate notes, floating and variable rate notes, and financings. As of June 30, 2011, $8.6 billion of student loan principal and related interest receivable and $281.6 million of cash equivalents and related interest receivable collateralized the $8.9 billion of student loan financings and notes and bonds payable.

The student loan auction rate security bonds, floating rate notes, 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, variable rate notes and financings

As of June 30, 2011, the student loan auction rate bonds, floating rate notes, variable rate notes and financings were reduced by $1.0 billion, which was due to scheduled debt payments.

Subsequent Event

On July 14, 2011, we purchased and cancelled $1.9 billion of taxable auction rate security bonds and $433.6 million of tax-exempt auction rate security bonds from the 1997 Master Trust for $2.1 billion that resulted in a $221.1 million deferred gain on tender. On that same day, the 2011-1 Trust issued $1.7 billion of floating rate notes with an interest rate of 3-month LIBOR plus 1.10% and a final maturity date of June 25, 2038. The $1.7 billion of floating rate notes were secured by cash and a pool of student loans that were originated under the FFEL program and the Federal Health Education Assistance Loan Program. On that same day, we sold $462.9 million of student loans to a financial institution for $452.8 million that resulted in a loss on sale of approximately $10.1 million.

Capital financings

Capital financings are collateralized with capital assets. The Capital Acquisition Series 2000A (the "Bonds") bond indenture included an optional redemption provision, prior to maturity, in which we could redeem the Bonds, in part or in whole, on or after December 15, 2010, at a redemption price of 100 percent of the principal amount plus accrued interest to the date fixed for redemption. On December 15, 2010, management exercised a call option on $61.1 million principal and $1.8 million of accrued interest of Capital Acquisition Series 2000A bonds.

Other financings

As of June 30, 2011, the other financings were reduced by $35.3 million, of which, $26.0 million of a revolving line of credit was paid off on August 16, 2010, prior to maturity. The remaining reduction of $9.3 million was due to scheduled debt payments.

Debt service requirements

The following table displays the debt service requirements based upon the stated maturities for the student loan auction rate bonds, floating rate notes, variable rate notes and financings, and the capital and other financings and estimated interest rates for the variable-rate debt.

(In thousands)		Student Loan Auction Rate Bonds, Floating Rate Notes, and Variable Rate Notes and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2012	$	135,800	84,564	1,965	3,133
2013		-	84,564	2,040	3,031
2014		634,482	84,537	2,125	2,924
2015		493,161	77,932	2,220	2,814
2016		-	76,139	2,315	2,698
2017-2021		305,979	377,747	13,320	11,561
2022-2026		252,600	368,507	16,970	7,719
2027-2031		358,273	352,615	87,114	2,816
2032-2036		171,500	341,738	-	-
2037-2041		1,581,597	317,012	-	-
2042-2046		3,915,501	200,308	-	-
2047-2051		887,850	9,142	-	-
	$	8,736,743	2,374,805	128,069	36,696

As of June 30, 2011, $8.7 billion of the $8.9 billion of the student loan notes, bonds and financings were variable-rate debt. Of the $8.7 billion, $5.4 billion resets based upon auctions every 28 days, $643.1 million resets based upon auctions every 35 days, $1.5 billion is indexed to the 1-month or 3-month LIBOR, $13.8 million is indexed to 3-month financial commercial paper, and $1.1 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, 2010, 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	$	7,395,950	-	(700,050)	6,695,900	-
Deferred amount on current refundings of student loan auction rate security bonds		(2,544)	-	204	(2,340)	-
Student loan floating rate notes		1,277,949	457,600	(140,017)	1,595,532	-
Deferred amount on current refunding of student loan floating rate notes.		-	(5,006)	310	(4,696)	-
Student loan variable rate funding notes		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		726,019	-	(582,019)	144,000	144,000
Student loan demand revenue bonds		1,170,800	-	(1,170,800)	-	-
Deferred amount on current refundings of student loan demand revenue bonds		(6,581)	-	6,581	-	-
		11,361,553	1,065,528	(2,687,881)	9,739,200	144,000
Capital financings:						
Capital acquisition bonds		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:						
Term financings		60,680	26,174	(13,980)	72,874	-
Capital acquisition refunding bonds		66,410	-	(1,865)	64,545	1,935
Unamortized discount on capital acquisition refunding bonds		(443)	-	27	(416)	-
Line of credit		72,000	-	(46,000)	26,000	26,000
		198,647	26,174	(61,818)	163,003	27,935
	$	11,636,408	1,091,702	(2,764,812)	9,963,298	233,055

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. For the year ending June 30, 2011, total operating lease expense was $13.1 million compared to $10.5 million in 2010.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) as of June 30, 2011 are:

(In thousands)		
2012	$	16,945
2013		13,176
2014		9,238
2015		7,648
2016 and thereafter		7,149
Total minimum lease payments	$	54,156

Capital Lease

We entered into capital leases on various pieces of information technology equipment during fiscal year 2010. As of June 30, 2011, our obligations under capital leases were $364 thousand compared to $4.5 million for 2010.

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.

On November 23, 2010, Governor Rendell signed H.B. 2497 into law as Act 120. This legislation preserves all the benefits in place for all members prior to January 1, 2011, but mandates a number of benefit reductions for members that join SERS on or after January 1, 2011. Below is a listing of some of the benefit reductions that are included in Act 120:

- Creates a new A-3 and an optional A-4 Class of Service for future non-judicial employees (Class A-3 members will contribute 6.25% of their pay toward their benefit, and they will accrue benefits at 2% of their final average salary for each year of credited service. Class A-4 members will contribute 9.3% of their pay toward their benefit, and they will accrue benefits at 2.5% of their final average salary for each year of credited service);
- Increases the vesting period for Class A-3 and A-4 members to 10 years;
- Increases normal retirement age for Class A-3 and A-4 members from 60 to 65;
- Gradually increases funding through the use of collars that cap employer contribution rate increases (3% in fiscal year 2011/12, 3.5% in fiscal year 2012/13, 4.5% each year after until no longer needed);
- Implements a shared risk provision that introduces the possibility of higher or lower member contribution rates for future members; and
- Re-amortizes the SERS existing liabilities over 30 years through an actuarial "Fresh Start".

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, 2011 and 2010, the required employer contribution rate was 4.11% and 3.15%, respectively. As noted above, Governor Rendell signed Act 120 into law on November 23, 2010, which gradually increases funding with collars (limits) that cap employer contribution rate increases. Effective July 1, 2011, the employer contribution rate will be 5.59% for the "A" Class of Service employees, 6.99% for the "AA" Class of Service employees and 4.83% for the "A-3" and "A-4" Class of Service employees for fiscal year 2011-12. According to the Commonwealth of Pennsylvania SERS 2010 actuarial report, Schedule K, page 2 (Projection of Expected Contributions and Benefits – Reflecting Act 120 Collars), the blended fiscal projections indicate the employer's rate will increase to 9.8% in 2012, increase to 25.6% by 2017, and remain above 23% through 2021. For the year ended June 30, 2011 and 2010, our contributions were $4.4 million and $3.2 million, respectively and these contributions were equal to the required contributions set by SERS.

Other Postemployment Benefits

Plan Description

The Commonwealth of Pennsylvania (Commonwealth) sponsors the Retired Employees' Health 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, 2011. For additional information on the REHP including the Commonwealth's total Other Post Employment Benefit (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).

Funding Policy

REHP contribution requirements are established by the Office of Administration and the Governor's Budget Office. All employing agencies and certain plan members of the Commonwealth must contribute specified amounts to the REHP.

REHP plan members with a retirement date between July 1, 2005 and June 30, 2007, must contribute 1.0% of their final annual gross salary toward the cost of REHP coverage. REHP plan members with a retirement date on or after July 1, 2007, must contribute a percentage of their final annual gross salary toward the cost of REHP coverage. The contribution rate shall be equal to the active employee contribution rate in effect at the date of retirement, which is a percentage of the employee's final annual gross salary. The contribution rate shall change thereafter in accordance with the active employee contribution.

For the year ended June 30, 2011, the contribution rate was $250 thousand per month or $3.0 million annually. The monthly contribution rate was based on a projected per retiree cost for fiscal year 2010 - 11 times the estimated number of PHEAA retirees enrolled in the REHP. As of June 30, 2011, we have made all required contributions to the REHP as determined 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. The monthly contribution rate was based on a projected per retiree cost for fiscal year 2009 - 10 times the estimated number of PHEAA retirees enrolled in REHP.

Effective July 1, 2011, our contribution rate will be $279 thousand per month or $3.3 million annually. This current level of funding is subject to future adjustments at the beginning of each fiscal year, based upon projected retiree healthcare costs for fiscal year 2011 - 12 and the estimated number of future retirees.

Allocated 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, 2011, the Commonwealth's REHP OPEB obligation was $883.2 million, which was a 36.3% increase from $648.0 million for 2010. The Commonwealth allocates the REHP OPEB obligation based on the ratio of employees in each department supporting the Commonwealth's business activity or component unit or organization, to the total of all employees of the Commonwealth. As of June 30, 2011, the Commonwealth determined our allocated share of the REHP OPEB obligation was $26.4 million, which was an increase from $17.6 million for 2010. We did not record these amounts in the accompanying financial statements. 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 a projected per retiree cost times the estimated number of PHEAA retirees enrolled in the REHP. For the year ended June 30, 2011, our contribution was $3.2 million, which was a 33.3% increase from $2.4 million for the year ended June 30, 2010.

Note 11 – Servicing Fees

As a servicer, we are responsible for servicing, maintaining custody of, and making collections on student loans. 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 “FLS Servicing”. We also categorize revenue earned from providing systems for other servicers and guarantors to use as “Remote Servicing”.

For the year ended June 30, 2011, servicing revenues were $219.8 million, which was a 14.1% increase from $192.7 million for 2010. As of June 30, 2011, we were servicing $118.3 billion of loans for customers, which was a 26.1% increase from $93.8 billion in 2010. As of June 30, 2011, customers using our servicing systems serviced $20.5 billion of loans, which was a 36.5% decrease from $32.3 billion in 2010. For the year ended June 30, 2011, other FFELP guarantors were managing $3.8 billion of guarantees using our computer services, which was a 13.6% decrease from $4.4 billion in 2010.

Our servicing agreements, some of which expired during the fiscal year ended June 30, 2011, 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. We record a provision for estimated claims under the agreements as “other” operating expenses in the financial statements.

For the year ended June 30, 2011, three loan-servicing customers provided $106.0 million of servicing fees. For the year ended June 30, 2010, five loan-servicing customers provided $85.4 million of servicing fees. No other individual customer provided servicing revenues more than 5% of total servicing fees for the years ended June 30, 2011 and 2010.

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)		2011	2010
Interest revenue	$	**179,605**	206,339
Interest expense		**125,543**	155,824
Net interest revenue		**54,062**	50,515
Provision for loan losses		**(2,973)**	(5,335)
Net interest revenue after provision for loan losses		**51,089**	45,180
Loss on student loan sales, net		**(1,557)**	(3,390)
Total operating revenues		**49,532**	41,790
Operating expenses		**51,458**	61,073
Operating loss		**(1,926)**	(19,283)
Financial aid		**(57)**	(179)
Loss before transfers		**(1,983)**	(19,462)
Transfers (to) from unrestricted net assets		**(25,623)**	5,630
Change in net assets		**(27,606)**	(13,832)
Net assets, beginning of period		**247,016**	260,848
Net assets, end of period	$	**219,410**	247,016

Statement of Net Assets

As of June 30 (in thousands)		2011	2010
Restricted cash and cash equivalents	$	**295,054**	318,010
Student loans receivable, net		**8,517,252**	9,508,117
Other, principally interest income receivable		**161,555**	191,825
Total assets		**8,973,861**	10,017,952
Student loan financings and notes and bonds payable, net		**8,726,497**	9,739,200
Other, principally accrued interest payable		**27,954**	31,736
Total liabilities		**8,754,451**	9,770,936
Net assets, restricted for debt service	$	**219,410**	247,016

Statements of Cash Flows

For the years ended June 30 (in thousands)		2011	2010
Cash flows from operating activities			
Interest received on student loans	$	**80,627**	98,288
Principal received on student loans		**1,074,162**	1,145,688
Student loan originations		**9**	(10)
Student loan purchases		**(11,452)**	(37,603)
Student loan sales, including net gains and losses		**49,629**	592,461
Payment of operating expenses		**(52,113)**	(63,951)
Net cash provided by operating activities		**1,140,862**	1,734,873
Cash flows from noncapital financing activities			
Proceeds from the issuance of noncapital debt		**-**	1,076,954
Principal paid on noncapital debt		**(1,015,174)**	(2,695,716)
Interest paid on student loan financings and notes and bonds payable		**(123,577)**	(165,699)
Other		**(25,330)**	6,706
Net cash used for noncapital financing activities		**(1,164,081)**	(1,777,755)
Cash flows from investing activities			
Interest received on investments		**263**	642
Net cash provided by investing activities		**263**	642
Net change in restricted cash and cash equivalents		**(22,956)**	(42,240)
Restricted cash and cash equivalents, beginning of period		**318,010**	360,250
Restricted cash and cash equivalents, end of period	$	**295,054**	318,010

There are 10 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 1.005 to 1.086 as of June 30, 2011. Four of the trusts have a minimum parity ratio requirement and as of June 30, 2011, the trusts complied with the minimum parity ratio requirement.

The master trust that issued auction rate securities holds $6.0 billion of debt. The parity ratio for this trust is 1.005 as of June 30, 2011 and 1.002 as of June 30, 2010. This trust does not have a parity ratio requirement.

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 restricts 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, 2011, unrestricted net assets amounted to $319.8 million. As of June 30, 2010, unrestricted net assets amounted to $215.3 million.

We have net assets that are restricted for debt service that are held under various indentures related to financing our student loan portfolios. As of June 30, 2011, net assets restricted for debt service amounted to $219.4 million. As of June 30, 2010, net assets restricted for debt service amounted to $247.4 million which were held under various indentures related to financing our student loan portfolio, except for $400 thousand that related to capital and other financings.

We have net assets that are restricted for financial aid grant programs, because of the Commonwealth of Pennsylvania grants and federal grants that relate to specific programs. These net assets are restricted until we disburse program-related grants. As of June 30, 2011, net assets restricted for financial aid grant programs amounted to $80.0 million. As of June 30, 2010, net assets restricted for financial aid grant programs amounted to $44.9 million.

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 FFELP to the Trust through the Foundation. We retain a 100 percent residual interest in these student loans purchased and held by the Trust.

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)		**2011**	2010
Present value of residual interest	$	**25,031**	28,375
Weighted average life		**9.00 years**	10.00 years
Constant prepayment rate		**4.0%**	4.0%
Residual cash flow discount rate		**4.1%**	4.8%

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, 2011, we earned $1.3 million of administration fees compared to $1.5 million in 2010. For the year ended June 30, 2011, we earned $1.3 million of servicing fees compared to $1.4 million in 2010. 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)		**2011**	2010
Assets:			
Cash and cash equivalents	$	**21,120**	23,839
Student loans receivable, net		**494,522**	553,006
Interest income receivable		**4,624**	4,918
Other assets		**2,118**	2,515
Total assets		**522,384**	584,278
Liabilities:			
Notes payable	$	**481,128**	548,778
Interest payable		**2,165**	1,973
Other liabilities		**6,183**	5,212
Total liabilities		**489,476**	555,963
Net assets	$	**32,908**	28,315

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.

On May 29, 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). The IRS Letter states that the Series P and Q Bonds were selected for examination "as part of a project initiative involving student loan bonds". The IRS Letter and the Information Document Requests delivered to the Agency in connection therewith requested that the Agency provide to the IRS information concerning the Series P and Q Bonds and the underlying student loans.

During November 2010, the IRS advised us that its position is that any potential settlement will include all of our tax exempt bonds issued pursuant to the Indenture dated August 1, 1997 (the "1997 Indenture"), and as a result any potential settlement amount would need to cover the Student Loan Revenue Bonds Senior Series N, Student Loan Revenue Bonds Subordinate Series O, Student Loan Revenue Bonds, Senior Revenue Bonds P, Student Loan Revenue Bonds, Subordinate Series Q, Student Loan Revenue Bonds, Senior Revenue Bonds W, Student Loan Revenue Bonds, Subordinate Series X, Student Loan Revenue Bonds, Senior Revenue Bonds Z, and Student Loan Revenue Bonds, Senior Revenue Bonds AA (collectively, the "Tax Exempt Bonds"). On July 14, 2011, we completed our tender offer and none of the P and Q Bonds remains outstanding. As of July 14, 2011, the remaining Tax Exempt Bonds approximate outstanding aggregate principal amount was $205.3 million.

We are continuing to provide the information requested by the IRS and we are cooperating with the IRS in the course of its examination. As of June 30, 2011, we believe it is probable that a loss contingency exists and we estimate that the range of loss could be $3 million to $10 million. We have accrued $3 million in the accompanying financial statements.

Legal Proceedings

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. Additionally, approximately 317 loans that were submitted to the above guarantor were also not reflected as guaranteed in the records of the above guarantor. As such, we continue to work with the guarantor on the documentation of the guarantee of these loans. As of June 30, 2011, we believe it is reasonably possible that a loss contingency exists, but due to the uncertain nature of this issue it is difficult to estimate a range of loss.

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, 2011, we believe it is reasonably possible that a loss contingency exists, but due to the uncertain nature of this issue it is difficult to estimate a range of loss.

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 ED. The matter was originally filed under seal in 2007, and the plaintiff was not permitted to serve the defendants until August 2009. ED 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 ED regarding a discrete portion of its 9.5% floor loan portfolio and received through requisite audits by the ED'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. Subsequently, the additional defendants settled and on November 18, 2010, a Final Order was entered in this matter, which, among other things, placed the previously dismissed claim against PHEAA among the ended causes. The plaintiff filed a Notice of Appeal on November 22, 2010. Previously dismissed parties filed their brief with the United States Court of Appeals for the Fourth Circuit on April 12, 2011. We will vigorously contest this matter and as of June 30, 2011, we believe it is remote that a loss contingency exists.

Lastly, we are involved in various legal matters in the normal course of business. We have considered the available information on these legal matters, and the criteria for a loss contingency, as defined by GASB, does not exist as of June 30, 2011.