



Quarterly Financial Report
March 31, 2010 and 2009

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This discussion and analysis of the financial performance of Pennsylvania Higher Education Assistance Agency (“PHEAA”) is required supplementary information. It introduces the basic financial statements and provides an analytical overview of our financial activities. Please read it in conjunction with the financial statements that follow this discussion.

About PHEAA

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

Our Keystone family of student loan programs is one way that has helped make higher education more affordable. The Keystone family of loans, which includes Stafford and PLUS loan programs, has helped reduce the cost of student loan borrowing, and it has increased efficiency, flexibility and lender choice within the financial aid community.

The Pennsylvania State Grant Program is the third largest state grant program in the nation. We administer the program on behalf of the Commonwealth of Pennsylvania each year, without taxpayer support. Our business earnings fund the administration of this program ensuring that every appropriated dollar goes directly to students.

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

We guarantee Federal Stafford, PLUS and consolidation loans enabling students to continue their pursuit of higher education. As of March 31, 2010, the original principal outstanding balance of student loans guaranteed was \$50.0 billion.

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

We save schools administrative costs through our advanced financial aid delivery products and services, such as our OneLINKSM Loan Guaranty System. OneLink is a real-time financial aid processing system that provides schools with loan guaranty, origination, and servicing functionality, allowing them control of the financial aid delivery process.

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 those programs outlined below.

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Self-funded				
Costs of operating state and federal governmental programs	\$ 3,175	3,440	\$ 10,149	10,897
Keystone loan program origination fees and benefits paid on behalf of borrowers	167	419	334	1,682
Support of The Pennsylvania Higher Education Foundation, Inc.	30	77	89	311
Federal default fees paid on behalf of borrowers	(3)	10,216	50	25,511
Other public service activities and outreach	321	994	1,099	3,785
	3,690	15,146	11,721	42,186
Financial support funded by our business partners				
Keystone loan program origination fees and benefits paid on behalf of borrowers	145	126	156	572
	\$ 3,835	15,272	\$ 11,877	42,758

We administer various grant programs to help students pursuing higher education. The most significant programs are funded by the Commonwealth of Pennsylvania and are as follows:

- The State Grant Program provides full-time students grants up to \$4,000 based upon financial need for the 2009-10 academic year. On April 22, 2010, the Board of Directors approved the award values for the State Grant Program for the upcoming 2010-11 academic year. The Board of Directors approved a maximum award of \$3,781 per recipient, which will allow over 167 thousand recipients to be eligible for the State Grant Program. However, the final maximum awards for the State Grant Program are contingent upon the Commonwealth of Pennsylvania passing their final 2010-11 fiscal year budget.
- The Institutional Assistance Grants Program provides grants to independent postsecondary education institutions to make sure both public and independent postsecondary institutions are viable in the Commonwealth.
- The Matching Funds Program provides financial assistance to higher education institutions to assist them in capturing federal funds that require a state or local match as part of the federal grant award.
- The New Economy Technology Scholarship Program provides financial assistance grants up to \$3,000 to students enrolled in a postsecondary science or technology program approved by the Pennsylvania Department of Education.
- 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 nine years. The maximum EAP award for full-time students is the lesser of the actual tuition charged for the full-time course of study, or 100% of the tuition charged to a Pennsylvania resident at a state-owned university.
- The Postsecondary Educational Gratuity Program (PEGP) assists birth or adoptive children of Pennsylvania police officers, firefighters, rescue and ambulance squad members, corrections employees and National Guard members who died in the line of duty since January 1, 1976. The program also includes the birth and adoptive children of Pennsylvania sheriffs, deputy sheriffs and certain other individuals who were on

federal or state active military duty who died in the line of duty since September 11, 2001. The PEGP covers all institutional charges for tuition, fees, room and board not covered by other grants and scholarships.

We support the Pennsylvania Higher Education Foundation, Inc., ("PHEF") which is a tax-exempt organization that supports postsecondary education. PHEF created the Nursing Education Grant Program and disbursed \$10.3 million in grants during its most recent fiscal year ended May 31, 2009.

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

Changes in Federal Laws

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

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

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

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

- Holds colleges and universities accountable by requiring greater disclosure in costs;

- Protects students from aggressive marketing practices by lenders;
- Simplifies the federal student aid application process;
- Allows students to receive Pell Grant scholarship aid year round;
- Increases college aid and support for veterans and military families;
- Expands loan forgiveness program; and
- Amends Truth-in-Lending Act to prevent unfair and deceptive lending practices.

On October 7, 2008, President Bush signed into law H.R. 6889, which amends H.R. 5715. H.R. 6889 does the following:

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

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

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

Operations

Our operations involve originating, purchasing, selling, guaranteeing, and servicing student loans that were originated under the FFEL and the alternative loan programs. Under our federal contract, we are in the process of meeting federal requirements to service student loans under the Direct Loan program. The FFEL and the Direct Loan programs are federal programs that allow undergraduate or graduate students at eligible postsecondary schools to obtain low-cost loans.

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

- Subsidized Stafford – The federal government pays the interest on these loans while the student is in school, during the grace period, and during deferments;
- Unsubsidized Stafford – The student is responsible for all interest;
- PLUS – This is a supplemental loan to parents and graduate students; and

- Consolidation – This allows the borrower to combine Stafford and certain other education-related loans, fix the rate of interest on the loans, and extend the repayment period.

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

The type of loan and the federal regulations in effect during the origination of the loan determines the interest rate charged to borrowers. For example, under the FFEL program, undergraduate borrowers that receive subsidized and unsubsidized Stafford loans on or after July 1, 2006, have an interest rate of 6.8%. PLUS loans disbursed to students on or after July 1, 2006, have an interest rate of 8.5%. For students wanting to consolidate one or more federal education loans into a single loan on or after July 1, 2006, have an interest rate that is the weighted average of all loans rounded upward to the nearest .125%, but the consolidated interest rate is capped at 8.25%.

Under the Direct Loan program, undergraduate students that receive a direct subsidized Stafford loans on or after July 1, 2006, have an interest rate of 5.6% - 6.0%. For graduate/professional students that receive a subsidized Stafford loans on or after July 1, 2006, have an interest rate of 6.8%. For students that receive a direct unsubsidized Stafford loan on or after July 1, 2006, have an interest rate of 6.8%. PLUS loans disbursed to students on or after July 1, 2006, have an interest rate of 7.9%. For students wanting to consolidate one or more federal education loans into a single loan on or after July 1, 2006, have an interest rate that is the weighted average of all loans rounded upward to the nearest .125%, but the consolidated interest rate is capped at 8.25%.

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

In the past, we purchased student loans related to the Health Education Assistance Loan (“HEAL”) Program. Under the HEAL Program, borrowers pay interest at a variable-rate that resets quarterly based upon the 91-day U.S. Treasury Bill plus a spread of up to 3%. The U.S. Department of Health and Human Services determines the actual limit on the interest rate spread for an individual loan.

Special Interest Subsidy and Special Allowance Payments

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

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

The special allowance rates are calculated using the following factors:

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

The federal government charges an origination fee to help offset the costs of interest, special allowance and reinsurance payments on a FFEL program loan. The federal government requires the up-front origination fees to be deducted from the proceeds of student loans and remitted to them. These fees decreased from 1% in 2008 to 0.5% in 2009.

Finally, the SAFRA limits special allowance payments to lenders on student loans first disbursed before July 1, 2010.

Guaranty Activities

Our major function as a guarantor is to use the Federal Student Loan Reserve Fund (Federal Fund) to guarantee 97% to 98% of borrower's outstanding loan balance if the borrower fails to pay the loan. Under federal regulations, we must manage the Federal Fund so that there is enough money to pay lenders when their normal collection efforts fail. The federal government reinsures the Federal Fund, and reinsurance rates vary based upon 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 loan disbursement dates;

- | | |
|--|------------|
| ▪ Before October 1, 1993 | 80% – 100% |
| ▪ Between October 1, 1993 and September 30, 1998 | 78% – 98% |
| ▪ On or after October 1, 1998 | 75% – 95% |

ED pays us a loan processing and issuance fee of 0.40% for loans we guarantee; however, new consolidation loans are exempt from this fee. ED also pays us an annual account maintenance fee of 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new guaranteed Stafford and PLUS loans. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. On October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. We discuss the federal default fees paid on behalf of borrowers within the section titled "**Changes in Net Assets - Grants and Other Financial Aid Activity**".

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

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

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

obtaining Title IV, Higher Education Act program assistance

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

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

The borrower regains all benefits of the rehabilitation program, including any remaining deferment eligibility, once the above program requirements are met. For rehabilitation payments, we retain 18.5% of the original principal balance, 100% of the collection costs (capped at 18.5% of principal and accrued interest) and 100% of accrued interest collected as revenue.

We earn default aversion fees when servicers involve us as a guarantor to avert potential defaults. The Federal Fund pays the default aversion fee, but if the loan subsequently defaults, we must return the fee to the Federal Fund. Since January 1, 2008, we have not recognized default aversion fee revenue, since we do not expect to collect these amounts from the Federal Fund. We manage the cash flow of the Federal Fund to pay default claims rather than to pay default aversion fees.

The SAFRA terminates our authority to make or guarantee new loans under the FFEL program after June 30, 2010. All new Stafford, Plus and Consolidation student loans will be made under the Direct Loan program on July 1, 2010. The elimination of the FFEL program will have an impact on our guaranty operations over time by, among other things, reducing our federal fee revenue, because of our inability to add new FFEL program loans to our portfolio.

Servicing Activities

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

We use our proprietary COMPASS system for full servicing of student loans for our external clients, as well as our own portfolio. Our personnel, lending institutions, academic institutions, and other higher education servicing agencies use COMPASS, which is a mainframe-based decision support tool. As of March 31, 2010, under our full servicing program, excluding those student loans serviced for ED, we are servicing a loan portfolio of approximately \$58.9 billion in student loans and under our remote servicing operation, approximately \$32.9 billion in student loans.

During 2009, ED selected us as one of four servicers to service a portion of the nation's growing federally-owned student loan portfolio. FLS, a division within PHEAA, is responsible for the servicing of the federal student loans. We began servicing loans for ED in September 2009. For the nine months ended March 31, 2010, we recognized \$5.4 million of revenue and as of March 31, 2010, we were servicing approximately \$9.3 billion of loans under this servicing contract.

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

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

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

Our green initiative includes the promotion of eBilling to our borrowers by encouraging them to eliminate their monthly paper bills. As of March 31, 2010, more than 315 thousand of our borrowers have opted for this green method of loan billing.

Loan Origination and Purchasing

We issued revenue bonds from 1983 until the present and we used the proceeds from those revenue bonds to make various types of student loans. We also purchased student loans from banks and other lenders from time to time. However, due to an inability to access the credit or financing markets, effective March 7, 2008, we suspended our activities as a lender for any new loans first disbursed on or after that date. In addition, we suspended making purchases under our forward purchase contracts with other lending institutions. As of March 31, 2010, we have student loan purchase commitments of \$122.3 million that we have been unable to fund or settle. All of the purchase commitments are with financial institutions and we continue to work with those institutions to renegotiate the terms and timing of these commitments.

Under the SAFRA, our authority to make or guarantee new loans under the FFEL program after June 30, 2010 is terminated. All new Stafford, Plus and Consolidation student loans will be made under the Direct Loan program on July 1, 2010. As mentioned above, we suspended our activities as a lender for any loans first disbursed on or after March 7, 2008, so the elimination of the FFEL program will have minimal impact on this line of business.

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 law and regulations, and the adoption of new accounting standards. These forward-looking statements are based on assumptions that involve risks and uncertainties and that are subject to change based on various important factors (some of which are beyond our control). Actual results may differ materially from those expressed or implied as a result of these risks and uncertainties, including, but not limited to, interest rate fluctuations; changes in political and economic conditions; competitive product and pricing pressures within our markets; market fluctuations; the effects of adopting new accounting standards; inflation; technological change; changes in law; changes in fiscal, monetary, regulatory, and tax policies and laws; success in gaining regulatory approvals when required; success in the timely development of new products and services; as well as other risks and uncertainties. Such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Description of the Basic Financial Statements

The Statements of Revenues, Expenses, and Changes in Net Assets report our revenues and expenses. The statements measure the results of our operations over a period of time.

The Statements of Net Assets include recorded assets and liabilities. Assets are what we own or control, and liabilities are what we owe. Net assets 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

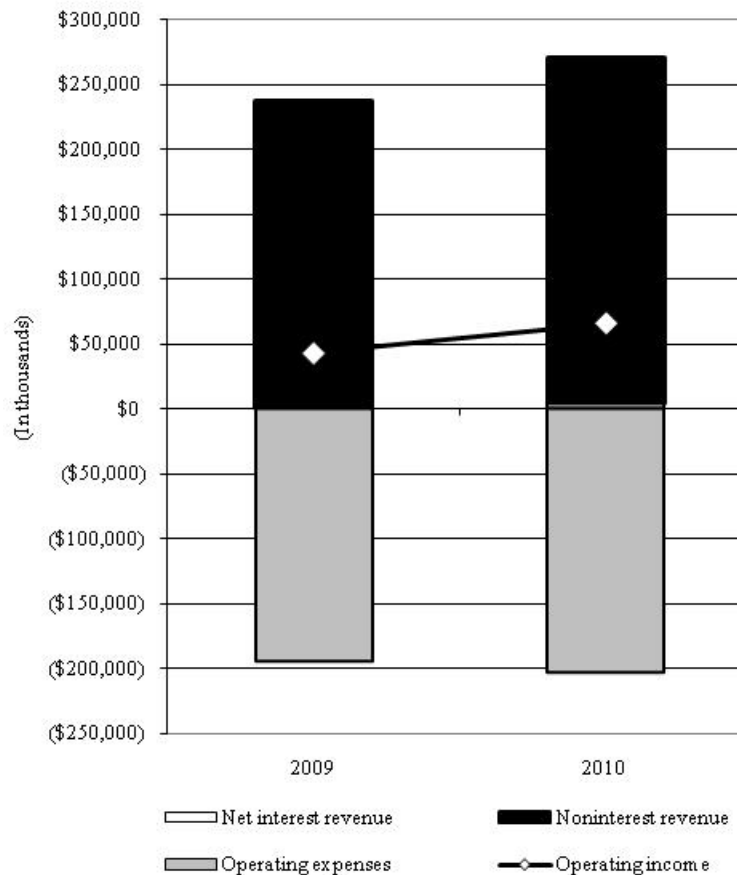
(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Student loan interest revenue	\$ 42,545	65,549	\$ 143,004	289,950
Investment interest revenue	1,932	468	8,261	4,078
Interest expense on student loan financings and notes and bonds payable	(40,424)	(68,633)	(134,799)	(281,736)
Interest expense on capital and other financings	(2,178)	(2,898)	(7,404)	(8,998)
Net interest revenue (expense)	1,875	(5,514)	9,062	3,294
Provision for loan losses	(1,042)	(902)	(4,419)	(3,019)
Net interest revenue (expense) after provision for loan losses	833	(6,416)	4,643	275
Servicing fees	45,563	39,296	142,626	119,162
Retention of collections on defaulted loans	33,564	21,984	89,322	78,386
Federal fees	12,789	13,274	35,769	36,238
Changes in fair value of residual interest, net	401	210	2,924	5,104
(Loss) gain on student loan sales, net	(176)	3	(3,635)	3
Default aversion fees, net of rebates	(578)	(42)	(1,181)	(1,337)
Other	38	30	94	339
Total noninterest revenue	91,601	74,755	265,919	237,895
Operating revenues	92,434	68,339	270,562	238,170
Operating expenses	(64,941)	(62,833)	(204,330)	(194,940)
Operating income	27,493	5,506	66,232	43,230
Commonwealth of Pennsylvania grants	30,197	41,311	437,856	463,782
Federal grants	1,637	1,980	7,087	7,696
Grants and other financial aid	(197,989)	(186,373)	(438,338)	(439,765)
Grant funds returned to the Commonwealth of Pennsylvania	(1,000)	(8)	(12,284)	(14,939)
Transfers to the Pennsylvania Higher Education Foundation	(30)	(77)	(89)	(311)
Change in net assets	\$ (139,692)	(137,661)	\$ 60,464	59,693

Statements of Net Assets

(In thousands)	March 31, 2010	June 30, 2009
Cash, cash equivalents, and investments, substantially restricted	\$ 703,290	594,808
Student loans receivable, net	9,818,727	11,169,840
Interest income receivable	161,716	197,302
Capital assets, net	56,436	59,783
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	140,294	107,655
Other	164,817	149,103
Total assets	11,045,280	12,278,491
Student loan financings and notes and bonds payable, net	10,007,245	11,361,553
Capital and other financings	238,598	274,855
Amounts related to the Federal Student Loan Reserve Fund	140,294	107,655
Other	201,116	136,865
Total liabilities	10,587,253	11,880,928
Net assets		
Invested in capital assets, net of related debt	(9,416)	(16,424)
Restricted for debt service	267,624	263,489
Restricted for financial aid grant programs	56,287	59,819
Unrestricted	143,532	90,679
Total net assets	\$ 458,027	397,563

Results of Operations

Nine months ended March 31



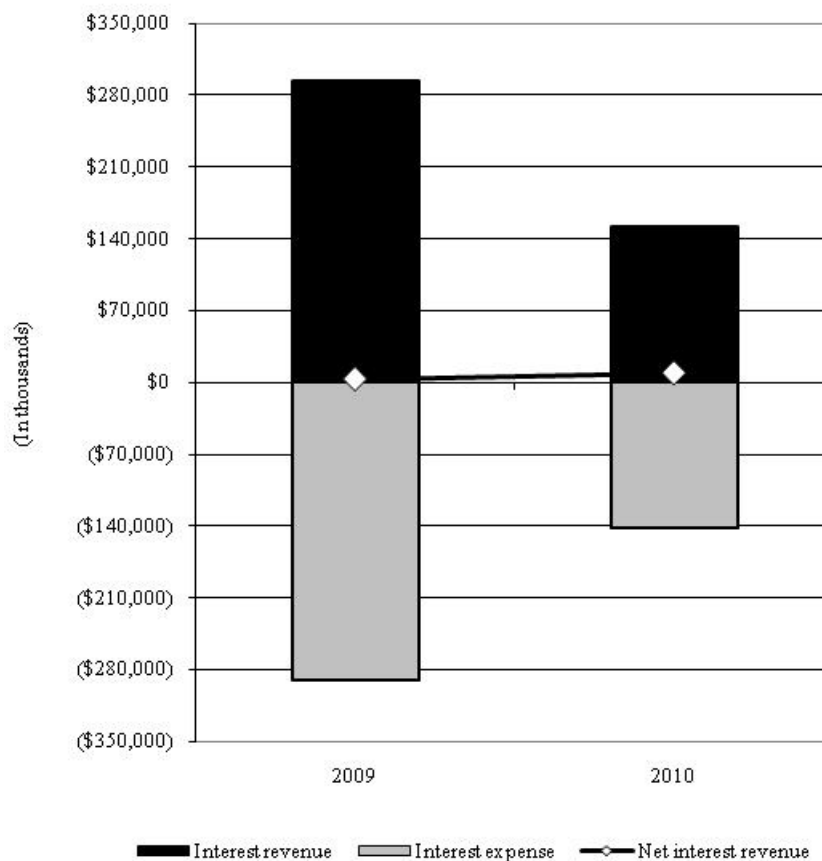
Operating income for the three months ended March 31, 2010, was \$27.5 million, an increase from operating income of \$5.5 million in 2009. Operating revenues were \$92.4 million in 2010, a 35.3% increase from \$68.3 million in 2009. Net interest revenue after provision for loan losses was \$833 thousand in 2010, an increase from net interest expense after provision for loan losses of \$6.4 million in 2009, which was due to lower U.S. Treasury bill rates and declining loan portfolio balances. Noninterest revenue was \$91.6 million in 2010, a 22.5% increase from \$74.8 million in 2009, which is due to increases in servicing fees and collections on defaulted loans. Operating expenses were \$64.9 million in 2010, a 3.3% increase from \$62.8 million in 2009.

Operating income for the nine months ended March 31, 2010, was \$66.2 million, a 53.2% increase from operating income of \$43.2 million in 2009. Operating revenues were \$270.6 million in 2010, a 13.6% increase from \$238.2 million in 2009. Net interest revenue after provision for loan losses was \$4.6 million in 2010, an increase from net interest revenue after provision for loan losses of \$275 thousand in 2009. Noninterest revenue was \$265.9 million in 2010, an 11.8% increase from \$237.9 million in 2009, which is due to increases in servicing fees and collections on defaulted loans. Operating expenses were \$204.3 million in 2010, a 4.8% increase from \$194.9 million in 2009.

A more detailed explanation of the results of operations follows.

Net Interest Revenue

Nine months ended March 31



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, which can also create net interest revenue.

For the three months ended March 31, 2010, net interest revenue was \$1.9 million, an increase from net interest expense of \$5.5 million in 2009. For the nine months ended March 31, 2010, net interest revenue was \$9.1 million, an increase from net interest revenue of \$3.3 million in 2009.

During 2010, the increase in net interest margin was due to declining loan portfolio balances and lower interest rates on our student loan holdings, which are based upon the 3-month financial commercial paper rate and the 91-day U.S. Treasury Bill rate. See **Note 7 – Notes and Bonds Payable and Other Financings** for more details on our student loan holdings and weighted-average interest rates.

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

For the three months ended March 31 (Balances in thousands)	2010		2009	
	Balances	Rate	Balances	Rate
Average interest earning assets				
Student loans receivable, net	\$ 10,147,525	1.68%	11,719,065	2.24%
Investments	814,320	0.95%	533,441	0.35%
	<u>\$ 10,961,845</u>	<u>1.62%</u>	<u>12,252,506</u>	<u>2.16%</u>
Average interest bearing liabilities				
Student loan financings and notes and bonds payable	\$ 11,019,578	1.47%	11,856,120	2.32%
Capital and other financings	260,461	3.34%	235,829	4.92%
	<u>\$ 11,280,039</u>	<u>1.51%</u>	<u>12,091,949</u>	<u>2.37%</u>
Net interest margin		<u>0.11%</u>		<u>(0.21)%</u>
For the nine months ended March 31 (Balances in thousands)	2010		2009	
	Balances	Rate	Balances	Rate
Average interest earning assets				
Student loans receivable, net	\$ 10,665,419	1.79%	11,770,250	3.28%
Investments	741,172	1.49%	500,904	1.09%
	<u>\$ 11,406,591</u>	<u>1.77%</u>	<u>12,271,154</u>	<u>3.19%</u>
Average interest bearing liabilities				
Student loan financings and notes and bonds payable	\$ 11,137,059	1.61%	11,902,653	3.16%
Capital and other financings	262,183	3.77%	238,526	5.03%
	<u>\$ 11,399,242</u>	<u>1.66%</u>	<u>12,141,179</u>	<u>3.19%</u>
Net interest margin		<u>0.11%</u>		<u>0.00%</u>

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

	Three months ended March 31		Nine months ended March 31	
	2010	2009	2010	2009
Student loan yields	2.93%	3.47%	3.01%	4.54%
Consolidation loan rebate fees	(0.73)	(0.67)	(0.71)	(0.68)
Premium amortization	(0.43)	(0.46)	(0.42)	(0.48)
Lender origination fees	(0.09)	(0.10)	(0.09)	(0.10)
Student loan revenue	1.68%	2.24%	1.79%	3.28%
Cost of funds	(1.47)	(2.32)	(1.61)	(3.16)
Net interest margin on student loans	0.21%	(0.08)%	0.18%	0.12%

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 three months ended March 31 (in thousands)	Increase (decrease)	Increase (decrease) attributable to change in	
		Rate	Volume
2010 vs. 2009			
Student loan interest revenue	\$ (23,004)	(14,214)	(8,790)
Investment interest revenue	1,464	1,218	246
	(21,540)	(12,996)	(8,544)
Student loan financings and notes and bonds payable interest expense	(28,209)	(23,366)	(4,843)
Capital and other financings interest expense	(720)	(1,023)	303
	(28,929)	(24,389)	(4,540)
	\$ 7,389	11,393	(4,004)

For the nine months ended March 31 (in thousands)	Increase (decrease)	Increase (decrease) attributable to change in	
		Rate	Volume
2010 vs. 2009			
Student loan interest revenue	\$ (146,946)	(119,729)	(27,217)
Investment interest revenue	4,183	2,227	1,956
	(142,763)	(117,502)	(25,261)
Student loan financings and notes and bonds payable interest expense	(146,937)	(128,815)	(18,122)
Capital and other financings interest expense	(1,594)	(2,486)	892
	(148,531)	(131,301)	(17,230)
	\$ 5,768	13,799	(8,031)

While the amount that we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 3% of the variable-rate loans change based upon changes in the 91-day U.S. Treasury Bill rate, and 97% change based upon changes in the 3-month financial commercial paper rate. The borrowers pay a fixed rate of 5.6% for loans originated on or after July 1, 2009. For the three and nine months ended March 31, 2010 and 2009, the decrease in the student loan earnings is due to decreases in the U.S. Treasury Bill rates, and negative special allowance as a result of decreases in the 3-month financial commercial paper rates for loans disbursed on or after April 1, 2006. The borrowers pay rates that are set under a different formula and generally reset annually on July 1.

Interest Rate Risk Management

Student loans are generally variable-rate assets, so we generally fund them with variable-rate debt.

In the table on the next page, we categorize variable-rate assets and liabilities by reset date and fixed-rate assets and liabilities by their maturity dates. An interest rate gap is the difference between the volumes of assets and liabilities maturing or re-pricing during specific future time intervals. The table includes only those assets and liabilities related to our student loan notes, bonds and financings. However, we have \$339.0 million of cash, cash equivalents and investments and \$63.1 million of student loans, as well as other assets and liabilities, not included in the analysis below, because they do not relate to the student loan revenue bonds.

If a period gap is positive, it means there are more assets than liabilities re-pricing during the period. If interest rates rise in a period with a positive gap, net interest revenue will increase. Conversely, if interest rates fall in a period with a positive gap, net interest revenue will decrease.

The opposite is true when the period gap is negative. This occurs when more liabilities than assets are re-pricing during the period. If interest rates rise in a period with a negative gap, net interest revenue will decrease. If interest rates fall in a period with a negative gap, net interest revenue will increase.

The gap analysis on the next page reflects rate-sensitive positions at March 31, 2010, and is not necessarily reflective of positions that existed throughout the period.

At March 31, 2010 (In thousands)	Interest rate sensitivity period					
	3 months or less	3 months to 6 months	6 months to 1 year	1 to 2 years	2 to 5 years	Over 5 years
Assets						
Student loans	\$ 9,250,762	148,752	310,566	20,920	23,650	936
Restricted cash and cash equivalents	364,320	-	-	-	-	-
Other assets	96,562	32,708	7,009	13,773	19,194	27,396
Total assets	9,711,644	181,460	317,575	34,693	42,844	28,332
Liabilities						
Student loan financings and notes and bonds payable	9,858,245	149,000	-	-	-	-
Other liabilities	41,576	691	-	-	-	-
Total liabilities	9,899,821	149,691	-	-	-	-
Net assets						
Restricted for debt service	\$ -	-	-	-	-	267,036
Period gap	\$ (188,177)	31,769	317,575	34,693	42,844	(238,704)
Cumulative gap	\$ (188,177)	(156,408)	161,167	195,860	238,704	-
Ratio of interest- sensitive assets to interest-sensitive liabilities and net assets	98.1 %	121.2 %	-	-	-	10.6 %
Ratio of cumulative gap to total assets	(1.8) %	(1.5) %	1.6 %	1.9%	2.3 %	- %

Provision for Loan Losses

The provision for loan losses represents our estimate of the costs related to the risk sharing on FFEL program loans and 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 July 1, 2006.

We report the provision for losses below as “provision for loan losses” within the Statements of Revenues, Expenses and Changes in Net Assets. In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions. We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio.

Presented below is an analysis of our provision for loan losses.

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Balance at beginning of period	\$ 7,372	10,287	\$ 7,315	11,343
Provision for losses	1,042	902	4,419	3,019
Charge-offs	(1,435)	(1,574)	(4,755)	(4,747)
Balance at end of period	\$ 6,979	9,615	\$ 6,979	9,615
Ending balance of student loans	\$ 9,513,811	11,020,589	\$ 9,513,811	11,020,589
Allowance as a percentage of ending balance of student loans	0.07%	0.09%	0.07%	0.09%

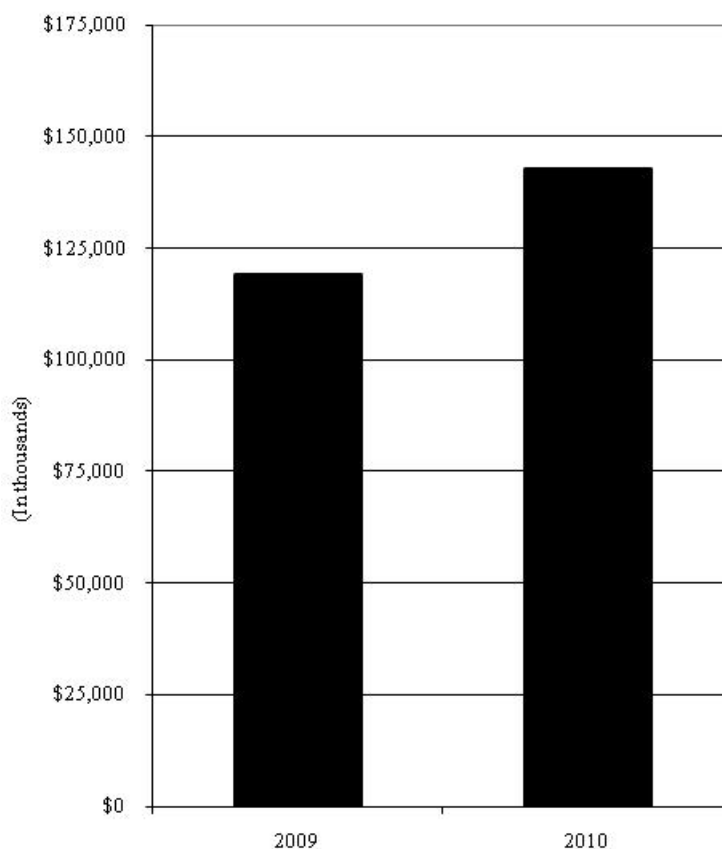
Delinquencies have the potential to adversely impact earnings through increased servicing, collection costs and charge-offs. The table below presents our student loan delinquency trends, but does not include those student loans categorized as in-litigation, uninsured, credit balances, and unamortized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

As of March 31 (in thousands)	2010		2009	
Loans in-school/in-grace	\$ 470,048		\$ 1,053,056	
Loans in deferment and forbearance:				
Deferment	1,423,877		1,760,016	
Forbearance	1,360,289		1,436,489	
Total loans in-school/in-grace, and deferment and forbearance	\$ 3,254,214		\$ 4,249,561	
Loans in repayment:				
Current	\$ 5,690,000	88.3%	\$ 6,177,711	88.4%
31-60 days	251,066	3.9%	250,847	3.6%
61 – 90 days	135,825	2.1%	135,374	1.9%
91 – 120 days	86,846	1.3%	111,053	1.6%
121 – 180 days	121,365	1.9%	128,813	1.9%
181 – 270 days	107,737	1.7%	114,707	1.6%
271 days or greater	29,830	0.5%	45,158	0.7%
Claims filed but not paid	21,340	0.3%	23,104	0.3%
Total loans in repayment	\$ 6,444,009	100.0%	\$ 6,986,767	100.0%

Noninterest Revenue

Servicing Fees

Nine months ended March 31



Servicing fee revenue is earned by servicing student loans owned by third parties. We categorize revenue earned from loans owned by financial institutions and secondary markets as “Commercial Servicing”; whereas, we categorize revenue earned from loans owned by ED as “FedLoan Servicing” (FLS).

For the three months ended March 31, 2010, total servicing fees were \$45.6 million, a 16.0% increase from \$39.3 million in 2009. During 2010, the increase in total servicing fees is mainly due to increased volume of loans serviced. Loans serviced by us for third party servicing clients averaged \$56.4 billion in 2010 compared to \$49.6 billion in 2009.

For the three months ended March 31, 2010, servicing fees related to Commercial Servicing were \$42.2 million, a 7.4% increase from \$39.3 million in 2009. Loans serviced by us for Commercial Servicing averaged \$49.7 billion in 2010 compared to \$49.6 billion in 2009. During September 2009, we began servicing loans for ED. For the three months ended March 31, 2010, servicing fees related to FLS were \$3.4 million compared to zero in 2009. Loans serviced by us for FLS averaged \$6.7 billion in 2010 compared to zero in 2009.

For the nine months ended March 31, 2010, total servicing fees were \$142.6 million, a 19.6% increase from \$119.2 million in 2009. In 2010, servicing fees increased due to increased volume of loans serviced, deconversion fees and early termination fees for loans PUT to ED. Loans serviced by us for third party servicing clients averaged \$52.5 billion in 2010 compared to \$48.6 billion in 2009.

For the nine months ended March 31, 2010, servicing fees related to Commercial Servicing were \$137.2 million, a 15.1% increase from \$119.2 million in 2009. Loans serviced by us for Commercial Servicing averaged \$49.0 billion in 2010 compared to \$48.6 billion in 2009. During September 2009, we began servicing loans for ED. For the nine months ended March 31, 2010, servicing fees related to FLS were \$5.4 million compared to zero in 2009. Loans serviced by us for FLS averaged \$3.5 billion in 2010 compared to zero in 2009.

We also provide systems for other servicers and guarantors for a fee. For the three months ended March 31, 2010, fees earned from servicing systems amounted to \$4.8 million, a 20.0% increase from \$4.0 million in 2009. For the three months ended March 31, 2010, loans serviced by other servicers using our systems averaged \$33.3 billion, which was a 4.9% decrease from \$35.0 billion in 2009.

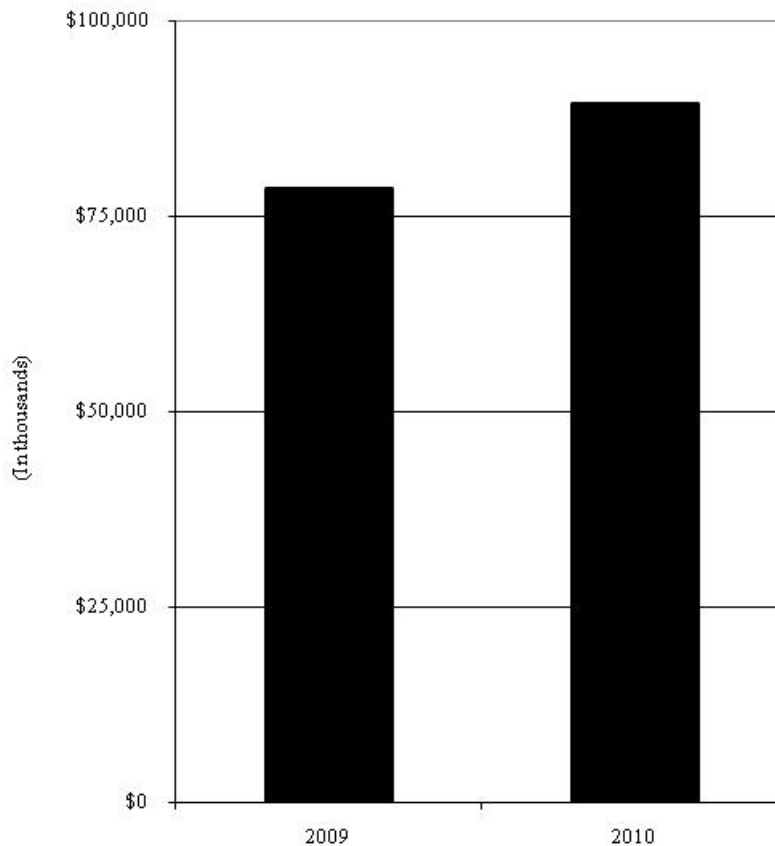
For the nine months ended March 31, 2010, fees earned from servicing systems amounted to \$12.5 million, a 12.6% increase from \$11.1 million in 2009. For the nine months ended March 31, 2010, loans serviced by other servicers using our systems averaged \$33.1 billion, which was a 3.2% decrease from \$34.2 billion in 2009.

For the three months ended March 31, 2010, fees earned from guaranty systems amounted to \$437 thousand, an 11.5% increase from \$392 thousand in 2009. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

For the nine months ended March 31, 2010, fees earned from guaranty systems amounted to \$1.3 million, a 30.0% increase from \$1.0 million in 2009. For the nine months ended March 31, 2010, the original principal amount outstanding for guarantors using our systems averaged \$4.5 billion, a 4.7% increase from \$4.3 billion in 2009. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

Retention of Collections on Defaulted Loans

Nine months ended March 31



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.

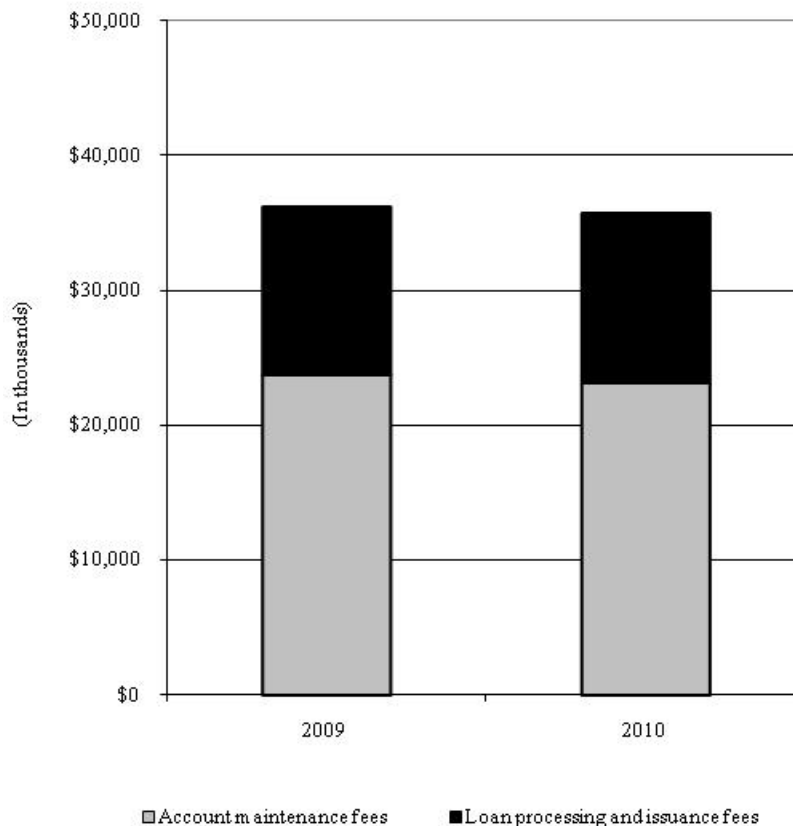
For the three months ended March 31, 2010, retention of collections on defaulted loans was \$33.6 million, a 52.7% increase from \$22.0 million in 2009. For the three months ended March 31, 2010, retention on rehabilitation collections was \$30.1 million, a 113.5% increase from \$14.1 million in 2009.

For the nine months ended March 31, 2010, retention of collections on defaulted loans was \$89.3 million, a 13.9% increase from \$78.4 million in 2009. For the nine months ended March 31, 2010, retention on rehabilitation collections was \$75.7 million, a 39.7% increase from \$54.2 million in 2009.

During 2010, the increase in the collections of defaulted loans was attributable to increasing loan defaults and by aggressively pursuing the collection of rehabilitation payments. The increase in rehabilitation payments in 2010 is due to the lack of eligible lenders purchasing rehabilitation loans during March 2009. In April 2009, we offered discounts to eligible lenders for purchasing rehabilitation loans from us. The discounts offered to eligible lenders reduce the amount of collections we retain on these loans.

Federal Fees

Nine months ended March 31



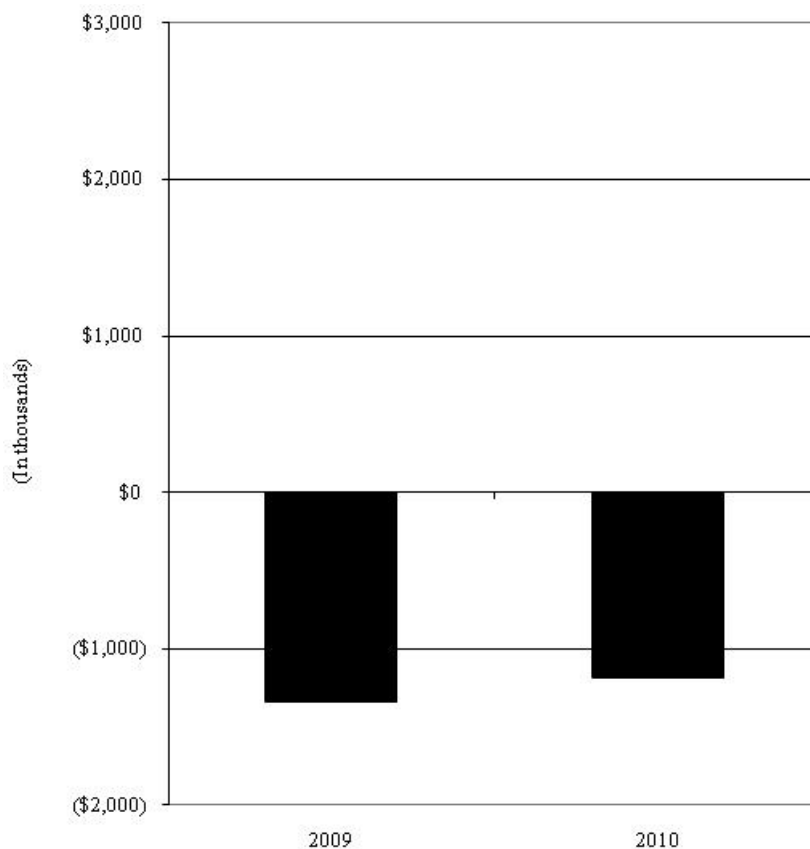
We earn federal fees from operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee of 0.40% on disbursed loans, which we guarantee; however, ED does not pay this fee on new consolidation loans. ED also pays us an annual account maintenance fee that is 0.06% of the original principal amount of loans guaranteed as long as the guarantee remains in force.

For the three months ended March 31, 2010, federal fees were \$12.8 million, a 3.8% decrease from \$13.3 million in 2009.

For the nine months ended March 31, 2010, federal fees were \$35.8 million, a 1.1% decrease from \$36.2 million in 2009. At March 31, 2010, the principal outstanding balance of loans guaranteed was \$50.0 billion compared to \$51.8 billion in 2009.

Default Aversion Fees

Nine months ended March 31



We earn default aversion fees when servicers involve us as guarantors to avert potential defaults and these fees are paid from the Federal Fund. The Federal Fund can only pay the default aversion fee once for a loan and if the loan subsequently defaults, we have to repay the fee to the Federal Fund. Since January 1, 2009, we have not recognized default aversion fee revenue due to the increased doubt about the collectability of the default aversion fees from the Federal Fund.

For the three months ended March 31, 2010, default aversion fees were negative \$578 thousand, an increase from a negative \$42 thousand in 2009.

For the nine months ended March 31, 2010, default aversion fees were negative \$1.2 million, a 7.7% decrease from a negative \$1.3 million in 2009. In 2010, the change in default aversion fees is due to a reduction in the amounts returned to ED due to subsequent loan defaults. We expect default aversion fees to be minimal in the future.

Change in Fair Value of Residual Interest, net

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

For the three months ended March 31, 2010, an increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was \$401 thousand compared to an increase of \$210 thousand in 2009.

For the nine months ended March 31, 2010, an increase in the aggregate carrying value of the residual interest in off-balance sheet securitizations was \$2.9 million compared to an increase of \$5.1 million in 2009. During 2010, the change was due primarily to the decline in the blended effective interest rate.

Operating Expenses

The following table displays operating expenses in more detail.

(In thousands)	Three months ended March 31, 2010			Three months ended March 31, 2009	
Personnel and Benefits	\$	36,503	56.2%	\$	37,203 59.2%
Professional services		9,142	14.1%		6,184 9.9%
Mail services		5,722	8.8%		4,904 7.8%
Information technology related expenses		4,902	7.5%		5,114 8.1%
Depreciation		2,466	3.8%		2,787 4.4%
Other		6,206	9.6%		6,641 10.6%
	\$	64,941	100.0%	\$	62,833 100.0%

(In thousands)	Nine months ended March 31, 2010			Nine months ended March 31, 2009	
Personnel and Benefits	\$	107,246	52.5%	\$	111,050 57.0%
Professional services		30,677	15.0%		23,543 12.1%
Mail services		15,572	7.6%		14,316 7.3%
Information technology related expenses		15,063	7.4%		15,792 8.1%
Depreciation		7,757	3.8%		8,945 4.6%
Other		28,015	13.7%		21,294 10.9%
	\$	204,330	100.0%	\$	194,940 100.0%

For the three months ended March 31, 2010, operating expenses were \$64.9 million, a 3.3% increase from \$62.8 million in 2009. The increase in 2010 is mainly due to increases in professional services.

For the nine months ended March 31, 2010, operating expenses were \$204.3 million, a 4.8% increase from \$194.9 million in 2009. The increase in 2010 is due to increases in professional services and costs associated with forward purchase contracts.

We have categorized expenses such as bank fees, building and grounds, telephone, and servicing liability as “other” operating expenses.

Personnel and Benefits

The following table displays Personnel and Benefits expenses:

(In thousands)	Three months ended March 31, 2010		Three months ended March 31, 2009	
Personnel and Benefits				
Compensation	\$ 25,983	71.2%	\$ 25,187	67.7%
Health care benefits for employees and retirees	5,542	15.2%	8,742	23.5%
Independent contractor fees	1,882	5.2%	1,589	4.3%
Employer's share of Social Security	1,879	5.1%	1,827	4.9%
Retirement contributions	778	2.1%	782	2.1%
Capitalized software development costs	(705)	(1.9%)	(668)	(1.8%)
Other	1,144	3.1%	(256)	(0.7%)
	\$ 36,503	100.0%	\$ 37,203	100.0%

(In thousands)	Nine months ended March 31, 2010		Nine months ended March 31, 2009	
Personnel and Benefits				
Compensation	\$ 77,414	72.2%	\$ 74,046	66.7%
Health care benefits for employees and retirees	17,107	16.0%	26,570	23.9%
Independent contractor fees	5,063	4.7%	4,365	3.9%
Employer's share of Social Security	5,664	5.3%	5,785	5.2%
Retirement contributions	2,365	2.2%	2,458	2.2%
Capitalized software development costs	(2,424)	(2.3%)	(1,877)	(1.7%)
Other	2,057	1.9%	(297)	(0.2%)
	\$ 107,246	100.0%	\$ 111,050	100.0%

For the three months ended March 31, 2010, personnel and benefit costs were \$36.5 million, a 1.9% decrease from \$37.2 million in 2009. For the three months ended March 31, 2010, healthcare benefits for employees and retirees were \$5.5 million, a 36.8% decrease from \$8.7 million in 2009. In 2010, the decrease in healthcare benefits for employees and retirees is due to a change in the estimate of the other post employment benefits liability.

For the nine months ended March 31, 2010, personnel and benefit costs were \$107.2 million, a 3.5% decrease from \$111.1 million in 2009. For the nine months ended March 31, 2010, healthcare benefits for employees and retirees were \$17.1 million, a 35.7% decrease from \$26.6 million in 2009. In 2010, the decrease in healthcare benefits for employees and retirees is due to a change in the estimate related to the other post employment benefits liability.

Permanent staff makes up 95.4% of the total personnel and benefits costs. For the three months ended March 31, 2010, permanent staff costs were \$35.3 million, a 2.8% decrease from \$36.3 million in 2009. For the nine months ended March 31, 2010, permanent staff costs were \$104.6 million, a 3.7% decrease from \$108.6 million in 2009.

The average permanent staff positions filled was 2,210 for the nine months ended March 31, 2010, which was a 5.5% increase from the 2,095 average permanent staff positions filled for the nine months ended March 31, 2009.

For the three months ended March 31 2010, independent contracting costs were \$1.9 million, an 18.8% increase from \$1.6 million in 2009. For the nine months ended March 31 2010, independent contracting costs were \$5.1 million, a 15.9% increase from \$4.4 million in 2009. We generally use independent contractors for specialized services, such as computer programming. Costs vary based upon changes in computer programming initiatives.

For the three months ended March 31, 2010, personnel costs relating to capitalized software development costs were \$705 thousand, a 5.5% increase from \$668 thousand in 2009. For the nine months ended March 31, 2010, personnel costs relating to capitalized software development costs were \$2.4 million, a 26.3% increase from \$1.9 million in 2009.

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

Professional Services

The following table displays professional services expenses:

(In thousands)	Three months ended March 31, 2010		Three months ended March 31, 2009		
Professional Services					
Collection agency fees	\$	4,332	47.4%	\$ 4,148	67.1%
Legal fees		2,669	29.2%	692	11.2%
Default aversion outsourcing fees		1,011	11.1%	969	15.7%
Audit fees		508	5.6%	118	1.9%
Consulting fees		102	1.1%	110	1.7%
Other professional fees		520	5.6%	147	2.4%
	\$	9,142	100.0%	\$ 6,184	100.0%

(In thousands)	Nine months ended March 31, 2010		Nine months ended March 31, 2009		
Professional Services					
Collection agency fees	\$	19,551	63.7%	\$ 15,224	64.7%
Legal fees		4,440	14.5%	3,203	13.6%
Default aversion outsourcing fees		2,469	8.0%	2,577	10.9%
Audit fees		1,126	3.7%	797	3.4%
Consulting fees		1,726	5.6%	290	1.2%
Other professional fees		1,365	4.5%	1,452	6.2%
	\$	30,677	100.0%	\$ 23,543	100.0%

Collection Agency Fees

For the three months ended March 31, 2010, collection agency fees were \$4.3 million, a 4.9% increase from \$4.1 million in 2009. For the nine months ended March 31, 2010, collection agency fees were \$19.6 million, a 28.9% increase from \$15.2 million in 2009. The increase in collections agency fees during 2010 is due to aggressive collections on an increasing portfolio of defaulted loans.

Provision for Servicing Liability

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

We present an analysis of our provision for servicing liability in the following table:

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Balance at beginning of period	\$ 9,020	9,957	\$ 9,115	8,172
Provision for losses	700	84	1,627	3,823
Charge-offs	(141)	(777)	(1,163)	(2,731)
Balance at end of period	\$ 9,579	9,264	\$ 9,579	9,264
Ending balance of student loans serviced	\$ 58,911,781	60,759,831	\$ 58,911,781	60,759,831
Allowance as a percentage of ending balance of student loans	0.02%	0.02%	0.02%	0.02%

Changes in Net Assets

The following table shows the changes in net assets:

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Operating income	\$ 27,493	5,506	\$ 66,232	43,230
Commonwealth of Pennsylvania grants	30,197	41,311	437,856	463,782
Federal grants	1,637	1,980	7,087	7,696
Grants and other financial aid	(197,989)	(186,373)	(438,338)	(439,765)
Grant funds returned to the Commonwealth of Pennsylvania	(1,000)	(8)	(12,284)	(14,939)
Transfers to the Pennsylvania Higher Education Foundation	(30)	(77)	(89)	(311)
Changes in net assets	\$ (139,692)	(137,661)	\$ 60,464	59,693

Grants and Other Financial Aid Activity

For the three months ended March 31, 2010, grants and other financial aid were \$198.0 million, a 6.2% increase from \$186.4 million in 2009. The increase during 2010 was due to us disbursing grant money to more schools during the current period as compared to the prior period. For the nine months ended March 31, 2010, grants and other financial aid were \$438.3 million, a 0.3% decrease from \$439.8 million in 2009.

The following table displays self-funded financial aid awarded through our various programs along with state and federally funded programs.

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Self-funded				
Keystone loan program origination fees and benefits paid on behalf of borrowers	\$ 167	419	\$ 334	1,682
Federal default fees paid on behalf of borrowers	(3)	10,216	50	25,511
Other	883	237	1,552	294
	1,047	10,872	1,936	27,487
State and federally funded				
State Grant Program	187,732	168,368	386,956	351,446
Institutional Assistance Grant Program	505	(124)	27,577	37,745
Matching Funds Program	2,427	3,016	12,825	13,032
New Economy Technology Scholarship Program	1,926	1,463	2,192	3,300
Other	4,352	2,778	6,852	6,755
	196,942	175,501	436,402	412,278
	\$ 197,989	186,373	\$ 438,338	439,765

For the three months ended March 31, 2010, self-funded financial aid was \$1.0 million, a 90.8% decrease from \$10.9 million in 2009. For the nine months ended March 31, 2010, self-funded financial aid was \$1.9 million, a 93.1% decrease from \$27.5 million in 2009. In 2010, the decrease in the self-funded financial aid was due to the suspension of paying the federal default fees on behalf of borrowers on loans guaranteed on or after January 1, 2009.

Loans guaranteed on or after July 1, 2006, are subject to a federal default fee equal to 1% of the loan's principal balance. Guarantors are required to deposit the 1% federal default fee into the Federal Fund for new Stafford and PLUS loans as guaranteed loans are disbursed. The guarantor may assess the federal default fee to the lender, and the lender may pass the federal default fee on to the borrower. In the past, we waived the federal default fee and paid the amount on behalf of the borrowers. On October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. For the nine months ended March 31, 2010, we paid fees totaling \$50 thousand to the Federal Fund for loans disbursed from July 1, 2009 through March 31, 2010. For the nine months ended March 31, 2009, we paid fees totaling \$25.5 million to the Federal Fund for loans disbursed from July 1, 2008 through March 31, 2009.

Other Changes in Net Assets

For the three months ended March 31, 2010, Commonwealth of Pennsylvania grants were \$30.2 million, a 26.9% decrease from \$41.3 million in 2009. For the nine months ended March 31, 2010, Commonwealth of Pennsylvania grants were \$437.9 million, a 5.6% decrease from \$463.8 million in 2009. The decrease during 2010 was due to the Commonwealth appropriating fewer funds to the State Grant Program due to the downturn in the economy.

For the three months ended March 31, 2010, federal grants were \$1.6 million, a 20.0% decrease from \$2.0 million in 2009. The decrease during 2010 was mainly due to the timing of the funds received from the federal government. For the nine months ended March 31, 2010, federal grants were \$7.1 million, a 7.8% decrease from \$7.7 million in 2009.

For the three months ended March 31, 2010, we contributed \$30 thousand of services to PHEF compared to \$77 thousand of services contributed during 2009. For the nine months ended March 31, 2010, we contributed \$89 thousand of services to PHEF compared to \$311 thousand of services contributed during 2009.

Net Asset Position

As of March 31, 2010, our net asset position was \$458.0 million and most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of \$143.5 million at March 31, 2010. Included in unrestricted net assets is \$50.0 million due from the Federal Fund that will likely be realized over the long term. The most substantial restriction on our net assets relates to restrictions for debt service, which amounted to \$267.6 million. Of that amount, \$267.0 million is related to our student loan notes, bonds and financings. Net assets restricted for financial aid grant programs amounted to \$56.3 million. The deficit in net assets invested in capital assets, net of related debt of \$9.4 million occurred because of differences between the timing of depreciation of the assets and principal payments on the debt.

Description of Debt Activity and Significant Capital Assets

Our principal funding need is securing capital to fund student loan originations and purchases. Our ability to raise debt could be limited in the future, because under our enabling legislation there is a formula that imposes a debt limit. As of March 31, 2010, our debt limit was \$26.1 billion and our outstanding debt amounted to \$10.2 billion.

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

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
<u>Capital market activity</u>				
Repayment of student loan demand revenue bonds	\$ (202,000)	(14,900)	\$ (1,170,800)	(15,800)
Repayment of student loan auction rate security bonds	(217,950)	-	(553,900)	-
Proceeds from issuing student loan floating rate notes	-	-	457,600	-
Repayment of student loan floating rate notes	(25,672)	(18,777)	(76,204)	(60,765)
<u>Student loan financings</u>				
Proceeds from student loan variable rate funding notes	182,905	-	619,355	-
Repayment of student loan variable rate funding notes	(33,451)	-	(60,074)	-
Repayment of student loan financings	(107,786)	(189,200)	(577,019)	(284,000)
<u>Capital financing activity</u>				
Proceeds from capital financings	-	-	-	4,650
Repayment of capital financings	(12,030)	(1,020)	(15,166)	(4,301)
<u>Other financing activity</u>				
Repayment of lines of credit	(10,000)	(7,000)	(36,000)	(14,035)
Proceeds from term financings	8,669	-	26,174	-
Repayment of term financings	(6,072)	-	(11,325)	(1,795)

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

(In thousands)	March 31, 2010	June 30, 2009
Land	\$ 2,946	2,946
Buildings and improvements	34,308	39,303
Software development	8,099	8,851
Purchased software	1,163	2,254
Other, principally information technology equipment	9,920	6,429
	\$ 56,436	59,783

The most significant ongoing capital item is software development. Mainly, our software development is customized systems for student financial aid processing that cannot be purchased from third party vendors. For the three months ended March 31, 2010, we capitalized \$705 thousand of software development compared to \$668 thousand in 2009. For the nine months ended March 31, 2010, we capitalized \$2.4 million of software development compared to \$1.9 million in 2009.

Federal Student Loan Reserve Fund

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

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

(In thousands)	March 31, 2010	September 30, 2009
Generally accepted accounting principles – net assets	\$ (35,166)	(27,017)
Deferred federal default fees	3,320	17,814
Gain contingency – default aversion fee rebate payable from PHEAA to the Federal Fund	5,961	7,143
Gain contingency – collections complement on future default collections	144,487	131,698
Regulatory net assets	\$ 118,602	129,638
Original principal outstanding	\$ 50,026,558	51,820,622
	0.24%	0.25%

For the three months ended March 31, 2010, purchases of defaulted loans were \$299.4 million, which was a 1.8% decrease from \$304.8 million in 2009. For the nine months ended March 31, 2010, purchases of defaulted loans were \$961.4 million, which was a 5.3% increase from \$913.4 million in 2009. See **Note 5 – 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
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May 14, 2010

	(Unaudited) Three months ended March 31,		(Unaudited) Nine months ended March 31,	
	2010	2009	2010	2009
<u>Interest revenue</u>				
Student loans	\$ 42,545	65,549	\$ 143,004	289,950
Investments	1,932	468	8,261	4,078
Total interest revenue	44,477	66,017	151,265	294,028
<u>Interest expense</u>				
Student loan financings and notes and bonds payable	40,424	68,633	134,799	281,736
Capital and other financings	2,178	2,898	7,404	8,998
Total interest expense	42,602	71,531	142,203	290,734
Net interest revenue (expense)	1,875	(5,514)	9,062	3,294
Provision for loan losses	(1,042)	(902)	(4,419)	(3,019)
Net interest revenue (expense) after provision for loan losses	833	(6,416)	4,643	275
<u>Noninterest revenue</u>				
Servicing fees	45,563	39,296	142,626	119,162
Retention of collections on defaulted loans	33,564	21,984	89,322	78,386
Federal fees	12,789	13,274	35,769	36,238
Changes in fair value of residual interest, net	401	210	2,924	5,104
(Loss) gain on student loans sales, net	(176)	3	(3,635)	3
Default aversion fees, net of rebates	(578)	(42)	(1,181)	(1,337)
Other	38	30	94	339
Total noninterest revenue	91,601	74,755	265,919	237,895
Operating revenues	92,434	68,339	270,562	238,170
<u>Operating expenses</u>				
Personnel	36,503	37,203	107,246	111,050
Professional services	9,142	6,184	30,677	23,543
Mail services	5,722	4,904	15,572	14,316
Information technology related expenses	4,902	5,114	15,063	15,792
Depreciation	2,466	2,787	7,757	8,945
Other	6,206	6,641	28,015	21,294
Total operating expenses	64,941	62,833	204,330	194,940
Operating income	27,493	5,506	66,232	43,230
Commonwealth of Pennsylvania grants	30,197	41,311	437,856	463,782
Federal grants	1,637	1,980	7,087	7,696
Grants and other financial aid	(197,989)	(186,373)	(438,338)	(439,765)
Grant funds returned to the Commonwealth of Pennsylvania	(1,000)	(8)	(12,284)	(14,939)
Transfers to the Pennsylvania Higher Education Foundation	(30)	(77)	(89)	(311)
Changes in net assets	(139,692)	(137,661)	60,464	59,693
Net assets, beginning of period	597,719	541,960	397,563	344,606
Net assets, end of period	\$ 458,027	404,299	\$ 458,027	404,299

See accompanying notes to financial statements.

	(Unaudited) March 31, 2010	June 30, 2009
Assets		
Cash and cash equivalents	\$ 21,740	29,514
Restricted cash and cash equivalents	371,062	367,096
Restricted cash and cash equivalents – due to customers	81,535	47,185
Investments	115,580	26,971
Restricted investments	113,373	124,042
Residual interest in off-balance sheet securitizations	26,124	23,200
Student loans receivable, net	9,818,727	11,169,840
Interest income receivable	161,716	197,302
Due from Federal Student Loan Reserve Fund, net	50,034	44,504
Capital assets, net	56,436	59,783
Deferred financing costs, net	38,851	42,047
Other assets	49,808	39,352
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education	140,294	107,655
Total assets	11,045,280	12,278,491
Liabilities		
Due to customers	81,535	47,185
Accounts payable and accrued expenses	114,809	89,680
Student loans financings and notes and bonds payable, net	10,007,245	11,361,553
Capital and other financings	238,598	274,855
Obligations under capital lease	4,772	-
Amounts related to the Federal Student Loan Reserve Fund	140,294	107,655
Total liabilities	10,587,253	11,880,928
Net assets		
Invested in capital assets, net of related debt	(9,416)	(16,424)
Restricted for debt service	267,624	263,489
Restricted for financial aid grant programs	56,287	59,819
Unrestricted	143,532	90,679
Total net assets	\$ 458,027	397,563

See accompanying notes to financial statements.

	(Unaudited) Nine months ended March 31,	
	2010	2009
<u>Cash flows from operating activities</u>		
Interest received on student loans	\$ 77,974	249,245
Principal received on student loans	861,457	831,363
Student loan originations	(286)	(2,149)
Student loan purchases	(19,701)	(348,857)
Student loan sales, including net gains	605,210	18,490
Servicing fees	141,445	114,468
Retention of collections on defaulted loans	83,791	81,314
Federal fees	31,946	32,892
Default aversion fees, net of rebate	(1,176)	(496)
Other	(3,541)	339
Payment of operating expenses	(178,981)	(192,413)
Net cash provided by operating activities	1,598,138	784,196
<u>Cash flows from noncapital financing activities</u>		
Proceeds from the issuance of noncapital debt	1,103,129	-
Principal paid on noncapital debt	(2,485,322)	(376,395)
Interest paid on student loan financings and notes and bonds payable	(119,658)	(311,338)
Issuance costs	(3,875)	(253)
Commonwealth of Pennsylvania grants received	437,856	463,782
Federal grants received	7,087	7,696
Grants and financial aid paid	(438,338)	(439,555)
Grant funds returned to the Commonwealth of Pennsylvania	(12,284)	(14,939)
Net cash used for noncapital financing activities	(1,511,405)	(671,002)
<u>Cash flows from capital and related financing activities</u>		
Proceeds from issuance of capital debt	-	4,650
Principal paid on capital debt	(15,166)	(4,301)
Interest paid on capital and other financings	(5,489)	(7,166)
Purchases of capital assets and development of software, net of disposals	362	(1,279)
Net cash used for capital and related financing activities	(20,293)	(8,096)
<u>Cash flows from investing activities</u>		
Proceeds from sales and maturities of investments	585,940	471,022
Purchases of investments	(663,880)	(530,689)
Interest received on investments	7,692	3,661
Net cash used for investing activities	(70,248)	(56,006)
Net change in cash and cash equivalents (including restricted cash)	(3,808)	49,092
Cash and cash equivalents (including restricted cash), beginning of period	396,610	311,914
Cash and cash equivalents (including restricted cash), end of period	\$ 392,802	361,006

(continued)

	(Unaudited)	
	Nine months ended	
	March 31,	
	2010	2009
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 66,232	43,230
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	7,757	8,945
Student loan financings and notes and bonds payable interest	119,658	311,338
Capital and other financings interest	5,489	7,166
Investment interest	(7,692)	(3,661)
Amortization of premium on loan purchases	31,889	41,382
Amortization of loan origination costs	(870)	8,988
Amortization of deferred financing costs	7,071	1,877
Amortization of deferred amount on refundings of student loan demand revenue bonds	6,735	600
Accretion discount on capital and other financings	59	57
Transfers to the Pennsylvania Higher Education Foundation	(89)	(311)
Changes in assets and liabilities:		
Decrease in interest income receivable	35,586	45,725
Increase in residual interest in off-balance securitizations	(2,924)	(5,104)
Decrease in student loans receivable	1,320,094	364,629
(Increase) decrease in amounts due from Federal Student Loan Reserve Fund	(5,530)	2,929
Increase in other assets	(10,456)	(9,150)
Increase (decrease) in accounts payable and accrued expenses	25,129	(34,444)
Total adjustments	1,531,906	740,966
Net cash provided by operating activities	\$ 1,598,138	784,196

See accompanying notes to financial statements.

Note 1 – About PHEAA

Organization

Pennsylvania Higher Education Assistance Agency (“PHEAA”), doing business as American Education Services (“AES”) and FedLoan Servicing (“FLS”), is a public corporation and government instrumentality created by the Pennsylvania General Assembly on August 7, 1963. Our mission is to improve higher education opportunities for Pennsylvanians.

The Commonwealth of Pennsylvania’s (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 as defined by GASB 14 – *The Financial Reporting Entity* and GASB 39 – *Determining Whether Certain Organizations Are Component Unit*. GASB 14 defines component units as legally separate organizations for which the elected officials of the primary government (Commonwealth) are financially accountable. In addition, component units can be other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete.

Blended Component Unit

We formed the PHEAA Student Loan Foundation, Inc. on August 6, 2002. The foundation is exempt from federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). Its charitable purpose is to carry out student loan securitization transactions for our benefit. The foundation is a blended component unit, because we appoint a majority of the foundation’s board of directors, we can impose our will on the foundation, and it provides services entirely to us. As a blended component unit, we consolidate the transactions of the PHEAA Student Loan Foundation, Inc into our financial statements.

On May 22, 2009, the PHEAA Student Loan Company, LLC (PHEAA SLC) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On June 1, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED that was authorized under section 459A of the Higher Education Act (HEA). In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose vehicle (PHEAA SLC). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC, so PHEAA SLC is a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

On November 2, 2009, the PHEAA Student Loan Company II, LLC (PHEAA SLC II) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFEL program; and issuing and selling one or more series of bonds, notes or other indebtedness secured by student loans. On November 10, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC II). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC II, so PHEAA SLC II is a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

On November 2, 2009, the PHEAA Student Loan Company III, LLC (PHEAA SLC III) was formed in the State of Delaware for the purpose of purchasing, acquiring, owning, holding, selling, assigning, pledging and dealing in education loans to students and parents of dependent students under FFEL program; and issuing and selling one or

more series of bonds, notes or other indebtedness secured by student loans. On November 12, 2009, we issued a notice of intent to participate in the Loan Purchase Commitment Program with ED. The Loan Purchase Commitment Program was authorized under section 459A of the HEA. In order to participate in the Loan Purchase Commitment Program, we created an individual bankruptcy remote special purpose entity (PHEAA SLC III). The PHEAA Student Loan Foundation is the sole equity member of PHEAA SLC III, so PHEAA SLC III is a blended component unit of the PHEAA Student Loan Foundation, Inc and its transactions are consolidated in the financial statements of the PHEAA Student Loan Foundation.

Discretely Presented Component Unit

The Pennsylvania Higher Education Foundation, Inc.

We supported the formation of The Pennsylvania Higher Education Foundation, Inc. (“PHEF”), which is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purposes include, but are not limited to, activities intended to improve or enhance postsecondary education opportunities for students in Pennsylvania and elsewhere. PHEF is a discretely presented component unit, because our Executive Committee appoints a majority of the foundation’s board of directors, we can impose our will on the foundation, but it does not provide services entirely to us. As a discretely presented component unit, we do not consolidate the transactions of PHEF into our financial statements, but we present them in the notes of the annual financial report.

PHEF’s audited financial statements are available on its website – www.higheredfoundation.org.

Related Organization

The Higher Education Foundation, Inc.

We also supported the formation of The Higher Education Foundation, Inc. (“HEF”), and it is also tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purpose is exclusively for the benefit of PHEF and the directors of PHEF are directors of HEF. The purpose of HEF’s formation was to assist with fundraising and program administration particularly for projects that may extend beyond Pennsylvania. We cannot impose our will on HEF, there is no financial burden or benefit associated with it; therefore, we do not consolidate the financial transactions of HEF into our financial statements. PHEF prepares consolidated financial statements that include transactions for HEF.

Note 2 – Recent Developments

On January 19, 2010, we entered into an \$8.7 million Note Purchase Agreement (NPA) with a financial institution, whereas the financial institution purchased the NPA in consideration for the redemption of the remaining 2001 Series B, 2002 Series A and 2002 Series B revenue bonds.

On January 29, 2010, we made an intra-entity transfer of \$188.6 million of principal and interest of student loans to the PHEAA SLC III. Previously, we entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A Funding, LLC (Conduit) through which the Conduit would purchase the variable FNPA at 97% of the collateral value of eligible student loans pledged or \$182.9 million. On January 29, 2010, we received \$182.9 million from the FNPA of which we used \$1.6 million of the proceeds to fund a reserve account, pay attorney’s fees and other costs associated with the FNPA. On that same day, we used the \$181.3 million of net proceeds from the FNPA and the \$8.7 million of proceeds from the NPA to redeem the remaining portion of the 2001 Series B, 2002 Series A and 2002 Series B revenue bonds.

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act (H.R. 4872). The Student Aid and Fiscal Responsibility Act (SAFRA), an attachment to H.R. 4872, terminates our

authority to make or guarantee new loans under the FFEL program after June 30, 2010. All new Stafford, Plus and Consolidation student loans will be made under the William D. Ford Federal Direct Loan program on July 1, 2010.

Note 3 – Summary of Significant Accounting Policies

Basis of Presentation and Accounting

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, as amended by Statement No. 37, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*, our financial statements have been prepared on the basis of the governmental enterprise fund concept, which pertains to financial activities that operate similarly to a private business enterprise. We follow the economic resources measurement focus and accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. While private business enterprises follow the accounting guidance issued by the Financial Accounting Standards Board (“FASB”), we follow the guidance issued by the Governmental Accounting Standards Board (“GASB”). As encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989, to be consistent with the accounting practices of the Commonwealth.

Use of Estimates

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

Cash Equivalents

Cash equivalents include investments in money market funds, U.S. government agency funds, and commercial paper with original maturities at acquisition of three months or less, and we report them at fair value.

Cash equivalents also include amounts invested in nonparticipating interest-earning investment contracts that provide a guaranteed return on principal over a specified time. These amounts include investments of bond proceeds that are used to originate or purchase student loans and we report them using a cost-based measure. We report these amounts as cash equivalents, because we may deposit and withdraw cash at any time without prior notice or penalty.

Restricted Cash and Investments

Restricted cash and investments include cash received from financial institutions pending disbursement for student loans, cash received for the benefit of servicing customers, and cash and investments of bond proceeds held by a trustee and restricted by the provision of the bond indentures and financing agreements. We consider these amounts restricted and they cannot be disbursed for any other purpose.

Investments

Investments include amounts invested with the State Treasury investment pool, which is a short-term investment portfolio maintained by the Commonwealth of Pennsylvania Treasury Department’s Bureau of Cash Management and Investments for the benefit of all Commonwealth funds, and other instruments including securities. We report these amounts at fair value based upon information provided by the Commonwealth of Pennsylvania’s Treasury Department.

Investments also include amounts invested in nonparticipating interest-earning investment contracts that provide a guaranteed return on principal over a specified period. These amounts include investments of funds reserved for debt service payments and we report these amounts using a cost-based measure.

Student Loans Receivable, net

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

In the past, we paid all of the up-front federal fees that could be charged to borrowers for loans originated by us. However, on October 2, 2008, management announced the suspension of paying the federal default fee on behalf of borrowers for loans guaranteed on or after January 1, 2009. We report the cost of providing these benefits with grants and other financial aid in the Statements of Revenues, Expenses and Changes in Net Assets.

Allowances for potential losses on our student loans can result from deficient servicing, risk sharing on defaults and uninsured loans. These allowances are based upon our ongoing evaluation of the loan portfolios, past and anticipated loss experience and the amount and quality of the loans. We maintain the allowances at a level that we believe is adequate to absorb estimated incurred losses, but our evaluation is inherently subjective and the required allowances may significantly change in the future. We do not write-off uncollectible loans that are not guaranteed or insured as we continue to pursue collection on those loans.

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

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

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

Capital Assets

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

We capitalize purchased computer software if the per unit costs, based on per license fee, is \$10,000 or more. We capitalize improvements or additions to existing software that constitute a capital outlay or increase the value or life of the asset by 25% of the original cost or life as a betterment and we record it as an addition of value to the existing

asset. We calculate depreciation based on the straight-line method over the estimated useful life of the purchased software.

Software development involves three phases: preliminary project phase, application development phase and post-implementation/operation phase. We expense the cost associated with the preliminary project and the post-implementation/operating phase. We capitalize internal and external costs associated with the application development phase. The capitalization of costs begins when the preliminary project phase is complete and management has implicitly authorized or commits to funding the software project with the intent it will be completed and used to perform its planned functions. Capitalization will cease no later than at the time when substantial testing is complete and the software is ready for its intended purpose or rendered into service. Upgrades and enhancements are modifications to existing internal-use software that result in additional functionality, that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may require a change to all or part of the existing software specifications. We capitalize upgrades and enhancements, as defined above. We report software development at cost net of amortization. We calculate amortization based on the straight-line method over the estimated useful life of the software developed.

We capitalize assets that cost \$10,000 or more; amounts under that threshold are expensed. The following estimated useful lives are used for significant asset categories:

- Buildings and improvements 7 – 40 years
- Furniture, furnishings and equipment 5 – 10 years
- Software (purchased and development) 3 – 5 years

Deferred Financing Costs

Deferred financing costs consist of underwriting and other costs of issuing financings. We amortize these costs over the term of the financing using the straight-line or effective interest method and these costs are included in interest expense.

Compensated Absences

Employees earn annual leave based upon years of service and may carry forward up to 45 days of unused annual leave at the end of each calendar year. We pay employees for accumulated annual leave at termination or retirement. Employees earn sick leave and may carry forward up to 300 days of unused sick leave at the end of each calendar year. We pay employees a portion of accumulated sick leave at retirement based upon a formula. We include in accrued expenses on the statements of net assets the estimated amounts payable upon retirement or termination under these arrangements.

Revenue Recognition

We recognize servicing fees as revenue when we provide the contractual services and when we record the unbilled amounts as accounts receivable. For federal loan processing and issuance fees related to our guaranty function, we recognize revenue as the guaranteed loans are disbursed, and we recognize account maintenance fees throughout the year at rates established by law. We recognize retention of collections on defaulted loans as revenue when we collect the cash on the defaulted loans.

We receive default aversion fees amounting to 1% of the principal and interest of a loan when the lender submits a default preclaim. If the loan later defaults, we must return these fees to the Federal Fund at the time of the loan default. Therefore, the revenue recognized from default aversion fees is net of the amount we estimate that we will have to be return to the Federal Fund. Since January 1, 2008, we have not recognized revenue related to default aversion fees, as we could not assure the ultimate collectability of those loans, so we have not transferred any of

these fees from the Federal Fund. However, the Federal Fund continues to recognize the entire default aversion fee returns as an expense when incurred.

Operating Revenues and Expenses

Operating revenues include net interest revenue earned on student loans and investments and fees earned from providing services. Operating expenses include the costs of providing services and operating all programs. We do not report as a component of operating income the grants we receive and the grants and financial aid we disburse.

Advertising

We incur advertising expenses to generate additional business and to make sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. As we incur advertising expenses, we expense them. For the three months ended March 31, 2010, advertising expense was \$21 thousand as compared to zero in 2009. For the nine months ended March 31, 2010, advertising expense was \$31 thousand as compared to \$44 thousand in 2009.

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 GASB Statement No. 14 – *The Financial Reporting Entity*. See **Note 10 - Student Loan Securitizations** for more details.

For transactions qualifying as sales according to GASB Statement No. 48 – *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, we retain a residual interest, which we recognize in the Statements of Net Assets as the residual interest in off-balance sheet securitizations. The residual interest is the right to receive cash flows from the student loans in excess of the amounts needed to pay servicing, administration, and other fees, as well as, the principal and interest on the bonds backed by the student loans. The residual interest is the present value of these future expected cash flows. We value the residual interest at the time of sale of the student loans to the trust and at the end of each subsequent quarter and we reflect the changes in fair value of residual interest, net on the statements of revenues, expenses, and changes in net assets.

Commonwealth of Pennsylvania and Federal Grant Revenues

Commonwealth and federal grants are nonexchange transactions. We use the receipts as a source of funds to disburse grants and financial aid. Our agreements contain restrictions requiring us to spend the money in accordance with the legislation or grant agreement, but generally do not refer to specific time requirements. Accordingly, we recognize the entire amount as revenue when we receive it.

Reclassifications

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

Correction of Immaterial Errors

During 2009, we identified certain prior period errors related to the reporting of activities in the Statements of Cash Flows in accordance with GASB 9 – *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. We corrected the prior period errors in the Statement of Cash Flows for the nine months ended March 31, 2009, as follows:

	As previously reported	Impact of errors	As adjusted
<u>Cash flows from operating activities:</u>			
Principal received on student loans	\$ 844,619	(13,256)	831,363
Student loan purchases	(343,662)	(5,195)	(348,857)
Student loan sales, including net gains	39	18,451	18,490
Interest received on investments	3,661	(3,661)	-
Interest paid on student loan financings and notes and bonds payable	(311,338)	311,338	-
Interest paid on capital and other financings	(7,166)	7,166	-
Net cash provided by operating activities	469,353	314,843	784,196
<u>Cash flows from noncapital financing activities:</u>			
Interest paid on student loan financings and notes and bonds payable	-	(311,338)	(311,338)
Net cash used for noncapital financing activities	(359,664)	(311,338)	(671,002)
<u>Cash flows from capital and related financing activities:</u>			
Interest paid on capital and other financings	-	(7,166)	(7,166)
Net cash used for capital and related financing activities	(930)	(7,166)	(8,096)
<u>Cash flows from investing activities:</u>			
Interest received on investments	-	3,661	3,661
Net cash used for investing activities	\$ (59,667)	3,661	(56,006)

We assessed the materiality of the above errors in the 2009 quarterly financial statements and determined that those errors are immaterial to the previously reported amounts.

Note 4 – New Accounting Pronouncements

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

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

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

During 2009, the GASB issued Statement No. 58 - *Accounting and Financial Reporting for Chapter 9 Bankruptcies*. The objective of this Statement is to provide accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. It requires governments to remeasure liabilities that are adjusted in bankruptcy when the bankruptcy court confirms (that is, approves) a new payment plan. This statement is effective for reporting periods after June 15, 2009.

Note 5 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education

As a part of our guaranty operations, we manage the Federal Fund for the ED. We pay claims on defaulted loans out of the Federal Fund, which belongs to the federal government. On the statements of net assets, we report the total assets of the Federal Fund under the caption “Federal Student Loan Reserve Fund assets held for the U.S. Department of Education.” We also report the same amount as a liability on the statements of net assets. Since the Federal Fund has both assets and liabilities, we use a net asset approach in the following tables to report activity in the fund.

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

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Additions				
Reinsurance from the U.S. Department of Education	\$ 288,156	292,902	\$ 924,901	877,461
Collections on defaulted loans	162,779	98,872	427,162	321,688
Federal default fees	13,773	13,736	32,047	31,571
Net appreciation (depreciation) in fair value of investments	14	5	(93)	126
Total additions	464,722	405,515	1,384,017	1,230,846
Deductions				
Purchases of defaulted loans from lenders	299,426	304,828	961,434	913,371
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections	115,574	73,973	304,067	233,889
Reimbursement to PHEAA for our retention of defaulted loans collections	42,278	21,984	111,245	78,386
Default aversion fees, net	6,201	6,348	13,447	18,868
Other	(3)	-	-	-
Total deductions	463,476	407,133	1,390,193	1,244,514
Net increase (decrease)	1,246	(1,618)	(6,176)	(13,668)
Net liabilities, beginning of period	(36,412)	(16,542)	(28,990)	(4,492)
Net liabilities, end of period	\$ (35,166)	(18,160)	\$ (35,166)	(18,160)

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

(In thousands)	March 31, 2010	June 30, 2009
Assets		
Cash	\$ 44,036	31,695
Receivable from the U.S. Department of Education	93,250	64,242
Other receivables	3,008	11,718
Total assets	140,294	107,655
Liabilities		
Accounts payable and accrued expenses	8,356	15
Payable to the U.S. Department of Education	15,763	-
Deferred federal default fees	3,320	10,147
Amounts payable to PHEAA	148,021	126,483
Total liabilities	175,460	136,645
Net liabilities	\$ (35,166)	(28,990)

Under the Higher Education Amendments of 1998, we are to act as a fiduciary in managing the assets of the Federal Fund.

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

During the nine months ended March 31, 2010 and 2009, we have managed the cash flow of the Federal Fund in a manner to assure our customers that sufficient funds are available to continue to pay default claims by not transferring default aversion fees that are due to us. In addition to paying default claims, we pay our share of retention on defaulted loan collections from the fund and we could in the future resume paying default aversion fees from the fund.

Note 6 – Student Loans Receivable

The following table shows our student loan holdings.

(In thousands)	March 31, 2010	June 30, 2009
FFEL:		
Consolidation	\$ 6,907,871	7,315,493
Stafford	2,263,446	3,053,956
PLUS	340,719	425,898
Supplemental Loans for Students	1,775	1,378
	9,513,811	10,796,725
HEAL	142,008	161,415
Privately insured loans	49,520	51,509
Uninsured loans	5,704	6,094
Unamortized premium on loan purchases	97,483	134,905
Unamortized loan origination costs	24,908	33,037
	9,833,434	11,183,685
Allowance for loan losses	(14,707)	(13,845)
Student loans receivable, net	\$ 9,818,727	11,169,840

Allowance for loan losses

We estimated and established an allowance for loan losses based upon our continuing evaluation of our student loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We maintain the allowances for loan losses at a level that is adequate to absorb estimated incurred losses, but our evaluation is inherently subjective and the required allowances may significantly change in the future. We do not write-off uncollectible loans that are not guaranteed or insured as we continue to pursue collection on those loans.

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

(In thousands)	March 31, 2010	June 30, 2009
Balance at beginning of period	\$ 14,320	16,939
Provision for losses	1,903	3,560
Charge-offs	(1,516)	(6,654)
Balance at end of period	\$ 14,707	13,845

Note 7 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings as of March 31, 2010 are as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings, demand revenue bonds and auction rate bonds:					
Student loan auction rate security bonds, due 2022-2047, at weighted-average rates of 5.33% at March 31, 2010 and 5.56% at March 31, 2009.	\$ 7,395,950	-	(553,900)	6,842,050	-
Deferred amount on current refunding of student loan auction rate security bonds.	(2,543)	-	153	(2,390)	-
Student loan floating rate notes, due 2016-2038, at weighted-average rates of 0.57% at March 31, 2010 and 1.25% at March 31, 2009.	1,277,949	457,600	(76,204)	1,659,345	-
Student loan demand revenue bonds, due 2018-2033, at weighted-average rates of zero at March 31, 2010 and 3.89% at March 31, 2009.	1,170,800	-	(1,170,800)	-	-
Deferred amount on current refunding of student loan demand revenue bonds.	(6,582)	-	6,582	-	-
Student loan variable rate funding notes, due 2014-2015, at an estimated weighted-average rate of 0.58% at March 31, 2010.	799,960	619,354	(60,074)	1,359,240	-
Student loan financings, due on demand at weighted-average rates of 0.82% at March 31, 2010 and 1.42% at March 31, 2009.	726,019	-	(577,019)	149,000	149,000
	11,361,553	1,076,954	(2,431,262)	10,007,245	149,000
Capital financings:					
Capital acquisition bonds, due 2010 at weighted-average rates of 6.25% at March 31, 2010 and 5.51% at March 31, 2009.	76,285	-	(15,166)	61,119	61,119
Unamortized discount on capital acquisition bonds.	(78)	-	38	(40)	-
	\$ 76,207	-	(15,128)	61,079	61,119

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Other financings:					
Line of credit, due 2010, at weighted-average rates of 2.76% at March 31, 2010 and 3.01% at March 31, 2009.	\$ 72,000	-	(36,000)	36,000	36,000
Capital acquisition refunding bonds, due 2010 - 2030, at weighted-average rates of 5.09% at March 31, 2010 and 2009.	66,410	-	(1,865)	64,545	1,935
Unamortized discount on capital acquisition refunding bonds	(442)	-	21	(421)	-
Term financing, due 2029 - 2030, at zero percent interest at March 31, 2010.	60,680	26,175	(9,460)	77,395	-
	198,648	26,175	(47,304)	177,519	37,935
	\$ 11,636,408	1,103,129	(2,493,694)	10,245,843	248,054

The note and bond indentures among other things require us to comply with various covenants. Student loans and investments collateralize all student loan financings, student loan floating rate notes, and student loan demand revenue bonds and auction rate notes. At March 31, 2010, \$9.9 billion of student loan principal and related interest receivable and \$353.3 million of investments and related interest receivable collateralized the \$10.2 billion of student loan financings and notes and bonds payable.

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

Student loan financings, demand revenue bonds, auction rate bonds, and other term financings

On December 7, 2009, we transferred \$449.4 million of eligible student loans to the PHEAA SLC II. On December 10, 2009, the PHEAA SLC II entered into a variable Funding Note Purchase Agreement (FNPA) with Straight-A Funding, LLC (Conduit) through which the Conduit purchased the variable funding note at 97% of the collateral value of eligible student loans pledged or \$436.4 million. On that same day, we entered into a \$9.8 million Note Purchase Agreement (NPA) with a financial institution, which is non-recourse debt to us. The financial institution funded the NPA in consideration of the redemption or defeasance of the 1988 Series A, B, C, E, 1994 Series A, 1997 Series A, 2000 Series A, 2001 Series A, and 2003 Series A-1 and A-2 bonds that were subject to the asset-backed securities transactions conduit refinancing.

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

and the “Pennsylvania Higher Education Assistance Agency Floating Rate Student Loan Asset-Backed Notes, Series 2009-2” official statements dated December 17, 2009 and December 21, 2009, respectively.

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

On January 19, 2010, we entered into an \$8.7 million NPA with a financial institution, whereas the financial institution purchased the NPA in consideration for the redemption of the remaining 2001 Series B, 2002 Series A and 2002 Series B revenue bonds.

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

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

Capital financings

Capital financings are collateralized with capital assets. During March 2010, we paid off \$12.0 million of tax-exempt lines of credit prior to maturity.

Other financings

As part of a mandatory reduction of revolving credit commitment with a financial institution, we reduced our line of credit by \$36.0 million as of March 31, 2010.

Debt service requirements

The following table displays the debt service requirements based upon the stated maturities for demand bonds and estimated interest rates for variable-rate debt after considering terms renegotiated after March 31, 2010.

(In thousands) Year of Maturity	Student Loan Notes, Bonds and Financings		Capital and Other Financings	
	Principal	Interest	Principal	Interest
2011	\$ 149,000	159,033	99,054	8,099
2012	-	158,634	1,965	6,703
2013	-	158,634	2,040	3,158
2014	-	158,634	2,125	3,056
2015	1,359,240	158,634	2,220	2,951
2016-2020	134,110	792,157	12,710	13,012
2021-2025	426,340	784,732	16,160	9,563
2026-2030	596,450	769,083	98,019	5,171
2031-2035	-	735,591	4,766	577
2036-2040	1,367,770	718,355	-	-
2041-2045	2,177,900	536,787	-	-
2046-2050	3,798,825	107,235	-	-
	\$ 10,009,635	5,237,509	239,059	52,290

As of March 31, 2010, \$10.0 billion of the student loan notes, bonds and financings are variable-rate debt. \$6.1 billion resets based upon auctions every 28 days. \$726.5 million resets based upon auctions every 35 days. \$1.8 billion is indexed to the 1-month or 3-month LIBOR, \$27.0 million is indexed to 3-month financial commercial paper, and \$1.4 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 March 31, 2009 was as follows.

(In thousands)	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due within One Year
Student loan financings, demand revenue bonds, and auction rate bonds:					
Student loan auction rate security bonds	\$ 7,463,500	-	-	7,463,500	-
Deferred amount on current refundings of student loan auction rate security bonds	(2,747)	-	153	(2,594)	-
Student loan demand revenue bonds	2,058,900	-	(15,800)	2,043,100	-
Deferred amount on current refundings of student loan demand revenue bonds	(7,178)	-	447	(6,731)	-
Student loan floating rate notes	1,366,043	-	(60,765)	1,305,278	-
Student loan financings	1,084,019	-	(284,000)	800,019	800,019
	11,962,537	-	(359,965)	11,602,572	800,019
Capital financings:					
Capital acquisition bonds	76,766	4,650	(4,301)	77,115	4,328
Unamortized discount on capital acquisition bonds	(129)	-	37	(92)	-
	76,637	4,650	(4,264)	77,023	4,328
Other financings:					
Line of credit	94,035	-	(14,035)	80,000	36,000
Capital acquisition refunding bonds	68,205	-	(1,795)	66,410	1,865
Unamortized discount on capital acquisition refunding bonds	(470)	-	20	(450)	-
	161,770	-	(15,810)	145,960	37,865
	\$ 12,200,944	4,650	(380,039)	11,825,555	842,212

Note 8 – 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

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Interest revenue	\$ 46,588	71,047	\$ 156,398	308,348
Interest expense	40,424	68,633	134,799	281,736
Net interest revenue	6,164	2,414	21,599	26,612
Provision for loan losses	(1,012)	(913)	(4,293)	(2,972)
Net interest revenue after provision for loan losses	5,152	1,501	17,306	23,640
(Loss) gain on student loan sales, net	(177)	3	(2,972)	3
Total operating revenues	4,975	1,504	14,334	23,643
Operating expenses	14,056	18,714	47,288	56,604
Operating loss	(9,081)	(17,210)	(32,954)	(32,961)
Financial aid	(21)	(311)	(174)	(1,338)
Loss before transfers	(9,102)	(17,521)	(33,128)	(34,299)
Transfers from unrestricted net assets	492	247	39,316	7,262
Change in net assets	(8,610)	(17,274)	6,188	(27,037)
Net assets, beginning of period	275,646	243,290	260,848	253,053
Net assets, end of period	\$ 267,036	226,016	\$ 267,036	226,016

Statement of Net Assets

(In thousands)	March 31, 2010	June 30, 2009
Restricted cash and cash equivalents	\$ 364,320	360,250
Student loans receivable, net	9,755,586	11,070,568
Other, principally interest income receivable	196,642	235,215
Total assets	10,316,548	11,666,033
Student loan financings and notes and bonds payable, net	10,007,245	11,361,553
Other, principally accrued interest payable	42,267	43,632
Total liabilities	10,049,512	11,405,185
Net assets, restricted for debt service	\$ 267,036	260,848

Statements of Cash Flows

(In thousands)	Nine months ended March 31,	
	2010	2009
<u>Cash flows from operating activities</u>		
Interest received on student loans	\$ 79,027	248,446
Principal received on student loans	875,005	839,034
Student loan originations	(16)	(1,599)
Student loan purchases	(33,662)	(347,462)
Student loan sales, including net gains	578,694	5,198
Payment of operating expenses	(50,120)	(57,373)
Net cash provided by operating activities	<u>1,448,928</u>	686,244
<u>Cash flows from noncapital financing activities</u>		
Proceeds from issuance of noncapital debt	1,086,414	-
Principal paid on noncapital debt	(2,447,457)	(360,565)
Interest paid on student loan financings and notes and bonds payable	(119,658)	(311,340)
Other	35,267	5,671
Net cash used for noncapital financing activities	<u>(1,445,434)</u>	(666,234)
<u>Cash flows from investing activities</u>		
Interest received on investments	576	2,841
Net cash provided by investing activities	<u>576</u>	2,841
Net change in restricted cash and cash equivalents	4,070	22,851
Restricted cash and cash equivalents, beginning of period	360,250	296,226
Restricted cash and cash equivalents, end of period	\$ 364,320	319,077

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

There are 10 separate trusts with parity ratios, a ratio of assets to liabilities, ranging from 1.002 to 1.057 at March 31, 2010.

The master trust that issued auction rate securities holds \$6.8 billion of debt. The parity ratio for this trust is 1.002 at March 31, 2010 and 1.000 at March 31, 2009. There is no parity ratio requirement for this trust.

Note 9 – Restrictions on Net Assets

Net assets restricted for debt service amounted to \$267.6 million at March 31, 2010. Of that amount, \$267.0 million is related to net assets held under various indentures related to financing our student loan portfolios, and the remaining \$600 thousand of net assets restricted for debt service is related to capital and other financings.

The \$56.3 million of net assets restricted for financial aid grant programs results from Commonwealth of Pennsylvania grants and federal grants related to specific programs. Those net assets are restricted until we disburse program-related grants.

Under Commonwealth law, our purpose is to increase higher education opportunities for Pennsylvania residents. Net assets that we report as unrestricted are statutorily restricted to our purpose. The Higher Education Amendments of 1998 also restrict our use of net assets related to 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.

Note 10 – Student Loan Securitizations

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

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

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

(Dollars in thousands)	March 31, 2010	June 30, 2009
Present value of residual interest	\$ 26,124	23,200
Weighted average life	10.25 years	11.00 years
Constant prepayment rate	4.0%	4.0%
Residual cash flow discount rate	5.0%	5.1%

When we sell student loan receivables in securitizations of student loans, we enter into a servicing agreement with the securitization trust and earn annual servicing fees from the trust of 0.25% per year on the outstanding balance of consolidation loans and 0.50% per year on the outstanding balance of Stafford and PLUS loans. We also entered into an administration agreement with the trust and we generally earn annual administration fees of 0.25% per year on the outstanding balance of student loans in the trust. For the three months ended March 31, 2010, we earned \$721 thousand of administration fees as compared to \$803 thousand in 2009. For the nine months ended March 31, 2010, we earned \$2.2 million of administration fees as compared to \$2.5 million in 2009. We report the amount earned in servicing fees on the statement of revenues, expenses, and changes in net assets.

The PHEAA Student Loan Trust I filed a monthly Form 8-K and an annual Form 10-K with the SEC through November 30, 2005 and those filings are available on the SEC's website at www.sec.gov. In December 2005, the PHEAA Student Loan Trust I filed Form 15 with the SEC to provide notice for the suspension of duty to file these reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934.

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

(In thousands)	March 31, 2010	June 30, 2009
Assets:		
Cash and cash equivalents	\$ 25,534	27,066
Student loans receivable, net	567,956	616,350
Interest income receivable	5,090	5,803
Other assets	2,632	2,948
Total assets	601,212	652,167
Liabilities:		
Notes payable	\$ 567,578	623,278
Interest payable	2,214	2,047
Other liabilities	4,952	4,146
Total liabilities	574,744	629,471
Net assets	\$ 26,468	22,696

Note 11 – Risk Management, Contingencies, and Legal Proceedings

Risk Management and Contingencies

We are exposed to various risks of loss, such as theft, damage to and destruction of assets. To handle those risks, we purchase insurance coverage, and there have been no material claims.

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

Due to our inability to access the credit and/or financing markets necessary to fund student loans, effective March 7, 2008, we suspended our activities as a lender for any new loans first disbursed on or after that date. As of March 31, 2010, we have student loan purchase commitments of \$122.3 million that we have been unable to fund or settle. Most of the student loan purchase commitments are with financial institutions and we continue to work with those financial institutions to renegotiate the terms and timing of these commitments.

On December 8, 2008, Ollie Green and Company, CPA's, on behalf of ED, Federal Student Aid (FSA), issued a report of their review of PHEAA. The purpose of this review was to determine PHEAA's compliance with the establishment of the federal and operating funds as required by the Higher Education Act of 1965, as amended. The final date for establishing these funds was December 6, 1998 with an October 1, 1998 effective date. On April 21, 2009, FSA assessed PHEAA \$11.2 million based on three of the four original findings. On May 20, 2009, PHEAA responded to these findings assessed by ED. PHEAA timely appealed the findings on March 9, 2010. On April 16, 2010, PHEAA's notification from ED indicated that they would not pursue two of the four original findings. However, ED indicated that the remaining two findings remain open pending PHEAA's appeal. As of March 31,

2010, PHEAA has not accrued the \$8.5 million in the accompanying financial statements, since we believe the loss contingency is not probable and PHEAA intends to prosecute its appeal of the findings pursuant to applicable law.

On June 19, 2008, the Student Loan Revenue Bonds, Senior Subseries P-1 and P-2 and Subordinate Series Q (collectively, the “Bonds”) issued by us in the original aggregate principal amount of \$150.0 million were selected for examination by the United States Department of Treasury, Internal Revenue Service (IRS). On April 30, 2009, we received an Information Document Request (IDR) (Request No. 2) asking to explain (i) the reallocation of student loans to and from the Bonds and (ii) why consolidation loan rebate fees paid to the Treasury reduce the yield on the student loans. On May 28, 2009, we responded to Request No. 2. On April 23, 2010, we received an IDR (Request No. 3) asking (i) to provide statements/documents to reconstruct the 2002 Series original loan allocation for settlement purposes and (ii) to provide an update on the status report for the 2002 bonds (i.e. outstanding, retired, refunded, etc...). On May 7, 2010, we responded to Request No. 3.

Legal Proceedings

In 2004, we entered into a settlement agreement with a student loan borrower and his lender regarding the servicing of his student loan debt. As part of the settlement agreement, the borrower’s lender directed PHEAA to update the credit reporting associated with the borrower’s underlying loans. We requested the requisite updates be made but a national credit reporting agency failed to update the reporting. The borrower/plaintiff filed a new legal action against us and the lender alleging that we violated the Fair Credit Reporting Act. If the plaintiff is successful, the plaintiff may be able to recover attorney’s fees and punitive damages. Discovery has closed in this case, and per the trial court’s local rules, the parties are awaiting permission to file motions for summary judgment. We will continue to vigorously contest all of the allegations set forth in the amended complaint and third-party complaint filed against us by the borrower’s lender. We intend to file a motion for summary judgment and we believe based on the completion of discovery that the plaintiff may prevail on certain counts of the amended complaint. As of March 31, 2010, it is difficult to estimate our potential liability on this complaint due to the speculative nature of the alleged damages.

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

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 March 31, 2010, it is difficult to estimate our potential liability and we are currently investigating the number of consolidation loans affected.

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

On January 28, 2010, St. Joseph's filed an Amended Statement of Claim, which essentially restated its position as noted above. On April 6, 2010, the Board of Claims, *sua sponte*, issued an Order stating that it lacked subject matter

jurisdiction to hear the case, and transferred the matter to the Commonwealth Court of Pennsylvania for additional adjudication. As of March 31, 2010, it is difficult to estimate our potential liability on this complaint due to the speculative nature of the damages.

On April 8, 2010, PHEAA was served with an amended complaint naming it as a defendant in the case captioned “The Education Loan Zone, LLC v. SunTrust Bank, et. al.”, which is currently pending in the United States District Court for the District of Maryland (CCB-CV-09-993). This civil action involves a commercial dispute between SunTrust Bank and its marketing subcontractor, The Education Loan Zone, LLC (TELZ). PHEAA, SunTrust Bank, and TELZ entered into a three party agreement governing TELZ sourcing of alternative student loan applications to SunTrust Bank for PHEAA's origination and servicing of SunTrust's alternative student loan products. The amended complaint filed by TELZ against PHEAA is comprised of two causes of action: breach of contract and tortious interference with the contractual relationship between TELZ and SunTrust Bank. We have not accrued a loss contingency in the accompanying March 31, 2010 financial statements, since we believe the loss contingency is not probable. We will vigorously defend against this action.

Lastly, we are involved in various legal matters in the normal course of business. Considering available information, we do not believe that resolution of any such matters will have a material impact on the financial statements.