Indiana Secondary Market for Education Loans, Inc.

Financial Statements and Supplemental Information for the Years Ended June 30, 2008 and 2007, and Independent Auditors' Report

KATZ, SAPPER & MILLER
Certified Public Accountants

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

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Independent Auditors' Report

Board of Directors
Indiana Secondary Market for Education Loans, Inc.

We have audited the accompanying statement of net assets of Indiana Secondary Market for Education Loans, Inc. ("ISM") , a component unit of the State of Indiana, as of June 30, 2008, and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the management of ISM. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ISM as of June 30, 2007, were audited by other auditors whose report dated September 21, 2007, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2008 financial statements referred to above present fairly, in all material respects, the financial position of ISM at June 30, 2008, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

The Management's Discussion and Analysis presented on pages 2-6 is not a required part of the basic financial statements, but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards,* we have also issued our report dated October 8, 2008, on our consideration of ISM's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Katz, Sapper & Miller, LLP

Indianapolis, Indiana
October 8, 2008

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

The financial analysis discussion and overview of Indiana Secondary Market for Education Loans, Inc. ("ISM") is required supplementary information. Among other things, it provides an analytical overview of ISM's condensed financial information and should be read in conjunction with the financial statements and related notes that follow.

Overview of Indiana Secondary Market for Education Loans, Inc.

ISM was established pursuant to Public Law No. 154 of the 1980 Indiana General Assembly and is a public benefit corporation organized exclusively for education purposes. ISM serves as the State of Indiana's designated secondary market for education loans and acts as an eligible lender under the Higher Education Act. ISM pursues its mission of enhancing access for Indiana residents pursuing education at post-secondary institutions by providing reduced cost loans and making direct loans for the purpose of consolidating all or a portion of a borrower's outstanding educations loans into one (1) loan.

ISM is currently governed by a nine member Board of Directors who are nominated by the Governor of the State of Indiana and elected by the remaining Directors. Taxable and tax-exempt bonds, note financings, and line of credit facilities are the primary sources of funding for ISM's programs. ISM administers a program for the purchase, origination and servicing of loans guaranteed and reinsured by the United States Department of Education ("US DOED") under the Federal Family Education Loan Program ("FFELP"). ISM's programs are designed to facilitate access for all Indiana residents to educational funding, primarily using federal student loans. In addition, ISM supports Indiana resident's pursuit of access by providing informational presentations and distributing educational materials related to education funding.

ISM's financial statements consist of the following: the statements of net assets, the statements of revenues, expenses and changes in net assets and the statements of cash flows. These financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as promulgated by the Government Accounting Standards Board. The statements of net assets present the financial position of ISM at the end of the fiscal year and include all assets, liabilities and net assets of ISM. The statements of revenues, expenses and changes in net assets present ISM's results of operations and changes in its net assets for the years ended June 30, 2008 and 2007. The statements of cash flows provide information about the sources and uses of ISM's cash resources for the years ended June 30, 2008 and 2007.

indiana secondary market for education loans, inc.

Management's Discussion and Analysis (continued, UNAUDITED)

Condensed Financial Information (in thousands)

Financial Position	2008	2007	2006
Cash and short-term investments	$ 88,313	$ 104,614	$ 193,027
Student loans receivable—net	1,864,607	1,680,417	1,288,564
Other assets	50,506	54,365	41,821
Total assets	$ 2,003,426	$ 1,839,396	$ 1,523,412
Lines of credit	$	$ 371,000	$ 56,850
Taxable bonds payable	1,693,200	1,143,200	1,143,200
Tax-exempt bonds payable	231,650	231,650	234,650
Other liabilities	9,797	13,625	11,213
Total liabilities	1,934,647	1,759,475	1,445,913
Total net assets	68,779	79,921	77,499
Total liabilities and net assets	$ 2,003,426	$ 1,839,396	$ 1,523,412

Operating Results	2008	2007	2006
Interest on student loans	$ 72,721	$ 54,604	$ 27,620
Special allowance on student loans	19,282	37,838	23,940
Interest income and other	3,590	10,758	7,442
Total operating revenues	95,593	103,200	59,002
Interest expense	88,792	81,899	40,857
Fees and debt issuance costs	3,258	2,937	2,221
Loan servicing and administration	15,537	14,987	11,189
Arbitrage rebate (recovery) provision	(1,030)	(1,040)	1,195
Distribution to the State of Indiana	178	1,995	508
Total operating expenses	106,735	100,778	55,970
Change in net assets	$ (11,142)	$ 2,422	$ 3,032

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED, UNAUDITED)

Financial Analysis

Financial Position

As of June 30, 2008, total assets increased $164 million compared to an increase in liabilities of $175 million, resulting in a decrease in ISM's net assets of $11 million or 14%. This compares to increases over the prior years in net assets of 3.12% in fiscal 2007 and 4.07% in fiscal 2006. This year to year decrease in the percentage of change in net assets is related to disruption in the credit markets generally and the impact of failures in the student loan auction securities specifically. In addition, ISM incurred costs related to restructuring the organization as a result of outsourcing loan servicing activities.

Cash and cash equivalents decreased 16% to $88 million in fiscal 2008 from $105 million in fiscal 2007, as compared to a 46% decrease to $105 million from $193 million in fiscal 2006. The decreases in cash and cash equivalents are the result of the normal use of cash to acquire loans and pay operating and debt service expenses.

Student loans receivable increased 11% from $1,680 million to $1,865 million in fiscal 2008, as compared to a 30% increase from $1,288 million in fiscal 2006 to $1,680 million in fiscal 2007. During fiscal year 2008, ISM purchased or originated $405 million of gross principal loans from financial institutions and loan production partners. This compares with $787 million during fiscal year 2007 and $958 million during fiscal year 2006, which represents a 49% decrease and 17% decrease in loans purchased from the previous two fiscal years. For fiscal year 2008, approximately $34 million were Stafford and PLUS loans while gross Consolidation Loan purchases totaled $405 million ($293 million representing volume provided by loan production partners).

The net loan activity less existing loan principal decreases through borrower, consolidation, claim payments, cancellation activity and loan sales resulted in an increase in the student loan portfolio of 11% from $1,680 to $1,865 during fiscal year 2008, as compared to 30% from $1,288 million to $1,680 million from fiscal year 2006 to fiscal year 2007. As of June 30, 2008, the student loan portfolio held by ISM was made up of approximately 87% Consolidation Loans and 13% Stafford and PLUS Loans.

Other assets decreased 6% from $54 million in fiscal year 2007 to $51 million in fiscal year 2008 , as compared to a 30% increase from $42 million in fiscal 2006 to $54 million in fiscal 2007. The majority of these decreases relate to lower special allowance rates and lower return on investments.

ISM finances the purchase of loans through the issuance of taxable and tax-exempt student loan revenue bonds and other forms of indebtedness. During fiscal year 2008, purchases were funded primarily from a $550 million taxable bond financing in November, 2008 .

During fiscal year 2008, ISM issued $550 million of taxable Auction Rate Certificates. During fiscal year 2007, ISM maintained revolving credit facilities originally issued at $280 million and established a variable floating note (VFN) program originally sized at $250 million. As of June 30, 2008, all lines of credit were closed and terminated. At June 30, 2007, $224 million and $147 million, respectively, of the lines of credit and VFN program were outstanding.

Total net assets at June 30, 2008 were $69 million, representing a decrease of 13.94% from $80 million at June 30, 2007. This compared to a 3.12% increase in fiscal year 2007. Pursuant to Board resolutions on December 17, 2002 and April 22, 2003, ISM has designated $5.60 million for use in higher education enhancement related projects as defined by the Indiana Commission for the Higher Education. This amount is included in unrestricted net assets.

Recent Developments

The College Cost Reduction and Access Act (the “CCRAA”) was signed September 18, 2007 by the United State Senate and the House of Representatives and signed by the President on September 27, 2007. The CCRAA was effective October 1, 2007. The CCRAA reduced participating lender yields by cutting special allowance rates and increasing lender origination fees. Certain provisions have: (1) reduced special allowance payments on Stafford and Consolidation Loans by 0.40 percentage points, (2) reduced special allowance payments on Parental Loans for Undergraduate Students (PLUS) loans by 0.70 percentage points for tax-exempt lenders, (3) maintained default insurance at 97 percent, but eliminated exceptional performer designation, and (4) increased lender paid origination fees by 0.50%.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED, UNAUDITED)

Operating Results

ISM's net assets decreased $11.14 million on operating revenues of $95.59 million for the fiscal year ended June 30, 2008, compared to an increase in net assets of $2.44 million from operating revenues of $103.20 million for the prior fiscal year. The current year change in net assets was primarily due to a decrease in operating revenues of $7.61 million related to a drop in interest rate indexes as a result of the deterioration in global credit during the fiscal year. As a result of the decrease in interest rates, interest earned on the student loan portfolio decreased. Additionally, interest expense on bonds increased by $6.89 million due to the increased cost of auction rate securities throughout the year and a general increase in amounts outstanding. The market for ISM's student loan auction securities was disrupted for most of the fiscal year, with auctions ultimately failing on or around February 14, 2008, and bond interest reverting to the Maximum Auction Rate.

Total operating revenues decreased 7.0%, from $103.20 million for the fiscal year ended June 30, 2007, to $95.59 million for the fiscal year ended June 30, 2008. Total operating revenues increased 74.90% from $59.00 million for the fiscal year ended June 30, 2006, to $103.20 million for the fiscal year ended June 30, 2007. Interest income on student loans increased 33.18% during the fiscal year ended June 30, 2008 due to the increase in ISM's student loan portfolio. The special allowance on student loans decreased during fiscal year 2008 from a lower general level of interest rates compared to the fixed rate on loans in ISM's portfolio.

Total operating expenses increased 5.91% from $100.78 million for the fiscal year ended June 30, 2007, to $106.74 million for the fiscal year ended June 30, 2008. Total operating expenses increased 80.06% from $55.97 million for the fiscal year ended June 30, 2006, to $100.78 million for the fiscal year ended June 30, 2007. This current year increase is directly related to an increase in loan servicing and administration expenses of $0.87 million incurred to support higher loan volumes , the increase in interest expense on debt arrangements of $6.89 million resulting from both the increase in bonds and an increase in the related interest rates.

Loan Servicing and ISM's Loan Purchase Programs

The impacts of CCRAA and current challenges related to the capital markets have necessitated changes in how our business operates and in how we approach loan servicing in general. Starting in February 2008, ISM disengaged its lender partners and ceased originating loans. In addition, margin stress created by the current environment has required us to review our business model with the goal of achieving cost savings and improving the efficiency with which we deliver our mission. Starting in July 2008, ISM transferred responsibility for servicing its loan portfolio to American Education Services from the current servicing center located in Indianapolis, Indiana. As part of that transfer, certain costs were incurred for moving, infrastructure and labor. At the end of fiscal 2008, that transfer was scheduled for mid-July 2008.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF NET ASSETS
AS OF JUNE 30, 2008 AND 2007
(In thousands)

	2008	2007
ASSETS		
CURRENT ASSETS:		
Cash and short-term investments:		
Unrestricted	$ 73,217	$ 100,037
Designated	3,547	4,577
Restricted	11,549	
Total cash and short-term investments	88,313	104,614
Student loans receivable — net	80,429	65,663
Accrued interest receivable — student loans receivable	40,413	44,308
Accrued interest receivable — cash and short-term investments	121	415
Prepaids and other assets	31	1,812
Total current assets	209,307	216,812
NON-CURRENT ASSETS:		
Student loans receivable — net	1,784,178	1,614,754
Prepaids and other assets	8,210	5,962
Capital assets — net	1,731	1,868
Total non-current assets	1,794,119	1,622,584
TOTAL	$ 2,003,426	$ 1,839,396
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Lines of credit	$	$ 371,000
Accounts payable and accrued expenses	4,827	3,218
Accrued interest payable	1,423	5,830
Total current liabilities	6,250	380,048
NON-CURRENT LIABILITIES:		
Bonds payable	1,924,850	1,374,850
Arbitrage rebate payable	3,547	4,577
Total non-current liabilities	1,928,397	1,379,427
Total liabilities	1,934,647	1,759,475
NET ASSETS:		
Invested in capital assets	1,731	1,868
Unrestricted	51,952	73,476
Restricted	15,096	4,577
Total net assets	68,779	79,921
TOTAL	$ 2,003,426	$ 1,839,396

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	2008	2007
OPERATING REVENUES:		
Interest on student loans	$ 59,892	$ 43,848
U.S. Secretary of Education:		
Special allowance	19,282	37,838
Interest subsidy	12,829	10,756
Interest income and other	3,590	10,758
Total operating revenues	95,593	103,200
OPERATING EXPENSES:		
Interest expense	88,792	81,899
Fees and debt issuance costs	3,258	2,937
Loan servicing and administration	15,537	14,986
Arbitrage rebate/(recovery) provision	(1,030)	(1,039)
Distributions to the State of Indiana	178	1,995
Total operating expenses	106,735	100,778
CHANGE IN NET ASSETS	(11,142)	2,422
NET ASSETS — Beginning of year	79,921	77,499
NET ASSETS — End of year	$ 68,779	$ 79,921

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Student loan interest and special allowance payments received	$ 84,458	$ 73,318
Purchase of student loans	(405,249)	(787,118)
Principal receipts on student loans	194,233	284,913
Cash received on sale of student loans	61,566	139,510
Cash payments for origination fees and premiums on student loans	(9,958)	(22,796)
Cash received for other operating activities	3,820	6,923
Cash payments for employees and vendors	(28,684)	(15,659)
Net cash used in operating activities	(99,814)	(320,909)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from issuance of bonds	550,000	
Proceeds from lines of credit	241,000	350,000
Repayment of bonds		(3,000)
Repayment of lines of credit	(612,000)	(35,850)
Payment of debt issuance costs	(2,097)	(253)
Interest paid on bonds	(93,198)	(78,185)
Net cash provided by noncapital financing activities	83,705	232,712
CASH FLOWS FROM CAPITAL ACTIVITIES:		
Purchase of capital assets	(380)	(216)
Cash received for leasehold incentives	188	
Net cash used by capital activities	(192)	(216)
CHANGE IN CASH AND SHORT-TERM INVESTMENTS	(16,301)	(88,413)
CASH AND SHORT-TERM INVESTMENTS — Beginning of year	104,614	193,027
CASH AND SHORT-TERM INVESTMENTS — End of year	$ 88,313	$ 104,614

See notes to financial statements. (Continued)

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007
(In thousands)

	2008	2007
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED IN OPERATING ACTIVITIES:		
Change in net assets	$ (11,142)	$ 2,422
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Amortization of loan and bond charges	10,023	9,291
Depreciation on capital assets	551	497
Interest expense	88,792	81,899
Provision for allowance for loan losses	900	900
Arbitrage rebate/(recovery) provision	(1,030)	(1,039)
Loss on sale of student loans	601	(4,071)
Change in assets and liabilities:		
Increase in student loans receivable	(194,824)	(397,618)
Decrease (increase) in accrued interest receivable	4,189	(18,580)
Decrease (increase) in prepaids and other assets	1,856	6,151
Increase (decrease) in other liabilities	270	(761)
Net cash used in operating activities	$ (99,814)	$ (320,909)
NONCASH OPERATING ACTIVITY — Capitalized interest and payment reapplications		$ 16,198

See notes to financial statements.

(Concluded)

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business — Indiana Secondary Market for Education Loans, Inc. ("ISM" or the "Company") is a non-profit corporation formed to purchase and originate student loans under the Federal Family Education Loan Program ("FFELP") provided for by the Higher Education Act ("the Act"). Outstanding bonds are payable as specified in the resolutions authorizing the related sale of the bonds, are not payable by funds received from taxation, and are not debts of the State of Indiana or any of its political subdivisions. ISM is a major, discretely presented, proprietary component unit of the State of Indiana.

The impacts of College Cost Reduction and Access Act (the "CCRAA") and current challenges related to the capital markets have necessitated changes in how ISM's business operates and in how ISM approaches loan servicing in general. Starting in February 2008, ISM disengaged its lender partners and temporarily ceased originating loans. In addition, margin stress created by the current environment has required ISM to review its business model with the goal of achieving cost savings and improving the efficiency with which ISM can accomplish its mission. Starting in July 2008, ISM transferred responsibility for servicing its loan portfolio to American Education Services from the current servicing center located in Indianapolis, Indiana. As part of that transfer, certain costs were incurred for moving, infrastructure and labor. The transfer was completed in July 2008.

ISM's bonds payable mature between 2030 and 2047. ISM's ability to meet its long-term obligations is dependent on borrowing costs, Department of Education subsidies and the ability to control operating expenses. Management has determined that obligations will be paid as due.

Basis of Presentation and Accounting — ISM's 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. The assets of each fund are restricted pursuant to the bond resolutions. For financial statement presentation purposes, the funds have been aggregated into one proprietary fund type. ISM's funds are accounted for on the flow of economic resources measurement focus and use the accrual basis of accounting. ISM applies all applicable Financial Accounting Standards Board pronouncements which do not conflict with Governmental Accounting Standards Board ("GASB") pronouncements.

Student Loans Receivable **—** Student loans receivable are stated at the principal amount outstanding adjusted for an estimated allowance for loan losses, unamortized purchase premiums, and origination fees paid on behalf of banks and borrowers. The related interest income generated from student loans is offset by premium and origination fee amortization expenses. ISM amortizes loan premiums and loan origination fees over the estimated average life of the loan on a straight-line basis ranging from 4 to 10 years, which approximates the effective interest method.

Interest on student loans is accrued based upon the actual principal amount outstanding. The U.S. Secretary of Education makes quarterly interest subsidy payments until the student is required, under the provisions of the Higher Education Act, to begin repayment. Repayment must begin generally within six months after the student completes their 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.

The U.S. Department of Education ("US DOED") provides a special allowance to lenders participating in the FFELP. For loans first disbursed prior to January 1, 2000, the special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of 91-day United States Treasury bills, to the average daily unpaid principal balance and capitalized interest of student loans held by the Company. For loans first disbursed from January 1, 2000, through June 30, 2006, the special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of the three-month financial Commercial Paper ("CP") rate, to the average daily unpaid principal balance and capitalized interest of student loans held by the Company. If a special allowance amount is a negative number on a loan first disbursed prior to April 1, 2006, special allowance will not be paid for that loan type for that quarter. If a special allowance amount is a negative number on a loan first disbursed after April 1, 2006, the lender must remit the excess interest ("negative SAP") to the U.S. DOED . The special allowance amount for a loan first disbursed on or after October 1, 2007, has additional provisions for lenders qualified as an eligible not-for-profit holder. Those eligible as not-for-profit lenders earn a 15 basis point higher yield. The special allowance is accrued as earned.

Cash and Short-Term Investments — Cash and short-term investments are cash equivalents consisting of United States Treasury bills, money market mutual funds and Guaranteed Investment Contracts ("GICs"), which are carried at cost and approximate market, with an original maturity of less than 90 days. ISM is restricted to investments that meet the rating requirements per the bond indenture. At June 30, 2008 and 2007, all short-term investments were money market funds and GICs. All cash and short-term investments whose proceeds are designated for the payment of arbitrage rebate liabilities are classified as designated cash and short-term investments (see Note 4).

As of June 30, 2008, ISM had the following short-term investments and maturities:

Investment Type	Fair Value (In thousands)	Investment Maturities (In Years) < 1	1–5	6–10	> 10
Guaranteed investment contracts	$ 14,070	$ 14,070	$	$	$
Money market funds	52,610	52,610			
	$ 66,680	$ 66,680	$	$	$

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2008.

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 14,070	unrated	unrated	unrated
Money market funds	52,610	AAAm		
	$ 66,680			

As of June 30, 2007, ISM had the following short-term investments and maturities:

Investment Type	Fair Value (In thousands)	Investment Maturities (In Years) < 1	1–5	6–10	> 10
Guaranteed investment contracts	$ 4,421	$ 4,421	$	$	$
Money market funds	82,295	82,295			
	$ 86,716	$ 86,716	$	$	$

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2007:

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 4,421	unrated	unrated	unrated
Money market funds	82,295	AAAm		
	$ 86,716			

Custodial risk is the risk that in the event of bank failure, ISM's deposits may not be returned to it. From time to time, certain short-term investment balances maintained by ISM exceed federally insured limits. As of June 30, 2008, ISM had cash and short-term investment balances of $88,113,000 with custodial risk. There are no limits on the amount that may be invested in any one financial institution or intermediary. The following shows an investment in an issuer that represents 5% or more of the total investments at June 30, 2008:

GE Funding Capital Market Services	17%

Allowance for Loan Losses — Guarantees on student loans originated after October 1, 1993 but before July 1, 2006, provide for a reduced recovery of 98% of loan principal and accrued interest on loans which default. Guarantees on student loans originated after July 1, 2006 provide for a reduced recovery of 97% of loan principal and accrued interest on loans which default. Accordingly, ISM provides for an allowance for the estimated loss associated with the portion not recoverable. This allowance is increased by a provision charged to operations and reduced for losses actually incurred, and is included in the financial statements as a reduction of student loans receivable. At June 30, 2008 and 2007, the allowance for loan losses was $2,965,000 and $2,065,000, respectively.

In completing the analysis of the adequacy of the allowance for loan losses, past collection experience, delinquency trends and size of the portfolio, economic conditions, and other factors are considered. Significant changes in these factors could impact the allowance and provision for loan losses. A large percentage of ISM's loans have not matured to a point at which predictable loss patterns have developed. Accordingly, the evaluation of the allowance for loan losses is inherently subjective as it requires material estimates that may be subject to change.

Debt Issuance Costs — Debt issue costs are amortized using a method that approximates the effective interest method over the terms of their respective agreements, ranging from 18 months to 40 years. Unamortized debt issue costs are included in prepaids and other assets and totaled $8,001,000 and $6,194,000 at June 30, 2008 and 2007, respectively.

Capital Assets — Capital assets consist of office furniture, equipment and leasehold improvements recorded at cost. Depreciation is charged to operations on the straight-line method over the estimated useful lives of the related assets or the term of the lease, which is 3 to 7 years depending on the asset class.

Net Assets — $51,952,000 and $73,476,000 of ISM's net assets and all related revenues were unrestricted at June 30, 2008 and 2007, respectively. ISM does, however, maintain debt and other arrangements which limit the use of assets as described in Note 3. In addition, pursuant to Board resolutions on December 17, 2002 and April 22, 2003, ISM has designated $5,422,000 ($7,100,000 as of June 30, 2006) for use in higher education enhancement related projects as defined by the Indiana Commission for the Higher Education. This amount is included in unrestricted net assets. At June 30, 2008 and 2007, ISM's restricted net assets of $3,547,000 and $4,577,000, respectively, reflect amounts restricted to fund the arbitrage rebate payable (see Note 5) and $1,731,000 and $1,868,000 reflect amounts invested in capital assets (see Note 6).

Loan Income and Related Expenses — Interest and special allowance on loans are recognized as income in the period earned and servicing costs are charged to expense as incurred. Premiums paid for student loans and origination fees paid on behalf of banks and borrowers are amortized using a method which approximates the effective interest method over the estimated life of the loans (10 years). At June 30, 2008 and 2007, unamortized premiums totaled $46,578,000 and $46,856,000, respectively, and unamortized origination and default fees totaled $14,155,000 and $13,653,000, respectively, and are included in the financial statements as a component of student loans receivable.

Servicing Fee — As of June 30, 2008, American Education Services, Nelnet Corporation, Sallie Mae Servicing, Affiliated Computer Services, and Great Lakes Education Loan Services service less than 5% of ISM's student loan portfolio. Servicing fee expense amounts are included in operating expenses in the statement of revenues and expenses and changes in net assets. In addition, ISM services 95% of the student loan portfolio and is charged servicing fees for the use of the AES Compass system. However, as of July 31, 2008, the loan portfolio servicing has been outsourced to AES.

Risk Management — ISM is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage for these various risks of loss is obtained through commercial insurance. There has been no significant reduction in insurance coverage from the prior year for all categories of risk. Commercial insurance is purchased in an amount that is sufficient to cover ISM's risk of loss. ISM will record an estimated loss from a claim as an expense and a liability if it meets the following requirements: (1) information available indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and (2) the amount of the loss can be reasonably estimated.

Operating Revenues and Expenses — Bond and loan issuances are the principal source of the funds. ISM derives revenue from short-term investments, servicing fees, interest on student loans and the U.S. Secretary of Education. ISM's expenses primarily consist of interest on debt arrangements and loan servicing and administration.

Income Taxes — ISM is a tax-exempt organization under the provisions of the Internal Revenue Code, Section 501(c)(3) and, accordingly, no provision for income taxes has been made in the accompanying financial statements.

Use of Estimates — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates that are particularly susceptible to change in the near-term relate to the determination of the arbitrage rebate payable and the allowance for loan losses.

2. STUDENT LOANS RECEIVABLE — NET

Student loans receivable consist of loans made under the Higher Education Act and are carried at their unpaid principal balance net of an allowance for loan losses plus unamortized purchase premiums, origination fees, and default fees. Student loans earn interest at various rates ranging from 6.62% to 10.00% depending upon the type of student loan and the date the student loan was made. Substantially all of the principal and accrued interest on student loans is insured by certain guarantee agencies which are reinsured by the federal government. At June 30, 2008 and 2007, the majority of ISM's student loans were guaranteed by the Pennsylvania Higher Education Assistance Agency (72% and 69% as of June 30, 2008 and 2007, respectively), California Student Aid Commission/EDFUND (14% and 15% as of June 30, 2008 and 2007, respectively), or United Student Aid Funds, Inc. (9% and 11% as of June 30, 2008 and 2007, respectively)

Student loans receivable, net as of June 30, 2008 and 2007, consisted of the following:

	2008	2007
	(In thousands)	
Student loans	$1,806,838	$1,621,973
Purchase premiums, origination fees and other — net	60,734	60,509
Less — allowance for loan losses	(2,965)	(2,065)
	$1,864,607	$1,680,417

3. BONDS PAYABLE

The following displays the aggregate changes in bonds payable for the fiscal years ended June 30, 2008 and 2007:

	2008	2007
	(In thousands)	
Bonds payable — beginning of year	$1,374,850	$1,377,850
Proceeds	550,000	
Repayments		(3,000)
Bonds payable — end of year	$1,924,850	$1,374,850

Bonds payable as of June 30, 2008 and 2007 consisted of the following:

	2008	2007
	(In thousands)	
Auction Rate Certificates	$ 1,924,850	$ 1,374,850

Bonds payable at June 30, 2008 include $1,693.20 million and $1,143.20 million of taxable and tax-exempt Auction Rate Certificates ("ARCs"), respectively. The ARCs mature on various dates between December 1, 2030 and May 1, 2047. Interest on the ARCs ranged from 1.05% to 14.0% and 3.55% to 5.50% during the years ended June 30, 2008 and 2007, respectively, and was payable either at each auction, which occurs every 28 or 35 days as stipulated in the related ARC agreement, or semiannually. The interest rates are reset via a "dutch auction." Since February 2008, the auction process to establish these rates has failed; thus, the ARCs will generally pay interest to the holder at a maximum rate as defined by the indenture. This failure also resulted in auctions occurring every 7 days.

The following table displays scheduled debt maturities and contractual interest payments for bonds payable at June 30, 2008 (in thousands):

Years Ending June 30	Principal	Interest	Total
2009	$	$ 162,223	$ 162,223
2010		162,223	162,223
2011		162,223	162,223
2012		162,223	162,223
2013		162,223	162,223
2014–2018		811,114	811,114
2019–2023		811,114	811,114
2024–2028		811,114	811,114
2029–2033	59,000	801,673	860,673
2034–2038	192,800	786,133	978,933
2039–2043	73,050	693,718	766,768
2044–2047	1,600,000	432,162	2,032,162
Total	$1,924,850	$5,958,143	$7,882,993

Bonds of each series are secured by (a) the proceeds derived from the sale of the bonds, (b) eligible loans, and (c) certain accounts established by the respective bond resolutions, including monies and securities therein.

The respective bond resolutions establish the following special trust accounts for each bond series, unless otherwise indicated:

Loan Accounts — The loan accounts are used to account for the proceeds of bond issues not required to be deposited in the debt service reserve accounts. Generally, amounts in the loan accounts may be expended (a) to finance eligible student loans, (b) to pay bond issue costs, and (c) to make deposits to the revenue accounts for the purpose of paying principal and/or interest on the bonds.

Revenue Accounts — The revenue accounts are used to account for all revenues received by ISM. Generally, amounts in the revenue accounts are used (a) to make principal and/or interest payments on the bonds, (b) to fund debt service reserve accounts, (c) to pay estimated program expenses to the operating account, and (d) to reimburse the issuers of insurance guaranteeing the bonds for amounts borrowed under the terms of the policies. Excess amounts in the revenue account may be transferred to the loan accounts or to optional redemption accounts.

Operating Accounts — Amounts deposited in operating accounts are used to pay reasonable and necessary program expenses for the bond issues.

Rebate Accounts — Amounts deposited in the rebate accounts are used to pay the United States Treasury amounts required by Section 148 of the Internal Revenue Code.

4. CASH AND SHORT-TERM INVESTMENTS

Cash and short-term investments as of June 30, 2008 and 2007, consisted of the following:

	2008	2007
	(In thousands)	
Special trust accounts:		
Unrestricted:		
Loan accounts	$ 42,187	$ 61,498
Revenue accounts	8,235	8,083
Designated — rebate accounts	3,547	4,577
	53,969	74,158
Restricted:		
Reserve accounts	11,549	
Operating account (includes $5,422 to the State of Indiana)	22,795	30,456
	$ 88,313	$ 104,614

5. WAREHOUSING ARRANGEMENTS

ISM maintained credit and/or loan agreements ("Agreements") with First Indiana Bank, N.A., Bank of America, N.A., and UBS Real Estate Securities, Inc. The Agreements were collateralized by loans pledged under the Agreements and certain cash balances and contain certain financial and restrictive covenants.

On August 13, 2007, ISM renewed the Agreement with Bank of America, N.A. through August 14, 2008. Interest on the line of credit was charged based on LIBOR plus the applicable margin, and at June 30, 2007 this line of credit balance was $200,000,000. The line was terminated and paid in full as of June 18, 2008.

On March 27, 2007 the Agreement with First Indiana Bank, N.A. was renewed through March 31, 2008. Interest was charged based on LIBOR plus the applicable margin; and at June 30, 2007, this line of credit balance was $24,000,000. The line was terminated and paid in full as of November 16, 2007.

On August 23, 2006, ISM entered into a loan agreement with UBS Real Estate Securities, Inc. that allowed borrowings up to a maximum of $250,000,000 through August 21, 2007. On August 14, 2007, the agreement was renewed through August 19, 2008, which increased the allowed borrowings to a maximum of $300,000,000. Interest was charged based on LIBOR plus the applicable margin; and at June 30, 2007 this loan balance was $147,000,000. This line was terminated and paid in full as of February 26, 2008.

The following table displays the aggregate changes in line of credit borrowings for fiscal years ended June 30, 2008 and 2007:

	2008	2007
	(In thousands)	
Lines of credit — beginning of year	$ 371,000	$ 56,850
Proceeds	241,000	350,000
Repayments	(612,000)	(35,850)
Lines of credit — end of year	$	$ 371,000

6. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2008 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$2,158	$ 209	$ 63	$2,304
Leasehold improvements	496	233		729
Total depreciable capital assets	2,654	442	63	3,033
Less accumulated depreciation	786	551	35	1,302
Net depreciable capital assets	$1,868	$(109)	$ 28	$1,731

Capital asset activity for the year ended June 30, 2007 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$1,944	$ 214	$	$2,158
Leasehold improvements	494	2		496
Total depreciable capital assets	2,438	216		2,654
Less accumulated depreciation	289	497		786
Net depreciable capital assets	$2,149	$(281)	$	$1,868

7. ARBITRAGE REBATE PAYABLE

In accordance with Section 148 of the Internal Revenue Code of 1986 (the "Code"), as amended, and the regulations promulgated thereunder, ISM is required to pay to the United States Treasury certain amounts related to the ISM tax-exempt bond issues. The amount required to be paid represents the excess of amounts earned over the interest cost of the tax-exempt borrowings as defined in the Code. Non-purpose rebate payments are due every fifth year and when the bonds are retired. Purpose rebate payments are due every tenth year and every fifth year thereafter during the life of each bond issue and when the bonds are retired. The rebate calculation utilizes various assumptions and allows for the selection of alternative calculation options under the Code. At June 30, 2008 and 2007, the estimated arbitrage rebate liability was $3,547,000 and $4,577,000, respectively, which has been provided for in the financial statements. The factors used in determining this estimate are sensitive to change in the future and the change in estimate may be material to the financial statements. However, the ultimate amount payable, if any, is dependent on the investment yields and bond rates in the future.

The following table displays the aggregate changes in the arbitrage rebate payable during the fiscal years ended June 30, 2008 and 2007:

	2008	2007
	(In thousands)	
Arbitrage rebate payable — beginning of year	$ 4,577	$ 5,616
(Recovery) provision	(1,030)	(1,039)
Ending balance	$ 3,547	$ 4,577

8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by ISM using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts ISM could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The estimated fair values of ISM's financial instruments as of June 30, 2008 and 2007, were as follows:

	2008	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and short-term investments	$ 88,313	$ 88,313
Student loans receivable — net	1,864,607	1,882,676
Accrued interest receivable	40,534	40,534
LIABILITIES:		
Bonds payable	1,924,850	1,882,167
Accrued interest payable	1,423	1,423

	2007	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and short-term investments	$ 104,614	$ 104,614
Student loans receivable — net	1,680,417	1,730,828
Accrued interest receivable	44,723	44,723
LIABILITIES:		
Bonds payable	1,374,850	1,358,210
Lines of credit	371,000	371,000
Accrued interest payable	5,830	5,830

Cash and Short-Term Investments — Cash and short-term investments are carried at cost, which approximates fair value.

Student Loans Receivable — Net — Loans are categorized by status (in-school, grace, repayment, and delinquent). The fair value is estimated by discounting the future cash flows using current rates of return required by investors in similar assets, less an estimated allowance for credit losses.

Accrued Interest Receivable — Accrued interest receivable is carried at cost, which approximates fair value.

Bonds Payable — For fixed-rate bonds, fair value was calculated based on quoted current market prices of the bonds. For variable rate bonds, the carrying amount is a reasonable estimate of its fair value.

Lines of Credit — For line of credit borrowings, the carrying amount is a reasonable estimate of its fair value.

Accrued Interest Payable — Accrued interest payable is carried at cost, which approximates fair value.

9. RETIREMENT PLANS

ISM established the Indiana Secondary Market 401(k) Retirement Plan (“Plan”) in July 2002. The Plan is a “Safe Harbor 401(k) Plan” as described in the Internal Revenue Code. All employees 18 or older are eligible to participate on the first day of the month following their hire date. ISM also may contribute a discretionary profit sharing benefit if the participants are employed at the end of the Plan year. ISM also matches participant contributions for an amount equal to 100% of participant contributions to a maximum of 4% of the participant’s annual earnings as the Safe Harbor contribution. Participants vest in ISM contributions 100% after one year of service. ISM’s contributions to the Plan during fiscal years 2008 and 2007 were approximately $165,000 and $423,000, respectively. Participants of the Plan contributed approximately $237,000 and $267,000 to the Plan during fiscal years 2008 and 2007, respectively.

ISM established a Top Hat 457 Plan for certain officers of ISM in December 2006. Pursuant to the plan document, benefits are paid upon separation of service from ISM. ISM’s contributions to the Plan during fiscal years 2008 and 2007 were $69,000 and $37,500, respectively.

10. COMMITMENT

ISM leases office space under the terms of a non-cancellable operating lease. Future minimum reported payments under this operating lease at June 30, 2008, were as follows:

Years Ending June 30	Rental Payments
2009	$ 557,000
2010	565,000
2011	573,000
2012	582,000
2013	590,000
Thereafter	1,512,000
	$ 4,379,000

Rent expense under this operating lease was approximately $594,000 and $294,000 for the fiscal years ended June 30, 2008 and 2007, respectively.

11. RESTRUCTURING

Beginning in February, 2008, a decision to restructure ISM resulted in a total of 96 employees being offered severance benefits, including 3 officers, with pay ranging from 9 to 48 weeks and health insurance benefits ranging from 2 to 24 months.

ISM no longer provides loan servicing for lenders and the portfolio servicing has been outsourced to American Education Services, beginning in July 2008.

Due to restructuring decisions ISM has contacted a commercial real estate broker in regard to subleasing the existing office space.

12. SUBSEQUENT EVENTS

Insurance coverage has been reduced due to restructuring changes that resulted in a reduction of ISM's work force.

At a special meeting of the Board of Directors on August 27, 2008, a resolution was passed to allow ISM to reacquire outstanding bonds through one or more public tender offers.

* * * * * *

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Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Year Ended June 30, 2008

Board of Directors
Indiana Secondary Market for Education Loans, Inc.

We have audited the financial statements of Indiana Secondary Market for Education Loans, Inc. (ISM), a component unit of the State of Indiana, as of and for the year ended June 30, 2008, and have issued our report thereon, dated October 8, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered ISM's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ISM's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ISM's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record process, or report financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in the internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ISM's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain other matters that we reported to management of ISM in a separate letter dated October 8, 2008.

This report is intended solely for the information and use of the Board of Directors, management, the specified lender clients, and the U.S. Department of Education and is not intended to be and should not be used by anyone other than these specified parties.

Katz, Sapper & Miller, LLP

Indianapolis, Indiana
October 8, 2008