

Audited Financial Statements

*Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities*

June 30, 2002

 **ERNST & YOUNG**

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Report of Independent Auditors

The Board of Trustees
Employees' Retirement System of
the Government of Puerto Rico
and its instrumentalities

We have audited the accompanying statements of plan net assets of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System) as of June 30, 2002 and 2001, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. 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 audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, in 2001 the System has adopted Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – For State and Local Governments*.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the System at June 30, 2002 and 2001, and the changes in its net assets for the years then ended in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The management's discussion and analysis and accompanying supplemental schedules of employer contributions and funding progress are presented for purposes of complying with requirements of the Governmental Accounting Standards Board, and are not a required part of the basic financial statements. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information contained in the management discussion and analysis and the supplemental schedules and, therefore, express no opinion on it.

Ernst + Young LLP

September 6, 2002
San Juan, Puerto Rico

Stamp No. 1825897
affixed to the
original copy
of this report.

Employees' Retirement System of the
Government of Puerto Rico and its Instrumentalities
June 30, 2002

MANAGEMENT'S DISCUSSION AND ANALYSIS

Within this section of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System or ERS) annual financial statements, the System's management provides a narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2002. The financial performance of the System is discussed and analyzed within the context of the accompanying financial statements and disclosures following this section.

Financial Highlights

- ERS assets exceeded liabilities by \$1,979,677,000 (net assets) for the fiscal year reported when compared to the prior year which assets exceeded liabilities by \$2,428,664,000.
- The fair value of ERS investments at June 30, 2002 amounted to \$1,166,862,000, compared to \$1,412,680,000 at June 30, 2001.
- ERS funded ratio of the actuarial accrued liability at June 30, 2000 and 1999 was 22 %.

Overview of the Financial Statements

Management Discussion and Analysis introduces ERS' basic financial statements. The basic financial statements include: 1) statements of plan net assets 2) statements of changes in plan net assets, and 3) notes to the financial statements. ERS also includes additional information to supplement the basic financial statements.

Basic Financial Statements

The System's financial statements consist of two basic financial statements. These statements provide information about the overall status of the System. The System uses full accrual accounting.

The first of the basic financial statements is the *Statement of Plan Net Assets*. This statement includes all of the System's assets and liabilities, with the difference reported as net assets. Overtime, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the System as a whole is improving or deteriorating.

The second of the basic financial statement is the *Statement of Changes in Plan Net Assets*. This statement reports changes in the System's assets during the year. All current year revenues and expenses are included regardless of when cash is received or paid.

The System is a pension trust fund of the Commonwealth of Puerto Rico. Pension trust resources are only held in trust to pay retirement benefits to participants.

Financial Analysis

The financial statements of the System for the fiscal year ended June 30, 2002 present a decrease in net assets as compared to the prior fiscal year of approximately \$449 million. This decrease is mostly the result of the net realized and net unrealized losses experienced in the investment portfolio during the 2002 fiscal year of approximately \$380 million, including an unrealized loss of \$146 million in the investment of PRTA Holdings Preferred Stock.

As of June 30, 2002, the System has \$1,980 million in total net assets consisting, in summary of the following:

- \$1,133 million in marketable securities
- \$34 million in alternative investments
- \$383 million in the investment in PRTA Holdings Preferred Stock
- \$269 million in loans to participants
- \$10 million in real estate
- \$122 million in net cash and equivalents
- \$28 million in other assets

As further explained in Note 5 of the financial statements, on June 24, 1998, the Senate and the House of Representatives issued Joint Resolution 209 to authorize the sale of 50% plus one stock of the Puerto Rico Telephone Company (PRTC) stock to a joint venture arranged by GTE Holdings (Puerto Rico) LLC (Verizon Communications) and Popular, Inc. (the Buyers). The Joint Resolution 209 further designated the use of the product of the Original Sale and ordered that the stock that was not sold on the Closing Date of the First Sale, as defined by the Resolution, be transferred to a subsidiary to be created by the Government Development Bank (GDB), to be held and disposed for the benefit of the Employees' System.

Subsequently, the GDB created a subsidiary, known as PRTA Holdings, to hold the remaining stock on behalf of the Employees' System. On December 28, 2000, PRTA Holdings issued and assigned its non-cumulative, non-voting preferred stock to the System, entitling the System to receive all the future benefits generated by the Puerto Rico Telephone Company (TELPRI) stock retained by the Government. During the fiscal years ended June 30, 2002 and 2001, the System received \$17.5 million and \$7.6 million, respectively, in dividends from TELPRI. During fiscal year 2003, the System has received approximately \$14.4 million in dividends from PRTC.

In connection with the first sale, an option was granted to the Buyers to acquire an additional 15% of the preferred stock at a fixed price of \$45.94 per share expiring on March 2, 2002. In January 2002, GTE Holdings (Puerto Rico) LLC and Popular, Inc. exercised the option and acquired the additional 15% of the preferred stock. As a result of that transaction, the System received approximately \$172 million.

For financial statements purposes, as of June 30 2002, the investment in PRTA Holdings Preferred Stock is presented based on the estimated value as of August 15, 2002 of the TELPRI stock, which consisted of an update of the certified appraisal made by an independent firm as of December 31, 2001, considering 7,000,000 shares at \$54.74 per share for a total value of approximately \$383 million.

Our investment portfolio, highly concentrated in stock, faced a significant decrease in value during the fiscal year 2002, directly related to the downturn in investment securities market which was negatively impacted by the events of September 11, 2001, and the fraud allegations in large and prominent companies in the United States. Therefore, for the fiscal year 2002, the portfolio recognized a depreciation of approximately \$380 million or a negative return of 16.47%.

Contributions, investment income and loan repayments are not sufficient to cover pension payments, expenses and loan originations; therefore, requiring the liquidation assets to cover current pension payments. For the fiscal year 2002, the excess of benefits paid and expenses over contributions and other income received represented approximately \$68 million.

For financial statements purposes, the amount of securities that as of June 30, 2002 were involved in the securities lending transactions was presented with the required disclosures, according to the current government accounting pronouncements. For the fiscal year 2002, income from the securities lending activity amounted to approximately \$136,000.

According to our last certified actuarial valuation as of June 30, 2000, the System's unfunded liability amounts to \$7,417 million for a capitalization level of 22%. The annual actuarial valuation for the fiscal year 2001 is in process. Based on our preliminary estimate of the unfunded actuarial obligation as of June 30, 2001, it represents approximately \$7,500 million for a capitalization level of 24%.

In order to improve the System's financial condition, the House of Representatives approved Joint Resolution 209 as further explained in Note 5 of the financial statements. In addition, the Legislature has approved the following laws:

Law 1, effective on April 1, 1990 change in benefits structure:

- Increase contributions rates: employers' from 8% to 9.275% and employees' from 7% to 8.275%
- Elimination of the merit pension (except for policemen and firemen)
- Establish that any increase in benefits will require actuarial studies and the law must state the financing source

For all participants joining the System after April 1, 1990

- Increase retirement age from 55 to 65 years old
- Annuity at 1.5% of salary for each year of service

Law 305, effective January 1, 2000 (*for all participants joining the System after January 1, 2000*)

- Closes of the defined benefit plan and creates a savings type (defined contribution) plan with only employee contributions in which the participant purchase an annuity at age of 60

- Employer contributions are used to capitalize the System
- Disability benefits provided by private insurance contract paid by employees

For the fiscal year 2002, the Board of Trustees approved a budget of \$34 million for the administrative and operations expenses of the System. The actual expenses amounted to \$31 million. For the fiscal year 2003 the budget approved amounts to \$33.3 million.

Requests for Information

The financial report is designed to provide a general overview of the System's finances, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Commonwealth of Puerto Rico Government Employees and Judiciary Retirement Systems Administration, 437 Ponce de León Avenue, Hato Rey, Puerto Rico

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Statements of Plan Net Assets

	June 30 ^a	
	2002	2001
	<i>(In Thousands)</i>	
Assets		
Cash and investments:		
Cash and cash equivalents	\$ 59,610	\$ 32,932
Cash and cash equivalents deposited with Government Development Bank of Puerto Rico:		
Unrestricted	104,370	79,211
Restricted	4,928	489
	<u>109,298</u>	<u>79,700</u>
	168,908	168,598
Marketable securities at fair value:		
Bonds and notes	102,613	110,364
Stocks	1,030,025	1,265,391
Mortgage notes acquired from third parties	212	611
Other investments	34,012	36,314
	<u>1,166,862</u>	<u>1,412,680</u>
Loans to plan members:		
Mortgage	61,663	63,662
Personal	195,195	191,586
Cultural trips	11,817	11,129
	<u>268,675</u>	<u>266,377</u>
Investment in PRTA Holdings, at appraised value	383,180	701,000
Total Cash and Investments	<u>1,987,625</u>	<u>2,492,689</u>
Accounts receivable:		
Employers	28,314	29,735
General Fund of the Commonwealth of Puerto Rico	13,318	9,259
The Commonwealth of Puerto Rico		
Judiciary Retirement System	3,110	1,908
Investment sales	2,710	5,134
Accrued interest	2,451	2,527
Other	20,372	8,049
	<u>70,275</u>	<u>56,612</u>
Property and equipment, net	7,837	8,267
Other assets	9,576	16,586
Total assets	<u>2,075,313</u>	<u>2,574,154</u>

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Statements of Plan Net Assets (continued)

	June 30	
	2002	2001
	<i>(In Thousands)</i>	
Liabilities		
Book overdraft	31,627	92,886
Short-term obligations	14,000	-
Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members	17,290	17,738
Investment purchases	3,281	5,812
Other liabilities	29,438	29,054
Total liabilities	<u>95,636</u>	<u>145,490</u>
Net assets held in trust for pension benefits	<u>\$1,979,677</u>	<u>\$2,428,664</u>

See accompanying notes.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Statements of Changes in Plan Net Assets

	Year ended June 30	
	2002	2001
	<i>(In Thousands)</i>	
Additions:		
Contributions:		
Employers	\$ 293,601	\$ 288,023
Participating employees	259,203	245,221
Law No. 127	14,627	14,211
Other Government Contribution - PRTA		
Holdings Preferred Stock	-	701,000
	567,431	1,248,455
Investment income:		
Realized gains or (losses)	(82,205)	(200,154)
Unrealized gains or (losses)	(298,313)	(101,718)
Dividend income	21,792	5,379
Interest income	43,509	50,345
	(315,217)	(246,148)
Less investment expense	4,887	5,755
	(320,104)	(251,903)
Other income	14,096	19,424
Total additions	261,423	1,015,976
Deductions:		
Annuities	621,021	551,845
Special	14,627	14,211
Death benefits	12,616	10,773
Refunds:		
Employers	1,390	1,223
Participating employees	33,452	22,622
	34,842	23,845
Administrative expenses	27,304	28,404
Total deductions	710,410	629,078
Net (decrease) increase in assets held in trust for pension benefits	(448,987)	386,898
Net assets held in trust for pension benefits:		
Beginning of year	2,428,664	2,041,766
End of year	\$1,979,677	\$2,428,664

See accompanying notes.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements

June 30, 2002

1. Organization and Summary of Significant Accounting Policies

Organization

The Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System) was created by Act No. 447 on May 15, 1951. The System began operations on January 1, 1952, at which date contributions by employers and participating employees commenced. The System is considered an integral part of the Commonwealth of Puerto Rico (the Commonwealth) financial reporting entity and is included in the Commonwealth's financial statements as a trust fund. The System, as a governmental retirement plan, is excluded from the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The responsibility for the proper operation and administration of the System is vested in a Board of Trustees, composed of two participating employees and one pensioner, who are appointed by the Governor of the Commonwealth, and four Commonwealth government agency representatives.

The following are the significant accounting policies followed by the System in the preparation of its financial statements:

Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with the provisions of Statement of Governmental Accounting Standards No. 25 (SGAS No. 25), *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. Participating employees and employers' contributions are recognized as revenues in the period in which the employee services are rendered. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of net assets held in trust for pension benefits, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions to net assets held in trust for pension benefits during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of "overnight deposits" guaranteed by the custodian bank and certificates of deposits in Government Development Bank (GDB). Restricted cash deposited with GDB consists of payments received from mortgage loan holders administered by the mortgage servicer, in the servicing of loans.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

1. Organization and Summary of Significant Accounting Policies (continued)

Investments

Investments are carried at fair value, except for certain mortgage notes, which do not have readily determinable fair values. The fair value of notes, bonds and stocks is based on quotations obtained from national securities exchanges. Securities transactions are accounted for on the trade date.

Mortgage notes acquired from third parties are held to maturity and are not readily marketable. Consequently, these are carried at amortized cost.

No investment in any organization represents 5% or more of the System's net assets held in trust for pension benefits.

Loans to Plan Members

Mortgage, personal and cultural trip loans to plan members are stated at their outstanding principal balance. No allowance for uncollectible amounts has been established since personal and cultural trip loans to plan members are secured by plan members' contributions and mortgage loans are secured by mortgage deeds and any unrestricted amount remaining in the escrow funds. Maximum amounts that may be granted to plan members for mortgage, personal and cultural trip loans are \$100,000, \$3,000 and \$5,000, respectively. The carrying value of these loans approximates their fair value.

The System services mortgage loans with aggregate principal balances of approximately \$29,384,000 and \$35,410,000 at June 30, 2002 and 2001, respectively, related to certain mortgages loans sold to FNMA for a fee of 0.25%. The income for 2002 and 2001 amounted to \$70,073 and \$109,332, respectively, and is recognized as interest income in the accompanying statement of changes in plan net assets.

In addition, at June 30, 2002 and 2001, the System had repurchased approximately \$110,000 and \$168,000, respectively, in mortgage loans that were sold during fiscal year 1998 to Federal National Mortgage Association (FNMA). The sale contract stipulates that the System must repurchase any loans with payments in arrears over 90 days.

Reserve for Life Insurance on Loans to Plan Members

Premiums collected and benefits claimed are recorded as additions and deductions of the guarantee insurance reserve for life insurance on loans to plan members, respectively.

Reclassifications

Certain amounts from fiscal year 2001 have been reclassified to conform to the current year's presentation.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

2. Plan Description

The System is a cost-sharing multi-employer defined benefit plan sponsored by the Commonwealth. Substantially all full-time employees of the Commonwealth and its Instrumentalities (Central Government Agencies, Municipalities and Public Corporations, including the System) are covered by the System under the terms of the Act No. 447 of 1951. All regular, appointed and temporary employees of the Commonwealth at the date of employment become plan members of the System. The System is optional for Government officers appointed by the Governor and Head of Agencies. At June 30, 2002 and 2001, membership consisted of the following:

	2002	2001
Retirees and beneficiaries currently receiving benefits	88,487	87,086
Current participating employees	156,009	151,060
Total membership	244,496	238,146

The plan members of the System, other than those joining the System after March 31, 1990, are eligible for the benefits described below:

Retirement Annuity

Plan members are eligible for a retirement annuity upon reaching the following age:

Policemen and Firemen:	Other Employees:
50 with 25 years of credited service	55 with 25 years of credited service
58 with 10 years of credited service	58 with 10 years of credited service

Plan members are eligible for monthly benefit payments determined by the application of stipulated benefit ratios to the plan member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by the System. The annuity, for which a plan member is eligible, is limited to a minimum of \$200 per month and a maximum of 75% of the average compensation.

Merit Annuity

Plan members are eligible for merit annuity with a minimum of 30 years or more of credited service. The annuity for which the plan member is eligible is limited to a minimum of 65% and a maximum of 75% of the average compensation.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

2. Plan Description (continued)

Deferred Retirement Annuity

A participating employee who ceases to be an employee of the Commonwealth after having accumulated a minimum of ten years of credited service qualifies for retirement benefits provided his/her contributions to the System are left within the System until attainment of 58 years of age.

Coordinated Plan

On the Coordinated plan the participating employee contributes a 5.775% of the monthly salary for the first \$550 and 8.275% for the excess over \$550. By the time they reach 65 years old and begin to receive social security benefits, the pension benefits are reduced by the following:

- \$165 per month if retired with 55 years of age and 30 years of credited service
- \$110 per month if retired with less than 55 years of age and 30 years of credited service
- All other between \$0.82 and \$1.00 per month.

Non-Coordinated Plan

On the Non-Coordinated plan the participating employee contributes an 8.275% of the monthly salary and does not have any change on the pension benefits upon receiving social security benefits.

Reversionary Annuity

A plan member, upon retirement, could elect to receive a reduced retirement annuity giving one or more benefit payments to his/her dependents. The life annuity payments would start after the death of the retiree for an amount not less than \$240 yearly or greater than the annuity payments being received by the retiree.

Occupational Disability Annuity

A participating employee, who as a direct result of the performance of his/her occupation is totally and permanently disabled is eligible for a disability annuity of 50% of the compensation received at the time of the disability.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

2. Plan Description (continued)

Nonoccupational Disability Annuity

A participating employee totally and permanently disabled for causes not related to his/her occupation, and with no less than 10 years of credited service, is eligible for an annuity of 30% of the average compensation of the first 10 years of credited services increased by 1% for every additional year of credited service in excess of 10 years up to a maximum of 50% of the average compensation.

Death Benefits

Occupational:

- Surviving spouse - annuity equal to 50% of the participating employee's salary at the date of the death.
- Children - \$10 per month for each child, minor or student, up to a maximum benefit per family of 100% of the participating employee's salary at the date of the death. If no spouse survives or dies while receiving the annuity payments, each child, 18 or under, is eligible to receive an annuity of \$20 per month up to the attainment of 18 years of age or the completion of his/her studies.

Nonoccupational:

- Beneficiary - the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of the death.

Post-retirement:

- Beneficiary with surviving spouse age 60 or over and child, 18 or under, up to 30% (60%, if not covered under Title II of the Social Security Act) of retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of \$500. On September 2, 2000, an amendment to Article 2-113 of Act No. 447 of May 15, 1951 was made to increase the minimum to \$750 to all cases in which the death date is on or after July 1, 2000.

Refunds

A participating employee who ceases his/her employment with the Commonwealth without right to a retirement annuity has the right to a refund of the contributions to the System plus any interest earned thereon.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

2. Plan Description (continued)

Amendments to Benefits Structure for Plan Members Who Joined the System on or After April 1, 1990

Act No.1 of 1990 made certain amendments applicable to new participating employees joining the System effective April 1, 1990. These changes consist principally of an increase in the retirement age from 58 to 65, a decrease in the benefit percentage of the average compensation in the occupational disability and occupational death benefits annuities from 50% to 40%, and the elimination of the Merit Annuity for participating employees (except policemen and firemen) who have completed 30 years of creditable service.

Amendments to Benefits Payable to Plan Members Effective January 1, 1998

Act No. 10 of 1992 provides, for increases of 3% every three years, of the pensions paid by the System to those plan members with three or more years of retirement. On August 9, 1998, Act No. 221 was approved which provides, retroactively to January 1, 1998, for increases of the pensions paid by the System to those plan members with three or more years of retirement. On June 13, 2001, Act No. 40 was approved which provides, for increases of 3% every three years, of the pensions granted by the System to the plan members before January 1, 1998. The law provides for grants from the general fund and contributions from municipalities and public corporations.

Early Retirement

On July 28, 1998 Act No. 182 was approved, which provides that effective March 31, 1998, plan members are eligible for early retirement upon attaining age 55 with 25 years of service or 30 years of service but under 55 years of age. Those who select early retirement between August 1, 1998 through December 31, 1998 (election date), under these conditions will receive monthly benefits equal to 75% of their average compensation, which is computed based on the highest 36 months of compensation recognized by the System. Plan members may also elect an alternative early retirement annuity upon attaining 25 years of service but less than 55 years of age. Under this election, plan members will receive monthly benefits equal to 65% of their average compensation. In these cases, the employer will contribute to the System an additional amount to cover the benefit payments until the participant reaches the normal retirement age in addition to employer and employee contributions.

On August 12, 2000, Act No. 174 was approved to allow certain participants to be eligible for early retirement upon attaining at least age 55 with 25 years of service, provided they make their election on or before April 1, 2001. Those who elected early retirement under this law will receive monthly benefits of 75% (if 25 or more years of service and age 55, or 30 or more years of services and age 50) or benefits of 65% (if 25 years of service but less than age 55) in their average compensation which is computed based on the highest 36 months of operations recognized by the System. In these cases, the employer is responsible for contributing to the System amounts to cover the benefit payments and the employer and employee contributions with respect to the participants covered until the participants reach the normal retirement age.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

2. Plan Description (continued)

Amendment to Act No. 447 Effective January 1, 2000 to create a Defined Contribution Plan

On September 24, 1999, an amendment to Act No. 447 of May 15, 1951, which created the System, was enacted to establish a defined contribution plan, known as System 2000 to cover employees joining the System on or after January 1, 2000.

Employees participating in the current system as of December 31, 1999, may elect either to stay in the defined benefit plan or transfer to System 2000. Persons joining the government on or after January 1, 2000, will only be allowed to become members of System 2000.

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there will be a pool of plan assets, which will be invested by the System, together with those of the current defined benefit plan. The Commonwealth will not guarantee benefits at retirement age. The annuity will be based on a formula which assumes that each year the employee's contribution (with a minimum of 8.275% of the employee's salary up to a maximum of 10%) will be invested as instructed by the employee in an account which either: (1) earns a fixed rate based on the two-year Constant Maturity Treasury Notes or, (2) earns a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (3) earns a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability benefits are not granted under System 2000. The employers' contributions (9.275% of the employee's salary) with respect to employees under System 2000 will continue and will be used to fund the defined benefit plan.

System 2000 will reduce the retirement age from 65 years to 60 for those employees who joined the current plan on or after January 1, 2000.

At June 30, 2002 and 2001, System 2000 membership consisted of the following:

	<u>2002</u>	<u>2001</u>
Current participating employees	<u>21,758</u>	<u>9,604</u>

Termination

Although the Commonwealth has not expressed any intent to terminate the plan, it may do so at any time. In the event of termination of the plan, the rights of all affected plan members and beneficiaries to whom benefits have been accrued under the plan shall be no forfeitable to the extent funded.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

3. Funding Policy

The contribution requirement to the System is established by law and is not actuarially determined. Required employers' contributions consist of 9.275% of applicable payroll in the cases of municipalities, central government and public corporations. Required employee contribution consists of 5.775% of the first \$550 of the monthly salary with the excess at 8.275% for the coordinated plan and 8.275% of the total monthly salary for participating employees' contributions for the non-coordinated plan. Commonwealth contributions should ultimately cover any deficiency between the participating employees' contributions and the System's pension benefit obligations and administrative costs.

The System received grants from the General Fund of \$71.7 million and \$66.5 million in 2002 and 2001, respectively to cover special laws. The grants are accounted net of benefits payments except for approximately \$14.6 million and \$14.2 million in 2002 and 2001, respectively, which are granted under the provisions of Law No. 127 of 1958, that covers the occupational disability of firemen, policemen and other personnel disabled during high risk circumstances.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2000, using the projected unit credit actuarial cost method. Significant assumptions underlying the actuarial computations include: (a) assumed rate of return on investments of 8.5%, (b) assumed compound rate of wage increases of 5% per year; and (c) assumed mortality rate based on the Group Annuity Table for 1951.

The actuarial accrued liability was approximately \$9,459,300,000 as of June 30, 2000. At June 30, 2000, the unfunded actuarial accrued liability was approximately \$7,417,500,000.

The Legislature of the Commonwealth enacted Act No. 1, effective April 1, 1990, which is directed to improve the solvency of the System for the next 50 years. Among other provisions, the legislation increases the level of contribution to the System and limits benefits for new participating employees by increasing the age from 58 to 65 years for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also reduces the level of occupational injury and death benefits received by new participating employees from 50% to 40% (see Note 2). In addition, participation in System 2000 will be required for all participants who start working for the Commonwealth effective January 1, 2000 (see Note 2).

As an employer, the System has contributed \$1,252,000 and \$1,116,000 which represented its contractually required contribution for the years ended June 30, 2002 and 2001, respectively.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

4. Cash and Investments

Cash Deposits

At June 30, 2002, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$137.3 million, which includes \$59.6 million at commercial banks, \$109.3 million at Government Development Bank of Puerto Rico (GDB) reduced by an overdraft of \$31.6 million. At June 30, 2001, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$19.7 million, which includes \$32.9 million at commercial banks, \$79.6 million at Government Development Bank reduced by an overdraft of \$92.8 million.

The \$59.6 million and the \$32.9 million deposited at commercial banks for years 2002 and 2001, respectively, are insured by the Federal Deposit Insurance Corporation up to \$100,000 or collateralized with securities held on behalf of the System by the Secretary of the Treasury of the Commonwealth of Puerto Rico, or the Secretary's agent in the name of the Secretary.

Pursuant to present statutes, deposits of financial institutions, other than with GDB, shall be in banks designated by the Puerto Rico Secretary of the Treasury as depository institution of public funds. Such deposits are guaranteed by sufficient collateral under the name and custody of the Secretary of the Treasury.

At June 30, 2002, cash consists of deposits in banks and is categorized following the "Guide to Implementation of GASB Statement 3 on Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements." The categories for deposits are the following:

Category 1 - insured or collateralized with securities held by the financial institution or by its agent in the System's name.

Category 2 - collateralized with securities held by the pledging financial institution's trust department or its agent in the System's name.

Employees' Retirement System of the Government
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Notes to Financial Statements (continued)

4. Cash and Investments (continued)

Cash Deposits (continued)

Category 3 – uncollateralized.

The carrying amount of the deposits approximates their fair value. The following presents the deposits categorized (in millions):

	Category			Market Value
	1	2	3	
Deposits in commercial banks	\$59.6	-	\$ -	\$ 59.6
Deposits in governmental banks	-	-	109.3	109.3
	59.6	-	109.3	168.9
Less: Overdraft in GDB	-	-	31.6	31.6
Total	\$59.6	-	\$ 77.7	\$137.3

Investments

The following table shows the cost and market value of the investments in marketable securities held by the System as of June 30, 2002 and 2001:

	2002		2001	
	Cost	Fair Value	Cost	Fair Value
U.S. Government and agencies, securities	\$ 20,384	\$ 20,993	\$ 20,958	\$ 21,382
Corporate bonds	80,563	81,620	85,672	88,982
Total bonds and notes	100,947	102,613	106,630	110,364
Domestic corporate stocks	874,579	812,389	963,534	1,040,177
International corporate stocks	276,400	217,636	279,555	225,814
Total stocks	1,150,979	1,030,025	1,243,089	1,265,391
Alternative investments	44,441	34,012	43,727	36,314
Total investments	\$1,195,420	\$1,166,650	\$1,393,446	\$1,412,069

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

4. Cash and Investments (continued)

Investments (continued)

Alternative Investments include the following:

	Total Commitment	Contributions to date	Cost	Fair Value
Grupo Guayacán, Inc.				
Guayacán Fund of Funds, LP	\$25,000,000	\$21,640,900	\$19,561,435	\$14,930,039
Guayacán Fund of Funds II, LP	25,000,000	11,312,500	11,165,352	8,256,525
Advent-Morro Equity Partners Inc.				
Guayacán Private Equity Fund, LP	5,000,000	3,930,032	3,831,792	4,098,260
Venture Capital Fund, Inc	800,000	800,000	800,000	542,400
Chase Capital Partners Equity Fund of Funds Corporate Investor II LTD	20,000,000	7,689,515	7,286,287	6,185,203
Martineau Bay Resort, S. en C. (S.E.)	1,795,750	1,795,750	1,795,750	-
Total	\$77,595,750	\$47,168,697	\$44,440,616	\$34,012,427

The Credit Risk categories for investments are:

Category 1- Insured or registered in the entity's name, or securities held by the entity or its agent in the entity's name.

Category 2- Uninsured and unregistered, with securities held by the counter party's trust department or agent in the entity's name.

Category 3- Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the entity's name.

Employees' Retirement System of the Government
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Notes to Financial Statements (continued)

4. Cash and Investments (continued)

Investments (continued)

Credit Risk Classification is as follows (in thousands):

	Category			Carrying Amount
	1	2	3	
Bonds and notes	-	-	\$ 102,613	\$ 102,613
Stocks	-	-	1,030,025	1,030,025
Alternative investments	-	-	34,012	34,012
	-	-	<u>\$1,166,650</u>	<u>\$1,166,650</u>

The System may issue Collateralized Promissory Notes (the Notes) to generate additional funds to carry out the investment objectives and to improve the investment portfolio. The Notes cannot exceed, in an aggregate principal amount, \$400,000,000 outstanding at any time, and a term to maturity up to 90 days so that at the end of each quarter the outstanding balance equals zero. The Notes are secured by a pledge on the System's securities. GDB acts as the System's agent for selling the Notes, effecting the pledge on the securities, securing them, investing their proceeds and acting as custodian of the securities purchased with the proceeds. GDB issues and sells the Notes through brokers and records the transfer of and make payments of principal and interest on the Notes, all under such terms and conditions, and at such interest rates and prices, as the GDB shall consider be in the best interest of the System. In connection with such issuance, GDB pays a commission from the proceeds of the Notes to these brokers. At June 30, 2002 there were no notes outstanding.

Securities Lending Transactions

During the year the System entered into securities lending transactions. The System's securities custodian, as agent, manages the securities lending program and receives liquid collateral. At June 30, 2002, the collateral received represents 102.55% of the fair value of the securities lent.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

4. Cash and Investments (continued)

Securities Lending Transactions (continued)

Securities lending obligations for which collateral was received at June 30, 2002 consisted of the following (in thousands):

<u>Securities Lent</u>	<u>Fair Value of Securities</u>
US Corporate Bonds	\$ 3,593
US Equity	<u>36,257</u>
Total	<u>\$39,850</u>

The underlying collateral for these securities had a market value of approximately \$40,864 thousands and was invested as follows:

Asset Backed Commercial Paper	\$ 7,239
Reverse Repo US Agency Delivered	797
Reverse Repo Mortgage - Backed Tri-Party	<u>32,828</u>
	<u>\$40,864</u>

The System has very low credit risk exposure to borrowers. The System rights to collateral are defined in the contractual agreement. There is excess collateral above 100%. In case of borrower default, the System has immediate rights to collateral. Borrower's creditworthiness is also proactively reviewed by the Lending Agent.

Employees' Retirement System of the Government
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Notes to Financial Statements (continued)

5. Investment in PRTA Holdings

On August 4, 1997, the Senate of Puerto Rico approved Law No. 54, which authorized the Government to commence negotiations to sell the Puerto Rico Telephone Company (PRTC). On June 24, 1998, the Senate and the House of Representatives issued Joint Resolution 209 to authorize the final sale of 50% plus one share of the stock of TELPRI to a joint venture created between GTE Holdings (Puerto Rico) LLC (a subsidiary of Verizon Communications) and Banco Popular de Puerto Rico (the Buyers) and to destinate the use of the sale proceeds.

In the same resolution, it was established that the shares of TELPRI's common stock that were not sold on the Closing Date of the First Sale, as defined in the Resolution, should be transferred to the Governmental Development Bank (GDB), and further, it also instructed GDB to create a subsidiary to hold and dispose of that stock for the benefit of the System. The First sale took place on March 2, 1998. After the First sale, the Government retained 43% of TELPRI's stock.

Subsequently, GDB created a subsidiary, known as PRTA Holdings and transferred the TELPRI's stock retained by the Government to that subsidiary. On December 28, 2000, PRTA Holdings issued and assigned its non-cumulative, non-voting preferred stock to the System, entitling the System to receive the benefits that the TELPRI's stock would generate in the future. PRTA Holdings' capital structure consists of 100 shares of common stock at \$0.01 each owned by GDB and 100 shares of non-convertible, non-voting preferred stock, owned by the System. As established by the Articles of Incorporation of PRTA Holdings, the product of the future sale of any shares of the TELPRI stock and any dividends declared by TELPRI will benefit the System.

During the years ended June 30, 2002 and 2001, the System received \$17.5 and \$7.6 million, respectively, consisting of the dividends declared and paid by TELPRI.

In connection with the First Sale of the TELPRI's stock on March 2, 1998, the Buyer was granted an option, to purchase an additional 15% of the TELPRI's stock at a fixed price of \$45.94 per share, expiring on March 2, 2002. The Buyer exercised the option on January 25, 2002. The total proceeds from the exercise of this option amounted to \$172 million.

As of June 30, 2002, the PRTA Holdings Preferred Stock is presented based on an estimated value as of August 15, 2002, of the TELPRI's stock, which consisted of an update of the certified appraisal made by an independent firm as of December 31, 2001.

Employees' Retirement System of the Government
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Notes to Financial Statements (continued)

5. Investment in PRTA Holdings (continued)

As of June 30, 2001, the PRTA Holdings preferred stock is presented based on the appraised value of the TELPRI's stock as certified by an independent firm as of December 31, 2000 and the price per share stated in the stock option contract granted to the Buyers applicable as follows:

As of June 30	2002	2001
Shares under purchase option contract:		
Number of shares	-	3,750,000
Price per share	-	\$45.94
Total value (in thousands)	-	\$172,275
Remaining Shares:		
Number of shares	7,000,000	7,000,000
Price per share	\$54.74	\$75.64
Total value (in thousands)	\$383,180	\$529,480
	Estimated value as of August 15, 2002	Appraised value as of December 31, 2000
Total combined value (in thousands)	\$383,180	\$701,755

6. Capital Assets

Capital assets include property and equipment. Purchased capital assets are valued at historical cost. Capital assets are depreciated based on the straight-line method over the assets' estimated useful life. There is no depreciation recorded for land. Generally, estimated useful lives are as follows:

Building and Improvements	50 years
Equipment	5-10 years

Employees' Retirement System of the Government
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Notes to Financial Statements (continued)

6. Capital Assets (continued)

Capital assets activity for the year ended June 30, 2002 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets, not being depreciated:				
Land	\$ 969	\$ -	\$ -	\$ 969
Total capital assets, not being depreciated	969	-	-	969
Capital assets, being depreciated:				
Building and Improvements	7,631	-	-	7,631
Equipment	9,771	305	7	10,069
Total capital assets, being depreciated	17,402	305	7	17,700
Less accumulated depreciation for:				
Building and Improvements	2,779	113		2,892
Equipment	7,325	620	5	7,940
Total accumulated depreciation	10,104	733	5	10,832
Total capital assets, being depreciated net	7,298	(428)	2	6,868
Capital assets, net	<u>\$ 8,267</u>	<u>\$(428)</u>	<u>\$2</u>	<u>\$ 7,837</u>

7. Other Assets

At June 30, 2002 and 2001, other assets consisted of the following:

	2002	2001
	<i>(In Thousands)</i>	
Repossessed and foreclosed properties	\$2,569	\$ 2,086
Executed land	7,007	14,500
	<u>\$9,576</u>	<u>\$16,586</u>

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

7. Other Assets (continued)

Reposessed and foreclosed properties consist mainly of properties acquired through foreclosure proceedings related to delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage loan upon foreclosure. These properties will be sold under a bidding process intended to recover the outstanding principal balance of the related mortgage loan. Gain or loss is recognized at the time of sale. Differences resulting from recognition of losses at the point of sale rather than upon foreclosure, as required by generally accepted accounting principles, are not material. Management believes that the carrying value of these properties approximates its fair value.

On February 19, 1991, the Metropolitan Bus Authority (MBA), a government agency transferred to the System a lot of land located in Hato Rey, as settlement for its debt with the System related to employer and participants' contributions and loans payments withholdings from June 1985 through December 1988. Since then, the System leases this land to a third party that operates it as a parking facility. Rental income for 2002 and 2001 amounted to approximately \$81,000 and \$62,000, respectively, and is reflected as part of other income in the accompanying statements of changes in plan net assets. According to an independent appraisal dated August 1, 2001, the market value of this land approximates \$22,550,000.

In 1998, part of the land was taken by the Government for the construction of a coliseum, and being financed by the Infrastructure Financing Authority (IFA). In May 2002, IFA compensated the System for 23,308.3979 square meters of the land with \$10 million. As a result, the System recognized a gain of \$2.5 million.

8. Reserve for Life Insurance on Loans to Plan Members

The System provides life insurance that guarantees the payment of the outstanding principal balance of mortgage, personal and cultural trip loans in case of death of a plan member. The plan members who obtain these loans from the System pay the coverage in its entirety. The life insurance rates are actuarially determined and do not vary by age, sex or health status.

9. Short-Term Obligation

On October 26, 2002, the System entered into a credit line facility agreement with a local commercial bank under the following terms and conditions:

Total Facility Amount	\$100 million
Interest Rate	0.25% over 90 days LIBOR
Maturity Date	September 5, 2002

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Notes to Financial Statements (continued)

10. Commitments and Contingent Liabilities

During the fiscal year 2002, disbursements from the credit facility amounted to \$75,500,000. At June 30, 2002, the outstanding principal balance on the credit line facility was \$14,000,000 with interest rates ranging from 2.170% to 2.215%.

The System is defendant or co-defendant in various lawsuits resulting from the ordinary conduct of its operations. Based on the advice of legal counsel and considering insurance coverage, management is of the opinion that the ultimate liability, if any, will not have a significant effect on the financial status of the System.

11. Accounts Receivable from Employers

Accounts receivable from employers consists of contributions and loan repayments due from municipalities and public corporations. The employers, other than central government agencies, have to pay directly to the System. According to Act 447, each employer must pay on a monthly basis, the amounts related to contributions and loan repayments, on or before the fifteenth day of the following month. After that date, interests are charged, as established by the Board Resolution number 91-05.

As of June 30, 2002 and 2001, the receivable from employers amounted to \$28.3 million and \$29.7 million, respectively.

Supplemental and Required Supplementary Information

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Schedule of Contributions
(Dollar amounts in Thousands)

Year Ended June 30	Annual Required Contribution	Contributions	Percentage Contributed
2000	\$890,800	\$527,400	59%
1999	845,000	491,800	58
1998	777,800	502,100	65
1997	722,300	454,600	62
1996	677,200	402,200	59
1995	608,800	380,700	63
1994	566,900	353,900	62

See notes to schedules of trend information.

Employees' Retirement System of the Government
of Puerto Rico and its Instrumentalities

Schedule of Funding Progress
(Dollar amounts in Thousands)

Actuarial Valuation Date	Actuarial Value of Plan Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Annual Covered Payroll
7/1/2000	\$2,041,800	\$9,459,300	\$7,417,500	22%	\$2,463,400	301%
7/1/1999	1,858,000	8,308,000	6,450,000	22%	2,575,000	250
7/1/1998	1,675,000	7,638,000	5,963,000	22%	2,366,000	252
7/1/1997	1,444,000	6,914,000	5,470,000	21%	2,363,000	231
7/1/1996	1,230,000	6,320,000	5,090,000	19%	2,223,000	229
7/1/1995	1,075,000	6,033,000	4,958,000	18%	2,087,000	238
7/1/1994	954,000	5,542,000	4,588,000	17%	1,867,000	246

See notes to schedules of trend information.

Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities

Notes to Schedules of Trend Information

1. Schedule of Funding Progress

The Schedule of Funding Progress provides information about the funded status of the System and the progress being made in accumulating sufficient assets to pay benefits when due.

2. Schedule of Contributions

The Schedule of Contributions provides information about the annual required contributions (ARC) and the extent to which contributions made cover the ARC. The ARC is the annual required contribution for the year calculated in accordance with certain parameters, which include actuarial methods and assumptions.

The System's Schedule of Contributions includes both Commonwealth's and participating employee's contributions as the Commonwealth contributions, ultimately, should cover any deficiency between the participating employees' contributions, the pension benefits and the System's administration costs.

3. Actuarial Data

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation Date	July 1, 2000
Actuarial Cost Method	Projected unit credit cost method
Amortization Method	Level percentage of the projected payroll
Remaining Amortization Period	26 years
Asset Valuation Method	Market value
Actuarial Assumptions:	
Investment rate of return*	8.5%
Projected salary increases*	5%
Cost of living adjustment	3%, every three years

*Includes inflation at 3.5%