

ARTHUR ANDERSEN LLP

**EMPLOYEES' RETIREMENT SYSTEM OF THE
GOVERNMENT OF PUERTO RICO AND ITS
INSTRUMENTALITIES**

*FINANCIAL STATEMENTS
AS OF JUNE 30, 1997 AND 1996
TOGETHER WITH AUDITORS' REPORT*

ARTHUR ANDERSEN LLP

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Trustees of
Employees' Retirement System of the
Government of Puerto Rico and its
Instrumentalities:

We have audited the accompanying statements of net assets available for benefits of Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System) as of June 30, 1997 and 1996, and the related statements of changes in net assets available for benefits for the years then ended. These financial statements and the schedules referred to below are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 explained in Note 3 to the financial statements, the report of the System's actuary reflects that, as of June 30, 1997 and 1996, the unfunded actuarial accrued liability was approximately \$5,470,000,000 and \$5,090,000,000, respectively.

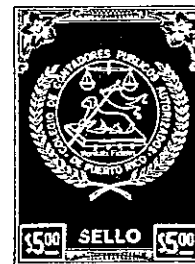
In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities as of June 30, 1997 and 1996, and the changes in its net assets for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information shown in the accompanying schedules of Funding Progress and Contributions and related notes are presented for purposes of additional analysis and are not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Arthur Andersen LLP

San Juan, Puerto Rico,
September 29, 1997.

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EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF PUERTO RICO AND ITS INSTRUMENTALITIES

STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS

JUNE 30, 1997 AND 1996

(In thousands)

	<u>1997</u>	<u>1996</u>
CASH AND INVESTMENTS:		
Cash and cash equivalents	\$ 126,760	\$ 67,661
Cash deposited with Government Development Bank for Puerto Rico-		
Unrestricted	108,314	96,559
Restricted	3,543	-
Total cash	<u>238,617</u>	<u>164,220</u>
Marketable Securities	888,660	763,653
Mortgage notes acquired from third parties	4,701	6,138
Other investments	1,577	-
Total cash and investments	<u>1,133,555</u>	<u>934,011</u>
 LOANS TO PLAN MEMBERS:		
Mortgage	124,603	126,911
Personal	150,202	139,411
Cultural trips	9,150	7,226
Total loans to plan members	<u>283,955</u>	<u>273,548</u>
Total cash, investments and loans to plan members	<u>1,417,510</u>	<u>1,207,559</u>
 ACCOUNTS RECEIVABLE:		
Employers	21,693	18,074
General Fund of the Government of Puerto Rico	3,325	5,590
The Commonwealth of Puerto Rico Judiciary Retirement System	1,268	1,651
Accrued interest	1,223	1,055
Other	3,472	3,290
Total accounts receivable	<u>30,981</u>	<u>29,660</u>
 PROPERTY AND EQUIPMENT, net	<u>9,768</u>	<u>9,151</u>
 OTHER ASSETS	<u>17,360</u>	<u>17,102</u>
Total assets	<u>1,475,619</u>	<u>1,263,472</u>
 ESCROW FUNDS OF MORTGAGE LOANS AND GUARANTEE INSURANCE		
RESERVE OF LOANS TO PLAN MEMBERS	17,556	17,683
 OTHER LIABILITIES	<u>13,592</u>	<u>16,277</u>
Total liabilities	<u>31,148</u>	<u>33,960</u>
Net assets available for benefits	<u>\$1,444,471</u>	<u>\$1,229,512</u>

The accompanying notes are an integral part of these statements.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT

OF PUERTO RICO AND ITS INSTRUMENTALITIES

STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

FOR THE YEARS ENDED JUNE 30, 1997 AND 1996

(In thousands)

	<u>1997</u>	<u>1996</u>
INCOME FROM CASH, INVESTMENTS AND LOANS:		
Interest and dividends	\$ 51,797	\$ 42,809
Net appreciation of investments	173,281	132,916
Other	5,334	2,891
	-----	-----
Total income from cash, investments and loans	230,412	178,616
	-----	-----
CONTRIBUTIONS:		
Employers	232,674	211,420
Participating employees	206,094	177,250
Special	15,849	13,522
	-----	-----
Total contributions	454,617	402,192
	-----	-----
Total additions	685,029	580,808
	-----	-----
BENEFITS AND EXPENSES:		
Annuities	416,676	376,647
Death benefits	8,492	10,247
Refunds-		
Employers	982	759
Participating employees	10,919	12,012
Administrative expenses	33,001	26,907
	-----	-----
Total deductions	470,070	426,572
	-----	-----
Net increase in net assets available for benefits	214,959	154,236
	-----	-----
NET ASSETS AVAILABLE FOR BENEFITS:		
Beginning of year	1,229,512	1,075,276
	-----	-----
End of year	\$1,444,471	\$1,229,512
	=====	=====

The accompanying notes are an integral part of these statements.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF PUERTO RICO AND ITS INSTRUMENTALITIES

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 1997 AND 1996

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

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 started 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.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of net assets available for 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 available for 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 custodial bank. Restricted cash deposited with Government Development Bank for Puerto Rico (GDB) consists of payments received from mortgage loanholders to be used by Banco Popular de Puerto Rico in the servicing of loan escrows.

Investments

Investments are carried at fair value, except for certain mortgage notes which have no market. The fair value of stocks is based on quotations obtained from national securities exchanges.

Securities transactions are accounted for on the trade date. Realized gains and losses on securities are determined by the average cost method and are included in the statement of changes in net assets available for benefits.

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 available for 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 loans to plan members are secured by mortgage deeds, plan members' contributions 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.

Guarantee Insurance Reserve

Premiums collected and benefits claimed are recorded as an addition and as a deduction of the guarantee insurance reserve, respectively.

2. PLAN DESCRIPTION:

The System is a defined benefit cost-sharing multi-employer plan sponsored by the Commonwealth. Substantially all full-time employees of the Commonwealth and its Instrumentalities are covered by the System under the terms of the Act No. 447 of 1951. All regular employees of the Commonwealth at the date of employment become plan members of the System as a condition to their employment. The System is optional for members of the Cabinet of the Governor, Heads of Agencies, and other appointed employees. At June 30 total membership consisted of the following:

	<u>1997</u>	<u>1996</u>
Retirees and beneficiaries currently receiving benefits	67,700	63,719
	=====	=====
Current participating employees	159,600	157,638
	=====	=====

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 |
|--|--|
| <ul style="list-style-type: none"> • Age 50 with 25 years of credited service or age 58 with 10 years of credited service | <ul style="list-style-type: none"> • 30 years of credited service or age 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 a 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.

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 a retirement benefit provided his/her contributions to the System are left within the System until attainment of 58 years of age.

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 payments would start after the death of the retiree in an amount not less than \$240 yearly nor 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 an annuity of 50% of the compensation received at the time of the disability.

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 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.

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.

**Amendment to Benefits Payable to 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 disability and death benefits annuities from 50% to 40%, and the elimination of the Merit Annuity for participating employees who have completed 30 years of creditable service.

**Amendment to Benefits Payable to Plan Members
Effective January 1, 1992**

Act No. 10 of 1992 provides, retroactive to January 1, 1992, 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 subject to approval by the Legislature and external funding. In accordance with this Act, a 3% cost of living adjustment was approved by the Legislature effective January 1, 1995.

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 nonforfeitable to the extent funded.

3. FUNDING POLICY:

The contribution requirement to the System is established by law and is not actuarially determined. Required contributions consist of 9.275% of applicable payroll in the cases of municipalities, central government and public corporations, and 5.775% or 8.275% for participating employees' contributions. Commonwealth contributions, ultimately, should cover any deficiency between the participating employees' contributions and, the pension benefits and the System's administration costs.

The special contributions of approximately \$15,849,000 and \$13,522,000 in 1997 and 1996, respectively, represent the reimbursement to the System of the benefits paid on behalf of the General Fund of the Commonwealth under the provision of Law No. 127 of 1958, which covers the occupational disability of firemen, policemen and others, and under the provisions of Law No. 23 of 1983, which covers half of the increase in pension benefit annuities.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 1997 and 1996, 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 as of June 30, 1997 and 1996, was \$6,914,000,000 and \$6,320,000,000, respectively. At June 30, 1997 and 1996, the unfunded actuarial accrued liability was approximately \$5,470,000,000 and \$5,090,000,000, respectively.

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).

As an employer, the System has contributed \$930,000, \$843,000 and \$771,800, which represented its contractually required contribution for the years ended June 30, 1997, 1996 and 1995, respectively.

4. CASH AND INVESTMENTS:

Pursuant to the provisions of Act No. 46 of 1988, the System may invest, with certain restrictions, in obligations of the Commonwealth and its Instrumentalities, the United States of America, private corporations and foreign countries. In addition, the System may invest in common and preferred stock, in income-producing real properties and in high-risk securities.

Cash and cash equivalents are guaranteed by the custodial bank. Cash deposited with Government Development Bank for Puerto Rico amounting to approximately \$111,857,000 and \$96,559,000 as of June 30, 1997 and 1996, respectively, is not collateralized.

Marketable securities at June 30, 1997 and 1996, consist of corporate stocks held by agents in the System's name. The cost of these investments at June 30, 1997 and 1996, was approximately \$675,869,000 and \$644,278,000, respectively.

The net changes in the appreciation of investments in marketable securities are as follows:

	<u>1997</u>	<u>1996</u>
	(In thousands)	
Stocks held at year-end	\$ 93,397	\$ 33,813
Securities sold during the year	79,884	99,103
	-----	-----
	\$173,281	\$132,916
	=====	=====

Other investments at June 30, 1997, include \$1,351,000 in Guayacán Fund of Funds, L. P. (the Fund), a Delaware limited partnership, which invests in United States and international private equity investment partnerships, which in turn, invest in equity and equity related investments primarily in private equity. The System is committed to invest up to \$25,000,000 in the Fund.

The System services mortgage loans with principal balances of approximately \$46,749,000 and \$52,913,000 at June 30, 1997 and 1996, related to certain mortgage loans sold to FNMA during 1996 for a fee of 0.25%.

The System issues Collateralized Promissory Notes (the Notes) to generate additional funds to carry out the investment objectives and to improve the investment portfolio. The Notes can not 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 to 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.

5. PROPERTY AND EQUIPMENT:

Property and equipment acquisitions are recorded at cost. Depreciation is provided using the straight-line method over the useful life of the asset. At June 30, 1997 and 1996, property and equipment consist of the following:

	<u>Estimated Useful Life</u>	<u>1997</u>	<u>1996</u>
		(In thousands)	
Land	-	\$ 969	\$ 969
Building	50 years	7,631	7,631
Furniture and equipment	5 - 10 years	7,870	6,613
		-----	-----
		16,470	15,213
Accumulated depreciation		(6,702)	(6,062)
		-----	-----
		\$ 9,768	\$ 9,151
		=====	=====

6. OTHER ASSETS:

At June 30, 1997 and 1996, other assets consist of the following:

	<u>1997</u>	<u>1996</u>
	(In thousands)	
Reposessed and in-substance foreclosed properties	\$ 2,860	\$ 3,570
Executed land	14,500	13,532
	-----	-----
	\$17,360	\$17,102
	=====	=====

Repossessed and in-substance foreclosed properties consist mainly of properties acquired or to be acquired upon foreclosure proceedings as collateral from delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage upon foreclosure. These will be sold under a bidding process intended to recover the outstanding principal balance. 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, is not material. Management believes that the carrying value of these properties approximates its fair value.

The executed land located in Hato Rey was acquired on February 19, 1991, from the Metropolitan Bus Authority (MBA), a government agency, as settlement for the debt MBA had with the System relative to employer and participants contributions and loans payments withholdings from June 1985 through December 1988. The System has been renting this land to a third party that operates it as a parking facility. Rental income for 1997 and 1996 amounted to \$240,000 and \$132,000, respectively, and is reflected as part of other income in the accompanying statements of changes in assets available for benefits. According to an independent appraisal dated April 1, 1996, the market value of this land approximates \$14,500,000.

7. GUARANTEE INSURANCE RESERVE OVER 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. This coverage is paid in its entirety by the plan members who obtain these loans from the System. The life insurance rates are actuarially determined and do not vary by age, sex or health status.

8. COMMITMENTS AND CONTINGENT LIABILITIES:

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.

9. RECLASSIFICATION:

A reclassification was made to the fiscal year 1996 statement of net assets available for benefits to conform it with the current year presentation.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT

OF PUERTO RICO AND ITS INSTRUMENTALITIES

SCHEDULE OF FUNDING PROGRESS

(Dollars amounts in thousands)

<u>Actuarial Valuation Date</u>	<u>Actuarial Value of Assets</u>	<u>Actuarial Accrued Liability (AAL)</u>	<u>Unfunded AAL (UAAL)</u>	<u>Funded Ratio</u>	<u>Covered Payroll</u>	<u>UAAL as a Percentage of Covered Payroll</u>
7/1/97	\$1,444,000	\$6,914,000	\$5,470,000	21%	\$2,363,000	231%
7/1/96	1,230,000	6,320,000	5,090,000	19%	2,223,000	229%
7/1/95	1,075,000	6,033,000	4,958,000	18%	2,087,000	238%
7/1/94	954,000	5,542,000	4,588,000	17%	1,867,000	246%
7/1/93	943,000	5,275,000	4,332,000	18%	1,882,000	230%
7/1/92	857,000	4,800,000	3,943,000	18%	1,672,000	236%

The accompanying notes to schedules are an integral part of this schedule.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT

OF PUERTO RICO AND ITS INSTRUMENTALITIES

SCHEDULE OF CONTRIBUTIONS

(Dollars amounts in thousands)

<u>Year Ended</u> <u>June 30</u>	<u>Annual Required</u> <u>Contribution</u>	<u>Contributions</u>	<u>Percentage</u> <u>Contributed</u>
1997	\$722,300	\$454,600	62%
1996	677,200	402,200	59%
1995	608,800	380,700	63%
1994	566,900	353,900	62%
1993	486,400	328,800	68%
1992	435,400	319,600	73%

The accompanying notes to schedules are an integral part of this schedule.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF PUERTO RICO AND ITS INSTRUMENTALITIES

NOTES TO SCHEDULES

JUNE 30, 1997 AND 1996

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 employees' 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 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, 1997
Actuarial Cost Method	Projected unit credit cost method
Amortization Method	Level percentage of the projected payroll
Remaining Amortization Period	29 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%