

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO

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

Financial Statements

June 30, 2004 and 2003

(With Independent Auditors' Report Thereon)

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**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**

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Independent Auditors' Report

The Board of Trustees of the
Employees' Retirement System
of the Government of the
Commonwealth of Puerto Rico:

We have audited the accompanying statement of plan net assets of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (formerly Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities) (note 1) (the System) as of June 30, 2004, and the related statement of changes in plan net assets for the year 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 audit. The financial statements as of and for the year ended June 30, 2003 were audited by other independent auditors whose report dated September 26, 2003 expressed an unqualified opinion.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 financial statements referred to above present fairly, in all material respects, the net assets of the System at June 30, 2004, and the changes in its net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Management's Discussion and Analysis presented on pages 3 through 11 and supplemental schedules of employers contributions and funding progress presented on pages 38 and 40 are supplementary information required by 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's Discussion and Analysis and supplemental schedules and, therefore, express no opinion on them.

December 17, 2004

Zayas, Morazzani & Co.

Stamp No. 2009158 of the Puerto Rico Society of Certified Public Accountants was affixed to original.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Management's Discussion and Analysis
June 30, 2004**

Introduction

Within this section of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (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, 2004. The financial performance of the System is discussed and analyzed within the context of the accompanying financial statements and disclosures following this section.

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.

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Financial Highlights

As of June 30, 2004, the System has \$2,235 million in total assets consisting, in summary of the following:

- \$1,269 million in marketable securities
- \$42 million in alternative investments
- \$404 million in the investment in PRTA Holdings Preferred Stock
- \$369 million in loans to participants
- \$8 million in real estate
- \$46 million in net cash and equivalents
- \$97 million in other net assets

The following provides a comparison of certain items within the financial statements:

- ERS assets exceeded liabilities by \$2,141,442,000 (net assets) for the fiscal year reported when compared to the prior year, for which assets exceeded liabilities by \$1,947,402,000.
- The fair value of ERS investments (excluding the investment in PRTA Holdings Preferred Stock and participants' loans) at June 30, 2004 amounted to \$1,310,835,000 compared to \$1,197,086,000 at June 30, 2003.
- ERS funding ratio of the actuarial accrued liability at June 30, 2003 is 17 %.
- Investment in PRTA Holdings Preferred Stock at June 30, 2004 amounted to \$404,390,000 compared to \$362,670,000 at June 30, 2003.
- Participants' loans amounted to \$369,203,000 at June 30, 2004 compared to \$281,796,000 at June 30, 2003.

The financial statements of the System for the fiscal year ended June 30, 2004 present an increase in net assets as compared to the prior fiscal year of approximately \$194 million. This increase was mostly the result of an increase in the fair value of the investments of \$114 million, plus an increase in the fair value of the investment in PRTA Holdings Preferred Stock of \$42 million and an increase of \$87 million in the loans portfolio, offset by a reduction in net cash of \$76 million.

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Our investment portfolio was re-structured during fiscal year 2003, to implement an asset allocation that would fulfill the System's cash flow needs as well as sustain an appropriate growth and return. The new asset mix and investment management structure provided asset growth, cash income and savings in management fees.

For financial statements purposes, the amount of securities that as of June 30, 2004 were involved in the securities lending transactions was presented with the required disclosures, according to the current government accounting pronouncements. For the fiscal year 2004, income from the custodian securities lending activity amounted to approximately \$78,000.

Budget Highlights

For the fiscal year 2004, the Board of Trustees approved a budget of \$34.5 million for the administrative and operational expenses of the System. The actual expenses amounted to \$29.8 million. For the fiscal year 2005 the budget approved amounts to \$35.8 million.

Investment in PRTA Holdings Preferred Stock

As further explained in Note 6 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 (now, 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, 2004 and 2003, the System received \$3.4 million and \$38 million, respectively, in dividends from TELPRI.

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For financial statements purposes, as of June 30 2004, the investment in PRTA Holdings Preferred Stock is presented based on the estimated value as of December 31, 2003 of the TELPRI stock, considering 7,000,000 shares at \$57.77 per share for a total value of approximately \$404 million.

Funding Status

The Employees System is the largest fund in the Island and it is the one facing the most significant challenges. This system, created by Act 447 of May 15, 1951, had the main purpose of attracting and retaining personnel in the government labor force.

Since its inception, the System lacked proper planning and the levels of contributions were relatively low (and still remain low in comparison to the level of benefits). Besides, all retirement systems in place before 1951 were merged into the System, which then had to absorb all their unfunded liabilities. Afterwards, in 1973, the benefits structure was enhanced however, without the appropriate increase in the contribution levels. As more people joined the government labor force and then retired under the new enhanced benefit structure, the gap between the assets available to pay benefits and the actuarial obligation started its steeping course.

In 1990, in an effort to contain the increase in the unfunded liability, the benefit structure was modified, basically to decrease the benefits and to postpone the retirement age from 55 to age 65 in order to provide a structure more affordable. Also, the level of contributions was raised and the Law 447 was amended to provide that any increase in benefits will require actuarial studies and must state the financing source.

Ten years after, the steeping course of the unfunded liability required further action. As a result, the defined benefit plan was totally closed to new participants joining the System on or after January 1, 2000. To provide a retirement alternative, the Government created a defined contribution plan funded only by employees' contributions. The new plan is known as the Retirement Savings Account Program or System 2000. Under System 2000, the employers' contributions continue at the same level as the defined benefit plan, but are being used to capitalize the defined benefit plan that was closed. Also under System 2000, the disability benefits are to be provided through a private insurance long term disability program to those participants that voluntarily elect to enroll in such program. Subsequent to June 30, 2004, on September 15, 2004, Law 296 was enacted to amend the dispositions on Law 305 regarding disbursements and the disability benefits program. After the amendment, any participant that leaves public service may request that the balance

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in his/her savings account be transferred to a qualified retirement vehicle such as an individual retirement account or a qualified retirement plan in Puerto Rico. Law 296 also provides flexibility on the establishment of the disability program; but still, the employees must finance the program.

Presently, the Employees' System consists of three different benefit structures, which are administrated according to their specifications in the Law. For all participants in the defined benefit plan, the level of contributions established by law is 8.275% of the employee salary. Under System 2000, employees' contributions range from 8.275% to 10% of the salary, as specified by the employee. Under all structures, employers' contributions are stated by law at 9.275% of the employee salary.

In fiscal years 2000 and 2001, the System reached its highest level of capitalization, having a 24% and 25%, respectively. Particularly in 2000, as the System marks its investments at market value, it recognized the double-digit positive returns on its investment portfolio that was directly related to the market performance during the years 1999 and early 2000. In fiscal year 2001, although already impacted by the market downturn phase that started in late 2000, the System recognized as part of its assets a contribution of \$701 million consisting of the investment owned by the Government in the Puerto Rico Telephone Company. The amount recognized was based on the appraisal value of the PRTC stock at December 31, 2000 as determined by an independent appraiser. At June 30, 2001 the recognition of that contribution offset the significant decrease in the System's total assets caused by the market downside.

As a result of the events of September 11, 2001 and afterwards, the corporate corruption cases, the market suffered further losses. Therefore, the System's investment portfolio market value decreased further as it happened to other retirement plans. In February 2002, an additional 15% of the PRTC stock was sold for \$1/2 million and the product was used to cover the System's cash flow needs for current pension payments. Meanwhile, the appraised value of the remaining shares of the PRTC stock dropped from \$529 million at June 30, 2001 to \$383 million at June 30, 2002 and to \$363 million at June 30, 2003.

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On the other hand, the System's actuarial obligation continues its increasing trend as a result of the continuous increase in the pensioners' population and its longevity and the fact that incoming pensioners have higher salaries and consequently, they are entitled to even higher annuities. Since 1990, there have been no other increases in the employers or employees contributions to cope with those factors and therefore, the level of contributions remains low in comparison to the level of pension benefits.

Market events plus the continuous increase in the actuarial liability have affected the System's capitalization. Based on the last actuarial valuation at June 30, 2003, the System's funding ratio is 17%, the actuarial obligation is \$11,191 million, total assets amount to \$1,947 million and the unfunded liability is \$9,244 million.

Facing an unstable market, in 2001 Management identified the need for a portfolio restructuring. The System's portfolio moved from a very aggressive allocation (75%) toward equities to a controlled allocation of a maximum of 65% in equities. To enhance the expected annual return, the strategy concentrated in the allocation of a 28% of the total portfolio to the participants' loans program with only 7% assigned to a core fixed income strategy. Those loans actually provide a higher return and lower risk in comparison to bonds, mostly because the System has the ability to rise the interest rates charged, the repayment comes from payroll deductions and the loans are guaranteed by participants' accumulated contributions. With the new asset allocation, the annual expected return is 9.81%, which adequately sustains the 8.5% discount rate used to compute the actuarial obligation.

To contain investment management fees, 70% of the domestic equities was allocated to an index fund that mirrors the S&P 500. This was done because that segment of the market is fairly efficient and it is more difficult for active managers to add value. This strategy has provided savings in investment management fees exceeding one million dollars per year. The remaining portion of the domestic equities was 20% assigned to a large cap core active manager, 5% to a small cap value manager and 5% to a small cap growth value.

The restructuring was completed in late calendar year 2002, and by the first and second quarters of 2003, the portfolio finally accomplished encouraging returns. For the semester ended June 30, 2003, the accumulated return was 8.84% and for fiscal year 2004, the return was 16.64%. The new asset allocation is the one that fulfills the System's needs and since it is more adequately balanced, it provides protection in case of another market downturn.

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The System's funding ratio is Management's major concern. The System faces the reality that benefits were enhanced for many years without the proper funding. Moreover, the System's funding is an important element in our credit analysis for government's bond issues. In fact, the unfunded liability is indeed, a long-term obligation of the government that needs to be taken into consideration by the credit rating agencies.

The bottom line is that the capital markets by themselves, cannot solve our funding problem alone. Somehow capital contributions must be increased and/or the liability must be reduced. Management has come up with recommendations to improve the System's financial health. Among those stands out the following:

- Increase in employees' and employers' contributions;
- Issuance of Pension Obligation Bonds with debt service being provided by the General Fund.

Government has already contemplated and evaluated favorably the issuance of \$2,000 million in Pension Obligation Bonds and providing an increase in level of contributions to 10% for both the employers and the employees. If implemented, those two steps will improve the System's capitalization and will provide additional cash flow for the upcoming years.

Increase in Economic Benefits for Retirees Established in Summer 2003

In summer 2003, the Government of Puerto Rico granted new benefits to the System's retirees to help them cope with the increase in the cost of living, which consisted of:

- Summer Bonus of \$100 payable annually every July, starting July 2003;
- Medicine Bonus of \$100 payable annually every July, starting July 2003;
- Increase in the Christmas Bonus from \$300 to \$400 annually every December, starting December 2003;
- Increase in the minimum monthly pension benefit from \$200 to \$300, effective January 1, 2004;

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- Increase in the monthly employer contribution for the medical plan from \$40 to \$100, effective January 1, 2004;
- Two increases of 3% in all pensions effective on January 1, 2001 and January 1, 2004;
- Increase in the pension benefit for widows and/or beneficiaries from 30% to 50% of the benefit received by the deceased retiree, effective January 1, 2004.
- Increase in death benefit from \$750 to \$1,000.

Following the requirements established by Law 1 of February 16, 1990, these benefits are financed through legislative assignments in the General Fund with respect to Central Government retirees and financed by the Municipalities and public corporations with respect to their retirees.

Initiatives to Provide Better Services to Our Participants and Retirees

The System serves around 158,000 active participants and 92,000 retirees and beneficiaries belonging to 140 different employers. It provides a range of close to 50 different types of services to its clientele, including pension applications, disability benefits, mortgage and personal loans and the collection and application of unpaid services. Because of that, our clientele frequently demands fast services, access to information and benefits orientation.

During fiscal year 2003, the System launched several initiatives to improve its services to its participants and retirees. They are:

- TELERETIRO - a telephone calls center to provide information about benefits and services. TELERETIRO operates through a toll-free number, with extended hours including Saturdays.
- Pre-Retirement Orientation Programs - a complete orientation for candidates for retirement through a two-days seminar where the candidates receive education regarding pension benefits, financial and legal matters, and motivation to plan and face a new stage in their lives.
- New Personal Loans Program that provides the granting of personal loans up to \$5,000 with a 5 year term.

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The System's management has taken several steps to improve the operational efficiency and productiveness, including the computerized information systems. With a strong commitment, the System's management continues its efforts to implement innovative initiatives to provide even better services to its clientele and protect the System's financial condition.

New Personal Loans Application

In 1998, as part of an effort to comply with Year 2000 requirements, a personal loan application was implemented. However, due to the magnitude of the personal loan business, that application proved to be totally deficient, limited to loan origination and lacking integration with the rest of the computerized applications. As a result, most administrative functions were unavailable making extremely difficult the accounting and collection of loans.

In year 2003, Management started the design and implementation of a new personal loan application, named Aplicación Integrada de Préstamos (AIP), which was designed tailor-made according to the System's needs and integrated with the other computerized applications. In June 2004, the new application was launched and the conversion of the loans data took place. The System finally has the appropriate tools to administer the personal loan portfolio. As of June 30, 2004 the personal loans portfolio subsidiary was reconciled to the general ledger accounts and the necessary adjustments were made to provide fairly stated balances. With respect to any past due loans, Management estimates that no additional provision is necessary since all loans are guaranteed with participants' accumulated contributions and aggressive collection efforts have already started.

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 00918.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Statements of Plan Net Assets
June 30, 2004 and 2003
(In Thousands)

| <u>Assets</u> | <u>2004</u> | <u>2003</u> |
|--------------------------------------|---------------------|------------------|
| Cash and investments | | |
| Cash and cash equivalents: | | |
| Deposits at commercial banks | \$ 12,673 | 35,038 |
| Deposits with Government Development | | |
| Bank of Puerto Rico: | | |
| Unrestricted | 31,853 | 28,112 |
| Restricted | 1,140 | 653 |
| | <u>32,993</u> | <u>28,765</u> |
| | 45,666 | 63,803 |
| Marketable securities at fair value: | | |
| Bonds and notes | 106,441 | 218,093 |
| Stocks | 1,162,762 | 944,904 |
| Other investments | 41,632 | 34,089 |
| | <u>1,310,835</u> | <u>1,197,086</u> |
| Loans and interest receivable from | | |
| plan members, net of allowance for | | |
| losses in 2004 | 369,203 | 281,796 |
| Investment in PRTA Holdings, at | | |
| appraised value | 404,390 | 362,670 |
| Total Cash and Investments | <u>2,130,094</u> | <u>1,905,355</u> |
| Accounts receivable: | | |
| Employers | 32,656 | 31,257 |
| General Fund of the Commonwealth | | |
| of Puerto Rico | 11,014 | 10,967 |
| The Commonwealth of Puerto Rico | | |
| Judiciary Retirement System | 3,472 | 2,179 |
| Investment sales | 606 | 573 |
| Accrued interest | 2,288 | 4,052 |
| Other | 38,662 | 17,567 |
| | <u>88,698</u> | <u>66,595</u> |
| Property and equipment, net | 8,330 | 7,583 |
| Other assets | 7,825 | 9,812 |
| | <u>96,453</u> | <u>83,972</u> |
| Total assets | \$ <u>2,234,947</u> | <u>1,989,345</u> |

(Continued)

See accompanying independent auditors' report
and notes to financial statements.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Statements of Plan Net Assets
June 30, 2004 and 2003
(In Thousands)

| <u>Liabilities</u> | <u>2004</u> | <u>2003</u> |
|--|---------------------|------------------|
| Book overdraft | \$ 58,028 | - |
| Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members | 19,887 | 18,231 |
| Investment purchases | 1,202 | 1,349 |
| Other liabilities | 14,388 | 22,363 |
| Total liabilities | <u>93,505</u> | <u>41,943</u> |
| Net assets held in trust for pension benefits | \$ <u>2,141,442</u> | <u>1,947,402</u> |

See accompanying independent auditors' report
and notes to financial statements.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Statements of Changes in Plan Net Assets
June 30, 2004 and 2003
(In Thousands)

| | <u>2004</u> | <u>2003</u> |
|---|---------------|---------------|
| Additions: | | |
| Contributions: | | |
| Employers | \$ 330,336 | 312,473 |
| Participating employees | 294,013 | 276,347 |
| Legislative Assignments for Law 127 | <u>14,553</u> | <u>17,931</u> |
| | 638,902 | 606,751 |
| Investment income: | | |
| Net appreciation/(depreciation) on investments | 258,702 | (36,440) |
| Dividend income | 6,693 | 42,561 |
| Interest income | <u>43,842</u> | <u>43,309</u> |
| | 309,237 | 49,430 |
| Less: Investment expense | <u>3,058</u> | <u>3,425</u> |
| | 306,179 | 46,005 |
| Other income | <u>6,813</u> | <u>11,127</u> |
| Total additions | 951,894 | 663,883 |
| Deductions: | | |
| Annuities | 672,578 | 614,500 |
| Benefits under Law 127 | 14,553 | 17,931 |
| Death benefits | 11,099 | 12,370 |
| Refunds: | | |
| Employers | 1,220 | 1,465 |
| Participating employees | <u>18,769</u> | <u>21,124</u> |
| | 19,989 | 22,589 |
| Net adjustments in the conversion to a new loan application (note 5) | 8,107 | - |
| Administrative expenses | <u>31,528</u> | <u>28,768</u> |
| Total deductions | 757,854 | 696,158 |
| Net increase/(decrease) in assets held in trust for pension benefits | 194,040 | (32,275) |
| Net assets held in trust for pension benefits: | | |
| Beginning of year | 1,947,402 | 1,979,677 |
| End of year | \$ 2,141,442 | 1,947,402 |

See accompanying independent auditors' report
and notes to financial statements.

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Notes to Financial Statements
June 30, 2004 and 2003

(1) Organization, and Summary of Significant Accounting Policies

Organization

The Employees' Retirement System of the Government of Commonwealth of Puerto Rico (formerly 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 Governmental Accounting Standards Board No. 25 (GASB No. 25), "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans". Participating employees and employer's 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.

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Financial Statements

(1) Organization, and Summary of Significant Accounting Policies,
Continued

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) and a commercial bank. Restricted cash deposited with GDB consists of payments received from mortgage loan holders administered by the mortgage servicer, in the servicing of loans.

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.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Financial Statements**

(1) Organization, and Summary of Significant Accounting Policies,
Continued

Investments, Continued

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. Maximum amounts that may be granted to plan members for mortgage, personal and cultural trip loans are \$100,000, \$5,000 and \$5,000, respectively.

The System services mortgage loans with aggregate principal balances of approximately \$19,989,000 and \$24,462,000 at June 30, 2004 and 2003, respectively, related to certain mortgages loans sold to FNMA for a fee of 0.25%. The income for 2004 and 2003 amounted to \$49,571 and \$58,001, respectively, and is recognized as interest income in the accompanying statement of changes in plan net assets.

In addition, at June 30, 2004 and 2003, the System repurchased approximately \$148,000 and \$128,000, 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.

(Continued)

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Notes to Financial Statements**

(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, 2004, membership consisted of the following:

| | |
|---------------------------------|----------------|
| Retirees and beneficiaries | |
| currently receiving benefits | 91,830 |
| Current participating employees | <u>135,088</u> |
| Total membership | <u>226,918</u> |

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:

50 with 25 years of credited service
58 with 10 years of credited service

Other Employees:

55 with 25 years of credited service
58 with 10 years of credited service

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(2) Plan Description, Continued

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 \$300 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.

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 the employee reaches 65 years old and begins 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 \$82 and \$100 per month
- Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases can be reduced over \$165 per month

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(2) Plan Description, Continued

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.

Non-occupational 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 1.5% of the average compensation of the first 20 years of credited services increased by 2% for every additional year of credited service in excess of 20 years.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(2) Plan Description, Continued

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.

Non-occupational:

- 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 50% (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 \$750.

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.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(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 February 16, 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 55 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.

Cost of Living Adjustment for Pension Benefits

Act No. 10 of May 21, 1992 provided 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. The Act requires further legislation to grant this increase every three years, subject to the presentation of actuarial studies regarding its costs and the source of financing. To protect the financial health of the System the increase granted during 2001 and the one granted on January 1, 2004 are being financed through grants from the General Fund and contributions from municipalities and public corporations.

Early Retirement Programs

During fiscal years 1999 and 2001, the Government provided two early retirement programs. To avoid any economic impact on the System, the employer is responsible for contributing to the System the 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. Presently, the System bills regularly all the amounts for which the employers are responsible.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(2) Plan Description, Continued

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

On September 24, 1999, Law 305, 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, were allowed to elect either to stay in the defined benefit plan or transfer to System 2000. Persons joining the Government on or after January 1, 2000, are only 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, rather should be provided to those participants that voluntarily elect to participate in a private insurance long-term disability program. The employers' contributions (9.275% of the employee's salary) with respect to employees under System 2000 will continue but 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.

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(2) Plan Description, Continued

At June 30, 2004, System 2000 membership within the System's total membership consisted of the following:

| | |
|---------------------------------|---------------|
| Current participating employees | <u>22,678</u> |
|---------------------------------|---------------|

(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 employers' and employees' contributions and the System's pension benefit obligations and administrative costs.

The System received grants from the General Fund of \$137.8 million and \$96.7 million in 2004 and 2003, respectively to cover special laws. The grants are accounted, net of benefits payments except for approximately \$14.6 million and \$17.9 million in 2004 and 2003, 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, 2003, 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 1983.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(3) Funding Policy, Continued

The actuarial accrued liability was approximately \$11,191,357,000 as of June 30, 2003. At June 30, 2003, the unfunded actuarial accrued liability was approximately \$9,243,955,000.

The Legislature of the Commonwealth enacted Act No. 1 of February 16, 1990 to improve the solvency of the System for the next 50 years. Among other provisions, the legislation increases the level of contributions to the System, reduces the benefits for new participating employees and increases the retirement age from 55 to 65 years. Further, through Act 305 of September 24, 1999, the defined benefit plan was closed and a defined contribution plan was created (as described in Note 2) for all participants who start working for the Commonwealth effective January 1, 2000.

As an employer, the System has contributed \$1,287,000 and \$1,171,000 which represented its contractually required contribution for the years ended June 30, 2004 and 2003, respectively.

(4) Cash and Investments

Cash Deposits

At June 30, 2004, the aggregate carrying amount of cash deposits and cash equivalents held by the System was an overdraft of approximately \$12.3 million, which includes \$12.7 million at commercial banks, \$33 million at GDB reduced by an overdraft of \$58.0 million. At June 30, 2003, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$63.8 million, which includes \$35 million at commercial banks, \$28.8 million at GDB.

The \$12.7 million and the \$35 million deposited at commercial banks for years 2004 and 2003, 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.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(4) Cash and Investments, Continued

Cash Deposits, Continued

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, 2004, cash consists of deposits in banks and is categorized following the "Guide to Implementation of GASB No. 3, "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.

Category 3 - uncollateralized

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

| | Category | | | Fair Value |
|--|----------------|----------|---------------|---------------|
| | 1 | 2 | 3 | |
| Deposits in commercial banks | \$ 12.7 | - | - | 12.7 |
| Deposits in GDB | - | - | 33.0 | 33.0 |
| | <u>12.7</u> | <u>-</u> | <u>33.0</u> | <u>45.7</u> |
| Less: overdraft in Treasury Department Fund | <u>-</u> | <u>-</u> | <u>58.0</u> | <u>58.0</u> |
| Total | \$ <u>12.7</u> | <u>-</u> | <u>(25.0)</u> | <u>(12.3)</u> |

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(4) Cash and Investments, Continued

Investments

The following table shows the fair value of the investments in marketable securities held by the System as of June 30, 2004 and 2003 (in thousands):

| | <u>Fair Value</u> | |
|--|---------------------|------------------|
| | <u>2004</u> | <u>2003</u> |
| U.S. Government and agencies, securities | \$ 23,325 | 44,425 |
| Corporate bonds | 83,116 | 173,668 |
| Total bonds and notes | <u>106,441</u> | <u>218,093</u> |
| Domestic corporate stocks | 866,200 | 719,525 |
| International corporate stocks | 296,562 | 225,379 |
| Total stocks | <u>1,162,762</u> | <u>944,904</u> |
| Alternative investments | <u>41,632</u> | <u>34,089</u> |
| Total investments | \$ <u>1,310,835</u> | <u>1,197,086</u> |

Alternative Investments include the following:

| | <u>Date of Commitment</u> | <u>Total Commitment</u> | <u>Contri- butions To Date</u> | <u>Cost</u> | <u>Fair Value</u> |
|---|-------------------------------|-----------------------------|--|-------------------|-------------------|
| Grupo Guayacán, Inc. | | | | | |
| Guayacán Fund of Funds, LP | September 1996 | \$ 25,000,000 | 23,279,099 | 19,615,651 | 14,810,101 |
| Guayacán Fund of Funds II, LP | August 1999 | 25,000,000 | 17,663,660 | 16,981,291 | 12,810,573 |
| Advent-Morro Equity Partner, Inc. | | | | | |
| Guayacán Private Equity Fund, LP | January 1997 | 5,000,000 | 3,930,032 | 3,831,792 | 4,224,402 |
| Venture Capital Fund, Inc. | November 1995 | 800,000 | 800,000 | 800,000 | 436,496 |
| Chase Capital Partners Equity Fund of Funds Corporate Investors II, LTD | July 2000 | 20,000,000 | 12,429,074 | 10,854,141 | 9,351,107 |
| Martineau Bay Resort, S. on C. (S.E.) | July 1998 | <u>1,795,750</u> | <u>1,795,750</u> | <u>1,795,750</u> | - |
| Total alternative investments | | \$ <u>77,595,750</u> | <u>59,897,615</u> | <u>53,878,625</u> | <u>41,632,679</u> |

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(4) Cash and Investments, Continued

Investments, Continued

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.

Credit Risk Classification is as follows (in thousands):

| | Category | | | Fair Value |
|-------------------------|----------|---|-----------|---------------|
| | 1 | 2 | 3 | |
| Bonds and notes | \$ - | - | 106,441 | 106,441 |
| Stocks | - | - | 1,162,762 | 1,162,762 |
| Alternative investments | - | - | 41,632 | 41,632 |
| Total | \$ - | - | 1,310,835 | 1,310,835 |

The investment in Martineau Bay represents an investment in a hotel resort that filed Chapter 11 under the United States Bankruptcy Code.

Securities Lending Transactions

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, 2004, the collateral received represents 103.15% of the fair value of the securities lent.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(4) Cash and Investments, Continued

Securities Lending Transactions, Continued

Securities lending obligations for which collateral was received at June 30, 2004 and 2003 consisted of the following (in thousands):

| | <u>Fair Value</u> | |
|------------------------|-------------------------|----------------------|
| | <u>2004</u> | <u>2003</u> |
| Securities Lent | | |
| U.S. Corporate Bonds | \$ 10,188 | 8,446 |
| U.S. Government | - | 13,479 |
| U.S. Equity | <u>77,704</u> | <u>13,680</u> |
| Total | \$ <u>87,892</u> | <u>35,605</u> |

The underlying collateral for these securities had a market value of approximately \$90,663 and \$36,512 thousand as of June 30, 2004 and 2003 and was invested as follows (in thousands):

| | <u>2004</u> | <u>2003</u> |
|------------------------------------|-------------------------|----------------------|
| Asset Backed Commercial Paper | \$ 14,386 | 4,893 |
| Reverse Repo U.S. Agency Delivered | - | 25,915 |
| Reverse Repo Government Delivered | 66,686 | - |
| Certificate of Deposit | - | 951 |
| Time Deposit | - | 1,901 |
| Promissory Note | - | 2,852 |
| Master Note | <u>9,591</u> | <u>-</u> |
| Total | \$ <u>90,663</u> | <u>36,512</u> |

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(4) Cash and Investments, Continued

Securities Lending Transactions, Continued

The System has very low credit risk exposure to borrowers. The System's 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.

(5) Loans and interest receivable from plan members

In June 2004, the System completed a significant phase in the development and implementation of a new computerized system for the accounting and management of loans.

The process allowed the determination of the balance of interest and charges receivable. The amount corresponding to interest as of June 30, 2003 was not identifiable since the former system did not allow such determination.

The System was also involved in the identification and validation of a portfolio of loans that was not activated in the former system.

An allowance for doubtful accounts was established as of June 30, 2004.

The net effect of the process in the financial statements of the System was recognized in the current year operations and amounted approximately \$8,107,000.

The allowance for loan losses considered the results of the updating of files in the conversion to the new system. In management's judgment, it is more than adequate to absorb possible credit losses and other adjustments inherent in the loan portfolio.

The loans receivable from participants are guaranteed by the contributions of participants and by other sources, including mortgage deeds and any unrestricted amount remaining in the escrow funds. In addition, collections on loans receivable are received through payroll deductions.

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(5) Loans and interest receivable from plan members, Continued

The composition of loans and interest receivable from plan members is summarized as follows (dollars in thousands):

| | <u>2004</u> | <u>2003</u> |
|---|-------------------|-------------------|
| Loans receivable: | | |
| Mortgage | \$ 72,375 | \$ 65,436 |
| Personal | 286,944 | 203,083 |
| Cultural trips | <u>16,245</u> | <u>13,277</u> |
| Total loans to plan members | 375,564 | 281,796 |
| Accrued interest receivable | <u>7,876</u> | <u>-</u> |
| | 383,440 | 281,796 |
| Less: Allowance for adjustments and losses in realization | <u>(14,237)</u> | <u>-</u> |
| Total loans and interest receivable, net | \$ <u>369,203</u> | \$ <u>281,796</u> |

(6) 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 or TELPRI). 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 designate the use of the sale proceeds.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(6) Investment in PRTA Holdings, Continued

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 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, 2004 and 2003, the System received \$3.5 and \$38 million, respectively, consisting of the dividends declared and paid by TELPRI.

In connection with the First Sale of 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.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(6) Investment in PRTA Holdings, Continued

As of June 30, 2004, the PRTA Holdings Preferred Stock is presented based on its estimated value per the most recent certified appraisal made by an independent firm as of December 31, 2003.

As of June 30, 2004, the PRTA Holdings Preferred Stock is presented based on an estimated value of the TELPRI's stock as follows:

| As of June 30, | <u>2004</u> | <u>2003</u> |
|----------------------------|-----------------|-------------------|
| Number of shares | 7,000,000 | 7,000,000 |
| Price per share | \$ <u>57.77</u> | \$ <u>51.81</u> |
| Total value (in thousands) | \$ 404,390 | \$ <u>362,670</u> |

(7) 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 |

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements

(7) Capital Assets, Continued

Capital assets activity for the year ended June 30, 2004 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 | 10,142 | 1,599 | 10 | 11,731 |
| Total capital assets, being depreciated | 17,773 | 1,599 | 10 | 19,362 |
| Less accumulated depreciation for: | | | | |
| Building and improvements | 3,004 | 113 | - | 3,117 |
| Equipment | 8,155 | 730 | 1 | 8,884 |
| Total accumulated depreciation | 11,159 | 843 | 1 | 12,001 |
| Total capital assets, being depreciated, net | 6,614 | 756 | 9 | 7,361 |
| Capital assets, net | \$ 7,583 | 756 | 9 | 8,330 |

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(8) Other Assets

At June 30, 2004 and 2003, other assets consisted of the following:

| | 2004 | 2003 |
|--------------------------------------|----------------|-------|
| | (In thousands) | |
| Reposessed and foreclosed properties | \$ 3,126 | 2,805 |
| Executed land | 4,699 | 7,007 |
| Total | \$ 7,825 | 9,812 |

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 accounting principles generally accepted in the United States of America, 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 2004 and 2003 amounted to approximately \$144,000 and \$132,000, respectively, and is reflected as part of other income in the accompanying statements of changes in plan net assets.

In 1998, part of the land was taken by the Government for the construction of a coliseum, and was 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.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(8) Other Assets, Continued

During fiscal year 2004, the Highway Authority compensated the System for 7,179.21 square meters of the land used for the construction of a section of the Tren Urbano. Total compensation amounted to \$3.4 million, as a result, the System recognized a gain of \$1.1 million.

As of June 30, 2004, a total of 14,618.0987 square meters of land remain. According to an independent appraisal as of May 17, 2004, the market value of this land approximates \$20,045,000.

(9) Guarantee Insurance Reserve for 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.

(10) 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.

(11) Accounts Receivable from Employers

Accounts receivable from employers consist 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, interest is charged, as established by the Board Resolution number 91-05.

As of June 30, 2004 and 2003, the receivable from employers amounted to \$32.6 million and \$31.2 million, respectively.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Financial Statements**

(12) Union of General Workers

On December 3, 2002 the Government Employees and Judiciary Retirement Systems signed an agreement with the Union of General Workers. This collective agreement empowers the Administrator and the Union to establish and negotiate an agreement that applies to all employees, except directors, chiefs, supervisors and all personnel that manages confidential information. The collective agreement expires on November 30, 2005.

SUPPLEMENTARY

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Schedule of Contributions
(Dollar amounts in Thousands)
June 30, 2004

| <u>Year Ended June 30,</u> | <u>Annual Required Contributions</u> | <u>Contributions</u> | <u>Percentage Contributed</u> |
|--------------------------------|--|----------------------|-----------------------------------|
| 2003 | \$ 802,500 | \$ 330,404 | 41% |
| 2002 | 802,500 | 308,228 | 38 |
| 2000 | 890,800 | 549,855 | 62 |
| 1999 | 845,000 | 491,800 | 58 |
| 1998 | 777,800 | 502,100 | 65 |
| 1997 | 722,300 | 454,600 | 62 |
| 1996 | 677,200 | 402,200 | 59 |

See notes to schedule of trend information.

SUPPLEMENTARY

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Schedule of Funding Progress
(Dollar amounts in thousands)
June 30, 2004

| 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 |
|--------------------------------|---|--|---------------------------|-----------------|------------------------------|--|
| 7/1/2003 | \$ 1,947,402 | \$ 11,191,357 | \$ 9,243,955 | 17% | \$ 3,334,441 | 277% |
| 7/1/2001 | 2,428,664 | 9,881,481 | 7,452,817 | 25 | 2,549,447 | 292 |
| 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 |

See notes to schedule of trend information.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Schedules of Trend Information
June 30, 2004

(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. The information was obtained from the last actuarial report as of June 30, 2003.

(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's contributions, ultimately, should cover any deficiency between the participating employees' contributions, the pension benefits and the System's administration costs.

The information was obtained from last actuarial report as of June 30, 2003.

(3) Actuarial Data

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Starting July 1, 2001, the actuarial valuation is being performed every two years. Additional information as of the latest actuarial valuation follows:

| | |
|-------------------------------|---|
| Valuation Date | July 1, 2003 |
| Actuarial Cost Method | Projected unit credit cost method |
| Amortization Method | Level percentage of the projected payroll |
| Remaining Amortization Period | 23 years |
| Asset Valuation Method | Market value |
| Actuarial Assumptions: | |
| Investment rate of return* | 8.5% |
| Projected salary increases* | 5% |
| Mortality Rate | Group Annuity Table for 1983 |
| Cost of living adjustment | None |

* Includes inflation at 3.5%