

**Employee's Retirement System
of the Government of the
Commonwealth of Puerto Rico**

*Financial Statements (with Independent
Auditors' Report Thereon) for the
Years Ended June 30, 2006 and 2005*

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT OF THE
COMMONWEALTH OF PUERTO RICO**

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

Management's Discussion and Analysis

June 30, 2006

Introduction

The Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System or ERS) administers retirement and other participant benefits, such as personal, cultural and mortgages loans, occupational and non-occupational disability annuities and death benefits. 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. The System presents the annual financial statements and provides a narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2006. The financial performance of the System is discussed and analyzed within the context of the accompanying basic financial statements and disclosures.

Overview of the Financial Statements

Management Discussion and Analysis introduces the 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.

Statement of Plan Net Assets and Statement of Changes in Plan Net Assets

Both these statements provide information about the overall status of the System. The System uses full accrual accounting.

The Statement of Plan Net Assets, 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 Statement of Changes in Plan Net Assets, reports changes in the System's net assets held in trust for pension benefits during the year. All current year revenues and expenses are included regardless of when cash is received or paid.

Notes to Basic Financial Statements

The notes to the financial statement provide additional information that is essential for an understanding of the data provided in the Statements of Plan Net Assets and Changes in Plan Net Assets.

Supplementary Information

The required supplementary information consists of two schedules and related notes concerning the funded status of the pension plan administered by the System.

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

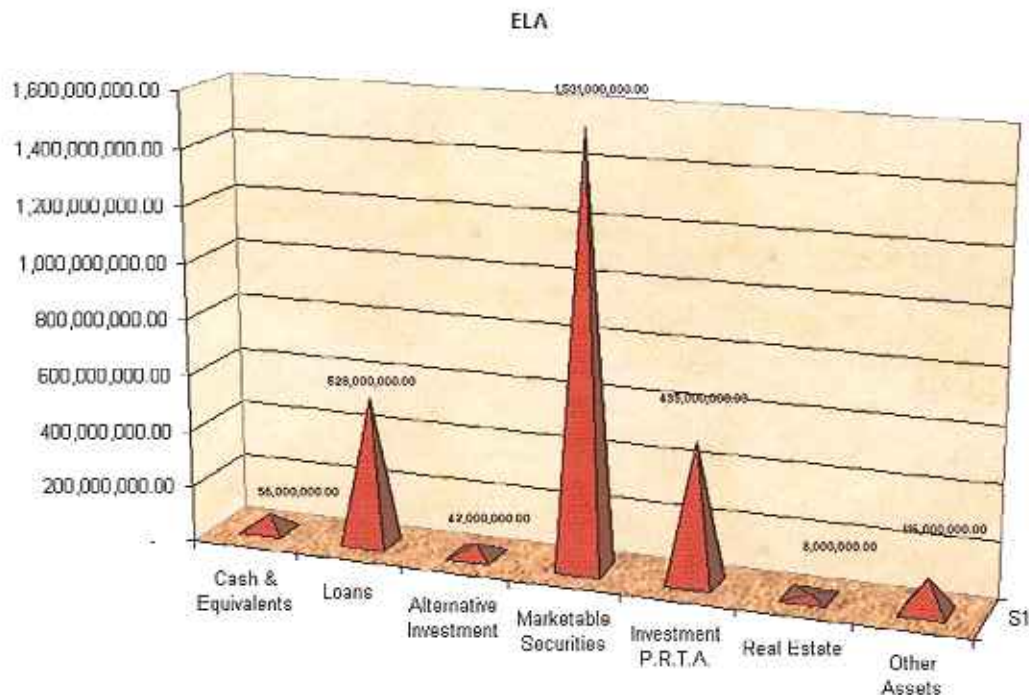
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Financial Highlights

The System provides the retirement benefits to employees of the Commonwealth of Puerto Rico. The System has \$2,776 million in total assets as of June 30, 2006. This amount consists of the following:

- \$1,531 million in marketable securities
- \$42 million in alternative investments
- \$495 million in the investment in PRTA Holdings Preferred Stock
- \$528 million in loans to participants
- \$8 million in real estate
- \$56 million in net cash and equivalents
- \$116 million in other net assets



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

- ERS assets exceeded liabilities by \$2,541,331,000 (net assets) for the fiscal year reported when compared to the prior year, for which assets exceeded liabilities by \$2,327,871,000.

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Management's Discussion and Analysis

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- The fair value of ERS investments (excluding the Investment in PRTA Holdings Preferred Stock and participants' loans) at June 30, 2006 amounted to \$1,573,335,000 compared to \$1,407,816,000 at June 30, 2005.
- ERS funding ratio of the actuarial accrued liability at June 30, 2005 is 19%.
- Investment in PRTA Holdings Preferred Stock at June 30, 2006 amounted to \$495,318,000 compared to \$486,080,000 at June 30, 2005.
- Participants' loans amounted to \$528,552,000 at June 30, 2006 compared to \$465,247,000 at June 30, 2005.

The financial statement of the System for the fiscal year ended June 30, 2006 presents an increase in net assets as compared to the prior fiscal year of approximately \$213 million. This was mostly the result of an increase in the fair value of marketable securities (\$165 million), increase in PRTA Holdings Preferred Stock investment and loans portfolio (\$72 million), increase in net cash (\$12 million) and increase in accounts receivable (\$24 million) offset by an increase in liabilities (\$60) million.

The System's net assets held in trust for benefits include employer and employee contributions as well as investment income. For fiscal year 2006, the employer and employee contributions increased by approximately \$34 million, from \$707 during fiscal year 2005 to \$741 million during fiscal 2006. The System recognized a net appreciation in the Fair Value of investments of \$2.8 million for fiscal year 2006.

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.

Budget Highlights

For the fiscal year 2006, the Board of Trustees approved a budget of \$37.5 million for the administrative and operational expenses of the System. For the fiscal year 2007 the budget approved amounts to \$38.3 million. In addition it also approved for a Construction Fund the amount of \$10.2 and \$1.7 for fiscal year 2005-2006 and 2006-2007 respectively.

Master Repurchase Agreement

The Board of Trustees approved on June 28, 2005 a Master Repurchase Agreement for the amount of \$150 million. As of June 30, 2006 the Repurchase Obligation was \$139 million.

(Continued)

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Management's Discussion and Analysis
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The transaction was recommended because of good collateral pricing, easy collateral transfer, weighted average rate cost less than L.I.B.O.R. and the Callan Associate Endorsement. This alternative was used to cover the overdraft with the Department of Treasury for the fiscal year ended June 30, 2005. This overdraft was mainly caused by the debt from Corporations, Municipalities and Central Government regarding employer's contributions to the Employees Retirement System.

The Repurchase Agreement was due on July 20th 2006 and was renewed for an additional 112 days.

Credit Agreement

On June 29, 2006, a financial institution (Banco Santander) approved a line of credit of \$112 million. The principal amount borrowed by the System as of June 30, 2006 was \$60 million. The 6.1175% interest rate under the Note will be made on the basis of 360 days a year. The maturity date is December 30, 2006, renewable for an additional 6 months.

Investment in PRTA Holdings Preferred Stock

As further explained in Note 7 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 Government Retirement System.

Subsequently, the GDB created a subsidiary, known as PRTA Holdings, to hold the remaining stock on behalf of the Government Retirement 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, 2006 and 2005, the System received \$45.7 million and \$14.9 million, respectively, in dividends from TELPRI.

For financial statements purposes, the investment in PRTA Holdings Preferred Stock is presented based on the estimated value as of June 30, 2006 of the TELPRI stock, considering 6,999,975 shares at \$70.76 per share for a total value of approximately \$495 million.

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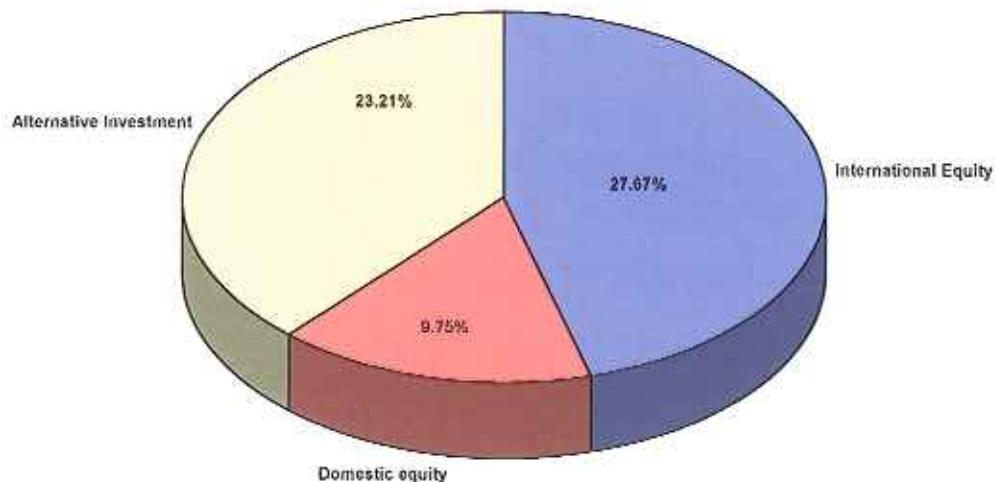
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Financial Analysis of the System

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.

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 of the Commonwealth of Puerto Rico that needs to be considered by the credit rating agencies.

The asset mix of the fund generated a positive gross return of approximately 10.32% for the year ended June 30, 2006. 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. The target asset mix for International Equity is 27.67%, Alternative Investment is 23.21% and Domestic Equity is 9.75% as shown in the following chart:



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Management's Discussion and Analysis
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Other Investments and Transactions

At June 30, 2006 and 2005, the System held approximately \$528.5 million and 465.2 million in loans to participants, respectively, which represents 25% of the total investment portfolio, excluding the investment in PRTA Holding Preferred Stocks. As of June 30, 2006 these loans consist of \$97 million in mortgage loans, \$406.5 million in personal loans and \$25 million in cultural loans including accrued interests receivable.

As of June 30, 2006 the System has participation in Limited Partnership Investments for approximate value of \$41.6 million which represents 2% of the investment portfolio. These investments have a gross return of 23.21% for the fiscal year.

The System earns additional investment income by lending investment securities to brokers via its custodian's securities lending program. The brokers provide collateral to the System and generally used the borrowed security to cover short sales and failed trades. The cash collateral received from the brokers is invested in order to earn interest. For financial statements purposes, the amount of securities as of June 30, 2006 that were involved in the securities lending transactions was presented with the required disclosures, according to the current government accounting pronouncements. For the fiscal year 2006, income from the custodian securities lending activity amounted to approximately \$158,000.

Funding Status

The Employees Retirement 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.

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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 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.

The Project number 476 which contemplates the issuance of \$2,000 million in Pension Obligation Bonds has been approved by the Senate, but awaits for the House of Representative and finally the signature of the Governor. The System presented legislation to increase the employers and employees contributions. This increase will be in a 2 year scale level from 8.275% thru 10% for the employees and in a 5 year level from 9.275% thru 12.50% for the employers. If implemented, those two steps will improve the System's capitalization and will provide additional cash flow for the upcoming years.

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, 2005, the System's funding ratio is 19%, the actuarial obligation is \$12,284 million, total assets amount to \$2,328 million and the unfunded liability is \$9,956 million.

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The bottom line is that the capital markets by themselves, cannot solve the System's funding problem. 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 rates;

Increase in Economic Benefits for Retirees Established in Summer 2003 and for fiscal year 2005, 2006 and 2007

For years 2003 thru 2007, the Government of Puerto Rico granted several 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.
- 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.
- Increase in the Christmas Bonus from \$400 to \$500 annually every December, starting, December 2005.
- On September 15, 2004 the Law 296 established that the refund paid to the employees who resign from the Commonwealth and retirees who receives the contribution plan would be deducted 10% for the Treasury Department.
- Increase from \$500 to \$550 and to \$600 in the Christmas Bonus for the retiree, effective on December 2006 and 2007 respectively.

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

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June 30, 2006

The Legislature approved Law 98 on May 16 2006, in which the Office of Management and Budget transferred \$42.9 million from Special Laws Funds to cover pension benefits and medical services.

Initiatives to Provide Better Services to Our Participants and Retirees

The System serves around 176,342 active participants and 95,221 retirees and beneficiaries belonging to approximately 216 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. These are:

- **TELERETIRO** – a telephone calls center to provide information about benefits and services. This service 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.
- **Personal Loans Program** that provides the granting of personal loans up to \$5,000 with a 5 year term.
- On December 2005 a new office for the Government Retirement System of P.R. was opened at Mayagüez, Puerto Rico. It serves approximately 1,600 clientele per month.

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.

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

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Management Discussion and Analysis

June 30, 2006

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 tailor-made designed 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.



PARISSI P.S.C.

Certified Public Accountants, Tax & Business Advisors

Independent Auditors' Report

The Board of Trustees
Employees' Retirement System of the Government of the
Commonwealth of Puerto Rico
San Juan, 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 (the System) as of June 30, 2006 and the related statement of changes in plan net assets for the year then ended. This financial statement is the responsibility of the System's management. Our responsibility is to express an opinion on this financial statement based on our audit. The financial statement of the System for the year ended June 30, 2005 was audited by other auditors whose report, dated December 21, 2005 expressed an unqualified opinion on that statement.

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 statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. 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 statement referred to above presents fairly, in all material respects, the net assets of the System at June 30, 2006, 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 statement taken as a whole. The accompanying Management's Discussion and Analysis presented on pages 1 through 10 and supplemental schedules of employers' contributions and funding progress presented on pages 44 through 46 are supplementary information required by the Governmental Accounting Standards Board, and are not a required part of the basic financial statement. 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 supplementary schedules and, therefore, express no opinion on them.

San Juan, Puerto Rico
October 17, 2006, except for supplementary schedules of employers'
contributions and funding progress, as to which the date is February 12, 2007.

Stamp No. 2199159 was affixed to
the original of this report
License Exp. December 1, 2008



**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Statements of Plan Net Assets

ASSETS	June 30,	
	2006	2005
	(in thousands)	
Cash and investments		
Cash and cash equivalents:		
Deposits at commercial banks	\$ 27,849	\$ 13,196
Deposits with Treasury Department of the Commonwealth	-	11,982
Deposits with Government Development Bank of Puerto Rico:		
Unrestricted	25,778	17,195
Restricted	2,156	1,578
	<u>27,934</u>	<u>18,773</u>
Cash and cash equivalents	55,783	43,951
Marketable securities at fair value:		
Bonds	154,825	166,440
Stocks	1,376,901	1,200,132
Other investments	41,609	41,244
	<u>1,573,335</u>	<u>1,407,816</u>
Loans and interest receivable from plan members, net of allowance for adjustments and losses in realization	528,552	465,247
Investment in PRFA Holdings, at appraised value	495,318	486,080
Total Cash and Investments	<u>2,652,988</u>	<u>2,403,094</u>
Accounts receivable:		
Employers	43,343	34,655
General Fund of the Commonwealth of Puerto Rico	10,401	21,463
The Commonwealth of Puerto Rico Judiciary Retirement System	3,161	1,376
Investment sales	1,279	2,090
Accrued interest	2,385	2,209
Accrued dividend	23,720	-
Other	23,579	21,896
Total accounts receivable	<u>107,868</u>	<u>83,689</u>
Capital assets	7,694	8,411
Other assets	<u>7,592</u>	<u>7,764</u>
TOTAL ASSETS	<u><u>\$ 2,776,142</u></u>	<u><u>\$ 2,502,958</u></u>

The accompanying notes are an integral part of these financial statements.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Statements of Plan Net Assets

	June 30,	
	2006	2005
LIABILITIES	(in thousands)	
Securities sold under agreements to repurchase	\$ 139,074	\$ 138,000
Line of credit	60,000	-
Funds of mortgage loans and guarantee insurance reserve for loans to plan members (note 4)	8,433	20,366
Investment purchases	1,179	2,079
Other liabilities	26,125	14,642
Total liabilities	<u>234,811</u>	<u>175,087</u>
 NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	 <u>\$ 2,541,331</u>	 <u>\$ 2,327,871</u>

The accompanying notes are an integral part of these financial statements.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Statements of Changes in Plan Net Assets

	Years Ended June 30,	
	2006	2005
	(in thousands)	
ADDITIONS:		
Contributions:		
Employers	\$ 398,372	\$ 374,823
Participating employees	342,697	332,376
Other special laws	16,684	14,731
	<u>757,753</u>	<u>721,930</u>
Investment income:		
Net appreciation on investments	189,515	186,643
Dividend income	49,938	19,112
Interest income	63,486	49,917
	<u>302,939</u>	<u>255,672</u>
Less: Investment expense	<u>10,123</u>	<u>3,750</u>
	292,816	251,922
Insurance premiums on loans to plan members	14,492	-
Other income	<u>8,778</u>	<u>7,925</u>
Total additions	1,073,839	981,777
DEDUCTIONS:		
Annuities	772,647	713,814
Benefits under other special laws	16,684	14,731
Death benefits	14,984	10,894
Refunds:		
Employers	1,666	1,734
Participating employees	20,707	17,947
	<u>22,373</u>	<u>19,681</u>
Insurance claims on loans to plan members	1,216	-
Administrative expense	<u>32,475</u>	<u>36,228</u>
Total deductions	<u>860,379</u>	<u>795,348</u>
Net increase in assets held in trust for pension benefits	213,460	186,429
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS:		
Beginning of year	<u>2,327,871</u>	<u>2,141,442</u>
END OF YEAR	<u>\$ 2,541,331</u>	<u>\$ 2,327,871</u>

The accompanying notes are an integral part of these financial statements.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(1) Organization and Summary of Significant Accounting Policies

The Employees' Retirement System of the Government of Commonwealth of Puerto Rico (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. Also, there are four Commonwealth government agency representatives which are the Secretary of the Treasury, the President of the Government Development Bank, the Executive Director of the Commonwealth's Human Resources Office (ORHELA), and the Municipal Affairs Commissioner.

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.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of 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.

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Notes to Basic Financial Statements
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(1) Organization and Summary of Significant Accounting Policies (Continued)

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 services in the servicing of loans and also expired checks not claimed by the participants.

Marketable Securities

Marketable securities 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 data.

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

Loans to Plan Members

Mortgages, 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 \$14,174 and \$16,994 million at June 30, 2006 and 2005, respectively, related to certain mortgages loans sold to FNMA for a fee of 0.25%. The income for 2006, and 2005 amounted to \$40,265, and \$44,935 respectively, and is recognized as interest income in the accompanying statement of changes in plan net assets.

In addition, as of June 30, 2006 and 2005, the System repurchased approximately \$98,721 and \$80,000, 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.

Insurance Premiums, Claims and Reserve for Life Insurance on Loans to Plan Members

Premiums collected and benefits claimed are recorded as additions and deductions respectively. The guarantee insurance reserve for life insurance on loans to plan members is revised each year and adjusted accordingly based on the annual higher claim amount of a five year period increased by a management determined percentage. As of June 30, 2006, the reserve for life insurance on loans to plan members was adjusted by management based on the outstanding loan balances.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

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

Capital Assets

Capital assets include building, furniture and equipment, capital leases and projects in progress. The System defines capital assets as assets, which have an initial individual cost of \$500 or more at the date of acquisition and have a useful life of four or more years. Capital assets are recorded at historical cost or at estimated historical cost if actual historical cost is not available. Donated capital assets are recorded at their estimated fair value at time of donation.

Capital assets are depreciated on the straight-line method over the assets estimated useful life. There is no depreciation recorded for projects in progress. The estimated useful lives of capital assets are as follows:

	<u>Years</u>
Building	50
Buildings improvements	10
Equipment, furniture, fixtures, and vehicles	5-10

Long-Lived Assets

The System reviews the carrying amount of its long-lived assets and identifies assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Any long-lived asset held for disposal is reported at the lower of their carrying amounts or fair value less cost to sell.

Future Adoption of Accounting Pronouncements

The GASB has issued the following accounting standards that have effective dates after June 30, 2006:

- GASB Statement No. 43, *Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans*, which is effective for fiscal years beginning after December 15, 2005.
- GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions*, which is effective for fiscal years beginning after December 15, 2006.
- GASB Statement No. 48, *Sales and Pledges of Receivable and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, which is effective for fiscal years ending December 31, 2007.

The impact of these statements on the System's basic financial statements has not yet been determined.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(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.

The figures represented below for fiscal year 2005 were updated during current fiscal year based on improvements and thorough analysis made to the data base which contains the retirees, beneficiaries, and the current participant employees' information. At June 30, 2006 and 2005, membership consisted of the following:

	<u>2006</u>	<u>2005</u>
Retirees and beneficiaries currently receiving benefits	95,221	93,073
Current participating employees	✓ 116,018	<u>120,987</u> - 54,517
Total membership	+ 60,324 <u>211,239</u>	<u>214,060</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

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.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(2) Plan Description (Continued)

Deferred Retirement Annuity

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

Coordinated Plan

On the Coordinated Plan the participating employee contributes a 5.775% of the monthly salary for the first \$550 and 8.275% for the excess over \$550. By the time 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

Non-Coordinated Plan

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

Reversionary Annuity

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

Occupational Disability Annuity

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

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(2) Plan Description (Continued)

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.

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, age 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, age 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.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(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. Since fiscal year 1992 to 2004 there have been other acts addressing the cost of living allowance (C.O.L.A.) as Act No. 207 of August 13, 1995, Act No. 221 of August 9, 1998, Act No. 40 of June 13, 2001, and Act No. 157 of June 27, 2003. To protect the financial health of the System, the increases granted pursuant to the above laws are being financed through grants from the General Fund of the Commonwealth and contributions from municipalities and public corporations.

Other Benefits Granted

For fiscal years 2003 to 2005 the Commonwealth of Puerto Rico granted additional benefits to the System's retirees. As of June 30, 2006 these increases are being funded through special appropriations from the General Fund of the Commonwealth for the amount corresponding to the Central Government agencies and by contributions from the public corporations and municipalities.

Incentive Retirement Programs

During fiscal year 2006 the Government of the Commonwealth of Puerto Rico issued executive order OF-2006-14 which establishes a voluntary incentive retirement program for those employees that comply with the legal requirements of years of services as of September 30, 2006 and notify their intention to become retiree on or before June 15, 2006. The economic incentive would be three or four months of salary depending on age and years of services. The executive order establishes that in order to avoid additional cost to the System that this program will be administered by the System, but will be funded with each agency's approved budget for fiscal year 2007.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(2) Plan Description (Continued)

Early Retirement Programs

During fiscal year 2001 the Government granted three additional retirement programs through Act No. 370, dated December 31st, 1999, Act No. 119 dated July 13th, 2000, and Act No. 174 dated August 12th, 2000. These acts applied to employees of the municipality of San Juan, employees of the State Insurance Fund Corporation and the employees within the three branches of the Government of the Commonwealth of Puerto Rico, respectively. These early retirement programs ended in fiscal year 2006, time in which the total employees became fully beneficiaries of the System. To avoid any economic impact on the System, the employer was 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.

Also during fiscal year 2006 the Government of the Commonwealth of Puerto Rico issued the Act No. 143, dated November 22, 2005, which implemented an early retirement program for the employees of the Puerto Rico Industrial Development Company ("PRIDCO") and Act No. 360, dated September 16th, 2004 which provided also, an early retirement program for the employees of the Puerto Rico Trade and Export Corporation ("PRTEC"). The actuarial cost of the implementation of the PRIDCO's early retirement program would be paid by the company prior to the implementation of the program as established in the act. The PRTEC would reimburse the annuities and other benefits paid by the System during a five year period plus the employer and employee contributions with respect to the participants covered until the participants reach the normal retirement age. Actually, the System bills regularly PRTEC all the amounts for which the corporation is responsible for. As of June 30, 2006, \$15 million and \$284 thousand have been received from PRIDCO and PRTEC respectively, to amortize the increase in additional annuities paid by the System.

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. People joining the public sector 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.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(2) Plan Description (Continued)

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.

The figures represented below for fiscal year 2005 were updated during current fiscal year based on improvements and thorough analysis made to the data base which contains the retirees, beneficiaries, and the current participant employees' information. At June 30, 2006 and 2005, System 2000 membership within the System's total membership consisted of the following:

	<u>2006</u>	<u>2005</u>
Current participating employees	✓ <u>60,324</u>	<u>54,517</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 \$113.6 million in 2006 and in 2005 to cover special laws. The grants are accounted as reduction of benefits payments, except for approximately \$16.7 and \$14.7 million in 2006 and 2005, 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.

The System, besides the contributions received from participants and employers, also receives legislative appropriations from special laws to cover additional benefits and the increase in benefits to retired employees. In the past years there have been laws that granted additional benefits; such as, summer and Christmas bonuses, medical plan contributions, and

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
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(3) Funding Policy (Continued)

various increases in cost of living allowances (3%), among others. Most of the funds used to cover these benefits are budgeted by the Commonwealth of Puerto Rico through legislative appropriations.

As of June 30, 2006 the System believes that they had to cover approximately \$73.9 millions of costs from its resources that should have been received through special laws. From these costs, as of June 30, 2006 and 2005 there were \$4.1 and \$17.5 million, respectively, included in the financial statements as receivables from the Commonwealth of Puerto Rico; the remaining amount has not been accrued pending a final review by the System and the acceptance by the Office of Management and Budget of the Commonwealth.

Actuarial information

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2005, 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.

As of June 30, 2005 the actuarial accrued liability and the unfunded actuarial accrued liability were approximately \$12,284 and \$9,956 millions, respectively.

The Legislative Assembly 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 increased the level of contributions to the System, reduced the benefits for new participating employees and increased 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 started working for the Commonwealth effective January 1, 2000 or after.

As an employer, the System has contributed \$1,536,000 and \$1,506,000 which represented its contractually required contribution for the years ended June 30, 2006 and 2005, respectively.

(4) Change in Accounting Estimate

During fiscal year ended June 30, 2006 the System changed its estimate of the reserve for life insurance on loans to plan members. The system provides life insurance that guarantees the payment of the outstanding principal balance of personal and cultural trip loans in case of a plan member's death. Previous management approach was to record as additions and deductions of the reserve for life insurance on loans to plan member's total premiums collected and total benefits claimed, respectively. The System's management decided to establish a reserve based on the insurance claims on loans to plan member's behavior for the

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(4) Change in Accounting Estimate (Continued)

last five years. As a result the System adjusted the amount reserved for life insurance on loans to plan members during fiscal year ended June 30, 2006 to reflect the most adequate liability that the System believes it would fulfill in the events of claims due to plan member's deaths. The effect of this change in estimate was a decrease of the guarantee insurance reserve for loans to plan's members by \$13.3 million, an increase of the insurance premiums on loan to plan's members by \$14.5 million and an increase of the insurance claims on loans to plan's members by \$1.2 million.

(5) Cash and Investments

Cash Deposits

At June 30, 2006, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$55.7 million, which includes \$27.8 million at commercial banks and \$27.9 million at Government Development Bank for Puerto Rico (GDB) which includes an overdraft of \$9.2 million at Treasury Department of the Commonwealth of Puerto Rico. At June 30, 2005, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$44.0 million, which included \$13.2 million at commercial banks, \$18.8 million at Government Development Bank for Puerto Rico (GDB) and \$12.0 million at Treasury Department of the Commonwealth of Puerto Rico.

The following table presents the carrying amount and the corresponding depository bank balances as of June 30, 2006 and 2005 (in thousands):

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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

	2006	
	<u>Carrying Amount</u>	<u>Depository Bank Balance</u>
Deposits at commercial banks	\$ 27,849	\$ 27,849
Deposits with Treasury Department	-	(70,812)
Deposits with GDB:		
Unrestricted	25,778	41,896
Restricted	2,156	2,156
	<u>27,934</u>	<u>44,052</u>
	<u>\$ 55,783</u>	<u>\$ 1,089</u>

	2005	
	<u>Carrying Amount</u>	<u>Depository Bank Balance</u>
Deposits at commercial banks	\$ 13,196	13,196
Deposits with Treasury Department	11,982	(95,540)
Deposits with GDB:		
Unrestricted	17,195	14,414
Restricted	1,578	1,578
	<u>18,773</u>	<u>15,992</u>
	<u>\$ 43,951</u>	<u>(66,352)</u>

The \$27.8 million and the \$13.2 million deposited at commercial banks for years 2006 and 2005, 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. As of June 30, 2006 and 2005, funds deposited at GDB for \$44.0 million and \$16.0 million, respectively, are uninsured and uncollateralized. On June 29, 2006, the System borrowed \$60 millions dollars to cover the overdraft on the Treasury Department.

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.

Deposits with financial institutions are subject to custodial credit risk when they are not covered by depository insurance and have one of the three following characteristics (GASB-40, paragraph 8):

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

1. Uncollateralized (no securities are pledged to the depositor government).
2. Collateralized with securities held by the pledging financial institution.
3. Collateralized with securities held by the pledging financial institution, or by its trust department or agent, but not in the depositor government's name.

Custodial Credit Risk Related to Deposits

Custodial credit risk is the risk that, in the event of a bank failure, the System's deposits might not be recovered. As of June 30, 2006 and 2005, \$44.0 million and \$16.0 million, respectively, of the System's deposits balance were exposed to custodial credit risk since it were uninsured and uncollateralized.

Investments

The following table shows the fair value of the investments in marketable securities held by the System as of June 30, 2006 and 2005 (in thousands):

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

Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(5) Cash and Investments (Continued)

	2006	2005
	(in thousands)	
US Government and agencies' securities		
Under Repurchase Agreement	\$ 91,504	\$ 93,041
Others	<u>202</u>	<u>6,421</u>
Total US Government and agencies' securities	91,706	99,462
US Corporate bonds		
Under Repurchase Agreement	56,654	52,613
Others	<u>6,465</u>	<u>14,365</u>
Total US Corporate bonds	63,119	66,978
Total Bonds	154,825	166,440
US Corporate stocks	948,269	865,857
Non-US Corporate stocks	<u>428,632</u>	<u>334,275</u>
Total Stocks	1,376,901	1,200,132
Private equity investments	<u>41,609</u>	<u>41,244</u>
Total Investments	<u>\$ 1,573,335</u>	<u>\$ 1,407,816</u>

Cash and equivalents and marketable securities include approximately \$148.2 and \$145.7 million as of June 30, 2006 and 2005, respectively, held as pledged collateral by a custodian bank in connection with a master repurchase agreement entered into as of the bonds payable (see Note 11).

The System's investments are exposed to custodial credit risk, credit risk, concentration of credit risk, foreign currency risk and interest rate risk. Following is a description of these risks as of June 30, 2006.

Custodial Credit Risk - Investments

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2006 securities investments were registered in the name of the System and were held in the possession of the System's custodian banks, State Street Bank and Trust, Citibank N.A., and Morgan Stanley.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Credit Risk

All fixed income securities at the time of purchase must be of investment grade quality. All issues shall be rated investment grade by at least two of the nationally recognized rating agencies. The portfolio is expected to maintain a minimum weighted average credit quality of either "A" or better using either Standard and Poor's or Moody's credit ratings. The following table presents the bonds and notes Moody's ratings as of June 30, 2006 and 2005, respectively (in thousands):

Moody's Rating	Investment Type	Market Value	
		2006	2005
AAA	US Government Bonds	\$ 84,702	\$ 89,678
AAA	Corporate Bonds	1,045	2,167
AA	Corporate Bonds	-	3,042
AA1	Corporate Bonds	2,710	4,752
AA3	Corporate Bonds	11,508	11,678
A1	Corporate Bonds	5,420	-
A2	Corporate Bonds	2,574	2,678
A3	Corporate Bonds	6,826	6,094
BAA	Corporate Bonds	-	5,819
BAA1	Corporate Bonds	5,429	5,841
BAA2	Corporate Bonds	12,584	8,031
BAA3	Corporate Bonds	4,264	5,518
BA1	Corporate Bonds	2,130	6,480
B1	Corporate Bonds	3,810	3,708
B2	Corporate Bonds	1,125	1,172
B3	Corporate Bonds	3,694	-
AGY	GNMA	-	1,419
NR	GNMA	7,004	8,363
Total bond and notes		\$ 154,825	\$ 166,440

Concentration of Credit Risk

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

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Interest Rate Risk

In accordance with its investment policy, the System manages its exposure to declines in fair values by structuring the investment portfolio so that securities mature to meet cash requirement for benefit payments, thereby avoiding the need to sell securities on the open market prior to maturity. Investments in equity securities are not subject to the maximum maturity policy since they do not carry a maturity date. The System is expected to achieve capital preservation and income generation by investing in diversified portfolio of marketable, investment grade core fixed income securities.

The following table summarizes the investments on debt securities of the System at June 30, 2006 (in thousands):

	Maturity from	Fair Value	Investment Maturities (In Years)			
			Less than 1	1-5	More than 5-10	More than 10
US Government and agencies securities						
REPO Agreement	(2006-2033)	\$ 91,504	\$ 74,829	\$ 4,987	\$ -	\$ 11,688
Other	(2030)	202	-	-	-	202
Sub-Total		91,706	74,829	4,987	-	11,890
Corporate Bonds						
REPO Agreement	(2006-2035)	56,654	2,574	6,744	29,629	17,707
Other	(2007-2027)	6,465	-	3,810	2,130	525
Sub-Total		63,119	2,574	10,554	31,759	18,232
Total Bonds and Notes		\$ 154,825	\$ 77,403	\$ 15,541	\$ 31,759	\$ 30,122

As of June 30, 2006, investments maturities are as follows:

<u>Maturity</u>	<u>Maximum Maturity</u>
Less than one year	50%
One to five years	10%
More than five to ten years	21%
More than ten years	19%

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Foreign Currency Risk

As of June 30, 2006, the System owned approximately \$428 million in an international equity commingled fund under the custody of Morgan Stanley investment bank, which represented approximately 74.03% of the total commingled fund. This pooled trust has an asset mix and country allocation as shown in the following table:

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Assets Mix			Percent
Cash and equivalents			0.94
Future contracts			8.76
Equity securities			90.30
Total			100.00
Country Allocation	Currency	Currency Code	Portfolio %
EMU			0.60
EMU			0.60
South Africa	Rand	ZAR	0.45
Africa			0.45
Poland	Zlotych	PLN	0.49
Russia	Rubles	RUB	1.51
Eastern Europe			2.00
Austria	Euro	EUR	0.78
Belgium	Euro	EUR	0.63
Finland	Euro	EUR	1.22
France	Euro	EUR	8.31
Germany	Euro	EUR	9.98
Greece	Euro	EUR	0.24
Netherlands	Euro	EUR	2.51
Portugal	Euro	EUR	0.14
Spain	Euro	EUR	2.27
Euro Europe			26.08
Brazil	Real	BRL	1.27
Mexico	Pesos	MXN	0.50
Latin America			1.77
Turkey	Lira	TRY	0.71
Middle East			0.71
Denmark	Kroner	DKK	0.40
Norway	Kroner	NOK	0.45
Sweden	Krona	SEK	2.13
Switzerland	Francs	CHF	5.23
United Kingdom	Pounds	GBP	20.27
Non-Euro Europe			28.48
Australia	Dollars	AUD	3.65
Hong Kong	Dollars	HKD	3.38
Japan	Yen	JPY	29.70
New Zealand	Dollars	NZD	0.01
Singapore	Dollars	SGD	1.80
Thailand	Baht	THB	0.43
Pacific			38.97
Cash			0.94
Cash			0.94
Total			100.00

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Investments in Limited Partnerships

The fair value of investments in limited partnerships amounted to approximately \$41.6 million and is presented within investments in the statements of net assets. The allocations of net gain and net loss to limited partners are based on certain percentages, as established in the limited partnership agreements. The distributions for these investments were as follows:

- During fiscal year 2006 there were no contributions to Guayacán Fund of Funds, L.P., a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of \$25 million. The Fund has commitments to invest in fifteen (15) US based and international venture partnerships and familiarizes the local pension funds with the private equity asset class without the risks inherent in geographically constrained investments.
- During fiscal year 2006 there were no contributions to Guayacán Fund of Funds II, L.P., a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of \$25 million. The Fund seeks to provide investors with a superior investment return and extensive diversification by investing in nineteen (19) Private Equity investment partnerships in the United States and Europe. The Fund also invests a portion of its assets in a Puerto Rico based Private Equity investment entity.
- During fiscal year 2006, \$476,758 were invested in Guayacán Private Equity Fund, a limited partnership organized pursuant to the laws of the state of Delaware and authorized to engage in business in the Commonwealth of Puerto Rico, in which the System has a total commitment of \$5 million. The purpose of the Partnership is to make equity investments in privately held companies as established in its charter.
- During fiscal year 2006 there were no additional contributions to Venture Capital Fund, Inc. (the Fund), a Puerto Rico corporation organized pursuant to Act Number 3 of October 6, 1987, as amended, known as the Puerto Rico Capital Investment Funds Act that is managed by Advent-Morro Equity Partners ("Advent-Morro"), in which the System has a total commitment of \$800 thousand. Advent-Morro is a Puerto Rico based private equity firm. The Fund was created to make private equity investments in operating companies which are based, or are operating or a combination both in Puerto Rico. Since inception, the Fund has invested in 25 companies some of which it continuous to provide capital for their expansion.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

- During fiscal year 2006 \$1,266,323 were invested in Chase Capital Partners Private Equity Fund of Funds II, LTD a limited partnership, organized by Chase as General Partner in which the System has a total commitment of \$20 million. The Fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investment opportunities across various sectors including buyouts, growth equity, venture capital and other special situations through partnership and direct investments.

As of June 30, 2006, the System had capital commitments and contributions as follows (in thousands):

Alternative investments include the following:

	<u>Date of Commitment</u>	<u>Total Commitment</u>	<u>FY 06 Contributions</u>	<u>Contributions to Date</u>	<u>Cost</u>	<u>Fair Value</u>
Grupo Guayacán, Inc.						
Guayacán Fund of Funds, LP	Sept. 1996	\$25,000	-	\$23,279	\$17,045	\$9,246
Guayacán Fund of Funds II, LP	Aug. 1999	25,000	-	19,639	18,290	16,916
Advent-Morro Equity Partner, Inc.						
Guayacán Private Equity Fund, LP	Jan. 1997	5,000	477	4,407	2,938	5,234
Venture Capital Fund, Inc.	Nov. 1995	800	-	800	800	737
Chase Capital Partners Private Equity Fund of Funds Corporate Investors II, LTD	Jul. 2000	20,000	1,266	16,307	12,160	9,476
Martineau Bay Resort, s. en c. (s.e.)	Jul. 1998	1,796	-	1,796	1,796	-
Total alternative investments		<u>\$77,596</u>	<u>\$1,743</u>	<u>\$66,228</u>	<u>\$53,029</u>	<u>\$41,609</u>

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

The alternative investments have as assets securities whose values have been estimated by the corresponding general partner or fund manager. Market values are not available. The estimated values may differ significantly from the amounts that could be obtained from dispositions or formal active markets if were available.

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, 2006 and 2005, the collateral received represents 103.23% and 103.27%, respectively, of the fair value of the securities lent.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(5) Cash and Investments (Continued)

Securities lending obligations for which collateral was received at June 30, 2006 and 2005 consisted of the following (in thousands):

	<u>Fair Value</u>	
	<u>2006</u>	<u>2005</u>
Securities Lent		
U.S. Equity	<u>\$ 35,885</u>	<u>\$ 63,150</u>

The underlying collateral for these securities had a market value of approximately \$37.0 and \$65.2 million as of June 30, 2006 and 2005, respectively, and was invested as follows (in thousands):

	<u>2006</u>		<u>2005</u>	
Asset Backed Commercial Paper	\$ 937	2.53%	\$ 19,037	29.19%
Reverse Repo U.S. Agency Delivered	5,191	14.01%	6,680	10.24%
Certificate of Deposits	2,811	7.59%	-	0.00%
Reverse Repo Mortgage Backed Tri-party	<u>28,108</u>	<u>75.87%</u>	<u>39,501</u>	<u>60.57%</u>
Total	<u>\$ 37,047</u>	<u>100%</u>	<u>\$ 65,218</u>	<u>100%</u>

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

(6) Loans and Interest Receivable from Plan Members

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 withholdings.

The allowance for loan losses is considered a general allowance for all categories of loans and interest receivable except mortgage loans, and also a specific allowance for the special collection project loans balances.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(6) Loans and Interest Receivable from Plan Members (Continued)

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

	<u>2006</u>	<u>2005</u>
Loans receivable:		
Mortgage	\$ 96,544	\$ 82,295
Personal	405,756	362,668
Cultural trips	23,762	19,750
Total loans to plan members	<u>526,062</u>	<u>464,713</u>
Accrued interest receivable	<u>16,727</u>	<u>14,771</u>
	542,789	479,484
Less: Allowance for adjustments and losses in realization	<u>(14,237)</u>	<u>(14,237)</u>
Total loans receivable, net	<u>\$ 528,552</u>	<u>\$ 465,247</u>

(7) 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 GTL 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.

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

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(7) Investment in PRTA Holdings (Continued)

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, 2006 and 2005, the System received \$40.7 and \$14.9 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.

As of June 30, 2006, 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 March 2006.

As of June 30,	<u>2006</u>	<u>2005</u>
Number of shares	6,999,975	6,999,975
Estimated prices per share	\$ <u>70.76</u>	\$ <u>69.44</u>
Total value (in thousands)	\$ <u>495,318</u>	\$ <u>486,080</u>

Generally accepted accounting principles require presentation of this investment based on its estimated value. Estimated values are characterized by greater subjectivity and imprecision than conventional historical cost information. Furthermore, amounts ultimately realized by the System from the disposal of the subject asset may vary significantly from the estimate presented.

(8) 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, must pay directly to the System. According to Act 447, each employer must pay on a monthly basis, the amounts regarding contributions and loan repayments, on or before the fifteenth day of the following month. After that date, interests are charged, as established by the Board Resolution number 91-05. As of June 30, 2006 and 2005, the receivable from employers amounted to \$43.3 million and \$34.7 million, respectively.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(9) Capital Assets

Capital assets activity for the year ended June 30, 2006 was as follows (in thousands):

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Capital assets, not being depreciated:				
Land	\$ 969	\$ -	\$ -	\$ 969
Capital assets, being depreciated:				
Building and improvements	7,631	-	-	7,631
Equipment	<u>12,677</u>	<u>186</u>	<u>83</u>	<u>12,780</u>
Total capital assets, being depreciated	<u>20,308</u>	<u>186</u>	<u>83</u>	<u>20,411</u>
Less accumulated depreciation for:				
Building and improvements	3,229	113	-	3,342
Equipment	<u>9,637</u>	<u>790</u>	<u>83</u>	<u>10,344</u>
Total accumulated depreciation	<u>12,866</u>	<u>903</u>	<u>83</u>	<u>13,686</u>
Total capital assets, being depreciated, net	<u>7,442</u>	<u>(717)</u>	<u>-</u>	<u>6,725</u>
Capital assets, net	<u>\$ 8,411</u>	<u>\$ (717)</u>	<u>\$ -</u>	<u>\$ 7,694</u>

(10) Other Assets

At June 30, 2006 and 2005, other assets consisted of the following (in thousands):

	<u>2006</u>	<u>2005</u>
Reposessed and foreclosed properties	\$ 2,893	\$ 3,065
Executed land	<u>4,699</u>	<u>4,699</u>
Total	<u>\$ 7,592</u>	<u>\$ 7,764</u>

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.

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

**Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005**

(10) Other Assets (Continued)

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 component unit of the Commonwealth of Puerto Rico, transferred to the System a piece of land located in Hato Rey, as a 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 2006 and 2005 amounted to approximately \$144,000 (based on a monthly payment of \$12,000) for each year 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 expropriated by the Commonwealth of Puerto Rico to be used as a construction site for the Coliseum of Puerto Rico, and was financed by the Infrastructure Financing Authority (IFA). In May 2002, IFA made an economic compensation to the System by \$10 million on behalf of 23,308 square meters of the land used. As a result, the System recognized a gain of \$2.5 million.

During fiscal year 2004, the Puerto Rico Highway and Transportation Authority, a component unit of the Commonwealth of Puerto Rico, compensated the System for 7,179 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, 2006, a total of 14,618 square meters of land remained under the possession of the System. According to an independent appraisal as of June 8, 2005, the estimated market value of this land approximates \$22.8 million.

(11) Securities Sold Under Agreements to Repurchase

During fiscal year 2005, securities underlying agreements to repurchase were delivered to, and are being held by, the counterparties with whom the repurchase agreements were transacted. The counterparties have agreed to resell to the System the same securities at the maturity of the agreements. The System may be required to provide additional collateral based on the fair value of the underlying securities.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(11) Securities Sold Under Agreements to Repurchase (Continued)

The following table presents the liability associated with the repurchase transactions, the amortized cost and market value of the collateral as of June 30, 2006 and 2005 respectively (in thousands):

	Fiscal Year 2006		
	Repurchase Liability	Amortized cost of collateral	Market value of collateral
U.S. Treasury securities	\$ 63,944	64,528	64,839
U.S. Government agencies securities	19,362	19,987	19,863
Collateralized mortgage obligations	7,200	7,017	6,802
Corporate bonds	<u>48,568</u>	<u>53,379</u>	<u>56,654</u>
Total	<u>\$ 139,074</u>	<u>\$ 144,911</u>	<u>\$ 148,158</u>

	Fiscal Year 2005		
	Repurchase Liability	Amortized cost of collateral	Market value of collateral
U.S. Treasury securities	\$ 64,299	64,528	64,552
U.S. Government agencies securities	19,391	19,987	20,126
Collateralized mortgage obligations	8,087	8,171	8,363
Corporate bonds	<u>46,223</u>	<u>46,712</u>	<u>52,613</u>
Total	<u>\$ 138,000</u>	<u>\$ 139,398</u>	<u>\$ 145,654</u>

The System initiated these repurchase agreements on June 29, 2005 with a maturity date of 90 days and thereafter had been renewed quarterly since its inception. The System believes that one of the options for the repurchase of securities previously sold would be obtained from a Pension Obligation Bonds issuance, which as of June 30, 2006 is still pending for approval from the Legislative Assembly for which the final outcome is undeterminable. As of June 30, 2006, the weighted average interest rate of the System's repurchase agreement was 5.07%.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(12) Line of Credit

The System entered into a credit agreement with a financial institution (Banco Santander) as of June 29, 2006 in which loans could be made from time to time in the aggregate principal amount not exceeding \$112 million at any time outstanding, at a variable rate subject to LIBOR plus the Applicable Margin (50 basis points in the case of LIBOR rate or 0 basis points in the case of Base Rate Advances). Total unpaid balance is due as of December 30, 2006 and is guaranteed by a pool of investments of the System. As of June 30, 2006 the outstanding balance of the line of credit was approximately \$60 million.

(13) 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 obtained 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.

(14) General Workers Union

On December 3, 2002 the Government Employees and Judiciary Retirement Systems signed an agreement with the General Workers Union. 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 expired on November 30, 2005, since negotiations for renewal of the agreement were not in place as of the expiration date of the original agreement, a waiver was granted by both parties up to September 29, 2006, day in which the new agreement was signed with an effective period from September 29, 2006 up to June 30, 2009.

(15) Reimbursement Claim

The System, besides receiving contributions from participants and the plan sponsor, also receives legislative appropriations from special laws to cover the increase in benefits to retirees. There have been several acts which established an increase of 3% in pension annuities every three years for those members who meet the requirements outlined by these acts (Act No. 10 of May 21, 1992, Act No. 207 of August 13, 1995, Act No. 221 of August 9, 1998, Act No. 40 of June 13, 2001, and Act No. 157 of June 27, 2003). Also there have been other laws that granted additional benefits, such as, summer and Christmas bonuses, and medical plan contributions, among others. Most of the funds needed to cover these benefits are budgeted by the Commonwealth through legislative appropriations. Nevertheless, the System believes that the costs of pension benefits from 1992 to June 30, 2004 pursuant to the above laws were not received in full by the System from legislative appropriations. The System had to cover approximately \$73.9 million from its resources that the System believes should have been received through special laws appropriations. As of June 30, 2006 the

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Notes to Basic Financial Statements
Years Ended June 30, 2006 and 2005

(15) Reimbursement Claim (Continued)

System has filed a reimbursement claim with the Office of Management and Budget of the Commonwealth to collect this amount. The final outcome of this claim cannot be presently determined, therefore no accruals has been made in the System's financial statements.

(16) Commitments and Contingent Liabilities

Loss Contingency

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.

SUPPLEMENTARY SCHEDULES OF
EMPLOYERS' CONTRIBUTIONS AND
FUNDING PROGRESS

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Schedule of Employers' Contributions
(in thousands)
June 30, 2006

<u>Year Ended June 30,</u>	<u>Annual Required Contributions</u>	<u>Contributions</u>	<u>Percentage Contributed</u>	<u>(Excess)/ Deficiency</u>
2006	\$ 564,217	N/A	N/A	N/A
2005	578,387	374,823	65%	(203,564)
2004	578,387	330,336	57%	(248,051)
2003	802,536	330,404	41%	(472,132)
2002	802,536	308,228	38%	(494,308)
2000	890,800	549,855	62%	(340,945)
1999	845,000	491,800	58%	(353,200)

Annual Required Contribution for the year ended June 30, 2001 is not available.
Information prior to June 30, 2001 is from June 30, 2001 Audited Financial Statements.

See notes to supplementary schedule of employers' contributions and funding progress.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
Schedule of Funding Progress
(in thousands)
June 30, 2006

Actuarial Valuation Date	Actuarial Value of Plan Assets	Actuarial Accrued Liability - Unit Credit (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Annual Covered Payroll
6/30/2005	\$ 2,327,871	\$ 12,283,865	\$ 9,955,994	19%	\$ 4,125,866	241%
6/30/2004	2,141,442	N/A	N/A	N/A	N/A	N/A
6/30/2003	1,947,402	11,191,357	9,243,955	17%	3,334,441	277%
6/30/2002	1,979,677	N/A	N/A	N/A	N/A	N/A
6/30/2001	2,428,664	9,881,481	7,452,817	25%	2,549,446	292%
6/30/2000	2,041,800	9,459,300	7,417,500	22%	2,463,400	301%
6/30/1999	1,858,000	8,308,000	6,450,000	22%	2,575,000	250%

Annual Required Contribution for the year ended June 30, 2001 is not available.
Information prior to June 30, 2001 is from June 30, 2001 Audited Financial Statements.

See notes to supplementary schedule of employers' contributions and funding progress.

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

**Notes to Supplementary Schedules of
Employers' Contribution and Funding Progress
June 30, 2006**

(1) 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, 2005.

(2) 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, 2005.

(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	June 30, 2005
Actuarial Cost Method	Projected unit credit cost method
Amortization Method	Level percent of pay
Remaining Amortization Period	21 years
Asset Valuation Method	Market value
Actuarial Assumptions:	
Investment rate of return*	8.50%
Projected salary increases*	5.00%
Mortality rate	Group Annuity Mortality Table for 1983
Cost of living adjustment	None

* Includes inflation at 3.50%