



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

(A Pension Trust Fund of the Commonwealth of Puerto Rico)

Basic Financial Statements as of and for the  
Year Ended June 30, 2010, Required Supplementary  
Information as of and for the year ended June 30, 2010,  
and Independent Auditors' Report

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)**

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Deloitte & Touche LLP  
Torre Chardón  
350 Chardón Avenue - Suite 700  
San Juan, PR 00918-2140  
USA

Tel: +1 787 759 7171  
Fax: +1 787 756 6340  
www.deloitte.com

## INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of the  
Employee's Retirement System of the Government of  
the Commonwealth of Puerto Rico

We have audited the accompanying statement of plan net assets of the Employee's Retirement System of the Government of the Commonwealth of Puerto Rico (the "System"), a pension trust fund of the Commonwealth of Puerto Rico, as of June 30, 2010, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the System as of June 30, 2010, 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.

The management's discussion and analysis and supplemental schedules listed in the table of contents are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the System's management. 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 such information and do not express an opinion on it.

As discussed in Note 1 to the basic financial statements, the System held investments valued at approximately \$1,164,303,000 (24 % of total assets) as of June 30, 2010, whose fair values have been estimated in the absence of readily determinable fair values. This estimate is based on information provided by the underlying fund managers.

As discussed in Note 1 to the basic financial statements, the System's unfunded actuarial accrued liability and funded ratio as of June 30, 2010, were \$17,836,770 million and 8.5% respectively. In the opinion of management, based on information prepared by consulting actuaries, the System will not be able to fully fund pensions after the fiscal year 2014, if measures are not taken to reduce the unfunded actuarial accrued liability and increase the funded ratio of the System. Management's plans concerning this matter are also described in Note 1.

*Deloitte & Touche LLP*

March 18, 2011

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**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
AS OF AND FOR THE YEAR ENDED JUNE 30, 2010**

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***Introduction***

The Employee's Retirement System of the Government of the Commonwealth of Puerto Rico (the "System") administers retirement and other plan member 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 (the "Commonwealth"). Pension trust resources are only held in trust to pay retirement benefits to plan members. The System presents in the Management's Discussion and Analysis an overview of the annual basic financial statements and provides a narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2010. The financial performance of the System is discussed and analyzed within the context of the accompanying basic financial statements and disclosures.

***Overview of the Basic Financial Statements***

The Management's Discussion and Analysis introduces the System's basic financial statements. The basic financial statements include the following: (1) Statement of Plan Net Assets, (2) Statement of Changes in Plan Net Assets, and (3) Notes to the Basic Financial Statements. The System 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 the accrual basis of accounting to prepare its basic financial statements.

The statement of plan net assets includes all of the System's assets and liabilities, with the difference reported as net assets held in trust for pension benefits. Over time, 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 the change in the System's net assets held in trust for pension benefits during the year. All current year additions and deductions are included regardless of when cash is received or paid.

***Notes to Basic Financial Statements***

The notes to the basic financial statements provide additional information that is essential for an understanding of the data provided in the statements of plan net assets and change in plan net assets.

***Required Supplementary Information***

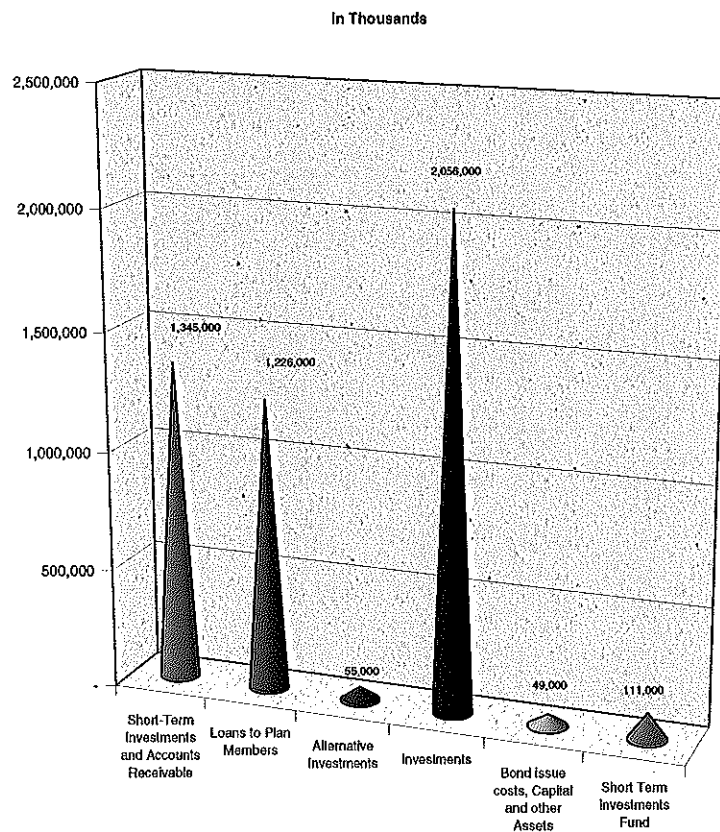
The required supplementary information consists of two schedules and related notes concerning the funded status of the pension plan administered by the System.

### *Financial Highlights*

The System provides retirement benefits to employees of the Commonwealth. The System's total assets as of June 30, 2010 and 2009, amounted to \$4,843 million and \$5,007 million, respectively.

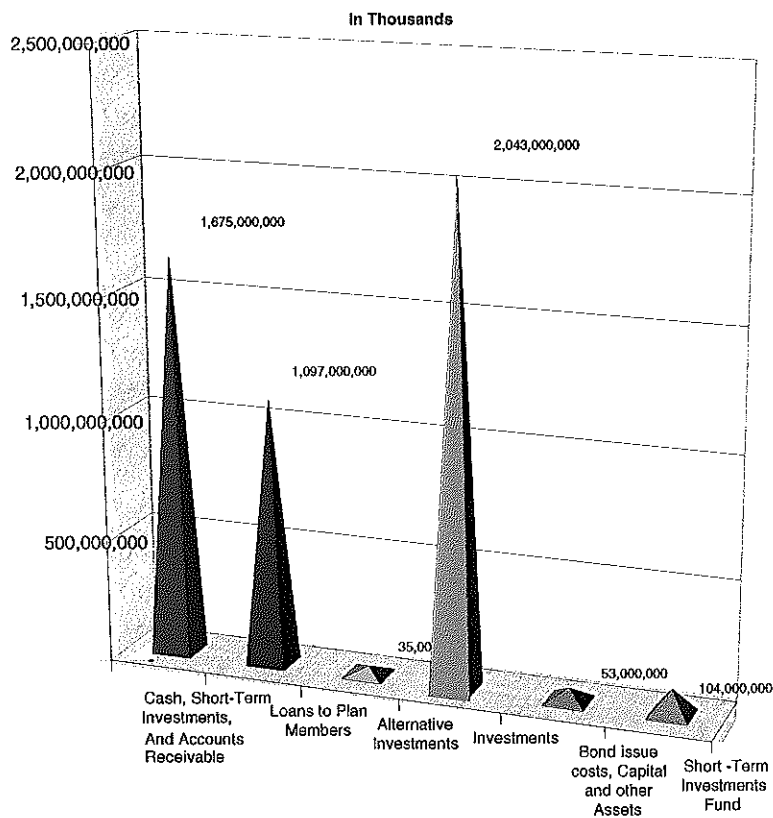
As of June 30, 2010, the System's total assets consist of the following:

- \$1,345 million in cash and short-term investments, and accounts receivable, excluding collateral for securities lending
- \$1,226 million in loans and accrued interest receivable from plan members
- \$55 million in private equity investments
- \$2,056 million of investments in bonds and stocks
- \$49 million in bond issue costs, capital and other assets
- \$111 million in a short-term investment fund



As of June 30, 2009, the System's total assets consisted of the following:

- \$1,675 million in cash and short-term investments, and accounts receivable, excluding collateral for securities lending
- \$1,097 million in loans and accrued interest receivable from plan members
- \$35 million in private equity investments
- \$2,043 million of investments in bonds and stocks
- \$53 million in bond issue costs, capital and other assets
- \$104 million in a short-term investment fund



The following schedules present comparative summary financial statements of the System's plan net assets and changes in plan net assets for fiscal years 2010 and 2009:

**Summary Comparative Statements of Plan Net Assets**

	2010	2009	Total Dollar Change	Total Percentage Change
	(in thousands)			
<b>Assets:</b>				
Cash and short-term investments, and total accounts receivable	\$ 1,456,038	\$ 1,778,965	\$ (322,927)	-18.2%
Investments	2,111,147	2,078,233	32,914	1.6%
Loans to plan members	1,226,155	1,097,444	128,711	11.7%
Capital assets and other	49,455	52,425	(2,970)	-5.7%
Total assets	<u>4,842,795</u>	<u>5,007,067</u>	<u>(164,272)</u>	<u>-3.3%</u>
<b>Liabilities:</b>				
Accounts payable and accrued liabilities	12,250	14,228	(1,978)	-13.9%
Book overdraft	22,933	37,961	(15,028)	-39.6%
Payables for securities lending	110,931	103,527	7,404	7.2%
Bond interest payable	13,876	13,876	—	0.0%
Insurance reserve for loans to plan members and investment settlements	14,241	20,298	(6,057)	-29.8%
Bonds payable	2,981,775	2,961,359	20,416	0.7%
Other liabilities	21,798	13,675	8,123	59.4%
Total liabilities	<u>3,177,804</u>	<u>3,164,924</u>	<u>12,880</u>	<u>0.4%</u>
Total net assets held in trust for pension benefits	<u>\$ 1,664,991</u>	<u>\$ 1,842,143</u>	<u>\$ (177,152)</u>	<u>-9.6%</u>

*Summary Comparative Statements of Changes in Plan Net Assets*

	2010	2009	Total Dollar Change	Total Percentage Change
	(in thousands)			
<b>Additions:</b>				
<b>Contributions:</b>				
Employers	\$ 381,243	\$ 400,405	\$ (19,162)	-4.8%
Participating employees	345,265	362,040	(16,775)	-4.6%
Special laws	188,843	192,254	(3,411)	-1.8%
Early retirement	3,399	47,146	(43,747)	-92.8%
Investment income (loss)	398,610	(351,633)	750,243	213.4%
Other	31,783	35,878	(4,095)	-11.4%
Total additions	<u>1,349,143</u>	<u>686,090</u>	<u>663,053</u>	<u>96.6%</u>
<b>Deductions:</b>				
Retirement and other benefits	1,249,776	1,174,629	75,147	6.4%
Refunds of contributions	45,146	34,530	10,616	30.7%
Interest on bonds payable	188,055	186,869	1,186	0.6%
General and administrative	33,063	32,590	473	1.5%
Other	10,255	22,415	(12,160)	-54.2%
Total deductions	<u>1,526,295</u>	<u>1,451,033</u>	<u>75,262</u>	<u>5.2%</u>
Decrease in plan net assets	<u>\$ (177,152)</u>	<u>\$ (764,943)</u>	<u>\$ 587,791</u>	<u>76.8%</u>

- The System total assets exceeded total liabilities by \$1,665 million (plan net assets) for the current fiscal year compared to the prior year, for which assets exceeded liabilities by \$1,842 million.
- Based on the last actuarial valuation as of June 30, 2010, the System's funding ratio of the actuarial accrued liability is 8.5%.
- Loans to plan members amounted to \$1,226 million as of June 30, 2010, compared to \$1,097 million as of June 30, 2009.

The basic financial statements of the System for the fiscal year ended June 30, 2010, presents a reduction in plan net assets of \$177 million when compared to the prior fiscal year. This was mostly the result of an increase on investments of \$33 million and an increase in loans and interest receivable from plan members of \$129 million and an offset by a decrease in cash and account receivable of \$323 million. This also includes a \$23 million cash overdraft owed to the Department of Treasury.

During fiscal year 2010, the plan member and employer contributions, including early retirement contributions, decreased by approximately \$80 million, from \$810 million during fiscal 2009 to \$730 million during fiscal year 2010. The System recognized a net appreciation in the fair value of investments of \$216 million during 2010, which represents an increase in fair value of investments of \$775 million from the net depreciation of \$559 million recognized in 2009.



### *Issuance of Bonds Payable*

During fiscal year 2007, the Board of Trustees approved the issuance of bonds payable to increase the funds currently available to pay pension benefits to certain beneficiaries and to reduce the unfunded accrued actuarial pension liability. As of June 30, 2010, bonds payable amounted to \$2,982 million.

### *Financial Analysis of the System*

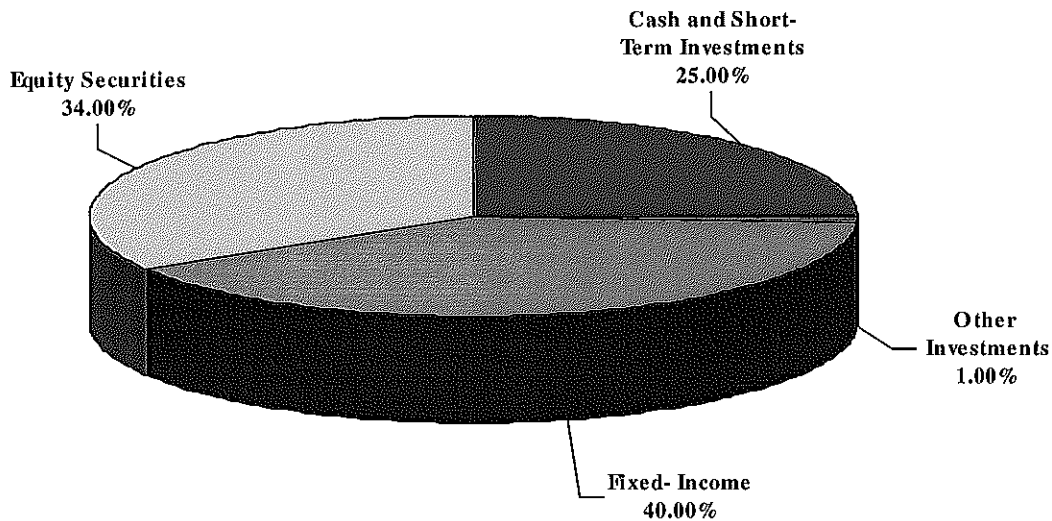
Since December 2009, the System, with the assistance of an external investment consultant, has performed various assets and liabilities studies. The purpose of these studies is to properly align the current and future liabilities of the System with its net assets.

In the development of these studies, the external consultant considered the current investment program status; actual liquidity needs; future contributions streams; possible changes in demographics, contribution flows, and general assumptions used by the System. Nevertheless, the results of these studies are long term in nature.

As of June 30, 2010, the approved asset allocation for the System is:

Asset Type	Target Allocation	Rebalancing Range
Domestic Equity	35%	30%-40%
International Equity	25%	20%-30%
Private Equity	1%	0% - 3%
Domestic Fixed-Income (including loans & mortgages)	30%	15%-35%
Inv. Commodities	5%	0%-10%
Inv. Global TAA	5%	0%-10%
Cash and Equivalents	0%	0%-5%

The new asset allocation of the System's investment portfolio fulfills the System's needs, and since it is more adequately balanced, it provides protection in case of a market downturn. As of June 30, 2010, the asset allocation of the System's investment portfolio is 40 % in fixed-income investments, including loans receivable, 34% in equity securities, 25% in cash and short-term investments, and 1% in other investments as shown in the following chart:



#### *Other Investments and Transactions*

As of June 30, 2010 and 2009, the System held approximately \$1,226 million and \$1,097 million, respectively, in loans and interest receivable from plan members, which represents 37 % and 35%, respectively of the total investment portfolio. As of June 30, 2010, loans and interest receivable from plan members consist of \$141 million in mortgage loans, \$1,005 million in personal loans, \$62 million in cultural trips loans, and \$27 million in accrued interest receivable, less \$9 million in allowance for adjustment and losses in realization. As of June 30, 2009, loans and interest receivable from plan members consist of \$128 million in mortgage loans, \$911 million in personal loans, \$49 million in cultural trips loans, and \$20 million in accrued interest receivable, less \$10.5 million in allowance for adjustment and losses in realization. As of June 30, 2010 and 2009, the fair value of the System's investment in limited partnerships amounted to \$55 and \$35 million, respectively, which represents approximately 2% and 1% of the investment portfolio, as of June 30, 2010 and 2009.

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 use the borrowed securities to cover short sales and failed trades. The cash collateral received from the brokers is invested in a short-term investment fund in order to earn interest. For financial statements purposes, the amount of securities that was involved in securities lending transactions as of June 30, 2010, has been presented, along with the required disclosures, in accordance with current government accounting pronouncements. For the years ended June 30, 2010 and 2009, net income from the securities lending activity amounted to approximately \$716,000 and \$247,000, respectively.

### *Funding Status*

The System was created by Act 447 of May 15, 1951, and since its inception it lacked proper planning and the levels of contributions were relatively low (and still remains low in comparison to the level of benefits). In addition, all retirement systems in place before 1951 were merged into the System, which then had to absorb all of their unfunded liabilities. Afterwards, in 1973, the benefits structure was enhanced, however, without the appropriate increase in 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 withstand the increase in the unfunded liability, the benefit structure was modified to decrease the benefits and to postpone the retirement age from 55 to 65, in order to provide a more affordable benefit structure. Also, the level of contributions was raised and Act No. 447 was amended to provide that any increase in benefits will require actuarial studies and must state the financing source.

Ten years later, the continuing increase in the unfunded liability required further action. As a result, the original defined benefit structure was closed to new plan members joining the System on or after January 1, 2000. To provide a retirement alternative, the System benefit structure was further amended to provide for a cash balance program, similar to a cash balance plan, to be funded only by employees' contributions. The new program is known as the Retirement Savings Account Program ("System 2000"). Under System 2000, the employers' contributions continue at the same level as the original defined benefit structure, but are being used to fund the accrued actuarial liability of the original defined benefit structure that was closed. Also under System 2000, the disability benefits are to be provided through a private insurance long term disability program to those plan members that voluntarily elect to enroll in such program. On September 15, 2004, Act No. 296 was enacted to amend the dispositions of Act No. 305 regarding disbursements and the disability benefits program. After the amendment, any plan member 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. Act No. 296 also provides flexibility on the establishment of the disability program; but still, the employees must finance the program.

Presently, the System consists of three different benefit structures, which are administrated according to their specifications in the Act. For all plan members, excluding System 2000 program participants, the level of contributions established by law is 8.275% of the employee salary. Under System 2000, employee's contributions range from 8.275% to 10% of the salary, as specified by the employee. Under all structures, employers' contributions are 9.275% of the employee salary.

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 had a negative effect over the System's actuarial unfunded liability. Based on the last actuarial valuation at June 30, 2010, the System's funded ratio is 8.5%, the actuarial obligation is \$19,502 million, total actuarial value of plan assets amounted to \$1,665 million, and the unfunded actuarial accrued liability amounted to \$17,837 million.

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 liabilities must be reduced. Management has come up with recommendations to improve the System's financial health. Among those, the increase in employees' and employers' contribution rates stands out.

On February 27, 2007, the System's administration and the Government Development Bank for Puerto Rico, acting as the System's fiscal agent, presented to the Board of Trustees, a financial transaction for the issuance of pension funding bonds in order to reduce the System's unfunded actuarial accrued liability. The System authorized the issuance of one or more series of bonds (the "Bonds") in order to increase the funds currently available to pay pension benefits to certain beneficiaries and to reduce the unfunded accrued actuarial pension liability. The System pledged future employer contributions to the payment of the Bonds, invested the proceeds of the Bonds and used these investments and the earnings thereon to provide such pension benefits to beneficiaries. On January 31, 2008, the System issued the first series of the Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A. On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B. Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C.

#### ***Increase in Benefits for Retirees Established for 2009, 2008, and 2007***

For the years 2010, 2009, 2008, and 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:

- Increase in the minimum monthly pension benefit from \$300 to \$400, effective July 1, 2007.
- Increases of 3% in all pensions effective on July 1, 2007, but computed retroactively to January 1, 2007.
- Increase from \$500 to \$550 and to \$600 in the Christmas Bonus for the retiree, effective in December 2006 and 2007, respectively.
- Increases of 3% in all pensions lower than \$1,250 effective on July 1, 2008. This increase could not exceed the amount limit of \$1,250.

Following the requirements established by Act 1 of February 16, 1990, these benefits are financed through legislative appropriations from the Commonwealth with respect to Central Government retirees and financed by the municipalities and public corporations with respect to their corresponding retirees. There were no additional benefits granted for fiscal years 2010 and 2009.

#### ***Capital Assets***

The System's investment in capital assets as of June 30, 2010 and 2009, amounted to approximately \$9 million and \$9.2 million, respectively, net of accumulated depreciation. Capital assets include land, building and improvements, construction in progress, and equipment. The building and improvements consists of the facilities in which the System has its operations.

#### ***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.

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**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)

**STATEMENT OF PLAN NET ASSETS  
AS OF JUNE 30, 2010  
(In thousands)**

ASSETS:

Cash and short-term investments:	
Deposits at commercial banks	\$ 54,175
Deposits with Government Development Bank for Puerto Rico:	
Unrestricted	51,446
Restricted	741,082
Deposits with Bank of New York	172,226
Collateral for securities lending	110,931
Total cash and short-term investments	<u>1,129,860</u>
Investments:	
Bonds and notes	563,454
Stocks	1,492,386
Private equity investments	55,307
Total investments	<u>2,111,147</u>
Total cash and investments	<u>3,241,007</u>
Loans and interest receivable from plan members — net of allowance for adjustments and losses in realization	<u>1,226,155</u>
Accounts receivable:	
Employers — net	273,139
Commonwealth of Puerto Rico	11,222
Due from the Commonwealth of Puerto Rico Judiciary Retirement System	19,138
Investments sold	12,189
Accrued investment income	6,597
Other	3,893
Total accounts receivable	<u>326,178</u>
Capital assets — net	<u>8,964</u>
Bond issue costs	<u>33,267</u>
Other assets	<u>7,224</u>
Total assets	<u>4,842,795</u>

(Continued)

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
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**STATEMENT OF PLAN NET ASSETS  
AS OF JUNE 30, 2010  
(In thousands)**

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**LIABILITIES:**

Accounts payable and accrued liabilities, including book overdraft of \$22,933	\$ 35,183
Payables for securities lending	110,931
Investments purchased	5,277
Bond interest payable	13,876
Funds of mortgage loans and guarantee insurance reserve for loans to plan members	8,964
Bonds payable	2,981,775
Other liabilities	<u>21,798</u>
 Total liabilities	 <u>3,177,804</u>

**CONTINGENCIES (Note 12)**

<b>NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedule of Funding Progress is presented on page 42)</b>	<b><u>\$1,664,991</u></b>
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See notes to financial statements.

(Concluded)

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)

**STATEMENT OF CHANGES IN PLAN NET ASSETS  
FOR THE YEAR ENDED JUNE 30, 2010**  
(In thousands)

<b>ADDITIONS:</b>	
Contributions:	
Employers	\$ 381,243
Participating employees	345,265
Early retirement	3,399
Special laws	<u>188,843</u>
Total contributions	<u>918,750</u>
Investment income:	
Net appreciation of investments	216,011
Dividend income	10,663
Interest income	<u>179,585</u>
Total investment income	406,259
Less investment expense	<u>7,649</u>
Net investment income	<u>398,610</u>
Other income	<u>31,783</u>
Total additions	<u>1,349,143</u>
<b>DEDUCTIONS:</b>	
Annuities	1,047,965
Benefits under special laws	188,843
Death benefits	12,968
Refunds of contributions:	
Employers	1,469
Participating employees	43,677
Interest on bonds payable	188,055
General and administrative	33,063
Other expenses	<u>10,255</u>
Total deductions	<u>1,526,295</u>
NET DECREASE IN NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	(177,152)
<b>NET ASSETS HELD IN TRUST FOR PENSION BENEFITS:</b>	
Beginning of year	<u>1,842,143</u>
End of year	<u>\$ 1,664,991</u>

See notes to financial statements.

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
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**NOTES TO BASIC FINANCIAL STATEMENTS  
AS OF AND FOR THE YEAR ENDED JUNE 30, 2010**

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**1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The Employee's Retirement System of the Government of the Commonwealth of Puerto Rico (the "System") is a defined benefit pension plan administered by the Puerto Rico Government Employees and Judiciary Retirement Systems Administration and 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 a pension trust fund of the Commonwealth of Puerto Rico (the "Commonwealth"). 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 on the 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 for Puerto Rico, the Executive Director of the Commonwealth's Human Resources Office, and the Municipal Affairs Commissioner.

As of June 30, 2010, the System has an unfunded actuarial accrued liability of approximately \$17,837 million, representing an 8.5% funding ratio, using net assets. In the opinion of management and based on information prepared by external consulting actuaries, if measures are not taken now to deal with this situation, the System will not be able to fully fund pensions beginning in fiscal year 2019; however, net assets held in trust for pension benefits will be exhausted during fiscal year 2014. This situation could have a direct negative effect on the Commonwealth's general fund, since most of the employers under the System are government agencies obligated to make actuarial contributions to fund the System.

To attend to these issues, the Governor of the Commonwealth (the "Governor"), by Executive Order OE-2010-10 dated March 12, 2010, created the Special Commission on the Retirement Systems Reform (the "Commission") to provide individual and/or group recommendations on actions that the executive and legislative branches can execute to provide immediate alternatives to ease the current crisis and long term solutions to improve the financial condition of the System.

On October 21, 2010, the Commission presented a report to the Governor that included specific recommendations addressing the current fiscal crisis and cash flow problems of the System. Among these recommendations, the Commission proposed increasing the contribution percentages, restructuring benefits and establishing certain limitations on loans, among other.

After reviewing the Commission's report, the System and the Commonwealth, with the assistance of the System's external consulting actuaries, concluded that annual increases in the employers' contribution rate would be required to fully fund pensions, without having to liquidate the System's investment portfolio. It is the intention of the Commonwealth to include such increase in contributions as part of its fiscal year 2012 budget and in the annual budgets thereafter. The Commonwealth is committed to finding a long-term solution to the funding situation of the System.

The successful implementation of these measures cannot be assured, as it is dependent upon future events and circumstances whose outcome cannot be anticipated.



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

*Basis of Presentation* — The accompanying basic financial statements have been prepared on the accrual basis of accounting in accordance with the provisions of Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, as amended by GASB Statement No. 50, *Pension Disclosures — an amendment of GASB Statements No. 25 and No. 27*. Participating employees and employer's contributions are recognized as additions in the period in which the employee services are rendered. Annuities, benefits, and refunds are recognized as deductions 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 (GAAP) requires management to make estimates and assumptions that affect the reported amounts of net assets held in trust for pension benefits and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of additions and deductions to net assets held in trust for pension benefits during the reporting period. Actual results could differ from those estimates.

*Cash and Short-Term Investments* — Cash and short-term investments consist of overnight deposits with the custodian bank, securities lending collateral, money market funds, and certificates of deposits in Government Development Bank for Puerto Rico (GDB) (a component unit of the Commonwealth) and commercial banks. Restricted cash deposited with GDB consists of payments received from mortgage loan holders administered by the mortgage servicers in the servicing of loans (escrow accounts), expired checks not claimed by the plan members, restricted for repayments, and proceeds from the issuance of the Series A and B Bonds restricted for investment purchases.

*Investments* — Investments are carried at fair value. The fair value of investments is based on quoted prices, if available. The System has investments valued at approximately \$1,164,303,000 or 24 % of total assets as of June 30, 2010, whose fair values have been estimated in the absence of readily determinable fair values. This estimate is based on information provided by the underlying fund managers. Such investments include private equity investments and non-exchange traded mutual funds.

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

*Loans to Plan Members* — Mortgage, personal, and cultural trip loans to plan members are stated at their outstanding principal balance. Maximum amounts that may be granted to plan members for mortgage, personal, and cultural trip loans are \$100,000, \$15,000, and \$10,000, respectively.

The System services mortgage loans with aggregate principal balances of approximately \$7.3 million at June 30, 2010, related to certain mortgage loans sold to the Federal National Mortgage Association (FNMA) for a fee of .25 %. The income for 2010 amounted to \$12,181 and is recognized as interest income in the accompanying statement of changes in plan net assets.

During 2010, the System repurchased approximately \$216,821 in mortgage loans that were sold during fiscal year 1998 to 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.

*Capital Assets* — Capital assets include building, building improvements, and furniture and equipment. 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 equal to or in excess of four years. Capital assets are recorded at historical cost or their estimated historical cost if actual historical costs are 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 construction in progress. The estimated useful lives of capital assets are as follows:

	Years
Building	50
Buildings improvements	10
Equipment, furniture, fixtures, and vehicles	5–10

The System evaluates capital assets under the provisions of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which establishes that, generally, an asset is considered impaired when its service utility has declined significantly and unexpectedly, and the event or change in circumstances is outside the normal life cycle of the asset. Management is then required to determine whether the impairment of an asset has occurred. Impaired capital assets that will no longer be used by the System are reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the System should be measured using the method that best reflects the diminished service utility of the capital asset. The impairment of capital assets with physical damage generally should be measured using a restoration cost approach, an approach that use the estimated cost to restore the capital asset to identify the portion of the historical cost of the capital asset that should be written off. During the year ended June 30, 2010, management assessed and determined that no impairment adjustment was deemed necessary.

*Recent Accounting Pronouncements* —In June 2007, the GASB issued GASB Statement No. 51, *Intangible Assets*, which was effective for periods beginning after June 15, 2009. GASB Statement No. 51 establishes guidance on the recognition, accounting, and financial reporting for intangible assets. The adoption of this statement did not have a material effect on the System’s financial statements.

In June 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which was effective for periods beginning after June 15, 2009. This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. The adoption of this statement did not have a material effect on the System’s financial statements.

In March 2009, the GASB issued GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which was effective upon issuance. GASB Statement No. 55 codifies all generally accepted accounting principles for state and local governments so that they derive from a single source. The adoption of this statement did not have a material effect on the System’s financial statements.

In March 2009, the GASB issued GASB Statement No. 56, *Codification of Accounting and Financial Reporting Contained in the AICPA Statements on Auditing Standards*, which was effective on issuance. The objective of GASB Statement No. 56 is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' (AICPA) Statements on Auditing Standards. GASB Statement No. 56 addresses three issues not included in the authoritative literature that establishes accounting principles—related party transactions, going concern considerations, and subsequent events. The adoption of this statement did not have a material effect on the System's financial statements.

In December 2009, the GASB issued GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*. This statement establishes accounting and financial reporting standards for all governments that have petitioned for relief under Chapter 9 of the U.S. Bankruptcy Code or have been granted relief under the provisions of Chapter 9, including governments that enter into bankruptcy and are not expected to emerge as a going concern. The adoption of this statement did not have a material effect on the System's financial statements.

The GASB has issued the following accounting pronouncements that have effective dates after June 30, 2010:

- a. GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which is effective for financial statements for periods beginning after June 15, 2010.
- b. GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which is effective for financial statements for periods beginning after June 15, 2011.
- c. GASB Statement No. 59, *Financial Instruments Omnibus*, which is effective for financial statements for periods beginning after June 15, 2010.
- d. GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which is effective for financial statements for periods beginning after December 15, 2011.
- e. GASB Statement No. 61, *The Financial Reporting Entity: Omnibus — an amendment of GASB Statements No. 14 and No. 34*, which is effective for financial statements for periods beginning after June 15, 2012.
- f. GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is effective for financial statements for periods beginning after December 15, 2011.

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

## **2. PLAN DESCRIPTION**

The System consists of different benefit structures pursuant to Act No. 447 of 1951, as amended, including a cost-sharing multi-employer contributory defined benefit program and a cash balance program, similar to a cash balance plan. The System is sponsored by the Commonwealth, public corporations, and municipalities of Puerto Rico. Substantially all full-time employees of the Commonwealth and its instrumentalities (Commonwealth Agencies, Municipalities, and Public Corporations, including the System) are covered by the System. 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 Commonwealth officers appointed by the Governor and Head of Agencies.

At June 30, 2010, membership of the System consists of the following:

Retirees and beneficiaries currently receiving benefits	106,538
Current participating employees — defined benefit	85,363
Cash Balance System 2000 participating employees	<u>55,279</u>
Total membership	<u>247,180</u>

Plan members, 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 Firefighters**

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 \$400 per month and a maximum of 75% of the average compensation.

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

*Deferred Retirement Annuity* — A participating employee who ceases to be an employee of the Commonwealth after having accumulated a minimum of 10 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

*Noncoordinated Plan* — On the noncoordinated 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.

*Nonoccupational Disability Annuity* — A participating employee totally and permanently disabled for causes not related to his/her occupation, and with no less than 10 years of credited service, is eligible for an annuity of 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.

##### *Nonoccupational:*

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

Postretirement — 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.

**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 2007 there have been other acts addressing the cost of living allowance (C.O.L.A.), such as Act No. 207 of August 13, 1995; Act No. 221 of August 9, 1998; Act No. 40 of June 13, 2001; Act No. 157 of June 27, 2003; and Act No. 35 of April 24, 2007.

On April 24, 2007, the Governor signed the Act No. 35 to provide for an increase of 3% of the pension paid by the System to those plan members whose monthly pension is less than \$1,250, effective on July 1, 2008.

To protect the financial health of the System, the increases granted pursuant to the above laws are being financed through annual appropriations from the Commonwealth and contributions from municipalities and public corporations.

**Other Benefits Granted** — For fiscal years 2003 to 2007, the Commonwealth granted additional benefits to the System's retirees. As of June 30, 2010, these increases are being funded through special appropriations from the Commonwealth for the amount corresponding to the Commonwealth agencies and by contributions from the public corporations and municipalities.

**Early Retirement Programs** — During fiscal year 2001, the Commonwealth granted three additional retirement programs through Act No. 370 of December 31, 1999, Act No. 119 of July 13, 2000, and Act No. 174 of August 12, 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 Commonwealth, respectively. These early retirement programs ended in fiscal year 2006, at which time, these employees became fully beneficiaries of the System. In order to avoid any economic impact on the System, the employers were responsible for contributing to the System the amounts to cover the benefit payments and the employer and employee contributions with respect to the plan members covered until the attainment of the normal retirement age.

During fiscal year 2006, the Puerto Rico Industrial and Development Company (PRIDCO) implemented an early retirement program for its employees under Act No. 143, dated November 22, 2005. PRIDCO will 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 plan members covered until the attainment of the normal retirement age.

During fiscal year 2008, the Commonwealth issued Act No. 70, dated July 13, 2007, to implement an early retirement program for the employees of the Puerto Rico National Parks Company. The Municipality of San Juan issued the Resolution No. 41, dated May 5, 2008, which provided an early retirement program for the municipality's employees. Also, GDB implemented an early retirement program for its employees under the Act No. 188 of December 12, 2007. The Puerto Rico National Parks Company has already made two payments and would reimburse the remaining balance on annuities and other benefits paid by the System in three installments on each July 31 starting on 2009 through 2011. The Municipality of San Juan will 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 plan members covered until they reach the normal retirement age.

The Land Authority of Puerto Rico (the "Land Authority") implemented an early retirement program for its employees under Law No. 59 of January 31, 2008. The Land Authority has already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting on 2009 through 2012.

The Right to Employment Administration (the "Administration") implemented an early retirement program for its employees under Law No. 275 of December 31, 2008. The Administration already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting on 2009 through 2012.

The Puerto Rico Environmental Quality Board (EQB) implemented an early retirement program for its employees under the Law 224 Act No. 7 dated August 9, 2008. The EQB already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting on 2009 through 2012.

The Puerto Rico Department of Labor and Human Resources (the "Department of Labor") implemented an early retirement program for its employees under the Law 136 dated July 29, 2008. The Department of Labor already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting on 2009 through 2012.

*Amendment to Act No. 447 Effective January 1, 2000, to Create System 2000* — On September 24, 1999, Law 305, an amendment to Act No. 447 of May 15, 1951, which created the System, was enacted to provide for a new benefit structure, similar to a cash balance plan, known as System 2000, to cover employees joining the System on or after January 1, 2000.

Employees participating in the System as of December 31, 1999, were allowed to elect either to stay in the defined benefit structure 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. Under System 2000, contributions received from participants are pooled and invested by the System, together with the assets corresponding to the defined benefit structure. There are no separate accounts for System 2000 participants. Future benefit payments under the original defined benefit structure and System 2000 will be paid from the same pool of assets. As a different benefit structure, System 2000 is not a separate plan, and as such, is not presented separately from the original defined benefit structure, pursuant to the provisions of GASB Statement No. 25. The Commonwealth does not guarantee benefits at retirement age.

The annuity benefits to participants is 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. Plan members 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 plan members 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 reduced the retirement age from 65 years to 60 for those employees who joined the current plan on or after January 1, 2000.

At June 30, 2010, System 2000's membership consisted of 55,279 current participating employees.

### **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 benefit structure and 8.275% of the total monthly salary for participating employee's contributions for the noncoordinated benefit structure. If necessary, additional non payroll related contributions from the Commonwealth should ultimately cover any deficiency between the participating employers' and employee's contributions and the System's pension benefit obligations and general and administrative deductions.

The System, besides the contributions received from plan members 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, and various increases in cost of living allowances (3%), among others.

Most of the funds used to cover these benefits are budgeted by the Commonwealth through legislative appropriations.

**Actuarial Information** — Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2010, using the projected unit credit cost method, with straight proration based on service to decrement. The significant assumptions underlying the actuarial computations include: (a) assumed rate of return on investments of 7.5%, (b) assumed compound rate of wage increases of 3% per year, (c) assumed inflation rate of 2.5%, (d) assumed cost of living adjustment of 0.99% annual COLA to approximate 3% triennial increases, and (e) assumed mortality as follows:

- Preretirement Mortality — For general employees and mayors, RP-2000 employee mortality rates, with white collar adjustments for males and females, projected on a generational basis using Scale AA. For members covered under Act No. 127, RP-2000 employee mortality rates, with blue collar adjustments for males and females, projected on a generational basis using Scale AA.
- Postretirement Healthy Mortality — Gender-specific mortality rates were developed based on a study of the plan's experience from 2003-2007.
- Postretirement Disabled Mortality — RP-2000 disabled annuitant mortality rates, without projection.

As of June 30, 2010, the actuarial accrued liability and the unfunded actuarial accrued liability were approximately \$19,502 million and \$17,837 million, respectively.

The Legislature of the Commonwealth enacted Act No. 1 of February 16, 1990, to improve the solvency of the System for the next 50 years. Among other provisions, the legislation 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 original defined benefit structure was no longer available to new employees and System 2000 was created (as described in Note 2) for all plan members who started working for the Commonwealth effective January 1, 2000, or after.

#### 4. FUNDED STATUS AND FUNDING PROGRESS

The System's funded status as of June 30, 2010, the most recent actuarial valuation date, is as follows (in thousands):

Actuarial Valuation Date	Actuarial Value of Plan Assets	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Annual Covered Payroll
June 30, 2010	<u>\$ 1,664,991</u>	<u>\$ 19,501,761</u>	<u>\$ 17,836,770</u>	<u>8.5 %</u>	<u>\$ 3,818,332</u>	<u>467.1 %</u>

The schedule of funding progress (see page 42), presented as required supplementary information (RSI) following the notes to the financial statements, presents multilayer trend information about whether the actuarial value of plan assets are increasing or decreasing over time relative to the AAL for benefits.



Additional information as of the date of the latest actuarial valuation is as follows:

Valuation date	June 30, 2010
Actuarial cost method	Projected unit credit cost method, with straight proration based on service to decrement
Amortization method	30 years closed, level dollar
Remaining amortization period	27 years
Asset valuation method	Market value of assets
Actuarial assumptions:	
Investment rate of return	7.5%
Projected salary increases	3.0% (no increase in 2010-11)
Projected payroll growth	2.5%
Inflation	2.5%
Mortality rate	Preretirement Mortality — For general employees and mayors, RP-2000 employee mortality rates, with white collar adjustments for males and females, projected on a generational basis using Scale AA. For members covered under Act No. 127, RP-2000 employee mortality rates, with blue collar adjustments for males and females, projected on a generational basis using Scale AA. Postretirement Healthy Mortality — Gender-specific mortality rates were developed based on a study of the plan's experience from 2003-2007. Postretirement Disabled Mortality — RP-2000 disabled annuitant mortality rates, without projection.
Cost of living adjustment	0.99% annual COLA to approximate 3% triennial increases.

## 5. CASH AND INVESTMENTS

**Custodial Credit Risk Related to Deposits** — Custodial credit risk is the risk that, in an event of a bank failure, the System's deposits might not be recovered. The Commonwealth requires that public funds deposited in Puerto Rico commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. Deposits with GDB, Bank of New York, and with other non Puerto Rico commercial banks are uninsured and uncollateralized, as these entities are exempt from compliance with the collateralization requirement.

As of June 30, 2010, depository bank balances of approximately \$1,159 million were uninsured and uncollateralized as follows (in thousands):

	Carrying Amount	Depository Bank Balance	Amount Uninsured and Uncollateralized
Deposits at commercial banks	\$ 54,175	\$ 54,175	\$ 54,175
Deposits with GDB	792,528	821,984	821,984
Deposits with Bank of New York	172,226	172,226	172,226
Collateral for securities lending	<u>110,931</u>	<u>110,931</u>	<u>110,931</u>
 Total	 <u>\$1,129,860</u>	 <u>\$1,159,316</u>	 <u>\$1,159,316</u>

**Investments** — The fair value of investments in marketable securities held by the System as of June 30, 2010, is as follows (in thousands):

<b>Bonds:</b>		
U.S. government and sponsored agencies' securities		\$ 259,277
Municipal bonds		48,021
U.S. corporate bonds		<u>256,156</u>
Total bonds		<u>563,454</u>
<b>Stocks:</b>		
U.S. corporate stocks		383,390
<b>Non-exchange traded mutual funds:</b>		
U.S.		659,850
Non-U.S.		<u>449,146</u>
Total stocks		<u>1,492,386</u>
Private equity investments		<u>55,307</u>
Total investments		<u>\$2,111,147</u>

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, 2010:

**Custodial Credit Risk Related to 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, 2010, 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 and Bank of New York, except for securities lent.

**Credit Risk** — All fixed-income securities at the time of purchase must be of investment grade quality. All issuances 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 Investor Service credit ratings.

The System's U.S. government and sponsored agencies' securities portfolio includes approximately \$60,405,000 of U.S. Treasury notes and approximately \$35,658,000 of mortgage-backed securities guaranteed by Government National Mortgage Association (GNMA), which carry the explicit guarantee of the U.S. government. The Moody's ratings of bonds as of June 30, 2010, excluding U.S. Treasury notes and mortgage-backed securities guaranteed by GNMA are as follows (in thousands):

Moody's Rating	Investment Type	Fair Value
Aaa	U.S. government and sponsored agencies' securities	\$ 163,214
Aaa	U.S. corporate bonds	42,951
Aa2	U.S. corporate bonds	21,618
Aa3	U.S. corporate bonds	5,696
A1	U.S. corporate bonds	32,221
A2	U.S. corporate bonds	51,384
A3	U.S. corporate bonds	22,357
Baa1	U.S. corporate bonds	29,838
Baa2	U.S. corporate bonds	29,666
Baa3	U.S. corporate bonds	13,636
Ba3	U.S. corporate bonds	686
B3	U.S. corporate bonds	627
NR	U.S. corporate bonds	5,353
WR	U.S. corporate bonds	123
A1	Municipal bonds	15,119
A2	Municipal bonds	1,617
A3	Municipal bonds	3,082
Aa1	Municipal bonds	9,800
Aa2	Municipal bonds	9,339
Aa3	Municipal bonds	208
Aaa	Municipal bonds	6,734
Baa1	Municipal bonds	2,122
Total bond and notes		<u>\$ 467,391</u>

**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. As of June 30, 2010, the System owned shares in the State Street Global Advisors' S&P 500 Flagship Securities Lending Fund (the "S&P 500 Fund"), the Russell 3000 Index Non Lending Fund (the "Russell 3000 Fund"), the Morgan Stanley Investment Management Active International Allocation Trust (the "Morgan Stanley Fund"), and the Invesco International Equity Trust Fund (the "Invesco Fund"), as follow:

Fund Name	Shares	Fair Value (In Thousands)
S&P 500 Fund	1,376,640	\$ 290,921
Russell 3000 Fund	38,509,231	368,930
Morgan Stanley Fund	29,376,466	392,293
Invesco Fund	2,030,457	<u>56,852</u>
Total		<u>\$ 1,108,996</u>

The investment objectives of the S&P 500 Fund and the Russell 3000 Fund are to match the return of the Standard & Poor's 500 Index and the Russell 3000 Index, respectively. The objective of the Morgan Stanley Fund is to achieve capital appreciation through exposure to non U.S. markets. The objective of the Invesco Fund is to achieve capital appreciation by investing primarily in the securities of foreign companies.

As of June 30, 2010, the investments underlying the S&P 500 Fund, the Russell 3000 Fund, the Morgan Stanley Fund, and the Invesco Fund had the following sector allocations:

Sector	Morgan Stanley Fund			
	S&P 500 Fund	Russell 3000 Fund	Morgan Stanley Fund	Invesco Fund
Information technology	18.70%	18.34%	6.94%	7.80%
Health care	12.13%	12.28%	8.23%	7.70%
Financials	16.29%	17.03%	19.56%	18.40%
Energy	10.57%	9.93%	8.80%	17.90%
Consumer staples	11.57%	9.77%	10.05%	4.50%
Industrials	10.40%	11.27%	13.36%	12.80%
Consumer discretionary	10.17%	10.96%	12.27%	9.50%
Utilities	3.74%	3.79%	4.37%	-
Telecommunication services	3.01%	2.78%	4.41%	6.80%
Materials	3.42%	3.85%	12.01%	5.70%
Other funds	-	-	-	8.90%

**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 requirements 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 a diversified portfolio of marketable, investment grade core fixed-income securities.

The contractual maturities of investments in debt securities as of June 30, 2010, are as follow (in thousands):

Maturity Between	Fair Value	Investment Maturities (In Years)			
		Less Than 1	Between 1-5	Between 5-10	More Than 10
U.S. government and sponsored agencies' securities (2010-2051)	\$274,307	\$ 12,278	\$ 80,053	\$ 53,598	\$128,378
Corporate bonds (2010-2044)	241,126	4,070	93,705	81,842	61,509
Municipal bonds (2012-2033)	48,021		5,424	8,945	33,652
<b>Total bonds</b>	<b>\$563,454</b>	<b>\$ 16,348</b>	<b>\$179,182</b>	<b>\$144,385</b>	<b>\$223,539</b>

As of June 30, 2010, investment maturities as a percentage of total debt securities are as follows:

Maturity	Maximum Maturity
Less than one year	3 %
One to five years	32 %
More than five to ten years	26 %
More than ten years	39 %

**Foreign Currency Risk** — As of June 30, 2010, the System's investment in the Morgan Stanley Fund amounting to approximately \$392 million represented 96.8% of the total commingled fund. Also, as of June 30, 2010, the System owned approximately \$57 million in shares of the Invesco Fund, which represented 37.53 % of the total commingled fund.

As of June 30, 2010, these pooled trusts had an asset mix and country allocation as shown in the following tables:

**Morgan Stanley:**

<b>Assets Mix</b>	<b>Percent</b>
Cash and equivalents	4.10
Future contracts	21.76
Equity securities	74.14
<b>Total</b>	<b>100.00</b>

<b>Country Allocation</b>	<b>Currency</b>	<b>Currency Code</b>	<b>Portfolio Percent</b>
Australia	Dollars	AUD	3.82
Hong Kong	Dollars	HKD	3.08
Singapore	Dollars	SGD	1.54
Japan	Yen	JPY	21.34
<b>Asia x Pacific</b>			<b>29.78</b>
Austria	Euro	EUR	0.45
Belgium	Euro	EUR	0.32
EMU	Euro	EUR	5.18
European Union Growth	Euro	EUR	1.34
European Union Quality	Euro	EUR	1.06
Finland	Euro	EUR	0.74
France	Euro	EUR	6.05
Germany	Euro	EUR	9.84
Italy	Euro	EUR	0.80
Netherlands	Euro	EUR	1.93
Spain	Euro	EUR	0.02
<b>Euro Europe</b>			<b>27.73</b>
Denmark	Kroner	DKK	0.55
Norway	Kroner	NOK	0.86
Sweden	Krona	SEK	1.93
Switzerland	Francs	CHF	6.30
United Kingdom	Pounds	GBP	17.75
<b>Non-Euro Europe</b>			<b>27.39</b>
United States	Dollars	USD	0.01
<b>North America</b>			<b>0.01</b>
Egypt	Egyptian Pound	EGP	0.23
<b>Africa</b>			<b>0.23</b>
China	Yuan Renmimbi	CNY	1.47
India	Indian Rupee	INR	1.43
Indonesia	Rupiahs	IDR	0.80
Malaysia	Ringgits	MYR	0.57
South Korea	Won	KRW	0.49
Taiwan	New Dollars	TWD	1.00
<b>Asia Emerging</b>			<b>5.76</b>
Poland	Zlotych	PLN	1.12
Russia	Ruble	RUB	1.26
Turkey	Turkish Lira	TRY	0.76
<b>Emerging Europe</b>			<b>3.14</b>
Brazil	Real	BRL	0.91
<b>Latin America</b>			<b>0.91</b>
Agriculture			0.96
<b>Thematic</b>			<b>0.96</b>
Cash			4.10
<b>Total</b>			<b>100.00</b>

**Invesco:**

<b>Assets Mix</b>	<b>Percent</b>
Short-term investments	3.50
Foreign stock	96.50
Total	<u>100.00</u>

<b>Country Allocation</b>	<b>Currency</b>	<b>Currency Code</b>	<b>Portfolio Percent</b>
Canada	Dollars	CAD	8.27
Finland	Euro	EUR	1.06
France	Euro	EUR	8.32
Germany	Euro	EUR	4.54
Greece	Euro	EUR	0.69
Netherlands	Euro	EUR	3.04
Italy	Euro	EUR	1.68
Spain	Euro	EUR	5.71
Euro Europe			<u>25.04</u>
Norway	Kroner	NOK	0.83
Switzerland	Francs	CHF	8.65
United Kingdom	Pounds	GBP	14.63
Non-Euro Europe			<u>24.11</u>
Australia	Dollars	AUD	6.69
Hong Kong	Dollars	HKD	3.69
Japan	Yen	JPY	21.80
Pacific			<u>32.18</u>
Other Countries — Invesco Emerging Markets Equity Trust			<u>6.90</u>
Total			<u>96.50</u>

**Investments in Limited Partnerships** — The fair value of investments in limited partnerships as of June 30, 2010, amounted to approximately \$55.3 million and is presented within private equity investments in the statement of plan 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 investments in limited partnerships were as follows:

- During fiscal year 2010, there were no additional contributions invested in 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. This fund has commitments to invest in fifteen (15) U.S. 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 2010, there were no additional contributions invested in 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. This 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. This fund also invests a portion of its assets in a Puerto Rico based private equity investment entity.
- During fiscal year 2010, there were no additional contributions invested in Guayacán Private Equity Fund, L.P., 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 this partnership is to make equity investments in privately held companies as established in its charter.
- During fiscal year 2010, approximately \$6,143,000 were invested in Guayacán Private Equity Fund II, L.P., a limited partnership organized in April 2007, pursuant to the laws of the State of Delaware, in which the System has a total commitment of \$15 million. This partnership intends to seek out, invest in, and add value to companies, which will be based or operating in Puerto Rico or in companies whose products or services are targeted at the U.S. Hispanic market, with specific interest in those companies where Advent-Morro Equity Partners, Inc. (Advent-Morro) know-how and track record can be leveraged to enhance investment selection and post-investment value-add. Advent-Morro is a Puerto Rico based private equity firm. Guayacán Private Equity Fund II, LP will strive to have a balanced mix of portfolio investments primarily focusing on later stage opportunities such as: expansion financing, leveraged buyouts, management buyouts, and recapitalizations. This partnership may invest in de-novo companies that are being set up to enter established industries via market consolidation opportunities and/or internal growth.
- During fiscal year 2010, there were no additional contributions to Venture Capital Fund, Inc., a Puerto Rico corporation organized pursuant to Act No. 3 of October 6, 1987, as amended, known as the Puerto Rico Capital Investment Funds Act, which is managed by Advent-Morro in which the System has a total commitment of \$800 thousand. This fund was created to make private equity investments in operating companies, which are based, are operating, or a combination of both, in Puerto Rico. Since inception, the fund has invested in 25 companies some of which it continues to provide capital for their expansion.
- During fiscal year 2010, approximately \$9,903,000 were invested in GF Capital Private Equity Fund, L.P., a limited partnership organized under the laws of the State of Delaware, in which the System has a total commitment of \$25 million. The purpose of this partnership is to make private equity investments in a variety of industries, including media and entertainment, branded consumer products, and software for media and telecommunications applications. This partnership's initiatives are focused on companies capitalized at between \$20 to \$400 million with a representation of buy-outs, growth capital, and recapitalizations.

- During fiscal year 2010, approximately \$218,000 were invested in Chase Capital Partners Private Equity Fund of Funds Corporate Investors II, LTD, a limited partnership, organized by Chase as General Partner, in which the System has a total commitment of \$20 million. This 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.
- The investment in Martineau Bay represents an investment in a hotel resort that filed under Chapter 11 of the United States Bankruptcy Code.

As of June 30, 2010, the date of commitment, total commitment, 2010 contributions, contributions to date at cost, and estimated value of investments in limited partnerships are as follows (in thousands):

	Date of Commitment	Total Commitment	FY 10 Contributions	Contributions to Date at Cost	Estimated Value
Grupo Guayacán, Inc.:					
Guayacán Fund of Funds, L.P.	Sept. 1996	\$ 25,000	\$	\$ 23,820	\$ 3,763
Guayacán Fund of Funds II, L.P.	Aug. 1999	25,000		23,681	8,883
Advent-Morro Equity Partners, Inc.:					
Guayacán Private Equity Fund, L.P.	Jan. 1997	5,000		4,645	4,364
Guayacán Private Equity Fund II, L.P.	Apr. 2007	15,000	6,143	14,744	13,197
Venture Capital Fund, Inc.	Nov. 1995	800		800	771
GF Capital Management & Advisors, LLC —					
GF Capital Private Equity Fund L.P.	Dec. 2006	25,000	9,903	14,949	14,480
Chase Capital Partners Private:					
Equity Fund of Funds Corporate Investors II, LTD.	Jul. 2000	20,000	218	18,955	9,849
Martineau Bay Resort, s. en c. (s.e.)	Jul. 1998	<u>1,796</u>		<u>1,796</u>	
Total alternative investments		<u>\$117,596</u>	<u>\$ 16,264</u>	<u>\$ 103,390</u>	<u>\$ 55,307</u>

**Securities Lending Transactions** — The System participates in a securities lending program, whereby securities are transferred to an independent broker or dealer in exchange for collateral in the form of cash, government securities, and/or irrevocable bank letters of credit equal to approximately 102% of the market value of the domestic securities on loan and 105% of the market value of the international securities on loan, with a simultaneous agreement to return the collateral for the same securities in the future. Collateral is marked to market daily and the agent places a request for additional collateral from brokers, if needed. The custodian bank is the agent for the securities lending program.

At the end of the year, there was no credit risk exposure to borrowers because the amounts the System owes the borrowers (the "collateral") exceeded the amounts the borrowers owe the System (the "loaned securities"). At June 30, 2010, the collateral received represented 102.29 % of the fair value of the domestic securities lent.

The securities on loan for which collateral was received as of June 30, 2010, consisted of the following:

Securities Lent	Fair Value
U.S. government and sponsored agencies' securities	\$ 55,770
U.S. corporate stocks	39,447
U.S. corporate bonds	
Non-exchange traded mutual funds:	
U.S.	6,268
Non-U.S.	<u>6,964</u>
Total	<u>\$ 108,449</u>



The underlying collateral for these securities had a fair value of approximately \$110,931,000 as of June 30, 2010. The collateral received was invested in a short-term investment fund sponsored by the custodian bank and is included as part of cash and short-term investments in the accompanying 2010 statement of plan net assets. As of June 30, 2010, the distribution of the short-term investment fund by investment type is as follows:

<b>Investment type</b>	<b>Percentage</b>
Securities bought under agreements to resell	67.16%
Commercial paper	3.69%
Certificates of deposit	1.29%
Floating rate notes	12.48%
Time deposits	15.38%

Under the terms of the securities lending agreement, the System is fully indemnified against failure of the borrowers to return the loaned securities (to the extent the collateral is inadequate to replace the loaned securities) or failure to pay the System for income distributions by the securities' issuers while the securities are on loan. In addition, the System is indemnified against loss should the lending agent fail to demand adequate and appropriate collateral on a timely basis.

## **6. LOANS AND INTEREST RECEIVABLE FROM PLAN MEMBERS**

Loans receivable from plan members are guaranteed by the contributions of plan members 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 maximum amounts that may be granted to plan members for personal and cultural trip loans are \$15,000 and \$10,000, respectively.

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.

As of June 30, 2010, the composition of loans and interest receivable from plan members is summarized as follows (in thousands):

Loans receivable:	
Personal	\$ 1,004,560
Mortgage	141,588
Cultural trips	<u>62,029</u>
Total loans to plan members	1,208,177
Accrued interest receivable	<u>27,048</u>
Total loans and interest receivable from plan members	1,235,225
Less allowance for adjustments and losses in realization	<u>(9,070)</u>
Total loans and interest receivable from plan members — net	<u>\$ 1,226,155</u>

## 7. ACCOUNTS RECEIVABLE FROM EMPLOYERS

As of June 30, 2010, accounts receivable from employers consisted of the following (in thousands):

Early retirement programs	\$ 85,693
Special laws	99,937
Employer and employee contributions	78,521
Interest on late payments	<u>22,700</u>
Total accounts receivable from employers	286,851
Less allowance for doubtful accounts receivable	<u>(13,712)</u>
Accounts receivable from employers — net	<u>\$273,139</u>

According to Act No. 447, each employer must pay on a monthly basis, the amounts corresponding to contributions and loan repayments, on or before the fifteenth day of the following month. After that date, interests are charged as established by the System.

The accounts receivable from employers related to special laws amounts to \$99.9 million as of June 30, 2010. The System has entered into installment payment agreements with approximately 24% of these employers, while the remaining 76% of employers have not entered into installment payments with the System.

An allowance for doubtful accounts receivable of \$4.6 million has been established for the amounts billed to these employers, which as of end of fiscal year have not replied to the System, either accepting or rejecting the amount billed to them, including a \$3.4 million allowance on the amounts receivable from Medical Service Administration (ASEM, by its Spanish acronym). It is the System's management understanding that the remaining receivable balances do not need an allowance for doubtful accounts since those employers have consistently showed an acceptable payment history toward the System.

As of June 30, 2010, accounts receivable from employers include accounts receivable from ASEM of approximately \$61 million, as follow (in thousands):

Employer and employee contributions	\$ 39,581
Special laws	13,404
Early retirement program	5,160
Interest	<u>15,452</u>
Total accounts receivable from ASEM	73,597
Less allowance for doubtful accounts receivable	<u>(12,465)</u>
Accounts receivable from ASEM — net	<u>\$ 61,132</u>

As of June 30, 2010, ASEM had not paid the System the corresponding employer contributions, early retirement program contributions, special laws contributions, and contributions withheld from employees since fiscal year 2005. The System made all the necessary efforts to collect the amounts owed by ASEM. These efforts included meetings with the Executive Officer of ASEM, the House of Representatives and the Senate of the Commonwealth, in order to establish a payment plan.

Subsequent to June 30, 2010, the Commonwealth's Legislature approved Law 2961 assigning funds to ASEM to settle its account receivable with the System as of June 30, 2010, excluding interests. On January 5, 2011, the System received an initial payment of \$54 million.

## 8. CAPITAL ASSETS

Capital assets activity for the year ended June 30, 2010, was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets, not being depreciated:				
Land	\$ 969	\$ -	\$ -	\$ 969
Construction in progress	<u>3,075</u>	<u>          </u>	<u>          </u>	<u>3,075</u>
Total capital assets, not being depreciated	<u>4,044</u>	<u>          </u>	<u>          </u>	<u>4,044</u>
Capital assets, being depreciated:				
Building and improvements	7,631			7,631
Equipment	<u>10,848</u>	<u>1,182</u>	<u>1,373</u>	<u>10,657</u>
Total capital assets, being depreciated	<u>18,479</u>	<u>1,182</u>	<u>1,373</u>	<u>18,288</u>
Less accumulated depreciation for:				
Building and improvements	3,681	568		4,249
Equipment	<u>9,671</u>	<u>807</u>	<u>1,359</u>	<u>9,119</u>
Total accumulated depreciation	<u>13,352</u>	<u>1,375</u>	<u>1,359</u>	<u>13,368</u>
Total capital assets being depreciated — net	<u>5,127</u>	<u>(193)</u>	<u>14</u>	<u>4,920</u>
Total capital assets — net	<u>\$ 9,171</u>	<u>\$ (193)</u>	<u>\$ 14</u>	<u>\$ 8,964</u>

## 9. OTHER ASSETS

As of June 30, 2010, other assets consist of (in thousands):

Executed land	\$ 4,699
Repossessed and foreclosed properties	<u>2,525</u>
Total	<u>\$ 7,224</u>

Repossessed 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. A gain or loss is recognized at the time of sale.

Differences resulting from the recognition of losses at the point of sale rather than upon foreclosure, as required by GAAP in the United States of America, are not material. Management believes that the carrying value of these properties approximates fair value.

As of June 30, 2010, a total of 14,618 square meters of executed land remained under the possession of the System. According to an independent appraisal performed as of June 8, 2005, the estimated market value of this land was approximately \$22.8 million.

## 10. BONDS PAYABLE

**Senior Pension Funding Bonds** — On February 27, 2007, the System’s administration and GDB, acting as the System’s fiscal agent (the “Fiscal Agent”), presented to the board of trustees, a financial transaction for the issuance of pension funding bonds in order to reduce the System’s unfunded actuarial accrued liability. The System authorized the issuance of one or more series of bonds (the “Bonds”) in order to increase the funds available to pay pension benefits to certain of its beneficiaries and reduce its unfunded accrued actuarial pension liability. The System pledged future employer contributions to the payment of the Bonds, invested the proceeds of the Bonds, and used these investments and the earnings thereon to provide pension benefits to its beneficiaries.

On January 31, 2008, the System issued the first series of Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A (the “Series A Bonds”). On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B (the “Series B Bonds”). Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C (the “Series C Bonds”).

As of June 30, 2010, the outstanding balance of the Bonds is as follows (in thousands):

### Description

#### Series A Bonds:

Capital Appreciation Bonds, maturing in 2028, bearing interest at 6.20%	\$ 52,198
Term Bonds, maturing in 2023, bearing interest at 5.85%	200,000
Term Bonds, maturing from 2031 through 2038, bearing interest at 6.15%	679,000
Term Bonds, maturing from 2039 through 2042, bearing interest at 6.20%	332,770
Term Bonds, maturing from 2055 through 2058, bearing interest at 6.45%	<u>332,000</u>

Total Series A Bonds outstanding	<u>1,595,968</u>
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#### Series B Bonds:

Capital Appreciation Bonds, maturing from 2028 through 2030, bearing interest at 6.40%	160,833
Capital Appreciation Bonds, maturing from 2031 through 2034, bearing interest at 6.45%	115,791
Term Bonds, maturing in 2031, bearing interest at 6.25%	117,100
Term Bonds, maturing from 2036 through 2039, bearing interest at 6.30%	270,000
Term Bonds, maturing from 2055 through 2058, bearing interest at 6.55%	<u>429,000</u>

Total Series B Bonds outstanding	<u>1,092,724</u>
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#### Series C Bonds:

Capital Appreciation Bonds, maturing in 2030, bearing interest at 6.50%	2,507
Term Bonds, maturing in 2028, bearing interest at 6.15%	110,000
Term Bonds, maturing in 2038, bearing interest at 6.25%	45,000
Term Bonds, maturing in 2043, bearing interest at 6.30%	<u>143,000</u>

Total Series C Bonds outstanding	<u>300,507</u>
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Total bonds outstanding	2,989,199
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Less bonds discount	<u>(7,424)</u>
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Bonds payable — net	<u>\$2,981,775</u>
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**Series A Bonds** — The aggregate principal amount of the Series A Bonds issued amounted to approximately \$1,589 million of which \$1,544 million were issued as term bonds (the “Series A Term Bonds”) and \$45 million were issued as capital appreciation bonds (the “Series A Capital Appreciation Bonds”). Interest on the Series A Bonds accrues, or compounds (in the case of the Series A Capital Appreciation Bonds), from their date of delivery. Interest in the Series A Term Bonds are payable monthly on the first day of each month, commencing on March 1, 2008. Interest on the Series A Capital Appreciation Bonds are not payable on a current basis, but are added to the principal of the Capital Appreciation Bonds on each January 1 and July 1, commencing on July 1, 2008 (“Compounding Dates”), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360-day year consisting of twelve 30-day months. The Series A Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series A Capital Appreciation Bonds, the accreted amount) of the Series A Bonds, plus accrued interest to the redemption date, and without premium. The Series A Bonds have the following debt service requirements (in thousands):

Years Ending June 30,	Principal	Interest
2011	\$ -	\$ 95,504
2012		95,504
2013		95,504
2014		95,504
2015		95,504
2016–2020		477,522
2021–2025	200,000	454,121
2026–2030	45,041	502,825
2031–2035	11,500	416,961
2036–2040	925,170	322,971
2041–2045	75,100	114,054
2046–2050		107,070
2051–2055	86,950	107,070
2056–2059	<u>245,050</u>	<u>26,235</u>
Principal outstanding and interest	1,588,811	3,006,349
Add (deduct) accreted value on bonds outstanding	<u>7,157</u>	<u>(7,157)</u>
Total Series A Bonds	<u>\$ 1,595,968</u>	<u>\$ 2,999,192</u>

**Series B Bonds** — The aggregate principal amount of the Series B Bonds amounted to approximately \$1,059 million of which \$816 million were issued as term bonds (the “Series B Term Bonds”) and \$243 million were issued as capital appreciation bonds (the “Series B Capital Appreciation Bonds”). Interest on the Series B Bonds accrues, or compounds (in the case of the Series B Capital Appreciation Bonds), from their date of delivery. Interest in the Series B Term Bonds are payable monthly on the first day of each month, commencing on July 1, 2008. Interest on the Series B Capital Appreciation Bonds are not payable on a current basis, but are added to the principal of the Series B Capital Appreciation Bonds on each January 1 and July 1, commencing on July 1, 2008 (“Compounding Dates”), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360-day year consisting of twelve 30-day months. The Series B Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series B Capital Appreciation Bonds, the accreted amount) of the Series B Bonds, plus accrued interest to the redemption date, and without premium.

The Series B Bonds have the following debt service requirements (in thousands):

Years Ending June 30,	Principal	Interest
2011	\$ -	\$ 52,428
2012		52,428
2013		52,428
2014		52,428
2015		52,428
2016–2020		262,141
2021–2025		262,141
2026–2030	141,071	262,141
2031–2035	218,564	232,866
2036–2040	270,000	183,023
2041–2045		140,498
2046–2050		140,498
2051–2055	96,250	140,498
2056–2059	<u>332,750</u>	<u>46,472</u>
Principal outstanding and interest	1,058,635	1,932,418
Add (deduct) accreted value on bonds outstanding	<u>34,089</u>	<u>(34,089)</u>
Total Series B Bonds	<u>\$1,092,724</u>	<u>\$1,898,329</u>

**Series C Bonds** — The aggregate principal amount of the Series C Bonds amounted to approximately \$300 million of which \$298 million were issued as term bonds (the “Series C Term Bonds”) and \$2 million were issued as capital appreciation bonds (the “Series C Capital Appreciation Bonds”). Interest on the Series C Bonds accrues, or compounds (in the case of the Series C Capital Appreciation Bonds), from their date of delivery. Interest in the Series C Term Bonds are payable monthly on the first day of each month, commencing on August 1, 2008. Interest on the Series C Capital Appreciation Bonds are not payable on a current basis, but are added to the principal of the Series C Capital Appreciation Bonds on each January 1 and July 1, commencing on July 1, 2009 (“Compounding Dates”), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360-day year consisting of twelve 30-day months. The Series C Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series C Capital Appreciation Bonds, the accreted amount) of the Series C Bonds, plus accrued interest to the redemption date, and without premium.

The Series C Bonds have the following debt service requirements (in thousands):

<b>Years Ending June 30,</b>	<b>Principal</b>	<b>Interest</b>
2011	\$ -	\$ 18,587
2012		18,587
2013		18,587
2014		18,587
2015		18,587
2016–2020		92,933
2021–2025		92,933
2026–2030		79,403
2031–2035	112,203	59,108
2036–2040	45,000	20,831
2041–2044	<u>143,000</u>	
Principal outstanding and interest	300,203	438,143
Add (deduct) accreted value on bonds outstanding	<u>304</u>	<u>(304)</u>
Total Series C Bonds	<u>\$ 300,507</u>	<u>\$ 437,839</u>
Total bonds	<u>\$2,989,199</u>	<u>\$ 5,335,359</u>

Activity of bonds payable during the year ended June 30, 2010, is as follows:

	June 30, 2009	Issuances	Accretion	Payments	June 30, 2010	Current Portion
Series A Bonds:						
Capital appreciation bonds	\$ 49,105	\$ -	\$ 3,093	\$ -	\$ 52,198	\$ -
Term bonds	<u>1,543,770</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,543,770</u>	<u>-</u>
Total Series A Bonds	<u>1,592,875</u>	<u>-</u>	<u>3,093</u>	<u>-</u>	<u>1,595,968</u>	<u>-</u>
Series B Bonds:						
Capital appreciation bonds	259,674	-	16,950	-	276,624	-
Term bonds	<u>816,100</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>816,100</u>	<u>-</u>
Total Series B Bonds	<u>1,075,774</u>	<u>-</u>	<u>16,950</u>	<u>-</u>	<u>1,092,724</u>	<u>-</u>
Series C Bonds:						
Capital appreciation bonds	2,349	-	158	-	2,507	-
Term bonds	<u>298,000</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>298,000</u>	<u>-</u>
Total Series C Bonds	<u>300,349</u>	<u>-</u>	<u>158</u>	<u>-</u>	<u>300,507</u>	<u>-</u>
Total bonds outstanding	2,968,998	-	20,201	-	2,989,199	-
Less bond discounts	<u>(7,639)</u>	<u>-</u>	<u>215</u>	<u>-</u>	<u>(7,424)</u>	<u>-</u>
Total bonds payable — net	<u>\$ 2,961,359</u>	<u>\$ -</u>	<u>\$ 20,416</u>	<u>\$ -</u>	<u>\$ 2,981,775</u>	<u>\$ -</u>

**Pledge of Employer Contributions Pursuant to Security Agreement** — The System entered into a Security Agreement with the Fiscal Agent for the benefit of the bondholders, pursuant to which the System pledged to the Fiscal Agent, and granted the Fiscal Agent a security interest in employer contributions made after January 31, 2008, which was the date of issuance of the first series of bonds, and the funds on deposit with the Fiscal Agent under the various accounts established under the Pension Funding Bond Resolution (the “Resolution”).

The Resolution and the Security Agreement constitute a contract between the System and the Fiscal Agent, on behalf of the owners of the bonds. The pledge, covenants and agreements of the System set forth in the Resolution and the Security Agreement shall be for the equal benefit, protection and security of the owners of the bonds, regardless of time or times of their issuance or maturity, and shall be of equal rank, without preference, priority or distinction of any of the bonds over any other bond, except as expressly provided in or permitted by the Resolution. The pledge by the System of the pledged funds, which consist of all employer contributions that are made after January 31, 2008, which was the date of issuance of the first series of bonds, in accordance with the Act and amounts on deposit in the different accounts created pursuant to the Resolution for the benefits of the owners of the bonds, is irrevocable so long as any bonds are outstanding under the terms of the Resolution.

#### **11. 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.

#### **12. CONTINGENCIES**

**Loss Contingencies** — The System is a 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.

**Gain Contingency** — The System, besides receiving contributions from participants and employers, 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 costs of pension benefits that increased from 1992 to 2004 were not received in full by the System from legislative appropriations.

On June 30, 2007, the System filed a reimbursement claim with the Office of Management and Budget of the Commonwealth to collect the remaining unfunded special laws appropriations. The final outcome of this claim cannot be presently determined; therefore, no receivable has been recorded in the System’s financial statements.



### 13. SUBSEQUENT EVENT

On July 2, 2010, the Commonwealth enacted Act No. 70 to establish a program that provides benefits for early retirement or economic incentives for voluntary employment termination to eligible employees, as defined. Act No. 70 establishes that early retirement benefits will be provided to eligible employees that have completed between 15 to 29 years of creditable services and will consist of monthly benefits ranging from 37.5% to 50% of each employees' monthly salary. Economic incentives are available to all eligible employees and will consist of a lump-sum payment ranging from one-month to six-month salary. Additionally, all employees that choose to participate in this program are eligible to receive health plan coverage for up to 12 months in a health plan selected by the Administrator of the Puerto Rico Government Employees and Judiciary Retirement Systems Administration (the "Administrator"). Eligible employees may elect to participate in this program within 30 days after a date to be determined by the Administrator, no later than December 31, 2012.

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**REQUIRED SUPPLEMENTARY SCHEDULES OF EMPLOYERS'  
CONTRIBUTIONS AND FUNDING PROGRESS**

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)

**SCHEDULE OF EMPLOYERS' CONTRIBUTIONS  
FOR THE YEAR ENDED JUNE 30, 2010**  
(In thousands)

<b>Year Ended June 30,</b>	<b>Actual Employer Contributions</b>	<b>Annual Required Contributions</b>	<b>Percentage Contributed</b>
2010	\$ 534,275	\$ 1,459,774	36.60%
2009	594,509	1,258,695	47.23%
2008 *	581,285	1,191,275	48.80%
2007 **	566,524	816,472	69.39%
2006 **	559,198	816,472	68.49%
2005	374,823	578,387	64.80%

\* In the development of the Fiscal Year 2007-2008 Annual Required Contribution the System has adopted a level dollar amortization method with a 30-year period to reflect the closing of the defined benefit plan to new entrants under System 2000 (the Retirement Savings Account Program).

\*\* Annual Required Contribution for the years ended June 30, 2007 and June 30, 2006 is restated to remove the offset of employer contributions on behalf of System 2000 members that was applied to the normal cost, and to include the Special Law Benefits. Actual Employer Contributions are restated to include receipts for Special Law pension benefits and early retirement incentives. These adjustments were made to allow for better comparability between the results of the later and the earlier valuations.

The above liabilities are for basic System benefits and selected System administered benefits.

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

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)**

**SCHEDULE OF FUNDING PROGRESS  
AS OF JUNE 30, 2010  
(In thousands)**

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 Covered Payroll
June 30, 2010	\$ 1,664,991	\$ 19,501,761	\$ 17,836,770	8.5 %	\$ 3,818,332	467.1 %
June 30, 2009	1,842,143	18,943,586	17,101,443	9.7 %	4,292,552	398.4 %
June 30, 2008	2,607,086	ND	ND	ND	ND	ND
June 30, 2007	2,891,501	16,769,512	13,878,011	17.2 %	4,246,409	326.8 %
June 30, 2006	2,541,331	ND	ND	ND	ND	ND
June 30, 2005 *	2,327,871	13,969,000	11,641,129	16.7 %	4,125,866	282.1 %

\* Accrued liability for June 30, 2005 is restated to include the Special Law benefits. This adjustment was made to allow for better comparability between the results of the current and the prior valuation.

The above liabilities are for basic System benefits and selected System administered benefits.

ND = Not determined

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

**EMPLOYEE'S RETIREMENT SYSTEM OF THE GOVERNMENT OF THE  
COMMONWEALTH OF PUERTO RICO**  
(A Pension Trust Fund of the Commonwealth of Puerto Rico)

**NOTES TO SUPPLEMENTARY SCHEDULES OF  
EMPLOYERS' CONTRIBUTIONS AND FUNDING PROGRESS  
AS OF AND FOR THE YEAR ENDED JUNE 30, 2010**

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**1. SCHEDULE OF EMPLOYERS' CONTRIBUTIONS**

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

The information was obtained from the last actuarial report as of June 30, 2010.

**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, 2010.

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