Audited Financial Statements

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

June 30, 2003

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

Audited Financial Statements

June 30, 2003

Contents

ERNST & YOUNG

Ernst & Young LLP
1000 Scotiabank Plaza
273 Ponce de Leon Avenue
Hato Rey, Puerto Rico 00917-1989

Phone: (787) 759 8212
Fax: (787) 753-0808
Fax: (787) 753 0813
www.ey.com

Report of Independent Auditors

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

We have audited the accompanying statements of plan net assets of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System) as of June 30, 2003 and 2002, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1 to the financial statements, in 2002 the System adopted Governmental Accounting Standards Board No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – For State and Local Governments."

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the System at June 30, 2003 and 2002, and the changes in its net assets for the years then ended in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Management's Discussion and Analysis presented on pages 2 through 6 and supplemental schedules of employer contributions and funding progress presented on pages 27 and 29 are supplementary information required by the Governmental Accounting Standards Board, and are not a required part of the basic financial statements. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information contained in the Management's Discussion and Analysis and supplemental schedules and, therefore, express no opinion on them.

Ernst & Young LLP

September 26, 2003
San Juan, Puerto Rico

Stamp No. 1920985
affixed to the original copy of this report.

Employees' Retirement System of the
Government of Puerto Rico and its Instrumentalities
For fiscal year ended June 30, 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS

Within this section of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (the System or ERS) annual financial statements, the System's management provides a narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2003. The financial performance of the System is discussed and analyzed within the context of the accompanying financial statements and disclosures following this section.

Overview of the Financial Statements

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

Basic Financial Statements

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

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

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

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

Financial Highlights

As of June 30, 2003, the System has $1,989 million in total assets consisting, in summary of the following:

- $1,163 million in marketable securities
- $34 million in alternative investments
- $363 million in the investment in PRTA Holdings Preferred Stock
- $282 million in loans to participants
- $8 million in real estate
- $64 million in net cash and equivalents
- $76.3 million in other net assets

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

- ERS assets exceeded liabilities by $1,947,402,000 (net assets) for the fiscal year reported when compared to the prior year which assets exceeded liabilities by $1,979,677,000.
- The fair value of ERS investments (excluding the Investment in PRTA Holdings Preferred Stock and participants' loans) at June 30, 2003 amounted to $1,197,086,000, compared to $1,166,862,000 at June 30, 2002.
- ERS funded ratio of the actuarial accrued liability at June 30, 2001 and 2000 was 25 % and 22%, respectively.
- Investment in PRTA Holdings Preferred Stock at June 30, 2003 amounted to $362,670,000 compared to $383,180,000 at June 30, 2002.
- Participants' loans amounted to $281,796,000 at June 30, 2003 compared to $268,675,000 at June 30, 2002.

The financial statements of the System for the fiscal year ended June 30, 2003 present a decrease in net assets as compared to the prior fiscal year of approximately $32.3 million. This decrease was mostly the result of the decrease in net cash and cash equivalents of $51 million plus the reduction of $21 million in the fair value of the Investment in PRTA Holdings Preferred Stock, offset by the $43 million aggregate increase in the investment portfolio and the participants' loans.

Our investment portfolio was re-structured during fiscal year 2003, by implementing a new asset allocation to fulfill the System's cash flow needs as well as to sustain an appropriate growth and return. In addition, the new asset mix and investment management structure provided savings in management fees. For the fiscal year 2003, the portfolio experienced an increase of approximately $43 million. During fiscal years 2001, 2002 and beginning of fiscal year 2003, the System's investment portfolio experienced several losses as a direct result of the market conditions prevailing during that period that were mainly caused by the adjustments in stock prices, especially those in the technology sector, followed by the terrorist attacks on September 11, 2001 and corruption cases in large U.S. companies. Finally, during the semester ended June 30, 2003 the market sustained a recovery and the System experienced positive returns of 8.84% (net of fees).

For financial statements purposes, the amount of securities that as of June 30, 2003 were involved in the securities lending transactions was presented with the required disclosures, according to the current government accounting pronouncements. For the fiscal year 2003, income from the custodian securities lending activity amounted to approximately $58,000. In addition, the System invests in a commingled fund, which engages in securities lending transactions that resulted in earning $8,731 as securities lending income.

Budget Highlights

For the fiscal year 2003, the Board of Trustees approved a budget of $33.3 million for the administrative and operational expenses of the System. The actual expenses amounted to $31 million. In December 2002, the Board of Trustees approved a budget increase of $62 thousand. For the fiscal year 2004, the budget approved amounts to $34 million.

Investment in PRTA Holdings Preferred Stock

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

Subsequently, the GDB created a subsidiary, known as PRTA Holdings, to hold the remaining stock on behalf of the Employees' System. On December 28, 2000, PRTA Holdings issued and assigned its non-cumulative, non-voting preferred stock to the System, entitling the System to receive all the future benefits generated by the Puerto Rico Telephone Company (TELPRI) stock retained by the Government. During the fiscal years ended June 30, 2003 and 2002, the System received $38 million and $17.5 million, respectively, in dividends from TELPRI.

In connection with the first sale, an option was granted to the Buyers to acquire an additional 15% of the preferred stock at a fixed price of $45.94 per share expiring on March 2, 2002. In January 25, 2002, GTE Holdings (Puerto Rico) LLC and Popular, Inc. exercised the option and acquired the additional 15% of the preferred stock. As a result of that transaction, the System received approximately $172 million.

For financial statements purposes, as of June 30, 2003, the investment in PRTA Holdings Preferred Stock was presented based on the estimated value as of June 30, 2003 of the TELPRI stock, considering 7,000,000 shares at $51.81 per share for a total value of approximately $363 million.

Funding Status

According to our last certified actuarial valuation as of June 30, 2001, the System's unfunded liability amounted to $7,453 million for a capitalization level of 25%. The actuarial valuation at June 30, 2003 is in process.

Since 1990, the Government has taken steps to improve the System's financial condition as follows:

- Law 1 of February 16, 1990 changed the benefits structure for employees joining the Government workforce on or after April 1, 1990. The changes in the structure consisted of:
  - Increase contributions rates: employers' from 8% to 9.275% and employees' from 7% to 8.275%;
  - Elimination of the merit pension (except for policemen and firemen);
  - Increase retirement age from 55 to 65 years old;
  - Annuity based on 1.5% of salary for each year of service;
  - Decrease in the disability benefits;
  - Establish that any increase in benefits will require actuarial studies and the law must state the financing source.

- Law 305 of September 24, 1999 closed the defined benefit plan and created a defined contribution plan (System 2000) with only employee contributions. Under System 2000,
  - The participant purchases with the balance in his/her savings account, an annuity at the time he or she reaches the retirement age.
  - The employer contributions continue but are used to capitalize the defined benefit plan.
  - The disability benefits must be provided through a private insurance long term disability program to those participants that voluntarily elect to enroll in such program.

Also, as explained hereby in the section: Investment in PRTA Holdings Preferred Stock, the System received a contribution from the Government.

Increase in Economic Benefits for Retirees Granted in Summer 2003

In summer 2003, the Governor of Puerto Rico, Sila M. Calderón granted six new benefits to the System's retirees to help them cope with the increase in the cost of living, which consisted of:

- Medicine Bonus of $100 payable annually every July, starting July 2003;
- Increase in the Christmas Bonus to $400 annually every December, starting December 2003;
- Increase in the minimum monthly pension benefit to $300, effective January 1, 2004;
- Increase in the monthly employer contribution for the medical plan to $100, effective January 1, 2004;
- Increase of 3% in all pensions granted before January 1, 2001, effective January 1, 2004;
- Increase in the pension benefit for widows and/or beneficiaries to 50% of the benefit received by the deceased retiree, effective January 1, 2004.

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

Initiatives to Provide Better Services to Our Participants and Retirees

The System serves around 170,000 active participants and 90,000 retirees and beneficiaries belonging to 140 different employers. It provides a range of close to 50 different types of services to its clientele, including pension applications, disability benefits, mortgage and personal loans and the payment of unpaid services. Because of that, our clientele frequently demands fast services, access to information and benefits orientation.

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

- TELERETIRO – a telephone calls center to provide information about benefits and services. TELERETIRO operates through a toll-free number, with extended hours including Saturdays.
- Pre-Retirement Orientation Program – a complete orientation for candidates for retirement through a two-days seminar where the candidates receive education regarding pension benefits, financial and legal matters, and motivation to plan and face a new stage in their lives.
- New Personal Loans Program – a program (to be launched in November 2003) that contemplates the granting of personal loans up to $5,000 with a 5 year term.

During fiscal years 2001 and 2002, the System's management already took steps to improve the processing time for service requests. As a result of those efforts, now personal loans are granted within three to five business days, pensions and other services alike are granted within one month. The System's management has also taken other steps to improve the operational efficiency and productiveness. With a strong commitment, the System's management continues its efforts to implement innovative initiatives to provide even better services to its clientele and protect the System's financial condition.

Requests for Information

The financial report is designed to provide a general overview of the System's finances, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Commonwealth of Puerto Rico Government Employees and Judiciary Retirement Systems Administration, 437 Ponce de León Avenue, Hato Rey, Puerto Rico, 00918.

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

Statements of Plan Net Assets (continued)

	June 30, 2003	June 30, 2002
	(In Thousands)	
Liabilities		
Book overdraft	-	31,627
Short-term obligations	-	14,000
Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members	18,231	17,290
Investment purchases	1,349	3,281
Other liabilities	22,363	29,438
Total liabilities	41,943	95,636
Net assets held in trust for pension benefits	$1,947,402	$1,979,677

See accompanying notes.

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

Statements of Changes in Plan Net Assets

	Year ended June 30, 2003	2002
	(In Thousands)	
Additions:		
Contributions:		
Employers	$ 312,473	$ 293,601
Participating employees	276,347	259,203
Legislative Assignments for Law 127	17,931	14,627
	606,751	567,431
Investment income:		
Net depreciation on investments	(36,440)	(380,518)
Dividend income	42,561	21,792
Interest income	43,309	43,509
	49,430	(315,217)
Less investment expense	3,425	4,887
	46,005	(320,104)
Other income	11,127	14,096
Total additions	663,883	261,423
Deductions:		
Annuities	614,500	621,021
Benefits under Law 127	17,931	14,627
Death benefits	12,370	12,616
Refunds:		
Employers	2,728	1,390
Participating employees	19,861	33,452
	22,589	34,842
Administrative expenses	28,768	27,304
Total deductions	696,158	710,410
Net decrease in assets held in trust for pension benefits	(32,275)	(448,987)
Net assets held in trust for pension benefits:		
Beginning of year	1,979,677	2,428,664
End of year	$1,947,402	$1,979,677

See accompanying notes.

1. Organization and Summary of Significant Accounting Policies

Organization

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

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

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

Basis of Presentation

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

Change in Accounting Principle

The System adopted the provisions of GASB No. 34 in fiscal year 2002, effective July 1, 2001. GASB No. 34 established financial and reporting standards for all state and local governments and related entities. GASB No. 34 did not have a significant effect on the System's financial position or changes in net assets. The only significant effect of the implementation of GASB No. 34 relates to the inclusion of Management's Discussion and Analysis as supplemental information.

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

Use of Estimates

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

Cash and Cash Equivalents

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

Investments

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

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

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

Loans to Plan Members

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

The System services mortgage loans with aggregate principal balances of approximately \$24,462,000 and \$29,384,000 at June 30, 2003 and 2002, respectively, related to certain mortgages loans sold to FNMA for a fee of 0.25%. The income for 2003 and 2002 amounted to \$58,001 and \$70,073, respectively, and is recognized as interest income in the accompanying statement of changes in plan net assets.

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

Loans to Plan Members (continued)

In addition, at June 30, 2003 and 2002, the System repurchased approximately $123,000 and $110,000, respectively, in mortgage loans that were sold during fiscal year 1998 to Federal National Mortgage Association (FNMA). The sale contract stipulates that the System must repurchase any loans with payments in arrears over 90 days.

Reserve for Life Insurance on Loans to Plan Members

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

2. Plan Description

The System is a cost-sharing multi-employer defined benefit plan sponsored by the Commonwealth. Substantially all full-time employees of the Commonwealth and its Instrumentalities (Central Government Agencies, Municipalities and Public Corporations, including the System) are covered by the System under the terms of the Act No. 447 of 1951. All regular, appointed and temporary employees of the Commonwealth at the date of employment become plan members of the System. The System is optional for Government officers appointed by the Governor and Head of Agencies. At June 30, 2003 and 2002, membership consisted of the following:

	2003	2002
Retirees and beneficiaries currently receiving benefits	87,648	86,020
Current participating employees	166,914	156,009
Total membership	254,562	242,029

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

2. Plan Description (continued)

Retirement Annuity

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

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

Plan members are eligible for monthly benefit payments determined by the application of stipulated benefit rations to the plan member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by the System. The annuity, for which a plan member is eligible, is limited to a minimum of $200 per month (increased to $300 effective January 1, 2004 – see Note 12) and a maximum of 75% of the average compensation.

Merit Annuity

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

Deferred Retirement Annuity

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

Coordinated Plan

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

- $165 per month if retired with 55 years of age and 30 years of credited service
- $110 per month if retired with less than 55 years of age and 30 years of credited service
- All other between $82 and $100 per month.
- Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases can be reduced over $165 per month.

2. Plan Description (continued)

Non-Coordinated Plan

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

Reversionary Annuity

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

Occupational Disability Annuity

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

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, 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.

2. Plan Description (continued)

Death Benefits (continued)

Post-retirement:

- Beneficiary with surviving spouse age 60 or over and child, 18 or under, up to 30% (60%, if not covered under Title II of the Social Security Act) (increased to 50% effective January 1, 2004) 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 58 to 65, a decrease in the benefit percentage of the average compensation in the occupational disability and occupational death benefits annuities from 50% to 40%, and the elimination of the Merit Annuity for participating employees (except policemen and firemen) who have completed 30 years of creditable service.

Cost of Living Adjustment for Pension Benefits

Act No. 10 of May 21, 1992 provided for increases of 3% every three years, of the pensions paid by the System to those plan members with three or more years of retirement. The Act requires further legislation to grant this increase every three years, subject to the presentation of actuarial studies regarding its costs and the source of financing. To protect the financial health of the System the increase granted during 2001 and the one to be granted on January 1, 2004 are being financed through grants from the General Fund and contributions from municipalities and public corporations.

Early Retirement Programs

During fiscal years 1999 and 2001, the Government provided two early retirement programs. To avoid any economic impact on the System, the employer is responsible for contributing to the System the amounts to cover the benefit payments and the employer and employee contributions with respect to the participants covered until the participants reach the normal retirement age. Presently, the System bills regularly all the amounts for which the employers are responsible.

2. Plan Description (continued)

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

On September 24, 1999, Law 305, an amendment to Act No. 447 of May 15, 1951, created the System, was enacted to establish a defined contribution plan, known as System 2000 to cover employees joining the System on or after January 1, 2000.

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

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

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

At June 30, 2003 and 2002, System 2000 membership within the System's total membership consisted of the following:

	2003	2002
Current participating employees	28,859	21,758

3. Funding Policy

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

The System received grants from the General Fund of $96.7 million and $71.7 million in 2003 and 2002, respectively to cover special laws. The grants are accounted, net of benefits payments except for approximately $17.9 million and $14.6 million in 2003 and 2002, respectively, which are granted under the provisions of Law No. 127 of 1958, that covers the occupational disability of firemen, policemen and other personnel disabled during high risk circumstances.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2001, using the projected unit credit actuarial cost method. Significant assumptions underlying the actuarial computations include: (a) assumed rate of return on investments of 8.5%, (b) assumed compound rate of wage increases of 5% per year; and (c) assumed mortality rate based on the Group Annuity Table for 1951.

The actuarial accrued liability was approximately $9,881,481,000 as of June 30, 2001. At June 30, 2001, the unfunded actuarial accrued liability was approximately $7,452,817,000.

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

As an employer, the System has contributed $1,171,000 and $1,252,000 which represented its contractually required contribution for the years ended June 30, 2003 and 2002, respectively.

4. Cash and Investments

Cash Deposits

At June 30, 2003, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately $63.8 million, which includes $35 million at commercial banks, $28.8 million at GDB. At June 30, 2002, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately $137.3 million, which includes $59.6 million at commercial banks, $109.3 million at GDB reduced by an overdraft of $31.6 million.

The $35 million and the $59.6 million deposited at commercial banks for years 2003 and 2002, respectively, are insured by the Federal Deposit Insurance Corporation up to $100,000 or collateralized with securities held on behalf of the System by the Secretary of the Treasury of the Commonwealth of Puerto Rico, or the Secretary's agent in the name of the Secretary.

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

At June 30, 2003, cash consists of deposits in banks and is categorized following the "Guide to Implementation of GASB No. 3, "Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements." The categories for deposits are the following:

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

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

Category 3 - uncollateralized.

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

	Category			Fair
	1	2	3	Value
Deposits in commercial banks	$35.0	$ -	$ -	$35.0
Deposits in GDB	-	-	28.8	28.8
Total	$35.0	$ -	$28.8	$63.8

4. Cash and Investments (continued)

Investments

The following table shows the fair value of the investments in marketable securities held by the System as of June 30, 2003 and 2002 (in thousands):

	2003 Fair Value	2002 Fair Value
U.S. Government and agencies, securities	$ 44,425	$ 20,993
Corporate bonds	173,668	81,620
Total bonds and notes	218,093	102,613
Domestic corporate stocks	719,525	812,389
International corporate stocks	225,379	217,636
Total stocks	944,904	1,030,025
Alternative investments	34,089	34,012
Total investments	$1,197,086	$1,166,862

Alternative Investments include the following:

	Total Commitment	Contributions To Date	Cost	Fair Value
Grupo Guayacán, Inc.				
Guayacán Fund of Funds, LP	$25,000,000	$22,779,099	$20,570,959	$12,958,854
Guayacán Fund of Funds II, LP	25,000,000	15,203,983	14,835,710	9,398,088
Advent-Morro Equity Partners Inc.				
Guayacán Private Equity Fund, LP	5,000,000	3,930,032	3,831,792	3,704,083
Venture Capital Fund, Inc	800,000	800,000	800,000	451,200
Chase Capital Partners Equity Fund of Funds Corporate Investor II LTD	20,000,000	9,540,273	8,813,732	7,577,182
Martineau Bay Resort, S. en C. (S.E.)	1,795,750	1,795,750	1,795,750	-
Total alternative investments	$77,595,750	$54,049,137	$50,647,943	$34,089,407

The Credit Risk categories for investments are:

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

4. Cash and Investments (continued)

Investments (continued)

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

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

Credit Risk Classification is as follows (in thousands):

	Category 1	Category 2	Category 3	Fair Value
Bonds and notes	$ -	$ -	$ 218,093	$ 218,093
Stocks	-	-	944,904	944,904
Alternative investments	-	-	34,089	34,089
	$ -	$ -	$1,197,086	$1,197,086

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

Securities Lending Transactions

The System entered into securities lending transactions. The System's securities custodian, as agent, manages the securities lending program and receives liquid collateral. At June 30, 2003, the collateral received represents 102.55% of the fair value of the securities lent.

Securities lending obligations for which collateral was received at June 30, 2003 and 2002 consisted of the following (in thousands):

	Fair Value of Securities 2003	2002
Securities Lent		
U.S. Corporate Bonds	$ 8,446	$ 3,953
U.S. Government	13,479	-
U.S. Equity	13,680	36,257
Total	$35,605	$39,850

4. Cash and Investments (continued)

The underlying collateral for these securities had a market value of approximately $36,512 and $40,864 thousand as of June 30, 2003 and 2002 and was invested as follows (in thousands):

	2003	2002
Asset Backed Commercial Paper	$ 4,893	$7,239
Reverse Repo U.S. Agency Delivered	25,915	797
Reverse Report Mortgage-backed In-party		-
Certificate of Deposit	951	-
Time Deposit	1,901	-
Promissory Note	2,852	-
Total	$36,512	

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

5. Investment in PRTA Holdings

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

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

5. Investment in PRTA Holdings (continued)

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

During the years ended June 30, 2003 and 2002, the System received $38 and $17.5 million, respectively, consisting of the dividends declared and paid by TELPRI.

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

As of June 30, 2003, the PRTA Holdings Preferred Stock is presented based on an estimated value as of June 30, 2003, of the TELPRI's stock, which consisted of an update of the certified appraisal made by an independent firm as of December 31, 2002.

As of June 30, 2003, the PRTA Holdings Preferred Stock is presented based on the estimated value of the TELPRI's stock as follows:

As of June 30,	2003	2002
Number of shares	7,000,000	7,000,000
Price per share	$51.81	$54.74
Total value (in thousands)	$362,670	$383,180

6. Capital Assets

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

Building and Improvements	50 years
Equipment	5-10 years

Capital assets activity for the year ended June 30, 2003 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets, not being depreciated:				
Land	$ 969	$ -	$ -	$ 969
Total capital assets, not being depreciated	969	-	-	969
Capital assets, being depreciated:				
Building and Improvements	7,631			7,631
Equipment	10,069	431	357	10,143
Total capital assets, being depreciated	17,700	431	357	17,774
Less accumulated depreciation for:				
Building and Improvements	2,892	113		3,004
Equipment	7,940	572	357	8,155
Total accumulated depreciation	10,832	685	357	11,159
Total capital assets, being depreciated, net	6,868	(254)	-	6,615
Capital assets, net	$ 7,837	$(254)	$ -	$ 7,583

7. Other Assets

At June 30, 2003 and 2002, other assets consisted of the following:

	2003	2002
	(In Thousands)	
Repossessed and foreclosed properties	$2,805	$2,569
Executed land	7,007	7,007
	$9,812	$9,576

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. Gain or loss is recognized at the time of sale. Differences resulting from recognition of losses at the point of sale rather than upon foreclosure, as required by generally accepted accounting principles, are not material. Management believes that the carrying value of these properties approximates its fair value.

On February 19, 1991, the Metropolitan Bus Authority (MBA), a government agency transferred to the System a lot of land located in Hato Rey, as settlement for its debt with the System related to employer and participants' contributions and loans payments withholdings from June 1985 through December 1988. Since then, the System leases this land to a third party that operates it as a parking facility. Rental income for 2003 and 2002 amounted to approximately $132,000 and $81,000, respectively, and is reflected as part of other income in the accompanying statements of changes in plan net assets. According to an independent appraisal dated August 1, 2001, the market value of this land approximates $22,550,000.

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

8. Guarantee Insurance Reserve for Loans to Plan Members

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

9. Commitments and Contingent Liabilities

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

10. Accounts Receivable from Employers

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

As of June 30, 2003 and 2002, the receivable from employers amounted to \$31.2 million and \$28.3 million, respectively.

11. Union of General Workers

On December 3, 2002 the Government Employees and Judiciary Retirement Systems signed an agreement with the Union of General Workers. This collective agreement empowers the Administrator and the Union to establish and negotiate an agreement that applies to all employees except directors, chiefs, supervisors and all personnel that manages confidential information. The collective agreement expires on December 2, 2005.

12. Subsequent Events

In June and July 2003, the Governor signed six laws that provided certain benefits to retirees as follows:

- Medicine bonus for \$100 paid in July 2003, payable annually every July.
- Increase in Christmas Bonus to \$400 to be paid in December 2003, payable annually every December.
- Increase in minimum pension payment to \$300 monthly, effective January 1, 2004.
- Increase in employer contribution for medical plan to \$100, effective January 1, 2004.
- Triennial 3% increase in all pensions, effective January 1, 2004.
- Increase in widow and/or beneficiaries benefit to 50% of the benefit received by the deceased pensioner, effective January 1, 2004.

12. Subsequent Events (continued)

All the benefits granted will be funded through legislative assignments in the General Fund with respect to Central Government's retired employees and by the Municipalities and Public Corporations with respect to their retired employees.

In August 2003, the System sold for $3.4 million 9,173.2698 square meters of the land it received in settlement of a debt, as explained in Note 7. As a result, the System will recognize a gain of approximately $500,000 during fiscal year 2004.

The Board of Trustees approved effective November 17, 2003 an increase in the amount granted on personal loans from $3,000 to $5,000. The System expects that this increase in loan limits will increase the loan portfolio to $400 million.

Supplemental Information

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

Schedule of Contributions
(Dollar amounts in Thousands)

June 30, 2003

Year Ended June 30	Annual Required Contributions	Contributions	Percentage Contributed
2001	$802,500	$547,400	68%
2000	890,800	527,400	59
1999	845,000	491,800	58
1998	777,800	502,100	65
1997	722,300	454,600	62
1996	677,200	402,200	59

See notes to schedules of trend information.

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

Schedule of Funding Progress
(Dollar amounts in Thousands)

June 30, 2003

Actuarial Valuation Date	Actuarial Value of Plan Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Annual Covered Payroll
7/1/2001	$2,428,664	$9,881,481	$7,452,817	25%	$2,549,447	292%
7/1/2000	2,041,800	9,459,300	7,417,500	22	2,463,400	301
7/1/1999	1,858,000	8,308,000	6,450,000	22	2,575,000	250
7/1/1998	1,675,000	7,638,000	5,963,000	22	2,366,000	252
7/1/1997	1,444,000	6,914,000	5,470,000	21	2,363,000	231
7/1/1996	1,230,000	6,320,000	5,090,000	19	2,223,000	229

See notes to schedules of trend information.

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

Notes to Schedules of Trend Information

June 30, 2003

1. Schedule of Funding Progress

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

2. Schedule of Contributions

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

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

3. Actuarial Data

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

Valuation Date	July 1, 2001
Actuarial Cost Method	Projected unit credit cost method
Amortization Method	Level percentage of the projected payroll
Remaining Amortization Period	25 years
Asset Valuation Method	Market value
Actuarial Assumptions:	
Investment rate of return*	8.5%
Projected salary increases*	5%
Mortality Rate	Group Annuity Table for 1951
Cost of living adjustment	3%, every three years for those increases granted in 1992 and 1998.

*Includes inflation at 3.5%