

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

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

Financial Statements

June 30, 2005 and 2004

(With Independent Auditors' Report Thereon)

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

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Independent Auditors' Report

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

We have audited the accompanying statements of plan net assets of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (formerly Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities) (note 1) (the System) as of June 30, 2005 and 2004, 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the financial statements referred to above present fairly, in all material respects, the net assets of the System at June 30, 2005 and 2004, and the changes in its net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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 11 and supplemental schedules of employers' contributions and funding progress presented on pages 40 through 42 are supplementary information required by the Governmental Accounting Standards Board, and are not a required part of the basic financial statements. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information contained in the Management's Discussion and Analysis and supplemental schedules and, therefore, express no opinion on them.

December 21, 2005

Zayas, Morazzani & Co.

Stamp No. 2107163 of the Puerto
Rico Society of Certified Public
Accountants was affixed to original.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Management's Discussion and Analysis
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Introduction

Within this section of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System or ERS) annual financial statements, the System's management provides a narrative discussion and analysis of the financial activities for the fiscal year ended June 30, 2005. The financial performance of the System is discussed and analyzed within the context of the accompanying financial statements and disclosures following this section.

Overview of the Financial Statements

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

Basic Financial Statements

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

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

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

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

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Financial Highlights

As of June 30, 2005, the System has \$2,503 million in total assets consisting, in summary of the following:

- \$1,367 million in marketable securities
- \$41 million in alternative investments
- \$486 million in the investment in PRTA Holdings Preferred Stock
- \$465 million in loans to participants
- \$8 million in real estate
- \$44 million in net cash and equivalents
- \$92 million in other net assets

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

- ERS assets exceeded liabilities by \$2,327,871,000 (net assets) for the fiscal year reported when compared to the prior year, for which assets exceeded liabilities by \$2,141,442,000.
- The fair value of ERS investments (excluding the Investment in PRTA Holdings Preferred Stock and participants' loans) at June 30, 2005 amounted to \$1,407,816,000 compared to \$1,310,835,000 at June 30, 2004.
- ERS funding ratio of the actuarial accrued liability at June 30, 2003 is 17 %.
- Investment in PRTA Holdings Preferred Stock at June 30, 2005 amounted to \$486,080,000 compared to \$404,390,000 at June 30, 2004.
- Participants' loans amounted to \$465,247,000 at June 30, 2005 compared to \$369,203,000 at June 30, 2004.

The financial statements of the System for the fiscal year ended June 30, 2005 present an increase in net assets as compared to the prior fiscal year of approximately \$186 million. This increase was mostly the result of an increase in the fair value of marketable securities of \$97 million, plus an increase in the fair value of the Investment in PRTA Holdings Preferred Stock of \$82 million and an increase of \$96 million in the loans portfolio, offset by a reduction in net cash of \$2 million, a decrease of \$5 million on account receivable and an increase of \$82 million in the liabilities.

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

For financial statements purposes, the amount of securities that as of June 30, 2005 were involved in the securities lending transactions was presented with the required disclosures, according to the current government accounting pronouncements. For the fiscal year 2005, income from the custodian securities lending activity amounted to approximately \$124,000.

Budget Highlights

For the fiscal year 2005, the Board of Trustees approved a budget of \$36.2 million for the administrative and operational expenses of the System. For the fiscal year 2006 the budget approved amounts to \$37.5 million.

Master Repurchase Agreement

The Board of Trustees approved on June 28, 2005 a Master Repurchase Agreement for the amount of \$150 million, of which only \$138 million were used as of June 30, 2005.

This alternative represents a collateralized borrowing and was used to cover the overdraft with the Department of Treasury. The transaction was recommended because of good collateral pricing, easy collateral transfer, weighted average rate cost less than L.I.B.O.R. and the Callan Associate Endorsement. This overdraft was mainly caused by the debt from Corporations, Municipalities and Central Government to the Employees' Retirement System.

The Repurchase Agreement was due on September 29th 2005, but it is renewable for 90 days.

Investment in PRTA Holdings Preferred Stock

As further explained in Note 6 of the financial statements, on June 24, 1998, the Senate and the House of Representatives issued Joint Resolution 209 to authorize the sale of 50% plus one stock of the Puerto Rico Telephone Company (PRTC) stock to a joint venture arranged by GTE Holdings (Puerto Rico) LLC (now, Verizon Communications) and Popular, Inc. (the Buyers). The Joint Resolution 209 further designated the use of the product of the Original Sale and ordered that the stock that was not

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sold on the Closing Date of the First Sale, as defined by the Resolution, be transferred to a subsidiary to be created by the Government Development Bank (GDB), to be held and disposed for the benefit of the Government Retirement System.

Subsequently, the GDB created a subsidiary, known as PRTA Holdings, to hold the remaining stock on behalf of the Government Retirement System. On December 28, 2000, PRTA Holdings issued and assigned its non-cumulative, non-voting preferred stock to the System, entitling the System to receive all the future benefits generated by the Puerto Rico Telephone Company (TELPRI) stock retained by the Government. During the fiscal years ended June 30, 2005 and 2004, the System received \$14.9 million and \$3.4 million, respectively, in dividends from TELPRI.

For financial statements purposes, as of June 30 2005, the investment in PRTA Holdings Preferred Stock is presented based on the estimated value as of December 31, 2004 of the TELPRI stock, considering 7,000,000 shares at \$69.44 per share for a total value of approximately \$486 million.

Funding Status

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

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

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

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

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

The System presented legislation on the increase in the employers and employees contributions. This increase will be in a 2 year scale level from 8.275% thru 10% for the employees and in a 5 year level from 9.275% thru 12.50% for the employers.

In fiscal years 2000 and 2001, the System reached its highest level of capitalization, having a 24% and 25%, respectively. Particularly in 2000, as the System marks its investments at market value, it recognized the double-digit positive returns on its investment portfolio that was directly related to the market performance during the years 1999 and early 2000. In fiscal year 2001, although already impacted by the market downturn phase that started in late 2000, the System recognized as part of its assets a contribution of \$701 million consisting of the investment owned by the Government in the Puerto Rico Telephone Company. The amount

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recognized was based on the appraisal value of the PRTC stock at December 31, 2000 as determined by an independent appraiser. At June 30, 2001 the recognition of that contribution offset the significant decrease in the System's total assets caused by the market downside.

As a result of the events of September 11, 2001 and afterwards, the corporate corruption cases, the market suffered further losses. Therefore, the System's investment portfolio market value decreased further as it happened to other retirement plans. In February 2002, an additional 15% of the PRTC stock was sold for \$172 million and the product was used to cover the System's cash flow needs for current pension payments. Meanwhile, the appraised value of the remaining shares of the PRTC stock dropped from \$529 million at June 30, 2001 to \$383 million at June 30, 2002 and to \$363 million at June 30, 2003. As of December 31, 2004, Telecomunicaciones de Puerto Rico, Inc. held by the ESOP is reasonably stated in the amount of \$69.44 per share, as expressed on a marketable minority basis, based on 25,000,000 shares issued and outstanding.

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

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

Facing an unstable market, in 2001 Management identified the need for a portfolio restructuring. The System's portfolio moved from a very aggressive allocation (75%) toward equities to a controlled allocation of a maximum of 65% in equities. To enhance the expected annual return, the strategy concentrated in the allocation of a 28% of the total portfolio to the participants' loans program with only 7% assigned to a core fixed income strategy. Those loans actually provide a higher return and lower risk in comparison to bonds, mostly because the System has the ability to rise the interest rates charged, the repayment comes from payroll

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deductions and the loans are guaranteed by participants' accumulated contributions. With the new asset allocation, the annual expected return is 9.81%, which adequately sustains the 8.5% discount rate used to compute the actuarial obligation.

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

The restructuring was completed in late calendar year 2002, and by the first and second quarters of 2003, the portfolio finally accomplished encouraging returns. For the semester ended June 30, 2003, the accumulated return was 8.84%, for fiscal years 2004 and 2005, the return was 16.64% and 9.18%, respectively. The new asset allocation is the one that fulfills the System's needs and since it is more adequately balanced, it provides protection in case of another market downturn.

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

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

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

Government has already contemplated and evaluated favorably the issuance of \$2,000 million in Pension Obligation Bonds and providing a step increase in the level of contributions to 10% to the employees in two years and to 12.5% to the employers in the next five years. If implemented, those two steps will improve the System's capitalization and will provide additional cash flow for the upcoming years.

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The budget of the government of the Commonwealth of Puerto Rico for the fiscal year 2005-2006 was not approved. As established by the Constitution, the same amounts budgeted for fiscal year 2004-2005 still in force. However, the System has to comply with certain special laws requiring the payments of certain benefits which amounts increased for 2005-2006. Since the required resources were not budgeted it is anticipated that the System will incurred in a deficit in the amount of \$39 million.

Increase in Economic Benefits for Retirees Established in fiscal years 2003, 2004 and 2005

For fiscal years 2003, 2004 and 2005, the Government of Puerto Rico granted several benefits and measures to the System's retirees to help them cope with the increase in the cost of living, which consisted of:

- Summer Bonus of \$100 payable annually every July, starting July 2003;
- Medicine Bonus of \$100 payable annually every July, starting July 2003;
- Increase in the Christmas Bonus from \$300 to \$400 annually every December, starting December 2003;
- Increase in the minimum monthly pension benefit from \$200 to \$300, effective January 1, 2004;
- Increase in the monthly employer contribution for the medical plan from \$40 to \$100, effective January 1, 2004;
- Two increases of 3% in all pensions effective on January 1, 2001 and January 1, 2004;
- Increase in the pension benefit for widows and/or beneficiaries from 30% to 50% of the benefit received by the deceased retiree, effective January 1, 2004.
- Increase in death benefit from \$750 to \$1,000;
- Increase in the Christmas Bonus from \$400 to \$500 annually every December, starting, December 2005.

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- On September 15, 2004 the Law 296 established that the refund paid to the employees who resign from the Commonwealth and retirees who receive the contribution plan would be deducted 10% for the Treasury Department.
- Increase from \$500 to \$550 and to \$600 in the Christmas Bonus for the retiree, effective on December 2006 and 2007 respectively.

Following the requirements established by Law 1 of February 16, 1990, these benefits are financed through legislative 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 180,000 active participants and 93,000 retirees and beneficiaries belonging to 140 different employers. It provides a range of close to 50 different types of services to its clientele, including pension applications, disability benefits, mortgage and personal loans and the collection and application of unpaid services. Because of that, our clientele frequently demands fast services, access to information and benefits orientation.

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

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

In December 2005 a new office for the Government Retirement System of P.R. was opened on Mayagüez.

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

Personal Loans Application

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

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

Requests for Information

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

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Statements of Plan Net Assets
June 30, 2005 and 2004
(In Thousands)

Assets	<u>2005</u>	<u>2004</u>
Cash and investments		
Cash and cash equivalents:		
Deposits at commercial banks	\$ 13,196	12,673
Deposits with Treasury Department of the Commonwealth	11,982	-
Deposits with Government Development Bank of Puerto Rico:		
Unrestricted	17,195	31,853
Restricted	1,578	1,140
	<u>18,773</u>	<u>32,993</u>
	43,951	45,666
Marketable securities at fair value:		
Bonds and notes	166,440	106,441
Stocks	1,200,132	1,162,762
Other investments	41,244	41,632
	<u>1,407,816</u>	<u>1,310,835</u>
Loans and interest receivable from plan members, net of allowance for losses	465,247	369,203
Investment in PRTA Holdings, at appraised value	486,080	404,390
Total Cash and Investments	<u>2,403,094</u>	<u>2,130,094</u>
Accounts receivable:		
Employers	34,655	32,656
General Fund of the Commonwealth of Puerto Rico	21,463	11,014
The Commonwealth of Puerto Rico Judiciary Retirement System	1,376	3,472
Investment sales	2,090	606
Accrued interest	2,209	2,288
Other	21,896	38,662
Total accounts receivable	<u>83,689</u>	<u>88,698</u>
Property and equipment, net	8,411	8,330
Other assets	<u>7,764</u>	<u>7,825</u>
Total assets	<u>\$ 2,502,958</u>	<u>2,234,947</u>

(Continued)

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

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Statements of Plan Net Assets
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(In Thousands)

<u>Liabilities</u>	<u>2005</u>	<u>2004</u>
Securities sold under agreements to repurchase	\$ 138,000	-
Book overdraft	-	58,028
Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members	20,366	19,887
Investment purchases	2,079	1,202
Other liabilities	14,642	14,388
Total liabilities	<u>175,087</u>	<u>93,505</u>
Net assets held in trust for pension benefits	\$ <u>2,327,871</u>	<u>2,141,442</u>

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

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Statements of Changes in Plan Net Assets
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(In Thousands)

	2005	2004
Additions:		
Contributions:		
Employers	\$ 374,823	330,336
Participating employees	332,376	294,013
Legislative Assignments under Law 127	14,731	14,553
	<u>721,930</u>	<u>638,902</u>
Investment income:		
Net appreciation on investments	186,643	258,702
Dividend income	19,112	6,693
Interest income	49,917	43,795
	<u>255,672</u>	<u>309,190</u>
Less: Investment expenses	3,750	3,058
	<u>251,922</u>	<u>306,132</u>
Other income	7,925	6,860
Total additions	981,777	951,894
Deductions:		
Annuities	713,814	672,578
Benefits under Law 127	14,731	14,553
Death benefits	10,894	11,099
Refunds:		
Employers	1,734	1,220
Participating employees	17,947	18,769
	<u>19,681</u>	<u>19,989</u>
Net adjustments in the conversion to a new loan application (note 5)	-	8,107
Administrative expenses	36,228	31,528
Total deductions	<u>795,348</u>	<u>757,854</u>
Net increase in assets held in trust for pension benefits	186,429	194,040
Net assets held in trust for pension benefits:		
Beginning of year	2,141,442	1,947,402
End of year	\$ 2,327,871	2,141,442

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

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

Organization

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

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

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

Basis of Presentation

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

(Continued)

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Notes to Financial Statements

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

Use of Estimates

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

Cash and Cash Equivalents

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

Marketable Securities

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

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

Marketable Securities, Continued

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

Loans to Plan Members

Mortgage, personal and cultural trip loans to plan members are stated at their outstanding principal balance. Maximum amounts that may be granted to plan members for mortgage, personal and cultural trip loans are \$100,000, \$5,000 and \$5,000, respectively.

The System services mortgage loans with aggregate principal balances of approximately \$16,994,000 and \$19,989,000 at June 30, 2005 and 2004, respectively, related to certain mortgages loans sold to FNMA for a fee of 0.25%. The income for 2005 and 2004 amounted to \$44,935 and \$49,571, respectively, and is recognized as interest income in the accompanying statement of changes in plan net assets.

In addition, at June 30, 2005 and 2004, the System repurchased approximately \$80,000 and \$148,000, 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.

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EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Financial Statements

(2) Plan Description

The System is a cost-sharing multi-employer defined benefit plan sponsored by the Commonwealth. Substantially all full-time employees of the Commonwealth and its Instrumentalities (Central Government Agencies, Municipalities and Public Corporations, including the System) are covered by the System under the terms of the Act No. 447 of 1951. All regular, appointed and temporary employees of the Commonwealth at the date of employment become plan members of the System. The System is optional for Government officers appointed by the Governor and Head of Agencies. At June 30, 2005 and 2004, membership consisted of the following:

	<u>2005</u>	<u>2004</u>
Retirees and beneficiaries		
currently receiving benefits	93,103	91,830
Current participating employees	<u>138,089</u>	<u>126,297</u>
Total membership	<u>231,192</u>	<u>218,127</u>

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

Retirement Annuity

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

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

Other Employees:
55 with 25 years of credited service
58 with 10 years of credited service

(Continued)

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

(2) Plan Description, Continued

Plan members are eligible for monthly benefit payments determined by the application of stipulated benefit ratios to the plan member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by the System. The annuity, for which a plan member is eligible, is limited to a minimum of \$300 per month and a maximum of 75% of the average compensation.

Merit Annuity

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

Deferred Retirement Annuity

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

Coordinated Plan

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

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

(Continued)

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

(2) Plan Description, Continued

Non-Coordinated Plan

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

Reversionary Annuity

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

Occupational Disability Annuity

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

Non-occupational Disability Annuity

A participating employee totally and permanently disabled for causes not related to his/her occupation, and with no less than 10 years of credited service, is eligible for an annuity of 1.5% of the average compensation of the first 20 years of credited services increased by 2% for every additional year of credited service in excess of 20 years.

(Continued)

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

(2) Plan Description, Continued

Death Benefits

Occupational:

- Surviving spouse - annuity equal to 50% of the participating employee's salary at the date of the death.
- Children - \$10 per month for each child, minor or student, up to a maximum benefit per family of 100% of the participating employee's salary at the date of the death. If no spouse survives, or dies while receiving the annuity payments, each child, 18 or under, is eligible to receive an annuity of \$20 per month up to the attainment of 18 years of age or the completion of his/her studies.

Non-occupational:

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

Post-retirement:

- Beneficiary with surviving spouse age 60 or over and child, 18 or under, up to 50% (60%, if not covered under Title II of the Social Security Act) of retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of \$750.

Refunds

A participating employee who ceases his/her employment with the Commonwealth without right to a retirement annuity has the right to a refund of the contributions to the System plus any interest earned thereon.

(Continued)

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

(2) Plan Description, Continued

Amendments to Benefits Structure for Plan Members Who Joined the System on or After April 1, 1990

Act No. 1 of February 16, 1990 made certain amendments applicable to new participating employees joining the System effective April 1, 1990. These changes consist principally of an increase in the retirement age from 55 to 65, a decrease in the benefit percentage of the average compensation in the occupational disability and occupational death benefits annuities from 50% to 40%, and the elimination of the Morit Annuity for participating employees (except policemen and firemen) who have completed 30 years of creditable service.

Cost of Living Adjustment for Pension Benefits

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

Early Retirement Programs

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

(Continued)

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

(2) Plan Description, Continued

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

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

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

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there will be a pool of plan assets, which will be invested by the System, together with those of the current defined benefit plan. The Commonwealth will not guarantee benefits at retirement age. The annuity will be based on a formula which assumes that each year the employee's contribution (with a minimum of 0.275% of the employee's salary up to a maximum of 10%) will be invested as instructed by the employee in an account which either: (1) earns a fixed rate based on the two-year Constant Maturity Treasury Notes or, (2) earns a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (3) earns a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability benefits are not granted under System 2000, rather should be provided to those participants that voluntarily elect to participate in a private insurance long-term disability program. The employers' contributions (9.275% of the employee's salary) with respect to employees under System 2000 will continue but will be used to fund the defined benefit plan.

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

(Continued)

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

(2) Plan Description, Continued

At June 30, 2005 and 2004, System 2000 membership within the System's total membership consisted of the following:

	<u>2005</u>	<u>2004</u>
Current participating employees	<u>41,545</u>	31,463

(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 \$112.4 million and \$137.8 million in 2005 and 2004, respectively to cover special laws. The grants are accounted as a reduction of benefits payments, except for approximately \$14.7 million and \$14.6 million in 2005 and 2004, respectively, which are granted under the provisions of Law No. 127 of 1958, that covers the occupational disability of firemen, policemen and other personnel disabled during high risk circumstances.

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

(Continued)

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

(3) Funding Policy, Continued

Up to June 30, 2005, the System had to cover approximately \$77.4 million from its resources that should have been received through special laws. Of this amount \$17.5 million are included in the financial statements as receivables from the Commonwealth, the remaining amount has not been accrued pending a final revision by the System and the acceptance by the Office of Management and Budget of the Commonwealth.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2003, using the projected unit credit actuarial cost method. Significant assumptions underlying the actuarial computations include: (a) assumed rate of return on investments of 8.5%, (b) assumed compound rate of wage increases of 5% per year, and (c) assumed mortality rate based on the Group Annuity Table for 1983.

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

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

As an employer, the System has contributed \$1,506,000 and \$1,287,000 which represented its contractually required contribution for the years ended June 30, 2005 and 2004, respectively.

(Continued)

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

(4) Cash and Investments

Cash Deposits

At June 30, 2005, the aggregate carrying amount of cash deposits and cash equivalents held by the System was approximately \$44.0 million, which includes \$13.2 million at commercial banks, \$18.8 million at the Government Development Bank for Puerto Rico (GDB) and \$12.0 million at Treasury Department of the Commonwealth of Puerto Rico. At June 30, 2004, the aggregate carrying amount of cash deposits and cash equivalents held by the System was an overdraft of approximately \$12.3 million, which includes \$12.7 million at commercial banks, \$33.0 million at GDB reduced by an overdraft of \$58.0 million at Treasury Department.

The following table presents the carrying amount and the corresponding depository bank balances as of June 30, 2005 and 2004 (in thousands):

	2005	
	<u>Carrying Amount</u>	<u>Depository Bank Balance</u>
Deposits at commercial banks	\$ 13,196	13,196
Deposits with Treasury Department	11,982	(95,540)
Deposits with GDB:		
Unrestricted	17,195	14,414
Restricted	<u>1,578</u>	<u>1,578</u>
	<u>18,773</u>	<u>15,992</u>
	<u>\$ 43,951</u>	<u>(66,352)</u>
	2004	
	<u>Carrying Amount</u>	<u>Depository Bank Balance</u>
Deposits at commercial banks	\$ 12,673	12,673
Deposits with Treasury Department	(58,028)	26,746
Deposits with GDB:		
Unrestricted	31,853	47,101
Restricted	<u>1,140</u>	<u>1,136</u>
	<u>32,993</u>	<u>48,237</u>
	<u>\$ (12,362)</u>	<u>87,656</u>

(Continued)

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

(4) Cash and Investments, Continued

The \$13.2 million and the \$12.7 million deposited at commercial banks for years 2005 and 2004, respectively, are insured by the Federal Deposit Insurance Corporation up to \$100,000 or collateralized with securities held on behalf of the System by the Secretary of the Treasury of the Commonwealth of Puerto Rico, or the Secretary's agent in the name of the Secretary.

As of June 30, 2005 and 2004, funds deposited at GDB for \$16.0 million and \$48.2 million, respectively, are uninsured and uncollateralized.

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, 2005 and 2004, cash consists of deposits in banks and is categorized following the "Guide to Implementation of GASB No. 3, "Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements", as amended.

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

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

(Continued)

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

(4) Cash and Investments, Continued

Custodial Credit Risk Related To Deposits

Custodial credit risk is the risk that, in the event of a bank failure, the System's deposits might not be recovered. As of June 30, 2005 and 2004, \$16.0 million and \$75.0 million, respectively, of the System's deposit balance of \$(66,352) million and \$87,656 million, respectively, was exposed to custodial credit risk since it was uninsured and uncollateralized.

Investments

The following table shows the fair value of the investments in marketable securities held by the System as of June 30, 2005 and 2004 (in thousands):

Investment Type	2005	
	Fair Value	Weighted Average Maturity (Years)
U.S. Treasury securities	\$ 64,552	0.14
U.S. Government agencies securities	25,127	0.74
Collateralized mortgage obligations	9,783	0.22
Corporate bonds	66,978	4.46
Domestic mutual funds	580,524	N/A
International mutual funds	334,275	N/A
Domestic corporate stocks	285,333	N/A
Alternative Investments	41,244	N/A
Total	\$ 1,407,816	5.56

Investment Type	2004	
	Fair Value	Weighted Average Maturity (Years)
U.S. Government agencies securities	\$ 10,067	1.41
Collateralized mortgage obligations	13,258	0.74
Corporate bonds	83,116	9.36
Domestic mutual funds	601,853	N/A
International mutual funds	296,562	N/A
Domestic corporate stocks	264,347	N/A
Alternative Investments	41,632	N/A
Total	\$ 1,310,835	11.51

(Continued)

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

(4) Cash and Investments, Continued

Investments, Continued

Alternative Investments include the following:

	<u>Date of Commitment</u>	<u>Total Commitment</u>	<u>Contri- butions To Date</u>	<u>Cost</u>	<u>Fair Value</u>
Grupo Guayacán, Inc.					
Guayacán Fund of Funds, LP	Sept. 1996	\$25,000,000	21,279,009	17,045,140	11,894,010
Guayacán Fund of Funds II, LP	Aug. 1999	25,000,000	19,639,466	10,220,425	14,019,694
Advent-Morro Equity Partner, Inc.					
Guayacán Private Equity Fund, LP	Jan. 1997	5,000,000	3,930,022	2,037,871	3,901,919
Venture Capital Fund, Inc.	Nov. 1995	800,000	800,000	800,000	\$24,000
Chase Capital Partners Equity Fund of Funds Corporate Investors II, LTD	July 2000	20,000,000	14,040,865	12,160,234	10,103,940
Martineau Bay Resort, S. en C. (S.E.)	July 1998	1,735,750	1,735,750	1,735,750	-
Total alternative investments		\$77,535,750	64,485,212	53,029,550	41,243,583

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

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

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.

(Continued)

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

(4) Cash and Investments, Continued

Credit Risk

The System's investment policy limits the investment in corporate debt securities to the top ratings issued by nationally recognized statistical rating organizations. The policy requires the debt securities portfolio to maintain a minimum weighted average credit quality of either "A" or better using either Standard & Poor's or Moody's Credit Ratings.

Custodial Credit Risk Related to Investments

Investments held by financial institutions are subject to custodial credit risk when they are uninsured or unregistered securities. These may be classified in one of the following three categories:

- Category A: Uninsured and unregistered investments held by the governmental entity or held by the governmental entity's agent in the name of the governmental entity.
- Category B: Uninsured or unregistered investments held in the name of the governmental entity, but held by the counterparty's trust department or the counterparty's agent.
- Category C: Uninsured and unregistered investments held by the counterparty, the counterparty's trust department, or the counterparty's agent, but not held in the governmental entity's name.

(Continued)

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

(4) Cash and Investments, Continued

Custodial Credit Risk Related to Investments, Continued

As of June 30, 2005 and 2004, the System's investments held by financial institutions were exposed to custodial credit risk as follows:

	<u>2005</u>	<u>2004</u>
Uninsured and unregistered investments held by the governmental entity's agent in the name of the governmental entity.	\$ 1,366,572	1,269,203
Uninsured or unregistered investments held in the name of the governmental entity, but held by the counterparty's trust department or the counterparty's agent.	-	-
Uninsured or unregistered investments held by the counterparty, the counterparty's trust department, or the counterparty's agent, but not held in the governmental entity's name.	<u>41,244</u>	<u>41,632</u>
	\$ <u>1,407,816</u>	<u>1,310,835</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.

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, 2005 and 2004, the collateral received represents 103.27% and 103.15%, respectively, of the fair value of the securities lent.

(Continued)

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

(4) Cash and Investments, Continued

Securities Lending Transactions, Continued

Securities lending obligations for which collateral was received at June 30, 2005 and 2004 consisted of the following (in thousands):

	<u>Fair Value</u>	
	<u>2005</u>	<u>2004</u>
Securities Lent:		
U.S. Corporate Bonds	\$ -	10,188
U.S. Equity	<u>63,150</u>	<u>77,704</u>
Total	\$ <u>63,150</u>	<u>87,892</u>

The underlying collateral for these securities had a market value of approximately \$65,218 and \$90,663 thousand as of June 30, 2005 and 2004 and was invested as follows (in thousands):

	<u>2005</u>	<u>2004</u>
Asset Backed Commercial Paper	\$ 19,037	14,386
Reverse Repo U.S. Agency Delivered	6,680	-
Reverse Repo Government Delivered	-	66,686
Reverse Repo Mortgage Backed Tri-party	39,501	-
Master Note	<u>-</u>	<u>9,591</u>
Total	\$ <u>65,218</u>	<u>90,663</u>

The System has very low credit risk exposure to borrowers. The System's rights to collateral are defined in the contractual agreement. There is 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.

(Continued)

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

(5) Loans and Interest Receivable from Plan Members

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

The process allowed the determination of the balance of interest and charges receivable. For prior years the amount corresponding to interest was not identifiable since the former system did not allow such determination.

The System was also involved in the identification and validation of a portfolio of loans that was not activated in the former system, but was part of the balance recorded in books.

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

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

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

	<u>2005</u>	<u>2004</u>
Loans receivable:		
Mortgage	\$ 82,295	\$ 72,375
Personal	362,668	286,944
Cultural trips	<u>19,750</u>	<u>16,245</u>
Total loans to plan members	464,713	375,564
Accrued interest receivable	<u>14,771</u>	<u>7,876</u>
	479,484	383,440
Less: Allowance for adjustments and losses in realization	<u>(14,237)</u>	<u>(14,237)</u>
Total loans and interest receivable, net	\$ <u>465,247</u>	\$ <u>369,203</u>

(Continued)

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

(6) Investment in PRTA Holdings

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

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

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

During the years ended June 30, 2005 and 2004, the System received \$14.9 and \$3.5 million, respectively, consisting of the dividends declared and paid by TELPRI.

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

(Continued)

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

(6) Investment in PRTA Holdings, Continued

As of June 30, 2005, the PRTA Holdings Preferred Stock is presented based on its estimated value per the most recent certified appraisal made by an independent firm as of December 31, 2004.

As of June 30,	2005	2004
Number of shares	7,000,000	7,000,000
Estimated price per share	\$ <u>69.44</u>	\$ <u>57.77</u>
Total value (in thousands)	\$ <u>486,080</u>	\$ <u>404,390</u>

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

(7) Capital Assets

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

Building and Improvements	50 years
Equipment	5-10 years

(Continued)

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

(7) Capital Assets, Continued

Capital assets activity for the year ended June 30, 2005 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	11,731	950	4	12,677
Total capital assets, being depreciated	19,362	950	4	20,308
Less accumulated depreciation for:				
Building and improvements	3,117	112	-	3,229
Equipment	8,884	753	-	9,637
Total accumulated depreciation	12,001	865	-	12,866
Total capital assets, being depreciated, net	7,361	85	4	7,442
Capital assets, net	\$ 8,330	85	4	8,411

(8) Other Assets

At June 30, 2005 and 2004, other assets consisted of the following:

	2005 (In thousands)	2004
Reposessed and foreclosed properties	\$ 3,065	3,126
Executed land	4,699	4,699
Total	\$ 7,764	7,825

(Continued)

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Financial Statements

(8) Other Assets, Continued

Reposessed and foreclosed properties consist mainly of properties acquired through foreclosure proceedings related to delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage loan upon foreclosure. These properties will be sold under a bidding process intended to recover the outstanding principal balance of the related mortgage loan. Gain or loss is recognized at the time of sale. Differences resulting from recognition of losses at the point of sale rather than upon foreclosure, as required by accounting principles generally accepted in the United States of America, are not material. Management believes that the carrying value of these properties approximates its fair value.

On February 19, 1991, the Metropolitan Bus Authority (MBA), a government agency transferred to the System a lot of land located in Hato Rey, as settlement for its debt with the System related to employer and participants' contributions and loans payments withholdings from June 1985 through December 1988. Since then, the System leases this land to a third party that operates it as a parking facility. Rental income for 2005 and 2004 amounted to approximately \$144,000 for each year and is reflected as part of other income in the accompanying statements of changes in plan net assets.

In 1998, part of the land was 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.

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

As of June 30, 2005, a total of 14,618.0987 square meters of land remain. According to an independent appraisal as of June 8, 2005, the estimated market value of this land approximates \$22,875,000.

(Continued)

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

(9) Securities Sold Under Agreements to Repurchase

At June 30, 2005, securities underlying agreements to repurchase were delivered to, and are being held by, the counterparties with whom the repurchase agreements were transacted. The counterparties have agreed to resell to the System the same securities at the maturity of the agreements. The System may be required to provide additional collateral based on the fair value of the underlying securities. The following table presents the liability associated with the repurchase transactions, the amortized cost and market value of the collateral as of June 30, 2005 (in thousands):

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

The System initiated these repurchase agreements on June 29, 2005 with a maturity date of September 29, 2005. Subsequent to the date of the auditors' report these repurchase transactions were renewed for ninety days with a maturity date of December 29, 2005. At June 30, 2005, the weighted average interest rate of the System's repurchase agreement was 3.44%.

(10) 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.

(Continued)

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

(11) 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.

(12) 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, 2005 and 2004, the receivable from employers amounted to \$34.6 million and \$32.6 million, respectively.

(13) 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 expired on November 30, 2005. As of the date of the auditors' report the negotiations of a new agreement were in process.

SUPPLEMENTARY SCHEDULE
OF TREND INFORMATION

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Schedule of Contributions
(Dollar amounts in Thousands)
June 30, 2005

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

See notes to schedule of trend information.

SUPPLEMENTARY SCHEDULE
OF TREND INFORMATION

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Schedule of Funding Progress
(Dollar amounts in thousands)
June 30, 2005

Actuarial Valuation Date	Actuarial Value of Plan Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Annual Covered Payroll	UAAL as a Percentage of Annual Covered Payroll
7/1/2003	\$ 1,947,402	\$ 11,191,357	\$ 9,243,955	17%	\$ 3,334,441	277%
7/1/2001	2,428,664	9,881,481	7,452,817	25	2,549,447	292
7/1/2000	2,041,800	9,459,300	7,417,500	22	2,463,400	301
7/1/1999	1,858,000	8,308,000	6,450,000	22	2,575,000	250
7/1/1998	1,675,000	7,638,000	5,963,000	22	2,366,000	252
7/1/1997	1,444,000	6,914,000	5,470,000	21	2,363,000	231
7/1/1996	1,230,000	6,320,000	5,090,000	19	2,223,000	229

See notes to schedule of trend information.

SUPPLEMENTARY SCHEDULE
OF TREND INFORMATION

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
Notes to Schedules of Trend Information
June 30, 2005

(1) Schedule of Funding Progress

The Schedule of Funding Progress provides information about the funded status of the System and the progress being made in accumulating sufficient assets to pay benefits when due. The information was obtained from the last actuarial report as of June 30, 2003.

(2) Schedule of Contributions

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

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

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

(3) Actuarial Data

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

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

* Includes inflation at 3.5%