

# GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

## Tax-Exempt Commercial Paper

### 2004 Program

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In the opinion of Sidley Austin Brown & Wood LLP, Issuer's Counsel, subject to certain conditions described under *Tax Exemption*, under the provisions of the Acts of Congress now in force, interest on the 2004 Program Notes offered hereunder will be exempt from federal income tax, and such Notes and the interest thereon will be exempt from state, Commonwealth and local income taxation. However, see *Tax Exemption* for a description of alternative minimum tax consequences with respect to interest on such Notes, other tax considerations and other matters.

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THE 2004 PROGRAM NOTES ARE UNSECURED AND UNSUBORDINATED INDEBTEDNESS OF THE ISSUER AND SHALL BE ON A PARITY WITH ALL OTHER GENERAL UNSECURED AND UNSUBORDINATED OBLIGATIONS OF THE ISSUER FOR BORROWED MONEY AND WITH UNSECURED AND UNSUBORDINATED ISSUER GUARANTEES OF OBLIGATIONS FOR BORROWED MONEY OF OTHERS NOW OR HEREAFTER OUTSTANDING.

NEITHER THE CREDIT OF THE COMMONWEALTH NOR THAT OF ANY OF ITS POLITICAL SUBDIVISIONS OR INSTRUMENTALITIES WILL BE PLEDGED FOR THE PAYMENT OF THE 2004 PROGRAM NOTES.

February 1, 2004

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## IMPORTANT NOTICE

This Information Memorandum contains summary information provided by Government Development Bank for Puerto Rico (the “Issuer” or “GDB”) in connection with its Tax-Exempt Commercial Paper, 2004 Program (the “2004 Program”). The 2004 Program will cover notes issued during the 18-month period beginning on the first date of issuance of such notes to finance capital expenditures as well as notes issued during such 18-month period to refinance, directly or through a series of refinancings, notes originally issued to finance capital expenditures. The Issuer may issue and have outstanding at any one time short term taxable and tax-exempt promissory notes or refunding notes up to a maximum aggregate amount of \$2,000,000,000. The amount of the Notes to be issued and outstanding under the 2004 Program (the “2004 Program Notes”), together with all other outstanding notes of the Issuer that are sold pursuant to the Issuer’s other commercial paper programs, will not exceed this maximum authorized aggregate amount. The Resolution also authorizes Subsequent Program Tax-Exempt Notes issued pursuant to a Subsequent Program. Except as described in the Section entitled “Tax Exemption”, Information Memorandum does not address Subsequent Program Tax-Exempt Notes. The Issuer has appointed Banc of America Securities LLC, Citigroup Global Markets Inc., Lehman Brothers Inc. and Morgan Stanley & Co. Incorporated (the “Dealers”) as its dealers for the 2004 Program Notes under the Program and has authorized and requested the Dealers to circulate this Information Memorandum in connection therewith.

The Issuer has confirmed to the Dealers that the information contained in this Information Memorandum, when read in conjunction with the most recently published annual report and accounts of the Issuer (copies of which may be obtained from any of the Dealers on request) and any subsequent interim statements concerning the Issuer, is in all material respects true, accurate and not misleading.

The Dealers have not independently verified the information contained herein. Accordingly, no representation, warranty or undertaking (express or implied) is made and no responsibility or liability is accepted by the Dealers as to the accuracy or completeness at any time of this Information Memorandum or any supplement hereto. No person has been authorized by the Issuer or the Dealers to give any information or to make any representation not contained in this Information Memorandum or any supplement hereto, and, if given or made, such information or representation must not be relied upon as having been authorized. This Information Memorandum should not be considered as a recommendation by any of the Dealers that any recipient hereof should purchase any of the 2004 Program Notes. Potential purchasers should determine for themselves the relevance of the information contained in this Information Memorandum, and their interest in the purchase of any Notes should be based upon such investigation as they deem necessary.

This Information Memorandum does not, and is not intended to, constitute or contain an offer or invitation to any person to purchase 2004 Program Notes. The distribution of this Information Memorandum and the offering for sale of the 2004 Program Notes in certain jurisdictions may be restricted by law. Any persons into whose possession this Information

Memorandum or any 2004 Program Notes come are required by the Issuer and the Dealers to inform themselves of, and to observe, any such restrictions. In particular, such persons are required to comply with the restrictions on offers or sales of 2004 Program Notes and on distribution of this Information Memorandum and other offering materials in relation to the 2004 Program Notes. The 2004 Program Notes are exempt from registration under the Securities Act of 1933 of the United States of America, as amended.

Each investor should review the Section entitled “Tax Exemption” for information about the treatment for taxation purposes of payments or receipts in respect of the 2004 Program Notes, and, furthermore, each investor contemplating acquiring 2004 Program Notes under the 2004 Program described herein is advised to consult a professional adviser in connection therewith.

**SUMMARY OF THE TERMS OF THE NOTES ISSUED UNDER  
THE 2004 COMMERCIAL PAPER PROGRAM**

- Issuer:** Government Development Bank for Puerto Rico.
- Amount:** All short-term notes of the Issuer sold pursuant to the Issuer's commercial paper programs, including the notes issued under the 2004 Commercial Paper Program and any other program as described herein, may not exceed \$2,000,000,000.
- Ratings:** Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc.: A-1.
- Form of the Notes:** 2004 Program Notes will be issued in book-entry form through the book-entry system of The Depository Trust Company. A Specimen of the Master Note is attached as Appendix B hereto.
- Term of Notes:** Not less than 1 day and not more than 270 days without any provision for automatic rollover (with no maturity date being later than 30 years from the date of the initial issuance of the 2004 Program Notes).
- Security for the Notes:** The 2004 Program Notes are unsecured and unsubordinated indebtedness of the Issuer and shall be on a parity with all other general unsecured and unsubordinated obligations of the Issuer for borrowed money, and with unsecured and unsubordinated Issuer guarantees of obligations for borrowed money of others now or hereafter outstanding. Neither the credit of the Commonwealth nor that of any of its political subdivisions or instrumentalities will be pledged for the payment of said Notes.
- Governing Law:** All rights and obligations under the Notes issued under the 2004 Commercial Paper Program will be governed by and construed in accordance with Puerto Rico law.
- Issuing and Paying Agent:** Citibank, N.A., 111 Wall St., 5th Floor, New York, NY 10043.
- Dealers:** Banc of America Securities LLC, Citigroup Global Markets Inc., Lehman Brothers Inc., Morgan Stanley & Co. Incorporated.
- Tax-Exemption:** In the opinion of Sidley Austin Brown & Wood LLP, Issuer's Counsel, subject to continuing compliance by the Issuer and the Borrowers with certain tax covenants referred to herein, under the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the 2004 Program Notes is not includable in gross income for federal income tax purposes. Interest on such Notes is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and

corporations; however, interest on the 2004 Program Notes will be includable in the computation of the alternative minimum tax imposed on corporations by the Code. Issuer's Counsel is further of the opinion that such Notes and the interest thereon are exempt from state, Commonwealth and local income taxation. The 2004 Program Notes are notes issued during the 18-month period beginning on the first date of issuance of such notes to finance capital expenditures as well as notes issued during such 18-month period to refinance, directly or through a series of refinancings, notes originally issued to finance capital expenditures. See *Tax Exemption* for a description of these and other tax considerations, among other matters.

**GOVERNMENT DEVELOPMENT BANK  
FOR PUERTO RICO  
Tax-Exempt Commercial Paper, 2004 Program**

**INTRODUCTION**

This Information Memorandum of Government Development Bank for Puerto Rico (the “Issuer” or “GDB”), which includes the cover page and the appendices, is provided to furnish information with respect to its Government Development Bank for Puerto Rico Tax-Exempt Commercial Paper, 2004 Program (the “2004 Program”). The 2004 Program will cover notes issued during the 18-month period beginning on the first date of issuance of such notes to finance capital expenditures as well as notes issued during such 18-month period to refinance, directly or through a series of refinancings, notes originally issued to finance capital expenditures (the “2004 Program Notes”). The 2004 Program Notes will be issued pursuant to a Resolution adopted by the Issuer on June 28, 2002 (the “Resolution”). The amount of the 2004 Program Notes to be issued and outstanding under the 2004 Program, together with all other outstanding notes of the Issuer sold pursuant to separate commercial paper programs (the interest on which other notes may or may not be excludable from gross income for federal income tax purposes), will not exceed at any one time a maximum authorized aggregate amount of \$2,000,000,000.

**THE 2004 PROGRAM NOTES**

The 2004 Program Notes are issued pursuant to the Resolution and other applicable provisions of law. The 2004 Program Notes will be issued in the form of a Master Note payable to The Depository Trust Company (“DTC”), or its nominee. The 2004 Program Notes will be issued through such book-entry system in denominations of \$100,000 and multiples thereof. The 2004 Program Notes will not mature earlier than one day or later than 270 days, without any provision for automatic rollover, from their respective dates of issuance (with no maturity date being later than 30 years from the date of the initial issuance of the 2004 Program Notes).

**SECURITY FOR THE 2004 PROGRAM NOTES**

THE 2004 PROGRAM NOTES ARE UNSECURED AND UNSUBORDINATED INDEBTEDNESS OF THE ISSUER AND SHALL BE ON A PARITY WITH ALL OTHER GENERAL UNSECURED AND UNSUBORDINATED OBLIGATIONS OF THE ISSUER FOR BORROWED MONEY AND WITH UNSECURED AND UNSUBORDINATED ISSUER GUARANTEES OF OBLIGATIONS FOR BORROWED MONEY OF OTHERS NOW OR HEREAFTER OUTSTANDING. NEITHER THE CREDIT OF THE COMMONWEALTH OF PUERTO RICO (THE “COMMONWEALTH”) NOR THAT OF ANY OF ITS POLITICAL SUBDIVISIONS OR INSTRUMENTALITIES WILL BE PLEDGED FOR THE PAYMENT OF THE 2004 PROGRAM NOTES.

## **USE OF PROCEEDS**

The proceeds of the 2004 Program Notes will be used to lend funds to, and purchase obligations of, the Commonwealth and its public corporations (collectively, the “Borrowers”), including advances to the Borrowers in anticipation of future bond issuances, for the purpose of financing their respective capital improvements. The proceeds of the 2004 Program Notes will not be used by the Issuer to lend funds to the private sector. However, the Issuer is authorized to lend funds to the private sector, and may, in certain circumstances, use proceeds from the sale of notes sold pursuant to separate commercial paper programs for this purpose.

## **BOOK-ENTRY ONLY SYSTEM**

The information concerning DTC’s book-entry system has been obtained from DTC, and neither the Issuer nor the Dealers take any responsibility for the accuracy thereof.

DTC, New York, New York, will act as securities depository for the 2004 Program Notes. One fully registered note will be issued and registered in the name of Cede & Co., DTC’s partnership nominee, in the aggregate principal amount of the 2004 Program Notes and will be deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (“Participants”) deposit with DTC. DTC also facilitates the settlement among Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in Participants’ accounts, thereby eliminating the need for physical movement of securities. “Direct Participants” include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others, such as securities brokers and dealers, banks, and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). The Rules applicable to DTC and its Participants are on file with the Securities and Exchange Commission.

Purchases of 2004 Program Notes under the DTC system must be made by or through Direct Participants, which will receive a credit for the 2004 Program Notes purchased by or through such Participant on DTC’s records. The ownership interest of each actual purchaser of a 2004 Program Note (“Beneficial Owner”) is in turn to be recorded on the Direct and Indirect Participants’ records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the

transaction. Transfers of ownership interests in the 2004 Program Notes are to be accomplished by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive definitive 2004 Program Notes, except in the event that use of the book-entry system for the 2004 Program Notes is discontinued.

To facilitate subsequent transfers, all 2004 Program Notes deposited by Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. The deposit of 2004 Program Notes with DTC and their registration in the name of Cede & Co. effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the 2004 Program Notes; DTC's records reflect only the identity of the Direct Participants to whose accounts such Notes are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Neither DTC nor Cede & Co. will consent or vote with respect to 2004 Program Notes. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts 2004 Program the Notes are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal payments and interest payments, if any, on the 2004 Program Notes will be made to DTC. Interest on the 2004 Program Notes will be calculated on the basis of the actual number of days elapsed in a year of 365 (or 366) days. DTC's practice is to credit Direct Participants' accounts on payable date in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on payable date. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, Citibank, N.A. (the "Issuing and Paying Agent"), or the Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC is the responsibility of the Issuer or the Issuing and Paying Agent, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the 2004 Program Notes at any time by giving reasonable notice to the Issuer or the Issuing and Paying Agent. Under such circumstances, in the event that a successor securities depository is not obtained, definitive 2004 Program Notes are required to be printed and delivered.

The Issuer may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event also, definitive 2004 Program Notes will be printed and delivered.

In the event the system of book-entry transfers is discontinued the following provisions will apply: The 2004 Program Notes will be dated the date of their respective authentication and issuance and will be issued in bearer form in denominations of \$100,000 and multiples thereof. The 2004 Program Notes will bear interest from their respective dates of issuance at the respective rates stated on the face of the 2004 Program Notes, but shall not exceed the maximum rate permitted under applicable Commonwealth law (currently 12% per annum), and will be payable on the maturity date stated on the face of the 2004 Program Notes or will be issued at a discount and not bear interest or bear interest at a variable rate, but in either case shall not have an effective interest rate that exceeds the maximum rate permitted under applicable Commonwealth law (currently 12% per annum). Interest on the 2004 Program Notes will be calculated on the basis of the actual number of days elapsed in a year of 365 (or 366) days. The 2004 Program Notes will not mature earlier than one day or later than 270 days, without any provision for automatic rollover, from their respective dates of issuance (with no maturity date being later than 30 years from the date of the initial issuance of the 2004 Program Notes). The 2004 Program Notes will be payable at maturity upon presentation and surrender at the principal office of the Issuing and Paying Agent at 111 Wall Street, 5th Floor, New York, NY 10043.

## **PRINCIPAL INFORMATION REGARDING THE ISSUER**

### **Government Development Bank for Puerto Rico - Introduction**

Government Development Bank for Puerto Rico was created by Act No. 17 of the Legislature of Puerto Rico, approved September 23, 1948, as amended (the "Charter"). It succeeded the Development Bank of Puerto Rico, which was created on May 13, 1942. The Charter provides that GDB's existence will be perpetual, and that no amendment to the Charter, or to any other law of the Commonwealth, will impair any outstanding obligation or commitment of GDB. The Charter provides powers for GDB to carry out the duties and responsibilities with which it is charged, including the acceptance of deposits of the Commonwealth and its public corporations and municipalities, the lending and borrowing of money and contracting of debts for its corporate purposes, and the capacity to sue and be sued.

GDB is generally exempt from Commonwealth taxation. It is required to have an annual examination and audit by certified public accountant of national reputation selected by the Board of Directors of GDB (the "Board of Directors"). As in the case of all Commonwealth banks, it is subject to examination and supervision by the Commissioner of Financial Institutions of the Commonwealth. The Controller of the Commonwealth, who is responsible to the Legislature, usually reviews the operations of GDB every two to three years.

### **Principal Functions and Policies**

GDB's primary purpose is to aid the Commonwealth in the performance of its fiscal duties and in its responsibility to develop the economy of Puerto Rico.

GDB acts as fiscal agent in connection with all short-term borrowings and bond issues of the Commonwealth, its public corporations and municipalities. All note and bond issues of public corporations and municipalities are subject to prior approval by GDB. GDB receives fees for rendering such services with respect to all bonds and certain notes. GDB issued

bonds or arranged for the issuance of bonds by the Commonwealth and its public corporations and municipalities in the aggregate amounts of \$7.4 billion in fiscal year 2003, \$8.7 billion in fiscal year 2002, \$3.3 billion in fiscal year 2001 and \$2.7 billion in fiscal year 2000.

In addition, GDB lends to, and purchases and guarantees certain obligations of, the Commonwealth and its public corporations and municipalities. GDB provides interim financing to these entities in anticipation of their refinancing such indebtedness in the U.S. tax-exempt market. In addition, GDB provides longer term financing to certain of these entities whose financial position currently precludes direct access to this market. In fiscal years 2002, 2001 and 2000, GDB and its subsidiaries disbursed individual bank lines of credit and other financing facilities to the public sector in aggregate amounts of approximately \$3.1 billion, \$2.5 billion and \$1.9 billion, respectively. For fiscal year 2003, the corresponding amount was \$3.3 billion.

GDB also lends to the private sector. GDB generally makes such loans with longer maturities than those available from commercial banks and, where possible, favors co-financing arrangements with private lenders. Guarantees by federal agencies are obtained whenever possible.

The financial statements of GDB for the year ended June 30, 2003, together with the independent auditors' report of KPMG LLP, dated November 26, 2003 are attached as Appendix A hereto.

### **Special Legislation Regarding GDB**

*Act No. 164 of 2001.* Act No. 164 of 2001 ("Act No. 164") authorized up to 30 annual legislative appropriations (beginning with fiscal year 2001-2002) in an amount not to exceed \$225,000,000 per year to amortize certain loans that GDB has made to various government agencies and public corporations. Act No. 164 prohibits GDB from making any additional loans to any governmental entity for which the source of repayment consists of appropriations from the General Fund without first obtaining the approval of the Legislature, except for (1) loans totaling together up to \$100,000,000 as long as (among other things) GDB obtains the written approval of the Governor and the Director of the Office of Management and Budget and (2) loans to any financially troubled governmental entity to enable it to honor its debt obligations.

*Act No. 82 of 2002.* Act No. 82 of 2002 ("Act No. 82") amended GDB's Charter to authorize GDB to transfer annually, beginning with fiscal year 2001, to the General Fund up to ten percent (10%) of its audited net income or \$10,000,000, whichever is greater. In June, 2002, GDB made payments to the General Fund of \$10 million for fiscal year 2001 and \$25.3 million for fiscal year 2002. During fiscal 2003, it made a transfer of \$11.6 million.

*Proposed Creation of the Special Communities Perpetual Trust.* On August 19, 2002, the Governor proposed in a special message to the Legislative Assembly the creation of a Special Communities Perpetual Trust (the "Trust") to provide funds for the rehabilitation and construction of housing units, new facilities, public works and other projects to help Puerto Rico's poor communities. Funds for the Trust will come initially from GDB and the Treasury Department, as well as from federal funds and bank contributions that qualify under

the Community Reinvestment Act of 1977. The first deposits into the Trust totaling \$1 billion are expected to come from a \$500 million transfer from GDB's unrestricted net assets and a \$500 million Trust borrowing from GDB or other financial institutions, which borrowing will be repaid from yearly appropriations of \$50 million for ten years from the Commonwealth's Public Improvements Fund. The necessary legislation to carry out the Governor's proposal was approved in November 2002.

### **Organization of GDB**

GDB is governed by a seven member Board of Directors appointed by the Governor of the Commonwealth with approval of the Council of Secretaries.

As of June 30, 2003, GDB, its subsidiaries and affiliates had approximately 468 employees, of which 196 were members of the Union of Employees of Government Development Bank for Puerto Rico.

The main offices of GDB are located at Minillas Government Center, De Diego Avenue, P.O. Box 42001, San Juan, Puerto Rico 00940, telephone (787) 722-2525. GDB also maintains an office at 140 Broadway, 38th Floor, New York, New York 10005, telephone (212) 422-6420.

### **Subsidiaries**

GDB has several subsidiaries which perform various functions. The principal subsidiaries and their functions are listed below:

*Tourism Development Fund.* The Puerto Rico Tourism Development Fund (“TDF”) was created in November 1993 to promote the hotel and tourism industry of Puerto Rico by making capital investments in or by providing financing directly or indirectly to entities that contribute or could contribute to the development of such industry. TDF is specifically authorized to issue, execute and deliver guarantees and letters of credit to secure payment on bonds. The initial capitalization of TDF was \$50,000,000. As of June 30, 2003, the Tourism Development Fund had outstanding guarantees with respect to the financing of various hotel projects totaling \$563 million. One of these projects is currently not making scheduled debt service payments, and TDF is making the corresponding payments under the related guaranty agreement. The initial principal amount of the financing for this project was approximately \$27.1 million. Another project is currently in default of its obligation to replenish its debt service reserve fund, and TDF may be required to start making the corresponding payments under the related guaranty agreement. The initial principal amount of the financing for this project was approximately \$75.3 million. As of June 30, 2003, the unrestricted net assets of TDF were approximately \$96 million and its allowance for losses on guarantees and letters of credit was approximately \$28.3 million.

*Capital Fund.* The Government Development Bank for Puerto Rico Capital Fund (the “Capital Fund”) was created in November 1992 for the purpose of investing and trading in debt obligations and publicly traded shares of domestic and foreign corporations separate from GDB's general investment operations. As of June 30, 2003, the Capital Fund had over \$58.2 million in such investments.

*Development Fund.* The Puerto Rico Development Fund (the “Development Fund”) was established in April 1977 to make loans to developing private enterprises in Puerto Rico. The Development Fund is also authorized to guarantee obligations of, and to make equity investments in, such enterprises or in venture capital funds that make such investments. As of June 30, 2003, the Development Fund had outstanding investment commitments of over \$5 million.

*Housing Finance Authority.* Puerto Rico Housing Finance Authority (“HFA”) was created in 2002 as a result of the merger through legislation (effective in February 2002) of Puerto Rico Housing Finance Corporation and Puerto Rico Housing Bank and Finance Agency (the operational arm of the Commonwealth’s Department of Housing, carrying out the Department’s various subsidy programs) (“Housing Bank”) to continue a program (begun in 1977) to provide public and private housing developers with interim and permanent financing through mortgage loans for the construction, improvement, operation and maintenance of rental housing for low and moderate income families in the Commonwealth. The merger consolidated into a single entity the responsibility for executing the Commonwealth’s various housing programs. HFA and its predecessors issue bonds and notes, whose proceeds are deposited in a separate trust and invested primarily in federally insured mortgage loans. As of June 30, 2003, \$1.6 billion of such bonds were outstanding.

The financial information prior to fiscal 2002 included in this Information Memorandum for GDB has been presented excluding the assets, liabilities and results of operations of the Housing Bank.

*Public Finance Corporation.* Puerto Rico Public Finance Corporation (“PFC”) was established in November 1984 to provide agencies and instrumentalities of Puerto Rico with alternate means of meeting their financing requirements. PFC currently has in its portfolio the debt of the Maritime Shipping Authority, the debt of the Commonwealth relating to certain tax claims owed by the Commonwealth to the municipalities and certain other matters, the debt of the Office for the Improvement of Public Schools, the debt of the Health Facilities and Services Administration, and a portion of the debt of Puerto Rico Aqueduct and Sewer Authority, among others. To acquire such debt, PFC issued its bonds of which \$4.2 billion was outstanding as of June 30, 2003. All such debt is payable from Commonwealth appropriations and as a result, PFC’s bonds are considered non-recourse to PFC.

### **Loans By GDB to the Commonwealth and Public Corporations**

GDB lends funds to the public corporations of the Commonwealth for capital improvements and operating needs. GDB’s loans to public corporations for capital improvements generally are construction loans and are repaid from the proceeds of future bond issues of the respective public corporations. Such loans may, however, also be repaid from the revenues of such public corporations, from accreting certificates of deposit held by GDB, from loans provided by sources other than GDB, from federal grants, and from the sale of assets of such public corporations. The amount of outstanding loans from GDB to the public corporations fluctuates annually, depending upon the capital program needs of the public corporations, the timing and level of their capital expenditures, and their ability to gain access to the long-term capital markets. As of June 30, 2003, loans outstanding to public corporations were approximately \$2.3 billion.

GDB also purchases general obligation and other bonds and notes of the municipalities of Puerto Rico, which obligations are issued by said municipalities to finance their public works projects and operational needs. The bonds and notes relating to public works projects are generally sold by GDB to Puerto Rico Municipal Finance Agency, which issues its bonds to acquire such bonds and notes. As of June 30, 2003, approximately \$448.5 million of such bonds and notes had been purchased and were held by GDB.

The following are descriptions of some of the public corporation recipients of GDB loans and the respective amounts of their outstanding indebtedness.

*Agricultural Department.* The Agricultural Department is engaged in providing loans to farmers and in building and leasing commercial buildings. As of June 30, 2003, outstanding indebtedness to GDB was approximately \$35.5 million.

*Agricultural Services Administration.* The Administration was created in 1977 as a legal entity separate from the agencies, instrumentalities, public corporations and political subdivisions of the Commonwealth and is attached to the Department of Agriculture. The Administration is authorized to provide all agricultural services to promote the development of farming and of agriculture in general. As of June 30, 2003, the Administration had \$20.6 million of indebtedness outstanding with GDB, payable from Commonwealth appropriations.

*Aqueduct and Sewer Authority.* Puerto Rico Aqueduct and Sewer Authority (“PRASA”) owns and operates a system of public water supply and sanitary sewer facilities.

PRASA needs to make a substantial investment in infrastructure and a major overhaul of its operations to maintain the viability of the existing system and to finance its expansion for new users. Funds for this investment are expected to be provided through a combination of revenues from PRASA, bond issues, legislative appropriations and federal grants. Debt service on revenue bonds is payable from net revenues of the system after payment of current expenses. Due to PRASA’s financial difficulties (discussed below) and its inability to access the bond market, Act No. 45 was enacted in July 1994 to provide a Commonwealth guaranty of the principal and interest payments to the bondholders of all outstanding revenue bonds issued by PRASA. In addition, Act No. 45 was amended in 2000 to extend the Commonwealth payment guaranty to all outstanding bonds issued by PRASA to the United States Department of Agriculture, Rural Development, and loans granted by the Clean Water and Drinking Water State Revolving Funds for the benefit of PRASA. The extended guaranty will cover additional debt obligations of PRASA issued before July 1, 2005.

PRASA has reported net losses of \$100.7 million, \$510,000, \$191.8 million and \$185.8 million during fiscal years 2000, 2001, 2002 and 2003, respectively. The net losses reported for fiscal years after 2000 are not comparable to the losses reported in prior fiscal years due to the implementation of a change in government accounting rules which allows governmental grants to be treated as revenues instead of as capital contributions. Without such favorable treatment of government grants, PRASA’s net loss would have been \$169.6 million in fiscal year 2001, \$349 million in fiscal year 2002 and \$189.3 million in fiscal year 2003. These losses reflect the continuing financial and operating difficulties that PRASA has experienced in recent years. The total debt of PRASA, including bonds and loans, was \$652.4 million as of June 30, 2003, of which \$178.7 million was owed to GDB.

Since May 1995, operations, management, repair and maintenance of PRASA's systems have been undertaken by private companies. The current agreement relating to the foregoing was entered into on May 2, 2002 with Ondeo Puerto Rico, Inc. ("Ondeo"), an affiliate of Ondeo Suez, S.A. ("Suez"), pursuant to which Ondeo was to undertake such activities with the objectives of eliminating PRASA's operating deficit and unaccounted-for-water, achieving environmental compliance, improving the planning and implementation of capital projects, and improving the general quality of the service. Suez guaranteed the performance of Ondeo's obligations under the agreement.

Ondeo was compensated under the agreement through a service fee component (the "SFC") consisting of a fixed part and a variable part, which would be adjusted to take into account additions and/or deletions of system components (new plants, pumping stations, etc.), uncontrollable circumstances and inflation. In addition, the agreement provided for a variable compensation component consisting of performance incentives which could not exceed 20% of total compensation.

PRASA's monetary obligations under the agreement were guaranteed by GDB up to the annual SFC (approximately \$363 million). Under legislation enacted in connection with the agreement, GDB would be reimbursed from Commonwealth appropriations for any payments made under this guarantee up to an annual amount equal to the then applicable SFC. Through the date of this Information Memorandum, no payments have been made by GDB under this guarantee.

Pursuant to an agreement entered into in January, 2004, Ondeo and PRASA agreed to terminate the May 2, 2002 agreement. Ondeo will continue to provide operating support to PRASA until mid-2004, after which time, the operation, management, repair and maintenance of the PRASA systems will return to PRASA.

Under the terms of this termination agreement, GDB's guarantee of PRASA's obligations to Ondeo was reduced to a maximum amount of \$37.5 million, initially through a modification of the original guarantee and subsequently by replacement of the guarantee with a letter of credit issued by GDB, in both instances for the maximum amount of \$37.5 million. GDB does not expect any liability under this obligation to have a material effect on its financial condition.

PRASA entered into an agreement with Thames-Dick Superaqueduct Partners, Inc. for the planning, design, construction, operation and maintenance of the North Coast Superaqueduct to supply additional potable water to certain municipalities, mainly in the San Juan Metropolitan Area. The total cost of the North Coast Superaqueduct was approximately \$390 million. GDB provided interim financing for this Project. Permanent financing was provided in August 2001 through the issuance of \$390,000,000 of bonds of Public Finance Corporation, payable from Commonwealth appropriations. The North Coast Superaqueduct started operations during January 2000.

*CRIM.* The Municipal Revenues Collection Center ("CRIM") was created in 1991 as a municipal entity charged with the collection, receipt and allocation of municipal tax revenues. As of June 30, 2003, CRIM had \$240.7 million in indebtedness outstanding with GDB payable from its revenues, which consist of the retention by CRIM of a small percentage of all collections made by it on behalf of the municipalities.

*Economic Development Bank.* The Economic Development Bank was created in July 1985 to engage primarily in granting small direct loans, providing loan guarantees to private enterprises, and making equity investments in such enterprises. Its initial capital was provided by a transfer of loans in the principal amount of \$15,000,000 previously administered by a now inactive subsidiary of GDB. As of June 30, 2003, outstanding indebtedness to GDB was \$13.1 million.

*Industrial Development Company.* The Industrial Development Company participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. The Company was merged with the Economic Development Administration in January 1998.

*Infrastructure Financing Authority (“AFI”).* AFI was created in June 1988 by virtue of Act No. 44 of June 21, 1988, as amended (“Act No. 44”), to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations and governmental instrumentalities of Puerto Rico authorized to develop infrastructure facilities and to establish alternate means for financing infrastructure facilities. AFI is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by public corporations and instrumentalities of the Commonwealth.

In January 1998, AFI expanded the assistance given to PRASA to include assistance covering the design and construction of various strategic regional water and sewer projects intended to provide improved services to targeted regions throughout the island, the implementation of an immediate action plan to address a number of small water and sewer rehabilitation projects, and legal and technical assistance in achieving compliance with certain environmental laws and in establishing a prioritized capital program. AFI is undertaking such projects at the request of PRASA.

In June 1998, Act No. 44 was amended to establish the Infrastructure Development Fund, a permanent trust fund which is being utilized by AFI for the financing of infrastructure projects. The Infrastructure Development Fund was initially funded in March 1999 with \$1.2 billion of proceeds received by the Telephone Authority from the sale of a controlling interest in Puerto Rico Telephone Company. This initial amount will remain permanently deposited in a segregated, perpetual account, denominated the “corpus account,” and must be invested exclusively in U.S. government or U.S. government-backed obligations. The income from such investment may only be used to finance infrastructure projects related to the Commonwealth’s water and sewer systems. Other moneys in the Infrastructure Development Fund not attributable to the corpus account or the investment income thereon may be used for other infrastructure projects. AFI is the custodian and administrator of the Infrastructure Development Fund. As of June 30, 2003, AFI’s indebtedness to GDB, payable from the aforementioned investment income, was \$9.8 million.

*Office of Court Administration.* The Administration was created in 1952 as part of the judicial branch of the Government of Puerto Rico to assist the Chief Justice of the Supreme Court of Puerto Rico in the proper administration of the courts of justice of Puerto Rico. As of June 30, 2003, outstanding indebtedness to GDB was \$43.5 million.

*Ports Authority.* Puerto Rico Ports Authority (the “Ports Authority”) owns and operates the major airport and seaport facilities in the Commonwealth. The Ports Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees and rentals for the lease of seaport equipment and property. As of June 30, 2003, the Ports Authority has various lines of credit, of which \$250.5 million was outstanding.

*Solid Waste Authority.* The Solid Waste Authority was created in 1978 to address the need for greater and better solid waste disposal controls and facilities. As of June 30, 2003, outstanding indebtedness to GDB was \$7.6 million.

### **Loans by GDB to Private Enterprises**

GDB’s loans to the private sector are primarily for the establishment or expansion of manufacturing entities, the construction of commercial and industrial buildings and the construction of hotel and tourist facilities. GDB’s newly created subsidiary, HFA, issues construction and permanent financing loans to the private sector for housing projects targeted to low- and moderate-income families. As of June 30, 2003, GDB’s outstanding loans to the private sector were \$300 million, net of an allowance for loan losses of \$23 million. These amounts would be reduced to \$24 million and \$3.3 million after excluding the mortgage lending activities of HFA.

In its lending to the private sector, GDB does not compete with private lenders or make loans to borrowers whose credit is not acceptable to such lenders. GDB offers longer maturities than are normally available from commercial banks and, where possible, participates in co-financing arrangements with private lenders. Guarantees by federal agencies are obtained whenever possible.

### **Finances of GDB**

Certain financial information of the Issuer is summarized below. *See* Appendix A attached hereto for the Issuer’s fiscal year 2003 audited financial statements. The financial information for the years ended June 30, 2003 and 2002 is presented in accordance with the requirements of Governmental Accounting Standards Board Statement No. 34 (“GASB 34”) and that basis of presentation makes them not comparable with the information included in the following tables for the fiscal years ended June 30, 2000 and 2001. Accordingly, the information in the following tables for fiscal years 2003 and 2002 is presented separately from the information for fiscal years 2000 and 2001.

*Statements of Condition Information.* The following tables set forth information on the statements of condition of GDB as of June 30, 2000, 2001, 2002 and 2003. This information should be read together with GDB’s Financial Statements and the related notes included in Appendix A to this Information Memorandum. The financial statements for the year ended June 30, 2003, and the report of the independent auditors KPMG LLP, are part of Appendix A attached hereto.

**STATEMENTS OF CONDITION INFORMATION**

	<b>2000</b>	<b>2001</b>
	(in thousands)	
<b>ASSETS</b>		
Cash and Due from Banks	\$ 16,452	\$ 15,651
Federal Funds Sold and Securities Purchased Under Agreements to Resell	782,104	1,605,540
Deposits Placed With Banks and Commercial Paper	82,483	20,966
Investments and Investment Contracts	3,199,590	1,620,489
Loans Receivable:		
Public entities and municipalities of the Commonwealth of Puerto Rico	3,329,042	3,710,506
Private sector, net	<u>218,253</u>	<u>144,468</u>
Total loans and other receivables, net	3,547,295	3,854,974
Accrued Interest Receivable:		
Investments and money market instruments	40,134	10,202
Loans to public entities and municipalities of the Commonwealth of Puerto Rico	179,891	258,173
Loans to the private sector	<u>1,333</u>	<u>1,038</u>
Total accrued interest receivable	221,358	269,413
Tax Liens Receivables	285,898	96,864
Accounts Receivable	---	208,594
Real Estate Owned	49,952	34,685
Other Assets	<u>67,355</u>	<u>96,420</u>
<b>TOTAL</b>	<u><u>\$8,252,487</u></u>	<u><u>\$7,823,596</u></u>

**STATEMENTS OF CONDITION INFORMATION**

	<u>2000</u>	<u>2001</u>
	(in thousands)	
<b>LIABILITIES AND CAPITAL</b>		
Deposits, Principally from the Commonwealth of Puerto Rico and its Public Entities		
Demand	\$2,047,353	\$2,392,064
Certificates of deposit	<u>1,500,154</u>	<u>766,590</u>
Total deposits	<u>3,547,507</u>	<u>3,158,654</u>
Certificates of Indebtedness	197,881	253,216
Securities Sold Under		
Agreements to Repurchase	19,850	—
Commercial Paper	1,408,832	1,250,430
Other Liabilities		
Accrued interest payable	60,358	29,366
Allowance for losses on guarantees and letters of credit	38,139	46,759
Miscellaneous	<u>54,320</u>	<u>198,846</u>
Total Other Liabilities	<u>5,326,887</u>	<u>4,937,271</u>
Other Borrowed Funds		
Notes payable	116,778	21,241
Bonds payable, net of discount	<u>1,161,673</u>	<u>1,132,999</u>
Total other borrowed funds	<u>1,278,451</u>	<u>1,154,240</u>
Total Liabilities	<u>6,605,338</u>	<u>6,091,511</u>
Fund Equity		
Contributed Capital	20,500	20,500
Retained Earnings	<u>1,626,649</u>	<u>1,711,585</u>
Total fund equity	<u>1,647,149</u>	<u>1,732,085</u>
<b>Total liabilities and fund equity</b>	<u><u>\$8,252,487</u></u>	<u><u>\$7,823,596</u></u>

## STATEMENT OF NET ASSETS

	June 30, 2002	June 30, 2003
<b>Assets:</b>		
Cash and due from banks	\$13,878,576	\$25,969,477
Federal funds sold	1,376,500,000	1,083,400,000
Deposits placed with banks	515,838,835	380,863,579
Investments and investment contracts	2,570,393,839	2,385,617,510
Loan receivable, net	2,229,643,229	2,601,193,779
Interest and other receivables	101,701,334	112,261,026
Due from Commonwealth of Puerto Rico	4,929,043	6,216,598
Due from other component units of the Commonwealth of Puerto Rico	1,227,468	-
Due from municipalities of Puerto Rico	250,000	-
Due from federal government	14,968,501	10,601,179
Internal balances	-	-
<b>Restricted Assets:</b>		
Cash	14,479,183	26,266,285
Deposits placed with banks	63,764,311	32,165,317
Securities purchased under agreement to resell	170,000,000	150,000,000
Investments and investment contracts	1,492,860,270	1,844,633,939
Loans receivable, net	34,609,559	35,070,435
Real estate available for sale	35,243,769	28,525,353
Capital assets	16,624,875	14,816,590
Other assets	19,532,422	129,372,782
<b>Total assets</b>	<b>\$8,676,445,214</b>	<b>\$8,866,973,849</b>
<b>Liabilities:</b>		
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:		
Demand	\$2,070,536,111	\$1,617,667,369
Certificates of deposit	1,797,572,902	1,918,890,138
Certificate of indebtedness	294,591,425	242,984,210
Securities sold under agreement to repurchase		40,017,333
Commercial paper	398,745,844	761,166,587
Note payable, due within one year		102,436
Accrued interest payable	15,381,613	12,015,831
Due to Commonwealth of Puerto Rico	237,027,099	6,924,271
Accounts payable and accrued liabilities	148,709,937	141,492,272
Allowance for losses on guarantees and letters of credit	35,874,349	31,338,585
Bonds payable due in more than one year	267,000,000	274,756,154
Note payable due in more than one year	10,029,360	9,926,924
<b>Liabilities payable from restricted assets:</b>		
Securities sold under agreement to repurchase	170,000,000	150,000,000
Accrued liabilities	8,470,586	6,998,899
<b>Bonds payable:</b>		
Due in one year	129,809,128	84,389,645
Due in more than one year	1,090,508,990	1,412,524,045
<b>Total liabilities</b>	<b>\$6,674,257,344</b>	<b>\$6,711,194,699</b>
<b>Net assets:</b>		
Invested in capital assets	16,624,875	14,816,590
<b>Restricted for:</b>		
Debt service	45,867,983	56,920,167
Affordable housing programs	349,744,238	353,003,027
Mortgage loan insurance	20,085,575	23,352,153
Unrestricted (deficit)	1,569,865,199	1,707,687,213
<b>Total net assets</b>	<b>\$2,002,187,870</b>	<b>\$2,155,779,150</b>

For further details, refer to the notes to the audited financial statements in Appendix A attached hereto.

*Statements of Income Information.* The following table sets forth information on the statements of income of GDB for each of the four fiscal years ended June 30, 2003. This information should be read together with GDB's Financial Statements and the related notes included in Appendix A to this Information Memorandum. The report of KPMG LLP, independent auditors, in respect to the financial statements of GDB for the year ended June 30, 2003 is set out in Appendix A hereto.

## STATEMENTS OF INCOME INFORMATION

	<u>2000</u>	<u>2001</u>
	(in thousands)	
<b>Investment income:</b>		
Interest income on federal funds sold and securities purchased under agreements to resell	\$ 30,309	\$ 36,473
Interest income on deposits placed with banks	10,587	6,623
Interest and dividend income on investments and investment contracts and tax lien receivables held in trust	153,084	125,321
Net decrease in fair value of investments	(7,540)	(10,998)
Total	186,440	157,419
Interest income on loans receivable:		
Public sector entities and municipalities of the Commonwealth of Puerto Rico	223,590	242,823
Private sector	15,924	13,162
Total	239,514	255,985
Total investment income	425,954	413,404
<b>Interest expense:</b>		
Deposits	139,146	145,074
Certificates of indebtedness	10,490	9,560
Federal funds purchased and securities sold under agreements to repurchase	1,695	5,504
Commercial Paper	48,982	42,843
Other borrowed funds	77,860	70,556
Total interest expense	278,173	273,537
Net investment income	147,781	139,867
(Provision) credit for loan losses	2,433	(2,678)
Net investment income after credit for loan losses	150,214	137,189
<b>Noninterest income:</b>		
Fiscal agency fees	3,593	5,971
Commitment, service and administrative fees	16,196	17,427
Income from sponsored housing programs	122	--
Other	17,588	15,315
Total noninterest income	37,499	38,713
<b>Noninterest expense:</b>		
Salaries and fringe benefits	20,380	20,747
Occupancy and equipment costs	5,422	6,734
Professional fees	21,774	17,954
Provision for loss on real property taxes receivable	5,000	--
Provision (credit) for losses on guarantees and letters of credit	(2,613)	24,052
Construction of Puerto Rico Art Museum	19,057	1,477
Other	16,193	20,002
Total noninterest expense	85,213	90,966
Net income	102,500	84,936
Fund equity at beginning of year	1,544,649	1,647,149
Fund equity at end of year	\$1,647,149	\$1,732,085

**STATEMENT OF ACTIVITIES**  
**Year ended June 30, 2002**

	Program Revenues				Net (Expenses) Revenues and Changes in Net Assets			
	Expenses	Charges for Services - Fees, Commissions, and Others	Charges for Services – Financing and Investment	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	Total
Functions/programs:								
Governmental activities								
General government	\$ 1,960,549	—	—	—	—	\$(1,960,549)	—	\$(1,960,549)
Housing subsidy program	43,921,776	—	\$23,806,277	\$49,953,562	\$54,748,200	84,586,213	—	84,586,213
Interest on long-term debt	25,496,330	—	—	6,955,582	—	(18,540,748)	—	(18,540,748)
Total governmental activities	<u>71,378,655</u>	<u>—</u>	<u>23,806,277</u>	<u>56,909,144</u>	<u>54,748,200</u>	<u>64,084,916</u>	<u>—</u>	<u>64,084,916</u>
Business-type activities:								
GDB Operating Fund	260,470,542	17,985,733	345,977,104	—	—	—	103,492,295	103,492,295
Housing Finance Authority	205,955,066	12,519,991	134,499,689	112,707,578	—	—	53,772,192	53,772,192
Tourism Development Fund	9,257,788	7,243,815	3,114,355	50,000,000	—	—	51,100,382	51,100,382
Public Finance Corporation	37,331,784	—	7,943,728	32,056,387	—	—	2,668,331	2,668,331
Capital Fund	69,718	—	(20,310,434)	—	—	—	(20,380,152)	(20,380,152)
Development Fund	41,920	—	502,027	—	—	—	460,107	460,107
Total Business-type activities	<u>513,126,818</u>	<u>37,749,539</u>	<u>471,726,469</u>	<u>194,763,965</u>	<u>—</u>	<u>—</u>	<u>191,113,155</u>	<u>191,113,155</u>
Total	<u>\$ 584,505,473</u>	<u>\$37,749,539</u>	<u>\$495,532,696</u>	<u>\$251,673,109</u>	<u>\$54,748,200</u>	<u>\$64,084,916</u>	<u>\$191,113,155</u>	<u>\$255,198,071</u>
General revenues:								
Unrestricted income						760,108	—	760,108
Contributions to others						—	(38,262,025)	(38,262,025)
Transfers						3,755,282	(3,755,282)	—
Total general revenues and transfers						<u>4,515,390</u>	<u>(42,017,307)</u>	<u>(37,501,917)</u>
Change in net assets						68,600,306	149,095,848	217,696,154
Net assets (deficit), beginning of year						<u>(29,465,347)</u>	<u>1,813,957,063</u>	<u>1,784,491,716</u>
Net assets, end of year						<u>\$39,134,959</u>	<u>\$1,963,052,911</u>	<u>\$2,002,187,870</u>

\*See details on next page.

**Statement of Revenues, Expenses, and Change in Net Assets- Enterprise Funds**  
**Year Ended June 30, 2002**

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Total</b>
Operating revenues:							
Investment income:							
Interest income on federal funds sold and securities purchased under agreement to resell	\$ 26,469,187	\$4,758,472	—	—	—	—	\$31,227,659
Interest income on deposits placed with banks	6,289,391	1,761,029	—	\$257,019	\$1,792,613	\$17,551	10,117,663
Interest and dividend income on investment and investment contracts and tax lien receivables	62,627,937	86,428,867	\$551,264	—	1,080,972	7,926,177	158,615,217
Loan receivable:							
Public sector	225,628,186	—	—	—	—	—	225,628,186
Private sector	1,012,601	16,647,628	—	—	—	—	17,660,229
Total interest income	<u>322,027,302</u>	<u>109,596,056</u>	<u>551,264</u>	<u>257,019</u>	<u>2,873,585</u>	<u>7,943,728</u>	<u>443,248,954</u>
Non interest income:							
Change in fair value of investments	23,939,804	22,394,001	(20,861,698)	245,008	240,770	—	25,957,885
Fiscal agency fees	10,449,115	—	—	—	—	—	10,449,115
Commitment, guarantee, service, and administrative fees	1,847,308	—	—	—	7,241,753	—	9,089,061
Mortgage insurance premiums	—	2,153,095	—	—	—	—	2,153,095
Servicing and contract administration fees, net	2,050,227	8,161,886	—	—	—	—	10,212,113
Net gain from sale of foreclosed real estate available for sale	—	2,509,632	—	—	—	—	2,509,632
Net gain on sale of capital assets	9,998	—	—	—	—	—	9,998
Payments from Commonwealth of Puerto Rico	—	380,828	—	—	—	—	380,828
Federal assistance programs	—	112,326,750	—	—	—	—	112,326,750
Other income	3,639,083	2,205,010	—	—	2,062	—	5,846,155
Total noninterest income (loss)	<u>41,935,535</u>	<u>150,131,202</u>	<u>(20,861,698)</u>	<u>245,008</u>	<u>7,484,585</u>	<u>—</u>	<u>178,934,632</u>
Total operating revenues	<u>363,962,837</u>	<u>259,727,258</u>	<u>(20,310,434)</u>	<u>502,027</u>	<u>10,358,170</u>	<u>7,943,728</u>	<u>622,183,586</u>
Operating expenses:							
Provision for loan losses	(1,500,000)	1,916,702	—	—	—	—	416,702
Interest expense							
Deposits	101,074,861	—	—	—	—	—	101,074,861
Certificate of indebtedness	11,068,752	49,080	—	—	—	—	11,117,832
Securities sold under agreements to repurchase	232,275	4,692,158	—	—	—	—	4,924,433
Commercial paper	20,779,220	—	—	—	—	—	20,779,220
Bonds payable	8,633,713	73,758,100	—	—	—	10,028,397	92,420,210
Total interest expense	<u>141,788,821</u>	<u>78,499,338</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>10,028,397</u>	<u>230,316,556</u>
Non interest expense:							
Salaries and fringe benefits	17,419,183	7,993,191	—	393	18,363	—	25,431,130
Occupancy and equipment costs	6,386,121	1,097,022	—	—	3,178	—	7,486,321
Legal and professional fees	9,323,960	1,370,610	69,718	6,800	353,428	71,444	11,195,960
Office and administrative	2,178,546	424,735	—	—	6,152	—	2,609,433
Subsidy and trustee fees	—	1,443,573	—	—	—	6,833,759	8,277,332
Provision for losses on guarantees and letters of credit	—	—	—	—	8,500,000	—	8,500,000
Federal assistance programs	—	112,326,750	—	—	—	—	112,326,750
Other	22,396,062	883,145	—	34,727	376,667	819,646	24,510,247
Total noninterest expenses	<u>57,703,872</u>	<u>125,539,026</u>	<u>69,718</u>	<u>41,920</u>	<u>9,257,788</u>	<u>7,724,849</u>	<u>200,337,173</u>
Total operating expenses	<u>197,992,693</u>	<u>205,955,066</u>	<u>62,718</u>	<u>41,920</u>	<u>9,257,788</u>	<u>17,753,246</u>	<u>431,070,431</u>
Operating income (loss)	<u>165,970,144</u>	<u>53,772,192</u>	<u>(20,380,152)</u>	<u>460,107</u>	<u>1,100,382</u>	<u>(9,809,518)</u>	<u>191,113,155</u>
Contributions to others							
Special item – net gain (loss) on early extinguishment of bonds	(38,260,025)	(2,000)	—	—	—	—	(38,262,025)
Transfers in	19,578,538	—	—	—	—	(19,578,538)	—
Transfers out	979,334	5,155,312	—	—	50,000,000	33,035,721	89,170,367
Change in net assets	<u>(83,035,721)</u>	<u>(8,910,594)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(979,334)</u>	<u>(92,925,649)</u>
Net assets, beginning of year	\$ 65,232,270	\$50,014,910	\$(20,380,152)	\$460,107	\$51,100,382	\$2,668,331	\$149,095,848
Net assets, end of year	<u>1,310,170,424</u>	<u>342,008,839</u>	<u>77,370,991</u>	<u>30,861,858</u>	<u>51,487,425</u>	<u>2,057,526</u>	<u>1,813,957,063</u>
Net assets, end of year	<u>\$1,375,402,694</u>	<u>\$392,023,749</u>	<u>\$56,990,839</u>	<u>\$31,321,965</u>	<u>\$102,587,807</u>	<u>\$4,725,857</u>	<u>\$1,963,052,911</u>

**Statement of Activities**  
**Year ended June 30, 2003**

	Program Revenues				Net (Expenses) Revenues and Changes in Net Assets			
	Expenses	Charges for Services-Fees, Commissions, and Others	Charges for Services – Financing and Investment	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-Type Activities	Total
Functions/programs:								
Governmental activities:								
General government	\$ 1,040,796	—	—	—	—	(1,040,796)	—	(1,040,796)
Housing subsidy program	80,571,622	—	34,587,092	31,922,636	37,026,968	22,965,074	—	22,965,074
Total governmental activities	81,612,418	—	34,587,092	31,992,636	37,026,968	21,924,278	—	21,924,278
Business-type activities:								
GDB Operating Fund	162,116,611	50,600,662	219,743,018	—	—	—	108,227,069	108,227,069
Housing Finance Authority	216,269,816	18,668,769	134,931,243	112,199,144	—	—	49,529,340	49,529,340
Tourism Development Fund	15,217,986	6,744,406	1,958,715	—	—	—	(6,514,865)	(6,514,865)
Public Finance Corporation	422,100	—	114,740	—	—	—	(307,360)	(307,360)
Capital Fund	46,405	—	1,728,355	—	—	—	1,681,950	1,681,950
Development Fund	41,086	—	(1,770,418)	—	—	—	(1,811,504)	(1,811,504)
Other	50,165	—	559	—	—	—	(49,606)	(49,606)
Total business-type activities	394,164,169	76,013,837	356,706,212	112,199,144	—	—	150,755,024	150,755,024
Total	\$475,776,587	\$76,013,837	\$391,293,304	\$144,121,780	\$37,026,968	\$21,924,278	\$150,755,024	\$172,679,302
General revenues:								
Unrestricted income						97,128	—	97,128
Contribution to others						—	(19,185,150)	(19,185,150)
Transfers						(45,010,472)	45,010,472	—
Total general revenues and transfers						(44,913,344)	25,825,322	(19,088,022)
Change in net assets						(22,989,066)	176,580,346	153,591,280
Net assets, beginning of year						39,134,959	1,963,052,911	2,002,187,870
Net assets, end of year						\$ 16,145,893	\$2,139,633,257	\$2,155,779,150

\*See details on next page.

**Statement of Revenues, Expenses and Change in Net Assets – Enterprise Funds**  
**Year ended June 30, 2003**

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Other Non major Funds</b>	<b>Total</b>
<b>Operating revenues:</b>								
Investment income								
Interest income on federal funds sold and securities purchased under agreements to resell	\$ 13,863,033	\$3,667,704	—	—	—	—	—	\$17,530,737
Interest income on deposits placed with banks	3,250,461	10,670,811	—	98,574	1,001,783	23,803	559	15,045,991
Interest and dividend income on investment and investment contracts and tax lien receivables	73,124,679	74,316,726	604,845	—	892,555	90,937	—	149,029,742
Total investment interest	90,238,173	88,655,241	604,845	98,574	1,894,338	114,740	559	181,606,470
Loans receivable:								
Public sector	113,572,935	—	—	—	—	—	—	113,572,935
Private sector	664,253	17,293,021	—	—	18,860	—	—	17,976,134
Total loans interest	114,237,188	17,293,021	—	—	18,860	—	—	131,549,069
Total interest income	204,475,361	105,948,262	604,845	98,574	1,913,198	114,740	559	313,155,539
Noninterest income:								
Changes in fair value of investments	15,267,657	28,982,981	1,123,510	(1,868,992)	45,517	—	—	43,550,673
Fiscal agency fees	7,925,837	—	—	—	—	—	—	7,925,837
Commitment, guarantee, services, and administration fees	2,362,599	3,720,569	—	—	7,665,473	—	—	13,748,641
Mortgage insurance premiums	—	2,120,872	—	—	—	—	—	2,120,872
Servicing and contract administration fees, net	2,333,859	6,402,107	—	—	—	—	—	8,735,966
Net gain from sale of foreclosed real estate available for sale	—	2,217,869	—	—	—	—	—	2,217,869
Payment from commonwealth of Puerto Rico	—	140,214	—	—	—	—	—	140,214
Federal assistance programs	—	112,199,144	—	—	—	—	—	112,199,144
Other income	37,978,367	4,067,138	—	—	353,933	—	—	42,399,438
Total noninterest income (loss)	65,868,319	159,850,894	1,123,510	(1,868,992)	8,064,923	—	—	233,038,654
Total operating revenues	270,343,680	265,799,156	1,728,355	(1,770,418)	9,978,121	114,740	559	546,194,193
<b>Operating expenses:</b>								
Provision for loan losses	—	—	—	—	1,275,000	—	—	1,275,000
Interest expense								
Deposits	80,769,369	—	—	—	4,738	—	—	80,774,107
Certificates of indebtedness	9,877,690	—	—	—	—	—	—	9,877,690
Securities sold under agreements to repurchase	8,126	4,356,613	—	—	—	—	—	4,364,739
Commercial paper	5,558,637	—	—	—	—	—	—	5,558,637
Bonds payable	8,809,901	85,517,888	—	—	—	—	—	94,327,789
Total interest expense	105,023,723	89,874,501	—	—	4,738	—	—	194,902,962
Noninterest expenses:								
Salaries and fringe benefits	22,186,969	8,081,692	—	35	—	—	37,216	30,305,912
Depreciation	2,800,137	272,075	—	—	1,716	—	—	3,073,928
Occupancy and equipment costs	3,352,593	832,997	—	—	60	—	8,625	4,185,650
Legal and professional fees	5,255,586	2,015,473	4,132	39,850	648,793	93,974	—	8,066,433
Office and administrative	737,504	54,365	42,273	—	—	328,088	—	1,162,230
Subsidy and trustee fees	39,983	2,309,290	—	—	—	—	—	2,349,273
Provisions for losses on guarantees and letters of credit	—	—	—	—	14,363,575	—	—	14,363,575
Federal assistance programs	—	112,199,144	—	—	—	—	—	112,199,144
Other	22,720,116	630,279	—	1,201	199,104	38	4,324	23,555,062
Total noninterest expenses	57,092,888	126,395,315	46,405	41,086	15,213,248	422,100	50,165	199,261,207
Total operating expenses	162,116,611	216,269,816	46,405	41,086	15,217,986	422,100	50,165	394,164,169
Operating income (loss)	108,227,069	49,529,340	1,681,950	(1,811,504)	(6,514,865)	(307,360)	(49,606)	150,755,024
Contributions to others	(19,185,150)	—	—	—	—	—	—	(19,185,150)
Special item – net gain (loss) on early extinguishment of bonds	—	56,254,866	—	—	—	—	300,000	56,554,866
Transfer in	—	(11,244,394)	—	—	—	—	—	(11,244,394)
Transfer out	(300,000)	—	—	—	—	—	—	(300,000)
Change in net assets	88,741,919	94,539,812	1,681,950	(1,811,504)	(6,514,865)	(307,360)	250,394	176,580,346
Net assets, beginning of year	1,375,402,694	392,023,749	56,990,839	31,321,965	102,587,807	4,725,857	—	1,963,052,911
Net assets, end of year	\$1,464,144,613	\$486,563,561	\$58,672,789	\$29,510,461	\$96,072,942	\$4,418,497	\$250,394	\$2,139,633,257

The following table sets forth, for each of the four fiscal years in the period ended June 30, 2003, the average interest rates earned by GDB on its total earning assets and the average interest rates paid by GDB for its total deposits and borrowed funds and the corresponding spreads.

	<u>Year ended June 30,</u>			
	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Average interest rate earned	5.65%	5.62%	5.92%	4.39%
Average interest rate paid	<u>4.37%</u>	<u>4.51%</u>	<u>3.79%</u>	<u>3.32%</u>
Spread	1.28%	1.11%	2.13%	1.07%

### **GDB Liquidity**

As of June 30, 2003, approximately \$4.7 billion or 52% of GDB's assets consisted of cash and equivalents or investment securities classified among the three highest rating categories. Approximately 42% of the investment securities portfolio (\$2 billion) matures in one year or less. Of the \$4.7 billion, approximately \$1.1 million (consisting of restricted securities and money market instruments) is pledged for the repayment of notes or for deposits with GDB.

### **Derivatives**

GDB's policy does not allow the use of derivatives for trading purposes or off-balance sheet leveraged transactions.

GDB uses derivatives in its asset and liability management activities, which includes hedging activities. The derivatives utilized are limited to interest rate swaps and caps, structured notes and indexed swaps.

The total notional amount in interest rate swaps to fix certain floating rate debt (in order to match this liability with corresponding long-term fixed rate securities) as of June 30, 2003 amounted to approximately \$637 million.

## **THE COMMONWEALTH OF PUERTO RICO**

### **Introduction**

Puerto Rico is located in the Caribbean approximately 1,600 miles southeast of New York City. According to the United States Census Bureau, the population of Puerto Rico was approximately 3,808,610 in 2000 compared to 3,522,000 in 1990. As of 1999, the population of San Juan, the island's capital and largest city, was approximately 439,000.

Puerto Rico came under United States sovereignty pursuant to the Treaty of Paris, signed on December 10, 1898, which ended the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In 1950, after a long evolution toward greater self-government for Puerto Rico, the Congress of the United States enacted Public Law 600,

which is “in the nature of a compact” and which became effective upon its acceptance by the electorate of Puerto Rico. It provides that those sections of existing law which defined the political, economic and fiscal relationship between Puerto Rico and the United States would remain in full force. It also authorized the people of Puerto Rico to draft and adopt their own Constitution. The Constitution was drafted by a popularly elected constitutional convention, overwhelmingly approved in a special referendum by the people of Puerto Rico and approved by the United States Congress and the President of the United States, becoming effective upon proclamation of the Governor of Puerto Rico on July 25, 1952. Puerto Rico’s relationship with the United States is referred to herein as commonwealth status.

The government of Puerto Rico exercises virtually the same control over its internal affairs as do the fifty states; however, it differs from the states in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives and limited voting powers. Most federal taxes, except those such as social security taxes, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on ordinary income earned from sources in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries.

The Commonwealth’s Constitution provides for the separation of powers of the executive, legislative and judicial branches of government. The Governor is elected every four years. The bicameral Legislature consists of a Senate and a House of Representatives and is elected for four-year terms.

Governmental responsibilities assumed by the government of Puerto Rico are similar in nature to those of the various state governments but more extensive in scope. The government of Puerto Rico assumes responsibility for local police and fire protection, education, public health and welfare programs, and economic development.

### **Economy of Puerto Rico**

The economy of Puerto Rico is closely integrated with that of the mainland United States. During fiscal 2002, approximately 89% of Puerto Rico’s exports were to the United States mainland, which was also the source of approximately 50% of Puerto Rico’s imports. In fiscal 2002, Puerto Rico experienced a \$18.2 billion positive adjusted merchandise trade balance.

The economy of Puerto Rico is dominated by the manufacturing and service sectors. The manufacturing sector has experienced a basic change over the years as a result of increased emphasis on higher wage, high technology industries such as pharmaceuticals, electronics, computers, microprocessors, professional and scientific instruments, and certain high technology machinery and equipment. The service sector, including finance, insurance and real estate, also plays a major role in the economy. It ranks second only to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment. In recent years, the service sector has experienced significant growth in response to the expansion of the manufacturing sector.

Gross product in fiscal 2002 was \$45.2 billion and gross product in fiscal 2001 was \$44.2 billion. This represents an increase in gross product of 2.3%.

## RATINGS

Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., have given the 2004 Program Notes a rating of A-1. Such rating reflects only the respective views of such organizations and the explanation of the significance of such ratings may be obtained only from the rating agency furnishing the same. There is no assurance that such rating will remain in effect for any given period of time or that it will not be revised downward or withdrawn entirely by such rating agencies if, in their respective judgment, circumstances so warrant. Any such downward revision or withdrawal of such rating may have an adverse effect on the market prices of the 2004 Program Notes.

## TAX EXEMPTION

### **2004 Program and Subsequent Programs**

The following discussion relates only to commercial paper notes of the Issuer, the interest on which is intended to be excludable from the gross income of the holders thereof for federal income tax purposes.

The Resolution establishes the 2004 Program covering 2004 Program Notes issued during the 18-month period beginning on the first date of issuance of such notes (such date of first issuance and the date of first issuance of at least \$50,000 of Subsequent Program Tax Exempt Notes referred to below is herein called the "issue date" of the program to which such first issuance relates) to finance capital expenditures, as well as notes issued during such 18-month period to refinance, directly or through a series of refinancings, notes originally issued to finance capital expenditures. The Resolution also provides for the establishment, from time to time, of new programs to succeed the 2004 Program or a subsequent program (each, a "Subsequent Program"). The Resolution provides that proceeds of commercial paper notes issued under a Subsequent Program within the 18-month period beginning on the issue date of that Subsequent Program may be used to finance or refinance (i) loans to the Borrowers as described above in *Use of Proceeds*, (ii) certain costs of issuance of commercial paper notes issued under that Subsequent Program, or (iii) commercial paper notes issued under the 2004 Program or any other prior Subsequent Program. Commercial paper notes issued under a Subsequent Program will be referred to herein as the "Subsequent Program Tax-Exempt Notes."

*2004 Program.* The Internal Revenue Code of 1986, as amended (the "Code"), includes requirements regarding the use, expenditure and investment of note proceeds and the timely payment of certain investment earnings, if any, to the Treasury of the United States, which the Issuer and the Borrowers must continue to meet after the issue date of the 2004 Program Notes in order that interest on the 2004 Program Notes not be included in gross income for federal income tax purposes. The failure by the Issuer or the Borrowers to meet these requirements may cause interest on the 2004 Program Notes to be included in gross income for federal income tax purposes retroactive to the issue date. The Issuer has covenanted to comply, and has covenanted to obtain similar covenants from the Borrowers, to the extent permitted by the Constitution and laws of Puerto Rico with the requirements of the Code in order for interest on the 2004 Program Notes to remain exempt from federal income taxes. Issuer's Counsel is not aware of any provision of the Constitution or laws of Puerto Rico

which would prevent the Issuer or the Borrowers from complying with the requirements of the Code.

In the opinion of Sidley Austin Brown & Wood LLP, Issuer's Counsel, subject to continuing compliance by the Issuer and the Borrowers with the tax covenant referred to above, under the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the 2004 Program Notes is not includable in gross income for federal income tax purposes. Interest on the 2004 Program Notes is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations; however, interest on the 2004 Program Notes will be includable in the computation of the alternative minimum tax on corporations imposed by the Code and may, therefore, affect a corporation's alternative minimum tax liability. Issuer's Counsel is further of the opinion that the 2004 Program Notes and the interest thereon are exempt from state, Commonwealth and local income taxation.

Ownership of the 2004 Program Notes may result in collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, certain foreign corporations, certain S Corporations with excess passive income, individual recipients of Social Security or Railroad Retirement benefits, taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry the tax-exempt obligations and taxpayers who may be eligible for the earned income tax credit.

Ownership of the 2004 Program Notes may also result in collateral income tax consequences under Puerto Rico law to financial institutions doing business in Puerto Rico.

Prospective purchasers of the 2004 Program Notes should consult their tax advisors as to applicability and impact of any collateral consequences.

Legislation affecting municipal securities is constantly being considered by the United States Congress. There can be no assurance that legislation enacted after the first date of issuance of the 2004 Program Notes will not have an adverse effect on the tax-exempt status of the 2004 Program Notes. Legislative or regulatory actions and proposals may also affect the economic value of tax exemption or the market price of the 2004 Program Notes.

*Subsequent Programs.* Subsequent Program Tax-Exempt Notes may be issued, from time to time, subject to the satisfaction of conditions set forth in the Resolution as described above. Subject to the satisfaction of certain conditions, including but not limited to, the receipt by Issuer's Counsel of representations and certifications of the Issuer and the Borrowers acceptable to Issuer's Counsel with respect to the use and investment of proceeds of each issue of Subsequent Program Tax-Exempt Notes, Issuer's Counsel expects to be able to deliver on the issue date of each Subsequent Program an opinion substantially similar to the opinion described above with respect to the 2004 Program Notes, and subject to the same limitations and conditions described above. New legislation, regulations, court decisions, rulings or other pronouncements that are enacted, promulgated or interpreted after the date hereof, however, may prevent Issuer's Counsel from rendering such opinion, otherwise affect the substance of such opinion or diminish the value of or otherwise affect the federal income tax treatment of the interest on Subsequent Program Tax-Exempt Notes. Prospective purchasers should consult their tax advisors with respect to any such changes.

## **LEGAL MATTERS**

The authorization and issuance of the 2004 Program Notes are subject to the approval of legality by Sidley Austin Brown & Wood LLP, New York, New York, Issuer's Counsel. The form of opinion of Sidley Austin Brown & Wood LLP, which will be dated and premised on law in effect on the date of the first delivery of 2004 Program Notes, is set forth in Appendix C hereto.

## **MISCELLANEOUS**

Appended to and constituting a part of this Information Memorandum are the Financial Statements of the Issuer for the year ended June 30, 2003, together with the independent auditors' report thereon of KPMG LLP, dated November 26, 2003 (Appendix A), the form of the Master Note (Appendix B), and the form of opinion of Sidley Austin Brown & Wood LLP, Issuer's Counsel (Appendix C).

Initially, the 2004 Program Notes are being issued without any liquidity facility in place in respect of such Notes. If, however, the Issuer decides at a future time to obtain a liquidity facility for all or any of the then outstanding 2004 Program Notes, the Issuer will give written 15-day advance notification to the holders of such 2004 Program Notes of the obtaining of such a facility, including the name and rating of the proposed issuer of such facility.

The Issuer will provide, when available, copies of its annual audited financial statements and other pertinent credit information relevant to the 2004 Program Notes to any Noteholder who requests the same in writing to Government Development Bank for Puerto Rico, 140 Broadway, 38th Floor, New York, New York 10005.



**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements  
and Required Supplementary Information

June 30, 2003

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## independent auditors' report



American International Plaza Suite 1100  
250 Ave. Muñoz Rivera  
San Juan, PR 00918-1819

The Board of Directors

Government Development Bank for Puerto Rico:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of Government Development Bank for Puerto Rico (the Bank), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2003, which collectively comprise the Bank's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Bank's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of Government Development Bank for Puerto Rico, as of June 30, 2003, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 32 through 43 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

**KPMG LLP**

November 26, 2003

Stamp No. 1901935 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report.



KPMG LLP, KPMG LLP, a U.S. limited liability partnership, is  
a member of KPMG International, a Swiss association.

## management's discussion and analysis

This section presents a narrative overview and analysis of the financial performance of Government Development Bank for Puerto Rico (the Bank) for the year ended June 30, 2003. The information presented here should be read in conjunction with the basic financial statements, including the notes thereto.

### (1) Financial Highlights

- Assets and liabilities of the Bank at June 30, 2003 amounted to \$8,867 million and \$6,711 million, respectively, for net assets of \$2,156 million or 24% of total assets.
- Change in net assets from the prior year amounted to \$153.6 million. The increase in net assets comprises \$176.6 million from business-type activities net of a decrease of \$23 million in net assets of governmental activities.

### (2) Overview of the Financial Statements

This discussion and analysis is required supplementary information to the basic financial statements and is intended to serve as introduction to the basic financial statements of the Bank. The basic financial statements comprise three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the basic financial statements.

**Government-wide Financial Statements** – The government-wide financial statements are designed to provide readers with a broad overview of the Bank's finances, in a manner similar to a private-sector business. The statement of net assets provides information on the Bank's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Bank is improving or deteriorating. The statement of activities presents information on how the Bank's net assets changed during the reporting period. Changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows.

**Fund Financial Statements** – A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Bank's funds are divided in two categories: governmental funds and enterprise funds.

- **Governmental Funds** – Governmental funds are used to account for the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of financial decisions related to the Bank's governmental activities. Both the governmental fund balance sheet and the governmental statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

- **Enterprise Funds** – Enterprise funds provide the same type of information as the business-type activities in the government-wide financial statements, only in more detail. The enterprise fund financial statements of the Bank provide separate information on the business-type activities of the Bank's blended component units, which are considered major funds of the Bank.

**Notes to the Basic Financial Statements** – The notes provide additional information that is essential to a full understanding of the data provided in the government-wide financial statements and the fund financial statements.

### (3) Government-wide Financial Analysis

Total assets and total liabilities of the Bank at June 30, 2003 amounted to \$8,867 million and \$6,711 million, respectively, for net assets of \$2,156 million or 24% of total assets. From the \$2,156 million in net assets, \$1,708 million or 79% are unrestricted, \$353 million or 16% are restricted for use in affordable housing programs, and the remaining 5% is invested in capital assets, restricted for debt service, and for the mortgage loan insurance program. Governmental and business-type activities are discussed separately in the following subsections.

**Governmental Activities**

Total assets of governmental activities amounted to \$367.4 million at June 30, 2003, before \$185.8 million in net balances due to business-type activities. Total liabilities amounted to \$165.4 million, for net assets of \$16.1 million or 8.9% of total assets. Net assets have been broken down into the amounts restricted for debt service of \$56.9 million and for affordable housing programs of \$117.8 million, and the unrestricted deficit of \$158.6 million, which means that the restrictions existing on the use of available assets will impede the Bank from satisfying its existing liabilities from those assets, and therefore that it will depend on future appropriations for the repayment of all its obligations.

Condensed financial information on assets, liabilities, and net assets of governmental activities is shown below (amounts in thousands):

	2003	2002	Change
<b>Assets</b>			
Due from Commonwealth of Puerto Rico	\$ 6,217	4,929	1,288
Due from municipalities and other component units of the Commonwealth of Puerto Rico	-	1,477	(1,477)
Due from federal government	10,601	14,968	(4,367)
Restricted:			
Cash and deposits placed with banks	11,488	14,971	(3,483)
Investments and investment contracts	326,985	319,135	7,850
Loans receivable, net	7,331	4,990	2,341
Other assets	4,754	4,686	68
Total assets before internal balances	367,376	365,156	2,220
Internal balances	(185,806)	(51,876)	(133,930)
Total assets	181,570	313,280	(131,710)
<b>Liabilities and Net Assets</b>			
Due to Commonwealth of Puerto Rico	-	75,000	(75,000)
Accounts payable and accrued liabilities	6,825	7,776	(951)
Notes payable:			
Due in one year	102	-	102
Due in more than one year	9,927	10,029	(102)
Bonds payable:			
Due in one year	36,395	32,770	3,625
Due in more than one year	112,175	148,570	(36,395)
Total liabilities	165,424	274,145	(108,721)
<b>Net assets</b>			
Restricted for debt service	56,920	45,868	11,052
Restricted for affordable housing programs	117,825	184,636	(66,811)
Unrestricted deficit	(158,599)	(191,369)	32,770
Total net assets	\$ 16,146	39,135	(22,989)

Investments and investment contracts amounted to \$327 million and account for the majority of assets held by governmental activities. These investments, together with cash and deposits placed with banks of \$11.5 million are held to provide the funds necessary for the execution of the various affordable housing programs managed by the Puerto Rico Housing Finance Authority (the Authority) and, to some extent, for debt service. Governmental activities also have balances due from the Commonwealth of Puerto Rico (the Commonwealth) and the federal government of \$6.2 million and \$10.6 million, respectively, that are related to the reimbursement of eligible expenses incurred in the New Secure Housing Program.

The increase in internal balances due to business-type activities is mainly due to two new borrowings with the GDB Operating Fund. One is a repurchase agreement entered into by Stage 7 of the Affordable Housing Mortgage Subsidy Program (AHMSP) in order to provide funds for the payment of \$75 million due to the Commonwealth related to the transfer of residual net assets of the former Housing Bank's governmental activities, as set forth by Act No. 103 of August 11, 2002. The other borrowing is a line of credit of \$89 million for Stage 9 of the AHMSP, which was launched during the year.

The most significant liabilities of governmental activities are the bonds and notes payable amounting to \$148.6 million and \$10 million at June 30, 2003, respectively. During the year, principal payments to service the bonds amounted to \$32.8 million.

Condensed financial information on expenses, program and general revenues, and changes in net assets of governmental activities is shown below (amounts in thousands):

<b>Year ended June 30, 2003</b>			
	<b>General government</b>	<b>Housing subsidy programs</b>	<b>Total</b>
Expenses	\$ 1,041	80,571	81,612
Program revenues:			
Charges for services – financing and investment	-	34,587	34,587
Grants and contributions	-	68,949	68,949
Net (expenses) revenues	\$ (1,041)	22,965	21,924
General revenues – unrestricted income			97
Transfers			(45,010)
Change in net assets			(22,989)
Net assets, beginning of year			39,135
Net assets, end of year		\$	16,146

Year ended June 30, 2002			
	General government	Housing subsidy programs	Total
Expenses	\$ 1,961	69,418	71,379
Program revenues:			
Charges for services – financing and investment	-	23,806	23,806
Grants and contributions	-	111,658	111,658
Net (expenses) revenues	\$ (1,961)	66,046	64,085
General revenues – unrestricted income			760
Transfers			3,755
Change in net assets			68,600
Net assets (deficit), beginning of year			(29,465)
Net assets, end of year		\$	39,135

Total expenses of governmental activities amounted to \$81.6 million for the year ended June 30, 2003, an increase of \$10.2 million or 14% with respect to the prior year. Expenses for housing subsidy programs increased to \$62.5 million from \$43.9 million in 2002. This increase is driven mostly by an increase in subsidies of the Key for Your Home Program, which amounted to \$41.6 million in 2003 compared to only \$5.1 million in 2002. Offsetting this large increase is a decrease in expenditures of \$9.7 million in the New Secure Housing Program. Interest on long-term debt decreased by \$7.5 million from \$25.5 million in 2002 to \$18 million in 2003. This reduction is consistent with the repayment of principal during the year with no offsetting new borrowings.

Revenues from financing and investing activities provided \$34.6 million in 2003 and \$23.8 million in 2002 to be used for the benefit of the housing subsidy programs. The increase in revenues from financing and investing activities is due to an increase in the average balance of investments associated with stages 8 and 9 of the AHMSP, launched in fiscal year 2002 and 2003, respectively. Grants received for housing subsidy programs amounted to \$68.9 million in 2003 compared to \$104.7 million in 2002. The reduction is mainly related to a decrease in reimbursements from the federal government for eligible expenditures incurred in the New Secure Housing Program. No grants were received during the year to service long-term debt.

General revenues and transfers for the year include \$45 million in net transfers to business-type activities, primarily related to the transfer of residual reserves of governmental funds that were used for debt service by the enterprise funds of the AHMSP.

**Business-Type Activities**

Condensed financial information on assets, liabilities, and net assets is presented below (amounts in thousands):

Assets	June 30		Change	
	2003	2002	Amount	%
Cash and due from banks	\$ 45,801	24,901	20,900	83.9%
Federal funds and securities purchased under agreement to resell	1,233,400	1,546,500	(313,100)	(20.2)%
Deposits placed with banks	407,975	568,089	(160,114)	(28.2)%
Investments and investment contracts	3,903,266	3,744,119	159,147	4.3%
Loans receivable, net	2,628,933	2,259,263	369,670	16.4%
Interest and other receivables	109,774	99,790	9,984	10.0%
Capital assets	14,817	16,625	(1,808)	(10.9)%
Other assets	155,631	52,002	103,629	199.3%
Internal balances	185,806	51,876	133,930	258.2%
	<u>8,685,403</u>	<u>8,363,165</u>	<u>322,238</u>	<u>3.9%</u>
<b>Liabilities and Net Assets</b>				
Deposits:				
Demand	1,617,667	2,070,536	(452,869)	(21.9)%
Certificates of deposit	1,918,890	1,797,573	121,317	6.7%
Certificates of indebtedness	242,984	294,591	(51,607)	(17.5)%
Securities sold under agreement to repurchase	190,017	170,000	20,017	11.8%
Commercial paper	761,167	398,746	362,421	90.9%
Accrued interest payable	12,016	15,382	(3,366)	(21.9)%
Due to Commonwealth of Puerto Rico	6,924	162,027	(155,103)	(95.7)%
Accounts payable and accrued liabilities	173,005	185,279	(12,274)	(6.6)%
Bonds and notes payable:				
Due in one year	47,995	42,799	5,196	12.1%
Due in more than one year	1,575,105	1,263,179	311,926	24.7%
Total liabilities	<u>6,545,770</u>	<u>6,400,112</u>	<u>145,658</u>	<u>2.3%</u>
Net assets:				
Invested in capital assets	14,817	16,625	(1,808)	(10.9)%
Restricted for:				
Affordable housing programs	235,178	165,108	70,070	42.4%
Mortgage loan insurance	23,352	20,806	2,546	12.2%
Unrestricted	1,866,286	1,761,234	105,052	6.0%
Total net assets	<u>\$ 2,139,633</u>	<u>1,963,773</u>	<u>175,860</u>	<u>9.0%</u>

### **Federal Funds Sold, Securities Purchased under Agreement to Resell, and Deposits Placed with Banks**

Federal funds and securities purchased under agreements to resell decreased by \$313.1 million or 20%, from \$1,547 million at June 30, 2002 to \$1,233 million at June 30, 2003. Deposits placed with banks amounted to \$408 million at June 30, 2003 compared to \$568.1 million at June 30, 2002. Both decreases respond to the reduction in available funds from deposits and to the payment of amounts due to the Commonwealth.

### **Investments and Investment Contracts**

Investments and investment contracts held in business-type activities amounted to \$3,903 million at June 30, 2003. This amount represents an increase of \$159.1 million or 4% when compared to prior year balance. This increase is the net effect of a reduction in the investments portfolio of the GDB Operating Fund of approximately \$230 million caused in part by a reduction in deposits, and an increase in the portfolio of investments of the Authority of approximately \$300 million funded with the proceeds of home mortgage revenue bonds issued during the year.

The investment portfolio comprised 44.9% of the total assets of the Bank's business-type activities at June 30, 2003, compared to 44.8% at the close of fiscal year 2002. Within the investment securities portfolio, \$1,518 million at June 30, 2003 and \$1,174 million at June 30, 2002 were restricted or pledged as collateral or payment source for specific borrowings.

### **Loans Receivable**

Net loans receivable of \$2,629 million accounted for 30% of total assets of business-type activities at June 30, 2003 (27% in 2002). The increase of approximately \$370 million in net loans was driven by an increase in public sector loans, where the largest increase was in loans to the Department of the Treasury of the Commonwealth of Puerto Rico (the Department of the Treasury).

Most of the public sector loans have designated repayment sources available through appropriations in the Commonwealth's budget in upcoming fiscal years. The Legislature generally has approved these appropriations to assist certain public sector entities in repaying their loans with the Bank. Furthermore, and in accordance with Act No. 164 of December 17, 2001, the Bank is no longer allowed to originate loans without a specific source of repayment being identified beforehand. Act No. 164 provides, however, for the Bank to originate new loans up to \$100 million without a specific source of repayment with authorization in writing from both the Commonwealth's Governor and the Director of the Office of Management and Budget. The Bank has not charged-off any loans from the public sector portfolio and accordingly does not establish an allowance for loan losses for any of these loans.

Private sector loans outstanding at June 30, 2003 and 2002 amounted to \$292.2 million and \$270.4 million, respectively, net of allowance for loan losses of \$23.4 million and \$24.3 million, respectively. The increase in loans responds to an aggressive campaign by the Puerto Rico Housing Finance Authority to originate construction and permanent mortgage loans. Activity in the private sector loans of the Bank was not significant.

### **Deposits**

Deposits mainly consist of interest-bearing demand deposit accounts, special government deposit accounts, and time deposits from the Commonwealth, its agencies, instrumentalities, and municipalities.

Demand deposits and certificates of deposit had a combined net decrease of \$332 million from \$3,868 million at June 30, 2002. The primary reason for this decrease is the exit of approximately \$250 million in escrow deposits from municipal loans that were sold in December 2002 to the Puerto Rico Municipal Finance Agency, another component unit of the Commonwealth.

### **Commercial Paper**

Commercial paper increased by 91% from \$398.7 million at June 30, 2002 to \$761.2 million at June 30, 2003. The increase is directly related to the corresponding increase in loans receivable which are in part funded with commercial paper.

**Other Borrowed Funds**

The decrease in the amount due to the Commonwealth results from the payment by the Puerto Rico Housing Finance Authority of amounts due to the Commonwealth pursuant to Act No. 103 of August 11, 2001.

Bonds payable increased by 24% from \$1,306 million at June 30, 2002 to \$1,623 million at June 30, 2003. This increase is the net effect of the issuance of \$452.5 million in Puerto Rico Home Mortgage Revenue Bonds by the Puerto Rico Housing Finance Authority during the year and the effect of the scheduled repayment of debt in August 2002. For additional information on the activity of bonds payable during the year, see note 12 to the basic financial statements.

Condensed financial information on expenses, program revenues, and changes in net assets for business-type activities is presented below (amounts in thousands):

Year ended June 30, 2003					
Activity	Expenses	Program revenues			Net revenues (expenses)
		Charges for services			
		Fees, commissions, and other	Financing and investment	Operating grants and contributions	
GDB Operating Fund	\$ 162,117	50,601	219,743	-	108,227
Housing Finance Authority	216,270	18,669	134,931	112,199	49,529
Tourism Development Fund	15,218	6,744	1,959	-	(6,515)
Public Finance Corporation	422	-	115	-	(307)
Capital Fund	46	-	1,728	-	1,682
Development Fund	41	-	(1,771)	-	(1,812)
Other	50	-	1	-	(49)
<b>Totals</b>	<b>\$ 394,164</b>	<b>76,014</b>	<b>356,706</b>	<b>112,199</b>	<b>150,755</b>
Contributions to others					(19,185)
Transfers from governmental activities					45,010
Change in net assets					176,580
Net assets, beginning of year					1,963,053
Net assets, end of year				\$	2,139,633

Year ended June 30, 2003					
Activity	Expenses	Program revenues			Net revenues (expenses)
		Charges for services			
		Fees, commissions, and other	Financing and investment	Operating grants and contributions	
GDB Operating Fund	\$ 260,470	17,986	345,977	-	103,493
Housing Finance Authority	205,955	12,520	134,499	112,708	53,772
Tourism Development Fund	9,258	7,244	3,114	50,000	51,100
Public Finance Corporation	37,332	-	7,944	32,056	2,668
Capital Fund	70	-	(20,310)	-	(20,380)
Development Fund	42	-	502	-	460
Totals	\$ 513,127	37,750	471,726	194,764	191,113
Contributions to others					(38,262)
Transfers to governmental activities					(3,755)
Change in net assets					149,096
Net assets, beginning of year					1,813,957
Net assets, end of year				\$	1,963,053

Activities presented in the statement of activities coincide with the major enterprise funds of the Bank. GDB Operating Fund generated financing and investment revenues of \$219.7 million from its loan and investment portfolios and generated \$50.6 million in other charges for services. These revenues covered \$162.1 million in expenses for net revenues from GDB Operating Fund of \$108.2 million, surpassing the net revenues of any other activity and contributing to the \$176.6 million in change in net assets for the year. The significant reduction in financing and investment revenues of the GDB Operating Fund is discussed below in the analysis of fund financial statements.

Puerto Rico Housing Finance Authority activities were the second largest contributor to the change in net assets with net revenues of \$49.5 million. The net revenues of \$51.1 million from the Tourism Development Fund in 2002 were mostly the result of a \$50 million transfer from the GDB Operating Fund, which was included within the expenses of the GDB Operating Fund. Likewise, the net revenues of the Public Finance Corporation for 2002 were net of a \$32 million transfer, also included within expenses of the GDB Operating Fund for 2002. These transfers from the GDB Operating Fund in 2002 help explain the 38% decrease in expenses of the GDB Operating Fund, as no such transfers occurred in 2003.

Contributions to others for 2003 include \$11.6 million transferred to the Commonwealth pursuant to Act No. 82 of June 16, 2002. The amount shown for 2002 includes \$10 million of the contribution for fiscal year 2001 because of the retroactive implementation of the Act No. 82, and \$25.3 million of the contribution for fiscal year 2002.

#### (4) Analysis of Fund Financial Statements

##### **Governmental Funds**

Through its blended component unit, the Puerto Rico Housing Finance Authority, the Bank has five major governmental funds: three special revenue funds and two debt service funds. Following, we provide an analysis of the financial position and changes in financial position of these major governmental funds.

##### *Affordable Housing Mortgage Subsidy Program – Stage 7*

At June 30, 2003, the fund's assets consisted substantially of its investment in collateralized mortgage obligations of \$97.8 million, which provided investment earnings during the year of \$10.1 million. The fund's primary liability is a repurchase agreement with the GDB Operating Fund, which was entered into with the purpose of providing the funds for the transfer to the budgetary fund of the Commonwealth of \$75 million in fund net assets pursuant to Act No. 103 of August 11, 2001.

Fund balance increased by \$5.3 million from \$17.1 million at June 30, 2002 to \$22.3 million at June 30, 2003, as investment earnings were more than sufficient to cover subsidy payments of \$3.8 million and interest payments of \$1.5 million.

##### *Subsidy Prepayment Refunding Bonds – Debt Service*

During the year ended June 30, 2003, Commonwealth appropriations of \$30.9 million and investment earnings of \$2 million were almost sufficient to cover debt service expenditures of \$33 million, for a net reduction in fund balance of approximately \$18,000.

At June 30, 2003, total bonds outstanding payable through this debt service fund amounted to approximately \$116.1 million.

##### *New Secure Housing Program*

During the year ended June 30, 2003, 229 eligible families occupied completed dwellings. Currently, the program continues to develop one additional housing project and has plans for 12 additional projects in the future.

During the year, the program recognized revenue from federal and Commonwealth appropriations of approximately \$9.6 million and \$8.4 million, respectively. Construction costs paid during the years 2003 and 2002 amounted to approximately \$10.3 million and \$18.9 million, respectively, and are included in payments for housing subsidy programs in the accompanying statement of revenues, expenditures, and changes in fund balances.

Fund deficit decreased by approximately \$7 million during the year, from a deficit of \$17.1 million at June 30, 2002 to a deficit of \$10.1 million at June 30, 2003. The deficit is primarily due to the deferral of federal grant revenue for which eligibility requirements have not been met. Deferred revenue at June 30, 2003 amounted to \$8.4 million.

##### *Special Obligation Refunding Bonds – Debt Service*

The fund received no Commonwealth appropriations during the year and made no debt service payments since final repayment of the Puerto Rico Urban Renewal and Housing Corporation bonds occurred in 2002. Earnings from investments and loans receivable provided \$6.5 million in revenues which, after covering various minor expenditures, provided for a change in net assets of \$6.1 million from \$18.1 million at June 30, 2002 to \$24.3 million at June 30, 2003.

##### *The Key for Your Home Program*

During the year, the fund received Commonwealth appropriations of \$22 million, which, together with transfers totaling \$18.1 million from the Stage 6 fund, helped finance subsidy payments totaling \$41.6 million during the year. The change in net assets was a reduction of \$1.1 million from \$10.4 million at June 30, 2002, to \$9.3 million at June 30, 2003.

### **Enterprise Funds**

Following is a discussion of the most significant changes in the Bank's enterprise funds. Our main focus will be on the GDB Operating Fund, since separate basic financial statements are issued for each of the Bank's other major enterprise funds, which are blended component units.

#### **GDB Operating Fund**

Total assets of the GDB Operating Fund amounted to \$6,824 million at June 30, 2003, compared to \$6,823 million at June 30, 2002. Reductions in federal funds and securities purchased under agreement to resell, deposits placed with banks and in investments and investment contracts are all in part related to a reduction in available funds from deposits and to an increase in internal balances due from governmental funds of the Bank. The increase in the portfolio of loans receivable of \$351.3 million or 17.5% was driven mostly by borrowings from the Department of the Treasury.

Total liabilities decreased by \$88 million to \$5,360 million at June 30, 2003. The most significant decrease was in deposits that decreased from \$4,338 million to \$3,944 million at June 30, 2003. The decrease in deposits is mainly caused by the exit of approximately \$250 million in escrow deposits of municipalities in connection with the sale of municipal loans to the Puerto Rico Municipal Finance Agency, another component unit of the Commonwealth, in December 2002. Commercial paper increased 91% or \$362.5 million from \$398.7 million outstanding at June 30, 2002 to \$761.2 million at June 30, 2003.

Change in net assets of the GDB Operating Fund increased 36% from \$65.2 million in 2002 to \$88.7 million in 2003. Following we discuss the various components of the change in net assets of the GDB Operating Fund, compared with the prior year.

#### **(a) Interest Income, Interest Expense, and Change in Fair Value of Investments**

Net interest income, the difference between interest income and interest expense, decreased from \$180.2 million in 2002 to \$99.4 million in 2003. Interest expense decreased by 26%, or from \$141.8 million to \$105 million, while interest income decreased by 37% or from \$322 million to \$204.5 million. Driving the reduction in net interest income was a decrease of 50% in interest income from loans. Fiscal year 2002 figures were affected by a nonrecurring opportunity provided to the GDB Operating Fund by Act No. 164 to restructure, retroactively to July 1, 2001, the portfolio of nonperforming public sector loans identified by the act. The restructuring entailed the capitalization of accrued interest at June 30, 2001 and an adjustment to the interest rate on the loans to a fixed 8% until their securitization. The difference between the rates of the original loans and the rate of the refinancing over an increased principal amount produced approximately \$30.8 million of additional interest income until the first related bond issued in December 2001. Also, interest income from loans decreased due to a lower average balance of loans, as approximately \$2.4 billion in loans were sold during 2002 with the approval of Act No. 164 and close to \$450 million in municipal loans were sold in December 2002 to the Puerto Rico Municipal Finance Agency.

The change in fair value of investments decreased from \$23.9 million in 2002 to \$15.3 million in 2003. As seen in the prior year, declining interest rates during 2003 yielded valuation gains in the investment portfolio.

#### **(b) Provision for Losses on Loans and on Guarantees and Letters of Credit**

The GDB Operating Fund recorded no provision in 2003. In 2002, after a revaluation of its private sector loan portfolio, the GDB Operating Fund had recorded an adjustment of \$1.5 million to reduce the allowance.

No provision for losses on guarantees and letters of credit was recorded in 2003 or 2002.

#### **(c) Noninterest Income**

Fiscal agency fees income decreased 24% from \$10.4 million in 2002 to \$7.9 million in 2003. Although bond issues managed by the GDB Operating Fund during 2003 did not reach the record levels of 2002, fiscal agency activity yielded more fees than any other period since 1993.

The increase in other income of \$34.3 million is due to the amortization in 2003 of \$37.7 million in deferred revenues representing the recovery of prior years' losses related to the Public Finance Corporation's tax liens transaction.

**(d) Noninterest Expenses**

Salaries and fringe benefits increased by 27% from \$17.4 million in 2002 to \$22.2 million in 2003. The \$4.8 million increase includes \$1.3 million for salary increases, \$0.6 million for a new productivity bonus, \$0.78 million of increased medical charges, and \$1.37 million of adjustment to vacation and sick leave accruals from a revision in rates.

The reduction of 36% in legal and professional fees is due to the completion of various internal projects that entailed management consulting services.

**(e) Contributions to Others**

Contributions to others in 2003 include a contribution to the General Fund of the Commonwealth of \$11.6 million pursuant to Act No. 82 of June 16, 2002. Act No. 82's contribution recorded in 2002 included \$10 million corresponding to fiscal year 2001 and \$25.3 million corresponding to fiscal year 2002. The reduction in the contribution for 2003 compared to the contribution for 2002 is due to a lower change in net assets and due to the prospective adoption by the board of directors of the Bank of a more restrictive interpretation of Act No. 82, beginning with fiscal year 2003. Contributions to others in 2003 also include \$5.5 million for the incorporation and capitalization of the Cooperative Development Investment Fund, \$350,000 for the Puerto Rico 2025 project, and \$300,000 for the newly created José M. Berrocal Finance and Economics Institute. Finally, contributions to others include grants of \$1 million and \$2 million in 2003 and 2002, respectively, to partially cover operational expenses of the Puerto Rico Art Museum.

*Puerto Rico Housing Finance Authority*

Total net assets of the Puerto Rico Housing Finance Authority's enterprise funds increased by \$94.5 million or 24% during the year. This change resulted from a net interest income after provision for loan losses of \$16.1 million during the year, noninterest income of \$130.9 million, and noninterest expenses of \$126.4 million, both including \$112.2 million received and expensed in connection with federal assistance programs, a \$29 million positive change in the fair value of investments, and net transfers from governmental funds of \$45 million.

*Capital Fund*

The Capital Fund's total net assets increased \$1.7 million or 3% during the year to \$58.7 million at June 30, 2003. This increase is mainly due to an increase in the fair value of its investments of \$1.1 million, which is presented as change in fair value of investments in the statement of revenues, expenses, and changes in net assets – enterprise funds. This increase in the fair value of investments is consistent with the moderate recuperation seen throughout in the equity markets, and represents a significant improvement when compared to the loss of \$20.9 million in 2002.

*Development Fund*

Net assets of the Development Fund decreased by \$1.8 million or 6% during the year to \$29.5 million at June 30, 2003. This decrease is mainly due to a net decrease of \$1.9 million in the market value of the group of companies in which the Development Fund has invested through the Guayacán Private Equity Fund.

*Tourism Development Fund*

Net assets of the Tourism Development Fund decreased by \$6.5 million or 6% during the year to \$96 million at June 30, 2003. The decrease in net assets, resulting from revenues, not being sufficient to cover the provision for losses on guarantees and letters of credit recorded during the year. Most of the provision recorded during the year was related to a specific allowance of \$10.5 million for the Cayo Largo Intercontinental Beach Resort project guaranty. At June 30, 2003, outstanding guarantees and letter of credit commitments of the Tourism Development Fund stood at \$563 million.

### *Public Finance Corporation*

Overall activity for the Public Finance Corporation, other than the sporadic issuances of noncommitment debt, has diminished significantly since the cancellation of the tax debts transaction in April 2002. Net assets decreased by \$307,000 because interest income, the Public Finance Corporation's only source of revenue, was not sufficient to cover operational expenses, primarily professional and servicing fees.

#### **(5) Debt**

Total bonds and notes outstanding at year-end amounted to \$1,782 million of which \$1,496.9 million are payable from restricted assets held by the Puerto Rico Housing Finance Authority. The only new bond issues during the year were the issuance of \$102.5 million in Homeownership Mortgage Revenue Bonds and \$350 million in Single Family Mortgage Revenue Bonds by the Puerto Rico Housing Finance Authority to fund its Affordable Housing Mortgage Subsidy Program. Repayments and other reductions in debt outstanding aggregated \$168.3 million. See note 12 to the basic financial statements for additional information on debt activities during the year.

#### **(6) Next Year's Events**

In July 2003, the Public Finance Corporation issued approximately \$382 million of Commonwealth Appropriations Bonds maturing at various dates through 2025. The proceeds of the bonds, except for their related cost of issuance, were used to restructure debt recorded as loans from the public sector by the Bank from the Department of the Treasury, the Puerto Rico Maritime Shipping Authority, and the Land Authority, according to Act No. 164 of December 17, 2001, created specifically to reduce the interest cost of these debts and of other debts of other agencies of the Commonwealth, and to assign a source of repayment thereof.

In July 2003, the Tourism Fund obtained a line of credit from the Bank for a maximum of \$155.3 million with the sole purpose of refinancing the Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (AFICA) Río Mar Associates bonds which the Tourism Fund guarantees. Said bonds have an outstanding balance of \$148.8 million at June 30, 2003.

On August 6, 2003, the Tourism Fund initiated foreclosure on the mortgage note it holds as collateral for the guarantee on the AFICA Cayo Largo bonds. The indenture of the AFICA Cayo Largo bonds requires the repayment of the bonds before the execution of the mortgage note. Therefore, in order to execute the mortgage note, the Tourism Fund obtained a line of credit from the Bank just prior to filing the foreclosure action, with which the Tourism Fund called the outstanding balance of the AFICA Cayo Largo bonds. Said bonds amounted to \$75.6 million.

Management believes that the specific allowance that has been established for this project, which is included as part of the noncurrent portion of the allowance for losses on guarantees and letters of credit, is adequate.

The Bank has a commitment to transfer \$500 million to the Special Communities Perpetual Trust approved by the Legislature of the Commonwealth pursuant to Joint Resolution No. 1027 of November 21, 2002. The Trust is an entity created for the purpose of financing a variety of initiatives, primary housing and infrastructure, directed to the betterment of disadvantaged communities. The funds will be disbursed from time to time, as needed by the Trust. As of June 30, 2003, disbursements amounted to \$500,000. However, it is expected that significant disbursements will be made in the next year.

#### **(7) Contacting the Bank's Financial Management**

This report is designed to provide all interested with a general overview of the Bank's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to Government Development Bank for Puerto Rico, PO Box 42001, San Juan, Puerto Rico, 00940-2001.

## basic financial statements:

### Statement of Net Assets

	Governmental activities	Business-type activities	Total
<b>Assets:</b>			
Cash and due from banks	\$ -	25,969,477	25,969,477
Federal funds sold	-	1,083,400,000	1,083,400,000
Deposits placed with banks	-	380,863,579	380,863,579
Investments and investment contracts	-	2,385,617,510	2,385,617,510
Loans receivable, net	-	2,601,193,779	2,601,193,779
Interest and other receivables	2,487,472	109,773,554	112,261,026
Due from federal government	10,601,179	-	10,601,179
Due from Commonwealth of Puerto Rico	6,216,598	-	6,216,598
Internal balances	(185,806,477)	185,806,477	-
Restricted assets:			
Cash	6,434,481	19,831,804	26,266,285
Securities purchased under agreement to resell	-	150,000,000	150,000,000
Deposits placed with banks	5,053,564	27,111,753	32,165,317
Investments and investment contracts	326,985,549	1,517,648,390	1,844,633,939
Loans receivable, net	7,331,128	27,739,307	35,070,435
Real estate available for sale	-	28,525,353	28,525,353
Capital assets	-	14,816,590	14,816,590
Other assets	2,266,670	127,106,112	129,372,782
Total assets	181,570,164	8,685,403,685	8,866,973,849
<b>Liabilities:</b>			
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:			
Demand	-	1,617,667,369	1,617,667,369
Certificates of deposit	-	1,918,890,138	1,918,890,138
Certificates of indebtedness	-	242,984,210	242,984,210
Securities sold under agreement to repurchase	-	40,017,333	40,017,333
Commercial paper	-	761,166,587	761,166,587
Note payable, due within one year	102,436	-	102,436
Accrued interest payable	-	12,015,831	12,015,831
Due to Commonwealth of Puerto Rico	-	6,924,271	6,924,271
Accounts payable and accrued liabilities	6,824,911	134,667,361	141,492,272
Allowance for losses on guarantees and letters of credit	-	31,338,585	31,338,585
Bonds payable due in more than one year	-	274,756,154	274,756,154
Note payable due in more than one year	9,926,924	-	9,926,924
Liabilities payable from restricted assets:			
Securities sold under agreement to repurchase	-	150,000,000	150,000,000
Accrued liabilities	-	6,998,899	6,998,899
Bonds payable:			
Due in one year	36,395,000	47,994,645	84,389,645
Due in more than one year	112,175,000	1,300,349,045	1,412,524,045
Total liabilities	165,424,271	6,545,770,428	6,711,194,699
<b>Net assets (deficit)</b>			
Invested in capital assets	-	14,816,590	14,816,590
Restricted for:			
Debt service	56,920,167	-	56,920,167
Affordable housing programs	117,825,086	235,177,941	353,003,027
Mortgage loan insurance	-	23,352,153	23,352,153
Unrestricted deficit	(158,599,360)	1,866,286,573	1,707,687,213
Total net assets	\$ 16,145,893	2,139,633,257	2,155,779,150

See accompanying notes to basic financial statements.

Statement of Activities

	Program Revenues			Net (expenses) revenues and changes in net assets		Total	
	Expenses	Charges for services – fees, commissions, and others	Charges for services – financing and investment	Operating grants and contributions	Capital grants and contributions		Governmental activities
<b>Functions/programs:</b>							
Governmental activities:							
General government	\$ 1,040,796	-	-	-	-	(1,040,796)	-
Housing subsidy program	80,571,622	-	34,587,092	31,922,636	37,026,968	22,965,074	-
Total governmental activities	81,612,418	-	34,587,092	31,922,636	37,026,968	21,924,278	-
Business-type activities:							
GDB Operating Fund	162,116,611	50,600,662	219,743,018	-	-	-	108,227,069
Housing Finance Authority	216,269,816	18,668,769	134,931,243	112,199,144	-	-	49,529,340
Capital Fund	46,405	-	1,728,355	-	-	-	1,681,950
Development Fund	41,086	-	(1,770,418)	-	-	-	(1,811,504)
Tourism Development Fund	15,217,986	6,744,406	1,958,715	-	-	-	(6,514,865)
Public Finance Corporation	422,100	-	114,740	-	-	-	(307,360)
Other	50,165	-	559	-	-	-	(49,606)
Total business-type activities	394,164,169	76,013,837	356,706,212	112,199,144	-	-	150,755,024
Total	\$ 475,776,587	76,013,837	391,293,304	144,121,780	37,026,968	21,924,278	150,755,024
General revenues - unrestricted income							
Contributions to others						97,128	-
Transfers						(45,010,472)	(19,185,150)
Total general revenues and transfers						(44,913,344)	45,010,472
Change in net assets						(22,989,066)	25,825,322
Net assets, beginning of year						39,134,959	176,580,346
Net assets, end of year						\$ 16,145,893	1,963,052,911
							2,139,633,257
							2,155,779,150

See accompanying notes to basic financial statements.

Balance Sheet - Governmental Funds

	Affordable Housing Mortgage Subsidy Program – Stage 7	Subsidy Prepayment Refunding Bonds – Debt Service	New Secure Housing Program	Special Obligation Refunding Bonds – Debt Service	The Key for Your Home Program	Other nonmajor governmental funds	Eliminations	Total governmental funds
<b>Assets</b>								
Interest and other receivables	\$ 513,864	188,737	-	411,339	18,338	1,355,194	-	2,487,472
Due from federal government	-	-	10,601,179	-	-	-	-	10,601,179
Due from Commonwealth of Puerto Rico	-	-	6,216,598	-	-	-	-	6,216,598
Due from other funds	-	-	400	5,033,844	5,172,239	2,502,904	(249,700)	12,459,687
Restricted:								
Cash and due from banks	-	3,000	-	42,367	-	6,389,114	-	6,434,481
Deposits placed with banks	-	-	-	3,517,125	-	1,536,439	-	5,053,564
Investments and investment contracts	97,834,322	32,187,500	-	-	3,959,017	193,004,710	-	326,985,549
Loans	-	-	-	7,331,128	-	-	-	7,331,128
Due from other funds	-	348,483	3,289,435	6,409,802	491,327	60,969,880	-	71,508,927
Other assets	-	-	1,632,569	-	634,101	-	2,266,670	-
<b>Total assets</b>	\$ 98,348,186	32,727,720	20,107,612	24,378,174	9,640,921	266,392,342	(249,700)	451,345,255
<b>Liabilities and Fund Balances</b>								
Liabilities:								
Accounts payable and accrued liabilities	\$ 42,272	78,937	6,602,847	66,790	-	34,065	-	6,824,911
Due to other funds	75,935,302	-	15,197,195	40,000	349,700	178,502,594	(249,700)	269,775,091
Deferred revenues	-	-	8,383,147	-	-	-	-	8,383,147
<b>Total liabilities</b>	75,977,574	78,937	30,183,189	106,790	349,700	178,536,659	(249,700)	284,983,149
Fund balances (deficit):								
Reserved for long-term loans receivable	-	-	-	6,412,177	-	596,405	-	7,008,582
Unreserved								
Special revenue	22,370,612	-	(10,075,577)	-	9,291,221	87,259,278	-	108,845,534
Debt service	-	32,648,783	-	17,859,207	-	-	-	50,507,990
<b>Total fund balances</b>	22,370,612	32,648,783	(10,075,577)	24,271,384	9,291,221	87,855,683	-	166,362,106
<b>Total liabilities and fund balances</b>	\$ 98,348,186	32,727,720	20,107,612	24,378,174	9,640,921	266,392,342	(249,700)	\$ 451,345,255

Amounts reported for governmental activities in the statement of net assets are different because:

Long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds	(158,599,360)
Deferred revenues in the governmental funds that do not provide current financial resources are recognized in the government-wide statements	8,383,147
Net assets of governmental activities	\$ 16,145,893

See accompanying notes to basic financial statements.

Statement of Revenues, Expenditures, and Changes in Fund Balances - Government Funds

	Affordable Housing Mortgage Subsidy Program – Stage 7	Subsidy Prepayment Refunding Bonds – Debt Service	New Secure Housing Program	Special Obligation Refunding Bonds – Debt Service	The Key for Your Home Program	Other nonmajor governmental funds	Total governmental funds
<b>Revenues:</b>							
Commonwealth appropriations for repayment of bonds and subsidy programs	\$ 549,740	30,915,603	8,433,147	-	21,956,149	5,561,626	67,416,265
Intergovernmental – federal government	-	-	9,562,761	-	-	-	9,562,761
Interest on investments	7,427,899	2,040,587	875	5,015,510	311,401	14,506,833	29,303,105
Interest income on loans, net	-	-	-	1,341,747	-	-	1,341,747
Change in fair value of investments	2,656,619	-	-	-	148,835	1,136,786	3,942,240
Other	-	-	-	95,828	-	1,300	97,128
<b>Total revenues</b>	<b>10,634,258</b>	<b>32,956,190</b>	<b>17,996,783</b>	<b>6,453,085</b>	<b>22,416,385</b>	<b>21,206,545</b>	<b>111,663,246</b>
<b>Expenditures:</b>							
<b>Current:</b>							
General government	11,333	12,000	236,697	292,203	99,550	389,013	1,040,796
Housing subsidy programs	3,812,112	-	10,319,987	27,003	41,556,649	6,822,637	62,538,388
Debt service:							
Principal	-	25,610,000	-	-	-	7,160,000	32,770,000
Interest	1,524,481	7,352,643	411,348	-	-	8,744,762	18,033,234
<b>Total expenditures</b>	<b>5,347,926</b>	<b>32,974,643</b>	<b>10,968,032</b>	<b>319,206</b>	<b>41,656,199</b>	<b>23,116,412</b>	<b>114,382,418</b>
Excess (deficiency) of revenues over (under) expenditures	5,286,332	(18,453)	7,028,751	6,133,879	(19,239,814)	(1,909,867)	(2,719,172)
<b>Other financing sources (uses):</b>							
Transfers in	-	-	-	-	18,134,251	11,244,394	29,378,645
Transfers out	-	-	-	-	-	(74,389,117)	(74,389,117)
<b>Total other financing sources and uses</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>18,134,251</b>	<b>(63,144,723)</b>	<b>(45,010,472)</b>
Net change in fund balances	5,286,332	(18,453)	7,028,751	6,133,879	(1,105,563)	(65,054,590)	(47,729,644)
Fund balances (deficit), beginning of year	17,084,280	32,667,236	(17,104,328)	18,137,505	10,396,784	152,910,273	214,091,750
Fund balances (deficit), end of year	\$ 22,370,612	32,648,783	(10,075,577)	24,271,384	9,291,221	87,855,683	166,362,106

See accompanying notes to basic financial statements.

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Funds Balances -  
Governmental Funds to the Statement of Activities

Amounts reported for governmental activities in the statement of activities are different because:

Net change in fund balances - total government funds	\$ (47,729,644)
Governmental funds report debt service payment on long- term debt as expenditures; however, this transaction has no effect in net assets	32,770,000
Net change in deferred revenues that do not provide current financial resources are not reported in the funds	<u>(8,029,422)</u>
	\$ <u><u>(22,989,066)</u></u>

See accompanying notes to basic financial statements.

Balance Sheet - Enterprise Funds

	GDB Operating Fund	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Eliminations	Total
<b>Assets:</b>									
Current assets:									
Cash and due from banks	\$ 25,500,459	37,106,401	-	12,705,938	6,337,368	1,188,860	256,158	(57,125,707)	25,969,477
Federal funds sold	1,138,731,324	-	-	-	-	-	-	(55,331,324)	1,083,400,000
Deposits placed with banks	360,000,000	9,770,661	-	-	30,239,447	11,092,918	-	(30,239,447)	380,863,579
Investments and investment contracts	1,957,096,055	11,553,458	58,693,960	-	94,402,654	3,790,247	-	-	2,125,536,374
Loans receivable, net	919,194,913	33,757,240	-	-	-	-	-	(222,499)	952,729,654
Accrued interest receivable	103,052,262	11,881,312	302	4,925	329,268	10,198	883	(5,505,596)	109,773,554
Other current receivables	91,822,600	22,894,382	-	377	151,683	-	-	(5,654,134)	109,214,908
Other assets	31,299	132,618	-	-	-	-	-	-	163,917
Due from (to) governmental funds	196,900,166	(11,093,689)	-	-	-	-	-	-	185,806,477
Total current assets	4,792,329,078	116,002,383	58,694,262	12,711,240	131,460,420	16,082,223	257,041	(154,078,707)	4,973,457,940
Noncurrent assets:									
Restricted:									
Cash	-	33,322,289	-	-	-	-	2,078,595	(15,569,080)	19,831,804
Securities purchased under agreement to resell	-	150,000,000	-	-	-	-	-	-	150,000,000
Deposits placed with banks	-	177,056,501	-	-	-	-	-	(149,944,748)	27,111,753
Investments and investment contracts	70,850,000	1,446,798,390	-	-	-	-	-	-	1,517,648,390
Loans receivable, net	-	27,739,307	-	-	-	-	-	-	27,739,307
Investments	481,110,554	-	-	16,810,826	-	-	-	(237,840,244)	260,081,136
Loans receivable, net	1,438,359,354	210,104,771	-	-	-	-	-	-	1,648,464,125
Real estate available for sale	21,753,932	6,771,421	-	-	-	-	-	-	28,525,353
Capital assets	14,009,643	800,084	-	-	6,863	-	-	-	14,816,590
Other assets	5,553,085	12,174,202	-	-	-	-	-	-	17,727,287
Total noncurrent assets	2,031,636,568	2,064,766,965	-	16,810,826	6,863	-	2,078,595	(403,354,072)	3,711,945,745
Total assets	\$ 6,823,965,646	2,180,769,348	58,694,262	29,522,066	131,467,283	16,082,223	2,335,636	(557,432,779)	8,685,403,685

(continued)

Balance Sheet - Enterprise Funds

...Continued

Liabilities	GDB Operating Fund	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Eliminations	Total
<b>Current liabilities:</b>									
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:	\$								
Demand	1,694,086,109	-	-	-	-	-	-	(76,418,740)	1,617,667,369
Certificates of deposit	2,007,128,609	-	-	-	-	-	-	(331,219,317)	1,675,909,292
Securities sold under agreement to repurchase	40,017,333	55,331,324	-	-	-	-	-	(55,331,324)	40,017,333
Commercial paper	761,166,587	-	-	-	-	-	-	-	761,166,587
Accrued interest payable	12,305,725	5,215,702	-	-	-	-	-	(5,505,596)	12,015,831
Accounts payable and accrued liabilities	81,620,842	40,206,627	21,473	11,605	7,104,221	1,258,571	5,870	(1,634,976)	128,594,233
Allowance for losses on guarantees and letters of credit	-	-	-	-	2,036,845	-	-	-	2,036,845
Due to Commonwealth of Puerto Rico	6,894,807	29,464	-	-	-	-	-	-	6,924,271
Total current liabilities payable from unrestricted assets	4,603,220,012	100,783,117	21,473	11,605	9,141,066	1,258,571	5,870	(470,109,953)	4,244,331,761
Current liabilities payable from restricted assets – bonds payable	-	47,994,645	-	-	-	-	-	-	47,994,645
Total current liabilities	4,603,220,012	148,777,762	21,473	11,605	9,141,066	1,258,571	5,870	(470,109,953)	4,292,326,406
<b>Noncurrent liabilities:</b>									
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:									
Certificates of deposit	242,980,846	-	-	-	-	-	-	-	242,980,846
Certificates of indebtedness	242,984,210	-	-	-	-	-	-	-	242,984,210
Allowance for losses on guarantees and letters of credit	3,048,465	-	-	-	26,253,275	-	-	-	29,301,740
Accrued liabilities	587,500	-	-	-	-	3,406,256	2,079,372	-	6,073,128
Bonds and notes payable	267,000,000	7,756,154	-	-	-	-	-	-	274,756,154
Restricted:									
Securities sold under agreement to repurchase	-	150,000,000	-	-	-	-	-	-	150,000,000
Accrued liabilities	-	-	-	-	-	6,998,899	-	-	6,998,899
Bonds payable	-	1,387,671,871	-	-	-	-	-	(87,322,826)	1,300,349,045
Total noncurrent liabilities	756,601,021	1,545,428,025	-	-	26,253,275	10,405,155	2,079,372	(87,322,826)	2,253,444,022
Total liabilities	5,359,821,033	1,694,205,787	21,473	11,605	35,394,341	11,663,726	2,085,242	(557,432,779)	6,545,770,428
<b>Net assets:</b>									
Invested in capital assets	14,009,643	800,084	-	-	6,863	-	-	-	14,816,590
Restricted for:									
Mortgage loan insurance	-	23,352,153	-	-	-	-	-	-	23,352,153
Affordable housing programs	-	235,177,941	-	-	-	-	-	-	235,177,941
Unrestricted	1,450,134,970	227,233,383	58,672,789	29,510,461	96,066,079	4,418,497	250,394	-	1,866,286,573
Total net assets	1,464,144,613	486,563,561	58,672,789	29,510,461	96,072,942	4,418,497	250,394	-	2,139,633,257
Total liabilities and net assets	\$ 6,823,965,646	2,180,769,348	58,694,262	29,522,066	131,467,283	16,082,223	2,335,636	(557,432,779)	8,685,403,685

See accompanying notes to basic financial statements.

Statement of Revenues, Expenses, and Changes in Net Assets - Enterprise Funds

	GDB Operating Fund	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Total
<b>Operating revenues:</b>								
Investment income:								
Interest income on federal funds sold and securities purchased under agreements to resell	13,863,033	3,667,704	-	-	-	-	-	17,530,737
Interest income on deposits placed with banks	3,250,461	10,670,811	-	98,574	1,001,783	23,803	559	15,045,991
Interest and dividend income on investment and investment contracts	73,124,679	74,316,726	604,845	-	892,555	90,937	-	149,029,742
Total investment income	90,238,173	88,655,241	604,845	98,574	1,894,338	114,740	559	181,606,470
Loans receivable:								
Public sector	113,572,935	-	-	-	-	-	-	113,572,935
Private sector	664,253	17,293,021	-	-	18,860	-	-	17,976,134
Total loans receivable	114,237,188	17,293,021	-	-	18,860	-	-	131,549,069
Total interest income	204,475,361	105,948,262	604,845	98,574	1,913,198	114,740	559	313,155,539
Noninterest income:								
Change in fair value of investments	15,267,657	28,982,981	1,123,510	(1,868,992)	45,517	-	-	43,550,673
Fiscal agency fees	7,925,837	-	-	-	-	-	-	7,925,837
Commitment, guarantee, service, and administrative fees	2,362,599	3,720,569	-	-	7,665,473	-	-	13,748,641
Mortgage insurance premiums	-	2,120,872	-	-	-	-	-	2,120,872
Servicing and contract administration fees, net	2,333,859	6,402,107	-	-	-	-	-	8,735,966
Net gain from sale of foreclosed real estate available for sale	-	2,217,869	-	-	-	-	-	2,217,869
Payments from Commonwealth of Puerto Rico	-	140,214	-	-	-	-	-	140,214
Federal assistance programs	-	112,199,144	-	-	-	-	-	112,199,144
Other income	37,978,367	4,067,138	-	-	353,933	-	-	42,399,438
Total noninterest income (loss)	65,868,319	159,850,894	1,123,510	(1,868,992)	8,064,923	-	-	233,038,654
Total operating revenues	270,343,680	265,799,156	1,728,355	(1,770,418)	9,978,121	114,740	559	546,194,193
<b>Operating expenses:</b>								
Provision for loan losses	-	-	-	-	1,275,000	-	-	1,275,000
Interest expense:								
Deposits	80,769,369	-	-	-	4,738	-	-	80,774,107
Certificates of indebtedness	9,877,690	-	-	-	-	-	-	9,877,690
Securities sold under agreements to repurchase	8,126	4,356,613	-	-	-	-	-	4,364,739
Commercial paper	5,558,637	-	-	-	-	-	-	5,558,637
Bonds payable	8,809,901	85,517,888	-	-	-	-	-	94,327,789
Total interest expense	105,023,723	89,874,501	-	-	4,738	-	-	194,902,962
Noninterest expenses:								
Salaries and fringe benefits	22,186,969	8,081,692	-	35	-	-	37,216	30,305,912
Depreciation and amortization	2,800,137	272,075	-	-	1,716	-	-	3,073,928
Occupancy and equipment costs	3,352,593	832,997	-	-	60	-	-	4,185,650
Legal and professional fees	5,255,586	2,015,473	4,132	39,850	648,793	93,974	8,625	8,066,433
Office and administrative	737,504	54,365	42,273	-	-	328,088	-	1,162,230
Subsidy and trustee fees	39,983	2,309,290	-	-	-	-	-	2,349,273
Provision for losses on guarantees and letters of credit	-	-	-	-	14,363,575	-	-	14,363,575
Federal assistance programs	-	112,199,144	-	-	-	-	-	112,199,144
Other	22,720,116	630,279	-	1,201	199,104	38	4,324	23,555,062
Total noninterest expenses	57,092,888	126,395,315	46,405	41,086	15,213,248	422,100	50,165	199,261,207
Total operating expenses	162,116,611	216,269,816	46,405	41,086	15,217,986	422,100	50,165	394,164,169
Operating income (loss)	108,227,069	49,529,340	1,681,950	(1,811,504)	(6,514,865)	(307,360)	(49,606)	150,755,024
Contributions to others	(19,185,150)	-	-	-	-	-	-	(19,185,150)
Transfer in	-	56,254,866	-	-	-	-	300,000	56,554,866
Transfer out	(300,000)	(11,244,394)	-	-	-	-	-	(11,544,394)
Change in net assets	88,741,919	94,539,812	1,681,950	(1,811,504)	(6,514,865)	(307,360)	250,394	176,580,346
Net assets, beginning of year	1,375,402,694	392,023,749	56,990,839	31,321,965	102,587,807	4,725,857	-	1,963,052,911
Net assets, end of year	\$ 1,464,144,613	486,563,561	58,672,789	29,510,461	96,072,942	4,418,497	250,394	2,139,633,257

See accompanying notes to basic financial statements.

Statement of Cash Flows - Proprietary Funds

	Government Development Bank	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Eliminations	Total
Cash flows from operating activities:									
Cash received from interest on loans	-	16,353,794	-	-	-	-	-	-	16,353,794
Cash paid for mortgage and construction loans originated	-	(161,333,292)	-	-	-	-	-	-	(161,333,292)
Principal collected on mortgage and construction loans	-	73,030,506	-	-	-	-	-	-	73,030,506
Cash received from insurance premiums	-	2,120,872	-	-	-	-	-	-	2,120,872
Guarantee fees collected	180,876	-	-	-	8,274,648	-	-	-	8,455,524
Cash received from other operating noninterest revenues	45,273,918	10,333,402	-	-	734,632	100,568	-	2,165,311	58,621,772
Cash received from fiscal agency fees	7,925,837	-	-	-	-	-	13,941	-	7,925,837
Cash received from real estate sold	-	-	-	-	3,543,991	-	-	-	3,543,991
Due (from) to Governmental Funds	(143,420,686)	-	-	-	-	-	-	-	(143,420,686)
Cash received from federal assistance programs	-	112,199,144	-	-	-	-	-	-	112,199,144
Cash payments to housing assistance programs	-	(112,199,144)	-	-	-	-	-	-	(112,199,144)
Cash payments to Commonwealth of Puerto Rico	(30,017,304)	-	-	-	-	-	-	-	(30,017,304)
Cash payments from other operating noninterest expenses	(49,790,208)	(3,757,657)	(32,721)	(35,976)	(1,444,647)	-	(7,079)	(1,634,976)	(56,703,264)
Disbursements for obligations guaranteed	-	-	-	-	(15,899,339)	-	-	-	(15,899,339)
Cash payments for salaries and fringe benefits	(22,186,969)	(8,081,692)	-	(35)	-	-	(37,216)	-	(30,305,912)
Net cash provided by (used in) operating activities	(192,034,536)	(71,334,067)	(32,721)	(36,011)	(4,790,715)	100,568	(30,354)	530,335	(267,627,501)
Cash flows from noncapital financing activities:									
Interfund loans	-	9,490,248	-	-	-	-	-	-	9,490,248
Contribution to others	(19,185,150)	-	-	-	-	-	-	-	(19,185,150)
Transfer in	-	56,254,866	-	-	-	-	300,000	-	56,554,866
Transfer out	(300,000)	(11,244,394)	-	-	-	-	-	-	(11,544,394)
Payment received from Commonwealth of Puerto Rico	-	140,214	-	-	-	-	-	-	140,214
Payment received from Government Development Bank	-	222,499	-	-	-	-	-	-	222,499
Payment of residual amount due to Commonwealth of Puerto Rico from the liquidation of the assets of the Puerto Rico Housing Bank Authority	-	(122,766,202)	-	-	-	-	-	-	(122,766,202)
Net increase (decrease) in:									
Deposits	(490,348,238)	-	-	-	2,931,507	-	-	62,252,593	(425,164,138)
Certificates of indebtedness	(60,000,000)	-	-	-	-	-	-	-	(60,000,000)
Securities sold under agreements to repurchase	40,017,333	35,450,668	-	-	-	-	-	(55,331,324)	20,136,677
Commercial paper	361,489,698	-	-	-	-	-	-	-	361,489,698
Proceeds from issuance of bonds and notes	-	458,001,258	-	-	-	-	-	-	458,001,258
Repayments of bonds	-	(139,470,198)	-	-	-	-	-	(6,788,726)	(146,258,924)
Interest paid	(87,225,892)	(90,247,470)	-	-	(4,738)	-	-	(4,627,088)	(182,105,188)
Net cash (used in) provided by noncapital financing activities	(255,552,249)	195,831,489	-	-	2,926,769	-	300,000	(4,494,545)	(60,988,536)
Cash flows from capital and related financing activities:									
Purchase of capital assets	(1,479,087)	(328,979)	-	-	-	-	-	-	(1,808,066)
Net cash used in capital and related financing activities	(1,479,087)	(328,979)	-	-	-	-	-	-	(1,808,066)
<b>\$</b>									

(continued)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements  
Year ended June 30, 2003

**Statement of Cash Flows - Proprietary Funds**

...Continued

	Government Development Bank	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Eliminations	Total
Cash flows from investing activities:									
Net decrease (increase) in:									
Federal funds sold and securities purchased	\$ 237,768,676	-	-	-	-	-	-	55,331,324	283,100,000
under agreements to resell	135,000,000	-	-	-	10,364,938	(10,229,742)	-	(11,110,358)	124,024,838
Deposits placed with banks	(6,659,978,822)	(1,522,860,881)	-	-	(175,809,152)	-	-	-	(8,358,648,855)
Purchase of investment securities	6,906,564,383	1,306,266,987	32,721	-	97,915,853	3,438,261	-	(17,374,151)	8,296,844,054
Proceeds from redemptions of investments	99,345,661	88,336,614	-	105,251	1,897,097	175,772	1,404	4,667,237	194,529,036
Cash received from investment interest	66,227,268	-	-	-	12,868	-	-	(40,149)	66,199,987
Cash received from loans interest	(3,362,786,740)	-	-	-	(1,275,000)	-	-	-	(3,364,061,740)
Origination of other loans	2,588,003,403	-	-	-	-	-	-	222,499	2,588,225,902
Principal collected on loans	448,520,000	86,309,627	-	-	-	-	-	-	534,829,627
Proceeds from sales of loans	-	(19,687,810)	-	-	-	-	-	-	(19,687,810)
Change in lines of credit receivable	-	(13,931,860)	-	-	-	-	-	-	(13,931,860)
Decrease in funds held in trust	-	162,779	-	-	-	-	-	-	162,779
Cash received from other assets	-	-	-	-	-	-	-	-	-
Net proceeds and other cash collected related to foreclosed real estate held for sale	-	9,584,856	-	-	-	-	-	-	9,584,856
Net cash provided by (used in) investing activities	458,663,829	(65,819,688)	32,721	105,251	(66,893,396)	(6,615,709)	1,404	31,696,402	351,170,814
Net change in cash	9,597,957	58,348,755	-	69,240	(68,757,342)	(6,515,141)	271,050	27,732,192	20,746,711
Cash, beginning of year	15,902,502	12,079,935	-	12,636,698	75,094,710	7,704,001	2,063,703	(100,426,979)	25,054,570
Cash, end of year	25,500,459	70,428,690	-	12,705,938	6,337,368	1,188,860	2,334,753	(72,694,787)	45,801,281
Reconciliation to enterprise funds balance sheet:									
Cash – unrestricted	\$ 25,500,459	37,106,401	-	12,705,938	6,337,368	1,188,860	256,158	(57,125,707)	25,969,477
Cash – restricted	-	33,322,289	-	-	-	-	2,078,595	(15,569,080)	19,831,804
Total cash, year-end	\$ 25,500,459	70,428,690	-	12,705,938	6,337,368	1,188,860	2,334,753	(72,694,787)	45,801,281
Reconciliation of operating income (loss) to net cash (used in) provided by operating activities:									
Operating income (loss)	\$ 108,227,069	49,529,340	1,681,950	(1,811,504)	(6,514,865)	(307,360)	(49,606)	-	150,755,024
Adjustments to reconcile net income to net cash (used in) provided by operating activities:									
Investment income	(90,238,173)	(88,655,241)	(604,845)	(98,574)	(1,894,338)	(114,740)	(559)	-	(181,606,470)
Loans income	(114,237,188)	-	-	-	(18,860)	-	-	-	(114,256,048)
Interest expenses	105,023,723	89,874,501	-	-	4,738	-	-	-	194,902,962
Provision for loan losses	-	-	-	-	1,275,000	-	-	-	1,275,000
Provision for losses on guarantees and letters of credit	-	-	-	-	14,363,575	-	-	-	14,363,575
Net (increase) decrease in fair value of investment	(15,267,657)	(28,982,981)	(1,123,510)	1,868,992	(45,517)	-	-	-	(43,550,673)
Net unrealized loss on derivatives	(19,312,782)	-	-	-	-	-	-	-	(19,312,782)
Gain on sales of loans	-	(3,923,748)	-	-	-	-	-	-	(3,923,748)
Net gain on sales of real estate owned – held for sale	-	(2,150,533)	-	-	-	-	-	-	(2,150,533)
Depreciation and amortization	2,800,137	272,075	-	-	1,716	-	-	-	3,073,928
Payments from Commonwealth of Puerto Rico	-	(140,214)	-	-	-	-	-	-	(140,214)
Disbursements for obligation guaranteed	-	-	-	-	(18,899,339)	-	-	-	(18,899,339)
Changes in operating assets and liabilities:									
Change in interest receivable on mortgage loans	-	(101,762,855)	-	-	-	-	-	-	(101,762,855)
Balance carried forward	\$ (23,004,871)	(85,939,656)	(46,405)	(41,086)	(11,727,890)	(422,100)	(50,165)	-	(121,232,173)

(continued)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements  
Year ended June 30, 2003

Statement of Cash Flows - Proprietary Funds

...Continued

	Government Development Bank	Housing Finance Authority	Capital Fund	Development Fund	Tourism Development Fund	Public Finance Corporation	Other nonmajor funds	Eliminations	Total
Balance brought forward	\$ (23,004,871)	(85,939,656)	(46,405)	(41,086)	(11,727,890)	(422,100)	(50,165)	-	(121,232,173)
Decrease (increase) in other assets (increase) decrease in due to (from) governmental funds	1,483,918	32,550	-	(99)	988,158	-	-	2,165,311	4,669,878
(Increase) decrease in real estate	(143,420,686)	-	-	-	-	-	-	-	(143,420,686)
Decrease (increase) in capital assets	(25,000)	-	-	-	3,543,991	-	-	-	3,518,991
Increase (decrease) in allowance for possible losses on guarantees and letters of credit	1,321,051	-	-	-	1,716	-	-	-	1,322,767
Decrease (increase) in mortgage loans receivable	-	-	-	-	(4,535,764)	-	-	-	(4,535,764)
Increase (decrease) in estimated liability for mortgage insurance losses	-	92,662	-	-	-	-	-	-	92,662
Decrease (increase) in due to Commonwealth of Puerto Rico	-	(39,668)	-	-	-	-	-	-	(39,668)
Decrease (increase) in other liabilities	(18,404,766)	-	-	-	-	-	-	-	(18,404,766)
Net cash (used in) provided by operating activities	(9,984,182)	14,520,005	13,684	5,174	6,939,074	522,668	19,811	(1,634,976)	10,401,258
	\$ (192,034,536)	(71,334,067)	(32,721)	(36,011)	(4,790,715)	100,568	(30,354)	530,335	(267,627,501)
Noncash investing and noncapital financing activities:									
Accretion of discount on investment securities and capitalized interest on loans	\$ 24,836,684	1,031,889	605,142	-	88,112	-	-	-	26,561,827
Accretion of discount on:									
Deposits	7,944,167	-	-	-	-	-	-	-	7,944,167
Certificate of indebtedness	8,392,785	-	-	-	-	-	-	-	8,392,785
Commercial paper	931,045	-	-	-	-	-	-	-	931,045
Bonds payable	-	(36,913,605)	-	-	-	-	-	-	(36,913,605)
Increase (decrease) in fair value of investment	15,267,657	28,982,981	1,123,510	(1,868,992)	45,517	-	-	-	43,550,673
Unrealized loss on embedded derivative	(19,312,782)	-	-	-	-	-	-	-	(19,312,782)
Amortization of bond issued cost (included in interest expenses)	693,107	-	-	-	-	-	-	-	693,107
Bond issue costs withheld from bond proceeds	-	4,256,017	-	-	-	-	-	-	4,256,017
Reclassification of capital assets to real estate available for sale	-	2,029,431	-	-	-	-	-	-	2,029,431
Change in estimated liability for mortgage insurance losses	-	(39,668)	-	-	-	-	-	-	(39,668)

See accompanying notes to basic financial statements.

## notes to basic financial statements

### (1) Reporting Entity

Government Development Bank for Puerto Rico (the Bank) is a component unit of the Commonwealth of Puerto Rico (the Commonwealth) created by Act No. 17 of September 23, 1948, as amended. The Bank's principal functions are to act as fiscal agent for the Commonwealth and its public entities and to make loans to public entities and private enterprises, which will further the economic development of Puerto Rico. The charter of the Bank provides for its perpetual existence, and no amendment to the charter, or to any other law of Puerto Rico, shall impair any outstanding obligations or commitments of the Bank. The Bank is exempt from taxation in Puerto Rico, except for excise taxes. The Bank's charter, as amended, allows the Bank to invest in securities issued by any corporate entity engaged in the economic development of Puerto Rico, as well as to guarantee loans and other obligations incurred by public and private entities.

Pursuant to Act No. 82 of June 16, 2002, which amended the Bank's enabling legislation, the Bank is authorized to transfer annually to the General Fund of the Commonwealth (the General Fund), up to 10% of its "net income" or \$10 million, whichever is greater. During the year ended June 30, 2002, management of the Bank initially defined "net income" as total change in net assets before the contribution to the General Fund from both governmental and business-type activities. In 2003, the board of directors approved a resolution modifying the definition of "net income" as the change in unrestricted net assets of business-type activities. The Bank adopted the new definition prospectively.

The Bank has the following blended component units: Puerto Rico Housing Finance Authority (the Housing Finance Authority or the Authority), Puerto Rico Tourism Development Fund (the Tourism Development Fund), Puerto Rico Development Fund (the Development Fund), Puerto Rico Public Finance Corporation (the Public Finance Corporation), Government Development Bank for Puerto Rico Capital Fund (the Capital Fund), José M. Berrocal Finance and Economics Institute (JMB Institute), and Puerto Rico Higher Education Assistance Corporation (the Education Assistance Corporation). The balances and transactions of the component units discussed above have been blended with those of the Bank in accordance with accounting principles generally accepted in the United States of America (GAAP) because, while legally separate, they were created and can be dissolved through resolutions of the Bank's board of directors. The board of directors of each of the blended component units is substantively the same as that of the Bank. Financial statements of each blended component unit may be obtained from the Bank.

The Housing Finance Authority (originally named the Puerto Rico Housing Finance Corporation) was created in 1977 to provide public and private housing developers with interim and permanent financing through mortgage loans for the construction, improvement, operation, and maintenance of rental housing for low- and moderate-income families. The Housing Finance Authority also issues bonds and notes, the proceeds of which are deposited in separate trusts and generally invested in federally insured mortgage loans on properties located in Puerto Rico and purchased by low- and moderate-income families. The Housing Finance Authority is authorized by the U.S. Department of Housing and Urban Development to administer the U.S. Housing Act Section 8 program in Puerto Rico and to act as an approved mortgager, both for multifamily rental units and for single-family homes. In addition, it is an authorized issuer of Government National Mortgage Association (GNMA) mortgage-backed securities, and is Puerto Rico's State Credit Agency for the Low-Income Housing Tax Credit Program under Section 42 of the U.S. Internal Revenue Code.

The Housing Finance Authority, in conjunction with the Puerto Rico Department of Housing, is the entity responsible for certifying projects under the New Secure Housing Program (known in Spanish as Nuevo Hogar Seguro), with the approval of the Federal Emergency Management Agency (FEMA). This program is directed to plan, coordinate, and develop the construction of new housing as a replacement to those destroyed by Hurricane Georges in 1998, and to attend the housing needs of families living in flood zone areas.

The Housing Finance Authority is also engaged in the origination and servicing of mortgage loans (up to a maximum loan balance of \$90,000) to low- and moderate-income families and in the underwriting of credit insurance for qualifying mortgage loans originated by other financial institutions to qualifying families. The Authority administers and accounts for moneys provided by the Commonwealth and the federal government to grant subsidies to low- and moderate-income families for housing acquisitions and for principal and interest payments on mortgage loans originated by other financial institutions to qualifying families.

The Tourism Development Fund was created in 1993 to promote the hotel and tourism industry of the Commonwealth, primarily through the issuance of letters of credit and guarantees. The Tourism Development Fund is also authorized to make capital investments and provide direct financing to tourism-related projects.

The Development Fund was created in 1977 to expand the sources of financing available for the development of the private sector of the economy of Puerto Rico and to complement the Bank's lending program. The Development Fund may also guarantee obligations of private sector enterprises and invest in their equity securities.

The Public Finance Corporation was created in 1984 to provide the agencies and instrumentalities of the Commonwealth with alternate means of satisfying financial needs. The resolution creating the Public Finance Corporation states that if it were to be dissolved or cease to exist without a successor public entity being appointed, any funds or assets not required for the payment of its bonds or any other obligation will be transferred to the Secretary of the Department of the Treasury of the Commonwealth (the Department of the Treasury) for deposit in the General Fund.

The Capital Fund was created in 1992 to expand the investment options available to the Bank and to administer, separately from the Bank's general investment operations, an equity investments process through professional equity investment managers. In January 2002, the board of directors authorized an increase in the capitalization of the Capital Fund of up to 10% of the total capital of the Bank, as well as the adoption of a new investment strategy, which included the hiring of two additional portfolio managers to diversify the Capital Fund investments in the equity markets. As of June 30, 2003, management deemed convenient to defer its implementation.

Other nonmajor funds include the JMB Institute and the Education Assistance Corporation. The JMB Institute was created in 2002 to complement the Bank's mission of promoting economic development by providing specialized training on the theory and practice of public finances and economics to talented young professionals in order to attract them to join the public service. The Education Assistance Corporation was created in 1981 to administer the Stafford Loan Program in Puerto Rico and guarantee the payment of student loans granted by financial institutions in Puerto Rico under certain terms and restrictions. The operations of this Fund were transferred to a guarantee agency designated by the U.S. Department of Education. The Education Assistance Corporation is currently inactive and is expected to be liquidated.

To minimize its risk of loss, the Bank purchases insurance coverage for public liability, hazard, automobile, crime, and bonding as well as medical and workmen's insurance for employees. The selection of the insurer has to be approved by the Puerto Rico Commissioner of Insurance Office. Insurance coverage for fiscal year 2003 remained similar to those of prior years. For the last three years insurance settlements have not exceeded the amount of coverage.

## (2) **Basis of Presentation and Summary of Significant Accounting Policies**

The accounting and reporting policies of the Bank conform to GAAP, as applicable to governmental entities.

The Bank applies all applicable Governmental Accounting Standards Board (GASB) pronouncements, as well as the following pronouncements issued before and after November 30, 1989, in its enterprise funds unless those pronouncements conflict or contradict GASB pronouncements: statements and interpretations issued by the Financial Accounting Standards Board, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

### (a) **Government-wide and Fund Financial Statements**

**Government-wide Financial Statements** – The statement of net assets and the statement of activities report information on all nonfiduciary activities of the Bank. The effect of interfund balances has been removed from the government-wide statement of net assets, except for the residual amounts due between governmental and

business-type activities. Interfund charges for services among functions of the government-wide statement of activities have not been eliminated. The Bank's activities are distinguished between governmental and business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. Business-type activities are financed in whole or in part by fees charged to external parties for goods or services. Following is a description of the Bank's government-wide financial statements.

The statement of net assets presents the Bank's assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- Invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.
- Restricted net assets result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.
- Unrestricted net assets consist of net assets that do not meet the definition of the two preceding categories. Unrestricted net assets often are designated, in order to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on use that are imposed by management, but such constraints may be removed or modified.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues include: (1) interest income on loans and investments, changes in the fair value of investments and fees and charges to customers for services rendered or for privileges provided, and (2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. Other items not meeting the definition of program revenues are reported as general revenues.

**Fund Financial Statements** – Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities. A fund is a separate accounting entity with a self-balancing set of accounts. The financial activities of the Bank that are reported in the accompanying basic financial statements have been classified into governmental and enterprise funds.

Separate financial statements are provided for governmental funds and enterprise funds. Major individual governmental funds are reported as separate columns in the fund financial statements, with nonmajor funds being combined into a single column. In the case of enterprise funds, each individual blended component unit of the Bank with the exception of JMB Institute and Education Assistance Corporation, which have been grouped as other nonmajor funds, have been reported as a separate major fund in the fund financial statements. In the case of the Authority, all of its activities not classified and reported as governmental funds have been reported as an enterprise fund of the Bank.

**(b) Measurement Focus, Basis of Accounting, and Financial Statements Presentation**

**Government-Wide Financial Statements** – The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met.

**Governmental Funds' Financial Statements** – The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Bank considers revenues to be available if they are collected within 120 days of the end of the current fiscal year. Principal revenue sources considered susceptible to accrual include federal and Commonwealth funds received by the New Secure Housing Program Fund. Other revenues are considered to be measurable and available only when cash is received. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Modifications to the accrual basis of accounting include:

- Employees' vested annual leave is recorded as expenditure when utilized. The amount of accumulated annual leave unpaid at June 30, 2003, has been reported only in the government-wide financial statements.
- Interest on general long-term obligations is recognized when paid.
- Debt service principal expenditures and claims and judgments are recorded only when payment is due.

**Governmental Funds** – The following governmental activities of the Bank are classified as major governmental funds:

- **Affordable Housing Mortgage Subsidy Program (Stage 7)** – This special revenue fund is used to account for the proceeds of specific revenue sources under Stage 7 that are legally restricted to expenditures to promote the origination of mortgage loans by commercial banks, to low- and moderate-income families. This fund is one of the nine funds that is under the Affordable Housing Mortgage Assistance Program, more fully described below. The remaining eight funds are reported in other nonmajor governmental funds.
- **Subsidy Prepayment Refunding Bonds – Debt Service (Act No. 115 Rent Subsidy Fund)** – This debt service fund is used to account for the Commonwealth appropriations to provide for the payment of principal and interest of certain bonds that were originally issued as part of a former mortgage subsidy program (see note 12).
- **New Secure Housing Program (Nuevo Hogar Seguro)** – This special revenue fund is used to account for federal and local resources directed to plan, coordinate, and develop the construction of new housing as a replacement for those destroyed by Hurricane Georges in 1998 and to attend the housing needs of those families living in flood zone areas.
- **Special Obligation Refunding Bonds – Debt Service** – This debt service fund accounts for the funds and assets transferred by the Commonwealth through legislative appropriations and from the liquidator of the Puerto Rico Urban Renewal and Housing Corporation (CRUV), respectively, for the payment of CRUV Bonds.
- **The Key for Your Home Program** – It was created to provide subsidy to low- and moderate-income families against costs directly related to the purchase and rehabilitation of housing units.

The following governmental activities of the Bank are accounted for in other nonmajor governmental funds:

- **Affordable Housing Mortgage Subsidy Program (the AHMSP)** – The AHMSP was created to promote the origination of mortgage loans to low- and moderate-income families by financial institutions in the private sector. The program contemplates the issuance of bonds by the enterprise funds to provide the funding to promote such loan originations.

Mortgage loan origination and servicing agreements with two major lending institutions in Puerto Rico. Under these agreements both financial institutions agreed to originate \$150 million in mortgage loans pursuant to the requirements of the AHMSP within a predetermined schedule of originations. The Bank provides a subsidy for the purchase price principal and interest payments on the mortgage loans originated under the agreement. Such loans are insured by the Mortgage Loan Insurance Program of the Bank. Loans originated, as well as servicing, are kept by the originating financial institution.

In addition, the Bank has another mortgage loan origination and servicing agreement that is similar to the previously described program with various lending institutions in Puerto Rico. Under this agreement, the financial institutions agreed to originate \$160 million in mortgage loans pursuant to the requirements of the AHMSP within a predetermined schedule of originations.

- **Interim Loan Insurance** – Up to June 30, 1989, the former Housing Bank, which subsequently became part of the Housing Finance Authority, provided an Interim Loan Insurance Program created by law to provide mortgage insurance to guarantee the payment of principal and interest on construction loans to developers of low- and moderate-income housing units financed through other financial institutions. Due to the significant claims paid by this program in previous years, it no longer provides insurance coverage and is in the process of liquidating foreclosed real estate. This activity receives legislative appropriations, when needed, to repay the outstanding bond debt and derives its revenue from investment income and sales of the properties acquired through foreclosure.

**Enterprise Funds' Financial Statements** – The financial statements of the enterprise funds are reported using the economic resources measurement focus and the accrual basis of accounting, similar to the government-wide statements described above.

Enterprise funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses are those that result from the Bank providing the services that correspond to their principal ongoing operations. Operating revenues are generated from lending, investing, banking and fiscal agency services, and other related activities. Operating expenses include interest expense, any provision for losses on loans or guarantees and all general and administrative expenses, among other things. Revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

**(c) Securities Purchased Under Agreements to Resell**

The Bank enters into purchases of securities under agreements to resell. The amounts advanced under these agreements generally represent short-term loans and are reflected as an asset. The securities underlying these agreements are usually held by the broker or his agency, with whom the agreement is transacted.

**(d) Investments and Investment Contracts**

Investments and investment contracts are carried at fair value, except for money market instruments and participating investment contracts with a remaining maturity at the time of purchase of one year or less and nonparticipating investment contracts, which are carried at cost; and investment positions in 2a-7 like external investment pools, which are carried at the pools' share price. Fair value is determined based on quoted market prices and quotations received from independent broker/dealers. Realized gains and losses from the sale of investments and unrealized changes in the fair value of outstanding investments are included in net change in fair value of investments in the accompanying fund financial statements.

**(e) Loans and Allowance for Loan Losses**

Loans are presented at the outstanding unpaid principal balance reduced by any charge-offs and the allowance for loan losses. The accrual of interest on loans to the private sector ceases when loans become past due over six months. For loans to public sector entities, the accrual of interest ceases when management determines that all of the following characteristics are present: (a) a loan is six months past due; (b) it has no current source of repayment; (c) is not covered by a formal commitment from the Commonwealth; and (d) has no designated collateral or such collateral is insufficient. Once a loan is placed in nonaccrual status, all accrued interest receivable is reversed from interest income. Interest income on nonaccrual loans is thereafter recognized as income only to the extent actually collected.

The allowance for loan losses is established through provisions recorded in the fund financial statements. The allowance is based on management's evaluation of the risk characteristics of the loan including such factors as the nature of individual credits outstanding, past loss experience, known and inherent risks in the portfolios, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and general economic conditions. Loan charge-offs are recorded against the allowance when management believes that the collectibility of the principal is unlikely. Recoveries of amounts previously charged off are credited to the respective allowance.

Loans considered to be impaired are generally reduced to the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent, by allocating a portion of the allowance for loan losses to such loans. If these allocations cause increases to the allowance for loan losses, such increase is reported as provision for loan losses. Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Interest income and cash receipts on impaired loans are accounted predominantly in the same manner as nonaccrual loans.

Management believes that no losses will be incurred by the Bank with respect to principal and interest on loans to the public sector (including municipalities), and, as a result, such loans are excluded from impairment classification and no allowance for loan losses is generally established for them. For public sector loans, excluding municipalities,

management bases its position in that in the past, the Director of the Office of Management and Budget of the Commonwealth (OMB) has included in the budget of the Commonwealth appropriations to assist certain public sector corporations, agencies, and instrumentalities in repaying their loans with the Bank. The Legislature has generally approved these appropriations, and such practice is intended to continue in the future. Further, in accordance with Act No. 164 of December 17, 2001, the Bank is no longer allowed to originate loans without a specific source of repayment being identified beforehand. The Act provides, however, for the Bank to originate new loans up to \$100 million without specific sources of repayment with authorization in writing from both the Commonwealth's Governor and the Director of the OMB.

In addition, loans financing the capital improvement programs of certain public corporations are generally bound and subject to repayment from the proceeds of future bonds issuance from these public corporations. The public corporations and the Commonwealth have never defaulted on their respective bonds. Although management of the Bank believes that no losses of principal and interest will be incurred by the Bank with respect to loans to the public sector, there can be no assurance that the Director of the OMB will include in the Commonwealth budget, and that the Legislature will appropriate sufficient funds in the future to cover all amounts due to the Bank by public sector entities requiring such support. Also, the participation of certain public corporations in the bond issuance market has been delayed waiting for the credit standing of the issuer to become more favorable. Because of the relationship among the Bank, the public sector entities, the Director of the OMB, and the Legislature, the timing and amount of any financial assistance and bonds proceeds to be provided to certain entities in repaying their loans cannot be reasonably estimated by the Bank, and therefore no allowance has been established in the case of public sector loans for any shortfall between the present value of the expected future cash flows and the recorded investment in the loans.

Loans to municipalities are collateralized by a pledge of a portion of property tax assessments of each municipality. These loans include bonds and notes issued by Puerto Rico municipalities which are acquired by the Bank as bridge financing until such financings can be packaged and securitized. Subsequently, from time to time, the Bank sells, at par, a selection of these bonds and notes to Puerto Rico Municipal Finance Agency (MFA), a component unit of the Commonwealth organized to create a capital market to assist municipalities in financing their public improvements programs. These loans, when sold, are pledged to secure the debt service payments for the bonds issued by MFA.

**(f) Allowance for Losses on Guarantees and Letters of Credit**

Management of the Bank periodically evaluates the credit risk inherent in the guarantees and letters of credit on the same basis as loans are evaluated. The Bank charges as expense the amount required to cover estimated losses by establishing a specific allowance component for guarantees and letters of credit relating to loans in default, determined on the basis of the estimated future net cash outlays in connection with the related guarantees, and a general component for the risk inherent in the other guarantees and letters of credit outstanding, established as a percentage of the principal amount of the underlying loans based on the Bank's charge-off experience on financial guarantees and management's best judgment.

The concentration of risk in the guarantees and letters of credit issued, predominantly those issued by the Tourism Development Fund (small number of large guarantees, geographical concentration in Puerto Rico, industry concentration in hotel and tourism), as well as the limited historical loss experience and other factors, compounds the uncertainty in management's estimate of the allowance for losses on guarantees and letters of credit. As a result, the aggregate losses on guarantees and letters of credit ultimately incurred by the Bank may differ from the allowance for losses as reflected in the accompanying basic financial statements, and such differences may be material.

The Executive Director of the Tourism Development Fund is required to certify each year to the Director of the OMB the amount, if any, that is necessary to reimburse the Tourism Development Fund for disbursements made in the previous year, in connection with obligations guaranteed in excess of fees and charges collected on such guarantees. The Director of the OMB has to include the amount subject to reimbursement in the General Budget of the Commonwealth for the following fiscal year for the Legislature's consideration and approval. The Legislature is not obligated to authorize such appropriations. During the year ended June 30, 2003, the Tourism Development Fund initiated a process with the OMB to claim certain reimbursements for disbursements made under the

guarantees in excess of fees and charges corresponding to fiscal years 2000 and 2002. Reimbursements from the Commonwealth, if any, are recorded as a receivable to the extent appropriated by the Commonwealth's Legislature.

**(g) Deferred Debt Issue Costs**

Deferred issuance costs are deferred and amortized over the life of the debt. Issuance costs are reported as deferred charges (an asset) and are amortized over the term of the related debt. Issuance costs of the bonds accounted for in the governmental funds are recorded as expenditures when paid.

**(h) Real Estate Available for Sale**

Real estate available for sale comprises properties acquired through foreclosure proceedings. It also includes loans that are treated as if the underlying collateral had been foreclosed because the Bank has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place. Those properties are carried at the lower of fair value minus estimated costs to sell or cost. At the time of acquisition of properties in full or in partial satisfaction of loans, any excess of the loan balance over the fair value of the properties minus estimated costs to sell is charged against the allowance for loan losses. Subsequent declines in the value of real estate available for sale are charged to expense when it is probable that a loss will be incurred. Results of operations and gain on sale related to foreclosed real estate available for sale are included within other income in the accompanying statement of revenues, expenses, and changes in net assets.

**(i) Estimated Liability for Mortgage Loan Insurance Losses**

The estimated liability for mortgage loan insurance losses is based on management's evaluation of potential losses on insurance claims after considering economic conditions and other pertinent factors. Such amounts are, in the opinion of management, adequate to cover estimated future normal mortgage loan insurance losses. Actual losses for mortgage loan insurance are charged and recoveries, if any, are credited to the accumulated estimated liability for mortgage loan insurance losses.

**(j) Capital Assets**

Capital assets, which include premises and equipment, are stated at cost less accumulated depreciation and amortization. Depreciation is charged to operations and included within other noninterest expense, and is computed on the straight-line basis over the estimated useful lives of the depreciable assets, which have been determined to be from three to five years for furniture and equipment. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Costs of maintenance and repairs, which do not improve or extend the lives of the respective assets, are charged to expense as incurred.

Generally, estimated useful lives are as follows:

Building	40 years
Leasehold improvements	5 - 10 years
Information systems	3 years
Office furniture and equipment	5 years
Vehicles	5 years

**(k) Securities Sold Under Agreements to Repurchase**

The Bank enters into sales of securities under agreements to repurchase. These agreements generally represent short-term financings and are reflected as a liability. The securities underlying these agreements are usually held by the broker, or his/her agent, with whom the agreement is transacted.

**(l) Compensated Absences**

The employees of the Bank are granted 30 days of vacation and 18 days of sick leave annually. Vacation and sick leave may be accumulated up to a maximum of 72 and 90 days, respectively. In the event of employee resignation, an employee is reimbursed for accumulated vacation and sick leave days up to the maximum allowed. The enterprise fund financial statements and the government-wide financial statements present the cost of accumulated vacation and sick leave as a liability. There are no employees paid by governmental funds.

**(m) Deferred Revenues**

Deferred revenues at the fund level arise when potential revenues do not meet the available criterion for recognition in the current period. Available is defined as due at June 30 and collected within 120 days. Deferred revenues at the government-wide level arise only when the Bank receives resources before it has a legal claim to them.

**(n) Refundings**

Refundings involve the issuance of new debt whose proceeds are used to repay immediately (current refunding) or at a future time (advance refunding) previously issued debt. The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is recorded as an addition to or deduction from the new debt.

**(o) No-Commitment Debt**

The Housing Finance Authority has issued notes and bonds in connection with the financing of low- and moderate-income housing projects. Certain of the obligations issued by the Authority are considered no-commitment debt and are excluded, along with the related assets held in trust, from the accompanying basic financial statements. The Bank and the Commonwealth, except for the assets held in trust and earnings thereon, are not liable directly or indirectly for the payment of such obligations.

Certain other collateralized obligations of the Authority are included in the accompanying basic financial statements either because they represent general obligations of the Housing Finance Authority or it maintains effective control over the assets transferred as collateral.

From time to time, the Public Finance Corporation issues bonds, the proceeds of which are used to purchase from the GDB Operating Fund promissory notes of the Commonwealth, its instrumentalities, and public corporations. The bonds are limited obligations of the Public Finance Corporation and, except to the extent payable from bond proceeds and investments thereon, are payable solely from the pledge and assignment of amounts due on the notes. Principal and interest on the notes are payable solely from legislative appropriations to be made pursuant to acts approved by the Legislature of the Commonwealth. The underlying notes represent debt of the issuing instrumentalities. The bonds are considered no-commitment debt for, and therefore neither the bonds nor the notes purchased with the proceeds therefrom are presented in the accompanying basic financial statements.

**(p) Governmental Funds – Reservations of Fund Balance**

The governmental fund financial statements present reservations of fund balance for portions of fund balances that are legally segregated for a specific future use or are not available for other future spending. Accordingly, the fund balance of the Special Obligation Refunding Bonds Fund – Debt Service is reserved by \$6.4 million for assets not to be collected within the next fiscal year.

**(q) Loan Origination Costs and Commitment Fees**

Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires that loan origination and commitment fees and direct origination costs be amortized over the contractual life of the related loan. The Bank generally recognizes commitment fees as income when collected and the related loan origination costs as expense when incurred. In the opinion of management, the difference between the two methods does not have a significant effect on the Bank's financial position and changes in financial position.

**(r) Mortgage Loan Servicing**

The Bank services loans for investors and receives servicing fees generally based on stipulated percentages of the outstanding principal balance of such loans. Loan servicing fees, late charges, and other miscellaneous fees are recognized as revenues as the related mortgage payments are collected, net of fees due to third-party services. No servicing asset or liability is recognized as these fees are considered adequate compensation.

**(s) Transfers and Servicing of Financial Assets**

Transfers and servicing of financial assets and extinguishments of liabilities are accounted and reported based on a consistent application of a financial components approach that focuses on control. This approach distinguishes transfers of financial assets that are sales from transfers that are secured borrowings.

The Bank services loans for investors and receives servicing fees generally based on stipulated percentages of the outstanding principal balance of such loans. Loan servicing fees, late charges, and other miscellaneous fees are recognized as revenue as the related mortgage payments are collected, net of fees due to any third party servicers. No servicing asset is recognized since fees are considered adequate compensation.

**(t) Derivative Instruments and Hedging Activities**

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, *Accounting for Derivative Instruments and Certain Hedging Activities*. SFAS No. 133 requires that all derivatives must be recorded on the balance sheet at their fair value and that the treatment of changes in the fair value of such instruments depends on the character of the derivative. The Bank partially adopted SFAS No. 133 as explained in the ensuing paragraphs.

For fair value hedges in which derivatives hedge the fair value of assets and liabilities, changes in the fair value of derivatives are reflected in the statement of revenues, expenses, and changes in net assets, together with changes in the fair value of the related hedged item. At June 30, 2003, the Bank had no fair value hedging derivatives.

For cash flow hedges, in which derivatives hedge the variability of cash flows related to floating rate assets, liabilities, or forecasted transactions, the accounting treatment depends on the effectiveness of the hedge. To the extent these derivatives are effective in offsetting the variability of the hedged cash flows, SFAS No. 133 requires that changes in the derivatives' fair value be reported as other changes in equity, also known as other comprehensive income (OCI), with these changes in fair value included in earnings of future periods when earnings are also affected by the variability of the hedged cash flows. However, in its guidance for the implementation of GASB Statement No. 34, GASB declared that the concept of OCI was not applicable to governmental entities and further indicated that any amounts which under FASB pronouncements were required to be recorded as changes to OCI should be reported in the statement of revenues, expenses, and changes in net assets under governmental accounting standards. The Bank adopted SFAS No. 133 as modified by such clarification. For the fiscal year ended June 30, 2003, the Bank recorded an other noninterest expense of \$19.3 million in connection with its cash flow hedges.

The fair value of derivative instruments not designated for hedging is recorded by the Bank in the balance sheet, and the change in fair value is reported in operations, as required by this statement. Derivative-like instruments embedded in contracts that meet certain criteria prescribed in SFAS No. 133 are separated from their host contract and carried at their fair value, while the host contract is accounted for based on GAAP applicable to instruments of that type that do not contain embedded derivative instruments.

**(3) Cash and Due from Banks, Federal Funds Sold, Deposits Placed with Banks, and Securities Purchased Under Agreement to Resell**

The table presented below discloses the level of custody credit risk assumed by the Bank based upon how its deposits were insured or secured with collateral at June 30, 2003. Cash, restricted cash, and deposits consist mainly of deposits in banks and are categorized as follows:

- **Category 1** – Insured or collateralized with securities held by the Bank or by its agent in the Bank’s name.
- **Category 2** – Collateralized with securities held by the pledging financial institution’s trust department or its agent in the Bank’s name.
- **Category 3** – Uncollateralized.

The reported amount and depository bank balances of deposits with financial institutions at June 30, 2003 were as follows:

	Category			Carrying amount	Depository bank balance
	1	2	3		
Cash and due from banks	\$ 28,459,082	-	23,776,680	52,235,762	47,967,178
Deposits placed with banks	946,662	-	412,082,234	413,028,896	413,028,896
Federal funds sold	-	-	1,083,400,000	1,083,400,000	1,083,400,000
	<u>\$ 29,405,744</u>	<u>-</u>	<u>1,519,258,914</u>	<u>1,548,664,658</u>	<u>1,544,396,074</u>

Reconciliation to government-wide statement of net assets:

Unrestricted:	
Cash and due from banks	\$ 25,969,477
Deposits placed with banks	380,863,579
Federal funds sold	1,083,400,000
Total unrestricted	<u>1,490,233,056</u>
Restricted:	
Cash and due from banks	26,266,285
Deposits placed with banks	32,165,317
Total restricted	<u>58,431,602</u>
Total balance	<u>\$ 1,548,664,658</u>

The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth.

The reported amount and the fair value of securities purchased under agreement to resell at June 30, 2003 amounted to \$150 million. At June 30, 2003, these agreements mature within 3 months. The average amount outstanding during the year amounted to approximately \$144 million with the largest amount outstanding at any month-end amounting to approximately \$270 million. The Bank's investment policies establish minimum amounts of acceptable collateral, as well as the price of the securities in collateral. The market prices of the collateral are revised monthly and the margin amount adjusted accordingly. This investment is part of the Bank's arbitrage activities, as permitted by law.

#### (4) Investments

The Bank's investment policies allow management to purchase or enter into the following investment instruments:

- U.S. government and agencies obligations
- Certificates and time deposits
- Bankers' acceptances
- Obligations of the Commonwealth of Puerto Rico, its agencies, municipalities, public corporations, and instrumentalities
- Federal funds
- Securities purchased under agreements to resell
- World Bank securities
- Mortgage- and asset-backed securities
- Corporate debt, including investment contracts
- External investment pools
- Stock of corporations created under the laws of the United States or the Commonwealth
- Options, futures, and interest-rate swap agreements for hedging and risk control purposes, as well as for the creation of synthetic products which qualify under any of the foregoing investment categories
- Open-end mutual funds with acceptable underlying assets and rated AAA by Standard & Poor's or AAA by Moody's

The Bank's investment policies also establish limitations and other guidelines on amounts to be invested in the aforementioned investment categories and on exposure by country. In addition, such policies provide guidelines on the institutions with which investment transactions can be entered into. In addition, the investment committee and the board of directors of the Bank will determine, from time to time, other transactions that the investment and the Department of the Treasury may enter into.

The accounting policy and legal and contractual provisions for investments are described in note 2. The Bank's investments are categorized as:

- **Category 1** – Insured or registered in the name of the Bank, or securities held by the Bank, or its agent in the Bank's name.
- **Category 2** – Uninsured and unregistered in the name of the Bank, with securities held by the counterparty's trust department or agent in the Bank's name.
- **Category 3** – Uninsured and unregistered in the name of the Bank, with securities held by the counterparty, or by its trust department, or agent not in the Bank's name.

The following table summarizes the investment risks of the Bank:

Securities type	Category			Carrying amount	Fair value
	1	2	3		
Obligations of the U.S. government, its agencies, and instrumentalities	\$ 1,938,368,901	310,723	-	1,938,679,624	1,938,679,624
Mortgage - and assets-backed securities	42,353,210	889,751,987	-	932,105,197	932,105,197
Corporate debt	66,212,499	-	-	66,212,499	66,212,499
External investment pools	-	48,636,053	-	48,636,053	48,636,053
Equity securities	58,495,202	-	-	58,495,202	58,495,202
Total investments	<u>\$ 2,105,429,812</u>	<u>938,698,763</u>	<u>-</u>	<u>3,044,128,575</u>	<u>3,044,128,575</u>
Noncategorized investment: Nonparticipating investment contracts				1,186,122,874	
Total investments				<u>\$ 4,230,251,449</u>	
Reconciliation to government-wide statement of net assets:					
Unrestricted investments				\$ 2,385,617,510	
Restricted investments				1,844,633,939	
Total investments				<u>\$ 4,230,251,449</u>	

Investments in external investment pools were subject to regulatory oversight by the Commissioner of Financial Institutions of Puerto Rico, except for \$416,506 which was not subject to regulatory oversight.

Investments and investment contracts, excluding equity securities and external investment pools, at June 30, 2003 are shown below by contractual maturity. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Obligations of the U.S. government, its agencies, and instrumentalities	Corporate debt	Non-participating investment contracts	Total
Within one year	\$ 1,898,285,140	55,237,499	116,164,351	2,069,686,990
After one to five years	40,394,484	10,975,000	668,764,526	720,134,010
After five to ten years	-	-	-	-
After ten years	-	-	401,193,997	401,193,997
Total	<u>\$ 1,938,679,624</u>	<u>66,212,499</u>	<u>1,186,122,874</u>	<u>3,191,014,997</u>
Mortgage-backed securities				932,105,197
Total			\$	<u>4,123,120,194</u>

As of June 30, 2003, the Bank had pledged investment and investment contracts to secure the following:

Payment of principal and interest on obligations issued by a blended component unit	\$ 1,520,517,081
Securities sold under agreements to repurchase	190,140,109
Certificates of indebtedness	62,484,000

**(5) Loans Receivable, Allowance for Loan, and Receivable Losses**

Loans at June 30, 2003 consist of the outstanding balance of credit facilities granted to the following (in thousands):

	Governmental Activities	Enterprise Funds		Total
		GDB Operating Fund	Housing Finance Authority	
Public corporations and agencies	\$ -	1,764,884	-	1,764,884
Municipalities	-	571,847	-	571,847
Total loans to public entities	-	2,336,731	-	2,336,731
Private entities	7,331	23,910	291,744	322,985
Allowance for possible losses	-	(3,309)	(20,143)	(23,452)
	7,331	20,601	271,601	299,533
Balance, end of year	\$ 7,331	2,357,332	271,601	2,636,264
Reconciliation to government-wide statement of net assets:				\$ 2,601,194
Unrestricted loans receivable, net				35,070
Restricted loans receivable, net				\$ 2,636,264

Public sector loans which as of June 30, 2003 were delinquent by 90 days or more amounted to approximately \$555 million. Of this total, nonaccrual loans amounted to approximately \$45.6 million. The gross interest income that would have been recorded if these loans had been accruing in accordance with their original terms was approximately \$3.2 million in 2003. Interest collected on these loans amounted to \$142,000 in 2003.

On December 5, 2002, the Bank sold municipal loans and bonds of various municipalities amounting to \$448.5 million to the MFA, another component unit of the Commonwealth.

Loans to the private sector include the outstanding principal balance of credit facilities granted by the Bank to private enterprises in Puerto Rico, the activities of which are deemed to further the economic development of Puerto Rico. They also include the outstanding principal balance of mortgage loans granted to low- and moderate-income families for the acquisition of single-family housing units and to developers of multifamily housing units in Puerto Rico. These credit facilities amounted to \$299.5 million at June 30, 2003 of which \$278.9 million are mortgage loans granted.

Nonaccrual private sector loans amounted to approximately \$41 million at June 30, 2003. The gross interest income that would have been recorded if these loans had been performing in accordance with their original terms would have amounted to \$2.4 million in 2003. Interest collected on these loans amounted to approximately \$66,000.

The following is a summary of the activity in the allowance for loan losses for the year ended June 30, 2003 (in thousands):

	Enterprise Funds		Total
	GDB Operating Fund	Housing Finance Authority	
Balance, beginning of year	\$ 3,309	20,974	24,283
Provision for loan losses	-	-	-
Charge-offs	-	(831)	(831)
Balance, end of year	\$ 3,309	20,143	23,452

The following is a summary of private sector loans of enterprise funds considered to be impaired as of June 30, 2003, and the related interest income for the year then ended (in thousands):

	Enterprise Funds		Total
	GDB Operating Fund	Housing Finance Authority	
Recorded investment in impaired loans:			
Not requiring an allowance for loan losses	\$ 1,680	-	1,680
Requiring an allowance for loan losses	2,000	27,533	29,533
Total recorded investment in impaired loans	\$ 3,680	27,533	31,213
Related valuation allowance	\$ 1,417	14,283	15,700
Average recorded investment in impaired loans	3,727	32,630	36,357
Interest income recognized on impaired loans	66	—	66

In September 2002 and June 2003, the Bank sold approximately \$41.6 million and \$40.4 million of mortgage loans receivable, respectively. The net proceeds from the sale of such loans amounted to approximately \$43.4 million and \$43 million, including accrued interest amounting to approximately \$198,000 and \$191,000, respectively. The net gain from each sale was approximately \$1.6 million and \$2.4 million, respectively. The proceeds were used to pay the Commonwealth a portion of the amount due at June 30, 2002, and for the origination of new mortgage loans.

**(6) Due from Federal Government and the Puerto Rico Department of Housing**

The amount due from the federal government amounting to \$10,601,179 consists of the reimbursement requests submitted to the federal government for eligible costs incurred to plan, coordinate, and develop the construction of new housing as a replacement for those destroyed by Hurricane Georges in 1998 and to attend the housing needs of those families living in flood zone areas. Amounts collected are subject to compliance audits under OMB Circular A-133 and federal auditors. Management believes that it has complied with the terms of the grant and that all amounts claimed will be collected and, therefore, no allowance for uncollectible account has been established.

The amount due from the Puerto Rico Department of Housing of \$20,050,769 consists of advances under two lines of credit of \$2,913,533 and \$9,618,331, and an account receivable of \$7,518,905. The approved amounts under these lines of credit are \$3 million and \$10 million, respectively. Such lines of credit were approved for expenses related with the project for the rehabilitation and redevelopment of the Santurce area within the Municipality of San Juan, described in note 12 and bear a fixed annual interest rate of 3%. The maturity date is 18 months after each disbursement under the lines of credit or when the target properties (note 12) are sold, whatever occurs first. The account receivable consists of the drawdowns under the facility described in note 12, which will be paid by the Puerto Rico Department of Housing as agreed. Management believes that the whole amount due from the Puerto Rico Department of Housing is collectible; therefore, no allowance for doubtful accounts was recorded in the accompanying basic financial statements at June 30, 2003.

**(7) Capital Assets**

Capital assets activity for the year ended June 30, 2003 was as follows:

	Beginning balance	Additions	Reductions/ reclassifications	Ending balance
Business-type activities:				
Capital assets not being depreciated:				
Land	\$ 4,220,000	-	(1,265,000)	2,955,000
Total capital assets not being depreciated	4,220,000	-	(1,265,000)	2,955,000
Capital assets being depreciated:				
Building	8,988,048	-	-	8,988,048
Leasehold improvements	1,239,441	-	-	1,239,441
Information systems	5,285,580	2,085,060	(1,921,949)	5,448,691
Office furniture and equipment	3,254,304	1,205,560	(647,154)	3,812,710
Software	-	406,749	3,330,722	3,737,471
Vehicles	373,822	30,512	(2)	404,332
Total capital assets being depreciated	19,141,195	3,727,881	(761,617)	23,630,693
Less accumulated depreciation and amortization for:				
Building	(337,052)	(224,701)	-	(561,753)
Leasehold improvements	(655,195)	(126,342)	-	(781,537)
Information systems	(3,635,210)	(1,401,094)	453,699	(4,582,605)
Office furniture and equipment	(1,927,368)	(512,586)	262,214	(2,177,740)
Software	-	(776,527)	(2,674,768)	(3,451,295)
Vehicles	(181,495)	(32,678)	-	(214,173)
Total accumulated depreciation and amortization	(6,736,320)	(3,073,928)	(1,958,855)	(11,769,103)
Total capital assets being depreciated, net	12,404,875	653,953	(1,197,238)	11,861,590
Total capital assets, net	\$ 16,624,875	653,953	(2,462,238)	14,816,590

During 2003, the Bank reclassified land amounting to \$1,265,000 to due from the Puerto Rico Department of Housing.

**(8) Deposits**

Deposits consist predominantly of interest-bearing demand accounts, special government deposit accounts, and time deposits from the Commonwealth, its agencies, instrumentalities, and municipalities. Interest expense on these deposits amounted to approximately \$80.7 million in 2003.

The Bank has a deposit from Microsoft, Inc. for \$200 million on which it pays interest based on the appreciation of the Microsoft, Inc. shares, for which it has entered into a swap to manage such risk (see note 15).

**(9) Securities Sold Under Agreements to Repurchase and Federal Funds Purchased**

The following is selected information concerning securities sold under agreements to repurchase and federal funds purchased:

Carrying amount at June 30, 2003	\$	190,017,333
Maximum amount outstanding at any month-end		250,000,000
Average amount outstanding during the year		215,971,554
Weighted average interest rate for the year		1.65%
Weighted average interest rate at year-end		1.09%

The following summarizes the activity of securities sold under agreements to repurchase and federal funds purchased for fiscal year 2003:

	Beginning balance	Issuances	Maturities	Ending balance
GDB Operating Fund	\$ -	183,117,333	143,100,000	40,017,333
Housing Finance Authority	170,000,000	1,360,000,000	1,380,000,000	150,000,000
Total	\$ 170,000,000	1,543,117,333	1,523,100,000	190,017,333

All sales of investments under agreements to repurchase are for fixed terms. In investing the proceeds of securities sold under agreement to repurchase, the Bank's policy is for the term to maturity of investments to be on or before the maturity of the related repurchased agreements. At June 30, 2003, agreements to repurchase securities sold matured on September 29, 2003 and federal funds purchased were due on July 1, 2003.

**(10) Certificates of Indebtedness**

Certificates of indebtedness consist of time deposits from corporations that have grants of tax exemptions under the Commonwealth's industrial incentives laws and that qualify for the benefits provided under Section 936 of the U. S. Internal Revenue Code. The following summarizes the certificates of indebtedness activity for fiscal year 2003:

	Beginning balance	Issuances	(Discount) accretion	Maturity	Ending balance	Due within one year
GDB Operating Fund	\$ 294,591,425	-	8,392,785	60,000,000	242,984,210	-

At June 30, 2003, the scheduled maturities of certificates of indebtedness are as follows:

Year ending June 30:	
2004	\$ -
2005	-
2006	195,600,210
2007	47,384,000
2008	-
	\$ 242,984,210

**(11) Commercial Paper**

The Bank issues commercial paper in the U.S. taxable and tax-exempt commercial paper markets, in the Eurodollar commercial paper market, and to corporations that have grants of tax exemption under the Commonwealth's industrial incentives laws and that qualify for the benefits provided under Section 936 of the U.S. Internal Revenue Code. Commercial paper represents unsecured obligations of the Bank.

The following information corresponds to commercial paper:

Carrying amount at June 30, 2003	\$ 761,166,587
Maximum amount outstanding at any month-end	761,166,587
Average amount outstanding during the year	438,292,242
Weighted average interest rate for the year	1.25%
Weighted average interest rate at year-end	1.03%

The following summarizes the commercial paper activity for fiscal year 2003:

	Beginning balance	Issuances	(Discount) accretion	Maturities	Ending balance
GDB Operating Fund	\$ 398,745,844	2,356,251,378	931,045	1,994,761,680	761,166,587

**(12) Bonds Payable and Noncurrent Liabilities**

The activity of bonds payable and other borrowed funds for the year ended June 30, 2003 is as follows:

	Beginning balance	Issuances/ accretion*	Reductions	Ending balance	Due within one year
Governmental activities:					
Commonwealth appropriation bonds and notes:					
Law 115 – Subsidy prepayment refunding bonds	\$ 141,700,000	-	25,610,000	116,090,000	28,880,000
Note payable – Stage 7 Affordable Housing Mortgage Subsidy Program	10,029,360	-	-	10,029,360	102,436
Total Commonwealth appropriation bonds and notes	151,729,360	-	25,610,000	126,119,360	28,982,436
General obligation bonds:					
Loan insurance claims refunding bonds	39,640,000	-	7,160,000	32,480,000	7,515,000
Total – governmental activities	\$ 191,369,360	-	32,770,000	158,599,360	36,497,436

	Beginning balance	Issuances net accretion*	Reductions	Ending balance	Due within one year
<b>Business-type activities:</b>					
<b>GDB Operating Fund:</b>					
Adjustable Refunding Bonds	\$ 267,000,000	-	-	267,000,000	-
<b>Housing Finance Authority:</b>					
Mortgage Trust III	1,254,403,874	-	(45,720,000)	1,208,683,874	44,620,000
<b>Revenue bonds:</b>					
Collateralized Mortgage Revenue Bonds	92,500,000	-	(11,800,000)	80,700,000	-
Single Family Mortgage Revenue Bonds – Portfolio I	44,725,000	-	(660,000)	44,065,000	690,000
Single Family Mortgage Revenue Bonds – Portfolio II (net of elimination of \$11,430,000)	18,140,000	-	(2,305,000)	15,835,000	-
Single Family Mortgage Revenue Bonds – Portfolio III	37,915,000	-	(16,725,000)	21,190,000	-
Single Family Mortgage Revenue Bonds, Stage IX-2002	-	350,000,000	-	350,000,000	-
Single Family Mortgage Revenue Bonds – Portfolio IV	91,987,000	-	(30,598,000)	61,389,000	825,000
<b>Mortgage Trust IV:</b>					
Collateralized mortgage obligations	98,872,472	-	(30,857,048)	68,015,424	-
Homeownership Mortgage Revenue Bonds 2000	108,615,000	-	(8,010,000)	100,605,000	1,340,000
Homeownership Mortgage Revenue Bonds 2001	125,190,000	-	(29,285,000)	95,905,000	519,645
Homeownership Mortgage Revenue Bonds 2003	-	102,500,000	-	102,500,000	-
Total revenue bonds	617,944,472	452,500,000	(130,240,048)	940,204,424	3,374,645
<b>Subtotal Housing Finance Authority</b>					
	1,872,348,346	452,500,000	(175,960,048)	2,148,888,298	47,994,645
Note payable to banks (operations and administration)	-	7,733,655	-	7,733,655	-
Less unaccreted discount	752,836,128	1,051,393*	(40,465,739)	713,421,783	-
<b>Total Housing Finance Authority</b>					
	1,119,512,218	459,182,262	(135,494,309)	1,443,200,170	47,994,645
	1,386,512,218	459,182,262	(135,494,309)	1,710,200,170	47,994,645
Less intrafund elimination	80,534,100	(6,566,226)	-	87,100,326	-
Total business-type activities	\$ 1,305,978,118	452,616,036	(135,494,309)	1,623,099,844	47,994,645

The annual debt service requirements to maturity, including principal and interest, for long-term debt as of June 30, 2003, are as follows:

	<b>GDB Operating Fund</b>	
	<b>Business-type activities</b>	
	<b>Principal</b>	<b>Interest</b>
Year ending June 30:		
2004	\$ -	1,682,100
2005	-	1,682,100
2006	-	1,682,100
2007	-	1,682,100
2008	-	1,682,100
2009-2013	-	8,410,500
2014-2018	267,000,000	2,523,150
	<u>\$ 267,000,000</u>	<u>19,344,150</u>

	<b>Housing Finance Authority</b>			
	<b>Governmental activities</b>		<b>Business-type activities</b>	
	<b>Principal</b>	<b>Interest</b>	<b>Principal</b>	<b>Interest</b>
Year ending June 30:				
2004	\$ 36,497,436	8,184,639	47,994,645	88,770,168
2005	34,208,457	6,323,722	63,304,338	87,920,427
2006	36,445,837	4,383,890	78,294,099	86,779,072
2007	41,668,666	1,817,869	60,740,929	85,454,786
2008	751,106	557,813	5,328,115	83,926,540
2009-2013	941,411	2,659,213	327,099,522	390,489,146
2014-2018	1,331,376	2,399,206	251,472,930	346,701,554
2019-2023	2,425,827	2,024,875	246,370,002	321,569,453
2024-2028	4,329,244	1,478,310	618,227,872	234,326,493
2029-2033	-	289,270	252,327,000	93,484,761
2034-2038	-	-	205,685,000	853,741
	<u>\$ 158,599,360</u>	<u>30,118,807</u>	<u>2,156,844,452</u>	<u>1,820,276,141</u>

**Governmental Activities**

Bonds and notes payable by governmental activities consist of the following:

Description and maturity date	Interest rate	Amount outstanding
Commonwealth Appropriation Bonds: Subsidy Prepayment Refunding Bonds: December 1, 2002 and each December 1 thereafter to December 1, 2006	5.10% - 5.25%	\$ 116,090,000
General Obligation Bonds: Loan Insurance Claims Refunding Bonds: December 1, 2002 and each December 1 thereafter to December 1, 2006	5.10% - 5.25%	32,480,000
Note payable Stage 7 Affordable Housing Mortgage Subsidy: June 30, 2003 and each June 30 thereafter to June 30, 2031	Note (b) below	10,029,360
Total governmental activities bonds and notes payable		\$ 158,599,360

**(a) Subsidy Prepayment Refunding Bonds and Loan Insurance Refunding Bonds**

The principal and interest of the Subsidy Prepayment Refunding Bonds and Loan Insurance Refunding Bonds are payable from and secured by amounts appropriated by the Legislature of the Commonwealth and paid by the Secretary of the Treasury for such purpose; and a pledge and assignment of all rights, title, and interest of the Authority in and to all moneys and securities in the funds and accounts established under the Subsidy Prepayment Refunding Bonds Indenture.

**(b) Note Payable to Puerto Rico Public Finance Corporation**

On December 27, 2001, the Authority entered into a loan agreement (the Note) with the GDB Operating Fund to finance a loan (the Old Note) of the Housing Bank, also with the GDB Operating Fund, as authorized by Act No. 164 of December 17, 2001. The Public Finance Corporation acquired and restructured the Note through the issuance of its Commonwealth appropriations bonds (PFC Bonds). The PFC Bonds were issued under trust indenture whereby Public Finance Corporation pledged and sold the Note, along with other notes under Act No. 164, to certain trustees and created a first lien on the revenue of the notes sold. The amount outstanding of the Note at June 30, 2003 was \$10,029,360 and matures on June 30, 2031. Interest on the unpaid principal amount of the Note is equal to the applicable percentage of the aggregate interest payable on the PFC Bonds. Applicable percentage is the percentage representing the proportion of the amount paid by Public Finance Corporation on the PFC Bonds serviced by the Note to the aggregate amount paid by Public Finance Corporation on all the PFC Bonds issued by Public Finance Corporation under Act No. 164.

**Business-Type Activities**

Bonds payable by business-type activities consist of the following:

Description and maturity date	Interest rate	Amount outstanding
Adjustable Refunding Bonds: January 1, 2015	Variable, 0.63% at June 30, 2003	\$ 267,000,000
Mortgage Trust III: January 1, 2001 and each July 1 and January 1 thereafter to July 1, 2011	Zero Coupon	168,562,567
January 1, 2001 and each July 1 and January 1 thereafter to January 1, 2021	Zero Coupon	240,568,985
January 1, 2026	Zero Coupon	87,100,327
Plus: unaccreted discount		712,451,995
Collateralized Mortgage Revenue Bonds: January 1, 2005 and every other January 1 thereafter to January 1, 2015	6.00%-6.30%	26,475,000
January 1, 2022	6.40%	21,705,000
January 1, 2029	6.50%	32,520,000
Single Family Mortgage Revenue Bonds – Portfolio I: October 1, 2002 and each April 1 and October 1 thereafter to October 1, 2010	5.15%-5.90%	6,340,000
October 1, 2015	6.10%	6,305,000
April 1, 2029	6.25%	31,420,000
Single Family Mortgage Revenue Bonds – Portfolio II: December 1, 2006	6.50%	1,210,000
December 1, 2023	7.00%	14,625,000
Single Family Mortgage Revenue Bonds – Portfolio III: February 1, 2007 and each February and August 1 to August 1, 2010	6.20%-6.60%	4,825,000
August 1, 2017	6.75%	3,935,000
August 1, 2020	6.85%	2,285,000
August 1, 2029	7.00%	10,145,000
		<u>10,145,000</u>
Balance carried forward		\$ <u>1,637,473,874</u>

Description and maturity date	Interest rate	Amount outstanding
Balance brought forward		\$ 1,637,473,874
Single Family Mortgage Revenue Bonds – Portfolio IV: December 1, 2003 and each December 1 and June 1 to August 1, 2007	5.75%-6.00%	4,230,000
December 1, 2015	6.15%	11,563,000
December 1, 2023	6.20%	19,790,000
December 1, 2026	6.20%	10,659,000
December 1, 2030	6.25%	15,147,000
Mortgage Trust IV: April 1, 2011	5.90%	25,681,806
May 1, 2015	6.00%	42,333,618
Single Family Mortgage Revenue Bonds – Portfolio IX: June 1, 2005 each December 1 and June 1 to December 1, 2012	3.10%-5.10%	49,530,000
December 1, 2017	5.40%	28,770,000
December 1, 2022	5.50%	46,455,000
December 1, 2032	5.60%	65,825,000
December 1, 2034	5.60%	159,420,000
Homeownership Mortgage Revenue Bonds 2000 Series: December 1, 2002 and each December 1 thereafter to December 1, 2012	3.80%-4.75%	16,010,000
June 1, 2020	4.40%	1,635,000
December 1, 2018	5.10%	14,085,000
June 1, 2020	5.15%	12,030,000
December 1, 2031	5.10%	21,990,000
December 1, 2032	5.20%	34,855,000
Homeownership Mortgage Revenue Bonds 2001 Series: December 1, 2033	5.20%	22,265,000
December 1, 2002 and each December 1 thereafter to December 1, 2012	2.75%-4.70%	16,685,000
December 1, 2023	5.50%	4,505,000
June 1, 2027	4.45%	22,745,000
June 1, 2028	5.30%	2,965,000
December 1, 2028	5.30%	26,740,000
Homeownership Mortgage Revenue Bonds 2003 Series: December 1, 2005 and each December 1 thereafter to December 1, 2013	1.75%-4.00%	18,825,000
December 1, 2017	4.375%	7,500,000
June 1, 2023	4.750%	11,640,000
December 1, 2023	4.750%	4,500,000
December 1, 2033	3.125%	16,000,000
June 1, 2034	4.875%	36,035,000
December 1, 2034	4.875%	8,000,000
Total		\$ 2,415,888,298

The Adjustable Refunding Bonds were issued in December 1985. Interest due on these bonds is payable monthly at a rate determined weekly, based on the factor necessary to produce as nearly as practicable a par bid for each bond on the date of determination, but not greater than 12% per annum in any case. The payment of principal and interest on the bonds is secured by a stand-by bond purchase agreement issued by a third party to a trustee. The payment of principal and interest is also guaranteed by the full faith and credit of the Commonwealth and is insured by MBIA Insurance Corporation. The bonds are convertible to a fixed rate commencing on any date at the election of the Bank. Such conversion will subject the bonds to mandatory tender for purchase on the effective date of the conversion to a fixed rate, but holders desiring to keep their bonds after conversion may waive such mandatory tender. Furthermore, as long as interest on the bonds is payable at a variable rate, each bondholder has the option to have any of the bonds purchased in whole or in part, in multiples of \$50,000, at par plus interest accrued to the purchase date. Prior to conversion of the bonds to a fixed rate of interest, the bonds are subject to mandatory tender for purchase, at the option of the Bank, on any interest payment date at par, with at least 10 days notice from the trustee.

On November 1, 2002, the Bank issued \$350,000,000 Single Family Mortgage Revenue Bonds Portfolio IX (the Portfolio IX Bonds) consisting of serial bonds and term bonds amounting to \$49,530,000 and \$300,470,000, respectively.

The proceeds from these bonds were used to provide funds for purchase and transfer to the trustee, mortgage-backed securities guaranteed by GNMA, Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage (FHLM) Corporation (collectively the Mortgage Certificates – Portfolio IX). The Mortgage Certificates – Portfolio IX are backed by pools of mortgage loans made by participating lending institutions to low- and moderate-income families to finance the purchase of qualified single-family residential housing in Puerto Rico. The Portfolio IX Bonds maturing on or after June 1, 2010 are subject to redemption in whole or in part, at the option of the Bank, prior to their stated maturity at the following redemption prices:

Redemption period	Redemption price
June 1, 2010 to May 31, 2011	102%
June 1, 2011 to May 31, 2012	101%
June 1, 2012 and thereafter	100%

On May 1, 2003, the Bank issued \$102,500,000 Home Mortgage Revenue Bonds consisting of \$102,500,000 2003 Series A. The proceeds from these bonds and notes were used to provide funds to purchase and transfer to the trustee mortgage-backed securities guaranteed by the GNMA, FNMA, or the FHLM Authority (collectively the Mortgage Certificates). The Mortgage Certificates are backed by pools of mortgage loans made by participating lending institutions to low- and moderate-income families to finance the purchase of qualified single-family residential housing in the Commonwealth. These bonds bear interest ranging from 1.75% to 4.875%, payable semiannually on each June 1 and December 1. The bonds are payable in full on their respective stated maturity dates, and are subject to redemption prior to their stated maturity dates, including redemption at par. The principal of and redemption premium, if any, and interest on the bonds and notes are payable solely from the proceeds of certain assets, including the Mortgage Certificates acquired from time to time by the trustee, certain investments, and proceeds of the bonds and notes.

In December 2002, the Bank entered into a nonrevolving credit facility (the Facility) with various lending institutions in the aggregate principal amount of up to \$50 million to provide funds to the Department of Housing for the rehabilitation and redevelopment of the Santurce sector of the Municipality of San Juan (the Plan or Project). Under this Plan, approximately 159 properties (the Target Properties) were identified and are intended to be acquired through purchase or expropriation, for sale to persons that will develop, re-develop, and/or construct, commercial and residential projects. The acquisition and sale of the Target Properties will be undertaken through the Department of Housing under Act No. 201 of the Legislature of the Commonwealth dated August 26, 2002. Therefore, the Department of Housing, not the Authority, will own all the Target Properties acquired under the Plan.

At June 30, 2003, the Facility has an outstanding amount of \$7,733,655, maturing in December 2004. The Facility bears a variable interest consisting of the 30-day London Interbank Offered Rate (LIBOR) plus 0.5% at the first day of each month. The Bank is obligated, under this credit agreement, to prepay the advances of the Facility upon the sale or disposition of all or any part of the mortgaged Target Properties in the amount of 100% of the net proceeds.

In February 1999, the Public Finance Corporation issued \$228.3 million Tax Debt Collateralized Bonds. The Tax Debt Bonds were special and limited nonrecourse obligations of the Public Finance Corporation, payable solely from: the tax lien receivables acquired from Municipal Revenue Collection Center (CRIM, as per its Spanish acronym), including interest accrued; any real and personal property acquired by the Public Finance Corporation through foreclosure or otherwise in connection with the tax lien receivables; and certain reserves established in connection with the bond indenture.

Management had initially foreseen that the collection of tax lien receivables and the established reserves would ultimately be sufficient to pay the Tax Debt Bonds. However, during fiscal years 2001 and 2002, the principal amount of approximately \$145.5 million of tax lien receivables was identified as defective. Under the terms of the trust indenture, CRIM and the Commonwealth were obligated to replace these defective tax liens with either new tax liens or cash in their corresponding proportional share. Also as part of the cancellation of the tax debts transaction this amount was collected from CRIM and the Commonwealth as described below.

The unfolding of events in connection with the transaction prompted the Bank, the Commonwealth's Secretary of the Treasury, and CRIM to devise a plan to prepay the bonds and cancel the transaction. The Commonwealth's Secretary of the Treasury acknowledged that the Bank had sustained losses as a result of this transaction and agreed to compensate the Bank for past losses as well as for estimated losses to be incurred in the cancellation and unwinding of the tax debts transaction. Consequently, the Commonwealth committed \$132 million for the cancellation of the tax debts transaction. Initially this amount was recorded as deferred credits and subsequently part was used for the payment of defective tax liens and to offset the losses incurred in the process of early extinguishments of bonds. During fiscal year 2003, the Bank recognized as other noninterest income \$37.7 million representing the amortization of the final balance deferred credits.

Upon notice of the intention of the Corporation to cancel the transaction and terminate the servicing agreement dated February 1, 1999 between the Corporation, Banco Popular de Puerto Rico as trustee, and JER Revenue Services P.R. (JER or the servicer), JER filed suit against the Bank, the Public Finance Corporation, and CRIM for breach of contract and loss of revenue under the contract. The suit also involves a disagreement between the Public Finance Corporation and JER as to the treatment of funds received to cure defective tax lien receivables for purposes of the incentive fee due to the servicer under the servicing agreement. The Court ordered the Public Finance Corporation to deposit \$7 million in escrow in connection with the suit. A deposit and a liability for said amount have been recorded in the books of the Public Finance Corporation. In addition, the Public Finance Corporation is a defendant in several lawsuits related to property tax debts of individuals. The Public Finance Corporation has also established an accrual, which, in the opinion of management, should be sufficient to cover any additional expenses, termination fees, or other costs from the complete cancellation of the agreement and transaction. As of June 30, 2003, the case is pending litigation.

Final resolution of the servicing agreement is pending the outcome of the legal case. The Public Finance Corporation, the Bank, the Department of the Treasury, and CRIM are negotiating a transferred tax debts assignment, allocation and servicing agreement with the purpose of transferring and assigning to CRIM the tax lien receivables for servicing and collection upon termination of the indenture and the servicing agreements, discharging the Public Finance Corporation of its obligations under the Subordinated Note and for the establishment of an order of priority for the distribution of future collections from the tax lien receivables.

The activity for noncurrent accrued liabilities during 2003 follows:

	Enterprise Funds			
	GDB Operating Fund	Public Finance Corporation	Education Assistance Corporation	Total
Balance, beginning of period	\$ 587,500	10,405,155	2,065,431	13,058,086
Additions	-	-	13,941	13,941
Balance, end of period	\$ 587,500	10,405,155	2,079,372	13,072,027

**(13) Restricted Net Assets – Mortgage Loan Insurance Fund**

The Housing Finance Authority is required by law to maintain a reserve for losses on insured mortgage loans, which is computed as a percentage of the outstanding principal balance of the insured mortgage loans and is not used to account for gain or losses. Losses incurred upon the foreclosure and subsequent gains or losses on the disposal of properties are credited/charged to the estimated liability for mortgage loan insurance losses. At June 30, 2003, the Housing Finance Authority had restricted net asset for such purposes of approximately \$23.4 million.

**(14) Financial Instruments with Off-Balance Sheet Risk**

In the normal course of business, the Bank is party to transactions involving financial instruments with off-balance sheet risk, to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and of contribution, standby letters of credit, financial guarantees, and interest rate exchange agreements. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of amounts recognized in the accompanying statement of net assets and fund balance sheets. These off-balance sheet risks are managed and monitored in manners similar to those used for on-balance sheet risks. The Bank's exposures to credit loss for lending commitments, financial guarantees, and letters of credit are represented by the contractual amount of those transactions. The notional amounts for other off-balance sheet risks express the dollar volume of the transactions, but the credit risk might be lower.

At June 30, 2003, the off-balance sheet risks consisted of the following (in thousands):

Financial instruments whose credit risk is represented by contractual amounts:		
Financial guarantees to:		
Public sector		\$ 83,384
Private sector		682,150
	Total	<u>\$ 765,534</u>
Standby letters of credit:		
Public sector		\$ 85,707
Private sector		113,435
	Total	<u>\$ 199,142</u>
Commitments to extend credit:		
Public sector		\$ 3,379,813
Private sector		32,264
	Total	<u>\$ 3,412,077</u>

Financial guarantees and letters of credit outstanding at June 30, 2003 include approximately \$563 million, issued by the Tourism Development Fund on several private hotel and tourism development projects. During 2003, the Tourism Development Fund made payments under such financial guarantees and letters of credit in the amount of \$18.8 million.

On July 1, 2002, the Bank issued a payment guarantee in favour of Ondeo de Puerto Rico, Inc. (Ondeo) in connection with a service contract for water and wastewater system management between Puerto Rico Aqueduct and Sewer Authority (PRASA), a component unit of the Commonwealth, and Ondeo (the service contract) whereby the Bank guarantees to Ondeo the full payment of the annual service fee due to Ondeo by PRASA under the service contract and any termination fee payable pursuant to such service contract. Under the provisions of Article 7 of Act No. 95 of June 30, 2002, any payments made by the Bank under the payment guarantee, up to an amount equal to the annual service fee established under the service contract, are reimbursable annually to the Bank from annual budgetary appropriations made by the Legislature of the Commonwealth.

Following is the 2003 activity for the noncurrent portion of the allowance for guarantees and letters of credit:

	Beginning balance	Provisions	Charges	Ending balance
GDB Operating Fund	\$ 3,048,465	-	-	3,048,465
Tourism Development Fund	14,116,612	12,136,663	-	26,253,275
	<u>\$ 17,165,077</u>	<u>12,136,663</u>	<u>-</u>	<u>29,301,740</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank, as applicable, evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies but may include property, plant, and equipment, and income-producing commercial properties. Standby letters of credit and financial guarantees are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

#### (15) Derivative Instruments

At June 30, 2003, the Bank had outstanding interest-rate swap agreements with other financial institutions as shown below:

Notional amount	Floating rate indicator	Receives		Pays		Maturity date
		Type	Rate at June 30, 2003	Type	Rate	
\$ 50,000	LIBOR	Variable	0.36%	Fixed	4.72%	July 1, 2006
60,000	LIBOR	Variable	0.36%	Fixed	4.71%	July 1, 2006
60,000	LIBOR	Variable	0.36%	Fixed	4.71%	July 1, 2006
267,000	VRDOs(1)	Variable	0.630%	Fixed	3.04%	August 1, 2004
<u>200,000</u>	MSFT(2)	Zero	-	Fixed	4.99%	February 28, 2006
<u>\$ 637,000</u>						

<sup>(1)</sup>VRDOs – Variable Rate Demand Obligations. The variable rate received under this agreement corresponds to the rate set on a weekly open-market auction in which the underlying bonds are offered for sale. The underlying bonds contain a put option permitting the bondholder to tender the bonds for purchase upon seven days' notice.

<sup>(2)</sup>MSFT – Microsoft share appreciation index which mirrors embedded derivative on \$200 million Microsoft certificate of deposit.

The Bank is exposed to interest rate risk in the event of nonperformance by the other parties to the interest-rate swap agreements. However, the Bank does not anticipate nonperformance by the counterparties.

**(16) Retirement System**

**(a) *Defined-Benefit Pension Plan***

The Employees' Retirement System of the Commonwealth of Puerto Rico and its Instrumentalities (the Retirement System), created pursuant to Act No. 447 of May 15, 1951, as amended, is a cost-sharing, multiple-employer, defined-benefit pension plan sponsored by and reported as a component unit of the Commonwealth. All regular employees of the Bank hired before January 1, 2000 and under 55 years of age at the date of employment became members of the Retirement System as a condition of their employment. No benefits are payable if the participant receives a refund of their accumulated contributions.

The Retirement System provides retirement, death, and disability benefits pursuant to legislation enacted by the Legislature of the Commonwealth. Retirement benefits depend upon age at retirement and the number of years of creditable service. Benefits vest after 10 years of plan participation. Disability benefits are available to members for occupational and nonoccupational disabilities. However, a member must have at least 10 years of service to receive nonoccupational disability benefits.

Members who have attained 55 years of age and have completed at least 25 years of creditable service, or members who have attained 58 years of age and have completed 10 years of creditable service, are entitled to an annual benefit, payable monthly for life. The amount of the annuity shall be 1.5% of the average compensation, as defined, multiplied by the number of years of creditable service up to 20 years, plus 2% of the average compensation, as defined, multiplied by the number of years of creditable service in excess of 20 years. In no case will the annuity be less than \$200 per month.

Participants who have completed 30 years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained 55 years of age will receive 65% of the average compensation, as defined; otherwise, they will receive 75% of the average compensation, as defined.

Commonwealth Legislation requires employees to contribute 5.775% of the first \$550 of their monthly gross salary and 8.275% for the excess over \$550 of monthly gross salary. The Bank is required by the same statute to contribute 9.275% of each participant's gross salary.

**(b) *Defined Contribution Plan***

The Legislature of the Commonwealth enacted Act No. 305 on September 24, 1999, which amended Act No. 447 to establish, among other things, a defined contribution savings plan program (the Program) to be administered by the Retirement System. All regular employees hired for the first time on or after January 1, 2000, and former employees who participated in the defined-benefit pension plan, received a refund of their contributions, and were rehired on or after January 1, 2000, become members of the Program as a condition to their employment. In addition, employees who at December 31, 1999 were participants of the defined-benefit pension plan had the option, up to March 31, 2000, to irrevocably transfer their prior contributions to the defined-benefit pension plan plus interest thereon to the Program.

Act No. 305 requires employees to contribute 8.275% of their monthly gross salary to the Program. Employees may elect to increase their contribution up to 10% of their monthly gross salary. Employee contributions are credited to individual accounts established under the Program. Participants have three options to invest their contributions to the Program. Investment income is credited to the participant's account semiannually.

The Bank is required by Act No. 305 to contribute 9.275% of each participant's gross salary. The Retirement System will use these contributions to increase its asset level and reduce the unfunded status of the defined-benefit pension plan.

Upon retirement, the balance in each participant's account will be used to purchase an annuity contract, which will provide for a monthly benefit during the participant's life and 50% of such benefit to the participant's spouse in case of the participant's death. Participants with a balance of \$10,000 or less at retirement will receive a lump-sum payment. In case of death, the balance in each participant's account will be paid in a lump sum to the participant's beneficiaries. Participants have the option of receiving a lump sum or purchasing an annuity contract in case of permanent disability.

Total employee contributions to the above-mentioned plans during the year ended June 30, 2003 amounted to approximately \$1,600,000. The Bank's contributions during the years ended June 30, 2003, 2002, and 2001 amounted to approximately \$1,810,000, \$1,443,000, and \$1,133,000, respectively. These amounts represented 100% of the required contribution for the corresponding year.

Additional information on the Retirement System is provided in its stand-alone financial statements for the year ended June 30, 2003, a copy of which can be obtained from the Employees' Retirement System of the Commonwealth of Puerto Rico and its Instrumentalities, PO Box 42003, San Juan, PR 00940-2003.

**(17) Commitments and Contingencies**

**(a) Lease Commitments**

The Bank leases office space principally from another component unit of the Commonwealth under noncancelable operating leases, the latest of which expires in 2006. Rent charged to operations in 2003 amounted to approximately \$1.2 million.

At June 30, 2003, the minimum annual future rentals under noncancelable leases were as follows:

Year ending June 30:	
2004	\$ 1,654,594
2005	567,597
2006	450,687
Total	\$ 2,672,878

**(b) Puerto Rico Art Museum**

During fiscal year 1996, the board of directors of the Bank approved a resolution, to designate certain real estate owned by the Bank for the site of what is known as the Puerto Rico Art Museum (the Museum). The resolution also indicated that the Bank would refurbish the property, including the parking facilities. Total cost amounted to \$54.9 million, which was previously charged to expenses of the Bank. The Museum has been organized as a not-for-profit organization and has a separate board of trustees. While legal title over the property remains with the Bank, it is currently expected that the property, including the parking facility which is operated by the Bank, will be transferred or sold to the Museum.

During fiscal year 2003, the board of directors of the Bank also approved a resolution authorizing the Bank to contribute \$1 million for the operating expenses of the Museum for fiscal year 2003. This contribution is included in contributions to others in the accompanying statement of revenues, expenses, and changes in net assets for 2003.

**(c) Contribution to the Special Communities Perpetual Trust**

On November 21, 2002, the Legislature of the Commonwealth approved Joint Resolution No. 1027, authorizing the Bank to transfer \$500 million as a contribution to the Special Communities Perpetual Trust (the Special Communities Trust), an entity created for the purpose of financing a variety of initiatives, primarily housing and infrastructure, directed to the betterment of disadvantaged communities across the island. As approved in the Joint Resolution, the contribution will be disbursed following approved laws and regulations. The board of directors of the Bank approved a regulation (the regulation), which calls for the disbursement of contributions based on the compliance with certain reimbursement requirements. As of June 30, 2003, disbursements amounted to \$500,000.

In addition, the Legislature approved on November 21, 2002 Joint Resolution No. 1028, which authorized the Special Communities Trust to borrow up to \$500 million in order to carry out the initiatives with which it was entrusted. The Joint Resolution authorizes the Bank to provide such financing, and requires the Director of the OMB to include in the budget of the Commonwealth submitted annually to the Legislature, for a period of ten fiscal years starting with the budget of fiscal year 2003-2004, the sum of \$50 million plus accrued interest for the

repayment of such borrowing. The appropriations shall be made from the product of the sale of public improvement bonds issued during each of said fiscal years. The Bank approved a line of credit with aggregate borrowings of \$500 million. Disbursements under this line of credit will also be subject to the regulation. Consequently, as of June 30, 2003, amounts drawn against the line of credit amounted to \$4,951,757.

As stated in the regulation, it is considered beneficial to the Special Communities Trust to initially disburse expenditures from borrowings under the line of credit due to the current low interest rate levels.

**(d) Cooperative Development Investment Fund**

On August 18, 2002, the Legislature of the Commonwealth approved Law No. 198, which creates the Cooperative Development Investment Fund. The purpose of this fund is to promote the development of cooperative entities. This fund will be capitalized through contributions to be provided by the Bank up to \$25 million to be matched by cooperative entities. During 2003, the Bank contributed \$5 million to the Cooperative Development Investment Fund, which has been included in contributions to others.

**(e) Other Risks Related to Mortgage Loans Servicing and Insurance Activities**

Certain loan portfolios of the Authority are administered by private servicers who are required to maintain an error and omissions insurance policy. The Authority has a program to manage the risk of loss on its mortgage loan lending and insurance activities.

**(f) Custodial Activities of Enterprise Funds**

At June 30, 2003, the Authority was custodian of \$37,756 in restricted funds of the CRUV. As of June 30, 2003, such funds are deposited with the Bank. These funds are not owned by the Authority's enterprise funds and thus are not reflected in the basic financial statements.

At June 30, 2003, the Authority was the custodian of approximately \$1.6 million designed for the improvements to be made to the Puerto Rico Department of Housing building. These funds were invested in accordance with the Authority's investment policy. The Authority's management has included these funds in the enterprise fund as an asset, included within cash and cash equivalents, and a liability to the Puerto Rico Department of Housing.

**(g) Loan Sales and Securitization Activities**

On July 13, 1992, the Puerto Rico Housing Bank entered into an agreement to securitize approximately \$20.7 million of mortgage loans into a FNMA certificate. The Puerto Rico Housing Bank agreed to repurchase, at a price of par plus accrued interest, each and every mortgage loan backing up such security certificate that became delinquent for 120 days or more. As of June 30, 2003, the aggregate outstanding principal balance of the loans pooled into the FNMA certificate amounts to \$1,419,591.

**(h) Mortgage Loan Servicing Activities**

The Authority acts as servicer for a number of mortgage loans owned by other investors. The servicing is generally subcontracted to a third party. As of June 30, 2003, the principal balance of the mortgage loans serviced for others is as follows:

Puerto Rico Urban Renewal and Housing Authority (CRUV) or its successor without guaranteed mortgage loan payments	\$ 144,032
Other investors, with guaranteed mortgage loan payments	<u>703,240</u>
Total	<u>\$ 847,272</u>

(i) **Litigation**

The Bank is defendant in several lawsuits arising out of the normal course of business. Management, based on discussion with legal counsel, is of the opinion that the ultimate liability, if any, resulting from these pending proceedings will not have a material effect on the financial position or results of operations of the Bank.

(18) **No-Commitment Debt and Programs Sponsored by the Housing Finance Authority**

The Public Finance Corporation has issued approximately \$5.6 billion of Commonwealth appropriation bonds (the Bonds) maturing at various dates through 2031. The proceeds of the Bonds, except for approximately \$298 million, have been used to provide the necessary funds to purchase from the Bank separate promissory notes of the Department of the Treasury of the Commonwealth, and its instrumentalities and public corporations (the Notes). The \$298 million referred to above were used to refund a portion of certain bonds issued by the Public Finance Corporation (also no-commitment debt) in fiscal years 1995 and 2000. The outstanding balance of the Bonds at June 30, 2003 amounted to approximately \$4.6 billion. The Bonds are limited obligations of the Public Finance Corporation and, except to the extent payable from bond proceeds and investment earnings thereon, are payable solely from a pledge and assignment of amounts due under the Notes. Principal and interest on the Notes are payable solely from legislative appropriations to be made pursuant to acts approved by the Legislature of the Commonwealth. These acts provide that the Commonwealth shall honor the payment of principal of and interest on the Notes, and that the Director of the OMB shall include in the budget of the Commonwealth submitted to the Legislature the amounts necessary to pay the principal and interest on the Notes. The underlying promissory notes represent debt of the issuing instrumentalities (all part of the Commonwealth or its component units), and, for purposes of the Public Finance Corporation, the Bonds are considered no-commitment debt. Neither the Bonds nor the Notes purchased with the proceeds therefrom are presented in the accompanying basic financial statements.

Certain bonds of the Housing Finance Authority are considered no-commitment debt as more fully described in note 1. At June 30, 2003, there were restricted assets held in trust by others, outstanding obligations, fund balances, and excess of fund revenue over expenses, net of transfers (all of which are excluded from the accompanying financial statements), as indicated below (unaudited):

Restricted assets	\$	123,216,210
Restricted liabilities (no commitment debt)		<u>105,576,967</u>
Restricted fund balance	\$	<u>17,639,243</u>
Excess of fund expenses over revenues	\$	635,681

In addition, the Housing Finance Authority, as a public housing agency, is authorized to administer the U.S. Housing Act Section 8 Program in Puerto Rico. The revenues and expenses of such federal financial assistance are accounted for in the Housing Finance Authority Fund.

Revenues and expenses during 2003 in connection with the administration of the U.S. Housing Act Section 8 Program amounted to \$112,199,144. These amounts exclude \$4,476,560 of administrative fees for services performed as contract administrator which are reimbursed by the U.S. Department of Housing and Urban Development.

## (19) Estimated Fair Value of Financial Instruments

For a significant portion of the Bank's financial instruments (principally loans and deposits) fair values are not readily available since there are no available trading markets. Accordingly, fair values can only be derived or estimated using valuation techniques, such as present-valuing estimated future cash flows using discount rates, which reflect the risk involved, and other related factors. It should be noted that minor changes in assumptions or estimation methodologies may have a material effect on the results derived therefrom.

The fair values reflected below are indicative of the interest rate environment as of June 30, 2003, and do not take into consideration the effects of interest rate fluctuations. In different interest rate scenarios, fair value results can differ significantly. Furthermore, actual prepayments may vary significantly from those estimated resulting in materially different fair values.

The difference between the carrying value and the estimated fair value may not be realized, since, in many of the cases, the Bank intends to hold the financial instruments until maturity, or because the financial instruments are restricted. Comparability of fair values among financial institutions is not likely, due to the wide range of permitted valuation techniques and numerous estimates that must be made in the absence of secondary market prices.

The following methods and assumptions were used by the Bank in estimating fair values of the financial instruments for which it is practicable to estimate such values:

- Short-term financial instruments, such as federal funds sold, cash and due from banks, repurchase and resale agreements, commercial paper, and accrued interest receivable and payable have been valued at the carrying amounts reflected in the balance sheet, as these are reasonable estimates of fair value given the relatively short period of time between origination of the instruments and their expected realization.
- Financial instruments that are primarily traded in secondary markets, such as most investments, were valued using either market price, pricing models, or quoted market prices of financial instruments with similar characteristics.
- Financial instruments that are not generally traded, such as certificates of deposit and investment contracts, and bonds issued with fixed interest rates, were fair valued, for the most part, using the present values of estimated future cash flows at the appropriate discount rates. Bonds issued with interest rates floating within certain ranges were fair valued at their outstanding principal balance. The fair value of liabilities with no defined maturities, such as demand deposits, was reported as the amounts payable upon demand.
- Loans to the public sector were valued according to the type of contractual interest rate. Loans to the public sector with interest rates floating within certain ranges were fair valued at their outstanding principal balance. Loans to the public sector with fixed interest rates were fair valued assuming that such loans were packaged and sold in the secondary market. The discount rates utilized were based on the rating of the Commonwealth and the market where the instruments would be sold and were adjusted for various other factors, including issuance costs. For delinquent public sector loans, the fair value was assumed to be equal to the carrying value, as historically the Bank has collected such amounts.
- Loans and commitments to extend credit to the private sector are mostly industrial development, tourism development, and low-cost housing development projects. For these types of loans and commitments, there is no secondary market, and the actual future cash flows may vary significantly as compared to the cash flows projected under the agreements, due to the degree of risk. Accordingly, management has opted not to disclose the fair value to these financial instruments, as such information may not be estimated with reasonable precision.
- Disclosure as to the fair value of commitments to extend credit, standby letters of credit, and guarantees relating to instrumentalities of the Commonwealth is omitted, as these arrangements are with component units of the Commonwealth.

- Interest rate swaps used in asset-liability management were valued using estimated market prices, based on discounted future cash flows.

	Reported or notional amount	Fair value
(In millions)		
Financial assets:		
Cash and due from banks	\$ 46	46
Federal funds sold and securities purchased under agreement to resell	1,233	1,233
Deposits placed with banks	408	408
Investments and investment contracts	3,903	4,049
Loans to public sector entities and municipalities	2,337	2,374
Accrued interest receivable and other receivable	110	110
Financial liabilities:		
Demand deposits	1,618	1,618
Certificates of deposit	1,919	1,919
Certificates of indebtedness	243	243
Securities sold under agreement to repurchase	190	190
Commercial paper	761	761
Due to Commonwealth of Puerto Rico	6,924	6,924
Accounts payable and accrued liabilities	141,666	141,666
Accrued interest payable	12	12
Bonds and notes payable	1,623	1,851
Derivative instruments:		
Interest rate exchange agreements	637	(46)
Equity index embedded on certificate of deposit	200	(16)

**(20) Interfund Balances and Transfers**

Following is a summary of the interfund balances as of June 30, 2003:

Receivable by fund	Payable by fund	Purpose	Interfund balances
Governmental funds: Key for Your Home Program New Secure Housing Program Other nonmajor fund (Portfolio IV) Other nonmajor fund (Portfolio IV) Subsidy Prepayment Refunding Bonds Other nonmajor fund (Law 124) Special Obligation Refunding Bonds – Debt Service Key for Your Home Program New Secure Housing Program Other nonmajor fund (Law 72) Other nonmajor fund (Law 72) Other nonmajor fund (Stage 8)	Enterprise funds: Housing Finance Authority Housing Finance Authority Housing Finance Authority Housing Finance Authority GDB Operating Fund GDB Operating Fund  GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund  Governmental funds: Other nonmajor fund (Law 72) Other nonmajor fund (Law 124) Other nonmajor fund (Stage 7) Key for Your Home Program Other nonmajor fund (Law 124) Other nonmajor fund (Portfolio IV) Other nonmajor fund (Law 72) Other nonmajor fund (Stage 7) Other nonmajor fund (Stage 8) Other nonmajor fund (Stage 9) New Secure Housing Program	Advance for subsidiaries Reimbursements of loan originations Collection of mortgages of debt service fund Reimbursement of bond issue costs Demand deposit and accrued interest Demand deposit and accrued interest  Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Certificates of deposit and interest Certificates of deposit and interest  Reimbursement of expenditures Reimbursement of expenditures Reimbursement of expenditures Reimbursement of expenditures Reimbursement of expenditures Reimbursement of expenditures Reimbursement of expenditures Securities purchase under agreement to resell and interest Loans and interest Loans and interest Loans and interest	\$ 5,172,239 400 4,784,144 2,527,427 348,483 394,615  6,409,802 491,327 3,289,435 5,419 1,867,596 58,702,248  (173,278) (169,906) (879,375) (100,000) (27,959) (40,000) (24,523) (75,055,928) (89,071,166) (89,060,282) (15,197,195) \$ (185,806,477)
Enterprise funds: Housing Finance Authority Development Fund Tourism Development Fund Public Finance Corporation Education Assistance Corporation José M. Berrocal Institute Housing Finance Authority Tourism Development Fund Housing Finance Authority GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund	Enterprise funds: GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund GDB Operating Fund Housing Finance Authority Housing Finance Authority Housing Finance Authority Housing Finance Authority	Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Demand deposit and accrued interest Certificates of deposit and interest Certificates of deposit and interest Guarantee investment contract Bonds payable Loans and accrued interest Securities purchase under agreement to resell and accrued interest Other	\$ 53,824,342 12,715,140 6,401,289 1,173,665 2,079,372 254,321 155,301,103 30,243,648 151,035,122 87,322,826 223,085 55,450,668 1,408,198 \$ 557,432,779

Following is a summary of interfund transfers for the year:

Transfer out	Transfer in	Purpose	Amount
Governmental funds:	Enterprise funds:		
Other major fund (Portfolio I)	Housing Finance Authority	Operating transfer	\$ 521,891
Other major fund (Portfolio III)	Housing Finance Authority	Operating transfer	19,158,368
Other major fund (Portfolio III)	Housing Finance Authority	Operating transfer	10,581,723
Other nonmajor fund (Portfolio IV)	Housing Finance Authority	Operating transfer	25,073,601
Other nonmajor fund (Law 124)	Housing Finance Authority	Operating transfer	919,283
Governmental funds:	Governmental funds:		
Other nonmajor funds (Stage VI)	Key for your Home Program	Operating transfer	18,134,251
Enterprise funds:	Governmental funds:		
Housing Finance Authority	Other nonmajor funds (Portfolio III)	Operating transfer	11,244,394
Enterprise funds:	Enterprise funds:		
GDB Operating Fund	Other nonmajor funds (JMBI Operating Fund)	Operating transfer	300,000

**(21) Subsequent Events**

In July 2003, the Tourism Fund obtained a line of credit from the Bank for a maximum of \$155.3 million with the sole purpose of refinancing the AFICA Río Mar Associates bonds which the Tourism Fund guarantees. Said bonds have an outstanding balance of \$148.8 million at June 30, 2003.

On August 6, 2003, the Tourism Fund initiated foreclosure on the mortgage note it holds as collateral for the guarantee on the AFICA Cayo Largo bonds. The indenture of the AFICA Cayo Largo bonds requires the repayment of the bonds before the execution of the mortgage note. Therefore, in order to execute the mortgage note, the Tourism Fund obtained a line of credit from the Bank just prior to filing the foreclosure action, with which the Tourism Fund called the outstanding balance of the AFICA Cayo Largo bonds. Said bonds amounted to \$75.6 million.

Management believes that the specific allowance that has been established for this project, which is included as part of the noncurrent portion of the allowance for losses on guarantees and letters of credit, is adequate.

In July 2003, the Public Finance Corporation issued approximately \$382 million of Commonwealth Appropriations Bonds maturing at various dates through 2025. The proceeds of the bonds, except for their related cost of issuance, were used to restructure debt recorded as loans from the public sector by the Bank from the Department of the Treasury, the Puerto Rico Maritime Shipping Authority, and the Land Authority, according to Act No. 164 of December 17, 2001, created specifically to reduce the interest cost of these debts and of other debts of other agencies of the Commonwealth, and to assign a source of repayment thereof.

Unless this certificate is presented by an authorized representative of The Depository Trust Company, a New York corporation (“DTC”), to GDB or its agent for registration of transfer, exchange, or payment, and any certificate issued is registered in the name of Cede & Co. or in such other name as is requested by an authorized representative of DTC (and any payment is made to Cede & Co. or to such other entity as is requested by an authorized representative of DTC), ANY TRANSFER, PLEDGE, OR OTHER USE HEREOF FOR VALUE OR OTHERWISE BY OR TO ANY PERSON IS WRONGFUL inasmuch as the registered owner hereof, Cede & Co., has an interest herein.

**UNITED STATES OF AMERICA  
COMMONWEALTH OF PUERTO RICO  
GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO  
2004 COMMERCIAL PAPER PROGRAM**

**MASTER NOTE**

February \_\_, 2004

Government Development Bank for Puerto Rico (“GDB”), for value received, hereby promises to pay to Cede & Co., as nominee of The Depository Trust Company, or to registered assigns: (i) the principal amount, together with unpaid accrued interest thereon, if any, on the maturity date of each obligation identified on the records of GDB (the “Underlying Records”) as being evidenced by this Master Note, which Underlying Records are maintained by Citibank, N.A. (the “Issuing and Paying Agent”); (ii) interest on the principal amount of each such obligation that is payable in installments, if any, on the due date of each installment, as specified on the Underlying Records; and (iii) the principal amount of each such obligation that is payable in installments, if any, on the due date of each installment, as specified on the Underlying Records. Interest payable on the Notes hereinafter defined of which this Master Note is one is computed on the basis of a year of 365 days (366 days in leap years) for the actual number of days elapsed. Payments shall be made solely from the sources stated on the Underlying Records by wire transfer to the registered owner hereof from the Issuing and Paying Agent without the necessity of presentation and surrender of this Master Note.

This Master Note represents the duly authorized short-term promissory notes of GDB (the “Notes”) to be issued by virtue of Resolution No. 7837, adopted by the Board of Directors of GDB on June 28, 2002 (the “Resolution”), a certified copy of which is on file with the Issuing and Paying Agent, in the maximum aggregate principal amount outstanding at any time, together with certain other short term promissory notes described in the Resolution and at the time outstanding, of \$2,000,000,000, for the purpose of providing funds for the authorized purposes of GDB, and is entitled to the benefits and is subject to the provisions of the Resolution. The Notes are payable from any available funds of GDB and will in all respects rank *pari passu* as to security and payment by GDB with all unsecured and unsubordinated obligations of GDB for borrowed money or guaranties of obligations for borrowed moneys of others now or hereafter outstanding. Neither the credit of the Commonwealth of Puerto Rico nor that of any of its political subdivisions or instrumentalities is pledged to the payment of the principal of and

interest on this Master Note. This Master Note shall be governed by the laws of the Commonwealth of Puerto Rico.

This Master Note is issued and the Resolution was adopted under and pursuant to the Puerto Rican Federal Relations Act and the Constitution and laws of the Commonwealth of Puerto Rico, including Act No. 17 of the Legislature of Puerto Rico, approved September 23, 1948, as amended. All acts, conditions and things required by the Puerto Rican Federal Relations Act and the Constitution and laws of Puerto Rico to happen, exist and be performed precedent to and upon the issuance of this Note have happened, exist and have been performed as so required.

This Note shall not be valid or become obligatory for any purpose or be entitled to any benefit or security under the Resolution until it shall have been authenticated by the execution by the Issuing and Paying Agent of the certificate of authentication endorsed thereon.

If this Note shall have been registered to "Bearer", this Note shall be bearer paper payable to bearer and freely transferable by delivery, and any person in possession hereof shall be authorized to represent himself as the absolute owner hereof and is hereby granted power to transfer absolute title hereto by delivery to a bona fide purchaser for value (present or antecedent) without notice or prior defenses or equities or claims of ownership enforceable against his transferor or any person in the chain of title and before the maturity of this Note, and this Note may be presented and surrendered for payment when due at the principal corporate trust office of the Issuing and Paying Agent.

At the request of the registered owner, GDB shall promptly issue and deliver one or more separate definitive notes evidencing each obligation evidenced by this Master Note. As of the date any such notes are issued, the obligations which are evidenced thereby shall no longer be evidenced by this Master Note.

IN WITNESS WHEREOF, Government Development Bank for Puerto Rico has caused this Master Note to be signed by or bear the facsimile signature of an authorized officer and its corporate seal to be impressed or a facsimile thereof to be imprinted hereon and attested by the facsimile signature of its Secretary, all as of the Date of Issuance first above written.

[SEAL]

GOVERNMENT DEVELOPMENT BANK  
FOR PUERTO RICO

Attest:

Secretary

By:

Authorized Officer

#### CERTIFICATE OF AUTHENTICATION

This Master Note is one of the Notes of the issue designated herein and issued under the provisions of the within-mentioned Resolution.

Date of Authentication:

CITIBANK, N.A.,  
Issuing and Paying Agent

By:

Authorized Officer

FOR VALUE RECEIVED, the undersigned hereby sells, assigns, and transfers unto

\_\_\_\_\_  
(Name, Address, and Taxpayer Identification Number of Assignee)  
this Master Note and all rights hereunder, hereby irrevocably consisting an appointing  
\_\_\_\_\_ attorney to transfer said Master Note on the books of GDB with full  
power of substitution in the premises.

Dated:

Signature(s) Guaranteed:

\_\_\_\_\_  
(Signature)

Notice: The signature on this assignment must correspond with the name as written upon the face of this Master Note, in every particular, without alteration or enlargement or any change whatsoever.

## SIDLEY AUSTIN BROWN &amp; WOOD LLP

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SAN FRANCISCO  
SHANGHAI  
SINGAPORE  
TOKYO  
WASHINGTON, D.C.

\_\_\_\_\_, 2004

Government Development Bank for  
Puerto Rico  
San Juan, Puerto Rico

Gentlemen:

We have examined Act No. 17 of the Legislature of Puerto Rico, approved September 23, 1948, as amended, creating Government Development Bank for Puerto Rico (hereinafter called “Development Bank”) as a corporation and a governmental instrumentality of the Commonwealth of Puerto Rico (hereinafter called the “Commonwealth”). We have also examined certified copies of the legal proceedings of the Board of Directors of Development Bank as to the adoption of Resolution No. 7837 on June 28, 2002 (the “Resolution”) authorizing the Issuing and Paying Agency Agreement, dated as of January 15, 2003, by and between Development Bank and Citibank, N.A. (the “Issuing And Paying Agency Agreement”), and other proofs submitted relating to the authorization, issuance and sale of not in excess of the following principal amounts of notes issued under the following described program (the “2004 Program”):

\$2,000,000,000  
Government Development Bank for Puerto Rico  
Commercial Paper Notes  
2004 Program

The 2004 Program will apply to notes issued by Development Bank under the Resolution during the 18-month period beginning on the first date of issuance of such notes to finance capital expenditures of the Commonwealth and its public corporations (collectively, the “Borrowers”) as well as notes issued by Development Bank under the Resolution during such 18-month period to refinance, directly or through a series of refinancings, notes originally issued to finance such capital expenditures (all such notes issued under the Resolution during such 18-month period being collectively called the “2004 Program Notes”). The proceeds of the 2004 Program Notes will be used to lend funds to, and purchase obligations of, the Borrowers, including advances to the Borrowers in anticipation of future bond issuances, for the purpose of financing their respective capital improvements.

The 2004 Program Notes are payable from any available funds of Development Bank on a parity with all other general unsecured and unsubordinated obligations of Development Bank for borrowed money and with unsecured and subordinated Development Bank guarantees of obligations for borrowed money of others now or hereafter outstanding.

We have also examined the form of the 2004 Program Notes.

From such examination we are of the opinion that:

1. Said Act No. 17, as amended, is valid.
2. Said proceedings have been validly and legally taken.
3. The 2004 Program Notes, when duly executed in the form and manner provided in the Resolution, duly authenticated by Citibank, N.A. in accordance with the Issuing and Paying Agency Agreement and delivered and paid for, will constitute legal, valid and binding obligations of Development Bank payable from any available funds of Development Bank.

4. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), regarding the use, expenditure and investment of 2004 Program Note proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the 2004 Program Notes is not includable in gross income for federal income tax purposes, and (ii) the 2004 Program Notes and the interest thereon are exempt from state, Commonwealth and local income taxation. No opinion is expressed as to the effect of any action taken or not taken after the date of this opinion without our approval (except for such action or omission to act as is otherwise provided for in the Resolution) or in reliance upon advice of counsel other than ourselves on the exclusion from gross income of the interest on the 2004 Program Notes for federal income tax purposes.

Interest on the 2004 Program Notes is not an item of tax preference for the purpose of computing the alternative minimum tax on individuals and corporations imposed by the Code. Such interest will, however, be includable in the computation of the alternative minimum tax imposed on corporations by the Code. The Code contains other provisions that could result in tax consequences, upon which we express no opinion, as a result of (a) ownership of the 2004 Program Notes or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is excluded from gross income.

Development Bank has covenanted to comply, and has covenanted to obtain similar covenants from the Borrowers, with the requirements of the Code, to the extent permitted by the Constitution and laws of the Commonwealth, so that interest on the 2004 Program Notes will remain exempt from federal income taxes to which it is not subject on the date of issuance of the 2004 Program Notes. We are not aware of any provision of the Constitution or laws of the Commonwealth which would prevent Development Bank or the Borrowers from complying with the requirements of the Code.

Respectfully submitted,