# Puerto Rico System of Annuities and Pensions for Teachers

Basic Financial Statements as of and for the
Year Ended June 30, 2009, Required Supplementary
Information as of June 30, 2009,
and Independent Auditors' Report

# PUERTO RICO SYSTEM OF ANNUITIES AND PENSIONS FOR TEACHERS

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## INDEPENDENT AUDITORS' REPORT

The Board of Trustees of
Puerto Rico System of Annuities and Pensions for Teachers:

We have audited the accompanying statement of plan net assets of the Puerto Rico System of Annuities and Pensions for Teachers (the "System") as of June 30, 2009, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the System as of June 30, 2009, and the changes in its net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis presented on pages 3 through 11 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the System's management. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

As discussed in Note 1 to the basic financial statements, the System held investments valued at approximately $784,667,000 (35.05% of total assets) as of June 30, 2009, whose fair values have been estimated in the absence of readily determinable fair values. This estimate is based on information provided by the underlying fund managers.

Our audit was conducted for the purpose of forming an opinion on the System's basic financial statements. The schedules of employer contributions and funding progress are presented for purposes of additional analysis and are not a required part of the basic financial statements. This supplementary information is the responsibility of the System's management. These schedules have been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Deloitte & Touche LLP

January 8, 2010

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The Puerto Rico System of Annuities and Pensions for Teachers (the "System") presents management's overview of the administrative and operational activities that had an impact on the System's net assets for the fiscal year ended June 30, 2009. The System administers retirement and other participant benefits, such as personal, cultural and mortgages loans, occupational and non-occupational disability annuities and death benefits.

## Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the System's basic financial statements, which are comprised of the following: 1) Statement of Plan Net Assets, 2) Statement of Changes in Plan Net Assets, and 3) Notes to Basic Financial Statements. Required supplementary information is also presented to supplement the basic financial statements.

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

Both these statements provide information about the overall financial status of the System. The Statement of Plan Net Assets includes all of the System's assets and liabilities, with the difference reported as net assets held in trust for pension benefits. The Statement of Changes in Plan Net Assets discloses changes in the System's net assets during the fiscal year.

## Notes to Basic Financial Statements

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

## Required Supplementary Information

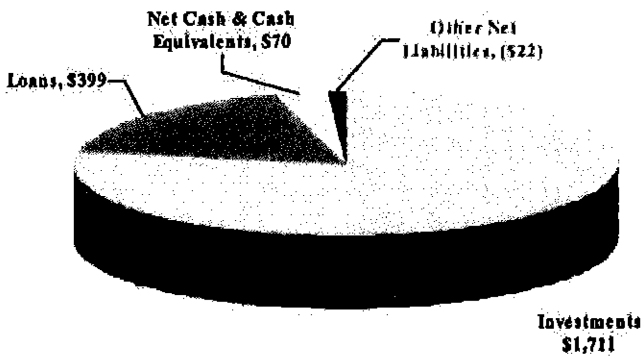
The required supplementary information consists of two schedules and related notes concerning the funded status of the pension plan administered by the System.

## Financial Highlights

The System's net assets as of June 30, 2008 decreased from approximately $2,785 million to $2,158 million as of June 30, 2009. The reduction was primarily due to the net depreciation in the fair value of the System's investment portfolio. The amount of $2,158 million in total net assets consists of the following:

- $1,711 million in investments
- $399 million in loans to plan members
- $70 million in net cash and cash equivalents
- ($22) million in other net assets (liabilities)

The total plan net assets are presented in the following chart (in millions):




Following is a comparison of certain items within the financial statements:

- The System's assets exceeded liabilities by $2,158 million (net assets) for the fiscal year ended June 30, 2009 when compared to the prior year which assets exceeded liabilities by $2,785 million.

- The fair value of the System's investments (excluding loans to participants) at June 30, 2009 amounted to $1,711 million, compared to $2,324 million at June 30, 2008.

- The System's funded ratio of the actuarial accrued liability at June 30, 2009 was 25%.

The following schedules present comparative summary financial statements of the System's net assets and changes in net assets for fiscal years 2009 and 2008:

## Summary Comparative Statements of Plan Net Assets

| | 2009 | 2008 | Amount of Change | Percentage Change |
|---|---|---|---|---|
| | (In thousands) | | | |
| Assets: | | | | |
| Cash and short term investments | $ 69,611 | $ 328,398 | $ (258,787) | (79)% |
| Investments — at fair value and loans | 2,110,599 | 2,701,078 | (590,479) | (22) |
| Accounts receivable | 31,606 | 26,229 | 5,377 | 21 |
| Capital assets | 26,167 | 26,223 | (56) | 0 |
| Other assets | 876 | 451 | 425 | 94 |
| Total assets | 2,238,859 | 3,082,379 | (843,520) | (27) |
| Liabilities: | | | | |
| Accounts payable and accrued liabilities | 10,113 | 9,061 | 1,052 | 12 |
| Insurance reserve for loans to plan members and investments settlements | 23,561 | 12,593 | 10,968 | 87 |
| Other liabilities | 47,592 | 275,379 | (227,787) | (83) |
| Total liabilities | 81,266 | 297,033 | (215,767) | (73) |
| Net assets held in trust for pension benefits | $2,157,593 | $2,785,346 | $(627,753) | (23) |

## Summary Comparable of Plan Net Assets Analysis

The decrease in cash and short-term investments is primarily attributable to a reduction in securities lending transactions. The collateral held on securities lending transactions decreased $227.6 million from $274 million as of June 30, 2008 to $47 million as of June 30, 2009. The remaining decrease in cash and short-term investments is due to normal fluctuations in short-term investments since it represents the amount of short-term investments held by investment managers at a point in time. The increase in accounts receivable is mainly attributable to an increase in receivables for investments sold due to market conditions and investment managers' decisions as of fiscal year end.

The decrease in fair value of investments is primarily attributable to the generally unfavorable market conditions experienced during fiscal year 2009 as evidenced by a decrease in the System's total investment return from a negative 6.52% in 2008 to a negative 15.98% in 2009. Detailed information regarding the investment portfolio is included in the Investment Portfolio and Capital Markets Overview section.

The increase in accounts payable and accrued liabilities is primarily due to an increase in investments purchased as a result of market conditions and investment managers' decisions as of fiscal year end. The increase in other liabilities is mainly due to the payables to independent brokers under the securities lending program.

## Summary Comparative Statements of Changes in Plan Net Assets

| | Years Ended June 30, 2009 | Years Ended June 30, 2008 | Amount of Change | Percentage Change |
|---|---|---|---|---|
| | (In thousands) | | | |
| Additions: | | | | |
| Contributions | $ 309,163 | $ 288,631 | $ 20,532 | 7 % |
| Investment income (loss) | (443,401) | (199,966) | (243,435) | 122 |
| Other income | 2,444 | 1,735 | 709 | 41 |
| Total additions | (131,794) | 90,400 | (222,194) | (246) |
| Deductions: | | | | |
| Benefits paid to participants | 470,474 | 442,237 | 28,237 | 6 |
| Administrative expenses | 25,485 | 25,537 | (52) | 0 |
| Total deductions | 495,959 | 467,774 | 28,185 | 6 |
| Net decrease in net assets held in trust for pension benefits | (627,753) | (377,374) | (250,379) | 66 |
| Net assets held in trust for pension benefits: Beginning of year | 2,785,346 | 3,162,720 | 377,374 | 12 |
| End of year | $2,157,593 | $2,785,346 | $(627,753) | (23) |

## Summary Comparable Statements of Changes in Plan Net Assets Analysis

During the fiscal year 2009, employers and employees' contributions increased due to salary increases by the Department of Education on January and July 2008. During the period, the Government's contribution for Special Laws benefits increased by approximately $7.5 million. The increase was intended to mainly cover an additional cost of living adjustment granted by the Government to qualified System retirees effective July 2008 and to cover the increase in benefits to retirees and beneficiaries during the fiscal year.

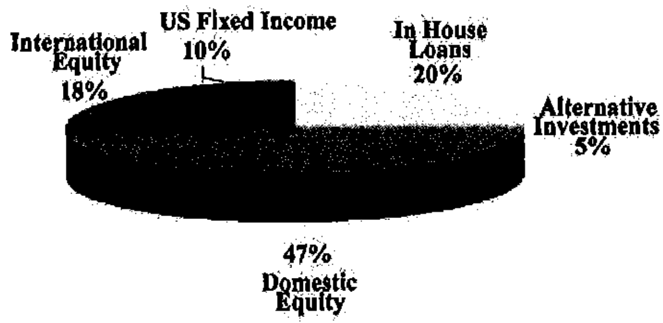
## Financial Analysis of the System

The System provides retirement benefits to teachers mainly within the public education system of the Commonwealth of Puerto Rico. The System's net assets held in trust for benefits at June 30, 2009 amounted to approximately $2,158 million, a decrease of approximately $628 million from approximately $2,785 million at June 30, 2008. Additions to the System's net assets held in trust for benefits include employer and member contributions, as well as investment income (loss). For fiscal year 2009, employer and member contributions increased by approximately $17 million, from approximately $245 million during fiscal year 2008 to approximately $262 million during fiscal 2009. The increase is due to a salary increase by the Department of Education on January and July 2008. The System recognized a net depreciation in the fair value of investments of approximately $519 million for fiscal year 2009.

In fiscal year 2004, the System started a re-engineering and mechanization project that involves different areas, such as Pensions and Finance. As of June 30, 2009, $6.7 million was capitalized as a result of the project in progress.

### Teacher's Retirement System's Investment Portfolio Overview

During the fiscal year ended June 30, 2009, there were no changes in the System's target asset allocation and manager structure. The fund's asset mix generated a negative gross return of -15.98% for the fiscal year ended June 30, 2009. The target asset mix is as follow:




### Economy and Capital Markets Overview

During the fiscal year 2008-2009 worldwide capital markets, (with the exception of sovereign debt) registered one of the weakest-recorded returns in history during the one year period. The fiscal year first quarter started with increasing concerns with securitized mortgages comprising loans to lower quality borrowers that quickly escalated to a global crisis at credit and liquidity markets. The crisis came to a tipping point in September 2008 with a series of events on a level that had not been witnessed before, ranging from the failures of major financial institutions to concerted actions by policy makers across the world to stem the crisis.

The month of September 2008 was especially severe for financial markets and world economies, as Lehman Brothers declared Chapter 11 bankruptcy, the FDIC negotiated the takeover of Washington Mutual by JP Morgan Chase (in effect helping the troubled economy avoid the largest bank failure in history), the Treasury provided $85 billion in emergency financing to AIG to address its liquidity crisis and the SEC temporarily prohibited short-selling of the stocks of hundreds of financial firms. The Federal Housing Finance Authority also placed Fannie Mae and Freddie Mac under government conservatorship, confirming the widespread assumption that these were truly government-backed entities.

The first quarter of fiscal year 2009 also had equity declines of -8.4% for the S&P 500 Index, -20.6% for the MSCI EAFE Index, and -27.0% for the MSCI Emerging Markets Index. During this period, all assets seemed to be perfectly correlated and experiencing significant negative performance. U.S. Treasury Securities (bonds/notes) posted the only positive performance, as investors fled all risky assets in search of safety. Treasury yields hit near-zero levels as investors sought near term security.

As the worldwide financial system nearly collapsed, central bankers and governments across the world initiated coordinated measures to deal with the crisis, with large fiscal stimulus programs combined with low interest rates, emergency liquidity measures, and explicit and implicit support to large financial institutions. In the U.S., the Federal Reserve reduced its target overnight lending rates to a historic low of 0.25%.

The following quarter began with a revised Emergency Economic Stabilization Act of 2008 being passed by the House of Representatives in early October. The nearly $700 billion stimulus package included assistance for homeowners, automakers, and banks. The extensive measures to reduce the tide of foreclosures, increase liquidity and prevent further bank failures demonstrated the extent to which the government was willing to use its extensive balance sheet to avoid a deepening of the recession and deflationary concerns. Although criticized for its broad bailouts, minimal oversight on the distribution of funds and the extension of government control over private industry, many economists agreed that such measures were necessary to overcome the tremendous headwinds facing the global economy. Foreign governments responded with similar stimulus efforts, although they were not quite as costly or expansive.

During the month of October 2008, domestic equity indices, responding to negative economic news, posted the weakest monthly returns since October 1987. The S&P 500 Index returned -16.8%, while the Russell 2000 Index returned -20.8% for the month. International markets posted one of the weakest monthly returns in its recent history. International developed-market equities, as measured by the MSCI EAFE Index, returned -20.2%, its worst month for the past 40 years. International emerging market equities, as measured by the MSCI EM Index, returned -27.4%.

As the crisis evolved, the U.S. government moved forward with several monetary policy initiatives aimed at restoring liquidity in the capital markets, including the Term Asset-Backed Securities Loan Facility (TALF), which was designed to attract investors to the new-issue asset-backed securities markets, and the Public-Private Investment Program (PPIP), which aims to restore liquidity for distressed securities such as non-agency residential mortgage-backed securities and commercial mortgage-backed securities. Governments across Europe and Asia followed suit by propping up banks and financial institutions and injecting liquidity into the financial system on a historic scale.

The combination of the various stimulus measures has had a calming effect on the markets as confidence and liquidity appears to be returning to the markets. The return of confidence rewarded risk-based assets and financial markets rebounded strongly in early March of 2009 through the end of the fiscal year 2009.

The last quarter of fiscal year 2009, and specifically April and May, extended the global market rally that begun in March 2009. The reduced risk perception led to a decline in credit spreads across fixed income sectors – high yield bonds were among the best performing bond sectors between January and June 2009, this high risk sector experienced a 30% return for the period.

The positive results of the U.S. Treasury's bank "stress tests," coupled with additional declines in the rate of job losses, led investors to regain their confidence and return to all the major sectors of the financial markets. The Bureau of Economic Analysis released an advance estimate on real GDP for the second quarter of -1.0%, which marked a significant improvement from the past two quarters as government spending increased amidst smaller declines in private inventories and investment. Consumer confidence also rebounded in spite of the bankruptcy filing of General Motors on June 1st, which was the fourth-largest bankruptcy in U.S. history. As the prospects for economic growth improved, commodities, which were one of the worst performing segments of the markets in the second half of 2008, rebounded significantly in 2009. Crude oil, which fell to below $40/barrel towards the end of 2008, rebounded to nearly $70/barrel by June 2009. The U.S. dollar, which benefited early during the fiscal year, as investors piled into the safety of U.S. Treasuries, came under pressure towards the end of the fiscal year as investors moved assets away to riskier, higher-yielding countries and currencies.

Given the extraordinary results experienced during the fourth fiscal quarter of 2009, we have outlined the fund's performance by asset class in order to provide a better assessment of the investment results.

**Industry Indices Performance Overview**

| Indices | Last Quarter FY 2009 | FY 2008-09 |
|---|---|---|
| S&P 500 | 15.93% | -26.21% |
| S&P 500 Citi Growth | 14.60% | -23.89% |
| S&P 500 Citi Value | 17.51% | -28.63% |
| Dow Jones 30 Industrials | 11.96% | -23.00% |
| NASDAQ | 20.32% | -19.14% |
| Russell 2000 | 20.69% | -25.01% |
| Russell 2000 Growth | 23.38% | -24.85% |
| Russell 2000 Value | 18.00% | -25.24% |
| MSCI EAFE | 25.43% | -31.35% |
| MSCI Emerging Markets Free | 34.89% | -27.82% |
| Barclays Aggregate | 1.78% | 6.05% |

## U.S. Equity Overview for the Fiscal Year 2009

The U.S. equity markets suffered significant loses across all sectors during the first 8 months of the fiscal year 2009. Such trend ended in March 2009 with positive month performance. The market rally that started in March continued all the way to mid-June and registered some of the largest equity gains in over a decade. The Financial sector of the economy led the rally fueled in part by the decision by FASB to ease mark-to-market accounting rules, which strengthened the overall confidence in the sector. As the market confidence increased during the quarter, market volatility slowed down with the VIX ending around 25 after starting the quarter above 40.

At June 30, 2009, the System held $896 million in U.S. equity securities which represents approximately 42% of the total investment portfolio. During the fiscal year ended June 30, 2009, investment in U.S. equity securities posted negative gross returns of -26.18%

## U.S. Fixed Income Overview for the Fiscal Year 2009

Not as severe as in the equity markets, U.S. Fixed Income market faced during the fiscal years 2009 unprecedented challenges derived from global concerns about liquidity and credit. As market participants confidence level improved in March 2009, non-investment grade corporate outperformed their investment grade counterparts. The two Government programs, TALF and PPIP, which were announced in the previous quarter, aided the recovery of securitized markets. The TALF program increased the supply and demand of eligible asset-backed securities, enabling spreads to contract significantly. The PPIP (Public Private Investment Program) also increased market confidence in the mortgage sector.

At June 30, 2009, the System held $426 million in domestic fixed income securities, which represents approximately 20% of the total investment portfolio. The System's fixed income money managers had a positive gross return of 3.97% for the fiscal year ended June 30, 2009.

## International Equity Overview for the Last Quarter of the Fiscal Year 2009

International equity markets exhibited the same pattern as domestic equity markets, they rallied significantly in April and May then stabilized off in June. Governments around the world took some complementary measures to keep their economies going. The ECB lowered interest rates to 1%, the Bank of England held rates constant at 0.5% and Japan launched a $150 billion stimulus plan. Similar to the U.S. market, the rally was led by inferior quality, riskier stocks and those sectors and stocks that had posted the largest losses in the previous quarter.

At June 30, 2009, the System held $363 million in foreign securities, which represents approximately 17% of the total investment portfolio. During the fiscal year ended June 30, 2009, investment in international equity securities posted negative gross returns of -29.18%

## Total Fund Performance

For fiscal year 2008-09, the System experienced overall negative returns due to the overall correlation between the U.S. and international equity markets. During the 2008-09 fiscal year, the fund experienced a negative gross return of -15.98% beating its targeted benchmark return of -16.48%.

## Other Investments and Transactions

At June 30, 2009 and 2008, the System held $399 million and $377 million in loans to participants, respectively, which as of June 2009 represents approximately 18% of the total portfolio. As of June 30, 2009, these loans consisted of $109 million in mortgage loans, $288 million in personal loans and $2 million in cultural trip loans. The loans to participants had a gross return of 10.26% for the fiscal year ended on June 30, 2009.

As of June 30, 2009, the System had participation in limited partnerships of private equity investments for an approximate value of $26 million, which represents approximately 1% of the investment portfolio.

The System earns additional investment income by lending investment securities to brokers via its custodian's securities lending program. The brokers provide collateral to the System and generally use the borrowed securities to cover short sales and failed trades. The cash collateral received from the brokers is invested in order to earn interest. For fiscal year 2008-2009, income from the custodian's securities lending activity amounted to approximately $1.4 million.

## Funding Status

The System performs an actuarial valuation of its assets and obligations at least every other year. The most recent actuarial valuation was performed as of June 30, 2009. According to such valuation, the System's unfunded liability amounted to approximately $6.6 billion with a funding level of 25%.

As a means to protect the System's financial health, Act No. 91 of March 29, 2004 established the practice of requiring an actuarial study identifying the funding status prior to granting new benefits.

## Request for Information

The financial report is designed to provide a general overview of the System's financial status, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Puerto Rico Teachers Retirement System, Capital Center Building, #235 Arterial Hostos Ave., North Tower, 8th floor, Hato Rey, P.R. 00919-1879.

# PUERTO RICO SYSTEM OF ANNUITIES AND PENSIONS FOR TEACHERS

## STATEMENT OF PLAN NET ASSETS
## AS OF JUNE 30, 2009
## (In thousands)

| | |
|---|---|
| ASSETS: | |
| Cash: | |
| Cash and short-term investments | $ 65,885 |
| Cash with fiscal agent | 450 |
| Cash deposited with Government Development Bank for Puerto Rico | 3,276 |
| Total cash | 69,611 |
| Investments — at fair value: | |
| Bonds | 425,911 |
| Stocks | 1,259,169 |
| Total investments — at fair value | 1,685,080 |
| Other investments — private equity investments | 26,139 |
| Total investments | 1,711,219 |
| Loans to plan members: | |
| Mortgage | 109,508 |
| Personal | 288,410 |
| Cultural trips | 1,462 |
| Total loans to plan members | 399,380 |
| Total investments and loans | 2,180,210 |
| Accounts receivable: | |
| Receivable for investments sold | 23,231 |
| Accrued interest and dividends receivable | 5,445 |
| Other | 2,930 |
| Total accounts receivable | 31,606 |
| Capital assets — net | 26,167 |
| Other assets | 876 |
| Total assets | 2,238,859 |
| LIABILITIES: | |
| Investments purchased | 18,981 |
| Payables for securities lending | 46,751 |
| Accounts payable | 4,188 |
| Accrued expenses | 5,925 |
| Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members | 4,580 |
| Other liabilities | 841 |
| Total liabilities | 81,266 |
| COMMITMENTS AND CONTINGENCIES (Notes 11 and 12) | |
| NET ASSETS HELD IN TRUST FOR PENSION BENEFITS (Schedule of Funding Progress is presented on page 33) | $2,157,593 |

See notes to basic financial statements.

## PUERTO RICO SYSTEM OF ANNUITIES AND PENSIONS FOR TEACHERS

**STATEMENT OF CHANGES IN PLAN NET ASSETS**
**FOR THE YEAR ENDED JUNE 30, 2009**
**(In thousands)**

| | |
|---|---|
| ADDITIONS: | |
| Contributions: | |
| Participating employees | $ 136,305 |
| Employer | 125,165 |
| Contributions transferred from other systems | 1,479 |
| Special | 46,214 |
| Total contributions | 309,163 |
| Investment income (loss): | |
| Interest income | 66,927 |
| Dividend income | 13,194 |
| Net depreciation in fair value of investments | (518,862) |
| Total investment loss | (438,741) |
| Less investment expense | 4,660 |
| Net investment loss | (443,401) |
| Other income | 2,444 |
| Total additions | (131,794) |
| DEDUCTIONS: | |
| Benefits paid to participants: | |
| Annuities and death benefits | 418,414 |
| Special benefits | 46,747 |
| Refunds of contributions | 5,313 |
| Administrative expenses | 25,485 |
| Total deductions | 495,959 |
| NET DECREASE IN NET ASSETS HELD IN TRUST FOR PENSION BENEFITS | (627,753) |
| NET ASSETS HELD IN TRUST FOR PENSION BENEFITS: | |
| Beginning of year | 2,785,346 |
| End of year | $2,157,593 |

See notes to basic financial statements.

## 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Puerto Rico System of Annuities and Pensions for Teachers (the "System") is a defined benefit plan administered by the Puerto Rico Teachers Retirement System and was created by Act No. 91 of March 29, 2004, that superseded Act No. 218 of May 6, 1951. The System is considered an integral part of the Commonwealth of Puerto Rico's (the "Commonwealth") financial reporting and is included in the Commonwealth's financial statements as a pension fund. The System, as a governmental retirement plan, is excluded from the provisions of the Employee Retirement Income Security Act of 1974.

The responsibility for the proper operation and administration of the System is vested in a Board of Trustees (the "Board"). The Board is composed of nine members, as follows:

- Three ex officio members, which are the Secretary of the Treasury, the Secretary of Education, and the President of the Government Development Bank for Puerto Rico (GDB), or their respective representatives.
- One member who is a representative of a teacher's organization designated by the Governor of the Commonwealth of Puerto Rico.
- Three teachers of the System, one of which represents currently certified teachers in active service, and two who represent retired teachers. These three teachers are appointed by the Governor of the Commonwealth of Puerto Rico.
- One member who is a representative of the entity that represents the proper unit under Act No. 45 of February 25, 1998, as amended.
- One additional member, as representative of the public interest, with knowledge of and experience in the administration and operation of financial systems, appointed by the Governor of the Commonwealth of Puerto Rico.

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

*Basis of Presentation* — The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with the provisions of Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and GASB Statement No. 50, *Pension Disclosures*. Participating employee and employer contributions are recognized as revenues in the period in which the employee services are rendered. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

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

*Cash and Short-Term Investments and Cash With Fiscal Agent* — Cash and short-term investments consist of "overnight deposits" with the custodian bank and a commercial bank, and money market funds. Cash with fiscal agent represents a fund account the System has at the Department of Treasury for the payment of payroll expenses.

*Investments* — Investments are carried at fair value. The fair value of investments is based on quoted prices, if available. The System has investments valued at approximately $784,667,000 or 35% of total assets as of June 30, 2009, whose fair values have been estimated in the absence of readily determinable fair values. This estimate is based on information provided by the underlying fund managers. Such investments include private equity investments and nonexchange traded mutual funds.

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

*Loans to Plan Members* — Mortgages, personal, and cultural trip loans to plan members are stated at their outstanding principal balance. No allowance for uncollectible amounts has been established since loans to plan members are collected through payroll withholding and secured by mortgage deeds, plan members' contributions, and any unrestricted amount remaining in the escrow funds. Maximum amounts that may be loaned to plan members for mortgage and cultural trip loans are $160,000 ($190,000 if the spouse is also a plan member) and $10,000, respectively. The maximum amount of personal loans to be granted to current participating employees is up to 90% of their accumulated contributions and $7,000 in the case of retirees currently receiving benefits.

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

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

| | Years |
|---|---|
| Buildings | 40 |
| Buildings improvements | 10 |
| Equipments, furniture, fixtures, and vehicles | 4–10 |

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

*Guarantee Insurance Reserve for Loans to Plan Members* — Premiums collected and benefits claimed are recorded as additions and deductions of the guarantee insurance reserve for life insurance on loans to plan members, respectively.

*Future Adoption of Accounting Pronouncements* — The GASB has issued the following accounting standards that have effective dates after June 30, 2009:

- GASB Statement No. 51, *Intangible Assets*, which is effective for periods beginning after June 15, 2009.
- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is effective for periods beginning after June 15, 2009.

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

## 2. PLAN DESCRIPTION

The System is a defined benefit plan sponsored by the Commonwealth. Substantially, all active teachers of the Commonwealth's Department of Education are covered by the System under the terms of Act No. 91 of March 29, 2004, that superseded Act No. 218 of 1951. The new law gives the Puerto Rico Teachers Retirement System's active employees as of March 29, 2004, the option to participate in the plan. Employees recruited by the Puerto Rico Teachers Retirement System after the approval of the new law become members of the plan. All active teachers of the Department of Education become plan members of the System at their date of employment. Licensed teachers working in private schools or other educational organizations can be members of the System at their own choice as long as the required employer and employee contributions are satisfied.

As of June 30, 2009, the membership consisted of the following:

| | |
|---|---|
| Retirees and beneficiaries currently receiving benefits | 33,224 |
| Current participating employees | 46,295 |
| Total membership | 79,519 |

The plan members of the System are eligible for the benefits described below:

*Retirement Annuity* — Plan members are eligible for monthly benefit payments determined by the application of stipulated benefit ratios to the plan member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by the System. The annuity for which a plan member is eligible is limited to a minimum of $400 per month and a maximum of 75% of the average compensation.

The plan members are eligible for retirement annuity benefits upon complying with the following:

| Age | Years of Creditable Services | Retirement Annuity Compensation |
|---|---|---|
| Fifty | Thirty or more | 75% of average compensation |
| Under fifty | Thirty or more | 65% of average compensation |
| Sixty | At least 10 but less than 25 | 1.8% of average compensation times years of service |
| Fifty | At least 25 but less than 30 | 1.8% of average compensation times years of service |
| Forty-seven but less than Fifty | At least 25 but less than 30 | 95% of the annual pension that would have received with 50 years of age |

*Deferred Retirement Annuity* — A participating employee who terminates service before age 60, after having accumulated a minimum of ten years of creditable services, qualifies for a deferred retirement annuity payable beginning at age 60. A participating employee who has completed 25 or more years of creditable services and is under the age of 47 at termination, qualifies for a deferred retirement annuity payable beginning at age 47. The vested rights described above are provided if his/her contributions to the System are left within the System until the attainment of the respective retirement age.

*Occupational Disability Annuity* — A participating employee, who as a direct result of the performance of his/her occupation becomes disabled, is eligible for an annuity of 1.8% of average compensation based on the highest 60 months or the number of months of creditable services, if less than five years, recognized by the System, times years of creditable services; but not less than $400 per month.

*Nonoccupational Disability Annuity* — A participating employee disabled for causes not related to his/her occupation, and with at least five years of credited service, is eligible for an annuity of 1.8% of average compensation based on the highest 60 months recognized by the System, times years of service; but not less than $400 per month.

*Death Benefits:*

Pre-retirement

- The beneficiaries receive the contributions made to the plan and 2% interest accumulated as of the date of death (after discounting debts with the System), plus an amount equal to the annual compensation of the member at the time of death.

Post-retirement

- The surviving spouse receives 50% of the retiree's pension and if there are children under 22 years of age or disabled (until disability ceases), they receive the other 50% of the pension. If there is no surviving spouse or children that qualify, the beneficiaries receive the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of $1,000.

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

*Early Retirement Program* — On January 27, 2000, Act No. 44 was approved, which provided that effective March 9, 2000, plan members are eligible for early retirement upon attaining the age of 50 and 28 years of services in the first year of implementation and age 50 and 25 years of service in subsequent years. Those who select early retirement under these conditions will receive monthly benefits equal to 75% of their average compensation, which is computed based on the highest 36 months of compensation recognized by the System. Effective July 31, 2001, the option for early retirement was closed.

*Special Benefits* — Special benefits include the following:

- *Christmas Bonus* — An annual bonus of $600 for each retiree and disabled member paid each December. The System pays $150 per retiree and disabled member and the remaining bonus is paid by the Commonwealth.

- *Summer Bonus* — An annual bonus of $100 for each retiree, beneficiary, and disabled member paid each July. This benefit is prorated if there are multiple beneficiaries and is funded by the Commonwealth.

- *Medication Bonus* — An annual bonus of $100 for each retiree, beneficiary, and disabled member paid each July to cover health costs. Evidence of coverage is not required. This benefit is funded by the Commonwealth.

- *Cost-of-Living Adjustments* — Act No. 62 of 1992 provided, subject to the approval of the Legislature of the Commonwealth (the "Legislature"), for increases of 3% every three years in pensions to those plan members with three or more years of retirement. In years 1995, 1998, 2001, 2004, and 2007, the Legislature has replicated the benefit granted per Act No. 62. This benefit is funded by the Commonwealth.

## 3. FUNDING POLICY

The law requires the employer to contribute 8.5% of the applicable payroll. Participating employees are required to contribute 9% of their compensation. Commonwealth contributions should ultimately cover any deficiency between the participating employees' contributions and the System's pension benefit obligations and administrative costs. The employer and participants' contributions will be evaluated at least every five years.

The special contributions of approximately $46,214,000 in 2009 represent contributions from the General Fund of the Commonwealth for the Special Benefits granted by special laws.

Calculations of the present value of benefits under the System were made by consulting actuaries as of June 30, 2009, using the entry age normal actuarial cost method. Significant assumptions underlying the actuarial computations include (a) assumed rate of return on investments of 8%, net of investment expense; (b) assumed compound rate of wage increases of 3.5% per year; and (c) assumed mortality rate based on the Group Annuity Table for 2000.

The actuarial accrued liability as of June 30, 2009, was approximately $8,722 million. As of June 30, 2009, the unfunded actuarial accrued liability was approximately $6,564 million.

## 4. FUNDED STATUS AND FUNDING PROGRESS

The funded status of the System as of June 30, 2009, the most recent actuarial valuation date, is as follows (dollar amounts in thousands):

| Actuarial Value of Plan Assets | Actuarial Accrued Liability (AAL) | Unfunded AAL (UAAL) | Funded Ratio | Annual Covered Payroll | UAAL Percentage of Annual Covered Payroll |
|---|---|---|---|---|---|
| $ 2,158,000 | $ 8,722,000 | $ 6,564,000 | 25 % | $ 1,418,000 | 463 % |

The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial values of plan assets are increasing or decreasing over time relative to the AAL for benefits.

Additional information as of the latest actuarial valuation follows:

| | |
|---|---|
| Valuation date | June 30, 2009 |
| Actuarial cost method | Entry age normal |
| Amortization | 30 years closed, level percent of payroll |
| Remaining amortization period | 28 years |
| Asset valuation method | Market value of assets |
| Actuarial assumptions: | |
| Investment rate of return | 8.00% |
| Projected salary increases | 3.5% general wage inflation, plus a service-based merit increase |
| Inflation | 2.50% |
| Cost of living adjustment | None |

## 5. DEPOSITS AND INVESTMENTS

Pursuant to the provisions of Act No. 91 of March 29, 2004, that superseded Act No. 218 of 1951, as amended, the System may invest in different types of securities, including domestic, international, and fixed income securities, among others.

**Deposits** — Custodial credit risk for deposits is the risk that in the event of bank failure, the System may not be able to recover deposits that are in the possession of an outside party. 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. Funds deposited with GDB are not covered by this Commonwealth requirement.

As of June 30, 2009, approximately $67 million of the depository bank balance of approximately $71 million was uninsured and uncollateralized as follows (in thousands):

| | Carrying Amount | Depository Bank Balance | Amount Uninsured and Uncollateralized |
|---|---|---|---|
| Cash | $ 5,851 | $ 7,445 | $ 2,899 |
| Short-term investments | 60,034 | 60,034 | 60,034 |
| Cash with fiscal agent | 450 | 450 | 450 |
| Cash deposited with GDB | 3,276 | 3,276 | 3,276 |
| Total | $ 69,611 | $ 71,205 | $ 66,659 |

As of June 30, 2009, uninsured and uncollateralized cash and cash equivalents amounting to $2.9 and $60 million, respectively, represents cash and money market funds held by the System's custodian bank. These deposits are exempt from the collateral requirement established by the Commonwealth.

**Investments** — The market value of the investments in marketable securities held by the System as of June 30, 2009, is as follows (in thousands):

| | |
|---|---|
| **Bonds:** | |
| U.S. government and sponsored agencies' securities | $ 233,774 |
| U.S. corporate bonds | 192,137 |
| Total bonds | 425,911 |
| **Stock:** | |
| U.S. corporate stocks | 330,474 |
| Non-U.S. corporate stocks | 170,167 |
| Non-exchange traded mutual funds: | |
| U.S. | 565,751 |
| Non-U.S. | 192,777 |
| Total stocks | 1,259,169 |
| Private equity investments | 26,139 |
| Total investments | $1,711,219 |

The System's investments are exposed to custodial credit risk, credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. Following is a description of these risks as of June 30, 2009:

**Custodial Credit Risk** — Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2009, securities investments were registered in the name of the System and were held in the possession of the custodian bank, except for securities lent.

**Credit Risk** — The System's investment guidelines prohibit the investments in securities with expected maturity dates beyond 30 years. All fixed income securities at the time of purchase must be of investment grade quality. Positions that drift below investment grade should be reported to a management representative of the System and monitored carefully. The portfolio is not expected to have more than 5% invested in securities that have drifted after purchase below investment grade quality. All issues shall be rated investment grade by at least two of the nationally recognized rating agencies.

The portfolio is expected to maintain a minimum weighted-average credit quality of either "A" or better using either Moody's or Standard and Poor's credit ratings.

| Moody's Rating | Investment Type | Fair Value (In thousands) |
|---|---|---|
| Aaa | Mortgage-backed securities | $ 190,650 |
| Aaa | U.S. government issues | 44,169 |
| Aaa | Asset-backed securities | 15 |
| | | 234,834 |
| Aa1 | Mortgage-backed securities | 500 |
| Aa2 | Corporate bonds | 4,755 |
| Aa2 | Mortgage-backed securities | 757 |
| | | 5,512 |
| Aa3 | Corporate bonds | 1,606 |
| A1 | Corporate bonds | 19,843 |
| A2 | Corporate bonds | 41,992 |
| A3 | Corporate bonds | 22,846 |
| A3 | Mortgage-backed securities | 25 |
| | | 22,871 |
| Baa1 | Corporate bonds | 46,878 |
| Baa1 | Asset-backed securities | 14 |
| Baa1 | Mortgage-backed securities | 16 |
| | | 46,908 |
| Baa2 | Corporate bonds | 27,473 |
| Baa2 | Mortgage-backed securities | 62 |
| | | 27,535 |
| Baa3 | Corporate bonds | 16,846 |
| Ba1 | Corporate bonds | 783 |
| Ba1 | Mortgage-backed securities | 222 |
| | | 1,005 |
| Ba3 | Corporate bonds | 888 |
| Ba3 | Asset-backed securities | 181 |
| | | 1,069 |
| B1 | Corporate bonds | 294 |
| B2 | Asset-backed securities | 7 |
| | Subtotal | $ 420,822 |

(Continued)

| Moody's Rating | Investment Type | Fair Value (In thousands) |
|---|---|---|
| B3 | Asset-backed securities | 100 |
| C | Corporate bonds | 47 |
| CA | Asset-backed securities | 117 |
| CA | Mortgage-backed securities | 18 |
| | | 135 |
| CAA1 | Mortgage-backed securities | 328 |
| Caa2 | Other asset-backed securities | 5 |
| NR | Corporate bonds | 3,128 |
| NR | Mortgage-backed securities | 765 |
| | | 3,893 |
| WR | Corporate bonds | 581 |
| | Total bonds and notes | $ 425,911 |

(Concluded)

**Concentration of Credit Risk** — There are no investments in any one issuer that represent 5% or more of total investments as of June 30, 2009. The System's investment guidelines specify that no more than 5% of a manager's assets at market shall be invested in the securities of any single issuer.

The System owns shares in the State Street Bank and Trust Company S&P 500 Flagship Securities Lending Fund (the "S&P 500 Fund"). As of June 30, 2009, the fair value of the System's investment in 3,065,921 shares of the S&P 500 Fund amounted to approximately $565.8 million. The investment objective of the S&P 500 Fund is to match the return of the Standard & Poor's 500 Index. As of June 30, 2009, the investments underlying the S&P 500 Fund had the following sector allocations:

| Sector | Percentage |
|---|---|
| Information Technology | 18.38 % |
| Health Care | 14.00 |
| Financial | 13.58 |
| Energy | 12.41 |
| Consumer Staples | 11.99 |
| Industrials | 9.85 |
| Consumer Discretionary | 8.96 |
| Utilities | 4.08 |
| Telecommunication Services | 3.53 |
| Materials | 3.22 |

**Interest Rate Risk** — The System is expected to achieve capital preservation and income generation by investing in a diversified portfolio of marketable, investment grade core fixed income securities. The System's investment guidelines specify that the duration of the portfolio is expected to vary no more than between 75% and 125% of the duration of the respective benchmark.

The investments on debt securities of the System as of June 30, 2009, are summarized as follows (in thousands):

| | Maturity From | Fair Value | Investment Maturities (In Years) Less than 1 | 1–5 | More Than 5–10 | More Than 10 |
|---|---|---|---|---|---|---|
| U.S. government and agencies securities | (2008 to 2051) | $233,774 | $10,706 | $23,990 | $ 8,389 | $190,689 |
| Corporate bonds | (2008 to 2049) | 192,137 | 4,189 | 43,562 | 47,691 | 96,695 |
| Total bonds | | $425,911 | $14,895 | $67,552 | $56,080 | $287,384 |

As of June 30, 2009, the percentages of investment maturities by category are as follows:

| Maturity | Maximum Maturity |
|---|---|
| Less than one year | 4 % |
| One to five years | 16 |
| More than five to ten years | 13 |
| More than ten years | 67 |

**Foreign Currency Risk** — The international portfolio is expected to achieve long-term, aggressive capital appreciation by investing in Core EAFE (Europe Australasia and the Far East) securities. The portfolio is expected to be broadly diversified with respect to exposures to countries, economic sectors, industries, and individual stock. No single issue is expected to exceed 5% (at market) of the portfolio.

Investments and deposits exposed to foreign currency risk as of June 30, 2009, are as follows:

| Investment Type | Local Currency | Fair Value (in thousands) |
|---|---|---|
| Foreign currency | Euro Currency | $ 1,448 |
| Foreign currency | Pound Sterling | 279 |
| Foreign currency | Japanese Yen | 973 |
| Foreign currency | Australian Dollar | 79 |
| Foreign currency | Hong Kong Dollar | 120 |
| Total cash exposed to foreign currency risk | | $ 2,899 |
| Shares in a commingled fund | Various (refer to countries below) | $ 192,777 |
| Common stock | Euro Currency | 42,440 |
| Common stock | Pound Sterling | 27,486 |
| Common stock | Japanese Yen | 32,916 |
| Common stock | Swiss Franc | 14,774 |
| Common stock | Swedish Krona | 9,694 |
| Common stock | Norwegian Krone | 1,383 |
| Common stock | Australian Dollar | 10,843 |
| Common stock | Hong Kong Dollar | 8,301 |
| Common stock | Danish Krone | 6,654 |
| Common stock | Singapore Dollar | 2,088 |
| Common stock | South Korean Won | 929 |
| Mutual funds | Pound Sterling | 4,261 |
| Total securities exposed to foreign currency risk | | 354,546 |
| Common stock | U.S. Dollar | 8,398 |
| Total | | $ 362,944 |

The System owns shares in an international equity commingled fund. As of June 30, 2009, the System owned approximately 7,258,161 shares that represent 35.82% of the total commingled fund which had the following countries weightings:

| Europe | Currency | Percent | Pacific Basin | Currency | Percent |
|---|---|---|---|---|---|
| Finland | Euro (Various) | 2.0 % | Australia | Australian Dollar | 2.4 % |
| France | Euro (Various) | 9.3 | Hong Kong | Hong Kong Dollar | 4.2 |
| Germany | Euro (Various) | 4.4 | Japan | Japanese Yen | 23.3 |
| Italy | Euro (Various) | 2.3 | | | |
| Netherlands | Euro (Various) | 9.2 | Total Pacific | | 29.9 |
| Norway | Norwegian Krone | 0.9 | | | |
| Spain | Euro | 3.9 | Emerging markets | Various | 6.7 |
| Sweden | Swedish Krona | 1.4 | | | |
| Switzerland | Swiss Franc | 6.8 | Canada | Canadian Dollar | 2.8 |
| United Kingdom | Pound Sterling | 20.4 | | | |
| Total Europe | | 60.6 % | Total equities | | 100.0 % |

**Investments in Limited Partnerships** — The System invested approximately $918,000 in limited partnerships during the fiscal year ended June 30, 2009. The investments were as follows:

- During the fiscal year 2009, $199,597 were invested in Guayacán Fund of Funds, L.P., a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of $20 million. The Fund has commitments to invest in 15 U.S.-based and international venture partnerships and ties local pension funds with the private equity asset class without the risks inherent in geographically constrained investments.

- During the fiscal year 2009, $142,260 were invested in contributions to Guayacán Fund of Funds II, L.P. a Delaware limited partnership created by Grupo Guayacán, Inc. as General Partner in which the System has a total commitment of $25 million. The Fund seeks to provide investors with a superior investment return and extensive diversification by investing in 19 Private Equity Investment partnerships in the United States and Europe. The Fund also invests a portion of its assets in a Puerto Rico-based Private Equity Investment entity.

- During the fiscal year 2009, $238,379 were invested in Guayacán Private Equity Fund, a limited partnership organized pursuant to the laws of the State of Delaware and authorized to engage in business in the Commonwealth, in which the System has a total commitment of $5 million. The purpose of the Partnership is to make equity investments in privately held companies as established in its charter.

- During the fiscal year 2009, there were no contributions to Invesco Venture Partnership Fund III, L.P., a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of approximately $5.5 million. The Partnership was organized to invest in other collective investment funds investing in alternative assets, including primarily United States and international funds that focus on both early and later-stage venture capital investments.

- During the fiscal year 2009, there were no contributions to Invesco Non-U.S. Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of $4.5 million. The Partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily investments focusing on non-U.S. buyouts, expansion capital, turnaround, mezzanine, and distressed investment partnerships.

- During the fiscal year 2009, $151,704 were invested in Invesco U.S. Buyout & Expansion Capital Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the System has a total commitment of approximately $3.7 million. The Partnership was organized to invest in other collective investment funds investing in alternative assets, including primarily investments focusing on small, midsize and large domestic buyout transactions.

- During the fiscal year 2009, $185,992 were invested in Chase Capital Partners Private Equity Fund of Funds II, LTD a limited partnership, organized by J.P. Morgan Alternative Asset Management, Inc. as investment manager in which the System has a total commitment of $15 million. The Fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investment opportunities across various sectors, including buyouts, growth equity, venture capital, and other special situations through partnership investments and direct investments.

The fair value of these investments at June 30, 2009, amounted to approximately $26 million and is presented within other investments in the statement of plan net assets. The allocations of net gains and losses to limited partners are based on certain percentages, as established in the limited partnership agreements.

As of June 30, 2009, the System had capital commitments and contributions as follows (in thousands):

| | Total Commitments | Fiscal Year Contributions | Cumulative Contributions | Fair Value |
|---|---|---|---|---|
| Guayacán Fund of Funds | $ 20,000 | $ 200 | $ 19,057 | $ 2,543 |
| Guayacán Fund of Funds II | 25,000 | 142 | 23,681 | 8,939 |
| Guayacán Private Equity Fund | 5,000 | 238 | 4,645 | 3,824 |
| Invesco Venture Partnership Fund III, LP | 5,498 | | 4,731 | 3,034 |
| Invesco Non-U.S. Partnership Fund III, LP | 4,500 | | 4,034 | 1,258 |
| Invesco U.S. Buyout & Expansion Capital Partnership Fund III, LP | 3,716 | 152 | 3,186 | 2,149 |
| Chase Capital Partners Private Equity Fund of Funds II, LTD | 15,000 | 186 | 14,368 | 4,392 |
| Total | $ 78,714 | $ 918 | $ 73,702 | $26,139 |

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

At year-end, there was no credit risk exposure to borrowers because the amounts the System owes the borrowers (the "collateral") exceeded the amounts the borrowers owe the System (the "loaned securities"). At June 30, 2009, the collateral received represented 102.64% of the fair value of the domestic securities lent and 105.37% of the fair value of the international securities lent.

The securities on loan for which collateral was received as of June 30, 2009, consisted of the following:

| Securities Lent | Fair Value |
|---|---|
| U.S. corporate stock | $ 16,546,599 |
| U.S. government and sponsored agencies' securities | 15,665,115 |
| U.S. corporate bonds | 7,805,264 |
| Non-U.S. corporate stock | 5,386,432 |
| Total | $45,403,410 |

The underlying collateral for these securities had a fair value of approximately $46,751,000 as of June 30, 2009. The collateral received was invested in a money market fund sponsored by the custodian bank and is included as part of cash and cash equivalents in the accompanying 2009 statement of plan net assets. As of June 30, 2009, the distribution of the short-term investment fund by investment type is as follows:

| Investment type | Percentage |
|---|---|
| Securities bought under agreements to resell | 53.67 % |
| Commercial paper | 20.01 |
| Certificates of deposit | 15.50 |
| Floating rate notes | 8.05 |
| Time deposits | 2.77 |

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

## 6. CAPITAL ASSETS

Capital assets additions are recorded at cost. Depreciation is provided using the straight-line method over the useful life of the asset. As of June 30, 2009, changes in capital assets consisted of the following (in thousands):

| | Estimated Useful Life (In Years) | Balance at June 30, 2008 | Additions | Retirements | Balance at June 30, 2009 |
|---|---|---|---|---|---|
| Depreciable: | | | | | |
| Building | 40 | $ 26,008 | $ - | $ - | $ 26,008 |
| Furniture and equipment | 4–10 | 1,961 | 30 | (77) | 1,914 |
| Computers and software | 5 | 4,633 | 13 | (112) | 4,534 |
| Capital leases | 5 | 106 | | | 106 |
| Building improvements | 10 | 39 | | | 39 |
| Vehicles | 5 | 42 | | | 42 |
| Total depreciable capital assets | | 32,789 | 43 | (189) | 32,643 |
| Accumulated depreciation and amortization | | (11,741) | (1,622) | 189 | (13,174) |
| Not depreciable — project in progress | | 5,175 | 1,523 | | 6,698 |
| Capital assets — net | | $ 26,223 | $ (56) | $ - | $ 26,167 |

On August 1, 1996, the System acquired the North Tower of Capital Center (the "Building") located in Hato Rey to serve as the System's main office facilities and to lease the additional space to third parties. Approximately one-half of the Building is being used for its operations and the other half for leasing to tenants. The Building was financed with Industrial Revenue Bonds. The Bonds were called during fiscal year 2007.

## 7. OTHER ASSETS

As of June 30, 2009, other assets consisted of repossessed and in-substance foreclosed properties amounting to approximately $876,000. Repossessed and in-substance foreclosed properties consist mainly of properties acquired or to be acquired upon foreclosure proceedings as collateral from delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage upon foreclosure. These properties will be sold under a bidding process intended to recover the outstanding principal balance.

## 8. LINE OF CREDIT

The System has a line of credit with the GDB of $15,000,000, which is due on October 31, 2010, and is guaranteed by a pool of investments of the System. As of June 30, 2009, the System has no outstanding balance under this line of credit.

## 9. GUARANTEE INSURANCE RESERVE FOR LOANS TO PLAN MEMBERS

The System provides life insurance that guarantees the payment of the outstanding principal balance of mortgage, personal, and cultural trip loans in case of death of a plan member. This coverage is paid in its entirety by the plan members who obtain these loans from the System. The life insurance reserve is determined by the actuary.

## 10. SPECIAL BENEFITS AND HEALTHCARE BENEFITS

The Commonwealth provides through the System certain Special Benefits (see Note 2) to retirees that are funded on a pay-as-you-go basis. As a result, these Special Benefits are 100% unfunded. During the year ended June 30, 2009, the System received contributions for Special Benefits amounting to approximately $46.2 million and paid Special Benefits of approximately $46.7 million.

The Commonwealth provides postemployment healthcare benefits (the "Healthcare Benefits") to the members of the Puerto Rico System of Annuities and Pensions for Teachers Medical Insurance Plan Contribution ("TRS MIPC"). The Healthcare Benefits are provided through the System and consist of a payment of up to $100 per month to the eligible medical insurance plan selected by the members of the TRS MIPC. The Healthcare Benefits are funded by the Commonwealth on a pay-as-you-go basis.

The funding of the Special Benefits and the Healthcare Benefits is provided to the System through legislative appropriations each January 1 and July 1. The legislative appropriations are considered estimates of the payments to be made by the System for the Special Benefits and the Healthcare Benefits throughout the year. Deficiencies in legislative appropriations are covered by the System's own funds until recovered through future legislative appropriations.

The System maintains a claim with the Office of Management and Budget of the Commonwealth (the "OMB") for deficiencies in legislative appropriations under Special Benefits and Healthcare Benefits paid for the period from 1992 to 2003, which amounts to approximately $107.4 million as of June 30, 2009 (see Note 12). For the period from 2004 to 2009, the System has received an excess of legislative appropriations over Special Benefits and Healthcare Benefits paid of approximately $807,000. The accumulated balance of Special Benefits and Healthcare Benefits paid, and legislative appropriations made by the Commonwealth from 2004 through 2009 are as follows (in thousands):

| Fiscal Year | Legislative Appropriations | Benefits Paid Healthcare | Benefits Paid Special | Total | Balance | Cummulative Balance |
|---|---|---|---|---|---|---|
| 2004 | $ 42,682 | $ 17,314 | $ 31,745 | $49,059 | $ (6,377) | $ (6,377) |
| 2005 | 62,883 | 23,626 | 31,829 | 55,455 | 7,429 | 1,051 |
| 2006 | 61,619 | 25,217 | 31,485 | 56,703 | 4,916 | 5,968 |
| 2007 | 57,960 | 26,247 | 33,025 | 59,272 | (1,312) | 4,655 |
| 2008 | 68,168 | 28,266 | 43,218 | 71,484 | (3,316) | 1,340 |
| 2009 | 75,548 | 29,333 | 46,747 | 76,080 | (533) | 807 |

## 11. COMMITMENTS

The System leases office facilities for the operation of its regional offices (Ponce, Mayagüez, Arecibo, Humacao, and Caguas) under operating lease agreements, which expire at different dates through 2012.

The minimum future payments under the existing operating leases as of June 30, 2009, are as follows (in thousands):

| Year Ending June 30 | Amount |
|---|---|
| 2010 | $ 249 |
| 2011 | 142 |
| 2012 | 106 |
| Total | $ 497 |

## 12. CONTINGENCIES

**Loss Contingencies** — The System is a defendant or codefendant in various lawsuits resulting from the ordinary conduct of its operations. Management and legal counsel believe that there are no contingent matters that would have a material adverse effect on the System's financial status.

**Gain Contingency** — The System, besides receiving contributions from participants and the plan sponsor, also receives legislative appropriations from special laws to cover the increase in benefits to retired teachers. Law No. 62 of September 4, 1992, as amended, establishes an increase of 3% in pension annuities every three years for those members who meet the requirements. In addition, there have been other laws that granted benefits, such as, Summer and Christmas bonuses, among others. Most of the funds used to cover these benefits are budgeted by the Commonwealth through legislature appropriations. Nevertheless, the costs of pension benefits that increased from 1992 to June 30, 2004, were not received in full by the System from legislative appropriations. The System had to cover $119,575,193 from its resources that should have been received through special laws. On May 31, 2004, the System made a claim with the OMB to collect this amount as per a resolution approved by the System's Board of Trustees. During 2009, the Department of Education of the Commonwealth paid $12,189,925 that was part of the amounts claimed to OMB. Since the parties involved in this claim are under a decisions committee, the remaining amount claimed has not been recorded in the System's financial statements.

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# REQUIRED SUPPLEMENTARY INFORMATION

## PUERTO RICO SYSTEM OF ANNUITIES AND PENSIONS FOR TEACHERS

**SCHEDULE OF EMPLOYER CONTRIBUTIONS**
**AS OF JUNE 30, 2009**
**(In thousands)**

| | Pension Plan | | |
|---|---|---|---|
| **Year Ended June 30** | **Annual Required Contribution** | **Actual Employer Contribution** | **Percentage Contribution** |
| 2009 | $ 393,871 | $ 172,841 | 43.88 % |
| 2008 | 341,495 | 159,101 | 46.59 |
| 2007 | 341,160 | 147,597 | 43.26 |
| 2006 | 220,821 | 150,215 | 68.03 |
| 2005 | 220,821 | 151,690 | 68.69 |
| 2004 | 217,002 | 132,403 | 61.01 |

The annual required contribution, actual employer contributions, and percentage contributed for the year ended June 30, 2004, have been revised and were obtained from the amounts presented in the 2009 actuarial report. The revisions were made based on our current actuary firm interpretation of the reporting requirements of the schedule.

See notes to schedules.

## SCHEDULE OF FUNDING PROGRESS
## AS OF JUNE 30, 2009
## (In thousands)

| Actuarial Valuation Date | Actuarial Value of Plan Assets | Actuarial Accrued Liability (AAL) | Unfunded AAL (UAAL) | Funded Ratio | Annual Covered Payroll | UAAL Percentage of Annual Covered Payroll |
|---|---|---|---|---|---|---|
| **Pension Plan** | | | | | | |
| June 30, 2009 | $2,158,000 | $8,722,000 | $ 6,564,000 | 25 % | $1,418,000 | 463 % |
| June 30, 2008 | | Not determined | | | Not determined | |
| June 30, 2007 | 3,163,000 | 7,756,000 | 4,593,000 | 41 | 1,370,000 | 335 |
| June 30, 2006 | | Not determined | | | Not determined | |
| June 30, 2005 | | Not determined | | | Not determined | |
| June 30, 2004 | 2,403,000 | 4,702,000 | 2,299,000 | 51 | 1,294,000 | 2 |
| June 30, 2003 | 2,143,000 | 4,540,000 | 2,397,000 | 47 | 1,195,000 | 2 |
| June 30, 2002 | 2,167,000 | 4,155,000 | 1,988,000 | 52 | 991,000 | 2 |

See notes to schedules.

## 1. SCHEDULE OF EMPLOYER CONTRIBUTIONS

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

## 2. SCHEDULE OF FUNDING PROGRESS

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

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