GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and
Required Supplementary Information

June 30, 2004

(With Independent Auditors' Report Thereon)

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Independent Auditors' Report

KPMG LLP
American International Plaza
Suite 1100
250 Muñoz Rivera Avenue
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, 2004, 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, 2004, 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 38 through 47 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

December 9, 2004, except as to note 17(c),
which is dated December 21, 2004.

Stamp No. 1988530 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.

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 or GDB) as of and for the year ended June 30, 2004. 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, 2004 amounted to $9,223 million and $6,907 million, respectively, for net assets of $2,316 million or 25% of total assets.
- Change in net assets for the year amounted to $160.4 million. The increase in net assets comprises $159.2 million from business-type activities and $1.2 million from 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 expendable resources, as well as balances of expendable 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.

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, 2004 amounted to $9,223 million and $6,907 million, respectively, for net assets of $2,316 million or 25% of total assets. From the $2,316 million in net assets, $1,903 million or 82% are unrestricted, $305 million or 13% are restricted for use in affordable housing programs, and the remaining 5% are 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 $269.3 million at June 30, 2004, before $117.2 million in net balances due to business-type activities. Total liabilities amounted to $134.8 million, for net assets of $17.3 million or 11% of total assets. Net assets have been broken down into the amounts restricted for debt service of $57.4 million and for affordable housing programs of $77.4 million, and the unrestricted deficit of $117.5 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 as of June 30, 2004 and 2003 is shown below (amounts in thousands):

			Change	
	2004	2003	Amount	Percent
Assets:				
Due from Commonwealth of Puerto Rico	$ —	6,217	(6,217)	(100.0)%
Due from federal government	15,595	10,601	4,994	47.1%
Restricted:				
Cash and deposits placed with banks	7,669	11,488	(3,819)	(33.2)%
Investments and investment contracts	235,730	326,985	(91,255)	(27.9)%
Loans receivable, net	4,860	7,331	(2,471)	(33.7)%
Other assets	5,469	4,754	715	15.0%
Total assets before internal balances	269,323	367,376	(98,053)	(26.7)%
Internal balances	(117,218)	(185,806)	68,588	(36.9)%
Total assets	152,105	181,570	(29,465)	(16.2)%
Liabilities and net assets:				
Accounts payable and accrued liabilities	10,282	6,825	3,457	50.7%
Notes payable:				
Due in one year	—	102	(102)	(100.0)%
Due in more than one year	10,339	9,927	412	4.2%
Bonds payable:				
Due in one year	36,105	36,395	(290)	(0.8)%
Due in more than one year	78,070	112,175	(34,105)	(30.4)%
Total liabilities	134,796	165,424	(30,628)	(18.5)%
Net assets:				
Restricted for debt service	57,406	56,920	486	0.9%
Restricted for affordable housing programs	77,451	117,825	(40,374)	(34.3)%
Unrestricted deficit	(117,548)	(158,599)	41,051	(25.9)%
Total net assets	$ 17,309	16,146	1,163	7.2%

Investments and investment contracts amounted to $236 million and account for the majority of assets held by governmental activities. These investments, together with cash and deposits placed with banks of $7.7 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 and, to some extent, for debt service. Governmental activities also have a balance due from the federal government of $15.6 million, that is related to the reimbursement of eligible expenses incurred in the New Secure Housing Program.

The Puerto Rico Housing Finance Authority repaid some notes with the Bank with the proceeds of periodic mortgage loans sales during fiscal year 2004, therefore, reducing the internal balance.

The most significant liabilities of governmental activities are the bonds and notes payable amounting to $114.2 million and $10 million at June 30, 2004, respectively. During the year, principal payments to service the bonds amounted to $34.5 million.

Condensed financial information on expenses, program and general revenues, and changes in net assets of governmental activities for the years ended June 30, 2004 and 2003 is shown below (amounts in thousands):

	Year ended June 30, 2004		
	General government	Housing subsidy programs	Total
Expenses	$ 1,511	133,073	134,584
Program revenues:			
Charges for services – financing and investment	—	16,791	16,791
Grants and contributions	—	134,213	134,213
Net (expenses) revenues	$ (1,511)	17,931	16,420
General revenues – unrestricted income			1,026
Transfers			(16,283)
Change in net assets			1,163
Net assets, beginning of year			16,146
Net assets, end of year			$ 17,309

	Year ended June 30, 2003		
	General government	Housing subsidy programs	Total
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

Total expenses of governmental activities amounted to $134.6 million for the year ended June 30, 2004, an increase of $53 million or 64.9% with respect to the prior year. Expenses for housing subsidy programs increased to $52.5 million or 65% with respect to the prior year. This increase is driven mostly by an increase in subsidies of the Key for Your Home Program, which amounted to $80 million in 2004 compared to only $41.6 million in 2003.

Revenues from financing and investing activities provided $16.8 million in 2004 and $34.6 million in 2003 to be used for the benefit of the housing subsidy programs. The decrease in revenues from financing and investing activities is due to a decrease in the average balance of investments during fiscal year 2004. Grants received for housing subsidy programs amounted to $134.2 million in 2004 compared to $68.9 million in 2003. The increase is mainly related to an increase 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 $16.3 million in net transfers to business-type activities, primarily related to the transfer of residual balances of governmental funds that were used for debt service by the enterprise funds of the Affordable Housing Mortgage Subsidy Program (AHMSP).

Business-Type Activities

Condensed financial information on assets, liabilities, and net assets as of June 30, 2004 and 2003 is presented below (amounts in thousands):

	June 30		Change	
	2004	2003	Amount	Percent
Assets:				
Cash and due from banks	$ 54,037	45,801	8,236	18.0%
Federal funds and securities purchased under agreement to resell	1,003,927	1,233,400	(229,473)	(18.6)%
Deposits placed with banks	308,704	407,975	(99,271)	(24.3)%
Investments and investment contracts	3,040,625	3,903,266	(862,641)	(22.1)%
Loans receivable, net	4,199,022	2,628,933	1,570,089	59.7%
Interest and other receivables	133,684	109,774	23,910	21.8%
Capital assets	15,204	14,817	387	2.6%
Other assets	198,188	155,631	42,557	27.3%
Internal balances	117,218	185,806	(68,588)	(36.9)%
Total assets	9,070,609	8,685,403	385,206	4.4%
Liabilities:				
Deposits:				
Demand	1,703,532	1,617,667	85,865	5.3%
Certificates of deposit	2,109,362	1,918,890	190,472	9.9%
Certificates of indebtedness	251,799	242,984	8,815	3.6%
Securities sold under agreement to repurchase	160,000	190,017	(30,017)	(15.8)%
Commercial paper	918,410	761,167	157,243	20.7%
Accrued interest payable	11,766	12,016	(250)	(2.1)%
Due to Commonwealth of Puerto Rico	8,397	6,924	1,473	21.3%
Accounts payable and accrued liabilities	104,054	173,005	(68,951)	(39.9)%
Bonds and notes payable:				
Due in one year	66,408	47,995	18,413	38.4%
Due in more than one year	1,438,053	1,575,105	(137,052)	(8.7)%
Total liabilities	6,771,781	6,545,770	226,011	3.5%
Net assets:				
Invested in capital assets	15,204	14,817	387	2.6%
Restricted for:				
Affordable housing programs	225,710	235,178	(9,468)	(4.0)%
Mortgage loan insurance	35,676	23,352	12,324	52.8%
Unrestricted	2,022,238	1,866,286	155,952	8.4%
Total net assets	$ 2,298,828	2,139,633	159,195	7.4%

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 $229 million or 18.6%, from $1,233 million at June 30, 2003 to $1,004 million at June 30, 2004. Deposits placed with banks amounted to $309 million at June 30, 2004 compared to $408 million at June 30, 2003. Both decreases respond primarily to the increase in the loan portfolio.

Investments and Investment Contracts

Investments and investment contracts held in business-type activities amounted to $3,041 million at June 30, 2004. This amount represents a decrease of $863 million or 22.1% when compared to prior year balance. This decrease is the net effect of a reduction in the investments portfolio of the GDB Operating Fund and the Puerto Rico Housing Operating Fund of $940 million and $100 million, respectively.

The investment portfolio comprised 33.5% of the total assets of the Bank's business-type activities at June 30, 2004, compared to 44.9% at the close of fiscal year 2003. Within the investment securities portfolio, $1,044 million at June 30, 2004 and $1,518 million at June 30, 2003 were restricted or pledged as collateral or payment source for specific borrowings.

Loans Receivable

Net loans receivable of $4,199 million accounted for 46% of total assets of business-type activities at June 30, 2004 (30% in 2003). The increase of approximately $1,570 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) including temporary financing to be repaid with certain federal grants.

Most of the public sector loans have designated repayment sources available through appropriations in the Commonwealth of Puerto Rico's (the Commonwealth) 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 not allowed to originate loans without a specific source of repayment being identified beforehand. Act No. 164 permits the Bank to originate new loans up to $100 million without a prior legislative approval but needs an 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, 2004 and 2003 amounted to $517.7 million and $292.2 million, respectively, net of allowance for loan losses of $45.2 million and $23.4 million, respectively. The increase in loans responds to an alternative source of financing provided by the Tourism Development Fund to some tourist projects, which represents $272 million in newly originated loans which balance at June 30, 2004 amounted to $218.5 million, net of an allowance for possible loan losses.

Capital Assets

Capital assets, net of accumulated depreciation, amounted to $15.2 million at June 30, 2004; an increase of $387,000 from prior year. The increase was driven by the purchase of banking software and its related licenses.

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 increase of $278 million from $3,537 million at June 30, 2003. The primary reason for this increase is an increase in the Department of the Treasury and private entities deposits, the latter as a result of the Bank's financing diversification policy.

Commercial Paper

Commercial paper increased by 20.7% from $761.2 million at June 30, 2003 to $918.4 million at June 30, 2004. The increase is directly related to the corresponding increase in loans receivable which are in part funded with commercial paper.

Other Borrowed Funds

Bonds payable decreased by 7.3% from $1,623 million at June 30, 2003 to $1,504 million at June 30, 2004. This decrease is the net effect of the issuance of a refinancing net of cost of $452,000 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 2003. 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 for the years ended June 30, 2004 and 2003 is presented below (amounts in thousands):

	Year ended June 30, 2004				
		Program revenues			
		Charges for services			
Activity	Expenses	Fees, commissions, and other	Financing and investment	Operating grants and contributions	Net revenues (expenses)
GDB Operating Fund	$ 136,284	17,666	254,398	—	135,780
Housing Finance Authority	219,259	21,101	82,693	113,744	(1,721)
Tourism Development Fund	13,373	7,432	4,569	—	(1,372)
Public Finance Corporation	7,779	8,944	228	—	1,393
Capital Fund	121	—	10,654	—	10,533
Development Fund	95	—	1,852	—	1,757
Other	101	—	1	—	(100)
Total	$ 377,012	55,143	354,395	113,744	146,270
Special item:					
Special Communities Trust					(3,340)
Net gain on early extinguishment of bond					(18)
Transfers from governmental activities					16,283
Change in net assets					159,195
Net assets, beginning of year					2,139,633
Net assets, end of year					$ 2,298,828

	Year ended June 30, 2003				
		Program revenues			
		Charges for services			
Activity	Expenses	Fees, commissions, and other	Financing and investment	Operating grants and contributions	Net revenues (expenses)
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)
Totals	$ 394,164	76,014	356,706	112,199	150,755
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

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 $254.4 million from its loan and investment portfolios and generated $17.7 million in other charges for services. These revenues covered $136.3 million in expenses for net revenues from GDB Operating Fund of $135.8 million, surpassing the net revenues of any other activity and contributing to the $159.2 million in change in net assets for the year.

The Capital Fund activities were the second largest contributor to the change in net assets with net revenues of $10.5 million. Other contributors to the change in net assets were the Development Fund and the Public Finance Corporation with net revenues of $1.8 million and $1.4 million, respectively.

(4) Analysis of Fund Financial Statements

Governmental Funds

Through its blended component unit, the Puerto Rico Housing Finance Authority (the Authority), the Bank has five major governmental funds: four special revenue funds and one debt service fund. Following, we provide an analysis of the financial position and changes in financial position of these major governmental funds. Fund balances at the beginning of the year have been restated to reflect changes in major fund designation.

Affordable Housing Mortgage Subsidy Program (Stage 8)

This fund is the Stage 8 of the AHMSP of the Authority. The fund's operating objective is to provide funds for low-income families to be used for the down payment on mortgages subsidy payments. The fund receives appropriations from the Commonwealth to fund these payments.

In overall, the fund's net assets increased approximately $46 million during the year 2004, mainly caused by the fact that during 2004 the Authority recognized as revenue the appropriation from the Commonwealth for the payment of housing assistance program expenditures.

Affordable Housing Mortgage Subsidy Program (Stage 9)

This fund is the Stage 9 of the AHMSP of the Authority. The fund's operating objective is to provide funds for low-income families to be used for the down payment on mortgages subsidy payments. The fund receives appropriations from the Commonwealth to fund these payments.

In overall, the fund's deficit increased approximately $13 million during the year 2004, mainly caused by a transfer of a similar amount to Mortgage Portfolio IX – Enterprise Fund.

Subsidy Prepayment Refunding Bonds – Debt Service

This fund is used to account for the resources available for the payment of certain bonds that were issued for the prepayment of subsidies. The fund received Commonwealth appropriations for approximately $30 million during 2004. The debt service requirements amounted to approximately $26.9 million.

At June 30, 2004, total bonds payable outstanding through this debt service fund amounted to approximately $89 million.

New Secure Housing Program

This fund is used to account for the resources available under the New Secure Housing Program to provide housing assistance benefits for specific participants that were affected by the effects of Hurricane Georges in 1998. This fund receives resources from the federal government, under the Federal Emergency Management Agency, intended to provide financial resources to eligible participants for the reconstruction of their homes. The Commonwealth must also contribute a share of the total costs of providing benefits (25% of total cost).

During fiscal year 2004 this fund recognized revenues from federal government and the Commonwealth appropriations of approximately $21.5 million and $400,000. Funds are requested from the federal government as eligible expenditures are incurred.

Construction costs paid during the year 2004 amounted to $26 million which are presented as housing subsidy payments in the accompanying statement of revenues, expenditures, and changes in fund balance – governmental funds.

Key for Your Home Program

This fund accounts for the subsidy to low- and moderate-income families with costs directly related to the purchase and rehabilitation of housing units. Total assets decreased by $7.8 million compared to 2003. Revenues amounted to $28 million mostly from the Commonwealth appropriations received during 2004. Payments for housing subsidy were $80 million. The fund received transfers amounting to $44.7 million in 2004 from a nonmajor governmental fund.

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 $7,471 million at June 30, 2004, compared to $6,824 million at June 30, 2003. 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 the $1,620 million or 68.7% increase in the portfolio of loans receivable which includes $272 million from the Tourism Development Fund, a component unit of the Bank.

Total liabilities increased by $509.6 million to $5,869 million at June 30, 2004. The most significant increase was in deposits that increased from $3,944 million to $4,351 million at June 30, 2004. As previously discussed, the source of the deposits increase is a growth of the Treasury deposits and of deposits from the private sector as a result of the Bank's efforts in diversifying its funding sources. Commercial paper increased 20.7% or $157.2 million from $761.2 million outstanding at June 30, 2003 to $918.4 million at June 30, 2004.

Change in net assets of the GDB Operating Fund increased 54.3% from $88.7 million in 2003 to $136.9 million in 2004. Following we discuss the various components of the change in net assets of the GDB Operating Fund, compared to 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, increased from $99.4 million in 2003 to $178.2 million in 2004. Interest expense decreased by 26.2%, or from $105 million to $77.5 million, while interest income increased by 25% or from $204.5 million to $255.7 million. Driving the increase in net interest income was a collection of $43.9 million of nonaccrued interest. Excluding said amount, the increase in interest income amounts to $7.3 million or 3.6%.

The change in fair value of investments decreased from $15.3 million in 2003 to $(1.3) million in 2004. The Bank's investment portfolio behaves inversely to the Treasury yield curve; thus, when the yield increases, the Bank's investments generally decrease in value.

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

In 2004, after a revaluation of its private sector loan portfolio, the GDB Operating Fund had recorded an adjustment of $661,000 to increase the allowance. The GDB Operating Fund recorded no provision in 2003.

No provision for losses on guarantees and letters of credit was recorded in 2004 and 2003.

(c) Noninterest Income

Fiscal agency fees income increased 6% from $7.9 million in 2003 to $8.4 million in 2004.

The decrease in other income of $33 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 4% from $22.2 million in 2003 to $23 million in 2004. The $855,000 increase includes $1.4 million for salary increases, $331,000 of net increase in benefits offset by a decrease of $849,000 in vacation and sick leaves liquidations.

The decrease of 17.5% in legal and professional fees is due to less activity in projects entailing management consulting services.

(e) Contributions to Commonwealth

Contributions to Commonwealth in 2004 include a contribution to the General Fund of the Commonwealth of $18.4 million ($11.6 million in 2003) pursuant to Act No. 82 of June 16, 2003.

Puerto Rico Housing Finance Authority

Total net assets of the Puerto Rico Housing Finance Authority's enterprise funds increased by $14.5 million or 3% during the year. This change resulted from a net interest income of $11.5 million, a credit to the provision for loan losses of $1.9 million, noninterest income of $114.8 million, and noninterest expenses of $129.9 million, both including $113.7 million received and expensed in connection with federal assistance programs, a $20 million negative change in the fair value of investments, and net transfers from governmental funds of $16.3 million.

Capital Fund

The Capital Fund's total net assets increased $10.5 million or 18% during the year to $69.2 million at June 30, 2004. This increase is mainly due to an increase in the fair value of its investments of $9.8 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 change in fair value of $1.1 million in 2003.

Development Fund

Net assets of the Development Fund increased by $1.8 million or 6% during the year to $31.3 million at June 30, 2004. This increase is mainly due to a net increase of $3.7 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

Total assets increased to $372.7 million from $131.5 in 2003 driven by a boost in the loan portfolio after some tourist projects borrowed money from the Tourism Development Fund to cancel the AFICA bonds originally financing said projects. Total assets also include a tourist project acquired by the Tourism Development Fund during the fiscal year. At June 30, 2004, outstanding guarantees and letter of credit commitments of the Tourism Development Fund stood at $294 million. Net assets of the Tourism Development Fund decreased by $1.4 million or 1.4% during the year to $94.7 million at June 30, 2004. The change results from a net interest income of $727,000, provision for losses on loans, guarantees and letters of credit of $3.6 million, change in fair value of investment of $100,000, noninterest income of $7.4 million and noninterest expenses of $5.9 million that includes a provision of $3.5 million for other real estate owned.

Public Finance Corporation

The Public Finance Corporation's total net assets decreased by $3.4 million or 76% during the year to $1.1 million at June 30, 2004. This change resulted from the liquidation of the tax lien related assets and obligations among the Public Finance Corporation and the Municipal Revenues Collection Center (CRIM, as per its Spanish acronym).

(5) Debt

Total bonds and notes outstanding at year-end amounted to $1,629 million of which $1,362 million are payable from restricted assets held by the Puerto Rico Housing Finance Authority. There was no new bonded debt issued during the year on the enterprise funds. Repayments and other reductions in debt outstanding aggregated $160.3 million. See note 12 to the basic financial statements for additional information on debt activities during the year.

(6) Next Year's Events

On September 10, 2004, the Tourism Development Fund increased its guarantee on the Coco Beach Golf & Country Club to secure AFICA bonds in the amount of $7.5 million to be used to finance certain cost overruns from the construction of the golf course and the club house. These bonds will begin to amortize in 2008; until then, they will accrue $1.9 million in interest where the total risk exposed by the Tourism Development Fund will amount to $9.4 million.

On August 10, 2004 and September 30, 2004, the Puerto Rico Housing Finance Authority sold mortgage loans with an outstanding balance of approximately $65 million, for $69 million resulting in a gain on sale of approximately $4 million.

(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, P.O. Box 42001, San Juan, Puerto Rico, 00940-2001.

		Governmental activities	Business-type activities	Total
Assets:				
Cash and due from banks	$	—	44,115,055	44,115,055
Federal funds sold and securities purchased under agreements to resell		—	843,927,000	843,927,000
Deposits placed with banks		—	296,925,112	296,925,112
Investments and investment contracts		—	1,996,709,996	1,996,709,996
Loans receivable, net		—	4,176,438,140	4,176,438,140
Interest and other receivables		3,116,672	133,683,868	136,800,540
Due from federal government		15,595,228	—	15,595,228
Due from Department of Housing		—	16,161,530	16,161,530
Internal balances		(117,217,563)	117,217,563	—
Restricted assets:				
Cash and due from banks		2,620,379	9,922,363	12,542,742
Securities purchased under agreement to resell		—	160,000,000	160,000,000
Deposits placed with banks		5,048,668	11,778,389	16,827,057
Investments and investment contracts		235,729,961	1,043,915,405	1,279,645,366
Loans receivable, net		4,859,820	22,584,244	27,444,064
Real estate available for sale		—	51,529,433	51,529,433
Capital assets		—	15,203,681	15,203,681
Other assets		2,352,443	130,497,012	132,849,455
Total assets		152,105,608	9,070,608,791	9,222,714,399
Liabilities:				
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:				
Demand		—	1,703,531,893	1,703,531,893
Certificates of deposit		—	2,109,361,891	2,109,361,891
Commercial paper		—	918,409,931	918,409,931
Accrued interest payable		—	11,765,792	11,765,792
Due to Commonwealth of Puerto Rico		—	8,397,314	8,397,314
Accounts payable and accrued liabilities		10,282,410	93,920,101	104,202,511
Certificates of indebtedness due in more than one year		—	251,798,513	251,798,513
Allowance for losses on guarantees and letters of credit		—	8,049,150	8,049,150
Bonds payable due in more than one year		—	267,000,000	267,000,000
Note payable due in more than one year		10,339,331	—	10,339,331
Liabilities payable from restricted assets:				
Securities sold under agreement to repurchase		—	160,000,000	160,000,000
Accounts payable and accrued liabilities		—	2,084,612	2,084,612
Bonds payable:				
Due in one year		36,105,000	66,408,087	102,513,087
Due in more than one year		78,070,000	1,171,053,021	1,249,123,021
Total liabilities		134,796,741	6,771,780,305	6,906,577,046
Net assets (deficit):				
Invested in capital assets		—	15,203,681	15,203,681
Restricted for:				
Debt service		57,405,742	—	57,405,742
Affordable housing programs		77,451,201	227,102,582	304,553,783
Mortgage loan insurance		—	35,675,728	35,675,728
Unrestricted assets (deficit)		(117,548,076)	2,020,846,495	1,903,298,419
Total net assets	$	17,308,867	2,298,828,486	2,316,137,353

See accompanying notes to basic financial statements.

Statement of Activities
Year ended June 30, 2004

	Expenses	Program revenues: Charges for services – fees, commissions, and others	Program revenues: Charges for services – financing and investment	Program revenues: Operating grants and contributions	Program revenues: Capital grants and contributions	Net (expenses) revenues and changes in net assets: Governmental activities	Net (expenses) revenues and changes in net assets: Business-type activities	Total
Functions/programs:								
Governmental activities:								
General government	$ 1,510,609	—	—	—	—	(1,510,609)	—	(1,510,609)
Housing subsidy program	133,073,603	—	16,790,924	112,720,528	21,492,792	17,930,641	—	17,930,641
Total governmental activities	134,584,212	—	16,790,924	112,720,528	21,492,792	16,420,032	—	16,420,032
Business-type activities:								
GDB Operating Fund	136,283,425	17,666,135	254,397,923	—	—	—	135,780,633	135,780,633
Housing Finance Authority	219,258,832	21,101,153	82,693,075	113,743,876	—	—	(1,720,728)	(1,720,728)
Tourism Development Fund	13,373,640	7,431,363	4,569,969	—	—	—	(1,372,308)	(1,372,308)
Public Finance Corporation	7,778,645	8,944,166	227,869	—	—	—	1,393,390	1,393,390
Capital Fund	120,595	—	10,653,552	—	—	—	10,532,957	10,532,957
Development Fund	94,748	—	1,852,100	—	—	—	1,757,352	1,757,352
Other nonmajor	101,234	—	794	—	—	—	(100,440)	(100,440)
Total business-type activities	377,011,119	55,142,817	354,395,282	113,743,876	—	—	146,270,856	146,270,856
Total	$ 511,595,331	55,142,817	371,186,206	226,464,404	21,492,792	16,420,032	146,270,856	162,690,888
General revenues:								
Unrestricted income						$ 1,026,016	—	1,026,016
Special item:								
Special Communities Trust						—	(3,340,319)	(3,340,319)
Net loss on early extinguishment of bond						—	(18,382)	(18,382)
Transfers						(16,283,074)	16,283,074	—
Total general revenues, transfers and special item						(15,257,058)	12,924,373	(2,332,685)
Change in net assets						1,162,974	159,195,229	160,358,203
Net assets, beginning of year						16,145,893	2,139,633,257	2,155,779,150
Net assets, end of year						$ 17,308,867	2,298,828,486	2,316,137,353

See accompanying notes to basic financial statements.

Assets	Affordable Housing Mortgage Subsidy Program – Stage 8	Affordable Housing Mortgage Subsidy Program – Stage 9	Subsidy Prepayment Refunding Bonds – Debt Service	New Secure Housing Program	Key for Your Home Program	Other nonmajor governmental funds	Total governmental funds
Interest and other receivables	$ 32,977	—	188,737	—	8,001	2,886,957	3,116,672
Due from federal government	—	—	—	15,595,228	—	—	15,595,228
Due from other funds	2,050	—	—	3,325	172,239	10,656,129	10,833,743
Restricted:							
Cash and due from banks	2,032,550	6,583	3,000	—	—	578,246	2,620,379
Deposits placed with banks	—	—	—	—	—	5,048,668	5,048,668
Investments and investment contracts	6,485,220	68,856,695	32,187,499	—	1,570,821	126,629,726	235,729,961
Loans receivable, net	—	—	—	—	—	4,859,820	4,859,820
Due from other funds	73,692,902	—	140	20,445	603	25,663,919	99,378,009
Other assets	—	—	—	—	65,276	1,874,760	1,940,036
Total assets	$ 82,245,699	68,863,278	32,379,376	15,618,998	1,816,940	178,198,225	379,122,516
Liabilities and Fund Balances							
Accounts payable and accrued liabilities	$ 12,583	—	78,937	9,870,888	—	320,002	10,282,410
Due to other funds	43,439,896	93,381,267	286,068	13,844,637	—	76,477,447	227,429,315
Deferred revenue	—	—	—	6,553,848	—	—	6,553,848
Total liabilities	43,452,479	93,381,267	365,005	30,269,373	—	76,797,449	244,265,573
Fund balance (deficit):							
Reserved for noncurrent assets	—	—	—	—	—	5,651,602	5,651,602
Unreserved:							
Special revenue	38,793,220	(24,517,989)	—	(14,650,375)	1,816,940	76,009,406	77,451,202
Debt service	—	—	32,014,371	—	—	19,739,768	51,754,139
Total fund balance (deficit)	38,793,220	(24,517,989)	32,014,371	(14,650,375)	1,816,940	101,400,776	134,856,943
Total liabilities and fund balance	$ 82,245,699	68,863,278	32,379,376	15,618,998	1,816,940	178,198,225	379,122,516

Amounts reported for governmental activities in the statement of net assets are different because:	
Total fund balance	$ 134,856,943
Deferred bonds issue cost that are recorded as expenditures in governmental funds, but are capitalized in the government-wide financial statement	412,407
Long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds	(124,514,331)
Revenues in the statement of activities that do not provide current financial resources are not reported as revenue in the funds	6,553,848
Net assets of governmental activities	$ 17,308,867

See accompanying notes to basic financial statements.

	Affordable Housing Mortgage Subsidy Program – Stage 8	Affordable Housing Mortgage Subsidy Program – Stage 9	Subsidy Prepayment Refunding Bonds – Debt Service	New Secure Housing Program	Key for Your Home Program	Other nonmajor governmental funds	Total governmental funds
Revenues:							
Commonwealth appropriations for repayment of bonds and subsidy programs	$ 48,316,782	—	30,068,844	399,235	28,043,851	7,721,115	114,549,827
Intergovernmental – federal government	—	—	—	21,492,792	—	—	21,492,792
Interest on investments	4,150,789	2,824,011	2,209,697	653	187,910	9,429,769	18,802,829
Interest income on loans, net	—	—	—	—	—	926,463	926,463
Change in fair value of investments	(803,100)	—	—	—	(115,444)	(2,019,824)	(2,938,368)
Other	—	—	—	—	—	1,026,016	1,026,016
Total revenues	51,664,471	2,824,011	32,278,541	21,892,680	28,116,317	17,083,539	153,859,559
Expenditures:							
Current:							
General government	28,271	—	6,000	—	—	1,476,338	1,510,609
Housing subsidy programs	2,554,010	64,486	—	26,217,989	80,344,146	6,754,997	115,935,628
Debt service:							
Principal	—	—	26,880,000	—	—	7,617,436	34,497,436
Interest	2,788,247	4,320,981	6,026,953	249,489	—	3,752,305	17,137,975
Bond issuance costs	—	—	—	—	—	412,407	412,407
Total expenditures	5,370,528	4,385,467	32,912,953	26,467,478	80,344,146	20,013,483	169,494,055
Excess (deficiency) of revenues over (under) expenditures	46,293,943	(1,561,456)	(634,412)	(4,574,798)	(52,227,829)	(2,929,944)	(15,634,496)
Other financing sources (uses):							
Refunding bond issued	—	—	—	—	—	4,541,441	4,541,441
Payment to refunded bond escrow agent	—	—	—	—	—	(4,129,034)	(4,129,034)
Transfers in	—	—	—	—	44,753,548	117,377	44,870,925
Transfers out	—	(11,605,389)	—	—	—	(49,548,610)	(61,153,999)
Total other financing sources and uses	—	(11,605,389)	—	—	44,753,548	(49,018,826)	(15,870,667)
Net change in fund balances	46,293,943	(13,166,845)	(634,412)	(4,574,798)	(7,474,281)	(51,948,770)	(31,505,163)
Fund balances (deficit), beginning of year	(7,500,723)	(11,351,144)	32,648,783	(10,075,577)	9,291,221	153,349,546	166,362,106
Fund balances (deficit), end of year	$ 38,793,220	(24,517,989)	32,014,371	(14,650,375)	1,816,940	101,400,776	134,856,943

See accompanying notes to basic financial statements.

Amounts reported for governmental activities in the statement of activities are different because:	
Net change in fund balances	$ (31,505,163)
Governmental funds report debt service payment on long-term debt as expenditures. However, this transaction has no effect in net assets.	34,497,436
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds.	(1,829,299)
Bond proceeds provide current financial resources to governmental funds, but issuing bonds increases long-term liabilities. This is the amount of proceeds from bonds issued during the year.	(4,541,441)
Bonds issuance costs are expenditures to governmental funds, but are deferred assets in the statement of net assets. This is the amount of bond issuance costs for the year.	412,407
Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net assets. This is the amount of repayments on bonds principal during the year.	4,129,034
Change in net assets of governmental activities	$ 1,162,974

See accompanying notes to basic financial statements.

Assets	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other nonmajor	Eliminations	Total
Current assets:									
Cash and due from banks	$ 43,663,643	20,120,079	13,845,586	5,821,765	—	12,656,600	409,012	(52,401,630)	44,115,055
Federal funds sold and Securities purchased under agreement to resell	888,002,703	—	—	—	—	—	—	(44,075,703)	843,927,000
Deposits placed with banks	270,000,000	26,925,113	49,638,990	—	—	—	—	(49,638,991)	296,925,112
Investments and investment contracts	895,235,450	—	33,111,708	—	69,282,842	—	—	—	997,630,000
Loans receivable, net	1,767,667,512	24,839,436	53,848,691	—	—	—	—	(75,590,079)	1,770,765,560
Accrued interest receivable	129,157,981	13,725,419	900,791	1,345	346	4,704	518	(10,107,236)	133,683,868
Other current receivables	94,861,853	16,951,262	541,249	—	—	—	—	(5,005,083)	107,349,281
Due from Department of Housing	—	16,161,530	—	—	—	—	—	—	16,161,530
Other assets	44,126	15,034	572,867	—	—	—	—	—	632,027
Due from governmental funds	111,199,804	6,017,759	—	—	—	—	—	—	117,217,563
Total current assets	4,199,833,072	124,755,632	152,459,882	5,823,110	69,283,188	12,661,304	409,530	(236,818,722)	4,328,406,996
Noncurrent assets:									
Restricted:									
Cash and due from banks	—	22,598,040	—	—	—	—	2,084,191	(14,759,868)	9,922,363
Securities purchased under agreement to resell	—	160,000,000	—	—	—	—	—	—	160,000,000
Deposits placed with banks	—	228,218,808	—	—	—	—	—	(216,440,419)	11,778,389
Investments and investment contracts	64,980,406	1,279,261,653	—	—	—	—	—	(300,326,654)	1,043,915,405
Loans receivable, net	—	22,584,244	—	—	—	—	—	—	22,584,244
Investments and investment contracts	949,897,061	—	30,567,314	—	—	18,615,621	—	—	999,079,996
Loans receivable, net	2,210,031,803	217,041,459	164,629,463	—	—	—	—	(186,030,145)	2,405,672,580
Real estate available for sale	21,753,932	4,750,259	25,025,242	—	—	—	—	—	51,529,433
Capital assets	14,301,772	897,514	2,032	—	—	—	2,363	—	15,203,681
Other assets	9,744,189	12,771,138	—	—	—	377	—	—	22,515,704
Total noncurrent assets	3,270,709,163	1,948,123,115	220,224,051	—	—	18,615,998	2,086,554	(717,557,086)	4,742,201,795
Total assets	$ 7,470,542,235	2,072,878,747	372,683,933	5,823,110	69,283,188	31,277,302	2,496,084	(954,375,808)	9,070,608,791

(Continued)

Liabilities and Net Assets	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other nonmajor	Eliminations	Total
Current liabilities:									
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:									
Demand	$ 1,769,116,568	30,408	—	—	—	—	—	(65,615,083)	1,703,531,893
Certificates of deposit	2,136,934,315	—	—	—	—	—	—	(472,530,903)	1,664,403,412
Securities sold under agreement to repurchase	—	44,075,703	—	—	—	—	—	(44,075,703)	—
Commercial paper	918,409,931	—	—	—	—	—	—	—	918,409,931
Accrued interest payable	15,144,158	4,827,807	1,901,063	—	—	—	—	(10,107,236)	11,765,792
Accounts payable and accrued liabilities	56,747,708	29,692,733	9,171,037	4,759,286	77,442	9,489	13,907	(6,551,501)	93,920,101
Due to Commonwealth of Puerto Rico	8,347,184	50,130	—	—	—	—	—	—	8,397,314
Notes payable	—	—	75,590,079	—	—	—	—	(75,590,079)	—
Total current liabilities payable from unrestricted assets	4,904,699,864	78,676,781	86,662,179	4,759,286	77,442	9,489	13,907	(674,470,505)	4,400,428,443
Current liabilities payable from restricted assets – bonds payable	—	66,408,087	—	—	—	—	—	—	66,408,087
Total current liabilities	4,904,699,864	145,084,868	86,662,179	4,759,286	77,442	9,489	13,907	(674,470,505)	4,466,836,530
Noncurrent liabilities:									
Certificates of deposits, principally from the Commonwealth of Puerto Rico and its public entities	444,958,479	—	—	—	—	—	—	—	444,958,479
Certificates of indebtedness	251,798,513	—	—	—	—	—	—	—	251,798,513
Allowance for losses on guarantees and letters of credit	1,000,000	—	7,049,150	—	—	—	—	—	8,049,150
Accrued liabilities	—	—	—	—	—	—	2,084,612	—	2,084,612
Bonds and notes payable	267,000,000	—	184,271,970	—	—	—	—	(184,271,970)	267,000,000
Noncurrent liabilities payable from restricted assets:									
Securities sold under agreement to repurchase	—	160,000,000	—	—	—	—	—	—	160,000,000
Bonds payable	—	1,266,686,354	—	—	—	—	—	(95,633,333)	1,171,053,021
Total noncurrent liabilities	964,756,992	1,426,686,354	191,321,120	—	—	—	2,084,612	(279,905,303)	2,304,943,775
Total liabilities	5,869,456,856	1,571,771,222	277,983,299	4,759,286	77,442	9,489	2,098,519	(954,375,808)	6,771,780,305
Net assets:									
Invested in capital assets	14,301,772	897,514	2,032	—	—	—	2,363	—	15,203,681
Restricted for:									
Mortgage loan insurance	—	35,675,728	—	—	—	—	—	—	35,675,728
Affordable housing programs	—	227,102,582	—	—	—	—	—	—	227,102,582
Unrestricted	1,586,783,607	237,431,701	94,698,602	1,063,824	69,205,746	31,267,813	395,202	—	2,020,846,495
Total net assets	1,601,085,379	501,107,525	94,700,634	1,063,824	69,205,746	31,267,813	397,565	—	2,298,828,486
Total liabilities and net assets	$ 7,470,542,235	2,072,878,747	372,683,933	5,823,110	69,283,188	31,277,302	2,496,084	(954,375,808)	9,070,608,791

See accompanying notes to basic financial statements.

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

For the year ended June 30, 2004

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other nonmajor	Total
Operating revenues:								
Investment income:								
Interest income on federal funds sold and securities purchased under agreements to resell	$ 10,062,667	2,058,778	—	—	—	—	—	12,121,445
Interest income on deposits placed with banks	2,112,984	13,128,325	496,205	6,982	—	47,306	794	15,792,596
Interest and dividend income on investment and investment contracts	48,755,515	72,839,180	1,034,857	220,887	843,270	—	—	123,693,709
Total investment interest	60,931,166	88,026,283	1,531,062	227,869	843,270	47,306	794	151,607,750
Loans receivable:								
Public sector	193,624,057	—	—	—	—	—	—	193,624,057
Private sector	1,127,681	17,417,249	2,938,725	—	—	—	—	21,483,655
Total interest on loans receivable	194,751,738	17,417,249	2,938,725	—	—	—	—	215,107,712
Total interest income	255,682,904	105,443,532	4,469,787	227,869	843,270	47,306	794	366,715,462
Noninterest income:								
Change in fair value of investments	(1,284,981)	(22,750,457)	100,182	—	9,810,282	1,804,794	—	(12,320,180)
Fiscal agency fees	8,363,836	2,196,408	—	—	—	—	—	10,560,244
Commitment, guarantee, service, and administrative fees	2,565,448	3,113,577	6,146,649	—	—	—	—	11,825,674
Mortgage insurance premiums	—	2,540,541	—	—	—	—	—	2,540,541
Servicing and contract administration fees, net	1,785,912	5,700,051	5,870	—	—	—	—	7,491,833
Net gain from sale of foreclosed real estate available for sale	—	4,215,305	—	—	—	—	—	4,215,305
Federal assistance programs	—	113,743,876	—	—	—	—	—	113,743,876
Other income	4,950,939	3,335,271	1,278,844	8,944,166	—	—	—	18,509,220
Total noninterest income	16,381,154	112,094,572	7,531,545	8,944,166	9,810,282	1,804,794	—	156,566,513
Total operating revenues	272,064,058	217,538,104	12,001,332	9,172,035	10,653,552	1,852,100	794	523,281,975
Operating expenses:								
Provision (credit) for losses on loans, guarantees, and letters of credit	661,164	(1,885,000)	3,647,576	—	—	—	—	2,423,740
Interest expense:								
Deposits	60,222,089	—	47,782	—	—	—	—	60,269,871
Securities sold under agreements to repurchase	180,988	3,466,851	—	—	—	—	—	3,647,839
Commercial paper	8,467,117	—	—	—	—	—	—	8,467,117
Certificates of indebtedness	9,757,200	—	—	—	—	—	—	9,757,200
Bonds payable	(1,107,552)	87,784,570	3,695,439	—	—	—	—	90,372,457
Total interest expense	77,519,842	91,251,421	3,743,221	—	—	—	—	172,514,484

(Continued)

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other nonmajor	Total
Noninterest expenses:								
Salaries and fringe benefits	$ 23,042,273	10,133,168	16,766	—	—	—	52,182	33,244,389
Depreciation and amortization	2,364,672	258,905	4,832	—	—	—	—	2,628,409
Occupancy and equipment costs	2,769,566	958,462	65	—	—	—	—	3,728,093
Legal and professional fees	4,336,409	2,665,615	809,662	164,842	7,614	94,523	36,778	8,115,443
Office and administrative	739,314	9,426	—	231,018	112,981	—	—	1,092,739
Subsidy and trustee fees	5,927	416,306	—	—	—	—	—	422,233
Federal assistance programs	—	113,743,876	—	—	—	—	—	113,743,876
Other	2,172,107	1,706,653	5,151,518	7,382,785	—	225	12,274	16,425,562
Total noninterest expenses	35,430,268	129,892,411	5,982,843	7,778,645	120,595	94,748	101,234	179,400,744
Total operating expenses	113,611,274	219,258,832	13,373,640	7,778,645	120,595	94,748	101,234	354,338,968
Operating income (loss)	158,452,784	(1,720,728)	(1,372,308)	1,393,390	10,532,957	1,757,352	(100,440)	168,943,007
Contributions to others	(22,672,151)	—	—	—	—	—	—	(22,672,151)
Special item:								
Net loss on early extinguishments of bonds	—	(18,382)	—	—	—	—	—	(18,382)
Special Communities Trust	(3,340,319)	—	—	—	—	—	—	(3,340,319)
Transfer in	4,748,063	16,359,101	—	—	—	—	247,611	21,354,775
Transfer out	(247,611)	(76,027)	—	(4,748,063)	—	—	—	(5,071,701)
Change in net assets	136,940,766	14,543,964	(1,372,308)	(3,354,673)	10,532,957	1,757,352	147,171	159,195,229
Net assets, beginning of year	1,464,144,613	486,563,561	96,072,942	4,418,497	58,672,789	29,510,461	250,394	2,139,633,257
Net assets, end of year	$ 1,601,085,379	501,107,525	94,700,634	1,063,824	69,205,746	31,267,813	397,565	2,298,828,486

See accompanying notes to basic financial statements.

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other Nonmajor	Eliminations	Total
Cash flows from operating activities:									
Cash received from interest on loans	$ —	15,951,678	—	—	—	—	—	—	15,951,678
Principal collected on mortgage and construction loans	—	53,156,957	—	—	—	—	—	—	53,156,957
Cash paid for mortgage and construction loans originated	—	(113,436,567)	—	—	—	—	—	—	(113,436,567)
Cash received from insurance premiums	—	2,224,771	—	—	—	—	—	—	2,224,771
Guarantee fees collected	78,326	—	6,222,488	—	—	—	—	—	6,300,814
Cash received from letter of credit reimbursement	—	—	905,186	—	—	—	—	—	905,186
Cash received from other operating noninterest revenues	1,670,253	13,157,303	—	—	—	—	5,240	(649,051)	14,183,745
Cash received from fiscal agency fees	8,363,836	—	—	—	—	—	—	—	8,363,836
Due to (from) governmental funds	85,700,362	—	—	—	—	—	—	—	85,700,362
Cash received from other operating noninterest revenues	—	113,743,876	—	—	—	—	—	—	113,743,876
Cash payments to housing assistance programs	—	(113,743,876)	—	—	—	—	—	—	(113,743,876)
Cash payments to the Commonwealth of Puerto Rico	(16,894,807)	—	—	—	—	—	—	—	(16,894,807)
Cash payments for other operating noninterest expenses	(19,501,445)	(15,459,567)	(3,502,161)	(2,656,616)	(64,626)	(96,865)	(41,015)	(4,916,525)	(46,238,820)
Disbursements for obligations guaranteed	—	—	(2,031,493)	—	—	—	—	—	(2,031,493)
Escrow deposit in court	—	—	—	6,998,899	—	—	—	—	6,998,899
Cash payments for salaries and fringe benefits	(23,042,273)	(10,133,168)	—	—	—	—	(52,182)	—	(33,227,623)
Net cash provided by (used in) operating activities	36,374,252	(54,538,593)	1,594,020	4,342,283	(64,626)	(96,865)	(87,957)	(5,565,576)	(18,043,062)
Cash flows from noncapital financing activities:									
Interfund loans, net	—	(17,318,605)	—	—	—	—	—	—	(17,318,605)
Contribution to others	(26,012,470)	—	—	—	—	—	—	—	(26,012,470)
Transfer in	4,748,063	16,359,101	—	—	—	—	—	—	21,107,164
Transfer out	(247,611)	(76,027)	—	(8,074,630)	—	—	247,611	—	(8,150,657)
Net increase (decrease) in:									
Deposits	399,122,902	—	2,287,579	—	—	—	—	(123,483,036)	277,927,445
Securities sold under agreements to repurchase	(40,017,333)	(9,405,632)	—	—	—	—	—	11,255,621	(38,167,344)
Commercial paper	156,943,336	—	—	—	—	—	—	—	156,943,336
Proceeds from issuance of bonds and notes	—	8,941,606	261,001,061	—	—	—	—	(262,759,235)	7,183,432
Repayments of bonds and notes	—	(156,432,029)	(1,139,012)	—	—	—	—	1,361,512	(156,209,529)
Payment received from the Commonwealth of Puerto Rico	—	3,889,240	—	—	—	—	—	—	3,889,240
Payment of residual amount due to the Commonwealth of Puerto Rico from the liquidation of the assets of the Puerto Rico Housing Bank	—	20,666	—	—	—	—	—	—	20,666
Interest paid	(57,249,459)	(59,862,203)	(1,842,158)	—	—	—	—	(18,401,366)	(137,355,186)
Net cash provided by (used in) noncapital financing activities	$ 437,287,428	(213,883,883)	260,307,470	(8,074,630)	—	—	247,611	(392,026,504)	83,857,492

(Continued)

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other Nonmajor	Eliminations	Total
Cash flows from capital and related financing activities:									
Purchase of capital assets	$ (2,656,801)	(318,275)	—	—	—	—	(2,363)	—	(2,977,439)
Net cash provided by (used in) capital and related financing activities	(2,656,801)	(318,275)	—	—	—	—	(2,363)	—	(2,977,439)
Cash flows from investing activities:									
Net decrease (increase) in:									
Federal funds sold and securities purchased under agreement to resell	250,728,621	—	—	—	—	—	—	(11,255,621)	239,473,000
Deposits placed with banks	90,000,000	—	(19,399,543)	4,094,018	—	—	—	85,895,215	160,589,690
Purchase of investment securities	(2,580,152,566)	(609,520,645)	(289,670,005)	—	(779,424)	—	—	202,325,022	(3,277,797,618)
Proceeds from redemptions of investments	3,091,537,490	707,320,511	320,691,303	3,790,248	824	—	—	(153,933,543)	3,969,406,833
Proceeds from sales of investments	100,000,000	—	—	—	—	—	—	—	100,000,000
Cash received from investment interest	50,769,196	82,344,690	1,366,904	480,986	843,226	47,527	1,159	16,747,446	152,601,134
Cash received from loans interest	163,002,803	—	2,333,877	—	—	—	—	1,949,125	167,285,805
Origination of loans	(6,348,229,162)	—	(272,126,371)	—	—	—	—	(1,361,510)	(6,621,717,043)
Principal collected on loans	4,729,501,923	—	2,410,563	—	—	—	—	262,759,235	4,994,671,721
Proceeds from sales of loans	—	69,982,617	—	—	—	—	—	—	69,982,617
Cash paid for foreclosed loans	—	(625,703)	—	—	—	—	—	—	(625,703)
Increase in other current receivables	—	1,141,344	—	—	—	—	—	—	1,141,344
Cash paid for property held in trust	—	(11,300,815)	—	—	—	—	—	—	(11,300,815)
Cash paid for other assets	—	(2,955,580)	—	—	—	—	—	—	(2,955,580)
Net proceeds and other cash collected related to foreclosed real estate held for sale	—	4,643,761	—	—	—	—	—	—	4,643,761
Net cash provided by (used in) investing activities	(452,841,695)	241,030,180	(254,393,272)	8,365,252	64,626	47,527	1,159	403,125,369	(54,600,854)
Net change in cash	18,163,184	(27,710,571)	7,508,218	4,632,905	—	(49,338)	158,450	5,533,289	8,236,137
Cash, beginning of year	25,500,459	70,428,690	6,337,368	1,188,860	—	12,705,938	2,334,753	(72,694,787)	45,801,281
Cash, end of year	$ 43,663,643	42,718,119	13,845,586	5,821,765	—	12,656,600	2,493,203	(67,161,498)	54,037,418
Reconciliation to enterprise funds balance sheet:									
Cash – unrestricted	$ 43,663,643	20,120,079	13,845,586	5,821,765	—	12,656,600	409,012	(52,401,630)	44,115,055
Cash – restricted	—	22,598,040	—	—	—	—	2,084,191	(14,759,868)	9,922,363
Total cash, year-end	$ 43,663,643	42,718,119	13,845,586	5,821,765	—	12,656,600	2,493,203	(67,161,498)	54,037,418

(Continued)

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other Nonmajor	Eliminations	Total
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:									
Operating income (loss)	$ 158,452,784	(1,720,728)	(1,372,308)	1,393,390	10,532,957	1,757,352	(100,440)	—	168,943,007
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:									
Investment income	(60,931,166)	(65,847,831)	(1,531,062)	(472,133)	(843,270)	(47,306)	(794)	—	(129,673,562)
Loans income	(194,751,738)	—	(2,938,725)	—	—	—	—	—	(197,690,463)
Interest expenses	77,519,842	91,823,428	3,743,221	—	—	—	—	—	173,086,491
Provision for loan losses	661,164	(1,885,000)	23,762,239	—	—	—	—	—	22,538,403
Provision for losses on guarantees and letters of credit	—	—	(20,114,663)	—	—	—	—	—	(20,114,663)
Provision for real estate	—	—	2,450,173	—	—	—	—	—	2,450,173
Net decrease (increase) in fair value of investment	1,284,981	—	(100,182)	—	(9,810,282)	(1,804,794)	—	—	(10,430,277)
Net unrealized gain on derivatives	10,228,099	—	—	—	—	—	—	—	10,228,099
Net gain on sales of real estate owned – held for sale	—	(3,579,198)	—	—	—	—	—	—	(3,579,198)
Net gain on sales of loans	—	(2,359,677)	—	—	—	—	—	—	(2,359,677)
Depreciation and amortization	2,364,672	220,845	—	—	—	—	—	—	2,585,517
Cash received from letter of credit reimbursement	—	—	905,186	—	—	—	—	—	905,186
Disbursements for obligation guaranteed	—	—	(2,031,493)	—	—	—	—	—	(2,031,493)
Changes in operating assets and liabilities:									
Net change in mortgage loans receivable	—	(60,279,610)	—	—	—	—	—	—	(60,279,610)
Change in interest receivable on mortgage loans	—	419,429	—	—	—	—	—	—	419,429
Decrease (increase) in other assets	(5,213,126)	(871,416)	(957,602)	—	—	—	2,363	(649,051)	(7,688,832)
Decrease (increase) in due to governmental funds	85,700,362	—	—	—	—	—	—	—	85,700,362
Decrease (increase) in capital assets	(292,129)	—	—	—	—	—	(2,363)	—	(294,492)
Escrow deposit in court	—	—	—	6,998,899	—	—	—	—	6,998,899
Increase (decrease) in allowance for possible losses on guarantees and letters of credit	(2,048,465)	—	—	—	—	—	—	—	(2,048,465)
Increase (decrease) in due to Commonwealth of Puerto Rico	1,452,377	—	—	—	—	—	—	—	1,452,377
Increase (decrease) in other liabilities	(38,053,405)	(10,458,835)	(220,764)	(3,577,873)	55,969	(2,117)	13,277	(4,916,525)	(57,160,273)
Net cash provided by (used in) operating activities	$ 36,374,252	(54,538,593)	1,594,020	4,342,283	(64,626)	(96,865)	(87,957)	(5,565,576)	(18,043,062)

(Continued)

	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Public Finance Corporation	Capital Fund	Development Fund	Other Nonmajor	Eliminations	Total
Noncash investing and noncapital financing activities:									
Accretion of discount on investment securities and capitalized interest on loans	$ 2,107,678	7,024,891	197,483	—	—	—	—	—	9,330,052
Loan to foreclosed real estate	—	—	27,475,415	—	—	—	—	—	27,475,415
Accretion of discount on:									
Deposits	7,690,896	—	—	—	—	—	—	(7,024,893)	666,003
Commercial paper	300,008	—	—	—	—	—	—	—	300,008
Certificate of indebtedness	8,814,303	—	—	—	—	—	—	—	8,814,303
Bonds payable	—	69,144,095	—	—	—	—	—	(6,774,833)	62,369,262
Increase (decrease) in fair value of investment	(1,284,981)	—	100,182	—	9,810,282	1,804,794	—	—	10,430,277
Unrealized gain on derivatives	22,711,899	—	—	—	—	—	—	—	22,711,899
Amortization of bond issued cost (included in interest expenses)	626,743	387,215	—	—	—	—	—	—	1,013,958
Change in estimated liability for mortgage loan insurance losses	—	315,770	—	—	—	—	—	—	315,770

See accompanying notes to basic financial statements.

Notes to Basic Financial Statements

(1) Reporting Entity

Government Development Bank for Puerto Rico (the Bank or GDB) 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. Management of the Bank has defined net income as the change in unrestricted net assets of business-type activities. In 2003, the Bank's board of directors approved such definition.

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 (U.S. 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 substantially the same as that of the Bank. Financial statements of each major 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 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, 2004, 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 Office of the Commissioner of Insurance of the Commonwealth. Insurance coverage for fiscal year 2004 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 U.S. 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 U.S. 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 assets 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, has 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.

(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 after the end of the 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, 2004, 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 (Stages 8 and 9)* – These special revenue funds are used to account for the proceeds of specific revenue sources under Stages 8 and 9, respectively, of the Affordable Housing Mortgage Subsidy Program (AHMSP) that are legally restricted to expenditures to promote the origination of mortgage loans by commercial banks to low- and moderate-income families. These funds are two of the ten funds that are under the AHMSP.

- *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.

- *Key for Your Home Program* – It was created to provide subsidy to low- and moderate-income families to cover costs directly related to the purchase and rehabilitation of housing units.

The following governmental activities of the Bank are accounted for in other 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 trust activities of the enterprise funds to provide the funding to promote such loan originations.

  The Bank has 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 agreements 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 and Finance Agency (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 revenues 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 these definitions 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.

(e) Loans Receivable and Allowance for Loan Losses

Loans in the enterprise funds 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. Nonaccrual loans are returned to an accrual status when management has adequate evidence to believe that the loans will be performing as contracted.

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 anticipated 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 of 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.

Loans recorded in the governmental funds are presented at the outstanding unpaid principal balance reduced by the allowance for loan losses. A reserve for noncurrent assets is recorded within fund balance representing amounts not expected to be collected within the next fiscal year.

(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.

When a guarantee is executed, the bank recognizes any disbursement as a nonperforming loan; therefore, no interest is accrued on the principal. After a specific analysis of the provision requirements, the related allowance included in the *Allowance for Guarantees and Letters of Credit* is reclassified to the *Allowance for Possible Loan Losses*. Any deficiency in the estimated allowance requirement is “replenished” through additional provision.

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.

Pursuant to the legislation under which TDF was credited, 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. This legislation currently does not expressly provide for the reimbursement of losses incurred by TDF on loans made directly by TDF. TDF is in the process of submitting an amendment to this legislation to provide for the reimbursement of such losses. 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. No reimbursements have been received nor appropriated in 2004.

(g) Debt Issue Costs

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, which is established by a third party professional assessment or based upon an appraisal, 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 or loss 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. Capital assets are defined by the Bank as assets which have a cost of $500 or more at the date of acquisition and have an expected useful life from three or more years. 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.

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 governmental fund level arise when potential revenues do not meet the available criterion for recognition in the current period. Available is defined as collected during the fiscal year or 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, 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 $4.9 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) 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 revenues 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.

(s) 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 (or statement of net assets) 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 follows the provisions of SFAS No. 133 as explained in the ensuing paragraphs.

On the date a derivative contract is entered into, the Bank designates the derivative as either a hedge of the fair value of a recognized asset or liability (fair value hedge), or a hedge of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

For all fair value hedging relationships the Bank formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed, and a description of the method of measuring ineffectiveness. This process includes linking all derivatives that are designated as fair-value to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Bank also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair value of hedged items. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a fair-value hedge 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, 2004, the Bank had no fair value hedging derivatives.

The Bank discontinues hedge accounting prospectively when it is determined that the derivative is no longer effective in offsetting changes in the fair value of the hedged item, the derivative expires or is sold, terminated, or exercised, the derivative is dedesignated as a hedging or management determines that designation of the derivative as a hedging instrument is no longer appropriate. When hedge accounting is discontinued because it is determined that the derivative no longer qualifies as an effective fair-value hedge, the Bank continues to carry the derivative on the balance sheet at its fair value and no longer adjusts the hedged asset or liability for changes in fair value. The adjustment of the carrying amount of the hedged asset or liability is accounted for in the same manner as other components of the carrying amount of that asset or liability.

For cash flow hedges, in which derivatives hedge the variability of cash flows related to floating rate assets or liabilities, the accounting treatment under SFAS No. 133 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. Consequently, the Bank follows the provisions of SFAS No. 133 as modified by such GASB clarification, by recording on the balance sheet or statement of net assets, the fair value of derivatives intended to hedge the variability of cash flows to be received or paid related to a recognized assets or liability but the change in fair value is reported as an adjustment to the interest income or expense which the derivative intended to hedge.

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.

When the Bank enters into a derivative instrument for the purpose of managing its exposure on another freestanding or embedded derivative instruments, the derivative is recorded at its fair value on the balance sheet or statement of net assets and recognizes any changes in fair value in the statement of revenues, expenses, and changes in net assets.

Interest expense for the year ended June 30, 2004 has been reduced by aproximately $22.2 million of net gain on derivative instruments intended to hedge variable cash flows on recorded liabilities.

(t) Future Adoption of Accounting Pronouncements

The GASB has issued the following accounting standards that have effective dates after June 30, 2004:

- GASB Statement No. 40, *Deposit and Investment Risk Disclosures an amendment of GASB Statement No. 3*, which is effective for fiscal years beginning after June 15, 2004.
- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which is effective for fiscal years beginning after December 15, 2004.
- GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which is effective for fiscal years beginning after December 15, 2004.
- GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section—an amendment of NCGA Statement 1*, which is effective for statistical sections prepared for periods beginning after June 15, 2005.

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

(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, 2004. 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, 2004 were as follows:

	Category 1	Category 2	Category 3	Depository bank balance	Carrying amount
Cash and due from banks	$ 2,537,337	—	16,330,984	18,868,321	56,657,797
Deposits placed with banks	837,126	—	312,915,043	313,752,169	313,752,169
Federal funds sold	200,000	—	817,100,000	817,300,000	817,300,000
	$ 3,574,463	—	1,146,346,027	1,149,920,490	1,187,709,966

Reconciliation to government-wide statement of net assets:

Unrestricted:	
Cash and due from banks	$ 44,115,055
Deposits placed with banks	296,925,112
Federal funds sold	817,300,000
Total unrestricted	1,158,340,167
Restricted:	
Cash and due from banks	12,542,742
Deposits placed with banks	16,827,057
Total restricted	29,369,799
Total balance	$ 1,187,709,966

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, 2004 amounted to $187 million. At June 30, 2004, these agreements mature within three months and a year. The average amount outstanding during the year amounted to approximately $182 million with the largest amount outstanding at any month-end amounting to approximately $250 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 Bank 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 1	Category 2	Category 3	Carrying amount	Fair value
Obligations of the U.S. government, its agencies, and instrumentalities	$ 1,320,218,326	66,264,761	—	1,386,483,087	1,386,483,087
Mortgage- and asset-backed securities	7,553,195	685,100,299	—	692,653,494	692,653,494
Corporate debt	62,837,050	—	—	62,837,050	62,837,050
External investment pools	—	36,333,777	—	36,333,777	36,333,777
Equity securities	69,440,995	—	—	69,440,995	69,440,995
Total investments	$ 1,460,049,566	787,698,837	—	2,247,748,403	2,247,748,403
Noncategorized investment:					
Nonparticipating investment contracts				1,028,606,959	
Total investments				$ 3,276,355,362	
Reconciliation to government-wide statement of net assets:					
Unrestricted investments				$ 1,996,709,996	
Restricted investments				1,279,645,366	
Total investments				$ 3,276,355,362	

Investments in external investment pools were subject to regulatory oversight by the Commissioner of Financial Institutions of Puerto Rico, except for $563,000 which were not subject to regulatory oversight. As of June 30, 2004, the Bank's investments in external investment pools included $17,876,310 invested with the Puerto Rico Government Investment Trust Fund, which is administered by the Bank.

Investments and investment contracts, excluding equity securities and external investment pools, at June 30, 2004 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	$ 828,650,682	—	416,234,051	1,244,884,733
After one to five years	433,933,959	62,837,050	241,068,006	737,839,015
After five to ten years	123,898,446	—	—	123,898,446
After ten years	—	—	371,304,902	371,304,902
Total	$ 1,386,483,087	62,837,050	1,028,606,959	2,477,927,096
Mortgage-backed securities				692,653,494
Total				$ 3,170,580,590

As of June 30, 2004, the Bank had pledged investments and investment contracts to secure the following:

Payment of principal and interest on obligations issued by a blended component unit	$ 1,361,665,468
Securities sold under agreements to repurchase	160,000,000
Certificates of indebtedness	62,484,000

(5) Loans Receivable and Allowance for Loan Losses

Loans at June 30, 2004 consist of the outstanding balance of credit facilities granted to the following (in thousands):

		Enterprise funds			
	Governmental activities	GDB Operating Fund	Tourism Development Fund	Housing Finance Authority	Total
Public corporations and agencies	$ —	3,075,290	—	—	3,075,290
Municipalities	—	606,021	—	—	606,021
Total loans to public sector	—	3,681,311	—	—	3,681,311
Private sector	14,846	36,738	243,515	282,699	577,798
Allowance for loan losses	(9,986)	(1,970)	(25,037)	(18,234)	(55,227)
	4,860	34,768	218,478	264,465	522,571
Balance, end of year	$ 4,860	3,716,079	218,478	264,465	4,203,882
Reconciliation to government-wide statement of net assets:					
Unrestricted loans receivable, net					$ 4,176,438
Restricted loans receivable, net					27,444
					$ 4,203,882

Public sector loans at June 30, 2004 include $873 million of lines of credit granted on June 29, 2004 to the Department of Treasury of the Commonwealth of Puerto Rico primarily or temporarily financing to be repaid with certain federal grants to be received.

From the total of public sector loans, approximately $402.7 million as of June 30, 2004 were delinquent by 90 days or more. 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 2004. No interest was collected on these loans in 2004.

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. In 2004, the Tourism Development Fund commenced providing direct loans to tourist projects, as part of the credit facilities they offer. The intention is to provide (i) alternative financing to some projects in the Tourism Development Fund guarantee portfolio, and (ii) interim financing to projects under construction. These credit facilities amounted to $487.8 million at June 30, 2004 of which $269.3 million are mortgage loans granted, and $218.5 are for tourist projects.

Nonaccrual private sector loans amounted to approximately $284 million at June 30, 2004. 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 approximately $10 million in 2004. Interest collected on these loans amounted to approximately $2.3 million.

The following is a summary of the activity in the allowance for loan losses for the year ended June 30, 2004 (in thousands):

		Enterprise funds			
	Governmental activities	GDB Operating Fund	Tourism Development Fund	Housing Finance Authority	Total
Balance, beginning of year	$ 9,986	3,309	1,275	20,143	34,713
Provision for loan losses	—	661	23,762	(1,885)	22,538
Charge-offs	—	(2,000)	—	(24)	(2,024)
Balance, end of year	$ 9,986	1,970	25,037	18,234	55,227

The following is a summary of private sector loans of the enterprise funds considered to be impaired as of June 30, 2004, and the related interest income for the year then ended (in thousands):

	Enterprise funds			
	GDB Operating Fund	Housing Finance Authority	Tourism Development Fund	Total
Recorded investment in impaired loans:				
Not requiring an allowance for loan losses	$ 1,501	—	—	1,501
Requiring an allowance for loan losse	—	27,136	75,590	102,726
Total recorded investment in impaired loans	$ 1,501	27,136	75,590	104,227
Related allowance for loan losses	$ —	10,294	22,000	32,294
Average recorded investment in impaired loans	2,591	27,674	44,094	74,359
Interest income recognized on impaired loans	59	—	—	59

In January 2004, the Housing Finance Authority sold approximately $35.9 million of single-family mortgage loans receivable, and in February 2004, $34.1 million of multifamily mortgage loans receivable. The net proceeds from the sale of such loans amounted to approximately $38 million. The net gain from each sale was approximately $1.9 million and $429,000, respectively.

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

The amount due from the federal government amounting to $15,595,228 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 granting agencies 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 accounts has been established.

The amount due from the Puerto Rico Department of Housing of $16,161,530 consists of advances under two lines of credit of $3,139,486 and $13,022,044. The approved amounts under these lines of credit are $3.2 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, 2004.

As of June 30, 2004, the Authority maintained a line of credit of $50 million with the Banco Popular de Puerto Rico to finance the operations of the project "Revitalización de Santurce," the balance of the same one was of $14,917,087. Also, $11,300,815 consists of some properties held in trust representing the collateral of the mentioned obligation.

(7) Capital Assets

Capital assets activity for the year ended June 30, 2004 was as follows:

	Beginning balance	Additions	Reductions/ reclassifications	Ending balance
Business-type activities:				
Capital assets not being depreciated:				
Land	$ 2,955,000	—	—	2,955,000
Total capital assets not being depreciated	2,955,000	—	—	2,955,000
Capital assets being depreciated:				
Building	8,988,048	—	—	8,988,048
Leasehold improvements	1,239,441	44,097	—	1,283,538
Information systems	5,448,691	1,235,455	(2,590,239)	4,093,907
Office furniture and equipment	3,812,710	477,354	(908,112)	3,381,952
Software	3,737,471	1,184,281	(528,886)	4,392,866
Vehicles	404,332	36,252	(1,488)	439,096
Total capital assets being depreciated	23,630,693	2,977,439	(4,028,725)	22,579,407
Less accumulated depreciation and amortization for:				
Building	(561,753)	(224,701)	—	(786,454)
Leasehold improvements	(781,538)	(91,799)	(2,286)	(875,623)
Information systems	(4,582,605)	(727,429)	2,593,397	(2,716,637)
Office furniture and equipment	(2,177,739)	(357,997)	945,301	(1,590,435)
Software	(3,451,295)	(1,187,067)	528,886	(4,109,476)
Vehicles	(214,173)	(39,416)	1,488	(252,101)
Total accumulated depreciation and amortization	(11,769,103)	(2,628,409)	4,066,786	(10,330,726)
Total capital assets being depreciated, net	11,861,590	349,030	38,061	12,248,681
Total capital assets, net	$ 14,816,590	349,030	38,061	15,203,681

(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 $60.2 million in 2004.

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

The Housing Finance Authority was designated by the Office of the Commissioner of Financial Institutions of the Commonwealth (the Commissioner) as an eligible similar institution under local Regulation 5105. This regulation permits the Authority to receive up to $250 million in eligible funds (commonly known as 936 tax-exempt funds), which are received through securities sold under agreements to repurchase and used for an arbitrage program.

The maturities of the investments made with proceeds obtained from the securities sold under agreements to repurchase are generally matched with the maturities of such obligations. As of June 30, 2004, $160,000,000 has been received and invested in repurchase agreements. The repurchase agreements are used to collateralize the securities sold under agreements to repurchase. As of June 30, 2004, the aggregate market value plus accrued interest of the underlying securities does not exceed the securities sold under agreements to repurchase including accrued interest.

The following is selected information concerning securities sold under agreements to repurchase:

Carrying amount at June 30, 2004	$ 160,000,000
Maximum amount outstanding at any month-end	350,869,344
Average amount outstanding during the year	179,117,213
Weighted average interest rate for the year	1.63%
Weighted average interest rate at year-end	1.27%

The following summarizes the activity of securities sold under agreements to repurchase for fiscal year 2004:

	Beginning balance	Issuances	Maturities	Ending balance
GDB Operating Fund	$ 40,017,333	335,025,000	375,042,333	—
Housing Finance Authority	150,000,000	1,530,000,000	1,520,000,000	160,000,000
Total	$ 190,017,333	1,865,025,000	1,895,042,333	160,000,000

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, 2004, securities sold under agreement to repurchase were due on July 21, 2004.

The program requires that net interest income generated by the investment of such funds must be used only for the following purposes:

- At least 50% shall be used to partially subsidize origination cost on mortgage loans to low- and moderate-income families.
- Strengthen the accrual for estimated mortgage loan insurance losses. The purpose of such strengthening is to increase the amount of mortgage loans insured by the fund. During the year, no transfers to the mortgage loan insurance fund for the above purpose were made.
- Subsidize the sale of mortgages with discounts.
- Provide for the expenses related to the administration of these funds.

During the fiscal year ended June 30, 2004, this investment generated a net interest income of $55,529.

Under the U.S. Internal Revenue Code and related arbitrage rebate regulations, the Authority is required, under certain provisions, to rebate to the U.S. federal government the excess earnings on investments purchased with certain bond proceeds whenever the yield on those investments exceeds the effective yield on the related tax-exempt bonds issued. During the fiscal year ended June 30, 2004, the Housing Finance Authority rebated $149,966 in arbitrage earnings to the U.S. Treasury. At the end of the fiscal year, no arbitrage rebate liability has been recognized.

(10) 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, 2004	$ 918,409,931
Maximum amount outstanding at any month-end	1,114,262,840
Average amount outstanding during the year	828,072,423
Weighted average interest rate for the year	1.04%
Weighted average interest rate at year-end	1.08%

The following summarizes the commercial paper activity for fiscal year 2004:

	Beginning balance	Issuances	(Discount) accretion	Maturities	Ending balance	Due within one year
GDB Operating Fund	$ 761,166,587	3,682,504,847	300,007	3,525,561,510	918,409,931	918,409,931

(11) 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 2004:

	Beginning balance	Issuances	(Discount) accretion	Maturities	Ending balance	Due within one year
GDB Operating Fund	$ 242,984,210	—	8,814,303	—	251,798,513	—

At June 30, 2004, the scheduled maturities of certificates of indebtedness are as follows:

Year ending June 30:	
2005	$ —
2006	204,414,513
2007	47,384,000
	$ 251,798,513

The bank has a deposit from Microsoft, Inc. for $200 million on which it pays interest based on the appreciation of Microsoft, Inc. shares to which it has entered into a swap to manage such risk.

(12) Bonds Payable and Noncurrent Liabilities

The activity of bonds payable and other borrowed funds for the year ended June 30, 2004 is as follows:

	Beginning balance	Debt Issued	Debt Paid	Reductions	Ending balance	Due within one year
Governmental activities:						
Commonwealth appropriation bonds and notes:						
Law 115 – Subsidy prepayment refunding bonds	$ 116,090,000	—	—	26,880,000	89,210,000	28,215,000
Note payable – Affordable Housing Mortgage Subsidy Program Stage 7	10,029,360	4,541,441	(4,129,034)	102,436	10,339,331	—
Total Commonwealth appropriation bonds and notes	126,119,360	4,541,441	(4,129,034)	26,982,436	99,549,331	28,215,000
General obligation bonds:						
Loan insurance claims refunding bonds	32,480,000	—	—	7,515,000	24,965,000	7,890,000
Total – governmental activities	$ 158,599,360	4,541,441	(4,129,034)	34,497,436	124,514,331	36,105,000

	Beginning balance	Issuances, net	Reductions	Ending balance	Due within one year
Business-type activities:					
GDB Operating Fund: Adjustable Refunding Bonds	$ 267,000,000	—	—	267,000,000	—
Housing Finance Authority: Mortgage Trust III	1,208,683,874	—	(44,620,000)	1,164,063,874	43,540,000
Revenue bonds:					
Collateralized Mortgage Revenue Bonds	80,700,000	—	(8,750,000)	71,950,000	1,100,000
Single Family Mortgage Revenue Bonds – Portfolio I	44,065,000	—	(690,000)	43,375,000	715,000
Single Family Mortgage Revenue Bonds – Portfolio II (net of elimination of $6,325,000)	15,835,000	—	(6,485,000)	9,350,000	—
Single Family Mortgage Revenue Bonds – Portfolio III	21,190,000	—	(470,000)	20,720,000	—
Single Family Mortgage Revenue Bonds, Stage IX-2002	350,000,000	—	—	350,000,000	2,675,000
Single Family Mortgage Revenue Bonds – Portfolio IV	61,389,000	—	(825,000)	60,564,000	901,000
Mortgage Trust IV:					
Collateralized mortgage obligations	68,015,424	—	(17,264,529)	50,750,895	—
Homeownership Mortgage Revenue Bonds 2000	100,605,000	—	(11,605,000)	89,000,000	1,240,000
Homeownership Mortgage Revenue Bonds 2001	95,905,000	—	(6,575,000)	89,330,000	520,000
Homeownership Mortgage Revenue Bonds 2003	102,500,000	—	(58,925,000)	43,575,000	800,000
Total revenue bonds	940,204,424	—	(111,589,529)	828,614,895	7,951,000
Subtotal Housing Finance Authority	2,148,888,298	—	(156,209,529)	1,992,678,769	51,491,000
Notes payable (operations and administration)	7,733,655	8,941,606	—	16,675,261	14,917,087
Less unaccreted discount	713,421,782	—	(37,162,193)	676,259,589	—
Total Housing Finance Authority	1,443,200,171	8,941,606	(119,047,336)	1,333,094,441	66,408,087
Tourism Development Fund notes payable to GDB	—	261,001,061	(1,139,012)	259,862,049	75,590,079
	1,710,200,171	269,942,667	(120,186,348)	1,859,956,490	141,998,166
Less intrafund elimination	(87,100,326)	(262,759,235)	(5,635,821)	(355,495,382)	(75,590,079)
Total business-type activities	$ 1,623,099,845	7,183,432	(125,822,169)	1,504,461,108	66,408,087

The annual debt service requirements to maturity, including principal and interest, for long-term debt as of June 30, 2004, are as follows:

	GDB Operating Fund	
	Business-type activities	
	Principal	Interest
Year ending June 30:		
2005	$ —	2,670,000
2006	—	2,670,000
2007	—	2,670,000
2008	—	2,670,000
2009	—	2,670,000
2010-2014	—	13,350,000
2015	267,000,000	1,112,500
	$ 267,000,000	27,812,500

	Housing Finance Authority			
	Governmental activities		Business-type activities	
	Principal	Interest	Principal	Interest
Year ending June 30:				
2005	$ 36,105,000	5,821,945	66,408,087	82,550,077
2006	36,515,748	4,252,501	62,217,070	80,892,685
2007	41,695,047	1,779,286	55,566,929	79,660,801
2008	38,503	562,122	56,040,116	78,230,079
2009	150,768	553,775	101,638,486	76,630,661
2010-2014	807,878	2,553,629	262,937,295	346,702,299
2015-2019	1,316,038	2,067,885	245,863,000	318,644,912
2020-2024	1,762,284	1,546,876	180,460,000	305,651,378
2025-2029	3,010,465	920,144	535,167,714	182,742,217
2030-2034	3,112,600	83,355	188,002,000	70,582,112
2035-2038	—	—	159,420,000	3,719,800
	$ 124,514,331	20,141,518	1,913,720,697	1,626,007,021

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	5.13%-7.50%	$ 89,210,000
General obligation bonds:		
Loan Insurance Claims Refunding Bonds:		
December 1, 2002 and each December 1 thereafter to December 1, 2006	5.00%-5.13%	24,965,000
Note payable Affordable Housing Mortgage Subsidy Program Stage 7:		
June 30, 2003 and each June 30 thereafter to June 30, 2031	Note (b) below	10,339,331
Total governmental activities bonds and notes payable		$ 124,514,331

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

The principal and interest of the Subsidy Prepayment and Loan Insurance Claims 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 the Affordable Housing Mortgage Subsidy Program Stage 7 note payable (the Old Note) of the Housing Bank, 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 revenues of the notes sold. The notes payable to the PFC were originally composed of a loan granted by the Bank, but which, pursuant to Act No. 164 of December 17, 2001, PFC acquired and restructured through the issuance of Commonwealth appropriation bonds. These bonds were issued under trust indenture agreements where PFC pledged the notes to certain trustees and created a first lien on the pledged revenue (consisting of annual Commonwealth appropriations earmarked to repay these notes) for the benefit of the bondholders.

During June 2004, PFC advance refunded a portion of certain of its outstanding Commonwealth appropriation bonds issued in 2001 under Act No. 164 of December 17, 2001. The Authority recognizes a mirror effect of this advance refunding by PFC in its own notes payable in proportion to the portion of the Authority's notes payable included in the PFC refunding. As a result, the Authority considered defeased and therefore removed from the balance sheet the portion refunded of $4,129,034. Refunding proceeds and bond issue costs of $4,541,441 and $412,407 were recognized and capitalized within the new refunding note and deferred through the note term. The aggregate debt service requirements of the refunding and unrefunded notes will be funded with annual appropriations from the Commonwealth.

As a result of this advance refunding, the Authority has decreased its aggregate debt service payments by approximately $2.4 million over the next 27 years and obtained an economic gain (the difference between the present values of the debt service payments of the refunded and refunding notes) or $320,225. At June 30, 2004, approximately $4.1 million of the notes refunded during June 2004 remain outstanding and are considered defeased.

The amount outstanding of the Note at June 30, 2004 was $10,339,331 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, 1.00% at June 30, 2004	$ 267,000,000
Mortgage Trust III:		
January 1, 2001 and each July 1 and January 1 thereafter to July 1, 2011	Zero Coupon	155,529,283
January 1, 2001 and each July 1 and January 1 thereafter to January 1, 2021	Zero Coupon	238,986,061
January 1, 2026	Zero Coupon	94,222,153
Plus: unaccreted discount		675,326,377
Collateralized mortgage revenue bonds:		
January 1, 2005 and every other January 1 thereafter to January 1, 2015	6.05%-6.30%	22,500,000
January 1, 2022	6.40%	19,805,000
January 1, 2029	6.50%	29,645,000
Single family mortgage revenue bonds – Portfolio I:		
October 1, 2002 and each April 1 and October 1 thereafter to October 1, 2010	5.45%-5.90%	5,650,000
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%	280,000
December 1, 2023	7.00%	9,070,000
Single family mortgage revenue bonds – Portfolio III:		
February 1, 2007 and each February and August 1 to August 1, 2010	6.50%-6.60%	4,355,000
August 1, 2017	6.75%	3,935,000
August 1, 2020	6.85%	2,285,000
August 1, 2029	7.00%	10,145,000
Balance carried forward		$ 1,576,458,874

Description and maturity date	Interest rate	Amount outstanding
Balance brought forward		$ 1,576,458,874
Single family mortgage revenue bonds – Portfolio IV:		
December 1, 2004 and each December 1 and June 1 and thereafter to August 1, 2007	5.75%-6.00%	3,405,000
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%	8,417,276
May 1, 2015	6.00%	42,333,619
Single family mortgage revenue bonds – Portfolio IX:		
June 1, 2005 and each December 1 and June 1 thereafter to December 1, 2012	3.10%-5.10%	49,530,000
December 1, 2017	5.40%	28,770,000
December 1, 2022	5.40%	49,455,000
December 1, 2032	5.60%	62,825,000
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%	13,025,000
June 1, 2020	4.40%	1,080,000
December 1, 2018	5.10%	12,500,000
June 1, 2020	5.15%	9,460,000
December 1, 2031	5.10%	21,990,000
December 1, 2032	5.20%	30,945,000
Homeownership Mortgage Revenue Bonds 2001 Series:		
December 1, 2033	5.20%	21,435,000
December 1, 2002 and each December 1 thereafter to December 1, 2012	2.75%-4.70%	15,120,000
December 1, 2023	5.50%	4,340,000
June 1, 2027	4.45%	19,835,000
June 1, 2028	5.30%	2,855,000
December 1, 2028	5.30%	25,745,000
Homeownership Mortgage Revenue Bonds 2003 Series:		
December 1, 2005 and each December 1 thereafter to December 1, 2013	1.75%-4.00%	8,010,000
December 1, 2017	4.375%	3,185,000
June 1, 2023	4.750%	4,950,000
December 1, 2023	4.750%	1,915,000
December 1, 2033	3.125%	6,795,000
June 1, 2034	4.875%	15,320,000
December 1, 2034	4.875%	3,400,000
Total		$ 2,259,678,769

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.

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, 2004, the Facility has an outstanding amount of $14,917,087, 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.

The activity for noncurrent accrued liabilities during 2004 follows:

		Enterprise funds			
		GDB Operating Fund	Public Financ Corporation	Education Assistance Corporation	Total
Balance, beginning of period	$	587,500	10,405,155	2,079,372	13,072,027
Additions (reductions)		(587,500)	(10,405,155)	5,240	(10,987,415)
Balance, end of period	$	—	—	2,084,612	2,084,612

(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, 2004, the Housing Finance Authority had restricted net asset for such purposes of approximately $35.7 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, 2004, 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	$	75,000
Private sector		352,037
Total	$	427,037
Standby letters of credit:		
Public sector	$	114,766
Private sector		20,000
Total	$	134,766
Commitments to extend credit:		
Public sector	$	3,884,274
Private sector		27,309
Total	$	3,911,583

Financial guarantees and letters of credit outstanding at June 30, 2004 include approximately $294 million issued by the Tourism Development Fund on several private hotel and tourism development projects. During 2004, the Tourism Development Fund made payments under such financial guarantees and letters of credit in the amount of $2 million.

On July 1, 2002, the Bank issued a payment guarantee in favor 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 guaranteed 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.

The service contract between Ondeo and PRASA was cancelled on January 15, 2004. It was agreed, as part of the negotiations, that each party will issue a reciprocating guarantee, for a maximum of $37.5 million, in exchange for the cancellation of the previous payment guarantee. This new guarantee will be cancelled no later than June 30, 2005.

Following is the 2004 activity for the noncurrent portion of the allowance for losses on guarantees and letters of credit:

		Beginning balance	Provisions	Transfer to loans and OREO allowances	Reimbursement	Ending balance
GDB Operating Fund	$	3,048,465	(2,048,465)	—	—	1,000,000
Tourism Development Fund		26,253,275	2,885,321	(22,999,984)	910,538	7,049,150
	$	29,301,740	836,856	(22,999,984)	910,538	8,049,150

During the current year, the Tourism Development Fund lend money to some tourism projects to cancel the AFICA bonds originally financing said projects. This represented a reduction in the provision for possible losses on guarantees and letters of credit due to the cancellation of the AFICA bonds.

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

The Bank had entered into several interest-rate related derivative instruments (swaps) and are equity-based exchange agreement to manage its exposure in certain debt instruments or derivative instruments as follows:

- Interest rate exchange agreements (swaps) to convert a portion of its floating rate certificate of indebtedness deposits to fixed rate.
- Interest rate exchange agreements to convert its variable rate bonds to fixed rate.
- An agreement to convert the payment on a deposit from Microsoft from a Microsoft share appreciation index to a fixed rate.

Additionally, on April 13, 2004, in anticipation of the issuance of the Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2004 B Bonds, the Bank, entered into interest rate exchange agreements (the Interest Rate Agreements) with three counterparties. At the same time, the Bank entered into several mirror swap agreements (mirror swaps) with the Commonwealth. The purpose of the Interest Rate Agreements was to hedge the Commonwealth's variable rate debt exposure and the interest rate risks associated therewith in relation to the Series 2004 B Bonds. The mirror swaps transfer the exposures and risks to the Commonwealth.

On November 18, 2004, upon enactment of legislation that expressly authorizes the Commonwealth to enter into agreements of the nature of the Interest Rate Agreements and, among other things, to pledge the full faith, credit and taxing power of the Commonwealth to all payments to be made under the Agreements, the Interest Rate Agreement were transferred to the Commonwealth in exchange for the cancellation of the mirror swaps.

At June 30, 2004, the Bank was a party to the following interest-rate swap agreements (notional amount in thousands):

		Receives		Pays		
Notional amount	Floating rate indicator	Type	Rate at June 30, 2004	Type	Rate	Maturity date
$ 50,000	3m LIBOR – 0.75	Variable	0.36%	Fixed	4.715%	July 1, 2006
60,000	5m LIBOR – 0.75	Variable	0.36%	Fixed	4.710%	July 1, 2006
60,000	3m LIBOR – 0.75	Variable	0.36%	Fixed	4.710%	July 1, 2006
267,000	VRDOs(1)	Variable	1.00%	Fixed	3.040%	August 1, 2004
200,000	MSFT(2)	MSFT(2)	—	Fixed	4.999%	February 28, 2006
55,925	59.8% of 1m LIBOR+25 bp	Variable	1.02%	Fixed	3.308%	May 27, 2021
56,000	59.8% of 1m LIBOR+25 bp	Variable	1.02%	Fixed	3.582%	June 27, 2024
56,000	58.3% of 1m LIBOR+24 bp	Variable	1.01%	Fixed	3.559%	June 29, 2027
55,975	58.3% of 1m LIBOR+24 bp	Variable	1.02%	Fixed	3.575%	June 29, 2028
19,290	58.3% of 1m LIBOR+24 bp	Variable	1.02%	Fixed	3.570%	June 27, 2029
30,710	58.3% of 1m LIBOR+24 bp	Variable	0.99%	Fixed	3.570%	June 27, 2029
50,000	58.3% of 1m LIBOR+24 bp	Variable	1.00%	Fixed	3.573%	June 29, 2029
61,975	58.3% of 1m LIBOR+24 bp	Variable	1.01%	Fixed	3.574%	June 30, 2031
62,000	57.3% of 1m LIBOR+24 bp	Variable	0.88%	Fixed	3.509%	July 1, 2032
55,925	LIBOR	Fixed(3)	3.308%	Variable	1.015%	May 27, 2021
56,000	LIBOR	Fixed(3)	3.582%	Variable	1.015%	June 27, 2024
56,000	LIBOR	Fixed(3)	3.559%	Variable	1.010%	June 29, 2027
55,975	LIBOR	Fixed(3)	3.575%	Variable	1.012%	June 29, 2028
19,290	LIBOR	Fixed(3)	3.570%	Variable	1.015%	June 27, 2029
30,710	LIBOR	Fixed(3)	3.570%	Variable	0.989%	June 27, 2029
50,000	LIBOR	Fixed(3)	3.573%	Variable	0.998%	June 29, 2029
61,975	LIBOR	Fixed(3)	3.574%	Variable	1.009%	June 30, 2031
62,000	LIBOR	Fixed(3)	3.509%	Variable	0.876%	July 1, 2032
$ 1,532,750						

(1)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.

(2)Microsoft share appreciation index which mirrors embedded derivative on $200 million Microsoft certificate of deposit.

(3)Mirror swaps with the Department of the Treasury of the Commonwealth.

By using derivative financial instruments to hedge exposure to changes in interest rates, the Bank exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the term of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Bank, which creates credit risk for the Bank. When the fair value of a derivative contract is negative, the Bank owes the counterparty and, therefore, does not possess credit risk. The Bank minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties whose credit rating is acceptable under the Guide of Investment Policy of the Bank.

Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest-rate contracts is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

The Bank assesses interest rate cash flows risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities. The Bank maintains risk management control systems to monitor interest rate cash flow risk attributable to both the Bank's outstanding or forecasted debt obligations as well as the Bank's offsetting hedge positions. The risk management control systems involve the use of analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on the Bank's future cash flows.

The Bank uses variable-rate debt to finance its operations. The debt obligations expose the Bank to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of a portion of its interest payments. To meet this objective, management enters into interest rate swap agreements to manage fluctuations in cash flows resulting from interest rate risk. These swaps change the variable rate cash flow exposure on the debt obligations to fixed cash flows. Under the terms of the interest rate swaps, the Bank receives variable interest rate payments and makes fixed interest rate payments, thereby creating the equivalent of fixed-rate debt.

(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 for the defined benefit pension plan and the defined contribution plan during the year ended June 30, 2004 amounted to approximately $1,755,274. The Bank's contributions during the years ended June 30, 2004, 2003, and 2002 amounted to approximately $1,732,562, $1,810,000, and $1,443,000, respectively. These amounts represented 100% of the required contribution for the corresponding year. Individual information for each option is not available since the allocation is performed by the retirement system itself.

Additional information on the Retirement System is provided in its stand-alone financial statements for the year ended June 30, 2004, 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 2004 amounted to approximately $1.2 million.

At June 30, 2004, the minimum annual future rentals under noncancelable leases were as follows:

Year ending June 30:		
2005	$	582,878
2006		457,300
Total	$	1,040,178

(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 or its use granted to the Museum for an indefinite period of time.

During fiscal year 2004, 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 2004. This contribution is included in contributions to others in the accompanying financial statements.

(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, 2004, disbursements amounted to $3.8 million.

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, 2004, amounts drawn against the line of credit amounted to $90,917,757.

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.

On December 21, 2004, the Governor of the Commonwealth issued an executive order establishing the creation, through the Bank, of an irrevocable trust to guarantee compliances with the abovementioned Joint Resolutions. As established by the order, the Bank will fund into the trust the previously unfunded amounts authorized under the Joint Resolutions. The beneficiary of the trust will be the Special Communities Trust.

(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. As of June 30, 2004 the Bank has contributed $5 million to the Cooperative Development Investment Fund.

(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, 2004, the Authority was custodian of $37,756 in restricted funds of the Puerto Rico Urban Renewal and Housing Corporation (CRUV, as per its Spanish acronym). As of June 30, 2004, 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, 2004, the Authority was the custodian of approximately $420,000 designated 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 Housing Bank and Agency entered into an agreement to securitize approximately $20.7 million of mortgage loans into a FNMA certificate. The Housing Finance Authority 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, 2004, the aggregate outstanding principal balance of the loans pooled into the FNMA certificate amounts to $1,246,385.

(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, 2004, the principal balance of the mortgage loans serviced for others is as follows:

CRUV or its successor without guaranteed mortgage loan payments	$	88,141
Other investors, with guaranteed mortgage loan payments		529,029
Total	$	617,170

(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.

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.

Resulting from the above-mentioned foreclosure proceedings, several of the principals of the Cayo Largo Hotel development (Cayo Largo Resort Associates, Cayo Largo Hotel, and D. Group Equity Holdings) have counterclaimed by filing complaints for alleged damages and breach of contract by the Tourism Fund aggregating to approximately $210 million. In addition, United States Fidelity and Guaranty Company (the insurer) has filed an action to obtain a declaration that it is not bound to perform under the performance and payment bond executed in connection with the construction and development of the project. All the counterclaims and other actions, the last of which was filed on February 11, 2004, are in early discovery stages.

On May 29, 2004, a settlement and release agreement to the suit filed by JER Revenue Services P.R. (JER), after the Public Finance Corporation (the Corporation) cancelled the servicing agreement it had with JER and dated February 1, 1999, was reached between the Corporation, the CRIM (together with the Corporation hereinafter referred to as Defendants), and JER. All parties herein mentioned agreed the following: the Corporation and CRIM would pay to JER the sum of $4.7 million, the settlement amount, and JER, in consideration of this settlement amount fully releases, acquits, and discharges the Defendants from any claim, suit, or any liability that JER had against them.

As part of the above, the Defendants agreed between them the following: each party will assume 50% of the cost of the settlement ($4.6 million), and the $7 million deposited in court would be distributed in the same proportion (50/50) between the Defendants and other assets as per the identified source or purpose.

As a result of the settlement agreement, the Corporation adjusted the balance of the legal claims reserve, but accrued a transfer to the Bank for the amount of assets remaining after the liquidation to partially compensate certain Bank losses of prior years associated with the tax debt collateralized bonds previously issued and early redeemed liens transaction. The effect was a net decrease in liabilities of $6.9 million.

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

The Public Finance Corporation has issued approximately $6.1 billion of Commonwealth appropriation bonds (the Bonds) maturing at various dates through 2031. The proceeds of the Bonds, except for approximately $1.7 billion, 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 $1.7 billion referred to above was used to refund a portion of certain bonds issued by the Public Finance Corporation (also no-commitment debt) between fiscal years 1995 and 2000. The outstanding balance of the Bonds at June 30, 2004 amounted to approximately $4.3 billion.

The Bonds are limited obligations of the Public Finance Corporation and, except to the extent payable from bond proceeds and investment earnings thereon, will be 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, 2004, 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	$	94,598,532
Restricted liabilities (no commitment debt)		79,001,654
Restricted fund balance	$	15,596,878
Excess of fund expenses over revenues	$	594,881

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 2004 in connection with the administration of the U.S. Housing Act Section 8 Program amounted to $113,743,876. These amounts exclude $4,419,746 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, 2004, 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.

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at June 30, 2004:

	Reported or notional amount	Fair value
	(In millions)	
Financial assets:		
Cash and due from banks	$ 57	57
Federal funds sold and securities purchased under agreement to resell	1,004	1,004
Deposits placed with banks	314	314
Investments and investment contracts	3,276	3,340
Loans to public sector entities and municipalities	3,681	3,954
Accrued interest receivable and other receivable	137	137
Financial liabilities:		
Demand deposits	1,704	1,704
Certificates of deposit	2,109	2,109
Certificates of indebtedness	252	252
Securities sold under agreement to repurchase	160	160
Commercial paper	918	918
Due to Commonwealth of Puerto Rico	8	8
Accounts payable and accrued liabilities	106	106
Accrued interest payable	12	12
Bonds and notes payable	1,629	2,410
Derivative instruments:		
Interest rate exchange agreements	1,533	(27)
Equity index option embedded in certificate of deposit	200	(13)

(20) Interfund Balance and Transfers

Following is a summary of the interfund balances as of June 30, 2004:

Receivable by Fund	Payable by Fund	Purpose	Interfund balances	
Governmental funds:	Enterprise funds:			
Key for Your Home Program	Housing Finance Authority	Advance for subsidiaries	$ 172,239	
Other nonmajor fund (Special Obligation Refunding Bonds – Debt Service)	Housing Finance Authority	Collection of mortgages of debt service fund	7,842,632	
New Secure Housing Program	Housing Finance Authority	Reimbursement of loan originations	3,325	
Other nonmajor fund (Portfolio IV)	Other nonmajor fund (Portfolio IV)	Reimbursement of bond issue costs	2,527,427	*
New Secure Housing Program	GDB Operating Fund	Demand deposit and accrued interest	20,445	
Other nonmajor fund (Law 115)	GDB Operating Fund	Demand deposit and accrued interest	140	
Other nonmajor fund (Law 124)	GDB Operating Fund	Demand deposit and accrued interest	690,378	
Special Obligation Refunding Bonds – Debt Service	GDB Operating Fund	Demand deposit and accrued interest	6,878,338	
Key for Your Home Program	GDB Operating Fund	Demand deposit and accrued interest	603	
Other nonmajor fund (Stage 7)	GDB Operating Fund	Demand deposit and accrued interest	18,095,115	
Affordable Housing Mortgage Subsidy Program (Stage 8)	GDB Operating Fund	Certificates of deposit and interest	73,694,953	
Enterprise funds:	Governmental funds:			
Housing Finance Authority	Other nonmajor fund (Law 72)	Reimbursement of expenditures	(252,559)	
Housing Finance Authority	Other nonmajor fund (Law 124)	Reimbursement of expenditures	(564,892)	
Housing Finance Authority	Other nonmajor fund (Special Obligation Refunding Bonds – Debt Service)	Reimbursement of expenditures	(40,000)	*
Housing Finance Authority	Other nonmajor fund (Stage 7)	Reimbursement of expenditures	(16,005,845)	
GDB Operating Fund	Other nonmajor fund (Stage 7)	Securities purchase under agreement to resell and interest	(59,914,061)	
GDB Operating Fund	Affordable Housing Mortgage Subsidy Program (Stage 8)	Loans and interest	(43,439,897)	
GDB Operating Fund	Affordable Housing Mortgage Subsidy Program (Stage 9)	Loans and interest	(93,381,267)	*
GDB Operating Fund	New Secure Housing Program (SRF)	Loans and interest	(13,844,637)	
Total internal balances, net			$ (117,517,563)	

Receivable by Fund	Payable by Fund	Purpose	Interfund balances
Enterprise funds:	Enterprise funds:		
Housing Finance Authority	GDB Operating Fund	Demand deposit and accrued interest	$ 32,352,432
Development Fund	GDB Operating Fund	Demand deposit and accrued interest	12,661,304
Tourism Development Fund	GDB Operating Fund	Demand deposit and accrued interest	13,848,872
Public Finance Corporation	GDB Operating Fund	Demand deposit and accrued interest	5,823,111
Education Assistance Corporation	GDB Operating Fund	Demand deposit and accrued interest	2,084,259
José M. Berrocal Institute	GDB Operating Fund	Demand deposit and accrued interest	409,109
Housing Finance Authority	GDB Operating Fund	Certificates of deposit and interest	224,104,801
Tourism Development Fund	GDB Operating Fund	Certificates of deposit and interest	49,641,867
Housing Finance Authority	GDB Operating Fund	Guarantee investment contract	206,451,495
GDB Operating Fund	Housing Finance Authority	Bonds payable	93,875,159
GDB Operating Fund	Housing Finance Authority	Loans and accrued interest	1,801,207
GDB Operating Fund	Tourism Development Fund	Loans and accrued interest	261,768,728
GDB Operating Fund	Housing Finance Authority	Securities purchased under agreement to resell and accrued interest	44,548,381
GDB Operating Fund	Public Finance Corporation	Other	4,748,063
GDB Operating Fund	Housing Finance Authority	Other	257,020
Total balances among enterprise funds eliminated			$ 954,375,808

* These balances are not expected to be collected/paid within the next fiscal year.

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	Transfer	$ 698,399
Other nonmajor fund (Portfolio III)	Housing Finance Authority	Transfer	833,338
Other nonmajor fund (Portfolio IV)	Housing Finance Authority	Transfer	3,221,975
Other nonmajor fund			
Affordable Housing Mortgage Subsidy			
Program (Stage IX)	Housing Finance Authority	Transfer	11,605,389
Governmental funds:	Governmental funds:		
Other nonmajor funds (Stage VII)	Key for your Home Program	Transfer	44,753,548
Other nonmajor fund (Portfolio I)	Other nonmajor funds (Portfolio IV)		41,350
Enterprise funds:	Governmental funds:		
Housing Finance Authority	Other nonmajor funds (Portfolio I)	Transfer	67,252
Housing Finance Authority	Other nonmajor fund (Portfolio IV)	Transfer	8,775
Enterprise funds:	Enterprise funds:		
GDB Operating Fund	Other nonmajor funds		
	(JMBI Operating Fund)	Transfer	247,611
Public Finance Corporation	GDB Operating Fund	Transfer	4,748,063

(21) Subsequent Events

On September 10, 2004, the Tourism Fund increased its guarantee on the Coco Beach Golf & Country Club to secure AFICA bonds in the amount of $7,497,854 to be used to finance certain cost overruns from the construction of the golf course and the club house. These bonds will begin to amortize in 2008; until then, they will accrue $1,907,146 in interest where the total risk exposed by the Tourism Fund will amount to $9,405,000.

On August 18, 2004 and September 30, 2004, the Authority sold mortgage loans with an outstanding balance of approximately $65 million. The net proceeds from the sale of such loans amounted to approximately $69 million, resulting in a gain on sale of approximately $4 million.