



**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**  
(A Component Unit of the Commonwealth of Puerto Rico)  
Basic Financial Statements and  
Required Supplementary Information  
June 30, 2014  
(With Independent Auditors' Report Thereon)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**  
**(A Component Unit of the Commonwealth of Puerto Rico)**

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## **Independent Auditors' Report**

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 the Government Development Bank for Puerto Rico (the Bank), a component unit of the Commonwealth of Puerto Rico (the Commonwealth), as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Bank's basic financial statements as listed in the table of contents.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement.

### ***Auditors' Responsibility***

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

### ***Opinions***

In our opinion, the financial statements referred to above present fairly in all material respects, the respective financial position of the governmental activities, business-type activities, each major fund, and the aggregate remaining fund information of the Government Development Bank for Puerto Rico as of June 30, 2014, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with U.S. generally accepted accounting principles.



***Emphasis of Matters***

*Uncertainty about Ability to Continue as a Going Concern*

The accompanying financial statements have been prepared assuming that the Bank (including its blended component units) will continue as a going concern. As discussed in note 4 to the financial statements, the Commonwealth and its public entities have not been able to repay their loans from the Bank, which has significantly affected the Bank's liquidity and ability to repay its obligations. These matters raise substantial doubt about the Bank's (including its blended component units) ability to continue as a going concern. Management's plans in regards to these matters are also described in note 4 to the financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinions are not modified with respect to this matter.

*Adoption of New Accounting Pronouncement*

As discussed in note 2 to the financial statements, in fiscal year 2014, the Bank adopted Governmental Accounting Standards Board Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Our opinions are not modified with respect to this matter.

***Other Matter***

*Required Supplementary Information*

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3 to 20 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**KPMG LLP**

July 5, 2016

Stamp No. E220568 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report.

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**Management's Discussion and Analysis**

This management's discussion and analysis section ("MD&A") provides a narrative overview and analysis of the financial activities of Government Development Bank for Puerto Rico and its component units (the "Bank" or "GDB") as of and for the year ended June 30, 2014. This MD&A is intended to serve as an introduction to GDB's basic financial statements, which have the following components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the basic financial statements. The following presentation is by necessity highly summarized, and in order to gain a thorough understanding of GDB's financial condition, the financial statements, including the notes thereto, and required supplementary information should be reviewed in their entirety.

**Financial Highlights**

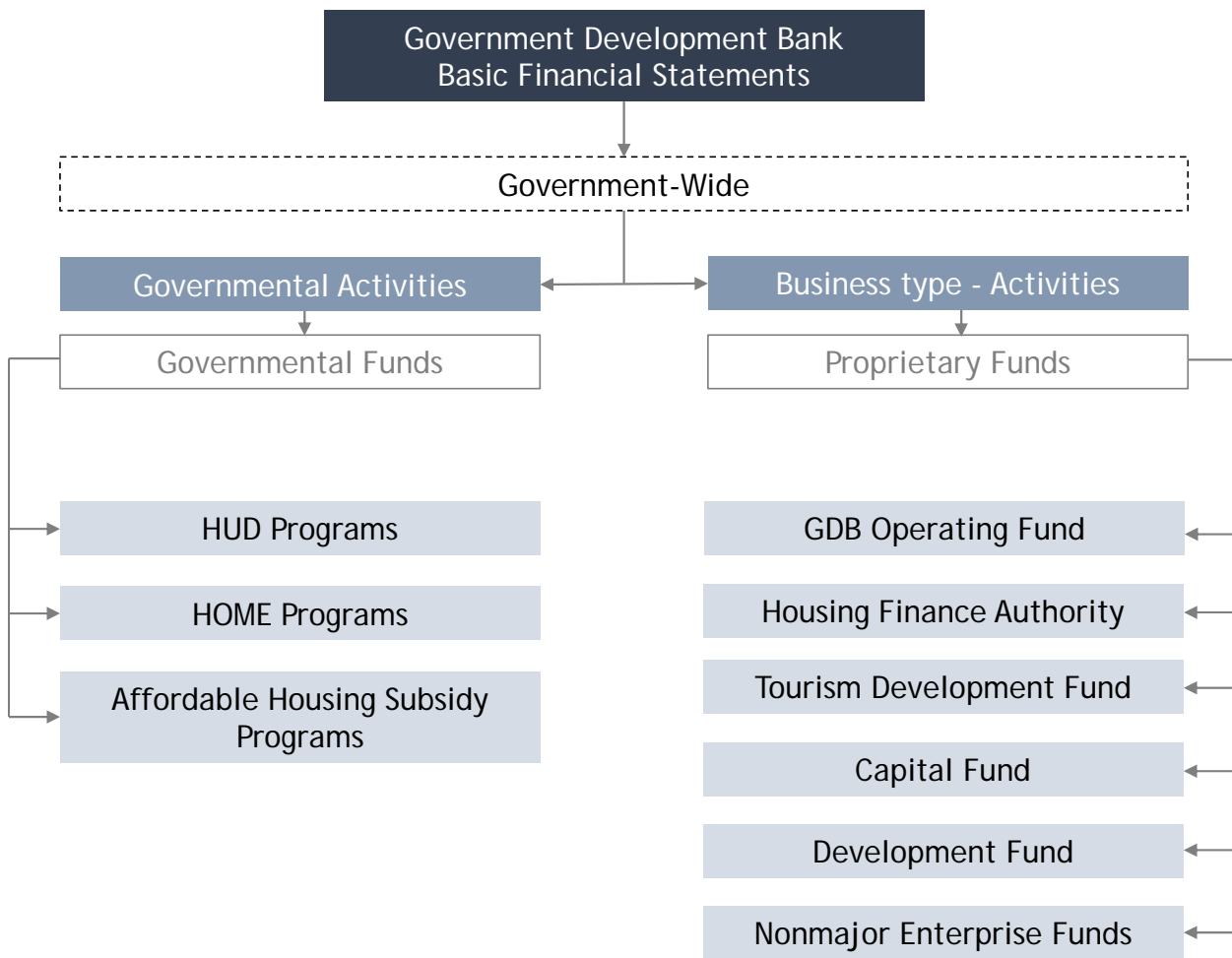
- The Bank adopted Governmental Accounting Standards Board ("GASB") Statement No. 65, *Items Previously Reported as Assets and Liabilities* ("GASB Statement 65"), effective July 1, 2013, and has applied it retroactively to the financial statements for all periods presented. GASB Statement 65 requires, among other things, that (1) deferred loss on refunding be reported as a deferred outflow of resources, (2) debt issuances costs are to be recognized as an expense in the period incurred and can no longer be deferred and amortized over the life of the debt, (3) loan origination fees, net of costs, are to be recognized in the period incurred and can no longer be deferred and amortized over the life of the loan, and (4) fees received for a commitment to originate or purchase a loan or group of loans should be recorded as a liability and, if the commitment is exercised, recognized as revenue in the period of exercise, and can no longer be deferred and amortized over the life of the loan as an adjustment of yield. As a result of the implementation of GASB Statement 65, the beginning net position of the Bank, as restated, decreased by approximately \$7.6 million.
- Total assets government-wide at June 30, 2014 amounted to \$10,347 million, a decrease of \$3,979 million, or 27.8%, from \$14,326 million at June 30, 2013. For fiscal year 2014, liabilities decreased by \$1,281 million, or 10.7%, to \$10,666 million at June 30, 2014 from \$11,947 million at June 30, 2013.
- Net position government-wide decreased from \$2,372 million at June 30, 2013 (as restated) to a deficit of approximately \$316 million at June 30, 2014. The decrease in net position of \$2,688 million in fiscal year 2014 is composed of a negative change in net position of approximately \$2,685 million from Business-Type Activities, impacted by a provision for loan losses of approximately \$2,552 million and a negative change in net position of approximately \$2.4 million from Governmental Activities. The ratio of net position to total assets decreased to .03% at June 30, 2014 from 16.6% at June 30, 2013.
- The operating income of the GDB Operating Fund decreased from \$178.9 million in 2013 to a loss of \$2,704 million, or a decrease of \$2,882.9 million in fiscal year 2014, impacted by a provision for loan losses of approximately \$2,512 million recognized during fiscal 2014.
- Interest income on loans in the GDB Operating Fund amounted to \$332.3 million in 2014, a decrease of \$173.9 million over the prior year. This decrease mainly relates to the reversal of interest income, net of subsequent collections, on non-accrual loans on the public sector loan portfolio of approximately \$204 million.
- The Bank collected a portion of the scheduled appropriation debt service for the fiscal year 2014 (approximately \$34.9 million of principal and \$190.6 million of interest). However, the significant delays experienced in the collection of a substantial portion of its public sector loan portfolio, coupled with the Bank's inability to monetize its loan portfolio either through individual loan sales or bundled loan sale transactions in the capital markets, have negatively impacted the Bank's cash flows from operations during the last two fiscal years. These trends are expected to continue absent a capital market transaction, agreement with its creditors, and payment by the Commonwealth of Puerto Rico (the "Commonwealth") of its appropriation lines of credit as budgeted. These events led management to assess the accruing status of its public sector loan portfolio and determined, based on the uncertainty surrounding the timely collection of interest on this portfolio, that non-accrual status on a substantial portion of its public sector loan portfolio is more appropriate. This assessment included the evaluation of the inherent credit risk the public sector loan portfolio bears and the need to recognize the imminent losses associated to such

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risk. For the first time in the history of the Bank, the Bank recognized a significant amount (approximately \$2,512 million) in provision for loan losses to reflect the effect of the estimated shortfall in the expected future debt service payments on this portfolio. The Bank considered both the primary and ultimate source of repayment on this portfolio and determined that most of the loans will be paid from debt appropriations assigned by the Commonwealth's Legislature. Therefore, the capacity of the Commonwealth's general fund to appropriate such debt service payments in the future was the principal factor considered while performing the credit risk analysis. Refer to Business-Type Activities section below and the accompanying financial statements and footnotes thereto, for additional information.

**Overview of the Financial Statements**

GDB's financial statements consist of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the basic financial statements. The following chart illustrates the structure of GDB for financial reporting purposes:



**(a) 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.

- (1) Statement of Net Position** – This statement provides information on the Bank's assets, deferred outflows of resources and liabilities, with the difference between the assets plus deferred outflow of resources less liabilities

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reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the Bank is improving or eroding.

- (2) **Statement of Activities** – This statement presents information on how the Bank's net position changed during the reporting period. All changes in net position are reported as soon as the underlying events giving rise to the change occurs, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods.

In the Statement of Net Position and the Statement of Activities, GDB's operations are divided into two kinds of activities:

- (1) **Governmental Activities** – Governmental Activities generally are financed through intergovernmental revenues and other non-exchange revenues.
- (2) **Business-Type Activities** – Business-Type Activities are financed in whole or in part by fees charged for goods or services and interest earned on investment securities and loans.

### *(b) Fund Financial Statements*

A fund is a fiscal and accounting entity with a self-balancing set of accounts that the Bank uses to keep track of specific sources of funding and spending for a particular purpose. The Bank's funds are divided into the following two categories:

- (1) **Governmental Funds**– Governmental Funds are used to account for the functions reported as Governmental Activities in the government-wide financial statements. However, unlike the government-wide financial statements, the Governmental Funds 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 fund statement of revenues, expenditures and changes in fund balances (deficit) provide a reconciliation to facilitate this comparison between Governmental Funds and Governmental Activities.

- (2) **Proprietary Funds**– Proprietary Funds provide the same type of information as the Business-Type Activities in the government-wide financial statements, but in more detail. The proprietary fund financial statements of the Bank provide separate information on the Business-Type Activities of the Bank's blended component units.

### *(c) Notes to the Basic Financial Statements*

The notes to the basic financial statements 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.

### **Government-Wide Financial Analysis**

Total assets, deferred outflow of resources, and total liabilities of the Bank at June 30, 2014, amounted to \$10,347 million, \$2.872 million and \$10,666 million, respectively, for a net deficit of \$316 million or .03% of total assets. Within assets, investments and investment contracts, loans receivable, accrued interest receivable, capital assets, other receivables and other assets show the most significant decline of \$800 million, \$3.2 billion, \$97.5 million, \$79.2 million, \$71.4 million and \$34.7 million respectively, over fiscal year 2013 ending balances. The proportion of investments and investment contracts to total assets decreased to 21.4% in 2014 from 21% in 2013.

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Loans receivable of \$6,382 million, net of an allowance for loan losses of approximately \$2,699 million, shows a decrease of \$3,279 million or 33.9%, from fiscal 2013 to 2014. The allowance for loan losses at the Government-Wide level was impacted by a provision for loan losses of approximately \$2,551 million, recognized during fiscal year 2014 in the Proprietary Funds. Loans as a percentage of total assets decreased 5.5% from 67.2% at the end of fiscal year 2013 to 61.7% at June 30, 2014.

**(d) Governmental Activities**

Total assets of Governmental Activities amounted to approximately \$91.1 million at June 30, 2014. Total liabilities amounted to \$220.8 million, for a net position (deficit) of \$129.7 million. Net position (deficit) has been broken down into amounts restricted for affordable housing programs of \$324,000, and the unrestricted component of net position (deficit) of approximately \$130 million, which means that the restriction on the use of available assets will not allow the Bank to satisfy its existing liabilities from those assets, and therefore, the Bank will depend on future Commonwealth appropriations for the repayment of part of its obligations. However, there is no assurance that the Legislative Assembly of the Commonwealth (the "Legislature") will authorize such appropriations in the future.

Condensed financial information on assets, liabilities and net position (deficit) of Governmental Activities as of June 30, 2014 and 2013, as restated, is shown below (in thousands):

	<b>June 30,</b>		<b>Change</b>	
	<b>2014</b>	<b>2013</b>	<b>Amount</b>	<b>Percent</b>
Assets:	(as restated)			
Cash and due from banks, and deposits placed with banks	\$ 5,919	\$ 16,143	\$ (10,224)	-63.33%
Investments and investment contracts	72,648	62,027	10,621	17.12%
Other assets	12,521	11,366	1,155	10.16%
Total assets	<u>91,088</u>	<u>89,536</u>	<u>1,552</u>	<u>1.73%</u>
Liabilities:				
Accounts payable and accrued liabilities	33,882	36,989	(3,107)	-8.40%
Notes payable – due in more than one year	3,434	3,431	3	0.09%
Total liabilities before internal balances	<u>37,316</u>	<u>40,420</u>	<u>(3,104)</u>	<u>-7.68%</u>
Internal balances	183,441	176,372	7,069	4.01%
Total liabilities	<u>220,757</u>	<u>216,792</u>	<u>3,965</u>	<u>1.83%</u>
Net position (deficit):				
Investment in capital assets	\$ 2	\$ 5	\$ (3)	-60.00%
Restricted for affordable housing programs	324	20,009	(19,685)	-98.38%
Unrestricted position (deficit)	<u>(129,995)</u>	<u>(147,270)</u>	<u>17,275</u>	<u>-11.73%</u>
Total net position (deficit)	<u>\$ (129,669)</u>	<u>\$ (127,256)</u>	<u>\$ (2,413)</u>	<u>1.90%</u>

Investments and investment contracts amounted to \$72.6 million and, together with cash and due from banks and deposits placed with banks of \$5.9 million, account for the majority of the assets held by Governmental Activities. These assets are restricted to provide funds for the execution of the various affordable and other housing programs managed by the Puerto Rico Housing Finance Authority (the "Housing Finance Authority"). Other assets are mainly restricted and are composed mostly of amounts due from the HUD and HOME federal programs. Accrued liabilities mainly consist of unpaid expenditures related to the HOME Program fund and of subsidies payable on various housing programs.



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Condensed financial information on expenses, program revenues and changes in net position (deficit) of Governmental Activities during the years ended June 30, 2014 and 2013 (as restated) is shown below (in thousands):

	<b>Year ended June 30, 2014</b>		
	<b>General</b>	<b>Housing</b>	
	<b>government</b>	<b>assistance</b>	<b>Total</b>
	<b>programs</b>	<b>programs</b>	
Expenses	\$ 5,525	\$ 172,436	\$ 177,961
Program revenues:			
Charges for services – financing and investment	-	4,105	4,105
Operating grants and contributions	-	163,522	163,522
Net expenses	<u>\$ (5,525)</u>	<u>\$ (4,809)</u>	<u>\$ (10,334)</u>
Transfers-in			7,921
Change in net position (deficit)			(2,413)
Net position (deficit) – beginning of year (as restated)			(127,256)
Net position (deficit) – end of year			<u><u>\$ (129,669)</u></u>

	<b>Year ended June 30, 2013</b>		
	<b>General</b>	<b>Housing</b>	
	<b>government</b>	<b>assistance</b>	<b>Total</b>
	<b>programs</b>	<b>programs</b>	
Expenses	\$ 6,884	\$ 230,365	\$ 237,249
Program revenues:			
Charges for services – financing and investment	-	3,923	3,923
Operating grants and contributions	-	170,501	170,501
Net expenses	<u>\$ (6,884)</u>	<u>\$ (55,941)</u>	<u>\$ (62,825)</u>
Transfers-in			1,226
Change in net position (deficit)			(61,599)
Net position (deficit) – beginning of year (as restated)			(65,657)
Net position (deficit) – end of year			<u><u>\$ (127,256)</u></u>

**Governmental Fund Results**

Operating grants and contributions decreased by \$7 million when compared to the prior year, from \$170.5 million in 2013 to \$163.5 million in 2014. The decrease is mainly related to the HOME Program because it received approximately \$12 million less in federal funds than in fiscal year 2013.

The loss in the operations of the Governmental Funds is mainly related to the fact that the Housing Finance Authority is subsidizing certain housing assistance programs with internally generated funds. During 2014, the change in net position (deficit) of the Governmental Activities increased by \$2.4 million from a deficit of \$127.2 million during the year ended in June 30, 2013, to a deficit of \$129.6 million during the year ended June 30, 2014. Such increase is mainly related to the continued use of the Housing Finance Authority's assets to provide subsidies to the citizens through housing assistance programs.

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An analysis of the financial position and results of operations of the Bank's major Governmental Funds follows:

**(e) HUD Programs**

This fund accounts for the U.S. Housing Act Section 8 programs administered by the Housing Finance Authority under the authorization of the U.S. Department of Housing and Urban Development (HUD). Presently, the Housing Finance Authority operates three programs whereby low-income families receive directly or indirectly subsidies to pay for their rent. The housing vouchers program enables families to obtain rental housing in a neighborhood of their choice. The other programs are project-based subsidies whereby housing developers are given incentives to keep their properties available for certain markets. The expenditures of the HUD programs increased \$2 million from \$141 million in 2013 to \$143 million in 2014 because additional vouchers were awarded when compared to the previous year.

**(f) HOME Program**

On July 31, 2014, the Governor of the Commonwealth (the "Governor") signed the HOME Voluntary Repayment Settlement Agreement (the Agreement) with HUD. The Agreement establishes the reimbursement to the HOME program of \$14.2 million, from nonfederal funds, for disallowed expenditures in connection with HUD-funded projects, as defined and described in the Agreement, in two installments of \$10 million and \$4.2 million due on October 1, 2014 and October 1, 2015, respectively. During the year ended June 30, 2014, the Affordable Housing Subsidy Program paid \$624,403 to the Home Program to cover the installment payments due under the \$1.8 million repayment plan. At June 30, 2014, the total liability amounted to approximately \$16 million and is included in accounts payable and accrued liabilities of Governmental Activities. This fund accounts for funds received from HUD for the administration of the HOME Program. The main purpose of this program is to increase the supply of decent and affordable housing for low and very low income families. The expenditures of the HOME Program amounted to approximately \$10 million for the fiscal year ended June 30, 2014, a decrease of \$12 million over the expenditures of the previous fiscal year. This decrease resulted from a hold from HUD to use program's funds, as a result of the requirements of the Agreement.

**(g) Affordable Housing Mortgage Subsidy Programs**

Affordable Housing Mortgage Subsidy Programs ("AHMSP") Act No. 124 – This fund is used to account for the proceeds of specific local revenue sources under the different subsidy programs. During 2014, approximately \$21 million was granted in subsidies of various programs.

At June 30, 2014, the Housing Finance Authority had various Governmental Funds in a deficit position. The Housing Finance Authority expects to cover these deficits through contributions from the Commonwealth. Refer to note 21 to the basic financial statements for additional information on these funds.

**Business-Type Activities**

Condensed financial information on assets, liabilities, deferred outflow of resources and net position as of June 30, 2014 and 2013 (as restated), is presented below (in thousands):

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	June 30,		Change	
	2014	2013 (as restated)	Amount	Percent
<b>Assets:</b>				
Cash and due from banks	\$ 80,272	\$ 65,017	\$ 15,255	23.46%
Federal funds sold and securities purchased under agreements to resell	605,987	450,000	155,987	34.66%
Deposits placed with banks	731,177	554,507	176,670	31.86%
Investments and investment contracts	2,143,548	2,953,531	(809,983)	-27.42%
Loans receivable – net	6,382,367	9,661,520	(3,279,153)	-33.94%
Accrued interest receivable	177,687	275,001	(97,314)	-35.39%
Real estate available for sale	82,546	65,595	16,951	25.84%
Other receivable, net	31,247	102,734	(71,487)	-69.58%
Other assets	630	1,282	(652)	-50.86%
Internal balances	183,441	176,372	7,069	4.01%
Capital assets	20,722	99,923	(79,201)	-79.26%
Total assets	<u>\$ 10,439,624</u>	<u>\$ 14,405,482</u>	<u>\$ (3,965,858)</u>	<u>-27.53%</u>
<b>Deferred outflow of resources:</b>				
Deferred loss on refundings	\$ 2,872	\$ 3,161	\$ (289)	-0.09%
<b>Liabilities:</b>				
<b>Deposits:</b>				
Demand	\$ 2,415,151	\$ 3,087,710	\$ (672,559)	-21.78%
Certificates of deposit	2,799,388	2,488,960	310,428	12.47%
Securities sold under agreements to repurchase	50,000	634,301	(584,301)	-92.12%
Accrued interest payable	41,998	48,952	(6,954)	-14.21%
Accounts payable, accrued liabilities, and other liabilities	368,226	359,651	8,575	2.38%
Bonds, notes, and mortgage-backed certificates payable:				0.00%
Due in one year	514,958	424,743	90,215	21.24%
Due in more than one year	4,439,080	4,865,381	(426,301)	-8.76%
Total liabilities	<u>\$ 10,628,801</u>	<u>\$ 11,909,698</u>	<u>\$ (1,280,897)</u>	<u>-10.76%</u>
<b>Net position:</b>				
Net investment in capital assets	\$ 9,352	\$ 89,609	\$ (80,257)	-89.56%
<b>Restricted for:</b>				
Mortgage loan insurance	72,545	64,954	7,591	11.69%
Affordable housing programs	32,264	35,941	(3,677)	-10.23%
Debt service	43,132	66,114	(22,982)	-34.76%
Other housing programs	1,357	693	664	95.82%
Unrestricted net position (deficit)	(344,954)	2,241,634	(2,586,588)	-115.39%
Total net position	<u>\$ (186,304)</u>	<u>\$ 2,498,945</u>	<u>\$ (2,685,249)</u>	<u>-107.46%</u>

**(h) Federal Funds Sold and Deposits Placed with Banks**

The Bank increased its federal funds sold by \$156 million, from \$450 million at June 30, 2013, to \$606 million at June 30, 2014. Deposits placed with banks increased by \$177 million, from \$555 million to \$731 million.

**(i) Investments and Investment Contracts**

Investments and investment contracts held in Business-Type Activities amounted to \$2,144 million at June 30, 2014. This amount represents a decrease of \$810 million or 27.4% when compared to the prior year balance of \$2,954 million. The investment portfolio has consisted primarily of U.S. Treasury Notes and U.S.-sponsored agency notes and

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mortgage-backed securities with very high credit ratings, reflecting the Bank's prudent and conservative investment policies. Most of the securities in the Bank's investment portfolio are AAA to A rated securities. The investment portfolio comprised 17.8% of the total assets of the Bank's Business-Type Activities at June 30, 2014, down by 2.7% as compared to 20.5% at the close of fiscal year 2013. Within the investment securities portfolio, \$297 million at June 30, 2014 and \$925.6 million at June 30, 2013, were restricted or pledged as collateral or payment source for specific borrowings.

**(j) *Loans Receivable, Allowance for Loan Losses and Allowance for Loan Losses on Guarantees and Letters of Credit***

Net loans receivable decreased by \$3,279 million or 33.9%, from the \$9,661 million balance at June 30, 2013 (as restated), to \$6,382 million at June 30, 2014, mainly as a result of the provision for loan losses of approximately \$2,551 million recorded during the fiscal year. The Bank's basic role is to provide financing support to the Commonwealth and its public entities and municipalities and other operational needs. To support the governmental efforts of improving and stimulating the Island's economy, the Bank also finances the development and construction of infrastructure, housing projects and hotels.

Loans to municipalities had a net increase of \$2.4 million over the prior year balance.

The estimates for recording incurred losses in the loan portfolio involve significant management judgment based on observable facts and circumstances, mostly those related to the ultimate source of repayment. For example, the original source of repayment of many loans granted to the Commonwealth and agencies evolved around the capacity to bond out such loan in capital/municipal markets. In those cases, the original loan documents identified such vehicle to access liquidity. In the case of loans granted to public corporations, even when the operating results and/or debt appropriations served as the original source of repayment, the Commonwealth limitations to timely provide for those payments are also considered by senior management.

The Bank considers the public sector loan portfolio as impaired based on current information and events, including the significant delays in the receipt of the scheduled debt service payment mentioned above. In management's opinion, it is highly probable that the Bank will be unable to collect all amounts due according to the loan's original contractual terms. The Bank's management used the results of their Fiscal and Economic Growth Plan (FEGP) specifically the set of cash flows and assumptions related to the forecast of the financing gaps for the next ten fiscal years for those entities within the FEGP, including the measures that could be implemented to reduce such gaps, to estimate the potential future debt service payments on its public sector loan portfolio including those payable from appropriations from the Commonwealth of Puerto Rico Legislature Assembly (the Legislature) establish an allowance for loans losses. Specifically, the Bank established an allowance for losses on these impaired, loans based on management's estimate of the present value of expected debt service payments discounted at the loans' effective interest rate. The Bank determined that as the ultimate source of repayment on this portfolio is the same, the general fund and/or appropriations from the Legislature, the allowance was determined for the related loans on a collective basis instead of on a loan by loan basis. To the extent the FEGP did not include specific entities, the Bank then individually evaluated for impairment the outstanding loans corresponding to those entities.

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In relation to interest income recognition, for loans to public sector entities, the Bank classified loans as nonaccrual when management determined that all of the following characteristics were present: (a) a loan was six months past due; (b) it had no current source of repayment; (c) it was not covered by a formal commitment from the Commonwealth; and (d) it did not have designated collateral or such collateral is insufficient. Based on these four elements, all of which had to simultaneously be present, the loan was placed in nonaccrual status and all accrued interest receivable was reversed from interest income. Interest income on nonaccrual loans was thereafter recognized as income only to the extent actually collected. Nonaccrual loans were returned to an accrual status when management had adequate evidence to believe that the loans would perform as contracted. However, based on the recent events previously and hereafter explained the Bank modified the interest income recognition policy during 2014, to classify a specific loan as nonaccrual if any of the following characteristics are present: (a) a significant delay (implies the collection of the recorded investment in a time frame significantly different from the terms and conditions, usually one year,) in the repayment of the loan is experienced; (b) the loan has no current source of repayment; (c) it is not covered by a formal commitment from the Commonwealth; and (d) it does not have a designated collateral or such collateral is insufficient. If any of these characteristics are present, the loan is placed in non-accrual. Once a loan is placed in nonaccrual status, all accrued interest receivable is reversed from interest income. Interest income on non-accrual loans is thereafter recognized as income only to the extent actually collected. Nonaccrual loans are returned to an accrual status when there is adequate evidence to believe that the loans will be performing as contracted. The accompanying financial statements include a reversal of interest income amounting to approximately \$204 million related to the implementation of this methodology.

As of June 30, 2014, the changes in the allowance for loan losses in the Proprietary Funds were as follows:

	<b>Proprietary Funds</b>				
	<b>GDB</b>	<b>Tourism</b>	<b>Housing</b>		
	<b>Operating</b>	<b>Development</b>	<b>Finance</b>	<b>Development</b>	<b>Total</b>
	<b>Fund</b>	<b>Fund</b>	<b>Authority</b>	<b>Fund</b>	
Balance – beginning of year	\$ 4,264	\$ 178,721	\$ 37,742	\$ 16,937	\$ 237,664
Provision for loan losses	2,512,463	30,092	1,598	7,309	2,551,462
Write-offs	-	(86,116)	(4,612)	-	(90,728)
Recoveries	-	-	716	-	716
Balance – end of year	<u>\$ 2,516,727</u>	<u>\$ 122,697</u>	<u>\$ 35,444</u>	<u>\$ 24,246</u>	<u>\$ 2,699,114</u>

Allowance for loan losses collective loans

The provision for loan losses in the GDB Operating Fund includes approximately \$2,500 million to provide for inherent credit losses of the public sector loan portfolio which were not individually evaluated for impairment and thus don't carry an individual impairment reserve. The Bank calculated this allowance following the guidelines previously mentioned.

This general allowance includes the provision for loan losses attributable to the Puerto Rico Highways and Transportation Authority (HTA) as this entity is included within the scope of the FEGP. The HTA had an authorized maximum of \$2,015.9 million in financing with the GDB with an outstanding balance of \$2,014.1 million in principal at June 30, 2014. All of these facilities have been extended repeatedly and have not paid as scheduled. This situation has created pressure on the liquidity of the GDB as it has not collected principal and interest in accordance with the original terms and conditions of the loan agreements. For instance, the GDB has granted concessions to the HTA to accommodate to the actual cash payment capacity of the public corporation. These particular credit facilities have increased the concentration risk of the GDB as well.

The HTA does not currently have sufficient funds available to fully repay its various obligations, including those owed to the Bank, as they come due or that are currently in default, and is working on extending the due date of the obligations or obtaining new financing to provide relief and/or funds to repay the existing amounts of principal and interest or bring the outstanding balances current at the various due dates as well as to continue to operate and to finance capital improvement projects. Additionally, significant support and funding for obligations of the HTA has previously been provided by sources from the Commonwealth and other entities that are part of the Commonwealth, such as the Bank.

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The Commonwealth and such entities are experiencing significant financial difficulties and may be unable to continue to extend, refinance or otherwise provide the necessary liquidity to the HTA as and when needed. As such, current defaults may not be cured and future defaults on the obligations of this entity may not be avoided. The management of the HTA has plans to address its liquidity situation and continue its services and believes it will be able to repay or refinance its obligations and also continue to operate as a separate governmental entity. However, there can be no assurance that the Commonwealth will continue to provide adequate support, will continue to allow the HTA to operate as a separate entity or that the affiliated or unaffiliated lenders will be able and willing to refinance or modify the terms of the entity's obligations. The Commonwealth could utilize taxes and other revenues assigned by law to the HTA to maintain sufficient liquidity to provide essential central government services. For instance, on December 1, 2015, the Commonwealth commenced using such taxes and revenues pledged to certain public corporations and agencies, including the HTA to meet its own obligations as needed. As such, there can be no assurance that management's current plans to repay or refinance the obligations or extend their terms will be achieved or that services will not have to be terminated, curtailed or modified.

Based on these events, and their impact on the ability of this public corporation to repay its obligations as they become due, the Bank estimated a specific impairment provision during fiscal 2014 of approximately \$800 million, based on the estimate of cash flows the Bank deems would be ultimately available to collect on the outstanding credit facilities of \$2,014.1 million.

*Private Sector Loans*

Private sector loans outstanding at June 30, 2014 and 2013 amounted to \$422 million and \$563 million, respectively, net of an allowance for loan losses of \$195.1 million and \$233.7 million at June 30, 2014 and 2013, respectively. The changes in the allowance for loan losses include the write off of \$73.6 million and \$12.5 million related to two tourism projects, respectively. Private sector loans mainly include loan facilities for the housing and tourism sectors through some component units of the Bank. Note that approximately \$12.7 million of allowance for loan losses for private loans (\$12.4 pertaining to DBR Owner and approximately \$.263 million pertaining to a small private loan portfolio) are accounted for under the GDB Operating Fund. Refer to Note 7 to the basic financial statements for further information on loans receivable and allowance for loan losses.

Allowance for Losses on Guarantees and Letters of Credit

As of June, 2014, the changes in the allowance for losses on guarantees and letters of credit in the Proprietary Funds were as follows:

	<b>Beginning balance</b>	<b>Provision (release)</b>	<b>Payments/ reductions/Credits</b>	<b>Ending balance</b>	<b>Due within one year</b>
Tourism Development Fund	\$ 247,845,254	\$ 35,736,700	\$ (93,172,872)	\$ 190,409,082	\$ 15,000,000
Development Fund	14,292,707	(2,398,628)	(184,997)	11,709,082	66,826
GDB Operating Fund	-	52,609,000	-	52,609,000	-
<b>Total</b>	<b>\$ 262,137,961</b>	<b>\$ 85,947,072</b>	<b>\$ (93,357,869)</b>	<b>\$ 254,727,164</b>	<b>\$ 15,066,826</b>

During fiscal year 2010, the Bank granted a loan to DBR Dorado Member LLC, as part of a credit facility amounting to \$231 million related to the construction of the Ritz Reserve Hotel in Dorado. The Tourism Development Fund participated in this credit facility. During fiscal 2014, the Bank and the Tourism Development Fund executed a redemption agreement with the borrowers of the credit facilities by which the Bank and the Tourism Development Fund were released of their duties as lender and guarantor, respectively, in exchange for certain conditions, including the payment by the Tourism Development Fund of \$15 million in cash and the Bank forgoing on the collection of the outstanding balance of the loan originally granted to DBR Dorado Member LLC. The amount of the release of the guaranty on the part of the Tourism Development Fund was approximately \$107 million.

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**(k) Real Estate Available for Sale and Other Receivables**

Real estate available for sale includes several properties received in fiscal year 2009 in lieu of payment of a loan whose principal balance and accrued interest receivable amounted to approximately \$144.2 million at December 30, 2008. As part of such agreement any subsequent loss or reduction of fair value shall be repaid by the Commonwealth or one of its components units. As of June 30, 2014, Other Receivables include approximately \$6.2 million of other receivable balance, net of repayments and allowance for uncollectible receivable, related to the losses or reductions in fair value from such properties. As of June 30, 2014, approximately \$76.2 million was recorded as an allowance for uncollectible receivables.

For the fiscal year 2015, the Office of Management and Budget of the Commonwealth paid approximately \$7.5 million on these receivables. Future appropriations will be subject to the approval of the Legislature.

**(l) Capital Assets**

Capital assets, net of accumulated depreciation, amortization and impairment, amounted to \$20.7 million at June 30, 2014, a decrease of \$79.2 million from the prior year. During fiscal year 2014, approximately \$73.7 million of capital assets were considered impaired. Additions to capital assets during the year ended June 30, 2014 aggregated to \$11.2 million principally in the land and other non-depreciable assets line item. Depreciation and amortization of \$1.9 million was charged to operations during fiscal year 2014. Refer to Note 10 to the basic financial statements for additional information on capital assets.

**(m) Deposits**

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

Demand deposits and certificates of deposit had a combined decrease of \$362 million, from \$5,577 million at June 30, 2013 to \$5,215 million at June 30, 2014. Deposits represent approximately 49.1% and 46.7% of total liabilities at June 30, 2014 and 2013, respectively.

**(n) Securities Sold under Agreement to Repurchase**

Securities sold under agreements to repurchase decreased by \$584 million or 92.1% from \$634 million to \$50 million at June 30, 2013 and June 30, 2014, respectively.

**(o) Long-Term Debt**

The Bank and the Housing Finance Authority redeemed several notes and bonds payable during fiscal year 2014, which explains the net decrease of \$333 million or 6.3% over the prior year balance of \$5,287 million. Gross debt originations and payments during the fiscal year ending June 30, 2014, amount to \$110 million and \$454 million, respectively.

The credit ratings of the Commonwealth and most of its public entities (including the Bank) were downgraded to non-investment grade categories subsequent to June 30, 2014. With respect to the Bank, Moody's Investors Service lowered its credit rating to "Ba2" and maintained its negative outlook, while Standard & Poor's Rating Services lowered its credit rating to "BB" and maintained it in "CreditWatch" with negative implications.

**(p) Puerto Rico Emergency Moratorium and Financial Rehabilitation Act**

As further explained in notes 4 and 7 to the basic financial statements, on April 6, 2016, Governor Alejandro J. Garcia Padilla signed into law Act 21-2016, known as the "Puerto Rico Emergency Moratorium and Financial Rehabilitation Act" (as amended, "Act 21"), Act 21 allows the Governor, among other things, to declare a moratorium on debt service

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payments and to stay related creditor remedies for a temporary period for the Commonwealth and certain government instrumentalities in Puerto Rico, including the Bank.

On April 8, 2016, the Governor signed Executive Order No. 2016-010 ("EO 10"), declaring the Bank to be in a state of emergency pursuant to Act 21. In accordance with the emergency powers provided for in Act 21, EO 10 implemented a regulatory framework governing the Bank's operations and liquidity, including prohibiting loan disbursements by the Bank and establishing a procedure with respect to governmental withdrawals, payments, and transfer requests with respect to funds held on deposit at the Bank. To that effect, EO 10 restricts the withdrawal, payment and transfer of funds held on deposit at the Bank to those reasonable and necessary to ensure the provision of essential services and authorizes the Bank to establish weekly limits on the aggregate amount of such disbursements. Moreover, EO 10 prohibits the Bank's depositors from printing or writing checks creditable against their accounts at the Bank, unless they obtain a temporary waiver from the Bank. Finally, pursuant to Act 21, EO 10 suspends Article 6 of Act No. 17 of September 23, 1948, as amended (the "Bank's Enabling Act"), which required the Bank to maintain a reserve of not less than 20% of its liabilities on accounts of deposits on demand.

On April 30, 2016, Governor García Padilla signed Executive Order 2016-014 ("EO 14"), which, among other things, (a) designates deposits and letters of credit of the Bank as "enumerated obligations" of the Bank, thereby making them "covered obligations" of the Bank and, therefore, subject to the stay provisions of Act 21, (b) declares a moratorium with respect to the financial obligations of the Bank (other than deposits and interest obligations that may be paid in kind), (c) provides that interest payments in respect of the Bank's financial obligations may be made to the extent authorized by the Governor, and (d) declares an emergency period with respect to certain obligations of Puerto Rico Infrastructure Financing Authority (PRIFA) that are secured by a letter of credit issued by the Bank. Pursuant to EO 14, on May 1, 2016, the Bank failed to make a principal payment of approximately \$367 million in respect of its notes.

Condensed financial information on expenses, program revenues and changes in net position for Business-Type Activities for the years ended June 30, 2014 and 2013, as restated, is presented below (in thousands):

<b>Activity</b>	<b>Year ended June 30, 2014</b>				
	<b>Expenses</b>	<b>Program revenues</b>			<b>Net revenues/ (expenses)</b>
		<b>Charges for services</b>			
		<b>Fees, commissions, and others</b>	<b>Financing and investment</b>		
GDB Operating Fund	\$ 3,051,340	\$ 18,120	\$ 322,655	\$ (2,710,565)	
Housing Finance Authority	42,868	18,812	26,660	2,604	
Tourism Development Fund	(15,476)	4,234	15,575	35,285	
Public Finance Corporation	5	-	1	(4)	
Capital Fund	35	-	-	(35)	
Development Fund	4,949	91	328	(4,530)	
Other non-major funds	87	-	2	(85)	
Total	<u>\$ 3,083,808</u>	<u>\$ 41,257</u>	<u>\$ 365,221</u>	<u>\$ (2,677,330)</u>	
Transfers to governmental activities				(7,921)	
Change in net position				(2,685,251)	
Net position – beginning of year (as restated)				2,498,946	
Net position – end of year				<u>\$ (186,305)</u>	



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<u>Activity</u>	<b>Year ended June 30, 2013</b>			
	<b>Program revenues (as restated)</b>			
	<b>Charges for services</b>			
	<b>Expenses</b>	<b>Fees, commissions, and others</b>	<b>Financing and investment</b>	<b>Net revenues/ (expenses)</b>
GDB Operating Fund	\$ 361,896	\$ 15,059	\$ 510,518	\$ 163,681
Housing Finance Authority	48,032	12,450	30,914	(4,668)
Tourism Development Fund	196,554	4,734	(6,408)	(198,228)
Public Finance Corporation	4	-	1	(3)
Capital Fund	34	14	-	(20)
Development Fund	20,179	101	331	(19,747)
Other nonmajor funds	127	-	2	(125)
Total	\$ 626,826	\$ 32,358	\$ 535,358	\$ (59,110)
Transfers to governmental activities				1,226
Change in net position				(60,336)
Net position – beginning of year (as restated)				2,559,282
Net position – end of year (as restated)				\$ 2,498,946

### Proprietary Funds

Following is a brief discussion of the most significant changes in the Bank's proprietary funds, not previously discussed. For more detailed information of the GDB Operating Fund refer to business-type activities section.

#### GDB Operating Fund

Net position decreased from \$2,174 million at June 30, 2013 (as restated) to a deficit of approximately \$759 million at June 30, 2014. The decrease in net position of \$2,933 million in fiscal year 2014 is impacted by a provision for loan losses of approximately \$2,512 million.

The operating income of the GDB Operating Fund decreased from \$178.9 million in 2013 to a loss of \$2,704 million, or a decrease of \$2,882.9 million in fiscal year 2014, impacted by a provision for loan losses of approximately \$2,512 million recognized during fiscal 2014.

Interest income on loans in the GDB Operating Fund amounted to \$332.3 million in 2014, a decrease of \$173.9 million over the prior year. This decrease mainly relates to the reversal of interest income, net of subsequent collections, on non-accrual loans on the public sector loan portfolio of approximately \$204 million.

#### Housing Finance Authority

Net position of the Housing Finance Authority decreased by \$5 million from \$557 million at June 30, 2013 to \$552 million at June 30, 2014, as a result of a decrease in total assets of \$36 million and an increase in total liabilities of \$54 million. The decrease in total assets is mainly due to the following:

- Cash increased from \$2.6 million at June 30, 2013 to \$14.2 million at June 30, 2014 or an \$11.6 million increase. As of June 30, 2014, the Housing Finance Authority redeemed investments in order to pay bonds that were due on July 1, 2015.

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- Investments and deposits placed with banks decreased from \$524 million at June 30, 2013 to \$463 million at June 30, 2014 or a \$61 million decrease. This decrease was principally the result of investment redemptions and sales to pay bonds and notes during the next fiscal year.
- Loans receivable, net, increased to \$307 million at June 30, 2014 from \$296 million in 2013 or an \$11 million increase.
- The decrease in long-term liabilities of approximately \$53 million is due to the payment of bonds and special obligation notes of \$34 million and \$30 million, respectively, netted by the amortization of bond discount of \$11 million.

### ***Tourism Development Fund***

Total assets decreased to \$276 million at June 30, 2014 from \$376 million in 2013 or a decrease of \$100 million, mainly related to the sale of the outstanding balance of a loan receivable of approximately \$87.5 million to a third party. The total amount due from the borrower was approximately \$161.2 million. The remainder amount of \$73.7 million was written off against the allowance for loan losses. The Tourism Development Fund mostly finances its loan portfolio through credit facilities obtained from the Bank. Notes payable due to the Bank amounted to \$46 million at June 30, 2014, for a decrease of \$288 million from June 30, 2013. Loans originated during the fiscal year amounted to approximately \$12.7 million. These loans are principally collateralized by real estate property to minimize the credit risk. The analysis of the allowance for loan losses required the recognition of a provision of \$30 million and the write off of approximately \$73.6 million and \$12.5 million related to two separate tourism projects, respectively.

At June 30, 2014, outstanding guarantees and letters of credit of the Tourism Development Fund amounted to \$587 million. Also, the exposure assessment required a net decrease of the allowance for possible losses on guarantees and letters of credit of \$57 million.

Change in net position of the Tourism Development Fund went from a \$169.4 million loss recorded last year to a gain of \$251 million in 2014. Gain during the year is principally due to the credit of \$57 million in allowance for guarantees and letters of credit recorded during the year and a transfer in of \$215.2 million from the GDB operating fund.

At June 30, 2014, the Tourism Development Fund had a net position of \$14.4 million.

### ***Capital Fund***

The Capital Fund had a net loss of \$35,132 for the year ended on June 30, 2014. 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. On May 31, 2010, the board of directors of the Capital Fund authorized the transfer of its investment portfolio of approximately \$72 million to the Tourism Development Fund. The transfer was completed on June 30, 2010. The Capital Fund's activities have been reduced significantly after June 30, 2010. On September 17, 2014, the Bank's board of directors approved a resolution to commence the liquidation process of the Capital Fund which was completed shortly thereafter.

### ***Development Fund***

The Development Fund's operating loss of \$4.5 million is mainly due to the provision for loan losses of \$7.3 million related to loans to the private sector and to the release of the allowance for losses on guarantees of \$2.4 million.

At June 30, 2014, the Development Fund had a net position of \$2.4 million.

### **Developments since Issuance of the Bank's Prior Audited Financial Statements and Update on the Liquidity Crisis**

The liquidity resources and the financial stability of the Bank have steadily deteriorated since April 11, 2014, the date on which the audited financial statements as of June 30, 2013 were issued, and have continued to deteriorate through fiscal years 2015 and 2016. This deterioration in the Bank's liquidity resources and financial condition arises mostly as a result of the same causes that

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have affected the Commonwealth, including lack of market access and the inability of the Commonwealth and its instrumentalities to repay their loans to the Bank on a timely basis. Moreover, GDB's liquidity resources have continued to decline as it has continued to fund, in a limited manner, certain financial needs of the Commonwealth and its instrumentalities while paying its debt service obligations. A summary of the Bank's current financial situation follows:

- On April 6, 2016, the Commonwealth enacted Act 21. The Governor has issued several executive orders under Act 21, including EO 10 and EO 14, which directly impact the Bank. As further discussed above, among other things, EO 10 imposed restrictions on disbursements from GDB and EO 14 declared a moratorium on the payment of GDB's debt obligations.
- Pursuant to EO 14, on May 1, 2016, the Bank failed to make a principal payment of approximately \$367 million in respect of its notes. The Bank was able to pay a total of \$336 million on December 1, 2015, \$267 million of which was guaranteed by the Commonwealth.
- On October 21, 2015, the Bank had announced that informal discussions with certain of its bondholders regarding a potential financing and liability management transaction ended as they did not result in a mutually acceptable arrangement. Other transactions were and are being considered, including the restructuring of GDB notes as part of the Commonwealth-wide restructuring efforts currently being pursued by the Commonwealth. The Bank was legally required under its enabling act, Act No. 17 of September 23, 1948, as amended (the "Act 17-1948"), to maintain reserves equal to 20% of its demand deposits. This requirement was met by investing in securities with maturities of up to 90 days and, as of February 29, 2016, amounted to approximately \$275 million. Such legal reserve requirement, however, was suspended pursuant to EO 10.
- These factors, along with the inability to complete certain financings (such as the exchange of certain HTA loans with the Bank with newly issued bonds backed by the petroleum product revenues as source of repayment and liability management transactions) have impacted the Bank's financial performance and financial position, its cash flows, its exposures to credit and liquidity risk and, finally, its capacity to service its borrowing facilities on a timely basis. This has affected the liquidity resources of the Bank and its ability to comply with the legal reserve requirement.
- The Bank sold two separate loan portfolios of mortgage loans of one of its subsidiaries, Housing Finance Authority, to third-party financial institutions. The proceeds of these transaction were approximately \$90 million, most of which was used by Housing Finance Authority to repay its outstanding credit facilities with the Bank.
- If the Bank does not obtain adequate funding from the Commonwealth for fiscal year 2017 and is not able to consummate a comprehensive debt restructuring, or to otherwise obtain additional funding or other arrangements with its creditors, the Bank may not be able to continue as a going concern and may need to pursue the resolution processes provided for by the Bank's Enabling Act, as amended pursuant to Act 21. Act 21 amended the receivership provisions of the Bank's Enabling Act to establish a set of rules better suited to confront the challenges that would be faced by the Bank if it were to go into receivership at some point in the future. It modified the process for the appointment of a receiver, including that the Governor (rather than a court) may appoint the receiver based on recommendations made by the Bank's Board of Directors or the Secretary of Treasury of the Commonwealth. As amended, the Bank's Enabling Act establishes that the receiver shall have, among other, the following powers: (i) to place the Bank into resolution, (ii) to evaluate and adjudicate claims against the Bank, (iii) to petition for the creation of a bridge bank, and (iv) to create subsidiaries to take over certain of the Bank's functions. If the Bank were to be placed into receivership at some point in the future, the Secretary of the Treasury would have the power to, if so requested by the Bank's receiver, organize a bridge bank. The new bridge bank could assume certain of the Bank's liabilities and purchase certain of its assets. If a bridge bank is created, creditor claims that are not assumed by the bridge bank would remain at the Bank, but all creditors shall be entitled to receive at least the amount such creditors would have received if the Bank were liquidated without a bridge bank on the date the receiver was appointed.

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**Commonwealth's Financial Situation, Fiscal and Economic Growth Plan and Ongoing Restructuring Efforts**

The following section discloses events concerning the liquidity issues faced by the Commonwealth but that also reveals matters that have affected the Bank's liquidity position and financial condition.

Krueger Report

On June 29, 2015, the Governor made public a report (the "Krueger Report") on the Commonwealth's economic and financial stability and growth prospects prepared by Dr. Anne O. Krueger, Dr. Ranjit S. Teja and Dr. Andrew Wolfe (the "Former IMF economists"), each of whom has previously occupied senior executive positions at the International Monetary Fund ("IMF"). The Former IMF economists were engaged to prepare this report on February 5, 2015. The report was subsequently updated as of July 13, 2015. The Krueger Report states that the Commonwealth faces an acute crisis in the face of faltering economic activity, fiscal solvency and debt sustainability, and institutional credibility. Some of the Krueger Report's principal conclusions include:

- (1) The economic problems of the Commonwealth are structural, not cyclical, and are not going away without structural reforms. The Krueger Report reviews the various shocks to Puerto Rico's economy in the last decade (including the decline in manufacturing activity and the housing market, the banking crisis and the 2007-2009 U.S. economic recession), and concludes that, even more significantly than those factors, other forces on the supply side have affected economic growth. The Former IMF economists' believe that the economy will continue to contract at a rate of at least 1% per annum, likely more in fiscal year 2015.
- (2) Fiscal deficits are much larger than assumed and are set to deteriorate. The Krueger Report points to a number of factors that contribute to the persistent deficits: (a) overly optimistic revenue projections and budget formulation; (b) lack of expenditure control and buildup of payables; (c) negotiated discounts on anticipated tax obligations; (d) extensive tax expenditures in the form of credits and exemptions; and, (e) lack of timely and reliable monitoring of fiscal trends. The report concludes that the standard measure of the fiscal balance that has been used historically, which is the Commonwealth's General Fund, greatly understates the true deficit and the challenge ahead. These deficits have worsened the prospect for debt sustainability. The report concludes that the actions taken by the Government to date to address the fiscal deficits are insufficient, and, thus, the fiscal deficits too are not going away and have to be closed through wide-ranging policy action.
- (3) The deficits of the central government (as measured in the Krueger Report) over the coming years imply an unsustainable trajectory of large financing gaps.
- (4) The Commonwealth's public debt cannot be made sustainable without growth, nor can growth occur in the face of structural obstacles and doubts about debt sustainability. To restore growth and confidence, Puerto Rico needs to implement ambitious measures as an integrated package in three principal areas: (a) structural reforms directed at restoring competitiveness, (b) fiscal reform and restructuring of public debt, and (c) institutional credibility.

The Krueger Report concludes that, even after factoring in a substantial fiscal effort, a large residual financing gap persists into the next decade, implying a need for debt relief. To close the financing gap, the Commonwealth would need to seek relief from a significant but progressively declining proportion of principal and interest falling due during fiscal years 2016-2024. The Krueger Report acknowledges that any debt restructuring would be challenging as there is no precedent of this scale and scope, but concludes that, from an economic perspective, the fact remains that the central government faces large financing gaps even with substantial adjustment efforts ("as there are limits to how much expenditures can be cut or taxes raised").

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Fiscal and Economic Growth Plan

During June 2015, the Governor issued Executive Order No. 2015-22 to create the Puerto Rico Fiscal and Economic Recovery Working Group (the "Working Group"). The Working Group was created to consider the measures necessary, including the measures recommended in the Krueger Report, to address the economic and fiscal crisis of the Commonwealth. The Working Group's members were the Governor's Chief of Staff, the President of the Bank, the Secretary of Justice, the President of the Senate and the President of the House of Representatives. It was tasked with the responsibility for developing and recommending to the Governor the FEGP. The FEGP had to contain the plans and the administrative and legislative measures necessary to address the short, medium and long-term fiscal and economic challenges facing the Commonwealth, including measures to: (i) address the financing gaps and the debt load on the public sector, (ii) achieve the execution of its budgets, (iii) achieve greater transparency with respect to statistics and the government's financial information, and (iv) carry out the structural reforms necessary to promote the economic growth and competitiveness of the Commonwealth.

On September 9, 2015, the Working Group presented a draft of the FEGP to the Governor and it was made public on that same day. An updated version of the FEGP was released on January 18, 2016. Among other matters, the FEGP projects that, absent further corrective action, the Commonwealth's cumulative financing gap from fiscal year 2016 to 2025 will be approximately \$63.4 billion. The FEGP contemplates that this financing gap could be reduced to approximately \$23.9 billion through a combination of revenue increases (including the recent increase in sales and use taxes, which is already in effect), expense reductions and economic growth, but that the remaining financing gap will need to be addressed by debt restructuring. The FEGP includes proposals for (a) economic growth and structural reform, (b) fiscal stability, and (c) institutional reform and transparency. The implementation of the FEGP, as proposed by the Working Group, would require executive action by the Governor and United States government and, as to certain matters, the approval of legislation by the Legislature.

The FEGP concludes that meaningful changes to federal policies are critical to the ability of the Commonwealth to meet its debt service costs while providing funding for essential services to its residents, most particularly changes in the areas of health care funding and tax policies for economic development. Moreover, the FEGP highlights the need for an orderly process to restructure the Commonwealth's liabilities, including those of the Bank.

Restructuring Proposal

Following the release of the FEGP, the Commonwealth has proposed to seek a restructuring of its outstanding debt and other tax-supported debt issued by certain instrumentalities, including the Bank. Since January 2016, Commonwealth officials and advisors have periodically met with the advisors of the Commonwealth's creditors to present and exchange various restructuring proposals, all of which have been made public.

There can be no assurance, however, that the Commonwealth will be able to successfully consummate its proposal or any other debt restructuring. As further described in Note 22, the Governor has issued several executive orders declaring emergency periods and suspending certain transfers and payments with respect to the Commonwealth and several of its instrumentalities. Pursuant to such executive orders, on July 1, 2016, the Commonwealth and several of its instrumentalities missed certain of their scheduled debt obligations.

Retention by the Commonwealth of Certain Revenues for the Payment of the Commonwealth's Public Debt

On December 1, 2015, the Governor signed Executive Order No. OE-2015-46 ("Executive Order No. 46"), which provides for the Commonwealth to begin redirecting certain revenues in light of recently revised revenue estimates and its deteriorating liquidity situation. Pursuant to Executive Order No. 46, certain available revenues that had been assigned to pay debt service on the debt of certain public corporations were redirected, pursuant to constitutional requirements, and segregated for the payment of "public debt" (debt issued or guaranteed by the Commonwealth). On December 8, 2015, the Governor signed Executive Order No. OE-2015-49 to delegate to the Director of the Office of Management and Budget the power to redirect the available revenues of the Commonwealth in accordance with the priority norms established by the enabling act of the Office of Management and Budget of the Commonwealth, Act No. 147 of June 18, 1980, as amended.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**  
(A Component Unit of the Commonwealth of Puerto Rico)  
Management's Discussion and Analysis (Unaudited)  
June 30, 2014

Laws to Establish Restructuring Framework

Act No. 71-2014, known as the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act"), was challenged by certain private investors in Federal court and was declared unconstitutional by the United States District Court for the District of Puerto Rico on February 6, 2015. The District Court's decision was upheld by the United States Court of Appeals for the First Circuit and subsequently upheld by the United States Supreme Court.

On June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which grants the Commonwealth and its component units access to an orderly mechanism to restructure their debts, in exchange for significant federal oversight over the Commonwealth's finances. In broad strokes, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, relief from creditor lawsuits through the enactment of a temporary stay on litigation, and two alternative methods to adjust unsustainable debt.

**Contacting the Bank's Financial Management**

This report is designed to provide all interested parties 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.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Net Position

June 30, 2014

<b>Assets</b>	<b>Governmental activities</b>	<b>Business-type activities</b>	<b>Total</b>
Cash and due from banks	\$ 2,730,071	\$ 80,271,319	\$ 83,001,390
Federal funds sold	-	605,987,000	605,987,000
Deposits placed with banks	3,188,808	731,176,444	734,365,252
Due from federal government	12,275,733	-	12,275,733
Investments and investment contracts	72,647,696	2,143,548,108	2,216,195,804
Loans receivable, net	-	6,382,367,056	6,382,367,056
Accrued interest receivable	171,421	177,687,028	177,858,449
Real estate available for sale	-	82,545,880	82,545,880
Capital assets:			
Land and other non-depreciable assets	-	16,945,000	16,945,000
Other capital assets	2,129	3,777,473	3,779,602
Other receivables, net	71,890	31,247,125	31,319,015
Other assets	-	630,133	630,133
Total assets	<u>91,087,748</u>	<u>10,256,182,566</u>	<u>10,347,270,314</u>
<b>Deferred outflows of resources</b>			
Deferred loss on refundings	-	2,872,326	2,872,326
<b>Liabilities</b>			
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:			
Demand	-	2,415,151,393	2,415,151,393
Certificates of deposit:			
Due within one year	-	2,586,913,113	2,586,913,113
Due in more than one year	-	212,474,950	212,474,950
Securities sold under agreements to repurchase	-	50,000,000	50,000,000
Accrued interest payable	70,752	41,998,585	42,069,337
Accounts payable and accrued liabilities:			
Due within one year	28,996,897	69,043,498	98,040,395
Due in more than one year	4,814,032	15,930,916	20,744,948
Internal balances	183,441,268	(183,441,268)	-
Allowance for losses on guarantees and letters of credit:			
Due within one year	-	15,066,826	15,066,826
Due in more than one year	-	239,660,338	239,660,338
Allowance for losses on mortgage loan insurance	-	5,050,728	5,050,728
Participation agreement payable:			
Due within one year	-	866,667	866,667
Due in more than one year	-	22,605,556	22,605,556
Bonds, notes and mortgage-backed certificates payable:			
Due within one year	-	514,957,921	514,957,921
Due in more than one year	3,434,253	4,439,080,410	4,442,514,663
Total liabilities	<u>220,757,202</u>	<u>10,445,359,633</u>	<u>10,666,116,835</u>
<b>Net Position (Deficit)</b>			
Net investment in capital assets	2,129	9,352,055	9,354,184
Restricted for:			
Mortgage loan insurance	-	72,545,011	72,545,011
Affordable housing programs	323,684	32,263,554	32,587,238
Debt service	-	43,131,537	43,131,537
Other housing programs	-	1,357,386	1,357,386
Unrestricted net position (deficit)	<u>(129,995,267)</u>	<u>(344,954,284)</u>	<u>(474,949,551)</u>
Total net position (deficit)	<u>\$ (129,669,454)</u>	<u>\$ (186,304,741)</u>	<u>\$ (315,974,195)</u>

See accompanying notes to basic financial statements.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Activities

Year ended June 30, 2014

	Program revenues				Net revenues/(expenses) and changes in net position (deficit)		Total
	Expenses	Charges for services – fees, commissions, and others	Charges for services – financing and investment	Operating grants and contributions	Governmental activities	Business-type activities	
Functions/programs:							
Governmental activities:							
General government and other	\$ 5,524,637	\$ -	\$ -	\$ -	\$ (5,524,637)	\$ -	\$ (5,524,637)
Housing assistance programs	172,436,285	-	4,105,030	163,521,883	(4,809,372)	-	(4,809,372)
Total governmental activities	<u>177,960,922</u>	<u>-</u>	<u>4,105,030</u>	<u>163,521,883</u>	<u>(10,334,009)</u>	<u>-</u>	<u>(10,334,009)</u>
Business-type activities:							
GDB Operating Fund	3,051,339,547	18,119,666	322,654,745	-	-	(2,710,565,136)	(2,710,565,136)
Housing Finance Authority	42,867,648	18,812,396	26,660,406	-	-	2,605,154	2,605,154
Tourism Development Fund	(15,476,610)	4,233,395	15,575,098	-	-	35,285,103	35,285,103
Public Finance Corporation	5,174	-	1,207	-	-	(3,967)	(3,967)
Capital Fund	35,232	25	75	-	-	(35,132)	(35,132)
Development Fund	4,949,312	91,275	327,561	-	-	(4,530,476)	(4,530,476)
Other nonmajor	87,741	68	2,499	-	-	(85,174)	(85,174)
Total business-type activities	<u>3,083,808,044</u>	<u>41,256,825</u>	<u>365,221,591</u>	<u>-</u>	<u>-</u>	<u>(2,677,329,628)</u>	<u>(2,677,329,628)</u>
Total	<u>\$ 3,261,768,966</u>	<u>\$ 41,256,825</u>	<u>\$ 369,326,621</u>	<u>\$ 163,521,883</u>	<u>\$ (10,334,009)</u>	<u>\$ (2,677,329,628)</u>	<u>\$ (2,687,663,637)</u>
Transfers in (out) – net					7,920,902	(7,920,902)	-
Change in net position (deficit)					(2,413,107)	(2,685,250,530)	(2,687,663,637)
Net position (deficit) – beginning of year, (as restated, see Note 2)					(127,256,347)	2,498,945,789	2,371,689,442
Net position (deficit) – end of year					<u>\$ (129,669,454)</u>	<u>\$ (186,304,741)</u>	<u>\$ (315,974,195)</u>

See accompanying notes to basic financial statements.



**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Balance Sheet – Governmental Funds

June 30, 2014

	<b>HUD Programs</b>	<b>Home Program</b>	<b>Affordable Housing Subsidy Programs</b>	<b>Total governmental funds</b>
<b>Assets:</b>				
Cash and due from banks	\$ 1,096,370	\$ 1,244,108	\$ 389,593	\$ 2,730,071
Deposits placed with banks	-	-	3,188,808	3,188,808
Due from federal government	1,027,663	11,248,070	-	12,275,733
Investments and investment contracts	-	-	72,647,696	72,647,696
Due from other funds	165,679	-	23,446,723	23,612,402
Interest and other receivables	2,843	-	240,468	243,311
<b>Total assets</b>	<b>2,292,555</b>	<b>12,492,178</b>	<b>99,913,288</b>	<b>114,698,021</b>
<b>Liabilities:</b>				
Due to other funds	775,069	2,748,389	203,530,212	207,053,670
Accounts payable and accrued liabilities	1,517,486	9,420,105	7,434,904	18,372,495
<b>Total liabilities</b>	<b>2,292,555</b>	<b>12,168,494</b>	<b>210,965,116</b>	<b>225,426,165</b>
<b>Fund balances (deficit):</b>				
Restricted for affordable housing programs	-	323,684	58,484,310	58,807,994
Unassigned	-	-	(169,536,138)	(169,536,138)
<b>Total fund balances (deficit)</b>	<b>-</b>	<b>323,684</b>	<b>(111,051,828)</b>	<b>(110,728,144)</b>
<b>Total liabilities and fund balances (deficit)</b>	<b>\$ 2,292,555</b>	<b>\$ 12,492,178</b>	<b>\$ 99,913,288</b>	<b>\$ 114,698,021</b>
Amounts reported for governmental activities in the statement of net position are different because:				
Total fund deficit				\$ (110,728,144)
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds				2,129
Bonds and notes payable are not due and payable in the current period and therefore are not reported in the funds				(3,434,253)
Accounts payable and accrued liabilities not due and payable in the current period				(15,438,434)
Accrued interest payable not due and payable in the current period				(70,752)
<b>Net position (deficit) of governmental activities</b>				<b><u>\$(129,669,454)</u></b>

See accompanying notes to basic financial statements.

(A Component Unit of the Commonwealth of Puerto Rico)  
Statement of Revenues, Expenditures, and Changes in Fund Balances (Deficit) – Governmental Funds  
Year ended June 30, 2014

	<b>HUD Programs</b>	<b>Home Program</b>	<b>Affordable Housing Subsidy Programs</b>	<b>Total governmental funds</b>
<b>Revenues:</b>				
Commonwealth appropriations for repayment of bonds and housing assistance programs	\$ -	\$ -	\$ 9,282,493	\$ 9,282,493
Intergovernmental – federal government	142,493,693	16,618,015	-	159,111,708
Interest income on deposits placed with banks	-	-	101,977	101,977
Interest on investments and investments contracts	-	-	4,147,109	4,147,109
Net decrease in fair value of investments	-	-	(42,079)	(42,079)
Other	66,297	829,049	1,123,196	2,018,542
Total revenues	<u>142,559,990</u>	<u>17,447,064</u>	<u>14,612,696</u>	<u>174,619,750</u>
<b>Expenditures:</b>				
<b>Current</b>				
General government and other	4,772,996	647,478	101,218	5,521,692
Repayment of disallowed costs	-	-	624,403	624,403
Housing assistance programs	137,786,994	9,692,907	21,321,871	168,801,772
Debt service				
Interest	-	-	7,995,328	7,995,328
Total expenditures	<u>142,559,990</u>	<u>10,340,385</u>	<u>30,042,820</u>	<u>182,943,195</u>
Excess (deficiency) of revenues over expenditures	-	7,106,679	(15,430,124)	(8,323,445)
<b>Other financing sources (uses):</b>				
Transfers-in	-	-	10,323,327	10,323,327
Transfers-out	-	-	(2,402,425)	(2,402,425)
Total other financing sources, net	<u>-</u>	<u>-</u>	<u>7,920,902</u>	<u>7,920,902</u>
Net change in fund balances (deficit)	<u>-</u>	<u>7,106,679</u>	<u>(7,509,222)</u>	<u>(402,543)</u>
Fund balances (deficit) – beginning of year	-	(6,782,995)	(103,542,606)	(110,325,601)
Fund balances (deficit) – end of year	<u>\$ -</u>	<u>\$ 323,684</u>	<u>\$ (111,051,828)</u>	<u>\$ (110,728,144)</u>
<b>Amounts reported for governmental activities in the statement of net position are different because:</b>				
Net change in fund balances (deficit) – total governmental funds				(402,543)
Decrease in estimate of contingency for disallowed costs not due and payable in the current period				4,364,506
Some expenses in the statement of activities do not require the use of current financial resources and, therefore, are not reported as expenditures in governmental funds.				(3,691)
Governmental funds report capital outlays as expenditures; however, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This amount is the depreciation for the year.				(2,945)
Disallowed costs previously reported in the statement of activities that are being reported as expenses in the governmental funds when the first installment payment was made.				624,403
Revenue previously reported in the statement of activities that are now being reported as revenues in the governmental funds.				(6,992,837)
Change in net position (deficit) of governmental activities				<u>\$ (2,413,107)</u>

See accompanying notes to basic financial statements.



**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Net Position (Deficit) – Proprietary Funds

June 30, 2014

<b>Liabilities and Net Position (Deficit)</b>	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Eliminations</b>	<b>Total proprietary funds</b>
Current liabilities:									
Deposits, principally from the Commonwealth of Puerto Rico and its public entities:									
Demand	\$ 2,452,123,870	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (36,972,477)	\$ 2,415,151,393
Certificates of deposit	2,794,089,953	-	-	-	-	-	-	(207,176,840)	2,586,913,113
Securities sold under agreements to repurchase	50,000,000	-	-	-	-	-	-	-	50,000,000
Accrued interest payable	43,176,957	-	-	-	-	-	-	(1,256,613)	41,920,344
Accounts payable and accrued liabilities	54,685,700	9,191,121	1,120,728	59,073	60,574	61,793	-	405,718	65,584,707
Allowance for losses on guarantees and letters of credit	-	-	15,000,000	-	-	66,826	-	-	15,066,826
Due to governmental funds	23,612,404	-	-	-	-	-	-	-	23,612,404
Participation agreement payable	-	-	866,667	-	-	-	-	-	866,667
Notes payable	476,883,505	-	662,494	-	-	-	-	(662,494)	476,883,505
Total current liabilities payable from unrestricted assets	5,894,572,389	9,191,121	17,649,889	59,073	60,574	128,619	-	(245,662,706)	5,675,998,959
Current liabilities payable from restricted assets:									
Accrued interest payable	-	78,241	-	-	-	-	-	-	78,241
Accounts payable and accrued liabilities	-	3,458,791	-	-	-	-	-	-	3,458,791
Allowance for losses on mortgage loan insurance	-	5,050,728	-	-	-	-	-	-	5,050,728
Bonds, notes and mortgage-backed certificates payable	-	38,074,416	-	-	-	-	-	-	38,074,416
Total current liabilities	\$ 5,894,572,389	\$ 55,853,297	\$ 17,649,889	\$ 59,073	\$ 60,574	\$ 128,619	\$ -	\$ (245,662,706)	\$ 5,722,661,135
Noncurrent liabilities:									
Certificates of deposit, principally from the Commonwealth of Puerto Rico and its public entities									
Certificates of deposit	300,036,293	-	-	-	-	-	-	(87,561,343)	212,474,950
Allowance for losses on guarantees and letters of credit	52,609,000	-	175,409,082	-	-	11,642,256	-	-	239,660,338
Accounts payable and accrued liabilities	13,084,355	2,489,538	7,196	-	-	349,827	-	-	15,930,916
Participation agreement payable	-	-	22,605,556	-	-	-	-	-	22,605,556
Notes payable	4,236,297,326	-	46,117,937	-	-	-	-	(46,117,937)	4,236,297,326
Noncurrent liabilities payable from restricted assets:									
Bonds, notes and mortgage-backed certificates payable	-	202,783,084	-	-	-	-	-	-	202,783,084
Total noncurrent liabilities	4,602,026,974	205,272,622	244,139,771	-	-	11,992,083	-	(133,679,280)	4,929,752,170
Total liabilities	10,496,599,363	261,125,919	261,789,660	59,073	60,574	12,120,702	-	(379,341,986)	10,652,413,305
Net position (deficit):									
Net investment in capital assets	7,670,030	1,682,025	-	-	-	-	-	-	9,352,055
Restricted for:									
Mortgage loan insurance	-	72,545,011	-	-	-	-	-	-	72,545,011
Affordable housing programs	-	32,263,554	-	-	-	-	-	-	32,263,554
Debt service	-	43,131,537	-	-	-	-	-	-	43,131,537
Other housing programs	-	1,357,386	-	-	-	-	-	-	1,357,386
Unrestricted	(766,749,876)	401,302,422	14,441,973	1,132,278	138,230	2,368,864	2,411,825	-	(344,954,284)
Total net position (deficit)	(759,079,846)	552,281,935	14,441,973	1,132,278	138,230	2,368,864	2,411,825	-	(186,304,741)
Total liabilities and net position (deficit)	\$ 9,737,519,517	\$ 813,407,854	\$ 276,231,633	\$ 1,191,351	\$ 198,804	\$ 14,489,566	\$ 2,411,825	\$ (379,341,986)	\$ 10,466,108,564

See accompanying notes to basic financial statements.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Revenues, Expenses, and Changes in Net Position (Deficit) – Proprietary Funds

	Year ended June 30, 2014							
	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Total proprietary funds</b>
Operating revenues:								
Investment income:								
Interest income on federal funds sold	\$ 995,530	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 995,530
Interest income on deposits placed with banks	1,202,487	2,108,633	774,554	1,207	-	6,584	2,499	4,095,964
Interest and dividend income on investments and investment contracts	32,179,892	8,366,610	882,407	-	75	320,977	-	41,749,961
Net increase (decrease) in fair value of investments	(43,980,335)	(388,423)	13,181,361	-	-	-	-	(31,187,397)
Total investment income (loss)	(9,602,426)	10,086,820	14,838,322	1,207	75	327,561	2,499	15,654,058
Interest income on loans receivable:								
Public sector	330,142,807	-	-	-	-	-	-	330,142,807
Private sector	2,114,364	16,573,586	736,776	-	-	-	-	19,424,726
Total interest income on loans receivable	332,257,171	16,573,586	736,776	-	-	-	-	349,567,533
Total investment income (loss) and interest income on loans receivable	322,654,745	26,660,406	15,575,098	1,207	75	327,561	2,499	365,221,591
Noninterest income:								
Fiscal agency fees	11,441,527	127,522	-	-	-	-	-	11,569,049
Commitment guarantee and other services fees	5,451,827	280,763	4,230,562	-	-	91,275	-	10,054,427
Mortgage loan insurance premiums	-	5,486,923	-	-	-	-	-	5,486,923
Release of allowance on mortgage loans insurance	-	127,799	-	-	-	-	-	127,799
Release of allowance for losses on other real estate owned	-	4,335,974	-	-	-	-	-	4,335,974
Servicing and contract administration fees, net	968,306	6,258,779	-	-	-	-	-	7,227,085
Other income	258,006	2,194,636	2,833	-	25	-	68	2,455,568
Total noninterest income	18,119,666	18,812,396	4,233,395	-	25	91,275	68	41,256,825
Total operating revenues	\$ 340,774,411	\$ 45,472,802	\$ 19,808,493	\$ 1,207	\$ 100	\$ 418,836	\$ 2,567	\$ 406,478,416

(Continued)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Revenues, Expenses, and Changes in Net Position (Deficit) – Proprietary Funds (Continued)

Year ended June 30, 2014

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Total proprietary funds</b>
Operating expenses:								
Provision for loan losses	\$ 2,512,463,372	\$ 1,598,345	\$ 30,091,494	\$ -	\$ -	\$ 7,308,765	\$ -	\$ 2,551,461,976
Interest expense:								
Deposits	46,549,527	-	-	-	-	-	-	46,549,527
Securities sold under agreements to repurchase	1,036,122	-	-	-	-	-	-	1,036,122
Commercial paper	6,000	-	-	-	-	-	-	6,000
Bonds, notes and mortgage-backed certificates	228,004,396	17,874,960	11,090,278	-	-	-	-	256,969,634
Total interest expense	275,596,045	17,874,960	11,090,278	-	-	-	-	304,561,283
Noninterest expenses:								
Salaries and fringe benefits	19,814,585	10,912,401	151,123	-	-	-	27,551	30,905,660
Depreciation and amortization	997,500	860,563	-	-	-	-	-	1,858,063
Occupancy and equipment costs	3,510,646	2,450,210	185	-	-	-	-	5,961,041
Legal and professional fees	12,625,834	3,500,210	517,771	5,174	33,240	39,175	53,128	16,774,532
Office and administrative	269,087	1,078,713	34,402	-	1,992	-	-	1,384,194
Subsidy and trustee fees	10,200	312,214	-	-	-	-	-	322,414
Provision (release) for allowance losses on guarantees and letters of credit	52,609,000	-	(57,436,172)	-	-	(2,398,628)	-	(7,225,800)
Provision for losses on other assets	88,820,150	-	-	-	-	-	-	88,820,150
Impairment loss on capital asset	73,748,362	-	-	-	-	-	-	73,748,362
Net loss from sale of foreclosed real estate available for sale	-	572,875	-	-	-	-	-	572,875
Other	3,863,573	3,718,842	74,309	-	-	-	7,062	7,663,786
Total noninterest expenses	256,268,937	23,406,028	(56,658,382)	5,174	35,232	(2,359,453)	87,741	220,785,277
Total operating expenses	3,044,328,354	42,879,333	(15,476,610)	5,174	35,232	4,949,312	87,741	3,076,808,536
Operating income (loss)	(2,703,553,943)	2,593,469	35,285,103	(3,967)	(35,132)	(4,530,476)	(85,174)	(2,670,330,120)
Nonoperating revenues (expenses):								
Gain on early extinguishment of notes payable	-	36,685	-	-	-	-	-	36,685
Contributions to others	(7,011,193)	(25,000)	-	-	-	-	-	(7,036,193)
Total nonoperating revenues (expenses) - net	(7,011,193)	11,685	-	-	-	-	-	(6,999,508)
Transfers-in	-	99,078	215,240,213	-	-	7,267,000	100,000	222,706,291
Transfers-out	(222,607,213)	(8,019,980)	-	-	-	-	-	(230,627,193)
Change in net position (deficit)	(2,933,172,349)	(5,315,748)	250,525,316	(3,967)	(35,132)	2,736,524	14,826	(2,685,250,530)
Net position (deficit) – beginning of year (as restated, see note 2)	2,174,092,503	557,597,683	(236,083,343)	1,136,245	173,362	(367,660)	2,396,999	2,498,945,789
Net position (deficit) – end of year	\$ (759,079,846)	\$ 552,281,935	\$ 14,441,973	\$ 1,132,278	\$ 138,230	\$ 2,368,864	\$ 2,411,825	\$ (186,304,741)

See accompanying notes to basic financial statements.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Cash Flows – Proprietary Funds

Year ended June 30, 2014

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Development Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Eliminations</b>	<b>Total proprietary funds</b>
Cash flows from operating activities:									
Cash received from interest on housing program loans	\$ -	\$ 13,429,251	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 13,429,251
Cash paid for housing program loans originated	-	(32,920,675)	-	-	-	-	-	-	(32,920,675)
Principal collected on mortgage and construction on housing program loans	-	49,290,477	-	-	-	-	-	-	49,290,477
Guarantee fees collected	-	-	6,033,395	-	-	39,521	-	-	6,072,916
Payment of guarantees	-	-	-	-	-	(184,997)	-	-	(184,997)
Cash received from other operating noninterest revenues	87,414,287	8,740,354	1,672	-	25	-	76	-	96,156,414
Cash paid from transit account:									
Cash payment for other operating noninterest expenses	(92,757,743)	(9,720,736)	(639,109)	-	(2,015)	(34,000)	(121,772)	(2,794,728)	(106,070,103)
Cash received from mortgage loans insurance premiums	-	5,291,019	-	-	-	-	-	-	5,291,019
Cash payments for salaries and fringe benefits	(20,729,868)	(11,622,927)	(150,928)	-	-	-	-	-	(32,503,723)
Cash payments to other governmental funds	(5,314,874)	(1,650,936)	-	-	-	-	-	-	(6,965,810)
Net cash provided by/(used in) operating activities	<u>(31,388,198)</u>	<u>20,835,827</u>	<u>5,245,030</u>	<u>-</u>	<u>(1,990)</u>	<u>(179,476)</u>	<u>(121,696)</u>	<u>(2,794,728)</u>	<u>(8,405,231)</u>
Cash flows from noncapital financing activities:									
Contributions to other entities	(7,421,343)	(25,000)	-	-	-	-	-	-	(7,446,343)
Transfers-in	-	3,954,619	-	-	-	7,267,000	100,000	-	11,321,619
Transfers-out	(7,367,000)	(11,875,521)	-	-	-	-	-	-	(19,242,521)
Net increase (decrease) in:									
Deposits	(672,578,937)	-	-	-	-	-	-	20,110	(672,558,827)
Certificates of deposit	454,157,068	-	-	-	-	-	-	(143,728,545)	310,428,523
Proceeds from issuance of securities sold under agreements to repurchase	9,942,712,064	-	-	-	-	-	-	-	9,942,712,064
Payment of securities sold under agreements to repurchase	(10,527,013,064)	-	-	-	-	-	-	-	(10,527,013,064)
Proceeds from issuance of bonds, notes, and mortgage-backed securities	110,000,000	-	-	-	-	-	-	-	110,000,000
Repayments of bonds, notes and mortgage backed securities	(392,980,000)	(64,700,693)	(70,604,044)	-	-	-	-	69,737,377	(458,547,360)
Payment of bond issue costs	(31,500)	-	-	-	-	-	-	-	(31,500)
Cash received for in-substance defeasance of bonds	-	36,685	-	-	-	-	-	-	36,685
Interest paid	(280,699,092)	(7,004,582)	(18,433,056)	-	-	-	-	18,788,306	(287,348,424)
Net cash provided by (used in) noncapital financing activities	<u>(1,381,221,804)</u>	<u>(79,614,492)</u>	<u>(89,037,100)</u>	<u>-</u>	<u>-</u>	<u>7,267,000</u>	<u>100,000</u>	<u>(55,182,752)</u>	<u>(1,597,689,148)</u>
Cash flows from capital and related financing activities – acquisition of capital assets	<u>(9,461,106)</u>	<u>(538,285)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(9,999,391)</u>

(Continued)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Cash Flows – Proprietary Funds (Continued)

Year ended June 30, 2014

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Development Fund</b>	<b>Nonmajor enterprise Funds</b>	<b>Eliminations</b>	<b>Total proprietary funds</b>
Cash flows from investing activities:								
Net decrease (increase) in:								
Federal funds sold and securities purchases under agreements to resell	\$ (155,987,000)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (155,987,000)
Deposits placed with banks	(186,074,563)	18,196,684	(152,520,366)	-	-	-	143,728,545	(176,669,700)
Purchases of investments	(4,086,323,148)	(2,293,875)	(2,568,364)	-	(25)	-	-	(4,091,185,412)
Proceeds from sales and redemptions of investments	4,670,227,376	45,154,634	153,917,823	-	2,015	-	-	4,869,301,848
Interest and dividends received on investments	39,212,615	10,603,238	1,184,925	1,207	-	327,594	2,500	(1,025,681)
Interest received on other than housing program loans	421,042,658	-	752,896	-	-	-	-	(17,762,622)
Origination of other than housing program loans	(3,869,519,075)	(25,000)	(12,654,953)	-	-	(2,987,140)	-	(3,885,186,168)
Fees collected on other than housing program loans	-	753,059	-	-	-	-	-	753,059
Principal collected on other than housing program loans	4,587,971,775	-	91,820,920	-	-	-	-	(69,737,377)
Proceeds from sale of real estate available for sale	7,346,500	1,481,204	-	-	-	-	-	8,827,704
Disbursements for acquisition and improvements to real estate available for sale	-	(2,900,642)	-	-	-	-	-	(2,900,642)
Net cash provided by (used in) investing activities	1,427,897,138	70,969,302	79,932,881	1,207	1,990	(2,659,546)	2,500	55,202,865
Net change in cash and due from banks	5,826,030	11,652,352	(3,859,189)	1,207	-	4,427,978	(19,196)	(2,774,618)
Cash and due from banks – beginning of year	64,462,608	2,595,802	21,710,611	1,190,045	-	6,419,012	2,430,818	(33,792,141)
Cash and due from banks – end of year	\$ 70,288,638	\$ 14,248,154	\$ 17,851,422	\$ 1,191,252	\$ -	\$ 10,846,990	\$ 2,411,622	\$ (36,566,759)
Reconciliation to proprietary funds:								
Statement of Net Position								
Cash and due from banks – unrestricted	70,288,638	3,584,931	17,851,422	1,191,252	-	10,846,990	2,411,622	(36,211,105)
Cash and due from banks – restricted	-	10,663,223	-	-	-	-	-	(355,654)
Total cash and due from banks at year end	\$ 70,288,638	\$ 14,248,154	\$ 17,851,422	\$ 1,191,252	\$ -	\$ 10,846,990	\$ 2,411,622	\$ (36,566,759)

(Continued)



**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Cash Flows – Proprietary Funds (Continued)

Year ended June 30, 2014

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Eliminations</b>	<b>Total proprietary funds</b>
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:									
Operating income (loss)	\$ (2,703,553,943)	\$ 2,593,469	\$ 35,285,103	\$ (3,967)	\$ (35,132)	\$ (4,530,476)	\$ (85,174)	\$ -	\$ (2,670,330,120)
Adjustments to reconcile operating income/(loss) to net cash provided by (used in) operating activities:									
Investment income	(34,377,909)	(10,475,244)	(1,648,193)	(1,207)	(75)	(327,561)	(2,499)	-	(46,832,688)
Interest income on other than housing program loans	(332,257,171)	-	(736,776)	-	-	-	-	-	(332,993,947)
Capitalized interest and deferred amortization on loans	-	(3,467,617)	-	-	-	-	-	-	(3,467,617)
Tax credit fees	-	(109,660)	-	-	-	-	-	-	(109,660)
Interest expense	275,596,045	17,874,960	11,090,278	-	-	-	-	-	304,561,283
Provision for loan losses	2,512,463,372	1,598,345	30,091,494	-	-	7,308,765	-	-	2,551,461,976
Provision for losses on other assets	88,820,150	-	-	-	-	-	-	-	88,820,150
Provision (release) for losses on guarantees and letters of credit	52,609,000	-	(57,436,172)	-	-	(2,398,628)	-	-	(7,225,800)
Payment of guarantees	-	-	-	-	-	(184,997)	-	-	(184,997)
Net (increase) decrease in fair value of investments	43,980,335	388,423	(13,190,129)	-	-	-	-	-	31,178,629
Provision (credit) for losses on real estate available for sale	1,998,500	(4,392,574)	-	-	-	-	-	-	(2,394,074)
Provision for losses on mortgage loan insurance	-	(127,799)	-	-	-	-	-	-	(127,799)
Net decrease in fair value of real estate available for sale	-	2,805,932	-	-	-	-	-	-	2,805,932
Amortization of prepaid assets	987,132	-	-	-	-	-	-	-	987,132
Net loss on sale of real estate held for sale	-	572,875	-	-	-	-	-	-	572,875
Depreciation and amortization	997,500	860,563	-	-	-	-	-	-	1,858,063
Impairment of capital assets	73,748,362	-	-	-	-	-	-	-	73,748,362
Origination of housing program loans	-	(32,920,675)	-	-	-	-	-	-	(32,920,675)
Principal collections on housing program loans	-	49,290,999	-	-	-	-	-	-	49,290,999
Changes in operating assets and liabilities:									
Interest receivable on housing program loans	-	318,299	-	-	-	-	-	-	318,299
Decrease (increase) in other assets	(5,888,733)	244,193	1,672	-	-	-	8	-	(5,642,860)
Increase (decrease) in other liabilities	(1,195,964)	(2,567,729)	(12,247)	5,174	33,217	5,175	(34,031)	(2,794,728)	(6,561,133)
Increase (decrease) in guarantee fees	-	-	1,800,000	-	-	(51,754)	-	-	1,748,246
Decrease (increase) in due from/(to) governmental funds	(5,314,874)	(1,650,933)	-	-	-	-	-	-	(6,965,807)
Net cash provided by (used in) operating activities	\$ (31,388,198)	\$ 20,835,827	\$ 5,245,030	\$ -	\$ (1,990)	\$ (179,476)	\$ (121,696)	\$ (2,794,728)	\$ (8,405,231)

(Continued)

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Cash Flows – Proprietary Funds (Continued)

Year ended June 30, 2014

	<b>GDB Operating Fund</b>	<b>Housing Finance Authority</b>	<b>Tourism Development Fund</b>	<b>Public Finance Corporation</b>	<b>Capital Development Fund</b>	<b>Development Fund</b>	<b>Nonmajor enterprise funds</b>	<b>Eliminations</b>	<b>Total proprietary funds</b>
Noncash investing and noncapital financing activities:									
Accretion or amortization of discount and capitalized interest on investments securities and deposits placed with banks	\$ (670,343)	\$ 1,976,403	\$ (8,694)	\$ -	\$ 79	\$ -	\$ -	\$ -	\$ 1,297,445
Capitalized interest on loans and other	10,864,160	3,467,617	-	-	-	-	-	-	14,331,777
Tax credit fees collected from loans to other receivables	(169,312)	-	-	-	-	-	-	-	(169,312)
Accretion of discount and capitalized interest on: Bonds and notes payable	494,860	11,099,658	-	-	-	-	-	-	11,594,518
Noncash transfer:									
Increase (decrease) in fair value of investments	(43,980,335)	(388,423)	13,181,361	-	-	-	-	-	(31,187,397)
Amortization of deferred loss	-	289,000	-	-	-	-	-	-	289,000
Interfund transfer of mortgage loans receivable to other real estate held for sale	-	31,921	-	-	-	-	-	-	31,921
Interfund transfer of mortgage loans receivable	-	103,156	-	-	-	-	-	-	103,156
Interfund transfer of other than housing loans and interest	(215,240,213)	-	215,240,213	-	-	-	-	-	-

See accompanying notes to basic financial statements.

## GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2014

### (1) Reporting Entity

The 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 “Act 17-1948”). The Bank’s principal functions are to act as fiscal agent, paying agent and financial advisor for the Commonwealth and its agencies, instrumentalities, and public corporations (collectively referred to as public entities) and municipalities; to grant interim and long-term loans to public entities and municipalities and private enterprises, which will further the economic development of Puerto Rico; and to act as depository or trustee of funds for the Commonwealth, its public entities and municipalities. 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. 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 17-1948, the Bank may transfer annually to the general fund of the Commonwealth up to 10% of its net income or \$10 million, whichever is greater. Management of the Bank has defined net income as the increase in unrestricted net position of business-type activities for a fiscal year. The Bank’s board of directors approved such definition. The Bank did not make this transfer for the year ended June 30, 2014.

The Bank has the following blended component units: Puerto Rico Housing Finance Authority (the “Housing Finance 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” or “PFC”), 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 resolution of the Bank’s board of directors. The board of directors of each of the blended component units is substantially the same as the Bank and the Bank may impose its will or obtain a financial benefit or financial burden from each of the blended components units.

The Housing Finance Authority 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 issue bonds and notes, the proceeds of which are deposited in separate trusts and, generally, invested in securities collateralized by mortgage loans (mortgage-backed) on properties located in Puerto Rico purchased by low and moderate-income families, or used to provide subsidies to such families for the acquisition of their primary residences. The Housing Finance Authority is authorized by the U.S. Department of Housing and Urban Development (“HUD”) to administer the U.S. Housing Act Section 8 Program in Puerto Rico, to administer the HOME Investment Partnerships (“HOME”) Program and to act as an approved mortgagor, 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. Some of the assets of the Housing Finance Authority are restricted for mortgage loan insurance operations as explained in note 14 of the basic financial statements.

The Housing Finance Authority is the State Housing Agency (“SHA”) in charge of implementing the Low-Income Housing Tax Credit Program (“LIHTC”) in Puerto Rico. The tax credits provide a financial incentive to construct, rehabilitate, and operate rental housing for low-income tenants. A 10-year tax credit is available for each unit set-aside for low-income use as long as eligible households occupy a specific portion of units in a building or project. The rents charged on the set-aside units are restricted and eligible households occupy them or such units becoming vacant must be held open for eligible households for at least 15 years, plus a minimum of 15 additional years that the Housing Finance Authority requires.

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**  
(A Component Unit of the Commonwealth of Puerto Rico)  
Notes to Basic Financial Statements  
June 30, 2014

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 economic development of the private sector in Puerto Rico and to complement the Bank's lending activities. 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 Treasury of the Commonwealth (the "Secretary of Treasury") for deposit in the Commonwealth's 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. On May 31, 2010, the board of directors of the Capital Fund authorized the transfer of its investments portfolio of approximately \$72 million to the Tourism Development Fund. The transfer was completed on June 30, 2010. The Capital Fund's activities have been reduced significantly after June 30, 2010. On September 17, 2014, the Bank's board of directors approved a resolution to commence the liquidation process of the Capital Fund.

Non-major 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 in a prior fiscal year. The Education Assistance Corporation is currently inactive.

**(2) Restatement of Net Position (Deficit) and Fund Balance (Deficit)**

The Bank adopted Governmental Accounting Standards Board Statement ("GASB") No. 65, *Items Previously Reported as Assets and Liabilities*, effective July 1, 2013 ("GASB Statement 65"); and has applied it retroactively to the financial statements for all periods presented. GASB Statement 65 requires, among other things, that: (1) deferred loss on refunding be reported as a deferred outflow of resources; (2) debt issuance costs are to be recognized as an expense in the period incurred and can no longer be deferred and amortized over the life of the debt; (3) loan origination fees, net of costs, are to be recognized in the period incurred and can no longer be deferred and amortized over the life of the loan; and, (4) fees received for a commitment to originate or purchase a loan or group of loans should be recorded as a liability and, if the commitment is exercised, recognized as revenue in the period of exercise and can no longer be deferred and amortized over the life of the loan as an adjustment of yield.

The following table illustrates the cumulative effect of the GASB Statement 65 adoption as reported in the government-wide financial statements (for governmental and business-type activities) and in the fund financial statements (business-type activities) at July 1, 2013:

**GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2014

	<b>Governmental activities</b>	<b>Business-Type activities / Proprietary funds</b>
Net position (deficit) - beginning of year, as previously reported	\$ (127,221,383)	\$ 2,506,527,379
Cumulative effect of GASB Statement 65 adoption at July 1, 2013 for:		
Debt issue costs	(34,964)	(34,012,419)
Origination fees	-	3,019,984
Commitment fees	-	23,410,845
Net position (deficit) - beginning of year, as restated	<u>\$ (127,256,347)</u>	<u>\$ 2,498,945,789</u>

Deferred loss on refundings amounting to approximately \$2.9 million was reclassified and presented as deferred outflow of resources in the proprietary funds and business type activities in accordance with GASB Statement 65.

**(3) Summary of Significant Accounting Policies**

The accounting and reporting policies of the Bank conform to Generally Accepted Accounting Principles in the United States (U.S. GAAP), as applicable to governmental entities. The Bank follows GASB statements under the hierarchy established by Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, in the preparation of its basic financial statements.

The preparation of basic 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/expenditures during the reported period. Actual results could differ from those estimates.

**(a) Basis of Presentation**

*Government-Wide Financial Statements*

The statement of net position and the statement of activities report information on all activities of the Bank. The effect of interfund balances has been removed from the government-wide statement of net position, except for the residual amounts due between governmental and business-type activities. Internal balances are not included in the total column of the government-wide statement of net position. 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 intergovernmental revenues and other non-exchange revenues. Business-type activities are financed in whole or in part by fees charged for goods or services and interest earned on investment securities and loans. Following is a description of the Bank's government-wide financial statements.

The statement of net position presents the Bank's assets, deferred outflows of resources, and liabilities, with the difference between assets plus deferred outflows of resources less liabilities, reported as net position. Net position is reported in three categories:

- Net investment in capital assets is a component of the net position which consists of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances of bonds, notes, mortgage and other debt that are attributed to the acquisition, construction, or improvement of those assets, if any. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction or improvement of those assets or related debt should be included in the component of net position.

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- Restricted component of the net position consists of restricted assets reduced by liabilities related to 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 component of net position consists of net amount of the assets, deferred outflow of resources, and liabilities that do not meet the definition of the two preceding categories. Unrestricted component of net position often is assigned, in order to indicate that management does not consider them to be available for general operations. Unrestricted component of net position often has constraints on use that are imposed by management, but such constraints may be removed or modified.

When both restricted and unrestricted components of net position are available for use, it is the Bank's policy to use restricted components of net position, and then, unrestricted components of net position as they are needed.

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, and (2) grants and contributions that are restricted to meet 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 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 activities of the Bank that are reported in the accompanying basic financial statements have been classified into governmental and proprietary funds.

Separate financial statements are provided for governmental funds and proprietary funds. Major individual governmental and proprietary funds are reported as separate columns in the fund financial statements, with non-major funds being combined into a single column. In the case of proprietary funds, each individual blended component unit of the Bank with the exception of JMB Institute and the Education Assistance Corporation, which have been grouped as other non-major funds, has been reported as a separate major fund in the fund financial statements.

Fund balances for each governmental fund are displayed in the following classifications depicting the relative strength of the spending constraints placed on the purposes for which resources can be used:

- Nonspendable – amounts that are not in spendable form or are legally or contractually required to be maintained intact.
- Restricted – amounts that are legally restricted by outside parties, constitutional provisions, or enabling legislation for a specific purpose.
- Committed – amounts that can be spent only for specific purposes determined by a formal action of the government's highest level of decision-making authority. Commitments are made and can be rescinded only by a formal action of the government's highest level of decision-making authority. The Bank's highest decision making level of authority rest with the Bank's board of directors. The Bank did not have any committed resources as of June 30, 2014.
- Assigned – intent to spend resources on specific purposes expressed by the governing body.

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- Unassigned – amounts that do not fall into any other category above. This is the residual classification for amounts in the GDB Operating Fund and represents fund balance that has not been assigned to other funds and has not been restricted, committed, or assigned to specific purposes in the General Fund. In other governmental funds, only negative unassigned amounts are reported, if any, and represent expenditures incurred for specific purposes exceeding the amounts previously restricted, committed, or assigned to those purposes.

When both restricted and unrestricted resources (the total amount of committed, assigned and unassigned fund balance) are available for use, it is the Bank's policy to use restricted resources first, and then, unrestricted resources as they are needed. Further, when components of unrestricted fund balance can be used for the same purpose, committed fund balance is depleted first followed by assigned fund balance. Unassigned fund balance is applied last.

The following governmental activities of the Bank are classified as major governmental funds:

- HUD Programs – This special revenue fund accounts for the subsidy to low and moderate-income families for the rental of decent and safe dwellings under the U.S. Housing Act Section 8 programs.
- HOME Program – This special revenue fund is used to account for the specific revenue sources related to the HOME Program. The objectives of this special revenue fund include: (1) expanding the supply of decent and affordable housing, particularly housing for low-income families; (2) strengthening the abilities of state and local governments to design and implement strategies for achieving adequate supplies of decent, affordable housing; (3) providing financial and technical assistance to participating jurisdictions, including the development of model programs for affordable low-income housing; and (4) extending and strengthening partnership among all levels of government and private sector, including for-profit and nonprofit organizations, in the production and operation of affordable housing.
- Affordable Housing Subsidy Programs – This special revenue fund is used to account for the proceeds of specific revenue sources under the different subsidy programs of the Housing Finance Authority, which are as follows:
  - Affordable Housing Mortgage Subsidy Programs (AHMSP) Act. No. 124 – Under this program, the Housing Finance Authority commits to provide a subsidy for the down payment and/or the principal and interest payments on mortgage loans originated under a predetermined schedule of originations. Loans originated, as well as servicing, are kept by the originating financial institution. There was no open schedule of originations under this program as of June 30, 2014.
  - My New Home Program – This program has revenues provided by Act. No. 122 of August 6, 2010, as amended, which assigned to the Housing Finance Authority, for a period of seven years, a portion of no less than 80% of the unreserved monies and other liquid funds abandoned or unclaimed in financial institutions that will be transferred to the general fund of the Commonwealth. This program provides subsidies to eligible families in the purchase of a principal residence through reimbursement of origination and closing costs.
  - My Own Home Program – This program has revenues provided by Act. No. 34 of June 26, 2013. This program provides subsidies to eligible families in the purchase of a principal residence through reimbursement of origination and closing costs.
  - Closing Costs Assistance Program – This program provides subsidies to eligible individuals or families for the purchase of an eligible principal residence. This program concluded on June 30, 2014.
  - New Secure Housing Program – This program provided federal and local resources directed to plan, coordinate, and develop the construction of new housing units as a replacement for those destroyed by Hurricane Georges in 1998, and to attend to the housing needs of those families living in hazard-prone areas.

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***(b) Measurement Focus and Basis of Accounting***

The government-wide and proprietary fund 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 at the time liabilities are incurred, regardless of the timing of the related cash flow takes place. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund's 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 to be received by the HUD Programs, HOME Program and Closing Costs Assistance Program. 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. However, principal and interest on general long term debt, claims and judgments, and compensated absences are recorded only when payment is due. General capital asset acquisitions are reported as expenditures in governmental funds. Proceeds of general long-term debt and acquisitions under capital leases are reported as other financing sources.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses are those that result from the Bank and its components units 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, advances, letters of credit, or guarantees and all general and administrative expenses, among others. Revenues and expenses not meeting these definitions are reported as non-operating 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/her agent with whom the agreement is transacted. As of June 30, 2014, there were no securities purchased under agreements to resell outstanding.

***(d) Investments and Investment Contracts***

Investments and investment contracts are reported 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 (guaranteed 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 or pricing service organizations or based on upon quoted prices for similar instruments in active markets. Realized gains and losses from the sale of investments and unrealized gains and losses of outstanding investments are included in net increase (decrease) in fair value of investments.



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

*General Policy* — Loans are presented at the outstanding unpaid principal balance reduced by the allowance for loan losses. The allowance for loan losses is established through a provision recorded in the statement of activities. The Bank determines the allowance for loan losses by portfolio sector, which consist of the public and private sector loans. The allowance for loan losses is based on management’s evaluation of the risk characteristics of the loans including such factors as the nature of individual credits outstanding, past loss experience, known and inherent risks in the portfolios, sources of repayment, 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 collection of the principal is unlikely. Recoveries of amounts previously charged off are credited to the respective allowance. Because of uncertainties inherent in the estimation process, management’s estimate of credit losses in the outstanding loans receivable portfolios and the related allowance may change if economic and other conditions differ substantially from the assumptions used in making the estimates. Such adjustments to original estimates, as necessary, are made in the period on which these factors and other relevant considerations indicate that loss levels vary from previous estimates. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.

*i. Allowance for Loan Losses– Public Sector*

The Bank's principal function is to provide financing to the Commonwealth and its public entities and municipalities. The financing activities include interim financing for capital improvements payable from the Commonwealth’s general obligation bonds or revenue bonds issued by the corresponding public entity, and loans to finance the Commonwealth’s budget deficit payable from the Puerto Rico Sales Tax Financing Corporation (the “Sales Tax Corporation” or “COFINA”), seasonal collection of income taxes and annual appropriations made by the Legislature Assembly of the Commonwealth of Puerto Rico (the Legislature or Legislative Assembly). The aggregate amount of these loans has increased in recent years as a result of (i) the deterioration of the fiscal situation and financial condition of the Commonwealth and its public entities, (ii) the inability to complete certain financing and liability management transactions due to limited market access and (iii) general market conditions, which in turn have negatively affected the ability of the Commonwealth and its public entities to permanently finance their capital expenditures and operating deficits by issuing bonds and notes.

The Bank considers the public sector loan portfolio as impaired based on current information and events, including the significant delays in the receipt of the scheduled debt service payment mentioned above. In management’s opinion, it is highly probable that the Bank will be unable to collect all amounts due according to the loan’s original contractual terms. The Bank’s management used the results of the Commonwealth’s January 2016 Fiscal and Economic Growth Plan (the FEGP), specifically the set of cash flows and assumptions related to the forecast of the financing gaps for the next ten fiscal years for those entities within the FEGP, including the measures that could be implemented to reduce such gaps, to estimate the potential future debt service payments on its public sector loan portfolio including those payable from appropriations from the the Legislature to establish an allowance for loan losses. Specifically, the Bank established an allowance for loan losses on these impaired loans based on management’s estimate of the presents value of expected debt service payments discounted at the loans’ effective interest rate. The Bank determined that as the ultimate source of repayment on this portfolio is the same, the general fund and/or appropriations from the Legislature, the allowance for loan losses was determined for the related loans on a collective basis instead of on a loan by loan basis. To the extent the FEGP did not include specific entities, the Bank then individually evaluated for impairment the outstanding loans corresponding to those entities. The Bank has separately evaluated the loans with municipalities and considered other factors on the determination of whether an allowance for loan losses is needed. Among the factors evaluated for loans to municipalities were future revenues, history of losses and payments, and financial condition of the municipalities among other factors.

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In relation to interest income recognition, for loans to public sector entities, the Bank had consistently used the policy that the accrual of interest ceased when management determined that all of the following characteristics were present: (a) a loan was six months past due; (b) it had no current source of repayment; (c) it was not covered by a formal commitment from the Commonwealth; and, (d) it did not have designated collateral or such collateral was insufficient. Based on these four elements, all of which had to simultaneously be present, the loan was placed in non-accrual status and all accrued interest receivable was reversed from interest income. However, based on the recent events previously and hereafter explained, the Bank modified the interest income recognition policy during 2014, to classify a specific loan as non-accrual if any of the following characteristics are present: (a) a significant delay (implies the collection of interest and principal on significantly different period from the terms and conditions, usually one year,) in the repayment of the loan is experienced; (b) the loan has no current source of repayment; (c) it is not covered by a formal commitment from the Commonwealth; and (d) it does not have designated collateral or such collateral is insufficient. If any of these characteristics are present, the loan is placed on non-accrual status. This modification to the interest income recognition policy was made to align it better with the increased inherent risk in the Bank's loan portfolio with the Commonwealth and its instrumentalities. Once a loan is placed in non-accrual status, all accrued interest receivable is reversed from interest income. Interest income on non-accrual loans is thereafter recognized as income only to the extent actually collected. Non-accrual loans are returned to an accrual status when there is adequate evidence to believe that the loans will be performing as contracted. During 2014, the Bank reversed \$204.4 million of interest income on \$6,117 million of loans which were placed on non-accrual status.

*ii. Allowance for Loan Losses – Private Sector*

Another function of the Bank is to provide financing to private entities that operate within specific industries of interest to the Commonwealth, due to the economic impact of their operations to the Puerto Rico economy. All of these transactions are approved by the Board of Directors of the Bank and as of June 30, 2014, are mainly related to the dairy, tourism industry and affordable housing programs in Puerto Rico. The Housing Finance Authority grants mortgage loans to low and moderate-income families for the acquisition of single-family housing units and to developers of low and moderate-income multifamily housing units in Puerto Rico. The accrual of interest on loans to the private sector ceases when loans become past due over six months.

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 establishing an allowance for loan losses.

As a general procedure, the Bank internally reviews appraisals as part of the underwriting and approval process and also for credits considered impaired. Appraisals may be adjusted by management due to their age, property conditions, geographical area or general market conditions as deemed necessary. The adjustments applied are based upon internal information, such as other appraisals and/or loss severity information available in several real estate market publications.

*(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 portfolio 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 debt in default, determined on the basis of the estimated future net cash outlays in connection with the related guarantees and letters of credit, or the fair value of the debt's collateral, 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 debt, based on the Bank's loss experience on financial guarantees and letters of credit, and management's best judgment.

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When a guarantee or letter of credit is honored, the Bank recognizes any disbursement as a non-performing 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 loan losses. Any deficiency in the estimated allowance requirement is recorded as an additional provision to the allowance for loan losses.

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 other economic 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 the Tourism Development Fund was created, the Executive Director of the Tourism Development Fund is required to certify each year to the Office of Management and Budget the amount, if any, that is necessary to reimburse the Tourism Development Fund for disbursements made, as defined, in the previous year in excess of revenues collected (net disbursement). On December 16, 2009, Act No. 173 was enacted, which amended the legislation that created the Tourism Development Fund, to modify the definition of net disbursement to include disbursements made by the Tourism Development Fund for (i) loans to third parties, (ii) the acquisition of loan participations, and (iii) the acceleration of maturities of loans, notes, bonds or other type of debt guaranteed by the Tourism Development Fund. However, Act No. 173 provides that such disbursements shall not be deemed made in the year in which the disbursement occurs but shall be deemed made in the year in which the Executive Director of the Tourism Development Fund determines that a loss was incurred with respect to a loan, note, bond or debt (such determination being referred to as a realized loss). The Director of the Office of Management and Budget may include the amount subject to reimbursement in the Commonwealth's general fund budget for the following fiscal year for the Legislature's consideration and approval. The Legislature is not obligated to authorize such appropriations. As of June 30, 2014, there were no outstanding claims for reimbursements requested by the Executive Director of the Tourism Development Fund to the Director of the Office of Management and Budget.

**(g) Debt Issue Costs**

Bond issue costs are recognized as an expense in the period incurred.

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

Real estate available for sale comprises properties acquired in lieu of payment. 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 cost or fair value, which is established by the Bank by using a third party professional assessment or based upon an appraisal, less estimated costs to sell. 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 less 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. Gain or loss on sale of real estate available for sale is included within revenues or expenses, respectively, in the accompanying statement of activities and within non-interest income or non-interest expense in the accompanying statement of revenues, expenses, and changes in net position, respectively.

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**(i) 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 that have a cost of \$500 or more at the date of acquisition and have an expected useful life of three or more years. Depreciation is charged to operations and included within expenses, and is computed on the straight-line basis over the estimated useful lives of the depreciable assets. 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:

<u>Capital asset</u>	<u>Years</u>
Building	40 years
Leasehold improvements	Lesser of 10 years or lease term
Information systems	3–5 years
Office furniture and equipment	5 years
Vehicles	5 years

The Bank reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable and in accordance with GASB 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. Events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment or approval of laws or regulations or other changes in environmental factors, technological changes or evidence of obsolescence, changes in the manner or duration of use of a capital asset, and construction stoppage. A capital asset generally should be considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset. The amount of the impairment of these assets is determined by comparing the carrying value with the fair value of the asset. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the assets.

**(j) Securities Sold under Agreements to Repurchase**

The Bank enters into sales of securities under agreements to repurchase. These agreements generally represent short-term borrowings 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. As of June 30, 2014, securities sold under agreement to repurchase amounted to \$50 million.

**(k) Compensated Absences**

The liability for compensated absences reported in the government wide and proprietary fund financial statements consists of unpaid, accumulated vacation and sick leave balances. In the governmental funds, a liability for compensated absences is recorded only to the extent the obligation has matured. The liability has been calculated using the vesting method, in which leave amounts for both, employees who currently are eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination, are included. The liability has been calculated based on the employee's current salary level and includes salary related costs.

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 60 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 government wide and proprietary fund financial statements present the cost of accumulated vacation and sick leave within accounts payable and accrued liabilities.

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On June 17, 2014, the Commonwealth enacted Act. No. 66, the “Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act” (the “Act 66-2014”). Among other changes, the Act 66-2014 lowered the maximum vacation leave days that any public entity’s employee accumulates from 90 days to 60 days, effective immediately after its enactment.

**(l) Allowance for Losses on Mortgage Loans Insurance**

The estimated liability for losses on mortgage loans insurance is based on management’s evaluation of potential losses on insurance claims after considering economic conditions, market value of related property, and other pertinent factors. Such amount is, in the opinion of management, adequate to cover estimated future probable mortgage loans insurance losses. Actual losses for mortgage loans insurance are charged, and recoveries, if any, are credited to the estimated liability for losses on mortgage loans insurance. Because of uncertainties inherent in the estimation process, management’s estimate of losses in the outstanding loans guarantee portfolio and the related liability may change in the near future.

**(m) Deferred Outflow/Inflow of Resources**

In addition to assets, the statement of net position and/or balance sheet reports a separate section for deferred outflow of resources. This separate financial statement element represents a consumption of net position that applies to a future period and so will not be recognized as an outflow of resources (expense/expenditure) until then. In addition to liabilities, deferred inflows of resources are presented. Deferred inflow of resources represent the consumption of net assets that is applicable to a future reporting period. On the government-wide and proprietary funds statement of net position, a deferred outflow has been recorded related to the loss on refundings of debt for the difference between the reacquisition price and the net carrying amount of the old debt. This deferred outflow will be amortized over the shorter of the life of the refunded or refunding debt.

**(n) Debt 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 reported as a deferred outflow of resources or a deferred inflow of resources and is recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

**(o) Conduit 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 Housing Finance Authority are considered conduit debt and are excluded, along with the related assets held in trust, from the accompanying basic financial statements. The Bank, the Housing Finance Authority 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 Housing Finance 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.

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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, and of certain of its public entities, or to refund such previously issued bonds. 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. The underlying notes represent debt of the issuing instrumentalities. The bonds are considered conduit debt, and therefore neither the bonds nor the notes purchased with the proceeds therefrom are presented in the accompanying basic financial statements.

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

The Bank recognizes loan origination and commitment fees as income in the period received and the direct loan origination costs as an expense in the period incurred.

**(q) *Guarantee Fees***

Guarantee fees are amortized over the life of the related guarantee using the straight-line method.

**(r) *Transfers of Receivables***

Transfers of receivables are accounted and reported as a sale if the Bank's continuing involvement with those receivable is effectively terminated. This approach distinguishes transfers of receivables that are sales from transfers that are collateralized borrowings.

The Bank's continuing involvement is considered to be effectively terminated if all of the following criteria are met: (i) the transferee's ability to subsequently sell or pledge the receivables is not significantly limited by constraints imposed by the Bank, either in the transfer agreement or through other means, (ii) the Bank does not have the option or ability to unilaterally substitute for or reacquire specific accounts from among the receivables transferred, except in certain limited circumstances, (iii) the sale agreement is not cancelable by either party, including cancellation through payment of a lump sum or transfer of other assets or rights, and (iv) the receivables and the cash resulting from their collection have been isolated from the Bank.

The Housing Finance Authority 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) *Mortgage Loans Insurance Premiums***

Premiums on insured mortgage loans are recognized as earned during the period of the insurance coverage.

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**(t) Future Adoption of Accounting Pronouncements**

The GASB has issued the following Statements:

**Accounting Pronouncements Issued But Not Yet Effective**

The following new accounting standards has been issued but not yet effective:

- GASB Statement No. 68, *Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27*. This Statement improves accounting and financial reporting by state and local governments for pensions. It also improves information provided by state and local governmental employers about financial support for pensions that is provided by other entities. This Statement replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, as well as the requirements of Statement No. 50, *Pension Disclosures*, as they relate to pensions that are provided through pension plans administered as trusts or equivalent arrangements (hereafter jointly referred to as trusts) that meet certain criteria. The requirements of Statements 27 and 50 remain applicable for pensions that are not covered by the scope of this Statement. This Statement will bring the effect of Statement 67 summarized in the previous note 1.cc, into the accounting records of the individual agencies, component units and municipalities, whose employees participate in the Retirement Systems.

The Commonwealth, as well as its component units (including the Bank), are considered “cost-sharing” employers of the Retirement Systems; therefore, they would report its allocated share of the Retirement System’s resulting Net Pension Liability from Statement 67 as follows:

- Based on their respective individual proportion to the collective net pension liability of all the governments participating
- The proportion should be consistent with the method used to assess contributions (percentage of payroll). The use of their respective long term expected contribution effort to Retirement Systems divided by those of all governments in the plan, is encouraged.

This Statement is not effective until fiscal year 2015. The Commonwealth is in the process of evaluating the impact of this Statement on its agencies and component units (including the Bank).

- GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*. This Statement establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term *government combinations* include a variety of transactions referred to as mergers, acquisitions, and transfers of operations.

The distinction between a government merger and a government acquisition is based upon whether an exchange of significant consideration is present within the combination transaction. Government mergers include combinations of legally separate entities without the exchange of significant consideration. This Statement requires the use of carrying values to measure the assets and liabilities in a government merger. Conversely, government acquisitions are transactions in which a government acquires another entity, or its operations, in exchange for significant consideration. This Statement requires measurements of assets acquired and liabilities assumed generally to be based upon their acquisition values. This Statement also provides guidance for transfers of operations that do not constitute entire legally separate entities and in which no significant consideration is exchanged. This Statement defines the term operations for purposes of determining the applicability of this Statement and requires the use of carrying values to measure the assets and liabilities in a transfer of operations.

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A disposal of a government's operations results in the removal of specific activities of a government. This Statement provides accounting and financial reporting guidance for disposals of government operations that have been transferred or sold. The requirements of this Statement are effective for government combinations and disposals of government operations occurring in financial reporting periods beginning after December 15, 2013, and should be applied on a prospective basis.

- GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*. This Statement amends paragraph 137 of Statement No. 68 to require that, at transition, a government recognize a beginning deferred outflow of resources for its pension contributions, if any, made subsequent to the measurement date of the beginning net pension liability. Statement No. 68, as amended, continues to require that beginning balances for other deferred outflows of resources and deferred inflow of resources related to pensions be reported at transition only if it is practical to determine all such amounts. The provisions of this Statement should be applied simultaneously with the provisions of Statement No. 68.
- GASB Statement No. 72, *Fair Value Measurement and Application*. This Statement requires a government to use valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value. The techniques should be consistent with one or more of the following approaches; the market approach, the cost approach, or the income approach. This Statement also establishes a hierarchy of inputs to valuation techniques used to measure fair value. That hierarchy has three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are inputs, other than quoted prices, included within Level 1 that are observable for the assets or liability, either directly or indirectly. Finally, Level 3 inputs are unobservable inputs, such as management's assumptions of the default rate among underlying mortgages of a mortgage-backed security. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2015.
- GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*. This Statement establishes requirements for defined-benefit pensions that are not within the scope of Statement No. 68, *Accounting and Financial Reporting for Pensions*, as well as for the assets accumulated for purposes of providing those pensions. In addition, it establishes requirements for defined contribution pensions that are not within the scope of Statement 68. It also amends certain provisions of Statement No. 67, *Financial Reporting for Pension Plans*, and Statement 68 for pension plans and pensions that are within their respective scopes. The provisions of this Statement that address accounting and financial reporting by employers and governmental nonemployer contributing entities for pensions that are not within the scope of Statement 68 are effective for financial statements for fiscal years beginning after June 15, 2016, and the provisions of this Statement that address financial reporting for assets accumulated for purposes of providing those pensions are effective for fiscal years beginning after June 15, 2015. The provisions of this Statement for pension plans that are within the scope of Statement 67 or for pensions that are within the scope of Statement 68 are effective for fiscal years beginning after June 15, 2015.
- GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. This Statement replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. It also includes requirements for defined-contribution OPEB plans that replace the requirements for those OPEB plans in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, as amended, Statement 43, and Statement No. 50, *Pension Disclosures*. The scope of this Statement includes OPEB plans-defined benefit and defined contribution-administered through trusts that meet the following criteria:
  - Contributions from employers and nonemployer contributing entities to the OPEB plan and earnings on those contributions are irrevocable.



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- OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms.
- OPEB plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the OPEB plan administrator. If the plan is a defined benefit OPEB plan, plan assets also are legally protected from creditors of the plan members.

This Statement also includes requirements to address financial reporting for assets accumulated for purposes of providing defined-benefit OPEB through OPEB plans that are not administered through trusts that meet the specified criteria. The provisions of this statement are effective for fiscal years beginning after June 15, 2016.

- GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. This Statement replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, for OPEB. Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, establishes new accounting and financial reporting requirements for OPEB plans. The scope of this Statement addresses accounting and financial reporting for OPEB that is provided to the employees of state and local governmental employers. This Statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about defined benefit OPEB also are addressed. In addition, this Statement details the recognition and disclosure requirements for employers with payables to defined-benefit OPEB plans that are administered through trusts that meet the specified criteria and for employers whose employees are provided with defined contribution OPEB. This Statement also addresses certain circumstances in which a nonemployer entity provides financial support for OPEB of employees of another entity. The provisions of this statement are effective for fiscal years beginning after June 15, 2017.
- GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. This Statement identifies in the context of the current governmental financial reporting environment the hierarchy of generally accepted accounting principles (GAAP). The “GAAP hierarchy” consists of the sources of accounting principles used to prepare financial statements of state and local governmental entities in conformity with GAAP and the framework for selecting those principles. This Statement reduces the GAAP hierarchy to two categories of authoritative GAAP and addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP. This Statement supersedes Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2015.
- GASB Statement No. 77, *Tax Abatement Disclosures*. This Statement establishes financial reporting standards for tax abatement agreements entered into by state and local governments. The disclosures required by this Statement encompass tax abatements resulting from both (a) agreements that are entered into by the reporting government and (b) agreements that are entered into by other governments and that reduce the reporting government’s tax revenue. The provisions of this Statement should be applied to all state and local governments subject to such tax abatement agreements. For financial reporting purposes, a tax abatement is defined as a reduction in tax revenue that results from an agreement between one or more governments and an individual or entity in which (a) one or more governments promise to forgo tax revenue to which they are otherwise entitled and (b) the individual or entity promises to take a specific action after the agreement has been entered into that contributes to economic development or otherwise benefits the governments or the citizens of those governments. A transaction’s substance, not its form or title, is a key factor in determining whether the transaction meets the definition of a tax abatement for the purpose of this Statement. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2015.

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- GASB Statement No. 78, *Pensions Provided Through Certain Multiple-Employer Defined Benefit Plans*. This Statement addresses a practice issue regarding the scope and applicability of Statement No. 68, *Accounting and Financial Reporting for Pensions*. This issue is associated with pensions provided through certain multiple-employer defined-benefit pension plans and to state or local governmental employers whose employees are provided with such pensions. Prior to the issuance of this Statement, the requirements of Statement 68 applied to the financial statements of all state and local governmental employers whose employees are provided with pensions through pension plans that are administered through trusts that meet the criteria in paragraph 4 of that Statement. This Statement amends the scope and applicability of Statement 68 to exclude pensions provided to employees of state or local governmental employers through a cost-sharing multiple-employer defined benefit pension plan that (1) is not a state or local governmental pension plan, (2) is used to provide defined-benefit pensions both to employees of state or local governmental employers and to employees of employers that are not state or local governmental employers, and (3) has no predominant state or local governmental employer (either individually or collectively with other state or local governmental employers that provide pensions through the pension plan). This Statement establishes requirements for recognition and measurement of pension expense, expenditures, and liabilities; note disclosures; and required supplementary information for pensions that have the characteristics described above. This Statement is not effective until fiscal year 2016.
- GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*. This Statement addresses accounting and financial reporting for certain external investment pools and pool participants. Specifically, it establishes criteria for an external investment pool to qualify for making the election to measure all of its investments at amortized cost for financial reporting purposes. An external investment pool qualifies for that reporting if it meets all of the applicable criteria established in this Statement. The specific criteria address (1) how the external investment pool transacts with participants; (2) requirements for portfolio maturity, quality, diversification, and liquidity; and (3) calculation and requirements of a shadow price. Significant noncompliance prevents the external investment pool from measuring all of its investments at amortized cost for financial reporting purposes. Professional judgment is required to determine if instances of noncompliance with the criteria established by this Statement during the reporting period, individually or in the aggregate, were significant. If an external investment pool does not meet the criteria established by this Statement, that pool should apply the provisions in paragraph 16 of Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as amended. If an external investment pool meets the criteria in this Statement and measures all of its investments at amortized cost, the pool's participants also should measure their investments in that external investment pool at amortized cost for financial reporting purposes. If an external investment pool does not meet the criteria in this Statement, the pool's participants should measure their investments in that pool at fair value, as provided in paragraph 11 of Statement 31, as amended. This Statement establishes additional note disclosure requirements for qualifying external investment pools that measure all of their investments at amortized cost for financial reporting purposes and for governments that participate in those pools. Those disclosures for both the qualifying external investment pools and their participants include information about any limitations or restrictions on participant withdrawals. This Statement is not effective until fiscal year 2016, except for certain provisions on portfolio quality, custodial credit risk, and shadow pricing. Those provisions are not effective until fiscal year 2017.
- GASB Statement No. 80, *Blending Requirements for Certain Component Units*. This Statement improves financial reporting by clarifying the financial statement presentation requirements for certain component units. This Statement amends the blending requirements established in paragraph 53 of Statement No. 14, *The Financial Reporting Entity*, as amended. This Statement amends the blending requirements for the financial statement presentation of component units of all state and local governments. The additional criterion requires blending of a component unit incorporated as a not-for-profit corporation in which the primary government is the sole corporate member. The additional criterion does not apply to component units included in the financial reporting entity pursuant to the provisions of Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. This Statement is not effective until fiscal year 2017.

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- GASB Statement No. 81, *Irrevocable Split-Interest Agreements*. This Statement improves accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. Split-interest agreements are a type of giving agreement used by donors to provide resources to two or more beneficiaries, including governments. Split-interest agreements can be created through trusts, or other legally enforceable agreements with characteristics that are equivalent to split-interest agreements, in which a donor transfers resources to an intermediary to hold and administer for the benefit of a government and at least one other beneficiary. Examples of these types of agreements include charitable lead trusts, charitable remainder trusts, and life-interests in real estate. This Statement requires that a government that receives resources pursuant to an irrevocable split-interest agreement recognize assets, liabilities, and deferred inflows of resources at the inception of the agreement. Furthermore, this Statement requires that a government recognize assets representing its beneficial interests in irrevocable split-interest agreements that are administered by a third party, if the government controls the present service capacity of the beneficial interests. This Statement requires that a government recognize revenue when the resources become applicable to the reporting period. This Statement is not effective until fiscal year 2018.
- GASB Statement No. 82, *Pension Issues—an Amendment of GASB Statements No. 67, No. 68 and No. 73*. This Statement addresses certain issues that have been raised with respect to GASB Statements No. 67, No. 68, and No. 73. The Statement is designed to improve consistency in the application of the pension standards by clarifying or amending related areas of existing guidance. Specifically, this Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. Prior to the issuance of this Statement, GASB Statements No. 67 and No. 68 required presentation of covered-employee payroll, which is the payroll of employees that are provided with pensions through the pension plan, and ratios that use that measure, in schedules of required supplementary information. This Statement amends GASB Statements No. 67 and No. 68 to instead require the presentation of covered payroll, defined as the payroll on which contributions to a pension plan are based, and ratios that use that measure. This Statement clarifies that a deviation, as the term is used in Actuarial Standards of Practice issued by the Actuarial Standards Board, from the guidance in an Actuarial Standard of Practice is not considered to be in conformity with the requirements of GASB Statement No. 67, GASB Statement No. 68, or GASB Statement No. 73 for the selection of assumptions used in determining the total pension liability and related measures. This Statement clarifies that payments that are made by an employer to satisfy contribution requirements that are identified by the pension plan terms as plan member contribution requirements should be classified as plan member contributions for purposes of GASB Statement No. 67 and as employee contributions for purposes of GASB Statement No. 68. It also requires that an employer's expense and expenditures for those amounts be recognized in the period for which the contribution is assessed and classified in the same manner as the employer classifies similar compensation other than pensions (for example, as salaries and wages or as fringe benefits). This Statement is not effective until fiscal year 2017, except for the requirements of this Statement for the selection of assumptions in a circumstance in which an employer's pension liability is measured as of a date other than the employer's most recent fiscal year-end. In that circumstance, the requirements for the selection of assumptions are effective for that employer in the first reporting period in which the measurement date of the pension liability is on or after June 15, 2017.

Management is evaluating the impact that these Statement will have on the Banks's basic financial statements.

#### (4) Uncertainties, Liquidity Risk and Going Concern

##### Introduction

The Bank has traditionally served as interim lender to the Commonwealth and its public corporations (also referred to herein as instrumentalities) and municipalities in anticipation of the issuance of long term bonds and notes by such entities in the municipal bond market. The Bank has also provided financing to the Commonwealth and its instrumentalities to finance their respective budget deficits, collateral requirements under swap agreements and to meet mandatory payments of obligations.

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As a result of this lending function, the Bank traditionally served as the principal source of short term liquidity for the Commonwealth, its public corporations and municipalities.

Loans to the Commonwealth and its instrumentalities constitute a significant portion of the Bank's assets. As a result, the Bank's liquidity and financial condition depends to a large extent on the repayment of loans made to the Commonwealth and its instrumentalities, which face significant fiscal and financial challenges. Conditions that adversely affect the ability of the Commonwealth and its instrumentalities to raise cash (including limited access to capital markets) and repay their interim and other loans to the Bank have an adverse effect on the Bank's liquidity and financial condition. Similarly, conditions that adversely affect the ability of the Bank to raise cash (including limited access to capital markets) or otherwise finance its loan portfolio also have an adverse effect on the Commonwealth and its instrumentalities, as the Bank's ability to continue providing interim financing to the Commonwealth and its instrumentalities is reduced.

The Bank faces significant risks and uncertainties and it currently does not have sufficient liquid financial resources to meet obligations when they come due, as further described below. As discussed below, pursuant to recently enacted legislation, the Governor has ordered the suspension of loan disbursements by the Bank, imposed restrictions on the withdrawal and transfer of deposits from the Bank, and imposed a moratorium on debt obligations of the Bank, among other measures.

GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* ("GASB 56"), establishes that the continuation of a legally separate governmental entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Information that may significantly contradict the going concern assumption would relate to a governmental entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of governmental operations, restructuring of debt, submission to the oversight of a separate fiscal assistance authority or financial review board, or similar actions. Indicators such as negative trends in operating losses and negative cash flows, possible financial difficulties such as nonpayment or default of debt and/or restructurings or noncompliance with capital or reserve requirements, and internal or external matters impacting the governmental entity's ability to meet its obligations as they become due, are factors that are considered in this evaluation.

The discussion in the following paragraphs regarding the liquidity risks, uncertainties and remediation plans of the Bank provides the necessary background and support for management's evaluation as to whether there is substantial doubt about the Bank's ability to continue as a going concern for 12 months beyond the date of the financial statements or for an extended period if there is currently known information that may raise substantial doubt shortly thereafter. As discussed below, the risks and uncertainties facing the Bank, and, more broadly, the Commonwealth and its other instrumentalities, together with other factors described in the basic financial statements, have led management to conclude that there is substantial doubt as to the ability of the Bank to continue as a going concern.

### **Factors Affecting Liquidity**

The Commonwealth currently faces a severe fiscal and liquidity crisis, the culmination of many years of significant governmental deficits, a prolonged economic recession (which commenced in 2006), high unemployment, population decline, and high levels of debt and pension obligations, among other factors. These factors have adversely affected the credit ratings of the Commonwealth and its instrumentalities and their ability to access the capital markets or obtain financing at reasonable interest rates, if at all. These adverse conditions are reflected in the deterioration of the Commonwealth's credit ratings. Since June 30, 2014, the principal rating agencies have continued to lower their rating on the general obligation bonds of the Commonwealth and various instrumentalities, which had already been placed within non-investment grade categories in February 2014. Current rating categories reflect high vulnerability to non-payment and the expectation of the rating agencies of defaults in several obligations.

During the fiscal year ended June 30, 2014, and subsequent to the end of such fiscal year, the Bank's liquidity position has been adversely affected by the Commonwealth and its instrumentalities' continued operational deficits and lack of capital markets access. These factors have resulted in delays in the repayment by the Commonwealth and its instrumentalities of outstanding loans with the Bank, which delays, in turn, have limited the Bank's ability to continue providing liquidity to the

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Commonwealth and its instrumentalities. The Commonwealth's General Fund budget for fiscal year 2014 included approximately \$291.3 million of appropriations to the Bank, including approximately \$270 million of appropriations to repay principal and interest on public sector loans. These appropriations were based on payment schedules proposed by the Bank, which are mostly based on a period of amortization of 30 years, at contractual interest rates. During fiscal year 2014, in order to address a significant revenue shortfall, Executive Order No. 2014-029 was signed by the Governor, which modified the budgetary appropriation originally approved by the Legislative Assembly of the Commonwealth and thus modified the principal and/or interest payments actually received by the Bank. The amount of the appropriation was reduced from approximately \$291.3 million to \$30.1 million. This reduction was compensated with the funds obtained from the \$3.5 billion General Obligation Bonds issuance of March 2014. For fiscal year 2015, the Commonwealth and the Bank renegotiated the terms of such loans and the Commonwealth appropriated and paid the renegotiated debt service on the public sector loan portfolio of the Bank. During fiscal year 2015 the Bank received \$153.9 million of appropriations.

The budget proposed by the Governor to the Legislative Assembly for fiscal year 2016 included an appropriation for the payment of debt owed by the Commonwealth and certain of its instrumentalities to the Bank of \$261 million, but was amended by the Legislative Assembly to reduce said appropriation to approximately \$18 million, all of which were received. Given the Commonwealth's deteriorating financial condition and ongoing fiscal crisis, there can be no assurance that the Commonwealth will be in a position to make any future appropriations for the payment of debt owed by the Commonwealth and its instrumentalities to the Bank.

As a result of the reductions in liquidity experienced subsequent to June 30, 2014, the Bank took a number of liquidity enhancing and conservation measures, and explored the sale of assets and other alternatives to address its liquidity needs. For example, one of the Bank's component unit sold approximately \$90 million of mortgage loans to third party investors, the proceeds of which were used to repay several outstanding lines of credit with the Bank. In light of the Bank's significant debt service obligations during fiscal year 2016, these measures, however, were not sufficient to maintain the Bank's operations in the ordinary course absent the completion of a capital market transaction, a restructuring of the Bank's debt, and the payment by the Commonwealth of debt service on the Bank's public sector loans payable from annual appropriations. As a result of the non-payment by the Commonwealth of the appropriation to the Bank and the Bank's inability to restructure its debt in light of the broader fiscal crisis faced by the Commonwealth, the Bank was not in a position to pay principal on its debt obligations due on May 1, 2016 and continue operations in the ordinary course. In April 2016 the Governor imposed on the Bank the emergency operational restrictions and debt moratorium described below. The Bank has continued to pay interest on its debt obligations.

### **Puerto Rico Emergency Moratorium and Financial Rehabilitation Act**

On April 6, 2016, the Governor signed into law Act 21-2016, known as the "Puerto Rico Emergency Moratorium and Financial Rehabilitation Act" (as amended pursuant to Act 40-2016, "Act 21"). Act 21 allows the Governor to declare a moratorium on debt service payments and to stay related creditor remedies for a temporary period for the Commonwealth and certain government instrumentalities, including the Bank. In respect of the Bank, Act 21 also allows the Governor to take any and all actions that are reasonable and necessary to allow the Bank to continue carrying out its operations. The temporary period set forth in Act 21 lasts until January 31, 2017, with a possible two-month extension at the Governor's discretion. The moratorium and stay provisions with respect to any obligations owed by the Bank require executive action of the Governor to become effective.

On April 8, 2016, the Governor signed Executive Order No. 2016-010 ("EO No. 2016-010"), declaring the Bank to be in a state of emergency pursuant to Act 21. In accordance with the emergency powers provided for in Act 21, EO No. 2016-010 implemented a regulatory framework governing the Bank's operations and liquidity, including prohibiting loan disbursements by the Bank and establishing a procedure with respect to governmental withdrawals, payments, and transfer requests with respect to funds held on deposit at the Bank. To that effect, EO No. 2016-010 restricts the withdrawal, payment and transfer of funds held on deposit at the Bank to those reasonable and necessary to ensure the provision of essential services and authorizes the Bank to establish weekly limits on the aggregate amount of such disbursements. Moreover, EO No. 2016-010 prohibits the Bank depositors from printing or writing checks creditable against their accounts at the Bank, unless they obtain a temporary waiver from the Bank. Finally, pursuant to Act 21, EO No. 2016-010 suspends Article 6 of Act No. 17 of

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September 23, 1948, as amended (the “the Bank’s Enabling Act”), which required the Bank to maintain a reserve of not less than 20% of its liabilities on accounts of deposits on demand.

Further, on April 30, 2016, the Governor signed Executive Order No. 2016-014 (“EO No. 2016-014”), which, among other things, (a) designates deposits and letters of credit of the Bank as “enumerated obligations” of the Bank, thereby making them “covered obligations” of the Bank and, therefore, subject to the stay provisions of Act 21, (b) declares a moratorium with respect to the financial obligations of the Bank (other than deposits and interest obligations that may be paid in kind), (c) provides that interest payments in respect of the Bank’s financial obligations may be made to the extent authorized by the Governor, and (d) declares an emergency period with respect to certain obligations of Puerto Rico Financing Infrastructure Authority (PRIFA) that are secured by a letter of credit issued by the Bank. Pursuant to EO No. 2016-014, on May 1, 2016, the Bank failed to make a principal payment of approximately \$367 million in respect of its notes.

Act 21 also included amendments to the Bank’s Enabling Act to include certain statutory options and tools useful for any resolution, reorganization or restructuring that the Bank may undertake in the future. Specifically, these amendments modernize the receivership provision in the Bank’s Enabling Act and authorize the creation of a temporary “bridge bank” to carry out the Bank’s functions and honor deposits.

Finally, Act 21 also created a new fiscal agency and financial advisory authority to assume the Bank’s role as fiscal agent, financial advisor and reporting agent for the Commonwealth, its instrumentalities, and municipalities.

**Management Plans and Going Concern Considerations**

Management has determined that, even under the framework of EO No. 2016-010 and EO No. 2016-014, the Bank will require additional sources of liquidity, in particular, through appropriations for the payment of debt service by the Commonwealth in fiscal year 2017 on the Bank’s appropriation loans or some other appropriation to the Bank and the consummation of a comprehensive restructuring of its debt obligations for the Bank to continue operating in fiscal year 2017 and beyond.

For fiscal year 2017, an appropriation for the payment of the Commonwealth’s loans with the Bank in the amount of \$375 million was included by the Office of Management and Budget in the budget that was submitted by the Governor to the Legislature. The budget bill approved by the Legislature on June 30, 2016, and subsequently signed by the Governor, however, included appropriations to the Bank in an aggregate amount of approximately \$250 million, distributed through several items. The use by GDB of such appropriations is restricted to certain specified purposes, such as specific deposit withdrawals. The budget provides that such appropriations shall be applied as a reduction in the Commonwealth’s debts with the Bank.

In addition, as part of the approval of the fiscal year 2017 budget, the Legislative Assembly approved an amendment to Article 2.04(b) of Act 83-1991 to allow the Center for Collection of Municipal Revenues (“CRIM” in Spanish) to retain certain funds that were previously be transferred to the Commonwealth for payment of debt, and to use these amounts to disburse municipal deposits that remain deposited in the Bank. The statute provides that the Commonwealth shall have a claim against the Bank’s estate in an amount equal to the total of the funds retained by CRIM pursuant to such amendment (estimated to be approximately \$115 million). As of the date of these financial statements, such bill is under consideration and has not been signed by the Governor.

The Bank announced on May 1, 2016 that it had negotiated a framework of indicative terms for a restructuring of the Bank’s notes with a group of noteholders (known as the “Ad Hoc Group”) holding approximately \$900 million of the Bank’s outstanding notes (the “Old Notes”). The framework included an understanding with the Ad Hoc Group regarding key terms for a restructuring of the portion of the Bank’s Old Notes held by the group and a path forward to a broader restructuring of all of the Bank’s Old Notes. The agreement on key terms was intended to provide a framework for the Bank and the Ad Hoc Group to continue negotiations with a view toward entering into an agreement in principle that would memorialize in full the terms and conditions of the proposed restructuring.

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The agreed key terms contemplate a two-step restructuring of the Bank's obligations, in which all holders of the Old Notes (including the Ad Hoc Group) would first exchange (an "Interim Exchange") their current holdings for new notes at the Bank (the "Interim Notes"), to be followed by an exchange of such Interim Notes as part of a future global restructuring of the debt of the Commonwealth and its instrumentalities, including that of the Bank (the "Global Restructuring"). As part of the agreed key economic terms, creditors would agree to haircut of 43.75% of the face amount of their Old Notes in the first-step exchange. In addition, as part of the transaction, bondholders would agree to the proposed treatment for their notes, in a second step exchange as part of a Global Restructuring, that would result in an agreed haircut of 53% of the face amount of their Old Notes. Many important terms of the transaction are currently being discussed as the parties continue to negotiate further details of the transaction, including several key open economic terms. In addition, the transaction would be subject to several conditions, which would need to be met over the coming months before the deal could proceed.

Importantly, the proposed terms of the Interim Exchange require 100% participation by all bondholders, including, in addition to the Ad Hoc Group, the state-chartered credit unions in Puerto Rico (or "cooperativas") and other large institutional groups on the Commonwealth. As a result, the proposed transaction is being designed to take into account the varied interests of all its creditors, and, as further details of the transaction are negotiated with the Ad Hoc Group, the Bank and the Commonwealth plan on continuing discussions with such other creditor groups to ensure that any agreement in principle reflects their concerns in a debt restructuring. Similarly, as a comprehensive deal for all of the Bank's stakeholders, the transaction contemplates providing a path forward to depositors, including by providing collateral for their deposits, as the Bank works through its challenges.

Without federal restructuring legislation, including the tools to bind non-consenting creditors, the transaction would be highly unlikely to reach the required participation levels. In the absence of federal legislation, the Bank would not be able to complete the deal as proposed, and the Commonwealth as a whole would not be able to move towards a comprehensive restructuring of the debt of the Commonwealth and its instrumentalities.

If the Bank does not obtain adequate funding from the Commonwealth for fiscal year 2017 and is not able to consummate a comprehensive debt restructuring, or to otherwise obtain additional funding or other arrangements with its creditors, the Bank may not be able to continue as a going concern and may need to pursue the resolution processes provided for by the Bank's Enabling Act, as amended pursuant to Act 21. Act 21 amended the receivership provisions of the Bank's Enabling Act to establish a set of rules better suited to confront the challenges that would be faced by the Bank if it were to go into receivership at some point in the future. It modified the process for the appointment of a receiver, including that the Governor (rather than a court) may appoint the receiver based on recommendations made by the Bank's Board of Directors or the Secretary of Treasury of the Commonwealth. As amended, the Bank's Enabling Act establishes that the receiver shall have, among other, the following powers: (i) to place the Bank into resolution, (ii) to evaluate and adjudicate claims against the Bank, (iii) to petition for the creation of a bridge bank, and (iv) to create subsidiaries to take over certain of the Bank's functions. If the Bank were to be placed into receivership at some point in the future, the Secretary of the Treasury would have the power to, if so requested by the Bank's receiver, organize a bridge bank. The new bridge bank could assume certain of the Bank's liabilities and purchase certain of its assets. If a bridge bank is created, creditor claims that are not assumed by the bridge bank would remain at the Bank, but all creditors shall be entitled to receive at least the amount such creditors would have received if the Bank were liquidated without a bridge bank on the date the receiver was appointed.

**(5) Cash and Due from Banks, Federal Funds Sold, and Deposits Placed with Banks**

Custodial credit risk is the risk that, in the event of a financial institution failure, the Bank's deposits may not be returned to it. 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 Treasury. The Bank does not have a formal policy for custodial credit risk for cash accounts opened with commercial banks outside Puerto Rico.

The Bank's policies for deposits placed with banks and federal funds sold establish maximum exposure limits for each institution based on the institution's capital, financial condition and credit rating assigned by nationally recognized rating

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agencies. Deposits placed with banks of approximately \$734 million mature in fiscal year 2015. Federal funds sold mature overnight and no collateral is required.

The table presented below discloses the level of custodial credit risk assumed by the Bank at June 30, 2014. As of June 30, 2014, \$1,384,185,872 of the depository bank balance of \$1,422,930,391 was uninsured and uncollateralized as follows:

	<b>Carrying amount</b>	<b>Depository bank balance</b>	<b>Amount uninsured and uncollateralized</b>
Cash and due from banks	\$ 83,001,390	\$ 82,578,139	\$ 69,394,806
Deposits placed with banks	734,365,252	734,365,252	708,804,066
Federal funds sold	605,987,000	605,987,000	605,987,000
Total	<u>\$ 1,423,353,642</u>	<u>\$ 1,422,930,391</u>	<u>\$ 1,384,185,872</u>

**(6) Investments**

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

- U.S. government and agencies obligations
- Certificates of deposit and time deposits
- Bankers' acceptances
- Obligations of the Commonwealth, its public entities, and municipalities
- Federal funds sold
- Securities purchased under agreements to resell
- World Bank securities
- Mortgage-backed and asset-backed securities
- Corporate debt, including investment contracts
- External investment pools
- Stock of corporations created under the laws of the United States of America 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 its equivalent by Moody's Investors Services



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The Bank's investment policies establish limitations and other guidelines on maturities and amounts to be invested in the aforementioned investment categories and by issuer/counterparty 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 Risk Management Committee ("RMC"), formerly known as the Asset Liability Management Committee ("ALCO") and the board of directors of the Bank will determine, from time to time, other transactions that the Bank may enter into.

**Credit Risk** – Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Bank's investment policies provide that investment transactions shall be entered into only with counterparties that are rated BBB+/A-1 or better by Standard & Poor's or equivalent rating by Moody's Investors Service or Fitch Ratings (Fitch), depending on the type and maturity of the investment and the counterparty to the transaction. Any exceptions must be approved by the Bank's board of directors. The investment policies also provide that purchases and sales of investment securities shall be made using the delivery versus payment procedures.

**Interest Rate Risk** – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Bank's investment policies also provide that the RMC is responsible for implementing and monitoring the Bank's interest rate risk policies and strategies. The RMC meets on a monthly basis to coordinate and monitor the interest rate risk management of interest sensitive assets and interest sensitive liabilities, including matching of their anticipated level and maturities, consistent with the Bank's liquidity, capital adequacy, risk and profitability goals set by the Bank's board of directors.

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The following table summarizes the type and maturities of investments held by the Bank at June 30, 2014. Investments by type in any one issuer representing 5% or more of total investments of either the Bank or its blended component units have been separately disclosed. 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.

Investment type	Within one year	After one to five years	After five to ten years	After ten years	Total
U.S. Treasury notes	\$ 65,543,682	\$ 115,116,719	\$ -	\$ -	\$ 180,660,401
U.S. sponsored agencies notes:					
Federal National Mortgage Association ("FNMA")	99,756,710	50,102,500	26,273,026	-	176,132,236
Federal Home Loan Bank ("FHLB")	324,050,270	225,243,557	33,640,645	-	582,934,472
Federal Home Loan Mortgage Corporation ("FHLMC")	110,259,700	129,691,388	75,800,750	-	315,751,838
Mortgage and asset-backed securities:					
Government National Mortgage Association ("GNMA")	523,180	251,584	3,571,440	114,012,785	118,358,989
FNMA	-	-	271,075	141,182,734	141,453,809
FHLMC	-	-	6,618	7,691,046	7,697,664
Interest-only strips	-	-	-	5,532,347	5,532,347
Other	-	159,091	-	58,942,685	59,101,776
Corporate debt:					
Investors Bond Fund	1,690,000	-	-	-	1,690,000
Andrew Mellon Foundation	3,009,060	-	-	-	3,009,060
Bank of Montreal	-	9,551,585	-	-	9,551,585
General Electric, Corp.	-	1,042,580	-	-	1,042,580
Gotham Funding, Corp.	49,994,555	-	-	-	49,994,555
Halkin Finance, LLC	49,989,444	-	-	-	49,989,444
Institution Secured Funding, LLC	99,993,861	-	-	-	99,993,861
Manhattan Asset Funding Co.	29,994,300	-	-	-	29,994,300
Royal Bank of Canada	-	25,049,750	-	-	25,049,750
First Puerto Rico Family of Funds	47,000,000	-	-	-	47,000,000
Puerto Rico Fixed Income I	24,250,000	-	-	-	24,250,000
Puerto Rico Fixed Income II	20,200,000	-	-	-	20,200,000
Puerto Rico Fixed Income V	4,100,000	-	-	-	4,100,000
Puerto Rico Investors Tax Free Fund I	1,300,000	-	-	-	1,300,000
Puerto Rico Investors Tax Free Fund II	4,750,000	-	-	-	4,750,000
Puerto Rico Investors Tax Free Fund III	9,990,000	-	-	-	9,990,000
Puerto Rico Investors Tax Free Fund IV	1,010,000	-	-	-	1,010,000
Puerto Rico Investors Tax Free Fund V	4,045,000	-	-	-	4,045,000
Puerto Rico Investors Tax Free Fund VI	2,215,000	-	-	-	2,215,000
Puerto Rico Tax Free Fund I	5,600,000	-	-	-	5,600,000
Puerto Rico Tax Free Fund II	17,950,000	-	-	-	17,950,000
External investment pools:					
Fixed-income securities	-	71,664,843	-	5,327,465	76,992,308
Israel Aid bonds	12,580,983	42,576,850	-	-	55,157,833
Nonparticipating investment contracts:					
Trinity Funding Co	-	-	-	20,481,044	20,481,044
Citibank, N.A.	-	17,628,800	-	-	17,628,800
Banco Popular de Puerto Rico	-	-	-	15,512,161	15,512,161
Banco Santander Puerto Rico	-	-	-	11,398,435	11,398,435
Total investments	<u>\$ 989,795,745</u>	<u>\$ 688,079,247</u>	<u>\$ 139,563,554</u>	<u>\$ 380,080,702</u>	<u>2,197,519,248</u>
External investment pools-					
Equity securities:					
Global Opportunities Capital Appreciation Fund					14,858,047
Preferred securities/interest:					
Grupo Hima San Pablo					3,615,209
Other					203,300
Total					<u>\$ 2,216,195,804</u>

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Investments in fixed-income external investment pools had an average maturity of more than one year. These investments include \$71,664,843 invested in the Puerto Rico Government Investment Trust Fund, a government-sponsored pool, which is administered by the Bank. This pool is subject to regulatory oversight by the Commissioner of Financial Institutions of Puerto Rico. The fair value of the pool is the same as the value of the pool shares.

At June 30, 2014, the total amount of \$35,643,915 of the Bank's investment in corporate debt maturing over one year, bears fixed interest rate. Also, at June 30, 2014, approximately 36.8% of the Bank's investments in mortgage and asset-backed securities were held by trustees in connection with bonds issued by the Housing Finance Authority, the terms of which generally provide for early redemption of the bonds if the securities are repaid early.

During fiscal year 2012, the Bank invested in interest-only strips to maximize yields and as a protection against a rise in interest rates. These securities are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to increased prepayments by mortgagees, which may result from a decline in interest rates. If interest rates decline, the value of interest-only strips declines. If interest rates increase, the value of interest-only strips increases. At June 30, 2014 the Bank had \$5.5 million of investments on interest-only strips.

During fiscal year 2013, the Tourism Development Fund entered into an agreement with a third party to redeem its investment in class B preferred special interest in Desarrolladora Del Norte, S. en C. for \$32 million in cash and an \$8 million non-interest bearing promissory note. The non-interest bearing promissory note requires annual payments of \$800,000 through June 2023. The Tourism Development Fund will forebear annual payments if Desarrolladora Del Norte, S. en C. maintains its hotels operations in Puerto Rico with approximately 600 employees and complies with other requirements during the term of the contract. Management of the Tourism Development Fund understands that the collection of the promissory note is contingent on future events, therefore, the amounts under such promissory note will be recognized once they are collected.

During the year ended June 30, 2014, proceeds from sales and redemption of investments from all the proprietary funds amounted to approximately \$4.9 billion. Gross gains and losses on sale and redemption of investments amounted to approximately \$10.8 million and \$54.3 million, respectively. Purchases of investments during the year ended June 30, 2014, amounted to approximately \$4.1 billion.

All of the Bank's investments in U.S. Treasury securities, mortgage-backed securities guaranteed by GNMA, and Israel Aid Bonds carry the explicit guarantee of the U.S. government. The credit quality ratings for investments in debt securities, excluding U.S. Treasury securities, mortgage-backed securities guaranteed by GNMA, and Israel Aid Bonds, at June 30, 2014, are as follows:

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Securities type	Credit Risk Rating <sup>(1)</sup>			Total
	AAA to A-	BBB	B	
U.S. sponsored agencies notes:				
FNMA	\$ 176,132,236	\$ -	\$ -	\$ 176,132,236
FHLB	582,934,472	-	-	582,934,472
FHLMC	315,751,838	-	-	315,751,838
Mortgage and asset-backed securities				
FNMA	141,453,809	-	-	141,453,809
FHLMC	7,697,664	-	-	7,697,664
Interest-only strips	5,532,347	-	-	5,532,347
Other	59,101,776	-	-	59,101,776
Corporate debt	412,725,135	-	-	412,725,135
External investment pools:				
Fixed-income securities	76,992,308	-	-	76,992,308
Non-participating investment contracts	38,109,844	11,398,435	15,512,161	65,020,440
<b>Total</b>	<b>\$ 1,816,431,429</b>	<b>\$ 11,398,435</b>	<b>\$ 15,512,161</b>	<b>\$ 1,843,342,025</b>

<sup>(1)</sup> Rating obtained from Standard & Poor's or equivalent rating by Moody's Investor Service or Fitch Rating.

The credit quality ratings of non-participating investment contracts are based on the credit quality ratings at June 30, 2014, of the counterparties with whom these contracts are entered into. The credit quality ratings of the counterparties should follow the ratings required by the investment policies of the Bank.

As of June 30, 2014, 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	\$ 240,857,500
Securities sold under agreements to repurchase	\$ 50,000,000

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**(7) Loans Receivable and Allowance for Loan Losses**

At June 30, 2014, loans consist of the outstanding balance of credit facilities granted to the following (in thousands):

	<b>GDB Operating Fund <sup>(1)</sup></b>	<b>Tourism Development Fund</b>	<b>Housing Finance Authority</b>	<b>Development Fund</b>	<b>Total</b>
Public corporations and agencies	\$ 6,249,426	\$ -	\$ -	\$ -	\$ 6,249,426
Municipalities	2,214,882	-	-	-	2,214,882
Allowance for loan losses	(2,504,000)	-	-	-	(2,504,000)
Net loans to public sector	5,960,308	-	-	-	5,960,308
Private sector	39,392	211,079	342,456	24,246	617,173
Allowance for loan losses	(12,727)	(122,697)	(35,444)	(24,246)	(195,114)
Net loans to private sector	26,665	88,382	307,012	-	422,059
Total loans receivable, net	<u>\$ 5,986,973</u>	<u>\$ 88,382</u>	<u>\$ 307,012</u>	<u>\$ -</u>	<u>\$ 6,382,367</u>

<sup>(1)</sup> Excluding loans to component units.

**(a) Public Corporations and Agencies**

Loans to the public sector, excluding municipalities, amounted to approximately \$6.2 billion at June 30, 2014. Loans to the Commonwealth and its public entities typically include working capital lines of credit payable from short-term tax and revenue anticipation notes issued by the Bank to finance the short-term liquidity needs of the Commonwealth, interim financing of capital improvements payable from Commonwealth's general obligation bonds or revenue bonds issued by the corresponding agency and, in recent years, loans to finance the Commonwealth's budget deficit previously payable from COFINA and currently payable from debt appropriations, uncollected taxes and annual appropriations made by the Legislature.

The loans for capital improvements generally are construction loans and are repaid from the proceeds of future bond issuances of the respective public entities. Such loans may, however, also be repaid from the revenues of such public entities, from loans provided by sources other than the Bank, from federal grants, and from the sale of assets of such public entities. The amount of outstanding loans from the Bank to the public entities fluctuates annually, depending upon the capital program needs of the public entities, the timing and level of their capital expenditures, and their ability to gain access to the long-term capital markets. The participation of certain of the Commonwealth and its public entities in the bond market has been adversely affected based on the current credit ratings of both the Commonwealth and the public entities. Refer to note 4 to the accompanying financial statements for additional information.

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At June 30, 2014, loans to public corporations and agencies of the Commonwealth amounting to \$6,249,426 are repayable from the following sources (in thousands):

<b>Repayment Source</b>	<b>Amount</b>
Proceeds from future bond issuances	\$ 2,276,522
General fund and/or legislative appropriations	3,629,077
Operating revenues	331,087
Other	12,740
	<u>\$ 6,249,426</u>

For the year ended June 30, 2014, disbursements and collections of principal of public sector loans with future bond issuances as the source of repayment amounted to approximately \$1,742 million and \$2,454 million, respectively. Public sector loans with Commonwealth's General fund and/or appropriations as source of repayment had disbursements and collections of principal amounting to approximately \$65.9 million and \$291.3 million, respectively, during the year ended June 30, 2014. Public sector loans with operating revenue and other as a source of repayment had disbursements and collections of principal amounting to approximately \$280.4 million and \$270.1 million, respectively, during the year ended June 30, 2014.

At June 30, 2014, approximately \$3.6 billion of the public sector loans are payable from legislative appropriations, or future tax revenues of, the Commonwealth. Accordingly, the payment of these loans is affected by budgetary constraints associated with the current economic and fiscal situation impacting Puerto Rico. Refer to note 4 for additional information on legislative appropriations.

The Commonwealth's general fund budget for fiscal year 2014 included \$291.3 million of appropriations to repay principal and interest on public sector loans whose repayment source was either from future issuance of Commonwealth's general obligations or COFINA bonds and other legislative appropriations. The Bank annually submits to the Office of Management and Budget (OMB), to be included in the Commonwealth's budget for legislative approval in each subsequent fiscal year, an amount established in the payment schedules, which are mostly based on a period of amortization of 30 years each, at contractual interest rates. During the 2014 fiscal year, Executive Order No. 2014-029 (the EO) was signed by the Governor, issued and implemented. The EO modified the debt service appropriation originally approved by the Legislature and thus modified the principal and/or interest payments actually received by the GDB. The Bank received \$30.1 million of appropriations of the initially approved \$291.3 million. During fiscal year 2015, the Bank received \$153.9 million of appropriations. The amount assigned to appropriation debt in the Commonwealth's budget for fiscal year 2015-16, includes approximately \$18 million for the debt service applicable to the Bank. However, the Act includes a special appropriation labeled "Fund for Economic Development and Payment of Obligations of Puerto Rico" from which managements expect the remainder of the requested debt service will be assigned and received. The Bank expects that future appropriations will be approved by the Legislature to comply with such schedules. However, there can be no assurance that the Director of Office of Management and Budget will include an amount for loan repayments in the Commonwealth's budget, and that the Legislature will appropriate sufficient funds in the future to cover all amounts due to the Bank on these loans.

As of June 30, 2014, the HTA had an authorized maximum of \$2,015.9 million in financing with the GDB with an outstanding balance of \$2,014.1 million in principal. Historically, these facilities have been repaid from proceeds of bond issuances. All of these facilities have been extended repeatedly and have not paid as scheduled. On December 1, 2015, the Commonwealth announced its intention to utilize Commonwealth's taxes and revenues pledged to certain public corporations and agencies, including the HTA, to meet its own obligations as needed. As such, there can be no assurance that the HTA management's current plans to repay or refinance the obligations or extend their terms will be achieved or that services will not have to be terminated, curtailed or modified.

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HTA does not currently have sufficient funds available to fully repay its various obligations, including those owed to the Bank, as they come due or that are currently in default, and is working on extending the due date of the obligations or obtaining new financing to provide relief and/or funds to repay the existing amounts of principal and interest or bring the outstanding balances current at the various due dates as well as to continue to operate and to finance capital improvement projects. Additionally, significant support and funding for obligations of the HTA has previously been provided by sources from the Commonwealth and other entities that are part of the Commonwealth, such as the Bank. The Commonwealth and such entities are experiencing significant financial difficulties and are unable to continue to extend, refinance or otherwise provide the necessary liquidity to the HTA as and when needed. As such, current defaults may not be cured and future defaults on the obligations of this entity may not be avoided. The management of the HTA has plans to address its liquidity situation and continue its services and believes it will be able to repay or refinance its obligations and also continue to operate as a separate governmental entity. However, there can be no assurance that the Commonwealth will continue to provide adequate support, will continue to allow the HTA to operate as a separate entity or that the affiliated or unaffiliated lenders will be able and willing to refinance or modify the terms of the entity's obligations.

During 2014, the Bank has disbursed and collected approximately, \$263.4 and \$162.8 million, respectively, related to loans of the HTA. During fiscal year 2015, the Bank has collected approximately \$27.1 million, related to loans of the HTA. There were no disbursements during fiscal year 2015.

Refer to Note 4 for additional information concerning matters that have negatively affected the ability of the public corporations, including the HTA, to timely repay its credit facilities.

	<b>GDB</b>
	<b>Operating</b>
	<b>Fund (in thousands)</b>
Recorded investment in impaired loans:	
Not requiring an allowance for loan losses	\$ -
Requiring an allowance for loan losses	6,239,258
Total recorded investment in impaired loans	<u>\$ 6,239,258</u>
Related allowance for loan losses	\$ 2,516,727
Average recorded investment in impaired loans	\$ 6,606,332
Interest income recognized on impaired loans	\$ 211,591

As of June 30, 2014, the majority of loans to public corporations and agencies totaling \$6.2 billion has been classified in non-accrual status. Interest income that would have been recorded if such non-accrual loans had been accruing in accordance with their original terms was approximately \$382.2 million in fiscal year 2014. Interest collected during fiscal year 2014 on these loans amounted to \$272 million.

The FEGP contains the plans and the administrative and legislative measures necessary to address the short, medium and long-term fiscal and economic challenges facing the Commonwealth and the Bank, including measures to: (i) address the financing gaps and the debt load on the public sector, (ii) achieve the execution of its budgets, (iii) achieve greater transparency with respect to statistics and the government's financial information, and (iv) carry out the structural reforms necessary to promote the economic growth and competitiveness of the Commonwealth.

The Bank's management used the results of the FEGP, specifically the set of cash flows and assumptions related to the forecast of the financing gaps for the next ten fiscal years for those entities within the FEGP, including the measures that could be implemented to reduce such gaps, to estimate the potential future debt service payments on its public sector loan portfolio including those payable from appropriations from the Legislature to establish an allowance for loans losses. The Bank developed several possible cash flow scenarios, by stressing certain key assumptions within the FEGP, to determine the amounts available for future debt service payments to the Bank. For each of the scenarios, the Bank determined the

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present value of the future debt service payments, discounted at the public sector portfolio's composite effective interest rate. Then, various probabilities were assigned to each of the scenarios to determine a range of possible loan losses to the Bank. The allowance for loan losses was estimated by averaging these probabilities. The Bank determined that as the ultimate source of repayment on this portfolio is the same, the general fund and/or appropriations from the Legislature, it treated the loans as homogenous to estimate the allowance for loan losses. To the extent the FEGP did not include specific entities, the Bank then individually evaluated for impairment the outstanding loans corresponding to those entities. The impairment losses recognized for these specific loans were based on the same loss percentages allowance determined for the homogeneous loan portfolio as previously explained.

During fiscal year 2014, the Bank recognized a provision for loan losses of approximately \$2.5 billion for inherent credit losses in its public sector loan portfolio.

**(b) Municipalities Loans**

Loans to municipalities amounted to approximately \$2.2 billion at June 30, 2014. For the year ended June 30, 2014, municipal sector loan disbursements and collections amounted to approximately \$165 million and \$170 million, respectively. The following table provides the sources of repayment of the loans to municipalities:

	<b>Principal (in thousands)</b>
Repayment source:	
Collections of property tax	\$ 1,373,930
Collections of municipal sales and use tax	580,889
Operating revenues and other	260,063
Total	<u>\$ 2,214,882</u>

These loans include approximately \$1.37 billion at June 30, 2014, which are collateralized by a pledge of a portion of property tax assessments of each municipality. Loans pledged with property tax assessments include bonds and notes issued by Puerto Rico municipalities which are originated by the Bank as bridge financing until such financings can be completed.

Loans to municipalities include approximately \$581 million at June 30, 2014, which are collateralized by a pledge of a portion of the municipal sales tax, which is deposited in special accounts with the Bank for the purpose of granting such loans to municipalities. The funds available in such accounts increase the borrowing capacity of the corresponding municipality.

Loans to municipalities include approximately \$260 million at June 30, 2014, which were provided mainly as interim loans to finance capital expenditures that are payable from revenues to be generated from a specific revenue generating project associated with the loan or to cover operating losses. Once operating loans are approved and if the municipality is not servicing the debt with its own funds, the Bank informs the Municipal Revenue Collection Center (CRIM for its Spanish acronym) in order to withhold property taxes revenues and remit them directly to the Bank before they are distributed to the municipalities. These loans include approximately \$7 million which were previously payable from future issuances of the Commonwealth's general obligations and are currently payable from legislative appropriations.

Municipality loans amounting to approximately \$1.5 million as of June 30, 2014, were identified as delinquent. No interest was collected on these loans during the year ended June 30, 2014.

**(c) Private Sector Loans**

Loans to the private sector include the outstanding principal balance of credit facilities granted by the Bank, the Tourism Development Fund and the Development Fund to private enterprises in Puerto Rico, the activities of which are deemed



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to further the economic and tourism development of Puerto Rico. Loans to the private sector 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 low and moderate-income multifamily housing units in Puerto Rico. These credit facilities, net of allowance for loan losses, amounted to approximately \$422 million at June 30, 2014, of which approximately \$307 million are mortgage loans for low and moderate-income housing units, approximately \$88 million are for tourism projects and approximately \$27 million are manufacturing loans.

Private sector loans classified as nonaccrual amounted to approximately \$281 million at June 30, 2014. Interest income that would have been recorded if these loans had been performing in accordance with their original terms was approximately \$15.8 million in 2014.

During fiscal year 2010, the Bank granted a loan to DBR Dorado Member LLC, as part of a credit facility amounting to \$231 million related to the construction of the Ritz Reserve Hotel in Dorado. The Tourism Development Fund participated in this credit facility. During fiscal 2014, the Bank and the Tourism Development Fund executed a redemption agreement with the borrowers of the credit facilities by which the Bank and the Tourism Development Fund were released of their duties as lenders and guarantor, respectively, in exchange for certain conditions, including the payment by the Tourism Development Fund of \$15 million in cash and the Bank forgoing on the collection of the outstanding balance of the loan originally granted to DBR Dorado Member LLC. The outstanding investment balance of the Bank as of June 30, 2014, of approximately \$12.4 million on this credit facility, was fully reserved.

The following is a summary of private sector loans considered to be impaired as of June 30, 2014, and the related interest income for the year then ended (in thousands):

	<b>GDB Operating Fund</b>	<b>Tourism Development Fund</b>	<b>Housing Finance Authority</b>	<b>Development Fund</b>	<b>Total</b>
Recorded investment in impaired loans:					
Not requiring an allowance for loan losses	\$ 93	\$ -	\$ 3,186	\$ -	\$ 3,279
Requiring an allowance for loan losses	12,727	211,079	42,522	24,246	290,574
Total recorded investment in impaired loans	<u>\$ 12,820</u>	<u>\$ 211,079</u>	<u>\$ 45,708</u>	<u>\$ 24,246</u>	<u>\$ 293,853</u>
Related allowance for loan losses	<u>\$ 12,727</u>	<u>\$ 122,697</u>	<u>\$ 26,796</u>	<u>\$ 24,246</u>	<u>\$ 186,466</u>
Average recorded investment in impaired loans	<u>\$ 12,826</u>	<u>\$ 315,010</u>	<u>\$ 45,100</u>	<u>\$ 22,852</u>	<u>\$ 395,788</u>
Interest income recognized on impaired loans	\$ 782	\$ -	\$ 1,251	\$ -	\$ 2,033

The following is an overall summary of the activity in the allowance for loan losses for the year ended June 30, 2014 (in thousands):

	<b>Proprietary Funds</b>				
	<b>GDB Operating Fund</b>	<b>Tourism Development Fund</b>	<b>Housing Finance Authority</b>	<b>Development Fund</b>	<b>Total</b>
Balance – beginning of year	\$ 4,264	\$ 178,721	\$ 37,742	\$ 16,937	\$ 237,664
Provision for loan losses	2,512,463	30,092	1,598	7,309	2,551,462
Write-offs	-	(86,116)	(4,612)	-	(90,728)
Recoveries	-	-	716	-	716
Balance – end of year	<u>\$ 2,516,727</u>	<u>\$ 122,697</u>	<u>\$ 35,444</u>	<u>\$ 24,246</u>	<u>\$ 2,699,114</u>

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**(8) Due from Federal Government**

The Housing Finance Authority, as a public housing agency, is authorized to administer the U.S. Housing Act Section 8 Programs in Puerto Rico. The revenues and expenses of such federal financial assistance are accounted for as a major governmental fund under the HUD Programs fund. Revenues and expenditures related to the administration of the U.S. Housing Act Section 8 Programs amounted to approximately \$142.6 million during the year ended June 30, 2014. This amount includes approximately \$4.8 million of administrative fees for services performed as contract administrator, which are reimbursed by HUD. As of June 30, 2014, the amounts due from federal government under the HUD Programs fund amounted to approximately \$1 million.

During the year ended June 30, 2014, the Housing Finance Authority expended approximately \$10.3 million of HOME Program funds. The Housing Finance Authority has approximately \$11.2 million due from the federal government as of June 30, 2014.

The New Secure Housing Program (the "NSH Program") constituted an inter-governmental effort to provide long-term hazard mitigation assistance to the Commonwealth by providing funding for relocation of eligible participants who were affected by Hurricane Georges in 1998 or who lived in hazard-prone areas under the Federal Emergency Management Agency Hazard Mitigation Grant Program (HMGP). Through a series of collaborative agreements, the Office of the Governor's Authorized Representative (the GAR) was named the grantee, the Puerto Rico Department of Housing (the "Department of Housing") was named the sub-grantee, and the Housing Finance Authority was named the administrator of the NSH Program.

Under the NSH Program, the Housing Finance Authority was responsible for administering the NSH Program, including contracting, supervising and paying the designers, inspectors, and legal services needed for the NSH Program. The Housing Finance Authority also provided all funding for the NSH Program through a \$67 million nonrevolving line of credit with the Bank. The Department of Housing was responsible for land acquisitions, auctioning projects, awarding construction contracts, qualifying participants, and selling housing units to eligible participants.

Under the terms of the grant, the construction of, and relocation of participants into new secure housing facilities was to be completed by December 31, 2007. In addition, FEMA would reimburse 75% of the allowable costs of the NSH Program. Funds collected under the NSH Program, since its inception, amounted to approximately \$113 million and are subject to compliance audits under OMB Circular A-133 and federal granting agencies audits.

In April 2007, FEMA discontinued reimbursing the Housing Finance Authority's allowable costs based on the NSH Program's non-compliance with the scheduled dates for construction activities and case management. The Department of Housing requested various extensions and reconsiderations the last one up to June 30, 2010 and FEMA granted such requests.

Although significant progress was made through June 30, 2010, in the construction activities and in the case management of the NSH Program, the Housing Finance Authority was not able to fully comply with the terms of the extensions granted by FEMA. On September 30, 2011, the Housing Finance Authority provided FEMA and the GAR, the NSH Program's closeout documentation which was reviewed by FEMA.

On January 30, 2012, the Housing Finance Authority and the Department of Housing entered into a transition agreement by which the Department of Housing would assume its obligations as the NSH Program sub-grantee and project owner, including vacant property dispositions, open space monitoring and other related matters. The Housing Finance Authority will continue to assume the amounts payable under the \$67 million nonrevolving line of credit with the Bank, until such debt can be assumed by the Commonwealth. The DOH would prospectively assume, without recourse, any additional funds that might be requested by FEMA for events of noncompliance, including related costs.

Based on all these facts and that no reimbursements have been received from FEMA since April 2007, management has decided to establish an allowance for the \$26 million due from FEMA at June 30, 2014.

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

Real estate available for sale at June 30, 2014, at fair value, consisted of the following:

	<u>Proprietary Funds</u>		<u>Total</u>
	<u>GDB Operating Fund</u>	<u>Housing Finance Authority</u>	
Land	\$ -	\$ 8,880,000	\$ 8,880,000
Residential (1-4 units)	-	4,501,923	4,501,923
Commercial	69,163,957	-	69,163,957
Total real estate available for sale	<u>\$ 69,163,957</u>	<u>\$ 13,381,923</u>	<u>\$ 82,545,880</u>

During fiscal year 2009, the Bank entered into an interagency agreement with a public entity of the Commonwealth whereby the Bank received several properties with appraised values (based on appraisals made near the transaction date) of \$155.9 million in lieu of payment of a loan whose principal balance and accrued interest receivable amounted to \$144.2 million at December 30, 2008. The interagency agreement provides that the agency of the Commonwealth shall transfer to the Bank additional properties to cover any deficiency in the properties values during a period of five years. On November 20, 2013, the agreement was extended until December 30, 2018.

As part of such agreement any subsequent loss or reduction of fair value shall be repaid by the Commonwealth or one of its components units. As of June 30, 2014, other receivables includes \$6.2 million of other receivable, net of an allowance for uncollectible receivable related to the losses or reductions in fair value from such properties.

**(10) Capital Assets**

Capital assets activity for the year ended June 30, 2014, was as follows:

	<u>Governmental activities</u>			
	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions/ reclassifications</u>	<u>Ending balance</u>
Capital assets:				
Information systems	\$ 66,329	\$ -	\$ -	\$ 66,329
Office furniture and equipment	37,074	-	-	37,074
Vehicles	66,135	-	-	66,135
Total capital assets	<u>169,538</u>	<u>-</u>	<u>-</u>	<u>169,538</u>
Less accumulated depreciation and amortization for:				
Information systems	(66,307)	-	-	(66,307)
Office furniture and equipment	(32,025)	(2,945)	-	(34,970)
Vehicles	(66,132)	-	-	(66,132)
Total accumulated depreciation	<u>(164,464)</u>	<u>(2,945)</u>	<u>-</u>	<u>(167,409)</u>
Capital assets governmental activities – net	<u>\$ 5,074</u>	<u>\$ (2,945)</u>	<u>\$ -</u>	<u>\$ 2,129</u>

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	<b>Business type – activities</b>			<b>Ending balance</b>
	<b>Beginning balance</b>	<b>Additions</b>	<b>Reductions/ reclassifications</b>	
Capital assets not being depreciated:				
Land	\$ 2,845,000	\$ -	\$ -	\$ 2,845,000
Land under development	87,172,697	8,313,801	(81,386,498)	14,100,000
Total capital assets not being depreciated	<u>90,017,697</u>	<u>8,313,801</u>	<u>(81,386,498)</u>	<u>16,945,000</u>
Capital assets being depreciated:				
Building	8,988,048	-	(8,988,048)	-
Leasehold improvements	4,683,319	105,310	(3,695)	4,784,934
Information systems	4,725,089	1,336,035	(364,507)	5,696,617
Office furniture and equipment	2,765,853	79,121	(60,666)	2,784,308
Software	2,499,278	143,682	-	2,642,960
Vehicles	257,849	21,442	(67,078)	212,213
Total capital assets being depreciated	<u>23,919,436</u>	<u>1,685,590</u>	<u>(9,483,994)</u>	<u>16,121,032</u>
Less accumulated depreciation and amortization for:				
Building	(2,808,765)	(224,701)	3,033,466	-
Leasehold improvements	(3,112,115)	(508,616)	3,695	(3,617,036)
Information systems	(3,392,782)	(665,743)	364,506	(3,694,019)
Office furniture and equipment	(2,360,093)	(156,895)	60,666	(2,456,322)
Software	(2,124,208)	(290,436)	-	(2,414,644)
Vehicles	(216,945)	(11,671)	67,078	(161,538)
Total accumulated depreciation and amortization	<u>(14,014,908)</u>	<u>(1,858,062)</u>	<u>3,529,411</u>	<u>(12,343,559)</u>
Total capital assets being depreciated – net	9,904,528	(172,472)	(5,954,583)	3,777,473
Capital assets business type activities – net	<u>\$ 99,922,225</u>	<u>\$ 8,141,329</u>	<u>\$ (87,341,081)</u>	<u>\$ 20,722,473</u>
Total capital assets – net				<u>\$ 20,724,602</u>

As of June 30, 2014, the Bank recorded long lived assets impairment charges totaling \$73.7 million, mostly related to a land under development. In December 1997, the Corporación Renovación Urbana y Vivienda (“CRUV”) transferred to the Bank certain properties with an approximate fair value of \$37.8 million (as appraised in 1997) in exchange for a debt cancellation. One of the properties received was Finca Rosso or Comunidad Río Bayamón Norte (hereinafter “CRBN”) Specifically, as part of its functions of furthering the economic development of Puerto Rico, the Bank was developing the infrastructure and public spaces of the CRBN as per a Master Plan. However, during fiscal year 2014, the Bank determined that the changes in circumstances associated with the service use of the property dramatically changed and thus recorded an impairment.

**(11) Deposits**

Deposits consist predominantly of interest-bearing demand accounts, special government deposit accounts, and time deposits from the Commonwealth, and its public entities. Interest expense on these deposits amounted to approximately \$46.6 million during fiscal year 2014.

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**(12) Securities Sold under Agreements to Repurchase**

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

Carrying amount at June 30, 2014	\$ 50,000,000
Maximum amount outstanding at any month-end	\$1,236,412,779
Average amount outstanding during the year	\$ 572,736,619
Weighted average interest rate for the year	0.18%
Weighted average interest rate at year-end	0.03%

The following summarizes the activity of securities sold under agreements to repurchase for the year ended June 30, 2014:

	<u>Beginning balance</u>	<u>Issuances</u>	<u>Maturities</u>	<u>Ending balance</u>
GDB Operating Fund	<u>\$ 634,301,000</u>	<u>\$ 9,942,712,064</u>	<u>\$ 10,527,013,064</u>	<u>\$ 50,000,000</u>

All sales of investments under agreements to repurchase are based on fixed terms. In investing the proceeds of securities sold under agreements to repurchase, the Bank's policy is for the term to maturity of investments to be on or before the maturity of the related repurchase agreements. At June 30, 2014, the total amount of securities sold under agreements to repurchase mature within one year.

**(13) Bonds, Notes, and Mortgage-Backed Certificates Payable, and Other Liabilities**

The activity of bonds payable and other borrowed funds for the year ended June 30, 2014, is as follows:

	<u>Beginning balance (as restated)</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Governmental activities –					
Commonwealth appropriation bonds and notes - note payable - AHMSP Act No. 124	\$ 3,500,735	\$ -	\$ -	\$ 3,500,735	\$ -
Less unaccreted discount	(70,179)	-	3,697	(66,482)	-
Total governmental activities	<u>\$ 3,430,556</u>	<u>\$ -</u>	<u>\$ 3,697</u>	<u>\$ 3,434,253</u>	<u>\$ -</u>

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	<b>Beginning balance (as restated)</b>	<b>Additions</b>	<b>Reductions</b>	<b>Ending balance</b>	<b>Due within one year</b>
Business-type activities:					
GDB Operating Fund:					
Adjustable Refunding Bonds	\$ 267,000,000	\$ -	\$ -	\$ 267,000,000	\$ -
Senior Notes 2006 Series B	236,490,000	-	(68,785,000)	167,705,000	68,810,000
Senior Notes 2006 Series C	81,960,000	-	-	81,960,000	81,960,000
Senior Notes 2010 Series A	433,702,000	-	-	433,702,000	-
Senior Notes 2010 Series B	151,259,000	-	-	151,259,000	-
Senior Notes 2010 Series C	217,715,000	-	-	217,715,000	-
Senior Notes 2010 Series D	96,411,000	-	-	96,411,000	-
Senior Notes 2011 Series A	70,000,000	-	(70,000,000)	-	-
Senior Notes 2011 Series B	650,000,000	-	(250,000,000)	400,000,000	-
Senior Notes 2011 Series H	1,399,045,000	-	-	1,399,045,000	-
Senior Notes 2011 Series I	397,935,000	-	-	397,935,000	80,000,000
Senior Notes 2012 Series A	1,000,000,000	-	(4,195,000)	995,805,000	245,805,000
Senior Notes 2013 Series B	-	110,000,000	-	110,000,000	-
Add (deduct) unamortized premium (discount)	(5,851,029)	-	494,860	(5,356,169)	308,505
Total GDB Operating Fund	<u>4,995,665,971</u>	<u>110,000,000</u>	<u>(392,485,140)</u>	<u>4,713,180,831</u>	<u>476,883,505</u>
Housing Finance Authority:					
Mortgage Trust III	147,850,002	-	(23,530,000)	124,320,002	26,795,000
Revenue bonds:					
Single Family Mortgage Revenue Bonds – Portfolio XI	16,600,000	-	(1,415,000)	15,185,000	315,000
Mortgage-Backed Certificates 2006 Series A	93,463,043	-	(9,188,138)	84,274,905	10,964,416
Total revenue bonds	<u>110,063,043</u>	<u>-</u>	<u>(10,603,138)</u>	<u>99,459,905</u>	<u>11,279,416</u>
Notes payable					
Special obligation notes (Home Purchase Stimulus Program)	76,444,600	-	(790,600)	75,654,000	-
Special obligation notes (Third Party Origination Program)	29,776,955	-	(29,776,955)	-	-
Plus unamortized premium	369,325	-	(39,240)	330,085	-
Less unaccrued discount	(70,045,391)	-	11,138,899	(58,906,492)	-
Total notes payable	<u>36,545,489</u>	<u>-</u>	<u>(19,467,896)</u>	<u>17,077,593</u>	<u>-</u>
Total Housing Finance Authority	<u>294,458,534</u>	<u>-</u>	<u>(53,601,034)</u>	<u>240,857,500</u>	<u>38,074,416</u>
Tourism Development Fund:					
Participation agreement payable	24,338,889	-	(866,666)	23,472,223	866,667
Notes payable to GDB	331,758,021	-	(284,977,590)	46,780,431	-
Total Tourism Development Fund	<u>356,096,910</u>	<u>-</u>	<u>(285,844,256)</u>	<u>70,252,654</u>	<u>866,667</u>
Total	5,646,221,415	110,000,000	(731,930,430)	5,024,290,985	515,824,588
Less intrafund eliminations	(331,758,021)	-	284,977,590	(46,780,431)	-
Total business-type activities	<u>\$ 5,314,463,394</u>	<u>\$ 110,000,000</u>	<u>\$ (446,952,840)</u>	<u>\$ 4,977,510,554</u>	<u>\$ 515,824,588</u>

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In accordance with GAAP, the Bank recorded approximately \$215 million within the intrafund eliminations corresponding to loans due from subsidiaries which are not expected to be collected within a reasonable period of time. The annual debt service requirements to maturity, including principal and interest, for long-term debt, (excluding notes payable by component units to the Bank) as of June 30, 2014, are as follows:

	<b>GDB Operating Fund</b>			
	<b>Business-type activities</b>			
	<b>Principal</b>	<b>Interest</b>	<b>Interest subsidy <sup>(1)</sup></b>	<b>Interest Total</b>
Years ending June 30:				
2015	\$ 476,575,000	\$ 220,689,143	\$ (4,984,359)	\$ 215,704,784
2016	876,040,000	193,545,576	(4,984,359)	188,561,217
2017	269,195,000	165,295,318	(4,984,359)	160,310,959
2018	277,490,000	145,416,665	(4,984,359)	140,432,306
2019	847,935,000	129,256,566	(4,984,359)	124,272,207
2020-2024	1,596,812,000	269,147,501	(24,921,794)	244,225,707
2025-2027	374,490,000	32,089,668	(11,214,807)	20,874,861
Total	<u>\$ 4,718,537,000</u>	<u>\$ 1,155,440,437</u>	<u>\$ (61,058,396)</u>	<u>\$ 1,094,382,041</u>

<sup>(1)</sup>The GDB Senior Notes Series 2010 B and 2010 D were issued as Build America Bonds. The Bank will receive a subsidy payment from the federal government equal to 35% of the amount of each interest payment. Subsidy payment after November 1, 2014 will be subject to sequestration of 7.3% from IRS due to adjustments to the Federal Government budget. As of June 30, 2014, total receivable from federal government amounted to approximately \$862,000.

	<b>Housing Finance Authority</b>			
	<b>Governmental activities</b>		<b>Business-type activities</b>	
	<b>Principal</b>	<b>Interest</b>	<b>Principal</b>	<b>Interest</b>
Years ending June 30:				
2015	\$ -	\$ 195,620	\$ 38,074,416	\$ 4,534,329
2016	103,049	192,958	17,546,769	4,096,693
2017	83,595	190,022	33,208,737	3,701,889
2018	86,478	186,839	19,877,460	3,331,224
2019	89,716	183,308	20,404,153	2,988,218
2020-2024	429,439	854,985	73,388,055	25,938,294
2025-2029	2,056,125	633,311	30,081,516	26,665,028
2030-2034	652,333	36,373	22,457,249	19,051,635
2035-2039	-	-	30,017,978	10,469,946
2040-2043	-	-	14,377,574	1,275,468
Total	<u>\$ 3,500,735</u>	<u>\$ 2,473,416</u>	<u>\$ 299,433,907</u>	<u>\$ 102,052,724</u>

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<b>Tourism Development Fund <sup>(2)</sup></b>			
<b>Business-type activities</b>			
		<b>Principal</b>	<b>Interest</b>
Years ending June 30:			
2015	\$	866,667	\$ 682,757
2016		866,667	657,033
2017		866,667	631,309
2018		866,667	605,585
2019		20,005,554	-
Total	\$	23,472,222	\$ 2,576,684

<sup>(2)</sup>Debt service requirements of this variable-rate debt assume that the interest rate effective at June 30, 2014 remains the same throughout the term of the debt.

**(a) Governmental Activities**

Bonds and notes payable of governmental activities as of June 30, 2014, consist of the following:

<b>Description and maturity date</b>	<b>Interest rate</b>	<b>Amount outstanding</b>
Note payable AHMSP Act No. 124 due on August 1, 2016 and each August 1, thereafter to August 1, 2031	6%	\$ 3,434,253

*Note Payable to Puerto Rico Public Finance Corporation* – On December 27, 2001, the Housing Finance Authority entered into a loan agreement (the “Note”) with the GDB Operating Fund to refinance the AHMSP Stage 7 note payable of the Housing Finance Authority, 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 (the “PFC Bonds”). The PFC Bonds were issued under certain trust indentures whereby the Public Finance Corporation pledged 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 (consisting of Commonwealth appropriations earmarked to repay these notes) for the benefit of the bondholders.

During June 2004, the Public Finance Corporation advance refunded a portion of certain of its outstanding Commonwealth appropriation bonds issued in 2001 under Act No. 164 of December 17, 2001. The Housing Finance Authority recognized a mirror effect of this advance refunding by the Public Finance Corporation on its own notes payable in proportion to the portion of the Housing Finance Authority’s note payable included in the Public Finance Corporation refunding. The aggregate debt service requirements of the refunding and unrefunded notes will be funded with annual appropriations from the Commonwealth.

The outstanding balance of this note at June 30, 2014, was \$3,434,253 and matures on August 1, 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. The applicable percentage is the percentage representing the proportion of the amount paid by the Public Finance Corporation on the PFC Bonds serviced by the Note to the aggregate amount paid by the Public Finance Corporation on all the PFC Bonds issued by Public Finance Corporation under Act No. 164, which was 6% at June 30, 2014.



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**(b) Business-Type Activities**

Bonds, notes and mortgage-backed certificates payable of business-type activities consist of the following:

<u>Description and maturity date</u>	<u>Interest rate</u>	<u>Carrying amount</u>
Remarketed Refunding Bonds – December 1, 2015	4.75%	\$ 267,000,000
GDB Senior Notes :		
Series 2006 B – Each December 1 until December 1, 2017	5.00	168,273,863
Series 2006 C – January 1, 2015	5.25	82,168,302
Series 2010 A – August 1, 2020	5.50	433,702,000
Series 2010 B – August 1, 2025	5.75	151,259,000
Series 2010 C – August 1, 2019	5.40	217,715,000
Series 2010 D – August 1, 2025	5.75	96,411,000
Series 2011 B – May 1, 2016	4.70	400,000,000
Series 2011 H – August 1, 2015, August 1, 2017, August 1, 2019, Each August 1, from 2021 to 2023, and August 1, 2026	3.80–5.20	1,399,045,000
Senior 2011 I – August 1, 2014 and August 1, 2018	3.375–4.35	394,847,458
Senior 2012 A – February 1, 2015, February 1, 2017 and February 1, 2019	3.448–4.375	992,759,208
Senior 2013 B – Each December 1, from 2017 to 2019	8.00	110,000,000
Mortgage Trust III:		
Each July 1 and January 1 until January 1, 2021	Zero Coupon	101,465,563
Single Family Mortgage Revenue Bonds –		
Portfolio XI – Each December 1 and June 1 until December 1, 2039	3.46–5.45	15,185,000
Mortgage-Backed Certificates, 2006 Series A –		
Principal and interest payable monthly from September 29, 2006 to August 29, 2030	2.95–6.56	78,035,033
Special Obligation Notes, 2010 Series A and B –		
Principal and interest payable monthly from July 1, 2019 to May 1, 2040	6.95–6.97	18,716,947
Special Obligation Notes, 2011 Series A – Principal and interest payable monthly from September 1, 2021 to September 1, 2041		
	7.00	10,485,973
Special Obligation Notes, 2012 Series A – Principal and interest payable monthly from June 18, 2022 to September 1, 2041		
	7.00	16,968,984
Total		<u>\$ 4,954,038,331</u>

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**(c) GDB Senior Notes, 2013 Series B**

On December 13, 2013, the Bank issued \$110,000,000 of Senior Notes, 2013 Series B (the 2013 Series B Notes). The 2013 Series B Notes consist of term notes maturing on various dates from December 1, 2017 to December 1, 2019, and carrying an interest rate of 8.00%, payable monthly on the first day of each month. These notes are guaranteed by the Commonwealth.

**(d) Special Obligation Notes (Third Party Origination Program)**

On May 30, 2014, the Housing Finance Authority repaid these notes in the amount of \$29.8 million and recorded a gain on early extinguishment of debt of \$36,685.

**(e) Participation Agreement Payable**

On April 10, 2006, the Tourism Development Fund entered into a debt restructuring agreement with Hotel Dorado, S.E. (the "Hotel") whereby the Tourism Development Fund, as guarantor of the Hotel's outstanding bonds, accelerated the payment of the bonds in exchange for a note receivable of \$26 million from the Hotel. In addition, on April 10, 2006, the Tourism Development Fund entered into a participation agreement with a financial institution whereby the Tourism Development Fund transferred its 100% participation (the "Participation") in the note receivable.

The Participation is subject to recourse and the Tourism Development Fund is obligated to purchase the loan from the financial institution upon the occurrence and during the continuance of an event of default under the participation agreement. The participation agreement also stipulates that the financial institution cannot sell, pledge, transfer, assign or dispose of the Participation without the Tourism Development Fund's consent. Accordingly, the Tourism Development Fund has recorded the note receivable as part of loans receivable and has recorded a participation agreement payable (i.e. a collateralized borrowing) in the accompanying statement of net position – proprietary funds.

The Participation bears a variable interest rate based on the three month LIBOR plus 2.7826%, until maturity on July 1, 2018. The outstanding principal balance of the note receivable and the corresponding participation agreement payable amounted to \$23.5 million as of June 30, 2014.

**(f) Other Liabilities**

The activity for non-current accounts payable and accrued liabilities of the business-type activities during the year ended June 30, 2014, follows:

Balance – beginning of period	\$ 18,609,720
Reductions	<u>(2,678,804)</u>
Balance – end of period	<u>\$ 15,930,916</u>

The activity for compensated absences included within accounts payable and accrued liabilities during the year ended June 30, 2014, follows:

	<b>Beginning balance</b>	<b>Provision</b>	<b>Reductions</b>	<b>Ending balance</b>	<b>Due within one year</b>
Vacation	\$ 2,375,053	\$ 2,668,866	\$ 2,577,101	\$ 2,466,818	\$ 2,225,184
Sick Leave	2,316,340	2,200,440	2,376,237	2,140,543	1,048,220
Total	<u>\$ 4,691,393</u>	<u>\$ 4,869,306</u>	<u>\$ 4,953,338</u>	<u>\$ 4,607,361</u>	<u>\$ 3,273,404</u>

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Prior to Act 66-2014, compensated absences were available to be liquidated by the employees during the year. Amounts due within one year are estimated based on history of reductions. On June 17, 2014, the Governor of the Commonwealth (the "Governor") signed the Act. No. 66, the "Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act" (the "Act 66-2104"). Among other changes, the Act 66-2014 lowered the maximum vacation leave days that any public entity's employee accumulate from 90 days to 60 days.

**(14) Mortgage Loan Insurance Fund**

The Mortgage Loan Insurance Fund was created by Act No. 87 of June 25, 1965, as amended, known as the Mortgage Loan Insurance. This act provides mortgage credit insurance to low and moderate-income families on loans originated by the Housing Finance Authority and other financial institutions. This activity can be increased through legislative appropriations, if and when needed, and derives its revenue from premiums charged to the borrowers, interest on investments, and sales of properties acquired through foreclosure. The Housing Finance Authority manages the risk of loss of its mortgage loan insurance activities by providing its insurance program only to financial institutions that (1) maintain certain defined minimum capital, (2) are qualified based on experience and resources, (3) perform certain collection efforts, and (4) comply with established procedures and requirements. In addition, the Housing Finance Authority requires certain loan-to-value ratios on loans insured and recording of the collateral in the property registry of the Commonwealth.

Additionally, the Housing Finance Authority created the Puerto Rico Housing Administration program, known in Spanish as "FHA Boricua", expanding the requirements and parameters under the existing act. The program allows citizens, paying an annual insurance premium, to originate mortgage loans with up to a 98% loan-to-value ratio. The program insures participating lending institutions in events of foreclosure. The program is financed through annual insurance premiums, commitment and transaction fees, and proceeds from any sale of foreclosed real estate. The program also requires participants to comply with various eligibility requirements.

The Commonwealth guarantees up to \$75 million of the principal insured by the mortgage loan insurance program. As of June 30, 2014, the mortgage loan insurance program covered loans aggregating to approximately \$546 million. An allowance of \$5.1 million was recorded as of June 30, 2014 as an estimate of the losses inherent in the portfolio.

The mortgage insurance loan total premium and investment income for the year ended June 30, 2014, are as follows:

Mortgage loans insurance premiums	\$ 5,486,923
Investment income	<u>792,157</u>
Total	<u>\$ 6,279,080</u>

The regulations adopted by the Housing Finance Authority require the establishment of adequate reserves to guarantee the solvency of the Mortgage Loan Insurance Fund. At June 30, 2014, the Housing Finance Authority had restricted net position for such purposes of approximately \$72.5 million.

**(15) 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. These financial instruments include commitments to extend credit, standby letters of credit, and financial guarantees. These instruments involve, to varying degrees, elements of credit risk in excess of amounts recognized in the accompanying statements of net position and fund balance sheet. 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.

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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.

At June 30, 2014, the off-balance-sheet risks consisted of the following (in thousands):

Financial instruments whose credit risk is represented by contractual amounts:

Financial guarantees – Private sector	\$ 592,210
Standby letters of credit – Public sector	\$1,288,733
Commitments to extend credit – Public sector	\$1,353,204

Following is the activity of the allowance for losses on guarantees and letters of credit for the year ended June 30, 2014:

	<b>Beginning balance</b>	<b>Provision (release)</b>	<b>Payments/ reductions/Credits</b>	<b>Ending balance</b>	<b>Due within one year</b>
Tourism Development Fund	\$ 247,845,254	\$ 35,736,700	\$ (93,172,872)	\$ 190,409,082	\$ 15,000,000
Development Fund	14,292,707	(2,398,628)	(184,997)	11,709,082	66,826
GDB Operating Fund	-	52,609,000	-	52,609,000	-
Total	<u>\$ 262,137,961</u>	<u>\$ 85,947,072</u>	<u>\$ (93,357,869)</u>	<u>\$ 254,727,164</u>	<u>\$ 15,066,826</u>

As further describe in note 7, the Tourism Development Fund was released of the guaranty of DBR Dorado Member, LLC. The amount of this release was approximately \$107 million.

***Government Development Bank***

On September 22, 2011, Autopistas Metropolitanas de Puerto Rico, LLC (“Metropistas”) and HTA, entered into a concession agreement (the “Concession Agreement”) of toll roads PR-22 and PR-5 (the “Toll Roads”). In connection with this transaction, the HTA received in exchange for the right to operate the Toll Roads a lump-sum payment of \$1.1 billion and a commitment to make immediate improvements to the Toll Roads amounting to \$56 million and to comply with world-class operating standards which may require HTA to invest more than \$600 million over the life of the concession.

In connection with the closing of the concession of the Toll Roads, the Bank executed a payment guarantee (the “Guaranty”) in favor of Metropistas pursuant to which it acts as guarantor of any “Termination Damages” due and payable in cash by the HTA under the Concession Agreement. In connection with the Guaranty, on September 22, 2011, the Bank and the HTA entered into a Reimbursement Agreement (the “Reimbursement Agreement”) whereby the HTA agreed to reimburse the Bank any amounts paid under the Guaranty. Under the Reimbursement Agreement, in order to reimburse the Bank fully for any payments made under the Guaranty, the HTA is required to issue bonds secured by the revenues generated by the Toll Roads within one year from the effective date of a termination of the Concession Agreement requiring the payment of Termination Damages. On September 22, 2011, the HTA approved the bond resolution under which such bond issue would be authorized. Pending such bond issues, the reimbursement obligation will be secured by the revenues of the Toll Roads generated after the termination of the Concession.

On July 24, 2013, Aerostar Airport Holdings, LLC (“Aerostar”) and the Puerto Rico Ports Authority (the “Ports Authority”) entered into a lease agreement (the “Lease Agreement”) of Luis Muñoz Marín International Airport (the “Airport”), for a

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term of forty years. In connection with the lease of the Airport, the Bank executed a payment guarantee (the “Bank Guaranty”) in favor of Aerostar for any “Termination Damages” due and payable in cash by the Ports Authority under the Lease Agreement. In accordance with the Bank Guaranty, Aerostar has the right to terminate the Lease Agreement mainly under three different noncompliance scenarios on the part of the Ports Authority.

First, if Aerostar has the right to terminate this Agreement in connection with an “Adverse Action” or “AA”, as defined in the Lease Agreement, and Aerostar has exercised such right, the Lease Agreement, subject to certain conditions specified in the Lease Agreement, shall terminate 120 days following the date of receipt of the AA-Notice by the Ports Authority, and on the “Reversion Date” the Ports Authority shall pay an amount (which amount shall be paid from general Ports Authority’s funds and not from Airport revenues) equal to the aggregate, without duplication, of (i) the Airport “Facility Leasehold Value”, as defined, as of the date of termination (which shall be determined as if no Adverse Action has occurred), plus (ii) the reasonable out-of-pocket and documented costs and expenses incurred by Aerostar as a direct result of such termination, plus (iii) the “Leasehold Compensation” calculated for the period between the date of the Adverse Action and the Reversion Date, less (iv) any insurance or condemnation proceeds payable to Aerostar.

Secondly, if termination relates to a default (a Default) on the part of the Ports Authority, that is, in accordance with Section 16.2 (b) (ii) or Section 16.2 (b) (iii) of the Lease Agreement, the Ports Authority shall be obligated to pay on the Reversion Date to Aerostar an amount (which amount shall be paid from general Ports Authority funds and not from Airport revenues) equal to the aggregate, without duplication, of (i) the Airport “Facility Leasehold Value” as of the date of termination, plus (ii) the reasonable out-of-pocket and documented costs and expenses incurred by Aerostar as a direct result of such termination, plus (iii) the “Leasehold Compensation” calculated for the period between the date of the Ports Authority’s Default and the date of termination, less (iv) any insurance or condemnation proceeds payable to Aerostar.

Thirdly, and as general provision, the Lease Agreement may be rescinded in accordance with Section 16.6 of the Lease Agreement which relates to termination pursuant to conviction or the entering of a plea of guilty in respect to any Act No. 458 Crime. If the Lease Agreement is rescinded or terminated pursuant to Section 16.6 (a) or (b) and, in the case of a rescission caused by the conviction or the entering of a plea of guilty for an Act No. 458 Crime, such crime was not committed in connection with the procurement of the Lease Agreement, then the Ports Authority shall be obligated to pay to Aerostar an amount equal to the lesser of (i) the Airport “Facility Leasehold Value” and (ii) the “Unamortized Leasehold Fee”. In connection with the Guaranty, on February 27, 2013, the Bank and the Ports Authority entered into a Reimbursement Agreement (the “Reimbursement Agreement”) whereby the Ports Authority agreed to reimburse the Bank any amounts paid under the Bank Guaranty.

***Puerto Rico Development Fund***

On January 19, 2012, the Boards of Directors of the Bank and the Development Fund approved a loan guarantee program (the “Guarantee Program”) to stimulate lending by private banks to businesses in Puerto Rico in order to promote job creation and economic development in Puerto Rico. On April 3, 2012, the Bank, the Development Fund and certain participating banks entered into guarantee and commitment and funding agreements in which the Development Fund will guarantee eligible loans made by those banks to eligible businesses up to a maximum of 30% of the principal amount of the loans, in accordance with criteria established in the Guarantee Program. The Bank has committed to provide up to \$200 million to the Development Fund to enable it to honor payments related to guarantees issued under the Guarantee Program. The Guarantee Program had a term of one year, and it ended on April 2, 2013. As of June 30, 2014, total loan balance under the Guarantee Program amounted to approximately \$49.7 million. The guarantee issued for each loan is in effect for a maximum term of seven years.

The Development Fund has entered into an agreement (the “Agreement”) with the Economic Development Bank for Puerto Rico (the “Economic Development Bank”) whereby the Development Fund would guarantee a portion of loans granted by the Economic Development Bank under a government program named The Key for Your Business (the “Program”). Under the Agreement, the Development Fund would assign \$15 million of its capital for the program. The Development Fund guarantees one-third of the outstanding principal balance of each loan plus accrued interest and certain other charges. The Development Fund charges one percent of the loan amount as a guarantee fee and no loan can exceed \$50,000. As of June

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30, 2014, the outstanding balance of loans guaranteed by the Development Fund amounted to approximately \$4.5 million and the allowance for losses on guarantees amounted to approximately \$243,000.

***Non-Appropriation of Funds for the Payment of Debt Service on PFC Bonds***

PFC, a component unit of the Bank, issued several series of bonds pursuant to a trust agreement between PFC and U.S. Bank National Association, as trustee (the “Trustee”), dated as of June 1, 2004 (the “Trust Agreement”), of which three series are outstanding (the “PFC Bonds”). The outstanding series are: (i) 2011 Series A Bonds – Act 164; (ii) 2011 Series B Bonds – Act 164 and PRASA Superaqueduct; and (iii) 2012 Series A Bonds – Act 164 Maritime. As of June 30, 2014, the outstanding balance of the PFC Bonds are approximately \$242.4 million, \$437.6 million, and \$410.7 million, respectively.

On July 1, 2015, Joint Resolution 63-2015 was enacted creating the Economic Development and Obligations Payment Fund (the “EDOP Fund”), to be funded with \$275 million from available resources. As of the date of the issuance of these financial statements, no moneys have been available to transfer to the EDOP Fund. Under the legislation, the utilization and distribution of the EDOP Fund requires a Joint Resolution of the Legislature. The EDOP Fund may only be used for economic development initiatives and for the payment of Commonwealth’s obligations. On August 10, 2015, a resolution was filed in the Senate authorizing the transfer of \$93.7 million from the EDOP Fund to the Bank in order to pay the unpaid interest and principal which was due on the PFC Bonds on August 3, 2015. This resolution has not been approved by the Legislature. On July 15, 2015, the Public Finance Corporation filed a notice with the Municipal Securities Rulemaking Board (“EMMA”) indicating that the Puerto Rico Legislative Assembly had not included in the approved budget for fiscal year 2016 the funds necessary to pay principal and interest on all outstanding PFC bonds. Such appropriation is the sole source of payment of principal and interest on such bonds. The EMMA notice indicated that the Office of Management and Budget had included the necessary appropriation for the payment of such debt service but such appropriation was not included in the budget that the Legislature ultimately approved and sent to the Governor for approval. As a result, except as indicated below, the Trustee for such PFC bonds did not receive the funds from fiscal year 2016 legislative appropriations to pay the debt service due during fiscal year 2016. The first payment of the debt service for fiscal year 2016 was due on August 3, 2015. On August 3, 2015, the Public Finance Corporation made a partial payment of interest in the amount of \$628,000 from funds held by the Public Finance Corporation representing funds remaining from prior legislative appropriations. On August 10, 2015, a resolution was introduced in the Legislative Assembly authorizing the payment of past due amounts to the Public Finance Corporation bondholders. However, this resolution has not been approved, and no legislative appropriation has been made to pay principal and interest on outstanding PFC bonds during fiscal year 2016.

The PFC bonds provides for a Bank Letter of Credit (each PFC Bond). As per the terms of such Letters of Credit and the Trust Agreement, the Trustee may draw up to the “stated amount” for each fiscal year in the event that the Trustee (a) has not received a timely notice by the President of Public Finance Corporation that the budget for the current fiscal year has been adopted by the Legislature and approved by the Governor of Puerto Rico, and (b) has not otherwise received the funds equal to the principal and interest payable on the PFC bonds for the current fiscal year. The yearly “stated amount” is intended to cover the differential between an increase in debt service under the PFC bonds for such year and the amount of appropriated funds for the previous year. The “stated amount” for fiscal year 2016 varies for each of the Bank’s Letters of Credit, as follows: (a) for the Series 2011 A Bonds, \$0; (b) for the Series 2011 B Bonds, \$20,202,474; and (c) for the Series 2012 A Bonds, \$0.

Based on legal counsel opinion, the Bank complied with the requirements of the Trust Agreement and duly notified the Trustee that the budget was approved and thus the conditions to draw the Bank’s Letters of Credit to make the payment did not ensue. Accordingly, the Bank did not recognize any contingent liability related to this nonappropriation as of June 30, 2014.

***Nonexchange Financial Guarantees***

Effective July 1, 2013, the Bank adopted the provisions of GASB Statement No. 70 – *Accounting and Financial Reporting for Nonexchange Guarantees* (“GASB Statement 70”). GASB Statement 70 requires the recognition of a liability when qualitative factors and historical data, if any, indicates that it is more likely than not that the Bank, as guarantor, will actually

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be required to make payments as a result of the guarantee agreement to a third-party obligation holder. The Bank extended a letter of credit to guarantee (along with the aforementioned reimbursement agreements) through a financing facility the repayment of the PRIFA related to the Puerto Rico Ports Authority (PRIFA Revenue Bonds Series A, B, and C). Given the current financial situation of the Ports Authority, the Bank's management believes that it is more likely than not that this particular guaranty will be honored. The fair value of the contingency as calculated by management is approximately \$52.6 million as of June 30, 2014 and is recorded in the GDB Operating Fund as an increase to the allowance for losses on guarantees and letters of credit.

**(16) Retirement System**

***(a) Defined Contribution Hybrid Program***

On April 4, 2013, the Legislature enacted Act. No. 3 which amended Act No. 447 and Act. No. 305 to establish, among other things, a defined contribution hybrid program (the Hybrid Program) to be administered by the Retirement System. All regular employees hired for the first time on or after July 1, 2013, and former employees who participated in the defined benefit pension plan and the defined contribution plan, and were rehired on or after July 1, 2013, become members of the Hybrid Program as a condition to their employment. In addition, employees who at June 30, 2013, were participants of previous plans will become part of the Defined Contribution Hybrid Program.

Participants in the defined benefit pension plan who as of June 3, 2013, were entitled to retire and receive some type of pension, may retire on any later date and will receive the annuity corresponding to their retirement plan, as well as the annuity accrued under the Hybrid Program. Participants who as of June 30, 2013, have not reached the age of 58 and completed 10 years of service or have not reached the age of 55 and completed 25 years of service can retire depending on the new age limits defined by the Hybrid Program and will receive the annuity corresponding to their retirement plan, as well as the annuity accrued under the Hybrid Program.

Participants in the defined contribution plan who as of June 30, 2013, were entitled to retire because they were 60 years of age may retire on any later date and will receive the annuity corresponding to their retirement plan, as well as the annuity accrued under the Hybrid Program. Participants in the Program who as of June 30, 2013, have not reach the age of 60 can retire depending on the new age limits defined by the Hybrid Program and will receive the annuity corresponding to their retirement plan, as well as the annuity accrued under the Hybrid Program.

Act. No. 3 requires employees to contribute ten percent (10%) of their monthly gross salary to the Hybrid Program. Employee contributions are credited to individual accounts established under the Hybrid Program. In addition a mandatory contribution equal to or less than point twenty five percent (0.25%) is required for the purchase of disability insurance.

The Bank was required to contribute 13.275% of each participant's gross salary for fiscal year 2014. The Retirement System will use these contributions to increase its level of assets and to reduce the actuarial deficit. Beginning on July 1, 2013, and up until June 30, 2016, the employer's contribution rate shall be annually increased by one percent (1%). Beginning July 1, 2016, and up until June 30, 2021, the employer's contribution rate that is in effect on June 30 of every year shall be annually increased on every successive July 1st by one point twenty-five percent (1.25%).

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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. In case of the pensioner's death the designated beneficiaries will continue receiving the monthly benefit until the contributions of the participant are completely consumed. In case of the participants in active service a death benefit will be paid in one lump sum in cash to the participant's beneficiaries. Participants with a balance of less than \$10,000 or less than five years of computed services at retirement will receive a lump-sum payment. In case of permanent disability the participants have the option of receiving a lump sum or purchasing an annuity contract.

Total employee contributions for the defined contribution Hybrid Program during the year ended June 30, 2014, amounted to approximately \$1,828,000. The Bank's contributions during the years ended June 30, 2014, 2013 and 2012 amounted to approximately \$2,255,946, \$2,142,000, and \$1,830,000, 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 on its standalone financial statements for the year ended June 30, 2013, a copy of which can be obtained from the Employees' Retirement System of the Commonwealth of Puerto Rico, P.O. Box 42004, San Juan PR 00940-2004.

***(b) Early Retirement Programs***

From fiscal year 2011 through fiscal year 2013 the Bank extended to its employees voluntary early retirement programs, based on provisions established on Act. No. 70, which was enacted July 2, 2010. Act No. 70 provided that eligible employees may retire from employment with the Commonwealth in exchange for an early pension, an economic incentive and other benefits. Act. No. 70 only applied to employees who were fifteen years or less from retirement in accordance with their applicable retirement plans.

The number of employees who have voluntarily separated from employment under the provisions of Act No. 70 were twenty one. Payments of such voluntary termination plans are expected to be made until November 1, 2030. Employee and employer contributions to the Retirement System and the employee annuity for the applicable period were discounted based on the average interest rate of return of unpledged investments.

In addition, during the fiscal years 1995, 2000 and 2007, the Bank's Board of Directors authorized early retirement's programs for certain Bank's employees, subject to different eligibility provisions that are detailed in the corresponding laws signed by the Governor of the Commonwealth. The costs incurred and accounted during the year ended June 30, 2014, consisted principally of the incremental actuarial costs, if any, of retiring earlier than under the original retirement plan to cover the costs of the medical and life insurance plans for such employees until reaching certain age. As of June 30, 2014, the number of employees still benefiting from such voluntarily separation programs are approximately 210. Employer contributions to the medical and life insurance plans for the applicable period were discounted based on management best estimate of the expected long-term plan performance.

During fiscal year 2014, total cost related to these early termination benefits amounted to approximately \$453,000. As of June 30, 2014, the total liability related to these termination benefits was approximately \$16.7 million recorded within accounts payable and accrued liabilities in the GDB Operating Fund.

**(17) Risk Management**

To minimize the risk of loss, the Bank purchases insurance coverage for public liability, hazard, automobile, crime, and bonding as well as workmen's compensation insurance for employees. The selection of the insurer has to be approved by the Public Insurance Office of the Department of the Treasury of the Commonwealth. Insurance coverage is updated annually to account for changes in operating risk. For the last three years, insurance settlements have not exceeded the amount of coverage.



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**(18) Commitments and Contingencies**

**(a) Lease Commitments**

The Bank leases office space from the governmental sector. Principally, office space is leased under an operating lease agreement that expires on July 1, 2039. During fiscal year 2010, the Bank entered into a lease agreement with the Puerto Rico Industrial Development Company (“PRIDCO”) for office space in PRIDCO’s New York Office. This agreement expires in 2022.

The Housing Finance Authority entered into a 30-year lease agreement with the Department of Housing to rent office space expiring in 2037. During the term of the lease, the Housing Finance Authority will pay an annual rent of \$1.5 million. The agreed upon rent includes parking spaces, maintenance and security services in common areas. The Department of Housing is responsible for the payment of utilities in exchange for an additional payment of \$350,000 payable in a lump sum on or before August 31st of each year.

Rent charged to operations in fiscal year 2014 amounted to approximately \$2.6 million. At June 30, 2014, the minimum annual future rentals under noncancelable leases are approximately as follows:

	<u>Amount</u>
Year ending June 30:	
2015	\$ 2,665,000
2016	2,665,000
2017	2,665,000
2018	2,669,000
2019	2,673,000
Thereafter	<u>46,726,000</u>
Total	<u>\$ 60,063,000</u>

**(b) Cooperative Development Investment Fund**

On August 18, 2002, the Legislature approved Act No. 198, which creates the Cooperative Development Investment Fund (the “Cooperative Fund”). The purpose of the Cooperative Fund is to promote the development of cooperative entities. The Cooperative 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, 2014, the Bank has contributed \$20.4 million, including interest to the Cooperative Fund, \$1.1 million of which was contributed during the year ended June 30, 2014.

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

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

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**(d) Mortgage Loan Servicing Activities**

The Housing Finance 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, 2014, the principal balance of the mortgage loans serviced for others is approximately as follows:

Puerto Rico Community Development Fund I	\$ 40,098,500
R-G Mortgage, Inc. or its successor	1,256,054
CRUV or its successor without guaranteed mortgage loan payments	<u>24,251</u>
Total	<u>\$ 41,378,805</u>

**(e) HOME Program**

The U.S. Office of Inspector General (“OIG”) has performed various examinations of the HOME Program covering fiscal years ended prior to July 1, 2010. These examinations covered periods in which the HOME Program was under the administration of the Department of Housing. These examinations identified instances of non-compliance with terms and conditions of the grant agreements, applicable federal law, and the HOME Program’s regulations, including but not limited to the expenditure of resources for ineligible purposes. OIG identified in its examinations disallowed costs amounting to approximately \$18.3 million. The Housing Finance Authority recorded a contingency for such disallowed costs, and additional amounts identified internally as potential disallowances, amounting to approximately \$20.4 million. On May 2013, the Housing Finance Authority entered into a three year repayment plan, starting on August 1, 2013, with HUD to return HOME funds amounting to approximately \$1.8 million that were determined to be disallowed costs within the \$18.3 million discussed above.

On July 31, 2014, the Governor signed the HOME Voluntary Repayment Settlement Agreement (the “Agreement”) with HUD. The Agreement establishes the reimbursement to the HOME Program of \$14.2 million, from nonfederal funds, for disallowed expenditures in connection with HUD-funded projects, as defined and described in the Agreement, in two installments of \$10 million and \$4.2 million due on October 1, 2014 and October 1, 2015, respectively. During the year ended June 30, 2014, the Affordable Housing Subsidy Program paid \$624,403 to the Home Program to cover the installment payments due under the \$1.8 million repayment plan. At June 30, 2014, the total liability amounted to approximately \$16 million and is included in accounts payable and accrued liabilities of governmental activities.

Other federal programs are also subject to audits. Such audits could result in claims against the resources of the Housing Finance Authority. No provision has been made for any liabilities that may arise from such amounts since the amount, if any, cannot be determined at this date.

**(f) Litigation**

The Bank and certain of its component units are defendants in several lawsuits arising out of the normal course of business. Management, based on advice of legal counsel, is of the opinion that the ultimate liability, if any, resulting from these pending proceedings will not have a material adverse effect on the financial position and results of operations of the Bank or its component units.

On December 2, 2014, the United States Securities and Exchange Commission (“SEC”) requested information about certain bond issuances of the Commonwealth and its component units. The Bank is cooperating in the inquiry, including by providing the SEC with documents and information. The SEC has advised that the information requests should not be construed as an indication that any violation of the federal securities laws has occurred. This matter is ongoing and, the Bank cannot predict when it will be concluded or its outcome.

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**(19) Conduit Debt and Programs Sponsored by the Housing Finance Authority**

The Public Finance Corporation has issued approximately \$8.1 billion of Commonwealth appropriation bonds (the Bonds) maturing at various dates through 2033. The proceeds of the Bonds, except for approximately \$4.6 billion, were used to provide the necessary funds to purchase from the Bank separate promissory notes of the Department of the Treasury and its public entities (the Promissory Notes). The \$4.6 billion referred to above was used to refund a portion of certain bonds issued by the Public Finance Corporation between fiscal years 1995 and 2005. The outstanding balance of the Bonds at June 30, 2014 amounted to approximately \$1.1 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 Promissory Notes. Principal and interest on the Promissory Notes are payable solely from legislative appropriations to be made pursuant to acts approved by the Legislature. These acts provide that the Commonwealth shall honor the payment of principal and interest on the Promissory Notes, and that the Director of the Office of Management and Budget shall include in the budget of the Commonwealth submitted to the Legislature the amounts necessary to pay the principal and interest on the Promissory Notes. The 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 conduit debt. Neither the Bonds nor the Notes purchased with the proceeds therefrom are presented in the accompanying basic financial statements.

In December 2003, the Housing Finance Authority issued \$663 million in Capital Fund Program Bonds Series 2003 to lend the proceeds thereof to the Public Housing Administration, a governmental instrumentality of the Commonwealth. Public Housing Administration utilized such funds for improvements to various public housing projects in the Commonwealth. The Capital Fund Program Bonds Series 2003 are limited obligations of the Housing Finance Authority, which will be paid solely from an annual allocation of public housing capital funds when received from HUD and other funds available under the bonds indenture. Accordingly, these bonds are considered conduit debt and are not presented in the accompanying basic financial statements. The outstanding balance of these bonds amounted to \$151,100,000 at June 30, 2014.

On August 1, 2008, the Housing Finance Authority issued the Capital Fund Modernization Program Subordinate Bonds amounting to \$384,475,000 and the Housing Revenue Bonds amounting to \$100,000,000. The proceeds from the issuance were mainly used to finance a loan to a limited liability company (the "LLC") and pay the costs of issuance. The \$384,475,000 bonds are limited obligations of the Housing Finance Authority, payable primarily by a pledge and assignment of federal housing assistance payments made available by HUD, with an outstanding balance of \$307,800,000 at June 30, 2014. The \$100,000,000 bonds were also limited obligations of the Housing Finance Authority, payable from amounts deposited in escrow accounts with a trustee and the proceeds of a loan to be made by the Housing Finance Authority to the LLC using moneys received as a grant from the Department of Housing. Payment of principal of the Housing Revenue Bonds was also secured by an irrevocable standby letter of credit issued by the Bank. The Housing Revenue Bonds were paid-off on September 30, 2011.

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**(20) Interfund (Internal) Balances and Transfers**

The following table is a summary of the interfund balances as of June 30, 2014, between governmental funds and proprietary funds:

Receivable by	Payable by	Purpose	Amount
Governmental fund:	Proprietary fund:		
AHS Programs	GDB Operating Fund	Demand deposits and accrued interest	\$ 2,548,606
AHS Programs	GDB Operating Fund	Investment agreements and accrued interest	16,104,387
HUD Programs	GDB Operating Fund	Demand deposits and accrued interest	165,679
AHS Programs	GDB Operating Fund	Certificates of deposit and accrued interest	4,793,732
		Subtotal	<u>23,612,404</u>
Proprietary fund:	Governmental fund:		
GDB Operating Fund	AHS Programs	Loans payable and accrued interest	(200,182,554)
Housing Finance Authority	Home Programs	Reimbursement of expenditures	(2,748,389)
Housing Finance Authority	HUD Programs	Reimbursement of expenditures	(775,069)
Housing Finance Authority	AHS Programs	Reimbursement of expenditures	<u>(3,347,660)</u>
		Total internal balances – net	<u>\$ (183,441,268)</u>

With the exception of investment agreements and accrued interest of approximately \$16 million and loans payable and accrued interest of approximately \$200.2 million, all of the remaining amounts due from internal balances or due to internal balances are due within one year.

The summary of interfund balances as of June 30, 2014, among proprietary funds, is as follows:

Receivable by	Payable by	Purpose	Amount
Proprietary funds:	Proprietary funds:		
Housing Finance Authority	GDB Operating Fund	Demand deposits and accrued interest	\$ 4,265,888
Development Fund	GDB Operating Fund	Demand deposits and accrued interest	10,847,609
Tourism Development Fund	GDB Operating Fund	Demand deposits and accrued interest	17,853,007
Public Finance Corporation	GDB Operating Fund	Demand deposits and accrued interest	1,191,351
Other nonmajor (Education Assistance Corporation)	GDB Operating Fund	Demand deposits and accrued interest	2,388,612
Other nonmajor (JMB Institute)	GDB Operating Fund	Demand deposits and accrued interest	23,213
Housing Finance Authority	GDB Operating Fund	Certificates of deposit and accrued interest	142,771,164
Tourism Development Fund	GDB Operating Fund	Certificates of deposit and accrued interest	153,220,711
GDB Operating Fund	Tourism Development Fund	Loans receivable and accrued interest	46,780,431
Total balance among proprietary funds eliminated			<u>\$ 379,341,986</u>

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The following table is a summary of interfund transfers for the year ended June 30, 2014:

<b>Transfer out</b>	<b>Transfer in</b>	<b>Transfer for</b>	<b>Amount</b>
Proprietary funds:	Governmental funds:		
Housing Finance Authority	AHS Program	Contribution	\$ 6,100,000
Housing Finance Authority	AHS Program	Subsidy payments	\$ 1,820,902
Proprietary funds:	Proprietary funds:		
GDB Operating Fund	Other nonmajor funds (JMB Institute)	Contribution	\$ 100,000
GDB Operating Fund	Development Fund	Contribution	\$ 7,267,000
GDB Operating Fund	Tourism Development Fund	Contribution	\$ 215,240,213

**(21) Funds Deficit**

The following governmental funds reflects a deficit at June 30, 2014: Affordable Housing Subsidy Programs for the amount of \$111 million. The deficit is due to the amounts borrowed by the Housing Finance Authority from the Bank that were used to provide housing subsidies.

**(22) Subsequent Events**

Subsequent events were evaluated through July 5, 2016 to determine if any such events should either be recognized or disclosed in the 2014 basic financial statements. The subsequent events disclosed below are principally those related to debt activities, including credit rating downgrade events, and other revenue and/or budget related matters that management believes are intrinsically related to the financial statements of the Bank. These might have been disclosed elsewhere in these financial statement but management believes they require specific mentioning based on their relevance and materiality as a whole.

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**(a) 2015 Tax and Revenue Anticipation Notes**

On October 10, 2014, GDB entered into a Note Purchase, Revolving Credit and Term Loan Agreement providing for the issuance of up to \$900 million aggregate principal amount of 2015 Series B Senior Notes guaranteed by the Commonwealth (the GDB Notes). The proceeds of the GDB Notes were used to make a loan to the Commonwealth evidenced by \$900 million aggregate principal amount of Tax and Revenue Anticipation Notes of the Commonwealth of Puerto Rico, Series B (2015) (the 2015 Series B TRANs). The GDB also purchased an additional \$300 million aggregate principal amount of Tax and Revenue Anticipation Notes of the Commonwealth of Puerto Rico, Series C (2015) (the 2015 Series C TRANs and, collectively with the 2015 Series B TRANs, the 2015 TRANs). The 2015 TRANs and the underlying GDB Notes have subsequently been paid in full.

**(b) Budgetary Events and Related Legislation**

The Legislature of the Commonwealth approved a \$9.8 billion budget for fiscal year 2016. The approved budget did not include an appropriation for the payment of PFC bonds. The budgetary appropriation for the payment of debts of the Commonwealth and its instrumentalities with GDB was reduced from approximately \$261 million, the amount included in the budget submitted by the Governor to the Legislative Assembly, to approximately \$18 million.

On July 24, 2015, the Secretary of the Treasury announced that the total revenues of the Commonwealth's General Fund (budgetary basis) for fiscal year 2015 were \$8.961 billion, which were \$76 million less than the revenues for fiscal year 2014 and approximately \$604 million below the original revenue estimate.

In October 2015, the Treasury Department reduced its fiscal year 2016 General Fund revenue estimate to \$9.446 billion, approximately \$354 million lower than originally projected. The Treasury Department revised its fiscal year 2016 General Fund revenue estimates again in January 2016. As revised, total estimated revenues for fiscal year 2016 are \$9.292 billion, which is approximately \$508 million lower than originally projected.

In order to address its liquidity constraints and the decrease in estimated revenues, the Commonwealth has implemented, among others, the following measures: (a) requiring advance payment to the Treasury Department from the two largest government retirement systems of funds required for the payment of retirement benefits to participants (instead of the usual reimbursements made by the retirement systems to the Treasury Department for pension benefits payments made by the Treasury Department on behalf of the retirement systems), (b) suspending during fiscal year 2016 Commonwealth set-asides required by Act No. 39 of May 13, 1976, as amended, for the payment of its general obligation debt, (c) delaying the payment of third-party payables or amounts due to public corporations, (d) deferring the disbursement of certain budgetary assignments, (e) delaying the payment of income tax refunds, and (f) retaining certain tax revenues assigned by the Commonwealth to PRHTA, PRIFA, Puerto Rico Convention Center District Authority (CCDA) and Puerto Rico Metropolitan Bus Authority (PRMBA) pursuant to Article VI Section 8 of the Constitution of the Commonwealth. The Commonwealth also has not paid debt service on PFC bonds, since these amounts were not appropriated in the fiscal year 2016 budget as a result of continuing liquidity constraints.

The Commonwealth has implemented \$233 million in aggregate reductions to budgetary appropriations through the elimination of certain contingency accounts, reductions in nonpriority program appropriations, and a decrease in the operating budgets of various agencies funded by the General Fund, including government's operational programs in health, security, social well-being, and additional cuts in the special additional contributions to the Retirement Systems.

**(c) Implementation of New Petroleum Products Tax**

Act 1-2015, as amended, amends PRIFA's enabling act to impose a new petroleum products tax and assign the revenues therefrom to PRIFA to secure the payment of bonds and notes issued by PRIFA. The PRIFA bonds and notes may be guaranteed by the Commonwealth provided the aggregate principal amount of such guaranteed bonds

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does not exceed \$2.95 billion, the nominal annual interest rate does not exceed 8.50% and the maturity does not exceed 30 years.

PRIFA originally planned to issue bonds secured by collections of the new petroleum products tax and use the proceeds therefrom to, among other uses, repay the PRIFA BANs, loans made by GDB to PRHTA and PRHTA's outstanding variable rate debt obligations owned by GDB. PRIFA and GDB abandoned such plans due to lack of market access under reasonable terms and the Commonwealth ongoing fiscal crisis.

**(d) *Non-Payment of PFC Bonds***

On July 15, 2015, PFC filed a notice with Electronic Municipal Market Access (EMMA) indicating that the Legislative Assembly had not included in the approved budget for fiscal year 2016 the funds necessary to pay principal and interest on all outstanding PFC bonds. Such appropriation is the sole source of payment of principal and interest on PFC bonds. The first payment of debt service on PFC bonds for fiscal year 2016 came due on August 3, 2015, on which date PFC made a partial payment of interest in the amount of \$628,000 (of the approximately \$58 million payment due on that date) from funds held by PFC representing funds remaining from prior legislative appropriations. As of June 30, 2016, PFC had missed payments of debt service on its bonds in the aggregate amount of approximately \$93 million.

**(e) *Retention by the Commonwealth of Tax Revenues Assigned to Certain Public Corporations and Priority of Payment Provisions***

On November 30, 2015, the Governor signed Executive Order No. OE-2015-46 (the Executive Order No. 46), which orders the Secretary of Treasury to retain certain revenues in light of recently revised revenue estimates and the Commonwealth's deteriorating liquidity situation. Pursuant to Executive Order No. 46, certain available resources of the Commonwealth assigned to PRHTA, PRIFA, CCDA and PRMBA to pay debt service on their obligations were retained by the Commonwealth (commonly referred to as the clawback), pursuant to Article VI, Section 8 of the Constitution of the Commonwealth and the statutory provisions pursuant to which such revenues were assigned to the applicable public corporations. As a result of the clawback of revenues mentioned above, PRIFA and PRMBA were not able to meet their debt service obligations due on January 1, 2016 in full and PRHTA and CCDA did so using moneys previously held by the bond indenture trustees in reserves or other accounts.

On December 8, 2015, the Governor signed Executive Order No. OE-2015-49 (Executive Order No. 49) to delegate to the Director of the OMB the power to implement the priority norms established in the enabling act of the OMB, Act No. 147 of June 18, 1980, as amended, for the disbursement of the Commonwealth's available revenues.

On January 8, 2016, the clawback of revenues referred to above was challenged in the Puerto Rico Federal District Court by the insurance companies of certain bonds impacted by the clawback, claiming such action violates certain clauses of the US Constitution. The Commonwealth intends to contest this case vigorously.

**(f) *Bonds Credit Rating Downgrade***

Currently, and after a series of credit downgrades, the credit rating of the Bank is non-investment grade.

**(g) *GDB***

On December 1, 2015, GDB met its scheduled principal and interest debt service payments on its notes, including the payment of \$267 million of principal on outstanding GDB notes guaranteed by the Commonwealth, described in note 13.

As of June 30, 2015, Puerto Rico municipalities maintained approximately \$515 million on deposit at GDB in special debt service deposit accounts which are funded primarily from the proceeds of a special property tax (Special Additional Tax). As of July 31, 2015, after the July debt service payment, the aggregate balance of debt service

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deposits related to the Special Additional Tax was \$266 million. These funds are collected by the CRIM and used for debt service payments of general obligations bonds issued by the municipalities and, by law, have to be deposited in trust at the GDB. On June 29, 2015, the CRIM filed suit requesting that GDB execute a deed of trust pursuant to Puerto Rico law. The CRIM also stopped transferring collected revenues to GDB until the deed of trust was executed. GDB opposed the CRIM's suit asserting that the law already provided a statutory trust and, hence, there was no need for a deed of trust as requested by the CRIM. On October 23, 2015, the parties announced that a settlement had been reached, that a deed of trust would be executed and that new investment guidelines for the municipalities' funds would be approved and applied thereon. On November 2, 2015, the parties executed the deed of trust and on November 4, 2015 a judgment was entered by the Court ending the litigation. The execution of the deed of trust and the new investment guidelines are not expected to have a material adverse effect on GDB's current liquidity or financial position.

The Commonwealth has also recently reformed and amended GDB's lending practices, financing capacity and oversight powers of public funds through Act No. 24-2014 and Act No. 97-2015. Act No. 24-2014 prohibits GDB, subject to certain limited exceptions, from making loans to public corporations' payable from future increases in rates, taxes or other charges. In essence, each public corporation seeking financing from GDB must demonstrate sufficient approved revenue streams to cover debt service on any GDB loan. Act No. 24 is intended to impose fiscal discipline on the public corporations, while preserving GDB's net position. In addition, Act No. 24 also (i) increases from \$550 million to \$2 billion the amount of GDB obligations that can be guaranteed by the full faith and credit of the Commonwealth to provide GDB with greater flexibility in its role of granting interim financing to public corporations and agencies; (ii) grants GDB the ability to exercise additional oversight over certain public funds deposited at private financial institutions and grants GDB the legal authority, subject to an entity's ability to request waivers under certain specified circumstances, to require such public funds (other than funds of the Legislative Branch, the Judicial Branch, the University of Puerto Rico, governmental pension plans, municipalities and certain other independent agencies) to be deposited at GDB, which is expected to result in a more efficient management of public resources; and (iii) provides a process through which the OMB may assume, on behalf of the Commonwealth, the repayment from budgetary appropriations (commencing fiscal year 2017) of certain obligations owed by governmental agencies or public corporations to GDB, up to a maximum amount of \$500 million.

Furthermore, on July 1, 2015, the Commonwealth enacted Act 97-2015, which prohibits GDB from lending to government entities (1) that are in default on any payment to GDB or (2) in the case of entities other than the Commonwealth, if the principal outstanding on all loans of that governmental entity with GDB exceed 5% of GDB's total loan portfolio. Furthermore, the Act provides that the use of proceeds of new GDB loans are limited to funding capital expenditures or working capital needs (in such case, with a maturity of one year or less), unless expressly authorized by law. In addition, the Act requires GDB to meet certain capital to assets, loan to deposit and other ratios in order to continue granting loans and clarifies the standard for personal liability of directors, officers and employees.



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The Act also creates the Public Debt Auditing Commission, which is charged with providing transparency and citizen participation in the review of the Commonwealth and public corporations' aggregate debt.

**(h) Other Recently Enacted Legislation**

On April 6, 2016, the Commonwealth enacted Act 21. The Governor has issued several executive orders under Act 21, including EO 10 and EO 14, which directly impact the Bank. As further discussed in Note 4, among other things, EO 10 imposed restrictions on disbursements from GDB and EO 14 declared a moratorium on the payment of GDB's debt obligations. Refer to Note 4 for additional information on Act 21 and these executive orders.

Act No. 71-2014, known as the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act"), was challenged by certain private investors in Federal court and was declared unconstitutional by the United States District Court for the District of Puerto Rico on February 6, 2015. The District Court's decision was upheld by the United States Court of Appeals for the First Circuit and subsequently upheld by the United States Supreme Court.

On June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which grants the Commonwealth and its component units access to an orderly mechanism to restructure their debts in exchange for significant federal oversight over the Commonwealth's finances. In broad strokes, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, relief from creditor lawsuits through the enactment of a temporary stay on litigation, and two alternative methods to adjust unsustainable debt.

On June 20, 2016, a substitute bill (House Bill 2962) was presented by the Finance and Budget Committee of the House of Representatives introducing a new provision to establish a debt restructuring mechanism between the Commonwealth and the Bank. House Bill 2962, among other things, authorizes the Bank to restructure its public sector loan portfolio, excluding loans taken by PREPA, PRASA and HTA. As of December 31, 2015, the aggregate balance of such portfolio, including principal and interest, was approximately \$4,366 million. The allowance for loan losses (the "ALL") for this portfolio approximates \$2,450 million, representing approximately 40% of the aggregate balance, which is consistent with the ALL recorded in the accompanying basic financial statements. The restructuring mechanism provided in the House Bill 2962 is based on the consolidation of selected public sector loans along with a reduction on the aggregate balance of such portfolio to its estimated realizable value. Therefore, the House Bill 2962 allows the Bank to recover the net book value or 60% of the selected public sector loans under a restructured single credit facility of approximately \$2,619 million (the "new loan") that will be assumed by the Commonwealth. As established in the House Bill 2962, the term of the new loan will be 35 years at a 5% fixed interest rate. The House Bill 2962 also secures and provides for the appropriation of \$375 million for the first payment of the new loan in fiscal year 2017 and subsequent payments of \$110 and \$160 million throughout fiscal year 2018 through 2022 and fiscal year 2023 through 2051, respectively. On June 30, 2016, House Bill 2962 was approved by the Legislature. However, as of the date of these financial statements, House Bill 2962 is under consideration and has not been signed by the Governor.

**(i) Additional Actions Under Act 21**

On May 17, 2016, the Governor signed an executive order, EO-2016-018, which, among other things, declares an emergency period with respect to HTA and suspend HTA's obligation to transfer certain revenues to the trustee.

On June 24, 2016, the Governor signed an executive order, EO-2016-027, which declared PRIFA's Tax Fund Revenue Bond Anticipation Notes Series 2015A (the PRIFA BANs), which are guaranteed by the Commonwealth, covered obligations of PRIFA and suspended all obligations to transfer money to PRIFA in respect of the PRIFA BANs.

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On June 30, 2016, the Governor signed an executive order, EO-2016-030 (EO 30), declaring the Commonwealth to be in a state of emergency and declaring a moratorium on the Commonwealth's obligation to make payments on bonds and notes issued or guaranteed by the Commonwealth. EO 30 of the Commonwealth to transfer moneys to such entities. EO 30 also suspends any obligation of the Office of Management and Budget of the Commonwealth to include an appropriation in the proposed budget submitted to the Legislative Assembly for the payments of bonds issued by PFC. Finally, EO suspends the payment of certain bonds and notes issued by PRIFA, HTA, and PBA.

On the same date, the Governor signed an executive order, EO-2016-031 (EO 31), which among other things, declares an emergency period with respect to CCDA, the Employee Retirement Systems (ERS), PRIDCO, University of Puerto Rico (UPR) and PFC. Also, EO 31 suspends certain obligations to transfer money to and from such entities and from Puerto Rico Tourism Company (PRTC) to GDB. Finally, EO 31 also suspends certain transfers of funds to and from HTA.

Pursuant to EO 30 and EO 31, the Commonwealth and several of its instrumentalities missed certain of their debt service obligations due on July 1, 2016.