# Government Development Bank for Puerto Rico

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and
Required Supplementary Information
as of and for the Year Ended
June 30, 2007, and
Independent Auditors' Report

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# Independent Auditors' Report

To the Members of the Board of Directors of
Government Development Bank for Puerto Rico

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of Government Development Bank for Puerto Rico (the "Bank"), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2007, which collectively comprise the Bank's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the respective 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 respective financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, business-type activities, each major fund, and the aggregate remaining fund information of Government Development Bank for Puerto Rico, as of June 30, 2007, and the respective changes in financial position and respective cash flows, were applicable thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the financial statements, loans to the Commonwealth of Puerto Rico, its agencies and instrumentalities amounted to approximately $5,233,511,000 or 44% of the Bank's total assets as of June 30, 2007. These loans are expected to be collected from appropriations from, bond issuances of, or revenues generated by the Commonwealth of Puerto Rico, its agencies and instrumentalities, and, accordingly, their collectibility may be affected by budgetary constraints, fiscal situation and the credit rating of the Commonwealth of Puerto Rico, its agencies and instrumentalities.

The management's discussion and analysis on pages 24 to 33 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of Government Development Bank for Puerto Rico's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

/s/ Deloitte & Touche LLP
San Juan, Puerto Rico

December 26, 2007

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# Management's Discussion and Analysis

This section presents a narrative overview and analysis of the financial performance of Government Development Bank for Puerto Rico (the "Bank" or "GDB") as of and for the year ended June 30, 2007. The information presented here should be read in conjunction with the basic financial statements, including the notes thereto.

## (1) Financial Highlights

- Assets and liabilities of the Bank at June 30, 2007 amounted to $11,927 million and $9,656 million, respectively, for net assets of $2,271 million or 19% of total assets.
- Net assets increased during the fiscal year by $174.8 million. The increase in net assets comprises $106.8 million from business-type activities, and $68.0 million from governmental activities.

## (2) Overview of the Financial Statements

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

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

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

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

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

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

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

## (3) Government-wide Financial Analysis

Total assets and total liabilities of the Bank at June 30, 2007 amounted to $11,927 million and $9,656 million, respectively, for net assets of $2,271 million or 19% of total assets. In the overall, the decision to reduce total assets resulted in a lower ratio of liabilities to assets and proportionately increased the net assets to total assets ratio, resulting in a stronger, healthier capital structure. From the $2,271 million in net assets, $1,947 million or 85.7% are unrestricted, $225 million or 9.9% are restricted for use in affordable housing programs, and the remaining $99 million or 4.4% are invested in capital assets, restricted for debt service, and for the mortgage loan insurance program. Governmental and business-type activities are discussed separately in the following subsections.

*Governmental Activities*

Total assets of governmental activities amounted to $158 million at June 30, 2007, before $32 million in net balances due to business-type activities. Total liabilities amounted to $33 million, for net assets of $94 million or 74.0% of total assets net of balances due to business-type activities. Net assets have been broken down into the amounts restricted for debt service of $25.5 million and for affordable housing programs of $78.6 million, and the unrestricted deficit of $10.4 million, which means that the restrictions existing on the use of available assets will not allow the Bank to satisfy its existing liabilities from those assets, and therefore that it will depend on future appropriations for the repayment of all its obligations.

Condensed financial information on assets, liabilities, and net assets of governmental activities as of June 30, 2007 and 2006 is shown below (amounts in thousands):

| | June 30, | | | |
|---|---|---|---|---|
| | 2007 | 2006 | Amount | Percent |
| Assets: | | | | |
| Other assets | $ 363 | $ 400 | $ (37) | (9.3)% |
| Restricted: | | | | |
| Cash and due from banks, and deposits placed with banks | 47,556 | 15,491 | 32,065 | 207.0% |
| Due from federal government | 18,823 | 18,043 | 780 | 4.3% |
| Investments and investment contracts | 86,787 | 173,216 | (86,429) | (49.9)% |
| Loans receivable–net | 2,899 | 3,749 | (850) | (22.7)% |
| Other assets | 2,005 | 2,527 | (522) | (20.7)% |
| Total assets before internal balances | 158,433 | 213,426 | (54,993) | (25.8)% |
| Internal balances | (31,606) | (112,583) | 80,977 | (71.9)% |
| Total assets | 126,827 | 100,843 | 25,984 | 25.8% |
| Liabilities: | | | | |
| Accounts payable and accrued liabilities | 22,933 | 23,241 | (308) | (1.3)% |
| Notes payable: | | | | |
| Due in one year | 39 | 45 | (6) | (13.3)% |
| Due in more than one year | 10,160 | 10,199 | (39) | (0.4)% |
| Bonds payable: | | | | |
| Due in one year | - | 41,650 | (41,650) | (100.0)% |
| Total liabilities | 33,132 | 75,135 | (42,003) | (55.9)% |
| Net assets: | | | | |
| Restricted for debt service | 25,504 | 55,682 | (30,178) | (54.2)% |
| Restricted for affordable housing programs | 78,596 | 22,354 | 56,242 | 251.6% |
| Unrestricted deficit | (10,405) | (52,328) | 41,923 | (80.1)% |
| Total net assets | $ 93,695 | $ 25,708 | $ 67,987 | 264.5% |

Investments and investment contracts amounted to $86.8 million and account for the majority of assets held by governmental activities. These investments, together with cash and due from banks, and deposits placed with banks of $47.6 million are held to provide the funds necessary for the execution of the various affordable housing programs managed by the Puerto Rico Housing Finance Authority and for debt service. Governmental activities also have a balance due from the federal government of $18.8 million that is related to the reimbursement of eligible expenses incurred in the New Secure Housing Program.

The most significant liabilities of governmental activities are the notes payable amounting to $10.2 million at June 30, 2007. During the year, principal payments to service bonds payable amounted to $41.7 million.

Condensed financial information on expenses, program and general revenues, and changes in net assets of governmental activities for the years ended June 30, 2007 and 2006 is shown below (amounts in thousands):

| | Year ended June 30, 2007 | | |
|---|---|---|---|
| | General Government | Housing Assistance Programs | Total |
| Expenses | $ 4,514 | $ 165,056 | $ 169,570 |
| Program revenues: | | | |
| Changes for services – financing and investment | | 10,829 | 10,829 |
| Operating grants and contribution | - | 199,284 | 199,284 |
| Net (expenses) revenues | $ (4,514) | $ 45,057 | 40,543 |
| Transfers-net | | | 27,444 |
| Change in net assets | | | 67,987 |
| Net assets–beginning of year | | | 25,708 |
| Net assets–end of year | | | $ 93,695 |

| | Year ended June 30, 2006 | | |
|---|---|---|---|
| | General Government | Housing Assistance Programs | Total |
| Expenses | $ 1,201 | $ 192,784 | $ 193,985 |
| Program revenues: | | | |
| Charges for services – financing and investment | | 13,355 | 13,355 |
| Operating grants and contributions | - | 187,815 | 187,815 |
| Net (expenses) revenues | $ (1,201) | $ 8,386 | 7,185 |
| Transfers-net | | | 12,201 |
| Change in net assets | | | 19,386 |
| Net assets–beginning of year | | | 6,322 |
| Net assets–end of year | | | $ 25,708 |

Revenues of the governmental activities for 2007 of $210 million increased by $9 million (4%), when compared to 2006, resulting mainly from an increase of $22 million in appropriations from the Commonwealth for the repayment of bonds and housing assistance programs offset by a decrease in revenues from the federal government of $14 million. Lower federal government revenues are mainly due to a $19 million decrease related to the New Secure Housing Program. There has been less construction activity in the program since it is coming to an end. Projects under the program are expected to be completed not later than December 31, 2008.

Governmental activities' expenses were also reduced by $24 million, mainly driven by a decrease of $22 million in expenses related also to the New Secure Housing Program. This decrease was partially offset by an increase of $6 million on the expenditures of the HUD programs from $114 million in 2006 to $120 million in 2007. The main increase aggregating $5 million took place in the Project Based Contract Administrator (PBCA) housing assistance and new construction programs as a consequence of fair-market rent increases on program-based projects.

*Business-Type Activities*

Condensed financial information on assets, liabilities, and net assets as of June 30, 2007 and 2006 is presented below (amounts in thousands):

| | June 30, | | Change | |
|---|---|---|---|---|
| | 2007 | 2006 | Amount | Percent |
| Assets: | | | | |
| Cash and due from banks | $ 29,688 | $ 29,434 | $ 254 | 0.9% |
| Federal funds sold | 945,500 | 1,935,000 | (989,500) | (51.1)% |
| Deposits placed with banks | 1,881,810 | 552,266 | 1,329,544 | 240.7% |
| Investments and investment contracts | 2,048,405 | 2,269,504 | (221,099) | (9.7)% |
| Loans receivable–net | 6,238,862 | 7,276,712 | (1,037,850) | (14.3)% |
| Interest and other receivables | 472,506 | 304,361 | 168,145 | 55.2% |
| Capital assets | 24,525 | 27,860 | (3,335) | (12.0)% |
| Other assets | 127,355 | 138,250 | (10,895) | (7.9)% |
| Internal balances | 31,606 | 112,583 | (80,977) | (71.9)% |
| Total assets | 11,800,257 | 12,645,970 | (845,713) | (6.7)% |
| Liabilities: | | | | |
| Deposits: | | | | |
| Demand | 2,013,883 | 2,046,781 | (32,898) | (1.6)% |
| Certificates of deposit | 3,444,110 | 3,736,497 | (292,387) | (7.8)% |
| Certificates of indebtedness | 11,800 | 54,884 | (43,084) | (78.5)% |
| Securities sold under agreements to repurchase | 455,000 | 515,000 | (60,000) | (11.7)% |
| Commercial paper | 575,861 | 985,131 | (409,270) | (41.5)% |
| Accrued interest payable | 47,742 | 54,829 | (7,087) | (12.9)% |
| Accounts payable, accrued liabilities and other liabilities | 113,009 | 119,845 | (6,836) | (5.7)% |
| Bonds and notes payable: | | | | |
| Due in one year | 187,678 | 111,429 | 76,249 | 68.4% |
| Due in more than one year | 2,773,629 | 2,950,845 | (177,216) | (6.0)% |
| Total liabilities | 9,622,712 | 10,575,241 | (952,529) | (9.0)% |
| Net assets: | | | | |
| Invested in capital assets | 24,525 | 27,860 | (3,335) | (12.0)% |
| Restricted for: | | | | |
| Affordable housing programs | 146,691 | 188,025 | (41,334) | (22.0)% |
| Mortgage loan insurance | 49,135 | 43,841 | 5,294 | 12.1% |
| Unrestricted | 1,957,194 | 1,811,003 | 146,191 | 8.1% |
| Total net assets | $ 2,177,545 | $ 2,070,729 | $ 106,816 | 5.2% |

**Federal Funds Sold and Deposits Placed with Banks**

The Bank reduced its federal funds sold by $989.5 million or 51.1%, from $1,935 million at June 30, 2006 to $945.5 million at June 30, 2007 to increase its deposits placed with banks, which provide a better yield. Deposits placed with banks amounted to $1,881.8 million at June 30, 2007 from $552.3 million at June 30, 2006.

**Investments and Investment Contracts**

Investments and investment contracts held in business-type activities amounted to $2,048 million at June 30, 2007. This amount also represents a decrease of $221 million or 9.7% when compared to the prior year balance.

The investment portfolio comprised 17.4% of the total assets of the Bank's business-type activities at June 30, 2007, compared to 17.9% at the close of fiscal year 2006. Within the investment securities portfolio, $1,253.5 million at June 30, 2007 and $1,447.6 million at June 30, 2006 were restricted or pledged as collateral or payment source for specific borrowings.

**Loans Receivable**

Net loans receivable of $6,239 million accounted for 52.9% of total assets of business-type activities at June 30, 2007 (57.5% in 2006). The decrease of $1,038 million in net loans was driven by a decrease in public sector loans of approximately $983 million. Some major borrowers, such as the Puerto Rico Aqueduct and Sewer Authority ($580 million), and the Ports Authority ($301.5 million), repaid their debt through the private placement of bond anticipation notes. Also, the Puerto Rico Electric Power Authority repaid $107 million through the issuance of bonds.

Act No. 91 of the Legislature of the Commonwealth of Puerto Rico, as amended, created the Puerto Rico Sales Tax Financing Corporation (the "Sales Tax Corporation") for the purpose of financing the payment, retirement or defeasance of certain outstanding obligations of the Commonwealth at June 30, 2006 payable to the Bank and the Public Finance Corporation. Debt payable from legislative appropriations is designated as extra-constitutional debt. As of June 30, 2007 and 2006, the Bank had $2.8 billion of extra-constitutional debt in its public loans portfolio. However, on July 31, 2007, the Sales Tax Corporation issued the 2007 Series A and B bonds from whose proceeds the Bank collected $1.7 billion or 61% of said loans (Refer to Note 5 to the basic financial statements).

Private sector loans outstanding at June 30, 2007 and 2006 amounted to $418 million and $474 million, respectively, net of an allowance for loan losses of $31 million and $52 million, respectively.

**Capital Assets**

Capital assets, net of accumulated depreciation and amortization, amounted to $24.5 million at June 30, 2007, a decrease of $3.3 million from prior year. The decrease was mainly due to the loss on disposition of other capital assets of approximately $4.5 million. See Note 7 to the basic financial statements for additional information on capital assets.

**Other Assets**

Other assets amounted to $127.4 million at June 30, 2007, a decrease of $10.9 million from prior year. The decrease is partially attributed to an adjustment of $1.9 million to the valuation of some real estate available-for-sale, and the reclassification as land of property originally held-for-sale where the Bank is going to build its new headquarters.

**Deposits**

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

Demand deposits and certificates of deposit had a combined decrease of $325 million, from $5,783 million at June 30, 2006 to $5,458 at June 30, 2007.

**Certificate of Indebtedness**

Certificates of indebtedness decreased by $43 million or by 78.5% from $55 million to $12 million at June 30, 2007, due to the maturity of certain deposits from private entities.

**Securities Sold Under Agreement to Repurchase**

Securities sold under agreements to repurchase decreased by $60 million or by 11.7% from $515 million to $455 million at June 30, 2007. This was mostly due to an emphasis in replacing said funding with certificates of deposits from private entities.

**Commercial Paper**

Commercial paper decreased by 41.5% from $985 million at June 30, 2006 to $575.9 million at June 30, 2007. Commercial paper has been progressively replaced with long-term debt issues.

**Other Borrowed Funds**

Bonds and notes payable decreased by 3.4% from $3,062 million at June 30, 2006 to $2,961 million at June 30, 2007. This decrease is the result of the annual debt service of $252 million, which was partially offset by issuances of $151 million. (Refer to note 12).

Condensed financial information on expenses, program revenues, and changes in net assets for business-type activities for the years ended June 30, 2007 and 2006 is presented below (amounts in thousands):

| | Year ended June 30, 2007 | | | |
|---|---|---|---|---|
| | | Program revenues | | |
| | | Charges for services | | |
| Activity | Expenses | Fees, commissions, and other | Financing and investment | Net revenues (expenses) |
| GDB Operating Fund | $ 500,702 | $ 15,137 | $ 565,727 | $ 80,162 |
| Housing Finance Authority | 85,318 | 12,203 | 106,599 | 33,484 |
| Tourism Development Fund | 11,955 | 3,278 | 24,533 | 15,856 |
| Public Finance Corporation | 20,404 | 10 | 20,256 | (138) |
| Capital Fund | 73 | 13 | 13,147 | 13,087 |
| Development Fund | 10,095 | 34 | 1,927 | (8,134) |
| Other nonmajor | 168 | - | 111 | (57) |
| Total | $ 628,715 | $ 30,675 | $ 732,300 | 134,260 |
| Transfers to governmental activities | | | | (27,444) |
| Change in net assets | | | | 106,816 |
| Net assets–beginning of year | | | | 2,070,729 |
| Net assets–end of year | | | | $ 2,177,545 |

| | Year ended June 30, 2006 | | | |
|---|---|---|---|---|
| | | Program revenues | | |
| | | Charges for services | | |
| Activity | Expenses | Fees, commissions, and other | Financing and investment | Net revenues (expenses) |
| GDB Operating Fund | $ 361,648 | $ 13,378 | $ 429,338 | $ 81,068 |
| Housing Finance Authority | 113,138 | 25,465 | 80,794 | (6,879) |
| Tourism Development Fund | 13,971 | 2,931 | 16,641 | 5,601 |
| Public Finance Corporation | 55 | | 79 | 24 |
| Capital Fund | 89 | 1 | 4,308 | 4,220 |
| Development Fund | 39 | 6 | 6,699 | 6,666 |
| Other nonmajor | 99 | | 9 | (90) |
| Total | $ 489,039 | $ 41,781 | $ 537,868 | 90,610 |
| Special items: | | | | |
| Reimbursement of net guaranty disbursements from Commonwealth of Puerto Rico | | | | 21,498 |
| Income from sponsored housing programs | | | | 18,039 |
| Net loss on in-substance defeasance of bonds payable | | | | (3,058) |
| Transfers to governmental activities | | | | (12,201) |
| Change in net assets | | | | 114,888 |
| Net assets–beginning of year | | | | 1,955,841 |
| Net assets–end of year | | | | $ 2,070,729 |

Activities presented in the statement of activities coincide with the major enterprise funds of the Bank. GDB Operating Fund generated financing and investment revenues of $565.7 million from its loan and investment portfolios, and $15.1 million in other charges for services. These revenues covered $500.7 million in expenses for net revenues from GDB Operating Fund of $80.2 million, surpassing the net revenues of any other activity.

The Housing Finance Authority activities were the second largest contributor to the change in net assets with net revenues of $33.5 million. Other contributors to the change in net assets were the Tourism Development Fund and the Capital Fund with net revenues of $15.9 million and $13.1 million, respectively.

## (4) Analysis of Fund Financial Statements

*Governmental Funds*

Through its blended component unit, the Puerto Rico Housing Finance Authority (the "Authority"), at June 30, 2007, the Bank has six major governmental funds. Following, we provide an analysis of the financial position and changes in financial position of these major governmental funds.

*Affordable Housing Mortgage Subsidy Program (AHMSP) (Stage 7)*

This major fund is the Stage 7 of the AHMSP of the Authority. The fund's operating objective is to provide funds for low-income families to be used for the down payment on mortgages for the acquisition of dwelling. The fund receives appropriations from the Commonwealth to fund these payments.

Expenditures exceeded revenues by $4 million for the year ended June 30, 2007. This is attributed to the payment of the annual debt service, which was funded with the proceeds of matured investments and investment contracts.

*Affordable Housing Mortgage Subsidy Program (AHMSP) (Stage 8)*

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

This fund transferred excess funds amounting to $7.1 million to AHMSP-Law 124 governmental fund.

*Affordable Housing Mortgage Subsidy Program (Stage 9)*

This major fund is the Stage 9 of the AHMSP of the Authority. The fund's operating objective is to provide funds for low-income families to be used for the down payment on mortgages for the acquisition of dwelling. The fund receives appropriations from the Commonwealth to fund these payments. During the year ended June 30, 2007, the fund received an appropriation from the Commonwealth in the amount of $65 million. These funds were used to repay advances from the GDB Operating Fund that were used to fund subsidy payments.

*New Secure Housing Program*

This fund is used to account for the resources available under the New Secure Housing Program to provide housing assistance benefits for specific participants that were affected by Hurricane Georges in 1998 or that live in hazard prone areas. This fund receives resources from the federal government, under the Federal Emergency Management Agency program, intended to provide financial resources to eligible participants for the reconstruction of their homes.

During 2007 and 2006, this fund recognized revenues from the federal government of $4.6 million and $23.8 million, respectively, and Commonwealth appropriations of $0.2 million and $5.7 million, respectively. Funds are requested from the federal government as eligible expenditures are incurred.

Construction costs paid during the years ended June 30, 2007 and 2006 amounted to $13 million and $35 million, respectively, which are presented as housing subsidy payments in the accompanying statement of revenues, expenditures, and changes in fund balances — governmental funds. The decrease in eligible expenditures is in direct relation to the completion of certain projects being developed and financed through this fund.

*The Key for Your Home Program*

This fund accounts for the subsidy to low- and moderate-income families of costs directly related to the purchase and rehabilitation of housing units. The fund had expenditures of $18 million and $20 million in 2007 and 2006, respectively. Currently, the fund has a fund balance of $3 million. In the past, this fund has received transfers from the AHMSP funds. Act No. 124, the enabling legislation pursuant to which the AHMSP was created, allows for the transfer of fund surplus identified in other stages under the act to be used, among other permissible uses, to increase the Key for your Home Program fund. Management is evaluating various alternatives to finance and continue with this program.

*HUD Programs*

This fund accounts for the U.S. Housing Act Section 8 programs administered by the Authority under the authorization of the U.S. Department of Housing and Urban Development (HUD programs). Presently, the Authority operates four 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 rent in certain markets. The expenditures on the HUD programs increased $5.5 million from $114.4 million in 2006 to $119.9 million in 2007. The main increase aggregating $5 million took place in the Project Based Contract Administrator (PBCA) housing assistance and New Construction programs as a consequence of fair-market rent increases on program based projects. Also, during 2007 a project subject to the Moderate Rehabilitation program opted out of the Section 8 program and HUD authorized additional Housing Choice Vouchers to relocate affected low-income families. This situation caused a decrease of $0.4 million in the expenditures of the Moderate Rehabilitation program and an increase of $0.9 million in the expenditures of the Housing Choice Voucher program.

*Subsidy Prepayment Refunding Bonds – Debt Service*

This fund was used to account for the resources available for the payment of certain bonds that were issued for the prepayment of subsidies. Final payment for bonds outstanding amounting to $32.4 million was made during the year. The fund was closed since it carried out its legal and financial purpose.

***Enterprise Funds***

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

*GDB Operating Fund*

Total assets of the GDB Operating Fund amounted to $10,699 million at June 30, 2007, compared to $11,790 million at June 30, 2006. This represents a decrease of $1,091 million, which was mainly driven by a net decrease in loans to the public sector of approximately $1,366 million. As previously discussed, several public entities repaid their debt with the Bank through the issuance of bonds or private placements. Other collections were $320 million from the Department of the Treasury, $82 million from the University of Puerto Rico, $80 million from the Puerto Rico Highway Authority and $140 million, from the Commonwealth's General Obligation Bonds.

With the proceeds from the collection of loans, the Bank cancelled most of its related funding, such as commercial paper ($409 million net decrease) in order to lower total assets and increase the net assets to total assets ratio. Additionally, there was a significant reduction in deposits of $636 million due to a decrease on the Department of Treasury account balance whose debt service deposits are currently held in a private entity.

Change in net assets of the GDB Operating Fund decreased 1.1% from $81.1 million in 2006 to $80.2 million in 2007. Following we discuss the various components of the change in net assets of the GDB Operating Fund, compared to the prior year.

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

Net investment income, the difference between investment income and interest expense, increased from $106.1 million in 2006 to $127.6 million in 2007. Interest expense increased by 35.6%, or from $323.2 million to $438.2 million, while interest income increased by 31.8% or from $429.3 million to $565.7 million. The increase in net interest income can be attributed to the increase in volume of investments and positive change in fair value of investments of $17.4 million.

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

In 2006, the Bank collected $12.7 million as a reimbursement from the Commonwealth of Puerto Rico in connection with a guarantee honored on behalf of Puerto Rico Maritime Shipping Authority during prior years. The reimbursement was then registered as a credit to losses on guarantees and letters of credit.

In 2007, after years of litigations, the Bank recognized an allowance of $11.8 million for a loan to a municipality due to uncertainties regarding its collection (Refer to note 5 to the basic financial statements).

***(c) Noninterest Income***

Fiscal agency fees income increased 8.2% from $8.1 million in 2006 to $8.8 million in 2007 due to more fiscal activity than that of the prior year.

***(d) Noninterest Expenses***

Salaries and fringe benefits increased only by $510 thousand or 2.0% in 2007.

The increase of 66% in other expenses is mainly due to a loss on disposition of other capital assets of approximately $4.5 million.

*(e) Nonoperating Expenses*

The decrease in nonoperating expenses of $1.7 million is mainly due to the decrease in the contributions to the Cooperative Development Investment Fund during year 2007.

*Housing Finance Authority*

Net assets of the Housing Finance Authority increased $6 million from $528 million as of June 30, 2006 to $534 million as of June 30, 2007. The Authority had total revenues of $119 million for the year ended June 30, 2007 an increase of $13 million from 2006. This increase is mainly due to more favorable market conditions, which took the fair value of the investments from a loss of $16 million in 2006 to a gain of $2 million in 2007, and to an increase of $8 million in investment and interest income resulting from higher investments average balances and improved interest rates. This increase was offset by a reduction in non-interest income of $13 million. Total operating expenses of the Authority went down from $113 million in 2006 to $85 million in 2007. The main factor of this decrease of $28 million was the collection of a loan from the Puerto Rico Department of Housing. During 2006, a $15 million reserve was established related to this loan which was reversed in 2007 upon collection.

*Capital Fund*

The Capital Fund's total net assets increased $13.1 million or 17.6% during the year to $87.6 million at June 30, 2007. This increase is mainly attributed to the net increase in fair value of investments of approximately $12.5 million and dividend and interest income of approximately $619,000.

*Development Fund*

The Development Fund's total net assets decreased $8.1 million or 20.0% to $32.6 million at June 30, 2007. The decrease was mainly due to the accrual of a reserve for litigation of $10 million during 2007. The decrease was partially offset by interest income on deposits of approximately $1.9 million. There was no dividend income in 2007 due to the sale of the equity investments in June 2006.

*Tourism Development Fund*

Total assets decreased to $356.6 million from $422.6 million in 2006. This decrease is mainly attributed to the payments received from loans and the sale of a mortgage note due from the Cayo Largo project. These collections were used to reduce related outstanding notes payable. At June 30, 2007, outstanding guarantees and letters of credit of the Tourism Development Fund amounted to $128.8 million. Net assets of the Tourism Development Fund increased $15.9 million or 12.6% during the year to $141.3 million at June 30, 2007.

*Public Finance Corporation*

Net assets decreased by approximately $138,000 or 13% from fiscal year 2006. The decrease is attributed to a negative interest rate spread during the first quarter of fiscal year 2007. Total assets increased approximately $19.5 million or 6.41% from prior year. The increase is attributed to accrued interest receivable from the Dedicated Sales Tax Fund, formerly known as the Imperative Interest Fund, on the $303 million that the Corporation disbursed for the 2007 debt service payment of its no-commitment debt

**(5) Debt**

Total bonds and notes outstanding at year-end amounted to $2,971 million of which $1,016 million are payable from restricted assets held by the Puerto Rico Housing Finance Authority. There were $151 million in new bonds issued during the year on the enterprise funds. Repayments and other reductions in debt outstanding aggregated $252 million. See Note 12 to the basic financial statements for additional information on debt activities during the year.

**(6) Contacting the Bank's Financial Management**

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

| ASSETS | Governmental Activities | Business-type Activities | Total |
|---|---|---|---|
| Cash and due from banks | $ - | $ 5,854,764 | $ 5,854,764 |
| Federal funds sold | | 945,500,000 | 945,500,000 |
| Deposits placed with banks | | 1,870,443,074 | 1,870,443,074 |
| Investments and investment contracts | | 794,926,883 | 794,926,883 |
| Loans receivable – net | | 6,231,555,111 | 6,231,555,111 |
| Accrued interest receivable | | 469,701,649 | 469,701,649 |
| Internal balances | (31,605,555) | 31,605,555 | - |
| Restricted assets: | | | |
| Cash and due from banks | 5,287,731 | 23,832,800 | 29,120,531 |
| Deposits placed with banks | 42,268,143 | 11,366,647 | 53,634,790 |
| Due from federal government | 18,823,323 | | 18,823,323 |
| Investments and investment contracts | 86,787,271 | 1,253,478,462 | 1,340,265,733 |
| Loans receivable – net | 2,898,997 | 7,307,166 | 10,206,163 |
| Interest and other receivables | 1,306,801 | 2,804,270 | 4,111,071 |
| Real estate available for sale | 697,692 | 1,328,756 | 2,026,448 |
| Other assets | | 6,363,700 | 6,363,700 |
| Real estate available for sale | | 66,688,439 | 66,688,439 |
| Capital assets: | | | |
| Land | | 10,970,990 | 10,970,990 |
| Other capital assets | | 13,554,257 | 13,554,257 |
| Other assets | 362,907 | 52,974,509 | 53,337,416 |
| TOTAL | 126,827,310 | 11,800,257,032 | 11,927,084,342 |
| **LIABILITIES** | | | |
| Deposits, principally from the Commonwealth of Puerto Rico and its public entities: | | | |
| Demand | | 2,013,882,933 | 2,013,882,933 |
| Certificates of deposit: | | | |
| Due within one year | | 3,262,176,709 | 3,262,176,709 |
| Due in more than one year | | 181,933,913 | 181,933,913 |
| Securities sold under agreements to repurchase | | 455,000,000 | 455,000,000 |
| Commercial paper | | 575,861,000 | 575,861,000 |
| Accrued interest payable | | 45,384,277 | 45,384,277 |
| Due to Commonwealth of Puerto Rico | | 1,048,626 | 1,048,626 |
| Accounts payable and accrued liabilities: | | | |
| Due within one year | | 49,927,284 | 49,927,284 |
| Due in more than one year | | 32,256,095 | 32,256,095 |
| Allowance for losses on guarantees and letters of credit: | | | |
| Due within one year | | 30,419 | 30,419 |
| Due in more than one year | | 2,462,924 | 2,462,924 |
| Certificates of indebtedness | | 11,800,000 | 11,800,000 |
| Participation agreement payable | | 26,000,000 | 26,000,000 |
| Bonds payable: | | | |
| Due within one year | | | |
| Due in more than one year | | 267,000,000 | 267,000,000 |
| Notes payable: | | | |
| Due within one year | 38,504 | 116,981,001 | 117,019,505 |
| Due in more than one year | 10,160,032 | 1,561,066,950 | 1,571,226,982 |
| Liabilities payable from restricted assets: | | | |
| Accrued interest payable | 569,260 | 2,357,275 | 2,926,535 |
| Accounts payable and accrued liabilities: | | | |
| Due within one year | 22,364,190 | 841,833 | 23,206,023 |
| Due in more than one year | | 441,652 | 441,652 |
| Bonds payable: | | | |
| Due within one year | | 70,697,619 | 70,697,619 |
| Due in more than one year | - | 945,561,556 | 945,561,556 |
| Total liabilities | 33,131,986 | 9,622,712,066 | 9,655,844,052 |
| **NET ASSETS (DEFICIT)** | | | |
| Invested in capital assets | | 24,525,247 | 24,525,247 |
| Restricted for: | | | |
| Debt service | 25,503,670 | | 25,503,670 |
| Affordable housing programs | 78,596,543 | 146,690,741 | 225,287,284 |
| Mortgage loan insurance | | 49,134,920 | 49,134,920 |
| Unrestricted net assets (deficit) | (10,404,889) | 1,957,194,058 | 1,946,789,169 |
| Total net assets | $ 93,695,324 | $ 2,177,544,966 | $ 2,271,240,290 |

See accompanying notes to basic financial statements.

| | | Program Revenues | | | Net Revenues (Expenses) and Changes in Net Assets | | |
|---|---|---|---|---|---|---|---|
| | Expenses | Charges for Services - Fees, Commissions, and Others | Charges for Services - Financing and Investment | Operating Grants and Contributions | Governmental Activities | Business-type Activities | Total |
| Functions/programs: | | | | | | | |
| Governmental activities: | | | | | | | |
| General government | $ 4,514,574 | $ - | $ - | $ - | $ (4,514,574) | $ - | $ (4,514,574) |
| Housing subsidy programs | 165,055,674 | | 10,829,191 | 199,283,851 | 45,057,368 | | 45,057,368 |
| Total governmental activities | 169,570,248 | - | 10,829,191 | 199,283,851 | 40,542,794 | - | 40,542,794 |
| Business-type activities: | | | | | | | |
| GDB Operating Fund | 500,701,743 | 15,136,838 | 565,727,353 | | | 80,162,448 | 80,162,448 |
| Housing Finance Authority | 85,317,231 | 12,202,874 | 106,598,996 | | | 33,484,639 | 33,484,639 |
| Tourism Development Fund | 11,955,052 | 3,278,012 | 24,533,174 | | | 15,856,134 | 15,856,134 |
| Public Finance Corporation | 20,403,785 | 9,986 | 20,256,163 | | | (137,636) | (137,636) |
| Capital Fund | 73,410 | 12,539 | 13,147,473 | | | 13,086,602 | 13,086,602 |
| Development Fund | 10,095,314 | 34,187 | 1,927,183 | | | (8,133,944) | (8,133,944) |
| Other nonmajor | 168,159 | | 110,540 | | | (57,619) | (57,619) |
| Total business-type activities | 628,714,694 | 30,674,436 | 732,300,882 | - | - | 134,260,624 | 134,260,624 |
| Total | $798,284,942 | $ 30,674,436 | $ 743,130,073 | $ 199,283,851 | 40,542,794 | 134,260,624 | 174,803,418 |
| Transfers – net | | | | | 27,444,572 | (27,444,572) | - |
| Change in net assets | | | | | 67,987,366 | 106,816,052 | 174,803,418 |
| Net assets – beginning of year | | | | | 25,707,958 | 2,070,728,914 | 2,096,436,872 |
| Net assets – end of year | | | | | $ 93,695,324 | $ 2,177,544,966 | $ 2,271,240,290 |

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
As of June 30, 2007

| | Affordable Housing Mortgage Subsidy Program-Stage 7 | Affordable Housing Mortgage Subsidy Program-Stage 8 | Affordable Housing Mortgage Subsidy Program – Stage 9 | New Secure Housing Program | The Key for Your Home Program | HUD Programs | Other Nonmajor Governmental Funds | Eliminations | Total Governmental Funds |
|---|---|---|---|---|---|---|---|---|---|
| **ASSETS** | | | | | | | | | |
| Due from other funds | $ - | $ - | $ - | $ 465,373 | $ 110,620 | $ - | $ 10,910,669 | $ (10,644,693) | $ 841,969 |
| Restricted: | | | | | | | | | |
| Cash and due from banks | | 17,386 | 57 | | | 5,026,370 | 243,918 | | 5,287,731 |
| Deposits placed with banks | | | | | | | 42,268,143 | | 42,268,143 |
| Due from federal government | | | | 18,823,323 | | | | | 18,823,323 |
| Investments and investment contracts | 22,079,010 | 2,169,494 | 13,908,017 | | | | 48,630,750 | | 86,787,271 |
| Loans receivable – net | | | | | | | 2,898,997 | | 2,898,997 |
| Due from other funds | | 13,181,978 | | 1,447,551 | 9,535,833 | 526,979 | 54,815,865 | | 79,508,206 |
| Interest and other receivables | 83,155 | 11,528 | 4,694 | 82,086 | 15,000 | 758,698 | 351,640 | | 1,306,801 |
| Real estate available for sale | | | | | | | 697,692 | | 697,692 |
| Other assets | | | | | | | | | - |
| TOTAL | $ 22,162,165 | $ 15,380,386 | $ 13,912,768 | $ 20,818,333 | $ 9,661,453 | $ 6,312,047 | $ 160,817,674 | $ (10,644,693) | $ 238,420,133 |
| **LIABILITIES** | | | | | | | | | |
| Due to other funds | $ 66,481,823 | $ - | $ 5,664,001 | $ 35,247,242 | $ 3,879 | $ - | $ 15,203,478 | $ (10,644,693) | $ 111,955,730 |
| Restricted: | | | | | | | | | |
| Accounts payable and accrued liabilities | 458,233 | 164,105 | 77,660 | 7,577,424 | 6,602,595 | 6,312,047 | 1,172,126 | | 22,364,190 |
| Deferred revenue | - | - | - | 18,905,409 | - | - | - | - | 18,905,409 |
| Total liabilities | 66,940,056 | 164,105 | 5,741,661 | 61,730,075 | 6,606,474 | 6,312,047 | 16,375,604 | (10,644,693) | 153,225,329 |
| **FUND BALANCES (DEFICIT)** | | | | | | | | | |
| Reserved for: | | | | | | | | | |
| Long-term loans receivable and other assets | | | | | | | 3,596,688 | | 3,596,688 |
| Debt service | | | | | | | 25,503,670 | | 25,503,670 |
| Unreserved – special revenue funds | (44,777,891) | 15,216,281 | 8,171,107 | (40,911,742) | 3,054,979 | | 115,341,712 | | 56,094,446 |
| Total fund balances (deficit) | (44,777,891) | 15,216,281 | 8,171,107 | (40,911,742) | 3,054,979 | - | 144,442,070 | - | 85,194,804 |
| TOTAL | $ 22,162,165 | $ 15,380,386 | $ 13,912,768 | $ 20,818,333 | $ 9,661,453 | $ 6,312,047 | $ 160,817,674 | $ (10,644,693) | $ 238,420,133 |

| | |
|---|---|
| Amounts reported for governmental activities in the statement of net assets are different because: | |
| Total fund balance | $ 85,194,804 |
| Deferred bond issue costs that are recorded as expenditures in governmental funds, but are capitalized in the government-wide financial statements | 362,907 |
| Long-term liabilities, including bonds and notes payable, are not due and payable in the current period and therefore are not reported in the funds | (10,198,536) |
| Accrued interest payable not due and payable in the current period | (569,260) |
| Revenues in the statement of activities that do not provide current financial resources are not reported as revenue in the funds | 18,905,409 |
| Net assets of governmental activities | $ 93,695,324 |

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, Expenditures, and Changes in Fund Balances - Governmental Funds
For the yerar ended June 30, 2007

| | Affordable Housing Mortgage Subsidy Program-Stage 7 | Affordable Housing Mortgage Subsidy Program-Stage 8 | Affordable Housing Mortgage Subsidy Program – Stage 9 | New Secure Housing Program | The Key for Your Home Program | HUD Programs | Subsidy Prepayment Refunding Bonds – Debt Service | Other Nonmajor Governmental Funds | Total Governmental Funds |
|---|---|---|---|---|---|---|---|---|---|
| **REVENUES** | | | | | | | | | |
| Commonwealth appropriations for repayment of bonds | $ 615,767 | $ - | $ 65,000,000 | $ 234,692 | $ - | $ - | $ - | $ - | $ 65,850,459 |
| Intergovernmental – federal government | | | | 4,559,646 | | 119,797,901 | | | 124,357,547 |
| Interest on investments and deposits placed with banks | 1,505,591 | 1,128,829 | 561,643 | 20,922 | 895,341 | | 868,199 | 5,536,258 | 10,516,783 |
| Interest income on loans – net | | | | | | | | 419,500 | 419,500 |
| Net decrease in fair value of investments | | (57,953) | | | | | | (49,139) | (107,092) |
| Other | | 1,036 | | 1,299,949 | 2,052,952 | | 56,630 | 517,764 | 3,928,331 |
| Total revenues | 2,121,358 | 1,071,912 | 65,561,643 | 6,115,209 | 2,948,293 | 119,797,901 | 924,829 | 6,424,383 | 204,965,528 |
| **EXPENDITURES** | | | | | | | | | |
| Current: | | | | | | | | | |
| General government | 9,913 | 8,500 | | | | 4,248,410 | 2,500 | 245,251 | 4,514,574 |
| Housing assistance programs | 2,109,758 | 866,766 | 858,904 | 13,177,573 | 18,105,802 | 115,549,491 | | 5,259,608 | 155,927,902 |
| Provision for loan losses | | | | | | | | 724,206 | 724,206 |
| Debt service: | | | | | | | | | |
| Principal | 45,047 | | | | | | 32,400,000 | 9,250,000 | 41,695,047 |
| Interest | 3,919,042 | | 821,166 | 1,528,245 | | | 1,215,000 | 1,148,042 | 8,631,495 |
| Total expenditures | 6,083,760 | 875,266 | 1,680,070 | 14,705,818 | 18,105,802 | 119,797,901 | 33,617,500 | 16,627,107 | 211,493,224 |
| Excess (deficiency) of revenues over (under) expenditures | (3,962,402) | 196,646 | 63,881,573 | (8,590,609) | (15,157,509) | - | (32,692,671) | (10,202,724) | (6,527,696) |
| Other financing sources (uses): | | | | | | | | | |
| Transfers-in | | | | | | | | 74,975,444 | 74,975,444 |
| Transfers-out | | (7,100,000) | (576,973) | | | | (10,254) | (39,843,645) | (47,530,872) |
| Total other financing sources (uses) | - | (7,100,000) | (576,973) | - | - | - | (10,254) | 35,131,799 | 27,444,572 |
| Net change in fund balance | (3,962,402) | (6,903,354) | 63,304,600 | (8,590,609) | (15,157,509) | - | (32,702,925) | 24,929,075 | 20,916,876 |
| Fund balances (deficit) – beginning of year | (40,815,489) | 22,119,635 | (55,133,493) | (32,321,133) | 18,212,488 | | 32,702,925 | 119,512,995 | 64,277,928 |
| Fund balances (deficit) – end of year | $ (44,777,891) | $ 15,216,281 | $ 8,171,107 | $ (40,911,742) | $ 3,054,979 | $ - | $ - | $ 144,442,070 | $ 85,194,804 |

See accompanying notes to basic financial statements.

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

For the year ended June 30, 2007

| | |
|---|---|
| Amounts reported for governmental activities in the statement of activities are different because: | |
| Net change in fund balances - total governmental funds | $ 20,916,876 |
| Repayment of the principal of long-term debt consumes the current financial resources of governmental funds | 41,695,047 |
| 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 | 244,429 |
| Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds | 5,147,514 |
| Governmental funds report the effect of issuance costs when debt is first issued, whereas these costs are deferred and amortized in the statement of activities. This amount is the amortization for the year | (16,500) |
| Change in net assets of governmental activities | $ 67,987,366 |

See accompanying notes to basic financial statements

## Balance Sheet - Enterprise Funds

As of June 30, 2007

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| ASSETS | | | | | | | | | |
| Current assets: | | | | | | | | | |
| Cash and due from banks | $ 5,750,881 | $ 6,038,885 | $ - | $ 42,477,336 | $ 5,102,398 | $ 1,219,026 | $ 2,432,286 | $ (57,166,048) | $ 5,854,764 |
| Federal funds sold | 945,500,000 | | | | | | | | 945,500,000 |
| Deposits placed with banks | 1,820,057,870 | 128,854,945 | | | 41,234,891 | | | (119,704,632) | 1,870,443,074 |
| Investments and investment contracts | 166,813,700 | 14,568 | 334,986 | | 35,199,183 | | | | 202,362,437 |
| Loans receivable – net | 2,455,109,277 | 6,378,243 | | | 325,000 | 198,329,030 | | (205,477,637) | 2,454,663,913 |
| Accrued interest receivable | 468,515,173 | 1,915,626 | 1,360 | 160,738 | 2,486,202 | 19,560,795 | 9,197 | (22,947,442) | 469,701,649 |
| Other current receivables | 25,980,933 | 1,692,865 | | | 381,091 | | 831 | | 28,055,720 |
| Other current assets | 685,851 | 210,237 | | | 65 | | | | 896,153 |
| Due from governmental funds | 108,912,119 | 3,043,611 | | | | | | | 111,955,730 |
| Restricted: | | | | | | | | | |
| Cash and due from banks | | 24,402,784 | | | | | | (569,984) | 23,832,800 |
| Deposits placed with banks | | 312,223,789 | | | | | | (300,857,142) | 11,366,647 |
| Investments and investment contracts | 49,787,500 | 203,947,143 | | | | | | | 253,734,643 |
| Loan receivable – net | | 852,226 | | | | | | | 852,226 |
| Accrued interest receivable | | 12,977,927 | | | | | | (10,174,479) | 2,803,448 |
| Other current receivables | | 822 | | | | | | | 822 |
| Total current assets | 6,047,113,304 | 702,553,671 | 336,346 | 42,638,074 | 84,728,830 | 219,108,851 | 2,442,314 | (716,897,364) | 6,382,024,026 |
| Noncurrent assets: | | | | | | | | | |
| Restricted: | | | | | | | | | |
| Investments and investment contracts | 442,816,442 | 766,407,276 | | | | | | (209,479,899) | 999,743,819 |
| Loans receivable – net | | 6,454,940 | | | | | | | 6,454,940 |
| Real estate available for sale | | 1,328,756 | | | | | | | 1,328,756 |
| Other assets | | 6,363,700 | | | | | | | 6,363,700 |
| Investments and investment contracts | 552,580,182 | 39,554,267 | 87,286,600 | | 32,342,489 | | | (119,199,092) | 592,564,446 |
| Loans receivable – net | 3,553,541,364 | 161,045,500 | | | 239,539,473 | 104,527,647 | | (281,762,786) | 3,776,891,198 |
| Real estate available for sale | 66,022,902 | 665,537 | | | | | | | 66,688,439 |
| Capital assets: | | | | | | | | | |
| Land | 10,970,990 | | | | | | | | 10,970,990 |
| Other capital assets | 11,055,105 | 2,496,789 | | | | | 2,363 | | 13,554,257 |
| Other assets | 15,142,636 | 8,880,000 | | | | | | | 24,022,636 |
| Total noncurrent assets | 4,652,129,621 | 993,196,765 | 87,286,600 | - | 271,881,962 | 104,527,647 | 2,363 | (610,441,777) | 5,498,583,181 |
| Total assets | $ 10,699,242,925 | $ 1,695,750,436 | $ 87,622,946 | $ 42,638,074 | $ 356,610,792 | $ 323,636,498 | $ 2,444,677 | $ (1,327,339,141) | $11,880,607,207 |

See accompanying notes to basic financial statements.

## Government Development Bank for Puerto Rico
(A Component Unit of the Commonwealth of Puerto Rico)

## Balance Sheet - Enterprise Funds
As of June 30, 2007

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| **LIABILITIES** | | | | | | | | | |
| Current liabilities: | | | | | | | | | |
| Deposits, principally from the Commonwealth of Puerto Rico and its public entities: | | | | | | | | | |
| Demand | $ 2,073,872,474 | $ - | $ - | $ - | $ - | $ - | $ - | $ (59,989,541) | $ 2,013,882,933 |
| Certificates of deposit | 3,682,738,483 | | | | | | | (420,561,774) | 3,262,176,709 |
| Commercial paper | 575,861,000 | | | | | | | | 575,861,000 |
| Accrued interest payable | 56,205,078 | 607,891 | | | 1,240,239 | 20,452,990 | | (33,121,921) | 45,384,277 |
| Accounts payable and accrued liabilities | 22,727,701 | 13,260,300 | 29,626 | 10,021,204 | 1,627,386 | 2,554 | 5,004 | 2,253,509 | 49,927,284 |
| Due to governmental funds | 79,508,206 | 841,969 | | | | | | | 80,350,175 |
| Due to Commonwealth of Puerto Rico | 1,013,951 | 34,675 | | | | | | | 1,048,626 |
| Allowance for losses on guarantees and letters of credit | | | | 30,419 | | | | | 30,419 |
| Notes payable | 109,140,710 | 7,844,436 | | | 7,144,462 | 198,329,030 | | (205,477,637) | 116,981,001 |
| Total current liabilities payable from unrestricted assets | 6,601,067,603 | 22,589,271 | 29,626 | 10,051,623 | 10,012,087 | 218,784,574 | 5,004 | (716,897,364) | 6,145,642,424 |
| Current liabilities payable from restricted assets: | | | | | | | | | |
| Accrued interest payable | | 2,357,275 | | | | | | | 2,357,275 |
| Accounts payable and accrued liabilities | | 841,833 | | | | | | | 841,833 |
| Bonds payable | | 70,697,619 | | | | | | | 70,697,619 |
| Total current liabilities | 6,601,067,603 | 96,485,998 | 29,626 | 10,051,623 | 10,012,087 | 218,784,574 | 5,004 | (716,897,364) | 6,219,539,151 |
| Noncurrent liabilities: | | | | | | | | | |
| Certificates of deposits, principally from the Commonwealth of Puerto Rico and its public entities | 391,413,812 | | | | | | | (209,479,899) | 181,933,913 |
| Certificates of indebtedness | 11,800,000 | | | | | | | | 11,800,000 |
| Securities sold under agreements to repurchase | 455,000,000 | | | | | | | | 455,000,000 |
| Allowance for losses on guarantees and letters of credit | 1,000,000 | | | | 1,462,924 | | | | 2,462,924 |
| Accounts payable and accrued liabilities | 29,703,459 | 259,904 | | | | | 2,292,732 | | 32,256,095 |
| Participation agreement payable | | | | | 26,000,000 | | | | 26,000,000 |
| Bonds and notes payable | 1,828,066,950 | | | | 177,826,709 | 103,936,077 | | (281,762,786) | 1,828,066,950 |
| Noncurrent liabilities payable from restricted assets: | | | | | | | | | |
| Allowance for losses on mortgage loan insurance | | 441,652 | | | | | | | 441,652 |
| Bonds payable | | 1,064,760,648 | | | | | | (119,199,092) | 945,561,556 |
| Total noncurrent liabilities | 2,716,984,221 | 1,065,462,204 | - | - | 205,289,633 | 103,936,077 | 2,292,732 | (610,441,777) | 3,483,523,090 |
| Total liabilities | 9,318,051,824 | 1,161,948,202 | 29,626 | 10,051,623 | 215,301,720 | 322,720,651 | 2,297,736 | (1,327,339,141) | 9,703,062,241 |
| **NET ASSETS** | | | | | | | | | |
| Invested in capital assets | 22,026,095 | 2,496,789 | | | | | 2,363 | | 24,525,247 |
| Restricted for: | | | | | | | | | |
| Mortgage loan insurance | | 49,134,920 | | | | | | | 49,134,920 |
| Affordable housing programs | | 146,690,741 | | | | | | | 146,690,741 |
| Unrestricted | 1,359,165,006 | 335,479,784 | 87,593,320 | 32,586,451 | 141,309,072 | 915,847 | 144,578 | | 1,957,194,058 |
| Total net assets | 1,381,191,101 | 533,802,234 | 87,593,320 | 32,586,451 | 141,309,072 | 915,847 | 146,941 | - | 2,177,544,966 |
| Total liabilities and net assets | $ 10,699,242,925 | $ 1,695,750,436 | $ 87,622,946 | $ 42,638,074 | $ 356,610,792 | $ 323,636,498 | $ 2,444,677 | $ (1,327,339,141) | $ 11,880,607,207 |

See accompanying notes to basic financial statements.

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

For the year ended June 30, 2007

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Total |
|---|---|---|---|---|---|---|---|---|
| OPERATING REVENUES: | | | | | | | | |
| Investment income: | | | | | | | | |
| Interest income on federal funds sold | $ 75,433,805 | $ - | $ - | $ - | $ - | $ - | $ - | $ 75,433,805 |
| Interest income on deposits placed with banks | 35,803,225 | 30,352,177 | | 1,927,183 | 2,655,414 | 702,319 | 110,540 | 71,550,858 |
| Interest and dividend income on investments and investment contracts | 67,093,643 | 62,134,307 | 619,057 | | 2,995,278 | | | 132,842,285 |
| Net increase in fair value of investments | 15,790,246 | 2,077,509 | 12,528,416 | | 635,552 | | | 31,031,723 |
| Total investment income | 194,120,919 | 94,563,993 | 13,147,473 | 1,927,183 | 6,286,244 | 702,319 | 110,540 | 310,858,671 |
| Interest income on loans receivable: | | | | | | | | |
| Public sector | 371,604,648 | | | | | 19,553,844 | | 391,158,492 |
| Private sector | 1,786 | 12,035,003 | | | 18,246,930 | | | 30,283,719 |
| Total interest income on loans receivable | 371,606,434 | 12,035,003 | - | - | 18,246,930 | 19,553,844 | - | 421,442,211 |
| Total investment income and interest income on loans receivable | 565,727,353 | 106,598,996 | 13,147,473 | 1,927,183 | 24,533,174 | 20,256,163 | 110,540 | 732,300,882 |
| Noninterest income: | | | | | | | | |
| Fiscal agency fees | 8,810,472 | 167,207 | | | | | | 8,977,679 |
| Commitment, guarantee and other service fees | 3,437,098 | 7,558,066 | | 34,187 | 2,516,520 | | | 13,545,871 |
| Mortgage insurance premiums | | 2,694,332 | | | | | | 2,694,332 |
| Net loss from sale of foreclosed real estate available for sale | | (37,735) | | | | | | (37,735) |
| Gain on sale of loans | | 741,316 | | | | | | 741,316 |
| Other income | 2,889,268 | 1,079,688 | 12,539 | | 761,492 | 9,986 | | 4,752,973 |
| Total noninterest income | 15,136,838 | 12,202,874 | 12,539 | 34,187 | 3,278,012 | 9,986 | - | 30,674,436 |
| Total operating revenues | 580,864,191 | 118,801,870 | 13,160,012 | 1,961,370 | 27,811,186 | 20,266,149 | 110,540 | 762,975,318 |
| OPERATING EXPENSES: | | | | | | | | |
| Provision for loan losses | 11,842,981 | 8,718,514 | | | (25,925,963) | | | (5,364,468) |
| Interest expense: | | | | | | | | |
| Deposits | 302,397,197 | | | | | | | 302,397,197 |
| Securities sold under agreements to repurchase | 22,618,003 | | | | | | | 22,618,003 |
| Commercial paper | 20,899,500 | | | | | | | 20,899,500 |
| Certificates of indebtedness | 1,278,083 | | | | | | | 1,278,083 |
| Bonds and notes payable | 90,981,624 | 74,081,994 | | | 18,310,516 | 20,400,381 | | 203,774,515 |
| Total interest expense | 438,174,407 | 74,081,994 | - | - | 18,310,516 | 20,400,381 | - | 550,957,298 |
| Noninterest expenses: | | | | | | | | |
| Salaries and fringe benefits | 26,179,902 | 11,059,997 | | | | | 41,844 | 37,281,743 |
| Depreciation and amortization | 1,549,599 | 591,137 | | | | | | 2,140,736 |
| Occupancy and equipment costs | 4,087,981 | 828,748 | | - | 60 | | | 4,916,789 |
| Legal and professional fees | 3,354,188 | 1,690,555 | 33,898 | 46,723 | 737,148 | 2,653 | 15,000 | 5,880,165 |
| Office and administrative | 615,599 | 255,549 | 39,512 | | | | | 910,660 |
| Subsidy and trustee fees | | 340,403 | | | | | | 340,403 |
| Provision for mortgager loan insurance | | 392,535 | | | | | | 392,535 |
| Provision (credit) for losses on guarantees and letters of credit | | | | 47,774 | (61,322) | | | (13,548) |
| Credit for amount due from Puerto Rico Department of Housing | | (15,037,672) | | | | | | (15,037,672) |
| Provision for doubtful accounts receivable | | | | | 17,890,635 | | | 17,890,635 |
| Other | 11,689,807 | 2,395,471 | - | 10,000,817 | 3,978 | 751 | 111,315 | 24,202,139 |
| Total noninterest expenses | 47,477,076 | 2,516,723 | 73,410 | 10,095,314 | 18,570,499 | 3,404 | 168,159 | 78,904,585 |
| Total operating expenses | 497,494,464 | 85,317,231 | 73,410 | 10,095,314 | 10,955,052 | 20,403,785 | 168,159 | 624,507,415 |
| OPERATING INCOME (LOSS) | 83,369,727 | 33,484,639 | 13,086,602 | (8,133,944) | 16,856,134 | (137,636) | (57,619) | 138,467,903 |
| NONOPERATING EXPENSES — Contributions to Cooperative Development Investment Fund and others | (3,207,279) | - | - | - | (1,000,000) | - | - | (4,207,279) |
| INCOME (LOSS) BEFORE TRANSFERS | 80,162,448 | 33,484,639 | 13,086,602 | (8,133,944) | 15,856,134 | (137,636) | (57,619) | 134,260,624 |
| TRANSFER IN | | 131,327,636 | | | | | | 131,327,636 |
| TRANSFER OUT | - | (158,772,208) | - | - | - | - | - | (158,772,208) |
| CHANGE IN NET ASSETS | 80,162,448 | 6,040,067 | 13,086,602 | (8,133,944) | 15,856,134 | (137,636) | (57,619) | 106,816,052 |
| NET ASSETS — Beginning of year | 1,301,028,653 | 527,762,167 | 74,506,718 | 40,720,395 | 125,452,938 | 1,053,483 | 204,560 | 2,070,728,914 |
| NET ASSETS — End of year | $ 1,381,191,101 | $ 533,802,234 | $ 87,593,320 | $ 32,586,451 | $ 141,309,072 | $ 915,847 | $ 146,941 | $ 2,177,544,966 |

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 - Enterprise Funds
For the year ended June 30, 2007

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | | | | | | | |
| Cash received from interest on housing program loans | $ - | $ 12,046,229 | $ - | $ - | $ - | $ - | $ - | $ - | $ 12,046,229 |
| Cash paid for housing program loans originated | | (47,582,269) | | | | | | | (47,582,269) |
| Principal collected on housing program loans | | 9,891,180 | | | | | | | 9,891,180 |
| Proceeds from sale of housing program loans | | 40,422,825 | | | | | | | 40,422,825 |
| Cash received from insurance premiums | | 2,694,332 | | | | | | | 2,694,332 |
| Guarantee fees collected | | | | | 2,424,824 | | | | 2,424,824 |
| Cash received from other operating noninterest revenues | 13,013,151 | 23,507,107 | 12,540 | 34,188 | 565,695 | 9,986 | | | 37,142,667 |
| Cash received from fiscal agency fees | 8,810,472 | | | | | | | | 8,810,472 |
| Due to (from) governmental funds | 86,936,336 | (5,958,831) | | | | | | | 80,977,505 |
| Cash payments for other operating noninterest expenses | (18,209,222) | (6,280,938) | (63,664) | (47,293) | (640,336) | (3,254) | (30,402) | (1,443,739) | (26,718,848) |
| Cash payments for salaries and fringe benefits | (25,758,263) | (10,958,197) | | | | | (41,844) | | (36,758,304) |
| Net cash provided by (used in) operating activities | 64,792,474 | 17,781,438 | (51,124) | (13,105) | 2,350,183 | 6,732 | (72,246) | (1,443,739) | 83,350,613 |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES: | | | | | | | | | |
| Contributions to others | (2,193,328) | | | | (1,000,000) | | | | (3,193,328) |
| Transfer-in | | 95,088,454 | | | | | | | 95,088,454 |
| Transfer-out | | (117,750,978) | | | | | | | (117,750,978) |
| Net increase (decrease) in: | | | | | | | | | |
| Deposits | (645,197,766) | | | | | | | 319,825,416 | (325,372,350) |
| Certificates of indebtedness | (43,084,000) | | | | | | | | (43,084,000) |
| Securities sold under agreements to repurchase | (60,000,000) | | | | | | | | (60,000,000) |
| Commercial paper | (409,270,418) | | | | | | | | (409,270,418) |
| Proceeds from issuance of notes payable | | 156,661,937 | | | 39,544,774 | | | (39,544,774) | 156,661,937 |
| Repayments of bonds and notes payable | (37,180,000) | (98,922,835) | | | (114,443,034) | (758,685) | | 119,964,843 | (131,339,711) |
| Payment of bond issue costs | | (2,168,693) | | | | | | | (2,168,693) |
| Cash paid for in-substance defeasance of bonds payable | | (159,664,000) | | | | | | | (159,664,000) |
| Interest paid | (435,758,030) | (36,492,466) | | | (19,656,052) | | | 18,677,020 | (473,229,528) |
| Net cash provided by (used in) noncapital financing activities | (1,632,683,542) | (163,248,581) | - | - | (95,554,312) | (758,685) | - | 418,922,505 | (1,473,322,615) |
| NET CASH FLOWS USED IN CAPITAL AND RELATED FINANCING ACTIVITIES — Purchases of capital assets | (1,672,662) | (302,820) | - | - | - | - | - | - | (1,975,482) |

(Continued)

See accompanying notes to basic financial statements

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | | | | | | | |
| Net decrease (increase) in: | | | | | | | | | |
| Federal funds sold and securities purchased under agreements to resell | $ 989,500,000 | $ - | $ - | $ - | $ - | $ - | $ - | $ | $ 989,500,000 |
| Deposits placed with banks | (1,316,500,000) | (41,561,845) | | | 19,375,875 | 303,023,792 | | (293,881,865) | (1,329,544,043) |
| Purchases of investment securities | (982,251,218) | (56,922,975) | (10,000,000) | | (17,442,428) | | | 9,020,823 | (1,057,595,798) |
| Proceeds from redemptions of investments | 1,167,046,800 | 155,429,732 | 9,894,186 | | 23,849,619 | | | (36,078,263) | 1,320,142,074 |
| Proceeds from sales of investments | 498,345 | | | | | | | | 498,345 |
| Cash advanced to Dedicated Sales Tax Fund | | | | | | (302,856,677) | | | (302,856,677) |
| Interest and dividends received on investments | 143,732,525 | 81,471,469 | 156,938 | 1,850,467 | 5,431,825 | 741,395 | 109,909 | (1,398,239) | 232,096,289 |
| Interest received on other than housing program loans | 217,967,947 | | | | 15,787,774 | | | (17,278,781) | 216,476,940 |
| Origination of other than housing program loans | (1,117,964,521) | | | | (44,065,141) | | | 39,544,774 | (1,122,484,888) |
| Principal collected on other than housing program loans | 2,470,761,084 | | | | 38,586,028 | | | (119,964,843) | 2,389,382,269 |
| Proceeds from sales of loans | | | | | 51,000,000 | | | | 51,000,000 |
| Net change in other assets | | 4,808,097 | | | | | | | 4,808,097 |
| Net proceeds and other cash collected related to foreclosed real estate held-for-sale | 150,790 | 627,906 | | | | | | | 778,696 |
| Net cash provided by (used in) investing activities | 1,572,941,752 | 143,852,384 | 51,124 | 1,850,467 | 92,523,552 | 908,510 | 109,909 | (420,036,394) | 1,392,201,304 |
| NET CHANGE IN CASH | 3,378,022 | (1,917,579) | | 1,837,362 | (680,577) | 156,557 | 37,663 | (2,557,628) | 253,820 |
| CASH — At beginning of year | 2,372,859 | 32,359,248 | | 40,639,974 | 5,782,975 | 1,062,469 | 2,394,623 | (55,178,404) | 29,433,744 |
| CASH — At end of year | $ 5,750,881 | $ 30,441,669 | $ - | $ 42,477,336 | $ 5,102,398 | $ 1,219,026 | $ 2,432,286 | $ (57,736,032) | $ 29,687,564 |
| RECONCILIATION TO ENTERPRISE FUNDS BALANCE SHEET: | | | | | | | | | |
| Cash – unrestricted | $ 5,750,881 | $ 6,038,885 | $ - | $ 42,477,336 | $ 5,102,398 | $ 1,219,026 | $ 2,432,286 | $ (57,166,048) | $ 5,854,764 |
| Cash – restricted | | 24,402,784 | | | | | | (569,984) | 23,832,800 |
| TOTAL CASH AT YEAR-END | $ 5,750,881 | $ 30,441,669 | $ - | $ 42,477,336 | $ 5,102,398 | $ 1,219,026 | $ 2,432,286 | $ (57,736,032) | $ 29,687,564 |

See accompanying notes to basic financial statements

(Continued)

## Government Development Bank for Puerto Rico
(A Component Unit of the Commonwealth of Puerto Rico)

## Statement of Cash Flows - Enterprise Funds
For the year ended June 30, 2007

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| Reconciliation of operating income (loss) to net cash provided by (used in) operating activities: | | | | | | | | | |
| Operating income (loss) | $ 83,369,727 | $ 33,484,639 | $ 13,086,603 | $ (8,133,945) | $ 16,856,134 | $ (137,636) | $ (57,619) | $ - | $ 138,467,903 |
| Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities: | | | | | | | | | |
| Investment income | (178,330,673) | (92,486,484) | (619,057) | (1,927,183) | (5,650,692) | (702,319) | (110,540) | | (279,826,948) |
| Interest income on other than housing program loans | (371,606,434) | | | | (18,246,930) | (19,553,844) | | | (409,407,208) |
| Interest expense | 438,174,407 | 74,081,994 | | | 18,310,516 | 20,400,531 | | | 550,967,448 |
| Provision (credit) for loan losses | 11,842,981 | 8,718,514 | | | (25,925,963) | | | | (5,364,468) |
| Provision (credit) for losses on guarantees and letters of credit | | | | 47,774 | (61,322) | | | | (13,548) |
| Provision (credit) for losses on other assets | (222,742) | | | | 17,890,635 | | | | 17,667,893 |
| Net increase in fair value of investment | (15,790,246) | (2,077,509) | (12,528,416) | | (635,552) | | | | (31,031,723) |
| Net interest income on derivatives | (1,154,538) | | | | | | | | (1,154,538) |
| Net increase in fair value of derivatives | (10,103,679) | | | | | | | | (10,103,679) |
| Net decrease in fair value of hedged item | 10,478,513 | | | | | | | | 10,478,513 |
| Net loss on sales of real estate available for sale | | 37,735 | | | | | | | 37,735 |
| Net gain on sales of loans | | (741,316) | | | | | | | (741,316) |
| Loss on disposition of capital assets | 4,480,397 | | | | | | | | 4,480,397 |
| Depreciation and amortization | 1,549,599 | 591,137 | | | | | | | 2,140,736 |
| Amortization of deferred loan fees and costs | | 244,395 | | | | | | | 244,395 |
| Impairment of real estate available-for-sale | 1,909,250 | | | | | | | | 1,909,250 |
| Changes in operating assets and liabilities: | | | | | | | | | |
| Housing program loans receivable | | (47,582,269) | | | | | | | (47,582,269) |
| Collections of mortgage and construction loans | | 9,891,180 | | | | | | | 9,891,180 |
| Proceeds from sale of housing program loans | | 40,422,825 | | | | | | | 40,422,825 |
| Interest receivable on housing program loans | | 11,226 | | | | | | | 11,226 |
| Increase in other receivables | | (579,920) | | | (267,460) | | | | (847,380) |
| Decrease (increase) in other assets | 7,705,835 | | | | (65) | | | | 7,705,770 |
| Decrease (increase) in due from governmental funds | 86,936,336 | (5,958,831) | | | | | | | 80,977,505 |
| Increase in estimated liability on mortgage insurance losses | | 392,535 | | | | | | | 392,535 |
| Increase (decrease) in other liabilities | (4,446,259) | (668,413) | 9,746 | 10,000,249 | 80,882 | | 95,913 | (1,443,739) | 3,628,379 |
| Net cash provided by (used in) operating activities | $ 64,792,474 | $ 17,781,438 | $ (51,124) | $ (13,105) | $ 2,350,183 | $ 6,732 | $ (72,246) | $ (1,443,739) | $ 83,350,613 |

See accompanying notes to basic financial statements

(Continued)

| | GDB Operating Fund | Housing Finance Authority | Capital Fund | Development Fund | Tourism Development Fund | Public Finance Corporation | Other Nonmajor | Eliminations | Total |
|---|---|---|---|---|---|---|---|---|---|
| NONCASH INVESTING AND NONCAPITAL FINANCING ACTIVITIES: | | | | | | | | | |
| Accretion of discount on investment securities and capitalized interest on investment securities | $10,636,801 | $ 9,042,521 | $ - | $ - | $ | $ - | $ - | $ (8,937,957) | $10,741,365 |
| Capitalized interest on loans and other | 42,811 | 478,919 | | | | | | | 521,730 |
| Real estate available for sale received in lieu of payment of loan receivable and accrued interest receivable | 6,185,000 | | | | | | | | 6,185,000 |
| Liabilities assumed from excess of fair value of real estate available for sale received over amounts applied to loan receivable and accrued interest receivable | 1,968,233 | | | | | | | | 1,968,233 |
| Real estate available for sale exchanged for capital asset | 8,125,990 | | | | | | | | 8,125,990 |
| Construction in progress transferred to accounts receivable | 6,814,701 | | | | | | | | 6,814,701 |
| Transfer of mortgage loans receivable to other real estate available-for-sale | | 3,622,983 | | | | | | | 3,622,983 |
| Origination of loans | | 331,600 | | | | | | | 331,600 |
| Accrued interest receivable | | | | | 1,977,083 | | | | 1,977,083 |
| Accrued interest payable | | | | | 1,977,083 | | | | 1,977,083 |
| Escrow deposit applied to loans receivable | | | | | 3,610,453 | | | | 3,610,453 |
| Interest expense capitalized to escrow deposit | | | | | 15,614 | | | | 15,614 |
| Accretion (amortization) of discount (premium) on: | | | | | | | | | |
| Deposits | 9,026,003 | | | | | | | (8,937,957) | 88,046 |
| Bonds payable | (4,608,998) | 36,103,767 | | | | | | (8,986,055) | 22,508,714 |
| Loans receivable | 2,445,738 | | | | | | | | 2,445,738 |
| Increase in fair value of investments | 15,790,246 | 2,077,509 | 12,528,416 | | 635,552 | | | (8,986,055) | 22,045,668 |
| Increase in fair value of derivatives | 10,103,679 | | | | | | | | 10,103,679 |
| Decrease in fair value of hedged item | (10,478,574) | | | | | | | | (10,478,574) |
| Dividends reinvested | 9,444,255 | | 462,198 | | 405,063 | | | | 10,311,516 |
| Amortization of bond issue cost (included in interest expense) | 980,389 | | | | | | | | 980,389 |
| Amortization of deferred loss | | 388,317 | | | | | | | 388,317 |
| Interfund transfer of investment | | 1,152,782 | | | | | | | 1,152,782 |
| Transfer of loan receivable to accounts receivable | | | | | 18,000,000 | | | | 18,000,000 |

See accompanying notes to basic financial statements.

(Concluded)

# Notes to Basic Financial Statements

## 1. REPORTING ENTITY

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

Pursuant to Act No. 82 of June 16, 2002, which amended the Bank's enabling legislation, the Bank may transfer annually to the General Fund of the Commonwealth (the "General Fund") up to 10% of its net income or $10 million, whichever is greater. Management of the Bank has defined net income as the increase in unrestricted net assets of business-type activities for a fiscal year. The Bank's board of directors approved such definition. The board of directors of the Bank approved not to make this transfer for the year ended June 30, 2007.

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

The Housing Finance Authority (formerly known as the Puerto Rico Housing Finance Corporation) was created in 1977 to provide public and private housing developers with interim and permanent financing through mortgage loans for the construction, improvement, operation, and maintenance of rental housing for low and moderate-income families. The Housing Finance Authority also issues bonds and notes, the proceeds of which are deposited in separate trusts and generally invested in mortgaged-backed securities collateralized by mortgage loans on properties located in Puerto Rico and purchased by low and moderate-income families. The Housing Finance Authority is authorized by the U.S. Department of Housing and Urban Development to administer the U.S. Housing Act Section 8 program in Puerto Rico and to act as an approved 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.

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

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

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

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

The Capital Fund was created in 1992 to expand the investment options available to the Bank and to administer, separately from the Bank's general investment operations, an equity investments process through professional equity investment managers. In January 2002, the Bank's board of directors authorized an increase in the capitalization of the Capital Fund of up to 10% of the net assets of the Bank, as well as the adoption of a new investment strategy, which included the hiring of two additional portfolio managers to diversify the Capital Fund investments in the equity markets. As of June 30, 2007, management, with the consent of the Bank's board of directors, deemed convenient to defer its implementation, and in the meantime elected a passive management considering it a more cost-effective mechanism.

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

To minimize its risk of loss, the Bank purchases insurance coverage for public liability, hazard, automobile, crime, and bonding as well as medical and workmen's insurance for employees. The selection of the insurer has to be approved by the Public Insurance Office of the Department of the Treasury. 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.

## 2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

***Government-wide and Fund Financial Statements***

***Government-wide Financial Statements*** — The statement of net assets 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 assets, except for the residual amounts due between governmental and business-type activities. Interfund charges for services among functions of the government-wide statement of activities have not been eliminated. The Bank's activities are distinguished between governmental and business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. Business-type activities are financed in whole or in part by fees charged to external parties for goods or services and interest earned on investment securities. Following is a description of the Bank's government-wide financial statements.

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

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

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

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

Separate financial statements are provided for governmental funds and enterprise funds. Major individual governmental funds are reported as separate columns in the fund financial statements, with nonmajor funds being combined into a single column, except for those governmental nonmajor funds, which management has elected to present separately in the financial statements. Fund balances at the beginning of the year are restated to reflect changes in major fund definition. In the case of enterprise funds, each individual blended component unit of the Bank with the exception of JMB Institute and Education Assistance Corporation, which have been grouped as other nonmajor funds, has been reported as a separate major fund in the fund financial statements. In the case of the Housing Finance Authority, all of its activities not classified and reported as governmental funds have been reported as an enterprise fund.

***Measurement Focus, Basis of Accounting, and Financial Statements Presentation***

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

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

- Employees' vested annual leave is recorded as expenditure when utilized. The amount of accumulated annual leave unpaid at June 30, 2007, has been reported only in the government-wide financial statements.
- Interest on general long-term obligations is generally recognized when paid.
- Debt service principal expenditures and claims and judgments are recorded only when payment is due.

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

- ***Subsidy Prepayment Refunding Bonds*** – Debt Service (Act No. 115 Rent Subsidy Fund) — This debt service fund is used to account for the Commonwealth appropriations to provide for the payment of principal and interest of certain bonds that were originally issued by a former mortgage subsidy program. During the year ended June 30, 2007, this fund was closed, and accordingly, it is included only in the accompanying statement of revenues, expenditures and changes in fund balances.

- ***New Secure Housing Program (Nuevo Hogar Seguro)*** — This special revenue fund is used to account for federal and local resources directed to plan, coordinate, and develop the construction of new housing as a replacement for those destroyed by Hurricane Georges in 1998 and to attend the housing needs of those families living in flood zone areas.

- ***The Key for Your Home Program*** — This fund was created to provide subsidy to low and moderate-income families with costs directly related to the purchase and rehabilitation of housing units.

- ***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.

- ***Affordable Housing Mortgage Subsidy Program (Stages 7, 8, and 9)*** — These special revenue funds are used to account for the proceeds of specific revenue sources under Stages 7, 8, and 9 of the Affordable Housing Mortgage Subsidy Program ("AHMSP") that are legally restricted to expenditures to promote the origination of mortgage loans by financial institutions in the private sector to low and moderate-income families. Under these stages the Housing Finance Authority commits to provide subsidy for the downpayment and/or the principal and interest payments on mortgage loans originated under a predetermined schedule of originations and, in the case of stage 9, to acquire such mortgages in the form of a mortgage-backed securities issued by the financial institution. Loans originated, as well as servicing, are kept by the originating financial institution. These funds are three of the seven funds that are under the AHMSP of the Authority. Management has elected to present these nonmajor funds separately in the balance sheet and statement of revenues, expenditures and changes in fund balance to be consistent with their presentation in prior years.

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

- ***Affordable Housing Mortgage Subsidy Programs (Stages 2, 3, 6, and 10)*** — These special revenue funds are similar to Stages 7, 8 and 9 described above. At June 30, 2007, the Housing Finance Authority had a commitment, expiring on July 15, 2008, for the acquisition of mortgage-backed securities amounting to approximately $204 million.

- ***Interim Loan Insurance*** — Up to June 30, 1989, the Puerto Rico Housing Bank and Finance Agency (the "Housing Bank"), which merged with and into the Housing Finance Authority during 2002, had an interim loan insurance program created by law to provide mortgage insurance to guarantee the payment of principal and interest on construction loans to developers of low and moderate-income housing units financed through other financial institutions. Due to the significant claims paid by this program in previous years, it no longer provides insurance coverage and is in the process of liquidating foreclosed real estate. This activity receives legislative appropriations, when needed, to repay the outstanding bond debt and derives its revenue from investment income and sales of the properties acquired through foreclosure.

- ***Special Obligation Refunding Bonds*** – **Debt Service** — This debt service fund accounts for the funds and assets transferred by the Commonwealth through legislative appropriations and liquidator of the former Corporación de Renovación Urbana y Vivienda ("CRUV").

- ***AHMS Mortgage Backed-Certificates***- This fund is used to account for specific revenue sources use to provide subsidy for the mortgages underlying the mortgage-backed securities held as collateral for the single family mortgage reserve Bonds, Series 2006.

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

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

***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. There were no securities purchased under agreements to resell outstanding at June 30, 2007.

***Investments and Investment Contracts*** — Investments and investment contracts are carried at fair value, except for money market instruments and participating investment contracts with a remaining maturity at the time of purchase of one year or less, and nonparticipating investment contracts (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. Realized gains and losses from the sale of investments and unrealized changes in the fair value of outstanding investments are included in net increase (decrease) in fair value of investments.

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

The allowance for loan losses is established through provisions recorded in the fund financial statements. This allowance is based on management's evaluation of the risk characteristics of the loan including such factors as the nature of individual credits outstanding, past loss experience, known and inherent risks in the portfolios, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and general economic conditions. Loan charge-offs are recorded against the allowance when management believes that the 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 estimate of credit losses in the outstanding loans receivable portfolios and the related allowance may change in the near future.

Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Interest income and cash receipts on impaired loans are accounted for predominantly in the same manner as nonaccrual loans.

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 a valuation allowance.

As discussed in Note 2 to the financial statements, loans to the Commonwealth of Puerto Rico, its agencies and instrumentalities amounted to approximately $5,233,511,000 or 44% of the Bank's total assets as of June 30, 2007. These loans are expected to be collected from appropriations from, bond issuances of, or revenues generated by the Commonwealth of Puerto Rico, its agencies and instrumentalities, and, accordingly, their collectibility may be affected by budgetary constraints, fiscal situation and the credit rating of the Commonwealth of Puerto Rico, its agencies and instrumentalities.

Management believes that no losses will be incurred by the Bank with respect to principal and interest on loans to the public sector (including municipalities), and, as a result, no allowance for loan losses is generally established for them. For public sector loans, excluding municipalities, management bases its position in that in the past, the Director of the Office of Management and Budget of the Commonwealth ("OMB") has included in the budget of the Commonwealth appropriations to assist certain public sector corporations, agencies, and instrumentalities in repaying their loans with the Bank. The Legislature of the Commonwealth (the "Legislature") has generally approved these appropriations, and such practice is anticipated to continue in the future. Further, in accordance with Act No. 164 of December 17, 2001, the Bank is no longer allowed to originate loans without a specific source of repayment being identified beforehand. The Act provides, however, for the Bank to originate new loans up to $100 million without specific sources of repayment with authorization in writing from both the Commonwealth's Governor and the Director of the OMB. In addition, on May 13, 2006, the Legislature enacted Act No. 91 that established the Dedicated Sales Tax Fund, known as FIA by the acronym of its Spanish name (the "FIA Fund"). Act No. 91 provides that the first one percent of the new sales and consumption tax will be used to repay certain outstanding obligations of the Commonwealth at June 30, 2006, payable to the Bank and the Public Finance Corporation, generally referred to as the extra-constitutional debt, including approximately $2.8 billion of loans due by the Commonwealth and certain of its instrumentalities to the Bank.

Act No. 91 was amended by Act No. 291, enacted on December 26, 2006, and by Act No. 56 enacted on July 6, 2007 to create the Puerto Rico Sales Tax Financing Corporation (the "Sales Tax Corporation") as an independent governmental instrumentality that will own and hold the FIA Fund for the purpose of financing the payment, retirement or defeasance of the extra-constitutional debt. Pursuant to Act No. 91, as amended, the Sales Tax Corporation issued Bonds Series A and B on July 31, 2007 (the "Sales Tax Corporation Bonds") for the payment and retirement of a portion of the extra-constitutional debt outstanding at June 30, 2006. From the proceeds of the Sales Tax Corporation Bonds, the Bank received $1.7 billion on July 31, 2007 in partial payment of the outstanding extra constitutional debt.

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

Loans to municipalities amounting to approximately $264 million at June 30, 2007 are collateralized by a pledge of a portion of property tax assessments of each municipality. These loans include bonds and notes issued by Puerto Rico municipalities which are acquired by the Bank as bridge financing until such financings can be packaged and securitized. Subsequently, from time to time, the Bank sells, at par, a selection of these bonds and notes to Puerto Rico Municipal Finance Agency ("MFA"), a component unit of the Commonwealth organized to create a capital market to assist municipalities in financing their public improvements programs. These loans, when sold, are pledged to secure the debt service payments for the bonds issued by MFA.

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

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

When a guarantee is executed, the Bank recognizes any disbursement as a nonperforming loan; therefore, no interest is accrued on the principal. After a specific analysis of the provision requirements, the related allowance included in the allowance for guarantees and letters of credit is reclassified to the allowance for 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 the limited historical loss experience and other factors, compounds the uncertainty in management's estimate of the allowance for losses on guarantees and letters of credit. As a result, the aggregate losses on guarantees and letters of credit ultimately incurred by the Bank may differ from the allowance for losses as reflected in the accompanying basic financial statements, and such differences may be material.

Pursuant to the legislation under which the Tourism Development Fund was created, the Executive Director of the Tourism Development Fund is required to certify each year to the Director of the OMB the amount, if any, that is necessary to reimburse the Tourism Development Fund for disbursements made in the previous year, in connection with obligations guaranteed in excess of fees and charges collected on such guarantees. This legislation currently does not expressly provide for the reimbursement of losses incurred by the Tourism Development Fund on loans made directly by the Tourism Development Fund. The Tourism Development Fund is in the process of submitting an amendment to this legislation to provide for the reimbursement of such losses. The Director of the OMB has to include the amount subject to reimbursement in the General Budget of the Commonwealth for the following fiscal year for the Legislature's consideration and approval. The Legislature is not obligated to authorize such appropriations. As of June 30, 2007 there were no outstanding claims for reimbursements.

***Debt Issue Costs*** — Debt issue costs are deferred and amortized, as a component of interest expense, over the term of the related debt using the effective interest method, or a systematic and rational method that approximates the interest method. Issuance costs of bonds accounted for in the governmental funds are recorded as expenditures when paid.

***Real Estate Available-for-sale*** — Real estate available-for-sale comprises properties acquired in lieu of payment and through foreclosure proceedings. It also includes loans that are treated as if the underlying collateral had been foreclosed because the Bank has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place. Those properties are carried at the lower of cost or fair value, which is established by a third party professional assessment or based upon an appraisal, minus 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 minus estimated costs to sell is charged against the allowance for loan losses. Subsequent declines in the value of real estate available-for-sale are charged to expenditure/expense. Gain or loss on sale related to foreclosed real estate available-for-sale is included within noninterest income in the accompanying statement of revenues, expenses, and changes in net assets.

***Allowance for losses on Mortgage Loan Insurance*** — The allowance for losses on mortgage loan 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 normal mortgage loan insurance losses. Actual losses for mortgage loan insurance are charged and recoveries, if any, are credited to the allowance for losses on mortgage loan insurance. Because of uncertainties inherent in the estimation process, management's estimate of losses in the outstanding loans guarantee portfolio and the related allowance may change in the near future.

***Capital Assets*** — Capital assets, which include premises and equipment, are stated at cost less accumulated depreciation and amortization, and are reported in the business-type activities column in the government-wide financial statements. Capital assets are defined by the Bank as assets which have a cost of $500 or more at the date of acquisition and have an expected useful life of three or more years. Depreciation is charged to operations and included within other noninterest expense, and is computed on the straight-line basis over the estimated useful lives of the depreciable assets. 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:

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|---|---|
| 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 |

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

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

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

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

***No-Commitment Debt*** — The Housing Finance Authority has issued notes and bonds in connection with the financing of low and moderate-income housing projects. Certain of the obligations issued by the Housing Finance Authority are considered no-commitment debt and are excluded, along with the related assets held in trust, from the accompanying basic financial statements. The Bank, 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.

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

***Governmental Funds – Reservations of Fund Balance*** — The governmental fund financial statements present reservations of fund balance for portions of fund balances that are legally segregated for a specific future use or are not available for other future spending.

***Loan Origination Costs and Commitment Fees*** — GASB No. 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, requires that loan origination and commitment fees and direct origination costs be amortized over the contractual life of the related loan. The Bank generally recognizes commitment fees as income when collected and the related loan origination costs as expense when incurred. In the opinion of management, the difference between the two methods does not have a significant effect on the Bank's financial position and changes in financial position.

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

Transfers of financial assets are accounted for as a sale, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the transferor, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the transferor does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

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

***Derivative Instruments and Hedging Activities*** — Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Certain Hedging Activities requires that all derivatives must be recorded on the balance sheet (or statement of net assets) at their fair value and that the treatment of changes in the fair value of such instruments depends on the character of the derivative. The Bank partially follows the provisions of SFAS No. 133 as explained in the ensuing paragraphs.

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

For all fair value hedging relationships, the Bank formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the hedged item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed, and a description of the method of measuring ineffectiveness. This process includes linking all derivatives that are designated as fair value to specific assets and liabilities on the balance sheet. The Bank also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair value of hedged items. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a fair-value hedge are reflected in the statement of revenues, expenses, and changes in net assets, together with changes in the fair value of the related hedged item.

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

For cash flow hedges, in which derivatives hedge the variability of cash flows related to floating rate assets or liabilities, the accounting treatment under SFAS No. 133 depends on the effectiveness of the hedge. To the extent these derivatives are effective in offsetting the variability of the hedged cash flows, SFAS No. 133 requires that changes in the derivatives' fair value be reported as other changes in equity, also known as other comprehensive income ("OCI"), with these changes in fair value included in earnings of future periods when earnings are also affected by the variability of the hedged cash flows. However, in its guidance for the implementation of GASB Statement No. 34, GASB declared that the concept of OCI was not applicable to governmental entities and further indicated that any amounts which under FASB pronouncements were required to be recorded as changes to OCI should be reported in the statement of revenues, expenses, and changes in net assets under governmental accounting standards. Consequently, the Bank follows the provisions of SFAS No. 133, as modified by such GASB clarification, by recording on the balance sheet or statement of net assets, the fair value of derivatives intended to hedge the variability of cash flows to be received or paid related to a recognized assets or liability, but the change in fair value is reported in the statement of revenues, expenses, and changes in net assets.

Derivative-like instruments embedded in contracts that meet certain criteria prescribed in SFAS No. 133 are separated from their host contract and carried at their fair value, while the host contract is accounted for based on GAAP applicable to instruments of that type that do not contain embedded derivative instruments.

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

***Future Adoption of Accounting Pronouncements*** — The GASB has issued the following Statements:

- GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions, which is effective for the Bank for periods beginning after December 15, 2007.
- GASB Statement No. 48, Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues, which is effective for periods beginning after December 15, 2006.
- GASB Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations, which is effective for periods beginning after December 15, 2007.

Adoption of these statements is not expected to have a material impact on the Bank's basic financial statements.

## 3. CASH AND DUE FROM BANKS, FEDERAL FUNDS SOLD, AND DEPOSITS PLACED WITH BANKS

The table presented below discloses the level of custodial credit risk assumed by the Bank at June 30, 2007. 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 the Treasury of the Commonwealth. The Bank does not have a formal policy for custodial credit risk for cash accounts opened with commercial banks outside Puerto Rico. These accounts are opened only with well-capitalized financial institutions.

The Bank' 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 agencies. Deposits placed with banks of approximately $1,924 million mature within one year. Federal funds sold mature overnight and no collateral is required. As of June 30, 2007, $2,904,455,887 of the depository bank balance of $2,904,683,044 was uninsured and uncollateralized as follows:

| | Carrying Amount | Depository Bank Balance | Amount Uninsured and Uncollateralized |
|---|---|---|---|
| Cash and due from banks | $ 34,975,295 | $ 35,105,180 | $ 34,878,023 |
| Deposits placed with banks | 1,924,077,864 | 1,924,077,864 | 1,924,077,864 |
| Federal funds sold | 945,500,000 | 945,500,000 | 945,500,000 |
| Total | $ 2,904,553,159 | $ 2,904,683,044 | $ 2,904,455,887 |

Reconciliation to the government-wide statement of net assets:

| | |
|---|---|
| Unrestricted: | |
| Cash and due from banks | $ 5,854,764 |
| Deposits placed with banks | 1,870,443,074 |
| Federal funds sold | 945,500,000 |
| Total unrestricted | 2,821,797,838 |
| Restricted: | |
| Cash and due from banks | 29,120,531 |
| Deposits placed with banks | 53,634,790 |
| Total restricted | 82,755,321 |
| Total | $ 2,904,553,159 |

## 4. INVESTMENTS

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

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

The Bank's investment policies establish limitations and other guidelines on 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 investment committee and the board of directors of the Bank will determine, from time to time, other transactions that the Bank may enter into.

The 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 Fitch Ratings or Moody's Investors Service, depending on the type and maturity of the investment and the counterparty to the transaction. The investment policies also provide that purchases and sales of investment securities shall be made using the delivery vs. payment procedures.

The Bank's investment policies also provide that the Asset Liability Management Committee ("ALCO") is responsible for implementing and monitoring the Bank's interest rate risk policies and strategies. The ALCO 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 and management.

The following table summarizes the type and maturities of investments held by the Bank at June 30, 2007. 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 bills | $ 29,563,348 | $ - | $ - | $ - | $ 29,563,348 |
| U.S. Treasury notes | 10,975,937 | 9,454,765 | | | 20,430,702 |
| U.S. sponsored agencies notes: | | | | | |
| Federal Home Loan Bank ("FHLB") | 60,752,110 | 322,166,900 | 74,700,000 | | 457,619,010 |
| Federal Home Loan Mortgage Corporation ("FHLMC") | | 25,000,000 | | | 25,000,000 |
| Federal Farm Credit Bank ("FFCB") | | | 4,775,711 | | 4,775,711 |
| Mortgage and asset-backed securities: | | | | | |
| Government National Mortgage Association ("GNMA") | 14,568 | 1,231,730 | 10,108,302 | 506,331,537 | 517,686,137 |
| Federal National Mortgage Association ("FNMA") | 1,849 | 53,971,339 | 53,775,303 | 45,473,575 | 153,222,066 |
| FHLMC | 3,577 | 34,498,130 | 84,309,921 | 20,378,609 | 139,190,237 |
| Other | 5,578,312 | 6,412,414 | | | 11,990,726 |
| Corporate debt: | | | | | |
| Morgan Stanley | | 27,652,250 | | | 27,652,250 |
| General Electric | 5,875,804 | 2,999,940 | | | 8,875,744 |
| Other | | 1,930,280 | | | 1,930,280 |
| External investment pools— | | | | | |
| Fixed-income securities | 139,386,154 | | | | 139,386,154 |
| Nonparticipating investment contracts: | | | | | |
| CDC Funding | 203,945,442 | | | 38,015,043 | 241,960,485 |
| American International Group | | | | 209,920,533 | 209,920,533 |
| Other | | | | 82,182,078 | 82,182,078 |
| Commonwealth agency bonds | - | - | - | 3,770,000 | 3,770,000 |
| Total investments | $ 456,097,101 | $ 485,317,748 | $ 227,669,237 | $ 906,071,375 | 2,075,155,461 |
| External investment pools— | | | | | |
| Equity securities: | | | | | |
| Russell 1000 Growth Common Trust Fund | | | | | 48,798,671 |
| Global Opportunities Capital Appreciation Fund | | | | | 10,835,678 |
| Other | | | | | 402,806 |
| Total | | | | | $ 2,135,192,616 |
| Reconciliation to the government-wide statement of net assets | | | | | |
| Unrestricted investments and investment contracts | | | | | $ 794,926,883 |
| Restricted investments and investment contracts | | | | | 1,340,265,733 |
| Total | | | | | $ 2,135,192,616 |

Investments in fixed-income external investment pools had an average maturity of less than 60 days; accordingly, they were presented as investments with maturity of less than one year. These investments include $14,351,537 invested with 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, 2007, the Bank's $32,582,470 investment in corporate debt with maturity over one year bears a fixed interest rate. Also, at June 30, 2007, approximately 65%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 provide for early redemption of the bonds if the securities are early repaid.

All of the Bank's investments in U.S. Treasury securities and mortgage-backed securities guaranteed by GNMA carry the explicit guarantee of the U.S. government. The credit quality ratings for investments in debt securities, excluding U.S. Treasury securities and mortgage-backed securities guaranteed by GNMA, at June 30, 2007 are as follows:

| | Credit Risk | | | |
|---|---|---|---|---|
| | Rating | | | |
| Securities type | AAA to A | BBB- | Not Rated | Total |
| U.S. sponsored agencies notes: | | | | |
| FHLB | $ 457,619,010 | | | $ 457,619,010 |
| FHLMC | 25,000,000 | | | 25,000,000 |
| FFCB | 4,775,711 | | | 4,775,711 |
| Mortgage and asset-backed securities: | | | | |
| FNMA | 153,222,066 | | | 153,222,066 |
| FHLMC | 139,190,237 | | | 139,190,237 |
| Other | 11,170,449 | | 820,277 | 11,990,726 |
| Corporate debt | 38,458,274 | | | 38,458,274 |
| External investment pools - Fixed-income securities | 139,003,445 | 47,722 | 334,987 | 139,386,154 |
| Nonparticipating investment contracts | 534,063,096 | | | 534,063,096 |
| Commonwealth agency bonds | 3,770,000 | - | - | 3,770,000 |
| Total | $ 1,506,272,288 | $ 47,722 | $ 1,155,264 | $ 1,507,475,274 |

The credit quality ratings of nonparticipating investment contracts are based on the credit quality ratings 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, 2007, the Bank had pledged investments and investment contracts to secure the following:

| | |
|---|---|
| Payment of principal and interest on obligations issued by a blended component unit | $ 1,016,259,038 |
| Securities sold under agreements to repurchase | 455,000,000 |
| Certificates of indebtedness | 11,800,000 |
| Interest rate swap agreements (notional amount) | 225,000,000 |

## 5. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans at June 30, 2007 consist of the outstanding balance of credit facilities granted to the following (in thousands):

| | | Enterprise funds | | | | |
|---|---|---|---|---|---|---|
| | Governmental Activities | GDB Operating Fund | Tourism Development Fund | Housing Finance Authority | Public Finance Corporation | Total |
| Public corporations and agencies | $ - | $ 4,930,653 | $ - | $ - | $ 302,858 | $ 5,233,511 |
| Municipalities | | 602,406 | | | | 602,406 |
| Allowance for loan losses | - | (11,860) | - | - | - | (11,860) |
| Total loans to public sector | - | 5,521,199 | - | - | 302,858 | 5,824,057 |
| Private sector | 3,773 | 474 | 244,963 | 199,333 | - | 448,543 |
| Allowance for loan losses | (874) | (264) | (5,099) | (24,602) | - | (30,839) |
| Total loans to private sector | 2,899 | 210 | 239,864 | 174,731 | - | 417,704 |
| Balance–end of year | $ 2,899 | $ 5,521,409 | $ 239,864 | $ 174,731 | $ 302,858 | $ 6,241,761 |

| | |
|---|---|
| Reconciliation to the government-wide statement of net assets: | |
| Unrestricted loans receivable–net | $ 6,231,555 |
| Restricted loans receivable–net: | |
| Governmental activities | 2,899 |
| Business-type activities | 7,307 |
| Total | $ 6,241,761 |

Public sector loans amounting to approximately $918 million as of June 30, 2007 were delinquent by 90 days or more, including approximately $28.9 million of loans classified as non-accrual. Interest income that would have been recorded if these loans had been accruing in accordance with their original terms was approximately $2.8 million in 2007. No interest was collected on these loans during the year ended June 30, 2007. On July 31, 2007 the Bank collected $233 million of principal for loans which were delinquent over 90 days included at June 30, 2007.

At June 30, 2007, the Bank has established an allowance for loan losses of $11,860,000 related to a loan granted to a municipality. This loan was granted in 1991 and was being repaid until 2001, when legal action was brought against the Bank and another public entity of the Commonwealth.

In 2005, a favorable judgment for the Bank was issued and the loan was required to be refinanced but, the borrower has not been able to meet its obligations. The Bank continues its efforts to collect in full this loan, however due to the uncertainties at June 30 2007, management decided to provide an allowance for the outstanding balance of the loan. The Bank's management believes that other loans to municipalities do not posses characteristics similar to this loan and, accordingly, believes that no additional allowance is required for the remaining outstanding balance of loans to municipalities.

Loans to the private sector include the outstanding principal balance of credit facilities granted by the Bank to private enterprises in Puerto Rico, the activities of which are deemed to further the economic development of Puerto Rico. They also include the outstanding principal balance of mortgage loans granted to low and moderate-income families for the acquisition of single-family housing units and to developers of low and moderate-income multifamily housing units in Puerto Rico, and direct loans to tourism projects. These credit facilities amounted to approximately $449 million at June 30, 2007 of which approximately $203 million are mortgage loans for low and moderate-income housing units and approximately $245 million are for tourism projects.

Private sector loans classified as non-accrual amounted to approximately $44.7 million at June 30, 2007. Interest income that would have been recorded if these loans had been performing in accordance with their original terms was approximately $2.1 million in 2007. No interest was collected on these loans for the year ended June 30, 2007.

The following is a summary of private sector loans of the enterprise funds considered to be impaired as of June 30, 2007, and the related interest income for the year then ended (in thousands):

| | Enterprise funds | | |
|---|---|---|---|
| | GDB Operating Fund | Housing Finance Authority | Total |
| Recorded investment in impaired loans: | | | |
| Not requiring an allowance for loan losses | $ 210 | $ - | $ 210 |
| Requiring an allowance for loan losses | 12,124 | 58,061 | 70,185 |
| Total recorded investment in impaired loans | $ 12,334 | $ 58,061 | $ 70,395 |
| Related allowance for loan losses | $ 12,124 | $ 9,288 | $ 21,412 |
| Average recorded investment in impaired loans | 6,404 | 59,280 | 65,684 |
| Interest income recognized on impaired loans | - | - | - |

The following is a summary of the activity in the allowance for loan losses for the year ended June 30, 2007 (in thousands):

| | | Enterprise Funds | | | |
|---|---|---|---|---|---|
| | Governmental Activities | GDB Operating Fund | Tourism Development Fund | Housing Finance Authority | Total |
| Balance–beginning of year | $ 657 | $ 281 | $ 34,000 | $ 17,290 | $ 52,228 |
| Provision for loan losses | 724 | 11,843 | (25,926) | 8,719 | (4,640) |
| Transfer from governmental funds | | | | 331 | 331 |
| Charge-offs | (507) | - | (2,975) | (1,738) | (5,220) |
| Balance–end of year | $ 874 | $ 12,124 | $ 5,099 | $ 24,602 | $ 42,699 |

During the year ended June 30, 2007, the Housing Finance Authority sold approximately $39.7 million of single-family mortgage loans receivable. The net proceeds from the sale of these loans amounted to approximately $40.6 million, including $170,229 of accrued interest. The net gain from the sale of single-family mortgage loans was approximately $741,000.

On May 25, 2007, the Tourism Development Fund sold a mortgage note due from the Cayo Largo project for a purchase price of $69 million, for which $51 million was received in cash on the closing date and $18 million was a deferred consideration. The loan had a carrying value of $47 million at the closing date. Additionally, an escrow deposit held by the Tourism Development Fund was released and the funds amounting to $3.6 million were credited to the loan. The deferred consideration will be paid once the purchaser has received (a) a return of all capital contributions and (b) a specified return on capital contributions. Due to uncertainties on the future realization of the deferred consideration, management decided to fully reserve the receivable.

Since one of the Bank's principal functions is to provide financing to the Commonwealth and its instrumentalities, the Bank's loan portfolio includes loans to various departments and agencies of the Commonwealth, to various public corporations, and to municipalities, which represent a significant portion of the Bank's assets. Loans to the Commonwealth and its agencies typically include working capital lines of credit payable from short-term tax and revenue anticipation notes issued by the Commonwealth, interim financing of capital improvements payable from Commonwealth general obligation bonds, and in recent years loans to finance the Commonwealth's budget deficit, which loans are payable from uncollected taxes and from annual appropriations made by the legislature of Puerto Rico. Loans to the public sector amounted to approximately $5.8 billion or 48.83% of the Bank's government-wide total assets at June 30, 2007.

Many of the public sector loans are payable from legislative appropriations from the Commonwealth. Accordingly, the payment of these loans may be affected by budgetary constraints, the fiscal situation and the credit rating of the Commonwealth. Significant changes in these factors may have an adverse impact on the Bank's financial condition. During fiscal years 2003, 2004, 2005, and 2006, the Bank granted loans to the Commonwealth for $250 million, $233 million, $550 million, and $741 million, respectively, to cover the Commonwealth's budget deficit. As of June 30, 2007, the outstanding principal amount of loans granted to finance the Commonwealth's budget deficit was $1.8 billion.

During fiscal years 2003, 2004, 2005 and 2006, the Commonwealth's recurring expenditures exceeded its recurring revenues. These shortfalls were covered with loans from the Bank and other non-recurring revenues. Although the Commonwealth has implemented various revenue-enhancing and cost-reducing measures to bring expenditures in line with revenues, and expects these and other measures to balance its revenues and expenses by the end of fiscal year 2009, the Commonwealth's recurring expenditures for fiscal year 2007 are expected to exceed its recurring revenues.

In addition, due mainly to the Commonwealth's financial situation, in May 2005, Moody's Investors Service ("Moody's") and Standards & Poor's Rating Services ("S&P") each announced downgrades to the Commonwealth's credit ratings. Moody's and S&P lowered the rating on the Commonwealth's appropriation debt to "Baa3" and "BBB-," respectively. On February 24, 2006, Moody's placed the Commonwealth's rating on Watchlist with negative implications. On March 22, 2006, S&P placed the Commonwealth's rating on CreditWatch with negative implications. On May 8, 2006, Moody's further downgraded the Commonwealth's appropriation debt rating from Baa3 to Ba1 and kept the ratings on Watchlist. On July 20, 2006, S&P confirmed its BBB- rating on the Commonwealth appropriation debt, and removed the rating from CreditWatch with negative implications. S&P's rating outlook, however, remains negative. On July 21, 2006, Moody's confirmed its Ba1 rating on the Commonwealth's appropriation debt and removed the rating from Watchlist with negative implications. On November 6, 2007, Moody's changed the rating outlook of the Commonwealth from negative to stable.

In response to the Commonwealth's deficits over the last several fiscal years and the anticipated deficit for fiscal year 2006, during the second half of fiscal year 2005 and the first half of fiscal year 2006 the Commonwealth took certain legislative and executive actions aimed at establishing the basis for a comprehensive tax and fiscal spending reform. The combination of those actions, designed to increase recurring revenues and control government spending, is intended to eliminate the Commonwealth's structural budget deficit within several years. There is no assurance, however, that the structural imbalance will be corrected by such date. These actions, include, among other, establishment of government-wide expenditure controls that set forth the basic principles that would govern the reform of the Commonwealth's tax system and fiscal spending policy and practices, a tax reform aimed at increasing revenues by expanding the tax base through the implementation of a sales and consumption tax, and a fiscal reform aimed at limiting the growth of expenditures in relation to past spending rates and stabilizing expenditure growth to a level below that of recurring revenues.

In an effort to address the Commonwealth's structural budget imbalance, the Legislature enacted Act No. 117 of July 4, 2006 ("Act 117"), which amended the Puerto Rico Internal Revenue Code of 1994 to provide, among other things, for a general sales and use tax of 5.5% (the "Sales Tax") to be imposed by the Commonwealth. The Act also eliminated the 5% general excise tax imposed on imported goods and the 3.6% general excise tax on goods manufactured in Puerto Rico, and provides certain income tax reductions to taxpayers. The Sales Tax was effective on November 15, 2006. Act 117 also imposed other measures to address the structural budget imbalance, such as fiscal reform, government reorganization plan, and special income tax rates to certain transactions occurring during the first semester of fiscal year 2007.

The Legislature enacted on May 13, 2006 Act No. 91, which created the Imperative Interest Fund (the "IIF"), as a separate fund to be administered by the Department of the Treasury of the Commonwealth and GDB. The IIF will generate revenues from collections of the first one percent of the Sales Tax. Such revenues shall be used for, among other, paying, refinancing or restructuring the extra-constitutional debt of the Commonwealth that was outstanding at June 30, 2006. Public sector loans to the Commonwealth, its agencies and instrumentalities that do not have the full faith and credit of the Commonwealth are considered extra-constitutional debt. As of June 30, 2007, approximately $2.8 billion of public sector loans are considered extra-constitutional debt subject to repayment from Sales Tax revenues collected by the IIF.

Act No. 91 was amended by Act No. 291, enacted on December 26, 2006, and by Act No. 56, enacted on July 6, 2007, to create the Puerto Rico Sales Tax Financing Corporation (the "Sales Tax Corporation") as an independent governmental instrumentality that will own and hold the IIF Fund for the purpose of financing the payment, retirement or defeasance of the extra-constitutional debt Pursuant to Act 91 ownership of the IIF, renamed as the Dedicated Sales Tax Fund (the "DSTF"), was transferred to the Sales Tax Corporation.

On July 31, 2007, the Sales Tax Corporation issued $2,668 million 2007 Series A bonds, and $1,333 million 2007 Series B bonds for the payment and retirement of a portion of the extra-constitutional debt owed to the Bank and the Public Finance Corporation, which was outstanding as of June 30, 2006. The Bank received $1.7 billion in partial payment of the $2.8 billion of its public sector loans considered extra-constitutional debt.

Although the Commonwealth is using its best efforts in order to maximize revenues and reduce expenditures, there is no assurance that its future revenues will be greater than its expenditures.

Management of the Bank believes that loans to the public sector will be collected, and that accordingly, no allowance for loan losses is needed at June 30, 2007.

## 6. DUE FROM FEDERAL GOVERNMENT

The amount due from the federal government amounting to $18,823,323 at June 30, 2007 consists of the reimbursable share from FEMA of eligible costs incurred to plan, coordinate, and develop the construction of new housing as a replacement for those destroyed by Hurricane Georges in 1998, and to attend the housing needs of certain families living in flood zone areas in Puerto Rico. Amounts collected are subject to compliance audits under OMB Circular A 133 and federal granting agencies auditors. Management believes that it has complied with the terms of the grant and that all amounts claimed will be collected and, therefore, no allowance for uncollectible accounts has been established.

## 7. CAPITAL ASSETS

Capital assets activity for the year ended June 30, 2007, was as follows:

| | Beginning Balance | Additions | Reductions/ Reclassifications | Ending Balance |
|---|---|---|---|---|
| Capital assets not being depreciated: | | | | |
| Land | $ 2,845,000 | $ 8,125,990 | $ - | $ 10,970,990 |
| Construction in progress | 10,701,311 | 372,684 | (11,073,995) | - |
| Total capital assets not being depreciated | 13,546,311 | 8,498,674 | (11,073,995) | 10,970,990 |
| Capital assets being depreciated: | | | | |
| Building | 8,988,048 | | | 8,988,048 |
| Leasehold improvements | 2,342,878 | 107,130 | | 2,450,008 |
| Information systems | 4,758,833 | 381,291 | (1,721,845) | 3,418,279 |
| Office furniture and equipment | 2,872,872 | 263,417 | (93,499) | 3,042,790 |
| Software | 4,673,468 | 850,960 | (1,751,395) | 3,773,033 |
| Vehicles | 431,087 | - | (173,202) | 257,885 |
| Total capital assets being depreciated | 24,067,186 | 1,602,798 | (3,739,941) | 21,930,043 |
| Less accumulated depreciation and amortization for: | | | | |
| Building | (1,235,856) | (224,701) | | (1,460,557) |
| Leasehold improvements | (318,228) | (447,867) | | (766,095) |
| Information systems | (3,800,328) | (610,446) | 1,429,231 | (2,981,543) |
| Office furniture and equipment | (1,831,200) | (327,649) | 238,983 | (1,919,866) |
| Software | (2,298,951) | (503,306) | 1,759,410 | (1,042,847) |
| Vehicles | (269,325) | (26,767) | 91,214 | (204,878) |
| Total accumulated depreciation and amortization | (9,753,888) | (2,140,736) | 3,518,838 | (8,375,786) |
| Total capital assets being depreciated–net | 14,313,298 | (537,938) | (221,103) | 13,554,257 |
| Total capital assets–net | $ 27,859,609 | $ 7,960,736 | $ (11,295,098) | $ 24,525,247 |

## 8. DEPOSITS

Deposits consist predominantly of interest-bearing demand accounts, special government deposit accounts, and time deposits from the Commonwealth, its agencies, instrumentalities, and municipalities. Interest expense on these deposits amounted to approximately $257.5 million in 2007.

## 9. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

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

| | |
|---|---|
| Carrying amount at June 30, 2007 | $455,000,000 |
| Maximum amount outstanding at any month-end | 544,405,000 |
| Average amount outstanding during the year | 461,850,122 |
| Weighted average interest rate for the year | 4.96% |
| Weighted average interest rate at year-end | 4.87% |

The following summarizes the activity of securities sold under agreements to repurchase for the year ended June 30, 2007:

| | Beginning Balance | Issuances | Maturities | Ending Balance |
|---|---|---|---|---|
| GDB Operating Fund | $ 515,000,000 | $ 157,191,000 | $217,191,000 | $ 455,000,000 |

All sales of investments under agreements to repurchase are for 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, 2007, securities sold under agreements to repurchase mature within four years.

## 10. COMMERCIAL PAPER

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

The following information corresponds to commercial paper:

| | |
|---|---|
| Carrying amount at June 30, 2007 | $575,861,000 |
| Maximum amount outstanding at any month-end | 633,210,418 |
| Average amount outstanding during the year | 502,901,832 |
| Weighted average interest rate for the year | 4.21% |
| Weighted average interest rate at year-end | 4.18% |

The following summarizes the commercial paper activity for fiscal year 2007:

| | Beginning Balance | Issuances | Maturities | Ending Balance | Due Within One Year |
|---|---|---|---|---|---|
| GDB Operating Fund | $ 985,131,418 | $ 2,438,380,000 | $ 2,847,650,418 | $ 575,861,000 | $ 575,861,000 |

## 11. CERTIFICATES OF INDEBTEDNESS

Certificates of indebtedness consist of time deposits from corporations that have grants of tax exemptions under the Commonwealth's industrial incentives laws. The following summarizes the certificates of indebtedness activity for the year ended June 30, 2007:

| | Beginning Balance | Issuances | Maturities | Ending Balance | Due Within One Year |
|---|---|---|---|---|---|
| GDB Operating Fund | $ 54,884,000 | $ 12,900,000 | $ 55,984,000 | $ 11,800,000 | $ - |

At June 30, 2007, certificates of indebtedness amounting to approximately $7.5 million contractually mature during the fiscal year ending 2011 and approximately $4.3 million contractually mature during the fiscal year ending June 30, 2012.

## 12. BONDS AND NOTES PAYABLE AND OTHER LIABILITIES

The activity of bonds payable and other borrowed funds for the year ended June 30, 2007 is as follows:

| | Beginning Balance | Debt Issued | Debt Paid | Reductions | Ending Balance | Due Within One Year |
|---|---|---|---|---|---|---|
| Governmental activities: | | | | | | |
| Commonwealth appropriation bonds and notes: | | | | | | |
| Law 115—Subsidy prepayment refunding bonds | $ 32,400,000 | $ - | $ (32,400,000) | $ - | $ - | $ - |
| Note payable—Affordable Housing Mortgage Subsidy Program Stage 7 | 10,243,583 | - | (45,047) | - | 10,198,536 | 38,504 |
| Total Commonwealth appropriation appropriation bonds and notes | 42,643,583 | - | (32,445,047) | - | 10,198,536 | 38,504 |
| General obligation bonds— Loan insurance claims refunding bonds | 9,250,000 | - | (9,250,000) | - | - | - |
| Total governmental activities | $ 51,893,583 | $ - | $ (41,695,047) | $ - | $ 10,198,536 | $ 38,504 |

| | Beginning Balance | Issuances, Net | Reductions | Ending Balance | Due within One Year |
|---|---|---|---|---|---|
| Business-type activities: | | | | | |
| GDB Operating Fund: | | | | | |
| Adjustable Refunding Bonds | $ 267,000,000 | $ - | $ - | $ 267,000,000 | $ - |
| Senior Notes Series A | 885,000,000 | - | - | 885,000,000 | - |
| Senior Notes Series B | 740,000,000 | - | (37,180,000) | 702,820,000 | 108,800,000 |
| Senior Notes Series C | 81,960,000 | - | - | 81,960,000 | - |
| Add unamortized premium | 21,418,314 | - | (4,608,998) | 16,809,316 | 340,710 |
| Unrealized gain on fair value hedge | (26,860,169) | - | 10,478,513 | (16,381,656) | - |
| Total GDB Operating Fund | 1,968,518,145 | - | (31,310,485) | 1,937,207,660 | 109,140,710 |
| Housing Finance Authority: | | | | | |
| Mortgage Trust III | 1,077,213,874 | - | (43,240,000) | 1,033,973,874 | 43,310,000 |
| Revenue bonds and mortgage-backed certificates: | | | | | |
| Collateralized Mortgage Revenue Bonds | 54,300,000 | | (54,300,000) | - | |
| Single Family Mortgage Revenue Bonds – Portfolio I | 41,830,000 | | (41,830,000) | - | |
| Single Family Mortgage Revenue Bonds – Portfolio III | 1,480,000 | | (1,480,000) | - | |
| Single Family Mortgage Revenue Bonds, Portfolio IV | 58,706,000 | | (58,706,000) | - | |
| Single Family Mortgage Revenue Bonds, Portfolio IX | 132,505,000 | | (3,605,000) | 128,900,000 | 2,250,000 |
| Single Family Mortgage Revenue Bonds, Portfolio X | 246,000,000 | | | 246,000,000 | 3,515,000 |
| Mortgage Trust IV-Collateralized mortgage obligations | 7,131,371 | | (7,131,371) | - | |
| Homeownership Mortgage Revenue Bonds 2000 | 66,195,000 | | (5,975,000) | 60,220,000 | 1,155,000 |
| Homeownership Mortgage Revenue Bonds 2001 | 71,775,000 | | (5,865,000) | 65,910,000 | 1,335,000 |
| Homeownership Mortgage Revenue Bonds 2003 | 32,485,000 | | (2,495,000) | 29,990,000 | 1,910,000 |
| Single Family Mortgage-Backed Certificates 2006 Series A | - | 165,643,717 | (11,393,339) | 154,250,378 | 17,222,619 |
| Total revenue bonds and mortgage-backed certificates | 712,407,371 | 165,643,717 | (192,780,710) | 685,270,378 | 27,387,619 |
| Subtotal | 1,789,621,245 | 165,643,717 | (236,020,710) | 1,719,244,252 | 70,697,619 |
| Notes payable to GDB and other financial institutions | 22,307,561 | 2,000,000 | (16,463,125) | 7,844,436 | 7,844,436 |
| Plus unaccreted premium | | 729,061 | (62,456) | 666,605 | |
| Less unaccreted discount and deferred loss on refundings | 603,193,289 | 17,356,445 | (36,097,144) | 584,452,590 | - |
| Total Housing Finance Authority | 1,208,735,517 | 151,016,333 | (216,449,147) | 1,143,302,703 | 78,542,055 |
| Tourism Development Fund: | | | | | |
| Participation agreement payable | 26,000,000 | - | - | 26,000,000 | |
| Notes payable to GDB | 259,869,431 | 39,544,774 | (114,443,034) | 184,971,171 | 7,144,462 |
| Total Tourism Development Fund | 285,869,431 | 39,544,774 | (114,443,034) | 210,971,171 | 7,144,462 |
| Public Finance Corporation— Note payable to GDB | 303,023,792 | - | (758,685) | 302,265,107 | 198,329,030 |
| Total | 3,766,146,885 | 190,561,107 | (362,961,351) | 3,593,746,641 | 393,156,257 |
| Less intrafund eliminations | (677,873,533) | (39,544,774) | 110,978,792 | (606,439,515) | (205,477,637) |
| Total business-type activities | $ 3,088,273,352 | $ 151,016,333 | $ (251,982,559) | $ 2,987,307,126 | $187,678,620 |

The annual debt service requirements to maturity, including principal and interest, for long-term debt, other than notes payable to financial institutions, as of June 30, 2007, are as follows:

| Year Ending June 30 | GDB Operating Fund Business-Type Activities Principal | Interest |
|---|---|---|
| 2008 | $ 108,800,000 | $ 97,550,029 |
| 2009 | 92,915,000 | 92,598,279 |
| 2010 | 72,450,000 | 88,549,425 |
| 2011 | 63,295,000 | 85,193,946 |
| 2012 | 62,665,000 | 81,495,863 |
| 2013-2017 | 641,020,000 | 313,245,488 |
| 2018-2022 | 10,635,000 | 259,084,063 |
| 2023-2027 | | 258,862,500 |
| 2028-2031 | 885,000,000 | 191,709,375 |
| Total | $ 1,936,780,000 | $ 1,468,288,968 |

The annual debt service requirements to maturity, including principal and interest, for long-term debt as of June 30, 2007, are as follows:

| Year Ending June 30 | Housing Finance Authority Governmental Activities Principal | Interest | Business-type Activities Principal | Interest |
|---|---|---|---|---|
| 2008 | $ 38,504 | $ 569,260 | $ 70,697,619 | $ 33,410,615 |
| 2009 | 150,768 | 562,122 | 69,097,807 | 33,561,574 |
| 2010 | 159,040 | 553,776 | 66,595,275 | 32,444,510 |
| 2011 | 150,872 | 545,427 | 65,077,421 | 31,350,281 |
| 2012 | 128,598 | 538,137 | 63,779,279 | 29,387,480 |
| 2013-2017 | 1,119,643 | 2,349,767 | 286,431,840 | 136,300,668 |
| 2018-2022 | 1,583,706 | 1,871,951 | 236,384,741 | 110,110,016 |
| 2023-2027 | 2,025,135 | 1,339,524 | 622,155,932 | 81,787,929 |
| 2028-2032 | 4,842,270 | 503,399 | 132,249,338 | 49,630,403 |
| 2033-2037 | | | 98,625,000 | 15,139,035 |
| 2038-2042 | - | - | 8,150,000 | 191,865 |
| Total | $ 10,198,536 | $ 8,833,363 | $ 1,719,244,252 | $ 553,314,376 |

| Year Ending June 30 | Tourism Development Fund Business-Type Activities Principal | Interest |
|---|---|---|
| 2008 | $ - | $ 1,977,083 |
| 2009 | 26,000,000 | 655,417 |
| Total | $ 26,000,000 | $ 2,632,500 |

*Governmental Activities*

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

| Description and Maturity Date | Interest Rate | Amount Outstanding |
|---|---|---|
| Note payable Affordable Housing Mortgage Subsidy Program Stage 7: Due each July 1 until July 1, 2031 | 4.10%-5.25% | $ 10,198,536 |

***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 Affordable Housing Mortgage Subsidy Program Stage 7 note payable (the "Old Note") of the Housing Bank, as authorized by Act No. 164 of December 17, 2001. The Public Finance Corporation acquired and restructured the Note through the issuance of its Commonwealth appropriations bonds ("PFC Bonds"). The PFC Bonds were issued under a trust indenture whereby the Public Finance Corporation pledged and sold the Note, along with other notes under Act No. 164, to certain trustees and created a first lien on the revenues of the notes sold. The notes payable to the Public Finance Corporation were originally composed of a loan granted by the Bank, which, pursuant to Act No. 164 of December 17, 2001, the Public Finance Corporation acquired and restructured through the issuance of Commonwealth appropriation bonds. These bonds were issued under trust indenture agreements whereby the Public Finance Corporation pledged the notes to certain trustees and created a first lien on the pledged revenue (consisting of annual Commonwealth appropriations earmarked to repay these notes) for the benefit of the bondholders.

During June 2004, 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 recognizes a mirror effect of this advance refunding by the Public Finance Corporation in its own notes payable in proportion to the portion of the Housing Finance Authority's notes 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 Note's outstanding balance at June 30, 2007 was $10,198,536 and matures on July 1, 2031. Interest on the unpaid principal amount of the Note is equal to the applicable percentage of the aggregate interest payable on the Public Finance Corporation Bonds. Applicable percentage is the percentage representing the proportion of the amount paid by Public Finance Corporation on the PFC Bonds serviced by the Note to the aggregate amount paid by Public Finance Corporation on all the PFC Bonds issued by Public Finance Corporation under Act No. 164.

*Business-Type Activities*

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

| Description and Maturity Date | Interest Rate | Amount Outstanding |
|---|---|---|
| Adjustable Refunding Bonds: | | |
| December 1, 2015 | Variable, 3.57% at June 30, 2007 | $ 267,000,000 |
| GDB Senior Notes : | | |
| Series A—March 1, 2031 and April 1, 2031 | 5.85% | 868,618,344 |
| Series B—December 1 until December 1, 2017 | 4.125%-5.00% | 716,472,388 |
| Series C—January 1, 2015 | 5.25% | 85,116,928 |
| Mortgage Trust III: | | |
| Each July 1 and January 1 until July 1, 2011 | Zero Coupon | 104,152,918 |
| Each July 1 and January 1 until January 1, 2021 | Zero Coupon | 242,448,907 |
| Single Family Mortgage Revenue Bonds – Portfolio IX— Each December 1 and June 1 until December 1, 2012 | 3.85-5.60% | 128,900,000 |
| Single Family Mortgage Revenue Bonds – Portfolio X— December 1, 2007 and each December 1 and June 1 thereafter to December 1, 2037 | 4.15%-5.65% | 246,000,000 |
| Mortgage-Backed Certificates, 2006 Series A June 29, 2026 through August 29, 2030 | 2.955%-6.56% | 138,637,350 |
| Homeownership Mortgage Revenue Bonds 2000 Series: Each June 1 and December 1 until December 1, 2032 | 4.25%-5.20% | 60,220,000 |
| Homeownership Mortgage Revenue Bonds 2001 Series: | | |
| Each December 1 thereafter until December 1, 2012 | 4.05%-4.70% | 9,035,000 |
| June 1, 2013 and each December 1 and June 1 thereafter to December 1, 2033 | 4.45%-5.50% | 56,875,000 |
| Homeownership Mortgage Revenue Bonds 2003 Series: | | |
| Each December 1 until December 1, 2013 | 2.55%-4.00% | 4,650,000 |
| June 1, 2013 and each December 1 and June 1 thereafter to December 1, 2033 | 4.375%-4.875% | 25,340,000 |
| Total | | $ 2,953,466,835 |

***Mortgage-Backed Certificates, 2006 Series A*** — On August 31, 2006, the Housing Finance Authority issued $165,643,717 Mortgage-Backed Certificates, 2006 Series A (the "Certificates"), which consist of eighteen class certificates maturing at various dates from June 29, 2026 through August 29, 2030, and carrying interest rates from 2.955% to 6.56%. The proceeds from the Certificates were used to advance refund outstanding bonds amounting to $153,561,000 and bearing interest ranging from 5.55% to 6.50%. The Housing Finance Authority used $159,664,000 from the net proceeds of the Certificates and other funds to purchase U.S. government securities, which were deposited in an irrevocable trust fund with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities have therefore been removed from the accompanying statement of net assets and balance sheet-enterprise funds. As a result of this advance refunding, and based on assumed prepayments, rates of the Certificates, applied on the date of issuance, the Housing Finance Authority decreased its total debt service requirements by approximately $67 million over the next 25 years, which resulted in an economic loss (the difference between the present values of the debt service payments of the refunded bonds and the Certificates) of approximately $1.5 million.

The Housing Finance Authority has refunded/in-substance defeased certain bonds by placing internally generated moneys or the proceeds of new bonds in irrevocable trusts to provide for all future debt service payments on the refunded or in-substance defeased bonds. Accordingly, the trust account assets and the related refunded/defeased bonds are not included in the Housing Finance Authority's financial statements. At June 30, 2007, the outstanding balance of refunded/in-substance defeased amounted to $109 million.

On August 1, 2006, the Housing Finance Authority redeemed, using its own funds, its $92,000,000 affordable Housing Mortgage Subsidy Program, Single Family Mortgage Revenue Bonds Portfolio III (Portfolio III Bonds). The Mortgage Certificates that served as collateral to secure the payment of the Portfolio III bonds were also assigned and pledged by the Authority as source of payment and security for the Mortgage-Backed Certificates, 2006 Series A.

In February 2007, the Housing Finance Authority converted a non-revolving credit facility into a revolving credit facility, (the "Facility") with a commercial bank and decreased the aggregate principal amount from $50 million to $25 million, to provide funds to the Department of Housing for the rehabilitation and redevelopment of the Santurce sector of the Municipality of San Juan (the "Project"). Under the Project, approximately 159 properties (the "Target Properties") were identified and are intended to be or were acquired through purchase or expropriation, for sale to persons that will develop, re develop, and/or construct, commercial and residential projects. The acquisition and sale of the Target Properties have been undertaken through the Department of Housing, under Act No. 201 of the Legislature of the Commonwealth dated August 26, 2002. Therefore, the Department of Housing, not the Housing Finance Authority, will own all the Target Properties acquired under the Project. At June 30, 2007, the Facility has an outstanding balance of $7,840,000, maturing in December 2007. The Facility bears a variable interest rate consisting of the 30 day London Interbank Offered Rate ("LIBOR") plus 0.40% at the first day of each month (5.72% at June 30, 2007). The Housing Finance Authority is obligated, under this credit agreement, to repay the advances of the Facility upon the sale or disposition of all or any part of the mortgaged Target Properties in the amount of 100% of the net proceeds. In connection with this project, the Housing Finance Authority has properties held in trust amounting to $8,880,000.

***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 Hotel's AFICA bonds, accelerated the AFICA bonds payment in exchange for a note receivable of $26 million (the "Note") 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 a 100% participation (the "Participation") in the Note.

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 as part of loans receivable and has recorded a participation agreement payable (i.e. a secured borrowing) in the accompanying balance sheet — enterprise funds.

The Note bears interest at a fixed rate of 7.5%, which is payable on a quarterly basis, and matures on April 9, 2009. The outstanding principal balance of the Note and the corresponding participation agreement payable amounted to $26 million as of June 30, 2006.

The activity for noncurrent accounts payable and accrued liabilities during the year ended June 30, 2007 follows:

| | |
|---|---|
| Balance–beginning of period | $ 42,950,582 |
| Additions | 109,885 |
| Reductions | (10,804,372) |
| Balance–end of period | $ 32,256,095 |

The activity for compensated absences included within accounts payable and accrued liabilities, during the year ended June 30, 2007 follows:

| | Beginning Balance | Provision | Reductions | Ending Balance | Due Within One Year |
|---|---|---|---|---|---|
| Vacation | $ 2,815,488 | $ 2,335,374 | $ 2,166,924 | $ 2,983,938 | $ 2,296,570 |
| Sickness | 2,440,598 | 2,778,717 | 2,191,606 | 3,027,709 | 2,718,819 |
| Total | $ 5,256,086 | $ 5,114,091 | $ 4,358,530 | $ 6,011,647 | $ 5,015,389 |

Compensated absences are available to be liquidated by the employees during the year.

## 13. RESTRICTED NET ASSETS — MORTGAGE LOAN INSURANCE FUND

The Housing Finance Authority is required by law to maintain an allowance for losses on insured mortgage loans, which is computed as a percentage of the outstanding principal balance of the insured mortgage loans. Losses incurred upon the foreclosure and subsequent gains or losses on the disposal of properties are credited/charged to the allowance for losses on mortgage loan insurance. At June 30, 2007, the Housing Finance Authority had restricted net assets for such purposes of approximately $49 million.

## 14. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

In the normal course of business, the Bank is party to transactions involving financial instruments with off-balance-sheet risk, to meet the financing needs of its customers. 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 statement of net assets and fund balance sheets. These off-balance-sheet risks are managed and monitored in manners similar to those used for on-balance-sheet risks. The Bank's exposures to credit loss for lending commitments, financial guarantees, and letters of credit are represented by the contractual amount of those transactions.

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, 2007, the off-balance-sheet risks consisted of the following (in thousands):

Following is the activity of the allowance for losses on guarantees and letters of credit for the year ended June 30, 2007:

| | |
|---|---|
| Financial instruments whose credit risk is represented by contractual amounts: | |
| Financial guarantees: | |
| Public sector | $ 125,000 |
| Private sector | 138,075 |
| Total | $ 263,075 |
| Standby letters of credit: | |
| Public sector | $ 520,913 |
| Private sector | 19,135 |
| Total | $ 540,048 |
| Commitments to extend credit: | |
| Public sector | $ 1,253,738 |
| Private sector | 13,638 |
| Total | $ 1,267,376 |

| | Beginning Balance | Provision (Credit) | Payments | Ending Balance | Due Within One Year |
|---|---|---|---|---|---|
| GDB Operating Fund | $ 1,000,000 | $ - | $ - | $ 1,000,000 | $ - |
| Tourism Development Fund | 1,524,246 | (61,322) | | 1,462,924 | |
| Puerto Rico Development Fund | - | 47,774 | (17,355) | 30,419 | 30,419 |
| Total | $ 2,524,246 | $ (13,548) | $ (17,355) | $ 2,493,343 | $ 30,419 |

## 15. DERIVATIVE INSTRUMENTS

The Bank has entered into several interest rate exchange agreements (swaps) to manage its exposure in certain debt instruments as follows:

- Interest rate exchange agreements to convert its variable rate bonds to fixed rate.
- Interest rate exchange agreements to hedge the changes in fair value of certain notes payable.

At June 30, 2007, the Bank was a party to the following interest-rate swap agreements (notional amount and fair value in thousands):

| Notional Amount | Floating Rate Indicator | Rate at June 30, 2007 | | | | Maturity Date | Fair Value June 30, 2007 |
|---|---|---|---|---|---|---|---|
| | | Receives | | Pays | | | |
| | | Type | Rate | Type | Rate | | |
| $ 267,000 | VRDOs(1) | Variable | 2.22% | Fixed | 3.040% | August 1, 2007 | $ 164 |
| 125,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | March 1, 2031 | (4,110) |
| 250,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | March 1, 2031 | (8,219) |
| 125,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | March 1, 2031 | (4,110) |
| 100,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | April 1, 2031 | (3,297) |
| 100,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | April 1, 2031 | (3,297) |
| 185,000 | 1m LIBOR | Fixed | 6.23% | Variable | 5.32% | April 1, 2031 | (6,099) |
| $ 1,152,000 | | | | | | | $(28,968) |

(1)Variable Rate Demand Obligations Rate — The variable rate received under this agreement corresponds to the rate set on a weekly open-market auction in which the underlying bonds are offered for sale.

On February 2, 2006, the Bank entered into various interest swap agreements with counterparties in connection with the issuance of its Senior Notes Series A (the "Senior Notes"). Under the terms of these agreements, the Bank receives fixed interest rate payments and makes floating rate payments, effectively converting the Senior Notes to a floating rate LIBOR based debt. The interest rate swap agreements may be terminated by the counterparties no earlier than March 1, 2007 and quarterly thereafter, matching the call option the Bank has on the Senior Notes.

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

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

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

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

## 16. RETIREMENT SYSTEM

*Defined Benefit Pension Plan*

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

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

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

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

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

*Defined Contribution Plan*

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

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

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

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

Total employee contributions for the defined benefit pension plan and the defined contribution plan during the year ended June 30, 2007 amounted to approximately $959,251 and $625,449, respectively. The Bank's contributions during the years ended June 30, 2007, 2006, and 2005 amounted to approximately $1,787,000, $2,242,000 and $1,864,000, 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.

On April 30, 2007, the Bank's board of directors authorized an early retirement program for certain Bank's employees, subject to the approval of the Legislature and the Governor of the Commonwealth. On December 12, 2007, a bill approved by the Legislature was signed into law by the Governor of the Commonwealth. The expected cost of this program is approximately $34 million.

Additional information on the Retirement System is provided in its stand-alone financial statements for the year ended June 30, 2007apprimately, a copy of which can be obtained from the Employees' Retirement System of the Commonwealth of Puerto Rico and its Instrumentalities, PO Box 42005, San Juan, PR 00940-2005.

## 17. COMMITMENTS AND CONTINGENCIES

*Lease Commitments*

The Bank leases office and storage space from the governmental and private sector. Principally, office space is leased under a short-term operating lease agreement that renews automatically every year, if it is not canceled by any of the parties before the beginning of each year. The storage space agreement expires in 2011. Rent charged to operations in fiscal year 2007 amounted to approximately $1.2 million. At June 30, 2007, the minimum annual future rentals under noncancelable leases are approximately as follows:

| Year Ending June 30, | Amount |
|---|---|
| 2008 | $ 402,000 |
| 2009 | 400,000 |
| 2010 | 413,000 |
| 2011 | 428,000 |
| Total | $ 1,643,000 |

*Cooperative Development Investment Fund*

On August 18, 2002, the Legislature approved Law No. 198, which creates the Cooperative Development Investment Fund. The purpose of this fund is to promote the development of cooperative entities. This fund will be capitalized through contributions to be provided by the Bank up to $25 million to be matched by cooperative entities. As of June 30, 2007, the Bank has contributed $13.0 million to the Cooperative Development Investment Fund, $2.2 million of which were contributed during the year ended June 30, 2007.

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.

*Loan Guarantees*

The Development Fund has entered into an agreement (the "Agreement") with Economic Development Bank for Puerto Rico ("EDB") whereby the Development Fund would guarantee a portion of loans granted by EDB under a government program named The Key for Your Business (the "Program"). Under the Agreement, the Development Fund would assign $10 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 guarantee fee and no loan can exceed $50,000. At June 30, 2007, outstanding guarantees amounted to approximately $4,094,000.

*Custodial Activities of Enterprise Funds*

At June 30, 2007, the Housing Finance Authority was custodian of $115,517 in restricted funds of CRUV. As of June 30, 2007, such funds are deposited with the Bank. These funds are not owned by the Housing Finance Authority's enterprise funds and thus are not reflected in the basic financial statements.

At June 30, 2007, the Housing Finance Authority was the custodian of $20,155 designated for the improvements to be made to the Puerto Rico Department of Housing building. The Housing Finance Authority's management has included these funds in the enterprise fund as an asset, included within cash and due from banks, and a liability to the Puerto Rico Department of Housing.

*Loan Sales and Securitization Activities*

On July 13, 1992, the Housing Bank entered into an agreement to securitize approximately $20.7 million of mortgage loans into a FNMA certificate. The Housing Finance Authority agreed to repurchase, at a price of par plus accrued interest, each and every mortgage loan backing up such security certificate that became delinquent for 120 days or more. As of June 30, 2007, the aggregate outstanding principal balance of the loans pooled into the FNMA certificate amounted to $780,187.

*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, 2007, the principal balance of the mortgage loans serviced for others is as follows:

| | |
|---|---|
| Popular Mortgage, Inc. | $13,937,736 |
| R-G Mortgage, Inc. | 8,741,367 |
| CRUV or its successor without guaranteed mortgage loan payments | 61,347 |
| Other investors, with guaranteed mortgage loan payments | 239,989 |
| Total | $22,980,439 |

*Litigation*

During 2007, the Development Fund recorded an accrued legal contingency reserve of $10 million due to a legal claim for which the court has issued an adverse judgment. The claim was brought by a former industrial client to whom the Development Fund had approved a line of credit to enhance their production capabilities. However, due to noncompliance of client with the conditions of the commitment letter issued by the Development Fund, as well as uncertainties regarding the client's ability to repay the financial facility prompted the Development Fund to cancel the commitment letter. The client sued the Development Fund claiming it was responsible for losses sustained. The court held that claimant had incurred in significant expenses to increase their production based on the resources they expected to have available through the line of credit. Eventually, they had to cease their operations. Management has estimated the amount of the claim to be $10 million based on consultation with its internal legal counsel. However, the ultimate liability is still pending court resolution and could differ from the estimated amount.

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

## 18. NO-COMMITMENT DEBT AND PROGRAMS SPONSORED BY THE HOUSING FINANCE AUTHORITY

The Public Finance Corporation has issued approximately $5.9 billion of Commonwealth appropriation bonds (the "Bonds") maturing at various dates through 2032. The proceeds of the Bonds, except for approximately $1.7 billion, have been used to provide the necessary funds to purchase from the Bank separate promissory notes of the Department of the Treasury of the Commonwealth, and certain of its instrumentalities and public corporations (the "Promissory Notes"). The $1.7 billion referred to above were used to refund a portion of certain bonds issued by the Public Finance Corporation (also no-commitment debt) between fiscal years 1995 and 2000. The outstanding balance of the Bonds at June 30, 2007 amounted to approximately $4.3 billion.

The Bonds are limited obligations of the Public Finance Corporation and, except to the extent payable from bond proceeds and investment earnings thereon, will be payable solely from a pledge and assignment of amounts due under the 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 of the Commonwealth. These acts provide that the Commonwealth shall honor the payment of principal and interest on the Promissory Notes, and that the Director of the OMB shall include in the budget of the Commonwealth submitted to the Legislature the amounts necessary to pay the principal and interest on the Notes. The underlying Promissory Notes represent debt of the issuing instrumentalities (all part of the Commonwealth or its component units), and, for purposes of the Public Finance Corporation, the Bonds are considered no-commitment debt. Neither the Bonds nor the Notes purchased with the proceeds therefrom are presented in the accompanying basic financial statements.

On May 13, 2006, the Legislature of the Commonwealth enacted by Act No. 91, which created the Imperative Interest Fund (the "Fund"), as a separate fund to be administered by the Department of the Treasury of the Commonwealth and the Bank. The Fund will generate funds from collections of the first one percent of the sales and consumption tax approved by the Legislature of the Commonwealth. Such funds shall be used for, among other, paying, refinancing or restructuring the extra-constitutional debt of the Commonwealth that was outstanding at June 30, 2006. The Bonds are considered extra-constitutional debt, and, accordingly will be paid from collections received by the Fund. Should the amounts generated by Act. No. 91 are not sufficient to cover debt service of the extra-constitutional debt, such shortfall is still subject to legislative appropriations.

Certain bonds of the Housing Finance Authority are considered no-commitment debt as more fully described in Note 2. At June 30, 2007, there were restricted assets held in trust by others, outstanding obligations, fund balances, and excess of fund expenses over revenues, net of transfers (all of which are excluded from the accompanying basic financial statements), as indicated below (unaudited):

| | |
|---|---|
| Restricted assets | $ 14,582,994 |
| Restricted liabilities (no-commitment debt) | 13,084,795 |
| Restricted fund balance | $ 1,498,199 |
| Excess of fund expenses over revenues | $ (147,397) |

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 ("PHA"), a governmental instrumentality of the Commonwealth. PHA 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 the U.S. Department of Housing and Urban Development and other funds available under the bonds indenture, accordingly, these bonds are considered no-commitment debt and are not presented in the accompanying basic financial statements. The outstanding balance of these bonds amounted to $619 million at June 30, 2007.

In addition, the Authority, as a public 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 HUD Programs. Revenues and expenditures related to the administration of the U.S. Housing Act Section 8 Programs amounted to $119,797,902 for the year ended June 30, 2007. This amount includes $4,708,782 of administrative fees for services performed as contract administrator, which are reimbursed by the U.S. Department of Housing and Urban Development.

## 19. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

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

The fair values reflected below are indicative of the interest rate environment as of June 30, 2007, and do not take into consideration the effects of interest rate fluctuations. In different interest rate scenarios, fair value results can differ significantly. Furthermore, actual prepayments may vary significantly from those estimated resulting in materially different fair values.

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

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

- Short-term financial instruments, such as cash and due from banks, federal funds sold, repurchase and resale agreements, deposits placed with banks, certificates of deposit, commercial paper, and accrued interest receivable and payable have been valued at the carrying amounts reflected in the statement of net assets, as these are reasonable estimates of fair value given the relatively short period of time between origination of the instruments and their expected realization.
- Financial instruments that are primarily traded in secondary markets, such as most investments, were valued using either quoted market prices or quotations received from independent brokers/dealers.
- Financial instruments that are not generally traded, such as long-term deposits placed with banks, certificates of deposit, certificates of indebtedness, and investment contracts, and bonds and notes issued with fixed interest rates, were fair valued, for the most part, using the present values of estimated future cash flows at the appropriate discount rates. Bonds and other borrowings issued with interest rates floating within certain ranges were fair valued at their outstanding principal balance. The fair value of liabilities with no defined maturities, such as demand deposits, was reported as the amounts payable upon demand.

- Loans to the public sector were valued according to the type of contractual interest rate. Loans to the public sector with interest rates floating within certain ranges were fair valued at their outstanding principal balance. Loans to the public sector with fixed interest rates were fair valued assuming that such loans were packaged and sold in the secondary market. The discount rates utilized were based on the rating of the Commonwealth and the market where the instruments would be sold and were adjusted for various other factors, including issuance costs. For delinquent public sector loans, the fair value was assumed to be equal to the carrying value, as historically the Bank has collected such amounts.
- Loans and commitments to extend credit, financial guarantees and standby letters of credit to the private sector are mostly industrial development, tourism development, and low-cost housing development projects. For these types of loans and commitments, there is no secondary market, and the actual future cash flows may vary significantly as compared to the cash flows projected under the agreements, due to the degree of risk. Accordingly, management has opted not to disclose the fair value to these financial instruments, as such information may not be estimated with reasonable precision.
- Disclosure of the fair value of commitments to extend credit, standby letters of credit, and financial guarantees relating to instrumentalities of the Commonwealth is omitted, as these arrangements are with component units of the Commonwealth.
- Interest rate swaps were valued using estimated market prices, based on discounted future cash flows.

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at June 30, 2007:

| | Reported or Notional Amount | Fair Value |
|---|---|---|
| | (In millions) | |
| Financial assets: | | |
| Cash and due from banks | $ 35 | $ 35 |
| Federal funds sold | 946 | 946 |
| Deposits placed with banks | 1,924 | 1,924 |
| Due from federal government | 19 | 19 |
| Investments and investment contracts | 2,135 | 2,158 |
| Loans receivable | 6,242 | 6,230 |
| Accrued interest receivable and other receivable | 474 | 474 |
| Financial liabilities: | | |
| Demand deposits | 2,014 | 2,014 |
| Certificates of deposit | 3,444 | 3,444 |
| Certificates of indebtedness | 12 | 12 |
| Securities sold under agreements to repurchase | 455 | 455 |
| Commercial paper | 576 | 576 |
| Accounts payable and accrued liabilities | 106 | 106 |
| Accrued interest payable | 48 | 48 |
| Bonds, notes, and participation agreement payable | 2,998 | 3,026 |
| Derivative instruments: | | |
| Interest rate exchange agreements | 1,152 | (29) |

## 20. INTERFUND BALANCES AND TRANSFERS

The following table is a summary of the interfund balances as of June 30, 2007 between governmental funds and enterprise funds:

| Receivable by | Payable by | Purpose | Amount |
|---|---|---|---|
| **Governmental fund:** | **Enterprise fund:** | | |
| New Secure Housing Program | GDB Operating Fund | Demand deposits and accrued interest | $ 1,447,551 |
| HUD Programs | GDB Operating Fund | Demand deposits and accrued interest | 526,979 |
| Other nonmajor funds (AHMSP Law 124) | GDB Operating Fund | Investment agreements and accrued interest | 597,754 |
| Other nonmajor funds (AHMSP Law 124) | GDB Operating Fund | Certificates of deposit and accrued interest | 47,666,215 |
| Other nonmajor funds (AHMSP Law 124) | GDB Operating Fund | Demand deposits and accrued interest | 423,301 |
| Affordable Housing Mortgage Subsidy Program-Stage 8 | GDB Operating Fund | Demand deposits and accrued interest | 77,236 |
| Affordable Housing Mortgage Subsidy Program-Stage 8 | GDB Operating Fund | Investment agreements and accrued interest | 13,104,742 |
| Other nonmajor funds (Special Obligation Refunding Bonds) | GDB Operating Fund | Certificates of deposit and accrued interest | 3,728,346 |
| Other nonmajor funds (Special Obligation Refunding Bonds) | GDB Operating Fund | Demand deposits and accrued interest | 2,400,249 |
| The Key for your Home Program | GDB Operating Fund | Certificates of deposit and accrued interest | 7,494,757 |
| The Key for your Home Program | GDB Operating Fund | Demand deposits and accrued interest | 2,041,076 |
| Subtotal and balance carried forward | | | 79,508,206 |

| Receivable by | Payable by | Purpose | Amount |
|---|---|---|---|
| Balance brought forward | | | $ 79,508,206 |
| **Governmental fund:** | **Enterprise fund:** | | |
| New Secure Housing Program | Housing Finance Authority | Reimbursement of expenditures | 465,373 |
| Other Nonmajor Funds (Special Obligation Refunding Bonds) | Housing Finance Authority | Reimbursement of loan originations | 265,976 |
| The Key for Your Home Program | Housing Finance Authority | Advances | 110,620 |
| Subtotal | | | 841,969 |
| Total | | | 80,350,175 |
| **Enterprise fund:** | **Governmental fund:** | | |
| GDB Operating Fund | New Secure Housing Program | Loans payable and accrued interest | (35,215,542) |
| GDB Operating Fund | Affordable Housing Mortgage Subsidy Program—Stage 7 | Securities purchased under agreements to resell and accrued interest | (53,384,963) |
| GDB Operating Fund | Affordable Housing Mortgage Subsidy Program—Stage 9 | Loans payable and accrued interest | (5,664,001) |
| GDB Operating Fund | Other nonmajor funds (AHMSP Stage 10) | Loans payable and accrued interest | (14,647,613) |
| Housing Finance Authority | Other nonmajor funds (Special Obligations Refunding Bonds) | Reimbursement of expenditures | (2,771) |
| Housing Finance Authority | Affordable Housing Mortgage Subsidy Program—Stage 7 | Reimbursement of expenditures | (2,456,833) |
| Housing Finance Authority | Other nonmajor funds AHMSP Law 124) | Reimbursement of expenditures | (552,307) |
| Housing Finance Authority | New Secure Housing Program | Reimbursement of loan origination | (31,700) |
| Total | | | (111,955,730) |
| Total internal balances—net | | | $ (31,605,555) |

| Receivable by Fund | Payable by Fund | Purpose | Amount |
|---|---|---|---|
| **Governmental fund:** | **Governmental fund:** | | |
| Other nonmajor funds (Special Obligation Refunding Bonds) | Affordable Housing Mortgage Subsidy Program—Stage 7 | Advances | $ 10,640,027 |
| Other nonmajor funds (Special Obligation Refunding Bonds) | The Key for your Home | Advances | 3,879 |
| Other nonmajor funds (Law No. 124) | Other nonmajor funds (Special Obligation Refunding Bonds) | Advances | 787 |
| Total balance among governmental funds eliminated | | | $ 10,644,693 |
| **Enterprise funds:** | **Enterprise funds:** | | |
| Housing Finance Authority | GDB Operating Fund | Demand deposits and accrued interest | $ 6,537,598 |
| Development Fund | GDB Operating Fund | Demand deposits and accrued interest | 42,638,074 |
| Tourism Development Fund | GDB Operating Fund | Demand deposits and accrued interest | 5,116,874 |
| Public Finance Corporation | GDB Operating Fund | Demand deposits and accrued interest | 1,225,978 |
| Other Nonmajor (Education Assistance Corporation) | GDB Operating Fund | Demand deposits and accrued interest | 2,292,742 |
| Other Nonmajor (JMB Institute) | GDB Operating Fund | Demand deposits and accrued interest | 148,751 |
| Housing Finance Authority | GDB Operating Fund | Certificates of deposit and accrued interest | 390,064,730 |
| Tourism Development Fund | GDB Operating Fund | Certificates of deposit and accrued interest | 41,247,101 |
| Housing Finance Authority | GDB Operating Fund | Guaranteed investment contracts and accrued interest | 209,522,160 |
| GDB Operating Fund | Housing Finance Authority | Bonds payable | 119,199,092 |
| GDB Operating Fund | Housing Finance Authority | Loans receivable and accrued interest | 579,033 |
| GDB Operating Fund | Tourism Development Fund | Loans receivable and accrued interest | 186,048,911 |
| GDB Operating Fund | Public Finance Corporation | Loans receivable and accrued interest | 322,718,097 |
| Total balance among enterprise funds eliminated | | | $ 1,327,339,141 |

The following table is a summary of interfund transfers for the year ended June 30, 2007:

| Transfer Out | Transfer In | Transfer for | Amount |
|---|---|---|---|
| **Governmental Funds:** | **Governmental Funds:** | | |
| Affordable Housing Mortgage Subsidy Program- | Other Nonmajor Funds (AHMSP Law 124) | Release of excess funds | 7,100,000 |
| Subsidy Prepayment Refunding Bonds-Debt Service | Other Nonmajor Funds (Interim Loan Insurance) | Residual net assets | 10,254 |
| Other Nonmajor Funds (Interim Loan Insurance) | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 350,424 |
| Other Nonmajor Funds (AHMSP Law 124) | Other Nonmajor Funds (AHMS Mortgage-Backed Certificates) | Residual net assets | 8,861,750 |
| Other Nonmajor Funds (AHMSP Portfolio I) | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 7,764,322 |
| Other Nonmajor Funds (AHMSP Portfolio III) | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 578,047 |
| Other Nonmajor Funds (AHMSP Portfolio IV) | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 2,977,473 |
| Other Nonmajor Funds (AHMSP Stage 6) | Other Nonmajor Funds (AHMSP Law 124) | Release of excess funds | 5,500,000 |
| Other Nonmajor Funds (Special Obligation Refunding Bonds) | Other Nonmajor Funds (Interim Loan Insurance) | Residual net assets | 180,148 |
| **Enterprise Funds:** | **Governmental Funds:** | | |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Law 124) | Subsidy payments | 38,540,585 |
| Housing Finance Authority | Other Nonmajor Funds (Interim Loan Insurance) | Residual net assets | 137,155 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Law 124) | Subsidy payments | 1,387 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 121,038 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Portfolio I) | Subsidy payments | 541,188 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 262,020 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Portfolio IV) | Subsidy payments | 63,456 |
| Housing Finance Authority | Other Nonmajor Funds (AHMS Mortgage-Backed Certificates) | Subsidy payments | 1,776,034 |
| Housing Finance Authority | Other Nonmajor Funds (AHMSP Law 124) | Residual net assets | 210,163 |

| Transfer Out | Transfer In | Transfer for | Amount |
|---|---|---|---|
| Governmental Funds: | Enterprise Funds: | | |
| Other Nonmajor Funds (AHMSP Law 124) | Housing Finance Authority | Residual net assets | 544,587 |
| Other Nonmajor Funds (AHMSP Law 124) | Housing Finance Authority | Debt service | 12,500 |
| Other Nonmajor Funds (AHMSP Law 124) | Housing Finance Authority | Residual net assets | 19,853 |
| Other Nonmajor Funds (AHMSP Portfolio III) | Housing Finance Authority | Residual net assets | 947,523 |
| Other Nonmajor Funds (AHMSP Portfolio IV) | Housing Finance Authority | Residual net assets | 2,534,006 |
| Affordable Housing Mortgage Subsidy Program-Stage 9 | Housing Finance Authority | Subsidy payments | 576,973 |
| Other Nonmajor Funds (AHMSP Stage 6) | Housing Finance Authority | Subsidy payments | 1,250,098 |
| Other Nonmajor Funds (AHMS Mortgage-Backed Certificates) | Housing Finance Authority | Issuance costs, escrow deposits and subsidy payments | 8,322,914 |
| Enterprise Funds: | Enterprise Funds: | | |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 17,556,536 |
| Housing Finance Authority | Housing Finance Authority | Subsidy payments | 168,188 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 6,858,283 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 4,365,738 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 33,169,840 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 13,902,909 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 4,464,087 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 36,346,872 |
| Housing Finance Authority | Housing Finance Authority | Residual net assets | 286,729 |

## 21. SUBSEQUENT EVENTS

*Housing Finance Authority*

The Housing Finance Authority is the mortgagee of record of a mortgage note in the original amount of $16,902,000 with an outstanding amount of $9,897,000 as of June 30, 2007. On August 2007, the mortgagor of such note filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. This mortgage is insured by the Federal Housing Administration pursuant to section 242 of the Housing Act, which provides mortgage insurance benefits. Subject to the FHA Insurance claims process, management expects recovery of principal and interest on the mortgage note, thus no provision has been established in the financial statements. The note was assigned by the original mortgagee, Government Development Bank of Puerto Rico, mainly for servicing and payment agency purposes as part of an AFICA Revenue Bond transaction.

On July 12, 2007, the Housing Finance Authority sold mortgage loans with an outstanding principal balance of approximately $5.5 million. Net proceeds from the sale of such loans amounted to approximately $5.56 million, including accrued interest of $24,168, resulting in a gain on sale of approximately $27,500.

The Housing Finance Authority created a collateralized multi-family rental unit loan program with partial or total deferred debt service payments for the construction or rehabilitation of projects participating, among other, from Section 42 of U. S. Internal Revenue Code, Low Income Housing Tax Credit Program. The loans will provide a gap financing to developers of multi-family rental units. The interest and principal will be collected at expiring rent control periods or at sale or refinancing events. The Soft Lending Housing Trust was assigned a $20 million contribution from the operating and administrative fund to be made in two $10 million installments in fiscal year 2008 and 2009.

The Housing Finance Authority created a subsidy program for the acquisition and pre-development of affordable housing projects. The program will acquire land, principally from other governmental entities, to facilitate the permitting process and ensure affordable housing development guidelines. The pre-developed lots will be sold through a competitive process to private developers to facilitate affordable housing projects by reducing their costs of acquisition and risks of pre-development. The acquisition and pre-development program was funded with a $15 million contribution from unrestricted governmental funds.

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