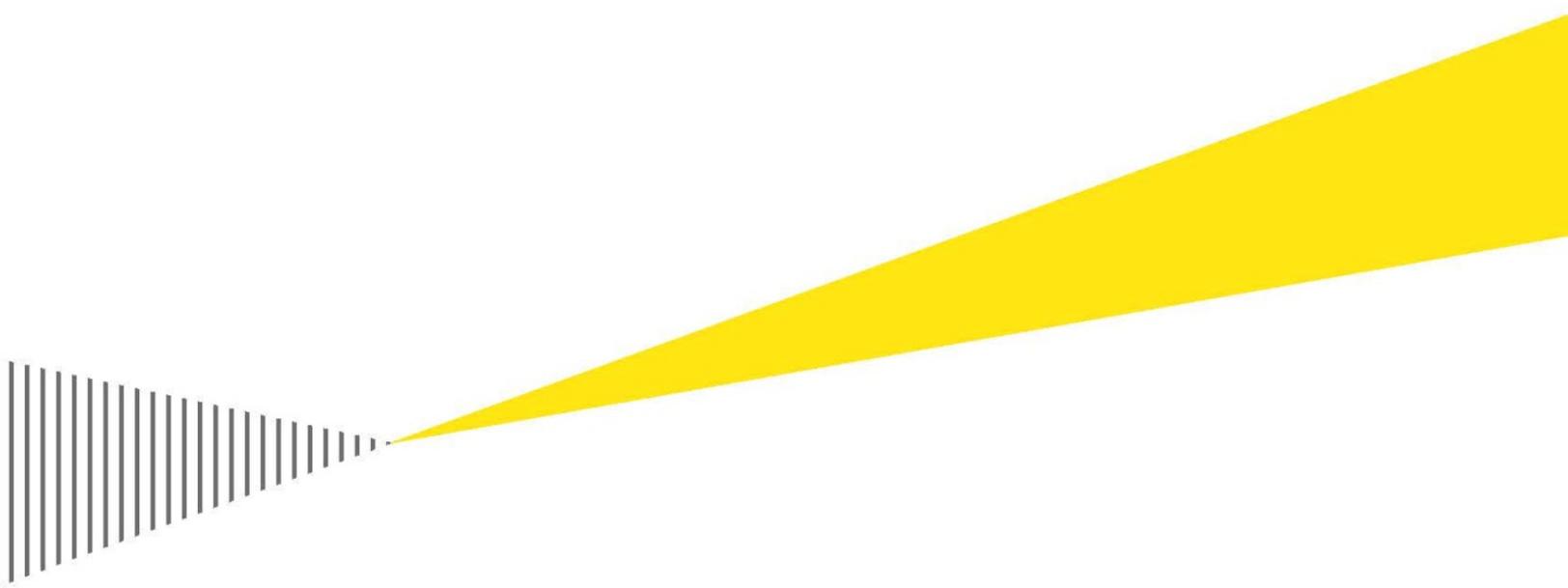


AUDITED FINANCIAL STATEMENTS
AND REQUIRED SUPPLEMENTARY
INFORMATION

University of Puerto Rico Retirement System
Year Ended June 30, 2014
With Report of Independent Auditors

Ernst & Young LLP



University of Puerto Rico Retirement System

Audited Financial Statements
and Required Supplementary Information

Year Ended June 30, 2014

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Report of Independent Auditors

The Board of Trustees
of the University of Puerto Rico Retirement System

Report on the Financial Statements

We have audited the accompanying financial statement of the University of Puerto Rico Retirement System (the System), which comprise the statements of fiduciary net position as of June 30, 2014, and the related statements of changes in fiduciary net position for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary position of the System at June 30, 2014, and the changes in its fiduciary net position for the year then ended in conformity with U.S. generally accepted accounting principles.

Emphasis of Matter

As discussed in Note 1 to the financial statements, as of July 1, 2013, the System implemented Governmental Accounting Standards Board (GASB) Statement No. 67, *Financial Reporting for Pension Plans – an Amendment of GASB Statement No. 25*. Our opinion is not modified with respect to this matter.

Required Supplementary Information

Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages 4 through 14 and the required supplementary information on pages 41 through 44 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.



Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 31, 2015, on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Ernst + Young LLP

March 31, 2015

Stamp No. E158140
affixed to
the original
of this report.

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited)

Year Ended June 30, 2014

Our discussion and analysis of the University of Puerto Rico Retirement System's (the System) financial performance provides an overview of the System's financial activities for the fiscal years ended June 30, 2014, and 2013.

Financial Highlights

- System's assets as of June 30th, 2014 are **\$1,324,028,384** and \$1,161,573,140 at the close of fiscal year 2014 and 2013, respectively (reported as net assets). Marketable securities are held in a trust to meet future benefit payments.
- The component of Additions to Fiduciary Net Position in the year 2014 is comprised of contributions of **\$129,588,674**, net investments of **\$206,595,170** and **\$8,247,730** in reimbursement from the University of Puerto Rico for retirees' medical insurance (maximum amount of \$125 per retiree).
- Additions to Fiduciary Net Position in fiscal year 2014 were **\$344,431,574**, compared to **\$281,649,897** in fiscal year 2013. The increase in additions in fiscal year 2014 was mainly caused by the net appreciation from investments and capital of **\$187,290,067**, in fiscal year 2014, compared to net appreciation of **\$126,386,135** in fiscal year 2013.
- Deductions to Fiduciary Net Position in fiscal year 2014 were **\$181,976,330** compared to **\$175,985,461** in fiscal year 2013. The difference was mainly caused by benefits paid to participants of **\$169,162,756** in fiscal year 2014, compared to **\$162,182,241** in fiscal year 2013. The increase in retirees receiving benefits increased to **8,082** at the end of fiscal year 2014 vs. **7,863** at the end of fiscal year 2013.

The Statement of Fiduciary Net Position and the Statement of Changes in Fiduciary Net Position

These statements include all assets and liabilities using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, all revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Fiduciary Net Position presents plan assets and liabilities, with the difference between the two reported as net assets. Over time, increases and decreases in net position measure whether the System's financial position is improving or deteriorating. The statement of Changes in Fiduciary Net Position presents how the System's net assets changed during the period to determine whether the System is becoming financially stronger or weaker and to understand changes over time in the funded status of the System.

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

Financial Analysis

The net assets during the year ended June 30, 2014 increased by approximately **\$162.5** million or **13.99%** from the prior year (see Statements of Changes in Fiduciary Net Assets for details). For fiscal year 2014 total assets increased **\$127.4** million or **9.11%** from prior year.

Statements of Fiduciary Net Assets

| | June 30, 2013 | June 30, 2014 | Percentage Change |
|---|------------------------|------------------------|----------------------|
| Assets | | | |
| Cash | \$24,198,235 | \$39,984,623 | 65.24% |
| Receivables | 76,165,148 | 41,075,631 | -46.07% |
| Investments | 1,040,132,790 | 1,195,667,654 | 14.95% |
| Alternative investment | 15,543,756 | 16,602,143 | 6.81% |
| Securities lending cash collateral | 97,502,608 | 88,785,830 | -8.94% |
| Loans to plan members | 124,139,301 | 124,365,792 | 0.18% |
| Other net of allowances | 18,222,210 | 16,852,940 | -7.51% |
| Capital assets | 3,633,863 | 3,674,252 | 1.11% |
| Total Assets | \$1,399,537,911 | \$1,527,008,865 | 9.11% |
| Liabilities | | | |
| Accounts payable and accrued expenses | \$27,526,126 | \$43,847,229 | 59.29% |
| Obligations under securities lending | 97,502,608.00 | 90,126,816 | -7.56% |
| Escrow deposits on mortgage loans | 231,158 | 265,173 | 14.72% |
| Other deposits | 2,618,249 | 3,119,655 | 19.15% |
| Payables for acquisition of investments | 110,086,630 | 65,621,608 | -40.39% |
| Total Liabilities | 237,964,771 | 202,980,481 | -14.70% |
| Net Assets | \$1,161,573,140 | \$1,324,028,384 | 13.99% |

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

Statements of Changes in Fiduciary Net Position

| | June 30, 2013 | June 30, 2014 | Percentage Change |
|---|--------------------------|--------------------------|------------------------------|
| Additions: | | | |
| Contributions | \$ 125,333,059 | \$ 129,588,674 | 3.40% |
| Net investment income | 146,290,472 | 206,595,170 | 41.22% |
| Medical insurance reimbursements from the University of Puerto Rico | 10,026,366 | 8,247,730 | -17.74% |
| Total additions | 281,649,897 | 344,431,574 | 22.29% |
| Deductions: | | | |
| Benefits paid to participants | 162,182,241 | 169,162,756 | 4.30% |
| General and administrative expenses | 3,776,854 | 4,565,844 | 20.89% |
| Medical insurance expenses paid to retirees from University of Puerto Rico | 10,026,366 | 8,247,730 | -17.74% |
| Total deductions | 175,985,461 | 181,976,330 | 3.40% |
| Net increase in net position restricted for pension | \$ 105,664,436 | \$ 162,455,244 | 53.75% |

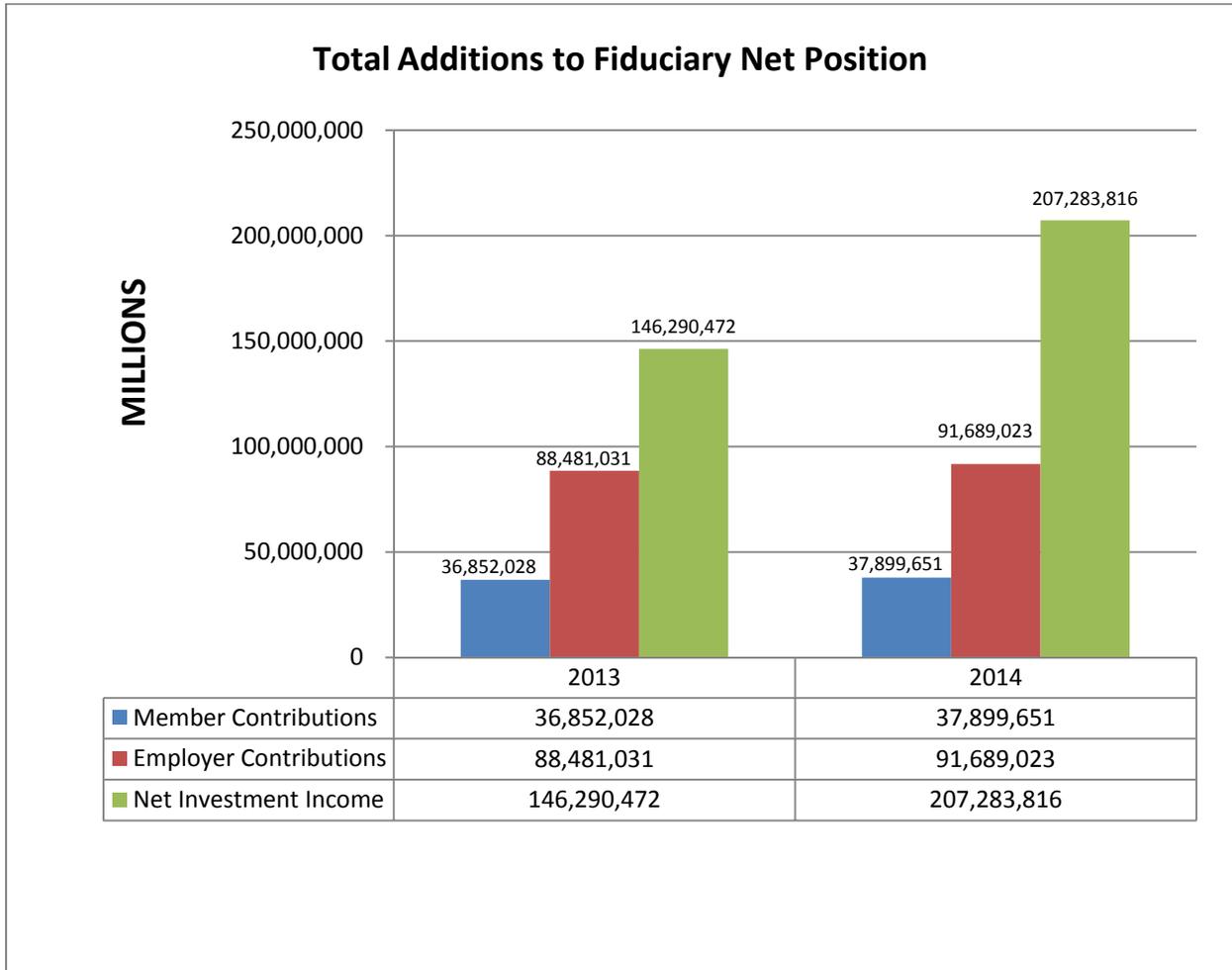
Contributions and Net Investment Income

The funds needed to finance retirement benefits are obtained through employer and employee contributions and through appreciation and income derived from investments. Contributions and net investment income for fiscal year 2014 amounted to approximately **\$336.2** million compared to **\$271.6** million for fiscal year 2013. The increase was mainly caused by the net appreciation of investments during fiscal year 2014.

University of Puerto Rico Retirement System

Management’s Discussion and Analysis (Unaudited) (continued)

Contributions paid by employees approximated **\$37.9** million and \$36.9 million for the years ended June 30, 2014 and 2013, respectively. This represented an increase of approximately **\$1.05** million or **2.84%**.



University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

General and Administrative Expenses

General expenses for the administration of the System are budgeted and approved as part of the annual budget process and are paid from the assets of the Retirement Fund. Expenses for some professional services, including outside legal counsel, auditor, investment managers, investment advisor, and actuarial services are paid directly from the System's Retirement Fund. In addition, the Board reviews and approves proposals for one-time, special projects as they arise. The cost of administrative expenses for the System are financed through plan contributions, investment earnings and retirement fund when deemed necessary.

Total general and administrative expenses for the System during fiscal year 2014 and 2013 amounted to **\$4,565,844**, and \$3,776,854 respectively, an increase of **\$788,990** or **20.89%**. As of July 1st, 2015 custody expenses will be reclassified to be included and considered as part of the total investment expenses since these costs are exclusively associated with the trading and transactions of the Retirement Fund.

Actuarial Standards

The actuarial calculations were performed by qualified actuaries according to generally accepted actuarial procedures and methods. The calculations are based on the current provisions of the System and on actuarial assumptions that are as of June 30, 2013 individually and in the aggregate, internally consistent and reasonably based on the actual experience of the System. In addition, the calculations were completed in compliance with the laws governing the System. The actuary is a member of the American Academy of Actuaries and meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained in this annual report.

Future actuarial results may differ significantly from the current results presented in this report due to such factors as the following: plan experience differing from that anticipated by the economic or demographic assumptions; changes in economic or demographic assumptions; increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as the end of an amortization period or additional cost or contribution requirements based on the plan's funded status); and changes in plan provisions or applicable law. Since the potential impact of such factors is outside the scope of a normal annual actuarial valuation, an analysis of the range of results is not presented herein.

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

This financial report consists of two basic financial statements as follows:

- The Statement of Fiduciary Net Position which reports the pension trust fund assets, liabilities, and resulting net position where Assets-Liabilities = Net Position held in trust for pension benefits available at the end of the fiscal year. It is a snapshot of the financial position of the pension trust funds at that specific point in time.
- The Statement of Changes in Fiduciary Net Position summarizes the pension trust fund financial transactions that have occurred during the fiscal year where Additions-Deductions=Net Change in Net Position. It supports the change that has occurred to the prior year's net position on the Statement of Fiduciary Net Position.

The following table summarizes the membership of the System as of June 30, 2013:

| Membership | Number |
|---|----------------------|
| Inactive members or their beneficiaries | |
| Currently receiving benefits | 7,863 |
| Inactive members entitled to but not yet receiving benefits | 8,394 |
| Active members | <u>11,008</u> |
| Total | <u><u>27,265</u></u> |

The long-term expected rate of return of the Retirement Fund investments was determined using a lognormal distribution analysis in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) which are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. The target asset allocation and best estimates of arithmetic real rates of return for each major asset class provided by the System's investment consultant are summarized in the following table:

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

| Investment Returns | | |
|-------------------------------|--------------------------|-------------------------------|
| Asset Class | Target Allocation | Long Term Expected ROR |
| Domestic Large Cap Equity | 40% | 7% |
| International Equity | 10% | 7% |
| Domestic small/mid cap equity | 10% | 8% |
| Fixed Income | 28% | 1% |
| Loans and mortgages | 12% | 6% |
| | 100% | |

The discount rate used to measure the total pension liability was 5.31 percent. The projection of cash flows used to determine the discount rate assumed that plan member contributions will be made at the current contribution rates and that Employer contributions will be made at rates equal to the difference between actuarially determined contribution rates and the member rate. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members until the plan year ending June 30, 2027. Therefore, the long-term expected rate of return on pension plan investments of 8% was applied to all periods of projected benefit payments through June 30, 2027 and the applicable municipal bond index rate of 4.35%, based on the Bond Buyer General Obligation 20-year Municipal Bond Index published monthly by the Board of Governors of the Federal Reserve System as of June 30, 2014, was applied to all periods of projected benefit payments after June 30, 2027. The Single Equivalent Interest Rate (SEIR) of 5.31% that discounts the entire projected benefit stream to the same amount as the sum of the present values of the two separate benefit payments streams was used to determine the total pension liability as of June 30, 2014. The SEIR at the beginning of the measurement period was 5.24% based on the long-term expected rate of return on pension plan investments of 8% applied to all periods of projected Page 5 benefit payments through June 30, 2027 and the applicable municipal bond index rate of 4.27% as of June 30, 2013 applied to all periods of projected benefit payments after June 30, 2027.

The following presents the net pension liability of the System, calculated using the SEIR discount rate of 5.31 percent, as well as what the System's net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (4.31 percent) or 1-percentage-point higher (6.31 percent) than the current rate (\$ thousands):

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

| | Discount Rate 1% Decrease | Current Discount Rate | Discount Rate 1% Increase |
|--------------------------------|--------------------------------------|----------------------------------|--------------------------------------|
| Discount rate | 4.31% | 5.31% | 6.31% |
| System's net pension liability | \$2,247,062 | \$2,104,040 | \$1,788,340 |

June 30, 2013 is the actuarial valuation date upon which the TPL is based. The result was rolled forward using standard actuarial techniques to the Measurement Date, June 30, 2014.

(In thousands)

2014

Total Pension Liability:

| | |
|---|--------------|
| Service cost | \$ 49,499 |
| Interest | 173,630 |
| Changes in benefit terms | - |
| Differences between expected and actual experience | (24,034) |
| Changes in assumptions | - |
| Benefit payments, including refunds of member contributions | (169,163) |
| Net change in total pension liability | 29,932 |
| Total pension liability, beginning | 3,398,136 |
| Total pension liability, ending (a) | \$ 3,428,068 |

Plan Net Position:

| | |
|---|---------------------|
| Contributions - employer | \$ 91,689 |
| Contributions - member | 37,900 |
| Net investment income | 206,595 |
| Benefit payments | (169,163) |
| Administrative expenses | (4,566) |
| Net change in fiduciary net position | 162,455 |
| Plan fiduciary net position, beginning | 1,161,573 |
| Plan fiduciary net position, ending | \$ 1,324,028 |
| Net Pension Liability (Asset) - Ending (a) - (b) | \$ 2,104,040 |

University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

| | 2014 |
|---|--------------------|
| Total Pension Liability (<i>In thousands</i>) | |
| Total pension liability | \$3,428,068 |
| Plan fiduciary net position | \$1,324,028 |
| Net pension liability | \$2,104,040 |
| Ratio of fiduciary net position to total pension liability | 38.62% |
| Covered-employee payroll | \$ 515,856 |
| Net pension liability as a percentage of covered-employee payroll | 407.87% |

Required Supplementary Information includes four required schedules of historical trend information as follows:

The Schedule of Changes in the Net Pension Liability (page 41) presents sources of changes in the net pension liability. The Schedule of the Net Pension Liability (page 42) includes historical information about the components of the net pension liability and related ratios, including fiduciary net position as a percentage of the total pension liability, and the net pension liability as a percentage of covered-employee payroll.

The Schedule of Employer Contributions (page 43) includes information about the actuarially determined contribution, contributions to the pension plan, and related ratios. Additionally, significant methods and assumptions used in calculating the actuarially determined contributions are presented in the notes to required supplementary information.

The Schedule of Investment Returns (page 44) includes the annual money-weighted rate of return on pension plan investments for each year.

Investments

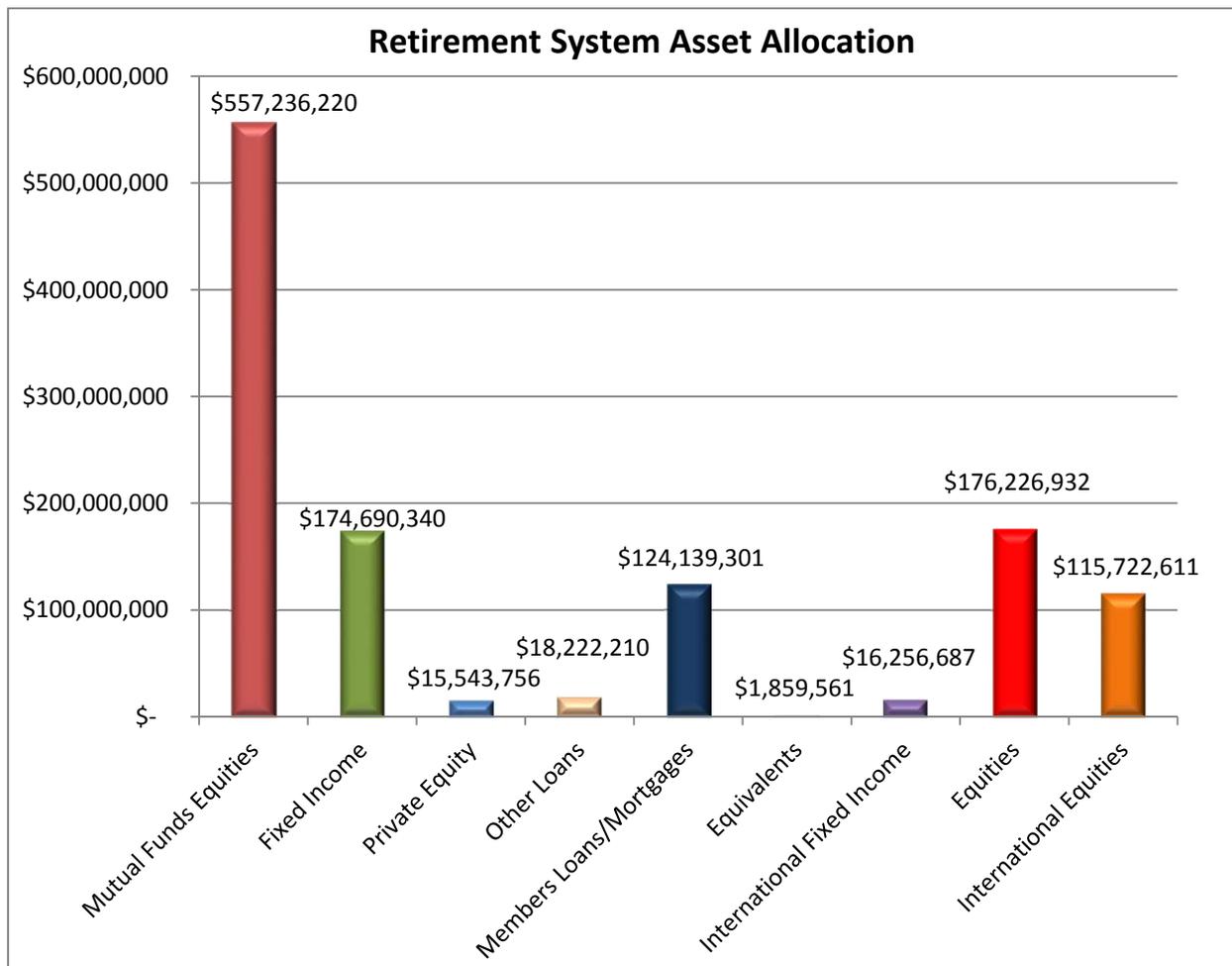
The System's investment portfolio appreciated in fair value by approximately **\$187.9** million during fiscal year 2014, as compared to fiscal year 2013 when it appreciated by **\$126.3** million. The net investment income for fiscal year 2014 amounted to **\$206.6** million an increase of **\$60.3** million or 41.2% compared to a net investment income of **\$146.2** million in fiscal year 2013. The increase was caused by the appreciation in the fair value of assets; since investment expenses are computed as a percentage of assets under management. Total investment expenses during fiscal year 2014 of **\$3,156,565** increased by **\$493,373** or **18.53%** as compared to fiscal year 2013.

University of Puerto Rico Retirement System

Management’s Discussion and Analysis (Unaudited) (continued)

Retirement System of Puerto Rico Asset Allocation

The System’s Retirement Fund comprises of more than **95%** of the total plan assets. Most of the assets are invested in marketable securities. The investment fund has **72%** of its assets in stocks and **13%** in fixed income investments, **3%** in cash equivalents, **10%** loans to participants, **1%** in international fixed income, and **1%** in private equity investments. Equity investments are diversified between domestic and foreign markets and among companies with small, medium and large capitalization. The table below shows the asset allocation as of June 30, 2014:



University of Puerto Rico Retirement System

Management's Discussion and Analysis (Unaudited) (continued)

Benefits Paid and Liabilities

For the fiscal year 2014, pension benefits paid to retirees and beneficiaries were approximately **\$169.1** million, which represents an increase of approximately **\$6.9** million or **4.3%** when compared to the prior year.

As of June 30, 2014, the Active members and Retired members were **10,728** and **8,082** respectively, as compared to 11,008 and 7,863 as of June 30, 2013.

During fiscal year 2014, total liabilities were **\$202.9** million, which represents an increase of **\$62.5** million or **44.5%** when compared to prior year. A 58% of our total liabilities consist of unsettled transactions. Overall, this amount represents accounts payable to agencies, deposits for distribution to employee's contributions and accounts payables for acquisition of investments.

Retirement System as a Whole

Fiscal year 2014, reported an increase in net position of **\$162.5** million due to the return of investments held by the Plan as these investments presented positive returns that amounted to approximately **\$155.5** million.

Contacting System Financial Management

This financial report is designed to provide the Government Board, Retirement Board, participants, taxpayers, investors, and creditors with a general overview of the System's finances and to demonstrate the System's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the University of Puerto Rico Retirement System at P.O. Box 21769, San Juan, Puerto Rico 00931-1769 and (787) 751-4550.

University of Puerto Rico Retirement System

Statement of Fiduciary Net Position

June 30, 2014

| | |
|---|------------------|
| Assets | |
| Cash and cash equivalents | \$ 39,984,623 |
| Investments at fair market value: | |
| U.S. Government and agencies' obligations | 56,441,450 |
| Foreign bonds | 20,289,189 |
| Corporate bonds and other debentures | 150,774,923 |
| Foreign common stock | 137,950,172 |
| Common stock | 765,352,688 |
| Mortgage-backed securities | 62,677,909 |
| Municipal bonds | 1,871,750 |
| Sovereign debt | 309,573 |
| Alternative investments | 16,602,143 |
| Invested securities lending cash collateral | 88,785,830 |
| Loans to plan members: | |
| First mortgages | 40,373,993 |
| Personal installments | 83,991,799 |
| Other, net of allowance for doubtful accounts of \$123,404 in 2014 | 16,852,940 |
| Other receivables | 210,745 |
| Accounts receivables: | |
| Accrued interest receivable on investments | 1,196,931 |
| Receivables from sale of investments | 39,270,851 |
| Contributions receivable from Puerto Rico Treasury Department | 389,173 |
| Accounts receivable from University of Puerto Rico | 7,931 |
| Capital assets, net of accumulated depreciation of \$876,894 in 2014 | 3,674,252 |
| Total assets | 1,527,008,865 |
| Liabilities | |
| Accounts payable and accrued expenses | 43,847,229 |
| Obligation under securities lending | 90,126,816 |
| Escrow deposits on mortgage loans | 265,173 |
| Other deposits and pending distribution funds | 3,119,655 |
| Payable for acquisition of investments | 65,621,608 |
| Total liabilities | 202,980,481 |
| Net assets held in trust for pension benefits | \$ 1,324,028,384 |

See accompanying notes.

University of Puerto Rico Retirement System
 Statements of Changes in Fiduciary Net Position

Year Ended June 30, 2014

Additions:

| | |
|---|---------------|
| Contributions: | |
| Employer | \$ 81,189,023 |
| Participants | 37,899,651 |
| Actuarial deficit funds collection | 10,500,000 |
| | 129,588,674 |
| Investment (loss) income: | |
| Net appreciation in fair value of investments | 187,942,407 |
| Interest | 17,116,166 |
| Dividends | 4,693,162 |
| | 209,751,735 |
| Less investment expenses | 3,156,565 |
| | 206,595,170 |
| Medical insurance reimbursements from University of Puerto Rico | 8,247,730 |
| Total additions | 344,431,574 |

Deductions:

| | |
|---|-------------|
| Benefits paid to participants | 169,162,756 |
| General and administrative expenses | 4,565,844 |
| Medical insurance expenses paid to retirees | 8,247,730 |
| Total deductions | 181,976,330 |
| Net increase in net assets held in trust for pension benefits | 162,455,244 |

Net assets held in trust for pensions benefits:

| | |
|-------------------|------------------|
| Beginning of year | 1,161,573,140 |
| End of year | \$ 1,324,028,384 |

See accompanying notes.

University of Puerto Rico Retirement System

Notes to Financial Statements

June 30, 2014

1. Organization and Summary of Significant Accounting Policies

Organization

The University of Puerto Rico Retirement System (the System) is the administrator of a single-employer defined benefit pension plan that was created by Act No. 135, approved on May 7, 1942. The System started operations on January 1, 1945, the date on which contributions by employees and the University of Puerto Rico (the University) commenced.

The responsibility for the proper operation and administration of the System is vested in the Finance and Retirement System Committee of the Government Board of the University in which certain members of such Board are members; which will then, notify of the decisions to the Members of the University's Government Board. The following are the significant accounting policies followed by the System in the preparation of its financial statements.

Basis of Presentation

The System's financial statements and notes to the financial statements are prepared under the provisions of Governmental Accounting Standards Board (GASB) Statement No. 67, *Financial Reporting for Pension Plans*-an amendment of GASB Statement No. 25.

The accompanying financial statements have been prepared on the accrual basis of accounting. Participants and employer contributions are recognized in the period in which the contributions are due and the employer has made a formal commitment to provide the contributions. Benefits are recognized when due and payable in accordance with the terms of the Plan.

Cash Equivalents

The Plan considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

1. Organization and Summary of Significant Accounting Policies (continued)

Investments

Investments are reported at fair value. Short-term investments, mainly certificates of deposit, are reported at cost, which approximates fair value. Marketable securities are valued based on quotations obtained from national security exchanges. Dividend income is recognized when received.

The fair value of investments held in foreign currencies are translated to U.S. dollars generally using current rates of exchange and the related translation adjustments are included as an addition to the unrealized change in fair value of investments which is recorded in the statement of changes in fiduciary net position as net appreciation in fair value of the investments.

The fair value of private equity fund investments is determined by the applicable fund manager.

Securities Lending

Cash received as collateral on securities lending transactions is used to purchase investments. These investments are reported as assets in the accompanying financial statement and are generally measured at fair value with the exception of repurchase agreements, which are reported at cost. A corresponding liability is also reported for the amount owed to the broker at the termination of the lending agreement. Additional disclosures about the Plan's securities lending transactions are provided in **Note 4**.

Loans to Plan Members

Loans to participants are carried at their unpaid principal balance, which approximates their fair value. Mortgage loans are collateralized by the participant's contribution to the pension plan and first mortgage liens on the underlying properties. These mortgages are valued on the basis of future principal and interest payments and are discounted at prevailing interest rates for similar instruments.

The System's Board of Trustees granted certain participants the option to select a supplemental pension benefit by making a retroactive contribution to the System. The participants who accept this option have to make a lump-sum payment to cover the related benefits. The participants could obtain an interest-bearing loan from the System to fund their contributions. As of June 30, 2014, the balance of other loans consisted of the principal balance of such contributions, which amounted to approximately **\$16.9** million net of allowance for uncollectible accounts.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

1. Organization and Summary of Significant Accounting Policies (continued)

Capital Assets

Capital assets are recorded at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the depreciable property. Amounts exceeding \$1,000 and with a useful life of three years or more are capitalized.

Expenditures for maintenance and repairs are charged to operations, while those for renewals and betterments are capitalized. Depreciation expense charged to operations during the year ended June 30, 2014 amounted to approximately **\$44,416**.

New Accounting Pronouncement

The System adopted and implemented GASB Statement No. 67, *Financial Reporting for Pension Plans*-an amendment of GASB Statement No. 25 as of July 1, 2013. The objective of this Statement is to improve financial reporting by state and local governmental pension plans. This Statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and inter-period equity, and creating additional transparency. This Statement replaces the requirements of Statements No. 25 *Financial Reporting for Defined Benefits Pension Plans*, and No. 50 *Pension Disclosures*. These requirements affect the financial reporting primarily through enhanced note disclosures and schedules of required supplementary information.

Highlights of the changes to these financial statements as a result of implementing GASB Statement 67 are as follows:

- The Statement of Plan Net Position and Statement of Changes in Plan Net Position have now been retitled as Statement of Fiduciary Net Position and Statement of Changes in Fiduciary Net Position, respectively.
- New Required Supplementary Information includes a Schedule of the Net Pension Liability, Schedule of Changes in the Net Pension Liability, Schedule of Employee Contributions and Schedule of Investment Returns. Notes to the RSI include significant methods and assumptions used in calculating the actuarially determined contributions.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

1. Organization and Summary of Significant Accounting Policies (continued)

New Accounting Pronouncement (continued)

- GASB Statement No. 67 only affects GAAP financial reporting requirements and does not prescribe funding methods which could be different. The System will continue to use a funding policy that follows a financing pattern which computes and requires contribution amounts (when expressed as a percentage of active member payroll) to remain approximately level from year to year.
- The discount rate used to calculate the present value of future benefit payments for reporting purposes is based upon the projected plan net position (PNP) using actuarial assumptions about contributions, benefit payments and the long-term expected rate of return. The System currently uses the long term discount rate of 5.31%.

2. Description of the System

General

The System is a single-employer defined benefit pension plan that covers all employees of the University with the exception of hourly, temporary, part-time, contract and substitute employees, and visiting professors. It is qualified and exempt from Puerto Rico and United States income taxes.

Participants consisted of the following as of June 30, 2014:

| | |
|---|----------------------|
| Retirees and beneficiaries receiving benefits | 8,082 |
| Terminated plan participants entitled to but not yet receiving benefits | 476 |
| Terminated non-vested plan participants entitled to return of their contributions | 7,941 |
| Active plan participants | 10,728 |
| Total | <u>27,227</u> |

Effective July 1, 2007, the Plan was amended by Certification No. 12. This certification was superseded by Certification No. 70 2013-2014 in which the automatic 3% increase in pension benefits was terminated.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System

General

Effective July 1, 2002, the Plan was amended, by establishing Certification 139, to offer participants an increase from \$50,000 to \$60,000 in the maximum salary subject to withholding contribution. The participants who elect this benefit may pay retroactively to their first day of employment the differences in withholding contributions for prior year salaries exceeding \$50,000 and up to a maximum of \$60,000 plus 8% interest.

Plan Amendments

Effective February, the Plan was amended by establishing Certification 94, to eliminates participants automatic increase of 3% in all benefits paid.

Effective July 1, 1998, the Plan was amended by establishing Certification 9f, to offer participants and increase from \$35,000 to \$50,000 in the maximum salary subject to withholding contributions. The participants who elect this benefit may pay retroactively to their first day of employment the differences in withholding contributions for prior year salaries exceeding \$35,000 and up to a maximum of \$50,000 plus 8% interest. Effective July 1, 1998, all new participants will have the option to contribute 9% of their salary up to \$50,000 or 11% of their salary up to \$69,556.44.

In addition, the maximum annual compensation for those participants who had not completed 20 years of service by July 1, 1979 is \$35,000. Also, the minimum pension is \$250 a month. Finally, the reduction for commencement of pension benefits prior to age 65 is 1/3% per month for participants who had not completed 20 years of service by July 1, 1979, and elected Certification 55, and for participants hired on or after January 1, 1990.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Contributions and Funding Policy

The contribution requirements of participants and the University are established and may be amended by the Board of Trustees. Participants are required to contribute as follows:

Participants who elect Certification No. 139: 11% of monthly compensation up to \$5,796.37

Participants who have not completed 20 years of service by July 1, 1979:

- If full supplement is elected: 7% of monthly compensation up to \$2,916.67
- If full supplement is not elected: 5% of monthly compensation up to \$2,916.67
- If Certification 94 is elected: 9% of monthly compensation up to \$4,166.67

Participants who have completed 20 years of service by July 1, 1979:

- If full supplement is elected: 7% of monthly compensation
- If full supplement is not elected: 4% of monthly compensation up to \$350.00, plus 6.5% of the excess

Participants who have not completed 20 years of service by July 1, 1979 and elect Certification 55:

- If full supplement is elected: 7% of monthly compensation up to \$2,916.67
- If full supplement is not elected: 4% of monthly compensation up to \$350.00, plus 6.5% of the excess up to \$2,916.67
- If certification 94 is elected: 9% of monthly compensation up to \$4,166.67
- If certification 139 is elected: 11% of monthly compensation up to \$5,796.37

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Contributions and Funding Policy (continued)

Participants who are hired between January 1, 1990 and June 30, 1998:

- 8% of monthly compensation up to \$2,916.67 or,
- If Certification 94 is elected: 9% of monthly compensation up to \$4,166.67
- If certification 139 is elected: 11% of monthly compensation up to \$5,796.37

Participants who are hired on or after July 1, 1998:

- 9% of monthly compensation up to \$4,166.67
- 11% of monthly compensation up to \$5,796.37

The University is supposed to contribute at an actuarially determined rate; the rate as of June 30, 2014 was 15.16%, of annual covered payroll. The actuarially determined employer contribution rate takes into account payment of administrative expenses.

Therefore, administrative expenses are paid out of the trust fund. The University contributed 15.8% of participants' payroll in 2014.

The contributions of the University were originally designed to fund, together with the contributions of the participants, the current service cost on a current basis and the estimated accrued benefit cost attributable to qualifying service prior to the establishment of the System over a 40-year period, but as a result of increasing benefits without a correlative increase in employer's contributions, they fall short of accomplishing the necessary funding.

Retirement Benefits

The System provides retirement, disability and death benefits to participants and beneficiaries. Cost-of-living adjustments are provided to participants and beneficiaries at the discretion of the Government Board of the University, formerly known as both the Board of Trustees and the Council on Higher Education of the University of Puerto Rico. Article XIII of the Rules and Regulations of the System, as amended, effective July 1, 1973, assigns the authority to establish and amend benefit provisions to the Government Board.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Retirement Benefits

Participants who have completed 20 years of service by July 1, 1979 are entitled to annual retirement benefits at any age after 30 years of service. Otherwise, participants are entitled to annual retirement benefits at age 55 after 30 years of service. Participants may elect to receive their retirement benefits at age 58 after 10 years of service, or at age 55 after 25 years of service.

The amount of service retirement annuity is as follows:

- For all participants except those who have completed 20 years of service by July 1, 1979:
 - Before age 65 – for participants with at least 30 years of service: 75% of average compensation. Amount is reduced by .5% for each month the member is under age 58 (Certification 37) and 55 (Certification 55), at time annuity begins.
 - Before age 65 – for participants with less than 30 years of service: 1.5% of average compensation per year of service for the participants with 20 or fewer years. Percentage increases by .05% for each year in excess of 20 years up to a maximum of 1.95% per year. Amount is reduced by .5% for each month the participant is under age 58 at time annuity begins.
 - After age 65 – if the member elected full supplement, the annuity is the same as before age 65. Otherwise, the annuity is reduced by .5% of average compensation not in excess of Social Security wage base in effect at retirement for each year of service. If the participants had less than 30 years of service and was under age 58 at the beginning date, adjustment is made before application of .5% reduction per month under age 58.
- For those members who have completed 20 years of service by July 1, 1979:
 - Before age 65 – for participants with at least 30 years of service: 75% of average compensation if age 55 at beginning date; 65% if under age 55. If the member completed 30 years of service before July 1973, the annuity is increased by 2% of average compensation for each year of service beyond 30 and before July 1973, but to no more than 85% of average compensation.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Retirement Benefits (continued)

- Before age 65 – for participants with less than 30 years of service: 1.5% of average compensation per year of service for participants with 20 or fewer years. Percentage increases by .05% for each year in excess of 20 years up to maximum of 1.95% per year. Amount is reduced by .5% for each month the participant is under age 58 at the time the annuity begins.
- At age 65 – if participants elected full supplement, the annuity is the same as before age 65. Otherwise, the annuity is reduced by .5% of first \$350 of average compensation for each year of service but not by more than primary Social Security benefit. If the participants had less than 30 years of service and was under age 58 at beginning date, adjustment is made before application of .5% reduction per month under age 58.
- For all participants who have not completed 20 years of service by July 1, 1979 and elect Certification 55, and for those hired on or after January 1, 1990:
 - Before age 65 – for participants with less than 30 years of service: 1.5% of average compensation per year of service for participants with 20 or fewer years. Percentage increases by .05% for each year in excess of 20 years up to a maximum of 1.95% per year.
 - Before age 65 – for participants with at least 30 years of service: 75% of average compensation for participants with at least 55 years of age at retirement date. Amount reduced by .5% for each month the participant is under age 55 at time annuity begins.
 - Age 65 – if participants elected full supplement, annuity is the same as before age 65. Otherwise, annuity is reduced by .5% of average compensation at time of retirement multiplied by years of service.
 - Minimum Annuity – \$250 per month - if a participant terminates before rendering 10 years of service, the right to receive the portion of his accumulated plan benefits attributable to the University's contributions is forfeited. However, the employee is entitled to receive, in a lump-sum payment, the value of his accumulated contributions.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Retirement Benefits (continued)

- If a participant terminates after rendering 10 years of service, and does not withdraw his contributions, the participant receives a retirement annuity payable beginning at age 60 based on the applicable benefit formula.
- Refund may also be obtained after 10 years of service, but the vested benefit is lost.

Disability Benefits

- Employees who become disabled receive annual disability benefits regardless of service if disability is due to occupational causes or after 10 years of service if disability is due to non-occupational causes. If the employee is also eligible for a retirement annuity, the benefit payable is the higher of the two. Disability benefits are paid as follows:
 - Before age 65 – if service related 50% of final salary. If not services related, 30% of average compensation plus additional 1% for each year of service over 10.
 - After age 65 – reduced to amount payable as retirement annuity, if that amount is less than disability retirement annuity, but reduced annuity plus primary Social Security benefit may not be less than original disability annuity.

Death Benefits

- Pre-retirement death benefit – if the death of an employee is service related, a death benefit equal to 50% of the final annual salary plus \$120 (\$240 if widow not receiving benefit) per year for each child under age 18 (21 if at school) is paid to the employee's beneficiaries. Maximum family benefit is 75% of the employee's final annual salary. If death is non-service related, a lump-sum is paid equal to the employee's contributions plus one year's final salary, but not less than \$6,000.
- Post retirement death benefits – employee's contributions are refunded to the extent that they exceed retirement payments already made, unless reversionary annuity was elected. Minimum payment is \$600. In addition, 50% of retirement annuity is payable to surviving spouse until death or remarriage or until they become eligible for Social Security benefits. Minimum annuity, \$75 per month, maximum annuity, \$150 per month.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

2. Description of the System (continued)

Christmas Bonus

- A \$400 annual bonus is given to all retired participants.

3. Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments as of June 30, 2014 is as follows:

| | |
|----------------------------|----------------------------|
| Cash | \$11,197,229 |
| Cash equivalents: | |
| Short-term investment fund | 28,787,394 |
| | <u>\$39,984,623</u> |

Pursuant to present statutes, deposits of financial institutions, other than with Government Development Bank of Puerto Rico (GDB), shall be in banks designated by the Puerto Rico Secretary of the Treasury as depository institutions of public funds.

4. Investments

The following table presents the fair value of investments of marketable securities as of June 30, 2014:

| | |
|---------------------------------------|-------------------------------|
| Marketable securities: | |
| U.S. Government obligations | \$ 2,573,335 |
| U.S. Government agencies' obligations | 53,868,115 |
| Foreign bonds | 20,289,189 |
| Corporate bonds and other debentures | 64,214,954 |
| Foreign common stock | 137,950,172 |
| Common stock | 174,635,738 |
| Mortgage-backed securities | 62,677,909 |
| Municipal bonds | 1,871,750 |
| Commingled Fund Equity | 677,276,919 |
| Sovereign debt | 309,573 |
| Total | <u>\$1,195,667,654</u> |

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

No more than 5% of any debt issue may be purchased as an investment, with the exception of the U.S. government securities or its agencies. No more than 10% of the assets at cost may be invested in the securities of a single issuer, with the exception of the U.S. government securities or its agencies.

The custody of these investments is held by the trust department of a commercial bank in the name of the System and the portfolio is managed by Investment Management Organization.

The UPR's Government Board has adopted the following strategic asset allocation:

| Asset Class | % Allocated | Range |
|---------------------------|--------------------|--------------|
| Domestic Large Cap Equity | 40% | +/-5% |
| Domestic Small/Mid Cap | 10% | +/-3% |
| International Equity | 10% | +/-3% |
| Fixed Income | 28% | +/-3% |
| Loans and Mortgages | 12% | +/-3% |

The overall investment fund does not have a strategic asset allocation to cash but individual managers will hold varying amounts of cash within their respective portfolios as part of the normal course of managing the assets.

From time to time, when the operating cash flow has excess disbursements the Executive Director is authorized to sell securities on behalf of the Retirement System not exceeding \$6,500,000.00 (Certification No. 97, 2013-2014). This will be executed according to market fluctuations and rebalancing requirements of the portfolio without diverging from the Investment Policy.

The overall investment fund does not have a strategic allocation to private equity. However, the overall investment fund may, from time to time, examine private equity investments that it deems acceptable. If an allocation to private equity is made it will be funded from the domestic equity asset class. At no time, will the allocation exceed 5% of total fund assets.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Private equity funds include the following at June 30, 2014:

| | June 30, 2014 | | | Fair Value |
|-------------------------------------|-------------------------|----------------------|---------------------|---------------------|
| | Total Commitment | Contributions | Distribution | |
| Grupo Guayacán, Inc.: | | | | |
| Guayacán Fund of Funds I, LP | \$ 5,000,000 | \$ 4,764,049 | \$ 8,113,357 | \$ 10,412 |
| Guayacán Fund of Funds II, LP | 6,000,000 | 5,683,539 | 7,010,711 | 697,532 |
| Guayacán Fund of Funds III, LP | 5,000,000 | 3,482,763 | 630,468 | 3,535,692 |
| Advent-Morro Equity Partners Inc.: | | | | |
| Guayacán Private Equity Fund I, LP | 2,500,000 | 2,322,582 | 4,058,236 | 1,758,157 |
| Guayacán Private Equity Fund II, LP | 5,000,000 | 3,984,473 | 797,101 | 4,037,610 |
| DCC Growth Fund, LP | 2,000,000 | 2,000,000 | - | - |
| McCoy Investment Fund 2 | 15,000,000 | 7,454,755 | 2,498,906 | 6,562,740 |
| Total | \$40,500,000 | \$29,692,161 | \$23,108,779 | \$16,602,143 |

Credit Risk

Issuer credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Investments issued or explicitly guaranteed by the United States government are excluded. The System's policy requires and limits investments in debt securities to only those in the top investment grade ratings issued by a nationally recognized statistical rating organization. As of June 30, 2014, the System's credit quality distribution for securities was as follows:

| | Carrying Value | Rating |
|--------------------------------------|-----------------------|---------------|
| Foreign bonds | \$20,289,189 | Aaa to BB+ |
| Corporate bonds and other debentures | \$64,214,954 | Aaa to BBB- |
| Mortgage backed securities | 62,677,909 | Aaa to BB+ |
| Municipal bonds | 1,821,750 | Aaa to BBB |

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Custodial Risk

The custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the System will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custody of the commingled fund is located at another financial institution. Investments of the System, which are under custody of a depository finance institution, are as follows:

| Security Type | Carrying Value |
|--------------------------------------|-------------------------------|
| Mortgage backed securities | \$ 62,677,909 |
| Corporate bonds and other debentures | 64,214,954 |
| Common stocks | 174,635,738 |
| U.S. Government obligation | 2,573,335 |
| Treasury bonds and notes | 53,868,115 |
| Foreign common stocks | 137,950,172 |
| Foreign corporate bonds | 14,964,282 |
| Foreign government bonds | 5,324,907 |
| Commingled Fund Equity | 677,276,919 |
| Sovereign Debt | 309,573 |
| Municipal Bonds | 1,871,750 |
| Total | <u><u>\$1,195,667,654</u></u> |

Security Lending

The System has a Security Lending Agreement (the Agreement) with its investment custodian (the Custodian). In this Agreement, the University agrees to lend certain securities upon request of a borrower. The Custodian is the managing agent in this agreement where upon request of a borrower, the Custodian lends, as mentioned before, securities in exchange of collateral. Collateral may consist of cash, other approved securities and/or letter of credit from the borrower. The Custodian has unrestricted right to invest any cash collateral; also, the Custodian may commingle any approved securities held as collateral with any other securities held under custody on behalf of the University. Under the Agreement, the borrower is compelled to return the securities lend by the University upon termination of the loan term.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Security Lending (continued)

Under the Agreement as disclosed above, the System received in cash collateral \$88,785,830. This cash collateral has been reinvested, in accordance with the Agreement, in fixed income investments that are exposed to custodial credit risk as disclosed in the executed agreement.

During fiscal year 2008-2009, there was a default in a Lehman Brothers and Sigma floating rate note in which securities lending collateral had been invested. These funds are invested into a collective investment trust fund, and are included on the Statement Fiduciary of Net Position. The purpose of the separate account is to provide a reserve account to offset expected losses. At year-end, the Plan had an unrealized loss in the Securities Lending Collateral pool of \$1,341,986, and had accrued \$90,126,816 in the separate account.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of investment in a single issuer. Information regarding investment in any one issuer that represents five percent or more of the System's total investments must be disclosed under GASB No. 40, excluding investments issued or explicitly guaranteed by the United States government. The System's portfolio is not exposed to concentration of credit risk since the investment policies does not allow to invest in any single issuer more than 5% of the total portfolio, except for Government securities.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Interest-Rate Risk

Interest-rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value is to changes in market interest rates. As of June 30, 2014, the weighted average maturity by investment type in each fund follows:

| Investment Type | Weighted Average Maturity (Years) | Fair Value |
|--|--|-----------------------|
| Corporate Bonds | 2.432 | \$ 64,214,954 |
| Mortgage Backed Securities | 2.091 | 62,677,909 |
| Municipal Bonds | 0.066 | 1,871,750 |
| Foreign Bonds | 0.660 | 20,289,189 |
| US Government Bonds and other governmental instruments | 4.036 | 56,751,023 |
| | | <u>\$ 205,804,826</u> |

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Foreign Currency Risk

A System's exposure to foreign currency risk derives from its positions in foreign currency denominated equities and fixed income investments. The System's investment policy permits it to invest up to 15% of total investments in foreign currency denominated investments. The following is a listing of foreign assets included in the Statement of Fiduciary Net Position as of June 30th, 2014:

| Security Type | Currency | Maturity | Carrying Value |
|----------------------|-----------------------|-----------------|-----------------------|
| Common Stocks | Australia Dollar | Not Applicable | \$ 3,145,803 |
| Common Stocks | Bermuda Dollar | Not Applicable | 4,066,546 |
| Common Stocks | Brazil Real | Not Applicable | 706,780 |
| Common Stocks | Cayman Islands Dollar | Not Applicable | 2,327,268 |
| Common Stocks | Canada Dollar | Not Applicable | 3,819,727 |
| Common Stocks | Channel Island | Not Applicable | 733,479 |
| Common Stocks | China Yuan | Not Applicable | 4,526,945 |
| Common Stocks | Denmark | Not Applicable | 2,066,942 |
| Common Stocks | Finland | Not Applicable | 39,523 |
| Common Stocks | France Francs | Not Applicable | 8,185,799 |
| Common Stocks | Germany Marks | Not Applicable | 11,984,018 |
| Common Stocks | Hong Kong | Not Applicable | 913,650 |
| Common Stocks | Indian Rupee | Not Applicable | 2,057,347 |
| Common Stocks | Indonesia | Not Applicable | 801,242 |
| Common Stocks | Ireland Euro | Not Applicable | 2,234,344 |
| Common Stocks | Israeli New Shekel | Not Applicable | 735,274 |
| Common Stocks | Italy Lire | Not Applicable | 1,330,903 |

(Continued)

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Foreign Currency Risk (continued)

| Security Type | Currency | Maturity | Carrying Value |
|-----------------|-----------------------|-------------------------|----------------|
| Common Stocks | Japan Yen | Not Applicable | 26,363,605 |
| Common Stocks | Korean Won | Not Applicable | 1,255,338 |
| Common Stocks | Luxembourg Euro | Not Applicable | 1,000,245 |
| Common Stocks | Mexico Peso | Not Applicable | 688,504 |
| Common Stocks | Netherlands Euro | Not Applicable | 4,010,836 |
| Common Stocks | Norway Euro | Not Applicable | 1,634,247 |
| Common Stocks | Singapore | Not Applicable | 2,330,110 |
| Common Stocks | Spain Euro | Not Applicable | 2,034,461 |
| Common Stocks | Sweden | Not Applicable | 2,170,057 |
| Common Stocks | Switzerland | Not Applicable | 15,563,057 |
| Common Stocks | Taiwan | Not Applicable | 996,175 |
| Common Stocks | United Kingdom Pounds | Not Applicable | 30,227,946 |
| Corporate Bonds | Australia Dollar | 07/17/2015 – 09/30/2043 | 1,858,775 |
| Corporate Bonds | Brazil | 11/06/2017 | 200,388 |
| Corporate Bonds | Cayman Islands Dollar | 01/27/2016 - 12/15/2021 | 973,858 |
| Corporate Bonds | Canada Dollar | 11/10/2014 - 06/15/2024 | 3,617,588 |
| Corporate Bonds | Chile | 03/06/2015 | 1,104,570 |

(Continued)

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Foreign Currency Risk (continued)

| Security Type | Currency | Maturity | Carrying Value |
|--------------------|-----------------------|-------------------------|-------------------------------------|
| Corporate Bonds | France | 10/22/2023-02/16/2044 | 777,750 |
| Corporate Bonds | Italy | 06/26/2024 | 404,728 |
| Corporate Bonds | Japan | 03/17/2017 | 262,982 |
| Corporate Bonds | Mexico Peso | 05/03/2019 - 01/18/2024 | 755,050 |
| Corporate Bonds | Neth. Antilles | 01/12/2023 | 103,993 |
| Corporate Bonds | Netherlands | 03/07/2017-09/25/2023 | 740,904 |
| Corporate Bonds | Norway | 01/15/2024-03/01/2024 | 435,425 |
| Corporate Bonds | Sweden | 04/04/2019 | 257,402 |
| Corporate Bonds | Switzerland | 01/23/2015 – 05/06/2044 | 2,013,073 |
| Corporate Bonds | United Kingdom Pounds | 03/31/2017-02/19/2043 | 1,457,798 |
| Governmental Bonds | Austria | 06/07/2015 | 796,976 |
| Governmental Bonds | Brazil | 01/22/2021-01/07/2025 | 534,716 |
| Governmental Bonds | Canada | 02/27/2019 | 140,437 |
| Governmental Bonds | Germany | 04/08/2016-11/20/2018 | 1,578,881 |
| Governmental Bonds | Netherlands | 11/03/2014 | 545,583 |
| Governmental Bonds | Norway | 10/31/2016 | 646,394 |
| Governmental Bonds | Supranational | 10/18/2016-06/15/2018 | 1,081,920 |
| Total | | | <u><u>\$ 158,239,360</u></u> |

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

4. Investments (continued)

Risk and Uncertainty

The Retirement Fund invests in various marketable securities. These are exposed to various risks; due to the level of risk inherent in securities it is possible that changes in the values of these securities could occur in the near term and that such changes could affect the amounts reported in the Statement.

5. Capital Assets

Property and equipment additions are recorded at cost. Depreciation is provided using the straight-line method over the useful life of the asset. For the year ended June 2014, changes in property and equipment, consisted of the following:

| | Beginning Balance at June 30, 2013 | Additions | Retirements | Ending Balance at June 30, 2014 |
|-------------------------------|---|-------------------------|---------------------------|--|
| Building | \$3,811,940 | \$ – | \$ – | \$3,811,940 |
| Equipment | 465,606 | – | (186,492) | 279,113 |
| Foreclosure Homes | 277,627 | 226,404 | (43,939) | 460,093 |
| | <u>4,555,173</u> | <u>226,404</u> | <u>(230,431)</u> | <u>4,555,147</u> |
| Less accumulated depreciation | (921,310) | – | 44,416 | (876,894) |
| | <u><u>\$3,633,863</u></u> | <u><u>\$226,404</u></u> | <u><u>\$(186,015)</u></u> | <u><u>\$3,674,252</u></u> |

6. Medical Insurance

The System reimbursed each retiree up to a maximum of \$125 monthly for medical plan expenses. For the year ended June 30, 2014 the medical plan expenses amounted to **\$8,247,730**. Medical expenses are paid by the retiree and reimbursed by the University of Puerto Rico.

7. Related Party Transactions

All employer contributions of the System are received from the University. In addition, the University reimburses the System for certain medical insurance expenses.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

8. Net Pension Liability of the Plan

The components of the net pension liability of the Plan at June 30, 2014, were as follows (in thousands):

| | |
|---|----------------------------|
| Total pension liability | \$ 3,428,068 |
| Fiduciary net position | (1,324,028) |
| Fiduciary's net pension liability | <u>\$ 2,104,040</u> |
| | |
| Fiduciary net position as a percentage of the total pension liability | 38.62% |

Actuarial Assumptions

The total pension liability was determined by an actuarial valuation as of June 30, 2013, using the following actuarial assumptions, applied to all periods included in the measurement:

| | |
|---------------------------|--|
| Inflation | 3.5 percent |
| Salary increases | 5.0 percent average, including inflation |
| Investment rate of return | 8.0 percent, net of pension plan investment expense, including inflation |

Mortality rates were based on the RP-2000 Healthy Annuitant Mortality Table, projected to 2018, as appropriate, with adjustments for mortality improvements based on Scale AA.

The actuarial assumptions used in the June 30, 2013, valuation were based on the results of an actuarial experience of the System. The result was rolled forward using standard actuarial techniques to the measurement date as of June 30, 2014.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

8. Net Pension Liability of the Plan (continued)

The long-term expected rate of return on pension plan investments was determined using log normal distribution analysis in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the pension plan's target asset allocation as of June 30, 2014 (see the discussion of the pension plan's investment policy) are summarized in the following table:

| Asset Class | Long-Term Expected Real Rate of Return |
|---------------------------|---|
| Domestic large cap equity | 6.5% |
| International equity | 7.0% |
| Domestic small cap equity | 7.9% |
| Fixed income | 0.8% |
| Real estate | 1.0% |
| Loan and mortgages | 5.7% |

Discount Rate

The discount rate used to measure the total pension liability was 5.31 percent. The projection of cash flows used to determine the discount rate assumed that plan member contributions will be made at the current contribution rate and that the Plan contributions will be made at rates equal to the difference between actuarially determined contribution rates and the member rate.

Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members until the plan year ending June 30, 2027. Therefore, the long-term expected rate of return on pension plan investments of 8% was applied to all periods of projected benefit payments through June 30, 2027 and the applicable municipal bond index rate of 4.35%, based on the Bond Buyer General Obligation 20-year Municipal Bond Index published monthly by the Board of Governors of the Federal Reserve System as of June 30, 2014, was applied to all periods of projected benefit payments after June 30, 2027. The Single Equivalent Interest Rate (SEIR) of 5.31% that discounts the entire projected benefit stream to the same amount as the sum of the present values of the two separate benefit payments streams was used to determine the total pension liability as of June 30, 2014.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

8. Net Pension Liability of the Plan (continued)

Discount Rate (continued)

The SEIR at the beginning of the measurement period was 5.24% based on the long-term expected rate of return on pension plan investments of 8% applied to all periods of projected Page 5 benefit payments through June 30, 2027 and the applicable municipal bond index rate of 4.27% as of June 30, 2013 applied to all periods of projected benefit payments after June 30, 2027.

Sensitivity of the Net Pension Liability of Changes in the Discount Rate

The following the net pension liability of the Plan, calculated using the discount rate of 5.31 percent, as well as the Plan's net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (4.31 percent) or 1-percentage-point higher (6.31 percent) than the current rate:

| | 1% Decrease (4.31%) | Current Discount Rate (5.31%) | 1% Increase (6.31%) |
|-----------------------|------------------------------------|--|------------------------------------|
| Net pension liability | \$2,247,062 | \$2,104,040 | \$1,788,340 |

9. Subsequent Events

Development of the Actuarial Value of Assets

Based on the most recent experience study of the Retirement System, the actuarial assumptions and methods used in the valuation of assets will change for fiscal year 2015. The following changes to the assumptions have been adopted by the Government Board for the fiscal year 2015:

- Change assumed rates of termination from age-based to service-based rates
- Reduce assumed rates of retirement (refers to % of retirement)
- Reduce assumed rates of disability retirement
- Update mortality to RP-2000 projected to 2020
- Reduce assumed salary increases to 3.75%

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

9. Subsequent Events (continued)

Development of the Actuarial Value of Assets (continued)

- Reduce assumed rate of investment return to 7.75% (for purposes of loan and payment plans rate will be maintained at 8%)
- Reduce price inflation assumption to 3%
- Reduce wage inflation assumption to 3.75%
- Reduce payroll growth assumption to 3%
- Increase administrative expense load to .7% of payroll

Effective March 17, 2014, the compensation limit for Certification 139 was frozen at \$69,556.44. Effective January 1, 2015, the formula for Non-Occupational Disability was amended to increase vesting from 10 years to 15 years and benefit paid would be based on 90% of what their merit pension will be.

Required Supplementary Information
(Unaudited)

University of Puerto Rico Retirement System

Schedule 1 – Schedule of Changes in the Net Pension Liability

Fiscal Year Ended June 30, 2014

(In thousands) (Unaudited)

| | |
|---|---------------------|
| Total Pension Liability: | |
| Service cost | \$ 49,499 |
| Interest | 173,630 |
| Changes in benefit terms | – |
| Differences between expected and actual experience | (24,034) |
| Changes in assumptions | – |
| Benefit payments, including refunds of member contributions | (169,163) |
| Net change in total pension liability | 29,932 |
| Total pension liability, beginning | 3,398,136 |
| Total pension liability, ending (a) | \$ 3,428,068 |
| Fiduciary Net Position: | |
| Contributions - employer | \$ 91,689 |
| Contributions - member | 37,900 |
| Net investment income | 206,595 |
| Benefit payments | (169,163) |
| Administrative expenses | (4,566) |
| Net change in plan net position | 162,455 |
| Fiduciary net position, beginning | 1,161,573 |
| Fiduciary net position, ending | \$ 1,324,028 |
| Employer's Net Pension Liability - Ending (a) - (b) | \$ 2,104,040 |

See notes to required supplementary information.

University of Puerto Rico Retirement System

Schedule 2 – Schedule of the Net Pension Liability

Year Ended June 30, 2014

(In thousands) (Unaudited)

| Actuarial Valuation Date | (1) Total Pension Liability | (2) Fiduciary Net Position | (3) Employer's Net Pension Liability (1) - (2) | (4) Plan Fiduciary Net Position as a % of the Total Pension Liability (2)/(1) | (5) Covered Employee Payroll | (6) Net Pension Liability as a % of Covered Payroll (3)/(5) |
|---|--|---|---|--|---|--|
| June 30, 2013 | \$ 3,428,068 | \$ 1,324,028 | \$ 2,104,040 | 38.62% | \$ 515,856 | 407.87% |

See notes to required supplementary information.

University of Puerto Rico Retirement System

Schedule 3 – Schedule of Employer Contributions

Last 10 Years

(Dollar values expressed in thousands) (Unaudited)

| Fiscal Year Ended June 30 | Actuarial Determined Contribution (ADC) | Contributions in Relation to the Actuarial Determined Contribution | Contribution Deficiency (Excess) | Covered Employee Payroll | Contributions as a Percentage of Covered Payroll (1) |
|--------------------------------------|--|---|---|---|---|
| 2014 | \$ 78,204 | \$ 91,689 | \$ (13,485) | \$ 515,856 | 17.77% |
| 2013 | 77,772 | 78,481 | (709) | 491,291 | 15.97% |
| 2012 | 77,186 | 75,140 | (2,954) | 491,063 | 15.30% |
| 2011 | 68,487 | 70,761 | (2,274) | 526,820 | 13.43% |
| 2010 | 63,722 | 71,177 | (7,455) | 558,961 | 12.73% |
| 2009 | 64,072 | 72,605 | (8,533) | 577,227 | 12.58% |
| 2008 | 59,246 | 81,553 | (22,307) | 543,538 | 15.00% |
| 2007 | 57,524 | 78,311 | (20,787) | 518,237 | 15.11% |
| 2006 | 55,400 | 73,658 | (18,258) | 490,263 | 15.02% |
| 2005 | 84,672 | 69,291 | 15,381 | 460,174 | 15.06% |

(1) ADC Rate for each fiscal year comes from actuarial valuation at start of that fiscal year (e.g., the June 30, 2014, Required Contribution was established in the June 30, 2013 actuarial valuation).

See notes to required supplementary information.

University of Puerto Rico Retirement System

Schedule 4 – Schedule of Investment Returns

Year Ended June 30, 2014

(Unaudited)

Annual Money-Weighted Rate of Return, net of investment expense: 17.8%

See notes to required supplementary information.

University of Puerto Rico Retirement System

Notes to Required Supplementary Information

June 30, 2014

1. Factors that Significantly Affect Trends in Amounts Reported

For the periods presented, there were no changes of benefit terms, changes in the size or composition of the population covered by the benefit terms, or changes of assumptions which significantly affect trends in the amounts reported.

2. Method and Assumptions Used in Calculations of Actuarially Determined Contributions

The actuarially determined contribution rates in the Schedule of Employer's Contributions are calculated as of June 30, two years prior to the end of the fiscal year in which contributions are reported. The following actuarial methods and assumptions were used to determine contribution rates reported in that schedule:

| Plan | Plan Employees |
|-------------------------------|-----------------------------------|
| Valuation date | June 30, 2013 |
| Actuarial cost method | Entry age normal |
| Amortization method | Level percentage of payroll, open |
| Remaining amortization period | 30 years |
| Asset valuation method | 5-year smoothed market |
| Actuarial assumptions: | |
| Investment rate of return | 8% |
| Projected salary increases | 5%, including inflation |

**Report on Independent Auditors on Internal Control
Over Financial Reporting and on Compliance and Other Matters
Based on an Audit of the Financial Statements
Performed in Accordance with *Government Auditing Standards***

The Government Board of
the University of Puerto Rico Retirement Systems

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of University of Puerto Rico Retirement Systems (the System), which comprise the statement of fiduciary net position, as of June 30, 2014, and the statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 31, 2015.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal controls that is less secure than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weakness may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Ernst + Young LLP

March 31, 2015

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of this report.

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