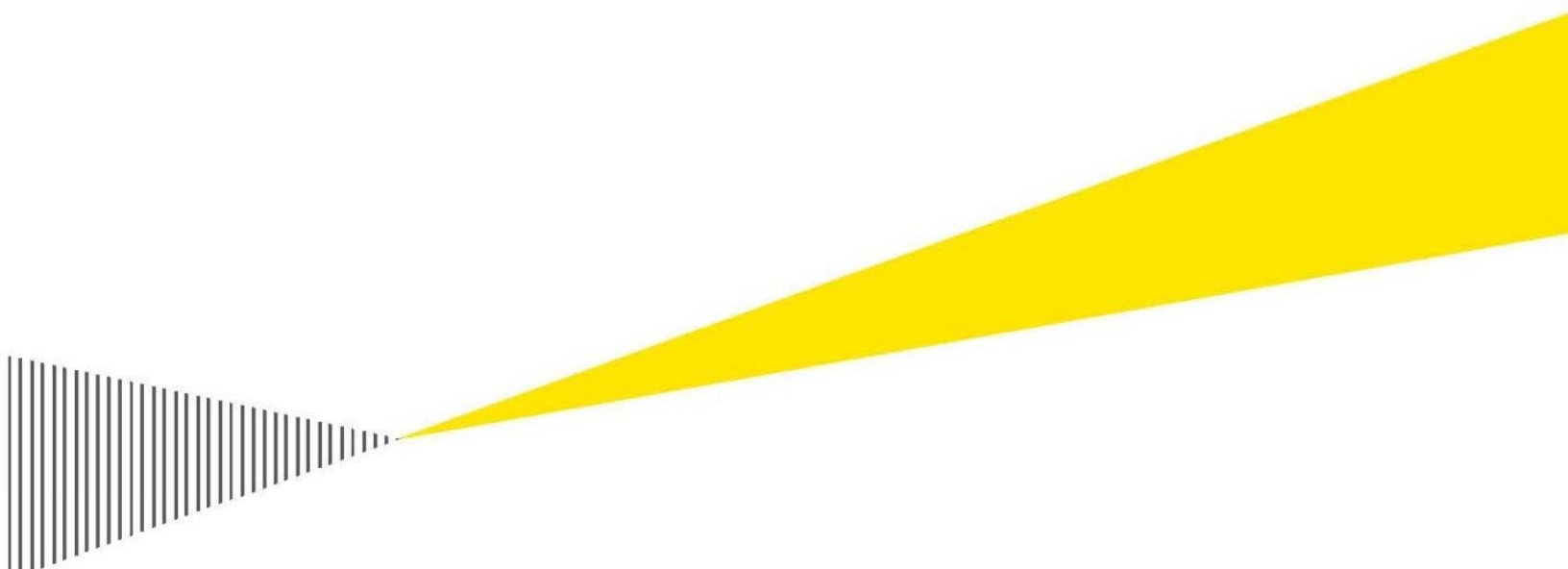


AUDITED FINANCIAL STATEMENTS  
AND REQUIRED SUPPLEMENTARY  
INFORMATION

University of Puerto Rico Retirement System  
Years Ended June 30, 2016 and 2015  
With Report of Independent Auditors



# University of Puerto Rico Retirement System

## Audited Financial Statements and Required Supplementary Information

Years Ended June 30, 2016 and 2015

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## Report of Independent Auditors

Government Board  
of the University of Puerto Rico Retirement System

### **Report on the Financial Statements**

We have audited the accompanying financial statements of the University of Puerto Rico Retirement System (the “System”), which comprise the statements of fiduciary net position as of June 30, 2016 and 2015, and the related statements of changes in fiduciary net position for the years 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 audits. We conducted our audits 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 audits 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 net position of the System at June 30, 2016 and 2015, and the changes in its fiduciary net position for the years then ended in conformity with U.S. generally accepted accounting principles.

### **The System's Ability to Continue as a Going Concern**

The accompanying financial statements have been prepared assuming that the System will continue as a going concern. As discussed in Note 2 to the financial statements, the System is highly dependent on funding from the University of Puerto Rico (the "University") which receives its funding from the Commonwealth of Puerto Rico (the "Commonwealth") appropriations to finance its operations. The financial difficulties experienced by the Commonwealth, including uncertainty as to its ability to fully satisfy its obligations, also raises substantial doubt about the System's ability to continue as a going concern.

Management's plans in regard to these matters are described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. 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 17 and the required supplementary information on pages 56 through 59 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 April 27, 2018, 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*

April 27, 2018

Stamp No. E318318  
affixed to  
the original  
of this report.

# University of Puerto Rico Retirement System

## Management's Discussion and Analysis (Unaudited)

Years Ended June 30, 2016 and 2015

### ***Introduction***

The University of Puerto Rico (the "University") was organized through Law No. 135 of May 7, 1942, known as the Act of the University (superseded by Act Number 1 of January 20, 1966 as amended (the "Act No. 1")), as a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the "Commonwealth"). On February 16, 1945 the University's Council on Higher Education, with the University's endorsement and consent, enacted a resolution to create, maintain, finance and manage the University of Puerto Rico Retirement Plan (the "System") effective January 1, 1945 in order to provide pension benefits to all university employees. The Act No. 1 designated the Governing Board as Trustee with the faculty to govern the System. In addition, the Governing Board appointed the System's Board to oversee the System administration and an Executive Director to manage its everyday affairs in accordance with the faculties and provisions of Certification Number 27 (1973-74), as amended. The System has functioned pursuant to the terms and conditions of Act No. 1 and Certification Number 27.

Our discussion and analysis of the System's financial performance provides an overview of the System's financial activities for the fiscal years ended June 30, 2016 and 2015.

### ***Financial Highlights***

- The Retirement Fund reflected a 3.93% when compared to its benchmark of 1.36%, while in fiscal year 2015 reflected a 5.61% return over its benchmark of 4.61% for that year.
- Sustainability ratio increased from 40.8% in fiscal year 2013, to 43.9% in fiscal year 2014, 46.6% in fiscal year 2015, and 47.50% in fiscal year 2016 demonstrating continued progress in the financial position.
- Fund performance ranked 1st and 2nd when compared against the Callan Associates peer comparison nationwide Callan Associates public fund database for June 2014, June 2015 and June 2016 respectively. Database consists of approximately 300+ public funds in the past 24 months.
- System's assets are \$1,332,667,783, \$1,342,996,274, and \$1,324,028,384,140 at the close of fiscal years 2016, 2015 and 2014, respectively (reported as net position). Marketable securities are held in a separate account to meet future benefit payments.

## University of Puerto Rico Retirement System

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

- The component of Additions to Fiduciary Net Position in the year 2016 is comprised of contributions of **\$116,643,497**, net investments income of **\$59,717,584**. The System administered **\$10,293,021** in reimbursements from the University of Puerto Rico for retirees' medical insurance (maximum reimbursed amount of \$125 per retiree per month).
- Total additions to Fiduciary Net Position in fiscal year 2016 were **\$186,654,102** compared to \$211,932,762 in fiscal year 2015 and \$343,958,751 in fiscal year 2014. The decrease in additions in fiscal year 2016 was mainly caused by lower employer contributions, and a decrease in net appreciation in fair value of investments due to market conditions from **\$58,444,468** in fiscal year 2015 compared to **\$38,990,044** in fiscal year 2016.
- Deductions to Fiduciary Net Position in fiscal year 2016 were **\$196,982,594** compared to \$192,964,872 in fiscal year 2015 and \$181,503,508 in fiscal year 2014. The increase was mainly caused by benefits paid to participants of **\$182,614,074** in fiscal year 2016, compared to \$176,871,770 in fiscal year 2015. Retirees receiving benefits increased to **8,418** at the end of fiscal year 2016 vs. 8,247 at the end of fiscal year 2015 and 8,082 in fiscal year 2014.

#### ***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 position. 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 position 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 of the System during the year ended June 30, 2016 decreased by approximately **\$10.33** million a decrease of **-.77%** against prior year (see Statements of Changes in Fiduciary Net Position for details). For fiscal year 2016 total assets decreased **\$79.6** million or **-5.22%** from prior year due to lower employer contributions, the sale of investments, and market conditions. For fiscal year 2015 total assets decreased \$1.74 million or **-.11%** from prior year.

#### Statements of Fiduciary Net Position

	June 30, 2014	June 30, 2015	June 30, 2016	2014-2015 Percentage Change	2015-2016 Percentage Change
<b>Assets</b>					
Cash	\$ 39,984,623	\$ 22,329,050	\$ 21,455,730	-44.16%	-3.91%
Receivables	41,075,631	51,810,197	37,111,826	26.13%	-28.37%
Investments	1,195,667,654	1,230,353,693	1,112,522,116	2.90%	-9.58%
Alternative investment	16,602,143	18,653,369	89,323,115	12.36%	378.86%
Securities lending cash collateral	88,785,830	59,665,343	41,192,853	-32.80%	-30.96%
Loans to plan members	124,365,792	123,400,063	127,624,233	-0.78%	3.42%
Other net of allowances	16,852,940	15,505,688	13,119,934	-7.99%	-15.39%
Capital assets	3,674,252	3,548,760	3,326,222	-3.42%	-6.27%
<b>Total assets</b>	<b>\$ 1,527,008,865</b>	<b>\$ 1,525,266,163</b>	<b>\$ 1,445,676,029</b>	<b>-0.11%</b>	<b>-5.22%</b>
<b>Liabilities</b>					
Accounts payable and accrued expenses	\$ 43,847,229	\$ 45,086,870	\$ 6,086,875	2.83%	-86.50%
Obligations under securities lending	90,126,816	60,946,003	42,416,316	-32.38%	-30.40%
Escrow deposits on mortgage loans	265,173	362,327	327,086	36.64%	-9.73%
Other deposits	3,119,655	3,584,486	3,797,540	14.90%	5.94%
Payables for acquisition of investments	65,621,608	72,290,203	60,380,430	10.16%	-16.47%
<b>Total liabilities</b>	<b>202,980,481</b>	<b>182,269,889</b>	<b>113,008,247</b>	<b>-10.20%</b>	<b>-38.00%</b>
<b>Net assets</b>	<b>\$ 1,324,028,384</b>	<b>\$ 1,342,996,274</b>	<b>\$ 1,332,667,782</b>	<b>1.43%</b>	<b>-0.77%</b>



# University of Puerto Rico Retirement System

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

### Statements of Changes in Fiduciary Net Position

	June 30, 2014	June 30, 2015	June 30, 2016	2014-2015 Percentage Change	2015-2016 Percentage Change
<b>Additions:</b>					
Contributions	\$ 129,588,674	\$ 123,844,672	\$ 116,643,497	-4.43%	-5.81%
Net Investment income	206,079,218	76,159,267	59,717,584	-63.04%	-21.59%
Medical insurance reimbursements from the University of Puerto Rico	8,247,730	11,403,965	10,293,021	38.27%	-9.74%
<b>Total additions</b>	<b>343,915,622</b>	<b>211,407,904</b>	<b>186,654,102</b>	<b>-38.53%</b>	<b>-11.71%</b>
<b>Deductions:</b>					
Benefits paid to participants	169,162,756	176,871,770	182,614,074	4.56%	3.25%
General and administrative expenses	4,049,892	4,164,280	4,075,499	2.82%	-2.13%
Medical insurance expenses paid to retirees from University of Puerto Rico	8,247,730	11,403,965	10,293,021	38.27%	-9.74%
<b>Total deductions</b>	<b>181,460,378</b>	<b>192,440,015</b>	<b>196,982,594</b>	<b>6.05%</b>	<b>2.36%</b>
<b>Net increase in net position restricted for pension</b>	<b>\$ 162,455,244</b>	<b>\$ 18,967,889</b>	<b>\$ (10,328,492)</b>	<b>-88.32%</b>	<b>-154.45%</b>

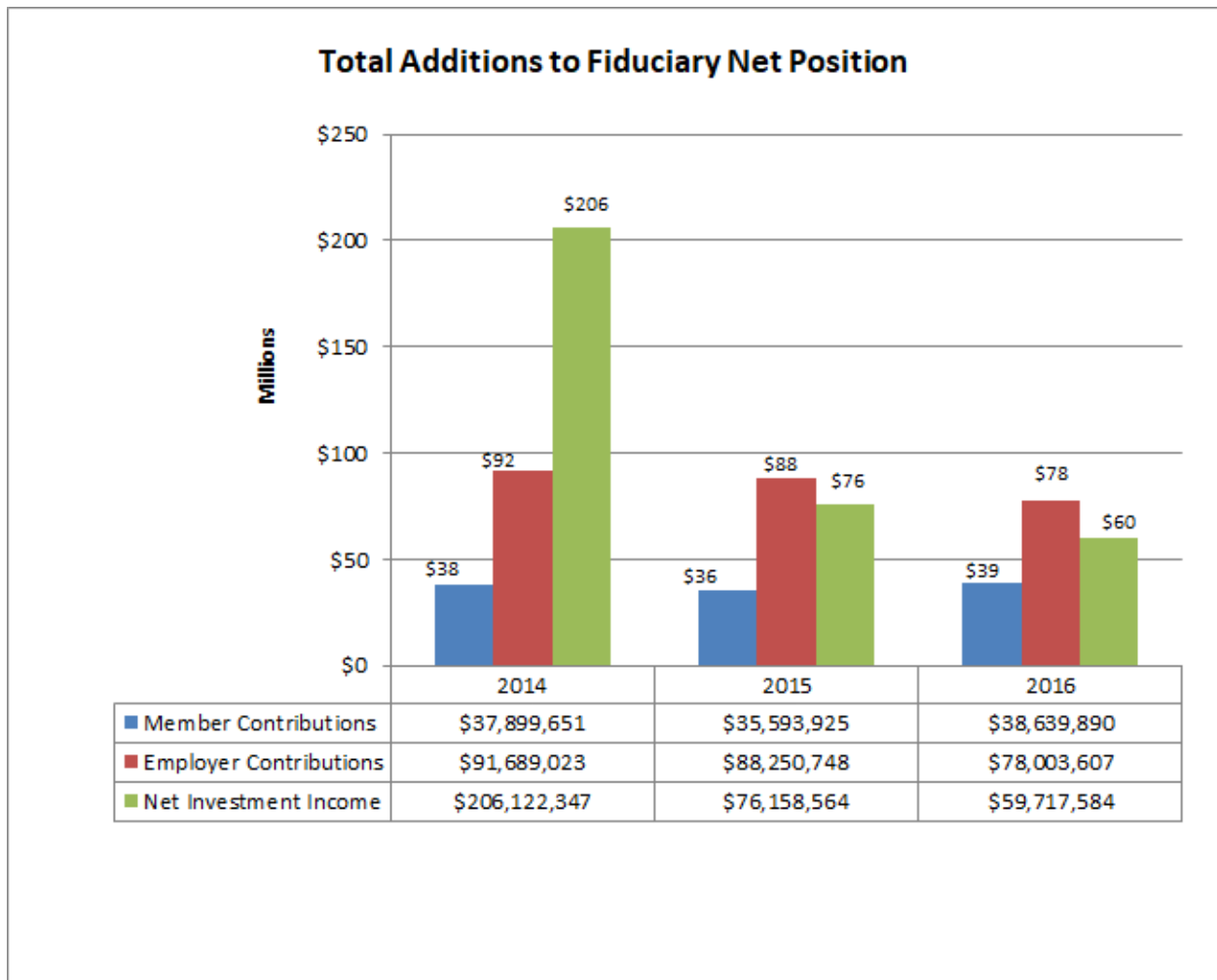
### *Contributions and Net Investment Income*

The funds needed to finance retirement benefits are obtained through employer and employee contributions and through net investment income. Contributions and net investment income for fiscal year 2016 amounted to approximately **\$176.37** million compared to \$200.0 million for fiscal year 2015. The decrease was mainly caused by lower employer contributions during fiscal year 2016 therefore an increase in sales of investments.

## University of Puerto Rico Retirement System

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

Contributions paid by employees approximated **\$38.6** million, \$35.6 million and \$37.9 million for the years ended June 30, 2016, 2015 and 2014, respectively. This represented an increase of approximately **\$3.0** million dollars or 8.56% for 2016 and a decrease of \$(2.3) million or (6.08) % for 2015.



## 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.

Total general and administrative expenses for the System during fiscal year 2016, 2015 and 2014, amounted to \$4,075,499, \$4,164,280 and \$4,049,892, respectively, a decrease of **\$88,781** or **(2.13)%** in 2016 and an increase \$114,388 or 2.82% in 2015. As of July 1, 2015 investment custodian expenses were reclassified to be included and considered as part of the total investment expenses since these costs are exclusively associated with the trading and other transactions of the Retirement Fund.

#### *Actuarial Standards*

Actuarial calculations are based on the current provisions of the System and on actuarial assumptions that are as of June 30, 2015 and 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 determine the actuarial amounts contained in this 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 Retirement Fund assets, liabilities, and resulting net position where  $\text{Assets-Liabilities} = \text{Net Position}$  held in trust for pension benefits available at the end of the fiscal year. It is a snapshot of the financial position of the Retirement Fund at that specific point in time.
- The Statement of Changes in Fiduciary Net Position summarizes the Retirement Fund financial transactions that have occurred during the fiscal year where  $\text{Additions-Deductions} = \text{Net Change in Net Position}$ . 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:

<b>Membership</b>	<b>2016</b>	<b>2015</b>
Inactive members or their beneficiaries currently receiving benefits	8,417	8,247
Inactive members entitled to but not yet receiving benefits	8,588	8,428
Active members	10,438	10,644
Total	27,443	27,319

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.

The discount rate used to measure the total pension liability was 5.89% as of June 30, 2016 compared to 6.37% on June 30, 2015. 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. For years beginning June 30, 2016 the contribution rates reflect amortization of the System’s unfunded actuarial accrued liability over a closed 40 – year period from that date as adopted by the University’s Board of Governors

## University of Puerto Rico Retirement System

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

Certification 146 (2014-2015) beginning on June 30, 2015. 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, 2060. Therefore, the long-term expected rate of return on pension plan investments of 7.75% was applied to all periods of projected benefit payments through June 30, 2045 and the applicable municipal bond index rate of 3.01%, 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, 2016, was applied to all periods of projected benefit payments after June 30, 2045. The Single Equivalent Interest Rate (SEIR) of 5.89% 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, 2016. The SEIR at the beginning of the measurement period was 6.37% based on the long-term expected rate of return on pension plan investments of 7.75% applied to all periods of projected benefit payments through June 30, 2044 and the applicable municipal bond index rate of 3.82% as of June 30, 2015 applied to all periods of projected benefit payments after June 30, 2044.

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

The Schedule of Changes in the University of Puerto Rico's Net Pension Liability (page 56) presents sources of changes in the net pension liability. The Schedule of the University of Puerto Rico's Net Pension Liability (page 57) 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 the University of Puerto Rico's Contributions (page 58) 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 59) 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 **\$38.99** million during fiscal year 2016, as compared to fiscal year 2015 when it appreciated by \$58.45 million and \$187.99 million in 2014. The net investment income for fiscal year 2016 amounted to \$59.72 million a decrease of \$16.44 million or (21.59)% compared to a net investment income of \$76.16

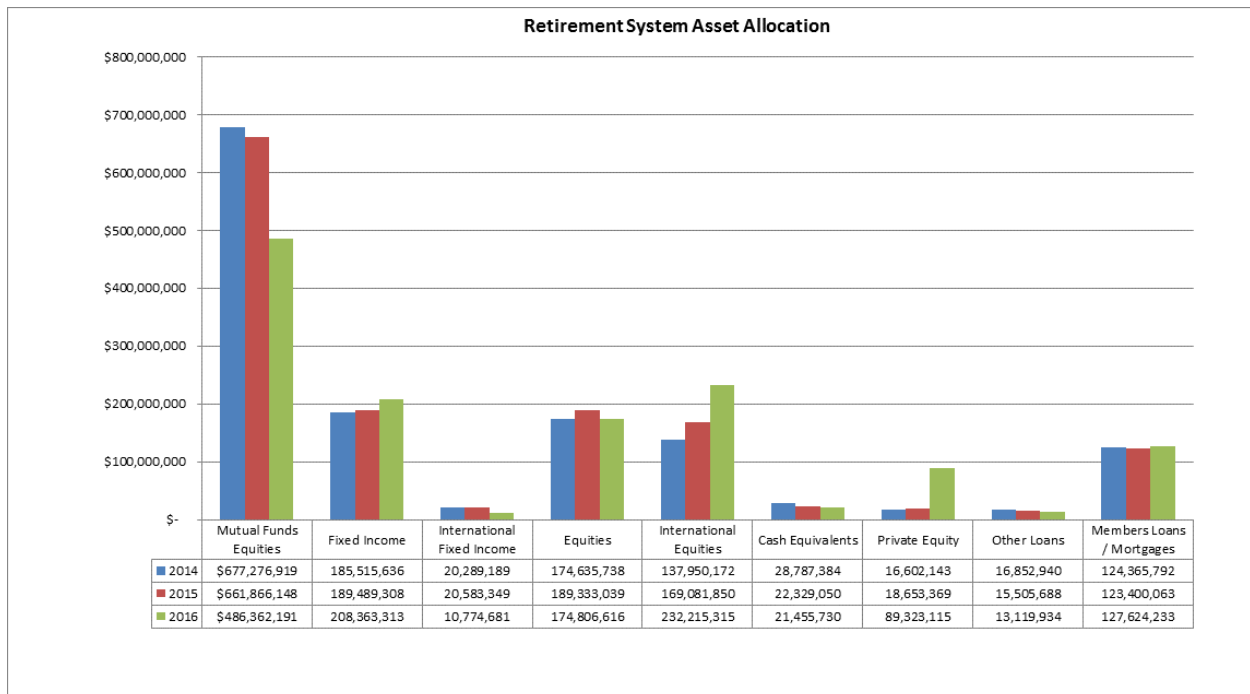
## University of Puerto Rico Retirement System

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

million in fiscal year 2015 and \$206.08 million in fiscal year 2014, a decrease of \$130 million as compared to previous year . The decrease was caused by changes in investment market conditions. Total investment expenses during fiscal year 2016 of **\$3,712,755** increased by **\$67,750** or **1.86 %** as compared to fiscal year 2015 and a decrease of \$27,512 or (.75)% as compared to fiscal year 2014.

#### *Asset Allocation of the University of Puerto Rico Retirement System*

The System’s Retirement Fund comprises of more than **96.4%** of the total plan assets. Most of the assets are invested in marketable securities. The investment fund has **66.54%** of its assets in stocks and **15.52%** in fixed income investments, **10.48%** loans to participants, **.80%** in international fixed income, and **6.65%** in private equity investments for the year ended June 30, 2016. 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, 2016, 2015 and 2014:



## University of Puerto Rico Retirement System

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

#### *Benefits Paid and Liabilities*

For the fiscal year 2016, pension benefits paid to retirees and beneficiaries were approximately **\$182.61** million, which represents an increase of approximately **\$5.74** million or **3.2%** when compared to the prior year. For the fiscal year 2015, pension benefits paid to retirees and beneficiaries were approximately \$176.9 million, which represents an increase of approximately \$7.7 million or 4.56% when compared to the fiscal year 2014.

As of June 30, 2016, the Active members and Retired members were **10,438** and **8,417** respectively, as compared to 10,644 and 8,247 as of June 30, 2015.

During fiscal year 2016, total liabilities were **\$113.01** million, which represents a decrease of **\$69.29** million or **38%** when compared to prior year. 40% of our total liabilities consist of unsettled transactions. During fiscal year 2015, total liabilities were \$182.3 million, which represents an increase of \$20.7 million or 10.2% when compared to prior year. 53% of our total liabilities consist of unsettled investment transactions. Overall, liabilities 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 2016, reported a negative net position of **(\$10.32)** million due to a decrease in employer contributions and the investments market conditions. These investments presented positive returns that amounted to approximately \$59.01 million compared to 76.70 the previous year.

Fiscal year 2015, reported a positive in net position of \$19.0 million due to the return of investments held by the Plan as these investments presented positive returns that amounted to approximately \$76.7 million.

#### *Economic Factors*

The Puerto Rico economy has been in a recession since 2006. There has been an overall contraction in sectors of Puerto Rico's economy, principally within the manufacturing and construction sectors, coupled with declines in retail sales, budget shortfalls and diminished consumer buying power resulting in higher costs of living.

## University of Puerto Rico Retirement System

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

The Commonwealth's recurring deficits, negative financial position, further deterioration of its economic condition (a prolonged economic recession which commenced in 2006), and inability to access the credit markets raise substantial doubt about the Commonwealth's ability to continue as a going concern. The significant financial difficulties being experienced by the Commonwealth has a significant adverse impact on the University, given its reliance on Commonwealth appropriations.

The Commonwealth and several of its component units face significant risks and uncertainties, including liquidity risk. The risks and uncertainties facing the Commonwealth, together with other factors, have led the Commonwealth's management to conclude that there is substantial doubt as to the ability of the primary government and of various discretely presented component units, to continue as a going concern. In addition, the Commonwealth's management believes that the pension trust funds, included as part of the fiduciary funds, carry a substantial risk of insolvency, if measures are not taken to significantly increase contributions to such funds.

The Commonwealth's very high level of debt and unfunded pension liabilities and the resulting required allocation of revenues to service debt and pension obligations have contributed to significant budget deficits during the past several years, which deficits the Commonwealth has financed, further increasing the amount of its debt. These matters and the Commonwealth's liquidity constraints, among other factors, have adversely affected its credit ratings and its ability to obtain financing at reasonable interest rates, if at all. As a result, the Commonwealth had relied more heavily on short-term financings and interim loans from the GDB, and other instrumentalities of the Commonwealth, which reliance has constrained the liquidity of the Commonwealth in general and the GDB, and increased near-term refinancing risk. These factors, among others, have also resulted in the non-payment by the Commonwealth and its instrumentalities of most of their outstanding debt obligations, including the outstanding GDB lines of credit which caused the discontinuance of GDB to provide liquidity to the Commonwealth and instrumentalities, such as the University, and have caused the default of GDB's debt obligations.



## University of Puerto Rico Retirement System

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

In addition, although neither the Commonwealth nor its component units, including the University, are eligible to seek relief under Chapter 9 of the United States Bankruptcy Code, on June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). PROMESA grants the Commonwealth and its component units access to an orderly mechanism to restructure their debts in exchange for significant federal oversight over the Commonwealth's finances. In broad terms, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board (the Oversight Board), relief from creditor lawsuits through the enactment of a temporary stay on litigation, and two alternative methods to adjust unsustainable debt.

PROMESA contains two methods to adjust Puerto Rico's debts. The first method is a streamlined process to achieve modifications of financial indebtedness with the consent of a supermajority of affected financial creditors (Title VI of PROMESA). This method has benefits such as potential speed relative to a traditional restructuring through a formal in-court process. The second method is a court-supervised debt-adjustment process, which is modeled on Chapter 9 of the U.S. Bankruptcy Code (Title III of PROMESA). This process includes the so-called "cram-down" power, which may provide Puerto Rico with flexibility in debt adjustment, but it also gives the oversight board total control over the adjustment process and includes certain provisions designed to protect creditor interests. On August 31, 2016, the U.S. President announced the appointment of seven members to the Oversight Board.

On January 29, 2017, the Commonwealth enacted Act No. 5, the Puerto Rico Financial Emergency and Fiscal Responsibility Act ("Act No. 5"). Act No. 5 is intended to facilitate and encourage a voluntary negotiation process under PROMESA between the Governor of Puerto Rico and/or the Puerto Rico Fiscal Agency and Financial Advisory Authority (FAFAA), on behalf of the Government of Puerto Rico, and the creditors of the Government of Puerto Rico and its instrumentalities. Act No. 5 authorizes the Government of Puerto Rico, within the parameters established by PROMESA, to designate certain services necessary for the health, safety and welfare of the residents of Puerto Rico and provided by the Government of Puerto Rico and its instrumentalities as "essential services", in accordance with the Constitution of Puerto Rico. Act No. 5 amended and repealed portions of the Act No. 21, as amended by Act 40-2016 and Act 68-2016 (the "Moratorium Act"). The Moratorium Act, and executive orders issued by the Governor under the Moratorium Act (the "Executive Orders"), permitted the Government of Puerto Rico to withhold the timely payment of its obligations at a point in time before the enactment of PROMESA.

## University of Puerto Rico Retirement System

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

On May 2, 2017, the legal shield granted by PROMESA protecting the Commonwealth from debt-related lawsuits expired. On May 3, 2017, the Oversight Board of PROMESA approved and certified the filing in the U.S. District Court for the District of Puerto Rico of a voluntary petition under Title III of PROMESA (a court-supervised debt-adjustment process) for Commonwealth to ensure the essential services to the public, the payment of the government payroll and the suppliers. This voluntary petition under Title III of PROMESA operates as an automatic stay of actions against the Commonwealth.

The Commonwealth expects that its ability to finance future budget deficits will be severely limited even if it achieves a comprehensive debt restructuring, and, therefore, that it will be required to, among other measures, reduce the amount of resources that fund important governmental programs and services in order to balance its budget. There is no assurance, however, that budgetary balance will be achieved and, if achieved, that such budgetary balance will be based on recurring revenues or expense reductions or that the revenue or expense measures undertaken to balance the budget will be sustainable on a long-term basis. Moreover, the measures to achieve budgetary balance through austerity may adversely affect the performance of the Commonwealth's economy which, in turn, may adversely affect governmental revenues. Unless the Commonwealth is able to obtain financing in the very near term or to reach restructuring or forbearance agreements with its creditors, it may not be able to honor all of its obligations as they come due while at the same time providing essential government services. Furthermore, the restructuring proposals presented by the Commonwealth depend on one hundred percent participation, which can only be achieved practically through a mechanism to bind holdout creditors. While PROMESA provides the Commonwealth tools to bind such holdouts and adjust its debts in an orderly manner, PROMESA gives the Oversight Board total control over such adjustment process and includes certain provisions designed to protect creditor interests, which are untested. There is thus no assurance that the federally appointed oversight board of PROMESA will be successful in achieving budgetary and fiscal balance through a debt restructuring or otherwise.

All of this has raised substantial doubt about the University's, and therefore the System's, ability to continue as a going concern and fully meet its obligations, as further discussed in Note 2 of the financial statements. We note that both the Commonwealth and the University have expressed substantial doubt about their respective ability to continue as going concerns in their most recently issued financial statements.

## University of Puerto Rico Retirement System

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

As mentioned above, the fiscal year ended June 30, 2016 presented significant economic challenges and difficulties for the University. As a result, the System's management focused hard on initiatives aimed at protecting the retirement fund of the University. On June 29, 2016 the University confirmed, restated and acknowledged in a public deed (the "Trust Deed") all acts and faculties as applied and lawfully enforced by the Governing Board in relation to the System and its trust fund from its inception to the present-day. Thus, through the execution of the Trust Deed, the University affirmed the public and governmental nature of the System founded in the year 1945 and its organization as a de facto trust. Pursuant to the Trust Deed, the System's assets remain completely autonomous and separate of the assets of the University, the Trustee and its members and continue to be exempt from the individual or collective action of their respective creditors.

#### ***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

Statements of Fiduciary Net Position

	June 30	
	2016	2015
<b>Assets</b>		
Cash and cash equivalents	\$ 21,455,730	\$ 22,329,050
Investments at fair value:		
U.S. Government and Agencies' obligations	67,225,694	38,316,850
Foreign bonds	10,774,681	20,583,349
Corporate bonds and other debentures	72,779,176	82,303,666
Foreign common stock	232,215,315	169,081,850
Common stock	174,806,616	189,333,039
Mortgage-backed securities	65,561,087	66,801,132
Municipal bonds	1,817,419	1,708,469
Sovereign debt	979,936	359,190
Commingled funds equity	486,362,191	661,866,148
Alternative investments	89,323,115	18,653,369
Invested securities lending cash collateral	41,192,853	59,665,343
Loans to plan members:		
First mortgages	44,381,362	39,589,301
Personal installments	83,242,871	83,810,762
Other, net of allowance for doubtful accounts of \$123,404 and \$72,782 in 2016 and 2015, respectively	13,119,934	15,505,688
Other receivables	211,749	211,521
Accrued interest receivable on investments	2,039,246	1,447,644
Receivables from sale of investments	31,729,150	39,520,205
Contributions receivable from Puerto Rico		
Treasury Department	1,894,378	1,807,837
Accounts receivable from University of Puerto Rico	1,237,303	8,822,990
Capital assets, net of accumulated depreciation of \$139,851 and \$1,015,226 in 2016 and 2015, respectively	3,326,222	3,548,760
Total assets	1,445,676,028	1,525,266,163
<b>Liabilities</b>		
Accounts payable and accrued expenses	6,086,875	45,086,870
Obligation under securities lending	42,416,315	60,946,003
Escrow deposits on mortgage loans	327,086	362,327
Other deposits and pending distribution funds	3,797,540	3,584,486
Payable for acquisition of investments	60,380,430	72,290,203
Total liabilities	113,008,246	182,269,889
Net position restricted for pensions	\$ 1,332,667,782	\$ 1,342,996,274

*See accompanying notes.*

University of Puerto Rico Retirement System

Statements of Changes in Fiduciary Net Position

	<b>Year Ended June 30</b>	
	<b>2016</b>	<b>2015</b>
<b>Additions:</b>		
Contributions:		
Employer	\$ 78,003,607	\$ 88,250,748
Participants	38,639,890	35,593,925
	<b>116,643,497</b>	123,844,673
Investment income:		
Net appreciation in fair value of investments	38,990,044	58,444,468
Interest	17,632,042	17,241,206
Dividends	6,808,253	4,118,598
	<b>63,430,339</b>	79,804,272
Less investment expenses	3,712,755	3,624,415
Net investment income	<b>59,717,584</b>	76,179,857
Medical insurance reimbursements from University	<b>10,293,021</b>	11,403,965
Total additions	<b>186,654,102</b>	211,428,495
<b>Deductions:</b>		
Benefits paid to participants	182,614,074	176,871,770
General and administrative expenses	4,075,499	4,184,870
Medical insurance expenses paid to retirees	10,293,021	11,403,965
Total deductions	<b>196,982,594</b>	192,460,605
Net (decrease) increase in net position	<b>(10,328,492)</b>	18,967,890
Net position restricted for pensions:		
Beginning of year	<b>1,342,996,274</b>	1,324,028,384
End of year	<b>\$ 1,332,667,782</b>	\$ 1,342,996,274

*See accompanying notes.*

# University of Puerto Rico Retirement System

## Notes to Financial Statements

June 30, 2016 and 2015

### **1. Organization and Summary of Significant Accounting Policies**

#### **Organization**

The University of Puerto Rico Retirement System (the “System” or “Plan”) 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. Assets of the Plan are legally held in a Trust, separate from the assets of the University of Puerto Rico, and are held solely for the purpose of meeting the Plan’s obligations.

The responsibility for the proper operation and administration of the System is vested in the Executive Director of the System which in turn will report to the Retirement System Committee of the Government Board of the University (the “Committee”). The Committee will then notify the Members of the University’s Government Board of any decisions made related to the System. The following are the significant accounting policies followed by the System in the preparation of its financial statements. The Government Board are the Trustees of the Plan.

#### **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.

#### **Investments**

Investments are reported at 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.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

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

#### **Investments (continued)**

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 statements 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 5.

#### **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 Government Board 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, 2016 and 2015, the balance of other loans consisted of the principal balance of such contributions, which amounted to approximately \$13.12 million and \$15.5 million, respectively, 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 years ended June 30, 2016 and 2015 amounted to approximately \$139,852 and \$138,332, respectively.

#### New Accounting Standards Adopted

In fiscal year 2016, the System adopted the following new statements of financial accounting standards issued by the GASB:

- GASB Statement No. 72, *Fair Value Measurement and Application* (GASB Statement No. 72), which is effective for reporting periods beginning after June 15, 2015. GASB Statement No. 72 requires the System to use valuation techniques which are appropriate under the circumstances and are either a market approach, a cost approach or an income approach. GASB Statement No. 72 establishes a hierarchy of inputs used to measure fair value consisting of three levels. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs are inputs, other than quoted prices included within Level 1, which are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs, such as management's assumption of the default rate among underlying mortgages of a mortgage-backed security. GASB Statement No. 72 also contains note disclosure requirements regarding the hierarchy of valuation inputs and valuation techniques that was used for the fair value measurements. There was not material impact on the System's financial statement as a result of the implementation of GASB Statement No. 72.
- GASB Statement No. 79 establishes specific criteria used to determine whether a qualifying external investment pool may elect to use an amortized cost exception to fair value measurement. Those criteria will provide qualifying external investment pools and participants in those pools with consistent application of an amortized cost-based measurement for financial reporting purposes. The statement also establishes additional note disclosures for qualifying external investment pools. There was no material impact on the University's financial statement as a result of the implementation of Statement No. 79.



# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

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

#### Future Adoption of Accounting Pronouncements

The GASB has issued the following statements:

- GASB Statement No. 73, Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68 (GASB Statement No. 73). The provisions of GASB Statement No. 73 that address accounting and financial reporting by employers and governmental non-employer contributing entities for pensions that are not within the scope of GASB Statement No. 68, are effective for financial statements for fiscal years beginning after June 15, 2016, and the requirements of this statement that address financial reporting for assets accumulated for purposes of providing those pensions are effective for fiscal years beginning after June 15, 2015. The requirements of Statement No. 73 for pension plans that are within the scope of GASB Statement No. 67 or for pensions that are within the scope of GASB Statement No. 68 are effective for fiscal years beginning after June 15, 2015. GASB Statement No. 73 extends the approach to accounting and financial reporting established in GASB Statement No. 68 to all pensions to reflect that for accounting and financial reporting purposes, any assets accumulated for pensions that are provided through pension plans that are not administered through trusts that meet the criteria specified in GASB Statement No. 68 should not be considered pension plan assets. It also requires that information similar to that required by GASB Statement 68 be included in notes to financial statements and required supplementary information by all similarly situated employers and non-employer contributing entities.
- GASB Statement No. 82 Pension Issues is to address certain issues that have been raised with respect to Statements No. 67, Financial Reporting for Pension Plans, No. 68, Accounting and Financial Reporting for Pensions, and No. 73, Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68. Specifically, this Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The requirements of this Statement are effective for reporting periods beginning after June 15, 2016.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### **2. Financial Condition and Liquidity**

The discussion in the following paragraphs regarding the System's financial and liquidity risks provides the necessary background and support for management's evaluation as to whether there is substantial doubt about the System's ability to continue as a going concern for 12 months beyond the date of the financial statements or for an extended period if there is currently known information that may raise substantial doubt shortly thereafter. GASB Statement No. 56, Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards, establishes that the continuation of a legally separate governmental entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Information that may significantly contradict the going concern assumption would relate to a governmental entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of governmental operations, restructuring of debt, submission to the oversight of a separate fiscal assistance authority or financial review board, or similar actions. Indicators such as negative trends in operating losses and negative cash flows, possible financial difficulties such as nonpayment or default of debt and/or restructurings or noncompliance with capital or reserve requirements, and internal or external matters impacting the governmental entity's ability to meet its obligations as they become due, are factors that are considered in this evaluation. The System sponsor (the University) faces significant risks and uncertainties, including liquidity risk, which is the risk of not having sufficient liquid financial resources to meet obligations when they come due. We note that both the Commonwealth and the University have expressed substantial doubt about their respective ability to continue as going concerns in their most recently issued financial statements. The risks and uncertainties facing the University together with other factors further described below, have led management to conclude that there is substantial doubt as to the ability of the System to continue as a going concern in accordance with GASB Statement No. 56.

The Commonwealth's recurring deficits, negative financial position, further deterioration of its economic condition (a prolonged economic recession which commenced in 2006), and inability to access the credit markets raise substantial doubt about the Commonwealth's ability to continue as a going concern. The significant financial difficulties being experienced by the Commonwealth has a significant adverse impact on the University, given its reliance on Commonwealth appropriations.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### **2. Financial Condition and Liquidity (continued)**

The Commonwealth and several of its component units face significant risks and uncertainties, including liquidity risk. The risks and uncertainties facing the Commonwealth, together with other factors, have led the Commonwealth's management to conclude that there is substantial doubt as to the ability of the primary government and of various discretely presented component units, to continue as a going concern. In addition, the Commonwealth's management believes that the pension trust funds, included as part of the fiduciary funds, carry a substantial risk of insolvency, if measures are not taken to significantly increase contributions to such funds.

The Commonwealth's very high level of debt and unfunded pension liabilities and the resulting required allocation of revenues to service debt and pension obligations have contributed to significant budget deficits during the past several years, which deficits the Commonwealth has financed, further increasing the amount of its debt. These matters and the Commonwealth's liquidity constraints, among other factors, have adversely affected its credit ratings and its ability to obtain financing at reasonable interest rates, if at all. As a result, the Commonwealth had relied more heavily on short-term financings and interim loans from the GDB, and other instrumentalities of the Commonwealth, which reliance has constrained the liquidity of the Commonwealth in general and the GDB, and increased near-term refinancing risk. These factors, among others, have also resulted in the non-payment by the Commonwealth and its instrumentalities of most of their outstanding debt obligations, including the outstanding GDB lines of credit which caused the discontinuance of GDB to provide liquidity to the Commonwealth and instrumentalities, such as the University, and have caused the default of GDB's debt obligations.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### **2. Financial Condition and Liquidity (continued)**

In addition, although neither the Commonwealth nor its component units, including the University, are eligible to seek relief under Chapter 9 of the United States Bankruptcy Code, on June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). PROMESA grants the Commonwealth and its component units access to an orderly mechanism to restructure their debts in exchange for significant federal oversight over the Commonwealth's finances. In broad terms, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board (the Oversight Board), relief from creditor lawsuits through the enactment of a temporary stay on litigation, and two alternative methods to adjust unsustainable debt.

PROMESA contains two methods to adjust Puerto Rico's debts. The first method is a streamlined process to achieve modifications of financial indebtedness with the consent of a supermajority of affected financial creditors (Title VI of PROMESA). This method has benefits such as potential speed relative to a traditional restructuring through a formal in-court process. The second method is a court-supervised debt-adjustment process, which is modeled on Chapter 9 of the U.S. Bankruptcy Code (Title III of PROMESA). This process includes the so-called "cram-down" power, which may provide Puerto Rico with flexibility in debt adjustment, but it also gives the oversight board total control over the adjustment process and includes certain provisions designed to protect creditor interests. On August 31, 2016, the U.S. President announced the appointment of seven members to the Oversight Board.

On January 29, 2017, the Commonwealth enacted Act No. 5, the Puerto Rico Financial Emergency and Fiscal Responsibility Act ("Act No. 5"). Act No. 5 is intended to facilitate and encourage a voluntary negotiation process under PROMESA between the Governor of Puerto Rico and/or the Puerto Rico Fiscal Agency and Financial Advisory Authority (FAFAA), on behalf of the Government of Puerto Rico, and the creditors of the Government of Puerto Rico and its instrumentalities. Act No. 5 authorizes the Government of Puerto Rico, within the parameters established by PROMESA, to designate certain services necessary for the health, safety and welfare of the residents of Puerto Rico and provided by the Government of Puerto Rico and its instrumentalities as "essential services", in accordance with the Constitution of Puerto Rico. Act No. 5 amended and repealed portions of the Act No. 21, as amended by Act 40-2016 and Act 68-2016 (the "Moratorium Act"). The Moratorium Act, and executive orders issued by the Governor under the Moratorium Act (the "Executive Orders"), permitted the Government of Puerto Rico to withhold the timely payment of its obligations at a point in time before the enactment of PROMESA.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### **2. Financial Condition and Liquidity (continued)**

On May 2, 2017, the legal shield granted by PROMESA protecting the Commonwealth from debt-related lawsuits expired. On May 3, 2017, the Oversight Board of PROMESA approved and certified the filing in the U.S. District Court for the District of Puerto Rico of a voluntary petition under Title III of PROMESA (a court-supervised debt-adjustment process) for Commonwealth to ensure the essential services to the public, the payment of the government payroll and the suppliers. This voluntary petition under Title III of PROMESA operates as an automatic stay of actions against the Commonwealth.

The Commonwealth expects that its ability to finance future budget deficits will be severely limited even if it achieves a comprehensive debt restructuring, and, therefore, that it will be required to, among other measures, reduce the amount of resources that fund important governmental programs and services in order to balance its budget. There is no assurance, however, that budgetary balance will be achieved and, if achieved, that such budgetary balance will be based on recurring revenues or expense reductions or that the revenue or expense measures undertaken to balance the budget will be sustainable on a long-term basis. Moreover, the measures to achieve budgetary balance through austerity may adversely affect the performance of the Commonwealth's economy which, in turn, may adversely affect governmental revenues. Unless the Commonwealth is able to obtain financing in the very near term or to reach restructuring or forbearance agreements with its creditors, it may not be able to honor all of its obligations as they come due while at the same time providing essential government services. Furthermore, the restructuring proposals presented by the Commonwealth depend on one hundred percent participation, which can only be achieved practically through a mechanism to bind holdout creditors. While PROMESA provides the Commonwealth tools to bind such holdouts and adjust its debts in an orderly manner, PROMESA gives the Oversight Board total control over such adjustment process and includes certain provisions designed to protect creditor interests, which are untested. There is thus no assurance that the federally appointed oversight board of PROMESA will be successful in achieving budgetary and fiscal balance through a debt restructuring or otherwise.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 2. Financial Condition and Liquidity (continued)

We note that both the Commonwealth and the University have expressed substantial doubt about their respective ability to continue as going concerns in their most recently issued financial statements.

The System has evaluated the current market and University situation and considered several facts to establish a mitigation action plan as follows:

- **Trust Regulations:**  
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 Employer commenced.
- **Fund administration:**  
The Retirement System located its assets in a separate Retirement Fund located in JP Morgan Chase New York in 1989. This Retirement Trust account was created to exclusively receive income, hold monies, and make disbursements on behalf of the Trust.
- **Investments Return:**  
As of June 30, 2016, the returns of the Retirement fund have presented positive results above market. In the last quarter of fiscal year 2015-2016, the market closed at -.20% and the System's closed with a return of .40%. Also, the funding ratio increased from 43.9% in June 30 2015 to 46.60%, and from 2015 and June 30, 2016 the funding ratio increased to **47.80%**.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 2. Financial Condition and Liquidity (continued)

- Contributions:

As stated in the plan document, the Retirement fund will not be used for disbursements, withdrawals, and transfer of any assets other than the exclusive use of funds for both pension and administrative expenses. Its securities, notes or other evidences of loans are clearly marked to indicate ownership by the System and are registered in the name of the System.

Its administration is separated from the administration of the University as established in Cert. 53 (1989-1990).

The System is qualified and exempt from Puerto Rico and United States income taxes like other peer governmental plans. There is uncertainty as to what actions the Oversight Board and the Commonwealth will take, if any, and the effects they may have on the Plan. PROMESA requires that any fiscal plan developed by the Commonwealth or any of its affiliates shall “provide for the adequate funding for public pension systems.” In addition, pursuant to the Trust Deed, the System’s assets remain completely autonomous and separate of the assets of the University, the Trustee and its members and continue to be exempt from the individual or collective action of their respective creditors.

The assets of the Retirement Fund have been well maintained over \$1.3 billion since 2014. Given the precarious scenarios in Puerto Rico, the Retirement Funds are likely not sufficient to sustain necessary withdrawals as projected over the life of the Plan, without further contributions by the University. However, we believe the Retirement funds can sustain withdrawals for approximately 15 years, assuming a constant rate of return of 7.75% and liabilities as currently projected. This analysis only includes the individual contributions that are part of the University automatic payroll deductions. The employer has stated clearly that payroll is a priority under the current scenario, and has asserted a commitment to fund the unfunded liability for the next 40 years to the extent it is able.

- Plan Regulatory Changes:

As a result of intensive research work made by the System administration and several meetings by the Retirement Board & the Government Board, retirement system regulatory changes have been approved for the current and next fiscal years. These measures emerged as initiatives implemented towards improving sustainability of the current defined benefit system. The System amendments are described in detail in notes 3 and 10.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 3. 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:

	<u>2016</u>	<u>2015</u>
Retirees and beneficiaries receiving benefits	8,417	8,247
Terminated plan participants entitled to but not yet receiving benefits	445	443
Terminated non-vested plan participants entitled to return of their contributions	8,143	7,985
Active plan participants	<u>10,438</u>	<u>10,644</u>
Total	<u>27,443</u>	<u>27,319</u>

#### Plan Amendments

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.

Effective July 1, 2014, the compensation limit for Certification 139 was frozen at \$69,556. Effective January 1, 2015, the formula for Non-Occupational Disability was amended to increase vesting from 10 years to 15 years and the benefit payable will be 90% of the member retirement benefit payable if the participant was to retire based on years of service.

Effective July 1, 1998, the Plan was amended by establishing Certification 94 (1997-1998), to offer participants an 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.



# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 3. Description of the System (continued)

#### Plan Amendments (continued)

Effective July 1, 2002, the Plan was amended, by establishing Certification 139 (2001-2002), 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. Effective July 1, 2002, 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.

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 55 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.

Effective July 1, 2015, following recommendations presented by the Retirement Board, the plan was amended by the Government Board through Certification No 140 - 2014-2015: active participants as of June 30, 2015 are divided into two groups:

1. Those who had 25 or more years of accredited service. These are not affected by the changes in regulation.
2. Those who had less than 25 years of accredited service. To this group, effective June 30, 2015, individual required contribution increased by 1% and the required age for retirement changed from 55 to 58 years.

#### 1. Certification no. 7:

Participant who had earned 20 years of services as of July 1, 1979:

- a. Employee who selected a complete supplementation with Social Security, contributes 7% of monthly compensation.
- b. Participant who selected a coordinated plan with Social Security, contributes 4% of the monthly compensation up to \$ 350, plus 6 ½% of the excess.
- c. No salary CAP.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**3. Description of the System (continued)**

**Plan Amendments (continued)**

2. Certification no. 37:

Participant who had not earned 20 years of services as of July 1, 1979, and the ones who had entered on July 1, 1978 through December 1989:

Participant with <b>25 years or more</b> accredited at July 30, 2015	Participants with <b>less than 25 years</b> accredited at June 30, 2015
5% up to \$35,000 (\$2,916.67)	6% up to \$35,000 (\$2,916.67)
9% up to \$50,000 (\$4,166.67)	10% up to \$50,000 (\$4,166.67)
11% up to \$69,556.44 (\$5,796.37)	12% up to \$69,556.44 (\$5,796.37)

3. Certification no. 55:

Mandatory applicable to all participants who entered beginning January 1, 1990 and those who enter before 1990 and are under the supplemented with social security plan and the ones who between January 1990 and December 1991 elected to fall under the coordinated with social security plan from Certification 55 (4/6.5%):

Participant with <b>25 years or more</b> accredited at July 30, 2015	Participants with <b>less than 25 years</b> accredited at June 30, 2015
7 or 8% Suppl or 4/6.5% Coord. until \$35,000 (\$2,916.67)	8 or 9% Suppl or 5/7.5 Coord. up to \$35,000 (\$2,916.67)
9% Suppl / Coord. up to \$50,000 (\$4,166.67)	10% Suppl / Coord. up to \$50,000 (\$4,166.67)
11% Suppl / Coord up to \$69,556.44 (\$5,796.37)	12% Suppl / Coord. up to \$69,556.44 (\$5,796.37)

Regulation for those who entered between July 1, 1998 and March 31, 2015:

Participant with <b>25 years or more</b> accredited at July 30, 2015	Participants with <b>less than 25 years</b> accredited at June 30, 2015
9% Suppl. up to \$50,000 (\$4,166.67)	10% Suppl. up to \$50,000 (\$4,166.67)
11% Suppl. up to \$69,556.44 (\$5,796.37)	12% Suppl. up to \$69,556.44 (\$5,796.37)

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**3. Description of the System (continued)**

**Plan Amendments (continued)**

Regulation for those who entered from April 1, 2015 to Regulation for those who entered as of July 1, 2015:

June 30, 2015:

Supplemented Individual Contribution Participant with Less than 25 years of accredited at July 30, 2015	Supplemented Individual Contribution
11% up to \$69,556.44 (\$5,796.37) until June 30, 2015	12% up to \$69,556.44 (\$5,796.37)
12% up to \$69,556.44 (\$5,796.37)	

**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

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
- If full supplement is not elected: 5% of monthly compensation up to \$2,916
- If Certification 94 is elected: 9% of monthly compensation up to \$4,166

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, 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
- If full supplement is not elected: 4% of monthly compensation up to \$350, plus 6.5% of the excess up to \$2,916

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 3. Description of the System (continued)

#### Contributions and Funding Policy (continued)

- If certification 94 is elected: 9% of monthly compensation up to \$4,166
- If certification 139 is elected: 11% of monthly compensation up to \$5,796

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

- 8% of monthly compensation up to \$2,916 or,
- If Certification 94 is elected: 9% of monthly compensation up to \$4,166
- If certification 139 is elected: 11% of monthly compensation up to \$5,796

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

- 9% of monthly compensation up to \$4,166
- 11% of monthly compensation up to \$5,796

#### Participants who are hired on or after April 1, 2015:

- 11% of monthly compensation up to \$5,796 fully supplemented

The University contributes at an actuarially determined rate; the rate as of June 30, 2016 and 2015 was 15.20% and 17.29%, respectively, of annual covered payroll. The actuarially determined employer contribution rate takes into account payment of administrative expenses. Administrative expenses are paid out of the trust fund.

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 Certification 146, 2014-2015, 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.

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### 3. Description of the System (continued)

##### Retirement Benefits (continued)

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 as follows:

- Cert. 55 - at age 55 after 30 years of service for those with 25 or more years at June 30, 2015, at age 58 for those with less than 25 years at June 30, 2015.
- Cert. 37 - at age 58.

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 55 but 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 (C37), 1/3% (C 55).
- 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.

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### 3. Description of the System (continued)

##### Retirement Benefits (continued)

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.
- 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 1/3% for each month the participant is under age 55 at time annuity begins.
- After 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.

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### **3. Description of the System (continued)**

##### **Retirement Benefits (continued)**

- 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.
- 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 15 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.

Effective December 15, 2014, (Certification 51, 2014-2015) non-occupational disability benefits regulation was amended. A disability due to non-occupational causes will be payable upon 15 years of service, the benefit payable will be 90% of the member's retirement benefit payable if the participant was to retire based on years of service. If the participant is eligible for a service retirement, benefit payable will be the higher of the two.

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 3. Description of the System (continued)

#### 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 if they do not exceed retirement payments already made, unless reverse annuity was elected. Minimum payment is \$600. In addition, an 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.

#### Christmas Bonus

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

### 4. Cash and Cash Equivalents

Cash and cash equivalents as of June 30, is as follows:

	<u>2016</u>	<u>2015</u>
Cash	\$21,455,730	\$22,329,050
Cash equivalents	-	-
	<u>\$21,455,730</u>	<u>\$22,329,050</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.



# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 5. Investments

The following is a summary of the fair value hierarchy of the fair value of investments of the Plan as of June 30, 2016 and 2015:

<u>Investments by Fair Value Level</u>	<u>Total</u>	<u>2016</u>		
		<u>Fair Value Measurements Using:</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Unobservable Inputs for the Assets (Level 3)</u>
U.S. Government Obligations	\$ 67,225,694	\$ —	\$ 67,225,694	\$ —
Common Stock	174,806,616	174,806,616	—	—
Mortgage Backed Securities	65,561,087	—	65,561,087	—
Municipal Bonds	1,817,419	—	1,817,419	—
Corporate Bonds and Other Debentures	72,779,176	—	72,779,176	—
Total Foreign Securities	232,215,315	232,215,315	—	—
Foreign Bonds	10,774,681	—	10,774,681	—
Pooled Funds	486,362,191	—	486,362,191	—
Sovereign Debt	979,936	—	979,936	—
Alternative Investments	89,323,115	—	—	89,323,115
	<u>\$ 1,201,845,230</u>	<u>\$ 407,021,931</u>	<u>\$ 705,500,184</u>	<u>\$ 89,323,115</u>

<u>Investments by Fair Value Level</u>	<u>Total</u>	<u>2015</u>		
		<u>Fair Value Measurements using:</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Unobservable Inputs for the Assets (Level 3)</u>
U.S. Government Obligations	\$ 38,316,850	\$ —	\$ 38,316,850	\$ —
Common Stock	189,333,039	189,333,039	—	—
Mortgage Backed Securities	66,801,132	—	66,801,132	—
Municipal Bonds	1,708,469	—	1,708,469	—
Corporate Bonds & Other Debentures	82,303,666	—	82,303,666	—
Total Foreign Securities	169,081,850	169,081,850	—	—
Foreign Bonds	20,583,349	—	20,583,349	—
Pooled Funds	661,866,148	—	661,866,148	—
Sovereign Debt	359,190	—	359,190	—
Alternative Investments	18,653,369	—	—	18,653,369
	<u>\$ 1,249,007,062</u>	<u>\$ 358,414,889</u>	<u>\$ 871,938,804</u>	<u>\$ 18,653,369</u>

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 5. 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.

Investments classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets.

Investment income securities, including U.S. sponsored agencies bonds and notes, U.S. municipal bonds, foreign government bonds, mortgage-backed securities, pooled funds and corporate bonds, classified in Level 2 of the fair value hierarchy are valued using matrix pricing techniques maintained by various pricing vendors. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. Fair value is defined as the quoted market value on the last trading day of the period. These prices are obtained from various pricing sources by our custodian bank. Alternative investments are classified in Level 3.

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:

<b>Asset Class</b>	<b>% Allocated</b>	<b>Range</b>
Domestic Large Cap Equity	25.6%	+/-5%
Domestic Small/Mid Cap	24.0%	+/-3%
International Equity	6.4%	+/-3%
Fixed Income	30.0%	+/-5%
Personal Loans and Mortgages	14.0%	+/-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.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. Investments (continued)**

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 (Certification No. 97, 2013-2014) per month. 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.

Private equity funds include the following at June 30, 2016 and 2015:

	<b>30-Jun-16</b>			
	<b>Total</b>			
	<b>Commitment</b>	<b>Contributions</b>	<b>Distribution</b>	<b>Fair Value</b>
<b>Grupo Guayacán, Inc.:</b>				
Guayacán Fund of Funds II, LP	\$ 6,000,000	\$ 5,683,539	\$ 7,240,144	\$ 418,177
Guayacán Fund of Funds III, LP	5,000,000	4,571,372	2,330,666	3,683,381
Guayacán Fund of Funds IV, LP	5,000,000	775,000	75,000	666,915
<b>Advent -Morro Equity Partners Inc.:</b>				
Guayacán Private Equity Fund I, LP	2,500,000	2,322,582	4,120,811	1,078,108
Guayacán Private Equity Fund II, LP	5,000,000	4,909,472	797,101	5,109,195
<b>McCoy Investment Fund 2</b>	<b>15,000,000</b>	<b>10,604,326</b>	<b>4,193,613</b>	<b>9,369,668</b>
<b>RREFF America REIT II</b>	<b>65,000,000</b>	<b>65,000,000</b>	-	<b>68,997,671</b>
<b>Total</b>	<b>\$ 103,500,000</b>	<b>\$ 93,866,291</b>	<b>\$ 18,757,336</b>	<b>\$ 89,323,115</b>

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. Investments (continued)**

	<b>30-Jun-15</b>			
	<b>Total Commitment</b>	<b>Contributions</b>	<b>Distribution</b>	<b>Fair Value</b>
<b>Grupo Guayacán, Inc.:</b>				
Guayacán Fund of Funds I, LP	\$ 5,000,000	\$ 4,764,049	\$ 8,121,850	\$ –
Guayacán Fund of Funds II, LP	6,000,000	5,683,539	7,240,144	489,805
Guayacán Fund of Funds III, LP	5,000,000	4,149,981	1,505,666	3,727,634
Guayacán Fund of Funds IV, LP	–	350,000	–	326,064
<b>Advent -Morro Equity Partners Inc.:</b>				
Guayacán Private Equity Fund I, LP	2,500,000	2,322,582	4,058,236	1,107,133
Guayacán Private Equity Fund II, LP	5,000,000	4,270,187	797,101	4,416,518
McCoy Investment Fund 2	15,000,000	9,554,326	4,193,613	8,586,215
<b>Total</b>	<b>\$ 38,500,000</b>	<b>\$ 31,094,664</b>	<b>\$ 25,916,610</b>	<b>\$ 18,653,369</b>

**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, 2016, the System's credit quality distribution for securities was as follows:

	<b>2016</b>	
	<b>Carrying Value</b>	<b>Rating</b>
Foreign bonds	<b>\$10,774,681</b>	<b>Aaa to BB+</b>
Corporate bonds and other debentures	<b>72,779,176</b>	<b>Aaa to BB-</b>
Mortgage backed securities	<b>65,561,087</b>	<b>Aaa to D</b>
Municipal bonds	<b>1,817,419</b>	<b>Aaa to BBB</b>

**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:

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. Investments (continued)**

**Custodial Risk (continued)**

Security Type	June 30	
	2016	2015
	Carrying Value	Carrying Value
Mortgage backed securities	\$ 65,561,087	\$ 66,801,132
Corporate bonds and other debentures	72,779,176	82,303,666
Common stocks	174,806,616	189,333,039
U.S. Government obligation	2,802,700	3,047,688
Treasury bonds and notes	64,422,994	35,269,162
Foreign common stocks	232,215,315	169,081,850
Foreign corporate bonds	8,382,673	16,719,879
Foreign government bonds	2,392,008	3,863,470
Commingled Fund Equity	486,362,191	661,866,148
Sovereign Debt	979,937	359,190
Municipal Bonds	1,817,419	1,708,469
Total	\$1,112,522,116	\$1,230,353,693

**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 for collateral. Collateral may consist of cash, other approved securities and/or letter of credit from the borrower. The Custodian has the 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 loaned by the University upon termination of the loan term.

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### **5. Investments (continued)**

##### **Security Lending (continued)**

Under the Agreement as disclosed above, the System had a cash collateral of **\$41,192,852** and **\$59,665,343** at June 30, 2016 and 2015, respectively. 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 2016 and 2015, the Plan had an unrealized loss in the Securities Lending Collateral pool of **\$57,197** and **\$60,326**, respectively, and had accrued an obligation of **\$42,416,315** and **\$60,946,003**, respectively, 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 do not allow the System 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)

**5. 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, 2016 and 2015, the weighted average maturity by investment type in each fund follows:

<b>Investment Type</b>	<b>Weighted Average (Years)</b>	<b>Fair Value</b>	
		<b>2016</b>	<b>2015</b>
Corporate Bonds	3.0879	\$ 72,779,176	\$ 82,303,666
Mortgage Backed Securities	3.8459	65,561,087	66,801,132
Municipal Bonds	0.0673	1,817,419	1,708,469
Foreign Bonds	0.4240	10,774,681	20,583,348
US Government agency obligations and Sovereign debt	2.5724	68,205,631	38,676,040
		<b>\$ 219,137,994</b>	<b>\$ 210,072,655</b>

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. Investments (continued)**

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 30, 2016:

**Foreign Currency Risk**

Security Type	Currency	Maturity	Fair Value
Common Stocks	Austria	Not Applicable	\$ 7,222,123
Common Stocks	Bermuda	Not Applicable	9,609,054
Common Stocks	Brazil	Not Applicable	2
Common Stocks	Cayman Islands	Not Applicable	3,534,126
Common Stocks	Canada	Not Applicable	7,472,087
Common Stocks	Channel Island	Not Applicable	3,707,967
Common Stocks	China	Not Applicable	3,446,404
Common Stocks	Denmark	Not Applicable	1,996,351
Common Stocks	Finland	Not Applicable	287,891
Common Stocks	France	Not Applicable	23,098,269
Common Stocks	Germany	Not Applicable	24,761,898
Common Stocks	Hong Kong	Not Applicable	2,056,079
Common Stocks	India	Not Applicable	2,966,840
Common Stocks	Indonesia	Not Applicable	743,258
Common Stocks	Ireland	Not Applicable	2,774,311
Common Stocks	Israel	Not Applicable	422,641
Common Stocks	Italy	Not Applicable	2
Common Stocks	Japan	Not Applicable	50,072,290
Common Stocks	Mexico	Not Applicable	1,964,705
Common Stocks	Netherlands	Not Applicable	10,109,039

*Continued*



University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. Investments (continued)**

**Foreign Currency Risk (continued)**

Security Type	Currency	Maturity	Fair Value
Common Stocks	Norway	Not Applicable	2,643,882
Common Stocks	Panama	Not Applicable	256,074
Common Stocks	Singapore	Not Applicable	856,958
Common Stocks	Spain	Not Applicable	3,833,015
Common Stocks	Sweden	Not Applicable	5,023,159
Common Stocks	Switzerland	Not Applicable	27,390,920
Common Stocks	Taiwan	Not Applicable	3,639,701
Common Stocks	United Kingdom	Not Applicable	32,325,618
Corporate Bonds	Canada	09/23/2019 - 05/15/2038	1,537,866
Corporate Bonds	Colombia	1/16/2025	99,517
Corporate Bonds	France	06/10/2020 - 10/22/2023	416,580
Corporate Bonds	Japan	3/17/2017	261,084
Corporate Bonds	Luxembourg	03/12/2018 - 03/15/2045	939,315
Corporate Bonds	Mexico	05/03/2019-06/02/2041	742,579
Corporate Bonds	Neth. Antilles	03/07/2017 - 09/25/2023	111,883
Corporate Bonds	Netherlands	3/7/2017 - 09/25/2023	1,694,388
Corporate Bonds	Switzerland	03/24/2017-04/27/2018	1,112,408
Corporate Bonds	United Kingdom	05/10/2017-05/11/2045	1,467,052
Governmental Bonds	Canada	2/27/2019-06/17/2019	829,923
Governmental Bonds	Germany	4/8/2016-9/05/2017	584,009
Governmental Bonds	Mexico	01/21/2021 - 01/23/2046	299,225
Governmental Bonds	New Turkish Lira	3/22/2024	250,900
Governmental Bonds	Panama		214,500
Governmental Bonds	Peru		213,450
Total			<b><u>\$ 242,989,996</u></b>

Foreign Currency Risk represent 22% of Total Assets.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**5. 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 materially affect the amounts reported in the Statement.

**6. Capital Assets**

Capital Assets additions are recorded at cost. Depreciation is provided using the straight-line method over the useful life of the asset. For the years ended June 30, 2016 and 2015, changes in Capital Assets, consisted of the following:

	<b>Beginning Balance at 1-July-15</b>	<b>Additions</b>	<b>Retirements</b>	<b>Ending Balance at 30-Jun-16</b>
Building	\$3,811,940	\$ –	\$ –	\$3,811,940
Equipment	292,639	–	–	292,639
Foreclosure homes	459,406	–	(82,687)	376,719
	<b>\$4,563,985</b>	<b>\$ –</b>	<b>(82,687)</b>	<b>\$4,481,378</b>
Less accumulated depreciation	<b>(1,015,225)</b>	–	<b>(139,852)</b>	<b>(1,155,077)</b>
	<b>\$3,548,760</b>	<b>\$ –</b>	<b>\$(222,539)</b>	<b>\$3,326,301</b>

	<b>Beginning Balance at 1-July-14</b>	<b>Additions</b>	<b>Retirements</b>	<b>Ending Balance at 30-Jun-15</b>
Building	\$3,811,940	\$ –	\$ –	\$3,811,940
Equipment	279,113	15,426	(1,900)	292,639
Foreclosure homes	460,093	–	(687)	459,406
	4,551,146	15,426	(2,587)	4,563,985
Less accumulated depreciation	<b>(876,894)</b>	–	<b>(138,331)</b>	<b>(1,015,225)</b>
	<b>\$3,674,252</b>	<b>\$15,426</b>	<b>\$(140,918)</b>	<b>\$3,548,760</b>

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 7. Medical Insurance

The System administered medical insurance employer's contributions to retirees and reimbursed each retiree up to a maximum of \$125 monthly for medical plan expenses. For the years ended June 30, 2016 and 2015, the medical plan expenses amounted to **\$10,293,021** and \$11,403,965, respectively. Medical expenses are paid by the retiree and reimbursed by the University of Puerto Rico.

### 8. 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.

### 9. Net Pension Liability of the University of Puerto Rico

The components of the net pension liability of the University of Puerto Rico at June 30, 2016 and 2015, were as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Total pension liability	<b>\$ 3,339,371</b>	\$ 3,139,723
Plan fiduciary net position	<b>(1,332,668)</b>	(1,342,996)
University of Puerto Rico's net pension liability	<b><u>\$ 2,006,706</u></b>	<b><u>\$ 1,796,727</u></b>
Plan fiduciary net position as a percentage of the total pension liability	<b>39.91%</b>	42.77%

### Actuarial Assumptions

The total pension liability at June 30, 2016, was determined by an actuarial valuation as of June 30, 2015, using the following actuarial assumptions, applied to all periods included in the measurement. The result was rolled forward using standard actuarial techniques to the measurement date of June 30, 2016:

Inflation	3.0%
Salary increases	3.75% average, including inflation
Investment rate of return	7.75%, net of pension plan investment expense, including inflation

# University of Puerto Rico Retirement System

## Notes to Financial Statements (continued)

### 9. Net Pension Liability of the University of Puerto Rico (continued)

#### Actuarial Assumptions (continued)

The rates of mortality for the period after service retirement are according to the RP-2000 Healthy Annuitant Mortality Table for ages 50 and greater and the RP-2000 Combined Mortality Table for ages less than 50, projected to 2020 using Scale BB, set back 5 years for males and set forward 1 year for females. Rates of mortality for the period after disability retirement are according to the RP-2000 Disability Mortality Table projected to 2020 using Scale BB set back 5 years for males and set forward 2 years for females.

The total pension liability was determined by an actuarial valuation as of June 30, 2015, using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.0 percent
Salary increases	3.75 percent average, including inflation
Investment rate of return	7.75 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, 2015, 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, 2016.

The long-term expected rate of return on pension plan investments was determined using a 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. 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 Callan are summarized in the following table:

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**9. Net Pension Liability of the University of Puerto Rico (continued)**

**Actuarial Assumptions (continued)**

Asset Class	Target Allocation	2016 Long-Term Expected Real Rate of Return	2015 Long-Term Expected Real Rate of Return
Domestic large cap equity	25.6%	5.00%	6.65%
International equity	24.0%	5.00%	7.00%
Domestic small/mid cap equity	6.4%	5.30%	7.90%
Fixed income	30.0%	0.75%	0.80%
Loan and mortgages	14.0%	2.75%	5.70%
Total	<u>100.0%</u>		

**Discount Rate**

Discount rate. The discount rate used to measure the total pension liability at June 30, 2016, was 5.89%. 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, 2045. Therefore, the long-term expected rate of return on pension plan investments of 7.75% was applied to all periods of projected benefit payments through June 30, 2045 and the applicable municipal bond index rate of 3.01%, 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, 2016, was applied to all periods of projected benefit payments after June 30, 2045. The Single Equivalent Interest Rate (SEIR) of 5.89% 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, 2016. The SEIR at the beginning of the measurement period was 6.37% based on the long-term expected rate of return on pension plan investments of 7.75% applied to all periods of projected benefit payments through June 30, 2044 and the applicable municipal bond index rate of 3.82% as of June 30, 2015 applied to all periods of projected benefit payments after June 30, 2044.

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### **9. Net Pension Liability of the University of Puerto Rico (continued)**

##### **Discount Rate (continued)**

Beginning June 30, 2016 the contribution rates reflect amortization of the System's unfunded actuarial accrued liability over a closed 40 – year period as adopted by the University's Board of Governors. 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, 2045. Therefore, the long-term expected rate of return on pension plan investments of 7.75% was applied to all periods of projected benefit payments through June 30, 2045 and the applicable municipal bond index rate of 3.82%, 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, 2016, was applied to all periods of projected benefit payments after June 30, 2045. The Single Equivalent Interest Rate (SEIR) of 5.89% 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, 2016.

The discount rate used to measure the total pension liability was 6.37 percent at June 30, 2015. 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, 2044. 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, 2044 and the applicable municipal bond index rate of 3.82%, 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, 2044, was applied to all periods of projected benefit payments after June 30, 2044. The Single Equivalent Interest Rate (SEIR) of 6.37% 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, 2015.

University of Puerto Rico Retirement System

Notes to Financial Statements (continued)

**9. Net Pension Liability of the University of Puerto Rico (continued)**

**Discount Rate (continued)**

The SEIR at the beginning of the measurement period was 6.37% and 4.35% for prior period, based on the long-term expected rate of return on pension plan investments of 8% for both periods applied to all periods of projected benefit payments through June 30, 2044. The applicable municipal bond index rate of 3.82% and 4.35% as of June 30, 2016 and 2015, respectively, applied to all periods of projected benefit payments after June 30, 2044.

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

The following presents the net pension liability of the University of Puerto Rico, at June 30, 2016, calculated using the SEIR discount rate of 5.89%, as well as what the University of Puerto Rico's net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (4.89%) or 1-percentage-point higher (6.89%) than the current rate (\$ thousands):

	<b>1% Decrease (4.89%)</b>	<b>Current Discount Rate (5.89%)</b>	<b>1% Increase (6.89%)</b>
University of Puerto Rico's net pension liability	\$2,382,209	\$2,006,703	\$1,688,137

## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### 9. Net Pension Liability of the University of Puerto Rico (continued)

##### Sensitivity of the Net Pension Liability of Changes in the Discount Rate (continued)

For June 30, 2015, the net pension liability of the University of Puerto Rico, calculated using the discount rate of 6.37 percent, as well as the University of Puerto Rico's net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (5.37%) or 1-percentage-point higher (7.37%) than the current rate (\$ thousands):

	1% Decrease (5.37%)	Current Discount Rate (6.37%)	1% Increase (7.37%)
University of Puerto Rico's net pension liability	\$2,144,842	\$1,796,727	\$1,501,031

#### 10. Retirement System Regulatory changes

As a result of intensive research work made by the Retirement System Administration and several meetings by the Retirement System Board & the Government Board, effective July 1, 2015 retirement system regulatory changes occurred. These measures emerged as initiatives implemented towards improving sustainability of the current defined benefit system.

Effective July 1, 2015, participation rules changed for all participants with less than 25 years of service. Retirement age eligibility and payroll contribution requirements were modified for participants under 25 years of credited services as of June 30, 2015 (*Governing Board Certification number 140, 2014-2015*).

- For participants with less than 25 years of service as of June 30, 2015, the eligible retirement age change from 55 to 58 years and the individual contribution increases an additional one percent (1%) over the one currently being deducted as of June 30, 2015. This increase in contribution does not represent changes in the employee current pension salary ceiling certification nor in the Social Security supplementation. Participants retain their right to exercise the option to change to Social Security supplementation and / or to change to another pension salary ceiling certificate in accordance with established rules and regulations for these changes.



## University of Puerto Rico Retirement System

### Notes to Financial Statements (continued)

#### **10. Retirement System Regulatory Changes (continued)**

- Participants who enter for the first time on July 1, 2015 and thereafter will contribute 12% of their salary to a maximum of \$69,556 salary ceiling supplemented with Social Security. These new participants will automatically fall into the provisions for Annuities Service Certification 55 (1989-1990) of the Higher Education Council, as amended.

#### **11. Subsequent Events**

##### **Commonwealth of Puerto Rico Regulatory Changes**

On June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which grants the Commonwealth and its component units access to an orderly mechanism to restructure their debts in exchange for significant federal oversight over the Commonwealth's finances. On August 31, 2016, the U.S. President announced the appointment of seven members to the Oversight Board.

Required Supplementary Information  
*(Unaudited)*

University of Puerto Rico Retirement System

Schedule 1 – Schedule of Changes in the University of Puerto Rico's  
Net Pension Liability

Fiscal Year Ended June 30, 2016  
(In thousands) (Unaudited)

	2016	2015
<b>Total Pension Liability:</b>		
Service cost	\$ 46,571	\$ 48,107
Interest	194,184	177,334
Changes in benefit terms	(14,671)	(45,209)
Differences between expected and actual experience	(4,733)	(323,974)
Changes in assumptions	160,911	32,269
Benefit payments, including refunds of member contributions	(182,614)	(176,872)
Net change in total pension liability	199,648	(288,345)
Total pension liability, beginning	3,139,723	3,428,068
Total pension liability, ending (a)	<u>\$ 3,339,371</u>	<u>\$ 3,139,723</u>
<b>Plan Fiduciary Net Position:</b>		
Contributions - employer	\$ 78,004	\$ 88,251
Contributions - member	38,640	35,594
Net investment income	59,009	76,684
Benefit payments	(182,614)	(176,872)
Administrative expenses	(3,363)	(4,689)
Other	(4)	–
Net change in plan net position	(10,328)	18,968
Plan fiduciary net position, beginning	1,342,996	1,324,028
Plan fiduciary net position, ending (b)	<u>\$ 1,332,668</u>	<u>\$ 1,342,996</u>
<b>University of Puerto Rico's Net Pension Liability - Ending (a) - (b)</b>	<u>\$ 2,006,703</u>	<u>\$ 1,796,727</u>

See notes to required supplementary information.

University of Puerto Rico Retirement System

Schedule 2 – Schedule of the University of Puerto Rico's Net Pension Liability

Last 10 fiscal years  
(In thousands) (Unaudited)

(1) University of Puerto Rico Total Pension Liability	(2) Plan Fiduciary Net Position	(3) University of Puerto Rico'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) University of Puerto Rico Net Pension Liability as a % of Covered Payroll (3)/(5)
\$ 3,339,371	\$ 1,332,668	\$ 2,006,703	39.91%	\$ 516,226	388.90%
3,139,723	1,342,996	1,796,727	42.77%	516,226	348.05%

Data comes from GASB Statement No. 67

Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

*See notes to required supplementary information.*

University of Puerto Rico Retirement System

Schedule 3 – Schedule of the University of Puerto Rico's Contributions

Last 10 Years

*(Dollar values expressed in thousands) (Unaudited)*

<b>Year Ended June 30</b>	<b>Actuarial Determined Contribution (ADC)</b>	<b>Contributions in Relation to the Actuarial Determined Contribution</b>	<b>Contribution Deficiency (Excess)</b>	<b>Covered Employee Payroll</b>	<b>Contributions as a Percentage of Covered Employee Payroll (1)</b>
2016	\$ 86,635	\$ 78,004	\$ 8,631	\$ 515,994	15.12%
2015	89,255	88,251	1,004	516,226	17.10%
2014	78,204	91,689	(13,485)	515,856	17.77%
2013	77,772	78,481	(709)	491,291	15.97%
2012	72,186	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%

(1) ADC Rate for each fiscal year comes from actuarial valuation at start of that fiscal year (e.g., the June 30, 2016)

*See notes to required supplementary information.*

University of Puerto Rico Retirement System

Schedule 4 – Schedule of Investment Returns

Last 10 years

*(Unaudited)*

	Year ended June 30,		
	2016	2015	2014
<b>Annual Money-Weighted Rate of Return, net of investment expense:</b>	<b>3.93%</b>	5.61%	17.80%

Includes loans and private equities

Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

*See notes to required supplementary information.*

# University of Puerto Rico Retirement System

## Notes to Required Supplementary Information

June 30, 2016

### **1. Factors that Significantly Affect Trends in Amounts Reported**

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

#### **Changes of Benefit Terms**

Effective July 1, 2014, the compensation limit for Certification 139 was frozen at \$69,556.44.

#### **Changes of Assumption:**

- Change assumed rates of termination from age-based to service-based rates
- Reduce assumed rates of retirement
- Reduce assumed rates of disability retirement
- Update mortality to RP-2000 projected to 2020
- Reduce assumed salary increases to 3.75%
- Reduce assumed rate of investment return to 7.75%
- Reduce price inflation assumption to 3.0%
- Reduce wage inflation assumption to 3.75%
- Reduce payroll growth assumption to 3.0%
- Increase administrative expense load to 0.70% of payroll
- Change amortization method from 30 year open to 30 year closed

University of Puerto Rico Retirement System

Notes to Required Supplementary Information (continued)

June 30, 2016

**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, for the fiscal year beginning on that date. The following actuarial methods and assumptions were used to determine contribution rates reported in that schedule:

<b>Plan</b>	<b>Plan Employees</b>
Valuation date	30-Jun-16
Actuarial cost method	Entry age normal
Amortization method	Level percentage of payroll, closed
Remaining amortization period	30 years
Asset valuation method	5-year smoothed market
Inflation	3.0%
Salary increase	3.75%, including inflation
Actuarial assumptions:	
Investment rate of return	7.75%

Based on the funding policy adopted by the University's Board of Governors, employer contributions for years beginning June 30, 2016 reflect amortization of the System's unfunded actuarial accrued liability over a closed 40-year period from that date.

To determine contributions the System uses the RP-2000 mortality table projected to 2020.





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**Report of 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 System

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 System (the System), which comprise the statement of fiduciary net position, as of June 30, 2016, and the related 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 April 27, 2018.

***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 (internal control) 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*

April 27, 2018

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affixed to  
the original  
of this report.

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