Government Development Bank for Puerto Rico

GDB

Expanding Horizons for the 21st century

Annual Report 2001

TABLE OF CONTENT

Achieving the Vision for the 21st Century

"A Puerto Rico dedicating its strength and force to satisfying the social and economic requirements of all Puerto Ricans… Realizing a new level of economic prosperity for all Puerto Ricans to share as they move into the new global economy of the 21st century."

Excerpted from Governor
Sila María Calderón's First
State of the Commonwealth
Message - March 14, 2001

The Government Development Bank for Puerto Rico (GDB), its subsidiaries and affiliates, are dedicated to providing the necessary financial resources to accomplish that vision. Each plays a highly specialized role in the financing matrix of Puerto Rico. They include:

Subsidiaries

Puerto Rico Housing Finance Corporation
Puerto Rico Development Fund
Puerto Rico Capital Fund
Puerto Rico Public Finance Corporation
Puerto Rico Tourism Development Fund

Affiliates

Puerto Rico Municipal Finance Agency
Puerto Rico Infrastructure Financing Authority
Puerto Rico Industrial, Tourist, Education, Medical and Environmental Control Facilities Financing Authority (AFICA)

The GDB directs their efforts in carrying out the financing requirements of the Commonwealth as the fiscal agent and financial advisor for the government of Puerto Rico, its instrumentalities, public corporations, agencies and municipalities. Financial innovation and strict fiscal responsibility are applied to that task to maximize the resources for social and economic development in the 21st century.

Juan Agosto-Alicea
President and Chairman of the Board
Government Development Bank for Puerto Rico

MESSAGE FROM THE PRESIDENT

Fiscal 2001 was a year of significant transition and positive change for Puerto Rico's economy and the Government Development Bank for Puerto Rico (GDB).

The new administration of Governor Sila María Calderón came into office in January 2001 with an aggressive agenda for sound fiscal management, the creation and retention of jobs and the stimulation of long-term economic activity to restore growth and open new avenues for prosperity in the 21st century. That agenda's primary goal is the generation of 100,000 new jobs through energetic industrial development initiatives and incentives that encourage private sector investment across the economic spectrum.

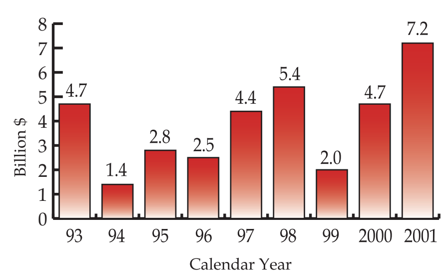
The GDB, as fiscal agent and financial advisor for the Commonwealth, plays a vital role in carrying that agenda forward. Moreover, we have expanded that traditional role to become an important resource in financial and operational planning for the various agencies and instrumentalities of government we serve. Our new board of directors provided valuable guidance in charting that course in the early months of this administration and we continue to rely on their astute judgment to develop innovative, yet responsible financing strategies.

Sound Fiscal Policy

The policy of this Administration and the GDB is to strictly adhere to sound financial practices and we moved rapidly to reinforce the financial underpinnings of the GDB in terms of its capital position and liquidity. Most significantly, the GDB instituted a debt restructuring plan in the last six months of fiscal 2001 that freed capital to invest in liquid assets. By December 31, 2001, liquid assets had risen to $2.8 billion, an increase of 350 percent from $612 million 12 months earlier.

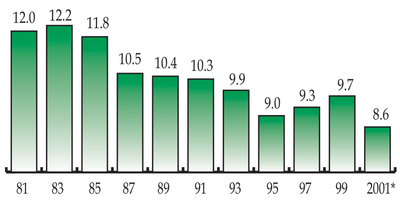
The GDB's swift action reassured the financial rating agencies, Moody's and Standard & Poor's, to hold firm in their credit confidence for Puerto Rico. The confidence of the market, in turn, enabled the GDB to structure and advance what will be a record $7.185 billion in public financing in calendar year 2001, providing new money for infrastructure development and to refinance existing debt for substantial savings to the people of Puerto Rico.

Bonds and Notes Issues of Commonwealth of Puerto Rico and Instrumentalities



Bonds issues by approved date.

Debt Service Ratio
Percent



* In this percentage, the 2002 Refunded Bonds are treated as not outstanding.

Taking advantage of windows of opportunity in a historically low interest rate environment, the GDB secured financing, which will provide $1.8 billion in new money for infrastructure development and $1.9 billion to refund existing debt for present value savings and debt service relief.

Moreover, the GDB was instrumental in setting the wheels in motion for legislative action to refinance $2.4 billion in debt over periods of 5, 10, 20 and 30 years and restrict the practice of issuing "extra-constitutional" debt without adequate sources of repayment and prior legislative approval.

As a result, the GDB is no longer the lender of last resort for government development projects that are not properly structured for repayment. Instead, the GDB is applying sound fiscal policies and the principles of financial responsibility to the economic development strategies of the Commonwealth.

Our Competitive Advantages

Those development strategies seek to build on the substantial economic advantages that are possible under our Commonwealth relationship with the United States to make the economy more competitive and productive on a global scale.

Puerto Rico's fiscal autonomy under the American flag means that investments on the island are as secure as they are on the U.S. mainland, with the added benefit of being treated as foreign source income by the U.S. Treasury for federal tax purposes. This unique circumstance is making possible the conversion of multinational businesses operating in Puerto Rico from 936 corporations to Controlled Foreign Corporations (CFCs).

The Calderón Administration has proposed and is vigorously lobbying for a congressional amendment to Section 956 of the U.S. Internal Revenue Code, which governs CFCs. The amendment would further improve the advantage of operating a CFC in Puerto Rico.

In addition, investors in tax exempt bonds continue to view the issues brought to market by the GDB with favor because of their triple tax-exempt advantage. Puerto Rico is the only bond-issuing jurisdiction that provides income exempt from local, state and federal taxation.

At the same time, Puerto Rico's highly attractive investment incentives package has been improved to encourage local entrepreneurship in a variety of industries, including manufacturing, construction, tourism and service sectors, as well as accelerating the approval process to make enterprises productive in the shortest possible time.

The GDB actively supports those efforts by applying innovative financial planning to the structuring of all debt issues and lending programs. This highly focused financing initiative is contributing significantly to the realization of the Calderón Administration's "Vision for the 21^{st} Century," thanks to the dedication of the new board of directors, the management team and the career personnel at the GDB.

Steering the Economic Course

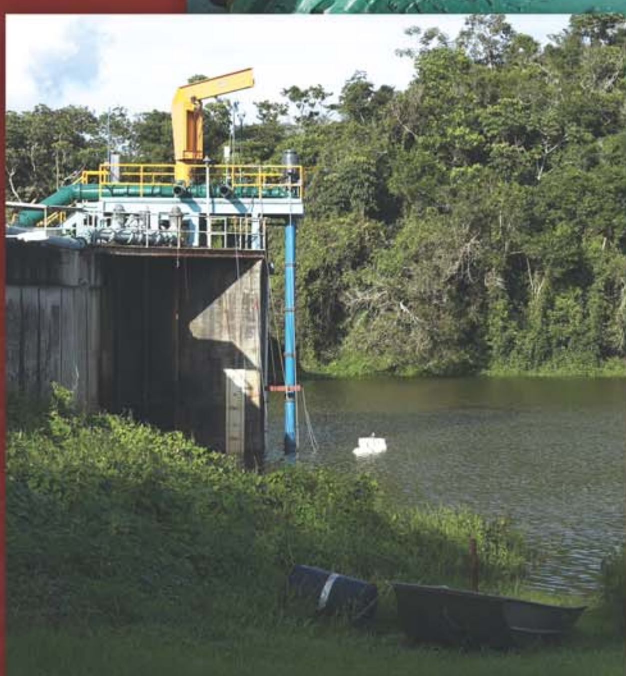
The service culture and new efficiencies established throughout the Bank are having a favorable impact on the financial outlook for the government agencies served by the GDB. Our commitment to constant improvement prompted the GDB to offer re-engineering services to agencies seeking greater efficiency. They include the Aqueduct and Sewer Authority, the Electric Power Authority, the Department of Health and the Department of Education.

Each of these agencies plays a key role in advancing the new "Vision for the 21^{st} Century," which seeks to make government services more responsive to the needs of the people of Puerto Rico. Reliable water and electric services are basic resources for a growing economy. Affordable and dependable health care are essential to the well being of all Puerto Ricans. And, a quality education is vital to competing in the knowledge-based global economy of the 21^{st} century.

Fiscal 2002 will mark the 60^{th} year in which the GDB serves the people of Puerto Rico. Over that long and illustrious history the GDB has forged a solid partnership with the capital markets to achieve economic progress in Puerto Rico. We greatly appreciate that investor support and pledge to do everything in our power to make sure that our mutual interests continue to be satisfied. Investors can be assured that the board of directors, management and staff of the GDB are firmly committed to the realization of those growth objectives in a secure and responsible fiscal environment.

Sincerely,

Juan Agosto Alicea
President



Water Filtration Plant

A project of AFI

The new water filtration and distribution plant in Cidra will benefit more than 15,000 families in the municipalities of Cidra, Aguas Buenas, Caguas and Aibonito. The $30 million facility will be completed in August 2003.

STREAMLINING OPERATIONS

The GDB has substantially revamped its investment and treasury operations to assure a solid liquidity position that enables the Bank to meet financial obligations to depositors and borrowers, now and in the future. This fundamental requirement was the first priority of the GDB as its new management took over in January 2001.

The GDB's public and private finance operations also moved rapidly to structure and bring to market an $800 million issue in Tax Revenue Anticipation Notes (TRANS) in September 2001 to cover general fund obligations. It was the first time a TRANS issue of such magnitude was successfully brought to market so early in the new fiscal year.

By June 30, 2001, almost $1 billion in financing was approved for the central government, its agencies and public corporations.

Other major issues structured in the last six months of fiscal 2001 were the general obligation bonds for $1.2 billion; $390 million for the Public Finance Corporation for the Super Aqueduct project; $175.7 million for the same entity to cover health care programs; and, $127 million for the Housing Finance Corporation for low interest loans. In addition, $400 million in financing was structured between the Housing Bank and the private sector to develop social interest housing across the island.

Innovations in financing also are being applied to meeting the needs of Puerto Rico's 78 municipalities. The municipalities are being encouraged to monitor their financing requirements through the GDB website and file loan applications by e-mail or fax, which accelerates the approval to finance public works projects. What used to take months to process is now being turned around in a matter of days or weeks.

Revitalizing Communities

The municipalities play an increasingly important role in realizing one aspect of the "Vision for the 21st Century," which seeks to revitalize core communities. The improvement and development of facilities and services at the municipal level is key to that revitalization. The GDB supported that effort with the disbursement of 88 loans to municipalities across the island, from January to the beginning of November 2001 for a total of $256.4 million in important public works projects.

New Secure Housing

Campanillas Sector of Toa Baja

223 units were built with a 75% subsidy from FEMA and 25% in matching funds from the Commonwealth of Puerto Rico to provide families with housing that is secure from floods and landslides.

Similarly, the construction of secure and affordable housing is a primary objective of the "Vision for the 21st Century," which is committed to developing 50,000 new housing units. That commitment will benefit from new efficiencies that will soon be achieved through the Puerto Rico Housing Finance Corporation, a GDB subsidiary, which is scheduled to be merged with the Puerto Rico Housing Bank in February 2002. The merger will eliminate redundancy and place responsibility for the financing of both single family and multi-family projects within one entity, the Puerto Rico Housing Finance Authority, with access to the capital markets for financing development projects.

An important element in realizing new housing objectives is advancing of the New Secure Home Program of the Federal Emergency Management Administration (FEMA). The Housing Finance Corporation was assigned management of the $186.1 million program because of its extensive experience in the housing market. The previous project manager, the Puerto Rico Infrastructure Finance Authority, a GDB affiliate, is now concentrated on support for water infrastructure projects.

Secure Housing Programs

The goal is to build approximately 2,500 homes by 2005 at a unit price of $70,000 under FEMA's Hazard Mitigation Grant Program, which seeks to relocate families that live in flood and landslide proned areas. FEMA allocated $139.6 million to the project and the Commonwealth will match approximately $46.5 million. Currently three projects are under construction in Toa Baja, Ponce and Canóvanas with a total of 582 units.

The Housing Finance Corporation has identified sites to develop another 1,800 units and is vigorously pursuing projects in Caguas, Jayuya, Morovis, Dorado, Arroyo, Guayama, and Yabucoa, among other municipalities.

In addition, the Corporation, provides the means to finance the construction, rehabilitation, repair or acquisition of housing for low and moderate income families. It administers the Low Income Housing Tax Credit Program under Section 42 of the U.S. Internal Revenue Code, allocating the credits to owners of low-income rental projects. Also, the Corporation is authorized by the U.S. Department of Housing and Urban Development to operate as an approved mortgagee for multifamily and single family home programs, among other endeavors that stimulate construction and increase employment opportunities.

Embassy Suites Dorado del Mar Beach Resort & Golf Resort

Dorado, Puerto Rico

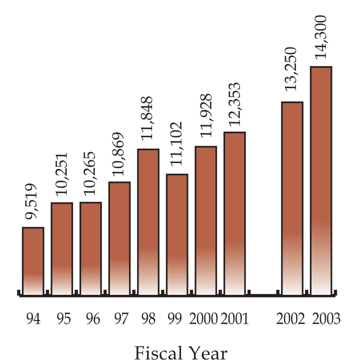
Nearly $40 million in AFICA bonds financed the construction of the resort, which was guaranteed by the Puerto Rico Tourism Development Fund. Embassy Suites Dorado del Mar consists of 174 hotel suites, an 18-hole championship golf course and other related amenities.

The Vision for the 21st Century is expanding the economy of Puerto Rico by building on the clusters of industry that demonstrate the greatest potential for growth in the knowledge-based global economy. Setting the stage for that development strategy, the GDB facilitated the necessary infrastructure projects through bond issues and other financing that will put public works in motion in the months ahead.

By the end of September 2001, more than $367 million in public works projects have been awarded. Also, the funding is in place for another $1.2 billion in public works projects, including roads, electric energy and ports.

The Administration further stimulated the participation of private sector investment in the months ahead by legislating new incentive measures that were structured in the last half of fiscal 2001 with the active participation of the GDB.

Total Number of Rooms



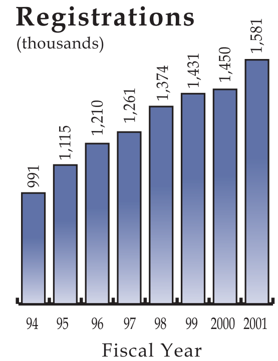
Incentives for "Pioneering Products"

Most notable are new incentives for companies that produce "pioneering products," such as technology innovations. Other legislated incentives include new tax incentives for companies that export products made in Puerto Rico, tax incentives for the rehabilitation of rental housing and the extension of a preferential 7 percent tax rate for secondary sale of the stock of publicly traded Puerto Rico corporations.

Local corporations also will benefit from the creation of an Entrepreneurial Fund by the Economic Development Bank, which will be capitalized with $10 million and receive matching funds from the U.S. Small Business Administration.

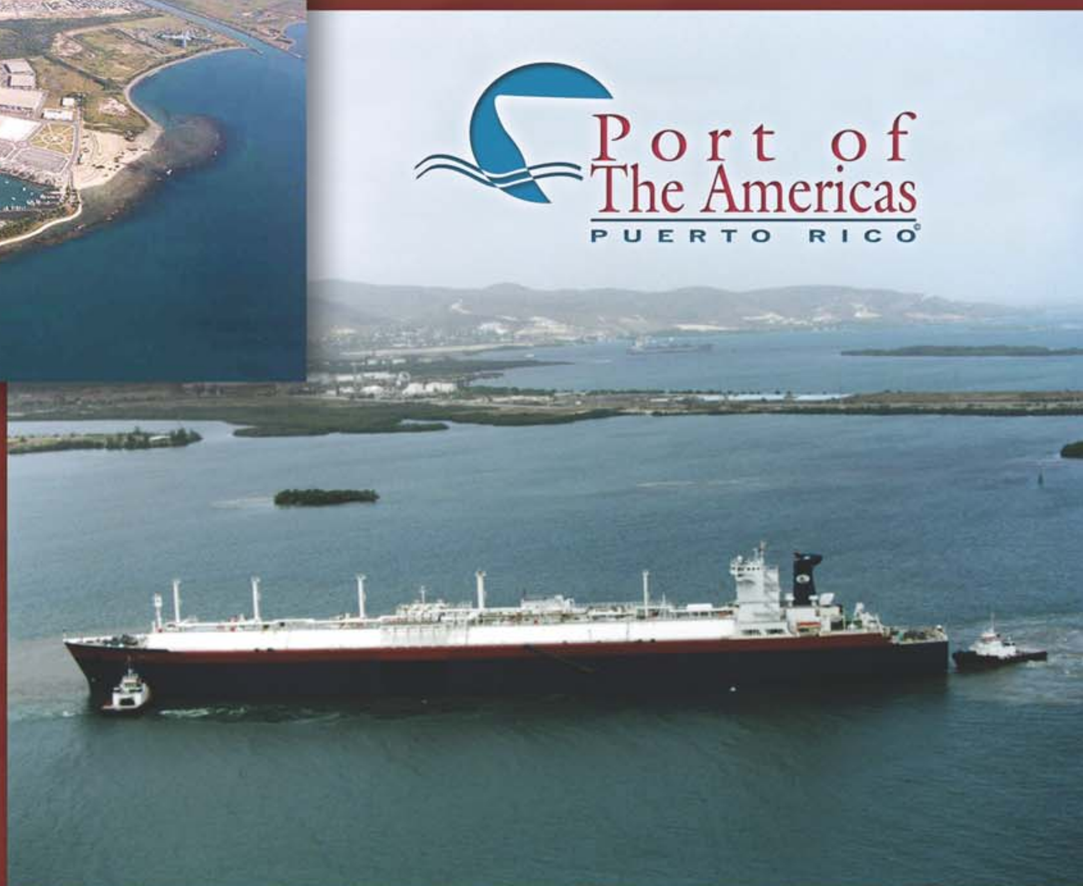
Tourism Initiatives

Tourist Hotel Registrations
(thousands)



Tourism remains a key growth industry for the future of Puerto Rico and the Administration is encouraging greater private sector investment through such incentives as tax exemption for timeshare projects and tax incentives to encourage private bank guarantees on tourism projects. The expectation of more active private bank guarantees enabled the GDB to lower its guarantee on certain AFICA bonds for hotel development from 60 percent to 10 percent since January 2001. In addition, the GDB will re-capitalize its Tourism Development Fund with $50 million for the development of hotels and other tourist facilities.

Currently, the AFICA financing facility is being used to fund six new projects for a total of $187.5 million. The financing for another 11 AFICA projects is in the pipeline for an additional $500 million in economic development projects.



Port of the Americas

Puerto Rico

The transshipment port planned for the south coast will receive mega-vessels from around the world with goods destined for the Caribbean, Central and South America, making Puerto Rico a major hub of global commerce. In addition, the port's free trade zone operations in manufacturing, assembly, logistics and the distribution of products will stimulate significat employment and economic activity.

Puerto Rico is uniquely positioned geographically and economically to serve as a hub for global trade and commerce in the immediate future. The fiscal autonomy of Commonwealth status in association with the United States is the bedrock of Puerto Rico's economic future.

As part of the U.S. dollar area, Puerto Rico provides stability and access to the most lucrative consumer market in the world, the U.S. mainland, as well as a free flow of goods that can be elaborated for emerging markets in Latin America and elsewhere. In addition, our bilingual and bicultural business environment, which has attracted major multinational corporations and stimulated the transfer of world class managerial and technical skills, makes Puerto Rico an ideal partner for North and South American business interests.

Port of the Americas

Hence, Puerto Rico is moving with all deliberate speed to develop the "Port of the Americas," a transshipment port to be located on the south coast of the island. The GDB is spearheading that development and will provide the necessary lines of credit for infrastructure development. The Puerto Rico Legislative Assembly has already provided a $10 million fund to finance the required studies and analyses for the project.

During the last six months of the fiscal year and throughout 2001, the Board of Directors for the port, its administration, working groups and expert consultants worked through feasibility and permitting processes. It is expected that the bidding process will begin in fiscal 2002 and the first phase of the port will be operational in five years.

The return to Puerto Rico's economy will be significant. It is estimated that approximately $3.6 billion a year will be pumped into the economy by the port five years after it starts operations. Further, 6,000 to 10,000 direct jobs and 15,000 to 20,000 indirect and induced jobs will be generated by the economic activity associated with the transshipment port.

Computer Center
Government Development Bank for Puerto Rico

The GDB has invested close to $10 million in the lastest computer systems and equipment to enhance our financial management and processing services, as well as providing ongoing technology training to improve the skills of the people who serve our clients -the government and ultimately the people of Puerto Rico.

Technoeconomic Corridor

In addition, collateral economic activity will stretch from the south coast as far as Aguadilla in the Western region, where air cargo services complementary to the port and its free trade zone operations will be provided. Those facilities also will serve the Technoeconomic Corridor, where high technology industrial clusters are being promoted to conduct research and development and new product elaboration, taking advantage of the lucrative tax incentives being offered by the Commonwealth.

Coliseum & Convention Center

Similarly, after re-focusing the financial structure and business plans of the projects, Puerto Rico is going ahead with the construction of the Coliseum in the Hato Rey financial district and the Convention Center and World Trade District in San Juan. Approximately $150 million in cost savings will be realized on the Convention Center and the marketing focus of both projects will be directed to building up the group and convention business, which is an important element of Puerto Rico's tourism growth plans.

Testing Our Revolve

Puerto Rico's resolve to improve the infrastructure for economic development was put to a severe test on September 11, 2001, when the Governor's key economic advisors and the GDB financing team were in New York to meet with the credit agencies in anticipation of an upcoming bond issue. The disaster at the World Trade Center, which is just a block away from the GDB's offices, caught everyone up in that tragic event.

Fortunately, our staff and all of our colleagues were spared from the holocaust at ground zero. We salute their courage, and the courage of all New Yorkers, who faced great adversity and worked through that tragedy. In the spirit of the City of New York, a week after that shocking attack, the GDB financing staff was back in New York to complete its task under extraordinarily difficult circumstances.

Cayo Largo Inter-Continental Beach Resort

Fajardo, Puerto Rico

Slated for opening in the fall of 2002, the development of Cayo Largo was financed with more than $75 million in AFICA bonds, guaranteed by the Puerto Rico Tourism Development Fund. The resort features 314 first class rooms, an 18-hole championship golf course, a tennis center and spa and has access to Puerto Del Rey, the largest marina in the Caribbean, as well as other amenities.

AN INVESTMENT IN THE FUTURE

The brick and mortar infrastructure development that the GDB is committed to support as the fiscal agent and financial advisor of the people of Puerto Rico is only part of the Vision for the 21st Century. That vision sees a larger role for all Puerto Ricans in the new global economy that is evolving, where knowledge is the primary currency for success.

Education in a healthy social environment and the ability to apply skills in gainful employment are, therefore, the most essential building blocks in achieving full participation in the promise of the years ahead. Futurists point to a world that is at once more demanding and, potentially, more rewarding, where new technologies, as yet undiscovered, will change how we live and work. Change, they suggest, will be the only constant of the 21st century.

The GDB seeks to give Puerto Rico's economy the ability to confront change and benefit from it as a thriving society. That task requires the most productive application of our resources, especially the financial resources of our people, which are finite.

The GDB, therefore, views its role going forward as being an innovative, yet prudent, development bank; going to the capital markets, borrowing and lending, on behalf of our clients, the people of Puerto Rico, to make an investment in their future that adds value and has purpose in achieving the Vision for the 21st Century.

BOARD OF DIRECTORS

Juan Agosto-Alicea
Chairman of the Board

Carmen Conde-Torres, Esq.
C. Conde & Associates

Fermín Contreras-Bordallo
Private Investor

Ramón Cantero-Frau
Vice-Chairman

Melba Acosta-Febo
Office of Management and Budget Executive Director

Juan A. Flores-Galarza
Secretary of the Treasury

Samuel H. Jové-Fontán
President
BMJ Foods PR, Inc.

SENIOR MANAGEMENT

Héctor Méndez-Vázquez
Executive Vice President
Director of Investment and Treasury

José V. Pagán-Beauchamp
Executive Vice President
Financing Director

Miriam Figueroa-Rodríguez, Esq.
Executive Vice President, General Counsel
and General Legal Adviser

Pedro A. Cintrón-Opio, CPA
Executive Vice President
Director, Administration and Operations

From left to right:
Héctor Jiménez-Juarbe - General Manager to the Port of the Americas
María E. Quintero - Director of Communications and Publications
Ismael Pérez-Rosado - Assistant to the President
Francisco J. Medina-Cardona - General Auditor
José R. Cestero - Executive Director, Puerto Rico Housing Finance Corporation

FINANCIAL CONDITION TRENDS
AS OF JUNE 30, (IN THOUSANDS)

	2001	2000	1999	1998	1997	1996
Total assets	$7,823,596	$8,252,487	$8,228,588	$7,858,424	$7,548,874	$7,015,085
Federal funds sold and securities purchased under agreements to resell	1,605,540	782,104	572,036	549,235	902,855	531,809
Deposits placed with banks and commercial paper	20,966	82,483	203,020	522,432	442,299	165,344
Investment and trading securities	1,620,489	3,199,590	3,383,323	3,644,354	2,959,337	3,781,987
Loans, net	3,854,974	3,547,295	3,315,640	2,881,853	3,036,611	2,409,828
Deposits	3,158,654	3,547,507	3,655,748	4,214,000	3,409,411	2,362,094
Other borrowed funds	1,154,240	1,278,451	1,664,561	1,121,504	1,114,203	1,173,349
Capital	1,732,085	1,647,149	1,544,649	1,437,956	1,305,276	1,155,413

FINANCIAL CONDITION TRENDS
AS OF JUNE 30, (IN THOUSANDS)

	2001	2000	1999	1998	1997	1996
Interest income on securities	$157,419	$186,440	$231,405	$247,948	$291,074	$312,185
Interest income on loans	255,985	239,514	157,257	188,892	172,423	150,210
Total interest income	413,404	425,954	388,662	436,840	463,497	462,395
Total interest expense	273,537	278,173	261,578	262,198	277,755	337,884
Net interest income	139,867	147,781	127,084	174,642	185,742	124,511
Provision for loan losses	2,678	(2,433)	(8,633)	(23,500)	6,185	2,767
Net interest income after provision for loan losses	137,189	150,214	135,717	198,142	179,557	121,744
Non-interest income	38,713	37,499	31,765	18,398	19,113	35,747
Non-interest expense	90,966	85,213	60,789	83,860	48,807	48,982
Net income	84,936	102,500	106,693	132,680	149,863	108,509

PROFITABILITY AND CAPITALIZATION
RATIOS AS OF, OR FOR THE YEAR ENDED JUNE 30

	2001	2000	1999	1998	1997	1996
Return on average assets	1.057%	1.244%	1.326%	1.722%	2.058%	1.430%
Excluding non-recurring items	1.057%	1.244%	1.326%	1.722%	2.058%	1.430%
Net income to average capital	5.027%	6.423%	7.154%	9.673%	12.181%	9.854%
Excluding non-recurring items	5.027%	6.423%	7.154%	9.673%	12.181%	9.854%
Average capital to average assets	21.02%	19.37%	18.54%	17.80%	16.90%	14.51%
Net interest margin	1.11%	1.28%	1.03%	1.61%	1.82%	0.97%
Net interest yield	1.90%	1.96%	1.69%	2.34%	2.61%	1.69%

This section presents management's discussion and analysis of the financial condition and results of operations of the Government Development Bank for Puerto Rico (the "Bank") and its component units. The accounting and reporting policies of the Bank and its component units conform to Generally Accepted Accounting Principles (GAAP) as applicable to governmental entities. The discussion and analysis should be read in conjunction with the financial statements, including the notes thereto.

The Bank has six component units: Puerto Rico Housing Finance Corporation, Puerto Rico Tourism Development Fund, Puerto Rico Development Fund, Puerto Rico Public Finance Corporation, Government Development Bank for Puerto Rico Capital Fund, and Puerto Rico Higher Education Assistance Corporation.

STATEMENTS OF CONDITION

Total assets decreased by $428.9 million or 5.2%, from $8.25 billion as of June 30, 2000 to $7.82 billion as of June 30, 2001. The Bank's high liquid earning assets, such as Federal funds sold and securities purchased under agreements to resell, and deposits placed with banks increased approximately $761.9 million, while loans increased approximately $307.7 million, accrued interest receivable $48 million and other assets $32.5 million. This increase was offset by a decrease in the investment and investment contract portfolio of approximately $1.579 billion, mainly due to the Bank's repositioning of its investment portfolio. Overall, the Bank had a strong liquidity position as mentioned above, which produced solid profitability and further strengthened the level of its capitalization. In addition, the Bank's net decrease in total assets derived from the combination of solid growth in liquid assets and loan portfolio, partly funded by the sale and maturities of investment securities, while reducing the amount of non-performing loans through better collections and restructuring initiatives. The average capital to average assets ratio increased from 19.37% as of June 30, 2000 to 21.02% as of June 30, 2001.

Earning Assets

The Bank's investment policies require purchasing only high quality securities that present minimal credit risk. The investment objective is to seek and obtain a high level of current income as is consistent with the preservation of capital and liquidity.

The fluctuation in total assets of $428.9 million is mainly due to the net effect of the following:

Liquidity Risk

Liquidity refers to the ability to fund current operations, including the cash flow requirements of depositors and borrowers as well as future growth. The Bank utilizes various sources of funding to help ensure that adequate levels of liquidity are always available. Diversification of funding sources is a major priority, as it helps protect the liquidity of the Bank from market disruptions. Since the duration and repricing characteristics of the Bank's borrowings determine, to a major extent, the overall interest rate risk of the Bank, they are actively managed.

The Bank raises its funding from a combination of private and government sources. These are the primary sources of funds for the Bank and are usually more stable than financing from institutional sources. The Bank has also established borrowing relationships with correspondent banks, which further support and enhance liquidity.

Federal Funds Sold and Securities Purchased under Agreements to Resell and Deposits Placed with Banks

The net increase of $761.9 million in fed funds and deposits when compared to balances as of June 30, 2000 considerably increased the Bank's liquidity. Maturities and other sources of funds were invested in money market accounts to satisfy liquidity needs of borrowers, to further the flexibility of the portfolio, and assure the possibility of investing in other instruments considered best suited for expected changes in a short-term interest rate market conditions.

Investments and Investment Contracts

Investments and investment contracts had a significant decrease of $1.579 billion when compared to the prior year figures. The Government Development Bank Capital Fund and Tourism Fund's investments reflected a decrease of $1.2 billion, $237 million, and $43 million, respectively. The reduction in GDB was mainly due to substantial redemption of investments used to fund the Public Sector Loan Portfolio. Meanwhile the reduction in the Capital Fund's investment portfolio is mainly due to the initiative to sell most of the securities comprising the portfolio attributed to market conditions. In the case of Tourism Fund, the decrease is basically the net effect of purchases and maturities of several securities.

Furthermore, as of June 30, 2000 deposits for debt service due on July 2000 of the Puerto Rico Treasury Department (the "Treasury") Tax Revenue Anticipation Notes (TRANs) were invested in obligations of the U.S. Government, its agencies and instrumentalities. During fiscal year 2001, the Bank did not issue any TRANs.

The Bank's investment portfolio comprises 20.7% of its total assets for fiscal year 2001 compared to 38.8% in 2000. The investment securities consisted primarily of Obligations of the U.S. Government, its agencies and instrumentalities ($465 million in 2001 and $1.5 billion in 2000), Obligations of the Government of Puerto Rico and its agencies ($13 million in 2001 and $201 million in 2000), mortgage and asset-backed securities ($850 million in 2001 and $916 million in 2000), equity securities ($77 million in 2001 and $311 million in 2000) investment contracts ($189 million in 2001 and $254 million in 2000) and others ($26 million in 2001 and $18 million in 2000). Within the investment securities portfolio, $740 million at June 30, 2001 and $835 million at June 30, 2000 were restricted or pledged as collateral or payment source for specific borrowings.

Loans and Other Receivables and Accrued Interest Receivable on Loans

Loans and other receivables of $3.85 billion account for 49% of total assets as of June 30, 2001 (43% in 2000). The applicable net variance is the net result of approximately $2.1 billion ($1.2 billion last year) of principal and interest collected and loans originated of $2.4 billion ($2 billion last year).

The Bank's private sector loans and other receivables outstanding at June 30, 2001 and 2000 amounted to $144 million and $218 million, respectively, net of allowance for loan losses of $18 million and $15 million, respectively. The decrease in the GDB's private sector loan portfolio balance was due to several significant loan repayments, two from the manufacturing sector of about $20 million each, and several others from the service sector amounting to $6.8 million. PR Housing, a component unit, had net collections of $11 million. In addition, the decrease in the loans portfolio was impacted by the Public Finance Corporation Tax Liens transaction. (Please, refer to the Tax Liens Receivable section herein.)

We believe that public sector credits, approximately 96% of total loans and other receivables (94% in 2000), have minimal risk. Most of the public sector credits have alternative payment sources available through appropriations in the Commonwealth's budget in upcoming fiscal years. The legislature generally has approved these appropriations to assist certain public sector entities in repaying their loans with the Bank. Furthermore, and in accordance with Act. No. 164, the Bank is no longer allowed to originate loans without a specific source of repayment being identified beforehand. The recently enacted law provides, however, for the Bank to originate new loans up to $100 million with confirmation in writing from both the Commonwealth's Governor and the Director of the Office of Management and Budget. The Bank has not charged-off any loans from the public sector portfolio and accordingly does not establish loan loss reserves for any of these credits.

Pursuant to Act No.164 of the Legislature of Puerto Rico, the Treasury Department, Government Development Bank and Office of Management and Budget were authorized to restructure and refinance some public entities debt with GDB that had no designated source of repayment. Projected debt at June 30, 2001 including accrued interest amounted to $2.4 billion. The refinancing provides for loans restructuring terms no longer than 30 years . The Legislature will assign annual payments from the general fund of the Commonwealth of Puerto Rico. Act No. 164 also allowed the Bank to transfer or sell the loans or any resulting obligation to financial institutions or in the capital markets.

By the end of December 2001, the Public Finance Corporation, a component unit of the Bank, was finalizing the issuance of $1.9 billion in various bond series of which $1.72 billion will be used to buy public loan notes from the Bank. This transaction is expected to generate approximately $61 million in interest income, as a result of recognizing previous non-accrued interest on the outstanding loans restructured.

Accrued interest receivable on loans as of June 30, 2001 and 2000 represented 6.7% and 5.1%, respectively, of the outstanding balance of the loans at the end of each fiscal year. The balance of loans past due over 90 days at the end of both fiscal years is $1.1 billion. Pursuant to Act 164, $476 million of loans past due over 90 days were refinanced and ultimately collected as mentioned above.

Total non-accrual loans were $211.7 million and $244.4 million or 5.4% and 6.86% of the outstanding balance of loans at June 30, 2001 and June 30, 2000, respectively. Within the non-accrual loans, loans to the public sector and private sector totaled $187.4 million and $24.3 million at June 30, 2001, and $217.1 million and $27.3 million at June 30, 2000, respectively.

Tax Lien Receivables
Accounts Receivable from CRIM and the Commonwealth of Puerto Rico

Tax lien receivables represent claims for the amount of *ad valorem* taxes assessed on real property located in Puerto Rico purchased from *Centro de Recaudación de Ingresos Municipales (CRIM).* These receivable accrue interest at an annual rate of 15 percent, compounded monthly; however, interest is recognized as income when collected, due to the uncertainty of collection. The receivables decreased by $189 million, from $285.9 million in 2000 to $96.9 million in 2001. Two main reasons explain the net variance: collections in the amount of $17.6 million and adjustments totaling $171.4 million.

During 2001 the estimated fair value of tax liens receivable was estimated at approximately $228.3 million, the price at which certain Tax Debt Bonds were issued. Therefore, the balance of the tax liens receivable and the related Subordinated Note was adjusted by $95.6, representing the difference between the face value of the tax liens receivable of $323.9 million originally recorded and their estimated fair value of $228.3 million. (Please, refer to Other Borrowed Funds and to Notes to the Combined Financial Statements for more details.)

During fiscal year ended June 30, 2001, the principal amount of approximately $75.8 million of tax lien receivables was identified as defective. Under the terms of the trust indenture, CRIM and the Commonwealth are obligated to replace these defects with either new tax liens or cash in their corresponding proportional share. As a result, the outstanding balance of the tax liens receivable was adjusted by the aforementioned amount and reclassified as accounts receivable from CRIM and the Commonwealth, respectively.

Pursuant to the loan agreement dated June 30, 1998 between the Bank and the Public Finance Corporation, the Public Finance Corporation borrowed from the Bank $140 million which was used to pay the Secretary of the Treasury the purchase price of the right to receive from CRIM a portion of certain delinquent property tax debts. The loan agreement also provided that the Public Finance Corporation's obligation to repay the loan to GDB was limited to the amounts received by the Public Finance Corporation from the Secretary of the Treasury's portion of the tax debt. As of June 30, 2000, based on advice from outside consultants, the Bank reassessed the present value of the future cash flow to be received in connection with these rights and determined that such amount was less than the acquisition price, and, therefore, established an allowance to reduce the rights to the amount expected to be realized, estimated at approximately $14 million. During the fiscal year ended June 30, 2001, the remaining outstanding balance of these rights was fully reserved.

However, the Secretary of the Treasury has acknowledged that the Bank has incurred in losses as a result of said transaction, and has agreed to compensate the Bank for its losses as well as for the estimated losses that the Bank and PFC might incur in the cancellation of the tax debt transaction. Consequently, the Commonwealth has agreed to pay the Bank approximately $132.8 million. This transaction has been reflected in the accompanying combined financial statements as of June 30, 2001 by recognizing an account receivable from the Secretary of the Treasury of such amount with a corresponding impact in operations of approximately $15.9 million. The remaining balance of $116.9 million was deferred until the associated tax debt receivable is finally collected. The deferred income remains within the other liabilities captioned in the accompanying combined balance sheets. (Please, refer to Loans and Other Receivables)

Total Liabilities

Total liabilities decreased by $513.8 million: $388.9 million in total deposits, $158.4 million in commercial paper, $124.2 million in other borrowed funds, and $19.9 million in securities sold under agreements to repurchase, and offsetting increases of $55.3 million in certificates of indebtedness, and $122.1 million of net increase in other liability accounts.

Deposits

Deposits consist mainly of interest bearing demand accounts; special government deposit accounts and time deposits from the Commonwealth, its agencies and instrumentalities. As of fiscal year-end, the Bank continues to maintain a stable deposit base.

Total deposits decreased from $3.5 billion at June 30, 2000 to $3.2 billion at June 30, 2001. Average balances were $3.8 billion in 2000 and $3.5 billion in 2001. However, demand deposits show an increase of $345 million or 16.8% when compared to June 30, 2000. The growth in demand deposits consists of over $200 million in escrow deposits from the municipalities and a more aggressive effort to attract more public deposits such as AFICA construction funds. The Bank was able to attract 936 deposits of approximately $102 million. In addition, the Bank was more aggressive in its efforts to raise private funding as evidenced by its ability to attract approximately $200 million from Microsoft Corporation.

The increase in demand deposits was offset by a $733.6 million decrease in certificates of deposit. As mentioned above, the balance as of June 30, 2000 included deposits related to the $700 million 2000 TRANs debt service due in July 2000; there were no TRANs issued for fiscal year 2001.

Commercial Paper

Commercial paper outstanding as of the end of fiscal year 2001 decreased slightly from $1.4 billion in 2000 to $1.25 billion in 2001, but averaged $1.2 and $1.3 billion, respectively. The program has remained in a close range on average because of an aggressive approach by the Bank to capture low-cost funding in the U.S. tax-exempt commercial paper market. The tax-exempt commercial paper is used to fund, on an interim basis, capital improvement projects that qualify for permanent tax-exempt financing. Some bond issues that replaced commercial paper were Puerto Rico Electric Power Authority ($263 million), Highway and Transportation Authority ($270 million) and University of Puerto Rico ($75 million), while new loans funded with commercial paper were Puerto Rico Health Department ($257 million), Puerto Rico Aqueduct and Sewer Authority ($171 million) and the Treasury Department ($164 million).

Other Borrowed Funds

Other borrowed funds decreased $124 million or 9.7% from $1.27 billion at June 30, 2000 to $1.15 billion at June 30, 2001. The decrease is mainly due to the following transactions:

The Public Finance Corporation had accepted at the time of inception in 1999 an amount payable to CRIM under a Subordinated Note of approximately $116.8 million and, accordingly, the obligation was recorded at such amount. However, upon further analysis of the transaction during fiscal year 2001, an adjustment was recorded against the subordinated obligation to CRIM to reduce it to its estimated fair value. (Refer to Tax Liens Receivable above.)

Bonds payable shows a net decrease of $28.6 million as compared to prior year figures. The bonds payable of Housing Finance Corporation had a net decrease of $16.3 million. There were three events that changed the composition of the outstanding bonds payable: the issuance of $17.7 million and $16.3 million of Homeownership Mortgage Revenue Bonds and Mortgage Trust III, respectively, and the redemption of the outstanding balance of $47.3 million in Mortgage Trust II. Also, the bonds payable of Public Finance Corporation decreased by $6 million during the period ended at June 30, 2001. The fluctuation is mainly due to principal repayments during the fiscal year.

RESULTS OF OPERATIONS

Net income decreased from $102.5 million in fiscal year 2000 to $84.9 million in fiscal year 2001. As follows we explain the main reasons for the reduction in the net income:

Net Investment Income

Net investment income decreased from $148 million in fiscal 2000 to $139 million in fiscal year 2001 or 5%, and net investment margin from 1.28% in 2000 to 1.12% in 2001. Interest income from investments decreased $29 million, from. $186 million in 2000 to $157 million in 2001. Following market trends the interest yield decreased 23 basis points and the average balance dropped by $455 million The decline of the stock market caused Government Development Bank Capital Fund, a component unit, to loss $50 million in the fair value of investments, representing a net unfavorable change of $53 million. Nevertheless, the long term interest curve dropped during 2001 as compared to 2000, generating a $28 million gain in the Puerto Rico Housing Finance Corporation investment securities portfolio. As of June 30, 2000, the short-term interest rate had an ascending trend while as of June 30, 2001 it had inverted; consequently, the market price of fixed instruments increased resulting in an unrealized gain of approximately $22 million in investments with approximate maturities of three years.

Average public loans ($3.52 billion) and absolute balances ($3.71 billion) increased as compared to year 2000 balances ($3.2 billion and $3.33 billion) to over $300 million, respectively. Interest income increased from $223.6 million to $242.8 or by $19.2 million due to a volume increase of $320 million counteracted by an interest yield drop of ten basis points. The interest rate yield includes the effect of interests collected during the year from loans in non-accrual status, $15.5 million in 2001 and $12.3 million in 2000.

Additionally, it is important to note that a highly liquid balance sheet generally produces a relatively low investment margin. Also, the cost of funds to the Bank as compared to commercial banking is higher due to the nature of its institutional clients. In total, net interest yield decreased from 1.96% in 2000 to 1.90% in 2001.

Provision For Losses on Loans and on Guarantees and Letters of Credit

As a result of the evaluation of the private sector loan portfolio as required by FASB Statement No. 114 "Accounting by Creditors for Impairment of a Loan" Puerto Rico Housing recorded a provision for possible loan losses of $2.7 million during 2001 while in 2000 the Bank recorded net credits for loan losses in the amount of $2.4 million.

Also, the Bank periodically evaluates the risk characteristics of the guarantees and letters of credit portfolio considering factors such as the nature of individual guarantees and letters of credit outstanding, operating results of creditors, past and current loss experience, and general economic conditions. During fiscal year 2001, the evaluation resulted in a provision of $24 million. The provision for losses on guarantees and letters of credit are presented within the non-interest expense caption.

Non-Interest Income

Fiscal agency fees income increased $2.4 million. The predominantly low interest rates of the bond market together with its characteristic stability in contrast to the fluctuations and uncertainties of the stock market resulted in a receptive market. Consequently, the Bank generated various bond issues, which increased in both its absolute number as well as in volume during fiscal year 2001 when compared to 2000.

In addition, commitment, service and administrative fees increased by $1.2 million. This increase was supported by fees on letters of credit and guarantees awarded to tourism related projects, fees earned on services provided in connection with bond issuances of the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority, a component unit of the Government of Puerto Rico, and administrative fees charged to housing projects by Puerto Rico Housing.

Other non-interest income shows a decrease of $2.2 million from the 2000 results. The main component of other income is the deferral of operating results related to the issuance of the tax-lien bonds and the acquisition of tax-lien receivables. Since the tax-lien bonds represent limited non-recourse obligations payable solely from the tax-lien receivables acquired and certain reserves established in connection with the bond indenture, any excess or shortfall of expenses over the revenues related to the assets held in trust is deferred with a corresponding credit to operations. We believe that recording income/expense on this transaction in any other way would result in a net income or loss in certain periods and the opposite in subsequent periods but resulting in zero income statement effect at the end of the term. The expenses related to this transaction are included in different line items of the income statement. Credits to the operations during fiscal years 2001 and 2000 amounted to $10.4 million and $12.6 million, respectively.

Also included within the other income line item are the results of property disposition. During fiscal year 2001 the Bank and a component unit sold other real state with gains of $4.8 million that represents a $2.5 increase when compared to a gain of $1.3 million during fiscal 2000. However, in fiscal year 2000 the Bank received the reimbursement of expenses incurred in the privatization efforts performed on behalf of other governmental entities as well as the payment of fees related to said services and others, in the amount of approximately $2 million. Additionally, prior to its sale during fiscal year 2000 one of the properties generated about $400,000 in rent income.

Non-Interest Expense

Non-interest expense increased by $5.7 million as compared to fiscal year 2000 results. The variance is the net effect of various components of expense: increases in salaries and fringe benefits ($400,0000) due to normal salary increases offset by a decrease in the average personnel as a result of the early retirement option, occupancy and equipment costs ($1.3 million) because of increases in management information system expenses, provision for losses on guarantees and letters of credit of $26.7 million as explained above, other expenses ($3.2 million), and decreases in professional service fees ($3.8 million), provision for loss on real property taxes receivable ($5 million), and the construction of the Puerto Rico Museum of Art ($17.6 million). As the construction of the Puerto Rico Museum of Art was mostly completed during fiscal year 2000, no significant expenses were recognized during 2001.

In June 2000, the board of directors of the Bank approved a resolution whereby the Bank offered an early retirement program option to qualifying employees who provided services as of July 1, 2000, pursuant to a law approved in June 2000 and effective until January 31, 2001, as amended. The costs of the early-retirement option amounted to approximately $13.4 million and are included within other expenses.

Also within other expenses are contributions to others, especially to governmental entities. Compared to fiscal year 2000, the contributions expense was reduced to approximately one third of the 2000 level or from $6.1 to $2.2 million in 2001 of which $2 million were allocated to partially cover the Puerto Rico Museum of Arts operations.

During 2000, the Bank sold its participation in a mortgage loan to the Tourism Fund for approximately $7.8 million. The component unit and another financial institution, which held the remaining participation in the loan, created Sunshine Isle Inn, LLC, a limited liability company (Sunshine) and contributed their respective participation in the loan. The†property collateralizing the loan was subsequently foreclosed. Expected net proceeds from the sale of the foreclosed property are expected to be lower than the investment of the Tourism Fund in Sunshine and accordingly, a provision of $3 million was recorded on said year to reduce the investment to its net realizable value of $4.8 million. The valuation established in 2000 prevailed for 2001 not requiring any further provision.

Internal Controls

The Bank is responsible for establishing and maintaining internal controls to ensure that the assets of the government are protected from loss, theft or misuse, and that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits requires estimates and judgments by management.

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