The Employees Retirement System of the Government of the Commonwealth of Puerto Rico (“Public Employees System”) and the Teachers Retirement System (“Teachers System”) (together, the “Retirement Systems” or the “Systems”) face an unfunded liability that threatens to unleash an economic crisis of catastrophic proportions on the Island. For decades, neither the Government nor government employees have contributed the amounts needed to fund the costs of pension benefits payable to retirees and to public employees who will eventually retire. As a result, the Retirement Systems have the lowest funded ratio of any government retirement system in the United States and will not have the funds needed to make pension payments to retirees. As soon as in FY 2013-2014, the Public Employees System will not have sufficient funds to cover its obligations, as its net assets$1 will be depleted.

We cannot keep postponing a comprehensive reform to the Retirement Systems. The moment to implement permanent solutions to the Systems’ unfunded liability problem is now.

$35.26 billion

Is the difference between the benefits payable to retirees and the assets available to pay such benefits as of June 30, 2011.

➢ For every dollar of benefits payable under the Public Employees System, we only have 6 cents.
➢ For every dollar of benefits payable under the Teachers System, we only have 20 cents.

INTRODUCTION

The actuarial deficit of the Retirement Systems was $35.26 billion$2 as of June 30, 2011.$3 To put the problem in perspective, the Retirement Systems’ actuarial deficit is equal to more than four times the annual revenues of the General Fund and more than half of Puerto Rico’s Gross National Product.$4 In order to meet pension payments over the next 26 years, the Government (central government, public corporations and municipalities) would have to inject into the Systems close to $2.85 billion a year,$5 money which the Government does not have.$6

Government pension plans in the U.S. are dragging an aggregate deficit of approximately $1.38 trillion.$7 States such as Rhode Island, California and Illinois have made difficult, but necessary decisions in recent years to stabilize the finances of their retirement systems.$8
The challenge faced by Puerto Rico is greater than the challenge faced by any U.S. jurisdiction due to the huge gap between Retirement Systems’ assets and liabilities. The numbers do not lie; they speak for themselves.

As of June 30, 2011, the funded ratio of the Public Employees System and the Teachers System was just 6% and 20%, respectively. Rhode Island, the U.S. state with the largest actuarial deficit, had a 49% funded ratio. In other words, as of that date, the Public Employees System had only 6 cents for each dollar needed to pay public employees’ pensions and the Teachers System had only 20 cents for each dollar needed to pay teachers’ pensions.

The magnitude of this problem does not accept half-measures and its solution requires reinventing and redesigning the Systems.

**Time Is Up**

The financial crisis faced by the Retirement Systems is not breaking news. Prior administrations knew of the problem but decided to take lukewarm measures that failed to address the magnitude of the crisis. Today, Puerto Rico cannot afford to think, once again, that it can look the other way and wait for the next administration to solve the problem. For the first time in history, Puerto Rico has no other option but to carry out a far-reaching reform of its pension systems that is fair to all stakeholders.

In the past, the easy solution from the political point of view had been to assign to the Systems additional resources from the General Fund. But the Government does not have the necessary resources in the General Fund to address the Retirement Systems’ unfunded liability. The General

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**In FY2012, the Government only contributed 32% of the annual recommended contribution.**

Fund also has a significant budget deficit that needs to be urgently addressed.

Given the extent of the actuarial deficit, totaling $35.26 billion, the Government’s aggregate contribution to the Systems for FY2012 should have been approximately $2.85 billion. However, the Government only contributed 32% of that amount. In order for the Government to make a $2.85 billion contribution to the Systems it would have to make drastic cuts to government services, including cuts to public safety, health and education budgets and personnel cuts.

The wellbeing of all of those living in Puerto Rico would be seriously affected if more funds from the General Fund are committed to pay the pensions of retirees. The more money is appropriated from the General Fund to fund the Retirement Systems, the less money we will have to meet the rest of our societal needs. More funds for the Retirement Systems mean fewer funds to teach our children, protect our homes, take care of our health, and improve the infrastructure we use every day.

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The Numbers Speak for Themselves | 2
The even more alarming fact is that the Public Employees System only has sufficient funds to cover its obligations through the next fiscal year since its net assets will be depleted in FY2013-2014. This means that the Public Employees System’s actuarial coverage will be 0% as of June 30, 2014 and that the Government will have to make additional appropriations from the General Fund to satisfy the Public Employees System’s obligations.

Without a doubt, the problem has reached critical levels. In its December 13, 2012 credit report, Moody’s downgraded Puerto Rico’s credit rating to just one level above junk. Moody’s warned: “Reform of the Commonwealth’s severely underfunded retirement systems is needed to avoid asset depletion and future budget pressure.” If we do not address the problem of the Retirement Systems now, the Commonwealth’s credit could be downgraded to junk status. This would make it impossible for the Government to continue financing its operations as usual and would be catastrophic for everyday life in Puerto Rico: the Government would not have the resources to continue providing all the services we are used to receiving; would not be able to pay the salaries of all of its employees; would not be able to pay obligations incurred with its service and material providers; would not keep funding the public works that enhance our quality of life; and would not have enough money to make pension payments. A downgrade to junk status would have serious effects on our economy (see item 5 on page 11).

The Retirement Systems’ crisis is no longer the exclusive problem of public employees who expect to enjoy certain retirement benefits; it is a systemic risk that threatens Puerto Rican society and the everyday life of all citizens living on the Island. The longer it remains unsolved, the more insolvent the Systems will get and the worse the adverse social effect of any solution.

Objectives of the Report
This report has three main objectives:

- Estimate the extent of the problem
- Diagnose the causes of the deficit
- Explain the consequences of doing nothing or enacting half-measures

This report seeks to explain, briefly and clearly, the biggest challenges the Retirement Systems are facing, focusing on those that need to be addressed as part of any solution. The report analyzes only the Public Employees System and the Teachers System, but the analysis applies in broad terms to other government retirement systems in Puerto Rico, such as the Puerto Rico Judiciary Retirement System, the University of Puerto Rico Retirement System and the Puerto Rico Electric Power Authority Retirement System.

Given the Government’s need to finance its operations and capital improvement works through financings in the capital markets and given our credit’s fragility and its current rating, we must solve this crisis with urgency. Nevertheless, it is more important that the solutions we propose are well thought-out, fair and permanent solutions to the problem.
The efforts of prior administrations have not been sufficiently comprehensive to solve the problem. The crisis we live today is the result of these lukewarm, fragmented efforts of the past. Our challenge is to act without delay outlining well thought-out, definitive solutions while avoiding the temptation to impose an incomplete and poorly designed reform. We all suffer if Puerto Rico is forced to make drastic cuts to essential public services in order to keep the Retirement Systems solvent or if a credit downgrade devastates the Island. There is no time to waste.

**WHAT WENT WRONG?**

The Public Employees System manages two types of pension plans: a defined benefit plan and a defined contribution plan. The defined benefit plan, in turn, consists of two benefit structures by way of two laws: Act 447 of 1951 (“Act 447”) and Act 1 of 1990 (“Act 1”). The defined contribution plan, better known as System 2000, is governed by Act 305 of 1999.

The Teachers System is a defined benefit plan, governed by Act 91 of 2004. Figure 1 provides additional details with respect to the benefits under each plan.

Undoubtedly, decisions made by both parties have been one of the main causes behind the current crisis in the Systems. The serious problem the Systems are facing goes back, in part, to the enactment of amendments and special laws increasing pension benefits to retirees without the Government having the funds to pay for the

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**Figure 1: Detail of Benefit Structure for the Public Employees System and the Teachers System**

<table>
<thead>
<tr>
<th>Public Employees System</th>
<th>Teacher</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Defined Benefit Plan</strong></td>
<td><strong>Defined Benefit Plan</strong></td>
</tr>
<tr>
<td><strong>Act 447 of 1951</strong></td>
<td><strong>Act 91 of 2004</strong></td>
</tr>
<tr>
<td>• Maximum merit pension of 75% (30 years in service and 55 years of age)</td>
<td>• Established a Defined Benefit Plan for new employees</td>
</tr>
<tr>
<td>• Benefit: 1.5% of average salary during the first 20 years in service and 2.0% of average salary during subsequent years</td>
<td>• Benefit: 1.8% of average salary during years in service</td>
</tr>
<tr>
<td>• Average salary computation based on highest salaries during any 36 month period</td>
<td>• Average salary computation based on highest salaries during any 36 month period</td>
</tr>
<tr>
<td>• Minimum benefit: $400/month</td>
<td>• Minimum benefit: N/A</td>
</tr>
<tr>
<td>• Retirement age(^{(a)}): 58 years</td>
<td>• Retirement age: 50 years</td>
</tr>
<tr>
<td>• Active members: 22,866</td>
<td>• Active members: 42,720</td>
</tr>
<tr>
<td>• Retired employees(^{(b)}): 109,097</td>
<td>• Retired employees(^{(c)}): 35,361</td>
</tr>
</tbody>
</table>

| **Defined Contribution Plan** | **Defined Contribution Plan** |
| **Act 1 of 1990** | **Act 305 of 1999** |
| • Reduced the benefit structure | • Closed the Defined Benefit Plan for new employees |
| • Benefit: 1.5% of average salary during years in service | • Benefit: There is no defined benefit. Pension depends on the employee’s contribution plus return on investment |
| • Average salary computation based on the last 5 years in service | • Upon retirement, the total value accrued is disbursed to the member’s account |
| • Minimum benefit: $400/month | • Minimum benefit: N/A |
| • Retirement age: 65 years | • Retirement age: 60 years |
| • Active members: 46,452 | • Active members: 62,043 |
| • Retired employees\(^{(b)}\): 7,540 | • Retired employees\(^{(b)}\): 21 |

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(a) Except for merit pensions and early retirement with reduced pension.
(b) According to data as of December 31, 2012. Including beneficiaries and disabled workers.
(c) According to data as of June 30, 2011. Including beneficiaries and disabled workers.
costs of those increases, thereby bleeding the Systems’ assets dry.

The main causes behind the crisis are described below:

1) **Inadequate contributions**

Since their inception, the Systems have not received adequate contributions from the central government or employees to maintain healthy solvency levels. During the past decades, the Government has made changes to the Public Employees System, granting more benefits to members without similarly raising employer and employee contributions and failing to provide alternate methods to cover these increased benefits.

Together with other laws, the laws described in Figure 2 slowly weakened the Public Employees System by increasing the benefits without providing for new contributions. As shown in Figure 3, the
Government has never paid the contribution recommended by the actuaries to cover retirement benefits. In order to start addressing the unfunded liability of the Systems, we would have had to contribute, during the last seven years, approximately $5 billion to the Public Employees System and approximately $1.8 billion to the Teachers System.

The General Fund did not have the funds needed to cover these amounts.

2) Impact of Special Laws

The so called “Special Laws” are a series of laws granting benefits in addition to those provided under Act 447 and Act 1. These Special Laws include:

- Summer bonus;
- Medication bonus;
- Christmas bonus;
- Contributions to medical plans;
- Merit pension;
- Other minimum pension benefits;
- Other minimum death benefits;
- Cost of Living Adjustments (COLAs); and
- Additional death or incapacity benefits for specific reasons (e.g., employees in high risk jobs who may die at work).

The annual cost of benefits granted under some of these Special Laws is approximately $260 million. The payment source for most benefits granted under the Special Laws is the General Fund or the budget of other government entities. Therefore, these benefits should not be paid with the Systems’ assets. Nevertheless, often the General Fund as well as public corporations and municipalities responsible for paying the benefits granted under these Special Laws simply do not pay them. The Systems have had to incur these costs, thus aggravating their deficit. These Special Laws benefits play a significant role in the delicate fiscal situation that both the General Fund and the Systems are facing.

3) Early retirement programs

The Government began promoting early retirement programs in 1994 to reduce the workforce. Although these measures reduced payroll expenses, a substantial portion of General Fund expenses, early retirement programs reduced the Systems’ revenues because they caused a proportional decrease in employer contributions. As soon as an employee stops working, the Government stops making employer contributions for that person. But the person receives a benefit usually equal or greater than the one they would have received had they stayed until their original retirement date. If the Government does not pay the required contributions to the Systems to cover the deficit caused by early retirement, a debt equal to or greater than the one anticipated results with respect to the person who retired early, while the revenues to cover it are less.

Since 1994, more than 20 early retirement programs have been implemented. Some of these programs offered pensions equal to 75% of the average salary of an employee with only 24 years of service, regardless of the age of the participant. The fundamental problem of these early retirement programs was that they did not achieve the goal of reducing the total Government deficit because: (i) the positions left by those employees were taken by new employees; (ii) individuals were granted pensions for 65% or 75% of the established salary average, for which the Government had contributed less than the actuarial recommendation; and (iii) government
employers were offered payment plans and some of those entities have not fully complied with those plans.

4) Changes in life expectancy of participants

The average life expectancy in Puerto Rico and the United States has increased to 78 during the last 60 years. This has caused retired employees to receive benefits for more years than originally expected. According to the most recent Health Department study, in 1950, a year before the creation of the Public Employees System, the life expectancy of Puerto Ricans was 59.5 years for men, 62.4 years for women, and 60.9 years for both sexes. The most recent Health Department data shows that in 2004 the life expectancy for men was 73.7 years, for women 80.9 years, and for both sexes 77.2 years, an increase in average life expectancy of approximately 16 years. The increase in life expectancy forces the Systems to pay pensions for longer than anticipated, which has negatively impacted the Systems.

5) Personal loan program

The Public Employees System offers and manages a program that offers personal loans, mortgage loans and loans for cultural travels for retirement plan participants. Participants may obtain up to $5,000 in personal loans for any use. In 2007, the System increased this amount to $15,000, which reduced the cash in the System by approximately $600 million between 2007 and 2010. This deficit has been covered by funds from the System itself and has required the liquidation of assets that would have otherwise been available to make pension payments. The following graph shows the disproportionate growth of the System’s loan portfolio as a result of the increased maximum loan amount:

Figure 4: Evolution of Loan Portfolio of the Public Employees System

Due to the amount of personal loans originated during recent years, the System’s loan portfolio now has a significant amount of illiquid assets. In an effort to improve the situation, in 2011, the Board of Trustees of the Public Employees System passed a resolution lowering the maximum loan amount back to $5,000 and, in 2012; it approved the sale of around $315 million in loans. With a balance of $804 million, as of December 2012, personal loans represent around half of the Public Employees System’s net assets and a serious obstacle to its solvency.

6) Issuance of Pension Obligation Bonds

In 2008, the Public Employees System issued close to $3 billion in pension obligation bonds (“POBs”). The purpose of this offering was to inject the proceeds of such sale into the Public Employees System, thus increasing its funded ratio. This
strategy had been used by some jurisdictions in the United States, including California, Oregon and Illinois. In issuing this type of debt instruments these jurisdictions assigned an external payment source to service the debt. However, unlike in other US jurisdictions, in Puerto Rico, POBs are obligations of the Public Employees System itself and government employer contributions constitute the repayment source for the bonds. Consequently, the Public Employees System has the obligation to repay the POBs from the employer contributions it receives. The term to repay this debt is 50 years, during which the Public Employees System will have to pay, in addition to the principal, around $6 billion in interest, which is equal to approximately 4 years of pension benefit payments due to retired employees. The capital injection into the Public Employees System achieved by the POBs represented an extension of only 5 to 6 years in the life of the assets.

**WE HAVE TO ACT NOW**

Implementing a comprehensive reform to address the crisis in the Systems is of utmost importance. If no significant changes are made to the present structure, all Puerto Ricans, including public employees, pensioners and all other productive sectors in our society will have to make huge sacrifices in order to pay the accrued pension obligations of the Systems. The deficit of the Retirement Systems has the following implications for all Puerto Ricans:

1) **The annual cost of the Systems is unsustainable**

Pursuant to laws currently in force, the employer contribution will increase every year until it reaches 21% and 20% of the salary of public employees and teachers, respectively, by 2020. See Figure 5. In order to be able to pay the employer contributions established by law, by 2020, the Government will have to contribute $2.15 billion; equal to 25% of General Fund revenues (that come from the taxes paid by all Puerto Ricans) just to cover the Systems’ pensions payments.

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*This reflects the increase in employer contribution pursuant to Act 116 for the Public Employees System and Act 114 for the Teachers System.*
According to projections provided by the Systems’ actuaries, if we do not make drastic changes to the Retirement Systems, present General Fund contributions to the Systems would have to increase significantly during the next 20 years in order to make pension payments. As shown in Figure 6, this means that by 2030, for every dollar the Government gets in revenues, 41 cents would be destined to pay pension obligations to public employees.

The Government does not have the resources to keep contributing more and more to the Systems. Furthermore, we are not telling pensioners and public employees the truth if we tell them that the General Fund has the capacity to keep doing it.

2) The burden falls on System 2000 participants

In the Public Employees System, System 2000 (see page 4) participants are contributing the same or more than other active members, but they will receive lower
benefits than participants under Act 447 and Act 1 when they retire. Moreover, if the necessary changes are not implemented, there is a possibility that the assets of the Public Employees System will be completely depleted by the time System 2000 participants begin to receive their retirement benefits.

On the other hand, as shown in Figure 7, today there are less active members in the Systems to support the increase in retired employees and beneficiaries. This reduction is due, in part, to early retirement programs (see page 6) and to a substantial reduction in the number of government employees. At this rate, there will be more pensioners than participants in the near future, which will intensify the financial pressure on the Systems.

3) Essential public services will be at risk

As explained above, the burden of pension expenses on the General Fund is too high and will keep growing. This jeopardizes the provision of basic services such as public security, medical coverage and public education that the Government should provide to citizens. For example, by 2022, the Government will have to set aside more than $2.7 billion to contribute to the Retirement Systems. This amount is greater than the annual budget of the Department of Education.

4) The Retirement Systems will run out of money

With $1.75 billion in net assets as of June 30, 2011, it is estimated that the Public Employees System will run out of net assets available to make pension payments as soon as 2014. As mentioned above, this

Figure 8: Evolution - Asset Depletion

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Contributions</th>
<th>Net Assets</th>
<th>Benefit Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>1,000</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>2014</td>
<td>1,500</td>
<td>1,000</td>
<td>500</td>
</tr>
<tr>
<td>2015</td>
<td>2,000</td>
<td>1,500</td>
<td>500</td>
</tr>
<tr>
<td>2016</td>
<td>2,500</td>
<td>2,000</td>
<td>500</td>
</tr>
</tbody>
</table>

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means that when the net assets run out, the Public Employees System will have an actuarial coverage of 0%. Even though the actuarial coverage of the Public Employees System will decrease to 0% by 2014, the Public Employees System does have an additional $3 billion from the POB issuance of 2008, which, estimates show, would extend its life until 2019. Nevertheless, the $3 billion are payable from the employer contributions the Public Employees System receives and, once depleted, there will not be enough money to make the total pension payment. With $2.39 billion in net assets as of June 30, 2011, the Teachers System will run out of funds in 2022.

5) If we don’t reform the Retirement Systems, Puerto Rico’s credit could be downgraded to junk, resulting in devastating consequences for the Island

As reported by the rating agencies, Puerto Rico’s credit could be downgraded to junk status if we do not reform the Retirement Systems. The downgrade would have an immediate effect on the pockets of all Puerto Ricans. Puerto Rico would enter a financial crisis. This would mean, among other things, that the capital markets would be closed to the government of Puerto Rico; a drastic devaluation of anywhere from 30% to 50% in the value of all Government and public corporations’ obligations; reduced short-term credit lines from the banks used by the Government to finance its operations; a significant increase in borrowing costs; loss of millions of dollars invested in individual retirement accounts (“IRAs”) and in public and private retirement plans that invest in Government bonds.

The effect of such a downgrade on government finances would be monumental. There would be a sudden drop in revenues and an inability to rely on public financings to fund Government operations as usual. This would have devastating consequences: government basic services would be severely affected. The road back from the crisis would be long and difficult.

SOLVING THE CRISIS CANNOT BE POSTPONED

Substantial changes to the Systems are needed to save the future of Puerto Rico and of new generations of Puerto Ricans. The undisputed fact is that the commitments the Government has made to provide security to more than 320,000 government employees, teachers, firefighters and police officers now represent the biggest financial challenge Puerto Rico has ever faced. Our only option is to end the structural problem we have been dragging for over 60 years and implement changes and actions that will guarantee solvent Systems and a healthy economy.

As recently as 2011, two laws with similar purpose were passed.¹⁸

“to strengthen the Retirement System Fund... in order to ensure its financial stability and guarantee that participants and pensioners may have a stable financial future and feel confident that at the end of their public service career they can count on a Retirement System that will offer them financial security as retired employees”¹⁹ [Unofficial translation]

However, none of these purposes were achieved. Puerto Rico faces the lowest actuarial coverage in its history and in the
The Numbers Speak for Themselves

history of any jurisdiction in the U.S. The financial future of pensioners and future generations of Puerto Ricans is at stake and public employees do not have a stable and secure retirement system.

We need to take urgent measures that:

- Provide to retired employees a level of security that is dignified
- Do not cut short the economic opportunities of future generations of Puerto Ricans, and that are fair to all taxpayers
- Do not affect the financing of essential public services
- Prevent a systemic risk to the Island’s economy
- Attract quality employees to the public sector

No individual solution will address the problem we face. In order to achieve a meaningful change that is fair to all stakeholders, we must enact a series of reforms. The magnitude of the Retirement Systems’ deficit is so serious that we have to take measures that have a significant effect.

In weighing solutions, we must always bear in mind that when we talk about pensions, we are talking about hard-working people who have worked for years and decades towards retirement. We cannot put their wellbeing at stake during the last years of their lives. At the same time, we have to come up with solutions that ensure the wellbeing of all Puerto Ricans. We have to take effective measures that make meaningful long-term effects. The time of looking the other way is over.

Let us reassess our social contract, decide what a fair retirement is, and examine the impact on all Puerto Ricans, so that together we can create a better Puerto Rico.
1 Public Employees System’s net assets exclude the proceeds from the Pension Obligation Bonds (POBs) issuance, because the Public Employees System is responsible for the repayment of the debt created by said issue. According to the Actuarial Valuation Report as of June 30, 2011, net assets totaled $1.72 billion. Public Employees System’s total assets include the funds received from the POBs issue and are $4.99 billion, as of June 30, 2011.

2 This number takes into account the assumptions described in the Actuarial Valuation Reports (“Puerto Rico Government Employees Retirement System, June 30, 2011 Actuarial Valuation Report” and the “Puerto Rico Teachers Retirement System, June 30, 2011 Actuarial Valuation Report”). The Actuarial Valuation Reports take into account an annual discount rate of 6.40%. The actuarial deficit is $25.49 billion for the Public Employees System and $9.768 billion for the Teachers System, including the obligation to make medical plan contributions. If we were to determine the actuarial deficit of the Systems using the new requirements issued by the Governmental Accounting Standards Board, an institution focusing on improving accounting standards for state and local governments, it would be $44.99 billion. Any demographic and/or economic changes in the actuarial valuation assumptions may positively or negatively affect this number.

3 The actuarial valuation reports of the Public Employees System and the Teachers System as of June 30, 2012 have not been completed; the combined actuarial deficit is expected to be greater than $35.26 billion.

4 General Fund revenues for FY2011 were $8.15 billion. Puerto Rico’s Gross National Product was $64.11 billion in FY 2011.

5 Annual Required Contribution (“ARC”). According to the Actuarial Valuation Reports as of June 30, 2011, the Public Employees System’s projected ARC for FY-2012 is $2.15 billion and the Teachers System’s ARC is $700 million. The computation of the ARC takes into account a stable investment yield rate of 6.40% per year for both Systems.

6 For FY2012, estimated employer contributions for the Public Employees System and the Teachers System were 33% and 30% of the ARC, respectively.


8 Rhode Island: Increased the minimum retirement age, eliminated COLAs and canceled the defined benefit plan. The cities of San Jose and San Diego in California eliminated bonuses to retired employees and discontinued automatic pension raises. Illinois increased the retirement age and capped the salary used for calculating pensions.

9 Rhode Island State Employees’ funded ratio for FY-2013.

10 Annual Required Contribution, as described in endnote 5.

11 The actuarial coverage only takes into account the net assets. It does not include the $3 billion from the POBs issue.


13 According to Actuarial Valuation Reports for the Public Employees System and the Teachers System as of June 30, 2011. This figure does not include some special laws, such as, COLA.
14 US National Center for Health Statistics, based on 2008 data.

15 Source: Public Employees System.


17 This figure assumes General Fund revenues of $8.75 billion, as of FY2013 budget.


19 Statement of Motives of Act No. 116 of July 6, 2011.