



INTRODUCTION



INTRODUCTION

Certificate of
Achievement
for Excellence
in Financial
Reporting

Presented to

Teachers' Retirement System
of the State of Illinois

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended

June 30, 2011

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Linda C. Davidson
President
Jeffrey L. Esser
Executive Director



LETTER OF TRANSMITTAL

December 19, 2012

To the Board of Trustees and TRS Members:

We are pleased to present the *Comprehensive Annual Financial Report* (CAFR) for the Teachers' Retirement System of the State of Illinois (TRS) for the fiscal year ended June 30, 2012. This year's report is a celebration of the many academic disciplines our members master and instill in future generations – mathematics; science; grammar, literature and composition; history and social studies; music, theater and fine arts; computer science; physical education; and vocational skills.

We can celebrate the contributions our members make to communities throughout Illinois and the report shows that TRS is a strong retirement fund for the near term. The long-term sustainability of the System, however, remains uncertain due to the bleak fiscal condition of the State of Illinois. We are further tested by an underperforming economy that creates significant political and fiscal challenges. Going forward, unless changes are made, these factors will further undermine the state's responsibility to fully fund teacher pensions annually and to keep retirement promises to TRS members first established in 1939.

Recognizing the difficulties of this environment, in 2012 TRS helped shape public debate in Illinois with warnings about the serious consequences of two fiscal trends on a collision course: pension debt growing faster than state revenues and the consistent failure of state government to provide actuarially adequate funding to pay down that debt. The results of the recent TRS actuarial valuation underscore this serious situation. With only 40.6 percent of the market-value assets required to pay benefits on hand as of June 30, 2012, TRS, together with the other Illinois pension systems, is the worst funded major pension system in the country. TRS's unfunded liability stands at \$52 billion. This means that we have only half of the assets needed to pay the benefits due to our members **who are already retired**. Paying off this debt will require over \$200 billion in state funds over the next 30 years. If there was a clear path forward to solve this vexing problem we could be less strident in our call for action, but that clear path has yet to emerge.

The need to act is more urgent than ever. The TRS Trustees have resolved that without any changes, the System faces the real possibility of future insolvency. There has been broad discussion of solutions, but action has been lacking.

Our members and the taxpayers of Illinois deserve a resolution to the uncertainty that has dominated this public discussion in recent years. A solution that puts TRS on permanently sound financial footing is needed. There are no magic answers awaiting discovery, only tough choices. Many other states have responded to their own pension funding challenges and taken the difficult steps necessary to ensure the future viability of their retirement systems. Illinois has not. As this CAFR is being readied, we await action by lawmakers on legislation that would result in controversial changes to the funding mechanism for pensions and to promised retirement benefits. Any change in the Pension Code will require tough choices from everyone with a stake in the future of TRS. Continued inaction will just make these choices more difficult in the future.

In response to this situation, the TRS Board of Trustees approved a resolution in early 2012 that acknowledged the threat of insolvency and established a five-point foundation to guide any pension change designed to secure the future. The five cornerstones of pension reform are:

- Require the use of standard actuarial practices to determine funding instead of alternate calculations required by state law that artificially lower state contributions. For example, the contribution for FY14 set by state statute is nearly \$1 billion less than the actuarially-determined amount.

- Require a guarantee in state law that ensures state government fully funds TRS and the state's other public pension funds in the future. We can't allow the current underfunding to repeat in the future.
- Amend state law and fix a serious financial inequity in the benefits and funding for Tier II pensions that significantly penalizes those members and creates future funding imbalances.
- Require that any changes enacted in the pension code may be administered professionally, efficiently, and fairly to all our members.
- Require that any changes to the pension code adhere to Article 13, Section 5 of the Illinois Constitution – the pension protection clause.

TRS is a promise keeper. Our fiduciary duty to ensure the long-term stability and strength of the system means that we must be certain that the retirement promises made by the State of Illinois to educators *are promises that can be kept for every one of our members*. We call for action now so that we can keep the pension promises made to teachers in the midst of their careers or at the start of their careers just as we have kept them for those already retired. Absent any corrective action, it is likely that we won't be able to keep those promises at some point in the future.

The state's pension promise is vital to teachers and communities in every corner of Illinois. TRS benefits provide our members with a stable income in retirement that supports them as productive members of society. Moreover, most TRS annuitants stay in Illinois and contribute to the state economy as they spend their pensions. TRS benefits support more than 32,000 jobs throughout the state and provide an annual economic stimulus in excess of \$4.4 billion.

Finally, TRS is required by law to publish a CAFR annually with information about the System's financial condition, investment methods and performance, actuarial conclusions that determine financial needs and statistical information about members, school districts, revenues and benefits. TRS management and staff are responsible for the accuracy of this report and for ensuring that all material disclosures have been made. TRS recognizes that the limitations of internal controls must be considered. These controls are designed to provide reasonable assurance regarding the safekeeping of assets, the reliability of financial records, the appropriate segregation of duties and responsibilities and the use of sound accounting and financial practices. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived and that the valuation of costs and benefits requires estimates and judgments by management. The objective of internal controls at TRS is a reasonable, not absolute, assurance that the System's financial statements are free of material misstatements. Three internal auditors who report directly to the Board of Trustees are employed to continually review and determine that all laws, rules, policies and procedures are followed.

Profile of TRS

TRS was established by the State of Illinois on July 1, 1939, to provide retirement, disability, and death benefits to teachers employed by Illinois public elementary and secondary schools outside the city of Chicago. A 13-member Board of Trustees governs TRS. The Board includes the state superintendent of education, six representatives of the public who are appointed by the governor, four members of TRS who are elected by active teachers, and two retired members who are elected by annuitants. The Board of Trustees appoints the executive director, who is responsible for the effective administration of TRS.

The annual budget for TRS administrative expenses is prepared by staff and approved by the Board of Trustees. The TRS annual operating budget request is prepared in conjunction with a review of the long-range strategic plan.

Financial Information

Our staff issues a CAFR within six months of the close of each fiscal year. The report contains basic financial statements presented in conformity with generally accepted accounting principles (GAAP) applied within guidelines established by the Governmental Accounting Standards Board (GASB).

A system of internal controls helps us monitor and safeguard assets and promote efficient operations. Each year TRS's financial statements, records, and internal controls are examined by a professional accounting firm who

serve as special assistant auditors employed by the Illinois Auditor General. In addition, an annual compliance attestation examination is performed to review compliance with applicable statutes and codes. The Independent Auditors' Report on TRS's financial statements is included in the Financial Section of this report.

Generally accepted accounting principles require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of a Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the report of the independent auditors.

Revenues and Expenses

The three sources of TRS funding include member contributions, investment income, and employer contributions through state appropriations and payments by school districts. TRS expenses include payments of benefits, refunds, and administrative expenses. Negative amounts are shown in parentheses () throughout this report.

Revenues (\$ millions)

Source	2012	2011	Increase (Decrease)	
			Amount	% Change
Member contributions	\$918	\$910	\$8	0.9%
State of Illinois	2,406	2,171	235	10.8
Employer contributions	155	154	1	0.6
Total investment income	224	7,235	(7,011)	(96.9)
Total	\$3,703	\$10,470	(\$6,767)	(64.6%)

Expenses (\$ millions)

Source	2012	2011	Increase (Decrease)	
			Amount	% Change
Benefits payments	\$4,554	\$4,228	\$326	7.7%
Refunds	84	77	7	9.1
Administrative/Other	19	18	1	5.6
Total	\$4,657	\$4,323	\$334	7.7%

TRS staff and the Board of Trustees remain vigilant in our efforts to improve the retirement system's funded status for our current and future members. We continue to invest prudently and in a disciplined manner for the benefit of our membership and for the long-term success of the retirement system. The TRS Board and staff believe the overall investment strategy remains sound and appropriate for our circumstances.

Investments

The TRS investment portfolio returned 1.3 percent, gross of fees, for the fiscal year ended June 30, 2012. Total TRS investment assets decreased approximately \$966 million during the year.

The TRS trust fund is invested by authority of the Illinois Pension Code under the "prudent person rule," requiring investments to be managed solely in the interest of fund participants and beneficiaries. The TRS Investment Policy guides TRS's investments. Investment principles include preserving the long-term principal of the trust fund, maximizing total return within prudent risk parameters, and acting in the exclusive interest of TRS members.

The Investment Section of this report contains a summary of the portfolio and investment activities.

Funding

During the year ended June 30, 2012, the funded ratio of the Teachers' Retirement System decreased from 46.5 percent to 42.1 percent. The actuarial value of assets at year end was \$37.9 billion and the actuarial accrued liability was \$90.0 billion. The decline in the funded ratio was due to an increase in the liability mainly due to new actuarial assumptions and the continued phase-in of prior investment losses. Under the smoothing methodology required by Public Act 96-0043, differences between actual and expected investment earnings are recognized prospectively over a five-year period. The actuarial value of assets now recognizes 80 percent

of the 2009 losses, 60 percent of the 2010 gains, 40 percent of the 2011 gains, and 20 percent of the 2012 shortfall to the actuarial rate of return.

The Actuarial Section of this report contains the actuary's letter and further information on TRS funding.

Major Initiatives

In FY12, TRS implemented and continued several initiatives that benefited its members and enhanced the retirement system:

- Launched a comprehensive project to digitize more than 400,000 TRS records in order to increase productivity, sharpen efficiency and better safeguard vital information;
- Provided extensive analysis and data to members, policymakers and stakeholders regarding the impact of various legislative proposals that would affect benefits and system funding;
- Undertook an extensive review of the System's actuarial assumptions, including the long-term assumed rate of investment return, in order to ensure that the methodology used to determine costs and benefits is as up-to-date as possible;
- Initiated the implementation of new financial reporting guidelines established by the Governmental Accounting Standards Board for use in fiscal year 2014, along with an education program to help members, stakeholders and the media understand the rationale, use and limitations of the new procedures.

GFOA Award

The Governmental Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to TRS for its *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2011. The Certificate of Achievement is a prestigious national award recognizing excellence in the preparation of state and local government financial reports.

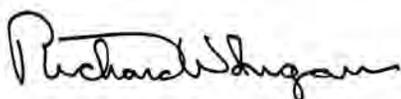
To be awarded the certificate, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents meet or exceed program standards. This report must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate of Achievement is valid for a period of one year only. TRS has received a certificate for the last 23 years. We believe our current report continues to meet the program requirements and are submitting it to the GFOA for consideration again this year.

Acknowledgements

Information for this report was gathered by and reflects the combined efforts of TRS staff under the leadership of the Board of Trustees and the executive director. It is intended to provide complete and reliable information as a basis for making management decisions, to determine our compliance with legal provisions, and as a means of determining responsible stewardship of the assets contributed by members and their employers.

This report is made available to members of the General Assembly, participating employers, and to other interested persons by request. The participating employers of TRS form a link between TRS and its members. Their cooperation contributes significantly to our success. We hope all recipients of this report find it informative and useful. This report is also available to the general public on our Web site, <http://trs.illinois.gov>.

We would like to take this opportunity to express our gratitude to staff, professional consultants, and others who have worked so diligently to ensure TRS's successful operation.



Richard Ingram
Executive Director



Jana Bergschneider, CPA
Director of Administration

BOARD OF TRUSTEES As of December 1, 2012



Enrique Vasquez

Front row, left to right: Janice Reedus; Cinda Klickna; President Christopher A. Koch, Ed. D.; Jan Cleveland; and Cynthia O'Neill
Back row, left to right: Vice President Molly Phalen; Michael Busby; Sharon Leggett; Marcia Campbell; Sonia Walwyn; Bob Lyons; and Executive Director Dick Ingram
Shown at right: Enrique Vasquez

EXECUTIVE CABINET MEMBERS As of December 1, 2012

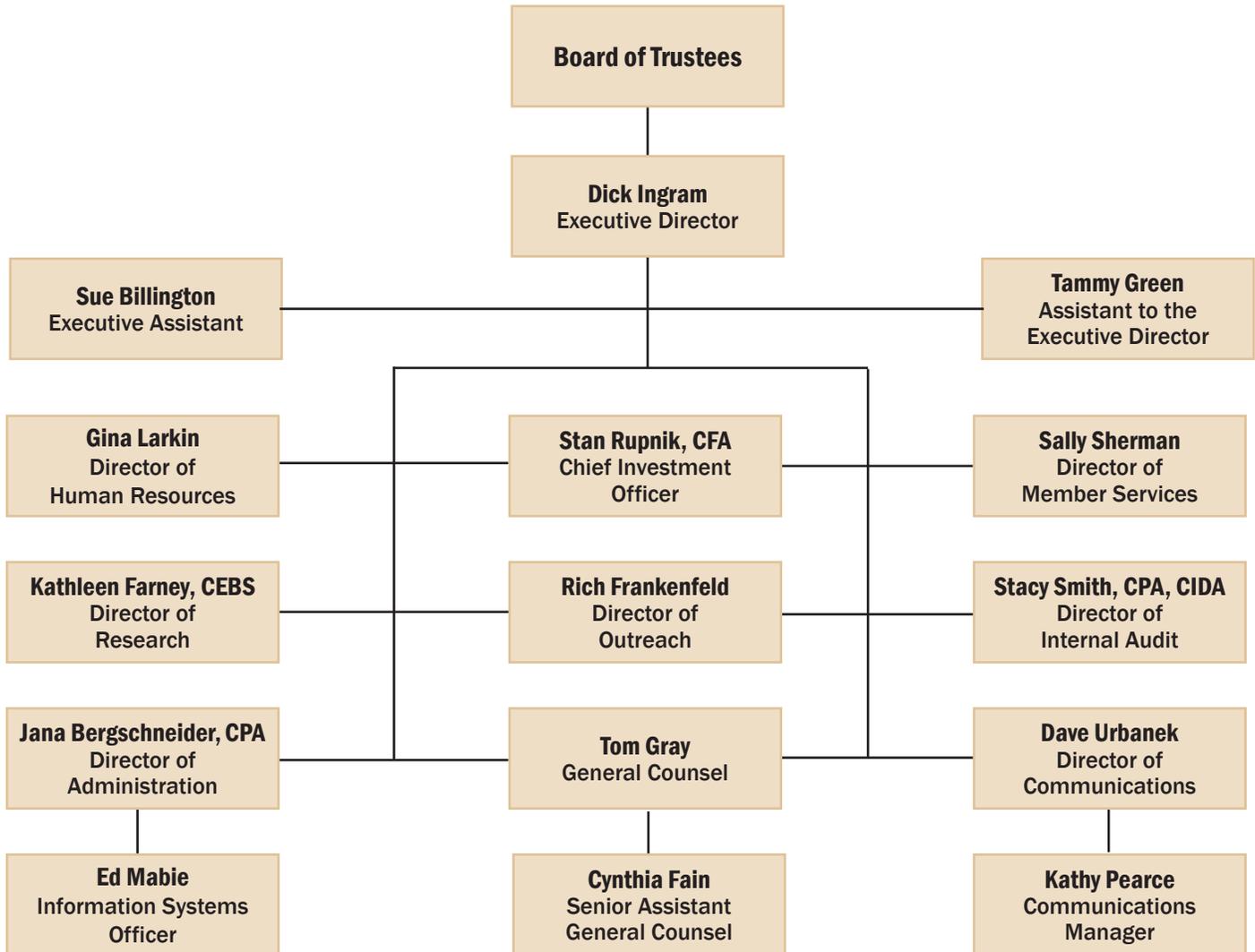


Director of
Outreach
Rich Frankenfeld

Front row, left to right: Executive Assistant Sue Billington; Senior Assistant General Counsel Cynthia Fain; Director of Research Kathleen Farney, CEBS; Director of Communications Dave Urbanek; and Director of Administration Jana Bergschneider, CPA
Back row, left to right: Director of Member Services Sally Sherman; Director of Internal Audit Stacy Smith, CPA, CIDA; Director of Human Resources Gina Larkin; General Counsel Tom Gray; Chief Investment Officer Stan Rupnik, CFA; Executive Director Dick Ingram; Communications Manager Kathy Pearce; Information Systems Officer Ed Mabie; and Assistant to the Executive Director Tammy Green
Shown at right: Director of Outreach Rich Frankenfeld

ORGANIZATIONAL STRUCTURE

Executive Cabinet Members as of December 1, 2012



CONSULTING AND PROFESSIONAL SERVICES

Actuary

Buck Consultants, LLC
Chicago, Illinois

External Auditors

(As special assistants to the Office of the Auditor General)

McGladrey LLP
Schaumburg, Illinois

Information Systems

CTG Inc. of Illinois
Springfield, Illinois

Sentinel Technologies
Chicago, Illinois

Share Point Business Solutions, Inc.
Springfield, Illinois

SunGard Availability Services
Chicago, Illinois

Consultants

Callan Associates Inc.
(real estate)
San Francisco, California

Houlihan Lokey Howard & Zukin Financial Advisors, Inc.
(private equity)
Los Angeles, California

Leinenweber Baroni & Daffada Consulting LLC
(legislative)
Springfield, Illinois

LP Capital Advisors, LLC
(private equity)
Sacramento, California

TorreyCove Capital Partners LLC
(private equity)
La Jolla, California

Risk Resources
(real estate insurance consulting)
Elmhurst, Illinois

R.V. Kuhns & Associates, Inc.
(general investment)
Portland, Oregon

Legal Services

Cavanagh & O'Hara
Springfield, Illinois

Groom Law Group, Chartered
Washington, DC

Heyl Royster Voelker & Allen
Springfield, Illinois

Holland & Knight LLP
Chicago, Illinois

Howard & Howard Attorneys PLLC
Peoria, Illinois

Jackson Walker LLP
Austin, Texas

Kopec White & Spooner
Springfield, Illinois

Loewenstein Hagen & Smith PC
Springfield, Illinois

Mayer Brown LLP
Chicago, Illinois

Morgan Lewis & Bockius LLP
New York, New York

Sorling Northrup
Springfield, Illinois

Master Trustee

State Street Bank and Trust Company
Boston, Massachusetts