LEGISLATIVE AUDIT COMMISSION

Review of
Teachers' Retirement System
Year Ended June 30, 2005

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REVIEW: 4260
TEACHERS' RETIREMENT SYSTEM
YEAR ENDED JUNE 30, 2005

FINDINGS/RECOMMENDATIONS - 1

IMPLEMENTED - 1

REPEATED RECOMMENDATIONS - 0

PRIOR AUDIT FINDINGS/RECOMMENDATIONS - 0

This review summarizes the auditors' reports of the Teachers' Retirement System for the year ended June 30, 2005, filed with the Legislative Audit Commission May 2, 2006. The auditors performed a compliance examination in accordance with State law and G*overnment Auditing Standards*. The auditors also performed a financial audit for the year ended June 30, 2005. The auditors stated at the financial statements of the Teachers' Retirement System were fairly presented.

The Teachers' Retirement System was established on July 1, 1939, for the purpose of providing retirement allowances and other benefits for teachers, annuitants, and beneficiaries. The System is funded through contributions from members, State of Illinois appropriations from the Common School, Education Assistance, General Revenue, and State Pension Funds, investment income, and, to a limited extent, through contributions from school districts. Management of the System is vested in a Board of Trustees, consisting of 11 persons, as follows: the State Superintendent of Education, ex-officio, who is the president of the Board; four persons, not members, appointed by the Governor; four members from the contributing memberships of the System elected by the contributing members; and two annuitants elected by the annuitant members. As of June 30, 2005, TRS membership consisted of 155,850 current active (contributing) members; 87,328 inactive (non-contributing) members; for a total of 243,178.

Mr. Jon Bauman is the current Executive Director and served in that capacity during the entire audit period.

The average number of employees was:

2005 - 168; 2004 - 165.

Financial Information

Appendix A summarizes the appropriations and the expenditures for the System for FY05 and FY04.

Appendix B presents a summary of the Teachers' Retirement System's plan net assets, with assets totaling $39.7 billion, liabilities totaling $5.69 billion, leaving almost $34.1 billion held in trust for pension benefits as of June 30, 2005. Investments are carried at fair value of $34.9 billion as of June 30, 2005, compared to $32 billion one year earlier.

Appendix B also presents a summary of the System's statements of changes in plan net assets. Revenues consist of member contributions, employer contributions (State appropriations and contributions from trust and federal funds), and investment earnings. Member contributions are established by the Illinois Pension Code at 9% of earnings. Employee contributions are collected through payroll deduction and are submitted by the participating employers directly to TRS for credit to each participant's accumulated contributions account.

Total additions were $5.1 billion in FY05 compared to $10.7 billion in FY04. In FY04, the System received $4.3 billion in one-time pension obligation bond proceeds as a result of PA 93-0002 which authorized the sale of $10 billion in General Obligation Bonds for the purpose of making contributions to designated retirement systems. Total additions were also less in FY05 because investment income decreased about $1.4 billion from FY04 to FY05. When the investment income is removed from plan net assets, the System's contributions fell behind expenses by almost $790 million. PA 94-0004 modified the Employee Retirement Option, changed the member contribution rate and added new employer contributions. The legislation contained a two-year funding reduction of approximately 50% in State contributions that will result in a total reduction of over $1 billion for TRS. State contributions will be higher in future years to make up for the funding reduction in FY06 and FY07, as the overall goal of 90% funding in 2045 is unchanged.

Total deductions were $2.3 billion in FY04 compared to $2.6 billion in FY05, an increase of $283 million, or 12.2%. The increase is due to an increase in the number of individuals receiving benefits, which was 82,575 in FY05 and 76,905 in FY04.

Administrative Expenses

Administrative expenses of the System are summarized in Appendix C. Administrative costs relating to investment expenses are not included in Appendix C. Total administrative expenses were $13,560,546 in FY04 to $14,403,715 in FY05, an increase of $842,169, or 6.2%. Expenditures for personal services increased in FY05 by $932,000 even though the number of employees increased by only three.

Investments

Appendix D provides a summary of the rates of return on the System's investments for FY05 and FY04. The 2005 investment return for the System was 10.8%, while the return for 2004 was 16.5%, net of fees. All asset classes produced positive returns. TRS' investment objective is to outperform the actuarial assumption rate of 8.5% over a long-term period of time. The five-year and 10-year returns are 4.7% and 9.5%, respectively. During FY05, TRS' investment portfolio allocation was as follows: 53.5% stocks; 29.4% bonds; 10% real estate; and 7.3% other.

Appendix E provides a summary of investment manager fees for FY05 and FY04. Fees are paid primarily on market values and the manager's portfolio performance. A graduated scale is used for most managers based on various increments per million dollars of market value. Investment manager fees totaled $104,221,360 during FY05. Vouchered fees are paid by TRS out of its master Trustee Account, and nonvouchered fees are deducted directly from the related funds. Investment commissions, which are fees paid to investment brokerage firms for the purchase and sale of investments, totaled $16,360,838 during FY05. These investment commissions are summarized in Appendix F.

System Underfunding

The funding (actuarial) requirements for FY98 were determined under Public Act 88-593, and provides for a 50-year funding plan which includes a 15-year phase-in period. Employer contributions as a percentage of active member payroll will be gradually increased until FY2010 and remaining at that percentage for the following 35 years. The System's funded ratio will be 90% at the end of the 50-year period. Beginning in FY96, State contributions were made through a continuing appropriation instead of through the appropriations process.

PA 94-004 suspended payments required under PA 88-593 for FY06 and FY07, and instead, fixed specific (lower) amounts for FY06 and FY07 contributions to retirement system. Contributions ramp up in FY08 through FY2010 so that by FY2011, contributions will be at an amount sufficient to meet 90% funding level by FY2045.

The following table indicates funding progress for FY1996 through FY2005:

Year	Assets	Liability	Unfunded Liability	Funded Ratio
FY96	$5.1 billion	$26.1billion	$11.0 billion	57.8%
FY97	17.4 billion	27.0 billion	9.6 billion	64.5%
FY98	20.0 billion	30.0 billion	10.0 billion	66.8%
FY99	22.2 billion	3.2 billion	0.7 billion	6.70%
FY2000	24.5 billion	5.9 billion	11.4 billion	68.2%
FY01	23.3 billion	39.2 billion	15.9 billion	59.2%
FY02	22.3 billion	43.0 billion	20.7 billion	52.0%
FY03	23.1 billion	46.9 billion	23.8 billion	46.3%
FY04	31.5 billion	50.9 billion	19.4 billion	61.9%
FY05	34.1 billion	56.1 billion	22.0 billion	60.8%

Accountants' Findings and Recommendations

Below is the finding and recommendation presented in the audit report. The recommendation is classified on the basis of updated information provided by Jon Bauman, Executive Director, via email received February 1, 2007.

Implemented

1. Develop a formal policy to address custodial credit risk as it relates to investments.

Finding: The Teachers' Retirement System (System) did not have a formal policy addressing custodial credit risk.

The Systems' financial statements are prepared in accordance with generally accepted accounting standards (standards). GASB 40, effective for FY2005, requires the System to disclose information regarding deposits and investments that are subject to various risks, with custodial credit risk being one of those risks. GASB 40 defines custodial credit risk as the risk that in the event of a financial institution failure, the System would not be able to recover the value of the investments in the possession of an outside party.

At June 30, 2005, the System identified the following investments that were noted as being uninsured and unregistered, with the securities held by a counter party, but not in the System's name (exposed to custodial credit risk):

Foreign Currency Held by Investment Managers	$ 20,862,357
Government Treasury Notes	902,555
Index Linked Government Bonds	31,220,983
Negotiable Ban Certificates of Deposit	7,751,882
Short Term Bills and Notes	55,285,738
Cash Deposits Held with Brokers for Variation Margin	49,238,508
Total	$ 165,262,026

Failure to have a formal policy addressing custodial credit risk can expose the investments of the System to the risk of loss in the event of a financial institution failure.

Response: Accepted. As a fiduciary, subject to the statutory fiduciary duties specifically set forth in Article 1 of the Pension Code, as well as Section 401(a) of the Internal Revenue Code governing qualified plans, the System is required to monitor credit risk. The System considered these to be its formal policy governing credit risk. The System's custodial credit risk monitoring practice has always included periodic review of the custodian's credit rating risk as well as ensuring the System is in full compliance with all statutory provisions governing custodian retention. Although there is no statute or GASB authority that requires a formal custodial credit risk policy, the System agrees to implement a formal written policy to address custodial credit risk and will continue to work with its custodian and investment managers to monitor custodial credit risk exposure.

Updated Response: Implemented. A written policy is in place in the form of an amendment to the TRS Investment Policy. It was adopted in May 2006.

Headquarters Report

The State Finance Act requires all State agencies to make semiannual headquarters reports to the Legislative Audit Commission. Each State agency is required to file reports of all of its officers and employees for whom official headquarters have been designated at any location other than that at which their official duties require them to spend the largest part of their working time.

In August of 2005, the Department indicated it had no employees spending more than 50% of their time working at locations other than their official headquarters.