REPORT DIGEST

TEACHERS' RETIREMENT SYSTEM

COMPLIANCE AUDIT
For the Year Ended:
June 30, 1996

Summary of Findings:

Total this audit	2
Total last audit	6
Repeated from last audit	0

Release Date:

State of Illinois
Office of the Auditor General

WILLIAM G. HOLLAND
AUDITOR GENERAL

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SYNOPSIS

- The System did not file investment manager contracts with the Office of the State Comptroller as required by law. In addition, the System did not file contracts for services which were paid by using "soft dollar" credits. These credits are issued to the System by certain brokers based on the level of activity of investment managers using that particular broker.

- The System had investment contracts with its former Chief Investment Officer. The services rendered involved hedging domestic equity, domestic fixed income and international equity programs. In addition, an enhanced equity index program and currency overlay programs were also run.

  For the year ended June 30, 1996 and the ten month period ended June 30, 1995 the amounts paid under the contracts totaled approximately $2.9 and $2.5 million, respectively. During this 22 month period, losses exceeded the predetermined benchmarks by approximately $178.9 million.

{Financial Data and Activity Measures are summarized on the reverse page.}

TEACHERS' RETIREMENT SYSTEM OF ILLINOIS
INFORMATION FROM FINANCIAL AND COMPLIANCE AUDITS
YEAR ENDED JUNE 30, 1996

OPERATING STATEMENT ANALYSIS	FY 1996	FY 1995
Revenues:		
Contributions - Members	$ 399,084,000	$ 430,761,000
Contributions - State of Illinois	330,074,000	267,146,000
Contributions - School Districts	59,288,000	331,023,000
Total Contributions	$ 788,446,000	$1,028,930,000
Total Investment Income	788,117,000	566,755,000
Gain on Sale of Investments	813,448,000	257,560,000
Security Lending Interest Expense	(47,448,000)	(52,828,000)
Total Revenues	$2,342,563,000	$1,800,417,000
Expenses:		
Total Benefits	$1,121,594,000	$1,111,676,000
Other Expenses	33,123,000	39,100,000
Total Expenses	$1,154,717,000	$1,150,776,000
Revenues in Excess of Expenses	$1,187,846,000	$ 649,641,000

INVESTMENT PORTFOLIO ANALYSIS - Book Value	JUNE 30, 1996	JUNE 30, 1995
Total Government Obligations	$2,542,684,127	$ 1,896,415,889
Total Corporate Obligations	1,868,412,414	1,518,434,985
International Notes	1,190,688,195	1,360,522,989
Preferred Stock (U.S. & International Combined)	45,172,416	18,714,329
Common Stock - U.S.	3,590,678,878	2,988,476,249
Common Stock - International	1,288,457,399	1,382,321,554
Short Term Investments	1,035,029,113	776,901,583
Real Estate Investments	2,331,186,129	2,223,887,753
Venture Capital	160,385,364	246,049,077
Currency Investment	47,551,357	87,343,764
Total Investment Portfolio at Book Value	$14,100,245,392	$12,499,068,172
Total Investment Portfolio at Market Value	$15,362,254,318	$13,230,761,238

ADMINISTRATIVE EXPENSES	FY 1996	FY 1995
Personal Services	$ 7,205,000	$ 7,150,000
Professional Services	614,000	615,000
Postage	307,000	345,000
Machine Repair and Rental	268,000	320,000
Other Contractual Services	460,000	518,000
Commodities	236,000	290,000
Occupancy Expense	393,000	370,000
Provision for Depreciation	546,000	731,000
Loss on Trade-in of Equipment	0	6,000
Total Administrative Expenses	$10,029,000	$10,345,000

SELECTED ACCOUNT BALANCES	JUNE 30, 1996	JUNE 30, 1995
Cash	$ 4,057,000	$ 1,055,000
Receivables	336,453,000	444,120,000
Accrued Investment Income Receivable	161,204,000	112,120,000
Investments, at cost	13,939,041,000	12,386,948,000
Collateral from Securities Lending	1,517,642,000	986,218,000
Property and Equipment	3,756,000	3,513,000
Total Assets	$15,962,153,000	$ 13,933,974,000
Total Liabilities	2,132,442,000	1,292,109,000
Net Assets Available for Benefits	$13,829,711,000	$ 12,641,865,000
Total Pension Benefit Obligation	26,141,794,000	23,980,566,000
Unfunded Pension Benefit Obligation	$(12,312,083,000)	$(11,338,701,000)

SUPPLEMENTARY INFORMATION	FY 1996	FY 1995
Total investment manager fees	$56,164,336	$51,309,039
Return on Investments		
Total market time weighted return	16.9%	13.4%
Average Number of System Employees	156	161
Number of Retirement Annuitants	52,532	52,740
Number of Survivor Benefit Annuitants	6,240	6,014
Number of Disability Benefit Recipients	892	880

EXECUTIVE DIRECTOR
During Audit Period: Mr. Robert Daniels
Currently: Mr. Robert Daniels

INTRODUCTION

This digest covers our State compliance audit of the System for the year ended June 30, 1996. A financial audit covering the year ended June 30, 1996 was previously issued.

FINDINGS, CONCLUSIO RECOMMENDATIONS

ALL CONTRACTS NOT FILED WITH STATE COMPTROLLER

Investment manager contracts were not filed with the State Comptroller

Contracts for services paid for using soft dollar credits were not filed with the State Comptroller

The System did not file all contracts with the Office of the State Comptroller as required by State law. In fiscal year 1996, the System had agreements with 65 external investment managers to manage portions of the System's investment portfolio which had a market value totaling $15.4 billion at June 30, 1996. Investment manager fees for fiscal year 1996 totaled approximately $56 million. None of these agreements were filed with the State Comptroller. In addition, the System did not file contracts for services which were paid by using soft dollar credits. These credits are issued to the System by certain brokers based on the level of activity of investment managers using that particular broker.

The Illinois Purchasing Act and the State Comptroller Act require that State agency contracts for professional or artistic services of more than $5,000 must be reduced to writing and filed with the State Comptroller. In addition, administrative rules promulgated by the State Comptroller explain that the filing requirements are applicable to all State agencies whether or not the State agency participates in transactions involving funds held by the State Treasurer.

Public accountability and oversight would be enhanced if the Board adopted a practice of reducing to writing the services it receives using soft dollar credits and filing those agreements with the State Comptroller. (Finding 1, page 10)

We recommended the System file all contracts with the Office of the State Comptroller as required by State law. System officials responded that the recommendation has been implemented. All contracts for investment managers and soft dollar purchases in excess of $5,000 have been filed with the State Comptroller.

OTHER FINDING

The remaining finding was less significant and the System's response indicates that they are addressing the condition. We will review the System's progress in implementing our recommendations in our next audit.

Mr. John Day, Director of Government Affairs at the System, provided responses to our recommendations. All responses were received on March 19, 1997.

FUTURE REPORTING REQUIREMENTS

Prospective change in financial reporting

In November 1994, the Governmental Accounting Standard's Board (GASB) issued Statement No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans". This Statement requires that plan assets be reported at fair value, rather than at cost. In addition, this Statement establishes a new financial reporting framework that will result in significant changes to the financial statements as well as the required supplementary information. The requirements of this Statement are effective for periods beginning after June 15, 1996, with earlier implementation encouraged. If comparative financial statements are presented, restatement of the prior year financial statements is required.

The System will adopt this Statement beginning with the fiscal year ending June 30, 1997. One effect of this Statement will be to increase the net assets and decrease the unfunded actuarial accrued liability of the System by the difference between fair value and cost of the net assets on the date of adoption. If the implementation of Statement No. 25 had occurred in fiscal year 1996, the net assets available for benefits at June 30, 1996 would have been $15,091,720,000, resulting in a funding ratio of 57.7%.

Funding ratio at market 57.7%

At present, investments are valued at cost or book value as specified by State law. Thus, implementation of Statement No. 25 will require a change of existing State law to comply with generally accepted accounting principles. Net assets available for benefits at June 30, 1996 were $13,829,711,000 resulting in a funding ratio of 52.9%. (Pages 38 & 39)

RELATED TRANSACTION

Funding ratio at cost 52.9%

On September 1, 1994, the System entered into a contract with Zimmerman Investment Management Company (ZIMCO). The president of ZIMCO is the former Chief Investment Officer of the System who resigned his position effective August 31, 1994. While employed by the System, the former Chief Investment Officer was responsible for overseeing the entire System investment program, including development of currency hedging and risk management overlay programs which were managed "in-house." Last year's audit disclosed this related transaction.

Former Chief Investment Officer under contract as Investment Manager

The System paid ZIMCO approximately $2.9 million in FY96 and $2.5 million in FY95. During this time, ZIMCO was responsible for hedging domestic equity, domestic fixed income and international equity investments. In addition, ZIMCO ran a currency overlay program and an enhanced equity index program.

It is standard industry practice to evaluate investment manager performance according to predetermined benchmarks. Benchmarks for the System's investment managers are either established in each manager's respective contract(s) or otherwise by the System. (For purposes of this report, benchmark returns have been extrapolated to dollar figures.)

In summary, total losses in ZIMCO-managed accounts through June 30, 1996, were approximately $266 million, of which some $234.3 million in losses occurred in FY95 and another $31.7 million in FY96. Comparing ZIMCO's performance to the benchmarks established by TRS shows these losses exceeded the benchmarks by approximately $178.9 million. These figures are derived from the chart on page 41 of the report.

ZIMCO losses exceed benchmarks by approximately $178.9 million

The assets underlying ZIMCO's risk management and overlay programs, with the exception of the Enhanced Equity Index Program, were managed and controlled by other TRS investment managers. System officials believe that changes in the assets underlying ZIMCO's risk management and overlay programs should be included in the analysis of ZIMCO's gains and losses, regardless of whether ZIMCO exercised any control over those underlying assets. Using the

System's analysis, the overall loss related to ZIMCO risk management and overlay programs through June 30, 1996, would be approximately $46 million, of which $53.4 million in losses occurred in FY95 and $7.4 million in gains occurred in FY96. These figures are derived from the charts on pages 41 and 42 of the report.

The report is intended to present an analysis of the related transaction gains and losses over which this individual investment **manager** had control and is not intended to encompass **overall** analysis of the System's risk management and overlay program.

WILLIAM G. HOLLAND, Auditor General

WGH:BLB:pp

SPECIAL ASSISTANT AUDITORS

KPMG Peat Marwick, LLP were our special assistant auditors for this audit.