ILLINOIS STATE BOARD OF INVESTMENT
An Internal Investment Pool of the State of Illinois

Financial Statements
June 30, 2012
(With Independent Auditors' Report Thereon)
Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

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Financial Statement Report

Summary

The audits of the accompanying financial statements of the Illinois State Board of Investment (ISBI) were performed by McGladrey LLP as of and for the years ended June 30, 2012 and 2011.

Based on their audits, the auditors expressed an unqualified opinion on the ISBI's basic financial statements.

McGladrey

Independent Auditors' Report

Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
Illinois State Board of Investment:

As Special Assistant Auditors for the Auditor General, we have audited the accompanying Statements of Net Assets of the Illinois State Board of Investment (ISBI), an internal investment pool of the State of Illinois, as of June 30, 2012 and June 30, 2011, and the related Statements of Changes in Net Assets for the years then ended, and the accompanying Statement of Net Assets of its investment trust fund, the Illinois Power Agency Trust Fund as of June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the ISBI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ISBI's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the ISBI, as of June 30, 2012 and June 30, 2011, and the changes in net assets for the years then ended, and its investment trust fund, the Illinois Power Agency Trust Fund, as of June 30, 2012, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated December 13, 2012 and December 14, 2011, on our consideration of the ISBI's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of these reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or compliance. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4-5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

McGladrey LLP

Schaumburg, Illinois
December 13, 2012

Management's Discussion and Analysis

In October 1969, the Illinois State Board of Investment (ISBI) was created by enactment of Article 22A of the Illinois Pension Code by the 76th General Assembly of Illinois. By statute, ISBI was given the responsibility for management of the assets of the General Assembly Retirement System, the Judges' Retirement System of Illinois and the State Employees' Retirement System of Illinois (Member Systems). Also in August 2007, by enactment of 30 ILCS 105/6z-75 of the Illinois Compiled Statutes ISBI was given responsibility for the management of the Illinois Power Agency Trust Fund. Board membership consists of five members appointed by the Governor and four ex officio members consisting of the State Treasurer and the Chairman of the Board of Trustees of each of the retirement systems. ISBI maintains its office in Chicago, Illinois.

The following Management's Discussion and Analysis (MD&A) provides an introduction and overview of the Illinois State Board of Investment (ISBI) financial activities for the fiscal years ended June 30, 2012 and 2011.

Financial Highlights

The net assets of ISBI totaled approximately $11.3 billion at fiscal year end June 30, 2012 compared to $11.5 billion at June 30, 2011. The decrease from the previous year is primarily the result of investment losses.

General Market Risk

ISBI is exposed to general market risk. This general market risk is reflected in asset valuations fluctuating with market volatility. Any impact from market volatility on ISBI's investment portfolio depends in large measure on how deep the market downturn is, how long it lasts, and how it fits within fiscal year reporting periods. The resulting market risk and associated realized and unrealized gains and losses could significantly impact ISBI's financial condition. The readers of these financial statements are advised that financial markets continue to be volatile and are experiencing significant changes on almost a daily basis.

Overview of the Financial Statements

ISBI's financial statements are prepared on an accrual basis in accordance with US generally accepted accounting principles promulgated by the Governmental Accounting Standards Board and are comprised of the Statements of Net Assets, the Statements of Changes in Net Assets and Notes to Financial Statements.

The Statements of Net Assets presents information on ISBI's assets and liabilities and the resulting net assets. These statements also reflect ISBI's investments along with the cash and short-term investments, receivables, and other assets and liabilities.

The gain in investments at June 30, 2012 is a result of an investment gain of .1% for the fiscal year, net of expenses which are shown in the Statements of Changes in Net Assets. The decrease in liabilities for fiscal 2012 compared with 2011 consisted mainly of a decrease in the securities lending cash collateral obligation. This decrease in the securities lending obligation is a result of ISBI's decision to reduce its risk to the credit markets as a result of the securities lending program. ISBI's securities lending program now focuses on intrinsic value lending rather than collateral investment return and emphasizes lending quality rather than loan quantity.

The Statements of Changes of Net Assets present information regarding changes during the fiscal year ended June 30, 2012. These statements reflect additions and deductions, which include the investment income and losses derived from realized and unrealized gains/losses, member system contributions, and income received from securities lending activities. Also reflected in the statements are deductions, which include withdrawals from the Member Systems and operating expenses of ISBI.

The net investment gains for the year ended June 30, 2012 were the result of upward movement in the securities markets. There was a decrease in withdrawals by the member systems. Fiscal year 2012 withdrawals were $248.7 million compared with $941.8

Condensed Summary of Net Assets

	June 30			2012/2011	2011/2010
	2012	2011	2010	Change	Change
	$	$	$	$	$
Cash	20,739,621	12,344,783	3,594,060	8,394,838	8,750,723
Receivables	88,691,020	66,419,100	68,431,963	22,271,920	(2,012,863)
Investments	11,257,803,766	11,498,251,354	9,665,737,091	(240,447,588)	1,832,514,263
Securities lending collateral	67,901,315	211,162,204	997,638,887	(143,260,889)	(786,476,683)
Prepaid Expenses	20,900	7,013	21,269	13,887	(14,256)
Capital Assets	37,599	36,348	50,391	1,251	(14,043)
Total assets	11,435,194,221	11,788,220,802	10,735,473,661	(353,026,581)	1,052,747,141
Liabilities	151,257,536	260,595,778	1,056,769,859	(109,338,242)	(796,174,081)
Total net assets	11,283,936,685	11,527,625,024	9,678,703,802	(243,688,339)	1,848,921,222

million in fiscal year 2011. Withdrawals are determined by the member retirement systems based on the State's funding and the Member Systems' benefit payment needs. As a result of employer and employee funding transfers being sent directly to the Retirement Systems withdrawals decreased for the year. The decrease in administrative expenses for fiscal year 2012 compared to 2011 is due to continuing renegotiation of fees with various investment managers and the decrease in the number of investment managers retained.

The net investment gains for the year ended June 30, 2011 were the result of an upward movement in the securities markets. The increase in assets for fiscal 2011 compared with 2010 consisted mainly of an increase in investments from the investment of proceeds from bonds issued by the State of Illinois and reinvested investment gains. The decrease in liabilities for fiscal 2011 compared with 2010 consisted mainly of a decrease in securities lending collateral obligations and a decrease in unsettled investment purchases.

Future Outlook

One of the more meaningful events for the portfolio in 2011 was a change in the actuarially assumed rate of return. Historically SERS had adopted 8.5% as the actuarially assumed rate of return, while the GARS and the JRS has assumed 8.0%. In September of 2010 SERS reduced its return assumption from 8.5% to 7.75%.

Condensed Statements of Changes in Net Assets

	Fiscal Years Ended June 30			2012/2011	2011/2010
	2012	2011	2010	Change	Change
	$	$	$	$	$
Additions:					
Net investment income (loss)	41,440,456	2,082,398,245	883,932,935	(2,040,957,789)	1,198,465,310
Contributions from the State of Illinois		745,546,496	809,401,372	(745,546,496)	(63,854,876)
Total additions	41,440,456	2,827,944,741	1,693,334,307	(2,786,504,285)	1,134,610,434
Deductions:					
Member Systems' withdrawals	248,725,000	941,800,000	661,000,000	(693,075,000)	280,000,000
Administrative expenses	36,403,795	37,223,519	37,684,777	(819,724)	(461,258)
Total deductions	285,128,795	979,023,519	698,684,777	(693,894,724)	280,338,742
Net increase (decrease) in net assets	(243,688,339)	1,848,921,222	994,649,530	(2,092,609,561)	854,271,692

Similarly, the GARS and JRS reduced their return assumptions from 8.0% to 7.0%. As a result of these adjustments to the assumed rates of return, and due to the fact it had been three years since an asset allocation study had been performed, the Board directed its consultant, Marquette Associates, to perform a new asset allocation study. At its June, 2011 meeting the Board amended its asset allocation policy, incorporating recommendations made by Marquette Associates which were implemented in fiscal 2012.

While no changes were made related to general asset allocation, changes were made within the respective asset classes. In particular:

Domestic Equity: Portfolio weightings were shifted away from large cap stocks toward mid cap and small cap stocks; reliance on active management was diminished in favor of passive management; and exposure was shifted away from growth to value.

International Equity: Allocation to the managed emerging market strategy was increased to 5% with the addition of a passively managed portfolio.

Fixed Income: Exposure to commercial real estate debt was reduced, while exposure to bank loans and high yield debt was increased. The Board also made a 3% allocation to non-US bonds.

Real Estate: Emphasis on core real estate was increased, with the establishment of a target of 80% core real estate and 20% non-core real estate.

Infrastructure/Real Assets: ISBI's infrastructure allocation was re-labeled Real Assets, with a 5% target and includes farmland.

Private Equity: No changes were made to the private equity portfolio.

The Notes to the Financial Statements provide additional information, which is necessary to fully understand the data provided in the financial statements.

Statements of Net Assets

JUNE 30, 2012

	Illinois State Board of Investment 2012	2011	Illinois Power Agency Trust Fund 2012*
	$	$	$
ASSETS			
Cash	20,739,621	12,344,783	24,854,573
Receivables:			
Foreign taxes	2,515,736	2,732,489	-
Accounts receivable	3,105,150	3,165,120	-
Investments sold	50,215,916	25,152,183	-
Interest and dividends	32,854,218	35,369,308	-
Total receivables	88,691,020	66,419,100	-
Prepaid expenses	20,900	7,013	-
Capital assets	37,599	36,348	-
Investments at fair value:			
U.S. Government and agency obligations	958,131,279	1,367,098,751	-
Foreign obligations	385,628,617	37,951,769	-
Corporate obligations	656,977,663	762,833,382	-
Domestic common stock and equity funds	3,253,103,566	3,380,198,858	-
Commingled funds	225,608,712	256,817,374	-
Foreign equity securities	2,012,774,573	2,195,201,185	-
Foreign preferred stock	592,156	40,032	-
Hedge funds	1,026,725,785	1,075,584,754	-
Real estate funds	967,346,450	780,336,465	-
Private equity	679,423,383	629,256,286	-
Money market instruments	255,922,180	303,501,465	-
Real assets	507,019,665	455,984,316	-
Bank loans	328,593,596	253,447,070	-
Foreign currency forward contracts	(43,859)	(353)	-
Total investments	11,257,803,766	11,498,251,354	-
Securities lending collateral	67,901,315	211,162,204	-
Total assets	11,435,194,221	11,788,220,802	24,854,573
LIABILITIES			
Payables:			
Investments purchased	72,653,715	36,930,925	-
Administrative expenses	6,151,301	6,947,640	-
Securities lending cash collateral obligation	72,452,520	216,717,213	-
Due to Illinois Power Agency	-	-	24,854,573
Total liabilities	151,257,536	260,595,778	24,854,573
Net assets	11,283,936,685	11,527,625,024	-

*The assets of the Illinois Power Agency Trust Fund came under management of the Illinois State Board of Investment in fiscal year 2012.

See notes to financial statements, pages 8-22

Statements of Changes In Net Assets

JUNE 30, 2012

	2012	2011
	$	$
ADDITIONS		
Investment income:		
Net increase (decrease) in fair value of investments	(263,503,741)	1,810,488,419
Interest and other	163,451,935	136,079,683
Dividends	138,635,610	132,335,702
Securities lending income	567,953	2,900,006
Securities lending rebates	2,588,568	968,335
Securities lending expenses	(299,869)	(373,900)
Total investment income	41,440,456	2,082,398,245
Contributions from the State of Illinois	-	745,546,496
Total additions	41,440,456	2,827,944,741
DEDUCTIONS		
Administrative expenses:		
Salaries and benefits:		
Salaries	1,168,774	1,182,265
Benefits	686,122	595,733
Operating expenses:		
Rent and utilities	176,600	171,595
Audit	167,200	151,830
Other	191,340	192,109
External support:		
Custody	220,000	218,026
Consulting and professional	1,344,901	1,236,508
Investment advisors/managers	32,248,528	33,319,362
Investment services and research	200,330	156,091
Total administrative expenses	36,403,795	37,223,519
Member Systems' withdrawals	248,725,000	941,800,000
Total deductions	285,128,795	979,023,519
Increase (decrease) in net assets	(243,688,339)	1,848,921,222
Net assets at beginning of year	11,527,625,024	9,678,703,802
Net assets at end of year	11,283,936,685	11,527,625,024

See notes to financial statements, pages 8-22

Note 1
Summary of Significant Accounting Policies

Reporting Entity
The Illinois State Board of Investment (ISBI) is considered to be an internal investment pool of the State of Illinois, operating from investment income and contributions from the State of Illinois. ISBI manages and invests the pension assets of three separate public employee retirement systems (Member Systems): General Assembly Retirement System, the Judges' Retirement System of Illinois, and State Employees' Retirement System of Illinois. ISBI also manages the assets of the Illinois Power Agency Trust Fund (Trust Fund). The Trust fund is reported as an investment trust fund of ISBI.

The assets of the Member Systems and the Trust Fund are accounted for in a single commingled fund. Separate information on each Member System's participation is presented in Note 3. The assets of the Trust Fund came under management of ISBI in fiscal year 2012. The assets and liabilities of the Trust Fund are reported on the Statements of Net Assets. There were no revenues and expenses for the Trust Fund in fiscal year 2012.

Basis of Accounting
Accounting records are maintained on an accrual basis. Units are allocated monthly to each Member System and the Illinois Power Agency Trust Fund based upon percentage of ownership. Administrative expenses are deducted monthly from income before allocation.

Valuation of Investments
Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed – closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter – bid prices; (3) Money Market Instruments – average cost which approximates fair values; (4) Real Estate Investments – fair values as determined by ISBI and its investment managers; (5) Alternative Investments (Private Equity, Hedge funds, Bank Loans and Real Assets) – fair values as determined by ISBI and its investment managers; (6) Commingled funds – fair values as determined by ISBI and its investment managers.

Investment Transactions and Investment Income
Investment transactions are accounted for on a trade date (date order to buy or sell is initiated) and dividend income is recognized on the ex-dividend date. Interest income is recognized on an accrual basis.

Custody and Investment Management Fees
ISBI has contracted with investment managers approved by the Board of Trustees to make investment decisions based on investment guidelines provided to them by ISBI staff and consultants. The investment managers serve as investment advisors to ISBI. ISBI pays an investment management fee to each investment manager for these services on a quarterly basis. The investment management fee is based upon contractual agreement provisions and is computed as a percentage of each manager's portfolio market value.

Management fees paid to Real Estate funds and Private Equity funds are calculated based upon the terms of each individual fund agreement and are reported in Investment Income on the Statements of Changes in Net Assets. Management fees paid to Hedge funds, certain Real Assets, Commingled funds and Bank Loan funds are calculated based on each manager's portfolio market value or ISBI's capital commitment and are reported as Investment Advisor/Managers Expense on the Statements of Changes in Net Assets. Certain other infrastructure fund fees are reported as investment income on the Statements of Changes in Net Assets.

ISBI has contracted with State Street Bank and Trust Company (State Street) to provide custody services for the pension systems assets. These services include safekeeping and transaction processing services for all pension assets of the Member Systems. State Street also provides cash management services and all necessary reporting for pension assets including performance reporting and accounting reports. There are no base charges for custody fees. Custody fees paid to State Street are paid based on set quarterly amounts per the Custodian Contract for performance and analytics services and various accounting data interface feeds.

Risk Management
ISBI, as part of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program. ISBI obtains commercial insurance for fidelity and surety and property. There have been no commercial insurance claims in the past five years.

Risks and Uncertainties
ISBI invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the Statements of Net Assets.

Use of Estimates
In preparing financial statements in conformity with U.S. generally accepted accounting principles, ISBI makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of additions and deductions during the reporting period. Actual results could differ from those estimates and assumptions and the differences may be material.

The determination of fair value for illiquid/alternative investments, such as investments in Real Estate and Private Equity funds, takes into account consideration of a range of factors, including but not limited to the price at which the underlying investments were acquired, the nature of the underlying investments, local market conditions, trading values on public exchanges for comparable underlying investments, current and projected operating performance of the underlying investments, and financing transactions subsequent to the acquisition of the investment. Determining fair value of such investments involves a significant degree of judgment by ISBI and its investment managers.

Because of the inherent uncertainty of the above referenced fair values, the estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Reclassification
Certain items in the 2011 financial statements have been reclassified to conform to the 2012 presentation.

Compensated Absences
The liability for compensated absences consists of unpaid, accumulated vacation and sick leave balances for ISBI employees. The liability has been calculated using the vesting method, in which leave amounts for both employees who are currently eligible to receive termination payments, and other employees who are expected to become eligible in the future to receive such payments upon termination are included. The liability has been calculated based on the employees' current salary and includes salary related costs (e.g., social security and Medicare tax). The liability is included in Administrative Expenses on the Statements of Net Assets and the annual increase or decrease in the liability is reflected in the Salaries Expense on the Statements of Changes in Net Assets.

Legislation that became effective January 1, 1998 capped the paid sick leave for all State Employees' Retirement System members at December 31, 1997. Employees continue to accrue twelve sick days per year, but will not receive monetary compensation for any additional time earned after December 31, 1997. Sick days earned between 1984 and December 31, 1997 (with a 50% cash value) would only be used after all days with no cash value are depleted. Any sick days earned and unused after December 31, 1997 will be converted to service time for purposes of calculating employee pension benefits.

Subsequent Events
ISBI has evaluated subsequent events for potential recognition and/or disclosure through December 13, 2012, the date the financial statements were available to be issued.

Note 2
Deposits, Investments, and Investment Risk

Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, ISBI's deposits may not be returned. All non-investment related bank balances at year-end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. As of June 30, 2012 and 2011, ISBI had non-investment related bank balances of $25,096,663 and $119,804, respectively. Of the June 30, 2012 cash balance $24,854,573 represents the transfer of the Illinois Power Agency Trust funds. This cash was held by the State Treasurer pending transfer to State Street Bank and Trust Company for investment. The transfer of these funds to State Street Bank and Trust Company for investment occurred on July 19, 2012. During fiscal year 2007, a Credit Risk Policy was implemented by ISBI staff and formally adopted by ISBI in July of 2007. The Policy outlines the control procedures used to monitor custodial credit risk. These assets are under the custody of State Street Bank and Trust Company. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standards & Poor and an Aa2 rating by Moody. Certain investments of ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, ISBI reports these types of cash equivalents as Money Market Instruments in the Statements of Net Assets. As of June 30, 2012 and 2011, ISBI had investment related bank balances of $20,601,170 and $12,234,333, respectively. These balances include USD and foreign cash balances. The USD cash balances had no exposure to custodial credit risk as a result of the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") in July 2010, the FDIC must provide unlimited deposit insurance coverage for balances held in US dollar non-interest bearing transaction accounts (DDAs) for a period of two years, beginning on December 31, 2010 and ending on December 31, 2012. At any given point and time the foreign cash balances may be exposed to custodial credit risk.

Investment Policy

ISBI's investment authority and responsibilities are specified in the Illinois Compiled Statutes, 40ILCS 5/22A. These statutes provide ISBI with the authority to manage and invest the assets of any Illinois pension or education fund.

As described in Note 1, ISBI currently manages and invests the assets of the General Assembly Retirement System, Judges' Retirement System, and State Employees' Retirement System. All investments undertaken by ISBI are governed by 40ILCS 5 adopted by the General Assembly in 1982, and other standards codified in the above reference to the statutes.

40ILCS 5/1-109 requires all members of the ISBI and other fiduciaries to "… discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and: With the care, skill, prudence and diligence…By diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses…"

Additionally, ISBI reports one investment trust fund, the Illinois Power Agency Trust Fund, which accounts for assets of the Trust Fund.

Investment Commitments

Real Estate and Private Equity investment portfolios consist of passive interests in limited partnerships. ISBI had outstanding commitments to these limited partnerships of approximately $478 million and $344 million as of June 30, 2012 and 2011, respectively. At the end of fiscal year 2012 and 2011, ISBI had outstanding commitments of $196 million and $321 million to separate real estate accounts, respectively. Also at the end of fiscal year 2012 and 2011, ISBI had outstanding amounts of $63 million and $102 million to real assets, respectively. ISBI would fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary.

Investment Liquidity

ISBI holds investments in hedge funds, real estate funds, private equity funds and real assets that are considered illiquid by the very nature of the investment. Market risk exists with respect to these investments as ISBI may not be able to exit from the investments during periods of significant market value declines.

Alternative Investments

Investments in hedge funds are structured to achieve a diversified hedged equity fund-of-funds portfolio. Capital is allocated to a select group of hedge fund managers that invest predominately in equity securities, both long and short. The investments shall be managed with the intent of preserving capital in a declining market and in a rising market they will generate a smaller return than the overall equity market.

ISBI's investments in Private Equity and Real Estate funds represent investment vehicles used for making investments in various equity and debt securities according to the investment strategies as determined by the fund managers at the commencement of the fund.

Investment strategies of Private Equity funds include, but are not limited to, leveraged buyouts, venture capital, growth capital and mezzanine capital.

Investment strategies of Real Estate investments include, but are not limited to, the purchase, development, ownership, management, rental and/or sale of real estate for profit. In May 2011 RLJ Lodging Fund II a limited partnership investment was exchanged by ISBI for 1,035,092 shares of restricted common stock as a result of an initial public offering (IPO) transaction conducted by RLJ Lodging Trust. Due to the fact that this holding is currently restricted for sale as a result of a lock-up agreement in place that specifies that during the period that commences 180 days from the date of the initial IPO the holders of the shares will not without prior written consent of the underwriting group directly or indirectly offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant for sale of, or otherwise dispose or transfer such shares. As of June 30, 2011 this holding was an illiquid asset as a result of this restriction. During 2012 the restriction attached to these shares expired and 1,043,923 in RLJ Lodging Trust shares were sold in March 2012. This includes an additional amount of 8,831 shares received during the year.

Certain real estate investments are leveraged whereby partnerships have been established to purchase properties through a combination of contributions from ISBI and through acquisition of debt. At June 30, 2012, real estate equities of approximately $967 million are reported at estimated fair value. Of this amount, $795 million is equity and $172 million is long term debt. At June 30, 2011 real estate equities of approximately $780 million were reported at estimated market value. Of this amount, $669 million was equity and $111 million was long term debt.

Required repayment of real estate debt, which is non-recourse debt is as follows as of June 30, 2012 and 2011:

Debt Maturities Year Ending June 30	2012 $	2011 $
2013	38,336,179	37,099,137
2014	-	-
2015	39,603,847	40,070,463
2016	28,761,199	33,400,000
2017	64,845,576	-
	171,546,801	110,569,600

ISBI's investments in Real Assets represent pooled investment vehicles used to seek capital appreciation and current income by acquiring, holding, financing, refinancing and disposing of infrastructure investments and farmland assets. Real Assets include various public works (e.g. bridges, tunnels, toll roads, airports, public transportation and other public works) that are made typically as a part of a privatization initiative on the part of a government entity.

A Commingled fund is a kind of mutual fund or common trust fund which consists of multiple kinds of assets from several accounts combined together. 'Commingling' these separate assets mitigates risk for the trader through investment diversification and reduces the cost of managing each account separately. Commingled funds are also called "pooled funds" and "master trusts."

Concentration of Credit Risk and Credit Risk for Investments

ISBI's portfolio of investments is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their investment management agreement. ISBI did not have any single issuer investment that exceeded 5% of the total net assets of ISBI as of June 30, 2012 and 2011. At June 30, 2012, Commingled funds totaled approximately $226 million. Of this amount, approximately $165 million is invested in fixed income securities. At June 30, 2011, Commingled funds totaled approximately $257 million. Of this amount, approximately $215 million invested in fixed income securities. These securities are not rated. The follow-

Note 2 (continued)
Deposits, Investments, and Investment Risk

ing table presents the quality ratings of debt securities held by ISBI as of June 30, 2012 and 2011:

	Moody's Quality Rating	2012	2011
		$	$
U.S. Government obligations and agency obligations	AAA	955,072,566	1,355,098,991
	AA	3,054,072	-
	Not rated	4,641	11,999,760
Total Government and agency obligations		958,131,279	1,367,098,751
Foreign obligations	AAA	186,587,716	-
	AA	70,836,832	2,972,737
	A	38,941,615	9,187,174
	BAA	17,922,423	-
	BA	13,976,279	7,107,320
	B	16,044,688	17,263,610
	CAA	1,411,638	-
	Not rated	39,907,426	1,420,928
Total foreign obligations		385,628,617	37,951,769
Corporate Obligations			
Bank and Finance	AAA	-	7,075,122
	AA	6,229,998	46,441,423
	A	65,118,722	110,462,063
	BAA	46,729,424	14,653,097
	BA	13,870,851	8,808,672
	B	17,295,104	17,167,398
	Not rated	1,045	802
Total Bank and Finance		149,245,144	204,608,577
Collateralized Mortgage Obligations	AAA	1,076,456	10,711,049
	Not rated	-	2,781,477
Total Collateralized Mortgage Obligations		1,076,456	13,492,526
Industrial	AA	36,473,262	36,746,537
	A	29,602,573	50,163,160
	BAA	75,478,624	81,696,395
	BA	59,680,342	62,382,115
	B	193,691,505	167,590,259
	CAA	10,775,593	9,516,061
	Not rated	6,530,791	17,752,514
Total Industrial		412,232,690	425,847,041
Other	AA	1,127,225	2,941,058
	A	22,075,563	12,003,588
	BAA	7,428,269	7,027,751
	BA	19,369,553	36,360,024
	B	43,572,387	51,094,875
	CAA	-	5,582,749
	Not rated	850,376	3,875,193
Total Other		94,423,373	118,885,238
Total Corporate Obligations		656,977,663	762,833,382
Money Market	Not rated	255,922,180	303,501,465
Total Money Market		255,922,180	303,501,465

Custodial Credit Risk for Investments

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, ISBI will not be able to recover the value of investments or collateral securities that are in the possession of a counterparty. As of June 30, 2012 and 2011, there were no investments that were uninsured and unregistered, securities held by the counterparty or by its trust department or agent but not in ISBI's name.

Interest Rate Risk

ISBI manages its exposure to fair value losses arising from interest rate risk by diversifying the debt securities portfolio and maintaining the debt securities portfolio to an effective weighted duration between 80% and 120% of the benchmark index. Duration is the measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2012 and 2011, ISBI benchmarked its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. At June 30, 2012 and 2011, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 3.9 years. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2012 and 2011 was 4.6 years. Below is the detail of the duration by investment type as of June 30, 2012 and 2011:

	2012		2011	
	Fair Value	Effective Weighted Duration	Fair Value	Effective Weighted Duration
Investment Type	$	Years	$	Years
U.S. Government and Agency Obligations				
U.S. Government	383,122,214	6.7	479,422,631	6.9
Agency	575,009,065	2.7	887,676,120	3.6
Foreign Obligations	385,628,617	6.1	37,951,769	4.3
Corporate Obligations				
Bank and Finance	149,245,144	3.9	204,608,577	4.2
Collateralized Mortgage Obligations	1,076,456	2.2	13,492,526	2.1
Industrials	412,232,690	4.0	425,847,041	4.4
Other	94,423,373	4.2	118,885,238	4.2
	2,000,737,559		2,167,883,902	

Note 2 (continued)
Deposits, Investments, and Investment Risk

Foreign Currency Risk

The international portfolio is constructed on the principles of diversification, quality growth, and value. Risk of loss arises from changes in currency exchange rates. International managers may also engage in transactions to hedge currency at their discretion. Certain investments held in infrastructure funds trade in a reported currency of Euro-based dollars valued at $53,539,234 and $50,878,191 as of June 30, 2012 and 2011, respectively. The following are the amounts of foreign investments by the currency in which they are denominated as of June 30, 2012 and 2011:

Securities Lending

ISBI participates in a securities lending program with Credit Suisse AG, New York Branch who acts as securities lending agent. Securities are loaned to brokers and, in return, ISBI receives cash and non-cash collateral. All of the securities are eligible for the securities lending program. Collateral consists solely of cash and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities).

	2012		2011	
Currency	Foreign Equity Securities and Foreign Preferred Stock	Foreign Government Obligations	Foreign Equity Securities and Foreign Preferred Stock	Foreign Government Obligations
	$	$	$	$
Australian Dollar	82,314,617	16,469,771	109,809,451	-
Brazilian Real	49,364,844	-	62,981,703	-
Canadian Dollar	126,199,484	27,179,367	144,335,493	-
Chilean Peso	1,098,684	2,308,184	-	-
Czech Koruna	536,589	2,520,227	-	-
Danish Krone	27,321,050	4,165,438	25,279,264	-
Egyptian Pound	1,810,173	-	1,549,693	-
English Pound Sterling	374,618,002	32,868,184	388,163,730	-
Euro Currency	394,894,819	103,642,653	550,189,912	-
Hong Kong Dollar	127,339,809	2,384,108	83,691,016	-
Hungarian Forint	1,457,562	-	1,711,349	-
Indonesian Rupian	9,446,308	-	1,735,957	-
Israeli Shekel	2,619,603	28,742	4,293,903	-
Japanese Yen	191,615,229	65,481,682	249,633,309	
Malaysian Ringgit	7,106,044	2,848,977	-	-
Mexican Peso	20,566,508	13,648,235	10,577,337	-
Moroccan Dirham	219,512	-	-	-
New Zealand Dollar	5,008,123	1,783,525	4,812,384	-
Norwegian Krone	24,657,161	6,403,137	25,479,679	-
Philippine Peso	2,219,444	-	-	-
Polish Zioty	2,949,201	8,408,688	-	-
Singapore Dollar	42,090,664	3,813,610	51,977,284	-
South African Rand	25,078,599	4,116,002	11,571,713	-
South Korean Won	71,317,427	13,526,890	62,696,222	-
Swedish Krona	27,254,280	10,680,201	35,264,901	-
Swiss Franc	138,838,635	7,455,551	154,181,296	-
Thailand Baht	3,954,203	4,274,188	-	-
Turkish Lira	2,811,622	-	-	-
Foreign Investments denominated in U.S. dollars	248,658,533	51,621,257	215,305,621	37,951,769
	2,013,366,729	385,628,617	2,195,241,217	37,951,769

In the event of borrower default, Credit Suisse AG, New York Branch provides ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to ISBI in connection with the in-kind redemption of ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment ("Quality D"). Credit Suisse is not responsible for any losses with regards to these legacy investments. This arrangement subjects ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of a counterparty to meet its obligations. These losses could include the loss of principal, interest and/or decreased expected cash flows in any of the investments held in ISBI's cash collateral account. In the event, a counterparty defaults on its obligations, ISBI would need to credit the cash collateral account with the amount of the default to make the account whole so that once loaned securities are returned, the cash pledged by borrowers is returned to them. As of June 30, 2012 and 2011, respectively, the collateral received exceeded the fair value of the securities loaned. As of June 30, 2012 and 2011, there were outstanding loaned investment securities having fair values of $115,655,166 and $221,448,333, respectively; against which collateral was received with a fair value of $120,556,697 and $230,083,146, respectively. Collateral received at June 30, 2012 and 2011 consisted of $72,452,520 and $216,717,213, respectively, in cash and $48,104,177 and $13,987,903, respectively, in securities for which ISBI does not have the ability to pledge or sell.

The cash collateral received is invested in a short term investment pool having a fair value of $67,901,315 and $211,162,204 as of June 30, 2012 and 2011, respectively. This investment pool had an average duration of 32.42 days and 31.18 days as of June 30, 2012 and 2011, respectively. Any decrease in the fair value of invested cash collateral is recorded as unrealized losses and reported as a component of the investment income/loss on the Statements of Changes in Net Assets.

Derivative Securities

In fiscal year 2010, ISBI implemented GASB Statement No. 53 Accounting and Financial Reporting for Derivative Instruments with respect to investments held in derivative securities. A derivative security is an investment whose payoff depends upon the value of other assets such as commodity prices, bond and stock prices, or a market index. ISBI invests in derivative instruments including forward foreign currency contracts, futures, rights and warrants. ISBI's derivatives are considered investment derivatives.

Foreign currency forward contracts (FX forwards) are used to protect against the currency risk in ISBI's foreign equity portfolio. A foreign currency forward contract is an agreement to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed-upon price. Fluctuations in the market value of foreign currency forward contracts are marked to market on a daily basis. These investments are reported at fair value in the investment section of the Statements of Changes in Net Assets. The gain or loss arising from the difference between the original contracts and the closing of such contracts is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Assets. In May 2011, ISBI removed language from the investment management agreements allowing managers to hedge foreign currencies and/or to hedge equity positions.

ISBI investment managers use financial futures to replicate an underlying security they wish to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). Additionally, financial futures are used in the ISBI fixed income portfolio to adjust portfolio strategy and overall portfolio duration. A financial futures contract is an agreement to buy or sell a specific amount at a specified delivery or maturity date for an agreed-upon price. The fair values of the futures contract vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The gain or loss is recognized in the net increase/decrease in the fair value of investments in the Statements of Change in Net Assets. Financial futures represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The cash or securities to meet these obligations are held in the investment portfolio.

ISBI investment managers use options in an attempt to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Financial options are an agreement that gives one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specified price, called the strike price, on or before a specified expiration date. As a writer of financial options, ISBI System receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option. All written financial options are recognized as a liability on ISBI's financial statements. As a purchaser of financial options, ISBI System pays a premium at the outset of the agreement and the counterparty bears the risk of an unfavorable change in the price of the financial instrument underlying the option. The gain or loss associated with options is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Assets.

Rights and warrants allow ISBI investment managers to replicate an underlying security they wish to hold (sell) in the portfolio. Rights and warrants provide the holder with the right, but not the obligation, to buy or sell a company's stock at a predetermined price. Rights usually expire after a few weeks and warrants can

Note 2 (continued)
Deposits, Investments, and Investment Risk

expire from one to several years. Under certain circumstances, a type of warrant called Participatory Notes (P-Notes) are used in the portfolio by ISBI investment managers that are not registered to trade in domestic Indian Capital Markets. P-Notes are issued by Indian based brokerage firms against an underlying Indian security permitting holders to get a share in the income from the security. These investments are reported at fair value in the investment section of the Statements of Net Assets within the common stock and foreign equity classifications. The gain or loss associated with rights and warrants is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Assets.

The fair values of the forward contracts are estimated based on the present value of their estimated future cash flows. Futures contracts are exchange traded instruments where the fair value is determined by the equilibrium between the forces of supply and demand. The fair value of a right or warrant closely tracks the intrinsic value of the underlying stock and can be determined either by formulaic methodology (most commonly Black-Scholes) or intrinsic value methodology.

The following table presents the investment derivative instruments aggregated by type that were held by ISBI as of June 30, 2012 and 2011:

Derivative transactions involve, to varying degrees, credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Derivatives which are exchange traded are not subject to credit risk. No derivatives held are subject to custodial credit risk. Market risk is the possibility that a change in interest (interest rate risk) or currency rates (foreign currency risk) will cause the value of a financial instrument to decrease or become more costly to settle. The market risk associated with derivatives, the prices of which are constantly fluctuating, is regulated by imposing strict limits as to the types, amounts and degree of risk that investment managers may undertake. These limits are approved by the Board of Trustees and management of ISBI and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2012 ISBI held futures contracts whose underlying instruments were exposed to interest risk but there were no GASB 53 reportable elements. At June 30, 2011, ISBI held no derivatives subject to interest rate risk. The ISBI has not adopted a formal policy specific to master netting arrangements.

	Changes in Fair Value		Fair Value at Year End		Notional Amount	
	2012	2011	2012	2011	2012	2011
	$	$	$	$	Number of Shares	Number of Shares
FX Forwards	(1,693,910)	(15,460,385)	(43,859)	(353)	N/A	N/A
Futures	N/A	N/A	N/A	N/A	(16,717,412)	65,250
Options	2,744,205	-	2,811,004	-	27,000	-
Rights	(166,937)	840,746	30,249	162,133	153,435	901,548
Warrants	(9,022,293)	16,898,459	68,676,781	66,421,545	7,663,933	5,272,322
	(8,138,935)	2,278,820	71,474,175	66,583,325	(8,873,044)	6,239,120

The table below shows the futures positions held by ISBI as of June 30, 2012 and 2011.

	2012		2011	
	Number of Contracts	Contract Principal*	Number of Contracts	Contract Principal*
Equity futures purchased	1,410	92,997,500	1,305	85,836,375
Fixed income futures purchased	382	48,411,940	-	-
Fixed income futures sold	421	63,940,695	-	-

*Contract principal amounts shown represent the market value of the underlying assets the contracts control. Contract principal is shown to present the volume of the transactions but does not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk. Contract principal values also do not represent actual values reported in the Statement of Net Assets.

ISBI's derivative investments in foreign currency forward contracts are held with counterparties. The credit ratings and net exposure as of June 30, 2012 and 2011 for the counterparties are as follows:

	2012			2011		
Moody's Rating*	Fair Value	Net Exposure	Percentage of Net Exposure	Fair Value	Net Exposure	Percentage of Net Exposure
	$	$	%	$	$	%
Aa3	45,189	45,189	11.5	188	188	0.01
Aa2	46,885	46,885	12.00	-	-	-
A3	84,367	84,367	21.59	2,736,018	2,736,018	99.99
A2	64,971	64,971	16.62	-	-	-
A1	3,119	3,119	0.80	-	-	-
Baa1	146,228	146,228	37.42	-	-	-
	390,759	390,759	100.00	2,736,206	2,736,206	100.00

The following are the amounts of foreign investments by the currency in which they are denominated as of June 30, 2012 and 2011:

	2012				2011			
	FX Forwards	Rights	Warrants	Options	FX Forwards	Rights	Warrants	Options
Currency	$	$	$	$	$	$	$	$
Australian Dollar	(85,578)	-	-	-	-	-	-	-
Brazilian Real	1,589	-	-	-	-	-	-	-
Canadian Dollar	(13,256)	10,733	-	-	-	-	-	-
Chilean Peso	1,450	1,296	-	-	-	-	-	-
Columbian Peso	(15,312)	-	-	-	-	-	-	-
Czech Koruna	9,411	-	-	-	-	-	-	-
Danish Krone	(30)	-	-	-	-	-	-	-
Egyptian Pound	(148)	-	-	-	-	-	-	-
English Pound Sterling	49,917	-	-	-	-	-	-	-
Euro Currency	118,889	18,220	6,103		(391)	153,078	-	-
Hong Kong Dollar	234	-	-	-	-	9,055	-	-
Indonesian Rupiah	(619)	-	-	-	-	-	-	-
Janpanese Yen	(19,071)	-	-	-	38	-	-	-
Malaysian Ringgit	(1,234)	-	-	-	-	-	-	-
Mexican Peso	27,008	-	-	-	-	-	-	-
New Zealand Dollar	46,885	-	-	-	-	-	-	-
Norwegian Krone	4,157	-	-	-	-	-	-	-
Polish Zloty	(32,461)	-	-	-	-	-	-	-
Singapore Dollar	(13,207)	-	-	-	-	-	-	-
South African Rand	14,798	-	-	-	-	-	-	-
South Korean Won	23,502	-	-	-	-	-	-	-
Swedish Krona	(154,835)	-	-		-	-	-	-
Swiss Franc	(5,251)	-	-	-	-	-	-	-
Thailand Baht	(697)	-	-	-	-	-	-	-
Investments denominated in U. S. dollars	-	-	68,670,678	2,806,363	-	-	66,421,545	-
	(43,859)	30,249	68,676,781	2,806,363	(353)	162,133	66,421,545	-

Note 3
Member Systems' Participation

	General Assembly	Judges'	State Employees'	Combined*
Member Systems' Income and Expenses Fiscal Year Ended June 30, 2012	$	$	$	$
Interest and dividends	1,378,334	15,081,300	285,627,911	302,087,545
Net securities lending income	12,853	142,258	2,701,541	2,856,652
Net decrease in fair value of investments	(1,321,914)	(13,563,440)	(248,618,387)	(263,503,741)
Total investment income	69,273	1,660,118	39,711,065	41,440,456
Administrative expenses	(165,570)	(1,815,417)	(34,422,808)	(36,403,795)
Net investment income (loss)	(96,297)	(155,299)	5,288,257	5,036,661
Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2012				
Net assets at beginning of year	57,346,442	587,794,578	10,882,484,004	11,527,625,024
Member systems' net withdrawals	(8,225,000)	(28,500,000)	(212,000,000)	(248,725,000)
Net investment income (loss)	(96,297)	(155,299)	5,288,257	5,036,661
Net assets at end of year	49,025,145	559,139,279	10,675,772,261	11,283,936,685

The source of net assets of the member systems since inception at June 30, 2012, is as follows:

	General Assembly	Judges'	State Employees'	Combined*
Member systems' net withdrawals	(68,350,878)	(124,685,969)	(1,804,219,267)	(1,997,256,114)
Accumulated net investment income	117,376,023	683,825,248	12,479,991,528	13,281,192,799
Net assets at fair value	49,025,145	559,139,279	10,675,772,261	11,283,936,685

** Combined column for the Member Systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

Note 3 (continued)
Member Systems' Participation

	General Assembly	Judges'	State Employees'	Combined*
Member Systems' Income and Expenses Fiscal Year Ended June 30, 2011	$	$	$	$
Interest and dividends	1,338,206	13,747,518	253,329,661	268,415,385
Net securities lending income	17,455	179,176	3,297,810	3,494,441
Net increase in fair value of investments	9,098,602	93,118,822	1,708,270,995	1,810,488,419
Total investment income	10,454,263	107,045,516	1,964,898,466	2,082,398,245
Administrative expenses	(183,751)	(1,901,411)	(35,138,357)	(37,223,519)
Net investment income	10,270,512	105,144,105	1,929,760,109	2,045,174,726
Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2011				
Net assets at beginning of year	51,638,586	506,463,522	9,120,601,694	9,678,703,802
Member systems' net withdrawals	(4,562,656)	(23,813,049)	(167,877,799)	(196,253,504)
Net investment income	10,270,512	105,144,105	1,929,760,109	2,045,174,726
Net assets at end of year	57,346,442	587,794,578	10,882,484,004	11,527,625,024

The source of net assets of the member systems since inception at June 30, 2011, is as follows:

	General Assembly	Judges'	State Employees'	Combined*
Member systems' net withdrawals	(60,125,878)	(96,185,969)	(1,592,219,267)	(1,748,531,114)
Accumulated net investment income	117,472,320	683,980,547	12,474,703,271	13,276,156,138
Net assets at fair value	57,346,442	587,794,578	10,882,484,004	11,527,625,024

** Combined column for the Member Systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

Note 4
Pensions

Plan Description

All of ISBI employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer, defined benefit, public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal years 2012 and 2011 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR). The SERS also issues a separate CAFR that may be obtained by writing to the SERS, 2101 South Veterans Parkway, P.O. Box 19255, Springfield, IL 62794-9255 or by calling 217/785-7444. The State of Illinois CAFR may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-6000.

A summary of SERS' benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established, are included as an integral part of the SERS' CAFR. Also included is a discussion of employer and employee obligations to contribute, and the authority under which those obligations are established.

Funding Policy

ISBI pays employer retirement contributions based upon an actuarially determined percentage of payroll. For fiscal year 2012 and 2011, the employer contribution rates were 34.190% and 27.988%, respectively. ISBI contributions to SERS for fiscal years 2012 and 2011 were $398,070 and $323,551, respectively, and were equal to the required contributions for each fiscal year.

Effective for pay periods beginning after December 31, 1991, the Board opted to pay the employee portion of retirement for ISBI employees covered by the State Employees' Retirement Systems. Generally, this pickup of employee retirement was part of the budget process and was, in part, a substitute for salary increases.

In November 2010 the Board amended the policy to pay the employee portion of retirement to only apply to current employees as of the date of the policy change. New employees from that date forward must pay their own employee portion of retirement contributions. ISBI contributions to SERS for the employee portion for fiscal years 2012 and 2011 were $43,558 and $43,521, respectively.

Member System Contributions and Withdrawals

Member systems' contributions are comprised solely of proceeds from bonds issued by the State of Illinois. As required by Public Act 96-1497, the State of Illinois issued $3.7 billion of General Obligation Bonds, Taxable Bond Series February 2011 on March 10, 2011 at an interest rate of 5.56%. The net bond proceeds were allocated among the five state-funded retirement systems to reduce their actuarial reserve deficiencies as provided in the Act. The State Employees' Retirement System, General Assembly Retirement System, and Judges' Retirement System received an allocation of bond proceeds equal to $745,546,496 on March 14, 2011. The monies were deposited into the Master Trust Account with the Illinois State Board of Investment the same day. The monies were combined with ISBI's other investments and invested in accordance with the asset allocation policy of ISBI during the year ended June 30, 2011. During fiscal year 2012, employer and employee funding transfers were sent directly by the State of Illinois to the Member systems, rather than to ISBI. As a result, ISBI reports no Contributions from the State of Illinois on the Statements of Changes in Net Assets for the year ended June 30, 2012. Member systems' withdrawals are determined by the member retirement systems based on the State's funding, the systems' benefit payment needs and the ability for ISBI to liquidate available assets. The total withdrawals for fiscal years 2012 and 2011 were $248,725,000 and $941,800,000, respectively.

Post-retirement Benefits

The State provides health, dental, and life insurance benefits for retirees and their dependents in a program administered by the Department of Healthcare and Family Services along with the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans. Health, dental and vision benefits include basic benefits for annuitants under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employees' Retirement System, do not contribute toward health, dental and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not have to contribute towards health, dental and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefits become $5,000.

The total cost of the State's portion of health, dental, vision and life insurance benefits of all members including post-employment health, dental, vision and life insurance benefits, is recognized as an expenditure by the State in the Illinois Comprehensive Annual Financial Report. The State finances the cost on a pay-as-you-go basis. The total costs incurred for health, dental, vision and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents.

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Healthcare and Family Services. A copy of the financial statements of the Department of Healthcare and Family Services may be obtained by writing to the Department of Healthcare and Family Services, 201 South Grand Ave. East, Springfield, Illinois 62763-3838.

Note 5
New Governmental Accounting Standards

Statement No. 62, *Codification of Accounting and Financial Reporting Guidance contained in pre-November 1989 FASB and AICPA Pronouncements*, was established to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in certain FASB and AICPA pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements. ISBI is required to implement this Statement for the year ending June 30, 2013.

Statement No. 63*, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*, was established to provide a framework that specifies where deferred outflows of resources and deferred inflows of resources, assets, liabilities and net position should be displayed on the financial statements. ISBI is required to implement this Statement for the year ending June 30, 2013.

Statement No. 65, *Items Previously Reported as Assets and Liabilities*, will be effective for ISBI beginning with its year ending June 30, 2014. This Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. This Statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term deferred in financial statement presentations.

Statement No. 66, *Technical Corrections – 2012 – an amendment of GASB Statements No. 10 and No. 62*, will be effective for ISBI beginning with its year ending June 30, 2014. The objective of this Statement is to improve accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, Statements No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, and No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This Statement amends Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, by removing the provision that limits fund-based reporting of an entity's risk financing activities to the general fund and the internal service fund type. This Statement also amends Statement 62 by modifying the specific guidance on accounting for (1) operating lease payments that vary from a straight-line basis, (2) the difference between the initial investment (purchase price) and the principal amount of a purchased loan or group of loans, and (3) servicing fees related to mortgage loans that are sold when the stated service fee rate differs significantly from a current (normal) servicing fee rate.

Statement No. 67, *Financial Reporting for Pension Plans*, will be effective for the ISBI beginning with its year ending June 30, 2014. This statement builds upon the existing framework for financial reports of defined benefit pension plans which includes a statement of fiduciary net posion (the amount held in a trust for paying retirement benefits) and a statement of changes in fiduciary net positio. This statement enhances note disclosures and RSI for both defined benefit and defined contribution pension plans and requires the presentation of new information about annual money-weighted rates of return in the notes to the financial statements and in 10-year RSI schedules.

Statement No. 68, *Accounting and Financial Reporting for Pensions*, will be effective for ISBI beginning with its year ended June 30, 2015. This statement requires governments providing defined benefit pensions to recognize their long-term obligation for pension benefits as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. This statement also enhances accountability and transparency through revised and new note disclosures and required supplementary information (RSI).

Management has not yet completed its assessment of these Statements; however, they are not expected to have a material effect on the overall financial statement presentation.

McGladrey

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited the Statements of Net Assets and Statements of Changes in Net Assets of the Illinois State Board of Investment (ISBI), as of and for the years ended June 30, 2012 and June 30, 2011, and the Statement of Net Assets of its investment trust fund, the Illinois Power Agency Trust Fund, as of June 30, 2012, and have issued our report thereon dated December 13, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Illinois State Board of Investment is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the ISBI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the ISBI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the ISBI's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in the internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the ISBI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, ISBI's Board of Trustees and the ISBI's management, and is not intended to be and should not be used by anyone other than these specified parties.

McGladrey LLP

Schaumburg, Illinois
December 13, 2012