STATE INVESTMENT COMMISSION
SEPTEMBER 16, 2011
11 A.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Friday, September 16, 2011, at 11:00 a.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; Ryan Keith, proxy for Governor Beshear; George Spragens, President, Farmers National Bank in Lebanon, Kentucky and Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Dwight Price, and Marcia Adams.

Other Guests: Mr. Ed Ross, Commonwealth of Kentucky Controller; Jamie Link, Deputy Secretary, Finance and Administration Cabinet and Kristi Culpepper from Legislative Research Commission (LRC).

Treasurer Hollenbach verified that a quorum was present and that the press had been notified of the meeting.

Treasurer Hollenbach called for a motion to approve the minutes from June7, 2011. A motion was made by Ms. Lori H. Flanery and seconded by Mr. George Spragens to approve the minutes as written. Motion **CARRIED**.

Securities Update - Mr. Price explained the Securities Lending Portfolio still contains the same two down-graded asset-backed securities. The two securities continue to make all scheduled interest payments in addition to approximately $1 million in principal pay down per quarter. The Commonwealth changed securities lending firms at the end of August from Credit Suisse to Deutsche Bank. Deutsche Bank has not begun to price these securities so the market prices have not changed from the previous report.

Treasurer Hollenbach asked whether the value of these securities is in the "ball park". Mr. Price responded the value was approximately $5 million dollars at a around 75 cents on the dollar which is relatively close to a live market price. Staff recommends holding these securities to continue to receive principal at par rather than selling at a deep discount.

Mr. Steve Jones continued the discussion with the update on the down-graded asset-backed securities in the direct portfolios. Principal losses are occurring on the first two securities on the list while all others continue to make full principal and interest payments. There is little change in the gain/loss column as the 2-3 year trend of tightening credit spreads has recently reversed. The jump in risk aversion in the markets from uncertainty with the US budget/debt situation and uncertainty of European sovereigns has increased in the spread of risky assets throughout most markets.

The lower section on the handout details five auction rate securities with a par value of $35.7 million dollars. Auction rate securities are issued backed by either collateral or guaranteed revenue source. Every 28-35 days, the underwriter holds an auction for holders to maintain the position at the market clearing rate, bid to hold at some specified rate or sell at par. The underwriter would purchase excess securities to assure liquidity. In February 2009, that market ceased to function as underwriters stopped committing capital to support auctions. At that point, nearly all auctions

"failed" leaving no liquidity and a rate determined by some formula related to the rate on the underlying collateral.

At one point, the Commonwealth held over $200 million of these securities in thirty different issues. Since the market collapsed, underwriters and issuers have worked together to retire these securities with a number of underwriters purchasing outstanding positions. The securities listed are the remaining outstanding positions from the original thirty. These have little or no liquidity as very few secondary market trades have occurred in this market. The existing positions are all slowly paying down principal but have effective maturities in the 2020s and 2030s. To date, the Commonwealth has lost roughly $900,000 on one of these securities as a restructuring was executed at a discount. This is informational for the Commission with no action needed.

Mr. Tom Howard added that the Kentucky Higher Education Student Loan Corporation (KHESLC) has been restructuring their outstanding auction rate securities at 80-95 cents on the dollar. Over time, many of these securities have been or will be replaced by the issuers with floating rate notes (FRNs) that have more liquidity, and a more definitive structure than the auction rate notes. Mr. Spragens asked what the average yield is on these securities. Mr. Jones replied that it is approximately 1.30% Mr. Lawson asked if these notes were straining the liquidity needs of the Commonwealth. Mr. Jones answered that the portfolio has well over one billion dollars of same day liquidity. Treasurer Hollenbach asked if there was any hope the auction rate market would bounce back. Mr. Jones did not believe it would, and Mr. Price said that lack of trust in underwrites supporting the auctions creates a large barrier. Mr. Lawson asked if these are variable instruments which will go up as the market improves. Mr. Jones answered that it is possible with the asset-backed securities as they have a coupon rate based on a spread to LIBOR. The auction rate securities will not improve as that rate is tied to the yield of the underlying loans. Mr. Lawson asked if the Commonwealth is receiving the 1.30% stated earlier. Mr. Jones replied affirmatively. Mr. Ross asked if the value of these will drop as rates change. Mr. Howard responded no, but pointed out that the securities' ability to continue to make payments is based on the performance of the underlying collateral some of which are government guaranteed student loans.

Mr. Spragens moved to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Mr. Lawson. Motion **CARRIED**

Financial Advisor Request for Proposals (RFP) - Mr. Tom Howard explained that staff is recommending that the Commission authorize OFM to issue a Request for Proposals (RFP) for an independent financial advisor, familiar with state governments to:

1. Review the Commonwealth's investment statutes and regulations for appropriateness and recommend any needed changes.

2. Review the investment performance benchmarks and make recommendation for any changes consistent with applicable statures and regulations.

3. Review the downgraded Asset Backed Securities and the Auction Rate Securities to advise the Commission on options to hold or liquidate the securities or offer other recommendations.

The RFP would be issued under the state's normal procurement process as required by KRS Chapter 45A for Personal Service Contracts.

The RFP is drafted and could be issued early next week. The goal is to have a preliminary report by the December meeting for consideration.

Treasurer Hollenbach added that he agreed with the proposal for an outside review as there was a new normal in the financial field. He asked if there were funds in the budget and what the cost would be. Mr. Howard answered that the Finance Cabinet has resources to pay for the review and expects a reasonable fee request. Responses are evaluated on technical ability and price so the low bidder may not necessarily be the winner. Discussion agreed to have the Secretary of Finance participate in the final RFP draft process; appoint OFM staff to review the responses; and for the Finance Secretary and the Treasurer to confer and agree, before the contract is signed.

A motion was made by Treasurer Hollenbach and seconded by Mr. Spragens to proceed with the RFP for a financial advisor for the Commission and with the Finance Secretary and the Treasurer concurring for the final contract. Motion **CARRIED**

Portfolio Performance - Mr. Price presented a series of graphs to the Commission showing various measures of portfolio performance. The Annual Cash Distributions chart shows cash distributions. back to 2007 with a decline in the amount of distributions in the last several years. The Comparative Yields graph shows the very low yields during the same time frame as the Federal Reserve has pushed short rates to near zero. Mr. Jones commented that the Short Term yield graph compares the portfolio to two indices. The portfolio has outperformed both. Mr. Price continued with the Liquidity graph showing daily liquidity of approximately $1 billion. The Annualized Yield graph shows the Intermediate pool's performance monthly plus 1 and 5 year rolling averages compared to its index. The chart shows a significant drop versus the index in August. This is due to different pricing services generating different prices from the taxable Muni's in the portfolio. The Commonwealth's custodial bank provides pricing information to OFM on a daily basis. When the change was made from US Bank to State Street on July 31, the source of prices changed. State Street had significantly lower prices for taxable munis. All of this change was reflected in performance on August 1, the first day using the new pricing source. The portfolio made money for the month though not as much as anticipated. Mr. Lawson asked what percentage of the portfolio is Muni's and where were they originated. Mr. Price responded approximately 3 – 4 percent of the portfolio is municipals from varying states.

Linked Deposit Program – Mr. Jones updated the Commission on the Linked Deposit Program. As of the end of the previous quarter, the Bank of Jamestown and the Deposit Bank of Carlisle have Loan-to-Deposit ratios less than the 70 percent required in this program. The other two participants on this report show their Non-Performing Loans-to-Capital ratios should be less than 25 percent. The Bank of McCreary has improved the Non-Performing Loans to Capital Ratio quarter to 26 percent, South Central Bank of Barren County has declined to 36 percent. Both exceed the 25 percent limitation. Staff reminded the Commission has the option but not the obligation to call these loans. Treasurer Hollenbach asked if these loans were called, would it potentially harm the institution and would it benefit the Commonwealth. Mr. Jones answered yes, it would hurt the bank and it would slightly reduce the Commonwealth's credit risk. Mr. Howard remarked that the funds would need to be reinvested during the currently low interest rate environment. Mr. Spragens said that these loans are under $10 million in aggregate. Mr. Jones added that with same day liquidity of

$1 billion dollars and next-day liquidity of another $1.5 billion dollars, the amount of this program is somewhat immaterial to the Commonwealth.

Treasurer Hollenbach asked about the newly announced Federal program with U.S. Agricultural Department and if the bankers had looked into this program. Mr. Lawson replied that he had researched the program but there is no demand for it in his area.

Other Business - Mr. Jones advised the Commission that upon completion of several RFPs, JP Morgan Chase is now serving as the Commonwealth's Depository Bank, State Street is serving as the Commonwealth's Custodial Bank, and Deustche Bank is serving as the Commonwealth's securities lending agent.

Mr. Lawson asked if there was any legal avenue for the Commission to respond to issues more quickly than a meeting in Frankfort. Mr. Howard stated that video conferencing is a possibility. The key statutory provision is that all participants can see the parties involved if any voting is conducted and the Transportation Cabinet building has the facilities to conduct meetings in this manner. Ms. Lori Flanery added that the University of Louisville or local Community Colleges may have the facilities available.

Treasurer Hollenbach asked the Commission members to supply questions for the soon to-be-hired Financial Advisor. Mr. Spragens asked Mr. Lawson about a half way point for a meeting outside of Frankfort. Mr. Howard said a meeting outside of Frankfort is possible and can happen at any time in the future subject to meeting notification to the press 24 hours in advance of the meeting. Additionally, Staff is available for conference calls and informal discussions at anytime.

With no further business before the committee, the meeting stands adjourned.

Respectfully submitted,

F. Thomas Howard
Secretary