

State Investment Commission

September 25, 2014

1:00 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on September 25, 2014 at 1:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Secretary Lori Flanery, Finance and Administration Cabinet; Secretary Mary Lassiter, proxy for Governor Beshear; W. Fred Brashear, II, President & CEO, Hyden Citizens Bank, Hyden, Kentucky; and William Fallon, President & CEO, The Bankers’ Bank of Kentucky, Frankfort, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director of OFM and Secretary to the Commission; Steve Jones, Deputy Executive Director; Sandy Williams, Deputy Executive Director; Brian Caldwell, Ian Blaiklock, J.D. Lester, Robin Brewer, Thomas Midkiff, John Brady, Liz Columbia and Tammy McCall.

Other Guests: Ed C. Ross, Controller, Finance and Administration Cabinet; and Joshua Nacey, Legislative Research Commission.

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

Treasurer Hollenbach called for Robin Brewer, notary, to administer the Oath of Office to Governor Beshear’s Appointees to the Commission: W. Fred Brashear, II and William Fallon.

Treasurer Hollenbach called for a motion to approve the minutes from the June 19, 2014, meeting. A motion was made by Secretary Lori Flanery and seconded by Secretary Mary Lassiter to approve the minutes as written. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Ryan Barrow.

Discussion of Minutes - Mr. Barrow explained that OFM staff prepares the minutes for several committees in addition to this Commission. He noted that the minutes from some of the other committees are more standardized and less technical. Because there are new members, OFM staff felt it was a good time to ask the Commission to consider the structure of the minutes and to assess if they are done in the most efficient and useful format in order to communicate the content of the meetings to the members and the public. Secretary Lori Flanery suggested that examples of other committee minutes that are more standardized be included in the next SIC meeting packet or be sent out in an email to the Commission members to be reviewed and compared. Treasurer Hollenbach agreed that it would be a good idea to review them for any changes to format and to get back with OFM staff.

Treasurer Hollenbach recognized Mr. Steve Jones.

Update on Cash Management Alternatives – Mr. Jones reminded the Commission of the presentation from the last meeting regarding the cash management process, the tools that are used, problems that are occurring, and the options for solutions to those problems.

As an update, Mr. Jones confirmed that on July 23, 2014, the SEC changed the rules governing money market mutual funds with a two year implementation. The changes move the funds to a floating net asset value and allow the non-government only funds to implement liquidity restrictions under certain circumstances. Mr. Jones stated that the funds are occasionally used to invest payroll and some point in the future the Commonwealth may want to move away from those funds. Additionally, Mr. Jones reminded the Commission that the limited term pool is managed according to the 2a-7 Rules and those rules are referenced in the Kentucky Administrative Regulations. That means that, once the new SEC rules are in place, the Commission will be stating through the regulation that it also has the authority to implement those liquidity restrictions. Mr. Jones stated he did not believe that authority existed and didn't think the Commission wanted to assert that it did. Because of that, sometime in the future and possibly by the next meeting, OFM staff will be presenting some recommendations on changes to that regulation.

Mr. Jones stated that at the last meeting different possibilities were mentioned regarding how to invest short term cash. The first option was the Insured Cash Sweep which is a transaction account similar to the CDARS program. OFM has opened such an account and has started to process small transactions. Within the next month or so the balance will be increased to approximately \$75-90 million. The second option discussed was to open additional depository relationships with other banks. Through the Kentucky Bankers Association (KBA), OFM anonymously contacted every bank that was a member and queried if any had the ability to handle substantially large deposits from the Commonwealth. One bank responded affirmatively, but some operational issues were discovered which negated that possibility. The third possible option was to tighten the relationship with the securities lending agent, Deutsche Bank. Mr. Jones explained that this program could provide roughly \$1 billion in cash but did involve an expense. This will serve as a back-up option in case of a liquidity problem.

During the discussions with Deutsche Bank, it was decided to change the limitations on the total loans to any one borrower. Right now OFM runs the program for the overall state while the Kentucky Workers' Compensation Funding Commission ("Workers' Comp") runs a similar program that is piggy backed on the OFM contract with the same agent. Each had a \$200 million limit to loan to any one particular borrower meaning that the combined exposure could be \$400 million. OFM staff believed that to be too high of an exposure. The exposure limit is being changed to \$300 million combined with no more than \$100 million at Workers' Comp. The Workers' Comp board approved that change the same morning of this meeting. Mr. Jones didn't think there was a need for the Commission to take any action on this decision since the program was run through OFM staff.

Mr. Jones reported that a repo consultant had been hired to help with the Bilateral Repo option that was discussed at the last meeting. In the past, the Commonwealth did the Tri-Party Repo with the primary broker dealers of the Federal Reserve. But now most of the primary broker dealers have been downgraded below what OFM staff is comfortable with, and more regulations are limiting their ability to do overnight repo transactions. Non-traditional counter-parties, which are not regulated by the Federal Reserve in their broker dealer capacity, are now being looked at by OFM. The consultant has identified some counter-parties that will be presented for approval at this meeting by Ian Blaiklock in his report on Credit Considerations. Currently, a repurchase contract with Investco is before the Finance and Administration Cabinet's General Counsel for review. Mr. Jones commented that this is a long term process but OFM is making progress.

Compliance Reporting/Trading Limits – Mr. Steve Jones updated the Commission regarding the progress that's been made on improving the compliance monitoring and reporting of all investment transactions. He explained that statutes, regulations, and SIC policies all place limitations on investment activities. OFM staff is working on putting together one document that lists all the restrictions that the Commonwealth is under. It is still a work in progress.

To manage all of the compliance, staff uses the Compliance Module within Bloomberg's Portfolio Order Management System. This module alerts certain individuals, including Mr. Ed Ross, and Mr. Ryan Barrow to any violation of the "rules" set up in the system. Since the last meeting, there were two alerts triggered. One alert concerned a 144A security that matured September 30, 2014. The Commission in 2011 ruled that the Commonwealth should not purchase any 144A securities, but did not require liquidation of existing positions. Holding this security triggered an alert but was not a violation of SIC policy. The second alert concerned a Bloomberg coding change to some securities. Money market mutual fund's classification was changed from an equity to a money market. This change triggered an alert because the position exceeded \$25 million, the limit for other money market securities. The rule in the compliance module was changed to reflect this change from Bloomberg. There was no actual violation.

Bridges Pool – Mr. Steve Jones stated that in December 2013 approximately \$650 million in treasuries were purchased to match the expected cash flows for the Downtown Bridges Project in Louisville. The Bridges Pool report as of September 16, 2014, shows what securities were remaining. The projected net cash flow graph depicted the excess cash available to be spent. Mr. Jones noted that in 2016 the cash balance will drop negative, but other revenue sources will cover that shortfall.

Intermediate Pool Performance – Brian Caldwell directed the Commission members to the Intermediate Term Pool report as of August 31, 2014. The Pool market value stood just under \$2.4 billion. The Yield to Worst was 0.51% and matched the benchmark. Quality remained high at Aaa. Duration was slightly over a year at 1.11 and just under a half year short of the benchmark. There was a very slight negative convexity of -0.08. The Portfolio Sector Allocations page showed a comparison between the Intermediate Pool and the Benchmark as of August 31, 2014. The only difference to the Portfolio's allocation from the last meeting was in Corporates. The allocation was reduced from 10% to 8%. The Portfolio Performance page showed the Pool performance versus the Benchmark as of August 31, 2014. For the month of August, the Pool matched the Benchmark. For the preceding three months to three years, the Pool outperformed the Benchmark. The 5 years to Since Inception performance was slightly under the Benchmark. Mr. Jones added that the Portfolio has run short duration of the Benchmark since Inception. During that time period the rates have generally fallen leading to slight under performance.

Limited Term Pool Performance – Ms. Kim Bechtel could not make the meeting so Mr. Jones presented in her absence. Mr. Jones discussed the monthly performance of the Limited Term Pool compared to the Local Government Investment Pool benchmark. The first graph showed the Commonwealth out-performing the benchmark in every month but two. The underperformance in those two months was driven by excess cash balances on and around June 30 and limited investment opportunities. The second page listed all the securities held in the Pool as of August 31, 2014. The next page showed a breakdown by security type and credit rating. The next page provided detail on the weighted average maturity and life plus liquidity positions. The Net Asset Value graph was steady as it should be. The largest daily withdrawals were the same as reported at the last meeting (the University of Kentucky Hospital funds in 2011 and 2013). The largest weekly withdrawals were

the same as the daily withdrawals. The largest individual accounts in the portfolio were the Employee Self-Insurance Fund at 34.91%, UK General Receipts Bond Issue at 15.37%, and the UK Building Fund at 4.65%. Mr. Jones stated that the daily liquidity requirement as set forth by the Commission is 15% and the weekly liquidity requirement is 30%. Staff recommended maintaining the current liquidity requirements of the Pool requiring no action from the Commission. The Commission took no action.

Linked Deposit Program (Country Bank Program) – Mr. J.D. Lester provided background and an update on the program. The purpose and goal of the program is to provide liquidity to state banks through 35 day repurchase agreements. All of the deposits are fully collateralized with levels ranging from 100 to 118%. Currently there are seven participating banks with a program valuation of \$13.7 million. The purpose of this report is to identify those banks which would not qualify to join the program but are already a member. It is the Commission's right, but not its obligation, to rule those banks ineligible. The Bank of Columbia's non-performing loans to capital ratio fell from 52% to 38%. Mr. Jones added that the bank was contacted and their plans are to have the ratio back under 25% within six months. Mr. Lester continued and stated the Bank of Jamestown and Farmers Deposit Bank showed no substantial changes with their loans to deposit ratio holding at less than 70%. The Bank of McCreary was on the list at the last meeting, but in the last quarter lowered their non-performing loans to capital ratio below the target rate of 25% and was removed. Staff recommended no action from the Commission. The Commission took no action.

Credit Considerations – Mr. Ian Blaiklock presented the updated list of Corporate Credits approved for investment purchases as of September 25, 2014. He stated that he has moved to another position outside of the Investment group within OFM; therefore, this may be his last time to report on the credit considerations. Mr. Blaiklock gave a review of OFM's internal credit review process. He reported that four names had been added since the June 19, 2014, meeting which was a direct result of the bilateral repo and are seeking approval for repurchase agreements only. No names were removed from the list of considerations from June's meeting. Treasurer Hollenbach asked for a motion to approve the credit list. A motion was made by Mr. William Fallon and seconded by Mr. Fred Brashear to adopt the Approved Credit List as presented. Motion **CARRIED**.

Other Business – Mr. Jones updated the Commission on some personnel changes that had occurred within the Investment group. Ian Blaiklock was promoted to a position that will enable him to support the entire office of OFM and not just the Investment group. Brian Caldwell is the lead in hiring a replacement to serve as the primary credit analyst. Interviews have taken place and the selection process is moving forward. JD Lester was hired June 23, 2014, and has taken over the cash management functions. He graduated from Transylvania University last Spring in Economics and has recently applied for the CFA program. Treasurer Hollenbach asked Mr. Lester where he was from and Mr. Lester replied he was from Madisonville.

With no further business, Treasurer Hollenbach made a motion to adjourn and was seconded by Mr. William Fallon. The meeting stands adjourned.

Respectfully submitted,



Ryan Barrow
Secretary