

**STATE INVESTMENT COMMISSION  
DECEMBER 11, 2008  
MINUTES**

The State Investment Commission Meeting was called to order on Thursday, December 11, 2008, at 2:00 p.m. in Room 76 of the Capitol Annex by Todd Hollenbach, State Treasurer. Other members present were Jonathan Miller, Secretary of the Finance and Administration Cabinet; Edmund Sauer, proxy for Governor Steve Beshear; and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Brett Antle, Stephen Jones, Dwight Price, Kim Bechtel, Rachael Putnam, Tom Midkiff, Robin Brewer and Marcia Adams.

Other Guests: Ed Ross, Comptroller, Commonwealth of Kentucky, Mary John Celletti, Deputy Treasurer, Lori Flanery, Deputy Secretary Finance and Administration Cabinet, Shawn Bowen & Kristi Culpepper of LRC and Travis Powell, Office of Legal Services. Additional presenters, Kevin McKenna and Dwight Skerritt from Credit Suisse.

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

Dwight Price introduced Mr. Kevin McKenna and Mr. Dwight Skerritt from Credit Suisse who manages the Commonwealth's securities lending program. They discussed a proposal of exchanging \$185 million face value of bonds currently held in the securities lending portfolio for a new security with the same face value issued by Credit Suisse. The bonds exchanged from the securities lending portfolio would include \$25 million positions in Washington Mutual and in Lehman brothers, both of which have defaulted. While details are still being discussed with staff, the new bond from Credit Suisse would be a subordinate note issued by the Swiss bank. The bond would have approximately a \$185 million par value, 10 year maturity and carry a floating rate of interest. The advantage to the Commonwealth is that the defaulted securities would be replaced with an investment grade security carrying an above market rate of interest.

Mr. Hollenbach remarked that this sounds like a great opportunity for the Commonwealth but asked how Credit Suisse benefited. Mr. McKenna answered that they hope to do more and different types of business with the Commonwealth in the future.

Mr. Spragens confirmed that Credit Suisse is proposing to take \$185 million face amount of bonds currently held by the Commonwealth with a significantly lower market value, and replace with a security of like face from Credit Suisse. He asked further about Credit Suisse's risk. Mr. McKenna responded that the bank may or may not hold the bonds to maturity. The securities may be sold depending on decision by Credit Suisse.

Mr. Hollenbach stated that credit risk has been mitigated by our regulatory scheme, which limits exposure to \$25 million per name. This proposal will require a regulatory exemption because it exceeds the \$25 million per name restrictions, but that this allows the Commonwealth to be made whole over a ten-year period.

Mr. Hollenbach questioned the floating rate. Mr. McKenna responded that staff is negotiating with Credit Suisse to determine the specific details. However, the yield will be an above market combination of amortization of the original issue discount plus a floating rate coupon. The coupon is required to support the securities lending program.

Mr. Hollenbach asked if there was a time frame on this. Mr. Price answered that the goal is to work on the specific details with a final proposal for the commission early next quarter. Staff asked the commission, not for formal approval, but instead for an expression of interest in continuing to develop the proposal. The Commission expressed that interest.

Mr. Hollenbach thanked Mr. McKenna and Mr. Skerritt for their time and presentation. They departed the meeting.

Treasurer Hollenbach called for a motion to approve the minutes from September 11, 2008. A motion was made by Mr. George Spragens and seconded by Sec. Jonathan Miller to approve the minutes of the September 11, 2008 meeting as written. Motion **CARRIED**.

**Market Update** - Dwight Price, Portfolio Manager, Office of Financial Management, expressed that the markets had already been discussed adequately.

**Auction Rate Notes** - Stephen Jones, Portfolio Manager, Office of Financial Management, updated the commission on the auction rate security positions. The situation has not changed since the last meeting as the securities remain illiquid but continue to pay above market rates. Citibank attempted to tender approximately \$2 to \$3 billion of certain auction rate notes. They were unsuccessful since there were not enough participants.

**TRAN** - Mr. Jones discussed the FY 2009 \$400 million dollar TRAN (Tax Revenue Anticipation Notes). Attachment A shows the performance year to date. Projections at the beginning of the year that the investments versus the floating side of the swap would provide little or no income. Actually, the Commonwealth has earned about half a million dollars. The fixed side of the swap versus the fixed rate debt has earned a little over two million dollars for a year to date total through the end of November of almost three million dollars. Projections for the total year are for \$5.9 million in income. To date this program is ahead of that projection.

**Securities Update** - Mr. Price discussed downgraded securities in the Commonwealth's portfolio. As discussed earlier, the Lehman and Washington Mutual positions will be included in the Credit Suisse transaction if that occurs. Staff will also consider the possibility of including the SLM (Sallie Mae) and HMFFT's in the transaction. As has been the case, all of these securities continue to perform. The HMFFT's continue to make monthly principal payments. Mr. Price continued that the unrealized loss continues to decline as the securities approach maturity.

Mr. Price continued with the second page with the downgraded securities in the Commonwealth's portfolio. The credit rating for the first one, Orleans (New Orleans) School Board, was withdrawn. The security does have FGIC insurance and matures in approximately six weeks.

Mr. Jones said the rest of these are various asset-backed securities. Some have been down graded because of mono line insurer downgrades and some by an apparent over reaction by the rating agencies. As has been the case, all of these securities continue to make all principal and interest payments with no impairment. Mr. Spragens asked if there is still some irrationality by the rating agency. Mr. Jones answered that the rating agencies have swung from one extreme to the other and are currently over doing the downgrades in the same manner as they previously applied overly high ratings.

Mr. Price added that prices are being driven by technical supply and demand forces rather than the underling economic fundamentals of the security. With the continued de-leveraging of hedge funds and investment banks, there are a great many more sellers than buyers. Additionally, many buyers are only buying the highest credit securities, which is why Treasury bills have effectively no yield.

Mr. Hollenbach questioned whether there were other investments out there that could be swapped into that would provide better appreciation potential and/or better safety. Mr. Price answered not with a triple A rating. Instruments with a lower credit rating could provide higher yields but at a give up in safety. Additionally, Mr. Jones added that the spreads between the ask and the bid side are so wide that few trading opportunities are available. Mr. Spragens made the motion to accept the list of downgraded securities for forbearance. It was seconded by Mr. Miller. Motion **CARRIED**.

**New Business** - Mr. Jones stated the Commonwealth held a five million dollar par bond issued by Lehman Brothers. It was sold for ten cents on the dollar resulting in approximately a four and a half million dollar loss. Mr. Jones noted that Mr. Hollenbach had questioned whether some weaker assets should be sold. Mr. Jones stated that OFM will do that and that this Lehman sale is an example of selling when the time is right.

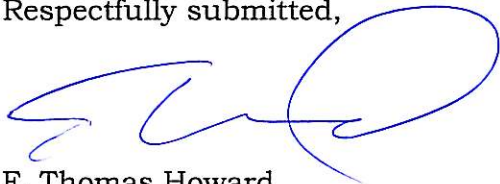
Mr. Hollenbach asked the commission if there were any further questions about the presentation from Mr. McKenna and Mr. Skerritt from Credit Suisse Bank. Mr. Spragens questioned how it made sense for Credit Suisse. Mr. Spragens continued that every transaction has to have something in it for both sides to make it work. He is not sure what is in it for Credit Suisse at this point. Mr. Hollenbach questioned that the SIC will need to understand it before approval, but is it a good, safe deal for the Commonwealth. Mr. Jones replied that a number of companies will be leaving the securities lending business. Credit Suisse will have the opportunity to pick up clients from these competitors. However, a headline of a large client departing, such as the Commonwealth, could lead to a run of clients leaving Credit Suisse. Mr. Price added that they are buying good will.

Mr. Hollenbach stated that this is the last meeting of a tumultuous year in the financial markets. He has learned a great deal and wanted to note for the record that he appreciates the job OFM staff has done. He believes staff has gone above and beyond anything asked and he has benefited greatly from their knowledge.

There was no other business for the commission at this time

A motion was made by Mr. Miller and seconded by Mr. Spragens to adjourn the meeting. Motion **CARRIED**.

Respectfully submitted,



F. Thomas Howard  
Secretary