

State Investment Commission

December 12, 2012

2 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on Wednesday December 12, 2012, at 2:00 p.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; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Steve Jones, Deputy Executive Director, Dwight Price, Kim Bechtel, Kurt Kemper, Ian Blaiklock, John Bailey, Rachael Dever, and Marcia Adams.

Other Guests: Mr. Ed Ross, Controller, Pamela Trautner, Director of Communications, Finance and Administration Cabinet, and Joshua Nacey 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 September 27, 2012. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes. Motion **CARRIED**.

Broker/Dealer Update - Mr. Dwight Price informed the Commission of a firm, Arbor Research & Trading from Chicago that had been dropped from the approved broker/dealer list due to inactivity. The company has a renowned economist, Jim Bianco, whose views and updates may be accessed from their website by clients. The company is qualified and therefore, staff is asking to add Arbor Research & Trading to the approved broker/dealer list. Treasurer Hollenbach asked staff to define the difference between the Primary Dealers and the Non-Primary Dealers on this list. Mr. Price responded that Primary Dealers are approved by the Federal Reserve Bank of New York and are required to participate when new Treasury issues are brought to market. The Non-Primary Dealers need other qualifications to be approved for the list, for instance, over \$100 million dollars of excess capital but are not approved by the Fed.

A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens to accept the updated Broker/Dealer list as presented. Motion **CARRIED**.

SEC 2a-7 Reports – Mr. Steve Jones presented the Limited Term Pool report to the Commission. The first chart shows the performance of the Limited Term Pool versus the Standard & Poor’s (“S&P”) Local Government Investment Pools. This measures the pool versus its peers and shows that the performance is considerably higher. This difference is due to the state’s lower fees. The spikes in the middle of each month represent an accounting effect from some asset-backed security payments. The next page lists all the individual securities owned with varied information on principal, maturity, etc. The third report provides the credit rating and sector distribution. The majority of the securities have high ratings with nothing below A1 in the short term ratings and AA- in the long term ratings. The next chart shows a breakdown of allocation to specific sectors. The largest Repurchase Agreements, at almost \$300 million, are backed by either Treasury Notes or

Government Agencies. The Investment Company sector is Money Market Mutual Funds. The next page of the report shows the liquidity and maturity history of the portfolio. The weighted average maturity (WAM) is restricted to less than 60 days. This graph shows that in July 2012, the WAM exceed this restriction. This was caused by a combination of new accounting structure and changes to intra-month cash flows. Staff now has the WAM in accordance with the target not to exceed sixty days. The next report shows the Net Asset Value and "shadow" Net Asset Value of the pool. If the shadow NAV diverges from \$1.00 by more than \$0.0025, staff would report to the Commission for a discussion of remedies. The graph shows no meaningful divergence.

This last page is an analysis of the Limited Term Pool liquidity which is not posted to the website. Staff prepares this quarterly, for the Commission, to determine adequate liquidity levels for the pool. There were no changes in largest daily withdrawals from the last meeting. The largest withdrawal, in January, 2011, was from the University of Kentucky ("UK") Hospital Fund for construction costs of \$130,242,889.13 (17.23% of the pool). The second largest was from the UK Investment Account for of \$100,000,000 (10.82%) in January 2012. The third largest was debt service payments for the Turnpike Authority of Kentucky ("TAK") in June 2012 for \$77,597,331.62 (8.44%). UK notifies staff in advance of any planned movement of funds for ease of management. OFM staff is responsible for the TAK payment. These same three withdrawals were also the largest weekly withdrawals in the analysis.

The final part of this analysis shows the largest accounts in this pool to be the Employee Self-Insurance Fund of \$162,447,811.40 (19.44% of the total pool), UK Hospital Fund of \$125,085,813.70 (14.97%), and the Federal Retiree Insurance Fund with \$95,729,679.84 (11.46%). While the first fund exceed 15% of pool balances, all withdrawals are budgeted giving staff advance warning of any substantial withdrawals.

Staff recommends setting the Weekly Liquidity at 30% and the Daily Liquidity at 15%. Mr. Spragens asked how often liquidity approaches 30%. Mr. Jones answered that it rarely has happened and is quickly adjusted.

A motion was made by Mr. Spragens and seconded by Mr. Lawson to accept the liquidity limits as presented and recommended. Motion **CARRIED**.

Treasurer Hollenbach asked about the sector distribution graph and if the Government Agency Repurchase Agreement segment would always be the largest component. Mr. Jones answered that it would be the largest unless there was a rapid withdrawal of cash. Cash come out of repos first but staff would reallocate to assure adequate liquidity.

Securities Update - Mr. Price discussed the handout information concerning down-graded securities in the Securities Lending Portfolio. The same two securities are on this list as previous reports. These securities continue to perform with roughly \$800,000 in principal paydowns per quarter. With only \$1,700,000 left outstanding, staff estimates these should be off the books by July 2013.

Mr. Jones continued with the down-graded securities in the state's direct portfolio, with only three left. The Wachovia security previously had a par of \$20 million. A nearly \$10 million par payment was received last month. One other one, Centex, shows a gain over its original purchase price. Staff is waiting until nearer fiscal year end to take further action. Staff recommends continuing to hold these downgraded securities.

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**.

Linked Deposit Program – Ms. Kim Bechtel noted that during this reporting period, Bank of Columbia's non-performing loan ratios rose enough to report their condition. Bank of Jamestown's ratios are improving. Clinton Bank has been added to this list because the loan to deposit ratio fell below 70%. Deposit Bank of Carlisle's loan to deposit ratio and non-performing loans to capital improved. Mr. Spragens asked if the information for the Bank of Columbia was year to date or the most recent quarter. Ms. Bechtel answered it was the most recent quarter. Mr. Lawson asked to be reminded of when this program ends. Ms. Bechtel stated that the banks on this list are in the repurchase program offered by the Commonwealth, which rolls every 35 days. Mr. Jones added there is no end date for the program. Mr. Jones reminded the Commission that all the linked deposit loans are collateralized with agency securities which staff monitors more frequently than statute requires. Mr. Spragens asked what nature of the collateral was. Mr. Jones answered it was all Agency Bonds and is held at State Street Bank.

Resolution 2012-01 – Recognizing Tom Howard, Commission Secretary on his Retirement

Mr. Price informed the Commission that Tom Howard has announced his retirement at the end of December. Ryan Barrow has been hired as his replacement. Secretary Flanery explained that the cabinet was able to arrange a three week overlap of a successor and retiree for three week. Mr. Barrow comes to state government from the City of Lexington, has an engineering degree, and three children. He has securities experience with Ross Sinclair and Associates. He worked with incoming State Budget Director, Jane Driskell in Lexington.

Sec. Flanery praised Mr. Howard's tenure as Executive Director of OFM describing his abilities as both analytical and creative. She continued that Mr. Howard is a master at relationships with both sides of the aisle and others throughout the Commonwealth and state agencies. During trips to New York with him, she saw his command of individual respect from the Wall Street community. His accomplishments in his role have definitely benefited the state over his tenure and will be greatly missed.

Mr. Price read the resolution into the record:

A RESOLUTION OF THE STATE INVESTMENT COMMISSION OF THE COMMONWEALTH OF KENTUCKY FOR RECOGNITION OF OUTSTANDING SERVICE BY F. THOMAS HOWARD, SECRETARY TO THE COMMISSION AND AS EXECUTIVE DIRECTOR OF THE OFFICE OF FINANCIAL MANAGEMENT.

WHEREAS, the State Investment Commission's objective to invest available public funds to maximize safety of principal, liquidity and yield while minimizing risk; and

WHEREAS, the Commission relies heavily upon the staff of the Office of Financial Management; and

WHEREAS, such advice, counsel and guidance requires a significant expenditure of time and resources on behalf of the Commission; and

WHEREAS, Tom Howard has dedicated his time and energy on behalf of the Commonwealth, as a staff member of the Office of Financial Management during his tenure from February 27, 1989 through December 31, 2012, including Executive Director of the Office of Financial Management as of October 1, 2005, with responsibility as Secretary to the Commission.

NOW THEREFORE BE IT RESOLVED by the Commonwealth of Kentucky, the State Investment Commission expresses its appreciation to Tom Howard, for his valued advice and professionalism during his service with the Office of Financial Management and assistance to the Commission.

Adopted this 12th day of December 2012.

Other Business – Mr. Jones updated the Commission on its recommendation for statutory changes. The Governor's legislative liaison is anticipating a bill to be filed in the upcoming legislative session. Staff will update the members with any changes.

The changes to regulations approved by the Commission at the last meeting have passed at the Administrative Regulation Review Committee. These have now been moved to the Interim Joint Appropriations and Revenue Committee (A&R). There is a regularly scheduled meeting on December 27th. The regulations will be in effect as of January 4th if A&R does not object.

Mr. Jones introduced Ian Blaiklock as OFM recently hired credit analyst. He is a graduate of Transylvania University and is a candidate for the CFA (Chartered Financial Analyst) designation.

Mr. Price commented on the Federal Reserve Board meeting the last two days. They indicated that rates will remain low until 2015. Mr. Lawson stated they removed some language from their regular statement. Mr. Price responded that was affirmative. Mr. Jones added that they established targets for the unemployment rate of 6.5%, and inflation expectations for 1-2 years out at 2.5%. They will remain accommodative until those thresholds are reached.

Mr. Jones notified the Commission that the Transaction Account Guarantee (TAG) Program which allows unlimited insurance on a deposit account will expire December 31, 2012. Staff is negotiating a collateral agreement with JP Morgan Chase with similar collateral requirements as current Tri-Party Repo agreements. The collateral will be segregated into a Federal Reserve Account.

With no further business, the meeting stands adjourned.

Respectfully submitted,



Ryan Barrow
Secretary