

State Investment Commission

December 12, 2014

2:00 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on December 12, 2014 at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were W. Fred Brashear, II, President & CEO, Hyden Citizens Bank, Hyden, Kentucky; William Fallon, President & CEO, The Bankers’ Bank of Kentucky, Frankfort, Kentucky; Ed Ross, proxy for Lori Flanery, Secretary of the Finance and Administration Cabinet; and John Hicks, proxy for Governor Beshear.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director of OFM and Secretary to the Commission; Steve Jones, Deputy Executive Director; Brian Caldwell, Ian Blaiklock, J.D. Lester, Hannah Hogston, Kim Bechtel and Tammy McCall.

Other Guests: Mr. George Spragens; Joshua Nacey, Legislative Research Commission; and Debbie Paulus, Office of Policy and Audit, Finance and Administration Cabinet.

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 the September 25, 2014, meeting. A motion was made by Mr. Bill Fallon and seconded by Mr. John Hicks to approve the minutes as written. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Steve Jones.

Mr. Jones presented two resolutions to the Commission and, since both resolutions were identical in nature, read the following into the record:

A RESOLUTION AND ORDER HONORING JON A LAWSON/GEORGE B. SPRAGENS IN RECOGNITION OF DEDICATED SERVICE

WHEREAS, the State Investment Commission (“the Commission”) has been ably served since the 4th day of November, 2010 by Mr. Jon Lawson, and the 29th day of September, 2006 by Mr. George Spragens, in their capacity as an appointed member, representing the Bluegrass Bankers Association and the Kentucky Bankers Association; and

WHEREAS, Mr. Lawson and Mr. Spragens were appointed as members to the Commission on that day and have capably performed all duties associated with this position; and

WHEREAS, Mr. Lawson and Mr. Spragens have represented the Commission in a positive and professional manner and have performed admirably as public servants; and

WHEREAS, Mr. Lawson and Mr. Spragans' terms expired from the Commission as of July 15, 2014; and

NOW THEREFORE, the Commission hereby recognizes the dedication and service given by Mr. Lawson and Mr. Spragans to the goals and objectives of the Commission,

AND DOES HEREBY DECLARE our heartfelt appreciation and best wishes to Mr. Lawson and Mr. Spragans for success in all their future endeavors both professionally and personally.

This Resolution and Order shall be in full force and effect from and after its adoption at a properly held meeting for the State Investment Commission this 12th day of December, 2014.

Mr. Jones expressed his personal appreciation for all of the effort and support that was provided through the years. Treasurer Hollenbach moved to pass both Resolutions by acclamation. All were in favor. **Motion CARRIED.** Treasurer Hollenbach added that both Mr. Spragans and Mr. Lawson were great in making him feel comfortable when he was first appointed to the Commission and he always had confidence in their direction for the Commission. He greatly appreciated their service. Mr. George Spragans stated that it was very interesting to have served on the Commission, especially in the past six years.

Updated Trading Authorization – Mr. Jones asked the Commission to approve Hannah Hogston to the Trading Limits as a Money Market Trader. She was hired to replace the vacancy that occurred when Ian Blaiklock was promoted within OFM. Treasurer Hollenbach moved to approve Hannah Hogston as a Money Market Trader. Mr. Fallon seconded, and the Motion **CARRIED.**

Update on Cash Management Alternatives – Mr. Jones updated the Commission on the issues regarding cash management alternatives that surround the availability of products in the market that are appropriate for the Commonwealth. He stated that since the last meeting, an Insured Cash Sweep (“ICS”) account was opened with Traditional Bank. The ICS account will hold approximately \$100,000,000, is fully insured by the FDIC, and offers same day liquidity. The ICS account is currently paying 25 basis points as opposed to the Repo account which is paying 11 basis points and has more credit risk. This will be used as one of the Commonwealth’s liquidity sources.

Mr. Jones stated that a repurchase agreement is currently being negotiated with the Investco Group. This will be a bilateral agreement which is different from the tri-party broker-dealer agreements used in the past. By contracting with Investco, the Commonwealth will avoid some of the month end problems with liquidity, will diversify the Commonwealth away from the exposure to the broker-dealer market, and will enable more earnings. Mr. Jones hoped that the first transaction would take place next month.

Updated on Compliance Reporting – Mr. Steve Jones updated the Commission regarding the improvements toward compliance monitoring. He stated that since the last meeting, two alerts were triggered. One alert was due to a ticket being improperly keyed as a buy rather than a sell. The mistake was reversed out and then keyed properly; therefore, there was no violation. The second alert was because a 144A security was in the portfolio. There is a rule which does not allow the Commonwealth to own a 144A security. The actual adopted policy is that the Commonwealth

cannot buy one, but can own one; therefore, there was no violation. There were no compliance violations since the last board meeting.

Mr. Jones introduced Ms. Debbie Paulus from the Office of Policy and Audit in the Finance and Administration Cabinet. He stated that she is working with OFM staff to go through all the relevant statutes and regulations and identify all rules to make sure they are covered in the compliance reporting system. Mr. Jones noted that once all findings from the compliance audit have taken place, OFM staff will bring to the Commission recommendations regarding any regulation changes that might be needed.

Bridges Pool – Mr. Jones explained that this portfolio provides cash for the Downtown Bridges Project in Louisville. The individual securities were purchased and par amounts were chosen in cooperation with the Transportation Cabinet to match the projected cash outflows. The projected net cash flow graph depicted the excess cash available to be spent. This pool falls under the purview of the SIC, however the investments within the pool are restricted and requires all investments to be “full faith and credit of the United States of America”. Mr. Jones stated that towards the end of the program, there will be about \$10,000,000 a month that will be available from the federal government. There have been no changes since the last meeting.

Intermediate Pool Performance – Brian Caldwell directed the Commission members to the Intermediate Term Pool report as of November 30, 2014. The Pool market value stood just over \$2.3 billion. The Yield to Worst was 0.49% which was slightly under the benchmark. Quality remained high at Aaa. Duration stood at about 1 year which is less than two-thirds of a year short of the benchmark. The Portfolio Sector Allocations page showed a comparison between the Intermediate Pool and the Benchmark as of November 30, 2014. The only difference to the Portfolio’s allocation from the last meeting was a little higher cash and agency position. Mr. Caldwell continued with the Portfolio Performance page, which showed the Pool performance versus the Benchmark as of November 30, 2014. For the month of November and the preceding three months, the Pool underperformed compared to the Benchmark. The performances from fiscal year to date, one year, and the remaining time periods closely matched the Benchmark.

Limited Term Pool Performance – Ms. Kim Bechtel discussed the monthly performance of the Limited Term Pool compared to the Local Government Investment Pool benchmark. The first page was the monthly performance graph showing the Commonwealth out-performing the benchmark. The second page listed all the securities held in the Pool as of November 30, 2014. The next page showed a breakdown by credit rating and sector distributions. Ms. Bechtel noted that the portfolio is highly rated in both assets and diversification. Mr. Jones added that the largest sector distribution of \$435,451,832.65 in Other Municipal Debt is made up of money that is borrowed from the other pools so there is no credit risk. Ms. Bechtel continued and stated the next page provided detail on the weighted average maturity and life plus liquidity positions. She noted that all the liquidity goals have been met with the Pool being well above 50% liquidity. The Net Asset Value graph was steady as it should be. The most recent largest daily withdrawal was over one year ago to the University of Kentucky Hospital on 11/21/13. 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 29.27%, UK General Receipts Bond Issue at 12.08%, and the UK Hospital at 9.02%. 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 stated 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 101 to 120%. 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 was 31% which is above the threshold of 25% and an improvement from the second quarter of this year. Mr. Jones added that six months ago the Bank of Columbia was contacted and they had projected to have the ratio back under 25% by the Spring of 2015. Mr. Lester continued and stated the Bank of Jamestown and Farmers Deposit Bank showed loans to deposit ratio holding at less than 70%. Staff recommended no action from the Commission. The Commission took no action.

Credit Considerations – Mr. Brian Caldwell presented the updated list of Corporate Credits approved for investment purchases as of December 12, 2014. He stated there were no additions or removals to the list from the last meeting. Staff asked for the approval of the credit list as is. A motion was made by Mr. Fred Brashear and seconded by Mr. Bill Fallon to approve the Corporate Credit List as is. Motion **CARRIED**. Mr. Caldwell informed the Commission that Ms. Hannah Hogston would be presenting the credit considerations going forward. He noted that Ms. Hogston was hired about two months ago and is a recent graduate from University of Kentucky where she majored in Mathematical Economics.

Other Business – Mr. Jones informed the Commission that the Auditor of Public Accounts ("APA") is performing their annual audit and OFM is included in the Cash Audit along with the Controller's Office. The audit produced two findings related to the investment side. The first finding is that the Bridges Pool was not marked to market daily. Mr. Jones explained that OFM has a process in place where prices are received in an automated download from the custodian. One security in that portfolio was in another Pool. When that portfolio was added the custodian forgot to include that account in the daily price downloads. OFM did not notice that for a while because there was still one security being priced so the price was still moving up and down a little. OFM saw the error and corrected it before the APA audit and a daily report has been implemented to prevent the error again; but, APA will still be including it in their annual audit.

Mr. Jones stated the other finding is regarding the Compliance Manager. He explained that in order to access POMS, execute trades, and to change the rules in the Compliance Manager, a Bloomberg terminal that has biometric security is required. Because of that, someone from OFM's Investment group has to do that. The APA stated that that role should actually lie in OFM's Accounting group. Mr. Jones stated that OFM disagrees. He informed the Commission that the cost of adding an extra Bloomberg machine with the required biometric security would be approximately \$23,000 and that would not be an efficient use of the Commonwealth's money. Mr. Jones further explained that historically the Commission's policy regarding compliance issue objectives was not to prevent the breaking of rules but to identify if that happens so that proper action can be taken. The reasoning for that was to have flexibility in case a situation arises that was not thought of before. A member of the Investment group, Ms. Kim Bechtel, is authorized to change the rules in the compliance manager and there is a log generated every time she does so. The APA stated in their findings that Ms. Bechtel could change a rule, process a trade she shouldn't, then change the rule back and it wouldn't be caught. Mr. Jones stated that was not accurate because there would be a log of the rule change that is reviewed on a weekly basis.

Treasurer Hollenbach asked if OFM had been able to discuss their position on the findings with APA. Mr. Ryan Barrow answered the official response to the findings was sent the week before the meeting and will be documented in the final findings. Mr. Barrow agreed that a conversation with APA would be beneficial regarding their recommendation to add a biometric security terminal within Accounting. He confirmed that the separation of duties within the Investment group and the Accounting group is more than adequate, and he expressed his concern regarding the \$23,000 cost increase that would be necessary to implement APA's recommendation. Treasurer Hollenbach asked if there were findings on last year's Cash Audit. Mr. Jones replied that these two findings were the first on OFM in five or six years. Treasurer Hollenbach asked if OFM staff would send to him and the other board members copies of both APA's proposed findings and OFM's response. Mr. Barrow said they would.

Mr. Jones asked for affirmation from the Commission on its standing philosophy of compliance; which is to not put compliance infrastructure in place to prohibit a trade, but allow Investments the ability to execute any type of trade, with the proper approvals and required documentation and allow Accounting to approve or stop a trade. Treasurer Hollenbach stated that he was satisfied that OFM staff is handling it properly. Mr. John Hicks gave his affirmation and stated it was a reasonable risk to take because there are other mechanisms in place to check compliance. Mr. Bill Fallon stated he had no problem with it. Mr. Fred Brashear stated that the auditors have to do their job and we have to do our job.

With no further business, Mr. Fred Brashear made a motion to adjourn and was seconded by Mr. Bill Fallon. The meeting stands adjourned.

Respectfully submitted,



Ryan Barrow
Secretary