

STATE INVESTMENT COMMISSION
DECEMBER 13, 2010
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Tuesday, December 13, 2010, at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Jonathan Miller, Secretary of the Finance and Administration Cabinet; Michael Alexander, 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, Kim Bechtel, Robin Brewer, and Marcia Adams.

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

Treasurer Hollenbach called for Robin Brewer, notary, to administer the Oath of Office to Governor Beshear's Appointees to the Commission, George Spragens and Jon Lawson.

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 28, 2010. A motion was made by Mr. George Spragens and seconded by Mr. Mike Alexander to approve minutes as written. Motion **CARRIED**.

Market Commentary - Mr. Price explained that the equity and commodity markets have rallied since April 2010 indicating strength in the overall economy. Yields in the fixed income markets have risen primarily due to signs of possible increases in inflation. At the same time, quantitative easing by the Federal Reserve has distorted the market. The Fed is purchasing substantial quantities of Treasury bonds in the open market. In effect, one arm of the federal government, the Treasury, is borrowing money from another arm of the federal government, the Fed. The result is that the Commonwealth is competing with the Fed in purchasing securities.

Treasurer Hollenbach asked about bond market bubbles. Mr. Price responded that with the Federal Reserve buying substantial size in the Treasury market, demand is artificially increased. This drives prices higher than would otherwise be the case. At some point, the Fed will stop buying. With the reduction in demand, prices may drop. In other words, the Fed may be creating a bubble which will eventually burst with bond price declines. Mr. Spragens added that as long as the Fed is buying, they will not raise the fed funds rate.

Treasurer Hollenbach asked about the deal between the President and the Senate Leadership to extend the unemployment benefits and the Bush tax cuts. Mr. Price responded that it should be stimulative for the economy in the short run. However the increased debt incurred will be inflationary in the long run. Mr. Jones added that estimates are that the deal has about 1-1.5 % GDP growth in each of the next two years.

Securities Update - Mr. Price discussed the handout to the Commission about securities held in the Securities Lending Portfolio. The two asset backed securities on the list have paid down roughly

\$1.4 million in principal and have made all interest payments. Although the securities are rated below AAA, they are still investment grade. Staff expects the securities to pay off within 12 to 18 months. Additionally, the unrealized loss has improved from roughly \$3 million at the last meeting to roughly \$2.5 million currently. At the last meeting, the Aleutian security was identified as potentially problematic. It has since paid off in full.

Mr. Jones explained that a Wachovia Commercial Mortgage Backed Security has been added to the second page of the handout which details securities held in the Commonwealth's direct portfolio. This security has been down graded due to an extension in the expected maturity. Most CMBS have 30 to 40 year amortization periods with an expectation of refinancing at the end of 10 years. Weakness in the commercial lending market will probably prevent refinancing the underlying loans at the 10 year point. Even with the addition of \$20 million par value of Wachovia, the total par value of securities on the handout has declined by \$8 million. The unrealized loss on these securities has declined by roughly \$10 million since the last meeting.

Mr. Jones identified the Countrywide Mortgage Backed Security, backed by Alt A mortgages as a problem. The security has experienced realized losses of \$740 thousand from missed reduced principal payments. This security is held in the Short Term pool which pays all income to the General Fund. Even with these losses, the pool in total has earned roughly \$1.35 million during this fiscal year. Treasurer Hollenbach asked if the Commonwealth would be better served to sell this particular security. Mr. Jones explained that it is currently paying about 70 to 80 cents on the dollar of principal while it could be sold for about 60 cents on the dollar. Holding the security should provide better benefit to the Commonwealth.

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

Prospectii – Mr. Jones explained that the investment pools are structured as a series of funds similar to a mutual fund. Although they are not registered with the SEC and subject to federal regulation of mutual funds, the structure allows for more efficient management of the investments. There are two primary pools, the Intermediate pool which is primarily composed of agency funds and the Short Term pool which is largely composed of the General Fund and other funds which pay to the General Fund. The Short Term pool is subdivided into the Short and the Limited pools. The Short is composed entirely of funds which pay to the General Fund while the Limited is composed of other operating funds which do not pay their income to the General Fund. This segregation is made because the General Fund has a negative balance for much of the year. It borrows from the agencies and pays interest equal to the yield of the pool. Mixing these borrowings with positive account balances at times distorts the allocation of earnings.

In the same manner as a mutual fund, these pools are governed by prospectii. The Commission members recently received red lined copies of the prospectii showing changes recommended by staff. These changes conform the prospectii with current statute and regulations along with minor changes such as correctly identifying the Commonwealth's custodial bank. Mr. Howard added that agencies frequently request this information to understand how their funds are invested.

Mr. Alexander made the motion to accept the Prospectii for the Commonwealth as presented. The motion was seconded by Mr. Spragens. Motion **CARRIED**.

Kentucky Bank Repo Program - Mr. Jones updated the Commission on the country bank repo programs. Through these programs, the Commonwealth loans funds to various community banks within the Commonwealth. These funds support economic development and agriculture loans plus provide a source of low cost liquidity for various banks within the Commonwealth. At the last meeting, 7 banks were identified which no longer met the financial restrictions for participation in the programs. Mr. Jones reminded the Commission that they have the right but not the obligation to call these loans, and that the Commission asked staff to research the conditions of the particular banks.

Two banks voluntarily withdrew from the program. One of the banks from September has returned to compliance but another bank has been added. Of those 5, the Deposit Bank of Carlisle is in a unique situation. The bank is taking certain actions required by federal regulators which will financially strengthen a sister institution. Once the actions are completed, probably within the next couple months, they will be back in compliance. With the other 4 banks, the last couple of years of difficulties in the economy and banking environment have created situations leading to non-compliance. Mr. Jones contacted each of the banks to discuss the situation. All 5 explained the importance of these programs to their financial strength. Each bank expressed the importance to their liquidity and capital positions. Each bank also explained that it would take some time to work through these situations.

Each of these repos is over-collateralized by either agency securities held at the Commonwealth's custodial bank or by letter of credit by a Federal Home Loan Bank. This provides substantial credit support for the Commonwealth. Mr. Jon Lawson asked how much was in the total program. Ms. Kim Bechtel answered that the Linked Deposit Program was approximately \$2 million and the 35-day Repo Program is approximately \$40 million. Mr. Jones added that with a 3 plus billion dollar portfolio, this is a relatively small program.

Treasurer Hollenbach asked if the obligations are governed by statutes or regulation. Mr. Jones answered that this program is governed by regulation. Treasurer Hollenbach asked what was required of the Commission concerning this program. Mr. Jones replied that the Commission has the right to exercise an action to mature these loans for the non-compliant banks. If the Commission decides not to mature the loans, then no action is required. Staff recommended no action. Mr. Lawson expressed his support for no action to be taken.

Mr. Jones offered that staff would increase the frequency with which the over-collateralization levels were checked. Second, staff would report to the Commission any change in non-performing loan to capital ratio in excess of 2% or change in loan to deposit ratio of greater than 5%. Mr. Spragens recommended these limitations. With that, the Commission chose to take no further action on this program.

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

Respectfully submitted,



F. Thomas Howard
Secretary