

**STATE INVESTMENT COMMISSION**  
**DECEMBER 9, 2009**  
**2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX**  
**FRANKFORT, KENTUCKY**

**MINUTES**

The State Investment Commission Meeting was called to order on Wednesday, December 9, 2009 at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, State Treasurer. Other members present were Jonathan Miller, Secretary of the Finance and Administration Cabinet; John Esham, proxy for Governor Steve Beshear; and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, and secretary to the Commission, Brett Antle, Deputy Executive Director, Steve Jones, Deputy Executive Director, Dwight Price, Kim Bechtel, and Marcia Adams.

Other Guests: Ed Ross, Controller, Mary John Celletti, Deputy Treasurer and Kristi Culpepper from L.R.C.

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 25, 2009. A motion was made by Mr. George Spragens and seconded by Secretary Jonathan Miller to approve minutes as written. Motion **CARRIED**.

**MARKET COMMENTARY** – Mr. Dwight Price explained that recent treasury market lows occurred in December of 2008. However, markets are almost back to that level on the short end as the 2 year Treasury is at 0.74% compared to a low of 0.65%. A flight to quality is driving Treasury rates down. Dubai is trying to renegotiate debt. Both Greece and Illinois were downgraded today. Credit is still very tight for non-treasury borrowers. At the same time, short term rates are extremely low due to Federal Reserve policy and excessive liquidity within the system. For example, a \$5 billion dollar, 30-day discount note issued yesterday with a maturity over year end yields 0.00%. It sold out completely.

Treasurer Hollenbach asked how projected income for this year compares to the previous 2 years. Mr. Price answered that 2 years ago, rates were at 3.5 percent. Today, overnight repos were going are significantly lower priced at 0.11%. Treasurer Hollenbach also asked how the projections were reported to the state budget director. Mr. Price responded that the intermediate pool has not dropped quite as much. The yield has fallen from about 2.75% the last couple years to 1.25% now. The pool has a mix of treasury and spread product with higher yields. Mr. Price also pointed out that the General Fund has a negative balance so it is borrowing at a very low rate.

Mr. Tom Howard added that the funds the budget group looks at most closely are the Road Fund and Capital Construction accounting. These are in the Intermediate Pool earning approximately 1.25%. The General Fund being negative has no bearing on overall Commonwealth earnings since the borrowing is from other Commonwealth funds that interest post to the General Fund. Mr. Jones

added that last year, the Commonwealth paid out over \$100 million in cash income. This year the income will be lower because the amount of funds invested is smaller and the yield is lower.

Treasurer Hollenbach questioned the recent Dubai situation and whether it was related to private entities domiciled in Dubai or sovereign debt. Mr. Price responded that it was private entities however a misperception existed that there was a government guarantee of the entities, of which there is not. Sec. Miller asked about the many Dubai nationals involved in the Kentucky horse industry and the impact on the Commonwealth economy. Mr. Price responded that these private entities should not affect the broader economy.

Treasurer Hollenbach asked Mr. Howard about the rating agency's new, global rating system that will rate municipal and corporate ratings equivalent. Mr. Howard responded that the credit crisis has put this effort on hold indefinitely. Treasurer Hollenbach asked that if the rating agencies moved to a global rating system, will that hurt municipalities more or corporations. Mr. Howard responded that theoretically, it should help the municipal sector. However, credit spreads have been wider in the municipal sector than in the private sector for the same credit rating. While rating agencies grant a credit rating, investors are doing independent assessments and relying less on the rating agencies. Investors make an independent value judgment on the prospects of timely repayment.

**Securities Update** - Mr. Price discussed the quarterly list of downgraded asset-backed securities that the Commonwealth holds.

The first three listed on the securities lending handout have been on the list for a while. The changes from last quarter show the improving trends. All three are making all principal plus interest payments and the market valuations are rising. The fourth security is new to the list. Aleutian, a corporate note has lost its credit rating. It is making all quarterly principal and interest payments.

Mr. Jones pointed out the addition of one security to the downgraded securities list. This security is backed by 2002 vintage subprime mortgages packaged by Countrywide. The security is performing as all principal and interest payments are being made while the credit support continues to grow. Even with this addition to the list, the portfolio has had almost \$7.5 million in pay downs since the September meeting. The market value has gone down approximately \$1 million. As a result, the unrealized loss has declined by about \$8.5 million dollars. The strategy of continuing to hold these securities results in continuing pay downs at par.

A second security, backed by home equity lines originated in 2005 by Countrywide, has not been making full principal payments. The security is backed by insurance from XL Capital. However, the New York regulators of the particular subsidiary of XL Capital have suspended all outgoing payments. Currently the Commonwealth has a claim of roughly \$380,000 on this policy. All coupon payments are being made. Eventually, the Commonwealth should receive all principal payments as the insurance company issues are resolved. Treasurer Hollenbach asked if XL Capital insured many of our securities. Mr. Jones answered that only one security carried XL Capital insurance.

Mr. Howard explained that most of the mono-line insurers are being split into two companies with entity holding mortgage related policies and the other holding municipal only policies. MBIA, which has changed its name to National, is now selling municipal insurance out of its new subsidiary.

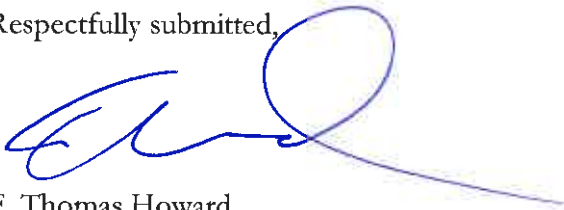
Treasurer Hollenbach asked if the trend in downgrades is slowing down and if problems in the commercial real estate industry will affect the Commonwealth's portfolio. Mr. Jones responded that the portfolio currently only has two CMBS's (Commercial Mortgage-Backed Security), and that the particular pieces are not exposed to the rollover as the securities mature before the underlying loans mature. Mr. Spragens added that commercial real estate creditors are banks with vested interest to find work outs for problem loans. The creditors are finding ways to extend principal and interest payments so that they eventually recoup the principal. Mr. Jones added that the portfolio has only had one addition to this list in six months, and maybe four or five taken off in the same time frame.

Mr. Spragens made the motion to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Secretary Miller. Motion **CARRIED**.

**Other Business** – Mr. Jones explained to the Commission that previously the Commonwealth had invested up to \$1 billion dollars in a NOW account issued under the TAGP (Transaction Account Guarantee Program). This NOW account carried insurance by the FDIC for the full amount of the deposit rather than the standard \$250,000 limit. During the program, US Bank and Citi were paying nearly fifty basis points. The FDIC extended the program from December 2009 until June 2010, however most large banks chose not to participate in the extension. US Bank and Citi continued the program but dropped their rates to unacceptably low levels. Staff has pulled all portfolio money out of those accounts and returned to the use of tri-party repo. Currently, repos are paying eight to eleven basis points collateralized at 102% of the deposit with high quality instruments.

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

Respectfully submitted,



F. Thomas Howard  
Secretary