

KENTUCKY ASSET/LIABILITY COMMISSION
MINUTES
FEBRUARY 9, 2011

The Kentucky Asset/Liability Commission (“ALCo” or the “Commission”) was called to order on Wednesday, February 9, 2011 at 3:00 p.m. in Room 182 of the Capitol Annex by Lori Flanery, Deputy Secretary, and proxy for Jonathan Miller, Secretary, Finance and Administration Cabinet and Chairman to the Commission. Other members present were Edgar C. Ross, Executive Director, Office of the Controller, Finance and Administration Cabinet, Mary Lassiter, State Budget Director, Todd Hollenbach, State Treasurer, and Mr. Eugene Harrell proxy for State Treasurer Todd Hollenbach.

The Office of Financial Management (“OFM”) Staff Members Present: Mr. Tom Howard, Executive Director of OFM and Secretary to the Commission, Deputy Director Brett Antle, Robin Brewer, Rachael Dever, and Marcia Hutcherson.

Other Guests Present: John Hicks from the Office of the State Budget Director (“OSBD”), Kristi Culpepper and Stuart Weatherford from the Legislative Research Commission (“LRC”), Katie Smith, Cabinet for Economic Development, John Esham from the Governor’s office, and Bill Burger from the Lieutenant Governor’s office.

Deputy Secretary Flanery verified with staff that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Ed Ross and seconded by Mr. Eugene Harrell to approve the previous meeting minutes. Motion **CARRIED** and the minutes of the July 16, 2010 meeting were approved as written.

Deputy Secretary Flanery introduced **Resolution 2011-01**:

A RESOLUTION PROVIDING FOR THE AUTHORIZATION, ISSUANCE, SALE AND DELIVERY OF NOT TO EXCEED \$300,000,000 FUNDING NOTES, 2011 GENERAL FUND FIRST SERIES (TAXABLE) OF THE KENTUCKY ASSET/LIABILITY COMMISSION, IN ONE OR MORE SERIES, FOR THE PURPOSE OF FINANCING OR REFINANCING OBLIGATIONS OWED UNDER SECTION 161.550(2) THE KENTUCKY REVISED STATUTES; AND AUTHORIZING A TRUST INDENTURE, FINANCING AGREEMENT, NOTE PURCHASE AGREEMENT, PRELIMINARY OFFICIAL STATEMENT, OFFICIAL STATEMENT AND OTHER AGREEMENTS THAT MAY BE ENTERED INTO, ALL RELATED TO SUCH NOTES.

Mr. Brett Antle stated that Resolution 2011-01 is for the financing of the Kentucky Asset/Liability Commission Funding Notes, 2011 General Fund First Series (Taxable) in an amount not to exceed \$300,000,000 to provide financing for the state’s share of obligations owed under KRS 161.550(2) to the Kentucky Teachers’ Retirement System (“KTRS”) Medical Insurance Trust Fund for fiscal years 2011 and 2012. This is the second transaction authorized by the 2010 Regular Session of the General Assembly in House Bill 531. The Preliminary New Bond Issue Report details the transaction as well as a preliminary debt service schedule. The funding being provided is \$145.9 million for FY 2011 and \$122.5 million for FY 2012. The transaction will be presented to the State Property and Buildings Commission, pending approval here,

immediately following this meeting and then to the Capital Projects and Bond Oversight Committee tentatively scheduled on Tuesday, February 15, 2011. JP Morgan is the Senior Managing Underwriter; Kutak Rock LLP is the Bond Counsel; and The Bank of New York Mellon is the Trustee. Staff recommends approval.

Mr. Tom Howard added that, from this refinancing, the interest cost of the obligations will be reduced from 7.5% to approximately 4.7% (subject to the market and time of sale) which will save the state approximately \$40 million dollars over the ten year amortization period of the loans. Combined with the first refinancing of this type that achieved \$88 million in cash flow savings, there should be a total cash flow savings to the General Fund of approximately \$128 million over an eleven year period.

A motion was made by Ms. Mary Lassiter and seconded by Mr. Ed Ross to approve Resolution 2011-01. Motion **CARRIED** and Resolution **2011-01** was **ADOPTED**.

Mr. Howard reported to the Commission that the ALCo 2007 Floating Rate Notes were issued in a variable rate form as Floating Rate Notes ("FRNs") and the Commonwealth entered into a series of cost of funds interest rate swaps at the same time to convert the FRNs into a fixed rate transaction. Those interest rate swaps carried certain terms and conditions that would require the Commonwealth to terminate those transactions if certain events occurred. The transaction was originally insured with Financial Guaranty Insurance Company, FGIC, now known as National, and was recently downgraded as part of Standard & Poor's ("S&P") reevaluation of bond insurers. As a result of the downgrade, Citi, our swap counterparty, has offered to transfer that swap to another counterparty with better terms and conditions to the Commonwealth. For example, Citi requires posting collateral once an additional termination event like a rating downgrade has been triggered under the swap documents. The Commonwealth cannot post collateral, so Citi has offered to transfer counterparty responsibilities to Deutsche Bank AG, who does not require collateral, with no cost to the Commonwealth. In effect, the Commonwealth will drop the insurance policy, which Citi relied upon as collateral for the transaction, and will take credit risk between us and the transferee. This will not change the terms or conditions of our existing payment structure where we have fixed rate payments in exchange for the floating rate payments from the counterparty to pay the FRN investors.

Staff is operating under the original 2007 swap documents, which give the Executive Director of the Office of Financial Management, as the authorized officer, the ability to execute those assignment documents without formal approval of the Commission. However, though it has not happened yet, staff wanted to inform the Commission of this pending transaction and that all the documents and the requirements of bond counsel are in order. This option was the most favorable of those evaluated. Another alternative would have required the Commonwealth to refund the notes and incur additional expense. This bank is an acceptable counterparty, and the internal investment staff have looked at the credit of Deutsche Bank and the documents with Citi which should result in a seamless transfer to a more advantageous position for the Commonwealth.

Ms. Lassiter asked what projects the Project Notes financed and the final maturity of the Notes. Mr. Howard answered that the Project Notes provided funding for the petroleum underground storage tank and the Louisville Arena with the final maturity being 2027 as well as the refunding of two existing series of SPBC Bonds with a final maturity of 2025. The Commission had four different series of Notes and four associated interest rate swaps associated with Notes to match exactly. There was no basis risk for what we would receive

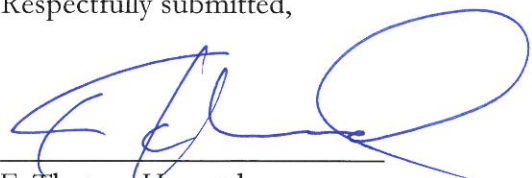
from the counterparty and what we would pay out to the investors. The insurance still resides with the Notes outstanding and will until they are paid off. The swap policy is separate and can be terminated if the new counterparty does not desire credit exposure.

Treasurer Hollenbach asked if it was common practice for banks to offer transfers from one bank to another competing bank when needs cannot be met anymore, and fees are involved. Mr. Howard answered that Citi is paying all costs associated with the transfer with no expense to the Commonwealth. In the current banking environment, banks are under tremendous pressure to liquidate certain types of assets. Citi was looking to remove this exposure from their balance sheet while Deutsche Bank was looking for this state government type of exposure. S&P also announced that they may downgrade insurers even more in the future.

Mr. Antle added that under the terms of the swap, if the insurer's credit ratings fell below a certain threshold, Citi as our current counterparty has the ability to establish an early termination date on the swaps at their discretion. We had the option to remedy this situation of additional insurance, additional credit support, or posting of collateral of which ALCo has no assets to be posted. This option was the best of the available remedies: a no cost assignment of the swaps to another counterparty and removing the insurer provisions on the swaps. Treasurer Hollenbach asked if the options were proposed by Citi or Deutsche Bank. Mr. Howard replied that the Commonwealth notified Citi that the insurer had been downgraded. OFM looked into the provisions of the contract and then looked at a number of options as well as Citi's proposal. Citi provided the current scenario being presented which we believe is the best option.

With no other business, the meeting stands adjourned.

Respectfully submitted,



F. Thomas Howard
Secretary