

STATE INVESTMENT COMMISSION
MARCH 18, 2010
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Wednesday, March 18, 2010 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; Edmund Sauer, 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, Steve Jones, Deputy Executive Director, Dwight Price, Kim Bechtel, Rachael Dever, and Marcia Adams.

Other Guests: Ed Ross, Controller, Kristi Culpepper from Legislative Research Commission (LRC) and Betty Pendergrass from Kentucky Worker's Comp Funding Commission (KWCFC).

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 December 9, 2009. A motion was made by Secretary Jonathan Miller and seconded by Mr. George Spragens to approve minutes as written. Motion **CARRIED**.

MARKET COMMENTARY – Mr. Dwight Price explained that since the last meeting, interest rates have set a low mark, credit spreads are tightening, and the S&P 500 is up. Unemployment has declined from its recent peak but is still elevated. Housing is stabilizing and the dollar has strengthened. Most projections are that unemployment will remain elevated throughout the year. Mr. Spragens stated that predictions for any interest rate moves by the Federal Reserve will not take place until the November meeting, after the upcoming elections. The Fed tries not to appear to be political and tends to wait until after an election before announcing changes. Treasurer Hollenbach asked if the country will avoid a double dip recession. Mr. Price answered that most likely it will. Mr. Jones added that housing prices are declining on a year over year basis, the month to month measurements are showing improvement with even California showing increases. Mortgage delinquencies and foreclosures are both declining. Mr. Spragens added that new building permits have increased recently implying that supply of new homes should continue to outpace demand.

Securities Update - Mr. Price discussed the quarterly list of downgraded asset-backed securities that the Commonwealth holds. The first three on the handout continue to pay principal and interest and are performing well. The Aleutian had lost its rating just before the previous SIC meeting and is not performing well. Staff is in discussions with Credit Suisse to handle the situation. Treasurer Hollenbach questioned how the previous arrangement with Credit Suisse was working out. Mr. Price responded very well, and that their credit rating is strong and anticipated to remain so.

Mr. Jones continued by stating that the Par values of the other down-graded securities continue to decline as pay-downs are received. The securities are showing a significant improvement in the market value. The Commonwealth continues to receive principal back at par with gradually improving market valuations. While the overall portfolio remains AAA-rated, at some point, some of these securities will be sold to reduce credit risk.

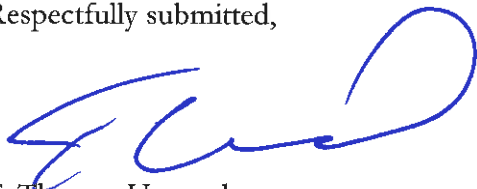
Secretary Miller made the motion to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Mr. Spragens. Motion **CARRIED**.

Other Business – Mr. Jones stated that Farmer’s Bank in Frankfort, the Commonwealth’s primary depository bank, has been in the news with some financial difficulties lately, although nothing is expected imminently which will affect Commonwealth transactions. Mr. Spragens asked if Farmers Bank is in the same holding company as United Bank. Mr. Jones responded affirmatively and explained that United has a cease and desist order which requires them to increase capital and loan loss reserves. Treasurer Hollenbach asked if there was anything within Farmers’ operations affecting the Commonwealth’s transactions. Mr. Jones replied that Farmers has a respondent relationship with J. P. Morgan Chase bank. Unfortunately, Chase is exiting from the respondent business. The Commonwealth has several large outgoing transactions monthly in which Farmer’s must rely on Chase’s larger balance sheet to fund, including the SEEK payments of over \$200 million. If Farmer’s Bank moves to the Federal Reserve System for respondent services, they will be unable to cover the daylight overdraft created by large outgoing ACH transactions. ACH settles at 8:30 in the morning, but the Commonwealth is unable to fund the transaction until later in the day. The Office of Financial Management is actively discussing the situation with both Chase and U.S. Bank to develop an approach to eliminate this potential problem Mr. Spragens asked if staff had conferred with other larger Kentucky institutions. Mr. Jones replied that he was not aware of any that could cover daylight overdrafts of the size needed by the Commonwealth. Mr. Howard reminded the Commission that the banking contracts are governed by procurement law and that the Commonwealth is contracted with Farmers for depository services and with U. S. Bank for custodial services. The Commonwealth can not contract for banking services with other banks without going through the RFP process.

Treasurer Hollenbach asked how a respondent bank makes money on this deal. Mr. Spragens stated that they charge Farmers a monthly fee just like a regular customer. Mr. Jones stated he expected to have a firm proposal from Chase and U. S. Bank in the near term. Treasurer Hollenbach asked if this arrangement is not made, will a new RFP be issued. Mr. Price replied that a new RFP will be issued sometime this summer as the current contract expires June 30, 2011. Mr. Jones added that the two retirement systems are also involved in this process as their benefit payments are also affected.

With no further business before the committee, a motion was made by Mr. Spragens and seconded by Edmund Sauer to adjourn the meeting. Motion **CARRIED**.

Respectfully submitted,



F. Thomas Howard
Secretary