

# STATE INVESTMENT COMMISSION

MARCH 20, 2008

## MINUTES

The State Investment Commission was called to order on Thursday, March 20, 2008, at 2:00 p.m. in Room 76 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.

Treasurer Hollenbach verified that a quorum was present and that the press had been notified of the meeting.

Treasurer Hollenbach noted that a correction in the fourth paragraph of the December minutes from "\$13 to \$13 billion" in assets was necessary and called for a motion to approve the minute as corrected. A motion was made by Mr. Spragens and seconded by Jonathan Miller to approve the minutes of the December 7, 2007 meeting as corrected. Motion **CARRIED**.

Dwight Price, Portfolio Administrator, Office of Financial Management, stated that the lack of liquidity in the market has caused the market to suffer considerably over the past few months. Mr. Price added that the decline started with the sub-prime mortgage crisis which triggered some devaluation of securities held by brokerage houses and hedge funds. Mr. Price stated the devaluation has caused de-leveraging in the markets. Mr. Price stated that when this happens, securities are sold which causes additional devaluation and additional collateral is required. Mr. Price noted that there was been some stabilization of the markets in the past few days.

Steve Jones, Portfolio Administrator, Office of Financial Management, stated that various federal government agencies have taken steps to flood the market with cash. He stated that the Federal Reserve has indicated that they will exchange \$200 million of mortgage backed securities for Treasuries. He further stated that Fannie Mae and Freddie Mac will also be taking \$200 million of mortgage backed securities out of the market. Mr. Jones stated that restrictions for the Federal Home Loan Bank have been lessened which will allow them to take \$300 billion of mortgage backed securities out of the market which will result in millions of dollars worth of liquidity.

Mr. Price noted that Federal Reserve has provided cash without driving the market down and that is part of the reason for the stabilization. Mr. Jones stated that the Federal Reserve's move on Bear Stearns has been a huge boost to the market. Mr. Price stated that the liquidity of the Commonwealth's portfolio has allowed for the purchase of some very high qualities securities at a much better yield than the same time last year. Mr. Jones noted that the Commonwealth has \$1 billion that is reinvested daily (same day liquidity) in addition to approximately \$1 billion available on a next-day basis.

Chairman Hollenbach asked if additional securities have been purchased as a result of the liquidity. Mr. Price indicated that he has been purchasing AA rated taxable municipals. Chairman Hollenbach asked how much the Commonwealth's portfolio was affected by overseas

economies. Mr. Price stated that the state of overseas' economies does not have any impact on the portfolio.

Mr. Jones stated that auction rate securities are securities with a long term maturity for which the interest rates are reset by a dutch auction. He added that every 7, 28, or 35 days a group of investors will place bids for the amount of securities and the rate at which they wish to purchase or hold securities. He continued that any securities that don't receive bids are usually picked up by the brokerage firm so that interest rates can be set at the end of the auction. Mr. Jones stated that because the brokerage firms are concerned about capital, they have not been willing to buy the excess which has resulted in about 60 percent of recent auctions left without enough bids to purchase all of the outstanding issue (failed auction). Mr. Jones noted that when this occurs, whoever owns the security at the beginning of the auction continues to own it and the rate is based upon a predetermined formula. Mr. Jones stated that the Commonwealth has approximately \$170 million exposure to this particular market; \$144 million of which is failing resulting in an attractive rate with no liquidity (no one to sell to). He added that the securities will continue to rollover every 7, 28, or 35 days or for as long as it takes the auction to clear or for the issuer to step in and refinance the securities. Mr. Jones assured members that this is not a credit problem, but purely a liquidity problem at the brokerage firms. He further stated that although the Commonwealth has a number of securities that are illiquid, most continue to earn an attractive yield.

Treasurer Hollenbach asked if the lack of liquidity in the market would affect the Commonwealth's position. Both Mr. Price and Mr. Jones stated that it would not because the portfolio has other liquidity. Treasurer Hollenbach asked if there should be concern because the auctions have failed. Mr. Jones indicated that was also correct.

Ed Ross asked what rate the Commonwealth was earning. Mr. Jones stated that he would be bidding at 5.5 percent after the meeting adjourned. Mr. Ross noted that South Carolina was in a similar situation and their interest rate jumped from 5 percent to 12 percent. Mr. Price stated that those rates have increased and firms are refinancing to a different security type.

F. Thomas Howard, Executive Director, Office of Financial Management, pointed out that the State Property and Buildings Commission (SPBC) is the General Fund issuer for capital projects. He stated that SPBC issued a floating rate note insured by FGIC with a corresponding swap that provided an attractive fixed rate cost of funds last May. Mr. Howard added that investors liked the formula and the insurance at the time and they sold for par, but since have expressed an interest in getting out of those securities.

Mr. Price discussed the Commonwealth's downgraded securities. He stated that the Commonwealth's asset-backed securities are required to be AAA rated and approval to hold these securities if the rating drops below AAA must be granted by the Commission. He noted that the Commonwealth currently holds four securities in the securities lending portfolio and

three of these securities in the Kentucky portfolios. He indicated that FGIC is the insurer causing the greatest problem with these securities. He added that FGIC has been downgraded to Baa3 by Moody's which resulted in the downgrade of these specific securities. Mr. Price stated that Credit Suisse has requested that these securities (securities lending portfolio) be rated on their own merit and expects them to be rated AA and A. Mr. Price asked that the Commission consider holding these securities until such time the Commonwealth can recover any losses they have resulted from the downgrade of the monoline insurers.

Mr. Jones stated that the Commonwealth holds three sub-prime mortgage backed securities. Mr. Jones noted that one of the securities will be paid off in July 2009; one of the securities is currently callable and at some point will be called at par; and the last security has approximately 50 percent credit support behind it. He explained that if 40 percent of the underlying loans stopped paying, the Commonwealth would not lose any money. He added that this is the Commonwealth's total exposure, and although there are there some unrealized losses, these securities will not be sold and will pay off. Mr. Jones added that to sell these on a dollar basis rather than the spread would result in a loss to the Commonwealth.

Mr. Howard noted that the sub-prime securities have been reaffirmed at the AAA rating and that they continue to perform.

Treasurer Hollenbach asked if the total unrealized loss on the three assets is \$924,000 and if the Commonwealth would be able to recover this loss. Mr. Jones stated that was correct. Treasurer Hollenbach asked if the loss was calculated in the earnings. Mr. Price indicated that was correct. Mr. Jones added one-third of that would be recouped within six weeks.

Mr. Jones stated that the Commonwealth holds three additional securities that were affected by the downgrade of monoline insurers and asked the Commission for forbearance to hold these securities. Mr. Jones noted that the first security is Capital One sub prime automobile loans (COAFT 2005-C A4B). Mr. Jones noted that "subprime auto loans" is not the same as subprime mortgage loans; subprime auto loans are used car loans. He added that if the security was rated on the underlying structure rather than the insurance, the rating would be likely be AAA. The second security is GMAC mortgages (RFMS2 2002-HSE 1A6). He stated that after analyzing the securities, it is expected that the structure will be able to pay off. The third security is Countrywide Home Equity Lines of Credit, (CWHEL 2005-K 2A3), is potentially the most problematic. He said that currently the Commonwealth is receiving pay down of principal at about 4 percent to 5 percent per month and it is expected to pay off in the fall of 2009. He further explained that at current experience, the structure will not be able to make all of the payments. He added that a cross collateralization position with Countrywide allows them to move the lines of credit to support the security. Mr. Jones stated that if the structure can't pay, the insurance company is required to pay. Mr. Jones noted that all securities are still rated as investment grade and are not considered junk bonds. Mr. Jones further noted that the Commonwealth is receiving about four to five percent a month pay down on the principal on the

Countrywide security. Mr. Jones added that Countrywide can move the lines of credit around and provide a better position for the Commonwealth. In addition, Mr. Jones added that the insurance company is required to pay if the structure can not. Mr. Jones stated he was confident that XL Market would be able pay in the event Countrywide could not.

Mr. Price stated that there were three corporate bonds with credit ratings that have dropped below A and will require approval from the Commission to hold. Mr. Price stated that Bear Stearns was taken over by the Federal Reserve and is expected to merge with J. P. Morgan. Mr. Price added that J. P. Morgan has agreed to cover all liabilities and obligations of Bear Stearns and has a credit rating of Aa2/AA-. Mr. Price stated that the bond matures in less than a year. Mr. Price stated that the second security is the Sallie Mae Corporation (Student Loan Corporation) which is the weakest of the three. Mr. Price stated that an attempt to take the Corporation private last summer resulted in a damaged credit rating. Mr. Price noted that the Corporation has undergone some changes to stabilize the company and additional equity has been issued and is expected to be liquid when the bond matures in 16 months. Mr. Price stated that the Washington Mutual bond is senior bank debt and is on the market to be purchased by another bank. Mr. Price stated that if that should happen it would take on the credit rating of the purchaser. Mr. Price reassured the Commission that all securities are currently paying and are considered investment grade securities. He added that even with these securities the Commonwealth's portfolio is still considered AAA.

A motion was made by George Spragens and seconded by Jonathan Miller to grant the Office of Financial Management (OFM) permission to retain those securities whose ratings have dropped and to sell only when OFM deems it prudent to do so and that to revisit this issue at the next quarterly meeting.

Treasurer Hollenbach asked if this was the first time that this type of forbearance has been necessary. Mr. Price stated that was correct. Treasurer Hollenbach further asked if the reason for the ratings downgrade of these securities had more to do with the downgrade of the monoline insurers rather than the assets that back the structure of the securities. Mr. Price indicated that was correct except for the three corporate securities. Mr. Price indicated that liquidity and sub-prime issues have caused the volatility in the corporate security market.

Mr. Spragens noted that if you are willing to show faith in the securities and ride the situation out, your loss is only a paper loss. He further stated that the closer to maturity these securities get, they continue to provide some cash flow and the unrealized loss will become smaller. Mr. Spragens felt it would be in the state's best interest to hold the securities.

Mr. Howard noted that these securities represent a very small exposure to the Commonwealth's portfolio. Mr. Jones added that the total market value of the Commonwealth's portfolio is \$3.7 billion. He also noted that with the unrealized losses mentioned, the Commonwealth has a \$17 million gain in the portfolio and there is \$40 million in income earned but not yet distributed.

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Treasurer Hollenbach asked if keeping these risky investments is precluding us from investing in much higher quality investments. Mr. Price stated that would be a valid concern if we were fully invested, but the fact that the Commonwealth is very liquid at this time allows the purchase of other, higher quality investments and allows for holding these securities until they mature.

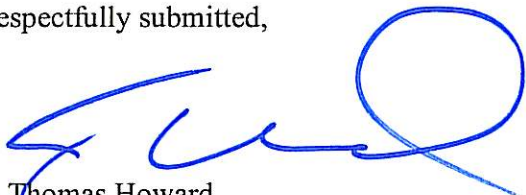
Treasurer Hollenbach asked if these securities would continue to be monitored. Mr. Price stated that was correct and that by the time the Commission meets in June all of these securities may have been sold.

Treasurer Hollenbach asked if the Commission would be interested in selling the Countrywide and Sallie Mae securities and granting forbearance on the remaining securities. Mr. Spragens stated that he would be more interested in retaining the securities until the market stabilizes.

With no further discussion on the motion, a vote was taken and the motion to hold the securities carried.

A motion was made by Jonathan Miller and seconded by George Spragens to adjourn the meeting. Motion carried.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'F. Thomas Howard', with a large circular flourish at the end.

F. Thomas Howard  
Secretary