

State Investment Commission

June 14, 2013

10:00 a.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on, June 14, 2013, at 10:00 a.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Robin Kinney, proxy for Lori Flanery, Secretary of the Finance and Administration Cabinet; Jane Driskell, proxy for Governor Beshear; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Sandy Williams, Deputy Executive Director, Dwight Price, Kim Bechtel, Kurt Kemper, Ian Blaiklock, and Marcia Adams.

Other Guests: Mr. Ed Ross, Controller, Finance and Administration Cabinet, Angie Offerman and Christine Robertson from Legislative Research Commission (LRC).

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 March 11, 2013. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes. Motion **CARRIED**.

2A-7 Rule Changes – Mr. Steve Jones began by telling the Commission the Securities and Exchange Commission (“SEC”) has proposed changes to the 2A-7 rules for management of money market mutual funds. One change suggested is moving Prime Institutional Money Market Mutual Funds from a fixed NAV (“Net Asset Value”) to a Floating NAV requiring a daily mark to market. The second proposed change is to allow boards of these same funds to enact liquidity restrictions in the form of either a redemption penalty or a redemption gate, which allows the funds to disallow redemptions for up to 90 days, if the fund fails certain liquidity guidelines. The Commonwealth’s Limited Term Pool would be subject to these changes if the SEC adopts either proposal. The Commonwealth would have the choice of either going to Floating NAV, or eliminating the exposure to non-government securities and maintaining Book Value accounting.

Treasurer Hollenbach asked how likely the SEC would make these proposed changes to the 2A-7 Rules. Mr. Jones believes that SEC will likely adopt the Floating NAV requirement for Institutional Prime Money Market funds. Mr. Jones expressed opposition to these proposals. Treasurer Hollenbach asked if the Commonwealth needs to take a position or if other states are lobbying the SEC about these proposed changes. Mr. Jones answered the notice was released one to two weeks ago and he was not aware of any actions by others at this time. Mr. Price added that at a Deferred Compensation meeting last week, one participant asked other Kentucky entities to submit letters to the SEC stating the downside of these proposed changes. He continued stating the Commission could send a letter explaining their view. The proposals are currently in the comment stage and staff does recommend the Commission send a letter with comments about the changes.

A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson for staff to draft a letter stating the Commonwealth's negative standing to the proposed 2A-7 Rules changes and after the members review, to forward to the SEC. Motion **CARRIED**.

2A-7 Reports – Mr. Steve Jones discussed a graph of the Limited Term Pool performance, which is above the Commonwealth's peers. The second page showed the detail listing of securities within the Pool. The next page showed the distribution by credit rating and sector. The next page shows and graphs the Weighted Average Maturity, Weighted Average Life, Daily Liquidity, and Weekly Liquidity ratios. At the end of March, the daily liquidity dropped to 9.28%, below the Commission's requirement. Two events lead to this. There was a \$100,000,000 withdrawal the prior day. Additionally, money was transferred to the Chase account because March 29 was Good Friday. The markets were closed that day, but the banks were open. It was necessary to have a large balance, fully collateralized, at the bank in case of any withdrawals that day. Actions were taken to bring daily liquidity back in line with the restriction the following week when markets reopened.

The Net Asset Value ("NAV") versus Shadow NAV graph showed almost two even lines centered at 1.000. The next page is a memo discussing liquidity requirements and the stress testing the Pool. The largest daily and weekly withdrawals as well as largest fund balances are identified. Staff recommends keeping the 15% Daily Liquidity and 30% Weekly Liquidity requirements. A motion is required if the Members wish to change the requirements. No action was taken by the Commission.

Linked Deposit Program – Ms. Kim Bechtel discussed the performance of the Linked Deposit Program and minor changes with the banks participating. The Bank of Columbia showed slight improvement since the last meeting in the Non-Performing Loans to Capital ratio. Ms. Bechtel reminded the Commission members that all these loans are well collateralized and that no action is required. No action was taken by the Commission.

Approved Broker/Dealer List – Mr. Dwight Price presented the annual list of Broker/Dealers qualified to do business with the Commonwealth. The list is separated by Primary Dealers and Non-Primary Dealers with an addition of two Non-Primary dealers, Bank of New York Mellon Capital Markets and Pierpont Securities. Some entities were removed as no financial reports were submitted or found online, or the entities did not qualify.

A motion was made by Mr. Lawson and seconded by Mr. Spragens to accept the Broker/Dealer List as presented. Motion **CARRIED**.

Trading Limits – Mr. Jones reported to the Commission that with staffing changes, it was necessary to adjust the Trading limits for each staff person. The proposed changes, with the Commission's approval, show the size of transactions each investment staff member will be able to perform in each market segment. The recommended levels are noted as Senior Portfolio Manager, Junior Portfolio Manager, and Money Market Trader with the appropriate staff designations by experience.

A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to accept the Trading Limits as presented. Motion **CARRIED**.

Securities Update - Mr. Price presented the report of asset-backed securities in the Commonwealth's securities lending portfolio that have been downgraded. The two listed securities

are the same as the previous meeting. During the last quarter, principal of \$987,672 was received with the unrealized loss falling to \$10,889. During July, these securities should be paid off.

Mr. Jones continues with the securities held in the direct portfolio. At the previous meeting in June, there were five listed. Only two remain after sales and maturities. These may be gone before the next meeting, therefore ending this report. Mr. Spragens asked staff to confirm that since this list of downgraded securities has been held with forbearance, the loss to the state has effectively been zero dollars. Mr. Jones answered that there have been some losses due to securities sold at prices lower than purchased. Since this report was initiated in 2008 and staff has continued to hold these with the Commission's forbearance, the recovery of the losses has been substantial and staff will present a report showing these significant numbers at the next meeting.

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

Credit Approval Process—Mr. Ian Blaiklock directed the members to the report of OFM's Corporate Credit Approach and Approved List to discuss the how OFM staff assesses entities. The overall credit approach is to monitor the default probability, agency ratings, and research analysis on industries and companies. The default monitoring consists of using a Bloomberg function, based on the Merton distance-to-default model, to track thousands of North American and European companies. The model affirms the company is solvent as long as the value of its assets is greater than the value of its liabilities. A key component is that the value of the assets of a firm are not directly observable so the model estimates the value of assets by linking the market cap and the value of debt, both of which are observable. The equity is viewed as a call option on the total assets and where the strike price is equal to the liabilities. This enables Bloomberg to value the assets, crucial in determining the default probability of the company. Staff uses the probability percentage that according to Bloomberg testing is 90% accurate. The daily and real-time changes are available to staff and used in this analysis as well. For the financials of a company, staff uses the CDS ("Credit Default Swap") spreads as indicators for default risk. Mr. Jones added that CDS is the most liquid way to trade directly on the credit of a company. It is a form of interest rate swap where a set amount is paid up front and then will be paid back only if the company experiences a default. Treasurer Hollenbach asked who would make a market in credit default swaps. Mr. Jones answered that all of the large international and investment banks utilize this market.

Mr. Blaiklock continued with the Daily Default Risk Monitor and discussed a sample report showing the securities currently being tracked by staff that have reached a threshold for absolute change for default probability or a CDS change. Mr. Jones stated that to produce this report, Mr. Blaiklock has created a series of databases and spreadsheets linked from Bloomberg data that comes together automatically for analysis and then the report is compiled and distributed to staff.

Mr. Blaiklock continued with the Industry & Company Analysis portion of the credit risk reporting. Staff chooses an industry that enables companies within that industry to generate consistent returns and cash. Once selected, staff researches companies within that industry that meet the Commonwealth's Statutory Rating Guidelines, and have a strong commercial paper presence. A peer group is identified for comparison. Staff additionally tracks daily news developments that could affect credit profile. Mr. Blaiklock directed the Commission members to reports included on two companies and how all this information is compiled into an individual report for each company. Mr. Blaiklock described the final element for Credit Analysis where staff will monitor a company's

standing with the Rating Agencies. Staff tracks the Russell 3,000 and Standard & Poor's ("S&P") 1,200 Global indices for companies newly meeting statutory guidelines. Mr. Jones added that Mr. Blaiklock's daily reports identify changes, which direct staff to investigate further.

Treasurer Hollenbach asked Mr. Blaiklock when company changes are evident, does this require assistance from Mr. Jones. Mr. Blaiklock replied that if his additional research pulled up something significant he would discuss with Mr. Jones on what other options were needed for continued monitoring. Treasurer Hollenbach also asked if any downgrade that causes staff to investigate further. Mr. Blaiklock replied that the Default Monitoring is set to a minimum threshold that identifies when a credit needs to be further researched.

Mr. Jones continued with the Corporate Credit – Approved for Purchase List of companies recommended by staff for Repurchase Agreements, Debt and Limitations, if any. Steve noted two additions to the existing list as well as one removal.

A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens to approve the Corporate Credit approved list as presented. Motion **CARRIED**.

Recognition Resolution – Mr. Jones read into the record, State Investment Commission Resolution 2013-01 for Dwight Price.

A RESOLUTION OF THE STATE INVESTMENT COMMISSION OF THE COMMONWEALTH OF KENTUCKY FOR RECOGNITION OF OUTSTANDING SERVICE BY DWIGHT PRICE, JR. AS FIXED INCOME TRADER/RISK MANAGEMENT ADMINISTRATOR OF THE OFFICE OF FINANCIAL MANAGEMENT.

WHEREAS, the State Investment Commission's objective to invest available public funds to maximize safety of principal, liquidity and yield while minimizing risk; and

WHEREAS, the Commission relies heavily upon the staff of the Office of Financial Management; and

WHEREAS, such advice, counsel and guidance requires a significant expenditure of time and resources on behalf of the Commission; and

WHEREAS, **Dwight Price** has dedicated his time and energy on behalf of the Commonwealth, as a staff member of the Office of Financial Management during his tenure from July 1, 1993 through June 30, 2013.

NOW THEREFORE BE IT RESOLVED by the Commonwealth of Kentucky, the State Investment Commission expresses its appreciation to Dwight Price, for his valued advice and professionalism during his service with the Office of Financial Management and assistance to the Commission.

Adopted this 14th day of June 2013.

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The Resolution was signed by Governor Steven Beshear and Treasurer Hollenbach.

Treasurer Hollenbach added his own words thanking Dwight for his contributions and assistance and his ability to put everyone at ease.

With no further business, the meeting stands adjourned.

Respectfully submitted,



Ryan Barrow
Secretary