

STATE INVESTMENT COMMISSION
JUNE 9, 2010
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Wednesday, June 9, 2010 at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, State Treasurer. Other members present were Ed Ross, proxy for 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, and Marcia Adams.

Other Guests: Kristi Culpepper and Kelly Dudley from Legislative Research Commission (LRC) and Jessica Schumacher, Intern from the Governor's Office.

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 18, 2010. A motion was made by Mr. George Spragens and seconded by Mr. Edmund Sauer to approve minutes as written. Motion **CARRIED**.

Securities Update - Mr. Price discussed the quarterly list of downgraded asset-backed securities the Commonwealth holds. The list in the securities lending portfolio is down to two Hedged Mutual Fund Fee Trust (HMFFT's) Asset-Backed Securities. They continue to perform well making all principal and interest payments. It is anticipated that within a year to eighteen months, these will pay off.

Mr. Steve Jones discussed the sixteen downgraded securities held in the Commonwealth of Kentucky's portfolio. Three securities on the list have been downgraded since the meeting in March. The overall par value of all of these securities has decreased by \$7.5 million over that same time period, which includes an increase of \$22 million from the three downgraded securities. With the forbearance granted to maintain this list of downgrades at the previous meetings, these securities have paid off approximately \$30 million of principal at par. The market value of this list continues to improve as does the unrealized loss. Treasurer Hollenbach asked what the Commonwealth would have received if they had been sold earlier. Mr. Jones answered it would have been a minimal amount, pennies on the dollar. The downgrades occurred at the height of the market unrest back in 2008. At that time, there would not have been a bid for these. Treasurer Hollenbach asked if there was an instance that would have benefited the portfolio had we sold them earlier. Mr. Jones responded that one security was at a premium and was sold for a gain. Staff continues to monitor opportunities for advantageous sales.

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 Mr. Ed Ross. Motion **CARRIED**.

Broker Dealer List – Mr. Price presented the updated Broker-Dealer list of firms which meet the Commonwealth's qualifications to conduct brokerage business. Every year, the Commission approves the list identifying all of the broker-dealers which the Office of Financial Management may

deal with during the next fiscal year. The only addition from last year is the Bank of Oklahoma (BOK) Financial Corporation, located in Little Rock, Arkansas. Mr. Spragens asked about the state's current relationship with Morgan Keegan in light of their legal issues. Mr. Price responded that business with this dealer has been geared back. Mr. Howard replied that all contracted business with Morgan Keegan will continue. Both the Department of Financial Institutions and the SEC are conducting administrative reviews which may result in fines or other regulatory actions. It may take a year for the situation to be resolved. Treasurer Hollenbach asked where Morgan Keegan was headquartered and Mr. Price responded, Memphis. Treasurer Hollenbach also inquired if the broker-dealers on the list are required to certify on a regular basis to show they are still qualified. Mr. Price stated each firm qualified is required to send financials annually and all are reviewed prior to updating this list and presentation to this Commission for approval. Treasurer Hollenbach asked if the new addition, BOK, has a presence in any other states. Mr. Price answered affirmatively, six other states including Arkansas, Arizona, Kansas, New Mexico, Texas, and Colorado, as well as Oklahoma.

With no further questions, Mr. Spragens made the motion to approve the Fiscal Year 2011 Broker/Dealer list. The motion was seconded by Mr. Ed Ross. Motion **CARRIED**

Credit Suisse-SEC Lending – Mr. Price explained that the Commonwealth holds a security in the Securities Lending Portfolio which has had its credit rating withdrawn. The rating was based on insurance coverage, which has since been withdrawn. Attempts to research this security have had limited success. Much information is unobtainable. Credit Suisse has preliminarily proposed exchanging this security plus two others for a surplus note issued by a strong domestic life insurance company. The surplus note would have a ten year maturity, a variable interest rate and a par value of approximately \$50 million. This structure would allow the Commonwealth to recoup the current unrealized loss over the next ten years. Treasurer Hollenbach asked if the security would be sold if this strategy is executed. Mr. Price answered affirmatively. This is just an overview of a potential transaction subject to negotiations and approval by the Commission at a future meeting.

Treasurer Hollenbach asked if the portfolio held anything directly impacted by the current Gulf oil spill. Mr. Price answered that the Commonwealth does not hold any British Petroleum (BP) but does hold Chevron which has not been affected.

Other Business – Mr. Jones explained certain issues the Commonwealth is experiencing with the primary depository bank, Farmers Bank. Farmers uses Chase as their respondent bank to settle certain outgoing cash transactions. Because of the size and timing of some Commonwealth Automated Clearing House (ACH) cash outflows, Farmers needs a respondent capable of handling these large transactions. A temporary solution is being implemented which will allow the Commonwealth to continue to do business as usual through the end of the fiscal year 2011. The solution involves several relationships between the Commonwealth, Farmers and U.S. Bank. The Commonwealth will establish an account with U.S. Bank for funding daylight overdrafts created by Farmers processing of the state's large ACH transactions. As a result, U.S. Bank is exposed to the Commonwealth's credit rather than Farmers. Additionally, the Commonwealth will establish a repo with U.S. Bank at rates comparable to current tri-party repo rates. Farmers will move its respondent business from Chase to U.S. Bank. Basically, Farmers Bank is just changing sub-contractors with this arrangement. Treasurer Hollenbach asked who was at risk. Mr. Jones responded that the Commonwealth was already at risk but taking no additional risk with this change.

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

Respectfully submitted,

F. Thomas Howard
Secretary