

**State Investment Commission**  
**September 27, 2012**  
**2 p.m. ~ Room 182 ~ Capitol Annex**  
**Frankfort, Kentucky**

The State Investment Commission (“the Commission”) meeting was called to order on Wednesday September 27, 2012, at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; Ashley Parrot, proxy for Governor Beshear; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Steve Jones, Deputy Executive Director, Dwight Price, Kim Bechtel, Kurt Kemper, and Marcia Adams.

Other Guests: Mr. Ed Ross, Controller, and Kristi Culpepper and Joshua Nacey 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 June 27, 2012. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes. Motion **CARRIED**.

**Information Statement** - Mr. Dwight Price discussed the Information Statement for the Intermediate Term Pool with the Commission members. The draft document has been updated to reflect the changes recommended by PFM Asset Management’s review earlier this year. It essentially states the guidelines for what and how staff can invest funds in the Intermediate Pool. Upon the Commission’s approval, this will be posted to OFM’s website for public access.

A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens to accept the Intermediate Pool Information Statement as presented. Motion **CARRIED**.

**SEC 2a-7 Reports** – Mr. Steve Jones discussed the Limited Term Pool Quarterly Report as required by the Commission. This report conforms to SEC Rule 2a-7 requirements. The first graph shows the performance versus the Standard & Poor’s (“S&P”) Local Government Investment Pool, which is an index of other pools managed in a similar way to the Commonwealth’s Limited Term Pool. The figures are on a net basis. The graph shows that the Commonwealth has out-performed its benchmark. The next page lists the amortized cost of the security holdings within the Limited Term Pool as of August 31<sup>st</sup>. The following page has a graph of the distribution of credit ratings of securities in the pool. The second graph shows the distribution of securities by sector. The final graph shows a history of the average weighted maturity and weighted average life of the pool. The weighted average maturity is required to be under 60-days. The graph shows that the pool violated that requirement in June, July and August. This occurred due to changes in the method of management of the pool and changes in the Commonwealth’s intra-month cash flows. The largest change in cash flows was the adoption of the Managed Care program which concentrated cash flows at the beginning of the month rather than the previous method of spreading those throughout the month. The management of the pool has adjusted to these changes has come back into compliance.

The final page is an analysis of the liquidity requirements of the Limited Term Pool. The Commission will need to review the pool quarterly and approve the daily and weekly liquidity requirements. The analysis shows the largest withdrawal on any day (January 2011) came from the University of Kentucky ("UK") Hospital Fund for construction costs of \$130,242,889 (17.23% of the pool). Second was the UK Investment Account withdrawal of \$100,000,000 (10.82%) in January 2012. The debt service payment for the Turnpike Authority of Kentucky ("TAK") in June 2012 for \$77,597,332 (8.44%) was third largest. Staff receives prior notice of the pending withdrawals from UK. OFM staff is responsible for the TAK payment. These same three withdrawals were also the largest weekly transactions in the analysis. The final part of this analysis shows the largest accounts in this pool to be the UK Hospital Fund of \$125,185,408 (14.43% of the total pool), the UK Building Fund with \$108,570,071 (12.51%) and the Health Insurance Fund of \$96,677,216 (11.03%). None of these funds exceed the 15% of total pool assets. Staff recommends setting the Weekly Liquidity at 30% and the Daily Liquidity of the Pool at 15%.

A motion was made by Mr. Jon Lawson and seconded by Secretary Lori Flanery to accept the Limited Term Pool Daily and Weekly Liquidity limits as presented and recommended. Motion **CARRIED**.

Treasurer Hollenbach asked Mr. Jones to confirm that the benchmark in the performance graph represents peers. Mr. Jones answered that the benchmark is a nationwide collection of state or local pools that are managed in the same manner as the Commonwealth's Limited Term Pool. These pools report their performance to S&P. These represent a peer group.

**Trading Authorizations** – Mr. Jones introduced new OFM employee, Kurt Kemper, a recent Bellarmine University graduate who is a CFA candidate and has passed the first CFA exam. Kurt is taking over many of Kim Bechtel's day to day responsibilities. She will move into a portfolio management role responsible for the Limited Term Pool. With the addition of Kurt to staff, and changes to Kim's responsibilities, it is necessary to update the staff trading limit authorizations. These are the restrictions for how much each individual can transact in any segment of the market. There are three levels starting with the "Money Market Trader", Kurt's position; next is "Junior Portfolio Manager", which is Kim's position and "Senior Portfolio Manager", assigned to Dwight Price and Steve Jones. Each level has a list of security types that can be traded and a limit on their maximum size. If a particular staff member needs to make a trade exceeding their limit, they need approval from a higher level staff member. Senior Portfolio Managers require approval from the Executive Director to exceed their limitations. These trading restrictions will be set up in the Bloomberg Compliance module for tracking. If any limitation is breached, an automated warning goes to the accounting staff and is logged into an electronic log file for the auditor's review.

Treasurer Hollenbach asked how the trading limits were decided. Mr. Price replied that the limits for the Senior Portfolio Manager levels are established by the authorizations in total for OFM to transact. Tighter limits are established as the level goes down from Junior Portfolio Manager to Money Market Trader. The limits are structured to prevent over extending transactions without proper authorization. Treasurer Hollenbach asked if there were industry references or best practices for recommended amounts. Mr. Price answered that not specifically as the size of limitations would depend on the size of the particular entity, but that the general approach is the market standard.

Treasurer Hollenbach asked about separation of duties, per auditor requests. Mr. Jones replied that staff uses the Portfolio Order Management System in Bloomberg. When a trade is executed electronically or via telephone with a broker, a ticket is entered into the Bloomberg system. That ticket goes directly to the OFM accounting group who can authorize settlement of the trade at the custodial bank. The custodian then confirms details of the trade with the broker. Two OFM staff members know of every trade because only investment staff can execute a trade and only accounting staff can settle a trade. Staff follows the industry standard that at least two staff members are aware of every trade. Mr. Price added that the trading limits have been in use for awhile. With the added staff member, adjustments were made to Junior Portfolio Manager, for Kim's limits and the Trader position.

A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the newly established trading limits so discussed and presented. Motion **CARRIED**.

**NRSRO Approval** – Mr. Jones stated that in following 2a-7 rules, the Commission should annually approve the Nationally Recognized Statistical Ratings Organizations ("NRSRO") referenced for compliance with credit rating limitations on security purchases. There are nine credit rating agencies, with five active in the United States. Three of those, Standard & Poor's ("S&P"), Fitch, and Moody's, are the most respected in the industry and staff would like the Commission to recognize these agencies for purposes of determining compliance with credit limitations.

A motion was made by Mr. George Spragens and seconded by Treasurer Hollenbach to approve the naming of Standard & Poor's, Fitch and Moody's as reference NRSROs. Motion **CARRIED**.

Mr. Lawson asked if the Commonwealth holds any LIBOR indexed securities and if the Commonwealth is involved in any of the current lawsuits. Mr. Price replied that staff is monitoring the proceedings and expects to qualify for a settlement. Mr. Jones added that the debt side will be impacted more, due to interest rate swaps outstanding. Investment staff will follow the debt side when they determine the course to take. Treasurer Hollenbach asked for more detail on the issue. Mr. Price explained it mainly was collusion with twelve banks daily plotting via emails to keep reported LIBOR rates low. Staff has estimated that the Commonwealth's damages are approximately \$1,000,000 but is awaiting class action proceedings to proceed.

**Securities Update** - Mr. Price stated that per the Commission's request, staff had prepared an analysis of the impact to the Commonwealth of forbearance on down-graded securities. The first page shows the impact of the securities lending portfolio. Mr. Price reminded the Commission that the Credit Suisse Subordinated Note was received in exchange for a series of down-graded and problematic securities. For that reason, this security is included in the analysis even though it meets credit guidelines. This security has increased in value by \$27,000,000 since acquisition. Three remaining down-graded securities have benefited the Commonwealth by approximately \$5,450,982 compared to sales at depressed prices. Another security paid off at par with a benefit of \$11,736,111. The overall economic benefit of forbearance has been \$44,644,480 in the securities lending portfolio.

Mr. Jones continued with the analysis of the direct portfolio. The maximum unrealized loss was approximately \$52.5 million on a current balance of roughly \$123.5 million. Through a combination of interest received, principal pay-downs, sale proceeds, and recovery of market value, the

Commonwealth has recovered \$40,146,235. The economic benefit to the Commonwealth of forbearance on downgraded securities is approximately \$85 million dollars.

Mr. Jones continued with the current list of down-graded securities still held in the Short Term Pool. Staff is targeting income for between \$0 and \$1 million for this fiscal year. As of September 21, the income from this pool, including gains and losses on sales, totals \$1.5 million. There are additional unrealized losses of roughly \$3.5 million dollars on the remaining securities. Staff hopes to liquidate the remaining 4 securities by fiscal year end while still meeting the pool income targets.

Mr. Price discussed the same two securities identified at previous meetings. At the June meeting, there was approximately \$3.3 million of principal remaining. The principal has been paid down by \$793,681 over the last quarter. The unrealized loss decreased by over \$165,285. With only \$2,500,000 principal remaining, staff hopes these will be paid off by June 2013 at par. Mr. Jones stated that two other securities currently meet regulatory guidelines but are under credit watch negative. These may cause staff actions prior to the next meeting. Staff continues to recommend forbearance for the listed down-graded securities.

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**.

Treasurer Hollenbach asked if staff was aware of any jurisdictions or other states that strictly adhere to the guidelines requiring them to sell securities once they fall below their guidelines. Mr. Price replied that he was not aware of any governmental entities requiring strict compliance. Mr. Jones added that if those down-graded securities were in a mutual fund, the manager would have been forced to liquidate. Some insurance companies may have been forced to liquidate if the NAIC (North American Industry Classification System) ratings were impacted.

**Linked Deposit Program** – Ms. Bechtel noted all banks on the list continue to improve. South Central Bank is in compliance with non-performing loans to capital ratios and will be removed from this list. Bank of Columbia non-performing loans to capital ratios improved by 2 percent and staff is not concerned for the loan to deposit ratio for Bank of Jamestown and Deposit Bank of Carlisle as they are not lending. Staff will continue to monitor each of these banks and report quarterly. Mr. Jones reminded the Commission that all the linked deposit loans are collateralized with agency securities.

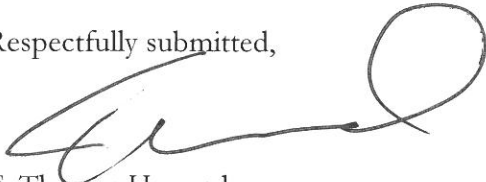
**Other Business** – Mr. Jones reminded the members of their approval to changes in the statutes discussed at the June meeting. Those changes are under review by the Governor's legislative liaison. Staff anticipates the changes to be introduced in the 2013 General Assembly Session. The Commission also approved changes to regulations and those are currently posted for public comment, which is followed by a legislative review period. Staff anticipates an effective date in January.

Mr. Jones notified the Commission that a second position for investment staff is currently posted with an anticipated hire date before the end of November. This future individual will work with Mr. Jones on credit research for the investments purchased for the Commonwealth. This will give OFM stronger credit research than only relying on the ratings generated by Moody's, Fitch and S&P for a

specific investment. Also in the future, staff will present an approved credit list of the securities staff is allowed to purchase.

With no further business, the meeting stands adjourned.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'F. Thomas Howard', with a large, stylized loop at the end.

F. Thomas Howard  
Secretary