

STATE INVESTMENT COMMISSION
SEPTEMBER 28, 2010
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Tuesday, September 28, 2010, at 2:00 p.m. in Room 182 of the Capitol Annex by Lori Flanery, Deputy Secretary of the Finance and Administration Cabinet and proxy for Governor Steven Beshear. Other members present were Jonathan Miller, Secretary of the Finance and Administration Cabinet; Eugene Harrell, proxy for Todd Hollenbach, State Treasurer; 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: Mr. Ed Ross, Commonwealth of Kentucky Controller, Kristi Culpepper and Kelly Dudley from Legislative Research Commission (LRC).

Deputy Secretary Flanery verified that a quorum was present and that the press had been notified of the meeting.

Deputy Secretary Flanery called for a motion to approve the minutes from June 9, 2010. A motion was made by Mr. George Spragens and seconded by Mr. Jonathan Miller to approve minutes as written. Motion **CARRIED**.

Securities Update - Mr. Price discussed the quarterly list of downgraded 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. The market prices have held steady. The securities continue to perform making all principal and interest payments. They are anticipated to pay off within a year to eighteen months. The securities lending portfolio also holds the Aleutian Floating Rate Project Notes (FRN). This note has a voluntary sinking fund, which has been skipped. However, in August, the security paid almost \$6 million of principal. It continues to make all interest payments. Staff anticipates the sinking fund payments to resume soon.

Mr. Price continued with the notification that the Commonwealth would not pursue negotiating another Credit Suisse deal to exchange the Aleutian Security as previously noted to the Commission as this is not necessary given the securities current performance.

Mr. Steve Jones discussed the additional Down-graded Securities held in the Commonwealth's direct portfolio. Certain changes were noted since the previous meeting of the Commission. Four securities have matured and one has been added. One of the four securities was backed by a hotel mortgage in Miami. The hotel has been sold with the proceeds used to pay off the security. By choosing to hold this security rather than sell it, the Commonwealth experienced a \$300,000 loss instead of \$12 million. The last item has been downgraded due to an extended expected maturity date, but it does continue to perform. It will take longer to receive the final principal payment. With the current changes, the bottom line shows the Commonwealth is \$21 million for the better from the previous meeting of the Commission. Mr. Spragens asked if the securities listed as Countrywide were now the responsibility of Bank of America. Mr. Jones responded affirmatively.

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. Jonathan Miller. Motion **CARRIED.**

Credit Suisse – Mr. Price reiterated that the Commonwealth would not be negotiating a restructuring deal with Credit Suisse due to the affected security's improvement previously mentioned.

Linked Deposit Program – Mr. Jones explained that the Commonwealth's Country Bank program. The Commonwealth funds certain small Economic Development and Agriculture loans by loaning funds to banks at attractive rates which are then used to fund loans the bank's clients. The Commonwealth also loans funds to community banks through the Country Bank Repo program in which banks borrow money at near market rates which is rolled over every 35 days. The funding for these programs comes from abandoned properties which is also part of the General Fund. The current balance of negative \$400 million dollars means no funds are available for additions to the program.

Mr. Jones continued that, quarterly, staff confirms that the credit standing of the banks in the programs meet the guidelines established through regulation. Currently, six banks do not meet these guidelines. Three banks do not meet the 70% loan to deposit ratio. Three banks do not meet the required 70% loan to deposit ratio. Three banks do not meet the required 25% non-performing loan to capital ratio. One bank does not meet either requirement. Mr. Price remarked that the banks also collateralize the deposit for additional credit support.

Mr. Jones continued that the regulations place these requirements on participating banks. Staff needs direction from the Commission on enforcing the existing regulations, offering forbearance or updating the financial requirements in the existing regulation. Deputy Secretary Flanery asked that if the regulations are enforced requiring the institutions be removed from the program, they are required to pay off the loans. Mr. Jones responded affirmatively.

Mr. Jones stated that rates are advantageous for the banks. Mr. Spragens added that if the loans were called, the banks would need to find another source for the funds for replacement. He suggested a communication to the affected banks concerning their non-compliance and effect of calling the loans to the banks. Secretary Miller asked Mr. Spragens his opinion on the anticipated response from his colleagues. Mr. Spragens stated that the amounts currently involved should not be devastating to the institution. Mr. Spragens also explained that federal bank regulators have emphasized liquidity in recent examinations and that these programs provide stable liquidity to the individual banks. He continued by explaining that the ability to bring the non-performing to capital ratios bank into compliance would difficult in a short time frame given the current economic environment.

Secretary Miller asked if changes to the regulation would require new legislation. Deputy Secretary Flanery responded that the current regulations allow that noncompliant banks "shall be subject to call at par by the commission." (200 KAR 14:081 Section 8 (3)) Mr. Spragens suggested contact with the State Department of Financial Institutions (DFI) for any input they may have on the regulations. Secretary Miller asked if the loans were called would those funds go directly into the General Fund deficit reduction. Mr. Price answered the funds are principal that would be reinvested.

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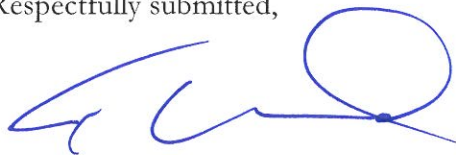
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After further discussion, the Commission requested staff to communicate with the DFI about reviewing the regulations as they are and providing the staff and Commission with recommendations for the next quarterly meeting.

With no further business before the committee, the meeting stands adjourned.

Respectfully submitted,

A handwritten signature in blue ink, consisting of a stylized 'F' followed by a large loop and a horizontal line.

F. Thomas Howard
Secretary