The State Investment Commission was called to order by Libby Milligan, proxy for Governor Ernie Fletcher at 11:00 a.m. on Friday, March 15, 2006 in Room 76 of the Capitol Annex in Frankfort, Kentucky. Other members present were Jennifer Sheehan, proxy for John Farris, Secretary, Finance and Administration Cabinet; Gregory Haskamp, proxy for Jonathan Miller, State Treasurer who participated via telephone; and George Spragens, President, Farmers National Bank, Lebanon, Kentucky.

Ms. Milligan verified that a quorum was present and that the press had been notified of the meeting.

Ms. Milligan called for a motion to approve the minutes of the December 15, 2006 meeting. A motion was made by George Spragens and seconded by Jennifer Sheehan to approve the minutes of the December 15, 2006 meeting. Motion CARRIED.

Kim Bechtel, Short-Term Money Manager, Office of Financial Management, presented information on the Linked Deposit Program. She stated that the Linked Deposit Program was administered by the Kentucky Agricultural Finance Corporation and the Cabinet for Economic Development. Ms. Bechtel also stated that this program allows Kentucky banks an opportunity to lend to borrowers who would not be able to receive the prime lending rate. She stated that the borrowers receive the prime lending rate and the banks receive prime minus four percent, subject to a floor.

Dwight Price, Portfolio Administrator, Office of Financial Management, stated that this program started when Frances Jones Mills was State Treasurer. He continued that the basis for the program was originally for small business loans and the maximum the small business could receive was $100,000. He added that should the borrower default, the bank is responsible for the loan.

Ms. Bechtel reported that the loan balance in the program as of February 28, 2007 was approximately $9.5 million. She stated that currently the Commonwealth is losing money because the borrowers refinanced higher rate loans to lower rate loans which only return 2 percent to 4.25 percent to the Commonwealth versus receiving 5.25 percent on Fed Funds in the current market.

Tom Howard, Executive Director, Office of Financial Management, pointed out that this account is a sub-account of the General Fund and rolls up into the General Fund balance which is a negative balance for most of the year. He continued that effectively the General Fund is borrowing from other agencies at the Fed Fund rate from the short-term pool and reinvesting at a lower rate. Mr. Howard added that as the balance increases and the number of loans increase,
the Commission may want to impose some policy constraints regarding the limits of the program.

George Spragens, President, Farmers National Bank asked if the recommendation would be to limit the volume or the dollar amount they could receive.

Mr. Price indicated that most likely the dollar amount would be limited, but that the final decision would be at the discretion of the Commission members. Mr. Price indicated that the Linked Deposit Rate is linked to the Abandoned Properties program and the KAPT program. Mr. Howard indicated that the Abandoned Properties account has a current balance of $169 million and the average balance has been $80 million since fiscal year 2000. Mr. Price indicated that although the program represents a small portion of the Commonwealth's portfolio, Ms. Bechtel spends a considerable amount of time administering the program's 180 plus loans. Mr. Price stated that any change to the program could be made through policy changes but if necessary staff could draft proposed changes to the statutes or regulations for the next legislative session.

Steve Jones, Portfolio Administrator, Office of Financial Management, presented the quarterly TRAN update. He stated that the Commonwealth borrowed $150,000,000 through the issuance of tax exempt, fixed rate notes at a cost of 3.86 percent. Mr. Jones further stated that the Commonwealth subsequently entered into an interest rate swap agreement with JP Morgan at exactly the same terms and received 5.61 percent on the transaction. Mr. Jones indicated that the Commonwealth is paying one month LIBOR on the swap. He indicated that to date the Commonwealth has earned approximately $1.9 million dollars on the swap. He concluded that by the end of the fiscal year (June 20, 2007) it is expected that the swap would meet the anticipated target of $2.5 million in earnings for the Commonwealth

Mr. Price informed the Commission that the securities lending contract with Credit Suisse was extended for an additional two years. Mr. Price stated that the Commonwealth has been using the securities lending program for approximately 15 years to lend its securities to other brokers and invest the cash it receives. He reported that to date earnings for calendar year 2006 were $2.3 million. Mr. Price informed the Commission that the Commonwealth receives 80 percent of the net earnings and Credit Suisse receives 20 percent.

Mr. Jones informed the members that last year the yield curve inverted and staff felt it would return to a more normal shape. With that expectation, staff entered into two interest rate swap positions that earned approximately $70,000. Mr. Jones stated that in June the yield curve flattened and staff entered into another interest rate swap position. He continued that the curve remains inverted which resulted in a market value loss of $120,000, but is confident that the yield curve will return to a normal position and a profit will be realized on the swap. Mr. Jones stated that he feels that this position, as a partial hedge against potential adverse movement in certain securities, should be maintained in the event the yield curve steepens.
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Mr. Spragens asked at what point is the yield curve expected to return to a normal curve. Mr. Jones indicated that he expects the curve to return to a normal curve when the Federal Reserve starts to move. He also pointed out that the growing problems in the housing market may force the Federal Reserve to make a move sooner than expected.

With no further business before the Commission, a motion was made by Ms. Sheehan and seconded by Mr. Spragens to adjourn the meeting. Motion carried and the meeting was adjourned.

Respectfully submitted,

F. Thomas Howard, Secretary
State Investment Commission