

## State Investment Commission

June 19, 2014

2:30 p.m. ~ Room 182 ~ Capitol Annex  
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on June 19, 2014 at 2:30 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Ed Ross, proxy for Secretary Lori Flanery, Finance and Administration Cabinet; Jane Driskell, proxy for Governor Beshear; George Spragens, President, Farmers National Bank in Lebanon, Kentucky; and Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director of OFM and Secretary to the Commission; Steve Jones, Deputy Executive Director; Sandy Williams, Deputy Executive Director; Kim Bechtel, Ian Blaiklock, Brian Caldwell, Jonathan Eakin, Marcia Adams, and Tammy McCall.

Other Guests: Katherine Halloran, Legislative Research Commission; and Joshua Nacey, Legislative Research Commission.

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 the March 24, 2014, meeting. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes as written. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Steve Jones.

**Compliance Reporting/Trading Limits** – Mr. Steve Jones began by reminding the Commission of the discussion from the last meeting concerning compliance with all the restrictions placed on investment portfolios. He pointed out that it had been about five years since APA (Auditor of Public Accounts) had any comments regarding this office which is an indication of a job well done by OFM staff. Between March 26, 2014 and May 30, 2014, \$14.9 billion of securities had been purchased by OFM with no compliance violations. Mr. Jones introduced staff’s improvements on compliance to the Commission. A comprehensive review has begun which documents all restrictions and what is being done to ensure compliance. That review will be shared with the Commission at a later meeting. A documentation process has been formalized for recording and documenting trading violations. OFM staff uses the Bloomberg Portfolio Order Management System Compliance (“System”) module which automatically runs a security check against a series of rules for each trade to ensure compliance with all restrictions. Additionally, at the end of each day, the System runs a check against the entire portfolio to ensure compliance. A preliminary review of all the rules within the System has been done and a more detailed review will take place at a later date. Mr. Jones further stated a common shared email box had been created in which explanations for violations were stored and will allow auditors to review details regarding each identified violation. The email distribution list for the notification of violations has been increased to include all of the accounting and investment staff plus the Executive Director and Controller.

Mr. Jones continued to inform the Commission of the violations that the System identified since March 24, 2014. There were 6 alerts triggered, but only one violation actually occurred and has been corrected. The violation was holding a certificate of deposit in the CDARS Program with a maturity of more than 9 months. The certificate was now within 9 months to maturity so it was no longer a violation.

Mr. Jon Lawson asked how long the System has been used by OFM and who input the guidelines into the System. Mr. Jones replied that Kim Bechtel input the guidelines. Ms. Bechtel added that she thought the Compliance Manager was approximately 11 years old. She stated the guideline parameters are input based upon statutes and OFM guidelines. Treasurer Hollenbach asked if Bloomberg offered any training or periodic updates for the system and were those offers being taken advantage of. Mr. Jones answered that OFM is contacted by Bloomberg approximately every other month regarding updates. Treasurer Hollenbach wished to commend OFM for taking the initiative in improving the monitoring and oversight for compliance. He added that, prior to this meeting, Mr. Jones had invited him to meet regarding these improvements. Mr. Jones had informed him that everyone who worked on the rules and regulations manual would have to sign off and verify their familiarity with it. Treasurer Hollenbach then asked how often were emails erased that are received in the common email box. Mr. Jones replied that since this process was new, OFM did not have a policy on retention at this time. Treasurer Hollenbach suggested that an annual printout of all the emails would be beneficial to provide to auditors. Mr. George Spragens added that duplicate copies of all emails were probably also available on OFM's servers, if they are backed-up appropriately. Mr. Jones noted that the emails received in the email box include only the explanations and the actual violations are saved on Bloomberg. Mr. Jonathan Eakin stated that he printed a report from Bloomberg on a weekly basis that showed all violations from the previous week. He had paper records of all violations going back 9 years and now that OFM is moving towards the electronic email box there would be no problem in keeping the emails in storage for approximately 10 years. Treasurer Hollenbach asked Mr. Jones to give a high level overview of the segregation of duties among OFM. Mr. Jones replied that several years ago OFM separated the Accounting group and the Investment group in order to separate the market activity from the accounting for that activity. The Investment group has the ability to initiate or execute a trade but cannot complete a trade. The Accounting group is responsible for approving all trades for settlement.

Mr. Jones presented to the Commission two changes to the trading limits. MaryAnn Mullins who worked at OFM has left state government. Mr. Jones recommended J.D. Lester to be approved as a money market trader to replace Ms. Mullins. Additionally, Mr. Jones asked for the Commission to approve Mr. Ed Ross, Controller, as a second approval authority for exceptions.

Treasurer Hollenbach called for a motion to approve the proposed Trading Limits starting immediately. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to accept the newly established Trading Limits. Motion **CARRIED**.

**Cash Management Alternatives** - Mr. Steve Jones presented the Cash Management Alternative proposal to explain OFM's recommendation and request for approval to contract with a bilateral repo consultant.

The first page of the presentation showed the volume of daily net cash transactions executed by the Commonwealth. The second page presents the current alternatives used to manage liquidity; the

balance at the depository bank, tri-party repurchase agreements with large broker-dealers, and prime money market mutual funds. The third page lists current or future limitations on each of these alternatives for use as a liquidity vehicle.

Page four listed the potential solutions of Insured Cash Sweep (ICS), additional depository relationships, opportunities with the securities lending program, and bilateral repos with non-traditional counter-parties. Page five highlighted the ICS program. Funds are wired to a Municipal Deposit Account which is held at a contact bank. The contact bank then distributes the funds to numerous other banks with each bank holding less than \$250,000 (FDIC insurance max). The monthly transaction limit is six and the rate of interest paid is approximately 15 basis point with FDIC coverage. The problem with the ICS is that the capacity is limited to about \$125 million dollars.

Page six detailed the option to pursue additional depository bank relationships. The limit of withdrawals from Municipal Deposit Accounts is six a month per bank, but if more deposit accounts are created with additional banks then, cumulatively, the amount of withdrawals could be increased. Mr. Jones asked two members of the Committee, Mr. Spragens and Mr. Lawson, if they thought any of the banks based in Kentucky would be interested. Mr. Spragens answered that, because of the size of the transactions, he couldn't think of any and asked if there had been any discussions in the past about establishing a bank for the Commonwealth. Mr. Ross answered that Tennessee at one time had something like that but doesn't now. Mr. Lawson stated there were probably a few banks in Kentucky who could take on what was described but not in the amounts that are needed. Mr. Spragens suggested that one source to contact would be the Kentucky Bankers' Association. Treasurer Hollenbach asked if a bank could ever exceed the limitation of 6 withdrawals per month and would they be fined if they did so. Mr. Lawson confirmed that the bank would decline the request for withdrawal, or they would proceed and be fined knowing that FDIC could tell them when they would have to stop.

Page seven reviewed the coordination with the current securities lending agent, Deutsche Bank. A meeting is scheduled to meet with them on July 11, 2014, to discuss short term cash outflows, investing excess cash, and possible duplications.

Page eight depicted a graph showing the current tri-party structure in which the Commonwealth is the cash provider, the tri-party custodian is Bank of New York Mellon (BONY), and the money center broker-dealer is Bank of America. Page nine showed a graph depicting the bilateral repo structure with a broker-dealer, which the Commonwealth has the ability to do now which would omit the tri-party custodian BONY. Mr. Jones stated this structure was not beneficial because additional fees and operational issues are not offset by higher rates. Page ten's graph depicted the bilateral repo with a non-traditional counter-party. Staff would communicate directly with the collateral providers with no broker-dealer operating in the middle. Collateral would be provided to the Commonwealth versus cash with interest to the Commonwealth. The advantage to this structure would be a decrease in the broker-dealer bid-ask spread shared by counter-parties of up to approximately 15 basis points. Mr. Spragens asked how many collateral providers would OFM try to pursue relationships with. Mr. Jones replied that it would depend on who the collateral providers are and what capacity they have. Some super national organizations, such as the International Monetary Fund (IMF), are big enough to cover everything that was needed and has a strong credit; therefore, only one or two would be needed. On the other hand, if a non-rated REIT is involved, it would be advisable to only allow a limited exposure to each and it would take more of them.

Page eleven listed the differences between the new repos from the current arrangements. The difference in the contractual arrangements is that there would be no tri-party custodial agreement. There would be an opportunity to negotiate extra collateral in the contract under the collateral haircut requirements. The credit review considerations are the same as what is being done now. The difference in the collateral monitoring procedures is that the monitoring would fall on OFM/Commission rather than a tri-party custodian. There would be additional expenses of less than ½ basis point for the custodial services. Another cost would be the expense for a repo consultant of approximately 1 basis point. The broker-dealer bid-ask spread share by the counter-parties would be roughly 15 basis points. There is a potential of approximately \$600,000 increase in annual earnings.

Page twelve outlined the role of the Repo Consultant. The consultant would need to identify potential counter-parties, aid in negotiation of the Master Repurchase Agreement and Annex, assist in pricing individual transactions, and provide other assistance as needed to establish and maintain the program. The consultant would be paid only a percent of executed transactions with no flat fees. Page thirteen listed the steps that OFM staff would need to follow going forward.

OFM staff requested approval from the Commission to post an RFP for a Repo Consultant under a personal service contract. Treasurer Hollenbach asked if there was a limited pool of qualified repo consultants to choose from in the market. Mr. Jones confirmed that there was a limited pool. Mr. Barrow noted that OFM staff had contacted other states that were considering the same alternative. Mr. Jones confirmed that he had discussions with New Mexico, Georgia, and the Kentucky Retirement System who are all actively pursuing this alternative.

Treasurer Hollenbach called for a motion for authorization of a RFP for a Repo Consultant personal service contract. A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens. Motion **CARRIED**.

**Bridges Pool** – Mr. Steve Jones stated that in December staff invested the proceeds of the KPTIA bonds which funds the Downtown Bridges Project in Louisville. This pool falls under the purview of the State Investment Commission, however the investments within the pool are governed by KRS 175D.075, which requires all investments to be “full faith and credit of the United States of America”. The current holdings showed the portfolio consisting entirely of Treasury Securities with maturities matching the expected draw schedule of the project. The longest maturity is December 2016. The income generated included the book income (amortization plus interest) earned as of June 3, 2014, of \$24,050.09 and the unrealized gain/loss of \$473,898.44. Mr. Lawson asked for the amount of the total project. Mr. Barrow replied the total project cost is approximately \$1.3 billion. Approximately \$200 million was issued years ago for site work, etc., and now the balance is being issued.

**Intermediate Pool Performance** – Brian Caldwell directed the Commission members to the Intermediate Term Pool report as of May 31, 2014. The Pool market value stood at approximately \$2.8 billion. The Yield to Worst was 0.51%, which was 0.12% more than the benchmark. Quality remained the same at Aaa. Duration was still running short by about a third of a year. Convexity had turned the corner when compared to the benchmark and showed a 0.05 difference. The Portfolio Sector Allocations page showed a comparison between the Intermediate Pool and the Benchmark. The primary differences were the Portfolio’s allocation to Munis, Corporates, and the ABS sectors. The Portfolio Performance page showed the Pool performance versus the Benchmark. For the month of May, the Pool underperformed slightly by 2 basis points. For the preceding three

months, the Pool outperformed by 8 basis points. For the fiscal year-to-date and 1 year, the Pool underperformed but over time the portfolio has performed in line with the benchmark.

**Limited Term Pool Performance** – Ms. Kim Bechtel discussed the monthly performance of the Limited Term Pool compared to the Local Government Investment Pool benchmark. The first graph showed the Commonwealth consistently out-performing the benchmark. The second page listed all the securities held in the Pool as of May 31, 2014. The next page showed a breakdown by security type and credit rating. The next page provided detail on the weighted average maturity and life plus liquidity positions. Ms. Bechtel stated liquidity had moved down a little because of the corporate income tax and quarter end budget cycle, but is still within the parameters. The Net Asset Value graph was steady as it should be. The largest daily withdrawals were the same as reported at the last meeting (the University of Kentucky Hospital funds in 2011 and 2013). The largest weekly withdrawals were the same as the daily withdrawals. The largest individual accounts in the portfolio were the Employee Self-Insurance Fund at 27.38%, UK General Receipts Bond Issue at 17.83%, and the UK Building Fund at 11.88%.

Staff recommended maintaining the current liquidity requirements of the Pool requiring no action from the Commission. The Commission took no action.

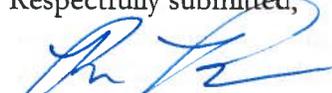
**Linked Deposit Program (Country Bank Program)** – Ms. Kim Bechtel provided an update on the program. There was an improvement with the Bank of Columbia to the non-performing loans section. The Bank of Jamestown remained steady with their loans to deposits. The Bank of McCreary showed an improvement and there should be another improvement to their non-performing loans section. The Farmers Deposit Bank showed a decrease in their loans to deposit. All deposits are fully collateralized to the benefit of the Commonwealth. The Commission took no action.

**Credit Considerations** – Mr. Ian Blaiklock presented the updated list of Corporate Credits approved for investment purchases as of June 19, 2014. One non-financial name had been added since March's meeting and none were removed from the list. Overall, the list had twenty-six financial names and forty-six non-financial names. Treasurer Hollenbach asked for a motion to approve the credit list. A motion was made by Ms. Jane Driskell and seconded by Mr. George Spragens to adopt the Approved Credit List as presented. Motion **CARRIED**.

**Approved Broker/Dealer List** – Mr. Ian Blaiklock presented the annual list of Broker/Dealers qualified to do business with the Commonwealth. The list was separated by Primary Dealers and Non-Primary Dealers and included the addition of TD Securities (USA) LLC as a Primary dealer and SunTrust Robinson Humphrey (Atlanta) as a Non-Primary dealer. Mr. Hollenbach asked if companies approached the Commission to apply for approval or did OFM staff seek them out. Mr. Blaiklock replied that were times when a company would ask to be added to the list. On an annual basis he conducts a review of all the companies' financials to ensure they meet all required statutory criteria. Some entities are removed if no financial reports were submitted or found online, or the entities did not qualify. A motion was made by Ms. Jane Driskell and seconded by Mr. Jon Lawson to accept the Broker/Dealer List as presented. Motion **CARRIED**.

With no further business, Treasurer Hollenbach called for a motion to adjourn. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson. The meeting stands adjourned.

Respectfully submitted,



Ryan Barrow  
Secretary