MINUTES OF MEETING

STATE BOARD OF FINANCE

August 6, 2019

A meeting of the State Board of Finance of the State of Arkansas was held in the conference room, office of the Treasurer of State, Suite 275, Victory Building, Little Rock, Arkansas, at 10:00 a.m., Tuesday, August 6, 2019, pursuant to notice duly given to each member of the Board by the Chairman.

The following members were present:

Larry Walther, Director, Department of Finance and Administration
Dennis Milligan, Treasurer of State
Andrea Lea, Auditor of State
Candace Franks, Arkansas Bank Commissioner
Edmond Waters, Arkansas Securities Commissioner
Chad Brown, Representing Governor Asa Hutchinson
Keith Konecny, Appointed Member
Cale Turner, Appointed Member
Jim Bob Britton, Appointed Member
Clay Conly, Appointed Member

Others present were Jason Brady, T.J. Fowler, Ed Garner, Martin Kelly, Damon Dortch, Stacy Peterson, and Celeste Gladden of the Treasurer's staff; Paul Louthian and Debbie Rogers of the Department of Finance and Administration; Andy Terry, PhD, CFA, from the University of Arkansas at Little Rock; Ashvin Vibhakar, PhD, CFA, from the University of Arkansas at Little Rock; and some members of the banking community. Representatives from the Arkansas Educational Television Network, a reporter for the Arkansas Democrat Gazette, and a KARK news crew were also present. Larry Walther served as acting Chairman in the absence of Governor Hutchinson and called the meeting to order with recognition of a quorum. Chairman Walther welcomed two new Board members: Clay Conly, Executive Vice President and Chief Retail Officer at First Western Bank in Rogers, Arkansas; and Jim Bob Britton, Owner and CEO of Metal Building Supply in Gravette, Arkansas. Mr. Conly was appointed by Speaker of the House Matthew Shepherd, to serve as a member of the general public. Mr. Britton was appointed by President Pro Tempore Jim Hendren, to serve as a person with knowledge and experience in commercial banking. Chairman Walther also introduced a new member of the State Treasury's investment team, Martin Kelly. Mr. Kelly will fill the position of Senior Investment Manager.

Minutes of the meeting held on May 6, 2019 were approved as distributed, after a spelling error was noted by the Chairman and corrected by the Secretary.

Chairman Walther recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report for the fourth quarter of fiscal year 2019. The Report is included in the Minutes as Attachment 1. Treasurer Milligan greeted the Board and stated that he plans to give a review of the investment portfolio and year end numbers along with an economic review and discussion of where he sees the Treasury going over the next year. He told the Board that in fiscal year 2019, the Treasury earned the state $116.9 million dollars. Treasurer Milligan said the short-term portfolio ended the quarter with $22.4 million dollars receipted, which is more than 20 percent higher than in previous quarters of this year; the long-term portfolio ended the quarter with $11.5 million, which was the lowest performing quarter for the entire fiscal year; and between both portfolios, total investment receipts for the fourth quarter exceeded $33.9 million dollars. Treasurer Milligan told the Board that the State Treasury Money Management Trust earned $927,000 as of June 30, 2019 at a rate of 2.70%. He said the local government pool has seen a slow decline in ROI since the beginning of the year, which is reflective of stagnant federal interest rates over the past eight months. Treasurer Milligan moved on to give his economic report to the Board. He pointed out that until last week, it had been eight months without any movement on interest rates from the Federal Open Market Committee, then the Fed cut interest rates by twenty-five basis points, indicating that there is still some concern about a slowdown of economic growth worldwide. Treasurer Milligan stated that long-term treasury rates are down as well, which led to the decrease in the mortgage-backed securities earnings he referenced earlier. Treasurer Milligan told the Board that all of this means that his team will need to reevaluate the investment strategy, because while there is no guarantee, all indicators point to continued downward pressure on interest rates. He told the Board that he will continue to push the investment team to evaluate and find the best possible position for the State. Treasurer Milligan concluded his presentation and asked the Board for any questions. Seeing no questions, Chairman Walther asked for a motion to accept the Treasurer's report into the record. The motion was made by Andrea Lea and seconded by Keith Konecny. All members were in favor.

Next, Chairman Walther made a motion to establish that no funds are available for deposit into the State Board of Finance certificate of deposit investment program. The motion was seconded by Candace Franks. All members were in favor.

Chairman Walther then made a motion that the Board direct the Treasurer of State to purchase warrants for the succeeding quarter, October 1, 2019 through December 31, 2019, pursuant to Act 1088 of 2013, and to keep reasonable amounts in demand deposit accounts and money markets during the next quarter for the transactions of the day-to-day activities of the State. The motion was seconded by Candace Franks. All members were in favor.

Chairman Walther then addressed the Board and stated that he has some annual motions to come before the Board. He then made the following motions:

- A motion for the approval of the record keeping systems of the Treasurer of State with the accounts recorded using the cash basis of accounting as necessary in its daily transactions, with adjusting entries to be made at each fiscal year end to properly report the operating results of the Treasurer of State on the accrual basis of accounting, which is consistent with generally accepted accounting principles (GAAP). The motion was seconded by Candace Franks. All members were in favor.

- A motion to approve the record keeping and reporting requirements of the Treasurer of State, to include at the minimum the following reports:

    a. Ledger Balance and Activity (Daily and Monthly)
    b. Fund Transactions by Type (Daily and Fiscal Year-to-Date)
    c. Checks Charge Off Detail by Line Item (Daily and Fiscal Year-to-Date)
    d. Safekeeping Inventory (Daily)
    e. Trust Fund Certificates of Deposit (Daily)
    f. Collateral Sufficiency (Daily)
    g. Demand Account Balances (Daily)
    h. Money Market Balances (Daily and Monthly)
    i. Return on Investment (Monthly and Fiscal Year-to-Date)

  The motion was seconded by Candace Franks. All members were in favor.

- A motion to approve the current Collateralization Policy of the Treasurer of State (included in the Minutes as Attachment 2). The motion was seconded by Edmond Waters. All members were in favor.

- A motion to approve the Code of Ethics for the members of the Board of Finance and the Code of Ethics and criminal background checks for the current employees of the Treasurer of State (included in the Minutes as Attachment 3 & 4). The motion was seconded by Keith Konecny. All members in favor. Chairman Walther addressed the Board and asked that they sign the Code of Ethics for fiscal year 2020.

- A motion to set the target ROI to 2.00%. The motion was seconded by Candace Franks. After some discussion, all members were in favor.

Chairman Walther moved on to discuss the next agenda item, the presentation of the UALR Interim Report. This Report is included in the minutes as Attachment 4. The Chairman recognized Treasurer Milligan to introduce the UALR consultants. Treasurer Milligan reminded the Board that earlier this year they recommended that the Treasury hire a team to conduct an independent review of investments and policies since it had been five years since the last one was done. He told the Board that the Treasury hired a panel of experts from UALR and that they are present at the meeting to provide a preliminary report of their findings. Treasurer Milligan introduced Dr. Andy Terry and Dr. Ashvin Vibhakar to the Board. Dr. Terry addressed the Board and stated that the study is still ongoing, however, Chairman Walther had asked that if during the study the consultants found anything at year end to discuss, they should bring it before the Board. He explained that as part of the ongoing study, they are looking at two things: performance and the investment policy statement; and in order to do that they have asked for a lot of data. Dr. Terry said that part of that data involves concentration and how much is invested as a percentage of the portfolio in either an asset class or a specific security. He explained that with respect to concentration, it appeared that the portfolio had a heavy concentration in a couple of single commercial paper issuers. Dr. Terry pointed the Board to Charts 1A and 1B of the report (the charts reflect Treasury and Money Management, respectively). Dr. Terry said, “this is aggregate concentration [of commercial paper]. The black line is the investment policy statement. The investment policy statement says it [commercial paper] should not exceed 30 percent. It does not say how that is to be measured or how it is implemented, it simply says 30 percent. So, if you draw the 30 percent line without regard to how to measure, then we don't want to go above the black line and that's the rule.” Dr. Terry continued, “the green line represents our measurement of the current aggregate concentration using the existing investment policy statement. What you can see is that they haven't violated the policy at all, even where it appears that the green line is above the black line, you can go back and technically look at, did they trade based on yesterday's balance? So, we didn't find a violation of investment policy statement at all.” Dr. Terry explained to the Board that the report is not about violating investment policy, it is more about the investment policy itself. He told the Board that the investment policy statement for the Treasury has two exclusions: it excludes commercial paper with less than eight days to maturity and it excludes commercial paper that is in the Money Management Trust portfolio. Dr. Terry said, “the red line represents what the percentage would look like if we removed those two exclusions, so you can see the red line is significantly above the 30 percent flat line. Again, nobody violated investment policy, so that is not the issue. The issue is that the real economic exposure in commercial paper is a bigger number if you count everything as opposed to exclusions that exist in the policy statement.” Dr. Terry pointed the Board to Charts 2A and 2B. He told the Board that the investment policy statement also discusses single issue exposure and has a 5 percent single issuer policy so that the portfolio does not have more than 5 percent in any single commercial paper issuer. Dr. Terry said, “the same story is true here that was true in the aggregate. Look at the green line, it is in compliance. But if we were to go back and include all commercial paper that the Treasury owns of these two issuers: Glencore on the left and CNPC Finance Company on the right; if you add in the commercial paper that has less than 8 days to maturity and Treasury's investment in those issuers in the Money Management Trust, then the economic exposure is really above 5 percent.” Dr. Terry reminded the Board that the report is not about violating an investment policy statement, it is about the existing investment policy statement excluding commercial paper with less than eight days to maturity and excluding investments in the Money Management Trust portfolio, which doesn't reflect the true exposure in either commercial paper as an asset class or in a single issuer. Dr. Terry told the Board that this report is part of a bigger study that is ongoing, but at this stage they would recommend removing the exclusion of commercial paper with maturity of less than eight days, in addition to the exclusion of Treasury’s investment in the Money Management Trust. Dr. Terry asked the Board for any questions.

Cale Turner asked for the rating requirement for commercial paper and if there had ever been a default. T.J. Fowler responded that currently the policy allows for A1-P1 paper out to 180 days, and A2-

P2 paper out to 90 days. Ed Garner responded that there had never been a default. Keith Konecny asked for clarification on the comment in the report that stated that the Board was looking more for growth and not safety, which is not the stance of Mr. Konecny. Dr. Vibhakar responded that what the consultants are saying is that in the policy there are unintended consequences to accept risk. He said that the policy clearly says safety of principle and liquidity are the biggest criteria, but by excluding paper of less than eight days, this leads to investments which can create a risk that may not be intended. Mr. Konecny asked if the consultants felt like the Treasury was taking on more risk than other states. Dr. Vibhakar responded that with respect to concentration, yes. Chairman Walther reiterated to the Board that the policy objectives are safety of the money, liquidity, and return, in that order. There was some discussion amongst the Board about other states and their policy statements versus their returns, and the feasibility of comparing those states to Arkansas. Dr. Vihakar remarked that the critical part of the policy is that the Board is giving guidance to the investment team, and when it comes to concentration, often what is talked about is a "Black Swan" event. He said that the question is not "Has a default ever occurred?", it is what impact it would have on the state if a default did occur.

Mr. Konecny asked if that during the period of time that the Treasury was over-weighted in the two single issuers, the investment team was aware of the situation. Mr. Garner responded that those positions were taken intentionally, and no positions were taken without design or awareness and analysis of risk within the portfolio. Mr. Garner explained that the team monitors the potential of credit deterioration, even on A1-P1 issuers. He told the Board that CNPC is the parent company of Petro China which is the third largest oil company in the world and that Glencore is the largest commodities company in the world. He said that these issuers are monitored both by stock price and using credit default swaps. Mr. Garner explained that risk is being managed by maturity restrictions, and considering how fast a company like that can deteriorate. He said that the investment team has never made investments without knowledge of the status of those companies and what is going on economically in the world certainly within a week period. Mr. Walther responded that there is a difference between Arkansas and the other states, as they do not have an exclusion for maturities less than 8 days. Dr. Terry responded that the probability of default on A1-P1 paper particularly with very low maturity is very small. He said that the consultants are not saying that this may happen, the issue is what if it does happen, he said, “all of your eggs are in one basket." Mr. Britton asked if there is ever any issue with finding other assets to purchase. Mr. Garner responded that there is always the option to place the money at a lower return. Chairman Walther stated that if the Board makes these changes, the Treasury will have lower risk and lower return. Commissioner Franks responded that this will be a safer option for the citizens of Arkansas.

Auditor Lea asked what the Board intended to do today. Chairman Walther responded that he recommends that they approve the report, and then get into specifics of changes to the policy. There was more discussion about having comparisons to other states’ policies versus their yields. T.J Fowler addressed the Board and said that the biggest problem in doing these comparisons is that no two states are exactly alike in how they invest their money. Dr. Terry added that in a lot of cases, the data is just not available. Dr. Vibhakar addressed the Board and asked the question, what is the priority: return, safety, or liquidity? Cale Turner responded that the Board just voted on a 2% return so the policies should allow the Treasury to get there. Chairman Walther said that his understanding is that even with the changes to the policy that are being recommended, 2% return is still appropriate, and while he would like as much return as possible, he has to consider at what cost or risk, because his understanding from the consultants is that none of the states have the same eight-day exclusion in their policy. Dr. Terry responded affirmatively, that was the case in the data from other states that he could find. Mr. Konecny addressed Ed Garner directly and asked if the change is made, could the 2% target still be met. Mr.

Garner responded affirmatively, that the target was set based on the possible implementation of the new policy. Chairman Walther asked for motion to accept the UALR report into the record. The motion was made by Chad Brown and seconded by Keith Konecny. All members were in favor.

Chairman Walther recognized T.J. Fowler to discuss the proposed changes to the investment policies. Mr. Fowler provided the Board with redlines of both the Treasury Investment Policy and the Money Management Trust Fund Investment Policy. These redlines are included in the Minutes as Attachments 5 and 6. The changes to the State Treasury Investment policy are summarized as follows: a change to the definition of "Total Portfolio" (pg. 3); adding the terminology "readily marketable" to the wording of permitted commercial paper (pg. 6); removal of the eight-day maturity exception (pg. 8); changing the wording to total portfolio rather than total assets (pg. 8); removing the exception for the portion of Treasury funds that are invested in the Money Management Trust (pg. 8); changing the ceiling of A2-P2 rated commercial paper to 5% of total portfolio (pg. 9); removing the ceiling of 10% on certificates of deposit (pg. 9). In regards to the removal of the ceiling on certificates of deposit, Mr. Fowler told the Board that the restriction was viewed as trying to mitigate credit risk, and neither the Treasury nor DF&A saw any substantial credit risk in certificates of deposit. The changes to the State Treasury Money Management Trust Investment Policy are summarized as follows: adding the terminology "readily marketable" to the wording of permitted commercial paper (pg. 6); removal of the eight-day maturity exception (pg. 8); changing the ceiling of A2-P2 rated commercial paper to 5% of total portfolio (pg. 9); removing the ceiling of 10% on certificates of deposit (pg. 9). Chairman Walther asked for a motion to approve the proposed changes to the Treasury Investment Policy. The motion was made by Edmond Waters and seconded by Candace Franks. All members were in favor. Next, the Chairman asked for a motion to approve the proposed changes to the State Treasury Money

Management Trust Investment Policy. The motion was made by Edmond Waters and seconded by Candace Franks. All members were in favor.

Chairman Walther told the Board that the next item on the agenda deals with a personnel matter and makes a motion that the Board go into executive session to discuss that matter. The motion was seconded by Andrea Lea. All members were in favor. After the executive session, the Chairman reported that no action was taken. Seeing no further questions or comments from the Board, Chairman Walther adjourned the meeting.

ATTEST:

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Secretary of the State Board of Finance of the State of Arkansas	Acting Chairman of the State Board of Finance of the State of Arkansas

Secretary's Note: All documents pertaining to the issues considered are filed in the permanent records of the State Board of Finance.