

FEDERATED CITY EMPLOYEES' RETIREMENT SYSTEM

Minutes of the Special Board Meeting

THURSDAY

SAN JOSÉ, CALIFORNIA

November 20, 2008

CALL TO ORDER

The Board of Administration of the Federated City Employees' Retirement System met at 8:27 a.m. on Thursday, November 20, 2008, in special session at the Department of Retirement Services, 1737 N. First St., Suite 600 - San José, California.

ROLL CALL

Present:

DAVID BUSSE

Jeffrey Perkins

Matt Loesch

Patrick Skillsky

Pete Constant

Forrest Williams

Bill Thomas

**CHAIR, Civil Service Representative
Public Member**

Employee Representative

Employee Representative

City Council Representative

City Council Representative

Vice-Chair, Retiree Representative

ALSO PRESENT:

Russell U. Crosby

-Secretary/Director

Carmen Racy-Choy -Staff

Mollie Dent

-City Attorney

Ali Amiry -Staff

Tamasha Johnson

-Staff

Ceara O'Fallon -Staff

Ron Kumar

-Staff

Patrick Thomas -SIS

Debbi Warkentin

-Staff

SPECIAL SESSION

Chair Busse called the meeting to order at 8:27 a.m.

NEW BUSINESS (Item 1)

1. Discussion and action on the Security Lending Program managed by The Northern Trust Company (custodian).

Mr. Thomas stated he has limited securities lending experience, but he has become much more aware of the issues over the last few weeks. Northern Trust administers the Plan's Security Lending Program. The custodian holds all of the assets for the Plan, and the Plan has allowed the custodian to administer a program, whereby they lend out the Plan's assets to borrowers, who use the assets for various purposes, such as short selling, delivering on trades and so forth. When the assets are lent to borrowers, the borrowers provide collateral against the assets, and then Northern Trust invests that collateral in short term instruments for the Plan. Capital markets overall have had some unpleasant events and short term commercial paper and various cash instruments have been affected, which in turn has impaired the collateral pool managed by Northern Trust – in some instances there is permanent impairment. They held some short term Lehman notes in the collateral pool. Lehman has gone bankrupt and recovery on that paper is about 9¢ on the dollar, so there are some realized losses. In addition, many corporate and asset backed type of instruments in the collateral pool have become impaired. A general principle for collateral pools is that they are managed like a money market account in a very low risk way, essentially the paper that is purchased is meant to be held to maturity at par, so the pricing is very low in the pool. Since the negative events in the markets, much of the collateral would not be sold for par because of the illiquidity in the markets. As a result of those events, Northern Trust has restricted their clients' activities in the securities lending pool, and has locked in clients and not allowed them full flexibility to leave the program. The reason they are restricting withdrawal from the pool is to make sure they do not have to try to sell the collateral assets as clients leave the lending program. Northern Trust has provided various options to their clients, which include staying in the pool, withdrawing altogether and paying the price of the impairment plus the total market value of their portion of

the collateral pool, or opting for a staged withdrawal. SIS does not feel that immediate withdrawal is a viable solution and does not recommend that option; however, if the situation continues to deteriorate it may make sense to take such drastic action.

Member Perkins asked if the Plan were to decide to take all of its money from the collateral pool and leave the program, do we have information about the characteristics of the collateral we would receive. Since we would have to buy the collateral at par and pay the amount that has been written down, would we know the collateral date of maturity, and what collateral we would be holding? It seems that this problem will continue until the Plan is completely out of the program. Mr. Perkins would like the Plan to be able to make an informed decision, and understand what securities are continuing to be lent out and if the Plan's portion of the collateral pool is continuing to get worse or better.

Mr. Thomas stated that Northern is incrementally improving the quality in shortening the duration of the collateral pool, so as the instruments in the pool roll off at par, Northern is taking that money and putting it in an overnight repo (very high quality, very short instruments) to dramatically reduce the risk in the pool. At this point a little over 50% of the collateral pool is in overnight repo instruments. This problem should correct itself. Northern's estimate is that it would take about a year to a year and a half for the collateral pool instruments to naturally roll off. While there are some instruments with longer maturities (two years), it is a very small percent (less than 3%). Of the total portfolio, about 23% is over a year, so over the next year conceivably the Plan would be over 75% in overnight repo's. However, there are many details which need to be addressed by Northern Trust because they would like to be able to continue to generate revenue, which is part of their rationale to keep clients in the pool. Today SIS would like authorization to cap the Plan's exposure to the securities lending program. Given the issues with the collateral pool, additional remedies should be pursued; Northern should be encouraged to make more contributions to the collateral pool and to increase the split of the revenue. Withdrawing from securities lending, although it is an option, is not recommended, but SIS does recommend that clients take the staged withdrawal approach from the program. It is a slow process and would take at least a year to get out, but the Plan should get into the queue to cap its exposure to the collateral pool.

The Secretary stated that each Friday clients are able to get onto the staged withdrawal queue. This is the first step and staff plans to continue to study the program and develop recommendations.

Member Williams would like to have Northern Trust attend a meeting. Also, if the Plan does the staged withdrawal, does it get back all that it has invested or is it still impacted by the losses that have already occurred?

Mr. Thomas stated that is unknown at this time. Northern has contributed the amount for the Lehman loss, but that loss was small. Going forward the exposure beyond Lehman is large. If things do not improve, SIS believes that there still may be a payable at the end of the program.

Member Loesch asked if SIS knew what was in the collateral pool prior to the economic impacts.

Mr. Thomas stated that Northern Trust has not been forthcoming with that information, but they have not directly held back the information about what holdings are in the pool.

The Board and *Mr. Thomas* discussed concerns and various options for the collateral pool.

Mrs. Racy-Choy stated this recommendation is to get into the withdrawal process; however, over the next few months staff will continue to look at the issue and seek additional answers.

Member Constant stated he feels that we are lacking a detailed analysis and assessment of our options, which he understands as this just came up in the last few days. He thinks Northern Trust needs to attend a meeting to discuss the various options and address our concerns and questions. As the term "mismanagement" has been used in discussion today, how could or would we have caught this sooner, who should have been providing the oversight, and what action should this Board take to prevent future occurrences of this type of situation. Also, if the Plan decided to get out of the collateral pool today has the impact been explored?

The Secretary stated that the Board did nothing wrong and there are many other public pension plans in a similar situation. Essentially, everyone that had Northern as their custodian is in this condition now. Other custodians may begin to feel an impact at some point. Another possibility is that we can join with some of the other plans in exerting a group influence on Northern to say this is not right. As a next step, the Plan should join with other Northern Trust clients as it appears that Northern violated some of their own guidelines - certainly prudent lending.

Mr. Thomas stated that there are guidelines for investment pools, and this investment pool is a very high quality one by guidelines. As far as we know there were no guideline infringements by Northern, but the question of lending and investing with the same entity is not good. With regard to fiduciary process and liability SIS does not see any issue there. SIS attempted to explore the impact, but the way that Northern conveyed the pricing of this pool as something they call the vendible pricing, which differs by some unknown amount to the actual price attainable for selling these instruments. SIS has directly asked Northern for a reasonable best estimate of what the difference is, but to this day has not been able to obtain that information. SIS agrees that the Board should have the investment portfolio manager attend a meeting to review the options.

Ms. Racy-Choy stated that the real risk is default. Citi Group is trading at \$5 today and if they were to go bankrupt the fixed income side of the market would be crippled. Staff will explore terminating the program altogether, but in the meantime staff recommends getting into a staged withdrawal while working on the analysis Ms. Racy-Choy reported that Northern has been invited to the December Board meeting. Northern has also allowed its index fund to take a portion of the collateral pool and segregate it, so their index funds accounted for one-third of the collateral pool and set it aside in an account, which will now be directly managed by those index funds. From the remaining funds, 25% of the lendable asset base has joined the staged withdrawal program. Staff have asked detailed questions of Northern, such as were the index funds treated the same way as the remaining customers, are investors who have joined the staged withdrawal option being treated fairly compared to the other customers or is Northern actually selling their best assets to support the staged withdrawal program, and are those who are remaining actually receiving inferior assets. To date staff has not received any answers from Northern on these issues, so whether all of their customers are being treated the same or not remains unknown.

Mr. Amiry stated that he will be meeting with Northern Trust to go over through the portfolio so he can do an in depth analysis of the risk structure, maturities, and the risk of default from other vendors.

Member Perkins stated a lot of this has to do with the whole economic situation so when we talk about mismanagement we need to keep in mind that all of the Plan's investments are going down daily. This issue with Northern should not be blown out of proportion given the current environment. We will find that the people that are causing this problem because their credit quality went down, which is not necessarily mismanagement. At present, we do not know that mismanagement is in the big picture.

(M.S.C. Perkins/Constant) to approve entering into the phased withdrawal program, staff to continue analysis as to all options and the impacts of each, to have Northern Trust at a meeting for discussion, and to sign on to the letter with other Plans. Motion carried 7-0-0.

ADJOURNMENT

There being no further business, at 9:13 a.m., **Chair Busse** adjourned the meeting.

DAVE BUSSE, CHAIR
BOARD OF ADMINISTRATION

ATTEST:

RUSSELL U. CROSBY, DIRECTOR
BOARD OF ADMINISTRATION