GASB STATEMENT NO. 40

DEPOSIT AND INVESTMENT RISK DISCLOSURES

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1. INTRODUCTION

Under GASB Statement No. 40, the University is required to expand the disclosure of deposit and investment risk. GASB Statement No. 40 (references to Q&A are to the GASB's *Guide to Implementation of GASB Statement No. 40 on Deposit and Risk Disclosures*):

- Amends the disclosures previously required by GASB Statement No. 3.
- Applies to the separately audited UCRS financial statements, including the UCRP, 403(b), and PERS–VERIP plans (see Q&A No. 7).
- Applies to the Campus Foundation disclosures in their separately audited financial statements.
- Applies, as indicated, to the separately audited Medical Centers, UC Press, CEB or Health and Welfare Plans given their participation in the University's STIP.

This document is primarily to document the University's position on the application of GASB Statement No. 40 to the University's financial statements. It is also used as a framework for discussions with the University's auditors. The University's position then provides the direction for the necessary changes to the guidelines and templates required from campus foundations documented in the GASB 39 Campus Foundation Financial Reporting Package. To the extent possible, the application of GASB Statement No. 40 as it relates to the separately audited campus foundation financial statements is also included for information purposes, although it is not a full substitute for an evaluation for the specific circumstances at each foundation or appropriate discussions with their external auditors.

GASB Statement No. 40 and the Guide to Implementation of GASB Statement No. 40 may be ordered from the GASB's website at www.gasb.org. A glossary of terms is included in Appendix A.

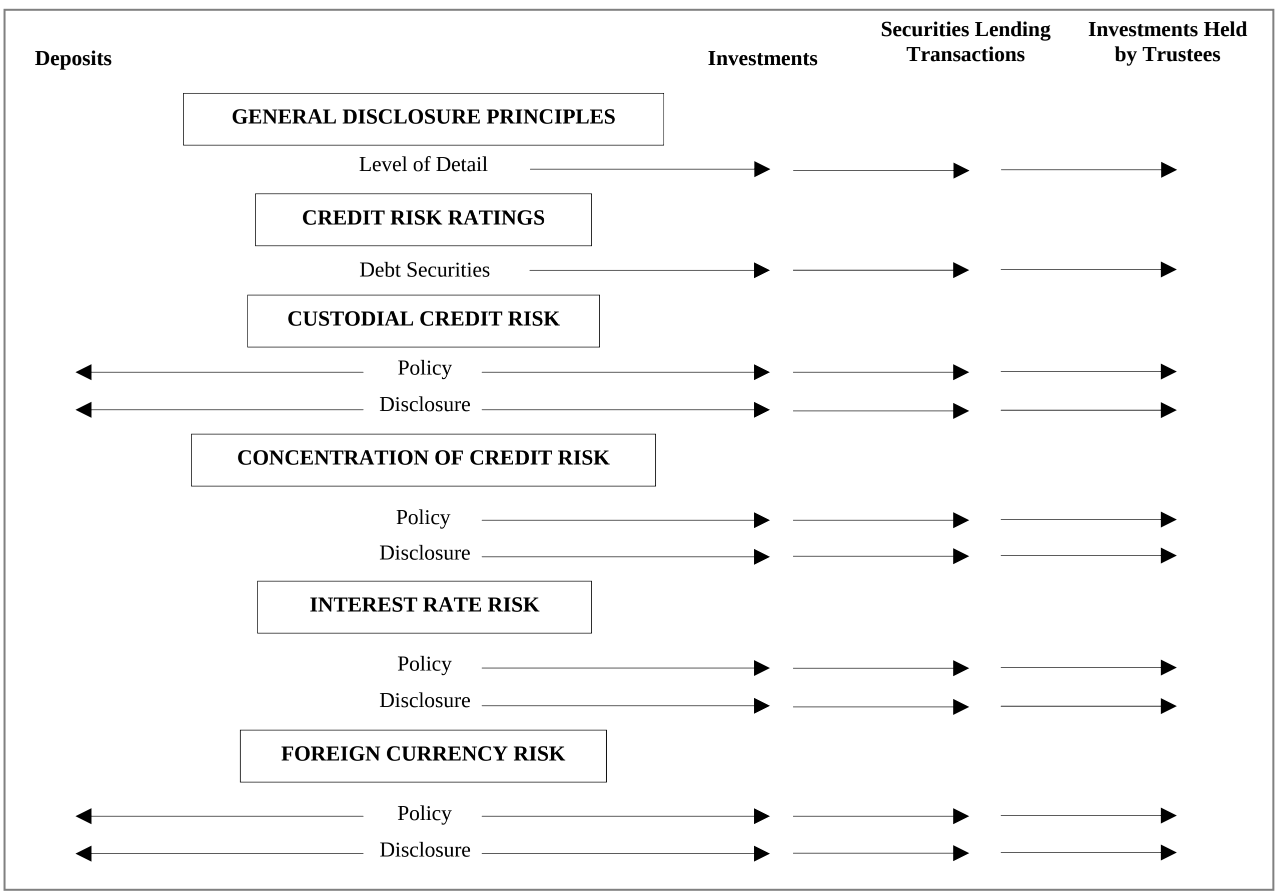
Portfolio information on the STIP and GEP can be found on the University's website at www.ucop.edu/treasurer. Portfolio information on the State Street Charitable Asset Management (CAM) Pool must be provided by State Street.

2. Broad Outline of GASB Statement No. 40 (GASB 40, ¶2)

GASB Statement No. 40 discusses new general disclosure principles, disclosures for the credit risk associated with debt securities, and other common deposit and investment risks.

- Investment disclosures must be organized by investment type and dissimilar investments must be disaggregated in the footnotes (see Q&A No. 1).
- UC must provide information about the credit risk associated with debt securities through disclosure of credit quality ratings.
- UC must evaluate the common risks for deposits and investments and provide the applicable disclosures in the following terms:
  - Credit risk, both custodial and concentration[1];
  - Interest rate risk; and
  - Foreign currency risk.

All forms of risk are applicable to investments, securities lending transactions and investments held by trustees. Only custodial credit risk and foreign currency risk are applicable to deposits. An evaluation of the deposits and investments, including securities lending activities and investments held by trustees, must be done in order to determine the policy and disclosure implications for each area (see Exhibits 1, 2 and 3 for the evaluation criteria). Exhibits 4, 5, 6, and 7 include draft footnotes to indicate how the information may be presented.



[1] Concentration of credit risk is defined in GASB Statement No. 40 as the risk of loss attributed to the magnitude of the institution's investment in a single issuer.

3. General Disclosure Principles (GASB 40, ¶4)

General Disclosure Principles—Investments

GASB Statement No. 40 provides guidance for the disclosure of investments by type of investment. Dissimilar investments, such as U.S. Treasury bills and U.S. Treasury strips, should not be aggregated into a single investment type. The GASB Statement No. 40 Implementation Guide states the following:

> *General Disclosure Principles—Question 1*
>
> *Q*—Statement 40, paragraph 4, requires investment disclosures to be organized by investment type, a level of aggregation previously required by Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. What is an "investment type"?
>
> *A*—Statement 40 does not define *investment type*. Prescribing a list of investment types may mislead readers of the financial statements considering the diversity of investments that may carry similar terminology but exhibit diverse risks. Different investment terms and risks are features that give investments differing forms. For example, a government may hold two U.S. Treasury Investments, one a ten-year bond and the other an interest-only strip. Although both are U.S. Treasury securities, they exhibit significantly different risk profiles. By not prescribing investment types, practitioners are able to apply professional judgment and select investment types that fit the facts and circumstances; however, investments with significantly different risk profiles should not be aggregated into a single investment type.

Therefore, the footnote disclosure previously in place has been disaggregated as described in the following table. Definitions for categorizing securities are provided in Appendix B.

Revised Footnote Disclosure—Investments

Previous Disclosure Detail	Revised Disclosure Detail
Equity securities: ▪ Domestic ▪ Foreign ▪ Private	Equity securities: ▪ Domestic ▪ Foreign
Fixed or variable income securities: ▪ U.S. Government	Fixed income securities: ▪ U.S. government guaranteed: ▫ U.S. Treasury bills, notes & bonds ▫ U.S. Treasury strips ▫ U.S. Treasury inflation protection securities (TIPS) ▫ U.S. government-backed securities ▫ U.S. government-backed–asset-backed securities

Revised Footnote Disclosure—Investments

Previous Disclosure Detail	Revised Disclosure Detail
■ Other U.S. dollar denominated	■ Other U.S. dollar denominated: □ Corporate bonds □ Commercial paper □ Repurchase agreements □ U.S. agencies □ U.S. agencies–asset-backed securities □ Corporate–asset-backed securities □ Certificates of deposit/time deposits □ Corporate structured financial instruments □ Supranational/foreign □ Other
■ Foreign	■ Foreign currency denominated □ Government/sovereign □ Corporate
Other investments	Commingled funds–absolute return Commingled funds–balanced funds Commingled funds–U.S. equity funds Commingled funds–non-U.S. equity funds Commingled funds–U.S. bond funds Commingled funds–non-U.S. bond funds Commingled funds–real estate investment trusts Commingled funds–money market funds
	Derivative instruments:[1] ■ Investment derivatives ■ Hedging derivatives
	Private equity
Mortgage loans	Mortgage loans
Insurance contracts	Insurance contracts
	Real assets
	Real estate
	Equitized market neutral investments
	Externally held irrevocable trusts
	Futures and options contracts
Other investments	Other investments

[1] Detailed information regarding the implementation of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is available on the UCOP GASB website.

The University may decide to continue reporting supplemental investment pool information and the composition of their investments by investment type. If so, the GASB Statement No. 40 disclosure requirements to disaggregate investments will not apply because it is supplemental, not required, disclosure information.

General Disclosure Principles—Investment of Cash Collateral

In accordance with GASB Statement No. 40, ¶4, the reported amounts of the investment of cash collateral must be disclosed by type of investment in a disaggregated manner. Therefore, the level of disclosure in the University's financial statements for the investment of cash collateral has been expanded as follows:

Revised Disclosure Detail—Investment of Cash Collateral

Investment of Cash Collateral

Equity securities:

- Domestic
- Foreign

Fixed income securities:

- U.S. government guaranteed
  - U.S. Treasury bills, notes & bonds
  - U.S. strips
  - U.S. TIPS
  - U.S. government-backed securities
  - U.S. government-backed–asset-backed securities
- Other U.S. dollar denominated:
  - Corporate bonds
  - Commercial paper
  - Repurchase agreements
  - U.S. agencies
  - U.S. agencies–asset-backed securities
  - Corporate–asset-backed securities
  - Certificates of deposit/time deposits
  - Corporate structured financial instruments
  - Supranational/foreign
  - Other
- Foreign currency denominated:
  - Government/sovereign
  - Corporate

Commingled funds:

- Money market funds

General Disclosure Principles—Investments Held by Trustees

Self-Insurance Programs

In accordance with GASB Statement No. 40 ¶4, the reported amounts of investments held by trustees related to self insurance programs must be disclosed by type of investment in a disaggregated manner. Therefore, depending on the securities held in the portfolios at year-end, the level of disclosure in the University's financial statements for investment held by trustees has been expanded as follows:

Revised Disclosure Detail—Investments Held by Trustees: Self Insurance Programs

Fixed income securities:

- U.S. government guaranteed:
  - U.S. Treasury bills, notes & bonds
  - U.S. strips
  - U.S. TIPS
  - U.S. government-backed securities
  - U.S. government-backed–asset-backed securities
- Other U.S. dollar denominated:
  - Corporate bonds
  - Commercial paper
  - Repurchase agreements
  - U.S. agencies
  - U.S. agencies–asset-backed securities
  - Corporate–asset-backed securities
  - Certificates of deposit/time deposits
  - Corporate structured financial instruments
  - Supranational/foreign
  - Other
- Commingled funds:
  - U.S. bond funds
  - Money market funds
  - U.S. equity funds

Long-Term Debt

Investments held by trustees related to long-term debt are deposited in commingled funds managed by the State of California Treasurer's Office. The University has concluded that these investments are effectively deposit mechanisms and should be evaluated as a deposit, not as an investment, as outlined in GASB Statement No. 40.

Capital Projects

The proceeds from the sale of state lease-revenue bonds are held for the University by the state Treasurer's Office in the Surplus Money Investment Fund (SMIF). The SMIF is administered by the Pooled Money Investment Board, an investment division of the state Treasurer's Office (http://www.treasurer.ca.gov/pmib/pmib.htm). Since the University records the entire capital lease obligation at the time the bonds are sold, generally prior to the start of construction, an asset is also recorded to record the University's eventual claim on these funds that will ultimately be remitted to the University as construction invoices are paid. The University has concluded that these investments are effectively deposit mechanisms and should be evaluated as a deposit, not as an investment, as outlined in GASB Statement No. 40.

General Disclosure Principles—Medical Centers, CEB, UC Press and H&W Plans

The general disclosure principles do not apply to the medical centers, CEB, UC Press, etc. investment in the STIP shown on their separately audited financial statements. In conjunction with the implementation of GASB Statements No. 34 and 35, the University concluded that these investments in the University's STIP are effectively demand deposit mechanisms for these participants (reference GASB Statement No. 31, GASB Statement No. 9, ¶50 and FASB Statement No. 95). Therefore, they will be evaluated as a deposit, not as an investment, as outlined in GASB Statement No. 40.

General Disclosure Principles—Campus Foundations

The general disclosure principles apply to the campus foundations. Each will need to perform their own review of deposits and investments to determine the nature and extent of the disclosure required, including policy disclosure.

If a campus foundation classifies their investment in the STIP as a cash and cash equivalent, the evaluation under GASB Statement No. 40 should be evaluated as a deposit, rather than an investment.

If a campus foundation classifies their investment in the STIP as an investment, similar to their classification of their GEP, they have a position in an external investment pool. As noted in the definitions described in Section 5, *Custodial Credit Risk*, in this document, an external investment pool is an arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio where one or more of the participants are not part of the sponsor's reporting entity. This is the case at UC for the STIP and GEP. The STIP and GEP investment pools are sponsored by the University and include participation by legally separate entities that are not part of the University's reporting entity. If the STIP and GEP investment pools included *only* the University and its component units, it would be an internal investment pool and not an external investment pool. Therefore, a campus foundation's investment in each of the STIP and GEP investment pools is a separate investment type. Investment-type disclosure does not "look through" to the investments in the pool, rather the position should be characterized as a position in an external investment pool (see Q&A No. 3) as a commingled fund.

For purposes of the University's footnote disclosure of campus foundation's investments in the STIP (other than those classified as a deposit) and GEP, they will be described as Commingled Funds, in the Balanced (GEP) or Money Market (STIP) fund categories There will be disclosure in the University's footnotes to the campus foundations' financial statements in order to highlight the related party nature of these campus foundation investments.

Please see the discussion of the GEP subsidiary pool structure provided in Section 13 if the foundation invests in a GEP subsidiary pool.

From the campus foundation's perspective, a campus foundation's investment in a State Street CAM pool is also an external investment pool since it is sponsored by the University and includes participation by other legally-separate organizations (i.e., other campus foundations) that are not part of any one campus foundations' reporting entity. Therefore, a campus foundation's investment in any of the State Street CAM pools will be categorized as a separate investment type in the appropriate "Commingled Funds" categories. The Russell 3000 will be included in the Commingled Funds–U.S. Equity category, the fixed income in the Commingled Funds–U.S. Bonds category, the

EAFE in the Commingled Funds–Non-U.S. Equity category, and the money market in the Commingled Funds–Money Market category.

Contact UCOP–Financial Accounting if a campus foundation auditor requests a confirmation that the STIP, GEP and CAM investment pools include participation by other legally separate entities.

Also, from the perspective of the campus foundations, if a campus foundation has individual securities that are “separately invested” by the Treasurer, the specific security must be included in the appropriate investment-type category.

Because the campus foundations are included in the UC financial statements and footnotes, investment type information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Financial Reporting Package (see Q&A No. 7).

4. CREDIT RISK RATINGS (GASB 40, ¶7)

Credit Risk—Investments and Investment of Cash Collateral

Fixed income securities are subject to credit risk, which is the chance that a bond issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

A bond's credit quality is an assessment of the issuer's ability to pay interest on the bond, and ultimately, to pay the principal. Credit quality is evaluated by one of the independent bond-rating agencies, for example Moody's Investors Service (Moody's) or Standard and Poor's (S&P). The lower the rating, the greater the chance—in the rating agency's opinion—that the bond issuer will default, or fail to meet its payment obligations. Generally, the lower a bond's credit rating, the higher its yield should be to compensate for additional risk.

Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk.

Investments where credit quality ratings <u>do</u> apply and are rated include the following**:**

- All corporate and foreign bonds;
- Commercial paper;
- Repurchase agreements unless the underlying security or obligation is explicitly guaranteed by the U.S. government (see Q&A No. 24);
- Bankers' acceptances (see Q&A No. 24);
- Government sponsored enterprise investments including the following: Federal Farm Credit Banks, the Federal Home Loan Bank System, Freddie Mac, Fannie Mae, and Sallie Mae (see Q&A No. 21);
- U.S. government-backed securities;
- Certificates of deposit (refers to negotiable CDs);
- U.S. agencies;
- U.S. strips;
- U.S. structured financial instruments; and
- Corporate structured financial notes.

If a credit quality disclosure is required and the investment is not rated, the disclosure must indicate that fact. If a debt instrument is not rated, but its issuer is rated, the credit quality rating of the issuer cannot be substituted (see Q&A No. 17). Investments where credit quality ratings <u>do</u> apply, but may not be rated include the following**:**

- External investment pools (see Q&A No. 20 and 22);
- Money market funds;
- Bond mutual funds (see Q&A No. 26 and 27); and
- Guaranteed insurance contracts—they may be rated if the individual contract, not the issuer, is rated.

Investments where credit quality ratings do apply, but are clearly not rated include the following:

- 2a7-like pools, such as the University's Absolute Return fund (see Q&A No. 20);
- Mortgage loans; and
- Guaranteed insurance contracts if the issuer, rather than the individual contract is rated.

Credit quality ratings do not apply to the following**:**

- Obligations explicitly guaranteed by the U.S. government, including U.S. treasury bills, notes, bonds, and inflation protected securities;
- Repurchase agreements where the underlying security is explicitly guaranteed by the U.S. government (see Q&A No. 24); and
- Other investments consisting primarily of the fair value of external trusts, limited partnership units, foreign currency contracts, commodities and real estate since they are not debt securities

The University has taken the position that investments in commingled funds that are balanced funds—part equity and part fixed income securities—are not subject to credit risk rating disclosure.

The footnote disclosure for debt securities must provide information about the credit risk policy and credit quality of certain debt securities as described by the rating agencies. The disclosure detail for investments and investment of cash collateral credit risk includes the following:

Revised Disclosure Detail—Credit Risk: Investments and Investments of Cash Collateral

Fixed or variable income securities:

- U.S. government guaranteed
- Other U.S. dollar denominated:
  - AAA
  - AA
  - A
  - BBB
  - BB
  - B
  - CCC or below
  - A1/P1/F1
  - Not rated
- Foreign currency denominated:
  - AAA
  - AA
  - A
  - BBB
  - BB
  - B
  - CCC or below
  - A1/P1/F1
  - Not rated

Revised Disclosure Detail—Credit Risk: Investments and Investments of Cash Collateral

Commingled funds: ▪ U.S. bond funds: Not rated ▪ Non-U.S. bond funds: Not rated ▪ Money market funds: Not rated
Mortgage loans: Not rated
Insurance contracts: Not rated

Investment derivatives:[1]
▪ Forward contracts on a to-be-announced basis:
  ▫ AAA
  ▫ AA
  ▫ A
  ▫ BBB
  ▫ BB
  ▫ B
  ▫ CCC or below

[1] Detailed information regarding the implementation of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is available on the UCOP GASB website.

Many securities have ratings from more than one rating agency, and sometimes those ratings differ. When multiple ratings exist, at a minimum, the rating indicative of the greatest degree of risk should be presented (see Q&A No. 19).

Ratings issued by rating agencies can be detailed. Numerical modifiers, 1, 2, and 3 in each generic rating classification AA, A, etc. may be added. Credit quality modifiers are not a required disclosure (see Q&A No. 19).

Credit Risk—Investments Held by Trustees

Self-Insurance Programs

The credit risk principles associated with debt securities apply to the investments held by trustees related to self-insurance programs. Depending on the securities held in the portfolios at year-end, the disclosure detail for these investments held by trustees may include the following:

Revised Disclosure Detail—Credit Risk: Investments Held by Trustees–Self Insurance Programs

Fixed income securities: ▪ U.S. government guaranteed ▪ Other U.S. dollar denominated: ▫ AAA ▫ AA ▫ A ▫ BBB ▫ BB ▫ B ▫ CCC or below ▫ A1/P1/F1 ▫ Not rated
Commingled funds: ▪ U.S. bond funds: Not rated ▪ Non-U.S. bond funds: Not rated ▪ Money market funds: Not rated

Long-Term Debt

The credit risk principles do not apply to investments held by trustees related to long-term debt because they are effectively deposit mechanisms and are evaluated as a deposit, not as an investment.

Capital Projects

The credit risk principles do not apply to the proceeds from the sale of state lease-revenue bonds because they are effectively deposit mechanisms and are evaluated as a deposit, not as an investment.

Credit Risk —Medical Centers, CEB, UC Press and H&W Plans

The credit risk principles do not apply to the medical centers, CEB, UC Press, etc. investment in the STIP shown on their separately audited financial statements because they are effectively demand deposit mechanisms for these participants and are evaluated as a deposit, not as an investment, as outlined in GASB Statement No. 40.

Credit Risk —Campus Foundations

The credit risk principles associated with debt securities apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

From the perspective of the campus foundations, their investment in the University's STIP or GEP is considered to be an investment in an external investment pool; therefore while they are required to disclose the credit quality rating of the investment pool, the investment pools are "unrated." (GASB Statement No. 40, ¶7).

A campus foundation's investment in a State Street CAM pool is an external investment pool, although as "commingled funds" they are "not rated."

Also, from the perspective of the campus foundations, if a campus foundation has individual debt securities as investments that are "separately invested" by the Treasurer, they are subject to credit quality disclosure of the specific underlying securities in the footnotes to the foundation's separately audited financial statements. Campus foundations will need to contact and work with the University Treasurer's Office to obtain this information for their footnote disclosure.

Since the campus foundations are included in the UC financial statements and footnotes, credit risk information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Financial Reporting Package (see Q&A No. 7).

5. CUSTODIAL CREDIT RISK (GASB 40, ¶ 8, 9 & 10)

Custodial Credit Risk—Deposits (GASB 40, ¶8)

University

The University’s bank accounts will be evaluated under the terms identified in GASB Statement No. 40 as deposit risks. Generally, deposits are either a) physically in one of four banks where the FDIC insures bank balances to $100,000, b) in a sweep account collateralized by federal government obligations held in the name of the bank, c) physically on a campus, or d) at a credit card processor.

The University’s policy with respect to custodial risk for demand deposit accounts is that accounts will be authorized at financial institutions that maintain minimum credit quality ratings from independent rating agencies. Financial institutions must maintain an issuer rating or long-term debt rating of A3 or higher as defined by Moody’s Investor Service, or A- or higher as defined by Standard & Poor’s Corporation.

See the *Evaluation of Common Deposit and Investment Risks* worksheets on Exhibit 1 for banking deposits to determine whether there will be a requirement for:

- A description of the deposit policy in the footnotes;
- The specific footnote disclosure required for deposits exposed to custodial credit risk; or
- Both a policy description and the specific disclosure in the footnotes.

Medical Centers, CEB, UC Press and H&W Plans

In conjunction with the implementation of GASB Statement No. 34 and 35, the University concluded that medical center, CEB, UC Press, and H&W plans, etc. investments in the University’s STIP are effectively demand deposit mechanisms for these participants. Therefore, they will be evaluated as deposit risk as outlined in GASB Statement No. 40.

For the medical centers, CEB, UC Press, H&W plans, etc, there is no custodial credit risk related to their deposits in STIP since they are all part of the University of California legal entity and the underlying investments are part of the University’s investment portfolio that does not have custodial credit risk. However, disclosure will need to be reviewed to explain there is no exposure on this basis, along with a policy statement indicating that substantially all cash is invested in the University’s STIP.

Campus Foundations

These custodial credit risk disclosure principles apply to the campus foundation’s deposits. Each will need to perform their own review to determine the nature and extent of the disclosure, including policy disclosure.

If a campus foundation maintains an accounting policy that classifies their investment in the STIP as a cash and cash equivalent, the evaluation under GASB Statement No. 40 should be evaluated as a deposit, rather than an investment. However, for purposes of determining whether there is custodial risk related to this deposit, the underlying nature of the transaction is that this is really an investment that qualifies as a cash and cash equivalent if that is the accounting policy selected. The STIP is in an external investment pool, therefore there is no deposit custodial credit risk disclosure required for campus foundations that classify their investment in the STIP as a cash equivalent.

Custodial Credit Risk—Investments (GASB 40, ¶9)

UC securities that are owned, including those that are owned and lent under securities lending arrangements, will be evaluated under the terms identified in GASB Statement No. 40 as investment risks.

GASB Statement No. 40, paragraph 9 specifies that:

> "Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government [in the name of the University or campus foundation], and are held either:
>
> a. The counterparty [the party that pledges collateral or repurchase agreement securities to the University (or campus foundation)or that sells investments to or buys them for the University (or campus foundation)];
>
> b. The counterparty's trust department or agent, but not in the government's name [in the name of the University or campus foundation]."

Discussion of custodial credit risk is found in GASB Statement No. 3, paragraph 68; GASB's Technical Bulletin No. 87-1; GASB Statement No. 40, paragraph 9; and the GASB 40 Implementation Guide, Question Number 28; and Comprehensive Implementation Guide–2005, Question Numbers 60 through 77. When evaluating whether custodial credit risk disclosure is required, it may be useful to review the history and intent as background information. This history and excerpts from the Implementation Guide are briefly summarized in Section 12.

Determining whether securities are held in the name of the University (or campus foundation) requires a detailed understanding of the custodial relationships.

- Per GASB Technical Bulletin 87-1, paragraph 10, if the custodian is the University's or campus foundation's agent, holding securities "in the name of the University/campus foundation" means establishing the University's/campus foundation's rights to the securities. The University's/campus foundation's rights to and claims on the securities should be unconditional. In the Depository Trust Company (DTC) book entry system, the conditions that indicate securities are held in the name of the University/campus foundation include having the securities held in a custodial or fiduciary account and identified as owned by or pledged to the University/campus foundation in the custodian's internal accounting records. A custodial or fiduciary account is an account maintained in the Federal Reserve or DTC system separate from the account holding the custodian's other securities. The use of a custodial or fiduciary account indicates the securities are owned by or pledged to someone other than the custodian, although it may not indicate the identity of that party.

- Per GASB Technical Bulletin 87-1, paragraph 11, if the custodian is the counterparty's trust department or agent, conditions that indicate whether the securities are held in the name of the University/campus foundation include the following:
  - Use of a separate custodial or fiduciary Federal Reserve or DTC account;
  - Identification of the securities as those of the entity in the custodian's internal accounting records; and
  - Recognition by the custodian of the University's/campus foundation's rights to the securities.

Investments in external investment pools and in open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form. An external investment pool is defined as follows:

> *External investment pool*. An arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio; one or more of the participants is not part of the sponsor's reporting entity. An external investment pool can be sponsored by an individual government, jointly by more than one government, or by a nongovernmental entity. An investment pool that is sponsored by an individual state or local government is an external investment pool if it includes participation by a legally separate entity that is not part of the same reporting entity as the sponsoring government. If a government-sponsored pool includes *only* the primary government and its component units, it is an internal investment pool and not an external investment pool.

An open-end mutual fund is defined as follows:

> *Open-end mutual fund*. An SEC-registered investment company that issues shares of its stock to investors, invests in an investment portfolio on the share-holders' behalf, and stands ready to redeem its shares for an amount based on its current share price. An open-end mutual fund creates new shares to meet investor demand, and the value of an investment in the fund depends directly on the value of the underlying portfolio. Open-end mutual funds include governmental external investment pools that are registered as investment companies with the SEC and that operate as open-end funds.

Similarly, investments in a partnerships, contracts with insurance companies, title documents held in the name of the University, real estate, commodities, limited partnership units, futures contracts, options, funds held in trust by others, foreign currency contracts, etc. are not subject to custodial credit risk disclosure since their existence is not evidenced by securities that exist in physical or book-entry form.

Custodial Credit Risk Associated with <u>Securities Owned</u> by the University and <u>Not Lent</u>

The securities owned by the University and not lent under securities lending transactions are not subject to custodial credit risk disclosure requirements. Securities are registered in the University's name by the custodial bank as an agent for the University, or are part of an external investment pool, invested in open-end mutual funds, or a book-entry in a partnership or fund's records.

State Street, as Custodian

The University's investments held at State Street Bank, the University's custodian, are held in street, or nominee, names as follows:

- Shellwater & Co.
- Cactusbreeze & Co.
- Picture & Co (relates only to the investment of cash collateral).

DTC recognizes the nominee names as State Street Bank for ease of transferring custody of securities. However, State Street's compliance department can provide documentation that the nominee names have been assigned to The Regents as beneficial owner and that these names are also known to the IRS as the University of California. State Street Bank, though listed as owner of record through the nominee names, simply holds and services the University's securities. They do not make investment decisions, exercise voting rights, or have any other powers associated with ownership, unless specifically authorized to do so by prior agreement.

State Street's creditors cannot attach the securities of The Regents. If State Street Bank were ever to file for bankruptcy, the University's securities would not be available to the creditors. Having securities in a street name does not change the beneficial ownership of the securities.

Other Custodians (Goldman Sachs)

The University's and the UCRS's investment portfolios may utilize investment managers where the securities are not held in the University's name or nominee names, are insured (Securities Investor Protection Corporation (SIPC) and excess SIPC bond provided by Customer Asset Protection Company (CAPCO)) and are held in custody outside of State Street. While the securities are registered in the custodian's name by the custodial bank, physical certificates are held in a vault, segregated in bulk on a fungible basis and identified on its books and records (in separate accounts) as interests of the University, as the client. As such, these investments are not exposed to custodial credit risk reporting requirements.

In the event of insolvency, creditors cannot attach the security accounts of the University. The University's securities are excludable from the real or personal property of the custodian as the assets are properly identified on the books and records of the custodian and properly segregated.

Disclosure

See the *Evaluation of Common Deposit and Investment Risks* worksheets on Exhibit 2 to determine the investments that require:

- A description of the investment policy in the footnotes;
- The specific footnote disclosure required for investments exposed to custodial credit risk; or
- Both a policy description and the specific disclosure in the footnotes.

When securities are lent to a borrower, UC relinquishes the physical security, but still retains ownership of the security. The borrower takes possession of the physical security; however, UC still receives the interest, dividends, etc.

Custodial Credit Risk Associated with Securities Owned by the University and Lent for which Cash Collateral is Received (GASB 40, ¶10b)

When a security is lent, the borrower is required to provide cash collateral (Credit Suisse/First Boston and Metropolitan West Securities, LLC) and either cash or securities collateral (State Street–Securities Finance) amounting to 100 percent (Metropolitan West) and between 102 and 105 percent (Credit Suisse/First Boston and State Street Securities Finance) of the market value of the security that is lent.

The underlying securities lent for cash collateral are not subject to custodial credit risk disclosure requirements because the collateral for the loans is reported in the statement of net assets.

Cash collateral received from borrowers is reported as a liability in the University's statement of net assets as "Collateral held for securities lending." Therefore, the underlying securities that are lent for the cash collateral, recorded as an asset and outlined in the footnotes in the University's Annual Report as "Securities lent for cash collateral" are not subject to custodial credit risk disclosure requirements. These statements apply to the cash collateral received on the securities lent by the University's current lending agents (Credit Suisse/First Boston, Metropolitan West and State Street Securities Finance).

Custodial Credit Risk Associated with Securities Owned by the University and Lent for which Securities Collateral is Received (GASB 40, ¶10c)

The underlying securities lent for securities collateral are not subject to custodial credit risk requirements. This conclusion, as outlined in GASB Statement No. 40, ¶10c, is focused instead on the type of collateral received (U.S. government securities), the custodial arrangements (external investment pool) and protection from creditors.

State Street

When the University lends securities for securities collateral (State Street Securities Finance), U.S Treasuries are delivered directly to the Regents primary custodian bank (State Street Corporation) from borrowers and physically held at the Federal Reserve Bank in New York. The U.S. Treasuries are delivered pursuant to a tri-party collateral agreement involving the borrower, State Street Securities Finance and the custodian. The U.S. Treasuries are held at the custodian's collateral account, an external investment pool, at the Federal Reserve Bank.

In the event of insolvency, assets held in custody or trust would not be available to the custodian bank's creditors because the assets are excludable from the real or personal property of the custodian. Therefore, any creditors of the custodian bank would not be able to reach and apply those assets as long as the assets are properly identified on the books and records of the custodian and properly segregated. Any U.S. Treasuries held at the Federal Reserve Bank would be held in a separate collateral account separate from the custodian bank's general assets, and would be separately marked on the custodian bank's books and records.

Other Securities Lending Agents (Credit Suisse/First Boston and Metropolitan West)

Neither Credit Suisse/First Boston nor Metropolitan West Securities receive securities collateral in their security lending programs. Both lending agents receive cash collateral which flows directly to the University's account with its custodian bank, State Street Corporation.

Disclosure

If the evaluation of the circumstances with respect to custodial credit risk for investments determined that additional disclosure is necessary, the level of disclosure in the financial statements has been expanded as follows, unless exception-based disclosure is more efficient:

Revised Disclosure Detail—Custodial Credit Risk: Investments

Equity securities:
▪ Domestic
  ▫ Exposed to custodial credit risk
  ▫ Not exposed to custodial credit risk
▪ Foreign
  ▫ Exposed to custodial credit risk
  ▫ Not exposed to custodial credit risk

Fixed or variable income securities:
▪ U.S. government guaranteed:
  ▫ U.S. Treasury bills
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. Treasury notes
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. Treasury bonds
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. Treasury strips
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. TIPS
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. government-backed securities
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ U.S. government-backed–asset-backed securities
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
▪ Other U.S. dollar denominated:
  ▫ Corporate bonds
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ Commercial paper
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk
  ▫ Repurchase agreements
    • Exposed to custodial credit risk
    • Not exposed to custodial credit risk

Revised Disclosure Detail—Custodial Credit Risk: Investments

- U.S. agencies
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- U.S. agencies–asset-backed securities
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- Corporate–asset-backed securities
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- Certificates of deposit/time deposits
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- Corporate structured financial instruments
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- Supranational/foreign
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk
- Other
  - Exposed to custodial credit risk
  - Not exposed to custodial credit risk

- Foreign currency denominated
  - Government/sovereign
    - Exposed to custodial credit risk
    - Not exposed to custodial credit risk
  - Corporate
    - Exposed to custodial credit risk
    - Not exposed to custodial credit risk

Investment derivatives:[1] - Exposed to custodial credit risk - Not exposed to custodial credit risk

[1] Detailed information regarding the implementation of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is available on the UCOP GASB website.

Custodial Credit Risk—Investments Held by Trustees

Self-Insurance Programs

Currently, securities held in trust by Trust Company of the West (TCW) are uninsured. Book entry assets are held by the Depository Trust Company (DTC) in their nominee name, Cede & Co.; physical securities are held by Mellon Bank in their nominee name, Mac & Co. Securities are held in omnibus accounts at DTC or Mellon Bank, but the assets are segregated into custodial accounts at TCW on behalf of each of TCW's clients (e.g., UC Regents). The assets remain the property of TCW clients.

Although the securities are uninsured, they are not subject to custodial credit risk because they are considered to be held in The Regents' name as outlined in the conditions set forth in ¶10 and ¶11 of GASB Technical Bulletin 87-1:

- **Paragraph 10.** *Entity's Agent:* "… <u>Holding securities "in the name of the entity" means establishing the entity's rights to the securities.</u> The entity's rights to and claims on securities it owns should be unconditional. The entity's rights to and claims on securities underlying repurchase agreements should be unconditional in the event of default by the counterparty to the agreement. In the Federal Reserve or DTC book entry system, <u>the conditions that indicate securities are held in the name of the entity include having the securities held in a custodial or fiduciary account and identified as owned by or pledged to the entity in the custodian's internal accounting records</u>. A custodial or fiduciary account is an account maintained in the Federal Reserve or DTC system separate from the account holding the custodian's own securities. <u>The use of a custodial or fiduciary account indicates that the securities are owned or pledged to someone other than the custodian</u>, although it may not indicate the identity of that party."
- **Paragraph 11.** *Counterparty's Trust Department or Agent:* "… <u>Conditions that indicate whether securities are held in the name of the entity include the use of a separate custodial or fiduciary Federal Reserve or DTC account, identification of the securities as those of the entity in the custodian's internal accounting records, and the custodian's recognition of the entity's rights to the securities…"</u>

Long-Term Debt

Securities held in trust by either Bank of New York or US Bank are uninsured and are held by the trustee bank in the name of the University. As such, the investments held by trustees associated with long-term debt are not subject to custodial credit risk.

Capital Projects

The University's participation in the state administered Surplus Money Investment Fund (SMIF) is subject to custodial credit risk disclosure as outlined in ¶8. The deposits are not covered by depository insurance and are collateralized with securities held by the state of California, but not in the University's name.

Custodial Credit Risk—Collateral Received from Securities Lending Transactions (GASB 40, ¶10)

Securities lending activities, including UC securities that are owned and lent, securities collateral received from the borrower and held by UC, and the investment of cash collateral received from the borrower and invested by UC will be evaluated under the terms outlined in GASB Statement No. 40, ¶9 as investment risks, as outlined below.

If the conclusion is that these securities are exposed to custodial credit risk, the following disclosures are required:

- The custodial arrangements for the collateral securities;
- the type of collateral received, as specified in GASB Statement No. 40, ¶4; and
- the fair value at the end of the fiscal year.

Custodial Risk Associated with the *<u>Investment of Cash Collateral</u>* *(GASB 40, ¶10a)*

<u>State Street</u>

Securities included in the investment of cash collateral are not exposed to custodial credit risk. The investment of cash collateral included in the University's financial statements is invested or held by the University's lending agent and custodian in a short-term internal investment pool in the name of the University. Although the securities are uninsured, they are registered in the name of the University (Picture & Co.).

See the preceding discussion of how the University's custodian holds the University's securities in nominee name as beneficial owner.

<u>Other Securities Lending Agents (Credit Suisse/First Boston and Metropolitan West)</u>

Securities included in the investment of cash collateral are not exposed to custodial credit risk. The investment of cash collateral included in the University's financial statements is invested or held by the University's lending agent and custodian as follows:

- Credit Suisse/First Boston—In investment holding (except for tri-party repurchase agreements) settled through DTC in a State Street Corporation custody account in the name of the University, uninsured. The collateral associated with tri-party repurchase agreements is held segregated in the University's name at the tri-party custodian of either JP Morgan/Chase or Bank of New York, and is indemnified by Credit Suisse.
- Metropolitan West Securities—In investments made in accordance with the approved investment guidelines and held in the name of the UC Regents in a State Street Corporation custody account. The collateral associated with tri-party repurchase agreements is held segregated in the University's name at the tri-party custodian of either JP Morgan/Chase or Bank of New York, and is indemnified by Wachovia.

<u>Campus Foundations</u>

Campus foundations that enter into securities lending transactions will need to undertake their own evaluation of the circumstances.

Custodial Credit Risk Associated with the *<u>Securities Received as Collateral</u>* *in Securities Lending Transactions (GASB 40, ¶10c)*

<u>State Street</u>

Under current arrangements, securities received by the University as collateral in a securities lending transaction are not subject to custodial credit risk disclosure requirements since they are held by State Street Bank in a pooled investment account that is an external investment pool.

As previously discussed under *Custodial Credit Risk Associated with Securities Owned by the University and Lent for which Securities Collateral is Received* above, when the University lends securities for securities collateral (State Street Securities Finance), U.S Treasuries are delivered directly to the Regents' primary custodian bank (State Street Corporation) from borrowers and physically held at the Federal Reserve Bank in New York. The U.S. Treasuries are delivered pursuant to a tri-party collateral agreement involving the borrower, State Street Securities Finance and the custodian. The U.S. Treasuries are held in the custodian's collateral account, an external investment pool, at the Federal Reserve Bank.

<u>Other Securities Lending Agents (Credit Suisse/First Boston and Metropolitan West)</u>

Neither Credit Suisse/First Boston nor Metropolitan West Securities receive securities collateral in their security lending programs. Both lending agents receive cash collateral which flows directly to the University's account with its custodian bank, State Street Corporation.

<u>Campus Foundations</u>

Campus foundations that enter into securities lending transactions will need to undertake their own evaluation of the circumstances in order to determine whether custodial credit risk disclosure is required.

Custodial Credit Risk—Campus Foundations

The custodial credit risk principles apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

From the perspective of the campus foundations, their investment in the University's STIP or GEP is considered to be an investment in an external investment pool, therefore they are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form and no disclosures are required for these specific investments (GASB Statement No. 40, ¶9).

Please see the discussion of the GEP subsidiary pool structure provided in Section 13 if the foundation invests in a GEP subsidiary pool.

Similarly, if a campus foundation invests in a State Street CAM pool, there is no custodial credit risk disclosure required by the campus foundation since it is also an external investment pool from the perspective of the campus foundation.

Also, from the perspective of the campus foundations, if a campus foundation has individual securities as investments that are "separately invested" by the Treasurer, they <u>**are**</u> exposed to custodial credit risk, although it is likely that these investments do not represent a significant portion of the investment portfolio and, therefore, disclosure may not be required on that basis. The securities are uninsured and are not registered in the name of the campus foundation; they are registered in the University's name. While the University does not have custodial risk disclosure requirements in these circumstances, the separate foundations do.

Since the campus foundations are included in the UC financial statements and footnotes, custodial credit risk information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Financial Reporting Package (see Q&A No. 7).

6. CONCENTRATION OF CREDIT RISK (GASB 40, ¶11)

Concentration of Credit Risk—Investments and Investment of Cash Collateral

Disclosure of the policy with respect to the concentration of credit risk and the investments must be made in the University's financial statements if any investments in any one issuer represent 5 percent or more of total investments.

For purposes of making the calculation, affiliates and subsidiaries of parent corporations may be engaged in similar activities and may have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. In these cases, the University (or UCRS or a campus foundation) should consider the credit risk of the parent company, its affiliates, and its subsidiaries in determining whether the University holds a concentration of credit risk. For example, if the University holds Ford Motor Co. common stock and a Ford Motor Credit Co. bond, they should be combined in the concentration of credit risk calculations (see Q&A No. 31). Investments issued or guaranteed by the U.S. government and investments in mutual funds, external investment pools and other pooled investments are excluded from the requirement.

Given The Regents' investment policies, it is highly unlikely that the 5 percent threshold would be met. Similarly, the fixed income guidelines also make it highly unlikely any issue could exceed 5 percent of the portfolio value. However, inclusion of affiliates and subsidiaries of the parent in the definition of the issuer, combined with aggregating equity and debt securities of the issuer, may result in UC exceeding the threshold.

The total investments, 5 percent threshold and largest individual holding in one issuer (equity or non-U.S. government fixed income securities) for the University, UCRP and DCP/403(b) will be analyzed as of June 30 of each year as follows:

			Largest Holding		
	Total Investments (x 000)	**5% Threshold** (x 000)	**Issuer**	**Amount**	**Percent**
University					
UCRP					
DCP/403(b)					
Investment of cash collateral:					
University					
UCRP					
DCP/403(b)					

This test must be conducted each year in order to verify that securities from any one issuer are below 5 percent of total investments and investment of cash collateral for the University, UCRP and DCP/403(b).

For the test of the University's assets, we will identify the top five issuers (excluding issuers that are excluded from this requirement, e.g., securities guaranteed by the U.S. government, open-end mutual funds, external investment pools, etc) in the GEP and STIP pools. These issuers, along with any related subsidiaries, will be used to compare to 5 percent of the total investments.

For the test for the UCRP assets, we will identify the top five equities and top five fixed income issuers (excluding issuers that are excluded from this requirement, e.g., U.S. government mutual funds, etc). These issuers, along with any related subsidiaries, will be used to compare to the 5 percent of the total investments.

For the test for the 403(b) assets, we will identify the top five equities in the Equity Fund and the top five fixed income issuers in the Bond Fund (excluding issuers that are excluded from this requirement, e.g., U.S. government mutual funds, etc). These issuers, along with any related subsidiaries, will be used to compare to the 5 percent of the total investments. The Savings Fund is virtually all U.S.government securities, the TIPS fund is also all U.S. government securities, and the ICC fund are contracts so there is no need to select securities from those Funds.

Concentration of Credit Risk—Investments Held by Trustees

Self-Insurance Programs

Generally, investments held by trustees related to self-insurance programs are held in commingled funds. Investments issued or guaranteed by the U.S. government and investments in mutual funds, external investment pools and other pooled investments are excluded from this reporting requirement

Should the investment holdings change, then the concentration of credit risk principles will apply to the investments held by trustees related to self-insurance programs. The University will identify the top five issuers in the combined self-insurance trusts, excluding issuers that are excluded from this requirement (e.g., securities guaranteed by the U.S. government, open-end mutual funds, external investment pools, etc.). These issuers, along with any related subsidiaries, will be used to compare to 5 percent of the total investments.

Long-Term Debt

The concentration of credit risk principles do not apply investments held by trustees related to long-term debt s because the University considers them to be a deposit rather than an investment.

Capital Projects

The concentration of credit risk principles do not apply to the proceeds from the sale of state lease-revenue bonds because the University considers them to be a deposit rather than an investment.

Concentration of Credit Risk—Medical Centers, CEB, UC Press and H&W Plans

The concentration of credit risk principles do not apply to the medical centers, CEB, UC Press, and H&W plans, etc, investment in the University's STIP shown on their separately audited financial statements since they are treated as a deposit.

Concentration of Credit Risk—Campus Foundations

The concentration of credit risk principles apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

Campus foundation investments in the STIP, GEP or a State Street CAM pool are not included in the concentration of credit risk tests since they are external investment pools from the perspective of the campus foundations. However, separate investments with the Treasurer must be considered in the concentration of credit risk test at the individual security level.

Since the campus foundations are included in the UC financial statements and footnotes, information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Reporting Package (see Q&A No. 7).

7. INTEREST RATE RISK (GASB 40, ¶14-16)

Interest Rate Risk—Investments, Investment of Cash Collateral and Unique Investments Terms

Interest rate information for the University's debt instruments, including individual securities, mutual funds, external investment pools or other pooled investments that do not meet the definition of a 2a7-like pool, must be disclosed by investment type using one of the following methods:

- Segmented time distribution
- Specific identification
- Weighted average maturity
- Duration
- Simulation model

Investments

The University will use the effective duration method for investment footnote disclosure purposes since it is most consistent with the method the Treasurer's Office uses to manage interest rate risk.

The University's position is that the effective duration for mortgage loans is zero when there are variable interest rates, zero for money market funds (other than the STIP) due to the $1.00/share constant, and zero for insurance contracts since there is no loss of principal from early withdrawal.

Although the STIP is classified as commingled money market funds (if they are not treated as cash and cash equivalents on the statement of net assets), investments in the STIP are subject to interest rate risk disclosure because the STIP does have some investment securities that mature in several years, as well as some mortgage-based securities that mature in 30 years.

In addition, the University also concludes that commingled balanced funds are not subject to interest rate risk disclosure since there is no interest rate risk profile for equity securities.

Disclosure in the investments and securities lending footnotes in the University's financial statements has been expanded to address interest rate risk as follows (GASB Statement No. 40, ¶15):

Revised Disclosure Detail—Interest Rate Risk: Investments

	Effective Duration
Fixed or variable income securities:	
▪ U.S. government:	
▫ U.S. Treasury bills	x.x
▫ U.S. Treasury notes	x.x
▫ U.S. Treasury bonds	x.x
▫ U.S. Treasury strips	x.x
▫ U.S. TIPS	x.x
▫ U.S. government-backed securities	x.x
▫ U.S. government-backed–asset-backed securities	x.x

Revised Disclosure Detail—Interest Rate Risk: Investments

	Effective Duration
▪ Other U.S. dollar denominated:	
▫ Corporate bonds	x.x
▫ Commercial paper	x.x
▫ Repurchase agreements	x.x
▫ U.S. agencies	x.x
▫ U.S. agencies–asset-backed securities	x.x
▫ Corporate–asset-backed securities	x.x
▫ Certificates of deposit/time deposits	x.x
▫ Corporate structured financial instruments	x.x
▫ Supranational/foreign	x.x
▫ Other	x.x
▪ Foreign currency denominated:	
▫ Government/sovereign	x.x
▫ Corporate	x.x
Commingled funds–U.S. bond funds	x.x
Commingled funds–non-U.S. bond funds	x.x
Commingled funds–money market funds	0.0
Investment derivatives[1]	x.x
Mortgage loans (fixed rates)	x.x
Mortgage loans (variable rates)	0.0
Insurance contracts	0.0
Investment derivatives[1]	
▪ Forward contracts on a to-be-announced basis	x.x

[1] Detailed information regarding the implementation of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is available on the UCOP GASB website.

Investments of Cash Collateral

The University will use the weighted average maturity method for securities lending footnote disclosure purposes since the nature of these investments are more likely to be liquid.

Disclosure in the investments and securities lending footnotes in the University's financial statements has been expanded to address interest rate risk as follows (GASB Statement No. 40, ¶15):

Revised Disclosure Detail—Interest Rate Risk: Investment of Cash Collateral

	Weighted Average Maturity
Fixed income securities:	
▪ U.S. government:	
▫ U.S. Treasury bills	x.x
▫ U.S. Treasury notes	x.x
▫ U.S. Treasury bonds	x.x
▫ U.S. Treasury strips	x.x
▫ U.S. TIPS	x.x
▫ U.S. government-backed securities	x.x
▫ U.S. government-backed–asset-backed securities	x.x
▪ Other U.S. dollar denominated:	
▫ Corporate bonds	x.x
▫ Commercial paper	x.x
▫ Repurchase agreements	x.x
▫ U.S. agencies	x.x
▫ U.S. agencies–asset-backed securities	x.x
▫ Corporate–asset-backed securities	x.x
▫ Certificates of deposit/time deposits	x.x
▫ Corporate structured financial instruments	x.x
▫ Supranational/foreign	x.x
▫ Other	x.x
▪ Foreign currency denominated:	
▫ Government/sovereign	x.x
▫ Corporate	x.x
Mortgage loans (fixed rates)	x.x
Mortgage loans (variable rates)	0.0
Insurance contracts	0.0
Commingled funds–U.S. bond funds	x.x
Commingled funds–non-U.S. bond funds	x.x
Commingled funds–money market funds	0.0

Disclosure of Unique Investment Terms (GASB 40, ¶16)

The terms of certain debt securities are such that they may be "highly sensitive to changes in interest rates that are not adequately considered in the duration disclosure of interest rate risk." In these cases, the <u>fair value of each particular investment type and its terms must be separately disclosed.</u>

Factors that may influence the determination of a highly sensitive investment include the term-to-maturity of the investment, the likelihood of exercise of any of the embedded options, whether any caps or floors may be reached, etc (see Q&A No. 45).

Investments that <u>are</u> highly sensitive to changes in interest rates include, but are not limited to the following:

- Mortgage backed securities (because mortgage borrowers have the option of prepaying their mortgages…see Q&A No. 47), such as mortgage pass-through securities issued by:
  - Fannie Mae (Federal National Mortgage Association),
  - Ginnie Mae (Government National Mortgage Association), and
  - Freddie Mac (Federal Home Loan Mortgage Corporation).
- Structured Notes, such as range notes and index amortizing notes (see Q&A No. 48).
- Step-up notes and bonds (see Q&A No. 48).
- Variable-rate investments with coupon multipliers, depending on the effect of the multiplier (see Q&A Nos. 48 and 53).
- Variable-rate investments with coupons that vary inversely with a benchmark index (see Q&A No. 48 and 54).
- Certain collateralized mortgage obligations (CMO's), including:
  - Interest-only tranches (see Q&A No. 50).
  - Principal-only tranches (see Q&A No. 51).
- Securities with reset dates
- Securities with embedded options
- Variable-rate investments with inverse floaters (see Q&A No. 54).
- Convertible securities
- Securities with interest rate floors and caps (see Q&A No. 58).

Investments that are <u>not</u> highly sensitive to changes in interest rates include, but are not limited to the following:

- Certain classes of CMS's including:
  - Planned amortization tranches (see Q&A No. 52),
  - Some targeted amortization class tranches (see Q&A No. 52),
  - Sequential pay tranches (see Q&A No. 52).

Investments that are highly sensitive to changes in interest rates at the University include:

- Mortgage pass-through securities;
- Collateralized mortgage obligations;
- Structured notes; and
- Variable rate investments.

Interest Rate Risk—Investments Held by Trustees

Self-Insurance Programs

The interest rate risk principles apply to the investments held by trustees related to self-insurance programs. The effective duration for the securities held in these trusts will be required.

Long-Term Debt

The interest rate risk principles do not apply to investments held by trustees related to long-term debt because the University considers them to be a deposit rather than an investment.

Capital Projects

The interest rate risk principles do not apply to the proceeds from the sale of state lease-revenue bonds because the University considers them to be a deposit rather than an investment.

Interest Rate Risk—Medical Centers, CEB, UC Press and H&W Plans

The concentration of interest rate risk principles do not apply to the medical centers, CEB, UC Press and H&W plans, etc. investment in the STIP shown on their separately audited financial statements since they are treated as a deposit.

Interest Rate Risk—Campus Foundations

The interest rate risk principles apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

Campus foundations will need to communicate with the Treasurer's Office to obtain the effective duration for the STIP, GEP and fixed income and money market portions of a State Street CAM pool.

Since the campus foundations are included in the UC financial statements and footnotes, interest rate risk information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Reporting Package (see Q&A No. 7). <u>In the case of interest rate disclosure, this means that campus foundations will report the effective duration for investments and weighted average maturities for investments of cash collateral.</u>

8. FOREIGN CURRENCY RISK (GASB 40, ¶17)

Foreign Currency Risk—Deposits

University

The University's deposits that are exposed to foreign currency risk must be disclosed, including the U.S. dollar balances, organized by currency denomination.

Although not a significant exposure to the University, the Education Abroad Program requires the use of foreign currencies in a variety of countries. At June 30, the U.S. dollar balances, organized by currency denomination are as follows:

Currency Denomination	**U.S. Dollars**
List currency denomination	
Total	**$**

Due to the relatively minor amount of exposure, the University will disclose the following in its *Cash* footnote:

- The policy with respect to foreign currency deposits;
- The number of countries; and
- The U.S. dollar balances in total, rather than for each country.

Medical Centers, CEB, UC Press and H&W Plans

The foreign currency deposit risk principles apply to the medical centers, CEB, UC Press and the H&W Plans. However, there is no foreign currency exposure in the STIP.

Campus Foundations

The foreign currency deposit risk principles apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

To the extent that campus foundations classify their investment in the STIP as a cash and cash equivalent (i.e., as a demand deposit) there is no foreign currency exposure in the STIP.

Since the campus foundations are included in the UC financial statements and footnotes, information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Reporting Package (see Q&A No. 7).

Foreign Currency Risk—Investments Held by Trustees

Self-Insurance Programs, Long-Term Debt and Capital Projects

Based on an analysis of the securities in the portfolios, there is no foreign currency risk associated with investments held by trustees. The provisions of the indenture agreements related to long-term debt preclude investments in foreign securities.

At each year-end, the University will review the portfolios for foreign currency risk and provide the appropriate disclosure, as necessary.

Foreign Currency Risk—Investments and Investment of Cash Collateral

University

All UC's investments, including equity, debt security or real estate, that are exposed to foreign currency risk must be disclosed, including the U.S. dollar balances, organized by currency denomination and investment type.

The University will disclose the following in its *Investments* and *Securities Lending* footnote:

- The policy with respect to foreign currency investments;
- The U.S. dollar balances, organized by:
  - Currency denomination, and
  - Investment type.

If the University has an investment in an international mutual fund, disclosure is not required for individual investments in the fund. Disclosure of the fair value and type of investment is sufficient (see Q &A, No. 62).

Disclosure in the *Investment* and *Securities Lending* footnotes in the University's financial statements has been expanded to address foreign currency risk as follow:

Currency Denomination	U.S. Dollars
Equity securities:	
List currency denomination	
Fixed income securities:	
List currency denomination	
Commingled funds (various currency denominations):	
Balanced funds	
Non-U.S. equity funds	
Non-U.S. bond funds	
Real estate investment trusts	
Investment derivatives: [1]	
List currency denomination	
Private equity:	
List currency denomination	
Real estate:	
List currency denomination	
Total	**$**

[1] Detailed information regarding the implementation of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, is available on the UCOP GASB website.

Medical Centers, CEB, UC Press and H&W Plans

The foreign currency investment risk does not apply to the medical centers, CEB, UC Press and H&W plans investment in the STIP shown on their separately audited financial statements since they are treated as a deposit.

Campus Foundations

The foreign currency investment risk principles apply to the campus foundations. Each will need to perform their own review to determine the nature and extent of the disclosure required.

If a campus foundation invests in the GEP or the State Street CAM EAFE pool, they include securities that are denominated in foreign currencies and require foreign currency risk disclosure. Both are external investment pools to the campus foundation. The State Street CAM EAFE pool qualifies as an international mutual fund where disclosure is not required for individual investments in the fund (see Q&A No. 62). While the GEP is not an international fund, and is certainly not a limited partnership that has investments in various foreign countries, there are aspects of the answer to Q&A No. 61 that are logical to apply to the GEP circumstance where disclosure is not required for individual investments in the fund. In addition, it is likely that the campus foundation's foreign currency-denominated investments contained in either the GEP or the State Street CAM EAFE pool are not significant in relation to the foundation's overall investments. Therefore, for the foundations, in the case of the GEP and the State Street CAM EAFE pool investments, disclosure of the fair value and type of investment is likely to be sufficient to acknowledge exposure to foreign currency risk. The campus foundations must work with the Treasurer's Office and State Street to determine their proportionate share of equity and fixed income investments in these two pools.

Since the campus foundations are included in the UC financial statements and footnotes, information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Reporting Package (see Q&A No. 7).

9. FUTURES AND OPTIONS CONTRACTS

University

If investment guidelines allow the use of futures and options contracts, there is a need for disclosure of the notional value of the contracts.

Medical Centers, CEB, UC Press and H&W Plans

This is not applicable.

Campus Foundations

Since the campus foundations are included in the UC financial statements and footnotes, information consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB 39 Campus Foundation Reporting Package.

10. LIQUIDITY RISK

University

Alternative investments are subject to liquidity risk. Alternative investments are defined as marketable alternatives (hedge funds), limited partnerships, private equity, venture capital funds and certain asset-backed securities.

Alternative investments include ownership interests in a wide variety of vehicles including partnerships and corporations that may be domiciled in the United States or off-shore. Generally, there is little or no regulation of these investment vehicles by the Securities and Exchange Commission or the applicable state agencies. Managers of these investments employ a wide variety of strategies and have areas of concentration including absolute return, venture capital or early stage investing, private equity or later stage investing and the underlying investments may be leveraged to enhance the total investment return. Each asset class has guidelines and policies regarding the use of leverage. Such underlying investments may include financial assets such as marketable securities, non-marketable securities, derivatives and other synthetic and structured investments as well as tangible and intangible assets.

These securities do not have a ready market and ownership interests in these investment vehicles may not be traded without the approval of the general partner or fund management. These investments are subject to the risks generally associated with equities and fixed income instruments with additional risks due to leverage and the lack of a ready market for acquisition or disposition of ownership interests.

Depending on the securities held in the portfolios at year-end, the disclosure detail for alternatives investments may include the following:

Disclosure Detail—Liquidity Risk

Alternative investments:

- Private equity
- Absolute return funds
- Corporate–asset-backed securities
- Real estate
- Real assets

Medical Centers, CEB, UC Press and H&W Plans

The liquidity risk principles do not apply.

Campus Foundations

The liquidity risk principles apply to the campus foundations. Since the campus foundations are included in the UC financial statements and footnotes, information consistent with the UC level of detail will need to be accumulated by completing the *Liquidity Risk* templates in the GASB 39 Campus Foundation Reporting Package.

APPENDIX A—GLOSSARY OF TERMS

Asset-backed securities
Assets that are composed of, or collateralized by, loans or receivables. Collateralization can consist of liens on real property, leases, or credit card debt.

Closed-end mutual fund
An SEC-registered investment company that issues a limited number of shares to investors which are then traded as an equity security on a stock exchange. See also Open-end mutual fund.

Debt security
Any security that represents a creditor relationship with an entity. It also includes (a) preferred stock that either is required to be redeemed by the issuing entity or is redeemable at the option of the investor and (b) a collateralized mortgage obligation (CMO) or other instrument that is issued in equity form but is accounted for as a nonequity instrument. However, it excludes option contracts, financial futures contracts, and forward contracts.

- Thus, the term *debt security* includes, among other items, U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, convertible debt, commercial paper, negotiable certificates of deposit, securitized debt instruments (such as CMOs and real estate mortgage investment conduits—REMICs), and interest-only and principal-only strips.
- Trade accounts receivable arising from sales on credit and loans receivable arising from real estate lending activities of proprietary activities are examples of receivables that do not meet the definition of a security; thus, those receivables are not debt securities. (If, however, they have been securitized, they would then meet the definition.)

Equity security
Any security that represents an ownership interest in an entity, including common, preferred, or other capital stock; unit investment trusts; and closed-end mutual funds. However, the term *equity security* does not include convertible debt or preferred stock that is either required to be redeemed by the issuing entity or is redeemable at the option of the investor.

External investment pool
An arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio; one or more of the participants is not part of the sponsor's reporting entity. An external investment pool can be sponsored by an individual government, jointly by more than one government, or by a nongovernmental entity. An investment pool that is sponsored by an individual state or local government is an external investment pool if it includes participation by a legally separate entity that is not part of the same reporting entity as the sponsoring government. If a government-sponsored pool includes *only* the primary government and its component units, it is an internal investment pool and not an external investment pool.

Fair value
The amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Individual investment accounts
An investment service provided by a governmental entity for other, legally separate entities that are not part of the same reporting entity. With individual investment accounts, specific investments are acquired for individual entities and the income from and changes in the value of those investments affect only the entity for which they were acquired.

Interest-earning investment contract
A direct contract, other than a mortgage or other loan, that a government enters into as a creditor of a financial institution, broker-dealer, investment company, insurance company, or other financial services company and for which it receives, directly or indirectly, interest payments. Interest-earning investment contracts include time deposits with financial institutions (such as certificates of deposit), repurchase agreements, and guaranteed and bank investment contracts (GICs and BICs).

Internal investment pool
An arrangement that commingles (pools) the moneys of more than one fund or component unit of a reporting entity. Investment pools that include participation by legally separate entities that are not part of the same reporting entity as the pool sponsor are not internal investment pools, but rather are external investment pools.

Investment
A security or other asset acquired primarily for the purpose of obtaining income or profit.

Money market investment
A short-term, highly liquid debt instrument, including commercial paper, banker's acceptances, and U.S. Treasury and agency obligations. Asset-backed securities, derivatives, and structured notes are not included in this term.

Open-end mutual fund
An SEC-registered investment company that issues shares of its stock to investors, invests in an investment portfolio on the share-holder's behalf, and stands ready to redeem its shares for an amount based on its current share price. An open-end mutual fund creates new shares to meet investor demand, and the value of an investment in the fund depends directly on the value of the underlying portfolio. Open-end mutual funds include governmental external investment pools that are registered as investment companies with the SEC and that operate as open-end funds.

Option contract
A contract giving the buyer (owner) the right, but not the obligation, to purchase from (call option) or sell to (put option) the seller (writer) of the contract a fixed number of items (such as shares of equity securities) at a fixed or determinable "strike" price on a given date or at any time on or before a given date.

Participation
The ability of an investment to capture market (interest rate) changes through the investment's negotiability or transferability, or redemption terms that consider market rates.

Restricted stock
Equity securities whose sale is restricted at acquisition by legal or contractual provisions (other than in connection with being pledged as collateral) except if that restriction terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can reasonably be expected to qualify for sale within one year, such as may be the case under SEC Rule 144 (17 *Code of Federal Regulations* §230.144) or similar rules of the SEC, is not considered restricted.

Security
A transferable financial instrument that evidences ownership or creditorship, whether in physical or book entry form.

Sponsoring government
A government entity that provides investment services—whether an investment pool or individual investment accounts—to other entities and that therefore has a fiduciary responsibility for those investments.

Stock rights
Rights given to existing stockholders to purchase newly issued shares in proportion to their holdings at a specific date.

Stock warrants
Certificates entitling the holder to acquire shares of stock at a certain price within a stated period. Warrants often are made part of the issuance of bonds or preferred or common stock.

Structured notes
Debt securities whose cash flow characteristics (coupon, redemption amount, or stated maturity) depend on one or more indexes, or that have embedded forwards or options.

2a7-like pool
An external investment pool that is not registered with the SEC as an investment company, but nevertheless has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940 (17 *Code of Federal Regulations* §270.2a-7). Rule 2a7 allows SEC-registered mutual funds to use amortized cost rather than market value to report net assets to compute share prices if certain conditions are met. Those conditions include restrictions on the types of investments held, restrictions on the term-to-maturity of individual investments and the dollar-weighted average of the portfolio, requirements for portfolio diversification, requirements for divesture considerations in the event of security downgrades and defaults, and required actions if the market value of the portfolio deviates from amortized cost by a specified amount.

APPENDIX B—CATEGORIZING SECURITIES

EQUITY SECURITIES

Equity securities include common and preferred stocks, convertible securities, American depository receipts, and securities of foreign corporations listed on the New York Stock exchange, American stock exchange, NASDAQ, and foreign exchanges.

Domestic

- Individual common and preferred stocks of U.S. corporations that are purchased in U.S. currency. This also includes common and preferred stocks in non-U.S. corporations that are traded in U.S. currency.

Foreign

- Individual common and preferred stocks of non-U.S. companies that are purchased in a local (non-U.S.) currency.
- Individual ADRs (American Depository Receipts).

FIXED INCOME SECURITIES

Fixed income securities include U.S. and foreign government securities, government agency bonds and domestic and foreign corporate bonds.

U.S. Government

U.S. Treasury Bills, Notes & Bonds

- Bills, notes or bonds that are issued, insured or guaranteed by the U.S. government.

U.S. Treasury Strips

- Stripped securities that are issued, insured or guaranteed by the U.S. government.

U.S. Treasury Inflation Protection Securities (TIPS)

- Treasury Inflation Protection Securities that are issued, insured or guaranteed by the U.S. government.

U.S. Government Backed Securities

- Bonds or notes issued by a federal government agency that are insured or guaranteed by the U.S. government.

U.S. Government Backed – Asset Backed Securities

- Asset-backed securities issued by a federal government agency that are insured or guaranteed by the U.S. government.

Other U.S. Dollar Denominated

Corporate Bonds

- Bonds or notes issued by U.S. corporations in U.S. dollar denominations.

Commercial Paper

- Commercial paper issued by U.S. corporations in U.S. dollar denominations.

Repurchase Agreements

- Repurchase agreements issued by U.S. corporations in U.S. dollar denominations that are not defined as a derivative instrument per GASB Statement No. 53.

U.S. Agencies

- Bonds or notes issued by U.S. federal agencies, but not insured or guaranteed by the U.S. government, in U.S. dollar denominations

U.S. Agencies-Asset Backed Securities

- Asset backed securities issued by U.S. federal agencies but not insured or guaranteed by the U.S. government in U.S. dollar denominations.

Corporate – Asset Backed Securities

- Asset backed securities issued by U.S. corporations in U.S. dollar denominations.
- TBA asset-backed securities that are not defined as a derivative instrument per GASB Statement No. 53.

Certificates of Deposit

- Certificates of deposit issued by U.S. corporations in U.S. dollar denominations.

Supranational/Foreign

- Bonds or notes issued by foreign sovereign, supranationals (i.e., an entity that is formed by two or more central governments through international treaty), foreign agencies or foreign corporations in U.S. dollar denominations.
- Asset backed securities issued by foreign sovereign, supranationals, foreign agencies or foreign corporations in U.S. dollar denominations.

Other

- Municipal bonds issued by institutions within the U.S (e.g., state, local or U.S. territory governments), in U.S. dollar denominations.
- Time deposits issued by U.S. banks or corporations, in U.S. dollar denominations.

Foreign Currency Denominated

Government/Sovereign

- Bonds or notes issued by foreign sovereign, supranationals (i.e., an entity that is formed by two or more central governments through international treaty), or foreign agencies denominated in currencies other than U.S. dollars.
- Asset backed securities issued by foreign sovereign, supranationals, or foreign agencies denominated in currencies other than U.S. dollars.

Corporate

- Bonds or notes of corporations denominated in currencies other than U.S. dollars.
- Asset backed securities of foreign corporations denominated in currencies other than U.S. dollars.

COMMINGLED FUNDS – ABSOLUTE RETURN

- Investments in an absolute return strategy through an external investment pool, for example long/short equity, market neutral equity, convertible bond arbitrage, distressed securities, currencies and global asset allocation.

COMMINGLED FUNDS – BALANCED FUNDS

- Investments in external commingled funds that have an asset allocation including both an equity and a fixed income component.
- From the perspective of the campus foundations, this category will also include their interest in the GEP managed by the Treasurer.

COMMINGLED FUNDS – U.S. EQUITY FUNDS

- Investments in external commingled funds that invest primarily in U.S. equity securities.
- From the perspective of the campus foundations, this category will also include their interest in the Russell 3000 pool at State Street CAM.
- U.S. equity funds that may be in a commingled global fund (an external commingled fund that invests U.S. dollars or foreign currencies primarily in equity securities from the U.S., international developed countries and emerging market countries). This will require an analysis of investments in commingled global funds to determine the allocation between U.S. equities and non-U.S. equities. If the foundation cannot determination the ratio, then contact Bob Yastishak at the Treasurer's Office at 510.987.9668 or robert.yastishak@ucop.edu.

COMMINGLED FUNDS – NON-U.S. EQUITY FUNDS

- Investments in external commingled funds that invest primarily in non- U.S. equity securities. Investments may be in U.S. or foreign currencies.
- From the perspective of the campus foundations, this category will also include their interest in the EAFE pool at State Street CAM.

- Non-U.S. equity funds that may be in a commingled global fund (an external commingled fund that invests U.S. dollars or foreign currencies primarily in equity securities from the U.S., international developed countries and emerging market countries). This will require an analysis of investments in commingled global funds to determine the allocation between U.S. equities and non-U.S. equities. If the foundation cannot determination the ratio, then contact Bob Yastishak at the Treasurer's Office at 510.987.9668 or robert.yastishak@ucop.edu.

COMMINGLED FUNDS – U.S. BOND FUNDS

- Investments in external commingled funds that invest primarily in U. S. fixed income securities.
- From the perspective of the campus foundations, this category will also include their interest the fixed income pool at State Street CAM.

COMMINGLED FUNDS – NON-U.S. BOND FUNDS

- Investments in external commingled funds that invest primarily in non-U.S. fixed income securities. Investments may be in U.S. or foreign currencies.

COMMINGLED FUNDS – REAL ESTATE INVESTMENT TRUSTS

- Investments in external commingled funds that invest primarily in companies that engage in the ownership, operation or development of income-producing real estate, such as REITs and Real Estate Operating Companies (REOCs).

COMMINGLED FUNDS – MONEY MARKET FUNDS

- Investments in external commingled funds that invest primarily in money market securities.
- From the perspective of the campus foundations, this category will also include their interest in the STIP managed by the Treasurer and the money market pool at State Street CAM.

DERIVATIVE INSTRUMENTS

- Investments that are classified as derivatives per GASB Statement No. 53. These investments are typically futures contracts, TBA mortgage-backed securities, options, forward contracts, foreign currency exchange contracts, synthetic guaranteed insurance contracts, select repurchase agreements and interest rate swaps. Investments that are classified as either hedging or investment derivatives should be included.

PRIVATE EQUITY

- Venture capital partnerships.
- Buy-out funds.
- Include both U.S. and foreign partnerships. Foreign partnership investment may be in U.S. or foreign currencies. In the future, if the foreign partnerships are a significant dollar value they may be broken out separately.

MORTGAGE LOANS

- Mortgage loans that are made directly by the University, the MOP program loans.
- Mortgage loans that are made directly by the Foundation.

INSURANCE CONTRACTS

- Insurance contracts issued by the insurance companies where only the interest rate is guaranteed. Insurance *policies* should be included as Other Investments. ***Note:*** Synthetic guaranteed insurance contracts, as defined by GASB Statement No. 53, should ***not*** be included in this category, but should be reported under derivative investments.

REAL ESTATE

- Direct investments in real estate, both private investments and publicly traded REIT's.

FUTURES AND OPTIONS CONTRACTS

- Future, forward and option investments on securities, indices and other risk factors that are not defined as a derivative instrument per GASB Statement No. 53.

EQUITIZED MARKET NEUTRAL INVESTMENTS

- Equity funds which are structured to be invested equally long and short in the market. These products are equitized or contain index future overlays of an S&P 500 index or similar market index (e.g., Russell 3000).

EXTERNALLY HELD IRREVOCABLE TRUSTS/FUNDS HELD IN TRUST BY OTHERS

- Charitable trusts where the assets are invested and administered by outside trustees and distributions are made to the beneficiary under the terms of the trust arrangement.

OTHER INVESTMENTS

- Limited partnership units
- Insurance policies
- Foreign currency contracts not defined as a derivative instrument per GASB Statement No. 53
- Commodities
- Other investments not included above

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 1—Deposits

	Are UC's deposits exposed to custodial credit risk? (¶8)							
	Are deposits covered by depostiory insurance? [1]	and either	Uncollateralized? [2]	or	Collateralized with securities held by the pledging institution? [2]	or	Collateralized with securities held by the pledging institution's trust department or agent, but not in UC's name? [2]	**Conclusion: Disclosure Required?**
Deposits:								
Physically in bank	No (A)		Yes		N/A		N/A	Yes (A)
Sweep	No (B)		No		No		Yes	Yes (B)
On campus (DIT)	No (C)		N/A		No		No	No (C)
At credit card processor (DIT)	No		Yes		No		No	Yes

Notes:

Deposits:

(1) If "yes," the deposit is <u>not</u> exposed to custodial risk. If "no," continue the evaluation in order to arrive at the conclusion.

(2) If "yes," the deposit <u>is</u> exposed to custodial credit risk and the specific disclosures required under GASB 40, ¶8 are applicable. If "N/A," because the answer to (1) is "yes," then the specific disclosures under GASB 40, ¶8 are <u>not</u> applicable.

(A) Primarily in Bank of America (main depository), Union Bank of California (concentration bank), Wells Fargo Bank (medical center depository) and Mellon Bank (ACH disbursement bank). The FDIC insures bank balances to $100,000 per account.

(B) Sweep funds are secured by federal government obligations. This is an account at Bank of America investment account where the deposit is collateralized.

(C) DIT are physically not at the bank; therefore, technically there is no custodial risk associated with DIT.

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 1—Deposits

	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	**Does UC need a <u>policy</u> disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)**			
				Credit Risk			
				Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Deposits:							
Physically in bank	N/A	N/A	Yes (D)	N/A	N/A	N/A	Yes
Sweep	N/A	N/A	N/A	N/A	N/A	N/A	No
On campus (DIT)	N/A	N/A	N/A	N/A	N/A	N/A	No
At credit card processor (DIT)	N/A	N/A	N/A	N/A	N/A	N/A	No

Notes

(D) See the attached schedule of deposits held in foreign currencies.

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Are UC's investment securities exposed to custodial credit risk? (¶9)							
					Are held either by…			
	Are securities insured? (2)	or	Are securities registered in the name of UC? (2) *List the Street Name, if applicable.*	and	The counterparty (3)	or	The counterparty's trust department but not in UC's name (3)	**Conclusion: Disclosure Required?**
Investments:								
Equity securities:								
Domestic:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes - Shellwater/Cactus Breeze (Russell 3000, UC Distribution)		N/A		N/A	No
Goldman Sachs	Yes		No(4)		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Foreign:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes - Cactus Breeze (EAFE)		N/A		N/A	No
Goldman Sachs	Yes		No(4)		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Fixed income securities:								
U.S. government:								
U.S. Treasury bills, botes, & bonds:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes - Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Are UC's investment securities exposed to custodial credit risk? (¶9)							
					Are held either by…			
	Are securities insured? (2)	or	Are securities registered in the name of UC? (2) *List the Street Name, if applicable.*	and	The counterparty (3)	or	The counterparty's trust department but not in UC's name (3)	**Conclusion: Disclosure Required?**
U.S. Treasury strips								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
U.S. TIPS								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
U.S. government-backed securities								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
U.S. government-backed asset-backed securities:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Other U.S. dollar denominated: Corporate bonds:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Are UC's investment securities exposed to custodial credit risk? (¶9)							
					Are held either by…			
	Are securities insured? (2)	or	Are securities registered in the name of UC? (2) *List the Street Name, if applicable.*	and	The counterparty (3)	or	The counterparty's trust department but not in UC's name (3)	**Conclusion: Disclosure Required?**
Commercial paper	No		Yes -Shellwater		N/A		N/A	No
Repurchase agreements	No		Yes -Shellwater		N/A		N/A	No
U.S. agencies	No		Yes -Shellwater		N/A		N/A	No
U.S. agencies - asset backed securities	No		Yes -Shellwater		N/A		N/A	No
Corporate - asset backed securities	No		Yes -Shellwater		N/A		N/A	No
Certificates of deposit/time deposits	No		Yes -Shellwater		N/A		N/A	No
Corporate structured financial instruments	No		Yes -Shellwater		N/A		N/A	No
Supranational/foreign	No		Yes -Shellwater		N/A		N/A	No
Other	No		TBD		N/A		N/A	TBD
Foreign currency denominated: Government/sovereign								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Corporate								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Yes -Shellwater		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Private equity	No		Book entry only in partnership's records		N/A		N/A	No
Absolute return	No		Book entry only in partnership's records		N/A		N/A	No
Mortgage loans	No		Title documents in Regents' name		N/A		N/A	No

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Are UC's investment securities exposed to custodial credit risk? (¶9)							
					Are held either by…			
	Are securities insured? (2)	or	Are securities registered in the name of UC? (2) *List the Street Name, if applicable.*	and	The counterparty (3)	or	The counterparty's trust department but not in UC's name (3)	**Conclusion: Disclosure Required?**
Insurance contracts:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Contracts in insurance company's records in Regents' name		N/A		N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Real estate:								
Ext inv pool(1)	N/A		N/A		N/A		N/A	No
Open-end mutual funds(1)	N/A		N/A		N/A		N/A	No
State Street	No		Title documents in Regents' name				N/A	No
Other custodians	N/A		N/A		N/A		N/A	N/A
Futures and options contracts	No		Do not know		N/A		N/A	TBD
Commingled funds - balanced funds	No		Commingled fund - Book entry in fund records		N/A		N/A	No
Commingled funds - U.S. equity funds	No		Commingled Fund - Book entry in fund records		N/A		N/A	No
Commingled funds - non-U.S. equity funds	No		Commingled fund - Book entry in fund records		N/A		N/A	No
Commingled funds - U.S. bond funds	No		Commingled fund - Book entry in fund records		N/A		N/A	No
Commingled funds - non-U.S. bond funds	No		Commingled fund - Book entry in fund records		N/A		N/A	No

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Are UC's investment securities exposed to custodial credit risk? (¶9)							
					Are held either by…			
	Are securities insured? (2)	or	Are securities registered in the name of UC? (2) *List the Street Name, if applicable.*	and	The counterparty (3)	or	The counterparty's trust department but not in UC's name (3)	**Conclusion: Disclosure Required?**
Commingled funds - money market funds	No		Commingled fund - Book entry in fund records		N/A		N/A	No
Other investments (List)	TBD		TBD		TBD		TBD	TBD

Notes

(1) Investments held in external investment pools or in open-end mutual funds are not exposed to custodial credit risk.

Investments:

(2) If "yes," the securities are <u>not</u> exposed to custodial credit risk. If "no," continue the evaluation in order to arrive at the conclusion.

(3) If "yes," the securities <u>are</u> exposed to custodial credit risk and the specific disclosures required under GASB 40 ¶9 are applicable.

(4)

While the securities are registered in the custodian's name by the custodial bank, physical certificates are held in a vault, segregated in bulk on a fungible basis and identified on its books and records (in separate accounts) as interests of the University, as the client. As such, our conclusion is these investments are not exposed to custodial credit risk reporting requirements. In the even of insolvency, creditors cannot attach the security accounts of the University. The University's securities are excludable from the real or personal property of the custodian as the assets are properly identified on the books and records of the custodian and properly segregated.

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	**Does UC need a policy disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)** Credit Risk			
				Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Investments:							
Equity securities:							
Domestic:							
Ext inv pool[1]	No	No	No	No	TBD	No	No
Open-end mutual funds[1]	No	No	No	No	TBD	No	No
State Street	TBD	No	No	No	TBD	No	No
Goldman Sachs	TBD	No	No	No	TBD	No	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign:							
Ext inv pool[1]	No	No	Yes	No	TBD	No	Yes
Open-end mutual funds[1]	No	No	Yes	No	TBD	No	Yes
State Street	TBD	No	Yes	No	TBD	No	Yes
Goldman Sachs	TBD	No	Yes	No	TBD	No	Yes
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Fixed income securities:							
U.S. government:							
U.S. Treasury bills, botes, & bonds:							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

				Does UC need a **policy** disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)			
				Credit Risk			
	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
U.S. Treasury strips							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
U.S. TIPS							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
U.S. government-backed securities							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
U.S. government-backed asset-backed securities:							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Other U.S. dollar denominated: Corporate bonds:							
Ext inv pool[1]	No	Yes	No	No	No	Yes	No
Open-end mutual funds[1]	No	Yes	No	No	No	Yes	No
State Street	TBD	Yes	No	No	TBD	Yes	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Does UC have a concentration of credit risk? (¶11)	Does UC have an interest rate risk? (¶14)	Does UC have foreign currency risk? (¶17)	Does UC need a policy disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)			
				Credit Risk			
				Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Commercial paper	TBD	Yes	No	No	TBD	Yes	No
Repurchase agreements	TBD	Yes	No	No	TBD	Yes	No
U.S. agencies	TBD	Yes	No	No	TBD	Yes	No
U.S. agencies - asset backed securities	TBD	Yes	No	No	TBD	Yes	No
Corporate - asset backed securities	TBD	Yes	No	No	TBD	Yes	No
Certificates of deposit/time deposits	TBD	Yes	No	No	TBD	Yes	No
Corporate structured financial instruments	TBD	Yes	No	No	TBD	Yes	No
Supranational/foreign	TBD	Yes	No	No	TBD	Yes	No
Other	TBD	Yes	No	No	TBD	Yes	No
Foreign currency denominated:							
Government/sovereign							
Ext inv pool(1)	No	Yes	Yes	No	No	Yes	Yes
Open-end mutual funds(1)	No	Yes	Yes	No	No	Yes	Yes
State Street	TBD	Yes	Yes	No	TBD	Yes	Yes
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Corporate							
Ext inv pool(1)	No	Yes	Yes	No	No	Yes	Yes
Open-end mutual funds(1)	No	Yes	Yes	No	No	Yes	Yes
State Street	TBD	Yes	Yes	No	TBD	Yes	Yes
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Private equity	TBD	No	No	No	TBD	No	No
Absolute return	No	Yes	No	No	No	Yes	No
Mortgage loans	TBD	Yes	No	No	TBD	Yes	No

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	**Does UC need a <u>policy</u> disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)**			
				Credit Risk			
				Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Insurance contracts:							
Ext inv pool[1]	No	N/A	No	No	No	No	No
Open-end mutual funds[1]	No	N/A	No	No	No	No	No
State Street	TBD	No	No	No	TBD	No	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Real estate:							
Ext inv pool[1]	No	No	No	No	No	No	No
Open-end mutual funds[1]	No	No	No	No	No	No	No
State Street	TBD	No	No	No	TBD	No	No
Other custodians	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Futures and options contracts	TBD	No	No	No	TBD	No	No
Commingled funds - balanced funds	No	Yes	No	No	No	Yes	No
Commingled funds - U.S. equity funds	No	No	No	No	No	No	No
Commingled funds - non-U.S. equity funds	No	No	Yes	No	No	No	TBD
Commingled funds - U.S. bond funds	No	Yes	No	No	No	Yes	No
Commingled funds - non-U.S. bond funds	No	Yes	Yes	No	No	Yes	TBD

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 2—Investments

				Does UC need a policy disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)			
				Credit Risk			
	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Commingled funds - money market funds	No	No	No	No	No	No	No
Other investments (List)	TBD	TBD	TBD	No	TBD	TBD	TBD

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 3—Investments Held by Trustees

	Are UC's deposits exposed to custodial credit risk? (¶8)						
	Are deposits covered by depostiory insurance? (1)	and either	Uncollateralized? (2)	or	Collateralized with securities held by the pledging institution? (2)	or	Collateralized with securities held by the pledging institution's trust department or agent, but not in UC's name? (2)	**Conclusion: Disclosure Required?**
Investments Held by Trustees:								
Evaluated as deposits:								
SPWB trustees	No		No		Yes		No	Yes
Evaluated as investments:								
Self-insurance: Trust Company of the West	N/A		N/A		N/A		N/A	N/A
Long-term debt: Bank of New York	N/A		N/A		N/A		N/A	N/A
Long-term debt: US Bank	N/A		N/A		N/A		N/A	N/A

Notes:

(1) If "yes," the deposit is not exposed to custodial risk. If "no," continue the evaluation in order to arrive at the conclusion.

(2) If "yes," the deposit is exposed to custodial credit risk and the specific disclosures required under GASB 40, ¶8 are applicable.
If "N/A," because the answer to (1) is "yes," then the specific disclosures under GASB 40, ¶8 are not applicable.

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 3—Investments Held by Trustees

	Are UC's investment securities exposed to custodial credit risk? (¶9)								
					Are held either by…				
	Are securities insured? (3)	or	Are securities registered in the name of UC? (3) *List the Street Name, if applicable.*	and	The counterparty(4)	or	The counterparty's trust department, but not in UC's name (4)		**Conclusion: Disclosure Required?**
Investments Held by Trustees:									
Evaluated as deposits:									
SPWB trustees	N/A		N/A		N/A		N/A		N/A
Evaluated as investments:									
Self-insurance: Trust Company of the West	No		No		No		Yes		Yes
Long-term debt: Bank of New York	No		Yes		Yes		No		No
Long-term debt: US Bank	No		Yes		Yes		No		No

Notes

(3) If "yes," the securities are <u>not</u> exposed to custodial credit risk. If "no," continue the evaluation in order to arrive at the conclusion.

(4) If "yes," the securities <u>are</u> exposed to custodial credit risk and the specific disclosures required under GASB 40 ¶9 are applicable.

Evaluation of Common Deposit and Investment Risks Under GASB 40

Exhibit 3—Investments Held by Trustees

	Does UC have a concentration of credit risk? (¶11)	**Does UC have an interest rate risk? (¶14)**	**Does UC have foreign currency risk? (¶17)**	**Does UC need a policy disclosure related to the following types of deposit or investment risks based upon the evaluation of the exposure? (¶6)** Credit Risk: Custodial credit risk	Concentrations of credit risk	Interest rate risk	Foreign currency risk
Investments Held by Trustees:							
Evaluated as deposits:							
SPWB trustees	N/A	N/A	No	No	No	No	No
Evaluated as investments:							
Self-insurance: Trust Company of the West	TBD(5)	Yes	TBD(6)	Yes	TBD	Yes	TBD(6)
Long-term debt: Bank of New York	TBD(5)	Yes	TBD(6)	No	TBD	Yes	TBD(6)
Long-term debt: US Bank	TBD(5)	Yes	TBD(6)	No	TBD	Yes	TBD(6)

Notes

(5) Evaluation of current portfolios indicate there is a concentration of credit risk (GECC Commerical Paper in the long-term debt portfolio). The University will evaluate the portfolios at each year-end.

(6) Current portfolios do not have foreign currency risk; however, they will continue to be evaluated each year-end.

EXHIBIT 4—FOOTNOTE: CASH
(University and Medical Center)

CASH—UNIVERSITY

See the University's *Cash* footnote at http://www.universityofcalifornia.edu/finreports/

CASH—MEDICAL CENTER
(Same approach for CEB, UC Press, H&W Plans, etc.)

See Medical Centers' *Cash* footnote at http://www.universityofcalifornia.edu/finreports/

EXHIBIT 5—FOOTNOTE: INVESTMENTS

INVESTMENTS—UNIVERSITY

See the University's *Investment* footnote at http://www.universityofcalifornia.edu/finreports/

EXHIBIT 6—FOOTNOTE: SECURITIES LENDING

SECURITIES LENDING—UNIVERSITY

See the University's *Securities Lending* footnote at http://www.universityofcalifornia.edu/finreports/

EXHIBIT 7—FOOTNOTE: INVESTMENTS HELD BY TRUSTEES

INVESTMENTS HELD BY TRUSTEES—UNIVERSITY

See the University's *Investments Held by Trustees* footnote at http://www.universityofcalifornia.edu/finreports/

13. HISTORICAL BACKGROUND

DETERMINING WHETHER SECURITIES ARE SUBJECT TO CUSTODIAL CREDIT RISK

In order to determine whether securities are subject to custodial credit risk under GASB Statement No. 40, paragraph 9 it may be useful to review the discussions of custodial credit risk presented in GASB Statement No. 3, paragraph 68, GASB's Technical Bulletin No. 87-1 and GASB Statement No. 40 Implementation Guide.

Paragraph 68 of GASB Statement No. 3 was superceded, in part, by GASB Statement No. 40, paragraph 9.

GASB Statement No. 3

GASB Statement No. 3, paragraph 68 describes the three categories of disclosure as it relates to custodial credit risk:

> **Paragraph 68.** The carrying amount and market value[11] of investments (including repurchase agreements) as of the balance sheet date should be disclosed in total and for each type of investment. The disclosure of carrying amounts by type of investment should be classified in these three categories of credit risk:
>
> a. Insured (see paragraph 25) or registered,[12] or securities held by the entity or its agent in the entity's name
>
> b. Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name
>
> c. Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount of any repurchase agreement that exceeds the market value of the underlying securities.)
>
> The term securities as used in this paragraph includes securities underlying repurchase agreements and investment securities.
>
> [11] If the governmental entity has invested in a pool managed by another government, such as city monies in a state treasurer's investment pool, no disclosure of the individual deposits and investments of the pool is required by this Statement unless the entity owns specific, identifiable investment securities of the pool. Instead, the investment in the pool should be treated as a type of investment with market value equal to the net realizable value of the entity's share of the pool based on the pool's valuation method.
>
> [12] Securities are considered registered for the purposes of this Statement only if registered in the name of the governmental entity.

GASB Technical Bulletin No. 87-1

GASB Technical Bulletin No. 87-1 was issued in order to assist entities in their evaluation of whether their circumstances fell into the categories prescribed in GASB Statement No. 3, paragraph 68.

Question 1

Paragraph 1. Should a financial institution or broker-dealer that purchases securities for a governmental entity be considered a counterparty for the purposes of applying paragraph 68 of GASB Statement 3?

Response

Paragraph 2. Yes. A financial institution or broker-dealer that acts as a purchasing agent by acquiring securities for an entity should be considered a counterparty for purposes of applying paragraph 68 of GASB Statement No. 3, whether the securities come from the institution's or broker-dealer's trading inventory or from the open market.

Paragraph 3. Paragraph 68 requires uninsured, unregistered investments (including repurchase agreements) to be classified in three credit risk categories based on *who* holds the securities (the governmental entity, the entity's agent, the counterparty's trust department or agent, or the counterparty) and, in the case of the counterparty's trust department or agent, *how* the securities are held (in the entity's name or not in the entity's name). Those three categories are:

a. Securities held by the entity or its agent in the entity's name (category a)

b. Securities held by the counterparty's trust department or agent in the entity's name (category b)

c. Securities held by the counterparty, or by its trust department or agent but not in the entity's name (category c).

Paragraph 4. The term agent as used in paragraph 68 refers to a financial institution or broker-dealer that is a *custodial agent* only. A governmental entity's custodial agent has a contractual relationship with the entity to h old, at the discretion of the entity, securities owned by or pledged to the entity. If a financial institution or broker-dealer is both the governmental entity's counterparty and the custodial agent in a transaction, its identity as the counterparty takes precedence in classifying securities for purposes of paragraph 68.

Paragraph 5. The term *trust department* as used in paragraph 68 refers only to the trust departments of financial institutions such as commercial banks, savings banks, and savings and loan associations. Assets held by those trust departments as custodial agents for outside parties are considered legally separate from the assets of the financial institution and are held strictly on a fiduciary basis. Those trust departments are authorized by and regulated under various state and federal laws. Nonfinancial institution broker-dealers do not have trust departments. Safe-keeping departments are not considered trust departments for the purpose of applying paragraph 68.

Paragraph 6. *Example 1:* A government instructs its broker to purchase $800,000 of U.S. government securities. The broker purchases the securities, holds them in its safekeeping account, and identifies them in its internal records as owned by the entity. The broker is a member of the Securities Investor Protection Corporation (SIPC) and, thus, its customers' accounts are insured to $500,000. In this situation, the government should classify $500,000 of its investment as insured (category a) and $300,000 as uninsured and unregistered, with securities held by the counterparty (category c).

Paragraph 7. *Example 2:* A governmental entity instructs a financial institution that is not a member of SIPC to purchase $800,000 of U.S. government securities. The financial institution's trading department purchases the securities and they are held by the financial institution's trust department. The trust department's internal records identify the securities as owned by the entity. The entity should classify the entire amount as uninsured and unregistered, with securities held by the counterparty's trust department in the entity's name (category b). However, if those securities are held in the financial institution's safekeeping department, even if held in the name of the entity, the entire amount should be classified as uninsured and unregistered, with securities held by the counterparty (category c).

Question 2

Paragraph 8. Some governmental entities, through their custodial banks, use the Federal Reserve and Depository Trust Company (DTC) book entry systems to hold their U.S. government, federal agency, and corporate securities. Those securities are not held or registered in the name of the governmental entity, but are instead held in the custodian's account at the Federal Reserve or at the DTC. How does the use of these book entry systems affect the disclosure by credit risk category required by paragraph 68 of GASB Statement 3?

Response

Paragraph 9. Governmental entities generally do not have their own accounts in the Federal Reserve or DTC book entry system; they have access to those systems through the accounts of Federal Reserve members or DTC participants.[1] Generally, only financial institutions and broker-dealers are members or participants. However, the fact that the Federal Reserve or DTC book entry system is used is not central to determining *who* holds the securities for purposes of applying GASB Statement 3. That is, the Federal Reserve or DTC generally should not be considered to be the party that holds the securities. Those systems are simply the "vault" in which the securities are held. The central question is, "In *whose* vault are the entity's securities held (i) the entity's agent, (ii) the counterparty's trust department or agent, or (iii) the counterparty?" As discussed below, if the entity's access to the book entry systems is provided through the accounts of its custodial bank, the securities are classified in category a, provided that they custodian is an agent of the entity, is holding the securities in the name of the entity, and is not the counterparty (or the trust department of the counterparty) to the sale or pledge of those securities to the entity.

1 Governmental entities may in certain situations maintain accounts in the Federal Reserve and Treasury book entry systems. These accounts do not have the flexibility of Federal Reserve member accounts and are generally used by governmental entities to hold securities on a long-term basis.

Paragraph 10. *Entity's Agent:* If the custodian is the entity's agent, the securities should be classified in category a, provided this agency relationship is based on a contractual relationship between the entity and the custodian that identifies the custodian as the entity's agent, and the securities are held in the name of the entity. Holding securities "in the name of the entity" means establishing the entity's rights to the securities. The entity's rights to and claims on securities it owns should be unconditional. The entity's rights to and claims on securities underlying repurchase agreements should be unconditional in the event of default by the counterparty to the agreement. In the Federal Reserve or DTC book entry system, the conditions that indicate securities are held in the name of the entity include having the securities held in a custodial or fiduciary account and identified as owned by or pledged to the entity in the custodian's internal accounting records. A custodial or fiduciary account is an account maintained in the Federal Reserve or DTC system separate from the account holding the custodian's own securities. The use of a custodial or fiduciary account indicates that the securities are owned or pledged to someone other than the custodian, although it may not indicate the identity of that party.

Paragraph 11. *Counterparty's Trust Department or Agent:* If the custodian is the counterparty's trust department or agent, credit risk classification depends on *how* the securities are held. If the securities are held in the name of the entity, they should be classified in category b. Conditions that indicate whether securities are held in the name of the entity include the use of a separate custodial or fiduciary Federal Reserve or DTC account, identification of the securities as those of the entity in the custodian's internal accounting records, and the custodian's recognition of the entity's rights to the securities. If the custodian is not holding the securities in the name of the entity, the securities should be classified in category c.

Paragraph 12. *Counterparty:* If the custodian in whose *Federal Reserve* account the securities are kept is the counterparty to the *sale* or *pledging* of securities, those securities should be classified in category c, regardless of any other measures the custodian has taken to segregate the securities. If the custodian in whose *DTC* account the securities are kept is the counterparty to the *sale* of securities, those securities also should be classified in category c. However, as discussed below, different conditions and rights may exist in the case of securities *pledged* through the DTC.

Paragraph 13. *Counterparty:* Pledging securities through the DTC book entry system involves a written agreement between DTC and the pledgee in which DTC agrees to follow the pledgee's instructions for handling those securities. The pledgee must be a DTC participant; therefore, entities must have a participant act on their behalf as the pledgee. DTC procedures and the written agreement between DTC and the pledgee provide that although pledged securities are initially placed in a segregated section of the pledgor's account, the pledgee has the right to demand that those securities be moved to its own account at any time and must approve any release of the pledge on the securities. In this situation, the securities should be considered to be in the pledgee's "vault" (that is, the pledgee has control) and should be classified in category a, b, or c, depending on *who* the pledgee is (the entity's agent or the counterparty's trust department or agent) and *how* the securities are held (in the entity's name or not in the entity's name).

GASB Statement No. 40

GASB Statement No. 40 was issued and paragraph 9 modified paragraph 68 of GASB Statement No. 3. Paragraph 9 of GASB Statement No. 40 states:

> **Paragraph 9.** Paragraphs 68 and 69 and their related footnotes [of GASB Statement No. 3] are superceded by the following:
>
> > Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government, and are held by either:
> >
> > a. The **counterparty** or
> >
> > b. The counterparty's trust department or agent but not in the government's name.
> >
> > If a government has investment securities at the end of the period that are exposed to custodial credit risk, it should disclose the investments' type, the reported amount, and how the investments are held. Investments in external investment pools and in open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form. Securities underlying reverse repurchase agreements are not exposed to custodial credit risk because they are held by the buyer-lender. The term *securities* as used in this paragraph includes securities underlying repurchase agreements and investment securities.

GASB Statement 40 Implementation Guide

The GASB Statement 40 Implementation Guide discusses the topic of custodial credit risk in Question 28. Here is where the discussion ties back to category c as discussed in the GASB Technical Bulletin 87-1.

> **Paragraph 28.**
>
> **Q—**Statement 3 required the display of three categories of custodial credit risk. How does Statement40 affect those three categories?
>
> **A—**An exception-based disclosure requirement was adopted in Statement 40 for reporting custodial credit risk. **Category 1 and category 2 disclosures have been eliminated. Disclosure of custodial credit risk is required only when a government has a category 3 [category c] exposure.** Because Statement 40 reduces custodial credit risk disclosures to one circumstance, all reference to categories of custodial credit risk has been eliminated.

In order to determine whether University or campus foundation securities are subject to custodial credit risk, analysis should focus on which of the categories outlined in GASB Statement No. 3 and GASB Technical Bulletin 87-1 apply.

- If the securities fall under *categories a or b* of paragraph 68 of GASB Statement No. 3 (and as illuminated by the Technical Bulletin), then *they are not subject* to custodial credit risk disclosure under paragraph 9 of GASB Statement No. 40.
- If the securities fall under *category c* of paragraph 68 of GASB Statement No. 3, then *they are subject* to custodial credit risk disclosure under paragraph 9 of GASB Statement No. 40.

Comprehensive Implementation Guide—2005: Chapter 1, Questions 60 – 77

Note: Proper evaluation of custodial credit risk depends on both who the securities custodian is and how the securities are held. This section on how the securities are held should be read together with the section on who the securities custodian is, starting at question 1.45.

How the securities are held

Chapter 1, Question 60

Q—How does one determine whether a security is or is not "held in the government's name"? (3-41)

A—Holding in the government's name means that the custodial systems and records indicate the government's rights in the securities. The way in which securities are "held in the government's name" differs between investment securities and collateral and repurchase agreement securities. There also are differences between paper and book entry securities. Questions 1.61 through 1.71 discuss issues relating to this criterion in different circumstances in which the custodian is a party other than the counterparty.

Collateral and repurchase agreement securities versus investment securities

Chapter 1, Question 61

Q—For collateral on deposits with financial institutions and for securities underlying repurchase agreements, do custodial systems and records have to show that the government is the owner of the securities to be considered "held in the name of the government" and consequently exempt from custodial credit risk disclosures? If not, what should the custodian's systems and records show? Are there differences in how the criterion is applied to collateral and repurchase agreement securities compared with investment securities? (3-42)

A—If securities are pledged to a government, whether to secure deposits or to secure repurchase agreements, the custodian's records and its system of holding the securities would not show that the government is the owner. The pledgor is the owner. The records and systems would, however, have to show that the government is the pledgee to be considered "held in the name of the government" and consequently be excluded from custodial credit risk disclosures.

The custodial systems and records needed to meet this criterion for investment securities are somewhat different. The government is the owner of these securities and, to be considered "held in the name of the government" and excluded from custodial credit risk disclosures, the custodian's records and its system of holding the investment securities have to show that the government, and not the custodian or some other party, is the owner of the securities.

Paper securities: Registered in the government's name

Chapter 1, Question 62

Q—Some securities are issued in paper form; that is, a certificate provides evidence of ownership. Sometimes securities certificates are registered in the government's name. How does one determine if these securities are "held in the name of the government" and consequently not exposed to custodial credit risk if they are registered in the government's name and held by a custodian? (3-43)

A—If securities are registered in the government's name and they have not been endorsed, they are not exposed to custodial credit risk. If the government has endorsed the registered securities, they should be evaluated as bearer securities or as street or nominee name securities as discussed in questions 1.63 and 1.64, respectively.

Paper securities: Bearer securities

Chapter 1, Question 63

Q—Some paper securities are issued in or endorsed to bearer form; the bearer or holder of the certificate is presumed to be the owner. Are bearer securities owned or pledged to a government and held by a custodian subject to custodial credit risk disclosures? (3-44)

A—To meet the "held in the name of the government" criterion for bearer securities owned by the government, two conditions have to exist. First, the custodian is required to have physical custody of the securities (or, as discussed in question 1.69, another party should be holding the physical securities in the name of the custodian for the benefit of the custodian's clients). Second, the custodian's internal records should identify the government as the owner of the bearer securities. For bearer securities pledged to the government as collateral for deposits or for repurchase agreements, the only difference for meeting the criterion is that the custodian's internal records should identify the government as the pledgee of the securities.

Paper securities: Street name and nominee name registration

Chapter 1, Question 64

Q—Two terms often used in describing how a government's securities are registered are *street name* and *nominee name*. What does it mean to have securities in street or nominee name? (3-45)

A—Fundamentally, securities held in street name and nominee name are the same for custodial credit risk purposes. Both terms indicate that the securities are issued in or endorsed to the name of a securities depository, broker-dealer, or other financial services company, on behalf of the true beneficial owners of the securities.

The term *nominee name* denotes arrangements used principally by institutional investors and financial agents (such as bank and trust companies) for the registration of securities held by them for their own account or the accounts of customers. In most instances, the nominee is a partnership formed solely for the purpose of acting as record holder of the securities. Perhaps the largest use of nominee name arrangements is by securities depositories on behalf of their participants.

The term *street name* is used by the securities industry to denote securities registered in the name of a brokerage firm or its nominee. Such securities frequently belong to customers of the firm.

Securities are held in street or nominee name to allow the transfer of the beneficial ownership of securities from one party to another without re-registration and with a minimum of physical movement of the paper. The use of street or nominee names for the registration of paper securities does not change the fact that a custodian is "holding in the name of the government." This is because of the presumption underlying the use of street or nominee name registration that another party may be the true beneficial owner.

Securities in the nominee name of a securities depository are referred to as "book entry" securities. Questions 1.65 through 1.68 discuss how to evaluate book entry systems for purposes of applying the "held in the name of the government" criterion. For securities owned by a government and registered in or endorsed to the street or nominee name of the custodial broker-dealer or other financial agent, the "held in the name of the government" criterion is met if the custodian's internal records identify the government as the owner of the securities. If the securities are pledged to the government as collateral for deposits or for repurchase agreements, the only difference in meeting the criterion is that the custodian's internal records should identify the government as the pledgee of the securities. Securities are held in street or nominee name to allow the transfer of the beneficial ownership of securities from one party to another without re-registration and with a minimum of physical movement of the paper. The presumption underlying the use of street or nominee name registration that another party may be the true beneficial owner.

Securities in the nominee name of a securities depository are referred to as "book entry" securities. Questions 1.65 through 1.68 discuss how to evaluate book entry systems for purposes of custodial credit risk. For securities owned or pledged to a government and registered in or endorsed to the street or nominee name of the custodial broker-dealer or other financial agent, the security is not subject to custodial credit risk disclosures if the custodian's internal records identify the government as the owner or pledgee of the securities

Book entry securities

Chapter 1, Question 65

Q—What is a book entry system for securities? How are securities in book entry systems owned by or pledged to governments? (3-46)

A—Book entry is a system that eliminates the need for physically moving bearer-form paper or re-registering securities certificates to transfer ownership. There are two types of book entry systems. The first is a system operated by or for the issuer of the securities. An example is the system operated by the Federal Reserve for the securities of the U.S. Treasury and various U.S. government agencies. The securities in the Federal Reserve System are referred to as book entry securities; these securities do not exist in paper form, but only as entries on the automated records of the Federal Reserve System. The second type of book entry system is a securities depository system, such as that operated by the Depository Trust Company. In a depository system, paper securities are held by the depository in bearer form or registered in the depository's nominee name. A depository also may hold securities in the Federal Reserve's book entry system.

A government's access to the securities in these book entry systems generally is through the accounts of members or participants of the system, generally financial institutions and broker-dealers. Governments do not have their own accounts to hold book entry securities except in limited situations involving the Federal Reserve and Treasury systems as described in question 1.67. (See also question 1.98 on Federal Reserve pledge accounts.) Members and participants can use separate accounts for securities belonging to their customers. Different systems refer to these customer accounts differently—for example, using the term *custodial* or *fiduciary*. Some depository system participants have opened separate accounts for large governmental investors, such as PERS.

For a government's book entry securities to meet the "held in the name of the government" criterion, two conditions have to exist. First, the securities should be held in the book entry system in an account designated as a customer account. (Alternatively, the securities can be in a street name or nominee name account. As discussed in question 1.64, there is the presumption with the use of street and nominee names that another party may be the true beneficial owner.) Second, the member or participant custodian's internal records should identify the government as the owner or pledgee of the securities.

Chapter 1, Question 66

Q—If securities are in the Federal Reserve System or a depository book entry system, can the operator of the system be considered the custodian of the securities? (3-47)

A—No, except for situations of joint custody of pledged securities. (See question 1.98 for an example of a joint custody arrangement.) Book entry system operators do not control the movement of securities among members or participants or among a member's or participant's separate accounts. The systems are simply the "vault" in which securities are held. Governments generally do not have their own accounts in the Federal Reserve or Depository Trust Company (DTC) book entry system; they have access to those systems through the accounts of the Federal Reserve members or DTC participants. Usually, only financial institutions and broker-dealers are members or participants. The Federal Reserve or DTC generally should not be considered to be the party that holds the securities. The systems are simply the "vault" in which securities are held. Instead, the custodian of book entry securities generally is the member or participant in whose account the securities are held. (See also question 1.69 on the use of correspondents.)

Chapter 1, Question 67

Q—What kinds of accounts can governments have in the Federal Reserve System? (3-48)

A—Described below are the three types of accounts that permit governments to directly hold U.S. government and federal agency book entry securities. Governments can obtain detailed information about these accounts from the district banks of the Federal Reserve. (See also question 1.98 on Federal Reserve pledge accounts.)

Book entry safekeeping accounts for state treasurers: One financial officer of a state, generally the state treasurer, may have up to two accounts in only one Federal Reserve Bank or Branch for the safekeeping of securities—an investment account for the state's own securities and a customer account for the securities of the local governments in the state. Except as discussed below, the states are not allowed to have accounts with which to make funds (cash) transactions. Therefore, for the state to purchase or sell securities at the same time it delivers or receives cash, the state has to work through the accounts of a financial institution that has both a funds account and a securities account with the Federal Reserve. Securities purchased and sold have to be transferred between the state's safekeeping account and the financial institution's securities account. Because of this, safekeeping accounts are practical only for securities that are to be held on a long-term basis.

TREASURY DIRECT: Governments also may have accounts in the Treasury Department Bureau of Public Debt's book entry system known as TREASURY DIRECT. The TREASURY DIRECT system will maintain an account for any individual or organization. Like the state treasurers' safekeeping accounts, TREASURY DIRECT accounts cannot be used for cash transactions and are practical only for holding securities on a long-term basis.

State-owned limited-purpose trust companies: A state can form a limited-purpose trust company to obtain access to a Federal Reserve funds account for purposes of investing in and trading book entry securities. This account would enable the state to take or make delivery of book entry securities at the same time it delivers or receives cash without going through the accounts of a financial institution.

To have a funds account, a state is required to establish a limited-purpose trust company through an act of its legislature. The trust company is required to obtain a guaranty of its obligations from the state, and the state is required to waive its sovereign immunity for any claims the Federal Reserve has for any liability the trust company incurs with respect to the funds account.

Chapter 1, Question 68

Q—A government invests in commercial paper issued by a corporation. No paper certificate is issued; instead, the corporation operates a book entry system for those securities. Are these securities that are subject to custodial credit risk disclosures? (3-49)

A—If the government is not the owner of record, custodial credit risk should be evaluated in the same manner as it would be with other book entry securities. (See question 1.65.)

The custodian's use of correspondents

Chapter 1, Question 69

Q—What if the government's securities are not in the possession of the custodian; that is, what if the securities are in the possession of another party that serves as the custodian's custodian? What conditions have to be evaluated to properly determine whether the securities are exposed to custodial credit risk? (3-50)

A—This is a fairly common situation because many financial institutions and broker-dealers use "correspondents" for custody of securities, both those they own and those they hold for clients. To simplify the following discussion, the named custodian is referred to as "custodian A" and the correspondent is "custodian Z."

For custodian A to be found to be holding the government's securities in the name of the government and consequently not exposed to custodial credit risk, custodian Z's records and procedures should recognize that the securities belong to custodian A's clients. Therefore, custodian Z should hold the securities in the name of custodian A for the benefit of custodian A's clients. For this to be true, two conditions should exist. First, custodian Z should hold the securities in bearer form, in street or nominee name, or in a customer account in a book entry system. Second, custodian Z's records should show that the securities are owned by custodian A's clients. That is, custodian A should be holding the securities in a street name, nominee name, or customer account with custodian Z. Custodian Z does not need to know which securities are owned by which of custodian A's individual clients.

If these two conditions do not exist, custodian A cannot be found to be holding the securities in the name of the government. This is because either (a) custodian Z is not holding in a custodial position for custodian A or (b) custodian Z believes the securities are owned by custodian A. In either case, the government's rights to the securities are not clear—and the government should disclose the securities as being exposed to custodial credit risk.

However, if custodian Z knows and acknowledges that specific securities are owned by or pledged to the government, the securities would not be exposed to custodial credit. However, in the absence of special arrangements, it is unlikely that a correspondent will know and acknowledge that specific securities are owned by or pledged to the government.

Chapter 1, Question 70

Q—A government purchases securities from Bank A and uses an unaffiliated Bank Z for custody. Bank Z is the government's regular custodial agent and holds the securities in the government's name. However, Bank Z uses Bank A as its correspondent for settlement of all transactions and safekeeping of all securities. Bank A is holding the securities for Bank Z on behalf of Bank Z's customers. Is this investment subject to custodial credit risk disclosures? (3-51)

A—No. The investment is not exposed to custodial credit risk because Bank Z is performing the custody function for the government despite its use of Bank A as correspondent. The facts of the question show that Banks A and Z are unaffiliated and the government's use of Bank Z for custody and Bank Z's use of Bank A as a settlement and safekeeping agent are ordinary and regular business arrangements. In the absence of such ordinary and regular arrangements, however, the investment might be exposed to custodial credit risk.

Obtaining information about how securities are held

Chapter 1, Question 71

Q—How does a government obtain information about how its securities are being held? (3-52)

A—The government's investment officers and external investment advisers and managers are able to supply much of the information that financial statement preparers need about how securities are being held. A custodian that is the government's agent also will be able to provide information about the form of securities (bearer, registered, or book entry) and whether correspondent custodians, street or nominee names, and custodial or fiduciary book entry accounts are being used. Safekeeping or trust receipts or some other notification from the custodian (such as periodic statements) and written confirmations with the custodian can provide information about whether its internal records identify the government as the owner or pledgee of securities.

If a custodian that is the counterparty's trust department or agent provides the government with notification about securities owned by or pledged to the government, that custodian is able to provide the government with the necessary information about custodial operations.

If a custodian that is the counterparty's trust department or agent does not provide the government with safekeeping or trust notices, it also may not be a useful source of information about custodial operations. This is because the custodian may not be "holding in the government's name" and may not be aware that the government has a valid interest in the securities. In this situation, as well as situations in which the counterparty is the custodian, information can be obtained from or through the counterparty. Although the deposits and investments would be subject to custodial credit risk disclosures in these situations, understanding the custodial operations will allow the government to be better informed about the nature of the custodial credit risk in the arrangement.

LANGUAGE AND FORMAT OF THE PRESENTATION

Chapter 1, Question 72

Q—Is a reconciliation from the Statement 3 and 40 disclosures to the statement of net assets/balance sheet required? If it is, there appears to be a conflict between Statements 3 and 40, and Statement 9. Statement 9 provisions may result in balance sheet reporting of "cash and cash equivalents" that differs from deposits. How can a reconciliation between Statement 3 and 40 disclosures and the balance sheet be accomplished given the provisions of Statement 9? How do the provisions of Statement 14 affect the reconciliation? (3-58)

A—Statements 3 and 40 do *not* require a reconciliation between the Statement 3/Statement 40 disclosures and the balance sheet. However, some preparers have presented one. The different perspectives on financial reporting taken in Statements 3 and 40 and in Statement 9 change the nature of the reconciliation, especially by adding some reconciling items. However, some preparers may continue to believe a reconciliation between the disclosures and the balance sheet would be useful to financial statement users.

If a government reports cash and cash equivalents in its balance sheet, that account might exclude some items that are treated in the Statement 3 and 40 disclosures as deposits—for example, nonnegotiable CDs with an original maturity over three months. Cash and cash equivalents also might include some items that are treated in Statement 3 and 40 disclosures as investments—for example, commercial paper and bankers' acceptances. Statement 9, footnote 5, also allows many investments in open-end mutual funds and external and internal cash management or investment pools to be reported as cash. These funds and pools are reported as investments in Statement 3 and 40 disclosures. All of these items of difference, therefore, would be part of a reconciliation between the Statement 3 and 40 disclosures and the balance sheet if one is presented.

The provisions of Statement 14 result in separate Statement 3 and 40 disclosures for discretely presented component units. In addition, it is possible that not all of those component units will require Statement 3 and 40 disclosures. Because Statement 14 requires that disclosures distinguish between information pertaining to the primary government and that of its discretely presented component units, it follows that a reconciliation could similarly distinguish between the primary government and its discretely presented component units. For the primary government total column presented on the balance sheet, the most likely approach would be to provide reconciliations for the primary government (including its blended component units), the relevant discretely presented component units, and any fiduciary funds.

SPECIFIC ISSUES ON DEPOSITS WITH FINANCIAL INSTITUTIONS

Valuation and Presentation Issues

Chapter 1, Question 73

Q—Should a deposit's custodial credit risk be based on the bank balance or the book balance of the deposits? (3-59)

A—The bank balance of a deposit is the amount shown on the financial institution's records, and the book balance is the amount shown on the government's records. Differences, if any, result primarily from deposits in transit and outstanding checks. The bank balance—the amount for which the financial institutions actually are liable as of the government's financial reporting date—is the government's risk exposure. This disclosure is intended to communicate the credit risk associated with deposits at financial institutions. Classifying deposits based on the book balance would not achieve the objective of this disclosure.

Chapter 1, Question 74

Q—In disclosing custodial credit risk of deposits with financial institutions, should uncollected funds be included as part of the bank balance? (3-60)

A—Conceptually, uncollected funds *should not* be included in the bank balance of deposits exposed to custodial credit risk. As a practical matter, however, they often are. Uncollected funds arise when a government makes a deposit in a financial institution and the government's account is credited for the deposit, but the depository financial institution has not yet received the money from the payor's financial institution. The amount of such uncollected funds can be substantial, in some cases amounting to millions of dollars daily.

If the FDIC liquidates a financial institution, the authority of the liquidation trustee is limited to those funds actually in the possession of the financial institution at the time it enters into liquidation. Funds collected after that time would be returned to the depositor rather than placed in the pool of assets managed by the liquidation trustee. Therefore, uncollected funds are not exposed to credit risk from the depository financial institution and should not be considered part of the bank balance. (See also question 1.87.)

Governments may not know precisely when their bank collects funds. Governments will know their posted balance. Balances are posted when deposits are made, and the posted balance obviously would include uncollected funds. Therefore, the posted balance would be greater than the collected funds balance.

Using the posted balance for deposits is a practical alternative to trying to determine the collected funds balance. If a portion of the posted balance is uncollateralized and uninsured, and the preparer believes that a material portion of those deposits may represent uncollected funds, the preparer may wish to consult with the financial institution to determine the collected funds balance, so as not to misrepresent the custodial credit risk exposure of the government's deposits.

Deposits made into an account may not be available for withdrawal for some period of time. Using the available balance as the bank balance also may be practical, provided that a financial institution's policy for making funds available to a government is consistent with the financial institution's collection of those funds. In some cases, however, it would not be appropriate to use the available balance. These would be cases in which the period between posting and availability of a deposit does not coincide with the actual collection of funds by the depository financial institution. As a result, the available balance may not include funds that have been collected, because of a lag between when a bank collects funds and when the bank allows its customers to use the funds. Therefore, the available balance may be less than the collected funds balance. Using the available balance in this situation would not fully report the government's credit risk exposure in deposits with financial institutions.

Chapter 1, Question 75

Q—In disclosing deposits exposed to custodial credit risk, should accrued interest be included as part of the bank balance? (3-61)

A—Yes. Accrued interest should be included in the bank balance for purposes of reporting custodial credit risk. (See question 1.88 for FDIC coverage on accrued interest.) The deposit disclosure is based on bank balance, which should measure the full liability a financial institution has for a government's deposits, including accrued interest.

Chapter 1, Question 76

Q—How should governments value the collateral covering deposits for purposes of applying tparagraph 8 of Statement 40? That is, should they use fair value or par value? (3-63)

A—Governments should use the fair value of collateral rather than par value or any other measure. Using fair value will express the amount of protection a government has to offset the credit risk associated with the deposits. Quantifying custodial credit risk based on the par value of collateral would not achieve this objective.

Chapter 1, Question 77

Q—In determining custodial credit risk for deposits, what does "uncollateralized" mean? Should the distinction between collateralized deposits exposed to custodial credit risk (Statement 40, paragraphs 8b and 8c) and "uncollateralized" deposits (paragraph 8a) be made in the note disclosure? (3-64)

A—There is a fundamental difference in risk between deposits that are not collateralized and those that are, even though the collateral is held by the pledging financial institution, or by its trust department or agent but not in the government's name. (If an uninsured deposit is not collateralized, a government has no security in the event of default. If an uninsured deposit is collateralized, a government does have security against such a default, even though custodial arrangements may pose potential risk.) Therefore, even though all of these situations subject a government to custodial credit risk, a government's note disclosure should appropriately describe its particular situation.
For example, if a government's deposits are not collateralized, the note disclosure should describe that deposits exposed to custodial credit risk are uncollateralized. If a government's deposits are collateralized but the custodial arrangements result in the deposits being exposed to custodial credit risk, the government should use language that describes that situation—for example, "collateralized with securities held by the pledging financial institution." For the note to describe this condition as uncollateralized could mislead the reader about the nature of the risk. If a government has some deposits that are uncollateralized and some that are collateralized but considered to have custodial credit risk because of the custodial arrangements, the government's description of custodial credit risk could indicate both conditions. That information could be presented in narrative as follows:

> Of the $234,567 of bank deposits subject to custodial credit risk disclosures, $123,456 is not collateralized and $111,111 is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in [name of government]'s name.

14. DISCUSSION OF THE UNIVERSITY'S GEP SUBSIDIARY POOL STRUCTURE AS IT RELATES TO BOTH PARTICIPANT INVESTORS AND THE GEP

BACKGROUND

The GEP pool structure at the University is being modified in order to allow the General Endowment Pool (GEP) participant investors the ability to overweight their position relative to certain standard General Endowment Pool asset class weightings if they choose. Participation in the new GEP subsidiary pools is not limited to the University and its component units; rather, they are available to any investor who participates in the GEP. There is no assurance that any non-UC investor will choose to overweight and make a direct investment in the new GEP subsidiary pools; however, since the GEP itself will be an investor in these GEP subsidiary pools, non-UC participants are automatically investors by virtue of their participation in the GEP itself.

Certain GEP subsidiary pools are being formed as an alternative to unitizing the GEP in order to avoid unnecessary administrative cost (although if the GEP were unitized, the private equity and real estate approach would likely remain the same so The Regents allocation isn't continually diminished by non-Regents decisions to partcipate). The substance of these subsidiary pools as they relate to the GEP is exactly the same as if the GEP were unitized, thereby allowing all participants in the GEP to choose their own asset allocation weights.

While the new subsidiary pools provide the GEP investors more flexibility, the structure is also utilized to hold and account for retirement system and defined contribution participation in these alternative investment strategies. This is a function of how the University administratively manages investments and participation in those investments and is not an inference that there are substantively different additional pool offerings.

Three new GEP subsidiary pools are under consideration to provide a means for participants to overweight their position relative to the GEP allocation. The UC Treasurer's Office will facilitate a campus foundation's, or other non-UC participant's, direct investment in the following (refer to the illustration included in this section):

- ***Private Equity Pool*—**Investment in private equity contracts with various private equity funds that include many participant investors from legally separate entities. The direct contracts with the private equity fund will be between UC and the private equity firm, although the subscription will be based upon the campus foundation's or other non UC participant's commitment. The fair value of the funds will be determined by UC using information provided by the private equity funds.

- ***Real Estate Funds*—**Investment in private real estate partnerships that include many participant investors from legally separate entities. The direct investment will be between UC and the various real estate partnerships that are managed by different managers using this investment style for many different participant investors, although the subscription will be based upon the campus foundation's or other non UC participant's commitment. The fair value of the funds will be determined by UC using information provided by the private equity funds.

- ***Absolute Return Funds***—Investment in absolute return funds. Absolute return funds are commingled funds with exposure to both fixed income and equity securities that include many participant investors from legally separate entities. The direct investment will be between UC and a variety of commingled funds managed by different managers using this investment style for many different participant investors. The pool that UC will establish will utilize State Street to aggregate the commingled funds' net asset values and provide the market value of the investment to the participants.

In all of these cases, the new pools are an extension of the GEP and facilitate overweighting of these asset classes for the participants in a manner that does not require the administrative costs associated with unitizing the GEP itself. UC is providing an administrative pricing service by aggregating the market values provided by the direct pool sponsors.

There are financial reporting questions, discussed below, that include:

- whether this is an internal or external investment pool;
- whether UC would value the investment at fair value or cost in its financial statements; and
- whether the campus foundations, or other non-UC participants, would value the investment at fair value or cost.

Based upon the discussion below, the conclusion for UC with respect to these GEP subsidiary pools is:

- UC sponsors the GEP subsidiary pools.
- The GEP subsidiary pools are *external* investment pools.
- The investments held by these subsidiary pools are alternative investments that, according to the GASB, do not have a readily determined fair value.
- Notwithstanding the fact that the GASB defines these types of investments as not having a readily determined fair value, because the GEP subsidiary pools are external investment pools, the investments must be reported at fair value for UC, UC's campus foundation and any other non-UC participant.

These new GEP subsidiary pools are a form of administrative convenience as an alternative to the cost of unitizing the GEP, although the substance is the same as unitizing the GEP. They are more in the vein of subsidiary accounts, or ledgers, rather than pools as the term is used by the GASB. However, for the purpose of the discussion they will be referred to as subsidiary pools.

FINANCIAL REPORTING : GASB CONSIDERATIONS

1) Is UC the "pool sponsor" of these new pools?

Yes, UC is defined as the sponsor of the pools because UC is making the direct investment on behalf of a campus foundation or another non-UC participant.

2) Given that UC is the "pool sponsor", are these internal or external investment pools from the perspective of a campus foundation or another non UC participant?

These new pools are "external pools" as defined by the GASB.

GASB Statement No. 31 defines internal and external investment pools as follows:

> *Internal investment pool*
> An arrangement that commingles (pools) the moneys of more than one fund or component unit of a reporting entity. Investment pools that include participation by legally separate entities that are not part of the same reporting entity as the pool sponsor are not internal investment pools, but rather are external investment pools.
>
> *External investment pool*
> An arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio; one or more of the participants is not part of the sponsor's reporting entity. An external investment pool can be sponsored by an individual government, jointly by more than one government, or by a nongovernmental entity. An investment pool that is sponsored by an individual state or local government is an external investment pool if it includes participation by a legally separate entity that is not part of the same reporting entity as the sponsoring government. If a government-sponsored pool includes only the primary government and its component units, it is an internal investment pool and not an external investment pool.

These new pools are clearly sponsored by UC. These are external pools because these new pools include participation by the GEP and the GEP includes participation by legally separate entities that are not part of UC's reporting entity. In addition to the participation in these pools by legally separate organizations that are not part of UC's reporting entity through the GEP, direct investment in these pools by these same organizations is NOT precluded if they should also choose to overweight.

3) Does the GASB literature require the specific investments in these new pools be reported at fair value, or at cost?

The investments in these circumstances should be recorded at fair value, not cost. GASB Statement No. 31 generally requires investments, including alternative investments such as private equity partnership interests, real estate interests and the NAV for absolute return funds, where there is not a readily determined fair value, to be reported at fair value if they are deemed to be external investment pools.

However, the GASB mandates that in a situation where an internal investment pool includes these same alternative investments must *not* be recorded at fair value, but be recorded using a cost-based measure (original investment at cost, plus additional investments at cost, less distributions) on the basis there is not a readily determinable fair value.

According to the GASB's response in their Q&A as outlined below, the alternative investments such as private equity partnership interests, real estate interests that are not publicly traded and the NAV for absolute return funds, do not have a readily determined fair value, so the valuation question is directly related to the conclusion as to whether these subsidiary pools are internal or external investment pools.

Question Number 23 from the GASB Statement No. 31 Implementation Guide states:

> *Q*—When is the fair value of an equity security, option contract, stock warrant, or stock right readily determinable?
>
> *A*—The fair values of those instruments are readily determinable if the sales prices or bid-and-asked quotations are currently available (1) on an exchange registered with the Securities and Exchange Commission (SEC), (2) in an over-the-counter market that is publicly reported by the National Association of Securities Dealers Automated Quotation (NASDAQ) systems or by the National Quotation Bureau, or (3) in a foreign market that is of a breadth and scope comparable to the preceding two U.S. markets (Statement 31, paragraph 3).

The question of valuation being dependent on whether the pool is an internal or external investment pool is also discussed in the GASB's Q&A.

Question Number 4 from the GASB Statement No. 31 Implementation Guide states:

> *Q*—Investments such as real estate and venture capital limited partnerships generally are not subject to Statement 31. How should these kinds of investments be valued?
>
> *A*—It depends on the type of entity reporting them. If the investments are held by defined benefit pension plans or IRC Section 457 deferred compensation plans, they should be reported at fair value, as provided in Statement 25 or Statement No. 32, Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans, respectively. Other than external investment pools, other governmental entities should report investments not subject to Statement 31 *(referring to private equity, real estate interests and absolute return funds in our situation)* using cost-based measures provided that there has not been an impairment in that value. (Impairment is discussed in Question 29.) (Statement 31 applies to all investments of governmental external investment pools.)

The conclusion is if there are alternative investments such as private equity or real estate partnership interests (not a publicly-traded REIT), or absolute return fund interests, they MUST be recorded at fair value if held by the UCRP, any of UC's defined contribution plans, the GEP (because it is an external investment pool), or the STIP (because it is an external investment pool). However, the same exact investment in an internal investment pool sponsored by UC MUST be recorded using a cost-based measure in both the financial statements of UC AND the campus foundations.

4) Although UC is forming the subsidiary pools in order to avoid the cost of unitizing the GEP, what are the conditions that UC must incorporate into the subsidiary pool implementation in order to substantiate reporting these alternative investments using at fair value?

If the ability to overweight asset classes within the GEP using a unitized structure is restricted to only UC and its component units, then the cost-based requirement for the overweighting portion of the private equity asset class cannot be avoided. This would result in an enormous administrative effort to report *within the* GEP at fair value the base case weighting of private equity, real estate or absolute return as it is an external pool, but report the overweighting position of these same investments *within the* GEP using a cost based measure.

However, if the ability to utilize overweighting using a unitized structure is available to the non-UC entities, as well as UC and its component units, regardless of whether the non-UC entities take advantage of the overweighting capability provided by unitization, then the GEP retains its external pool status for all private equity, real estate and absolute return investments and fair value would be used.

Given this conclusion, accomplishing the same goal of allowing GEP participants to overweight in asset classes through the use of subsidiary pools rather than through unitization should not result a different answer for financial reporting in terms of valuing the investments at fair value, as opposed to a cost-based measure.

5) Do the general disclosure principles in GASB Statement No. 40 (paragraph 4 and 5) require a separate investment type in a campus foundation's or non UC particpant's investments footnote for investment in these pools?

Different asset classes should be separately shown as an investment type in the footnote, depending on the relative materiality of the investment. However, since the investments contained in the internal pools are all of a commingled fund nature, there is no requirement to "look through" to the commingled fund and disclose the individual investments in the commingled fund itself. In this case, the total amount of private equity, absolute return and real estate funds would be separately disclosed as an asset class in the footnote.

6) What additional credit risk rating disclosure would be necessary in a campus foundation's investments footnote under GASB Statement No. 40, paragraph 7?

Since private equity and real estate investments are not fixed income investments subject to credit risk, credit quality ratings do not apply.

For purposes of GASB Statement No. 40 disclosure, the absolute return investments are of the nature of a commingled mutual fund. It is considered to be a balanced fund, including both equity and fixed income strategies. Credit risk rating disclosure does not apply to balanced funds. Further, for any portion of an absolute return fund that is invested in debt securities, GASB Implementation Guide Q&A No. 27 would suggest that disclosure that the fund is "not rated" would be required, and there would not be a requirement to look through to the individual investments in the funds.

7) What custodial credit risk disclosure would be necessary in a campus foundation's investments footnote under GASB Statement No. 40, paragraphs 8 and 9?

Investments in private equity funds or real estate partnerships and mutual funds, such as the absolute return funds or REIT's, are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form.

8) What concentration of credit risk disclosures would be necessary in a campus foundation's or other non-UC participant's investments footnote under GASB Statement No. 40, paragraphs 11-13?

Investments in private equity funds, absolute return and REIT funds would be excluded from this requirement due to their nature as mutual funds under paragraph 11. However, there would be disclosure that UC manages all of these investments.

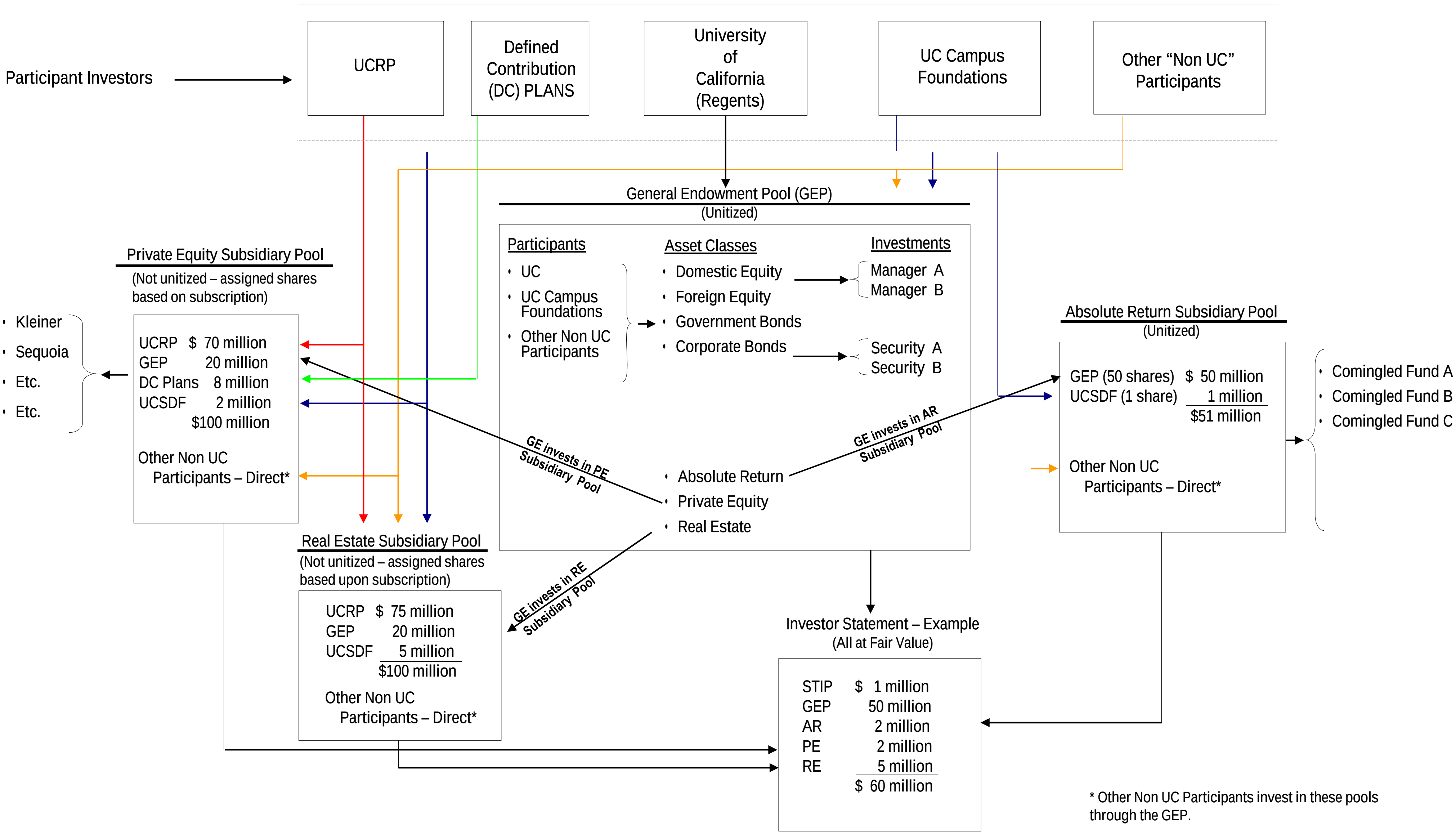
9) What interest rate risk disclosure would be necessary in a campus foundation's investments footnote under GASB Statement No. 40, paragraphs 14-16?

This is not applicable for private equity and real estate investments. Since absolute return funds are balanced funds, there is not an interest rate risk disclosure requirement for this investment type either. There obviously is no interest rate risk profile for equity securities.

10) What foreign currency risk disclosure would be necessary in a campus foundation's investments footnote under GASB Statement No. 40, paragraph 17?

Existing investments in private equity, absolute return and real estate funds are not exposed to foreign currency risk. However, if underlying investments were exposed to foreign currency risk, the amount and currency denomination would be a required disclosure.

ILLUSTRATION OF GEP SUBSIDIARY POOL STRUCTURES AS THEY RELATE TO BOTH PARTICIPANT INVESTORS AND THE GEP



* Other Non UC Participants invest in these pools through the GEP.