This document reflects the result of analyses, discussions and review by UCOP staff to date. The document is subject to change pending additional discussions with PwC; however, it represents the best information available to date.

University of California
Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.*

Issues Resolution Memo No. 53.10

Assessing Custodial Credit Risk for Exchange-Traded Futures or Foreign Currency Exchange Contracts

(Updated: April 14, 2010)

Background

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, refers to GASB Statement No. 40, *Deposits and Investment Risk Disclosures*, for guidance on the appropriate custodial and credit risk disclosure for hedging derivative instruments that are exchange-traded.

Define Issues

The University must review the newly-required disclosure requirements contained in GASB Statement No. 53 for exchange-traded hedging derivative instruments, such as futures or foreign currency exchange contracts, to determine how they apply to the University's financial statements, the separate financial statements of the medical centers, UC Press, CEB, etc., those of the University of California Retirement Plan, University of California Retirement Savings Plan, campus foundation financial statements, or the University of California Retiree Health Benefit Trust (UCRHBT) financial statements.

Authoritative Guidance

The authoritative guidance for credit risk under Statement No. 53 is as follows:

> Paragraph 73. *Risks*. For hedging derivative instruments, governments should disclose, if applicable, their exposure to the following risks that could give rise to financial loss. Risk disclosures are limited to hedging derivative instruments that are reported as of the end of the reporting period. Disclosures required by this paragraph may contain information that also is required by other paragraphs. However, these disclosures should be presented in the context of a hedging derivative instrument's risk:

a. *Credit risk*. If a hedging derivative instrument reported by the government as an asset exposes a government to credit risk, the government should disclose that exposure as credit risk and disclose the following information:

(1) The credit quality ratings of counterparties as described by nationally recognized statistical rating organizations—rating agencies—as of the end of the reporting period. If the counterparty is not rated, the disclosure should indicate that fact.

(2) The maximum amount of loss due to credit risk, based on the fair value of the hedging derivative instrument as of the end of the reporting period, that the government would incur if the counterparties to the hedging derivative instrument failed to perform according to the terms of the contract, without respect to any collateral or other security, or netting arrangement.

(3) The government's policy of requiring collateral or other security to support hedging derivative instruments subject to credit risk, a summary description and the aggregate amount of the collateral or other security that reduces credit risk exposure, and information about the government's access to that collateral or other security.

(4) The government's policy of entering into master netting arrangements, including a summary description and the aggregate amount of liabilities included in those arrangements. Master netting arrangements are established when (a) each party owes the other determinable amounts, (b) the government has the right to set off the amount owed with the amount owed by the counterparty, and (c) the right of setoff is legally enforceable.

(5) The aggregate fair value of hedging derivative instruments in asset (positive) positions net of collateral posted by the counterparty and the effect of master netting arrangements.

(6) Significant concentrations of net exposure to credit risk (gross credit risk reduced by collateral, other security, and setoff) with individual counterparties and groups of counterparties. A concentration of credit risk exposure to an individual counterparty may not require disclosure if its existence is apparent from the disclosures required by other parts of this paragraph, for example, a government has entered into only one interest rate swap. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

However, under footnote 12 to paragraph 73a, the credit risk disclosures do not extend to derivatives that are exchange-traded. For these derivatives, disclosures for amounts held by broker-dealers are evaluated by applying the custodial credit risk disclosures found in GASB Statement No. 3 and 40. Specifically, footnote 12 states:

> The credit risk disclosures in this paragraph do not extend to derivatives that are exchange-traded, such as futures contracts. For those derivatives, disclosures for amounts held by brokers/dealers is evaluated by applying the custodial credit risk disclosures found in Statements No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, and No. 40, *Deposit and Investment Risk Disclosures*.

Discussion

For the University of California, University of California Retirement Plan, University of California Retirement Savings Plans and UCRHBT

The following analysis has been adapted from the discussion on GASB Statement No. 40 as it relates to this circumstance for custodial credit risk—exchange traded derivative instruments (GASB 40, ¶9)

UC securities that are owned, <u>including exchange-traded derivative instruments</u>, are evaluated under the terms identified in GASB Statement No. 40 as an investment risk associated with custodial credit risk.

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. When evaluating whether custodial credit risk disclosure is required, it may be useful to review the history and intent as background information. This history is briefly summarized in Section 12 of the IRM on GASB Statement No. 40.

Determining whether securities are held in the name of the University's financial reporting entities 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.

Custodial Credit Risk Associated with Exchange Traded Derivative Instruments Owned by the University

<u>The exchange-traded derivative instruments owned by the University are *not* subject to custodial credit risk disclosure requirements. These securities are registered in the University's name by the custodial bank as an agent for the University.</u>

All of the University's exchange traded derivative instruments are held at Goldman Sachs, the University's counterparty, in the name of the University.

Goldman Sach'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.

Note: Foreign currency exchange contracts and TBAs are *not* subject to custodial credit risk disclosure requirements as they are not exchange traded derivative instruments.

For the Campus Foundations

The custodial credit risk principles for exchange-traded derivative instruments 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, GEP or HIP is considered to be an investment in an external investment pool, therefore they are not required to report or disclose derivative instruments in these pools.

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.

Since the campus foundations are included in the UC financial statements and footnotes, if there are direct investments in derivative instruments outside of external investment pools custodial credit risk information for any exchange-traded hedging derivative instruments consistent with the UC level of detail will need to be accumulated by updating the templates in the GASB Statement No. 39 Campus Foundation Financial Reporting Package.

For the Medical Centers, UC Press, CEB, etc.

The custodial credit risk principles for exchange-traded derivative instruments also apply to the separately audited statements of the Medical Centers, UC Press, CEB, etc. However, from their perspective, their investment in the University's STIP is considered to be an investment in an external investment pool, therefore they are not required to report or disclose derivative instruments in these pools.

Next Steps—Required Actions

Responsibility	Required Completion Date	Action Item/Task
N/A	N/A	None