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University of California

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

(Issued: February 13, 2010)

Issues Resolution Memo No. 53.4

Assessing Whether the University's Guaranteed Investment Contracts (GIC's) are Derivative Instruments Subject to the Disclosure Requirements of GASB Statement No. 53

Background

In June 2008, the GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. The Statement addresses the recognition, measurement and disclosure requirements for derivative instruments entered into by the University. Such instruments may include contracts related to Guaranteed Investment Contracts (GIC's) if they are deemed to be Synthetic Guaranteed Investment Contracts (SGIC's). GIC's are not derivative instruments and are reported at fair value and SGIC's are derivative instruments and must be reported at contract value.

The University regularly enters into GIC's with a variety of insurance companies in their ICC Fund.

Define Issues

The University must determine whether its Guaranteed Investment Contracts are derivative contracts in the form of Synthetic Guaranteed Investment Contracts, as defined by the GASB.

Authoritative Guidance

Paragraph 67 of GASB Statement No. 53 states:

Fully benefit-responsive Synthetic Guaranteed Investment Contracts (SGIC's)—the combination of the underlying investments and the wrap contract—should be reported at contract value. An SGIC is fully benefit-responsive if **ALL** of the following criteria are met:

- (a) The SGIC prohibits the University from assigning or selling the contract or its proceeds to another party without the consent of the issuer.

- (b) Prospective interest crediting rate adjustments are provided to plan participants and the University on a designated pool of investments by a financially responsible third party. Those adjustments provide assurance that probable future rate adjustments that would result in an interest crediting rate of less than zero is remote. The pool of investments in total meets both of the following criteria:
- (1) Is of high credit quality such that the possibility of credit loss is remote, and
 - (2) May be prepaid or otherwise settled in such a way that the University and plan participants would recover contract value.
- (c) The terms of the SGIC require all permitted participant-initiated transactions with the government to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the University, such as withdrawals for benefits, loans, or transfers to other investment choices.
- (d) Some events may limit the University's ability to transact with participants at contract value. Examples are premature termination of contracts, layoffs, plan terminations, bankruptcies, and early retirement incentives. The probability of such an event occurring within one year of the date of the financial statements is remote.
- (e) The University allows participants reasonable access to their investments. The following conditions do not affect the benefit responsiveness of an SGIC:
- (1) In plans with a single investment choice, restrictions on access to assets by active participants are consistent with the objective of the plan (for example, retirement benefits).
 - (2) Participants' access to their account balances is limited to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan.
 - (3) Administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-income investment options to limit arbitrage among those investment options (that is, equity wash provisions).

If plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, participants would not have reasonable access to their investments.

Discussion

Definition of a Traditional GIC

Before considering the derivative implications of a synthetic guaranteed investment contract (SGIC), a traditional guaranteed investment contract (GIC) must be understood. In a traditional GIC, the issuer of the contract takes deposits from a benefit plan or other institutional customers and purchases investments that are held in its general account. (Equity investments may also be acquired, although they are less common than fixed income investments.) The benefit plan is a creditor of the issuing company and therefore has credit risk, although generally the GIC issuers have a high credit-quality rating. The issuer is contractually obligated to repay the principal and specified interest guaranteed to the benefit plan. The plan's provisions typically permit the participant to withdraw funds from the fund at book value (also referred to as account or contract value) for specified reasons, such as loans, hardship withdrawals, and transfers to other investment options offered by the plan. A benefit-responsive GIC contains provisions that mirror the plan's participant-directed withdrawal/transfer provisions. Therefore, the issuer is at risk that

interest rates could increase, reducing the price of the fixed-income investments backing the GIC liability, while those investments may have to be sold at a loss to cover withdrawals.

Definition of a Synthetic GIC

A synthetic GIC is a contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the policyholder (such as a benefit plan) owns the assets underlying the synthetic GIC. (With a traditional GIC, the policyholder owns only the contract itself that provides the plan with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the policyholder and typically consist of government securities, private and public mortgage-backed securities, and other asset-backed securities, and investment grade corporate obligations. To enable the policyholder to realize a specific known value for the assets if it needs to liquidate them, synthetic GICs utilize a "wrapper" contract that provides market and cash flow risk protection to the policyholder. This wrapper or guarantee may be provided in a variety of structures. In one structure, the issuer provides cash advances to fund the policyholder's cash withdrawal requirements if the invested asset values have decreased. Other structures include:

1. A swap agreement whereby the synthetic GIC issuer exchanges a fixed return for the market value of supporting assets, if needed for benefit payments.
2. An agreement by the issuer to buy assets at book value if a sale is needed to make benefit payments.
3. A payment upon termination of the contract equal to the difference between a hypothetical book value of plan assets and their market value. (Provisions of benefit responsive traditional GICs and synthetic GICs generally prohibit the benefit plan and its sponsor from taking any actions that would encourage participant withdrawals and transfers.)

Synthetic GICs can be viewed as the issuer selling a put option to the policyholder. For many synthetic GICs, the option premium is in the form of a fee charged on the outstanding contract book value. For some forms of synthetic GICs, the option premium for the put option is not explicitly stated but, instead, is embedded in the determination of the investment return guaranteed to the policyholder.

In any of the structures, various methods can be used to limit the synthetic GIC issuer's exposure to net payments under the contract. In the current marketplace, most synthetic GICs pass many of the asset and cash flow related risks to the policyholder. Structures to limit such risk include the following:

- Reset of the crediting rate or maturity date: cash flow volatility (for example, timing of benefit payments) as well as asset underperformance can be passed through to the policyholder through adjustments to future contract crediting rates and/or contract maturities. Formulas are typically provided in the contract which adjust renewal crediting rates to recognize the difference between the fair value and book value of remaining assets in the segregated portfolio.
- Impaired securities may also be excluded directly from book value guarantees.

- Investment guidelines: carefully structured investment policy can limit significantly the cash volatility of assets in the segregated portfolio (for example, limit callable securities, mortgage backed securities, etc.).
- Buffer funds: cash and cash equivalents are maintained and are accessed first in order to fund benefit payments and thus limit the potential for synthetic GIC issuer's assets to be accessed to make benefit payments.
- Liquidation structure of pension plan: pro rata or tiered structures dictate the order of accessing various plan assets, including synthetic GIC assets, for benefit payments.

As with other types of GICs, the specific terms and conditions of synthetic GICs are negotiated on a case-by-case basis. However, those contracts fall into several broad structural categories, as discussed in the attachment.

Hypothetical Example to Illustrate Concepts Related to Synthetic GICs

On January 1, 2000, ABC issues a synthetic GIC contract to the XYZ Pension Fund. XYZ has a fixed return plan option that provides participants with a guaranteed 6 percent return for a 3-year period. The plan's invested assets consist of one public, \$50 million par value, 6.50 percent, AA-rated, fixed-rate, non-callable, semi-annual payment bond that matures at par on December 31, 2002. (A simplistic assumption that is unrealistic since the plan would diversify its exposure by owning various bonds.) XYZ acquired the bond at par on January 1, 2000. ABC is charging XYZ 12 basis points per year on the \$50 million plan balance, or \$60,000 per year. Assume that the market yield applicable to this bond immediately increased to 8 percent and caused the following events to occur:

- The bond price decreased to \$48,342,000.
- All plan participants requested that their funds be transferred to another plan fund.
- XYZ exercised its put option to transfer the bond to ABC in exchange for a \$50 million cash payment.
- ABC honored its synthetic GIC obligation and acquired the bond for \$50 million.
- XYZ used the \$50 million proceeds to make the transfer of participant funds to the newly selected fund.

Synthetic GICs Fall into Several Broad Structural Categories

- *Buy and Hold.* Typically, a “buy and hold” synthetic contract covers a limited class of assets, usually high-quality bonds expected to be held to maturity. There is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor—for example, 3 percent or zero percent. The term of the contract generally is consistent with the maturity of the underlying assets. Although buy-and-hold contracts are structured to permit participant withdrawals and transfers at book

value, generally no withdrawals are expected. The arrangements between the benefit plan and the wrap provider typically contain provisions outlining operating and investing guidelines for the benefit plan. These guidelines are designed to ensure the availability of other sources of liquidity sufficient to satisfy expected levels of net participant-directed withdrawals and transfers, without the need to access the assets wrapped by the synthetic GIC. While participants can make withdrawals or transfers at book value, in most cases, the benefit plan can terminate the contract at the market value of the assets at any time, but it can withdraw at contract value only at maturity or earlier with a specified notification period.

- *Actively Managed.* With an actively managed synthetic GIC, the assets often are managed by an outside investment manager, but may be managed by the insurer. Generally, the contract is “evergreen”—that is, there is no specified maturity date—and there is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor, frequently zero percent and typically not less than zero percent. Participant-directed withdrawals and transfers are made at book value, with future interest returns adjusted to recognize the difference between the fair value and book value of the remaining assets covered by the synthetic GIC, but typically not below a zero interest rate. Benefit plan-initiated withdrawal provisions are similar to those for buy-and-hold GICs.
- *Fixed Rate/Fixed Maturity.* This contract is essentially the same as a traditional general account GIC. The synthetic GIC issuer guarantees a fixed rate for a fixed and certain term and assumes the investment risks and rewards of the assets. If the assets earn less than the guaranteed return, the insurance company absorbs the loss. If the assets earn more than was assumed in pricing, the income recognized by the insurer will be greater than the “wrap fee” assumed in the pricing. Typically, the insurer also will be the investment manager because of the assumption of investment risk.

Note that participant-initiated withdrawals and transfers of fixed-rate/fixed-maturity contracts are permitted at book value but are expected to occur infrequently. Withdrawals initiated by the benefit plan generally are permitted only at the market value of the asset.

Next Steps—Required Actions

Responsibility	Required Completion Date	Action Item/Task
UCOP/ TO	Annually	During the annual assessment of derivative instruments, review and document GIC’s to ensure they are not derivative instruments in the form of SGIC’s under GASB Statement No. 53.