

G40 Q+A

IMPLEMENTATION GUIDE

Guide to Implementation of GASB Statement 40 on Deposit and Investment Risk Disclosures

Questions and Answers

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The Governmental Accounting Standards Board has authorized its staff to prepare Implementation Guides that provide timely guidance on issues encountered during the implementation and application of GASB pronouncements. The GASB has reviewed this Implementation Guide and does not object to its issuance.

The information in this Implementation Guide need not be applied to immaterial items.

QUESTIONS AND ANSWERS

General Disclosure Principles

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.

2. Q—How should the investments of an internal investment pool be disclosed under the requirements of Statement 40?

A—Statement 31 defines an internal investment pool as “[a]n arrangement that commingles (pools) the moneys of more than one fund or component unit of a reporting entity.” For financial reporting purposes, the funds participating in the pool report their pro rata share of participation in the pool. Internal investment pools are a government’s own cash and investments and accordingly require all applicable Statement 40 risk disclosures attributable to the primary government.

3. Q—A government has a position in an external investment pool. Does the investment-type disclosure “look through” to the investments of the pool, or should the investment be characterized as an investment in an external investment pool?

A—A position in an external investment pool is in itself a type of investment. Therefore, a government’s position in an external investment pool should be characterized as an investment in an external investment pool.

Level of Detail

4. Q—Can a government present deposit and investment disclosures by portfolio?

A—The level of detail guidance provided in paragraph 5 indicates that disclosures generally should be made for the primary government, including its blended component units, with additional risk disclosures as necessary. A government should consider the risks of its portfolios as risks of the primary government when determining the appropriate level of detail disclosures. Disclosures for the primary government may be aggregated by portfolio.

For example, a government holding separate portfolios for governmental and business-type activities, individual major funds, nonmajor funds in the aggregate, or fiduciary fund types should disclose such risks of those portfolios when the risk exposures are significantly greater than the deposit and investment risks of the primary government.

5. Q—Can a single nonmajor fund cause the reported nonmajor funds in the aggregate to have interest rate risk that is significantly greater than that of the primary government?

A—Yes. A government may have a nonmajor fund with an investment that is exposed to interest rate risk. Depending upon the magnitude of the investment's interest rate risk as related to the total interest rate risk of the aggregated nonmajor funds (for example, nonmajor governmental funds) and the primary government, the government may be required to report the interest rate risk of the aggregated nonmajor funds in accordance with paragraph 5. Disclosures for nonmajor funds should be made if the risk within the aggregated nonmajor fund total is significantly greater than the interest rate risk of the primary government. For example, a government may hold a variable-rate investment with a coupon set at 1.5 times the three-month London Interbank Offered Rate (LIBOR) in a nonmajor special revenue fund. If this investment's risk exposure is significant to the total of aggregated governmental nonmajor funds and the primary government's interest rate risk exposure as a whole is significantly less than that of the aggregated governmental nonmajor funds, the appropriate interest rate risk disclosures should be made for the aggregated governmental nonmajor funds.

6. Q—A government manages its investments according to maturity. Short-term investing activities are conducted in an internal investment pool. Longer-term investments for specific funds—such as debt service reserve and capital projects funds—are purchased on an individual basis. Should short-term and long-term investing activity be delineated in the investment disclosures?

A—Statement 40 focuses on the deposit and investment risks of the primary government and permits aggregation of such disclosures. However, a government may choose to segregate certain of its investing activities to disclose the risks associated with each maturity. The existence of large differences in investing practices, such as internal pooling or purchasing discrete investments, may be indicative of a need for separate disclosure. For example, a city's aggregate weighted average maturity of its investment portfolio could be 0.71 years, disclosed as follows:

	<u>Fair Value as of 6/30/03</u>	<u>Weighted Average Maturity (in Years)</u>
Internal investment pool	\$645,782	0.23
Debt service reserve fund	60,000	0.90
Capital projects fund	250,000	1.90
Aggregate	<u>\$955,782</u>	0.71

The focus of this disclosure is on the aggregate weighted average maturity of the entire investment portfolio; however, disclosure is made at the fund level for the weighted average maturity of the capital projects fund when the risk exposure is significantly greater than that of the primary government.

7. Q—What level of detail should be applied to discretely presented component unit deposit and investment risks?

A—Current guidance regarding component unit level-of-detail requirements can be found in paragraph 63 of Statement No. 14, *The Financial Reporting Entity*, as amended by Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, as amended:

Notes essential to fair presentation in the reporting entity basic financial statements encompass:

- a. Governmental and business-type activities, major funds individually, and nonmajor funds in the aggregate of the primary government (including its blended component units).
- b. Major discretely presented component units considering both:
 - (1) The unit’s significance relative to the total discretely presented component units.
 - (2) The nature and significance of the unit’s relationship to the primary government.

Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component unit basis. A specific type of disclosure might be essential for one component unit but not for another depending on the component unit’s significance relative to the total component units included in the component units column(s) and the individual component unit’s relationship with the primary government.

8. Q—Does Statement 40 continue the Statement 3 requirements to disclose certain risks that were greater during the year than at the end of the reporting period or to disclose investments held during the year but not as of the end of the reporting period?

A—No. Statement 40 focuses on the impact of the risk exposure at the date of the statement of net assets of the primary government, including its blended component units, as a whole, except when deposit or investment risks are not apparent because of other deposit or investment balances. Statement 40 looks at the risk exposure as of that date as an indicator for potential loss of resources. Risks not present at that date do not offer the same level of predictive value, and therefore the government should evaluate its risk exposure as of the date of the financial statements regardless of the activity between funds during the reporting period. For example, a government holds an investment in XYZ corporate bonds that receives a rating downgrade. If the government moves the bond from its capital projects fund to its general fund during the year, no disclosure of the investment’s risk exposure during the time it was held in the capital projects fund needs to be disclosed.

9. Q—A county government’s investments are divided among three separately elected officials. Should investment disclosures be presented for each elected official?

A—No. Statement 40 provides guidance on the level of detail of deposit and investment risk disclosures in paragraph 5. Disclosures generally should be made for the primary government, including its blended component units, with additional risk disclosures as warranted based on risk exposure as discussed in paragraph 5. Statement 40 does not address separate disclosures indicating the division of responsibility within the primary government. A government with a diversified responsibility for investments should consider the risks of those individual responsibility units to be risks of the primary government, or another level of detail as provided in paragraph 5, in determining the appropriate level of detail disclosures.

Deposit and Investment Policies

10. Q—Does Statement 40 define *investment policy* or require an investment policy to be formally adopted?

A—Diversity in practice prevents specifically defining what is meant by either a *deposit* or *investment policy*. However, for the purposes of Statement 40, an *investment policy* is considered to be a formally adopted policy that sets forth a government's allowable deposits or investments. An investment policy may be formally adopted through legal or contractual provisions or by other means, usually by the governing board. However, a government's informal policies or general investment practices are not a required disclosure. For these policies and practices, the government would disclose that no policy had been adopted if a required disclosure was applicable. For example, historically an airport authority has invested in securities rated in the top category of credit risk as issued by nationally recognized statistical rating organizations (NRSROs). The airport authority is not required by an investment policy to invest in top rated securities but has been doing so for the past ten years absent any investment policy. In this case, the authority would disclose that no credit risk policy has been adopted.

Paragraph 6 indicates that only brief disclosures are required and a government should not include all details of its investment policies in its disclosures. Many investment policies are extremely long and can be quite detailed. If broad cash management and investment policies have been adopted, only a brief description of the policy that is related to the risks discussed in Statement 40 should be disclosed.

11. Q—If a local government's investment policy is more stringent than its statutory investment authority, is it necessary to disclose its statutory investment authority? For example, a government's investment policy may limit its exposure to credit risk by permitting the government to invest in only U.S. government obligations or those obligations explicitly guaranteed by the U.S. government.

A—Disclosure is required for both the government's investment policy and the statutory investment authority. Although certain provisions of Statement 3 have been changed by the issuance of Statement 40, the requirement to disclose the types of investments authorized by legal or contractual provisions (Statement 3, paragraph 65) was not amended, superseded, or rescinded. Information about the government's ability to *invest* in the instrument is important to a user's evaluation of potential risk.

12. Q—A state government issues a bond that contains specific covenants related to the investment of the proceeds. Should this be considered an investment policy?

A—Yes. The disclosure of relevant deposit or investment policies communicates to the readers of the financial statements a government's tolerance for risk. The disclosure of such policies, when identified risks warrant such a disclosure, serves to indicate the risk tolerance information that Statement 40 was designed to convey.

13. Q—A government's investment policy is limited to complying with its state's investment statutes. What investment policy disclosures should be made?

A—State laws vary, and many only identify authorized investments. If a government's investment policy is limited to complying with its state's investment statutes, the relevant portions of the state statute relating to the risks required to be disclosed under Statement 40 should be disclosed. When state law has not addressed a risk, such as interest rate risk, the disclosure should indicate that the reporting government has not adopted an investment policy on that point.

14. Q—A government's investment policy indicates that the government is restricted to investments in obligations of the U.S. government, or those obligations explicitly guaranteed by the U.S. government. Is a credit risk investment policy disclosure required?

A—No. If the government is not required to disclose its exposure to credit risk, a credit risk policy disclosure is not required.

Credit Risk

15. Q—Do the credit quality ratings of all nationally recognized statistical rating organizations (NRSROs) need to be disclosed? What if a government invests in a security that receives split ratings? That is, NRSROs issued different ratings on the same security. What credit quality disclosures should be made?

A—There are several recognized NRSROs at this time. Currently, the Securities and Exchange Commission reviews the qualifications of applicant credit quality rating firms to determine if they meet the criteria for becoming an NRSRO. Statement 40 does not specifically address whether the credit quality ratings of all NRSROs need to be disclosed.

Many securities have ratings from more than one NRSRO, and sometimes those ratings differ. When multiple ratings exist, at a minimum, the rating indicative of the greatest degree of risk should be presented. However, a government may also choose to disclose additional credit quality ratings, thereby presenting the user with additional credit risk information from which to ascertain the credit risk of the investment.

16. Q—Does the rating of each debt investment need to be disclosed? Or can the ratings be aggregated?

A—Consistent with the requirements in both paragraphs 4 and 7, credit risk disclosures may be aggregated by investment type or by credit quality rating. A portfolio consisting of various debt investments with differing credit quality ratings may be aggregated and displayed by credit quality. For example, a government may choose to disclose that its investment portfolio contains AAA/Aaa rated government agency securities and AA/Aa rated corporate bonds. A government holding investments with split ratings should, at a minimum, aggregate the investment with the rating indicative of the greatest degree of risk. (See question 15.)

17. Q—If a debt investment is unrated—for example, a guaranteed investment contract—but its issuer is rated, should the credit risk of the issuer be disclosed?

A—No. Displaying the credit quality ratings of issuers may be misleading as to the credit risk of the individual debt investment. The credit quality rating is intended to measure the probability of timely repayment of principal and interest on the debt securities being issued by the borrowing institution. An issuer's debt issues may have different credit quality ratings. If the debt investment is unrated but the issuer is rated, governments should indicate that the debt investment is unrated, as required by paragraph 7.

18. Q—Do all positions with credit exposure need to be listed separately? For example, how would a large portfolio disclose the credit quality rating of its investments?

A—To avoid unreasonably long disclosures, a government may choose to present aggregated credit risk disclosures for its portfolio of investments. Such disclosures may include the percentage of the portfolio constituted by each of the investment types with different categories of ratings as follows:

**Credit Quality Distribution for Securities
with Credit Exposure as a Percentage of Total Investments**

Fannie Mae (Federal National Mortgage Association)	AAA	20%
Sallie Mae (Student Loan Marketing Association)	AAA	12%
Freddie Mac (Federal Home Loan Mortgage Corporation)	AAA	20%
Mortgage bonds	AAA	10%
Mortgage bonds	AA	5%
Mortgage bonds	BBB	3%
Corporate bonds	AAA	10%
Corporate bonds	AA	15%
Corporate bonds	A	5%

19. Q—Statement 40 requires that the credit quality ratings of NRSROs be disclosed, but it does not specifically identify to what detail the disclosures are required to be made. Ratings issued by the NRSROs can be quite detailed. For example, since October 1996, Moody's Investors Service (one of the NRSROs) has applied numerical modifiers 1, 2, and 3 in each generic rating classification from Aa to B. The modifier 1 indicates that the issue ranks in the higher end of its generic rating category, the modifier 2 indicates a midrange ranking, and the modifier 3 indicates that the issue ranks in the lower end of its generic category. Although they do not use numerical modifiers, other NRSROs use pluses and minuses as modifiers. Should credit quality disclosures include such detail as numerical modifiers?

A—Credit quality modifiers are not a required disclosure.

20. Q—An external investment pool is a 2a7-like pool as defined by Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, but is not rated. Is a credit risk disclosure required?

A—Yes. Although the SEC's Rule 2a7 of the Investment Company Act of 1940 includes restrictions on the type of investments a pool may hold, a 2a7-like pool may still be exposed to credit risk. If the pool is rated, the credit quality of the 2a7-like pool should be disclosed, or if the pool is unrated, the disclosure should indicate that fact.

21. Q—Are government-sponsored enterprise (GSE) investments subject to credit risk disclosures?

A—Yes. GSEs are independent organizations sponsored by the federal government. Common examples of GSEs are the Federal Farm Credit Banks, the Federal Home Loan Bank System, Freddie Mac (Federal Home Loan Mortgage Corporation), Fannie Mae (Federal National Mortgage Association), and Sallie Mae (Student Loan Marketing Association). GSEs generally serve as financial intermediaries, making loans or issuing loan guarantees to borrowers or sectors identified by Congress. Funds may be raised in a variety of ways, excluding taxes, but in no case are the liabilities of the GSE to be backed by the full faith and credit of the federal government. As created by Congress, the federal government implies an interest in the securities the GSEs issue, hence the implicit guarantee. This differs from the explicit guarantee for certain agency securities, which states that the securities are backed by the full faith and credit of the U.S. government (for example, Ginnie Mae).

22. Q—A state government sponsors an unrated external investment pool. Does the GASB require the pool to get a rating?

A—No. In the event that the external investment pool is not rated, the state government and other participants in the pool should disclose the fact that the pool is unrated, as provided for in paragraph 7.

23. Q—A government limits its corporate debt investments to the two highest credit quality ratings. Is it required to disclose dollar values for each rating, or may the disclosure indicate that all corporate debt investments have the two highest ratings?

A—As defined in the standard, credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Although credit risk exposure is not a quantitative risk, the *magnitude* of a government's credit risk exposure may be conveyed by disclosing the dollar value for each rating category. A disclosure indicating that all corporate debt investments have the two highest ratings as issued by NRSROs is not sufficient to clearly communicate the credit risk of those investments.

24. Q—Are repurchase agreements and bankers' acceptances subject to credit risk disclosures?

A—Repurchase agreements are not subject to credit risk if the securities underlying the repurchase agreement are exempt from credit risk disclosures. Securities underlying repurchase agreements often take the form of U.S. Treasuries or obligations explicitly guaranteed by the U.S. government, which are not considered to have credit risk. Bankers' acceptances constitute an irrevocable primary obligation of the accepting bank, a contingent obligation of the drawer, and an obligation of any other institution that has endorsed the acceptance. However, because bankers' acceptances are not obligations of the U.S. government, nor are they explicitly guaranteed by the U.S. government, they are not afforded the credit risk exemption provided in paragraph 7, and their credit risk should be disclosed.

25. Q—After the close of the fiscal year but before the financial statements are prepared, a debt investment's credit quality rating is downgraded. Should this be reported as a subsequent event?

A—NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, requires disclosure of a subsequent event when the omission of the disclosure would cause the financial statements to be misleading. Whether or not a debt investment's credit quality rating downgrade is material to the reporting entity's financial statements calls for the exercise of professional judgment. Restrictions on the types of investments allowed by legal or statutory provisions and by the government's investment policy may prevent a government from having a large credit risk exposure in a single entity's investment (concentration of credit risk). A single investment's downgrade after the date of the financial statements generally may not represent a subsequent event requiring disclosure. However, should a government have a concentration of credit risk in a single investment, credit quality rating downgrades after the date of the financial statements may expose the government to a significantly higher level of credit risk exposure that may require disclosure as a subsequent event. For example, a bond downgraded after the date of the financial statements on account of a bankrupt issuer may indicate a large investment loss for the government. If the value of the investment is significant to the government's total investment portfolio, disclosure of such an event may be required.

26. Q—A government invests in a mutual fund that restricts its investments to obligations of the U.S. government or those explicitly guaranteed by the U.S. government. Is the credit quality rating of this mutual fund required to be disclosed?

A—Yes. The SEC's Rule 35d-1 of the Investment Company Act of 1940 prohibits the use of mutual fund names that imply that either the fund or its holdings are guaranteed or approved by the U.S. government. This rule serves to acknowledge the fact that despite the holdings within the fund's portfolio, mutual funds are exposed to some degree of credit risk. Although U.S. government securities and agencies are guaranteed, mutual funds that invest in these securities are not.

27. Q—If a bond mutual fund is unrated but substantially all of the underlying securities within the fund are rated, should the government disclose the average rating of the underlying investments?

A—A mutual fund may not be rated by NRSROs for various reasons, including the inability to rate certain of the holdings within the mutual fund portfolio. Paragraph 7 requires that the government disclose the fact that the mutual fund investment is not rated.

Custodial Credit Risk

28. Q—Statement 3 required the display of three categories of custodial credit risk. How does Statement 40 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 exposure. Because Statement 40 reduces custodial credit risk disclosures to one circumstance, all reference to categories of custodial credit risk has been eliminated.

29. Q—Is a government subject to custodial credit risk on the portion of the reported amount of any repurchase agreement that exceeds the fair value of the underlying securities?

A—Yes. Custodial credit risk includes the portion of the reported amount of any repurchase agreement that exceeds the fair value of the underlying securities. The disclosure of the repurchase agreement's custodial credit risk is consistent with Statement 40 and paragraph 68c of Statement 3, as amended.

30. Q—Is collateral associated with securities lending or derivative activities subject to custodial credit risk?

A—Both collateral associated with securities lending and that associated with derivatives activity are subject to custodial credit risk only when it is reportable as an asset of the government. Paragraph 7 of Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, provides that "[s]ecurities lending transactions collateralized by letters of credit or by securities that the governmental entity does not have the ability to pledge or sell unless the borrower defaults should not be reported as assets and liabilities in the balance sheet." Paragraph 10 of Statement 40 addresses the disclosure requirements for securities lending collateral. Collateral associated with derivatives activities is subject to the same exception-based custodial credit risk disclosures provided for in paragraph 8 or 9 depending upon the nature of the collateral (deposit or investment).

Concentration of Credit Risk

31. Q—Should investments in affiliates and subsidiaries of parent corporations be aggregated for determining the concentration of credit risk of an issuer?

A—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, a government should consider the credit risk of the parent company, its affiliates, and its subsidiaries in determining whether a government holds a concentration of credit risk.

Interest Rate Risk

32. Q—Statement 40 specifies five interest rate risk disclosure methods. May a method be used that is not one of the five?

A—No. The GASB's research indicates that the five interest rate risk disclosure methods prescribed in paragraph 15 are commonly used in practice. The selection among the five methods was permitted to allow a government to choose a disclosure method that is most consistent with the manner in which the government manages its interest rate risk. Because these five methods can adequately communicate a government's interest rate risk exposure, no additional alternatives are permitted.

33. Q—May different interest rate risk disclosure methods be used in succeeding years?

A—Yes. Statement 34 adopts the guidance provided in Accounting Principles Board Opinion No. 20, *Accounting Changes*. Opinion 20, paragraph 7, indicates that "[a] change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods of applying them." Similar to a government using different methods to disclose interest rate risk among its various investment portfolios or funds within the same year, a government may choose to present different interest rate risk disclosures from year to year. To be consistent with its own management practices, a government may need to adopt a different method of reporting interest rate risk in subsequent years to accommodate a change in management, to accommodate a change in portfolio composition, or for other varying reasons. Any government choosing to change interest rate risk disclosure methods should also disclose the nature and reason for the change in accordance with paragraph 17 of Opinion 20.

34. Q—When a debt investment carries a call option, is there a preferable way of disclosing the call option?

A—The majority of the interest rate risk disclosure methods outlined in paragraph 15 can adequately communicate the effects of call options on debt investments. However, governments using the specific identification method of disclosing interest rate risk will need to separately disclose any call options existing on their debt investments. Call options may be identified in the narrative disclosure or may be footnoted to a schedule displaying the government's exposure to interest rate risk. (See questions 39, 41, and 44.)

35. Q—May one interest rate risk disclosure method be used for short-term investments and another used for long-term investments?

A—Yes. Governments may choose among the interest rate risk disclosure alternatives provided in paragraph 15 so that their disclosure methods are consistent with the way the government identifies and manages interest rate risk. A government may manage its overall interest rate risk by separately identifying the interest rate risk associated with different maturity investments. Investments with interest rates that are fixed for longer periods

of time are likely to be subject to more variability in their fair values as a result of future changes in interest rates. To better manage this risk, a government may, for example, choose a more sophisticated method of measuring interest rate risk and may therefore have the information available to disclose that risk using a more complex disclosure model. Allowing a government to report interest rate risk using different methods based on the terms of the investments will enable the government to better align its disclosures with its management practices.

36. Q—What should be considered the maturity of a mutual bond fund when preparing the interest rate risk disclosure?

A—Maturity measures the length of time until a bond issuer is required to pay its investors. Because mutual bond funds invest in many debt issues with different maturity dates, the maturity date of the fund is not fixed. Unlike a 2a7 or a 2a7-like fund, the net asset value for a bond fund changes.

Bond funds generally own many debt investments with differing maturities, so a bond fund reports duration or average maturity—the average of all the debt investment maturities in a fund's portfolio, weighted by the par value of each investment. For example, a mutual bond fund with a weighted average maturity of 8.5 months could be reported using the segmented time distribution as an investment with a maturity of less than one year.

37. Q—A mutual bond fund or external investment pool has demand features, permitting participants to withdraw their positions with short notice. Does this feature cause the investment's maturity to be very short-term, such as under the segmented time distribution method to be presented as having a maturity of less than one year?

A—No. Consideration should be given to the distinction between a mutual bond fund's *maturity* and the flow of deposits and withdrawals. Governments may add monies to mutual bond funds or external investment pools or withdraw monies based on cash flow needs rather than when the investments mature. As stated in question 36, a bond fund may report average maturity weighted by the par value of each bond. It is the focus on the bond fund's maturity that should be considered when designating the investment into the appropriate time distribution for interest rate risk disclosure.

38. Q—A government holds a variable-rate investment with a coupon that resets every three months. How does the reset impact the government's interest rate risk disclosure?

A—Statement 40 defines interest rate risk as “the risk that changes in interest rates will adversely affect the fair value of an investment.” The fair value of repricing securities (debt investments with a coupon that resets on a specific date or frequency) is generally less susceptible to fluctuations in value because the variable-rate coupon resets back to the market rate on a periodic basis. Interest rate risk disclosure methods that consider investment time horizons and maturities (weighted average maturity, segmented time distribution, and duration) generally make assumptions regarding the maturity of the investment for interest rate risk purposes. Effectively at each reset date, a debt investment with a variable-rate coupon reprices back to par value, thus eliminating the interest rate risk on the investment at each periodic reset. Similar to the actual maturity of the investment, the debt investment's price will not fluctuate when the coupon rate is equal to the market rate of interest, and consequently many governments may assume that the maturity for interest rate risk purposes is the length of time until the next reset date rather than the stated maturity. In accordance with paragraph 15, governments should disclose any maturity assumptions that affect interest rate risk information.

However, governments holding investments with variable-rate coupons should consider the effects of caps, floors, and collars (a combination of caps and floors) in the determination of the investments' maturities. For example, a government holds a variable-rate investment having a three-month coupon reset with a cap of 4 percent. If interest rates at the time of the reset were 5 percent, the cap would prevent the investment from repricing to par, causing the fair value of the investment to remain below par and take on the characteristics of a fixed-rate bond, should interest rates remain over the cap of 4 percent.

Both the repricing of the debt investment's coupon to the market rate and the shorter assumed maturity of the instrument tend to lower the magnitude of the interest rate risk associated with the debt investment. However, variable-rate investments with coupon resets may also be coupled with a cap, a floor, or a collar. Such features may prevent reset to par at each reset date, both affecting the maturity and the fair value of the investment. A government should analyze the effects of these features on the fair value of its investments when determining interest rate risk.

Specific Identification

39. Q—Under the specific identification method, how would a government illustrate a debt investment with a variable coupon that resets each quarter?

A—The specific identification method requires a government to list its investments and the investments' respective maturities. For interest rate risk purposes, the government may consider a variable-rate debt investment with a quarterly reset to have a maturity equal to the length of time until its next reset date. In addition to the identification of the investment, the government should disclose, either as a narrative or as a footnote to the schedule, the maturity assumption related to the investment's coupon reset and the terms of the investment in accordance with the provisions of paragraph 16.

Weighted Average Maturity

40. Q—Under the weighted average maturity method of disclosing interest rate risk, what are the cash flows assumptions that are used in the calculation? Do they include such items as principal payments occurring on a periodic basis prior to maturity, interest payments, or the effects of callable bonds?

A—The weighted average maturity method expresses investment time horizons—the time when investments become due and payable—in years or months, weighted to reflect the dollar size of individual investments within an investment type. The cash flows assumptions associated with the weighted average maturity method focus on the maturity value of the instrument, taking into consideration principal payments occurring on a periodic basis prior to maturity. The weighted average maturity method also requires governments to make assumptions as to the effective maturity of callable investments, which should be disclosed. (See question 34.)

Duration

41. Q—Does Statement 40 specify which method of duration should be disclosed?

A—No. There are three common types of duration used to report interest rate risk—Macaulay duration, modified duration, and effective duration. Duration methods can be calculated using analytical software.

Macaulay duration is a measurement of the weighted average term to maturity of a bond's cash flows whereby the weighting is based on the present value of each cash flow divided by the price.

Modified duration is a measure of the price sensitivity of a bond to interest rate movements. It is equal to the Macaulay duration divided by $(1 + [\text{bond yield}/k])$ where k is the number of compounding periods per year.

Effective duration is a method of disclosing interest rate risk that measures the expected change in value of a fixed-income security or portfolio for a given change in interest rates. Because effective duration makes assumptions regarding the most likely timing and amounts of variable cash flows, it is particularly useful for measuring interest rate risk of callable bonds, collateralized mortgage obligations, and other mortgage-backed securities.

Both modified duration and effective duration provide a measure of risk that changes proportionately with market rates. For example, if interest rates fell by 1 percent, the value of a security or portfolio having a modified or effective duration of 3.0 generally would increase in price by 3 percent. Duration methods can be calculated using analytical software.

Duration, as a measurement of the impact of interest rates on bond prices, is only an approximation. Effective duration tends to be a more accurate measure of interest rate risk when there are large changes in prevailing interest rates, unlike both Macaulay and modified duration whose error magnifies as the changes in prevailing rates get larger.

Whereas effective duration makes assumptions regarding the most likely timing and amounts of variable cash flows, Macaulay and modified duration do not take into account such variable cash flows. Some believe that neither modified duration nor Macaulay duration is accurate for debt investments or portfolios with call options, mortgage securities, or put options. Accordingly, effective duration, and similar variations, may need to be utilized when analyzing a bond portfolio consisting of bonds with call options, prepayment provisions, and any other variable cash flows to better gauge the effect of a change in interest rates on the fair value of the portfolio.

Simulation Model

42. Q—What are acceptable simulation models for purposes of applying the Statement 40 disclosure requirements?

A—Acceptable simulation models include those that illustrate the changes in the fair value of a bond or portfolio for a given change in interest rates (sensitivity analysis) or incorporate value-at-risk (VaR) analysis into its investment portfolio assessment to determine its potential future financial losses within a given timeframe. Sensitivity analysis models include market value models and option-adjusted spread models, among others. VaR models include variance/co-variance, historical simulation, and Monte Carlo simulation. The variance/co-variance model, for example, relies on statistical relationships to describe how changes in different markets can affect a portfolio of instruments with different characteristics and market exposures.

The Securities and Exchange Commission's regulations—which are not authoritative—for quantitative risk disclosures may be useful for examining types of simulation models. Item 305 of Regulation S-K and Item 11 of Form 20-F became effective for public companies in two phases beginning June 15, 1997. These rules require companies to furnish quantitative information using one or more of three prescribed methods—tabular presentation (which encompasses one of the interest rate methods described in paragraph 15), sensitivity analysis, and VaR. For example, these rules require that a 95 percent confidence interval be used for VaR disclosures and, consistent with the requirements in paragraph 15, disclosure of the major assumptions used to generate the model.

43. Q—Can a government holding mortgage-backed securities or securities with call options utilize an option-adjusted spread (OAS) simulation model to disclose its interest rate risk?

A—Yes. As noted in the previous question, Statement 40 does not address the type of simulation model that a government is required to use to disclose its interest rate risk. OAS is the spread relative to a risk-free interest rate that equates the theoretical present value of a series of uncertain cash flows of an instrument to its current market price. OAS can be viewed as the compensation an investor receives for assuming a variety of risks less the cost of any embedded options. Evaluating the OAS of an investment requires the determination of the component of a security's yield that is attributed to embedded options. Governments choosing to utilize an OAS model may find that they can incorporate assumptions regarding the uncertainty of cash flows associated with such variable securities that would otherwise need to be disclosed under the requirements of paragraph 16 for

highly sensitive investments. Generally when constructing an OAS model, a government would need to simulate a sufficiently large number of random future interest rate scenarios, or interest rate paths, and then apply a prepayment model to project cash flows along each simulated path. OAS models can be generated with specialized investment software.

44. Q—Should a simulation model include the effects of interest rate decreases?

A—The simulation model is designed to estimate changes in an investment's or a portfolio's fair value, given hypothetical changes in interest rates. Many investments or portfolios illustrate adverse changes in fair values from increasing interest rates; however, governments may have investments or portfolios where the opposite would be true. In these cases, governments using the simulation model would disclose the scenario in which a decrease in interest rates would adversely affect the instrument's or portfolio's fair value. The simulation model method of disclosing interest rate risk is designed to show how changes in interest rates will negatively affect an investment's or a portfolio's fair value.

However, governments may choose to disclose additional scenarios in which changes in interest rates positively affect the instrument's or portfolio's fair value. By seeing the effect of both interest rate increases and interest rate decreases on the investment's or portfolio's fair value, users can identify investments or portfolios with nonsymmetrical returns. Such information conveys to the reader the presence of embedded options within the investment or the portfolio. For example, a \$7 million investment may exhibit the following fair value fluctuations given hypothetical changes in interest rates:

<u>Basis Point Change</u>	<u>Fair Value</u>
-300	\$7,125,800
-200	7,125,800
-100	7,095,500
0	7,000,000
+100	6,735,050
+200	6,425,600
+300	6,112,300

Although the government will not experience a fair value loss when interest rates decline, its fair value gain is limited to \$125,800. This gain may indicate the government's assumption as to any call options embedded within the investment. In this case, the government may believe that the investment will be called once interest rates drop by 200 basis points.

Highly Sensitive Investments

45. Q—What factors may be considered in the determination of whether an investment's fair value is highly sensitive to interest rate changes?

A—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 embedded options, whether any caps or floors may be reached, the size of the portfolio relative to the government or the government's cash needs, the consequences of liquidity tightening by the state or local government, and the investment objective of the portfolio (for example, general fund—short term, versus pension fund—long term) among others.

46. Q—A government holds a fixed-rate bond with a long term to maturity. Is this bond considered an investment that is highly sensitive to changes in interest rates?

A—Yes. However, because such an investment's maturity information may have been disclosed in the basic interest rate risk disclosure (paragraph 15), no additional disclosure as a highly sensitive investment may be required. The magnitude of price fluctuations experienced by debt investments as a result of interest rate changes varies dramatically between short-term and long-term maturities. The longer it takes for a debt investment to mature, the greater fair value will decline when interest rates increase because the holder is subject to the lower coupon rate for a longer period of time. There is a large difference between the fair value fluctuations of debt investments that mature in one or two years versus debt investments that may mature in fifteen years or more. For example, if interest rates rise from 6 to 7 percent, a 6 percent coupon bond with one year remaining to maturity will theoretically lose 1 percent of its fair value. However, a bond with a 6 percent coupon maturing in twenty years will theoretically see a drop in its fair value by approximately 10 percent. Hence, the fair value of long-term debt investments tends to be more sensitive to interest rate changes than the fair value of short-term debt investments.

47. Q—What are some asset-backed securities that are highly sensitive to changes in interest rates?

A—Because mortgage borrowers have the option of prepaying their mortgages, asset-backed securities 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) are examples of common highly sensitive investments.

Prepayment options embedded in some investments cause those investments to be highly sensitive to changes in interest rates. Prepayments by the obligees of the underlying assets reduce the total interest payments to be received by holders of the asset-backed investments. Generally when interest rates fall, obligees tend to prepay the assets (for example, mortgagees prepaying mortgages to take advantage of the lower rates through refinancing), thus eliminating the stream of interest payments that would have been received under the original amortization schedule. This reduced cash flow diminishes the fair value of the asset-backed investment. However, if the asset-backed investment is not able to be repaid, it is less likely to be as susceptible to interest rate changes because obligees have less incentive to prepay their obligations.

48. Q—What are examples of other investments that could be considered investments with fair values that are highly sensitive to changes in interest rates?

A—Examples of other investments that may be highly sensitive to interest rate changes are structured notes, such as range notes and index amortizing notes, step-up notes and bonds, variable-rate investments with coupon multipliers, and coupons that vary inversely with a benchmark index. (See questions 53 and 54.) Range notes are investments whose coupon payment varies (for example, either 6 percent or 3 percent) depending on whether the current benchmark (for example, thirty-year Treasury) falls within a predetermined range (for example, between 4.75 percent and 5.25 percent). The significant interest rate spread that these investments cover and their reliance on a benchmark interest rate generally cause such notes to be considered highly sensitive investments.

Index amortizing notes are a form of structured note whereby the outstanding principal value amortizes according to a predetermined schedule that is usually linked to a designated index. With these investments, payment schedules are not stable. The timing of future cash flows and, consequently, the average life and the yield-to-maturity of the note remain uncertain. When the underlying index rises above a certain level, the average life of the note usually becomes longer. Conversely, should the index drop below the established level, the principal quickly amortizes according to the schedule. Changes in interest rates can have a substantial impact on the cash flows to be received and, consequently, the fair value of the note.

Step-up notes are another form of an investment that may be highly sensitive to changes in interest rates. In a step-up note, the investor holds a note that grants the issuer the option to call the investment on certain specified dates. At each call date, should the issuer not call the note, the coupon rate of the note increases (steps up) by an amount specified at inception. The call feature embedded within a step-up note causes the fair value of the instrument to be highly sensitive to interest rate changes.

49. Q—Are collateralized mortgage obligations (CMOs) considered to be investments with fair values that are highly sensitive to interest rate changes?

A—CMO securities come in a wide variety of forms with different cash flows and expected maturity characteristics that have been designed to meet specific investment objectives. The CMO structure enables the issuer to direct the principal and interest cash flow generated by the collateral to the different tranches in a prescribed manner to meet these different investment objectives. Depending on the type of tranche held, the CMO security may or may not be considered an investment with a fair value that is highly sensitive to interest rate changes. Tranches usually not highly sensitive to changes in interest rates may be considered highly sensitive on account of higher-than-expected prepayments that may make what appears to be a more stable tranche become volatile. The longer the term to maturity of a particular CMO tranche, the more susceptible the tranche is to fluctuations in fair value. (See questions 50–52.)

50. Q—Are interest-only (IO) tranches highly sensitive to interest rate changes?

A—Yes. IO tranches pay owners only some part of the interest paid on mortgages (in the case of a CMO) in the underlying pool. Consequently, the fair value of an IO tranche is based on the cash flows associated with the interest payments on the outstanding mortgages that make up the underlying pool. In falling interest rate environments, the underlying mortgages are subject to a higher propensity of prepayment by homeowners who are taking advantage of lower rates to refinance their mortgages. Prepayment of the underlying mortgages causes the fair value of the IO to decline on account of the decrease in interest cash flows caused by the prepayments. The risk of prepayment in IO tranches is so significant that the investor in the IO tranche may not be able to recover any portion of the initial investment, and the fair value of the tranche may decline to zero. The severity of the potential fair value loss associated with IO tranches leads them to be classified as investments highly sensitive to changes in interest rates.

51. Q—Are principal-only (PO) tranches highly sensitive to interest rate changes?

A—The fair values of most PO tranches are highly sensitive to prepayment rates and therefore interest rates. If interest rates are falling and prepayments accelerate, the value of the PO tranche will increase. On the other hand, if rates rise and prepayments slow, the value of the PO tranche will drop. The uncertainty of the timing of the cash flows makes the fair value of a PO tranche highly sensitive to changes in interest rates, due to the relationship between interest rates and prepayments.

52. Q—What are examples of investments with fair values that are *not* highly sensitive to interest rate changes?

A—Examples of investments that have fair values that are generally not sensitive to interest rate changes are certain tranches of collateralized mortgage obligations (CMOs). CMOs are mortgage-backed securities that are composed of several classes of bonds all backed by the same mortgage collateral. These classes of bonds are known as tranches—related securities offered at the same time, but having different risks, rewards, or maturities. For example, a CMO structure might have tranches with one-year, two-year, five-year, and twenty-year maturities. Tranches that are not generally highly sensitive to changes in interest rates are planned amortization class (PAC) tranches, some targeted amortization class (TAC) tranches, and sequential-pay CMO tranches.

PAC tranches use a mechanism similar to a "sinking fund" to establish a fixed principal payment schedule that directs cash-flow irregularities caused by faster- or slower-than-expected prepayments away from the PAC tranche and toward another "companion" or "support" tranche. Accordingly, the payment schedule, yield, and average life of the tranche are expected to remain stable until maturity. PAC payment schedules are protected by priorities that ensure that PAC payments are met first out of principal payments from the underlying mortgage loans. These characteristics of PAC tranches make them fairly insensitive to interest rate changes that may cause the underlying mortgages to be prepaid. TAC tranches are similar to PAC tranches, although they specify a prepayment rate at which the principal payment schedule is fixed.

Sequential-pay CMOs have tranches that pay in a strict sequence. Each tranche receives regular interest payments, but the principal payments received are made to the first tranche alone, until it is completely retired. Once the first tranche is retired, principal payments are applied to the second tranche until it too is fully retired, and the process continues until the last tranche is retired. Generally the first few tranches in a sequential-pay CMO, similar to PAC tranches, are fairly insensitive to interest rate changes because even if the underlying mortgage holders choose to prepay, the first tranche will continue to receive principal payments from other tranches until the first is retired.

53. Q—A government holds a variable-rate investment with a multiplier. Is this an investment with a fair value that is highly sensitive to changes in interest rates?

A—A variable-rate investment with a multiplier may be considered to be an investment with a fair value that is highly sensitive to changes in interest rates because small changes in interest rates will be amplified by the underlying multiplier. These larger changes in the coupon payment affect the amount of future cash flows to be received by the holder of the bond, which consequently affects the fair value of the investment. Whereas variable-rate investments usually reprice back to par on interest rate reset dates, the fair value of variable-rate investments with multipliers may significantly change depending on the nature of the multiplier. Paragraph 16a of Statement 40 identifies a variable-rate investment whose coupon is based on 1.25 times the three-month LIBOR rate as a highly sensitive investment. However, a variable-rate investment with a coupon rate set at 1.05 times the three-month LIBOR would not necessarily qualify for the same categorization considering that the effect of the multiplier, while present, may not greatly impact the fair value of the investment.

Additionally, consideration needs to be made regarding whether the simple multiplier causes the instrument to take on the characteristics of an inverse floater. Paragraph 16b identifies one such inverse floater as a highly sensitive investment. (See question 54.)

54. Q—Is a variable-rate investment with a coupon that varies inversely with a benchmark index an investment with a fair value that is highly sensitive to changes in interest rates?

A—A variable-rate investment with a coupon that varies inversely with a benchmark index may be highly sensitive to changes in interest rates. As depicted in paragraph 16b, a variable-rate investment with a coupon set at 4 percent minus the three-month LIBOR with a floor of 1 percent is shown to be an example of a highly sensitive investment. Usually with most variable-rate debt investments, as interest rates change, the fair value of the debt investment reprices to par at each interest rate reset date. However, with inverse floater instruments, not only does the fair value of the debt investment change as interest rates change, but the fair value changes according to both the change in the market rate of interest and the rate of interest paid by the coupon. For example, if the three-month LIBOR from paragraph 16b were to increase from 1.5 percent to 3.0 percent, the fair value of the debt investment would be calculated using a coupon rate of 1 percent instead of 2.5 percent, causing an investment that had a positive fair value to become an investment with a negative fair value.

A simulation model depicts the monetary impact that changes in interest rates have on a variable-rate investment with a coupon that varies inversely with a benchmark index. For example, a government purchases both a \$1 million conventional bond at par with a coupon payment of 4 percent and a \$1 million inverse variable-rate bond with a coupon that varies by the difference between 7 percent minus LIBOR. Coupon payments are made semiannually and the bonds mature in three years. The sensitivity of the inverse variable-rate bond for hypothetical changes in interest rates is as follows:

	<u>Fair Value</u>	<u>Cash Flows</u>	<u>Impact on Fair Value of Basis Point Increase of:</u>		
			<u>100 Points</u>	<u>200 Points</u>	<u>300 Points</u>
Conventional bond:					
4%	\$1,000,000	\$1,120,000			
5%	972,459	1,120,000	\$972,459		
6%	945,828	1,120,000		\$945,828	
7%	920,072	1,120,000			\$920,072
Inverse floater:					
4%	\$971,993	\$1,090,000			
5%	917,378	1,060,000	917,378		
6%	864,570	1,030,000		864,570	
7%	813,501	1,000,000			813,501

55. Q—Paragraph 16 indicates that for investments that are highly sensitive to changes in interest rates, “[d]isclosure information for similar investments may be aggregated.” For governments holding significant concentrations of highly sensitive investments with varying terms, how may the government choose to display the aggregated disclosure requirements?

A—Provided that the portfolio percentage disclosures do not confuse the content of the disclosures, a government may choose to aggregate its highly sensitive investment terms as percentages of the total portfolio. Governments may have long-term strategic asset allocation policies that provide diversification over many asset classes in order to reduce interest rate risk. For example, a public employee retirement system (PERS) holds a portfolio of 125 individual highly sensitive investments. Thirty of the investments represent 20 percent of the fair value of the portfolio and contain coupon multipliers ranging from 1.25 to 2.5 times the three-month LIBOR rate. The PERS in this case may disclose that 20 percent of the fair value of its portfolio is invested in securities with coupon multipliers ranging from 1.25 to 2.5 times the three-month LIBOR. Alternatively, a government may choose to aggregate its highly sensitive investment terms by dollar value. For example, the PERS may indicate that \$25 million of the portfolio’s investments are contained within securities with coupon multipliers ranging from 1.25 to 2.5 times the three-month LIBOR.

56. Q—Is the need for disclosure of the effects of highly sensitive investments affected by the other securities held in the portfolio?

A—Individual securities held in the portfolio may be highly sensitive to changes in interest rates, and a government should consider the effect of those instruments on the interest rate risk of the entire portfolio when determining appropriate disclosures. The interest rate risk disclosure methods outlined in paragraph 15 generally consider the effects of offsetting investments that either increase or decrease a government’s exposure to interest rate risk. For example, a government may choose to present its interest rate risk using the weighted average maturity of the government’s portfolio, thereby taking into consideration the aggregate effect of all investments on the government’s interest rate risk. Governments holding investments that are highly sensitive to changes in interest rates should also analyze the effect of such instruments on the interest rate risk of the entire portfolio, making appropriate disclosures of the terms of those instruments when the terms are not expressed in the interest rate risk disclosure method selected. For example, a government holds a variable-rate investment with a coupon set at 2.25 times the three-month LIBOR. The effective duration of the portfolio,

including the variable-rate investment, is 5.46 years, whereas the effective duration of the portfolio without the variable-rate investment is 4.87 years. The variable-rate investment serves to increase the government's exposure to interest rate risk, which is communicated in the interest rate risk disclosure method selected from paragraph 15. Additional terms and the fair value of the investment should be disclosed in accordance with paragraph 16.

57. Q—In disclosing a portfolio's sensitivity to interest rate changes, a simulation model communicates the effects of volatile investments. In this case, would the additional disclosures for highly sensitive investments required by paragraph 15 be necessary?

A—The interest rate risk disclosure methods listed in paragraph 15 range in sophistication from the simple to the complex. Some of the methods in paragraph 15 for disclosing interest rate risk may incorporate sufficient information required of highly sensitive investments so that additional disclosures may not be required. A disclosure that describes the effects of interest rate changes on aggregate portfolio values in both increasing and decreasing interest rate assumptions may include many, if not all, of the investment terms that paragraph 16 would require to be disclosed. (See question 44.) Specific additional disclosures that should be reported for highly sensitive investments when a simulation model is used to disclose interest rate risk have not been prescribed.

58. Q—How would the presence of interest rate floors and caps affect the determination of highly sensitive investments?

A—Interest rate floors and caps set the minimum and maximum interest rates to which a variable-rate investment is exposed, reducing the magnitude of fluctuations in fair value caused by interest rate changes. The effects of the cap, floor, or a combination of the two (known as a collar) need to be considered in determining whether an investment is highly sensitive to changes in interest rates. Investments containing a cap, a floor, or a collar may be considered highly sensitive investments because of the associated interest rate option. (See question 45.)

Investments containing an interest rate option also may be highly sensitive notwithstanding the presence of interest rate floors and caps. For example, a government owns a variable-rate investment with a coupon that is set at 1.75 times the three-month LIBOR with a cap of 4 percent, an investment that would be considered highly sensitive if no cap were present. When LIBOR reaches 2.28 percent, the variable-rate investment's coupon will be capped at 4 percent ($2.28 \text{ percent} \times 1.75$). If LIBOR stays between 2.28 percent and 4 percent, the fair value of the investment remains over par; however, when LIBOR rises above 4 percent, the investment acts as a fixed-rate investment with a coupon of 4 percent, and its fair value drops accordingly to increases in LIBOR. If the bond has a long maturity, it may be considered to be an investment with a fair value highly sensitive to changes in interest rates. (See question 46.)

Foreign Currency Risk

59. Q—May interest rate risk of debt investments denominated in foreign currencies be included in the interest rate risk disclosure?

A—Yes. Governments are not required to segregate investments denominated in foreign currencies from their other investment risk disclosures. Governments may choose to include the interest rate risk of such investments within their interest rate risk disclosures or may choose to present all of the investment risks that the foreign-denominated investment bears within the foreign currency risk disclosure. For example, a government may choose to display its exposure to interest rate risk using the specific identification method. In that case, the government may list each foreign investment by investment type, the currency in which they are denominated, the maturity of each investment, and the investments' fair values.

60. Q—Are foreign currency risk disclosures limited to debt investments?

A—No. Foreign currency risk disclosures should be made for all investments, including debt, equity, and real estate investments.

61. Q—A limited partnership has investments in various countries. Do foreign currency risk disclosures “look through” the partnership to identify the foreign currency risks?

A—Consistent with the requirements established for external investment pools, no disclosure is required for the individual deposits or investments of the limited partnership. (See question 3.) Consequently, a government holding an investment in a limited partnership would not be required to report the risks associated with the *individual* investments of the limited partnership. Disclosure of the fair value and type of investment is sufficient to acknowledge the government’s exposure to foreign currency risk. However, in the case that an investment in a limited partnership is in itself an investment in foreign currency investments, paragraph 17 disclosures should be followed. For example, a government invests in a limited partnership that holds all of its investments (which are significant to the total assets of the limited partnership) in Japan. Should exchange rates become significantly unfavorable, the financial viability of the limited partnership may be called into question. Consequently, the government’s financial viability of its investment in the limited partnership may also become questionable because of the foreign exchange risk attributable to Yen borne by the partnership.

62. Q—A government has an investment in an international mutual fund. How much foreign currency disclosure detail is required?

A—A government’s investment in an international mutual fund does not require disclosure of the individual investments within the fund. Provided that the government does not hold a significant portion of its assets in the international mutual fund, disclosure of the fair value and type of the investment is sufficient to acknowledge the government’s exposure to foreign currency risk.

63. Q—In order to manage its exposure to foreign currency risk, a private-purpose trust entered into a foreign currency overlay—a management plan utilizing derivatives that is designed to enhance returns while reducing overall portfolio volatility caused by foreign currency risk. In the trust’s foreign currency risk disclosure, how would the effects of the overlay be communicated?

A—A government implementing a foreign currency overlay would still be required to disclose the foreign currency risk inherent in its underlying investments in accordance with paragraph 17 of Statement 40. Foreign currency investment derivatives contained within the overlay program are subject to the same foreign currency disclosures as are the underlying investments. Additionally, foreign currency derivatives not reported at fair value on the statement of net assets are subject to the disclosure requirements established in Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*. Required disclosures include the objective of the derivative, the terms of the derivative, the fair value of the derivative, and risk exposures including credit risk, interest rate risk, and termination risk among others.

Effective Date

64. Q—A primary government chooses to implement Statement 40 prior to its required implementation date. Are all of the primary government’s component units required to implement Statement 40 at the same time as the primary government?

A—Yes. Similar to Statement 34 implementation guidance, component units should implement the requirements of Statement 40 no later than the same year as their primary government. The Statement 40 requirement to disclose custodial credit risk on an exception basis precludes consistency between component units that may

be disclosing categories of custodial credit risk under Statement 3 and the primary government that may not disclose custodial credit risk at all. Presenting Statement 3 custodial credit risk disclosures along with the Statement 40 exception-based disclosure method may mislead users of the financial statements as to the relative custodial credit risk of category 1 and category 2 deposits and investments.

To meet the requirement of implementing Statement 40's disclosures no later than the same year as the primary government, component units with fiscal year-ends that are different from their primary government's may have to implement the requirements of the standard early.

GLOSSARY

This paragraph contains definitions of certain terms as they are used in Statement 40 and in this Implementation Guide; the terms may have different meanings in other contexts.

Concentration of credit risk

The risk of loss attributed to the magnitude of a government's investment in a single issuer.

Counterparty

The party that pledges collateral or repurchase agreement securities to the government or that sells investments to or buys them for the government.

Credit risk

The risk that an issuer or other counterparty to an investment will not fulfill its obligations.

Custodial credit risk

The custodial credit risk for *deposits* is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for *investments* is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party.

Depository insurance

Depository insurance includes:

- a. Federal depository insurance funds, such as those maintained by the Federal Deposit Insurance Corporation.
- b. State depository insurance funds.
- c. Multiple financial institution collateral pools that insure public deposits. In such a pool, a group of financial institutions holding public funds pledge collateral to a common pool.

Duration

A measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price.

Embedded option

A provision or term in a financial instrument that allows one party to change the timing or amount of one or more cash flows associated with that instrument. Examples include prepayment options on asset-backed securities.

Federal Deposit Insurance Corporation

A corporation created by the federal government that insures deposits in banks and savings associations.

Foreign currency risk

The risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

Interest rate risk

The risk that changes in interest rates will adversely affect the fair value of an investment.

Issuer

An issuer is the entity that has the authority to distribute a security or other investment. A *bond issuer* is the entity that is legally obligated to make principal and interest payments to bond holders. In the case of mutual funds, external investment pools, and other pooled investments, *issuer* refers to the entity invested in, not the investment company-manager or pool sponsor.

Reset date

The time, frequently quarterly or semiannually, that a bond's variable coupon is repriced to reflect changes in a benchmark index.

Segmented time distributions

Segmented time distributions group investment cash flows into sequential time periods in tabular form.

Simulation models

Simulation models estimate changes in an investment's or a portfolio's fair value, given hypothetical changes in interest rates. Various models or techniques may be used, such as "shock tests" or value-at-risk.

Specific identification

In the context of interest rate risk disclosures, the specific identification method does not compute a disclosure measure but presents a list of each investment, its amount, its maturity date, and any call options.

Uncollateralized deposit

An uncollateralized deposit does not have securities pledged to the depositor-government.

Variable-rate investment

An investment with terms that provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a fair value that will be unaffected by interest rate changes.

Weighted average maturity

A weighted average maturity measure expresses investment time horizons—the time when investments become due and payable—in years or months, weighted to reflect the dollar size of individual investments within an investment type.