



STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

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Statement of Position Custodial Credit Risk: Investment Policy Considerations

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This Statement of Position is not legal advice and is subject to revision.

GASB Statement No. 40 requires the notes to financial statements to disclose a public entity's investment policy provision regarding custodial credit risk or, alternatively, to disclose the fact that the investment policy does not address custodial credit risk.¹ The extent to which a public entity's deposits or investments are subjected to custodial credit risk must also be disclosed.

Unlike other deposit- or investment-associated risks, custodial credit risk is the risk of loss associated with the counter-party's failure. One of the most confusing aspects of custodial credit risk concerns the concept of the "counter-party." Normally, a broker is considered to be an agent of an investor. For the purposes of analyzing custodial credit risk for investments, however, a broker is a "counter-party." A "counter-party" in this context is defined to include any entity that obtained the investment on a public entity's behalf.

Custodial credit risk differs in its application between bank deposits and investments.

Bank Deposits

With regard to bank deposits, compliance with Minn. Stat. ch. 118A eliminates custodial credit risk. These statutes require that all of a public entity's deposits be protected by deposit insurance, bond or pledged collateral. In the event of failure of the depository, there is no custodial credit risk because a public entity can look to deposit insurance, the bond or the collateral to be made whole.

Public entities should obtain the required documentation to show compliance with Minn. Stat. ch. 118A. Minnesota Statutes, section 118A.03, subd. 4, requires a written assignment of collateral and, to be enforceable, the assignment must comply with the requirements of the Federal Institutions Reform, Recovery and Enforcement Act (FIRREA).² Compliance with this Federal Act requires an additional step be taken. When obtaining a written assignment, the government depositor must make sure that the written assignment is approved by the depository bank's board of directors or loan committee. Documentation of this approval, such as a copy of the minutes or a resolution of the board or committee, should be obtained and maintained in the entity's records. Since compliance with state and

¹ This disclosure required by GASB Statement No. 40 carries forward the concept of custodial credit risk first identified in GASB Statement No. 3.

² Pub. L. No. 101-73, 101 Stat. 187 (1989) (codified as amended at 12 U.S.C. § 1818 (Supp. III 1991)).

federal law will eliminate custodial credit risk, auditors include in their annual audits an examination for compliance with both state and federal law.

GASB Statement No. 40 requires not only disclosure of the amount of deposits that are exposed to custodial credit risk, but also whether the public entity addresses custodial credit risk for both deposits and investments in its investment policy.

We recommend that public entities address both deposit and investment custodial credit risk in their investment policies. For “deposit” custodial credit risk, we suggest the following language:

The _____ [city, county, school district, etc.] will minimize deposit Custodial Credit Risk, which is the risk of loss of failure of the depository bank (or credit union), by obtaining collateral or bonds for all uninsured amounts on deposit, and by obtaining necessary documentation to show compliance with state law and a perfected security interest under federal law.

Investments

With regard to custodial credit risk related to investments, there is no state law that requires public entities to eliminate this risk. However, compliance with state safekeeping laws will greatly reduce or eliminate custodial credit risk.

Minnesota Statutes, section 118A.06, limits who can hold a public entity’s investments to:

- The Federal Reserve Bank;
- Banks with corporate trust powers;
- Primary reporting dealers to the Federal Reserve Bank of New York; and
- Broker-dealers, to the extent they have insurance through the Securities Investors Protection Corporation (SIPC) or have excess SIPC coverage.

The financial entity holding the government’s securities must acknowledge the government entity’s ownership in writing.

By requiring that broker-dealers have SIPC coverage and excess SIPC coverage in order to hold public investments, this statute effectively eliminates custodial credit risk under the GASB criteria for those situations where a broker-dealer purchases and holds public investments. The other method for eliminating custodial credit risk is to have the broker-dealer transfer the investments to a custodian to hold on the public entity’s behalf.

Investment Policy Provisions

Investments Obtained Through a Broker

For “investment” custodial credit risk, the following language establishes policies to eliminate custodial credit risk applicable to public investments:

The _____ [city, county, school district] will eliminate investment Custodial Credit Risk by permitting brokers that obtained investments for the _____ [city, county, school district] to hold them only to the extent there is SIPC and excess SIPC coverage available. Securities purchased that exceed available SIPC coverages shall be transferred to the _____’s [city, county, school district] custodian.

State statute requires that a broker certification form be signed by the broker or other agent prior to obtaining investments on behalf of a public entity.³

³ Minn. Stat. § 118A.04, subd. 9.

Investments Obtained From or Through a Bank

Sometimes public entities will obtain securities from or through a bank. This is often the case where a sweep account is used to transfer public deposits to an investment account, or sometimes a repurchase agreement account.

The following language eliminates custodial credit risk:

The _____ [city, county, school district] will eliminate investment custodial credit risk by permitting banks to hold security investments of _____ [city, county, school district] only to the extent they are transferred to the bank's trust department. Security investments not held in the bank's trust department will be held by _____'s [city, county, school district] custodian.

The following pooling provision will reduce custodial credit risk to a level set by the public investor's governing board:

In no case will the investments subject to custodial credit risk exceed ___% of _____'s [city, county, school district] investment portfolio.

There are different approaches to investment custodial credit risk. The Office of the State Auditor recommends that public entities adopt policy provisions that protect, to the greatest extent possible, the public entity's investments. If you have questions, please feel free to contact the Legal Department at the Office of the State Auditor.