

THE ASSOCIATION OF GLOBAL CUSTODIANS

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THE CHASE MANHATTAN BANK
CITIBANK, N.A.
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INVESTORS BANK & TRUST COMPANY
MELLON TRUST/BOSTON SAFE DEPOSIT
& TRUST COMPANY
THE NORTHERN TRUST COMPANY
STATE STREET BANK AND TRUST COMPANY

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March 15, 2001

VIA AIR COURIER

Annette Knief
Financial Services Manager
National Association of
Insurance Commissioners
2301 McGee Street
Suite 800
Kansas City, Missouri 64108-2604

RE: Proposed Amendment to Section 2.B(15) of the Model
Regulation on the Use of Clearing Corporations and
Federal Reserve Book-entry System By Insurance
Companies

Dear Ms. Knief:

This letter is submitted on behalf of the Association of Global Custodians ("Association"), an informal group of nine banks that are major providers of global custody services to U.S. institutional investors.¹ The Association appreciates the opportunity to comment on the proposed amendment to Section 2.B(15) of the Model Regulation and apologizes for submitting this letter after the March 7 comment deadline. Because of the

¹/ The members of the Association are The Bank of New York, Boston Safe Deposit & Trust Company, Brown Brothers Harriman & Co., The Chase Manhattan Bank, Citibank, N.A., Deutsche Bank AG, Investors Bank & Trust Company, The Northern Trust Company, and State Street Bank and Trust Company.

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importance of this matter to the major custody banks, we respectfully request that our comments nonetheless be considered.

Summary

The Association urges that the NAIC withdraw the proposed amendment. We believe that the proposal is inconsistent with the role of a bank custodian and would do little to protect policyholders against the misappropriation of insurance company assets. Moreover, if implemented, the proposal would impose significant costs and burdens on custodian banks. These added costs would inevitably be reflected in higher custody fees and ultimately borne by policyholders.

Proposal

The proposal would require that the agreement between an insurance company and its custodian contain a provision obligating the custodian to monitor the insurer's account and to assume two new responsibilities --

- The custodian must provide written notification (within seven business days) to the commissioner in the insurer's state of domicile if "during any period of 30 consecutive days" the insurer has withdrawn "securities greater than or equal to twenty five percent (25%) of its total portfolio (par value for bonds, market value for equities)."
- The custodian must provide written notification (which must be received within three days) to the commissioner in the insurer's state of domicile if the custodial agreement with the insurer has been terminated.

We understand that this proposal is intended as a response to the activities of Martin Frankel. Mr. Frankel is alleged to have acquired control of certain small insurance companies and to have caused those companies to transfer assets to accounts at a brokerage firm that he also controlled. Rather than investing

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the transferred funds for the benefit of the insurers, Mr. Frankel and his confederates appropriated them to their own use.

The Proposal Is Inconsistent With the Role of a Custodian

Custodians are service providers, not fiduciaries to their institutional custody clients, such as insurance companies, and are not privy to their clients' investment strategies and business plans. The proposal would fundamentally alter the role of the custodian by requiring it to determine whether transfer and delivery instructions received from a client constitute "withdrawals;" to develop systems to continuously value client assets and to compare those values to the client's "total portfolio;" and to report the results to a regulatory body.

If this change could be expected to result in a material increase in the safety of insurer assets at a reasonable cost, it might merit consideration.² As demonstrated below, however, the proposal, while costly, will do little or nothing to forestall embezzlement by dishonest insurance company management.

The Proposal is Unlikely To Be Effective

The proposal is unlikely to be effective in curbing abuses such as are alleged to have occurred in the Frankel case. This is true for several reasons.

First, insurers typically hold their liquid assets in several accounts, and large transfers out of one account may entail only a minor readjustment of an insurer's overall investment position. At best, a custodian could only determine whether changes had occurred with respect to the particular

^{2/} In this regard, we note that members of the Association hold assets for many clients, such as SEC-registered investment companies and ERISA plans, that are subject to stringent regulation. However, no other regulator has seen fit to impose on custodian banks a reporting obligation concerning asset withdrawals or account terminations.

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assets it holds for the insurer. Contrary to the language of the proposal, a custodian would have no way of determining what percentage those assets are of the insurer's "total portfolio." As a result, reports from any one custodian would often provide a skewed or fragmented picture of the insurer's overall activity.

Second, the proposal is apparently based on the notion that large "withdrawals" from an insurer's custody account and account terminations are symptomatic of fraud. This reflects a misunderstanding of the operation of a custody account. It is common for clients, including insurance companies, to engage in active trading of assets held in custody. Trading inherently involves the "withdrawal" of assets, such as when securities and cash are delivered out to settle transactions. If an insurer's investment strategy changes, the insurer may rapidly liquidate its portfolio in a certain type of investment. Even free deliveries from a custody account are not unusual and may occur for a variety of legitimate business reasons. In short, most "withdrawals" of assets are not indicators of wrongdoing.³

Third, the reporting system in the proposal seems to combine changes resulting from the removal of assets from an account with changes resulting from price movements. In particular, the proposal calls for measurement of the magnitude of withdrawals of non-debt securities by reference to market prices. As a result, equity price fluctuations, alone or coupled with asset withdrawals, could apparently trigger reporting.⁴

^{3/} Similarly, in the vast majority of cases, the termination of a custody account is not evidence of misconduct. On the contrary, terminations are usually the result of asset servicing or pricing-related issues.

^{4/} By tying debt security valuation to par, the proposal may create another kind of anomaly. The routine removal from the account of debt securities that have materially declined in market value (such as because of a ratings downgrade) could trigger reporting, even though the impact on the economic value of the insurers total assets in custody was slight.

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Fourth, the proposed reporting requirement would be easy to evade. Unscrupulous insurance company officials could substantially deplete an account without generating reports simply by timing their withdrawals so that the 25 percent threshold was not crossed in any 30 day period. This conduct would be analogous to "smurfing" in the context of money laundering.

For these reasons, while the proposal is likely to generate huge volumes of reports, those reports will be of little value. Reporting will be a common occurrence as insurers trade their portfolios, market values rise and fall, and transfers among custodians and brokerage firms occur for routine purposes. State insurance departments would likely need staff additions to review and analyze this avalanche of reporting in the hope of identifying the tiny fraction that might be even indicative of embezzlement.⁵ More likely, the reports will simply prove useless.

The Proposal Would Impose Significant Costs

While we do not believe that the proposal would accomplish its intended purposes, it would impose significant, industry-wide costs. For major custody banks, such as the members of the Association, the amendment would require an expensive systems redesign.

These costly systems modifications would be the result of several factors. First, the calculations required by the

^{5/} Even if "withdrawals" or account terminations were, on rare occasions, red flags signaling possible misconduct by insurance company controlling persons, it is difficult to see what would be accomplished by after-the-fact reports concerning these events. By the time an insurance commissioner's staff received a report of an asset withdrawal and divined its significance, many weeks would have passed. Strengthening internal controls aimed at preventing improper transactions, rather than requiring post-hoc notices, would appear to be the more fruitful course of action.

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proposal would force custodians to apply different accounting methodologies to different securities held in the same account, since par value must be tracked for bonds and market value for equities. Moreover, the new valuations would have to be computed on a daily basis. While the existing accounting software of most custodian banks could likely cope with simultaneously valuing bonds at par and shares at market value, combining these valuations with account changes based on deliveries out of the account, and generating reports on a daily basis to meet the 30 consecutive days requirement, would be a complex undertaking.

These new systems requirements, along with the additional staff needed to discharge the custodian's monitoring and reporting duties, would increase custody costs significantly. Those expenses would be borne by the insurer in the form of higher custody fees. Insurers, in turn, could be expected to reflect these added costs in the premiums charged to policyholders.

In this regard, the Association also urges the NAIC to recognize that these costs would be imposed to implement a very broad response to a narrow problem. The insurance company clients of the banks in the Association are almost exclusively large institutions with massive portfolios of marketable assets. We do not believe that the case has been made to justify major, industry-wide expenditures on custodian oversight tools to monitor the account activity of this type of institution. The Frankel case seems instead to illustrate the need for a narrowly focused response that seeks to impose greater oversight of small insurers with limited internal audit and control capabilities. That is the type of insurer on which Mr. Frankel is alleged to have preyed.

* * *

Although we believe that the proposed amendment to Section 2.B(15) is ill-advised, the Association does not, of course, mean to suggest that criminality by insurer management, such as apparently occurred in the Frankel case, should be taken lightly. We respectfully suggest, however, that the solution to these

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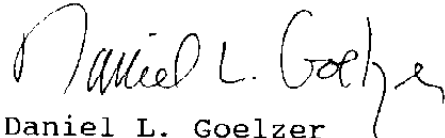
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problems lies in increasing the resources of state insurance commissioners and in imposing stronger internal control requirements on small insurers, not in attempting to require that bank custodians assume industry-wide oversight responsibilities for their clients.

As noted at the outset, the Association regards this matter as extremely important to the custody banking industry, and very much appreciates the opportunity to comment. We would of course be happy to discuss our comments with you and your colleagues, or to provide any additional information concerning our views that you may require. If you have questions, please feel free to contact me.

Best regards.

Sincerely,



Daniel L. Goelzer
Counsel to the Association
of Global Custodians