THE ASSOCIATION OF GLOBAL CUSTODIANS

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June 6, 2001

VIA FACSIMILE AND AIR COURIER

The Honorable Kathleen Sebelius
Chair, NAIC Executive Committee

The Honorable John Oxendine
Chair, NAIC Reinsurance Task Force
C/o Bryan Fuller
NAIC Reinsurance Manager

National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, Missouri 64108-2604

RE: Proposed Amendments to Sections 7E and 10B of the Credit for Reinsurance Model Regulation

Dear Ms. Sebelius and Mr. Oxendine:

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. The Association appreciates the opportunity to comment on the proposed amendments to Sections 7E and 10B of the Credit for Reinsurance Model Regulation ("Proposal"). We apologize for submitting this letter at a late date in the approval process and respectfully request that our comments nonetheless be considered.

Summary

The member banks of the Association often serve as trustees pursuant to reinsurance trust agreements, and the Association is therefore interested in the Proposal. The Proposal would require the trustee to assume a contractual obligation to draw on a letter of credit held in such a trust "if the letter of credit will otherwise expire without being renewed or replaced." In addition, the Proposal apparently seeks to impose strict liability on a trustee for failing to draw "where such draw would be required."

The Association believes that, in this context, strict liability is not the appropriate standard and could inhibit the use of letters of credit. If the trustee has exercised reasonable care and has acted in good faith, it should not be subjected to damages that could potentially be astronomical, relative to the fees typically collected for serving as a trustee, without having the opportunity to demonstrate to a court that liability is, under the particular facts and circumstances, unwarranted. Strict liability is especially inappropriate in this context because, in some situations, uncertainty could exist concerning whether a draw is "required." The threat of non-fault liability may inhibit reputable banks from agreeing to hold letters of credit in trust.

The Association urges that the provision in proposed Section 7E(9) that deems a failure to draw on a letter of credit "negligent and/or willful" should be deleted. At minimum, the trustee should be afforded the opportunity to show that its failure to draw was not culpable.

Discussion

Under the Proposal, a letter of credit would qualify as an asset of a reinsurance trust only if the trustee has the right and the obligation, pursuant to the deed of trust or some other binding agreement, "to immediately draw down the full amount of the letter of credit and hold the proceeds in trust for the beneficiaries if the letter of credit will expire without being renewed or replaced." The trust agreement must also provide that the trustee will be liable for its negligence, willful misconduct or lack of good faith. However, "where such draw would be required,"

the failure of the trustee to draw "shall be deemed to be negligence and/or willful misconduct."

Taken together, the effect of these provisions appears to be to impose automatic liability if a trustee fails to draw on a letter that would otherwise expire without being renewed or replaced, even if the trustee was not negligent, did not act with willful misconduct and acted in good faith. Stated differently, if a court, in hindsight, concluded that a letter of credit held in trust had expired without being renewed or replaced, the trustee would be treated as if it had acted negligently or willfully, regardless of the surrounding circumstances. Such liability would apparently be "strict" -- that is, independent of fault.

In the Association's view, conditioning the use of letters of credit on the trustee's strict liability is unjustified. While we are mindful of the importance to policyholders of adequate funding to support reinsurance obligations, we do not believe that acting as the trustee of a reinsurance trust that holds a letter of credit is comparable to the type of conduct that traditionally gives rise to strict liability.[1] In fact, even other, potentially more serious, trustee violations of the Model Regulation would not result in strict liability. If, for example, the trustee were to permit the withdrawal of trust assets without the consent of the beneficiary in violation of Section 10B(6), the trustee would apparently be liable only if it had acted negligently or willfully. We are aware of no basis for singling out trustees that hold letters of credit for strict liability, while providing for negligence-based liability in the case of trustees holding more conventional assets.

Further, strict liability is inappropriate in the context of trustee decision-making concerning letters of credit because, in some circumstances, legitimate uncertainty could exist concerning whether a draw is required. Knowledge of whether or not a letter of credit will be replaced or renewed may not always be

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1/ In tort law, the usual rule is that liability results from negligence or some other deviation from behavioral norms. In contrast, strict liability usually applies only to persons who chose to engage in inherently dangerous or socially undesirable activities that have a high potential of causing injury.

evident from the terms of the letter and may depend in part on representations to the trustee by the issuing bank or the grantor. The Proposal seems to assume that there is no conceivable circumstance in which the trustee, based on the information available to it, might in good faith erroneously conclude that no draw is required. In contrast, the Association believes that there could well be circumstances in which the imposition of strict liability on the trustee will require it to pay for a loss as to which another party is in fact culpable.[2] The trustee should not be precluded from attempting to make such a showing.

Finally, as a result of the application of a strict liability standard, major banks that typically serve as trustees may be compelled to make a business decision to refuse to accept letters of credit as reinsurance trust assets. At a minimum, the potential for huge liabilities, independent of whether the trustee was at fault, will unquestionably be a significant factor in determining the pricing of reinsurance trust services. If banks that agree to hold letters of credit for reinsurance trusts significantly increase their fees, the effect may be to make letters of credit an economically unattractive alternative for re-insurers. Even if letters of credit continue to be utilized by re-insurers, it is inevitable that trustee fee increases will be passed on by re-insurers to ceding insurers, and, in turn, to policyholders in the form of higher premiums. We respectfully suggest that the likely unintended consequences, such as deterring the use of letters of credit or increasing premiums, far out weigh the benefits of imposing strict liability on trustees that agree to hold letters of credit.

Recommendation

For these reasons, the Association believes trustees should, at a minimum, have the opportunity to rebut the presumption of negligence or willful misconduct

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2/ Unlike the more typical strict liability situation, there is no advantage to the trustee in purposefully engaging in the conduct in question (i.e., allowing a letter of credit to expire without drawing upon if a draw is required). Situations can, however, be imagined in which the issuing bank or the grantor would benefit from the expiration of the letter without a draw-down.

embodied in Section 7E(9) of the Proposal. This could be accomplished in several ways. The most straightforward solution would be to simply delete the second sentence of proposed Section 7E(9). This would have the effect of putting trustee errors with respect to letter of credit draws on the same footing as other violations of the Model Regulation.

Methods of addressing the problem we have identified could be suggested. The objective, however, should be to protect from strict liability a trustee who has acted with reasonable care and in good faith and to afford the trustee the opportunity to persuade a court that, under all of the circumstances, liability for the failure to draw on a letter of credit should not rest with the trustee.

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The Association believes this matter is important to banks acting as trustees for reinsurance trusts and appreciates the opportunity to comment. We would be pleased to discuss our views with you and your colleagues, or to provide any additional information that you may require. If you have questions, please feel free to contact me, or my colleague Margaret R. Blake, at the address above.

Sincerely,

Daniel L. Goelzer /MRB

Daniel L. Goelzer
Counsel to the Association
of Global Custodians

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