The HOT SPOT

Custodian Banks: Risks are Manageable with Appropriate Safeguards (11/01/2016)

The U.S. insurance industry typically employs third-party service providers for a variety of day-to-day operations, particularly within the investment management process. A critical third-party service provider to insurance companies is the custodian bank, whose primary role is to hold in safekeeping the assets of its clients. The use of custodian banks is a customary and common market practice used by most, if not all, market participants, both on the institutional and retail side. Other key custody services and responsibilities include: 1) providing daily and/or monthly pricing of assets; 2) monitoring and posting income and principal payments; 3) settling securities transactions; and 4) providing recordkeeping and reports of assets in custody. Custodian banks offer the convenience of monitoring and storing assets electronically, minimizing the risk of loss or misplacement to physical security certificates. In addition, custodial services provide efficiency to clients in that they significantly reduce the in-house resources and expertise needed to handle middle- and back-office operations; for example, the back-office operation faces one entity—the custodian bank—instead of many. Custodian banks also provide standardization of post-trade settlement and monitoring processes, resulting in more efficient business practices overall.

The National Association of Insurance Commissioners (NAIC) developed specific guidelines related to custodian bank relationships and custodial agreements in the *Model Act on Custodial Agreements and the Use of Clearing Corporations* (#295) and the *Model Regulation on Custodial Agreements and the Use of Clearing Corporations* (#298). Model #295 "authorize[s] domestic insurance companies to utilize modern systems for holding and transferring securities without physical delivery of securities certificates," while Model #298 offers specific requirements insurers should consider when choosing a custodian bank and entering into a custodial agreement. Because these models are not required for accreditation purposes, many states have not yet adopted them, and their domiciled insurers do not have to meet the models' requirements. However, the NAIC's *Financial Condition Examiners Handbook* incorporates many of the models' specific requirements to provide examiners of insurance companies comprehensive guidance on how to adequately evaluate and assess the appropriateness of custodial agreements.

U.S. insurance companies provide information related to their custodian bank relationships and custodial agreements in the investment section of the general interrogatories of the annual financial statements, with data points collected on five questions specific to the topic. However, the data and information reported is somewhat limited and, therefore, difficult to draw definite conclusions from. Nonetheless, based on the limited data as of year-end 2015, the majority of insurance companies appear to be operating under custodial agreements that generally follow the specific guidelines suggested by the two NAIC models. Of the almost 4,500 CoCodes answering the question "Were all stocks, bonds and other securities ... held pursuant to a custodial agreement with a qualified bank or trust company?" 93% of the reporting CoCodes replied "Yes." This general interrogatory

allows examiners to identify where additional focus and questions are needed to gain comfort in the suitability of custodial agreements.

For the custodial agreements that comply with NAIC requirements, insurers provided the names of their custodian banks; note that one insurer can have more than one custodian bank relationship. Almost 50% of the industry's reported custodial agreements were with large, national banks such as Bank of New York Mellon, J.P. Morgan Chase, Wells Fargo, State Street and Bank of America. Regional banks such as U.S. Bancorp, M&T Bank, Comerica Bank and PNC Financial represented 20%, while foreign banks (or their subsidiaries operating in the U.S.) such as Bank of Tokyo-Mitsubishi, UBS and Royal Bank of Canada represented 5%. The remaining balance, or 28%, consisted of local banks and non-bank financial institutions.

As with any third-party service provider, several risks should be considered when insurance companies enter into custodial agreements. Counterparty risk—the risk faced by one party that the other party will not satisfy the obligations of the contract—is a main concern, but it is a common risk that arises when entering into investment transactions. Custodian banks are typically selected based on not only their expertise and strength of operational procedures and controls, but also on their financial strength and stability. Model #298 defines a custodian as "a national bank, state bank, federal home loan bank or trust company that shall at all times ... be no less than adequately capitalized as determined by the standards adopted by the regulator charged with establishing standards for, and assessing, the institution's solvency" or "a broker/dealer that shall be registered with ... the Securities and Exchange Commission, maintains membership in the Securities Investor Protection Corporation, and has a tangible net worth equal to or greater than" $250 million. Both definitions should ensure that insurers enter into custody arrangements with custodian banks that are adequately capitalized.

Approximately 75% of the industry's reported custodial agreements are with large, national or regional financial institutions that are regulated by a banking regulatory authority such as the Federal Reserve, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). These financial institutions dominate the market, and barring any significant changes to their financial strength, counterparty risk in this case should be minimal. However, the insurance industry also enters into other financial transactions—derivative transactions, in particular—with many of the commonly used custodian banks, which could potentially result in heightened risk if there is a particular concentration of financial transactions with any one financial counterparty. Diversifying custodian and other financial relationships can, therefore, mitigate the risk of a significant loss in the event of one counterparty's failure. Having said that, assets held in custodial accounts are protected against a custodian bank's insolvency in the U.S., whereby those assets are not subject to the claims of general creditors. Custodian banks also are subject to enhanced supervision and prudential standards under the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, whereby they must ensure key systems and services continue to operate until custodial assets can be transferred to another custodian bank as part of their resolution plans.

Outsourcing services to custodian banks also can lead to operational risks wherein losses materialize as a result of: 1) trades not processed or settled properly; 2) data not appropriately stored or safeguarded; 3) records not accurately maintained; and/or 4) assets not appropriately segregated from assets of other custodian

accounts. As custodian banks typically possess a significant level of operational expertise and scale, the first three operational risks listed above are relatively minimized. However, at the same time, these operational risks can still arise—and possibly be heightened—given the large volume of transactions that custodian banks process on a daily basis. In addition to the fiduciary duty each party owes to the other given the contractual-based relationship, the *Financial Condition Examiners Handbook* outlines a number of safeguards and controls that custodial agreements should contain and examiners should verify during examinations to limit such operational risks. Suggested safeguards include: 1) indemnification for any loss of securities in the custodian's custody; 2) replacement of securities or value of securities; 3) examination of custodian records upon written notice; 4) maintenance of records and information relied upon by the insurance company for the preparation of its annual statement and supporting schedules; and 5) the restriction that foreign banks be allowed to hold foreign securities only. Note there is no explicit safeguard related to asset segregation.

An added risk relates to a common market practice wherein securities are held "in street name," meaning the owner listed on the security certificate—where the market norm is to hold assets in electronic form, rather than physical certificates—is not the specific investor but the bank, broker, custodian or trust company that the investor uses to purchase the security. The bank, broker, custodian or trust company maintains records to track the investor who is the "beneficial" owner. This practice provides convenience, efficiency and safety. It allows for: 1) ease of transfers when a security is bought or sold, thereby speeding up the trade settlement process; and 2) the ability to hold securities electronically, reducing the possibility of physical damage, loss or theft of the security certificate. Although there might be a perceived risk in doing so, holding securities "in street name" is a common market practice that streamlines the investment process and provides cost efficiencies to all market participants. Furthermore, assets held by banks in a custodial capacity do not become the assets of the bank and should be maintained separately from the bank's assets.

Because the use of custodian banks is a standard market practice, the risks outlined above are broad market concerns that not only insurance companies face, but also other institutional investors and retail investors. However, these risks can be managed or reduced if: 1) custodian relationships are diversified; and 2) appropriate safeguards and precautions are included in custodial agreements as suggested in Model #295, Model #298 and the *Financial Condition Examiners Handbook*.