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INVESTMENT CUSTODIAL/SAFEKEEPING AGREEMENT GUIDANCE FOR GROUP CAPTIVES

Updated Investment Custodial/Safekeeping Agreement guidance for Group Captives
Supersedes Memo #97/4 dated October 22, 1997

Originally issued on October 22, 1997, Memo #97/4 aimed to safeguard group captives from potential losses resulting from negligence by their investment custodians. The memo required group captives to maintain updated and signed investment custodial/safekeeping agreements for any parties having duties and to ensure those agreements contain a statement indemnifying the insurer from negligence or dishonesty from the custodian.

This information, along with additional criteria in the NAIC Financial Condition Examiners Handbook (FCEH) is evaluated by exam teams during each group captive's statutorily required exam. The FCEH guidance is based on the Model Act and the Model Regulation on Custodial Agreements and the use of Clearing Corporations (#295 and #298, respectively). The Department believes strongly that Companies should have the necessary safeguards in place to protect its assets, however we also recognize that there may be occasions where it is not possible to comply with every provision. One provision in particular that has been difficult for some insurers, especially smaller insurers, is the indemnification clause that is required in our Memo #97/4 which states the following:

That the Bank or Trust company shall indemnify the Depositor for any lost securities caused, in whole or in part, by the negligence or dishonesty of the Bank or Trust company. In the event that there are lost securities for which the Bank or Trust company is obligated to indemnify the Depositor, the Bank or Trust company shall promptly replace the securities or the value thereof, together with the value of any loss of rights or privileges resulting from said lost securities.

Custodians are occasionally reluctant to change their contract wording to incorporate the language required by Memo 97/4, leaving insurers without the required protective clauses and out of compliance with State of Vermont requirements. In these situations, insurers would ultimately need to decide whether to remain out of compliance with authoritative guidance or move to another custodian that offers the appropriate protective clauses, often at greater cost to the insurer.

To provide some flexibility not afforded by Memo 97/4 with regards to the indemnification provision, we have decided to retire the memo effective immediately. The Exam Team will, however, continue to evaluate custodial agreements utilizing exam program steps within the FCEH during exams. As previously mentioned, the FCEH program steps are based on Model Act 295 and Model Regulation 298. The Department expects that companies will incorporate adequate safeguards over custodial agreements in accordance with the Model Act and Model Regulation, which will be subject to exam team evaluation during examinations. In situations

where insurers do not comply with the safeguards detailed in the Model Act and the Model Regulation, the Company should be prepared to describe why they are unable to comply and discuss the benefits of their arrangement as well as how the risk of loss is mitigated.