MONTANA STATE AUDITOR
JOHN MORRISON

Protecting Montana's consumers through insurance and securities regulation

EXHIBIT 1
DATE 3-2-05
SB 37

Indemnification Agreement for Domestic Insurers Act SB 37

SB 37 Required to Protect Montana's Assets

Most of the assets of insurance companies are in the form of stocks, bonds, and other securities. Typically these securities are held by banks and brokerage firms that are acting as custodians on behalf of the insurance companies. This bill requires an agreement between the insurer and the custodian requiring the custodian to indemnify the insurer if there is a loss of the securities resulting from the intentional or negligent act or omission of the custodian while in the custody of the custodian.

Montana currently lacks indemnification statute

Current Montana law requires that examinations of insurance companies be conducted in accordance with the guidelines and procedures set forth in the National Association of Insurance Commissioners Examiners' Handbook. During the 2004 accreditation examination of the Montana Insurance Financial Examinations Division by the National Association of Insurance Commissioners a note was made regarding Montana's lack of an indemnification statute. The Examiners' Handbook includes a procedure that requires examiners to confirm that an acceptable agreement between the insurer and its custodian is in place.

Good business practice for Montana

Having such agreements in place is a good business practice. It would prevent a significant loss by the insurer if there were a loss of the securities held by a custodian and if the custodian was not willing to provide indemnification.

840 Helena Avenue, Helena, MT 59601/Phone 1-800-332-6148 (406) 444-2040/Fax:(406) 444-3497 www.state.mt.us/sao / stateauditor@mt.gov

g. The controlled insurer shall provide the controlling producer with its underwriting standards, rules and procedures, manuals setting forth the rates to be charged, and the conditions for the acceptance or rejection of risks. The controlling producer shall adhere to the standards, rules, procedures, rates and conditions. The standards, rules, procedures, rates and conditions shall be the same as those applicable to comparable business placed with the controlled insurer by a producer other than the controlling producer.

h. The contract shall specify the rates and terms of the controlling producer's commissions, charges or other fees and the purposes for those charges or fees. The rates of the commissions, charges and other fees shall not be greater than those applicable to non-controlling producers for comparable business (i.e., same kinds of insurance and risks, similar policy limits, and quality of business) placed with the controlled insurer.

i. Controlling producer compensation based on insurer profits shall not be determined or paid until at least five years after the premiums on liability insurance are earned and at least one year after the premiums are earned on any other type of insurance. Commissions shall not be paid until an independent casualty actuary or loss reserve specialist has confirmed the sufficiency of the controlled insurer's reserves on remaining claims, including incurred but not reported (IBNR).

j. The contract shall specify a percentage limit of writings the controlling producer is entitled to make relative to the controlled insurer's surplus and total writings. The insurer may establish a different limit for each line or subline of business. Notification by the controlled insurer to the controlling producer is required when the established limit is approached. Once the limit has been reached, the controlled insurer is prohibited from accepting business from the controlling producer. The controlling producer shall not attempt to place business with the controlled insurer if it has been notified that the limit has been reached.

Regulator Use Only

k. The controlling producer may bind facultative reinsurance contracts pursuant to obligatory facultative agreements if the contract with the controlled insurer contains underwriting guidelines for assumed and ceded business that includes a list of reinsurers with which automatic agreements are in effect, the coverages and amounts or percentages that may be reinsured, and commission schedules. Otherwise, for business placed by the producer, the controlling producer is entitled to negotiate but is unable to bind reinsurance on behalf of the controlled insurer.

J. Custodial or Safekeeping Agreements

When conducting financial examinations, the custodial or safekeeping agreements should be considered and evaluated with this guidance.

1. An insurance company may by written agreement provide for the custody of its securities with a custodian. If permitted by the state of domicile, the custodian must either be a broker/dealer that is registered with and subject to jurisdiction of the Securities and Exchange Commission, maintains membership in the Securities Investor Protection Corporation, and has a tangible net worth equal to or greater than $250,000,000; or a national bank, state bank, or trust company adequately capitalized and qualified to accept

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securities as determined by the standards adopted by the U.S. banking regulators and regulated by state banking laws or a member of the Federal Reserve system. Custodial agreements shall be authorized by a resolution on behalf of the board of directors or an authorized committee of the insurance company. The agreement should state that certificated securities of the insurance company shall be held separate from all other securities. Those securities held indirectly by a custodian or in a clearing corporation shall be separately identified on the custodian's official records as being owned by the insurance company. Registered custodial securities shall be registered in the name of the company, in the name of a nominee of the company, in the name of the custodian or its nominee, or clearing corporation or its nominee. The securities, other than those held to meet deposit requirements, shall be held subject to the instructions of the insurance company, and shall be withdrawable upon the demand of the insurance company. Confirmation of all transfers should be provided to the insurance company in hard-copy or in electronic format.

2. Custodial or safekeeping agreements with an agent or clearing corporation meeting the requirements herein should contain satisfactory safeguards and controls, including but not limited to the provisions provided below. For the purpose of this guidance, an agent is a national bank, state bank, trust company or broker/dealer with an account in a clearing corporation or a member of the Federal Reserve System. A clearing corporation is a corporation as defined in Article 8 of the Uniform Commercial Code that is organized for the purpose of effecting transactions in securities by computerized book-entry, including the Treasury/Reserve Automated Debt Entry Securities System (TRADES) and Treasury Direct book entry securities systems, except those securities issued under the laws of a foreign country.

Regulator Use Only

a. The custodian is obligated to indemnify the insurance company for any insurance company's loss of securities in the custodian's custody, except that, unless domiciliary state law, regulation or administrative action otherwise require a stricter standard (Section 2.b. sets forth an example of such a stricter standard), the custodian shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the custodian;

b. If domiciliary state law, regulation or administrative action requires a stricter standard of liability for custodians of insurance company securities than that set forth in Section 2.a., then such stricter standard shall apply. An example of a stricter standard that may be used is that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the custodian's custody occasioned by the negligence or dishonesty of the custodian's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction;

c. In the event of a loss of the securities for which the custodian is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced;

d. The custodian shall not be liable for any failure to take any action required to be taken hereunder in the event and to the extent that the taking of such action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosions, stoppage of labor, strikes or other differences with employees, laws,

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regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control;

e. In the event that the custodian gains entry in a clearing corporation through an agent, there should be a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of domicile may accept a standard of liability applicable to the agent that is different from the standard liability;

f. If the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner;

g. During regular business hours, and upon reasonable notice, an officer or employee of the insurance company, an independent accountant selected by the insurance company and a representative of an appropriate regulatory body shall be entitled to examine, on the premises of the custodian, its records relating to securities, if the custodian is given written instructions to that effect from an authorized officer of the insurance company;

h. The custodian and its agents, upon reasonable request, shall be required to send all reports which they receive from a clearing corporation, which the clearing corporation permits to be redistributed including reports prepared by the custodian's outside auditors, to the insurance company on their respective systems of internal control;

i. To the extent that certain information maintained by the custodian is relied upon by the insurance company in preparation of its annual statement and supporting schedules, the custodian agrees to maintain records sufficient to determine and verify such information.

j. The custodian shall provide, upon written request from a regulator or an authorized officer of the insurance company, the appropriate affidavits, with respect to the insurance company's securities held by the custodian;

k. The custodian shall secure and maintain insurance protection in an adequate amount; and

l. The foreign bank acting as a custodian, or a U.S. custodian's foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. A U.S. custodian must hold all other securities.

3. Except as provided below, the examiner shall verify such securities by actual inspection and count, and whenever necessary ascertain whether the securities are the specific ones acquired by the company:

Regulator Use Only

Examiners Handbook

Financial Condition

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making progress ... together

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kinds of insurance and risks, similar policy limits, and quality of business) placed with the controlled insurer.

i. Controlling producer compensation based on insurer profits shall not be determined or paid until at least five years after the premiums on liability insurance are earned and at least one year after the premiums are earned on any other type of insurance. Commissions shall not be paid until an independent casualty actuary or loss reserve specialist has confirmed the sufficiency of the controlled insurer's reserves on remaining claims, including incurred but not reported (IBNR).

j. The contract shall specify a percentage limit of writings the controlling producer is entitled to make relative to the controlled insurer's surplus and total writings. The insurer may establish a different limit for each line or subline of business. Notification by the controlled insurer to the controlling producer is required when the established limit is approached. Once the limit has been reached, the controlled insurer is prohibited from accepting business from the controlling producer. The controlling producer shall not attempt to place business with the controlled insurer if it has been notified that the limit has been reached.

k. The controlling producer may bind facultative reinsurance contracts pursuant to obligatory facultative agreements if the contract with the controlled insurer contains underwriting guidelines for assumed and ceded business that includes a list of reinsurers with which automatic agreements are in effect, the coverages and amounts or percentages that may be reinsured, and commission schedules. Otherwise, for business placed by the producer, the controlling producer is entitled to negotiate but is unable to bind reinsurance on behalf of the controlled insurer.

J. Custodial or Safekeeping Agreements

When conducting financial examinations, the custodial or safekeeping agreements should be considered and evaluated with this guidance.

1. An insurance company may by written agreement provide for the custody of its securities with a custodian; which is deemed to be a national bank, state bank, or trust company adequately capitalized, regulated, and qualified to accept securities as determined by the standards adopted by the U.S. banking regulators or the Federal Reserve system. This custodial agreement shall be authorized by a resolution on behalf of the board of directors or an authorized committee of the insurance company. The agreement should state that certificated securities of the insurance company shall be held separate from all other securities or in a fungible bulk. A fungible bulk of securities consists of classes of securities that are substitutable or interchangeable with others of the same class, such as bearer securities or commons stocks of the same denomination. Those securities held in a fungible bulk by the custodian, in a clearing corporation, or in the Federal Reserve book-entry system, shall be separately identified on the custodian's official records as being owned by the insurance company. Registered custodial securities shall be registered in the name of the company, in the name of a nominee of the company, in the name of the custodian or its nominee, or clearing corporation or its nominee. The securities, other than those held to meet deposit requirements, shall be held subject to the instructions of the insurance company, and shall be withdrawable upon the demand of the insurance

provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner;

g. That during regular business hours, and upon reasonable notice, an officer or employee of the insurance company, an independent accountant selected by the insurance company and a representative of an appropriate regulatory body shall be entitled to examine, on the premises of the custodian, its records relating to securities, if the custodian is given written instructions to that effect from an authorized officer of the insurance company;

h. The custodian and its agents, upon reasonable request, shall be required to send all reports which they receive from a clearing corporation or the Federal Reserve book-entry system which the clearing corporation or the Federal Reserve permits to be redistributed and reports prepared by the custodian's outside auditors, to the insurance company on their respective systems of internal control;

i. To the extent that certain information maintained by the custodian is relied upon by the insurance company in preparation of its annual statement and supporting schedules, the custodian agrees to maintain records sufficient to determine and verify such information.

j. That the custodian shall provide, upon written request from a regulator or an authorized officer of the insurance company, the appropriate affidavits, with respect to the insurance company's securities held by the custodian;

k. That the custodian shall secure and maintain insurance protection in an adequate amount;

l. That the foreign bank acting as a custodian, or a U.S. custodian's foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. A U.S. custodian must hold all other securities.

3. Except as provided hereunder in Sections "a" through "h," the examiner shall verify such securities by actual inspection and count, and wherever necessary ascertain whether the securities are the specific ones acquired by the company:

a. Securities on deposit with state officials need not be counted [provided] if a certificate of verification is secured directly from the custodian or insurance commissioner.

b. Where domiciliary state law, regulation, or administrative action does not prohibit the use of custodial arrangements under which actual inspection or count of specific securities acquired is not possible, and the insurance company uses such an arrangement, the examiners shall:

- Apply the provisions of Sections d. and g. below, in cases where the custodian, under the controlling custodial or safekeeping agreement, is permitted to carry securities so held in fungible bulk or otherwise commingled form;
- Apply the provisions of Sections e. and g. below, in cases where the custodian, under the controlling custodial or safekeeping agreement, directly or indirectly participates in the Federal Reserve System book-

company. Confirmation of all transfers should be provided to the insurance company in hard-copy or in electronic format.

2. Determine that any custodial or safekeeping agreement with an agent, or clearing corporation meeting the requirements herein contains satisfactory safeguards and controls, including but not limited to the following provisions. For the purpose of this guidance, an agent is a national bank, state bank, or trust company with an account in a clearing corporation or a member of the Federal Reserve System. A clearing corporation is a corporation as defined in Article 8 of the Uniform Commercial Code that is organized for the purpose of effecting transactions in securities by computerized book-entry, except those securities issued under the laws of a foreign country.

   a. That the national bank, state bank, or trust company, as custodian is obligated to indemnify the insurance company for any insurance company's loss of securities in the custodian's custody, except that, unless domiciliary state law, regulation or administrative action otherwise require a stricter standard (Section 2.b. sets forth an example of such a stricter standard), the bank or trust company shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the custodian;

   b. If domiciliary state law, regulation or administrative action requires a stricter standard of liability for custodians of insurance company securities than that set forth in Section 2.a., then such stricter standard shall apply. An example of a stricter standard that may be used is that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the custodian's custody occasioned by the negligence or dishonesty of the custodian's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction;

   c. That in the event of a loss of the securities for which the custodian is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced;

   d. That the national bank, state bank or trust company as custodian shall not be liable for any failure to take any action required to be taken hereunder in the event and to the extent that the taking of such action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosions, stoppage of labor, strikes or other differences with employees, laws, regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control;

   e. That in the event that the custodian gains entry in a clearing corporation through an agent, there should be a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of domicile may accept a standard of liability applicable to the agent that is different from the standard liability;

   f. That if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall

3.

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