Fall/Winter 2013

Insights

Banking in Bermuda Magazine

Bermuda: Open for Business

An interview with the Hon. Dr. E. Grant Gibbons, JP, MP, Minister of Economic Development

The CEO Roundtable

Discussions with the CEOs of Bermuda's Banks

2013 KPMG in Bermuda BANKING SURVEY

KPMG
cutting through complexity

Contents

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Top row from left: Horst Finkbeiner (BCB), Brendan McDonagh (Butterfield), Ian Truran (Capital G), Richard Moseley (HSBC), David Harper (KPMG), Neil Patterson (KPMG). Bottom row from left: James Berry (KPMG), Richard Hobday (KPMG), Craig Bridgewater (KPMG).

Welcome

Welcome to *Insights*, which includes KPMG in Bermuda's third edition of our survey of Bermuda's banking sector. We once again have partnered with The Bermudian Publishing Company Ltd. to bring you some insight into Bermuda's banking sector. We continue with our approach of providing you an overview of the financial performance of Bermuda's banks and the insights of the Chairmen of the Boards of Directors and the Chief Executive Officers of each of the banks. We are grateful to both the Chairmen and the CEOs for their willingness to be involved in our survey and to talk candidly about what they see as the challenges and opportunites for the sector. These individuals double as general business and community leaders and it is gratifying to have had the opportunity to gather their thoughts and present them as a part of this publication.

2012 continued to provide a challenging operating landscape for the banking industry both in Bermuda and globally. Banks have experienced an extended period of low interest rates, significant challenges in their loan and mortgage portfolios, continued regulatory developments, and the imperative of increasing the efficiency of their delivery models.

These factors combine to reduce interest income, increase loan impairment charges, and require the diversion of resources to compliance and risk functions—all of which puts downward pressure on margins and net income.

As a professional services firm, we continually seek to provide valuable insights into businesses, their sectors and the challenges they may face. We have done so in this year's publication through discussions with the Chairmen and CEOs of Bermuda's banks, a discussion with the Minister of Economic Development—Dr. the Hon. E. Grant Gibbons, JP, MP, a review of developments in key regulations related to the banking industry including anti-money laundering (AML) and the Foreign Account Tax Compliance Act (FATCA), an overview of credit and investment conditions in Bermuda, and a review of social media and mobile banking—a distribution channel that can increase contact with customers and increase the efficiency of product delivery.

We hope you enjoy the commentary and insights that we have provided.

By Craig Bridgewater
Head of Banking, KPMG in Bermuda

The CEO Roundtable

Most of the Bank CEOs we spoke to last year believed that the turnaround was a medium term possibility and that Bermuda needed to be focusing on what it can do to make this new economic reality work. Since then, a new government has taken office, there has been some significant policy shifts and an increased level of government engagement to encourage businesses in Bermuda to create jobs. This is having a positive effect, with a lot more positive talk about the future of Bermuda's economy and the actions which are being taken to help create those new jobs Bermuda needs. This year, our discussion with the CEOs centred on the key areas of focus in the banking sector: the economy, the business drivers, customers, risk management and information technology. The impact of the new government's initiatives and the tough decisions needed to get Bermuda's economy back on track were also key themes of this year's discussion. Below are extracts of the roundtable discussion with the CEOs.

At the Table:

HORST FINKBEINER
COO, Bermuda Commercial Bank

RICHARD MOSELEY
CEO, HSBC Bank Bermuda Limited

IAN TRURAN
President & CEO, Capital G Bank Limited

NEIL PATTERSON
Chairman, KPMG in Bermuda

BRENDAN MCDONAGH
Executive Chairman & CEO, Butterfield Bank

CRAIG BRIDGEWATER
Head of Banking, KPMG in Bermuda

JAMES BERRY
Managing Director, KPMG in Bermuda

RICHARD HOBDAY
Senior Manager, KPMG in Bermuda

DAVID HARPER
Senior Manager, KPMG in Bermuda

The Economy

Bermuda's economy has been through some difficult times in the last few years. Do you think the new government's policies are on the right track? What further actions are needed to kick start the economic recovery in Bermuda?

Brendan McDonagh (Butterfield): The Government has to tackle the long-term demographic challenge of a falling population to enable Bermuda to have a long-term sustainable recovery.

Richard Moseley (HSBC): Early days but we have seen a massive increase in engagement. I would like to see the extension of the 60/40 rule to encourage more high net worth individuals to move here and further action to encourage long term residents to commit here.

Ian Truran (Capital G): The policies and actions of the government appear to be appropriate, with a focus on economic growth. However to really change the direction of the economy (not just slowing the decline), the government must take a three-tiered approach: government spending has to be more appropriate to delivery of services; the creation of the SAGE Commission is a step in the right direction; develop incentives to increase the levels of productivity in the workforce; and new sources of economic growth need to be developed. The BBDC is actively working with government to consider steps to continue to make us attractive as an international financial business centre. Within our tourism product, gaming is an obvious opportunity, as the effect on tourism and the construction industry will be immediate and powerful, followed by trickledown growth to the provision of goods and services.

Craig Bridgewater (KPMG in Bermuda): The government is engaged and things are moving in the right direction. There are still a number of tough decisions that need to be made to get things back on track, but to date the new government has shown to date the leadership needed to make those tough decisions.

Horst Finkbeiner (BCB): The new government seems to be on the right track, not only in terms of the changes to policy but also in

terms of changes in culture. International businesses that I have spoken with have commented very favourably with the warm reception they get from officials in every branch of government, from arriving at the airport to getting administration completed through the various ministries. My worry is that Bermuda faces ongoing significant threats to the viability of its international business sector. First is the implementation of U.S. FATCA and similar legislation from other countries that are trying to plug gaps in their tax regimes. The continued attempts by U.S. Senator Neal to 'close the loophole' for the insurance industry in the form of the recently announced Neal-Menedez Bill is another potential threat. And the current climate of moral distaste for the offshore financial sector cannot be ignored. These are potential threats that in my opinion our government should take a serious view of.

2012 was a very difficult year for the Bermuda banking industry as a whole, with some banks recording record loan impairment charges. Do you see 2013 as a year when the banks will be more profitable? What are you focused on to generate better returns for your shareholders?

Richard Moseley (HSBC): It is a challenging economic environment with asset price declines, but we had some exceptional items in 2012, so 2013 should be better.

Ian Truran (Capital G): While many impaired loans have already been identified, it is probable that more will surface as the continuing recession depletes customers' resources, leading to arrears. Furthermore, the values of real-estate have the potential to continue to significantly impact earnings. New land policies and tax rates implemented in 2013 have resulted in positive sentiment around residential real estate, however, at this time it is too early to determine if sentiment is translating into stabilisation. Commercial real estate continues to be impacted by an oversupply. Consequently, I believe that profitability will continue to be affected in 2013. Better returns must come from increased non-interest revenue sources and continued improvements in efficiencies across the banks.

Horst Finkbeiner (BCB): Our work to increase shareholder return is focused on the basics: strong client satisfaction, expanding the client base, and cost management.

Brendan McDonagh (Butterfield): I do not see loan impairment charges decreasing to the extent they drive higher profits unless a bank had a single large impairment last year. Improvements in profitability will come primarily from cost management.

Do you see any signs that Bermuda's economy may be coming out of recession? What are your expectations for growth in the next two or three years?

Neil Patterson (KPMG in Bermuda): In the last six months there has been a noticeable positive shift in the perspectives shared by our clients on the future outlook, which is encouraging. We are starting to see increases in activity of our business lines and are cautiously optimistic about where the economy is headed.

Richard Moseley (HSBC): There is definitely a lot more positive talk, however I think 2013 will be flat at best, with some recovery in 2014. I don't currently see things heading back to boom times, as there is less need for the extra two thousand jobs on the island that existed during those times.

Horst Finkbeiner (BCB): I do not foresee any meaningful recovery yet. The recent activity in the commercial property market may only signal opportunistic purchasing. However any significant construction work that comes out of this will help move things along.

Ian Truran (Capital G): Not at this time, however, the initiatives discussed above can change our expectations. The pro-business approach being taken by government is positive; however we must be conscious of the headwinds in front of us as many countries look to penalise entities doing business in countries like Bermuda. We are in the "crosshairs" of the U.S. and U.K. and the decisions that we make today will have significant impacts to our ongoing viability.

Brendan McDonagh (Butterfield): There is no immediate sign of imminent recovery but there is a more positive attitude among business and political leaders. I would say the economy will be flat at best for the duration of 2013.

What needs to be done to encourage better lending opportunities and access to loans in Bermuda?

Ian Truran (Capital G): High quality lending is fundamental to maintaining the health of the banking sector. Entrepreneurs need to be more creative in accessing capital. Banks are not equity investors, and the high risk associated with start-up requests is not appropriate for banks to undertake with their depositors' funds. An alternative is government sponsored initiatives that reduce downside risk for banks to participate.

Brendan McDonagh (Butterfield): Banks should always be focused on high quality lending and minimising credit losses. Banks will lend if the opportunity is right.

Richard Moseley (HSBC): To encourage better lending opportunities there needs to be more equity, more support for business, and less "red tape."

What are your views on the outlook for deposit and lending interest rates in 2012-2015 in Bermuda?

Brendan McDonagh (Butterfield): There will likely be no change unless there is a movement in U.S. rates.

Richard Moseley (HSBC): Minimal change although yield curve should move more positive.

Ian Truran (Capital G): Global rates remain flat and I believe that Bermuda's rate structure will follow. There is a risk that lending rates increase as banks attempt to recover some of the increased costs of doing business, as well as some of the losses being incurred as a result of greater risks in their portfolios.

Customers

With Bermuda being in the fifth year of recession, what advice do you have for your customers in terms of their own financial affairs?

Ian Truran (Capital G): Customers need to deleverage if they haven't done so already. Debt can be useful in a growth environment, but in a recession excess debt does more harm than good. On the personal side, many customers who are facing reduced income levels must consider lifestyle changes, so that they can live within their current means. Short term sacrifice for long term financial health should be their mantra.

Brendan McDonagh (Butterfield): If they are experiencing difficulties, they should seek advice from knowledgeable sources. We have financial advisers and credit specialists who can assist customers in restructuring their debts to make things more manageable.

Richard Moseley (HSBC): Manage finance carefully and if you have a loan, call your bank early when there are issues.

Should the recent banking developments in Cyprus and the losses incurred by those depositors trigger any changes in Bermuda? What are your thoughts on the recent insurance scheme put in place for depositors?

Horst Finkbeiner (BCB): The attempts by the Cyprus government to seize certain client account balances as a means to recapitalise (part of the 'bail-in' process) a bank were extraordinary, and I understand that this is a policy endorsed and adopted by the G20 in 2010. I do not think that government should remove the 'moral hazard' for banks (and indeed bankers and bank directors) that get themselves into trouble and I do not think this is something for Bermuda. The implementation of the deposit insurance scheme will be welcomed by banking customers in Bermuda.

Brendan McDonagh (Butterfield): Whilst the new deposit scheme will take many years to build up a sufficient fund to cover a Bermuda banking crisis, the Cyprus situation is very different. In Cyprus, the banking system relied upon a significant proportion of offshore

deposits, which was a factor in that Government's decision to trigger losses in deposits.

Richard Moseley (HSBC): The BMA needs to remain very vigilant. The insurance scheme is irrelevant for our customers but arguably good for Bermuda, but the premiums levied on banks and, in turn, customers should be risk based to encourage lower risk banking practices.

James Berry (KPMG in Bermuda): Bermuda has a very different economic and banking environment to Cyprus, with the banks in Bermuda maintaining significant capital buffers. The deposit insurance scheme is a positive development for Bermuda and reinforces the sound regulatory environment here in Bermuda. However, it comes at a cost, which will understandably largely be borne by those the deposit insurance scheme is designed to protect.

Customers around the world are using social media more and more and millions now have access to mobile payments through their smart phones. What impact is this trend having on Bermuda?

Ian Truran (Capital G): Customers around the world are actively engaging with corporations through social media, and our customers are no different. Social Media is an instant channel for our clients to communicate to us, and we actively listen and respond to their comments, queries and requests via these channels.

We have seen mobile usage on Capital G platforms grow significantly in 2013. With the widespread use of tablets and smart phones, it is easy to do eBanking on the go. Applications that are still yet to catch on, which are widely popular in the U.S., are mobile wallets and tap and go technologies.

Whether there is a need for us to introduce these applications into Bermuda, we'll let our customers decide. One thing we will always ensure is that every new web platform we build will always have the capability for mobile friendly components.

The major challenge with mobile banking, both locally and globally, is the rapid evolvement of technology. Investing significantly in one product that will be obsolete in six months is not feasible. It is important to find the right product which can grow alongside the rapid growth of technology.

Richard Moseley (HSBC): This is a developing trend in Bermuda and we are planning investment in this area over the next 12 months. Bigger banks are better positioned to provide this technology, as they can spread the significant costs involved more widely.

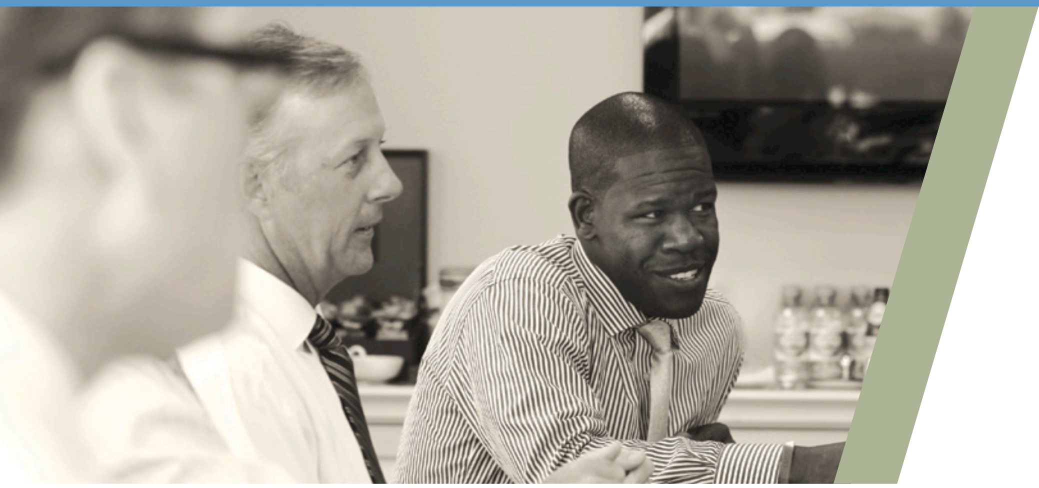
Brendan McDonagh (Butterfield): This trend is developing in Bermuda with greater smart phone use and we are responding to the demands of our customers. Butterfield has put significant focus and investment into enhancing services available through alternate delivery channels.

David Harper (KPMG in Bermuda): Mobile banking and the use of social media both represent a significant opportunity for banks in Bermuda to improve the banking experiences of customers. We have seen globally that banks that best enhance their customers' user experiences gain a significant competitive advantage.

Risk Management

Has the recession in Bermuda changed your risk appetite and the way you manage the Bank's risks?

Richard Moseley (HSBC): Yes, recognition that stress testing and earnings power is



critical to absorb credit related losses.

Horst Finkbeiner (BCB): Certainly. We have kept largely out of the lending business and will continue to do so until we are comfortable that the economy is recovering.

Ian Truran (Capital G): As the question is focused to Bermuda, the risk appetite has probably not been changed, although the manner in which risks are managed has changed. Again, credit risk has probably seen the most significant changes due to the recession.

Brendan McDonagh (Butterfield): In today's environment, proactively managing risks within tolerances is critical. One change we have introduced has been to reduce the loan-to-value requirement for residential mortgages.

Property foreclosures have become much more prevalent in Bermuda over the past couple of years due to the recession. Selling properties cheaply can create a "self fulfilling prophecy", especially in a small property market like Bermuda. How are you handling this challenging situation?

Brendan McDonagh (Butterfield): We work with customers who are experiencing difficulty servicing their mortgages to come up with mutually agreeable arrangements. We try and avoid foreclosures and make it the last option.

Richard Moseley (HSBC): We are working with customers to avoid repossessions where possible, but markets need to act as markets.

Information Technology & Business Change

Staying competitive in a very challenging environment and meeting customers' demands for real time access to their accounts requires significant, ongoing investment in IT. How do you manage this investment process in the current low profit environment?

Richard Moseley (HSBC): By leveraging our group's resources.

Horst Finkbeiner (BCB): Major capital projects in IT tend to be very long-term strategic projects that extend beyond economic cycles. If the strategic business rationale behind such projects is sound, they should deliver long-term benefits regardless of the economy.

Ian Truran (Capital G): In the past couple of years, Capital G has invested significantly in core infrastructure and core systems to position the bank for future growth. In the current challenging economic environment, a more prudent business case is needed to support any investment, technological or otherwise. Balancing the cost of any such investment against the value to the organisation and to our clients is critical.

Brendan McDonagh (Butterfield): We must balance IT expenditure that improves customer services with expenditure that improves productivity. Some investments can do both. We seek to have a clear cost/benefit analysis for any expenditure before committing. We also complete post-implementation reviews to make better informed decisions on future IT spending.

Have the requirements of your stakeholders changed over the past few years? Has that changed your areas of focus as a CEO?

Richard Moseley (HSBC): Yes, risk management has become more critical and so has segmentation (we cannot be all things to all people).

Ian Truran (Capital G): Absolutely. The role of the CEO is to navigate through the requirements of all the stakeholders, understanding what is required, setting expectations and then managing and reporting against these.

Brendan McDonagh (Butterfield): At a high level, it is always a balance between shareholder return, customer service and employee engagement. Although the dynamics of balancing those interests can change as economic shifts occur, ensuring we address the interests of all stakeholders continues to be critical to our business.

Horst Finkbeiner (BCB): BCB in particular has seen enormous changes since 2010 when the bank was sold to a new investor group, and these changes have included a complete update of our risk and governance structures. Other stakeholders have driven change; our clients are more focused on safety, rating agencies require greater transparency, and regulators have driven changes in capital levels and governance. All of these things demand attention from the management team and the board.

Are board members and sub-committees in your banks focused on the same things they were before the recession? Are board members more demanding? How has this impacted your role?

Brendan McDonagh (Butterfield): Clearly the regulatory environment has put pressure on directors to know more about the business. The paper workload for sub-committees has increased significantly. One of my roles is to ensure the increased paperwork does not hinder effective board management.

Richard Moseley (HSBC): Corporate governance has always been critical but robust management information reporting and scenario planning now more so.

Horst Finkbeiner (BCB): There is a greater emphasis on governance and risk, which is aligned with the expansion of our business and the demands of our stakeholders.

Ian Truran (Capital G): I do not believe that the "recession" can be considered the catalyst for a more focused governance perspective. Regulation, financial results and an increasing accountability of board members are responsible for this. This has resulted in them being more demanding and has a direct correlation on the role of the CEO.

Anti-Money Laundering/Anti-Terrorist Financing & Politically Exposed Persons

Global efforts to combat money laundering and terrorist financing are intended to make our communities safer. They aim to highlight monetary flows that could potentially be linked with criminal behavior and put a regulatory obligation on individuals and organizations to perform due diligence measures on customers associated with those monetary flows. This often costly obligation placed on individuals and organizations is aimed at highlighting payments that may be linked with criminal activities. Criminal activities, just like legitimate activities, need money to pay bills and reward those involved. Without the ability to make those payments, normal activities grind to a halt or at least are significantly hindered. The regulatory due diligence measures imposed, are also aimed at ensuring timely information is provided by individuals and organizations to the police to assist in targeting these criminal activities.

As with most regulations, the measures taken to target a few negatively impact many. These globally driven anti money laundering and terrorist financing measures are already impacting most customers that interact with financial institutions globally. Banking customers in Bermuda are no exception.

Global AML/ATF regulations are continuously evolving. In February 2012, the Financial Action Task Force (FATF), which is the body responsible for directing changes to global AML/ATF regulations, issued revised recommendations which expanded the definition of politically exposed persons ("PEPs") to include:

Foreign PEPs – individuals who are or have been entrusted with prominent public functions by a foreign country, e.g. Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials;

Domestic PEPs – individuals who are or have been entrusted with prominent public functions domestically; and finally

International Organization PEPs – persons who are or have been entrusted with a prominent function by an international organization, e.g. members of senior management or individuals who have been entrusted with equivalent functions, i.e. directors, deputy directors and members of the board or equivalent functions.

This definition change is important as currently in Bermuda only Foreign PEP's are required to be treated as PEP's. With the change in the definition, Bermuda PEPs and International organization PEP's will now be captured by the regulatory definition of a PEP.

Furthermore, the revised PEP definition applies to family members or close associates of PEPs, further broadening the scope of individuals potentially covered. A "family member" is defined as an individual who is related to a PEP either directly (consanguinity) or through marriage or similar (civil) forms of partnership, and a "close associate" is an individual who is closely connected to a PEP, either socially or professionally.

Local regulations require regulated individuals and organizations to perform enhanced due diligence measures on most PEP's, due to the higher risk nature of those relationships. Meaning, if you are a PEP, you are likely to be asked more questions about your financial affairs and required to provide greater levels of information and documentation when opening accounts with financial institutions, including banks.

Why do PEPs pose a higher risk of money laundering and terrorist financing?

Historical evidence has shown that PEPs are more likely to be involved in bribery and corruption crimes (which are predicate money laundering offences), as their position and influence could potentially be abused for personal gain. Furthermore, the international nature of their position, including their networks, presents an increased risk of them being exposed to such criminal activity.

So does that mean Bermuda banks should not do business with PEP's?

No. It just means that they may represent a higher risk group of customers, and as such the regulations require enhance due diligence to be performed to minimize the potential risks associated with doing business with a PEP.

What will be the effects on Bermuda's banking customers?

The effect of broadening the definition of a PEP will result in more customers being classified as PEPs and being subjected to enhanced due diligence requirements. In a country such as Bermuda, that has a small closely linked population, this may mean that many people may be classified as a PEP by proxy of family or association.

As explained above, financial institutions, including banks will be required to take reasonable steps to determine whether a customer (or a beneficial owner in reference to entity customers) is a PEP. Such steps may come in the form of the inclusion of additional questions on account application forms or increased scrutiny and questioning when undertaking relevant transactions.

Once the new definition of a PEP is adopted in Bermuda, Bermuda banking customers should be prepared for the possibility that they will be asked to provide increasing levels of information, as well as be under increased levels of scrutiny when dealing with your banks. If it does impact you personally, remember the financial institutions are just complying with their regulatory requirements which are intended to make our communities safer. Less criminal activity in our communities which will enable greater prosperity, now that sounds like something worth the effort!

By Charles Thresh
Managing Director, KPMG in Bermuda

Bermuda: Open for Business

An interview with the Hon. Dr. E. Grant Gibbons, JP, MP, Minister of Economic Development

Since the One Bermuda Alliance (OBA) was elected in December 2012, there has been a sense in the business community of a renewed focus on delivering on the message that "Bermuda is open for business."

Lori Rockhead and Craig Bridgewater of KPMG sat with the Hon. Dr. E. Grant Gibbons, JP, MP, Minister of Economic Development to gain an understanding of his agenda to develop business in Bermuda.

What have your priorities been as Minister of Economic Development?

The impact of spending by existing international business cuts across the entire Bermudian economy, and so my first priority was to restore a sense of confidence in the business community. Reaching out to existing international businesses was a first step to letting them know we are happy that they are here and we understand the contribution they make to the economy.

It is essential that the Government works in partnership with business, and these early conversations with international business leaders gave me the opportunity to discuss how Bermuda can encourage company growth by businesses already domiciled in Bermuda, while similarly attracting new business.

This is the reason that the Bermuda Business Development Corporation (BBDC) was created; to form public-private partnerships with the goal of growing business.

We recognized that the departure of a portion of the critical mass of intellectual capital from Bermuda has negatively impacted the economy and this trend has to be reversed. Since 2005, 3,000 jobs held by Bermudians and another 2,000 jobs held by non-Bermudians were lost. We need to preserve intellectual capital created by the combined efforts of Bermudians and non-Bermudians. Every non-Bermudian employed in Bermuda creates jobs for two Bermudians.

It was clear that the immigration term limits were having a detrimental effect on employment which is why it was important to move quickly to eliminate the term limits. At the same time, we have taken steps to protect Bermudians' rights to employment through appropriate legislation and enforcement.

What are you most excited about that Bermuda is doing differently or planning on launching to support attracting new companies to Bermuda?

We promised to create 2,000 jobs. Job creation will come from every sector of the economy including tourism, retail, international business, energy projects, etc. Early on we found that there were a number of tourism and resort development projects that were in various stages but generally were progressing slowly. Through the Economic Development Committee (EDC), we've taken an active part in coordinating the Government's efforts to encourage the successful development of hospitality ventures. It is essential that Government ministries work together. The EDC is chaired by the Premier and includes the Ministers of Economic Development, Finance, Tourism and Transport and Public Works. We meet weekly. We track the progress of projects and ensure that there is a coordinated response to resolve any problems.

Working together as a team is critical because all of the pieces have to be in place for Bermuda's economy to grow. For instance, we need to have airlift and hotel accommodation not only for tourism but also for international business.

How does the International Business Concierge Service support your goal of attracting inward foreign investment and new companies to Bermuda?

We need to do a better job of attracting new business. Bermuda is behind other jurisdictions in respect to making it easy to set up businesses. The Business Development Unit of the Ministry of Economic Development and the BBDC are working together on the Concierge Service. The Concierge Service helps companies that are new to Bermuda by being a single point of contact for handling all Government applications. The Concierge also helps to connect new businesses with relocation services and professional networks making it easier for new companies to set up here.

We already have had one new company who was assisted from start to finish through the process of setting up business in Bermuda and other companies are currently in the process. So far, we have received extremely positive feedback on the Concierge Service.

There has been a perception that it is difficult to do business in Bermuda. The Concierge Service is helping to get the message out that doing business in Bermuda is not difficult and that we have a service to help new companies.

A fundamental tenant in business is that it is less costly to retain existing customers than secure new customers. What has the Ministry been doing to retain existing international businesses?

On my first day as Minister of Economic Development, I called every ABIR CEO to let them know that we appreciated them and the contribution their companies make to Bermuda. Several CEOs expressed that they had never been contacted before by a Government minister.

The key indicators for the banks are real estate values, interest rates and the state of the general economy (growth rates, retail index, tourism figures, employment/unemployment). What is your outlook for these indicators?

We keep coming back to the Government and the importance the Government plays in instilling confidence in the economy through our actions. By building a renewed sense of confidence in the business community, we are seeing a reverse in the downward trend of key economic indicators. The Government has to be seen to be facilitating business growth. The Ministry of Finance has established certain macro-economic parameters which we must meet to lay the foundation for economic growth. One of the fundamental tenants is that the Government must live within its means while balancing the social needs of the community.

I see hopeful signs of economic growth in terms of new job creation and bringing back jobs that were lost, for example, the Green family's investment in hospitality. The EDC is seeing a number of projects that will improve the indicators.

What is the Ministry doing to encourage growth in Bermuda's banking sector?

Job creation and economic growth are fundamental to the growth of Bermuda's banking sector. Many home owners have rental units and they need to have tenants in them to support their mortgages.

There is some evidence that governments that focus on economic growth in areas where the country already has a level of skill and expertise are more successful than attempting to diversify into new sectors.

Is Bermuda's approach to economic growth consistent with this approach or are you looking at attracting new industries?

Building from the competencies that you already have is central to the way we are preceding but we are still looking at opportunities to diversify the economy.

We are looking at existing businesses and how the Government can support growth of companies that are already operating in Bermuda. That is why I made it my first priority to call international business CEOs. We are also looking at the hospitality sector to encourage new hotel development. We're looking at energy costs and how bridging technologies, such as natural gas, can be used to bring down energy costs which will impact on every business and household.

"By building a renewed sense of confidence in the business community, we are seeing a reverse in the downward trend of key economic indicators... The Ministry of Finance has established certain macro-economic parameters which we must meet to lay the foundation for economic growth."

How open is Bermuda to new industries?

We are at an early stage but we have been successful in securing Bermuda's satellite site. Satellite is a potential new source of revenue. Bermuda is now in the game and it opens up the potential for other space industry companies. We are looking at certain areas of bio science; for instance, diagnostic and analytic services. The aircraft and shipping registries are being bolstered as we had insufficient expertise to take advantage of opportunities to grow.

We are supporting the asset management sector by refining our value proposition in order to increase the number of small to medium size asset managers. Partnering with the BBDC we are working on a case-by-case basis to improve our positioning and target new opportunities. The BBDC recently held an asset management think tank and we had a similar tourism summit that is core to understanding clients' needs and attracting new business in these areas. We are also looking at the trust and wealth management sectors. Partnerships are key to growing the economy.

Do you think there is a need for more competition in certain areas of financial services?

The impact on ISP/internet pricing from the new telecommunications regulation has already proved positive, and so the advantage of opening up the industry is evident. There certainly needs to be more discussion in this areas in order to determine what is best for Bermuda, and we will consider each sector to determine how best to grow business.

What is the Ministry doing to educate the public on the benefits of inward investment and international business?

This is an area that we recognise needs to be addressed. We have been focused on getting certain economic sectors moving and getting new business. The BBDC will be making communication one of its goals as it is important that everyone understands the importance of attracting new business.

It's been a busy first few months, what are your plans for the next year?

I plan to continue building on what we have started. To consolidate partnerships and start to see the impact of the work we have been doing. The importance of planning cannot be underestimated.

No matter how much we wanted to get moving to grow the economy we have remained committed to developing our plans for economic growth, in order to fully understand the needs and constraints we face. The BBDC is a good example of this, as it has the right structure, has new leads for several task groups including asset managers, trust and private clients. We expect to see the fruits of our efforts in the ILS and asset management sectors in the next year.

Craig Bridgewater
Head of Banking,
KPMG in Bermuda

Lori Rockhead
Senior Manager,
KPMG in Bermuda

The Scope for Better Regulation

There has been a strong and understandable reaction from politicians and regulators to the financial crisis. But are we on the right track or do we have to adjust the direction of travel?

Waves of regulatory reforms have been introduced to make financial institutions safer, to make the financial system more stable, and to shift the costs of failures from taxpayers to the creditors of failing institutions. These initiatives have ranged from tougher requirements on individual financial institutions to the 'macro-prudential' approach to financial stability, and from resolution regimes to more robust financial market infrastructure.

The Growth Agenda

Additional regulation is not however a 'free good'. It increases the cost, reduces the availability and reduces innovation in financial services. It reduces the returns to investors in financial institutions. And it reduces economic growth. This has been seen most powerfully and immediately in the downward spiral of bank deleveraging and weak or negative economic growth in Europe. Further substantial costs are likely to arise from constraints on the ability of banks to provide credit, trade finance and risk management services to their customers.

A modest reduction in economic growth during normal times may be a reasonable price to pay to avoid financial crises. Post-crisis regulation was supposed to prevent future failures and financial instability, at a small cost in terms of foregone economic growth. But the waves of regulatory reforms seem to have taken some countries and the global financial system beyond the 'tipping point'—the costs of ever more regulation have begun to exceed the benefits. In practice, regulatory reforms have exercised a substantial drag on economic growth, while their impact on the safety of the financial system remains uncertain.

Better Regulation

The industry needs better regulation, more attuned to the needs of the wider economy, not 'more and more of everything'. Bermuda needs to strike a balance between regulation and its impact on the wider economy. Bermuda needs to re-focus on the importance of credit, trade finance and the management of risk by corporates for economic growth, international trade and development.

Financial institutions, users of financial services, politicians and regulators all need to address this agenda. All stakeholders have a role to play in achieving a better outcome. This paper focuses on some of the issues that need to be addressed by the three key constituencies—financial institutions, investors and end-users, and regulators and politicians.

Financial Institutions

Regulation is not constructed in a vacuum. It responds to the standards and behaviours of regulated entities. Financial institutions, and in particular banks, therefore, have a strong incentive to behave more responsibly, not only to restore trust and confidence but also to enable regulators to ease back.

This requires financial institutions to make real and demonstrable progress in changing their cultures and behaviours; delivering much higher standards of governance, risk management and customer treatment; focusing more clearly on products and services that benefit the wider economy; making better disclosures of asset quality and risks; and not 'gaming' the regulatory system.

Investors & End-users

Investors in financial institutions and the end-users of financial services also need to play their part in addressing the balance between regulation and economic growth. They need to be more realistic about what both financial institutions and regulation can achieve.

Investors need to recognise that the risk/reward landscape has changed and that return on equity expectations needs to be adjusted accordingly. They also need to understand better the business models and risks of financial institutions, and put pressure on financial institutions to change these where necessary, in particular in a world where failures are more likely to result in the bailing-in of creditors than a bailing-out by taxpayers.

End-users of financial services need to remain alert to the impact of regulation on the cost and availability of products and services, and to enter regulatory debates with evidence on the implications of regulation for end-users.

Regulators & Politicians

Regulators should take proper account of the cumulative impact of their multiple reform initiatives and of the uncertainty surrounding the many unfinished parts of the regulatory agenda. Regulators should also be more sensitive to the impact of regulation on the wider economy; recognise that banking is a risk business, and that future failures will occur; and focus more on the possible sources of the next crisis rather than plugging all the holes exposed by the last crisis.

Finally, many politicians should recognise the importance of finance as a contributor to and facilitator of economic growth, and to be more realistic about what regulation can achieve and its impact on the wider economy.

Moving On: Bank Culture & Behaviour

Many banks (and other financial institutions) are seeking to restore trust and confidence, not least by making significant and meaningful changes to their cultures and behaviours, and to their corporate and risk governance.

This is not only important in itself, but is a key element in enabling regulators to take a less intrusive and intensive approach. Improved culture, more responsible behaviour, and higher standards of corporate governance, risk management, customer treatment and disclosure by financial institutions will allow regulators to take a less heavy-handed approach and reduce the overall burden of regulation.

Currently, regulation is attempting to deliver cultural and behavioural change at one remove, by mitigating the adverse impacts of poor standards of culture and behaviour. Capital and liquidity measures are designed to increase the cost of risk-taking; structural separation measures to encourage banks to take different approaches to their retail and investment banking activities; resolution measures to reduce risk-taking by removing the prospect of government support if banks fail; governance measures to heighten the focus of boards and senior management on risk; remuneration measures to reduce the incentives for inappropriate and excessive risk-taking; and conduct measures to increase the focus of financial institutions on the design and distribution of financial products and on the incentives of retail customer-facing sales and advice staff.

Regulation cannot do this alone. Banks and other financial institutions should seize control of their own destinies. Improvements in culture, behaviours and governance in financial institutions can also facilitate better regulation by allowing regulators to rely more on regulated firms to deliver good outcomes. This in turn should deliver benefits for financial institutions themselves for financial stability, and for economic growth and development.

This will require a massive shift by many banks—they will find it difficult to achieve the necessary shifts in culture and behaviour. Short-term profitability is not always closely aligned with the fair treatment of customers and good customer service, especially in markets—both retail and wholesale—where customers are unable or unwilling to engage on an informed basis. The old mantra of "what is good for business must also be good for customers" has been shown to be seriously flawed, with too many cases of banks placing their own interests ahead of the interests of their customers.

Moreover, the industry has been slow to recognise and address these problems and to accept that the cultural and behavioural issues here cannot be solved simply by high-level statements about "putting customers first" and by blunt adjustments to remuneration structures.

With contribution by KPMG International and David Harper
Senior Manager, KPMG in Bermuda

DEPOSIT INSURANCE SCHEME

The government passed the Bermuda Deposit Insurance Act 2010 (the "Act"), on September 3, 2010 (full details are available on the BMA's website at www.bma.bm). The Board of the Bermuda Deposit Insurance Scheme has been formed and is tasked with establishing and overseeing the deposit insurance scheme in Bermuda (the "Scheme") and the deposit insurance fund (the "Fund").

The Scheme is designed to only cover Bermuda dollar deposits of individuals, an individual that places a deposit in an account of the scheme member in the name of a partnership, an unincorporated association or sole proprietorship, certain charities and companies registered in the Register of Small Businesses. The Act outlines that depositors covered by the scheme will be "...entitled to compensation from the fund of a specific amount which shall not exceed $25,000 regardless of the number or amount of insured deposits...."

Unlike deposit insurance schemes in certain other jurisdictions which is only triggered in the event of a failure, Bermuda has adopted the model of building up a fund in case of a failure. So, how will the fund be built up? Well very simply, the scheme is designed to place annual levies (or annual premiums) on scheme members (i.e. banks) who KPMG expect will pass on some or all of that additional cost to those the scheme is designed to offer protection.

It will take considerable time for the fund to build up to a level that could support claims in the event of a bank failure. The deposit insurance scheme is a long term initiative and like all ambitious goals, it is recognized that it will take considerable time to achieve.

The scheme in Bermuda is expected to become effective late this year.

Tax Morality and the Foreign Account Tax Compliance Act (FATCA)

Why FATCA is here, why it is something that you need to understand and why it needs to be on your "to do" list this year.

FATCA represents the mechanism the U.S. government has put in place to provide the U.S.'s Internal Revenue Service ("IRS") with greater information on which to assess the completeness and accuracy of tax returns filed by U.S. tax payers. This piece of U.S. legislation has a global impact and has spurred a widespread debate on tax morality, as other governments have taken, or are taking, similar steps to better understand and assess the tax obligations of those subject to taxation in their countries.

FATCA and potentially similar legislation enacted by other governments, will directly impact the investment fund, investment management, and investment administration sectors.

Why are we taxed and the taxation dilemma?

The historical reasons for taxation range from improving health to funding wars. Income tax has become a primary means for most governments to finance the cost of running their respective country and providing public services. However, not everyone agrees with how government spends taxpayers' money, which makes tax one of the most controversial forces in politics. How much we pay and what governments choose to do with our money are fundamental to how we see the society in which we choose to live.

Taxation regimes tend to develop complexities, as successive governments use this component of fiscal policy to influence economic activity and investment flows in their economy. Tax incentives afforded to sectors or structures that governments wish to promote often lead to specific tax planning by a taxpayer that may be contrary to what the government had intended, for example through the use of tax "loopholes". As a consequence, there is often a "taxation gap", being the difference between what ought to be collected, given a certain amount of economic activity, against what is actually collected. The 2008 financial crisis and subsequent global downturn has taken its toll on government finances, and tax authorities in most developed countries are being pressed to raise more revenue from their tax bases, often with a conflicting desire to stimulate economic activity through selected tax incentives.

Tax morality

Most people have argued that tax planning is a legal issue and not a matter of morality. Those that subscribe to this philosophy take the position that tax planning to minimise their tax burden is legitimate in all circumstances, provided they follow the requirements of the applicable tax laws.

Paying tax may be a legal requirement, but it is not always a moral one—many pay because the law says they should. However, given the choice, not many would wish to live in a society without the services funded by taxation that taxpayers often take for granted.

The financial crisis has generated a renewed focus on the link between taxation and morality. Public opinion is growing more hostile toward global corporations and high net worth individuals perceived as not paying their "fair share". Today, society is keenly aware of the importance of tax within their national economies, and there is a growing sense that taxes have not been shouldered collectively on a fair and proportional basis.

Changing public perceptions are giving tax authorities a stronger mandate for tackling tax avoidance and evasion. In fact, tax morality has been used to justify moves to upset long-standing principles such as bank confidentiality rights and taboos against extra-territorial and retrospective tax legislation, enabling governments to arm their tax authorities with tough new tax enforcement tools, such as FATCA.

Introduction of FATCA

When FATCA was enacted, U.S. Congress estimated that tax evasion by U.S. persons holding assets outside of the U.S. equated to lost tax revenue of up to $100 billion per annum. The fundamental objective of FATCA is to provide an information reporting mechanism to identify those U.S. persons who may be evading taxes by holding assets outside of the U.S.

FATCA introduces a new regulatory compliance and reporting regime which compels certain foreign entities to disclose U.S. persons with "financial accounts" outside of the U.S. To compel foreign entities to comply with the new reporting requirements, FATCA introduces a 30% withholding tax on U.S. source fixed, determinable, annual or periodic income and gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. That is an almighty stick that most will not want to be hit with!

FATCA represents an extra-territorial piece of tax legislation, which has forced tax authorities around the globe to work together more closely than ever before. This has resulted in several inter-governmental agreements ("IGAs") to share taxpayer information.

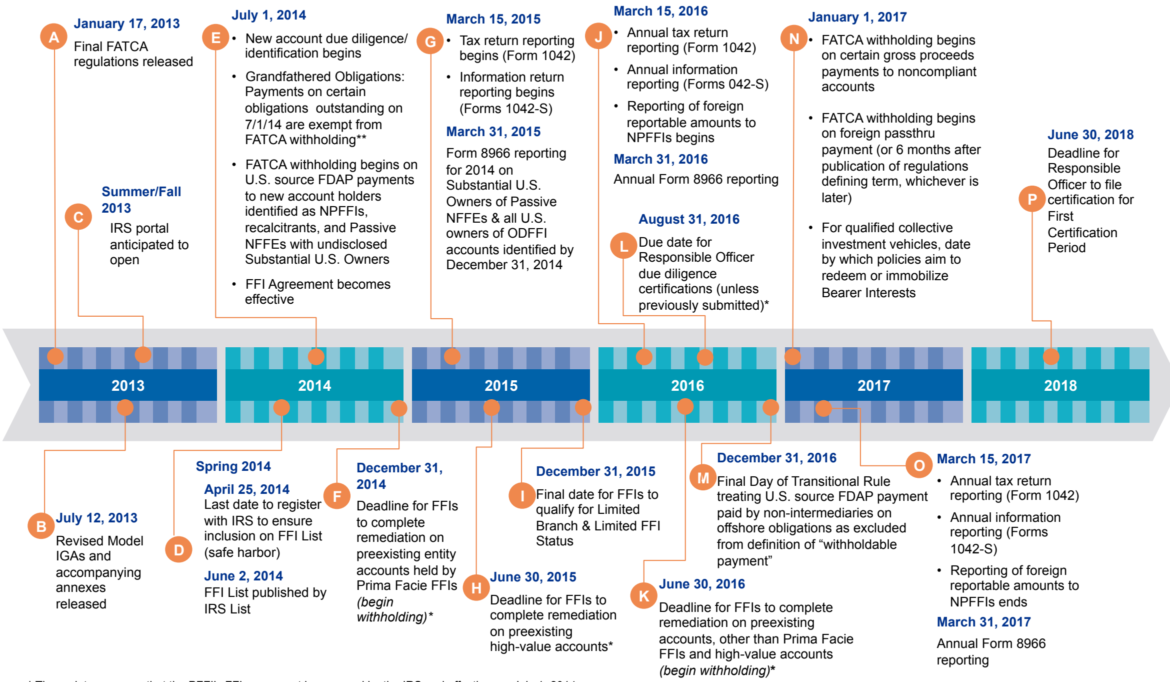
Governments are actively negotiating, when entering into IGAs with the U.S., to benefit impacted entities in their jurisdiction or protect them from undue penalty. But governments are also using the IGAs to gain more information on their own taxable citizens from the U.S. government and others. Currently, there are two model intergovernmental agreements with the U.S., being Model 1 and Model 2.

Foreign financial institutions ("FFIs") within countries that have entered into a Model 1 IGA will be required to report FATCA-style information to their local tax authorities, rather than the IRS. The local tax authority will then relay the requisite information on to the IRS, "government to government". Some Model 1 IGAs, also provide for reciprocity, with U.S. withholding agents having to report details of non-U.S. account holders and investors to the IRS, which in turn will pass that information to the tax authority of the "partner" jurisdiction.

Under a Model 2 IGA, FFIs in that partner jurisdiction will have to register with the IRS and comply with the terms of an agreement they enter into directly with the IRS.

As the world observes and learns from FATCA, many countries are likely to put in place similar legislation which some have dubbed "son of FATCA". On April 9, 2013, the

FATCA Time Line for Foreign Financial Institutions (“FFIs”)



* These dates assume that the PFFI’s FFI agreement is approved by the IRS and effective on July 1, 2014
** Payments treated as dividend equivalents, under section 871(m), may be treated as Grandfathered up to 6 months after the publication of regulation implementing 871(m)
Payments treated as foreign passthru payments may be treated as Grandfathered up to 6 months after the publication of implementing regulations

U.K. announced an agreement with France, Germany, Italy and Spain to develop and pilot a multilateral tax information exchange process, similar to the Model 1 IGAs under the U.S. FATCA regime.

Bermuda has signaled its intention to sign a Model 2 IGA with the U.S. and plans to sign a similar agreement with the U.K.

Are you ready for FATCA?

FATCA withholding starts July 1, 2014. The IRS has stated that FFIs need to register by April 25, 2014 to avoid delays in receiving a notice of registration acceptance and obtaining the Global Intermediary Identification Number (“GIIN”) needed to demonstrate FATCA compliance. Full details of the timetable of compliance for FFIs are provided above.

To comply with FATCA, FFIs may have to change the way new customers are approved and documented. In some cases, institutions are faced with updating their IT infrastructures to ensure they have the tools to withhold tax on applicable payments and report the requisite information to the IRS.

An FFI is any non-U.S. entity that does the following: accepts deposits in the ordinary course of business; holds financial assets for the benefit of others as a substantial portion of its business; is an investment entity; is a specified insurance company (i.e. cash surrender value products and annuities, primarily written in life insurance-related products); or is an entity that is a holding company or treasury centre.

Therefore, it is generally concluded that non-U.S. banks, investment funds, investment managers and custodians will be categorized as FFIs. Our research suggests that most FFIs are not ready for FATCA. If you are in this camp, it’s not too late but time is getting short.

Here are some of the steps you need to take: align yourselves with knowledgeable advisors to leverage their global knowledge and expertise; ensure that C-level executives are actively engaged; manage time and resource expectations—there is no plug and play solution available, so all companies will need to go through a thorough impact assessment; entity or departmental needs may be different, but consider the need for central sponsorship and ownership, supported by a multidisciplinary team; and perform an impact assessment by identifying entities that are FFIs and will need to be registered—for example, each entity within an investment complex will need to be registered and adopt policies, procedures and systems to comply with FATCA that have the flexibility to adapt to the changes expected.

The FATCA requirements introduce a series of business and system requirements that are simple in concept, but can be difficult and costly to implement. The price of noncompliance with the new rules is high. If you have not done so already, the time to consider the impact of FATCA is now.

How will FATCA impact customers of FFIs, like customers of Bermuda’s Banks?

The FATCA requirements imposed enhanced information gathering and reporting obligations on FFIs. As such, as an existing customer of an FFI you may be requested to provide additional information to your bank to enable the bank to fulfill its obligations under FATCA and avoid the bank being required to impose withholding taxes on amounts due to you. For new customers, the information collected at account opening is going to increase in most cases, to meet these new requirements. We hear you! More, more, more…life is getting more difficult, that is agreed. We can assure you that the FFIs, banks, funds, etc are not happy about it either. But it is important to provide the information requested, as if you don’t assist the FFIs, it may result in money out of your pocket and money that gets sent on its way to the IRS!

By Catherine Sheridan Moore
Head of Tax, KPMG in Bermuda

Banking on Credit

Legend has it that modern day banking originated in Europe during the Middle Ages. Gold was used as currency which, as you can imagine, was impractical to carry around with you at all times and unsafe to leave at home. People started storing their gold at the goldsmith who already had the necessary facilities for safe storage of gold. In return for the service, the goldsmith was paid a small fee. Initially people collected their gold every time they needed it, but soon, this became inconvenient and the goldsmith started issuing receipts which people started using as a form of currency—the first paper currency. During the course of time, the goldsmiths realised that the gold was sitting in their vaults for many years untouched, as people traded their notes. The entrepreneurial goldsmiths started issuing notes to people who needed capital, by way of a loan, in order to generate additional value from the idle gold. When the depositors realised what the goldsmiths were doing, they demanded a cut of profits. The goldsmith started paying them interest on their gold deposits to appease them.

This was the evolution of the simple community bank as we know it. Today's banks work on similar principles, except that because of the development of capital markets, the investment strategy of the banks is not limited to loans as investments are made in debt securities, equities, and loans to other banks to name a few. This change in strategy has required banks to find the optimal mixture of return vs liquidity and credit risk.

Return: Return is simply the amount by which the sum returned exceeds the sum advanced. Typically, the shorter the term of the investment, and the higher the credit quality of the counterparty, the lower the return, and, vice versa.

Liquidity: There is an inherent mismatch in the liquidity of loans and deposits. Deposits can be withdrawn on short notice, while loans typically have much longer terms. This means that the bank must consider the level of liquidity in their investment strategy in order to ensure that they would have the liquidity to repay deposits should there be a significant withdrawal of deposits.

Credit risk: Credit risk is most simply defined as the potential that a borrower will fail to meet his obligations in accordance with agreed terms. The higher the credit risk the greater the return, but, of course, if the borrower is unable to repay the cash, then the return is nil or negative. Banks are subject to both external credit risk (economy, natural disasters, etc.) and internal credit risk (credit writing quality, diversification, etc.). The current economic downturn in Bermuda could be considered an external factor over which the banks have no control. The magnitude of the risk is, however, somewhat dictated by the internal credit risk at each institution.

It is no secret that Bermuda banks have suffered considerable credit losses in the past few years. So what has led to these credit losses? The fact of the matter is, that where loans to customers are concentrated so highly in a small jurisdiction such as ours the same events that lead to an increase in the number of defaults lead to a decrease in the collateral which the banks hold as security.

Prior to 2008, the Bermudian economy was booming as GDP continued to increase, the population was growing, property prices were increasing exponentially, rental income was increasing, and commercial and residential properties were being developed to take advantage of the demand. Reviewing the government statistics since 2008, the unemployment rate increased from 4% in 2009 to 8% in May 2012, directly resulting in less borrowers being able to maintain their monthly loan payments. The defaults were exacerbated by the increasing number of expatriate workers leaving the island. This has had a significant impact on those who hold investment properties for rental, or who rent parts of their own residences. The severe drop in demand significantly impacted on whether, and at what price, these properties could be rented. The combination of unemployment and the decrease in rental demand has resulted in a significant number of borrowers defaulting on their loans.

Considering commercial loans, two of the largest types of commercial loans in recent times have been for commercial and residential real estate development loans, and loans in the hospitality industry. Just looking around the skyline of Bermuda, it is easy to see the number of new commercial spaces that have gone up since 2008. Further, government statistics indicate that the number of jobs has dropped significantly over the period. Again, simple supply and demand economics dictate that prices have fallen and many commercial properties stand empty. Likewise, new residential developments have not been as profitable as planned due to the drop in demand, as discussed above. The struggles of the hospitality industry have been well documented with a number of hotels in receivership and restaurant closures.

The number of defaults in residential and commercial loans has been at unprecedented levels for Bermuda. Accounting standards require that impaired loans are measured at their recoverable value. For secured loans, in the absence of evidence that the borrower has an alternative means of repayment, the loans are written down to the amount expected to flow from the proceeds of the sale of the collateral. That does not necessarily mean that that the banks first course of action will be to foreclose on the property, it is simply an accounting entry.

Banks are not in the property game and do not want the cost, uncertainty, publicity, etc. that goes along with foreclosure. Further, a rush of foreclosures would swamp the market with supply and artificially decrease the values. This is not a good result for the borrower, the lender, or the jurisdiction. So what are the potential solutions? Well, the only way to find out is to contact your bank on a timely basis, to find out what solutions they are willing to offer.

A consistent theme of the banks' public comments is the willingness to work with borrowers in the current economic environment. Timely open and upfront communication of difficulties in meeting obligations is recommended.

By Richard Hobday
Senior Manager, KPMG in Bermuda

Social Media & Mobile Banking

A key trend in banking over the next few years will be the rising popularity and capability of mobile banking and the use of social media.

These are not easy times for today's bankers. On the one hand, increased regulatory pressure and public scrutiny is pushing the issue of trust to the top of the business agenda and, the same time, new technologies and customer preferences are forcing banks to adapt their business models and evolve at an unprecedented pace.

Mobile has transitioned into a 'must have' for many customer segments, thanks largely to the proliferation of smart phones across the global market and the 'on the go' internet access they provide. With mobile internet usage expected to exceed desktop internet use by 2014, mobile banking services will become ever more important.

The widespread consumer adoption of social media is also hard to ignore. More than 70% of organisations operating around the world are now active on social media, however, retail banks seem to be lagging behind in its adoption.

A recent KPMG survey of 35 global banks showed almost two-thirds believe that adoption of social medial will grow to "medium adoption in a fairly structured way" in the next two to three years. Also, nearly 90% of respondents used social networking to achieve customer engagement, with the promotion of products/services and the coverage of upcoming events.

Social media provides banks with a new means of understanding their customers. Existing modes of customer communication tend to view customers in one dimension—as a bank customer. In reality, however, customers are multi-dimensional and motivated by a range of different influences. Social media enables banks to achieve a more holistic view of their customers based on their social interactions, and therefore allows banks to develop more targeted approaches to new product promotion, collect more valuable customer information and create a better customer experience.

More than any other banking channel, social media is all about customer experience. Customers will expect banks to be more transparent in their interactions over social media. It will also require banks to be open to criticism—even encourage it—in order to provide a better customer experience.

However, social media also presents a danger where the actions of both customers and employees pose a reputational risk for banks. As an example, in Brazil, clients recognised the power of social media to motivate their banks to provide faster, more responsive customer service. Before long, banking customers were not just tweeting about their complaints with banks, they were posting photos and videos too, creating a much larger impact and capturing the imagination of friends and the general public. As a result, social media has become a significant risk for most Brazilian banks.

In response to the risk, Brazilian banks have created departments dedicated to monitoring and responding to social media conversations. Brazil's banks are also starting to sharpen their focus on security. In some cases, cyber criminals have been targeting customers with "phishing" attacks based on their interaction with banks over social media. Criminals are also starting to leverage the wealth of public information available on many people's social media profiles to "engineer" passwords or provide positive identifications during call center requests (common security questions include names of first pets, primary school teachers, or mother's maiden names, all of which can easily be harvested from public profiles).

Brazil's banks' experience with phishing and hacking attacks enabled by social media is shared by banks around the world, including here in Bermuda where banks have seen a rise in cyber attacks, particularly phishing attacks. Hackers are becoming increasingly persistent and sophisticated, and as a result, so are most of the security measures of banks. Those banks that fall victim to attack will lose the trust of their customers and those that are able to demonstrate better, user-friendly measures will benefit from their competitors' loss.

Mobile banking is increasingly becoming the focal point of the customer interaction strategy of banks, driven by the changing demands of customers. Early adoption of mobile banking was slow due to technological challenges, limited standardization, fragmented commercial efforts, and the lack of a sustainable and trusted business model. However, mobile financial services are experiencing a global surge, especially in emerging markets.

Mobile banking allows customers to use mobile devices to transfer funds, make inter-bank mobile payments, make balance enquiries, request cheque books, pay bills, recharge mobile phones, as well as a substitute for a multitude of credit card and debit card transactions. The automation of these processes significantly increases the convenience for customers.

To date, banks have focused on developing a mobile banking service that is secure and offers an acceptable user experience. Going forward, delivering an effective marketing and sales capability through mobile banking channels will be crucial for banks around the world to meet the new demands of customers who are becoming increasingly portable.

The use of tablet devices also creates new possibilities as product presentation becomes more interactive and transparent. Banks will be able to demonstrate and explain complex products without face-to-face contact. As a result, customers will become more independent of branches and their employees. This may lead to significant cost reductions for banks depending on their size.

Banks' ability to present personalised, actionable marketing messages in context has turned the internet into a large and effective sales channel. Banks with strong internet banking propositions now sell a quarter of their retail products this way, and the proportion of sales are rising steadily year-on-year. Therefore, as the mobile channel attracts customers, it will need to earn its keep as a revenue generator, as well as a service channel, by generating appropriate sales levels.

Institutions such as Bankinter in Spain have shown how this can be done in a way that makes sense for mobile, without destroying the customer experience. In collaboration with Amdocs Mobile Banking solutions, Bankinter has built a cost effective customer communication channel that allows customers to receive alerts, respond to targeted sales offers, access, and manage their bank account information through a mobile device.

Continued on page 19

BACKGROUND

The Bermuda banking sector is made up of four banks of different sizes and different levels and types of services, the players being: Bermuda Commercial Bank ("BCB"); Capital G Bank Limited ("Capital G"); HSBC Bank Bermuda Limited ("HSBC Bermuda"); and The Bank of N.T. Butterfield & Son ("Butterfield Bank").

These differences make direct comparisons difficult. This survey is intended to highlight and discuss trends in the sector and discuss some of the common challenges market participants face in the short term. The financial analysis included herein is for the five year period from 2007 to 2012. The source of all the financial information is the audited financial statements of each entity or calculations using such information.

The reporting periods for the banks and their focuses have not been consistent, and, as such, it is important to consider the information below when making comparisons:

BCB is the only bank in Bermuda to primarily focus on lending to other financial institutions. BCB's year end is September 30 and its financial statements are prepared in accordance with International Financial Reporting Standards (IFRS).

Butterfield Bank is listed on the Bermuda Stock Exchange and has a December 31 year end. Butterfield Bank prepares its financial statements in accordance with accounting principles generally accepted in the U.S.

Capital G has a residential lending focus and a December 31 year end, but had a January 31 year end prior to December 31, 2009. Capital G converted to IFRS during 2011 and restated certain 2010 balances.

HSBC Bermuda is part of a large global banking network. HSBC Bermuda has a December 31 year end and prepares its financial statements in accordance with IFRS.

All amounts disclosed are in thousands (000's) of Bermuda dollars.

2013 KPMG in Bermuda BANKING SURVEY

2012 OVERVIEW

The 2012 year in Bermuda banking was once again defined by the low interest rate environment continuing to impact the ability to earn revenues, coupled with the economic recession and related credit impact. Bermuda banks have however proved resilient despite the tough environment. For the second consecutive year all four banks were profitable in 2012.

BALANCE SHEET

Although the discussion below is focused on the assets of the banks, it is important to note that the primary driver for the growth in the balance sheet is customer deposits. Essentially, for every dollar that a depositor places with a bank, the banker must decide how best to invest that dollar of cash. When doing so the bank will consider such factors as risk, return, and liquidity. Figure 1 indicates the size of each of the bank's balance sheets, while Figure 2 indicates how these customer deposits have been invested by the banks.

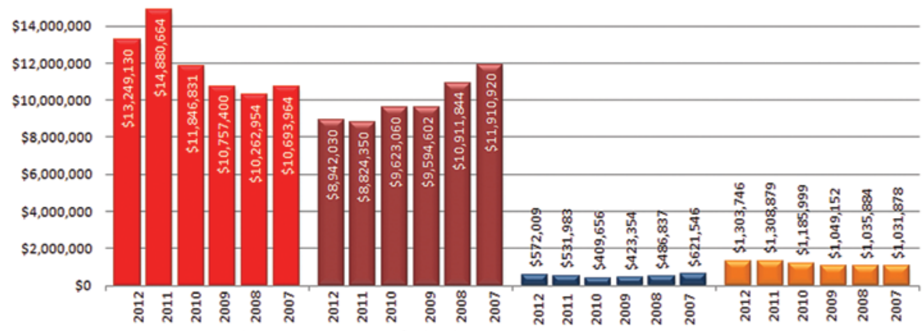
Butterfield Bank and Capital G have remained very stable with regard to the level and make up of total assets.

HSBC Bermuda's balance sheet has shrunk by $1.6 billion since the end of 2011 due to an outflow of funds held at December 31, 2011. The outflow of deposits was settled primarily through realisation of financial investments, primarily treasury bills, as indicated by the significant decline in this asset category.

BCB, comparatively, has shown some growth stemming from the bank's profit, as well as unrealised growth in their investment portfolio. Looking at the composition of BCB's assets there has been a slight shift in the composition, with a higher proportion invested in financial investments than the prior year. Management attributes this shift to the re-allocation of funds into longer term assets in line with the lengthening of their customer deposit maturity.

Figure 3 shows the gross customer loans to customer deposits ratio for each of the banks actively involved in lending. The ratio indicates that Capital G is most highly invested (80%) in loans to customers. The results of this strategy are evident in the interest margins (Figure 4), where Capital G comfortably exceeds the interest margins earned by their competitors. The ratio is also a key measure of risk, as loans to customers are typically long dated, while deposits are payable on call, causing a liquidity mismatch which is

Figure 1: Total Assets



common to community banks.

PROFITABILITY

Looking at interest margins extending back to 2007, pre the financial crisis, the severe impact of the low interest rates is clearly evident. Some of this sharp decline is due to the historically low interest rates, while an element can also be attributed to change in investment strategy as the banks inevitably trend towards more liquid, lower risk, lower return type investments in the wake of the financial crisis, and in order to react to regulatory pressures. These challenges are not unique to Bermuda, but rather are common to the banking industry globally.

To combat the lower net interest earned, the banks have a few options available to them: find other sources of revenue or develop new products; implement sustainable cost savings; and invest in higher returning assets (this comes at a trade off of increased risk).

Both HSBC and BNTB pointed to sale of non-core subsidiaries and “streamlining” of operations as strategies implemented in 2012.

Capital G were able to grow their revenues slightly while keeping expenses fairly stable year on year.

BCB have sought to expand their corporate and trust services business through the amalgamation with Paragon Trust Services Limited and Charter Corporate Services Limited. Their headcount also increased from 49 employees at September 30, 2011 to 69 at September 30, 2012 partly as a result of the acquisitions, and partly due to growth in their banking division.

As depicted in Figure 5, the overall profitability of the Bermuda banks has suffered since 2007. This is partly due to the low interest rate environment, and partly due to credit losses. HSBC, Butterfield Bank and Capital G continue to be negatively impacted by loan impairment charges. BCB, who are not actively engaged in lending, have achieved a comparatively better return on equity in the past two years.

With no real indication that interest rates are on the increase, or that the economic tides in Bermuda are improving, profitability will likely remain under pressure in the foreseeable future. The additional costs associated with the regulatory changes such as FATCA, and deposit insurance, may also have a toll on profitability going forward.

LOAN IMPAIRMENTS

Of the banks actively involved in lending

Figure 2: Composition of Total Assets

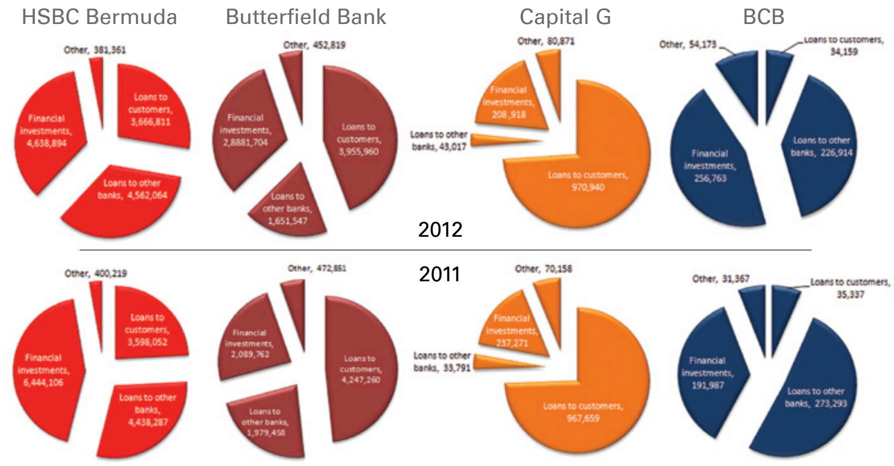


Figure 3: Gross Customer Loans to Deposits Ratio

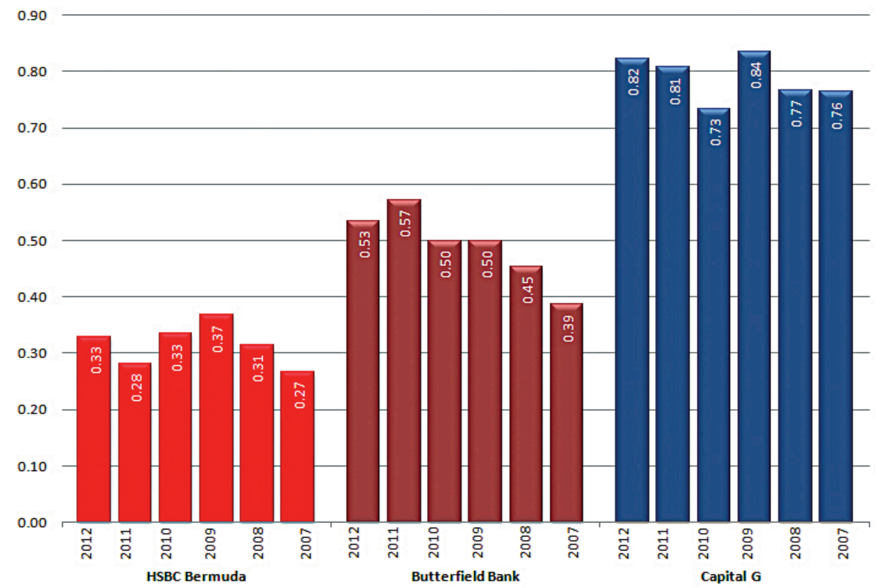


Figure 4: Total Interest Income as a Percentage of Net Interest Before Credit Losses

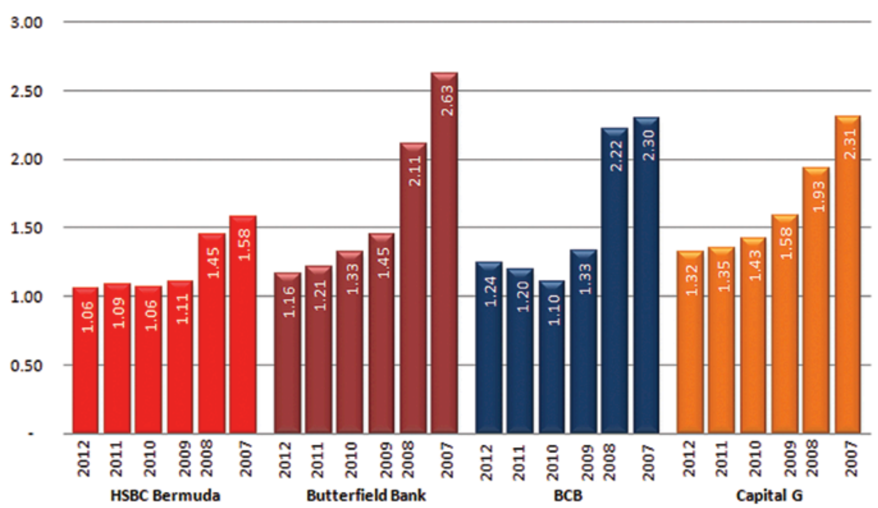


Figure 5: Net Profit as a Percentage of Equity

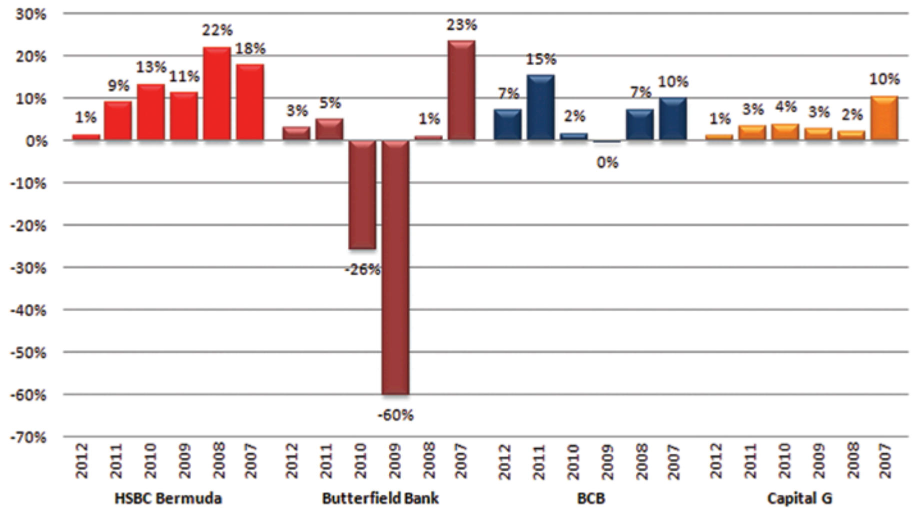


Figure 6: Impaired Loans as a Percentage of Gross Loans

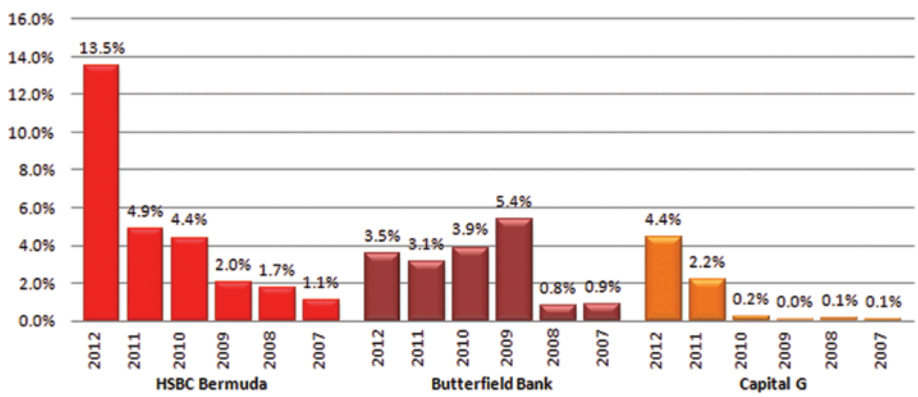
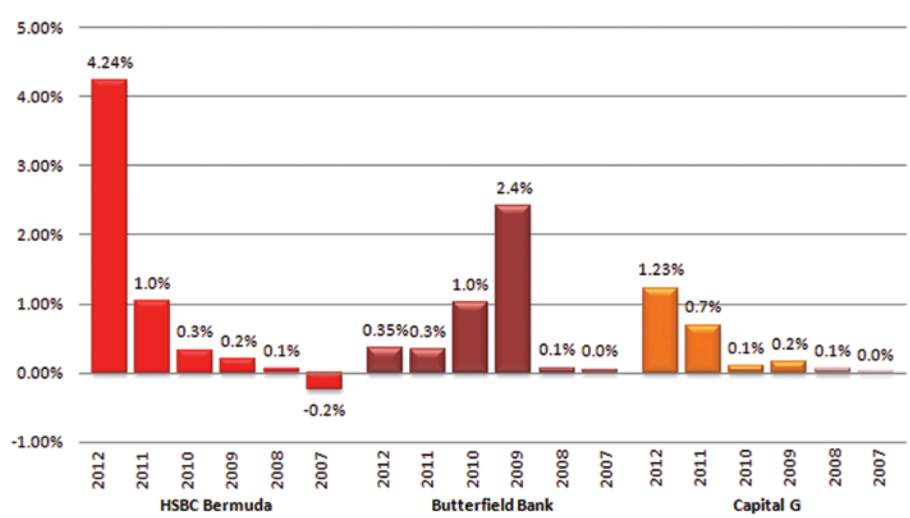


Figure 7: Impairment Expense as a Percentage of Gross Loans



activities, all showed a marked increase in impaired loans—that is loans that are not performing. This increase is driven by increased loan defaults due to the economic downturn as evidenced in the negative change in GDP, and increasing unemployment rates. A shrinking of the population has also resulted in significant decreases in rental incomes which has had an impact on home owners' ability to service their debts.

Coupled with the increase in impaired loans, we have also seen property valuations take a significant tumble. In the absence of evidence of the ability of the borrower to repay secured loans, banks typically use the value of the collateral held as security to measure the amount of impairment. This means that many of the same factors leading to an increase in defaults, simultaneously leads to an increase in the loss on default. The net effect is a considerable increase in impairment losses over the past few years. HSBC Bermuda management attributed the significant uptick in their loan losses in 2012 in a large part to "material and connected real estate loans in North America". Also, looking back at Butterfield's 2009 and 2010 results, the large losses were attributed to a few individually significant commercial exposures in the hospitality sector.

A consistent theme of the Banks' media comments was the willingness to work with borrowers in the current economic environment. This is also evident when one looks at the foreclosed assets in each of the portfolios. The amount of foreclosures relative to the delinquent loans is a clear indication that banks are willing to work with borrowers and treat foreclosures as a last resort. This is clearly in the best interest of the banks and the jurisdiction.

CAPITAL ADEQUACY

The three major objectives of the regulator are to: protect the depositors; reduce the systemic risk of disruption to the economy in the event of a banking failure; and reduce the risks of banks being used for criminal activity, such as money laundering.

We have already discussed, in an earlier article, implementation of deposit insurance, which is one of the strategies adopted by the Bermuda Government to protect depositors. This is however, a back-up plan in the event of a banking failure, and, as everyone knows, prevention is better than the cure.

In order to monitor the financial health of the Island's banks, the BMA currently adopts the Basel II approach to capital adequacy. Basel

II allows the BMA the ability to set minimum regulatory capital requirements for each bank, as well as monitor their adherence to these minimums on an ongoing basis. It also requires each Bank to disclose information about their capital, risk exposures, risk assessment processes, and capital adequacy. These disclosures allow informed market participants to gauge the capital adequacy of the banks. These disclosures are known as the Capital and Risk Management Pillar III disclosures, and are available on the websites of each of the four banks in Bermuda.

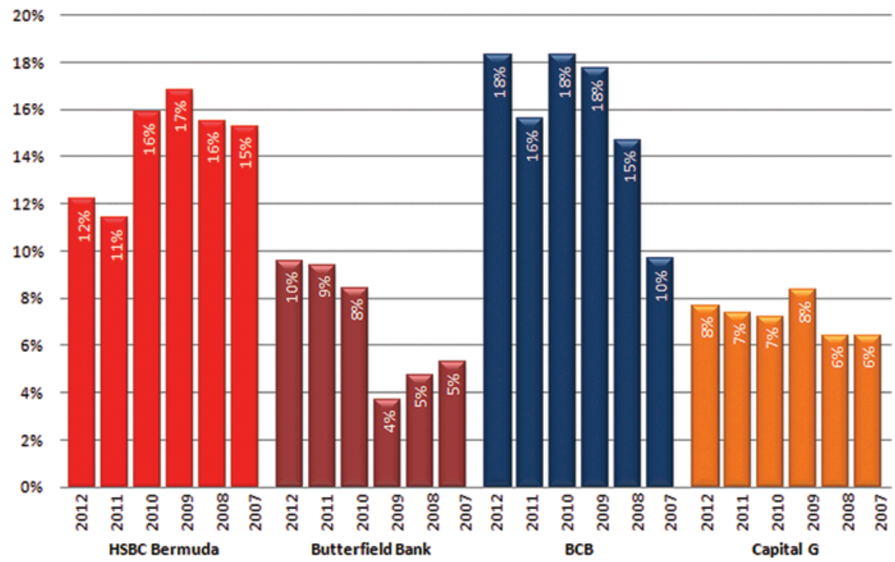
Despite the difficult times the capital ratios of the banks remain strong, exceeding international standards (International Basel II Tier 1 minimum capital requirements are 8%). It should be noted, as it has been in prior years, that the BMA does require Bermuda based banks to maintain a premium above the international standards in order to compensate for the concentration risk associated with lending in the Bermuda market.

Capital adequacy and risk management will continue to be closely monitored by regulators worldwide in the lead up to the implementation of Basel III, which is designed to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

Figure 8: Basel II Tier 1 Capital Ratio

Bank	2012	2011	2010
Capital G	13%	14%	17%
HSBC Bermuda	28%	33%	31%
Butterfield Bank	19%	18%	16%
BCB	26%	32%	27%

Figure 9: Equity as Percentage of Total Assets



Social Media & Mobile Banking

Continued from page 15

Mobile banking is still in its early adoption phase, and a large section of the population remains concerned about security and fraud risk. Banks will need to tackle these perceptions. Equally, as mobile becomes more mainstream, banks must work hard to stay ahead of the fraudsters by providing ever stronger protection. New methods will be needed that do not compromise the experience.

On the upside, mobile devices can play a key role in security by supporting out-of-band authentication in a multi-channel environment. For instance, alerting has already become a useful tool in reducing the impact of compromised cards and online banking credentials.

Mobile banking is expected to gain traction in Bermuda soon, due to the significant investments being made by the industry in enhanced technology. As the world continues to see development and growth in mobile devices, Bermuda banks are expected to follow suit to maintain their competitiveness in the industry.

Security measures for consumers

With the increase in social media activity and potential mobile banking opportunities here in Bermuda, consumers must also understand the security risks involved and their related responsibilities. While mobile banking and social media interactions are intended to improve their customer experience and offer greater convenience, they could represent additional areas of risk for personal information to be stolen and fraud.

Consumers are reminded of the following preventative measures:

1. Create strong passwords for online accounts that include capital letters and special characters.

2. Limit sharing of personal information on social media.

3. Ensure different passwords are kept for different accounts to prevent hackers from hacking into multiple accounts with the same password.

4. Never provide your password to any requests via email even if they look like they are legitimate sources (e.g. your bank). Banks will never ask you to reconfirm your login or password via e-mail by clicking on a link. If you are unsure, call the bank through their direct line and confirm the legitimacy of the request.

5. Ensure you have an up-to-date anti-virus software installed on your computer.

Banks continue to increase security measures to counteract the information technology security risks related to new technologies, like social media and mobile banking. But consumers are reminded that they play a key role in minimising the risks and need to remain vigilant and take appropriate actions to personally prevent loss of personal information and fraud.

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