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INSIGHTS

2015 KPMG BANKING IN BERMUDA MAGAZINE

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Preface

As we launch the fifth edition of our Banking in Bermuda Magazine, quite a bit has changed since producing the 2014 publication. A significant development, and one that has injected a marked increase in positive business sentiment, is the announcement that Bermuda will host the 35th America's Cup in June 2017, and a number of the races and events that will precede it over the next two years. This development will inevitably bring an increase in economic and social activity to the Island.

Specifically related to banking, we have seen significant "clean up" and de-risking of the balance sheets of Bermuda's banks, allowing them to place an increased focus on accretive business activities, customer offerings and the proactive pursuit of managing business as usual operating risks. The Bermuda Monetary Authority has also introduced its Basel III regime which became effective on January 1, 2015. This provides the Bermuda banking industry with clarity on the new requirements and timeline for implementation and compliance. Business always welcomes certainty and these I'm sure are welcome developments for the industry and the jurisdiction.

In general, we have seen a requirement for an increased and expanded role for Boards of Directors in the financial services industry, be it for banks, funds, trusts or insurance. This is being demanded by regulators and shareholders and indeed expected by customers. There is an increased need for Directors to be involved in helping to identify and manage risks while also providing input into business strategy.

A lot has changed. The one constant that we can rely on, particularly in the local and global financial services industry, is change.

In the 2015 edition of *Insights*, we at KPMG, as well as the heads of the Bermuda banking industry and the Bermuda Monetary Authority, have given you some insight into the change that is occurring.

Craig I.V. Bridgewater
Head of Investments & Banking, KPMG in Bermuda

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Banking in Bermuda: An Overview

Bermuda's banks have a long and important history in the community and have played a key role in shaping the island as it is today. The banks are increasingly focused on customer centricity and responding to customers looking to engage in new ways with their banks, such as the desire for tailored banking services and new channels, including mobile applications. The banks are also responding to more informed and active shareholders, who are continuing to seek acceptable returns on equity, but at the same time requiring effective management of other significant risks such as reputation and data security.

This is all set in the context of an island emerging from recession, where low interest rates and challenges within loan and mortgage portfolios continue to prevail. On top of this, there is a continuing increase in regulation, the requirement for more information to be reported, as well as increased capital requirements. It is a challenging time for the banking industry.

Bermuda's banks continue to face an increasing regulatory burden, including an intensification in the amount and precision of reporting. Much of this has been enshrined in regulation and statutory instruments such as the Foreign Account Tax Compliance Act ("FATCA"), enhanced know-your-client ("KYC") and anti-money laundering ("AML") standards, and the advent of Basel III and its related capital adequacy requirements and liquidity coverage ratios.

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& **Alex McInnes**
Senior Manager, KPMG in Bermuda

Despite the difficult recent times, the capital ratios of our banks remain strong, exceeding international industry standards. The Bermuda Monetary Authority ("BMA") requires 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 and the absence of a central bank.

To combat the lower net interest margin being earned, most of the banks have sought other sources of revenue, primarily fee income. The banks are further looking to grow their revenues and their customer base by better understanding the needs of their customers and creating a more positive customer experience. The banks are looking to seek insight to ensure they can offer products and services aligned to customers' needs; to connect internal and external data to create value and gain competitive advantage; to adopt a distribution strategy that optimises return on investment and also meets customers' needs; and to provide consistent error-free processing regardless of the service channel.

A recent survey conducted by KPMG suggests that in major international markets, customer satisfaction with banks is increasing as a result of the banks' continued investment in security, technology and operational excellence. It was found that banking customers place highest importance on two attributes: value for money; and honest, trustworthy staff. The Bermuda banks are focusing on these attributes in developing the products and services offered to their customers.

Bermuda's four banks continue to evolve and to contribute to the maintenance of the strong reputation of Bermuda banking and the financial services industry in general.

Bermuda's four banks continue to evolve and to contribute to the maintenance of the strong reputation of Bermuda banking and the financial services industry in general. This is at the same time as dealing with forces transforming the industry including the growth agenda; management of cost; the compliance with regulation and managing its impact on business models and economics; and customers demanding ever higher levels of service and value. Investment is being made in technology to enable both customer experiences and to increase the efficiency and effectiveness of operations. The future of banking in Bermuda remains positive.

The Future of Banking: Transformation

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& **Alex McInnes**
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The banking industry is coming out of a period of survival, into a future of transformation. Transformation in terms of how it responds to its customers; the products and services that are offered; how they adapt in response to new competitors in the market; and how the operating models are transformed to deliver banking services in this new world.

It is being recognised by the banking industry that an overall business growth strategy based on customer connectivity will play a large role in determining future success.

It is likely that we will see branches shrink in size and offer a wider range of services to their customers including executing a number of transactions on behalf of their customers, as well as offering advice for a host of products, including investments, mortgages, and deposit accounts.

It is the banks' younger customers who will embrace this transformation. Many want to stay in control and be empowered with their own finances, so there is an opportunity for banks to respond to this 'do it yourself' approach. Additionally, many are now holding financial products with multiple banks, so banks need to be considering what incentives they can put in place to lure customers across, while minimising exploitation of rewards.

Key to this transformation will be changing the behaviours and preferences of both the customers, young and old, and the staff. The banks will need to focus on education in order to meet the joint demands of connecting with customers, growing revenues and reducing costs.

We are likely to see transformation in products and services in response to customer needs as well as in response to increasing regulation. Onerous regulatory capital requirements have led many banks to focus on business areas that are less capital intensive such as asset and wealth management. Many executives believe asset and wealth management will be a top growth driver over the next few years.

Traditional banks are increasingly facing competition in the provision of products and services from outside the industry. Such competitors include supermarkets and online opportunities including 'crowd-funding', the person-to-person lending and investing trend. Unfortunately for traditional banks, non-bank entities will continue to seek and exploit weak spots in the traditional banking industry.

One of the key challenges in banking going forward will be how to optimise performance within multiple constraints; for example, how to evolve their business models to grow, whilst at the same time, reducing expenses, modernising their technology platform, and increasing regulatory capital. Transformation of fundamental business and operating models and simplification of organisations and processes are essential to establish a competitive advantage in an increasingly complex world.

Bermuda's banks need to embrace the transformation that lies ahead if they want to succeed. Staying the same is not an option.

For too many banks, the journey to date has focused almost entirely on meeting new and tougher capital, leverage, and liquidity requirements. But following this path on its own does not represent a strategy for a viable and sustainable future. Banking management and boards need to aggressively pursue a transformation in how they think and act in relation to their businesses and their customers. They need to charge ahead in creating better banking experiences for customers; in designing profitable and customer-centric products and services; in focusing on cost-and-process-optimisation opportunities; and, in attracting and retaining the best talent. Bermuda's banks need to embrace the transformation that lies ahead if they want to succeed. Staying the same is not an option.

CEO Roundtable:

KPMG's Discussion with the CEOs of Bermuda's Banks

Key areas of discussion included:

- ✓ The future of banking
- ✓ Change
- ✓ Private banking & wealth management
- ✓ Cyber and data security
- ✓ Lending
- ✓ Regulation
- ✓ Reporting
- ✓ Capital

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At the table:

Peter Horton, CEO, Bermuda Commercial Bank Limited
Brendan McDonagh, Chairman and CEO, The Bank of N. T. Butterfield & Son Limited
Ian Truran, CEO, Clarien Bank Limited
Richard Moseley, CEO, HSBC Bank Bermuda Limited
Craig Bridgewater, Head of Investments & Banking, KPMG in Bermuda
Charles Thresh, Managing Director, KPMG in Bermuda
James Berry, Managing Director, KPMG in Bermuda
Alex McInnes, Senior Manager, KPMG in Bermuda
Sherrisse Facey, Manager, KPMG in Bermuda

The impact of technological advances, increased regulatory and reporting requirements, data and cyber security risks and have undoubtedly changed the way in which banking has been conducted in recent years. This is forcing banks to critically review their business operating models on a continuous basis for efficiency whilst prioritising customers' needs and maximising shareholders' wealth. These are some of the key themes of this year's roundtable discussion with the CEOs as they discuss the impact of these areas on their current and future operations as well as how they are adapting to these changes to enable them to increase their competitiveness and improve customer experiences.

The future of banking

How do you envision banking in Bermuda in five years' time? What role will technology play in that?

Horton: I think there are two key drivers that will influence the future shape of banking in Bermuda; technology is certainly one driver and the second will be regulation, both domestic and international. With regards to technology, I think it will bring substantial improvements to the client product offering, accessibility and service standards. All of these factors will culminate in a significant transformation to the entire customer experience five years from now. Regulatory change, largely Basel III and FATCA / CRS, will determine the type of business banks will undertake with the combination of both liquidity and capital management significantly influencing the business model and ultimate offering.

> "Given the size of the market, nobody is going after innovative technology as a game changer."
>
> -McDonagh

McDonagh: Technology has had a significant impact on banking over the last several years, both in terms of how our customers interact with our bank, and how we process transactions. There is no doubt that technology will continue to impact the banking model, largely around customer information and operations. Given the size of the Bermuda market, the banks here are not necessarily early adopters of new technology, but we do bring technology-based processing and service solutions

on-stream as quickly as we can as they become cost-effective.

Moseley: Increased digital connectivity. Increased utilisation of customer relationship management. Also, with increased trade outside of the U.S., retailers may start to look at other suppliers to provide more variety of product and they will be looking for more trade financing support to enable them to make those connections safely.

Truran: Far more automated and "mobile". While I do not anticipate branches becoming extinct, I do anticipate far less utilisation. There will be non-bank financial companies competing for deposit balances and transaction activity through person-to-person and business-to-business automation.

What are the key changes ahead in terms of banking distribution channels? For example, in relation to branches, telephone banking, online banking, mobile banking.

Horton: I foresee the biggest change in mobile banking. We are witnessing the growth of a generation that is more tech savvy and mobile channels are growing rapidly as they deliver convenience and simplicity for users.

McDonagh: The majority of our customers make use of multiple channels (branch, ATM, online and mobile) to do their banking. We are seeing an ongoing, gradual shift to higher volumes in electronic banking, but there is still significant demand for face-to-face transaction services. Over the longer term, as customers continue to migrate to electronic services, there will inevitably be consolidation and discontinuation of some legacy services; that is how the industry evolves.

Moseley: We will see increased digital connectivity. We expect to see a continued evolution of this type of technology as people now expect instant access to money and data. Physical branches are still relevant going forward; people want that physical connectivity from a social perspective and for more complex products.

Truran: Technology continues to play a significant role in the evolution of banking globally. With the advancements in mobile devices consumers expect greater flexibility and accessibility when it comes to transacting and interacting with the financial services provider. Brick and mortar branch locations will still play an important role in banking, particularly for those clients who desire a more personalised and intimate approach in receiving financial advice. Distribution channels such as ATMs, interactive kiosks, online and mobile banking will however continue to make everyday banking more accessible, faster and easier.

What type of innovation would you like to see in the banking industry over the next five years?

Horton: I would like to see greater innovation in respect of the on-boarding process. Today, compliance requirements dictate, quite rightly, that this is an extremely meticulous and thorough process, and one which results in increased costs for banks and is time consuming for our clients. I think this innovation would improve the client experience, improve the quality of the compliance process and hopefully reduce the current cost of fulfilling these requirements.

McDonagh: There are a lot of new technology developments we are seeing in banking and payment processing overseas, from depositing cheques by taking a photo using a smart phone app, to card readers that plug into phones / iPads. And those technologies will make their way to Bermuda in due course. But it goes back to the issue of scale and when we can bring in that innovation at a reasonable cost for our customers.

Moseley: Increased utilisation of the data that is available. Also, we expect mobile banking will become more popular as one is able to transact more and more on smart

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phones. Also, I would like to see cross-border account opening being simplified.

> To try and bring in an innovative solution that is solely revenue driven is almost impossible based on scale, it is often driven by cost avoidance or risk mitigation.
>
> -Truran

Truran: Globally, the banking industry has been able to take advantage of greater automation in the operating model, across operational functions and client service delivery. In Bermuda, we too need to be able to take advantage of this in order to reduce the costs of doing business. In doing so however, we will need to reshape our organisations so that this does not result in job losses but our teams doing value-added functions.

What is the greatest threat to Bermuda's banks?

Horton: I would see the greatest challenge as being changes in the regulatory landscape. There is the obvious cost to the business of investing in the necessary infrastructure to remain both compliant and current. In addition, is the more fundamental challenge of realigning business models whether it be in terms of the type of clients banks are prepared to offer banking services to in a CRS or FATCA environment, or the increasing demands on liquidity and capital arising in a Basel III environment.

McDonagh: I would say that the greatest influence on the health of Bermuda's banking industry is the state of the economy. I think all of Bermuda's banks are confident in their ability to compete with potential new entrants, as long as the playing field for all industry participants is a level one in terms of regulation and licensing requirements.

Moseley: Bermuda banks have gone through a very difficult time. We must remember that the banks' performance is closely linked to the performance of the economy, which has had a difficult period over the last six years, making it very challenging for anybody in business. Our collective challenge is making sure that the economy starts to pick up and we need to see that in terms of increased jobs in the private sector.

Truran: Today, the greatest threat to Bermuda's banking industry is a lack of recovery in our economy. We need more people employed, both Bermudian and non-Bermudian, thereby increasing the size of our economy.

Change

What significant growth and / or change is your bank currently going through? For example, in relation to new products, new revenue sources.

Horton: Our current priorities are to develop a significantly enhanced client proposition in terms of our service proposition and product offering. We are making significant investments in technology and people to support the new client proposition. Over the next 12 months, service improvement, new products and enhanced e-banking access will begin to become evident within the market place. We believe an important part of the enhanced client experience will be fulfilled by our move to new premises in the LP Gutteridge building, a significant investment is being made in this project and we hope to open our doors during the first half of 2016.

McDonagh: As a general observation, over the longer term, a bank can only grow organically at the same rate at which the

economy grows. Over the last 12 months, we have completed acquisitions in core businesses and markets that have driven top-line and bottom-line growth.

Moseley: We have increased strategic dialogue with the larger insurance companies, and have led a variety of debt capital market issues to help these customers as they expand globally and provided them with support and global thought leadership perspectives. We are also developing our U.S. custodian capability. We have also seen significant growth in the insurance linked securities market and have been working with our colleagues in New York on the corporate trust and loan agency side of the business.

Truran: The Bank is continuing its investment in new and upgraded solutions to meet its clients' needs. We are pleased to be offering the first chip and pin enabled debit card on island, we will be offering new and improved credit cards with an impressive rewards programme later this summer followed by a new, more robust online banking platform. In addition, we are investing in our asset management offering through partnerships with best in class managers that will provide access to new asset classes and the ability to access performance and analytics through a web-based portal.

Private banking and wealth management

What role do you think private banking and wealth management will play in the shaping of banks and banking in offshore jurisdictions such as Bermuda?

Horton: Private banking and wealth management are experiencing significant challenges at the moment and whilst they are an important part of an offering, their role is not as significant as in the past. Yes, it is essential to offer private banking and wealth management services, but they alone will not shape the future of the marketplace. The combination of disintermediation and the ease with which consumers can select their financial partners are increasing factors that are changing the traditional offering and landscape. Therefore, I see the bigger priority to be around the relative attractiveness of the jurisdiction, the quality and consistency of service, convenient access and the products that are available.

McDonagh: Although there is demand for wealth management services in Bermuda among international high net worth clientele, presently, wealth management services provided by Bermuda's banks are largely domestically focused. So the local wealth management business really is not under threat from changing legislation or foreign competition. As long as we have economic stability, we have a robust industry. If the economy gets smaller, then there is less wealth to manage. As the island prospers, there is more wealth to manage, and the industry grows in size and profitability.

Moseley: As global wealth increases, it presents an opportunity for banking firms to ensure they have a wealth offering that caters to the needs of high net worth customers. The global strategy for HSBC's Private Bank is to service the corporate clients of the group. This enables us to meet both the business and personal banking needs of the clients we most want to retain. For a company like HSBC with a very strong corporate franchise, this indicates strong growth prospects for the future.

Truran: International financial centers like Bermuda, will continue to serve as an attractive domicile because of its stellar global reputation, internationally trained and recognised professionals, a legal system based on English Common Law, robust infrastructure, sensible regulation and tax neutrality. Banks play an integral part in servicing this growing market and I think you will see more clients moving towards smaller, boutique styled banks when it comes to managing their wealth.

Cyber and data security

What do you see as the greatest cyber / data security risk(s) facing your bank and how do you manage this risk?

Horton: The entire cyber / data security risk area demands close attention from us, rather than focusing on one type of threat. The threats come from so many different places within that bigger banner of cyber and data security. It must be understood and embraced as an issue at all levels of the business and should be a standing item on the agenda of all Boards. In addition to awareness, it is important to continually invest in maintaining a strong security environment, training and procedures.

McDonagh: Internationally, the statistics paint a fairly clear picture: cybercrime is on the rise; and Bermuda is not immune from it. The challenge, going forward, is that the risks do not lie in the obvious places and in staying one step ahead of the criminals. That takes money, resources and diligence. But the unfortunate truth is that one way to learn about your vulnerabilities is when the fraudsters have been successful.

Moseley: HSBC benefits from being part of a large and strong global team, who work to ensure that our systems are kept secure. Locally, our focus is on internet banking and making sure that it is as secure as possible. We introduced a security token 2-3 years ago, which provides a second layer of authentication. This has been very well received by customers and has had a material impact in reducing the level of fraud. We have enabled customers to download software called Trusteer Rapport, which enables them to identify approved sites.

Truran: We deploy a layered approach to protecting against cyber risk. This involves a combination of manual and automatic capabilities for proactive prevention,

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detection and reaction. These approaches are applied to the infrastructure, application process, and staff and client education aspects of our business.

With the increased challenges being faced by banks relating to issues such as phishing and skimming of credit cards, what are you doing to actively manage this risk?

Horton: We actively communicate with customers and try to respond quickly if something happens. We are also working on migrating to chip and pin for our credit cards.

McDonagh: Customer education is central to the effort to combat fraud, even for simple things like not sharing your PIN. Bermuda has been and will continue to be the target of overseas criminals. Collectively, all the banks in Bermuda have worked together to support customer education with anti-phishing campaigns and the like. But the bad guys keep getting smarter, and as a result, our systems and protocols for protecting customers also have to get smarter on an ongoing basis.

Moseley: We have quite sophisticated fraud protection systems and have made real progress on internet security but can never relax. On the card side there is a trade-off between keeping the bad guys out and inconveniencing customers, but most people appreciate that we are trying to protect them and us. Again, we also benefit from being able to leverage the HSBC Group in this regard. While customers are aware of phishing, education of customers on this topic is a continuous process.

Truran: We use layers of fraud protection and regularly train staff in prevention. Customer reaction has been positive as they appreciate action taken to prevent a fraudster from taking advantage of them and we have been able to significantly reduce phishing from occurring but we remain vigilant and constantly look at ways of protecting our customers.

What governance role is the Board playing in monitoring and addressing the cyber / data security risks facing your bank?

Horton: The Board is talking about it more proactively, rather than reactively as in the past. We are taking a progressive approach and are looking to build awareness, and from that, stimulate internal challenge and debate around the issue.

McDonagh: We have cyber risk specialists within our Risk Management team who are responsible for monitoring industry trends and developments within in the Bank, and presenting solutions to the Board Risk Committee, which advises the full Board. This is an area of priority for the Board, because we know that it's not just a matter of potential dollar losses arising from cyber-attacks or data loss that are the concern, it is the knock-on reputational impact that any breach could have on the Bank.

Moseley: The Board and the audit and risk committee review a tremendous amount of data in the quarterly board and audit and risk reports. They review what is being done to protect our customers and the bank, the level of operational losses and where there are incidents (i.e. phishing and / or malware), and how quickly we are responding. The Board is very focused on both protecting the bank and getting the customer service right.

Truran: The Board has an established Risk Committee solely focused on risk management, including cyber / data security. The Board stays informed and invests proactively in preventative solutions and then receives regular and focused reporting from the Operating Risk Committee of management in order to keep the Bank's assets and its clients' assets protected against the threat.

Lending

What changes have you made to your appetite for lending in recent years?

How is the bank managing the risks presented by lending activity?

McDonagh: There is no doubt that following the global financial crisis, prior to which many banks had over lent to customers, banks have tightened up their lending policies. That is not a bad thing as long as people continue to have access to lending facilities they need and can afford. Lending has to be based more on earning ability, versus asset value.

Moseley: The jurisdiction has returned to what can be termed as a "more pre-bubble environment." Our approach as a Bank is to lend in a sustainable way, which is important for both business and individual customers and shareholders. We are helping people think through their business and learn to use management information more effectively. This will materially reduce the risk of having more difficult dialogue in the future.

Truran: Being largely Bermuda focused and strongly residential lent, we have had our challenges. It is in our best interest to work with our customers, who want to work with us, but there comes a time to deal with hard times and we have been going through such times for the past couple of years. We are however certainly open to good new lending proposals.

What role do you believe that lending by banks plays in the expansion of the Bermuda economy?

McDonagh: Lending by banks is key to helping expand the economy. If there is demand for financing for feasible projects, Bermuda's banks will be there to supply the credit. But to be clear, it is not the supply of lending capacity by banks that will generate economic activity; it is the demand for lending by people who have realistic business cases. It is important that we are diligent in assessing the creditworthiness of projects in order to help support growth in our economy.

Moseley: It is really important. Only where customers are confident to leave their

funds with banks by way of deposits are banks subsequently in a position to lend these funds out. So banks have a very important role in terms of supporting the right borrowers to make those investments through a combination of equity and debt. We are very happy to play our role as a debt provider but it is important that there is an appreciation that this is a combination of a good business plan and the right mix of equity and debt.

Truran: We want to lend but we can not simply say yes in all cases in the challenging environment we find ourselves. We want to see Bermuda on an upturn, and we want to be part of the expansion to come.

Regulation

What current or upcoming regulation do you believe has, or will have, the greatest impact on the banking industry? For example, the capital and liquidity requirements of Basel III, the reporting requirements of FATCA / CRS.

Horton: Without a doubt, Basel III will have the most notable impact on both the capital and liquidity sides of the business. The drivers of Basel III are causing banks to take a long hard look at the types of activity they can engage in. Basel III will impact the levels of liquidity maintained and the cost of capital charged against certain asset classes causing the entire asset and liability management cycle to come under greater rigour and efficiency.

> “Basel III is going to have a huge impact going forward.”
>
> -Horton

McDonagh: The implementation of Basel III is going to have a large impact as it affects the amount of capital that banks will need to hold going forward. Shareholders also expect returns in the form of dividends and Basel III will have the effect of limiting the amount of capital available for distribution to shareholders. That means, unless investors are prepared to accept a lower return, sustainable shareholder returns will have to come out of increased earnings, which in a small and saturated market can create pressure on pricing over the long term.

Moseley: All of those regulations have an impact on the industry, principally in terms of ensuring that we are able to report effectively under the new requirements. At the end of the day, FATCA provides the U.S. with what they are looking for and also gives us better information about our clients. Probably the one which will have the most impact on the overall business is Basel III, with the focus being on how deposits will be treated going forward, which will materially impact pricing and the appetite of banks to accept certain deposits. We will also see a greater focus on the value of the overall relationship rather than focus on purely deposit value.

Truran: We believe that the reporting requirements of FATCA and the Common Reporting Standard (CRS) will continue to drive the need for more effective systems and knowledgeable staff. We believe that with the new tax information requirements of CRS, FATCA and UK FATCA, along with the AML / CFT requirements of the new FATF regime, we will be challenged to continually increase the quantity and quality of customer due diligence information. Basel III will significantly impact bank strategies going forward. The full impacts of these regulations are not yet known.

Reporting

What do you see as the opportunities presented by the availability of this information / data from recent reporting requirements such as FATCA, perhaps in relation to strategic decisions made by the business?

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McDonagh: We have a transparent, cooperative and professional financial services industry. Being seen as compliant with relevant international legislation and putting systems and procedures in place to address the changing requirements will hold the island in good stead as an important and attractive international finance centre. However, the flipside is that if a particular area / segment of business is becoming so heavily regulated that the costs of compliance become unmanageable, you will likely see banks shed some business segments over the longer term. If a business becomes unprofitable, then you are going to make the strategic decision to exit that business.

Moseley: Basel III forces us to look very closely at the value of each deposit, leverage / capital ratios etc., so it is forcing us to review our pricing to make sure it reflects the value-add in the future, rather than what is currently under Basel II. FATCA helps us in terms of gaining a better understanding of our customers. The reputation of Bermuda is enhanced by showing our willingness to participate and provide the right information.

Truran: As we collect more data from our customers and implement more powerful IT systems to maintain this data, we are exploring new ways to collate our data to provide more relevant and accurate reporting. The more accurate reporting we have at our disposal, the more possibilities we create to support the business decisions we can make as a financial institution.

> We need to have 2020 vision as to what we want Bermuda to look like beyond the America's Cup in 2017.
>
> -Moseley

Capital

How have increased capital requirements impacted on your operations, and on strategic decisions made in relation to the future of your operations?

Horton: The biggest single impact is that when we are discussing the business, we are referring to capital that is required by that part of the business. We are more capital sensitive and capital smart, and this has become a central debate. It is both a regulatory and commercial driver, and will require every bank to re-evaluate the way they do business.

McDonagh: We are at an early stage in the industry looking at capital allocation. We will need to be a bit more granular going forward and evaluate the customer segments more closely, as different customers use up different types of capital. Similarly, different types of loans have different risk weights, and we do calculate that and we are getting better at it, but it is not yet flowing through to pricing decisions.

Moseley: HSBC Group has a strong capital position and has the objective to maintain this, exceeding both consolidated and local regulatory capital requirements at all times.

Truran: Basel III requirements have increased the Bank's required levels of regulatory capital thereby impacting returns for the Bank's shareholder. This has led to the need for the Bank to diversify its operating model from the traditional retail lending and capital intensive business, into less capital intensive and higher margin product lines such as wealth and asset management.

Business Models:

Dealing with Change

The banking business model is evolving rapidly and becoming more complex. Over the past few years, banks seeking greater margins through sophisticated products must also manage technological change, the growth of new and existing risks such as cyber and an influx of new regulations, whilst ensuring compliance and meeting rising client service demands.

Adjusting to the speed of change has been a big challenge for banks across the world. It is therefore critical to ensure the appropriate steps are taken to deliver sustainable operational development.

What is ahead?

The increasing regulatory pressures on bank structures include higher costs of doing business, constraints on balance sheet composition (based on capital efficiency), business activities, legal and operational structure, and supervisory intervention in banks' business models and strategy.

Banks also face a variety of economic and commercial pressures, including low interest rates, market over-capacity, strong competition (particularly for non traditional sources), technological change, low margins and high cost bases.

Offshore banks face a unique set of challenges. Since the economic downturn, there has been a flurry of regulatory changes, such as Basel III that came into force in Bermuda in 2015, as well as a growing global debate on tax transparency and the role of international financial centres. Under this spotlight, offshore banks are under increasing pressure to demonstrate stronger compliance and transparency. Much of this pressure comes from onshore governments.

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Meanwhile, customers are increasingly transient with their investments, both between institutions and also jurisdictions.

The commercial and operational synergies on which many banking business models were based are increasingly being challenged by these pressures. The rules of the game have changed and the business model needs to change accordingly, particularly in the following areas:

1. Product and customer propositions and pricing;
2. Balance sheet size and composition, and capital planning;
3. Legal structure, across types of business and across jurisdictions; and
4. Operational structure, including governance, management, organisational structure, risk management and compliance, distribution channels, payment and settlement arrangements, trade and other transaction booking, and the provision of services to support critical economic functions.

Figure 1: Challenges facing the banks

CUSTOMERS

- Fewer, more expensive, products and services
- Regulatory constraints on product and service offerings
- Less liquid securities
- Driven to alternative channels of intermediation

REGULATORS

- Banks and the financial system sounder and more stable
- Higher costs for banks and their customers
- Promotion of non-bank sources of financing

INVESTORS

- Looking to adequate returns
- Prepared to accept lower returns if risk is correspondingly lower
- Debt coupons will reflect threat of bail-in

Source: KPMG International, April 2015

Building a viable and sustainable business model

A viable and sustainable business model should deliver adequate returns, sufficient capital and liquidity resources, and acceptable solvability.

A fundamental overhaul of a bank's business model requires:

1. A clear understanding of performance.
   Banks need to understand the relative and absolute performance of their operating entities and business lines across the four dimensions illustrated in the business model in figure 2. Therefore, a clear understanding is required of return on equity (RoE), cost of equity (CoE), profitability, capital requirements, leverage, and resolvability for each business line.

2. Managing out non-performing exposures.
   Many banks, including those in Bermuda, have recognised significant allowances for loan losses and are continuing to take measures to mitigate further losses, including restructuring loans, so that the ongoing impact on operations is reduced.

3. Capital optimisation.
   With increased regulatory constraints, such as the implementation of Basel III, it is even more critical to optimise portfolios.

4. Re-pricing.
   Having de-risked the balance sheets, banks are in a position to review investments in order to improve net interest income and operating margins.

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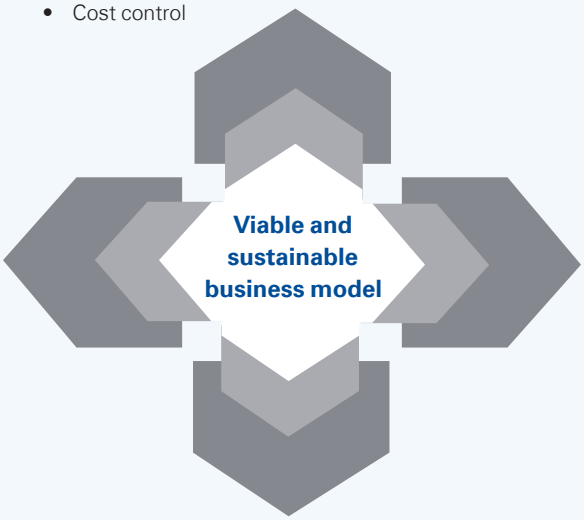
Managing Director, KPMG in Bermuda
& **Shannon Sun**
Manager, KPMG in Bermuda

5. Cost reduction to improve profitability.
   - Simplification of operating models and platforms;
   - IT investment for longer term benefits; and
   - Centralised / streamlined infrastructure platforms that are capable of supporting multiple business propositions.

6. A revised strategy.
   Producing a strategy that has clear and proactive views of which business activities to provide, in which geographies, and for which customers.

Figure 2: Components of the business model



Profitability

- RoE more than covers cost of equity
- Successful provision of profitable business lines
- Cost control

Liquidity

- Meet all regulatory liquidity requirements
- Meet internally assessed liquidity and funding requirements
- Liquidity planning
- Ability to access additional liquidity as and when required

Capital

- Meet all regulatory capital and leverage requirements
- Meet internally assessed capital requirements
- Capital planning

Resolvability

- Meet all legislative requirements on structure and resolution
- Credible and effective recovery and other contingency planning
- Facilitate resolution planning by the authorities
- Legal and operational structure, continuity of critical economic functions and of the services that support them

Source: KPMG International, April 2015

Written by:
Tim Ramsey
Managing Director, KPMG LLP
& **Alex McInnes**
Senior Manager, KPMG in Bermuda

Wealth Management:

Trends and Opportunities in the Wealth Management Industry

The wealth management industry is experiencing unprecedented challenges and growth opportunities. The pace and complexity of change is overwhelming, and it will only increase. KPMG has been tracking these trends and considering the potential implications for the wealth management industry. Changes in demographics, technology, the environment and social values are set to re-draw the corporate landscape. We feel that the industry will need to radically reshape to remain relevant.

Demographic change

The demographics of wealth management customers are changing: Emerging and developing economies in the east and south are growing in power, influence and potential. Asia's global economic power is expected to surpass North America and Europe combined, by 2030. China is expected to overtake the U.S. as the largest economy based on purchasing power parity before 2030. The influence of eastern and southern economies is likely to bring significant religious and cultural shifts.

The growing middle class is increasingly seeking wealth management services. By 2030, 60% of the world's population will be middle class, an increase from 27% in 2009. Middle class growth is particularly strong in emerging markets. By 2030, 80% of the global middle class will reside in developing regions, up from 58% in 2010.

The clients of tomorrow are likely to be very different to those of today, presenting opportunities and challenges:

- Generational shifts: the industry needs to engage younger generations and capture clients earlier;
- Gender shifts: women will be increasingly important clients; and
- Wealth shifts: the developing world's growing economic influence will alter the cultural and religious landscape.

We believe that demographic transformation, combined with technological advancement and social shifts, will significantly change the profile, needs and requirements of investors. Clients will be considerably more diverse in terms of who they are, where they are located and what they need, want, and expect from the industry.

In order to effectively target and service this increasingly diverse client base, we believe client profiling, data analytics and operational flexibility will play increasingly important roles going forward.

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Manager, KPMG in Bermuda

Product and service opportunities

Investor preferences are changing: there is increased demand for non-traditional asset classes and solutions including multi-assets and outcome-oriented strategies.

The potential of social media in wealth management has not been fully realised. 40% of asset managers are not active on social media. Only 15% of asset managers use social media for dialogue with clients. Increasingly consumers and investors demand immediate and 24/7 access across a wide range of media types. Investors will increasingly demand transparent and simple products. Consumers will increasingly expect personalised propositions and service. Increased connectivity and new technologies are already changing consumer expectations around personalisation.

There will be opportunities for wealth management to play a broader role in the industry's value chain as client demands of investment providers continue to change. Clients are likely to value broader or newer aspects of the proposition set, outside the core investment management process. This could include:

- The extent of advice, support, information and education;
- The ease of use and simplicity of the process;
- The access provided in terms of breadth of proposition set, asset classes available and ability to aggregate solutions and financial positions across a range of financial providers;
- The depth of understanding of a client's individual needs, risk-return appetite and the readiness to tailor a personalised financial solution and service model accordingly; and
- A degree of certainty and protection offered that intended outcomes will be delivered.

Competition

There has been little genuine product innovation in the sector, rather incremental developments to existing products. There is the potential for new entrants with more innovative product solutions to cause disruption to the wealth management industry. Many emerging models are already challenging the status quo by building a brand profile and distribution footprint; creating trust with diverse clients where financial services brands struggle; and redesigning client engagement strategies and the product offering.

Conclusion

We believe that while the trends described above present a range of challenges, there are also significant opportunities for the wealth management industry. In determining how to respond, we pose the following questions to wealth management providers:

1. What will your clients of the future look like?
2. How will the industry value chain be impacted and what role do you want to play?
3. How will your proposition and service model need to change to meet evolving client needs?
4. What are the implications for your brand and market profile?
5. What opportunities are available to extend or reshape your existing geographical footprint to take advantage of emerging market developments?
6. How well positioned is your operating model to support the propositions required and satisfy investors' increasing demand for information, education, personalisation and immediacy of access across a range of media?
7. How are you capturing and leveraging internal and external data to help you better engage with clients and remain relevant?
8. How are you ensuring that a risk focus is embedded within your organisation to meet the increasing scrutiny demanded by regulators and investors alike but in such a way that it does not stifle innovation?
9. What people skills and capabilities will you require in the future?

This is great news for existing players who are able to take advantage, but also for new entrants that may find it too attractive a market to ignore.

We believe there is a significant prize up for grabs. Not only is the industry likely to be considerably larger in 15 years time than it is today, but perhaps more interestingly, we believe it will have a more important role to play in clients' lives and society in general.

This is great news for existing players who are able to take advantage, but also for new entrants who may find it too attractive a market to ignore.

Based on KPMG's "Investing in the Future" publication: https://www.kpmg.com/dutchcaribbean/en/Documents/Publications/Investing-In-The-Future-report-fs.pdf

Basel III

Basel III is part of the continuous effort made by the Basel Committee on Banking Supervision to enhance the banking regulatory framework. Largely in response to the credit crisis, banks are now required to maintain specified leverage ratios and meet certain capital requirements. In this section, we hear from our regulator, the Bermuda Monetary Authority ("BMA"), on the implementation of Basel III in Bermuda. We then outline the key elements of the Basel III rules in Bermuda.

Written by:
Tom O'Rourke
Assistant Director, Bermuda Monetary Authority

Update from the BMA:
Awareness and Planning = Effective Implementation

While many jurisdictions around the globe continue to debate and adjust their plans for implementing the full range of Basel III changes, the Bermuda banking sector is now operating under codified Basel III rules and submitting regulatory reports on that basis.

The impetus for the change started in late 2010, with an extensive document released by The Basel Committee on Banking Supervision ("BCBS") entitled "A global regulatory framework for more resilient banks and banking systems", and has now culminated in enhanced quality of bank capital and elevated standards for both capital adequacy and liquidity. The BMA commenced the process of analysing and comprehending the BCBS framework and subsequently prepared a Discussion Paper (DP) that was distributed to the banking sector in December 2011.

During 2012, the Bermuda Monetary Authority received constructive comments back from the banking sector in response to the DP and commenced the creation of financial models to perform an impact analysis also termed a "Quantitative Impact Study" (QIS). The QIS process provided the BMA with a fair degree of confidence that the Basel III pillars of capital strengthening and increased liquidity resilience could be implemented without much of an impact on the existing balance sheet structures of the banks. In fact, in the aftermath of the financial crisis, the Bermuda banking sector had already commenced the transition toward enhanced capital strength and increased liquidity (the main tenets of Basel III) by increasing the level of common equity in their respective capital accounts and buttressing their stocks of high quality liquid assets. Consequently, the Basel III promulgation of a Common Equity Tier One (CET1) ratio for the primary capital measurement indicator and the introduction of a Liquidity Coverage Ratio (LCR) were consistent with actions already underway in the banking sector.

In late 2013, the BMA ended the QIS phase and issued a Consultation Paper (CP) that included adjustments and enhancements based on comments received from the banks and from observations gleaned through the several rounds of QIS performed. The QIS process enabled the BMA to assess where the banks stood in relation to meeting key Basel III requirements such as the CET1 ratio and the LCR. The issuance of the CP placed the jurisdiction firmly on the pathway to final adoption of Basel III.

> The Bermuda Monetary Authority commenced the process of analysing and comprehending the BCBS framework and subsequently prepared a Discussion Paper that was distributed to the banking sector in December 2011.

During 2014, the BMA formed a working group with the Finance Sub-Committee of the Bermuda Banker's Association (comprising CFOs from each institution and BMA staff) to work through the handful of issues that were identified in the responses to the CP. The BMA realised that due to Bermuda's unique position as a jurisdiction with no central bank, historically, verifiable, deposit flows well in excess of domestic loan demand, and a nascent deposit insurance scheme, that ongoing close consultation with the CFO group was essential to ensuring the proper crafting of a final rule. These meetings led to a productive exchange of ideas on alternative ways to capture historic deposit flows that would be more in line (and more operationally relevant) with documented experience in the Bermuda banking sector and more reflective of the business relationships that the banks have with long standing clients.

The BMA also sought out international expertise by retaining a consultant who was able to provide a regulatory perspective from the UK and European Banking sectors and this insight was used by the BMA to ensure that the jurisdictional departures[1] from the standard Basel III approach were both limited in scope and in full keeping with the underlying BCBS objectives of capital strengthening and increased liquidity. The BMA also looked at the Basel III framework of several other, well-regarded, jurisdictions in an effort to align Bermuda with best practices and to determine whether our approach was sufficiently robust without being punitive. This exercise was highly valuable to the BMA in establishing the appropriate Leverage Ratio for the jurisdiction at 5%.

On January 1, 2015 the final rule for Basel III went into effect and the first regulatory reports were filed at the end of the first calendar quarter of 2015. While the BMA views 2015 as a year to work through the technical issues involved with the reporting changes, it is confident that the essence of Basel III is now in place and that each

[1] *These departures were granted to address the fact that Bermuda does not have a central bank and in recognition of the unique deposit relationships that exist in this market.*

Written by:
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Assistant Director, Bermuda Monetary Authority

bank operating in this jurisdiction will be able to fully comply with the prescribed requirements as they phase in between now and 2019. We are also confident that the adoption of Basel III will keep Bermuda's banks at the forefront of demonstrating consistent adherence to global standards and continued operation in a prudential manner.

As stated in the opening to this article, the combination of awareness, foresight and planning on the part of the Bermuda banking sector made the ultimate implementation of this global standard an effective one and serves as a model for handling future mandates[2] introduced by the BCBS and other recognised global standards setters. The BMA looks forward to working with the banks on future challenges to improve overall resiliency, enhance risk management, and tailoring the prudential supervision programme to stay abreast of emerging trends.

The BMA looks forward to working with the banks on future challenges to improve overall resiliency, enhance risk management and tailoring the prudential supervision programme to stay abreast of emerging trends.

[2] BCBS is actively working on guidance to banks containing revisions to Risk Weighted Asset computations, revamped Large Exposure reporting and a Net Stable Funding requirement to augment the existing LCR.

Quotes from our further discussion with the BMA:

"What is coming next for Basel III is in relation to further tweaks to the risk weightings of assets following the Basel Committee on Banking Supervision's recent Consultative Document."

"We are currently analysing the impact of the Basel III Net Stable Funding Ratio (NSFR), which we aim to issue in early 2016. However, this is not deemed to be a big issue for our banks as it just supplements the Liquidity Coverage Ratio (LCR)."

"We are fortunate to have the standing committees of banks working effectively with us."

"Regulation that will have an impact on the banking industry in the near future includes the Special Resolution Regime. We are currently working through the mechanics of how it will be applied and work in practice."

"We have an excellent working relationship with the Bermuda Banker's Association Finance Sub-Committee, comprising all bank CFOs who have been working effectively with us on the Basel III initiatives."

KPMG in Bermuda thanks Marcia Woolridge-Allwood, Shauna MacKenzie and Tom O'Rourke for their time and comments.


Capacity planning
Branches

Basel III Update

The Basel Committee on Banking Supervision ("BCBS"), formed in 1974, is the primary global standard setter for the prudential regulation of banks. Following the 2008 financial crisis, the committee stepped up its regulatory reform rules through the creation of Basel III with an aim of setting more stringent standards to prevent the recurrence of a similar crisis.

Basel III builds on the three pillars contained within Basel II by raising both the quality and quantity of the regulatory capital base. Pillar I relates to minimum capital requirements, Pillar II relates to the supervisory review process and Pillar III relates to market discipline in the form of disclosure.

Following the 2008 financial crisis, the committee stepped up its regulatory reform rules through the creation of Basel III with an aim of setting more stringent standards to prevent the recurrence of a similar crisis.

National regulators have responsibility for implementing the framework in each country. The Bermuda Monetary Authority ("BMA") issued its final rule for implementing Basel III in Bermuda which became effective on January 1, 2015, and will be introduced on a phased basis over the next four years. Banks in Bermuda were expected to report in a Basel III consistent manner commencing with the Prudential Information Return ("PIR") for Q1 2015.

Changes through Basel III which have been implemented through the BMA's final rule include:

- **Increased quality of capital:** Capital is defined as the sum of Tier 1 or going concern capital which includes common equity and retained earnings and Tier 2 or gone concern capital. Tier 3 capital no longer qualifies as regulatory capital. The BMA recognises qualifying minority interests as regulatory capital where it meets certain classification criteria outlined in Basel III.
- **Capital ratios:** Common Equity Tier 1 ("CET1") capital must be at least 4.5% of risk-weighted assets at all times, Total Tier 1 capital must be at least 6.0% of risk-weighted assets at all times and total capital must be at least 8.0% of risk-weighted assets at all times. While these provide the minimum Pillar I requirements, it is important to note that the BMA will continue to require additional capital to be held for Pillar II factors as well as to incorporate the following additional Basel III buffers:
  - Capital conservation buffer: Banks will be required to build up and retain additional capital outside periods of economic stress which can then be drawn down if significant losses occur. Bermuda banks will be required to build this buffer up to a level of 2.5% of risk-weighted assets by 2019.
  - Countercyclical buffer: The BMA will assess the need for banks to hold up to 2.5% of additional capital to protect against periods of excessive credit or other pressures in the banking sector.
  - Domestic Systemically Important Banks ("D-SIB"): Consistent with the Basel framework, the BMA will assess the extent to which each bank presents a degree of material systemic risk to the economy of Bermuda and will require each bank to hold an additional capital buffer of between 0.5% to 3.0%.

As a result of the Pillar II add-ons and the additional buffers, it is expected that Bermuda banks will be required to hold capital well in excess of the Pillar I minimums required by Basel III.

- **Reduced leverage ratio:** The leverage ratio acts as a non-risk sensitive backstop measure to reduce the risk of buildup of excessive leverage in the financial system. The BMA has adopted the introduction of a 5% leverage ratio calculated as the ratio of Tier 1 Capital to total exposure, where exposure includes both on-balance sheet and off-balance sheet exposure.

  This leverage ratio is higher than the minimum required by the BCBS and is considered appropriate for a jurisdiction with no central bank and no fully funded deposit insurance scheme.
- **Liquidity coverage ratio ("LCR"):** The LCR requirements are intended to constrain leverage in the banking sector and introduce additional safeguards by ensuring that banks have an adequate stock of high quality liquid assets ("HQLA"). HQLA include assets which would be allocated to Level 1 or 2 of the fair value hierarchy under generally accepted accounting principals. These assets must be unencumbered and able to cover net cash outflows over a 30 day period under a stress scenario. During a period of financial stress, banks may use their stock of HQLA resulting in the ratio falling below 100%. The BMA adopted the LCR implementation timetable consistent with the dates published in Basel III. The minimum requirement will begin at 60%, rising in equal annual steps of 10% to reach 100% on January 1, 2019.

  This graduated approach is designed to ensure that the LCR can be introduced

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& **Astrid Arthur**
Manager, KPMG in Bermuda

without disruption to the orderly strengthening of the banking system or the ongoing financing of economic activity.

- **Net stable funding ratio ("NSFR"):** The NSFR aims to ensure that banks have enough funding resources over the next 12 months to provide for the expected funding needs over the same period. The BMA has delayed the implementation of the NSFR to January 2018 as indicated under the Basel III rules.

The implementation of Basel III requirements by the BMA will require Bermuda's banks to take steps to ensure that both the quality and quantity of capital requirements are met as well as ensuring compliance with new liquidity measures. Governance, risk management and reporting frameworks will also be critical in ensuring that Bermuda's banks comply with the regulations.

Basel III is just one component of ensuring Bermuda's regulatory regime keeps pace with the wave of global regulatory change in the banking industry. It is expected that the BMA will continue to incorporate global banking regulation in Bermuda where appropriate, such as with the legislation expected later in 2015 for a Special Resolution Regime ("SRR"). The introduction of the SRR will give the BMA greater power to take action where a severe economic loss is suffered by a Bermuda bank.

The SRR not only aligns Bermuda with global regulatory developments but is also seen as appropriate in a jurisdiction with no central bank.

The level of global regulatory change in recent years has been unprecedented and the successful implementation in individual jurisdictions, including Bermuda, will deliver a stronger, more resilient banking sector for global markets.

For further details on Basel III in Bermuda please refer to: http://www.bma.bm/document-centre/BASE%20II/Basel%20III%20for%20Bermuda%20Banks%20-%20Final%20Rule.pdf

(All dates are as of January 1)	2015	2016	2017	2018	2019
Minimum CET1 CAR Capital Adequacy Ratio ("CAR")	4.50%	4.50%	4.50%	4.50%	4.50%
Capital Conservation Buffer	0.00%	0.63%	1.25%	1.88%	2.50%
Minimum CET1 CAR plus Capital Conservation Buffer	4.50%	5.13%	5.75%	6.38%	7.00%
Minimum Total CAR	8%	8%	8%	8%	8%
Minimum Total CAR plus Capital Conservation Buffer*	8.00%	8.63%	9.25%	9.88%	10.50%
Leverage ratio	5%	5%	5%	5%	5%
LCR	60%	70%	80%	90%	100%

** excludes the Domestic Systematically Important ("D-SIB") buffer*

Source: Extract from the BMA's Basel III for Bermuda banks - Final Rule, January 2015

Cyber Security:

Impact of fraud on banks and on customers and how to better manage cyber and data risk.

As mentioned in the article on Governance (see page 34), the challenges for banks and their Boards of Directors in 2015 are expected to continue into 2016. Technology will continue to dominate the spotlight, with the accelerating speed of technology change and cyber security topping the list. The focus on technology by stakeholders is also likely to increase and we expect to see regulators in Bermuda and worldwide sharpening their scrutiny of data security efforts, as well as disclosures and communications about cyber security risks and breaches.

The risk and governance structures, including the audit committee, have a critical role to play in ensuring that their organisations have robust cyber security defences – not in understanding the minutiae of the technology involved, but in leading governance and policy.

This means being able to answer questions such as:

- What are the key assets requiring protection?
- How are they being protected?
- Who is responsible for protecting them?
- What level of cyber security risk is considered acceptable?
- How would the organisation respond to a major cyber security incident?

Against the background of this pressing need to address cyber related governance, the recently released KPMG 2014 Audit Committee Member Survey revealed both underlying issues with the quality of information received about cyber security and a lack of interaction with the technology function, which can only serve to exacerbate the problem. Organised crime has found cyberspace to be a lucrative opportunity. Exploiting vulnerabilities in computer systems allows criminals to compromise and remotely control computers; recording key strokes, monitoring screen displays and manipulating the computer user into divulging sensitive data. Cyberspace allows the attacker to be anywhere in the world, routing their attacks through multiple countries and jurisdictions, complicating investigation and law enforcement.

Disgruntled employees can also collect large amounts of sensitive company information and remove it easily from company premises; they can also introduce malicious software which can corrupt a bank's databases or sabotage network operations. Corporate espionage by firms is common place in cyberspace. Attacks often target sensitive, intellectual property, and there have been instances of major banks having being compromised over many months with large amounts of sensitive data being stolen.

Written by:
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Chairman, KPMG in Bermuda
& **Chris Eaton**
Senior Manager, KPMG in Bermuda

Activism is also common place in cyberspace. Sabotage and denial of service attacks are becoming increasingly frequent internationally.

Management faces the task of ensuring that its organisation understands the risks and sets the right priorities. This is no easy task in light of the technical jargon involved and the pace of change. The amount of data generated and consumed by the banking sector continues to grow exponentially, as does the rate at which organisations share data through online networks. Even in a country the size of Bermuda, we potentially have many thousands of computers and peripheral devices that all have the potential of being linked together as "internet of things", which increases inter-dependencies exponentially. Organisations are also increasingly opening their IT systems to a wide range of technologies and vendors resulting in the possible loss of direct control of data security.

Focusing on technology alone to address these issues is not enough. There is a commonly held belief that when we invest in best-of-class technical tools, we are safe. The reality is that effective cyber security may be less dependent on technology than we think. The world of cyber security is dominated by specialist suppliers that sell technical products, such as products that enable rapid detection of intruders. These tools are essential for basic security, and must be integrated into the technology architecture, but they are not the basis of a holistic and robust cyber security policy and strategy. The investment in technical tools should be the output, not the driver, of cyber security strategy. Good security starts with developing a robust cyber defense capability. Although this is generally led by the IT department, the knowledge and awareness of the end user is critical. The human factor is, and remains, for both IT professionals and the end user entity, the weakest link in relation to security. Investment in the best tools will only deliver the return when people understand their responsibilities to keep their networks safe. Social engineering, in which hackers manipulate employees to gain access to systems, is still one of the main risks that organisations face.

Technology cannot help in this regard and it is essential that managers take ownership of dealing with this challenge. They have to show genuine interest and be willing to study how best to engage with the workforce to educate staff and build awareness of the threat from cyber-attack. This is often about changing the culture such that employees are alert to the risks and are proactive in raising concerns with supervisors.

A cyber security breach may impact financial systems and assets, intellectual property and trade secrets, brand and online presence and business continuity. Because of this pervasive impact across the organisation, banks should understand and approach cyber security as an enterprise-wide risk management issue, and not as an IT issue. As such, those charged with governance and risk oversight should test whether the bank has:

- Identified the critical information assets which it wishes to protect against cyber-attack – the crown jewels of the organisation – whether financial data, operational data, employee data, customer data or intellectual property;
- Intelligence processes in place to understand the threat to the company's assets, including their overseas operations;
- A way of identifying and agreeing the level of risk of cyber-attack that the bank is prepared to tolerate for a given information asset;
- Controls in place to prepare, protect, detect and respond to a cyber-attack – including the management of the consequences of a cyber security incident;
- A means of monitoring the effectiveness of their cyber security controls, including, where appropriate, independently testing, reviewing and assuring such controls; and
- A programme of continuous improvement, or where needed, transformation, to match the changing cyber threat – with appropriate performance indicators.

Banks should understand and approach cyber security as an enterprise-wide risk management issue, and not as an IT issue.

Cyber security is an important concern for every banking organisation. Daily occurrences demonstrate the risk posed by cyber attackers—from individual, opportunistic hackers, to professional and organised groups of cyber criminals with strategies for systematically stealing intellectual property and disrupting business.

Focusing on technology alone to address these issues is not enough. Effectively managing cyber risk means putting in place the right governance and the right supporting processes, along with the right enabling technology.

This complexity, however, cannot be an excuse for boards and management to divest responsibility to technical "experts." It is essential that organisational leaders take control of allocating resources to deal with cyber security, actively manage governance and decision-making over cyber security, and build an informed and knowledgeable organisational culture.

Interview:

The Hon. E.T. Robert (Bob) Richards, Minister of Finance.

The Hon. E.T. (Bob) Richards, Minister of Finance, shares his vision for the future of banking in Bermuda with Mr. Craig Bridgewater, Head of KPMG Bermuda's Investments & Banking practice.

You began your career in banking, working for banks in both Canada and Bermuda. What insight into the banking industry did you gain from this experience?

I started working in banking after university and before becoming a portfolio manager for 25 years. As a portfolio manager, I frequently invested in the banking industry. I also worked for a time at the Bermuda Monetary Authority (BMA). The experience I gained throughout my professional career, has given me a solid foundation as Minister of Finance with responsibility for the Bermuda Banking Sector.

Based on your banking experience, what do you feel are the current opportunities and issues facing Bermuda's banking sector?

In most countries, there is a fractional reserve system with a central bank which sets the country's bank policy based on a combination of what's good for the bank shareholders, bank customers, the country and the economy. Through the central bank, the government can persuade, cajole and force, if necessary, banks to conduct their affairs in ways which are in keeping with national interests particularly in relation to the economy.

As Bermuda does not have a central bank there is no such direct influence on the banks as it relates to the interests of the country or the economy.

Does your 'wish list' include a Bermuda central bank?

From a practical perspective, a central bank is not necessarily the solution for Bermuda. Certainly, central banks have had mixed results in some of the Caribbean islands. However, if a fractional reserve system was in place, the Government could use its powers under the system to get banks to increase its provision of financing.

I am the first Cabinet Minister to publicly address the role of banks and to appeal to them to consider the economy and country. Notwithstanding that, there has been a continued decreasing trend in the rate of lending locally, although I am pleased to note that one of the local banks is beginning to increase its level of new lending.

There is no doubt that non-performing loans have contributed to the banks tightening their lending policies. However, banks also need to take responsibility for the lending policies which resulted in the loans being made.

Written by:
Craig Bridgewater
Head of Investments & Banking, KPMG in Bermuda
& **Lori Rockhead**
Senior Manager, KPMG in Bermuda

What is the solution for stimulating the capital market in Bermuda?
Without credit expansion being led by the local banks and the lack of a well-developed capital market in Bermuda, we need inward, direct investment. Traditional inward investment routes are no longer available as the international banking sector showed no inclination to come to Bermuda and those international institutions – mainly Canadian, are scaling back their regional investments.

There is $1 trillion in assets in Bermuda's (re)insurance market. I would like to have just 0.0001% of that money invested in Bermuda which would create cash flow, jobs and positive momentum for the economy of the island. This is why the Government is considering opening the market to more banks.

> There is $1 trillion in assets in Bermuda's (re) insurance market. I would like to have just 0.0001% of that money invested in Bermuda which would create cash flow, jobs and positive momentum for the economy of the island.

How do you propose to protect the public's need to have a quality, retail banking service?
The Government is working on how to create an environment which would allow for restructuring the banking system to allow for both "A" Banks and "B" Banks. Unquestionably, "A" Banks, such as those we currently have, perform a crucial role in the economy and we need to retain at least two A Banks. The outdated requirement of local banks to offer 'retail' banking is a barrier to attracting new entrants to Bermuda's banking sector and needs to be addressed.

The upside of having "B" Banks would be that Bermuda already has a number of experienced former bankers who are available owing to recent downsizing by Bermuda's local banks.

My job as Minister of Finance is to represent the interests of the banks' customers.

Are the Government's policies up to the task of creating a restructured banking sector?
The BMA has grown substantially over the years with the main focus being on (re)insurance and funds. With relation to banking, the BMA is working on a plan for financial stability, including analysing 'what if' scenarios, which is beginning to gather some momentum.

I feel strongly that it is important not to look at the banking industry in terms of just a 'set of risks' but also in terms of opportunity. We need ways to encourage the industry to take advantage of opportunities which will be good for Bermuda.

In the next session of Parliament, I expect to introduce new legislation related to financial stability, the Special Resolution Regime, which will address risks and modernise the playing field within the banking industry. Banking is an opportunity for the Bermuda economy. The Government does not want Bermuda to be an 'offshore' banking center as 'offshore banking' offers little long term benefit to the world. We want to create an environment for international banks with an approximate service to offer the (re)insurance and asset management industries that exist already locally, may wish to set up here.

What's your five year plan for the Bermuda banking sector?
I would like to have the Bermuda Deposit Insurance Scheme up and running, the Special Resolution Regime implemented, and a well-functioning banking sector with a number of "B" banks operating in Bermuda and at least two local "A" banks.

Any final thoughts, Minister?
We are all a part of the whole and we need to work together. I would like to see bankers play an increasing role in the recovery programme through the provision of working capital to allow businesses to thrive.

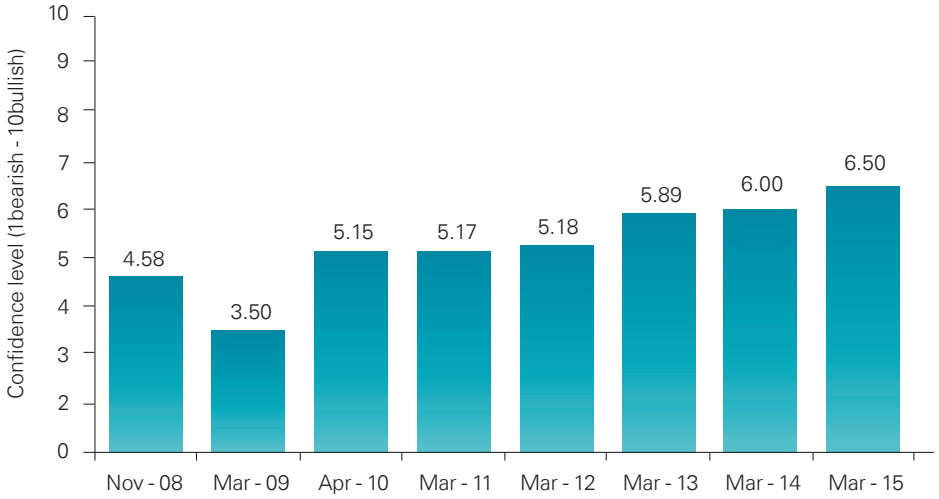
2015 Caribbean Hospitality Financing Survey

KPMG recently completed its 11th Annual Hospitality Financing Survey for the Caribbean and Bermuda. The survey highlights lending trends in the region's hospitality and tourism industry and the outlook for the future of the industry. The survey includes the views of Bermudas banks.

Our Annual Caribbean Financier Confidence Barometer, which is always one of the best indicators of financiers' sentiment, shows that banks are the most confident they have been since 2008. On a scale of 1 (bearish) to 10 (bullish), bank confidence shows a rating of 6.50 which is the sixth year in a row that confidence has grown amongst banks (see figure 1).

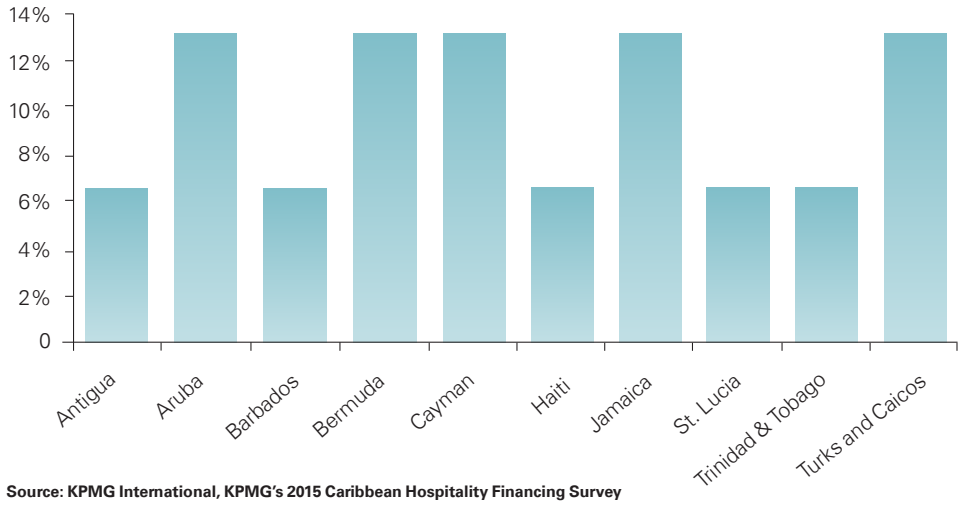
This year's survey also canvassed the views of other non-bank capital providers, who are even more confident than banks. The level of confidence of the non-banks is at very high levels that must bode well for the future particularly given that equity and mezzanine financing are typically more difficult to secure than bank finance. The reasons for the increased confidence levels appear to be numerous but include growth in the U.S. economy, the main feeder market for the Caribbean and Bermuda, improved airlift into the region, and a general feeling that those existing operators who have survived the recession are now more robust and well positioned for future growth. These levels of confidence are encouraging but, for the time being at least, renewed confidence does not appear to be translating into readily available capital.

Figure 1: Caribbean financier confidence barometer - Banks



Source: KPMG International, KPMG's 2015 Caribbean Hospitality Financing Survey

Figure 2: Banks' top countries for new lending



Source: KPMG International, KPMG's 2015 Caribbean Hospitality Financing Survey

Written by:
Steve Woodward
Head of KPMG Enterprise, KPMG in Bermuda

Financing trends

After so many difficult years and with so much enhanced confidence, financing must now surely be readily available? It appears from our survey responses that the situation is not quite so simple.

None of the banks think it is a perfect time to lend to the hospitality sector and 13% actually stated that they are not interested at all. The majority of bank respondents (87%) indicated that either they consider Caribbean lending opportunities to be high risk / high return and so they would proceed cautiously (50%) or they would critique Caribbean opportunities like any other project (37%).

When specifically asked what projects had been financed in the last year, the banks' comments were very informative – again revealing an extremely cautious, conservative lending approach. Approved borrowers were in "established" locations with "proven trading performance" and most loans were to existing operators for renovation, expansion, refinancing, etc.

Banks explained why the more favourable economic environment is generally not yet translating into more available capital for tourism related projects. For lessons learned during the economic recession, most responses related to increased sponsor recourse and risk management.

> "Any unsecured risk needs strong sponsor support going forward."

When looking at which location in the Caribbean financiers are most bullish about, in terms of lending opportunity, responses were again highly informative with numerous different jurisdictions being mentioned, and banks tending to differ regarding those countries in which they are most inclined to fund projects.

There have not been any dramatic changes in average loan terms. The headline issue is not really the term of the loans, but the availability of loan finance, or lack thereof.

Other trends

When asked to identify the current issues of critical interest to hoteliers, airlift was identified as the most critical issue cited by 88% of bank respondents. Ability to secure financing was the second most critical issue (75%).

Numerous other issues were raised such as the role of government, the impact of new taxes, e.g. VAT, the impact of high utility costs, the need to maintain competitiveness versus other regions such as Central and South America, and the need to invest in infrastructure.

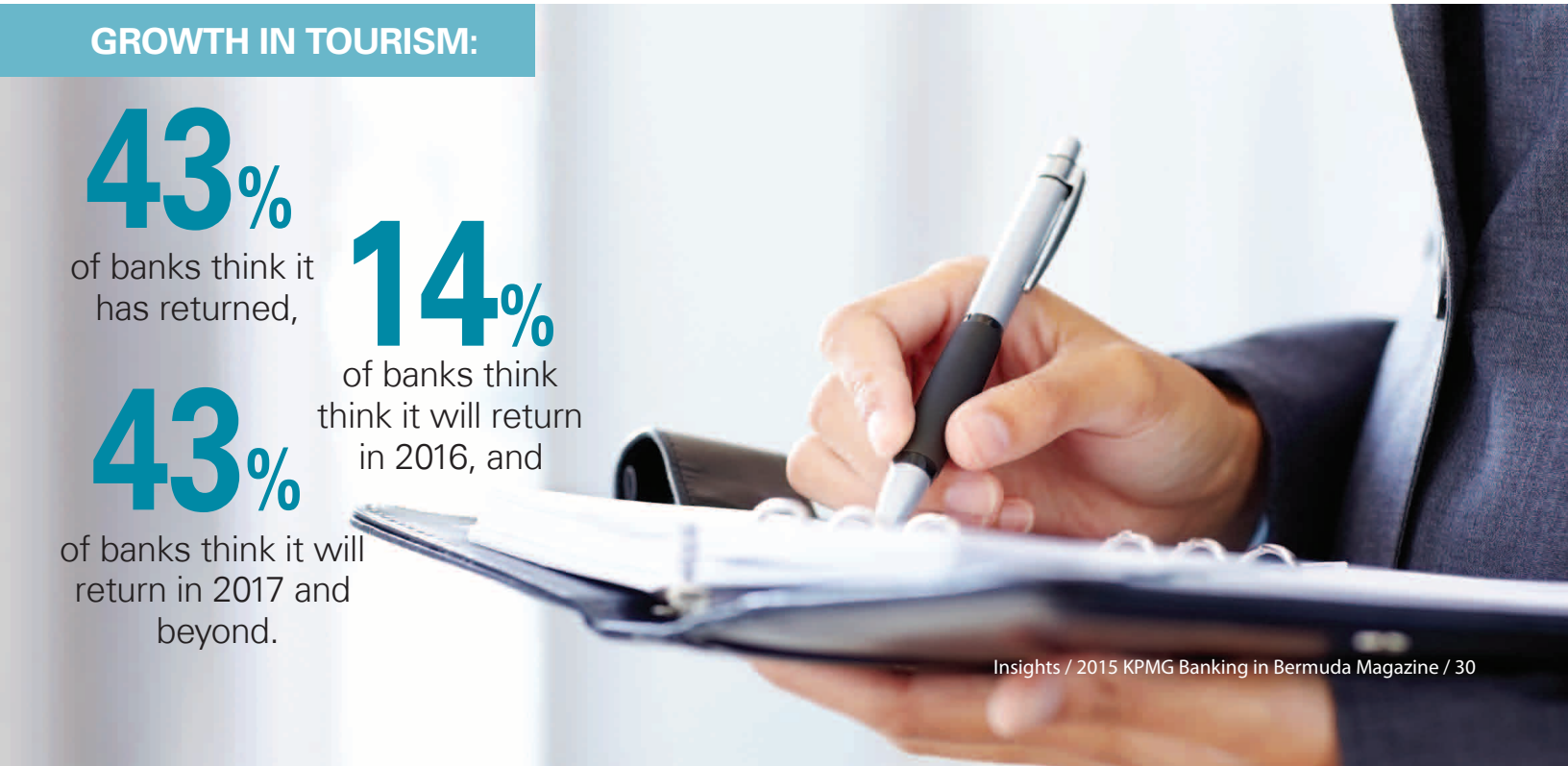
So how are we to interpret these findings? Without wishing to be accused of "ducking the issue" the answer would appear to be that it is actually a very unusual financing environment to predict. Confidence is way up on prior years, there is liquidity in the system but financing is not readily available. Clearly there remain some obstacles that are still holding back the flow of capital into the region.

GROWTH IN TOURISM:

43% of banks think it has returned,

14% of banks think think it will return in 2016, and

43% of banks think it will return in 2017 and beyond.



Reporting:

OECD's Common Reporting Standard for Automatic Exchange of Information

Global communications and business relationships have made it easier for individuals and entities to minimise tax by investing assets outside of their country of residence. However, increasing regulatory scrutiny and intergovernmental exchanging of tax related financial information is evolving to fight tax evasion.

United States (U.S.) FATCA and the "son of FATCA" introduced by the United Kingdom (UK) has resulted in most offshore jurisdictions entering into intergovernmental agreements (IGAs) with both the U.S. and the UK, to exchange tax related information on account holders within their jurisdiction. These developments have seen many other countries, facilitated by the Organisation for Economic Co-operation and Development (OECD), wish to participate in government-to-government exchange of tax information.

On February 13, 2014 the OECD released a framework document for the Automatic Exchange of Information (AEoI), commonly referred to as the Common Reporting Standard (CRS). The CRS is intended to become the new global standard for automatic exchange of tax related financial information (covering bank accounts and other financial assets held outside the person's or entity's country or countries of tax residence). The CRS is intended to be a "common" global standard on tax information collection and reporting across

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Senior Manager, KPMG in Bermuda

jurisdictions, to maximise efficiency and reduce costs of compliance for financial institutions.

Many aspects of the CRS are consistent with the U.S. Model 1 IGA FATCA approach, including each government committing to obtaining financial information from their financial institutions in their jurisdictions and to automatically exchange related information with other jurisdictions on an annual basis.

However, there are a number of areas where the CRS deviates from the Model 1 IGA FATCA agreement, such as the removal of minimum threshold limits and new account opening definitions. This will considerably increase the scope of the CRS over FATCA and therefore the amount of work required to be performed by affected businesses. Further, the CRS does not have carve outs for low risk, non-financial entities and therefore imposes increased obligations on financial institutions to collect information on such entities. Unlike FATCA, the following are not excluded from the CRS: financial institutions with a local client base, local banks, certain retirement funds, financial institutions with only low-value accounts, some investment advisors and investment managers, and certain investment trusts.

As of June 2015, 61 jurisdictions have signed a multilateral competent authority agreement to automatically exchange information under the CRS, with the first exchange of information by September 2017. The signatory jurisdictions included Ireland, Liechtenstein, Malta, the UK, the UK's Crown Dependencies of Isle of Man, Guernsey and Jersey; and, the UK's Overseas Territories of Bermuda, Anguilla, the British Virgin Islands, the Cayman Islands, Gibraltar, Montserrat, and the Turks & Caicos Islands. As of June 2015, 94 jurisdictions have commited to implement the CRS.

The U.S. has not committed to adopting the CRS, so U.S. FATCA is currently here to stay. We understand the CRS will replace the son of FATCA introduced by the UK. So, most entities will, in the near future, be focused on compliance with U.S. FATCA and the CRS, meaning at least two parallel regimes for each jurisdiction to adhere to. Further, each CRS jurisdiction will need to enact local enabling law, which may result in many small variations across jurisdictions.

The development of the CRS is something businesses in international financial centres need to be following, as it has far reaching impacts on both the financial institutions and non-financial institutions. As with FATCA, the scope of the CRS is broad in order to reduce the risk of circumvention. Thus, it will apply not just to banks, but also funds, investment managers, corporate administrators, trusts, trustees, investment firms and certain insurance companies.

FATCA and the CRS affect most areas of a financial institution's business. Therefore, it is more important than ever to plan for the impact of these regulatory requirements and design as efficient a response as possible.

Each CRS jurisdiction will need to enact local enabling law, which may result in many small variations across jurisdictions.

Challenges that the U.S. might face while not adopting CRS

While the U.S. is not currently a signatory to the multilateral competent authority agreement, any branch or subsidiary of a U.S. financial institution in an implementing jurisdiction will need to comply with the CRS in that jurisdiction. The fact that the U.S. has not implemented the CRS may actually create additional challenges for U.S.-based financial institutions in coordinating implementation across the various jurisdictions in which they do business.

Core elements of the CRS

The CRS is designed to capture and trace the following for parties' tax and financial information:

- Financial information to be reported with respect to reportable accounts including all types of investment income (including interest, dividends, income from certain insurance contracts and other similar types of income), and also account balances and sales proceeds from financial assets.
- Financial institutions that are required to report under the CRS include not only traditional banks and custodians, but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance companies.
- Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations). The CRS encompasses the requirement to look through passive entities to report on the individuals (beneficial owners) that ultimately control these entities. Further, the standard captures a broad scope of financial account information on those customers, such as account balances and investment income.

To classify the reportable accounts, financial institutions must follow due diligence procedures. Pre-existing accounts will need to be remediated in accordance with the new standards. Financial institutions will have to be well-equipped operationally with internal controls, system flags and reports to monitor the changes, and additional information to alleviate any identified issues.

Information exchange under the CRS is envisaged to be reciprocal, but the same framework could, in principle, be used when there is no desire for reciprocity. In addition to the multilateral competent authority agreements implementing the exchange of information between

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jurisdictions, the OECD document provides common reporting and due diligence rules that will need to be introduced into domestic law of participating countries.

Implementing the Common Reporting Standard

CRS relies on automatic exchange of information by building a rigorous framework and platform around the following:

1. Common standard of information reporting - Building a legal framework and domestic laws to replicate the reporting and due diligence requirement as stated by the CRS. It will be a significant development for financial institutions, which will face complex new customer due-diligence and reporting obligations under the CRS.
2. Legal and operational challenges - All financial institutions must also build a framework, administrative capacity and processes to ensure adequate data protection and that confidential data is only used for the purpose as listed in the agreement.

Existing systems designed to comply with FATCA will require adjustment to comply with the CRS. Financial institutions will have to adopt, or build, a common and flexible technical architecture to exchange information and report to other countries in a standard automatic exchange plan, while dealing with differences between FATCA and CRS (including any territorial variations under CRS).

Financial institutions must consider the impact on the overall customer experience of CRS, and keep requests for information to a minimum. Account holders must receive accurate and timely tax reporting information as required under the domestic rules of each country, and be made fully aware of the impact of the new regulatory landscape. There could be nothing more embarrassing or damaging than giving clients tax reporting information that does not match up to the information that has been exchanged between governments.

Is there any good news?

FATCA and the CRS leveraged off the customer due diligence financial institutions have become accustom to collecting to comply with local Anti Money Laundering ("AML") regulatory requirements. As such, if an organisation has been through a robust process of improving its AML regulatory compliance framework, it should only require incremental changes to its existing framework to comply with FATCA and the CRS.

The development of the CRS was on the back of demand from international financial instructions for a common standard to reduce the cost, and improve the effectiveness of, compliance with these new information collection and reporting requirements. 94 countries have committed to adopt the CRS, as such it should help ensure there is greater consistency, and reduce the need for individual countries developing their own frameworks. We can only hope that individual countries do not feel the need to expand on the minimum standards set under the CRS.

KEY DATES

- **February 22, 2014**
  G20 endorsed the global standard for Automatic Exchange of Informations (AEoI)
- **July 15, 2014**
  OECD issues commentary for the model Competent Authority Agreements and Common Reporting Standard
- **October 29, 2014**
  As of June 2015, 61 countries signed multilateral competent authority agreements to automatically exchange information
- **January 1, 2016**
  CRS go-live date for early adopter countries
- **January 1, 2017**
  Proposed start of reporting for early adopter countries

Governance

Bermuda and its banking community are still coming to grips with the economic challenges of the past few years and we expect these, and other new challenges to continue dominating the governance agenda throughout 2015 / 2016.

The spotlight on the board of directors continues to intensify as regulators and investors scrutinise the board's contribution to strategy, risk and compliance. Drawing on insights from the KPMG network's interactions with directors and business leaders over the past 12 months, eight flags have emerged that boards should keep in mind as they develop and carry out their 2015 / 2016 agendas.

Focus on the bank's plans to grow and innovate

The new "normal" of low growth will likely continue to challenge banks. Boards have a critical role to play in helping the bank not only avoid missteps, but also take smart risks to grow, innovate, and stay competitive. What kind of discussions is the board having about growth opportunities? How do you ensure that the bank's culture and processes create the right environment for growth through innovation? How do you measure and reward innovation success? Are you tapping into emerging areas?

Reassess the board's role in strategy:

The complex, volatile, and uncertain business environment today has made the "annual review and concur" model of the board's oversight of strategy obsolete. The challenging landscape requires a frank reassessment of the board's role in strategy. Fortunately, Bermuda is not unique in dealing with these challenges, and a lot of thought leadership is being generated from which Bermudian banks can benefit, as evidenced by a number of publications including the National Association of Corporate Directors (NACD) report released in October 2014. This proposes, amongst other recommendations, a framework for deeper board engagement in strategy – from formulation, monitoring execution, and testing the continuing validity of assumptions, to recalibrating strategy throughout the year.

Consider whether the board needs to recalibrate how its committees communicate and coordinate on risk oversight

Despite the clear benefits of board committees, (including increased focus on key risks), a complex committee structure poses its own risk of fragmented board oversight. Do you have the right committee structure to oversee the major risks facing the bank? Are risk responsibilities clear? Does the audit committee have too much on its plate? Is it time for a separate risk committee or a re-balancing of responsibilities? How do you communicate and coordinate the oversight activities of standing committees? Consider overlapping committee memberships, particularly when inter-committee coordination is of strategic importance. Are committee chairs communicating regularly to make sure they understand what's going on in the other committees? Are committee reports to the board robust, or perfunctory? Is the information provided fit for purpose?

Reassess the bank's vulnerability to business interruption, and its crisis readiness

Bermuda banks have traditionally reacted well to natural disasters; and hurricane preparedness plans are generally mature. However, the global inter-connectedness of businesses, markets and risk poses new and complex challenges for Bermuda's banks. Is the bank's crisis response plan robust and ready for enactment? Is the plan actively tested and updated as needed?

Sharpen the board's focus on cyber risk and security

Increasing threats to corporate information systems and intellectual property, as well as compliance risks, the potential for lawsuits, reputational damage, and loss of customers have elevated cybersecurity to the board level and as a critical business priority (where we believe it should be). Regulators worldwide have sharpened their scrutiny of companies' data security

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Neil Patterson
Chairman, KPMG in Bermuda
& **David Harper**
Senior Manager, KPMG in Bermuda

efforts, as well as disclosures and communications about cybersecurity risks and breaches. Ensuring the adequacy of a bank's cyber defenses needs to be a critical aspect of risk management and oversight. Is cybersecurity risk given regular and adequate time on the board's agenda? What are the biggest vulnerabilities and the most critical data sets? What are the results of the most recent penetration tests and external assessments of our cyber defences? Do we have a cyber-incident response plan? Does the board meet regularly with the Chief Information Officer? The board has an important role to play in helping elevate the bank's cyber risk mindset to an enterprise level, encompassing key business leaders and business decisions, including new product development and acquisitions.

Do we have the right people on the board?

Is the board asking itself whether it has the right mix of skills, backgrounds, experiences, and diversity? Is there enough time devoted to "white space" at meetings? Boards need to determine whether they have the right mix to provide strategic direction and effective oversight of the bank. It is becoming increasingly apparent that boards may benefit from bringing industry experts, or tech-savvy independent directors on board to help consider emerging risks such as cyber in a meaningful way.

Set the tone and closely monitor leadership's commitment to that tone, as well as the culture throughout the organisation

The year ahead will likely be a continuation of pressure and change, and a good measure of complexity and uncertainty. In this environment, it is more important than ever to be acutely sensitive to the tone from (and example set by) leadership, and to reinforce the culture of the organisation, i.e. what the bank does, how it does it, and the culture of compliance and moral propriety. Is the board hearing views from those below senior management and outside the bank? Are there dissenting views? Do the directors walk the floors regularly? The tone and culture throughout the bank's global operations and the extended organisation is critical. How confident is the board that it has a good sense of the culture in the bank's global operations? Do the bank's compensation policies and practices send the right message about accountability and long-term performance?

Promote engagement with shareholders

In the recent KPMG Audit Committee Institute's Global Audit Committee Survey, some 60% of respondents said that, as a result of the activist environment, their company has increased its level of engagement with shareholders – but 40% have not. The importance of proactive outreach to shareholders – "honest communications about how and why decisions are being made" – is characteristic of the present environment, and the board should be a central player in shareholder engagement. Do we know and engage with our largest shareholders, and understand their priorities? Executive compensation, management performance, strategy, separating unrelated businesses, capital allocation, and board composition are likely on their radar.

Based on KPMG's "2015 Global Audit Committee Survey" publication:
https://www.kpmg-institutes.com/content/dam/kpmg/auditcommitteeinstitute/pdf/2015/2015-global-audit-committee-survey.pdf

Interviews:

Senior management executives from Bermuda's banks shared with us their experiences in their respective roles and functions, and provided insight on their current areas of focus, including technology, growth, customer service and globalisation, along with challenges faced by them in the execution of their roles.

HSBC Bank Bermuda Limited
Darren Smith, Head of Global Markets & Mike Walker, Head of Commercial Banking

The Bank of N. T. Butterfield & Son Limited
Michael Collins, Senior Executive Vice President, Bermuda

Bermuda Commercial Bank Limited
Niel Harper, Chief Information Officer

Clarien Bank Limited
Clare Spearing, Head of Private Banking & Bob Wilson, Chief Banking Officer

With: **Darren Smith**
Head of Global Markets, HSBC
& **Mike Walker**
Head of Commercial Banking, HSBC

HSBC Bank Bermuda Limited (HSBC)

is currently focused on the customer journey, growing with their customers, transforming customer experiences and providing value added services. HSBC's Darren Smith and Mike Walker expand on this below:

Please describe your current role and how your experience led you to this role?

Darren: I am responsible for the global markets business (Global Markets) for HSBC Bermuda, that is all of the aspects of market business for the company. I have worked in the markets industry for 28 years, mainly in London, primarily working with corporates but also with institutional clients.

Mike: I am the Head of Corporate and Commercial Banking (CMB), responsible for all aspects of that area including relationship management, payments and cash management, and global trade financing for all customers. I previously worked in other countries such as Switzerland, Georgia, Armenia and Malta with HSBC, in commercial banking roles.

Please explain the key responsibilities of your team and how they work together?

CMB is ultimately responsible for the corporate client relationships in the Bank and Global Markets are a product provider. Both of our functions work closely together with our clients to gain a full understanding of their needs and requirements to deliver optimal solutions for them, such as spot and forward foreign exchange, payments and cash management, trade, or a full financing pitch. Both areas closely co-operate to achieve the best possible outcome for our clients.

How do functions in your bank such as commercial banking and global markets contribute towards providing value for your customers?

We add the most value when we work closely with our clients. Through the connections we have with our business partners both locally and globally, we are able to leverage that expertise and then deliver solutions to our clients. The value of our global footprint is one of our strongest points but also the connectivity across the local product providers is a key value add that we can offer to clients.

What role do you think data analytics play in understanding the needs of customers?

Data analytics is really important for us to help our customers to understand where opportunities exist and, how best to manage the risks that they have in the market, particularly in today's world. It also allows us to go to customers with our proprietary modelling tools. For example, we have a foreign exchange modelling system called FXCompass, into which we input information such as customer debt exposure, trade FX activities, etc. which then allows us to demonstrate to customers where we believe there is risk in their business, which we can then overlay by showing them solutions to alleviate the risk and help them with that risk profile.

What role does technology play in transforming customer experience in your bank?

Technology is moving every single day. Everything happens now using technology. We use HSBCnet as our secure, global solution for internet banking. It is also mobile now via HSBCnet Mobile. Technology allows one to be relevant, and gives one the ability to trade currencies 24 hours a day through an electronic platform. However, face-to-face interaction is still our customers' preference and our preferred way of doing business.

How does globalisation impact your banking operations and how do you see globalisation shaping the future of banking locally?

Globalisation affects all businesses, not just banking, and is not just about the customer growing - it is about us growing with them and, from Bermuda, it is about us understanding how the customer is growing and in what country, so we can become relevant to them in that country. Therefore, an increased number of our daily conversations are with our global partners to deliver a global solution to our customers. Locally, you will have seen the number of mergers and acquisitions taking place. It is not only about Bermuda looking outwards but also seeing the world coming to the Island. Given our footprint and global reach, that is how we can help customers.

> "It is not only about Bermuda looking outwards but also seeing the world coming to the Island."

What do you see as being the key focus of your respective areas in the short and medium term future?

Taking regulatory changes such as Basel III and turning them into opportunities for customers; maintaining a high level of understanding on topics such as trade and payment flows, and in the larger picture, capital and investment flows. Also, we continue to add value to customers by bringing additional expertise to the Island, e.g. global economists, industry matter experts, etc.

With: **Michael Collins**
Senior Executive Vice President, Bermuda, Butterfield

The Bank of N.T. Butterfield & Son Limited (Butterfield)

is currently focused on its growth agenda, including engagement of customers and employees, Butterfield's Michael Collins expands on this below:

Please describe your current role and how your experience led you to this role?

My current role is Senior Executive Vice President - Bermuda, responsible for the Bermuda jurisdiction. My experience started at JP Morgan in 1985, where I spent six years, then joined Bank of Bermuda (now HSBC) for 17 years, before moving to Butterfield in late 2009.

What are the key risks / challenges that you face in your role?

The biggest issues for banks globally are employee engagement and customer service. Increased regulatory, financial and technology pressure leads to an incredible amount of change in banks. The critical goal during these periods of intense change is to try to retain a level of customer service to keep your customer wedded to you over the years. The only way to accomplish that is to have a level of engagement amongst your employees that supports a level of customer service that keeps customers wanting to come back.

What do you see are the key opportunities for an offshore bank, such as Butterfield?

The offshore market is going through a difficult time with tax and KYC compliance. The compliance world is changing aggressively everyday, and as a bank that operates in international financial centres, we are part of that world and we have to keep up. There is a huge amount of dislocation in the offshore market, due to scale and onshore pressure. What is exciting for Butterfield is that we are the premier independent bank both on the retail side and wealth management side in Bermuda and Cayman. As some banks re-evaluate and pull back, there are huge opportunities for us to grow.

What role do you think private banking and wealth management will play in the shaping of banks and banking in offshore jurisdictions such as Bermuda?

Private wealth is incredibly mobile today. The offshore world provides an important link to that mobility of wealth, and we provide products and services that are catering to the globally mobile wealthy. Our challenge in dealing with international clients is in verifying that sources of funds are legitimate. We see an opportunity to become experts in data management that facilitates that kind of verification.

What poses the greatest threat to the banking industry in Bermuda?

The greatest threat today for the banking industry in Bermuda is the macroeconomic environment. The economic circumstances in Bermuda have changed substantially over the last five years. Banks generally grow with the economy, so you would expect us to pace with GDP. Bermuda has lost 15-20% of its GDP over the last five years, but Butterfield has been able to hold its ground with growing deposits and we have maintained our loan position. The economy now appears to be getting better.

How important is it for the Bermuda banks to stay ahead of developments in banking distribution channels?

This is very important. For community banking it is important to have multiple channels such as branches, online and mobile banking. We recognise the need to have automated channels for corporates, commercial companies, private banking, and a segment of the retail client base. We also recognise that, while it is expensive, branch networks are important, because we have to service the entire population, and that connection with the whole family is important.

What changes are you seeing in the needs and expectations of your customers?

Bermudians and residents are becoming much more sophisticated in terms of what they expect from their banks. Any customer will want more products and services at lower costs, so there is always that natural tension as the banks try to provide enhanced service and still make a reasonable return on equity. People are using technology more. Butterfield and the other Bermudian banks do a good job in providing a broad array of products, services and automated channels relative to our size, for example, providing multicurrency accounts, wire transfers, online and mobile banking.

> "We will succeed, as Bermuda succeeds."

To what will you devote significantly more attention in the next 12 months, compared with the last 12?

Over the last five years, we completed a re-capitalisation, cleaned up our balance sheet, and managed down our problem loans. We are looking to grow deposits and loans, but will have to do this prudently. As the economy picks up, we will naturally get the opportunity to lend more on the residential side. We need to build growth on a platform that recognises the changing global regulatory environment. We will succeed as Bermuda succeeds.

With: **Niel Harper**
Chief Information Officer, BCB

Bermuda Commercial Bank Limited (BCB)

is currently focused on their technology offering and how it is going to drive value to customers. BCB's Niel Harper expands on this below:

Please describe your current role and how your experience led you to this role?

I am currently the Chief Information Officer (CIO) at Bermuda Commercial Bank (BCB). In this role, I have overall responsibility for the information and communications technologies (ICTs) that support the strategic enterprise goals and the day-to-day operational requirements of the business. I have 20 years of experience in areas such as IT governance and strategy, telecoms engineering, cyber security, datacentre operations, and internet regulation and policy, working with organisations such as CIBC, AT&T, Cingular Wireless, Cable & Wireless, Internet Society, and the Internet Engineering Task Force.

> "CIOs will need to take greater ownership of innovation as part of a customer-centric business cycle. Speed to market will be integral to the success of BCB and other Bermuda-based financial institutions."

What are the key risks / challenges that your team face?

One of the main challenges that we face is fostering a culture of technology risk management and mitigating controls across the IT team and throughout the wider business. IT infrastructure planning is another key challenge for us; specifically around managing performance and capacity with the resource constraints that currently exist.

How significant are the cyber / data security risks facing the Bermuda banking industry?

The security risks facing the Bermuda banking industry are no different from those being encountered by banks and other corporations across the globe. One area of concern for me is the skills gap that exists with regards to recruiting cyber security professionals. We are seeing that attackers are moving away from system exploits and reverting to social engineering, but with new and more innovative techniques.

What are the top three issues that keep you up at night in relation to your role as CIO?

The top three issues that stay at the forefront of my mind are enterprise data security, maintaining optimal service uptime (business continuity management), and the hiring, motivation, and retention of talented employees.

To what will you devote significantly more attention to in the next 12 months, compared with the last 12?

In the next 12 months, I will be devoting my attention towards talent development. This will have a cascading positive effect in numerous areas across the IT function, such as more effective data governance, leveraging existing technologies to support business objectives, and setting stretch goals for myself and the team with regards to constantly innovating in support of competitive advantage and improving customer and shareholder value.

What progress is being made in relation to data analytics and the use of data to improve Management's understanding of the customer, as well as to add value for the customer?

Business intelligence and data analytics are key strategic elements in BCB's playbook. As we continue to enhance our core systems, our ability to extract customer and product insights from our data sources will be integral to meeting the evolving needs of our clients and in enhancing our competitiveness in the marketplace.

How has the role of the CIO changed over the last 3-5 years?

Over the last 3-5 years, the role of the CIO has become less about managing IT infrastructure and more about becoming an innovation partner. When I say 'innovation partner', I mean that it is now more incumbent upon CIOs that they better understand how business units and data owners can leverage existing data sets (i.e. to enhance business critical processes, identify and capture market opportunities, and reduce or exploit risks).

What role do you see technology playing in the Bermuda banking industry in the next 3-5 years?

Technology will serve as a ways and means of alleviating economic pressures on financial institutions. The increased use of cloud services will reduce CAPEX outlays, shrink human resource needs, and support business agility. Technology will also provide Bermuda-based banks with access to new products / services, new markets, and more flexible and efficient channels for customers. Conversely, technology will also represent increased risks in the form of new entrants threatening disintermediation or existing players introducing disruptive offerings.

With: **Clare Spearing**
Head of Private Banking, Clarien
& **Bob Wilson**
Chief Banking Officer, Clarien

Clarien Bank Limited (Clarien)

is currently focused on growth, including product offerings such as wealth management with a philosophy of always putting their clients at the centre of their financial services processes. Clarien's Clare Spearing and Bob Wilson expand on this below:

Please describe your current role and how your experience led you to this role?

Clare: I am the Head of Private Banking, and have been in relationship management and sales for about 12 years, previously having worked at Butterfield and HSBC in sales leadership roles. In January, 2015 I joined Clarien after spending almost two years with the Bermuda Business Development Agency as Head of Operations.

Bob: I am the Chief Banking Officer, with overall strategic oversight of the business which includes personal & commercial banking, corporate and institutional, lending and private banking. I first joined Clarien in 2013, following an extensive career with Butterfield and Natwest in the UK.

Please explain the key responsibilities of your banking team?

Clare: Our highly qualified team of private bankers service a broad range of predominantly local and high net worth individuals, families and associations. We are ultimately in the business of building relationships. It's at the core of everything that we do for our clients.

Bob: The team of banking professionals across the business focus on providing financial services to a wide-range of clients across the demographic spectrum. As a community focused, full service bank our team is focused on first understanding the financial position of our clients and providing them with products and services that will support them with their overall personal goals and ambitions.

What are the key risks / challenges that you face?

Clare: Regulatory compliance remains the most significant challenge for all banks globally. From Basel III to FATCA, banks are working aggressively to ensure they adhere to Bermuda regulatory requirements and global standards. This comes at a significant cost to the bank. Competitive pressures and the evolution of the consumer make banking challenging.

Bob: Competition remains high, particularly with the continuous invasion by onshore bankers. As a locally owned bank, our commitment is to the people of Bermuda. We are an employer of more than 180 employees and provide financial services to more than 22,000 residents. We want to see Bermuda strive and recover from what has been several difficult years for our economy.

What are your key priorities in terms of adding value for the customer?

First and foremost we pride ourselves on service delivery. It is what differentiates us from the competition. This year alone we are making major investments in new products such as debit and credit cards, online and mobile banking.

Which customer groups are you focusing on to drive the growth agenda of the bank?

With the introduction of the new products this year we remain uniquely positioned to grow our Bermuda-based business across the personal, commercial and private banking segments. Simultaneously, Clarien has taken steps to expand its business outside of Bermuda. We have once again partnered with some well-known and highly respected global firms to help us grow in key international markets.

What do you see as being the key focus of the Banking team in the next 3-5 years?

We expect that increased regulation will continue to challenge banks and demand a lot of our attention; however, we recognise that we must also keep ahead of technological advances in the industry, which is a rapidly changing environment, and we must focus on growth, through product innovation, streamlined processes, exceptional customer service and by being more strategic about the clients we serve.

> "First and foremost we pride ourselves on service delivery. It is what differentiates us from the competition."

What role do you think private banking and wealth management will play in the shaping of banks and banking in offshore jurisdictions such as Bermuda?

It plays an extremely important role as today, most people are global in nature. The high net worth individuals certainly are. There is a growing number of high net worth and ultra-high networth individuals, with the U.S. being the dominant player but there are lots of emerging markets at which we continue to look. People want value and need advice. Since the collapse of the financial markets people are taking a more proactive role in the management of assets and are willing to pay for it.

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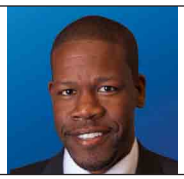


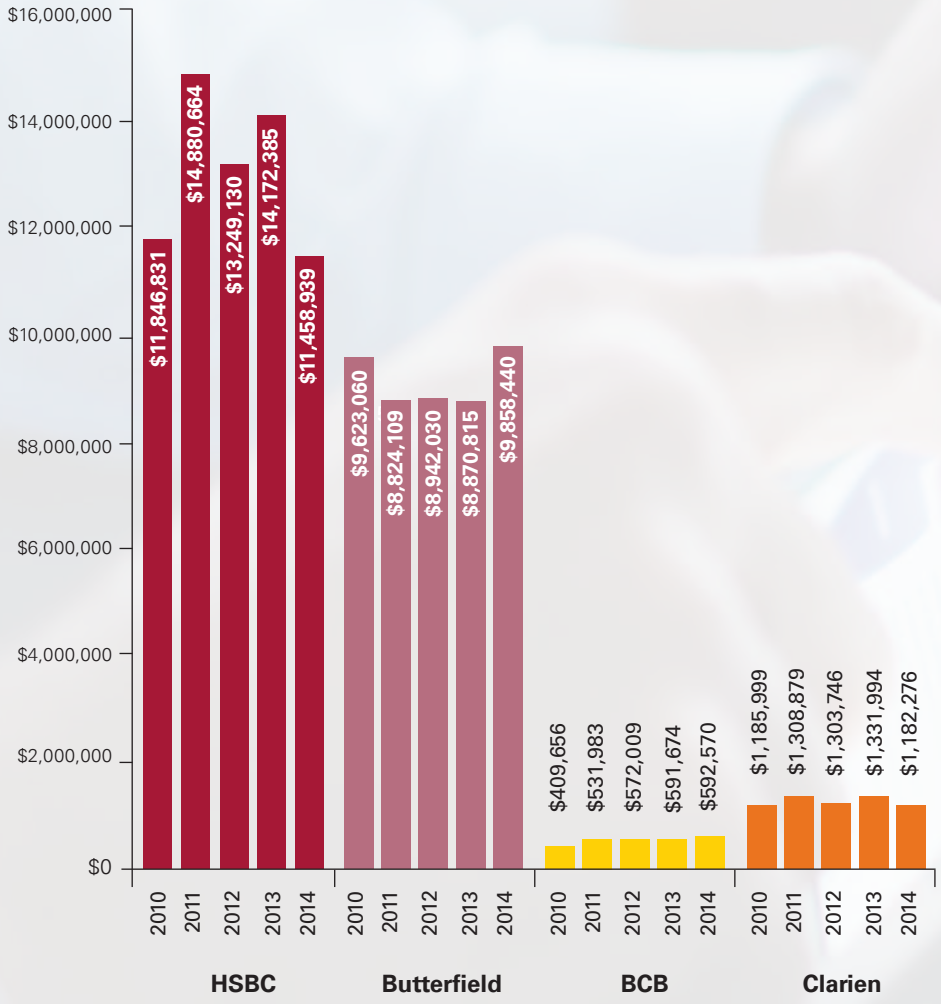
Bermuda's banks:

2015 KPMG in Bermuda Banking Survey

The Bermuda banking sector is made up of four banks of different sizes and types of services. The banks are: HSBC Bank Bermuda Limited ("HSBC"); The Bank of N.T. Butterfield & Son Limited ("Butterfield"); Clarien Bank Limited ("Clarien"); and Bermuda Commercial Bank Limited ("BCB").
These differences make direct comparisons difficult. This survey is intended to highlight trends in the sector and discuss some of the common challenges market participants face in the short term. 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 are not consistent, and as such, it is important to consider the information below when making comparisons:

- HSBC is part of a large global banking network. HSBC has a December 31 year end and prepares its financial statements in accordance with International Financial Reporting Standards ("IFRS").
- Butterfield is listed on the Bermuda Stock Exchange and has a December 31 year end. Butterfield prepares

Figure 1: Total assets (in '000s)



its financial statements in accordance with accounting principles generally accepted in the U.S.

- Clarien has had a residential lending focus to date and a December 31 year end. Clarien converted to IFRS during 2011 and restated certain 2010 balances. Comparatives have not been restated for the purposes of this analysis.
- BCB's year end is September 30 and its financial statements are prepared in accordance with IFRS.

2014 at a glance

On the whole, Bermuda's banking sector shrank slightly in 2014.

Bermuda's banking sector total assets decreased by approximately $1.9 billion, **8%** in 2014.

All four banks remained profitable for the fourth consecutive year, and although the weighted average net profit to equity of 7.4% earned across the sector is less than the U.S. industry average of 9% it is significantly up from the prior two years.

Net interest income continued to decline in 2014 and loan impairment charges remained elevated. With the low interest rate environment, and regulatory capital reform causing pressure on interest margins, banks have sought to either reduce their costs (i.e. become more efficient) or bolt on services to earn additional fees to dilute the cost base.

Reductions of their cost base has proven possible and has been a factor in maintaining profitability despite low margins and increased impairment losses.

Bermuda's banks were all profitable in 2014 for a fourth consecutive year despite a continuing economic recession in Bermuda, and a global low interest rate environment continuing to impact the ability to earn revenue.

Total assets: **$11,458,939,000**	DOWN 19%
Net profit as a % of equity: **5%**	UP 1%
Tier 1 capital ratio: **24%**	UP 3%

HSBC earned profits of $48 million in 2014 (5% as a percentage of equity). Although this is not a significant increase on their 2013 profits, when eliminating the losses attributed to discontinued operations, of $23 million, the profit from continuing operations of $71m (7% as a percentage of equity) represents a significant improvement in operating performance. The discontinued operations relate primarily to their Cayman subsidiary. In 2014, following a strategic review, HSBC entered into an agreement to sell the majority of their Cayman subsidiary assets and liabilities and relinquish their Cayman Islands Banking License.

Loan impairment charges remained high during 2014, although significantly down from 2013 levels. Impaired loans, as a percentage of gross loans decreased slightly, largely due to the write-off of uncollectable amounts during 2014, indicating a realisation of previous provisions.

HSBC's total assets declined significantly, from $14.2 billion at the end of 2013, to $11.5 billion at the end of 2014. A major part of the decrease in 2014 is due to the sale of assets in their Cayman operations, while the remainder relates to a reduction in deposits.

HSBC's Tier 1 capital ratio strengthened from 21% to 24% which significantly exceeds the increasing regulatory requirements. Capital and liquidity positions remain key strengths of HSBC Bank.

Total Assets: **$9,858,440,000**	UP 11%
Net profit as a % of equity: **12%**	UP 2%
Tier 1 capital ratio: **19%**	DOWN 1%

Butterfield continued to build on a strong performance in 2013, increasing net profit as a percentage of equity from 10% to 12% in 2014. During the year, Butterfield grew their trust and fiduciary services business with the acquisition of the Legis Group trust and corporate services business in Guernsey. Butterfield also expanded its Cayman operations with the acquisition of certain assets and liabilities from HSBC.

In April 2015, Butterfield announced the buy-back of 80 million shares from Canadian Imperial Bank of Commerce (CIBC). CIBC's stake in Butterfield was acquired in March 2010 as part of a $550 million recapitalisation of Butterfield, after it was significantly impacted by bad loans and mortgage-backed securities. CIBC had invested $150m at a price of $1.21 per share.

Butterfield re-acquired the shares for $1.50 per share when Butterfield shares were trading at $1.97 on the BSX prior to the announcement, so the repurchase represents a 23% discount to the traded value, which is reflective of the size of the holding in relation to the volume of trading on the BSX. Following on from the acquisition, on June 2, 2015, Chairman and CEO Brendan McDonagh announced that Butterfield is evaluating the merits of an international listing in order to introduce broader liquidity into the share register and facilitate access to a wider pool of international investors.

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Total assets: **$592,570,000**	FLAT 0%
Net profit as a % of equity: **8%**	FLAT 0%
Tier 1 capital ratio: **25%**	UP 3%

BCB's year to September 30, 2014 was another fairly steady year. Total assets at September 30, 2014 were consistent with 2013, and profits for the year represented 8% of equity, again consistent with 2013.

The profitability was driven by strong realised gains on the investment portfolio. In their annual discussion and analysis, BCB management noted that the gains on the investment portfolio are driven by general market performance, and therefore remain susceptible to fluctuation. As a result management remains focused on diversifying its income streams and building up core profitability.

Tier 1 capital ratio remained extremely strong at 25%, up from 22% in 2013, and the highest amongst the Bermuda banks.

Despite the stable financial metrics, 2014 did bring some changes at BCB. The management team were revamped, with new staff in key positions such as CEO, CFO, and COO. BCB also acquired new premises during the year.

Management highlighted that a substantial investment was made to upgrade BCB's IT infrastructure and plans to implement a new core banking technology software.

These investments in people and systems indicate a strategic investment in the long term future of the bank.

Total assets: **$1,182,276,000**	DOWN 11%
Net profit as a % of equity: **1%**	DOWN 2%
Tier 1 capital ratio: **15%**	UP 2%

Clarien experienced a very active year. In January 2014 Clarien announced that CWH Ltd had acquired a majority ownership in the bank, and in April 2014 rebranded themselves as Clarien Bank (previously Capital G Bank), which was anticipated to take the Bank in a new direction focusing on asset management.

However, in April 2015, just one year after the rebranding, Clarien announced that Edmund Gibbons Limited had returned as the sole shareholder effectively unwinding the CWH transaction.

Despite the distractions, Clarien managed to make a small profit, equivalent to 1% of equity. Management noted an increase in core earnings during the period and attributed the low profitability "predominantly to large, one-off expenses that will not have any continuing effect on earnings going forward".

Total assets declined by 11% between December 2013 and December 2014. Impaired loans as a percentage of gross loans increased from 5% to 7%.

The Tier 1 capital ratio for Clarien increased from 13% to 15% during the year, despite the fact that equity as a percentage of total assets remained constant, reflecting a fall in risk weighted assets.

Figure 2: Impaired loans as a % of gross loans

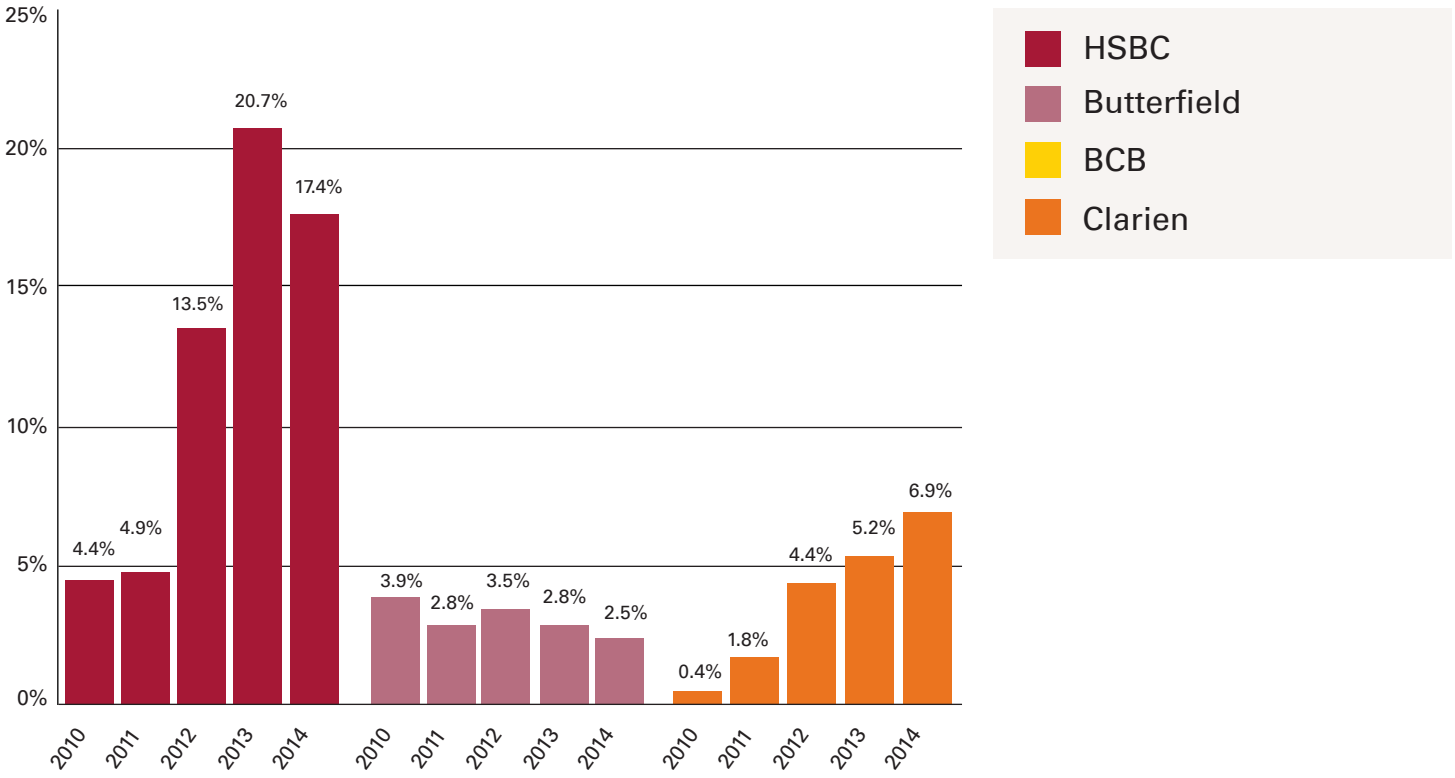
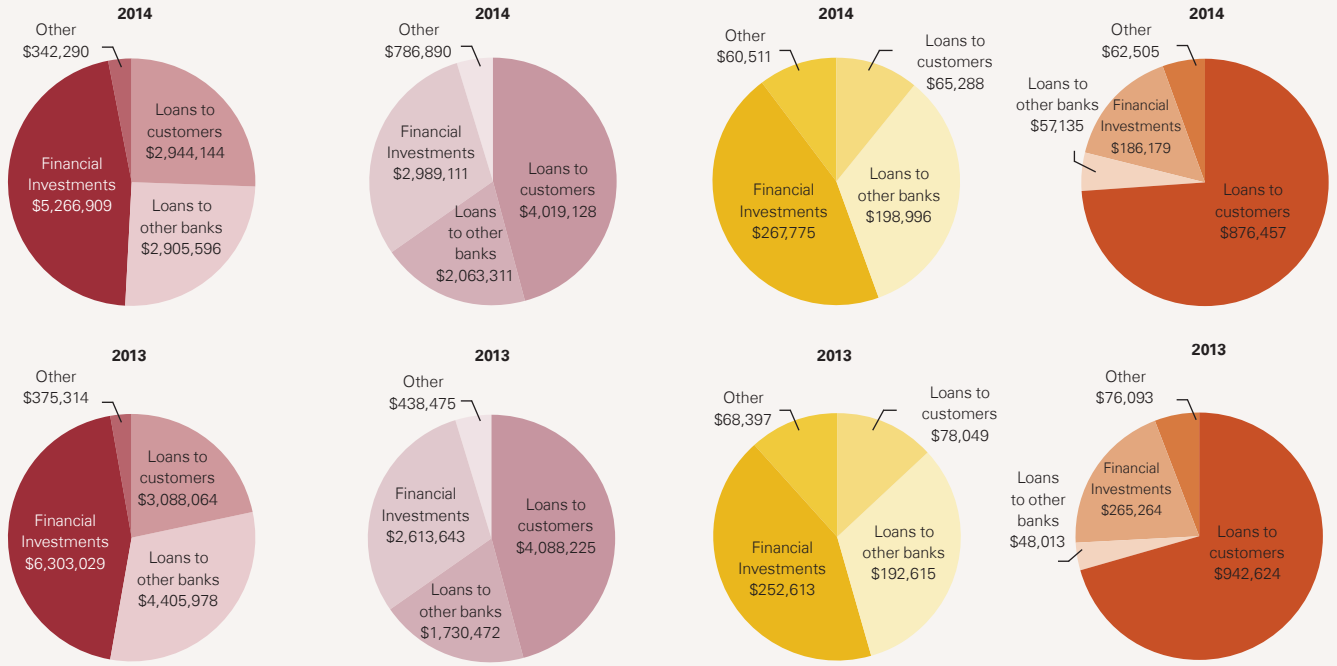


Figure 3: Composition of total assets (in '000s)



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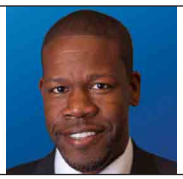
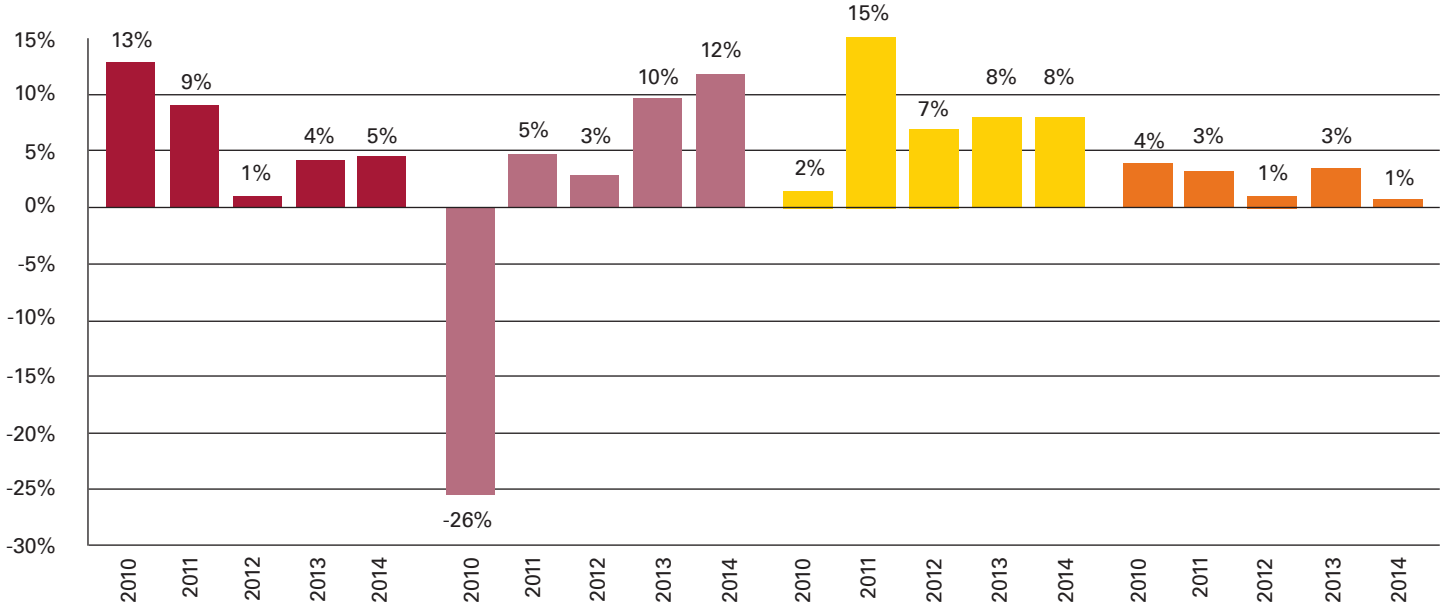


Figure 4: Net profit as a % of equity



Equity

Capital ratios of the banks remain strong, consistent with the prior year, exceeding international industry standards.

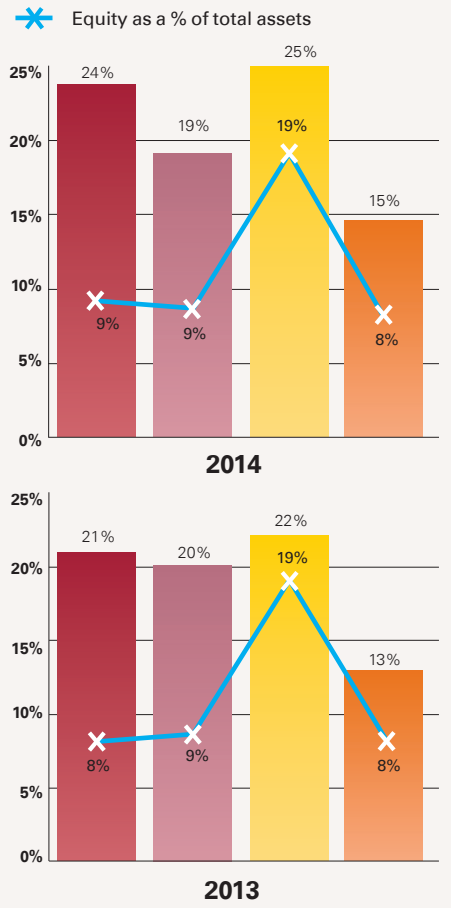
In order to monitor the financial health of the Island's banks, in 2014 the BMA employed the Basel II approach to capital adequacy. Basel II allows the BMA the ability to set minimum regulatory capital requirements for each bank, as well as monitor their adherence to these minimums on an ongoing basis. One of the common capital measures used under Basel II, is the Tier 1 capital ratio, which is the ratio of a bank's core equity capital to its total risk-weighted assets (RWA). The assets are risk-weighted by adding a capital charge to certain categories of assets which are considered to be more risky.

Figure 5 shows the Tier 1 capital ratio, and also the equity to total assets ratio. This illustrates that although the equity to total assets ratio for HSBC, Butterfield, and Clarien are very similar, the Tier 1 Capital ratio for Clarien is much lower than its competitors. This is largely due to the high concentration of customer loans, which are generally assigned a higher risk weighting.

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 and the absence of a central bank. Banks are required to disclose information about their capital, risk exposures, risk assessment processes and capital adequacy. These disclosures, known as the Capital and Risk Management Pillar III disclosures, allow an informed market participant to gauge the capital adequacy of the banks, and are available on the websites of each of the four banks.

Capital adequacy and risk management will continue to be closely monitored by regulators worldwide with the implementation of Basel III, which is increasing bank capital requirements.

Figure 5: Tier 1 capital ratio



“Bermuda’s four banks continue to evolve and to contribute to the maintenance of the strong reputation of Bermuda banking and the financial services industry in general. Despite the challenges presented by increasing costs and regulation, this is a time of change and opportunity for the banks. The future of banking in Bermuda remains positive.”

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