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**BERMUDA MONETARY AUTHORITY**

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***Regulatory Update***  
**August 2005**

*(Incorporating Financial Statistics for the  
Quarter ended March 2005)*

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## **(I) REGULATORY DEVELOPMENTS**

### **a) International Monetary Fund (IMF) Offshore Financial Centre Framework**

The Authority has submitted to the IMF aggregate data regarding Bermuda's financial services sector, following up on the jurisdiction's agreement earlier this year to participate in the Offshore Financial Centre Framework initiative. The information covers primarily collective investment schemes, insurance companies and banks, and most of it is already published in the Authority's Annual Report or in other publications. The IMF developed this initiative as part of their objective to establish minimum global standards of transparency for the financial sector. It is anticipated that the IMF will publish a report later this year based on the data gathered from all jurisdictions participating in the initiative.

### **b) Banking and Trust**

#### ***Monetary Advisory Committee – Working Group on Customer Due Diligence Procedures***

The Working Group on Customer Due Diligence Procedures, bringing together representatives of Bermuda's banks and deposit companies, met during June to consider the practical implementation of risk-based standards for customer identification and account monitoring. In particular the Group is considering how far the Bermuda framework should seek to clarify, either in the Proceeds of Crime Guidance Notes or elsewhere, specific industry standard criteria for defining higher and lower risk customers, together with the enhanced (or as appropriate reduced) due diligence requirements associated with these designations.

### **c) Investments**

#### ***Investment Business Regulation***

The Authority is holding discussions with European regulators regarding its supervisory approach for investment groups based in Bermuda that seek to carry on business within the European Economic Area. This reflects the potential impact of recent legislative and regulatory developments within the European Union, most notably the Financial Groups Directive and the Capital Requirements Directive, where a third country supervisor is not able to provide equivalent regulation on a consolidated group basis. Accordingly, the Authority is working to further develop its prudential framework for such groups in order to be able to demonstrate equivalence in such cases. It will be preparing, as a basis for industry consultation, proposals for specific amendments to its regulatory policies and practices with a view to further refining the approach to consolidated supervision that would apply to such groups.

## (II) LEGISLATIVE DEVELOPMENTS

### a) *Proceeds of Crime Act and Regulations – Possible Amendments*

The Authority has circulated, on behalf of the National Anti-Money Laundering Committee, details of the proposed amendments to the Act and Regulations which are expected to be brought forward shortly by Government. These changes would provide the necessary underpinning to a series of detailed amendments to the Proceeds of Crime Guidance Notes that have already been circulated widely to industry on a consultative basis. Detailed discussions with industry sectors and representative bodies on the revised Guidance Notes will begin in September.

### b) *Insurance*

#### *Insurance Amendment Act*

The Authority has circulated to industry bodies for consultation further detailed proposed amendments to the Insurance Act 1978 and its related Regulations.

This activity is the next phase of enhancement to the regulatory framework for insurance, and based in part on the Authority's review of Bermuda's insurance legislation against the IAIS Insurance Core Principles. This phase builds on the implementation earlier this year of the Insurance Amendment Act 2004 and the issuing of related Guidance Notes. During this latest round of industry consultation it has emerged that terms previously used in Guidance Note 4 – The Role of the Loss Reserve Specialist - need clearer definition and could be open to inconsistent interpretation, particularly with respect to how actuaries are now expected to assess the adequacy of insurers' loss reserves.

Consequently, the Authority has temporarily withdrawn Guidance Note 4 for review and revision. The Authority has notified industry that the revised guidance will not become effective until insurers file their 2006 year-end Statutory Return, to allow companies time to make the adjustments that will be required based on the pending revisions.

### c) *Banking and Trust*

#### *Credit Union Act 1982*

The Authority has completed its review of the existing regulatory framework for credit unions. The review was designed to assess the continued appropriateness of the framework, which has been in place without enhancement in changing market conditions for several years. As a result of the review the Authority has developed, and forwarded for consideration by the Minister of Finance, a series of recommendations for changes to the Act and supervisory arrangements for credit unions.

### (III) OTHER DEVELOPMENTS

#### a) IAIS Captive Issues Paper

The Authority has submitted its comments to the IAIS Captive Issues Working Group regarding their consultative paper '*The Regulation and Supervision of Captive Insurance Companies*'. The stated intention of the document is to act as a source of reference on the nature of captive insurance and to increase the understanding of both its role and relationship to the traditional insurance and reinsurance markets. The document is part of an ongoing discussion related to the long-held IAIS position that supervisory standards for captives should be compatible with international standards, given that some captives directly or indirectly underwrite third-party risk. The paper also considers the application of the IAIS Insurance Core Principles to captive insurance.

The Authority continues to emphasise in its comments the appropriateness of applying a differentiated, risk-based regulatory approach for the captive market as compared to traditional commercial insurance markets, given that the majority of captive insurers write little or no third-party risk. The Authority was represented at the last meeting of the Captive Issues Working Group to review and refine the current draft of the paper, which took place in London on August 18<sup>th</sup> and 19<sup>th</sup> 2005.

#### b) Insurance Department Restructuring

The Authority has made a number of structural changes to the Insurance Department, formally creating two operational areas. Deputy Director Shelby Weldon is now responsible for the functions of the Compliance Team, while Shanna Lespere (former Assistant Director, Investment) has been appointed to the new position of Deputy Director, Licensing and Authorisations. The changes became effective as of July 18<sup>th</sup> 2005.

#### c) Seminars, Conferences and Publications

**Shanna Lespere**, Assistant Director, **Martin McHugh**, Senior Analyst and **Jodie Rudo**, Analyst, represented the Investment Department at a meeting of the Offshore Group of Collective Investment Scheme Supervisors, which took place in Bridgetown, Barbados on June 1<sup>st</sup> – 3<sup>rd</sup> 2005. The meetings included wide-ranging discussions on cross-border regulatory cooperation, progress with compliance with international regulatory standards, as well as providing the opportunity for extensive bilateral contacts on matters of mutual interest.

**Cheryl-Ann Lister**, Chairman and Chief Executive Officer, spoke on behalf of the Authority at the 12<sup>th</sup> annual Global Alternative Investment Management (GAIM) Forum held in Lausanne, Switzerland on June 7<sup>th</sup> – 9<sup>th</sup> 2005. The conference attracts both high quality investors and speakers related to the hedge fund industry, covering a diverse programme of alternative investment topics as well as regulatory developments.

**Mrs. Lister** also spoke at the Institutional Investor Risk Management Roundtable, which took place at the Fairmont Hamilton Princess in Bermuda on June 13<sup>th</sup> – 15<sup>th</sup> 2005. She provided an overview of regulatory developments for the insurance market in Bermuda to the delegates in attendance, who comprised CEOs and senior risk management executives from the US and Europe.

**Mrs. Lister** was also a member of a Bermuda delegation that participated in Bermuda International Business Association meetings with partners from major law firms in New York from June 20<sup>th</sup> – 21<sup>st</sup> 2005. The meetings provided attendees with information about Bermuda as a jurisdiction for funds and alternative investment products in terms of the regulatory framework and market developments.

On June 29<sup>th</sup> 2005 **Munro Sutherland**, Superintendent, Banking, Trust & Investment and **Ann Daniels**, Assistant Director, Banking & Trust, attended the 25th Annual Conference of the Offshore Group of Banking Supervisors (OGBS), held in the Cayman Islands. The meeting – attended by, among others, representatives from 16 of the 19 OGBS member jurisdictions – focused on a number of international initiatives concerned with financial regulation and anti-money laundering/combating the financing of terrorism (AML/CFT). The meeting also reviewed regulatory developments in member jurisdictions.

Immediately prior to the meeting, OGBS members participated in a seminar organised by the Basel-based Financial Stability Institute. The seminar focused on the Basel II Capital Adequacy proposals, and the risk-based approach to financial regulation and AML/CFT.

d) *New Staff*

Kayla Roberts and Anthony Roberts Jr. have joined the Insurance Department as Senior Analysts in the Licensing and Authorisations Team.

Dave Bean has joined the Compliance Team in the Insurance Department as a Senior Analyst.

Marcelo Ramella has joined the Policy, Research and Communications Department as Senior Research Analyst.

## **Special Feature – Banking Supervision and The Basel II Capital Accord**

In June 2004, the G-10 countries, along with Switzerland and Luxembourg, represented on the Basel Committee on Banking Supervision, the international standard setting body, concluded negotiations on the Basel II Capital Accord. . This new Accord represents a major development and refinement of the regulatory capital and other prudential standards applied to banks operating internationally. Supervisory authorities around the world are now hard at work, in close consultation with their banking industries on preparing for the implementation of the new provisions.

Basel II seeks to achieve a more comprehensive and risk-sensitive approach to banking supervision. It provides a framework in which improved risk management within banks is rewarded through reduced minimum capital requirements. The Accord also increases the public disclosure requirements for banks, thereby reinforcing supervisory oversight of banks by enabling market participants to make better judgements over the quality of each bank. Implementing the new Accord will involve extensive changes in regulatory requirements and approaches, presenting challenges for banks and supervisors alike. As a result, even Basel Committee member countries are not planning to implement the Accord until 2007/2008. For other jurisdictions, including Bermuda, transition is likely to take longer. A firm timetable for completion of the process has not yet been set at this stage. Rather, the Authority is engaged in an on going consultative process with the banks, to ensure that the various issues involved are fully considered and addressed. It will then be working closely with the banks on a stage-by-stage implementation process, ensuring that supervisors and banks are adequately prepared, to facilitate a smooth transition.

Basel II will replace the original 1988 Capital Accord, which established the first internationally accepted definition and measure of bank regulatory capital. The 1988 Accord, which was adopted in over 100 countries, quickly gained international acceptance as a global standard, and enhanced the stability and transparency of the international financial system.

However, the simplicity and inflexibility of the 1988 Accord led to some distortions. In addition, major developments in risk measurement and management within banks over the past 20 years have lessened the current framework's ability to align regulatory capital in banks with the real risks in their business. As a result regulators and the banking industry recognised that it was necessary to develop new approaches that could more accurately gauge risks, as well as provide an incentive for banks to improve their risk identification, measurement, monitoring and control practices.

Regulators have sought to ensure that developing the new Accord and moving to a risk sensitive approach will not impact the market negatively by reducing the overall amount of capital within the international banking industry. The aim is to maintain adequate levels of capital in order to continue protecting both the depositors and other users of bank services, and ultimately to preserve the stability of the international financial system and the global economy.

Equally, supervisors recognised that the new model should be flexible enough to apply both to highly sophisticated global banks and to smaller institutions offering fewer, simpler product and managing their risks in less refined and complex ways. Therefore, while the 1988 Accord focused on a single risk measure and has a ‘one size fits all’ approach, Basel II offers a range of options for calculating the capital charges for different elements of risk — progressively increasing in risk-sensitivity and complexity — depending on the sophistication of banks’ systems.

The new framework comprises three so-called ‘pillars’:

**Pillar 1: Minimum capital requirements** - this pillar aligns minimum capital requirements more closely with banks’ actual underlying risks, and is a more refined version of the traditional 1988 Accord. Those risks include credit risk and market risks, as under the previous model, but for the first time a specific capital charge for banks’ operational risk will now be included.

**Pillar 2: Supervisory review process** – this involves a development and refinement of the traditional on- and off-site review process conducted by supervisors. However, the new Accord places much greater emphasis on the responsibility of banks’ management in the risk management and internal control processes, and on encouraging banks to develop and use better risk management techniques. The process will enable supervisors to evaluate a bank’s assessment of its own risks and then determine whether that assessment is appropriate. Banks will be expected to operate above the minimum regulatory capital ratios. This process aims to allow early intervention by supervisors in the event of problems arising and is a means of verifying that banks fully understand their risk profile and are sufficiently capitalised against their risks.

**Pillar 3: Market discipline** – this pillar sets clearer disclosure requirements for banks with respect to their capital structure, risk exposures and capital adequacy. The intent is to strengthen incentives for prudent risk management, since greater transparency in banks’ financial reporting should enable market participants to make better judgements of the quality of banks as counterparties, and reduce the likelihood of them simply relying on the fact that banks are subject to prudential supervision.

Overall, the framework also seeks to promote more effective corporate governance in the banking sector, consistent with general trends in the current corporate environment. Therefore banks adopting Basel II will be expected to implement a sound and comprehensive planning and governance system to oversee all aspects of their risk measurement and management processes. There will be a heightened expectation that the board of directors, senior managers and audit and other control functions of a bank will exercise their duties effectively and rigorously.

In Bermuda, as in other jurisdictions, implementing the new Accord will be a major project. However, the Authority believes that the existing regulatory framework for Bermuda’s banking industry provides a sound foundation on which to implement Basel

II. Indeed, the International Monetary Fund concurred with this view in their assessment of Bermuda's regulatory arrangements published early in 2005, and commended the effectiveness of the Authority's supervision, concluding that all the current Core Principles adopted by the Basel Committee were observed or largely observed.

Accordingly, the Authority has been moving to develop its approach to Basel II in recent months. The Authority is also working on implementing certain elements of the current Basel framework not yet fully introduced in Bermuda because they have not been material in the context of banks' current business. These elements include most notably the introduction of a market risk calculus (the "1996 Market Risk Amendment" to the 1988 Accord), which involves banks allocating their business for capital adequacy reporting purposes between 'banking book' and 'trading book' items, unless the amounts of market risk can be shown to fall below a minimum threshold. The Authority will be providing the banks with its proposals for implementing these market risk requirements shortly, as a basis for consultation.

In addition, the Authority has been discussing, in a working party involving representatives of all Bermuda's banks, its intended approach to implementing the Basel II framework. This process is on going. The Authority proposes to be in a position to offer banks access to so-called 'advanced' methodologies where they have a business case to support such a development. However, in general banks in Bermuda do not see a pressing need, at least in the short-term, to seek to migrate to the more complex capital measurement approaches. Certainly, in relation to credit risk measurement, most banks expect to make use of the 'standardised' option rather than looking to apply an 'internal ratings-based' methodology. On the other hand, regarding the new operational risk requirement, some banks are likely to opt for the standardised or advanced approach in place of the simpler 'basic indicator' approach. An eventual outcome along these lines seems plausible, given that banks in Bermuda have always operated very conservatively, maintaining capital ratios well in excess of the minimum requirements.

The Authority is currently working on follow-up papers on Basel II implementation which consider further the various elements of the Basel II project — notably, looking at the Authority's proposed approach to the relevant credit and operational risk options available under the Accord. This material will be circulated to industry shortly for consideration as part of the next phase of the on going consultations with the market.

## STATISTICAL ANNEXE

### BERMUDA MONEY SUPPLY

(BD\$ millions)	2003-Q4	2004-Q1	2004-Q2	2004-Q3	2004-Q4	2005-Q1
Notes & Coins in Circulation*	94	86	90	90	100	93
Deposit liabilities:						
Banks and Deposit Companies (unconsolidated)	3,232	3,387	3,491	3,544	3,558	3,579
	<b>3,326</b>	<b>3,473</b>	<b>3,581</b>	<b>3,634</b>	<b>3,658</b>	<b>3,672</b>
Less: Cash at Banks and Deposit Companies	28	21	24	23	27	24
BD\$ Money Supply	<b>3,298</b>	<b>3,452</b>	<b>3,557</b>	<b>3,611</b>	<b>3,630</b>	<b>3,648</b>
% Growth on Previous Period	<b>2.39%</b>	<b>4.68%</b>	<b>3.06%</b>	<b>1.52%</b>	<b>0.51%</b>	<b>0.49%</b>
% Growth Year on Year	<b>10.49%</b>	<b>12.42%</b>	<b>13.79%</b>	<b>12.11%</b>	<b>10.09%</b>	<b>5.68%</b>

\* This table includes the supply of Bermuda dollars only. United States currency is also in circulation in Bermuda but the amount has not been quantified.

### BD\$ DEPOSIT PROFILE - COMBINED BANKS AND DEPOSIT COMPANIES (Unconsolidated)

(BD\$ Millions)	2003-Q4	2004-Q1	2004-Q2	2004-Q3	2004-Q4	2005-Q1
Deposit Liabilities	3,232	3,387	3,491	3,544	3,558	3,579
Less:						
Loans, Advances and Mortgages	(2,567)	(2,566)	(2,667)	(2,752)	(2,865)	(2,942)
Surplus deposits	<b>665</b>	<b>821</b>	<b>824</b>	<b>792</b>	<b>693</b>	<b>637</b>
Percentage of Deposit Liabilities Lent	<b>79.4%</b>	<b>75.8%</b>	<b>76.4%</b>	<b>77.6%</b>	<b>80.5%</b>	<b>82.2%</b>



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**COMBINED BANKS AND DEPOSIT COMPANIES FOREIGN CURRENCY POSITION**  
**(Consolidated)**

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<b>(BD\$ millions)</b>	<b>2003 - Q4</b>	<b>2004 - Q1</b>	<b>2004 - Q2</b>	<b>2004 - Q3</b>	<b>2004 - Q4</b>	<b>2005 - Q1</b>
Total Foreign Currency Assets	19,504	20,386	20,948	19,252	17,221	19,211
Less: Other Assets	189	289	323	241	284	285
Less: Foreign Currency Loans to Residents	743	779	854	753	850	917
Net Foreign Currency Assets	18,571	19,318	19,772	18,257	16,087	18,009
Foreign Currency Liabilities	17,695	18,546	18,926	17,234	15,278	17,253
Add: BD\$ Deposits of Non-Residents	174	156	176	161	142	117
Net Foreign Currency Liabilities	17,869	18,702	19,101	17,485	15,420	17,370
<b>Net Foreign Currency Position (cons.)</b>	<b>702</b>	<b>616</b>	<b>670</b>	<b>772</b>	<b>667</b>	<b>639</b>

Totals may not add due to rounding

2004-Q3 Figures amended to reflect revised data

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**COMPANIES PARTNERSHIPS & PERMITS STATISTICS APPLICATIONS**

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**APPLICATIONS APPROVED  
SUMMARY Q1-2005**

	2003-Q4	2004-Q1	2004-Q2	2004-Q3	2004-Q4	2005-Q1
<b>Exempted Companies</b> (Bermuda companies exempted from the 60% Bermudian ownership requirement)	309	256	244	260	287	266
<b>Exempted Partnerships</b> (partnerships established in Bermuda to carry on business in or from within Bermuda)	31	25	11	13	27	23
<b>Overseas Partnerships</b> (overseas partnerships applying for permits to carry on business in or from within Bermuda)	0	0	1	0	2	2
<b>Overseas Permit Companies</b> (overseas companies applying for permits to carry on business in or from within Bermuda)	4	5	14	3	10	13
<b>Unit Trusts</b>	11	21	3	10	19	12
<b>Continuation Companies</b> (companies from other jurisdictions continuing into Bermuda as exempted companies)	23	5	8	3	11	4
<b>Unlimited Liability Companies</b>	3	0	0	0	1	0
<b>Local Companies</b>	50	59	62	48	53	62
<b>Total Applications Approved*</b>	<b>431</b>	<b>371</b>	<b>343</b>	<b>337</b>	<b>410</b>	<b>382</b>

\* Quarterly Numbers are amended to reflect more up-to-date consent information.

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**COLLECTIVE INVESTMENT SCHEMES STATISTICS**


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	2003-Q4	2004-Q1	2004-Q2	2004-Q3	2004-Q4	2005-Q1
Mutual Funds	817	849	834	855	879	906
Umbrella Funds	57	62	69	72	70	64
Sub-Funds	395	422	441	409	500	524
Segregated Account Companies	9	13	20	26	29	38
Segregated Accounts	43	46	87	137	159	177
<b>Total</b>	<b>1,321</b>	<b>1,392</b>	<b>1,451</b>	<b>1,499</b>	<b>1,637</b>	<b>1,709</b>
Unit Trusts	72	93	65	74	96	100
Umbrella Trusts	67	67	72	72	75	77
Sub-Trusts	82	115	195	119	203	217
<b>Total</b>	<b>221</b>	<b>275</b>	<b>332</b>	<b>265</b>	<b>374</b>	<b>394</b>
<b>TOTAL</b>	<b>1,542</b>	<b>1,667</b>	<b>1,783</b>	<b>1,764</b>	<b>2,011</b>	<b>2,103</b>
<b>TOTAL NET ASSET VALUE (IN BILLIONS)</b>	<b>\$115.84</b>	<b>\$129.60</b>	<b>\$133.02</b>	<b>\$141.25</b>	<b>\$158.18</b>	<b>\$166.50</b>

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## ADDITIONS TO THE INSURANCE REGISTER

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	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
<b>Class 1</b>	13	7	10	4	11	2
Single-parent captive insuring only risks of its owners or affiliates of the owners						
<b>Class 2</b>	4	7	1	0	4	3
(a) a multi-owner captive insuring risks of its owners or affiliates of the owners;						
(b) a single-parent and multi-owner captive:						
(i) insuring the risks related to or arising out of the business or operations of the owners and affiliates, and/or						
(ii) deriving up to 20 percent of its net premiums from unrelated risks						
<b>Class 3</b>	15	5	3	6	10	6
Insurers not included in Class 1, 2 or 4, such as						
i) Reinsurers writing third party business;						
ii) Insurers writing direct policies with third party individuals;						
iii) Single parent, group, association, or joint venture captives where more than 20% of their net premiums written arises from risks which are unrelated to the business of the owners;						
iv) Finite reinsurers and rent-a-captives						
<b>Class 4</b>	0	0	0	1	0	0
Insurers and reinsurers capitalised at a minimum of \$100 million underwriting direct excess liability and/or property catastrophe reinsurance risk						
<b>Long-Term Insurers</b>	4	2	2	2	5	3
Insurers writing long-term (or life) business						
<b>Composites</b>	0	0	0	1	0	0
Insurers writing combination of long-term (or life) business and Class 1, 2, 3 or 4 business						
<b>Total additions during quarter</b>	36	17	16	14	30	14

Bermuda Monetary Authority  
31 Reid Street  
Hamilton HM 12  
Telephone 441-295-5278  
Fax 441-292-7471