

<b>Securities</b>	
Regulation and information sharing on collective investment schemes	Suggested changes to the Collective Investment Scheme Act and Regulations should be carried through; these would address many of the gaps in collective investment regulation.
Regulation of issuers and secondary markets	Regulation of issuers should become the direct responsibility of the BMA, who would be responsible for unlisted issuers, for supervision of the BSX regulation of listed issuers, and for the introduction of further rules for shareholder protection
Resources of the regulator	Additional staff training is required to enhance technical skills, especially in the areas of inspections and oversight of BSX functions.

## I. INTRODUCTION

1. At the invitation of the Government of Bermuda, a Module II offshore financial center (OFC) assessment of financial regulation and supervision in Bermuda was carried out from March 17 to 29, 2003, within the framework of the OFC Assessment Program approved by the Executive Board of the Fund in July 2000. Assessments were undertaken of the regulation and supervision of the banking, insurance, and securities sectors, and of the arrangements in place for AML/CFT.

2. Volume I of the report briefly describes the financial system and regulatory and supervisory arrangements for the financial sector in Bermuda and provides reports on observance of standards and codes (ROSCs) based on the detailed assessments in Volume II. Volume II provides the detailed assessments carried out on the basis of the Basel Core Principles for Effective Banking Supervision, the IAIS's Insurance Core Principles (of October 2000), IOSCO's Objectives and Principles for Securities Regulation, and the AML/CFT methodology for assessing compliance with the Financial Action's Task Force 40+8 Recommendations.

3. The IAIS Core Principles at the time of the assessment mission specifically excluded the reinsurance business which dominates the Bermuda market. However, Bermuda applies a single system of supervision to its entire insurance sector, thus, the Principles were naturally applied to the supervision of reinsurers.

## II. FINANCIAL SYSTEM OVERVIEW

4. This section provides an overview of the financial institutions and markets in Bermuda and the legal and institutional framework for the regulation and supervision of the financial system.

### A. Background

5. Bermuda is an overseas territory of the United Kingdom. It has internal self-government with the United Kingdom remaining responsible for defense, external affairs, internal security, and the administration of the police force. These responsibilities are vested in a governor who resides in Bermuda and who is appointed by the reigning Monarch of the United Kingdom. The Legislature consists of a 36 seat House of Assembly elected under universal franchise from single member constituencies, and an appointed Senate.

6. Bermuda's legal system is based on English common law, the doctrines of equity, and Bermuda statute law dating from 1612.

7. Physically, Bermuda has eight major and some 130 smaller islands with a land mass of 21 square miles and a population of 62,400 (2001 estimate). It is 570 miles east of North Carolina, one hour ahead of Eastern Standard Time (EST), and about two hours flight from New York—an important advantage for financial services.

8. Bermuda issues its own currency, the Bermudian dollar, which is pegged to the US dollar at par. While exchange control legislation remains in force, residents are free to hold foreign currency. Bermuda has a payroll tax (on income from employment) of up to 12.5 percent, and stamp duty on property transfer to heirs but no taxes on unearned income.<sup>3</sup> The main areas of economic activity are tourism and international business services, particularly insurance, with strong growth in the latter more recently. Together financial intermediation and international business activity contributed approximately 26 percent of GDP in constant terms between 1999 and 2001. Hotel and restaurant sales fell slightly to 5 percent of output in 2001. The buoyancy created by the offshore center is also responsible for an increase in the number of jobs every year since 1997, with the exception of 2001. Estimated per capita income in 2000 was \$55,068.<sup>4</sup>

### **B. Financial Institutions and Markets**

9. **Bermuda has four licensed<sup>5</sup> banks, the two largest of which have significant international operations focused on asset administration and management.** The banks are highly liquid with low credit and Bermudian exposure—the loan/deposit ratio is below 25 percent and Bermudian dollar assets less than 15 percent of total assets between 1999 and 2002 (see Table 1). This reflects the largest banks' market orientation towards international, fee-earning business. Total consolidated assets of deposit taking institutions (banks and deposit finance companies) were \$18.7 billion at end-December 2002.

10. There are 29 **trust companies** with unlimited licenses. Under the Trust (Regulation of Trust Business) Act, 2001, unlimited licenses are issued only to companies, authorizing them to provide the services of a trustee as a business and to solicit business from the public. Trust companies include licensed banks and their subsidiaries, as well as other companies. Limited trust licenses, issued to partnerships and individuals, place a ceiling on the trust assets that may be held.

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<sup>3</sup> The authorities have reported that subsequent to the mission the maximum tax rate on income from employment has risen to 13.75 percent.

<sup>4</sup> Source: Bermuda Government Statistics Department. Purchasing power parity GDP per capita has been estimated at \$34,800 (<http://www.cia.gov>).

<sup>5</sup> Bermuda law requires at least 60 percent domestic ownership of Bermuda companies that undertake domestic business. Since banks are required by law to provide domestic services, this restriction has effectively shaped the banking market. However, the MOF is now prepared to grant banks exemptions from the 60 percent ownership requirement and an international banking group was permitted to purchase a Bermuda bank in early 2004. Branches of foreign banks are not eligible for licensing.

11. **Bermuda insurance industry includes some 1,600 insurance and reinsurance companies<sup>6</sup> with active companies having \$172 billion in assets, and writing over \$48 billion in annual gross premiums in 2001.** The industry has in recent years attracted an increasing number of reinsurance and large commercial direct insurers offering, in particular, alternative risk transfer products.<sup>7</sup> It is the world's largest captive insurance center with some 940 active companies and more than double the number registered in the next largest jurisdiction, the Cayman Islands.<sup>8</sup> While an initial important source of attraction included low taxes, the concentration of insurance skills and specialization and flexibility and timeliness of incorporation, now appear to be of dominant importance in attracting both firms and their customers. In particular, the concentration of insurance skills (especially actuaries and specialized underwriters) has created economies of scale for risk managers and others seeking corporate insurance. They can very rapidly and conveniently obtain information and prices from a range of companies present in a very small area.

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<sup>6</sup> This refers to incorporated companies, there were fewer active companies. See Also Box 3.

<sup>7</sup> See Box 1 for a discussion of different commercial insurance arrangements.

<sup>8</sup> See *Business Insurance*, March 10, 2003, page 10, [www.businessinsurance.com](http://www.businessinsurance.com).

Table 1. Bermuda: Financial Structure

Sector	1999	2000	2001	2002
(In million Bermudian dollars, unless otherwise specified)				
<b>Banks and Deposit Companies</b>				
Total Assets	15,696	17,341	17,974	18,700
<i>Of which:</i> Foreign Currency	13,466	14,749	15,429	15,982
Deposit Liabilities	14,007	15,499	16,344	16,727
Loans and Advances	3,212	3,709	3,626	4,153
Loan/Deposit ratio	22.93	23.93	22.19	24.83
Other assets (deposits and investments)	11,671	12,581	13,590	13,839
<b>Collective Investment Schemes</b>				
Mutual funds (number)	1,132	1,150	1,301	1,294
Unit trusts (number)	113	112	120	132
Total CIS Net Asset Value	33,930	46,030	55,990	68,100
(\$ billion, except where otherwise noted)				
<b>Insurance Industry by Regulatory Class 1/ 2/</b>				
<b>Classes 1 and 2</b>				
Gross premiums	5.9	7.1	8.4	8.6
Net premiums	3.8	5.5	6.8	6.4
Total assets	39.4	39.2	40.3	39.6
Capital and surplus	18.0	17.3	16.1	15.3
Number incorporating annually	22	35	34	52
<b>Class 3</b>				
Gross premiums	16.9	22.0	26.5	34.7
Net premiums	13.7	18.4	22.4	28.1
Total assets	59.6	68.4	80.1	91.3
Capital and surplus	24.3	27.4	30.1	30.9
Number incorporating annually	49	43	58	37
<b>Class 4</b>				
Number	12	17	27	29
Gross premiums	4.6	6.5	10.2	17.5
Net premiums	3.3	5.5	8.3	15.5
Total assets	23.6	27.0	40.3	56.8
Capital and surplus	10.2	11.9	17.1	23.6
Number incorporating annually	2	1	9	3
<b>Long-term insurers</b>				
Premiums	3	2.6	3.9	2.4
Total assets	9	11.5	12.0	16.4
Capital and surplus	1.9	2.6	2.5	5.9
Number incorporating	11	15	8	4
Total number incorporating annually	84	94	109	96

Source: Bermuda Monetary Authority (BMA), and BMA, *Report and Accounts*, 2002 and 2003

1/ See Box 3 for a discussion of the different classes of insurance. Data for Classes include both companies holding general and those holding composite business licenses.

2/ 2002 data for insurance was updated in 2004.

### Box 1. Large-scale Insurance and Reinsurance Insurance Industry Arrangements

There are several corporate structures and risk-management arrangements peculiar to insurance markets of the Bermuda-type market. As the name suggests, alternative risk transfer (ART) supplies an alternative to traditional insurance through vehicles and products, which tend to target the specialized needs of corporations. Alternative vehicles include captive insurance.

A captive insurance company is a separate legal entity, which provides insurance for a non-insurer parent company's and other corporate group members' risks. Over 90 percent of captives worldwide<sup>1</sup> are single-owner or pure, underwriting only parent company property and liability risks, or acting as a reinsurer for the parent company's customers' travel, creditor, and warranty insurance. Since some jurisdictions only allow risks such as workers compensation to be underwritten by a licensed insurer, a captive may also provide reinsurance for parent risks ceded to it by a commercial insurance company (the fronting company), which is licensed in the state in which the insured is located.

Association captives allow related insureds, such as members of an industry or trade association, to operate a captive. They frequently underwrite liability risks, such as medical malpractice.

Protected cell captives, or rent-a-captives, enable several insured to share captive facilities, with the businesses segregated from each other into cells. Each participating company pays a fee and provides collateral to protect the captive from underwriting losses.

Captive insurance has a number of advantages, some of which are shared with ART arrangements in general.<sup>2</sup> When insurance is used to cover the risk of highly predictable events, captives allow the parent company to obtain insurance at less cost since the corporation retains the payments otherwise made to an insurer. Lower-risk companies can also lower their insurance costs by differentiating themselves from a riskier market. Cash flow may be improved to the corporation because it retains the cash paid as premium in advance of a claim. Otherwise, uninsurable risks may be covered by a captive whose improved knowledge of the parent firm allows it to provide viable insurance.

Captives are usually managed by specialist captive manager firms which provide services such as accounting, claims handling, underwriting, arranging reinsurance, advice on the use of the captive, and, in the case of Bermuda, the Principle Representative function required by the Insurance Act. The Bermuda Insurance Management Association has 45 members, half of whom manage more than 10 captives.

Reinsurance provides insurance cover for direct business or primary insurers. Insurers are able to accept risk because the volume of similar risks they underwrite means that they can predict losses and set premiums at the level required to cover losses. Reinsurance is needed to allow for divergence between the outcome and predictions, and for events which occur with low frequency and high severity. Reinsurance companies diversify the assumed risk by spreading their operations over many countries and types of business. In cases where the potential loss is very large, several reinsurance companies may retain part of the risk, syndicating the coverage among themselves. Some direct insurance companies also provide significant reinsurance.

<sup>1</sup> See *Captive Overview*, October 11, 2002, [www.fitchratings.com](http://www.fitchratings.com).

<sup>2</sup> See *Captive Overview*, *op.cit.*, and SwissRe, "The Picture of ART," *Sigma*, No. 1/2003.

## Box 2. Trends in the Insurance Industry

The commercial insurance market is subject to cycles in which low premium rates and easier contract conditions (a soft market) alternate with higher rates and low availability of cover (a hard market). The cyclical trend towards hardening in the insurance market sharpened following September 11. The tragedy led to the largest losses ever experienced by the insurance industry (an estimated \$40–50 billion, as compared with the previous highest of \$20 billion associated with Hurricane Andrew).<sup>1</sup> Premium rates have risen, deductibles increased, coverage for certain risks are reduced, and tougher conditions, such as higher credit ratings are being imposed. These conditions have had two effects that help explain recent growth in the Bermudian market. Restricted capacity, high premium rates raised potential profits attracting capital into the industry, both through start-up operations and funds raised by existing companies in reinsurance and large-scale direct insurance. The ability to incorporate in a timely manner in a reputable, high skill-level jurisdiction enabled investors to take rapid advantage of conditions. These conditions also stimulated the growth of alternate risk transfer arrangements, among which are captive insurance companies. While many industry participants expect these conditions to continue through 2004, there are some analysts that argue that the hard market will be shorter lived.<sup>2</sup> The cyclical pattern partially contradicts the risk alleviation rationale for the insurance market in that it both creates uncertainty for the insured, and by, for example, encouraging rash underwriting in soft, highly competitive markets, can create instability in the industry.

<sup>1</sup> See Jardine Lloyd Thompson Group plc, *Insurance Market Overview*, September 2002.

<sup>2</sup> Benfield Group Limited, January 2003, *The Big Squeeze: Insurance Market Review, 2002–2003*, [www.benfieldgroup.com](http://www.benfieldgroup.com).

**12. The Bermuda securities industry is dominated by investment advisers and collective investment schemes.** There were 1,426 classified<sup>9</sup> collective investment schemes with assets under management estimated at \$68 billion as of end 2002. There were 54 licensed investment businesses (the bulk of which are portfolio managers or investment advisers) and a large number of investment providers exempt from licensing. The jurisdiction is a center for offshore operations of large international funds and fund administrators. Most of these funds are held by offshore investors—generally institutions or wealthy individuals. The islands also host a number of offshore hedge funds. There is a small industry dedicated to full service brokerage for both Bermudian residents and non-residents. The Bermuda Stock Exchange had a total market capitalization of \$150 billion at end December 2002. Although the Exchange was established for the domestic market, domestic listed companies only represent \$1.3 billion of total capitalization. It hosts an electronic auction market, and operates a Mezzanine Market for pre-IPO start up companies. The large part of listings is international firms also listed on onshore exchanges and traded secondarily in Bermuda. Of domestic listings, more than two thirds are listed investment funds.

<sup>9</sup> The CIS regulations establish a classification regime for three categories of investment funds.

### C. Regulatory Framework, Oversight and Market Integrity Arrangements

13. The BMA has, since the start of 2002, been the sole licensing, regulatory, and supervisory authority for Bermuda's financial services sector. The BMA is accountable to the MOF who appoints its Board of Directors, but is under the direction of its own Board of 11 members appointed for a period of three to five years. Three of the board members are executive directors: the Chairman, the Superintendent of Banking, Trust, and Investment, and the Supervisor of Insurance. Insurance licensing decisions are assisted by the statutory Insurance Advisory Committee.

14. The key laws governing the sector include:

- *Bermuda Monetary Authority Act*, 1969, as amended, establishes the BMA, its objectives, and general authority to supervise financial institutions, including the Bermuda Stock Exchange;
- *Banks and Deposit Companies Act*, 1999, as amended, governs licensed deposit-taking institutions, naming the BMA their regulatory and supervisory authority;
- *Trusts (Regulation of Trust Business) Act*, 2001, provides for the licensing and supervision of trust service providers;
- *Insurance Act*, 1978, as amended, provides the legal framework for insurance regulation; its 2001 amendment transfers the authority from the Ministry of Finance to the BMA;
- *Investment Business Act*, 1998,<sup>10</sup> grants the BMA authority to license and supervise all defined investment businesses;
- *The Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations* 1998 (CIS Regulations), establishes powers for the BMA to classify and regulate CIS;
- *The Bermuda Stock Exchange Act*, 1992, makes the BSX responsible for regulation of its listed companies; and
- *Companies Act*, 1981, sets out incorporation requirements, including, that companies carrying on business domestically have at least 60 percent local ownership. An exempt company is exempted from this requirement and must confine itself to international business. Exempt (from foreign ownership restrictions) companies in Bermuda are mainly incorporated to serve as investment vehicles, corporate holding companies, mutual funds, and for insurance underwriting. Companies are registered

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<sup>10</sup> Subsequent to the mission, this legislation was replaced by the Investment Business Act, 2003 (IBA/03).



by the Registrar of Companies, which reports to the Financial Secretary of the Ministry of Finance.

15. The BMA has the regulatory and supervisory responsibility for AML/CFT oversight among entities in banking, insurance, and investment and trust activity. The National Anti-Money Laundering Committee (NAMLC), which serves in an advisory capacity to the MOF and on which the BMA is represented, issues guidance, which is applicable to most prudentially regulated institutions. FT is criminalized as an offense by way of an Order in Council extended by the United Kingdom to its Overseas Territories, which gives effect to the provisions of the UN Security Council Resolution 1373. The FIU is established as part of the Police and is a member of the Egmont Group. It has both administrative responsibilities with respect to suspicious activity reports and investigative powers. The principal instruments to combat money laundering and the financing of terrorism are:

- *Proceeds of Crime Act*, 1997 which defines the scope of predicate offenses; an amendment Act which extends the scope of predicate offenses to include the proceeds of all indictable offenses (including fiscal offenses); and *Proceeds of Crime (Money Laundering) Regulations*, 1998, which provide for customer due diligence, record keeping, and suspicious activity reporting;
- Guidance Notes on the Prevention of Money Laundering, 1998, which substantiate the provisions in the Regulations; and Guidance Notes on the Prevention of Money Laundering (Fiscal offenses) 2001;
- *Criminal Justice (International Cooperation) (Bermuda) Act*, 1994, which provides for mutual legal assistance between Bermuda and other countries and territories; and
- *Terrorism (United Nations Measures) (Overseas Territories) Order*, 2001, which criminalizes financing of terrorism as an offense.

### III. STRENGTHS AND VULNERABILITIES IN THE FINANCIAL REGULATORY AND SUPERVISORY ARRANGEMENTS

16. This section gives a brief summary of the findings of the assessments as regards the banking, insurance, securities sectors, and the AML/CFT regime. It also describes the legal arrangements governing the company and company service provider sector and draws together sectoral conclusions on cross-border cooperation and information sharing.

#### A. Banking and Securities

17. **BMA employs a risk-focused approach to on-site supervision**, identifying those areas of higher risk in banks, and deploying on-site resources to reviewing closely how banks manage those risks. Its prime strategic supervisory focus, nevertheless, is moral suasion, supported by extensive sanctions. The BMA utilizes a series of meetings conducted with senior management throughout the year to discuss financial performance, strategic plans, and

supervisory issues, and to articulate requirements for implementing corrective measures where needed. BMA uses external auditors to supplement on-site work, by validating prudential returns and potentially carrying out special audits or investigations as requested by BMA.

18. **The supervisory and regulatory framework complies well with the Basel Core Principles.** There is some concern about the possible risk to operational independence arising out of the ministerial power to give directions to the BMA and to approve the budget. However, the ministerial power of direction is expressly constrained such that directions cannot be inconsistent with the BDCA. Enhancements to on-site and off-site supervision, which will require some further increase in staffing are necessary.

19. **The regulatory framework and practice in the securities sector is largely sound.** The BMA has focused on market intermediaries and collective investment schemes—and in a short period of time has established a strong licensing and inspection system. The assessment against the IOSCO Principles noted that additional staff training would enhance the BMA's current program. Proposed changes to legislation will address outstanding concerns with respect to licensing, sanctioning and inspection authority.<sup>11</sup> Collective investment scheme rules need further refinement in certain aspects—generally to reflect requirements that are imposed in practice.

20. **Issuer regulation should be centralized and greater focus given to enhanced shareholder protection rules.** The proposed criminalization of insider trading and market manipulation should be supplemented with an insider transaction reporting system.<sup>12</sup> The BSX plays an important role, both as a systems operator and a regulator. This should be supported with closer oversight by the BMA and the development of BMA staff skills in the area of trading systems, issuers, and clearing and settlement.

## **B. Insurance**

21. **Some deficiencies were noted in the assessment against the IAIS Core Principles. While the BMA has broad powers to supervise the sector, these are not fully exploited.** The BMA carries out its supervisory functions in close cooperation with the insurance industry. This is especially evident in the licensing process, where the Authority utilizes an Insurers' Admission Committee, a sub-committee of the Insurance Advisory Committee (IAC), to provide recommendations to the supervisor on new licensees. Supervisory objectives include financial stability and soundness of financial institutions but do not consider policyholder protection, although its materiality is limited to a relatively small group, given the size of the consumer market.

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<sup>11</sup> These issues were addressed in the IBA/03 which came into effect in January 2004.

<sup>12</sup> The authorities have reported that subsequent to the mission amendments to the criminal code have criminalized insider trading and market manipulation.

22. The assessment of the regulatory system indicates that a level of oversight appropriate to the sophistication of the industry could be achieved through explicit outsourcing. The supervisor should set more detailed financial rules, requiring detailed information from the industry and establishing stricter requirements on assets and liabilities, introduce additional verifications on the data provided by the companies, and institute a differentiated approach for domestic insurance. Providing the supervisor with greater responsibility for setting corporate governance rules could also be a useful addition to the system. Box 3 describes the regulated structure.

### Box 3. Regulating and Assessing Corporate Insurance

#### Regulated structure

Bermuda's insurance sector is unique in that it is primarily comprised of international insurers including single owner captives, insurers providing cover for sophisticated players, and reinsurers. There is also a small domestic market. Regulations allow for the following classes of insurer:

Class 1: a single-parent captive

Class 2: a single-parent captive where at least 80 percent of net premiums is written for persons related to the owners, or a multi-owner captive underwriting only the risks of their parents or affiliates;

Class 3: an insurer not registrable as Classes 1, 2, or 4

Class 4: requires statutory capital and surplus of \$100 million or more, and explicitly excludes captives registrable as Classes 1 or 2. This class includes all reinsurers underwriting excess liability insurance and property catastrophe reinsurance.

Long-term: insurer registered for long-term business only.

Any of Classes 1 through 4 may register to carry on only general business, or both long-term and general (composite) insurance business. In 2001 the relative size of the classes in the overall market can be inferred from their gross premiums:

Bermuda: Insurance Industry, 2001

	Gross Premiums, 2001		
	Number 1/	(in million dollars)	(percentage)
<b>Insurers</b>			
By Regulatory Group			
Class 1	387	2,085	4.30
Class 2	448	6,386	13.19
Class 3	522	26,038	53.77
Class 4	31	10,208	21.08
Long-term only	148	3,707	7.66
Total	1,536	48,423	100.00
<i>Of which</i> , domestic			
General Business	6	169.2	0.35
Long-term Business		115.3	
		53.9	

Source: Bermuda Monetary Authority, Supervision Department

Notes: All classes include long-term insurers.

1/ The total companies here reflect registered (licensed) companies rather than all incorporated entities.

Class 3 is the single largest group in terms of gross premiums, followed by Class 4. Any of the classes may include reinsurers. Domestic insurance is also offered by non-resident insurance undertakings.

Box 3. Cont'd

The Basis of Insurance Assessment

Discussions with the industry indicate that both Classes 3 and 4 include direct insurers; although many such insurers in Class 3, and all in Class 4 deal, only with large, knowledgeable corporate clients. Class 3 includes a range of company types: small commercial insurers that do not write excess liability insurance or property catastrophe reinsurance, single-parent captives where more than 20 percent of net premiums written is from risks unrelated to the business of their owners, multi-owner captives writing third-party business and protected cell captives.

Jurisdictions' approach to the regulation and supervision of reinsurers varies. It is widely agreed that important segments of the IAIS Core Principles, particularly those concerned with market conduct, are not directly applicable to reinsurance, and their applicability to captive insurance has been questioned. However, there appears to be convergence towards agreement that reinsurance should be supervised. In October 2002, the IAIS adopted principles on minimum requirements for supervision of reinsurers, noting that single-parent or group reinsurance captives may not pose the same risk as do other reinsurers and may therefore be separately regulated. The IAIS currently provides no other guidance on the treatment of captives. The IAIS is currently revising its core principles to explicitly include reinsurers, and the European Union is developing a directive on the subject.<sup>1</sup>

Bermuda has been in advance of this movement since they have regulated reinsurance since 1978, adopting a single regulatory framework for the entire sector, differentiating in 1995 among groups by risk-based regulatory requirements with regard to minimum capital and surplus, reporting requirements, and inspections, which are increasingly demanding as one moves from Class 1 to Class 4.

In view of the important component of direct insurance and the uniform regulatory regime applied by Bermuda, the mission used the 2000 IAIS Core Principles as the basis for assessing the regulation imposed by the Bermudian system, taking simultaneous account of the unique features of the Bermudian system. It was clear, for example, that the market conduct provisions of the ICP would be of limited applicability.

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<sup>1</sup>The revised IAIS Core Principles were approved in October 2003.

### C. Anti-Money Laundering and Combating the Financing of Terrorism

23. **Bermuda has a generally adequate legal framework to combat ML and FT, and the infrastructure is relatively well-developed for the implementation of its AML/CFT framework.** ML is criminalized on the basis of the Vienna Convention and the scope for predicate offenses extends to all indictable offenses. The BMA undertakes its oversight in relation to AML/CFT through on- and off-site surveillance mechanisms. A number of its staff have received specific training to assist them in undertaking these functions. The assessment found that more substantial legislation against FT should be introduced, and that the FIU will need to be strengthened in terms of resources and personnel if it is to carry out its investigative and intelligence responsibilities more effectively. The framework for introduced business and insurance oversight was felt to be in need of further refinement and development to minimize the risk of potential abuse.

#### **D. Companies and Company and Trust Service Providers**

24. **Corporations in Bermuda are subject to a high degree of oversight on entry, a feature of some offshore financial centers.** Responsibilities relating to the approval of companies seeking incorporation are shared between the BMA and the Ministry of Finance. The BMA initially processes and vets all applications in connection with the incorporation of companies. This process includes verifying an applicant's personal details and general background checks. In the case of a company proposing to conduct restricted activities, the BMA then makes a recommendation to the MOF whose ministry undertakes a further review of the application. The Companies Act, 1981, lays down a series of requirements regarding physical presence, board composition, and resident representatives or officers for corporations.

#### **E. Cross-Border Cooperation and Information-Sharing**

25. **Overall, appropriate legal provisions and gateways exist for information-sharing and cooperation with foreign authorities.** The Insurance Act and the Investment Business Act would benefit from amendment or clarification with respect to the sharing of client information. Proposed amendments to the IBA will address information sharing specific to the securities sector.<sup>13</sup>

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<sup>13</sup> The issue of information sharing has been addressed in Sections 78–81 of the IBA/03.

## IV. OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARIES

### A. Basel Core Principles<sup>14</sup>

#### **Institutional and macroprudential setting, market structure—overview**

26. Bermuda has a small number of licensed deposit-taking institutions. The legislation provides for two types of license—a full banking license and a deposit company license. A banking license requires the institution to provide certain minimum services to the public in Bermuda, including current accounts, several other types of deposit accounts, various types of credit facilities, and foreign exchange services. Deposit companies are specialized local mortgage lenders, whose deposit liabilities are restricted to savings or other similar types of deposit accounts.

27. Currently, there are four licensed banks and one deposit company. Two of the banks have extensive international operations. Overall, Bermuda's banks are established in 15 jurisdictions and have combined total assets of \$18.7 billion for the year ending December 31, 2002. For the two larger internationally active banks in the system, fee income derived from trust and related services, investment services and foreign exchange, exceeds 50 percent of revenue.

28. Overall, Bermudian banks continue to perform well, principally because of the high profitability of non-traditional banking services. Their earning capacity continues to underpin capital growth, enabling aggregate capital to remain at strong levels.

29. Liquidity risk is closely monitored by the BMA, especially since there is no lender of last resort or deposit insurance mechanism. The banks maintain highly liquid balance sheets, with limited appetite for traditional bank lending products and extensive portfolios of high quality marketable securities. As of December 31, 2002, aggregate loans and advances represented only 22 percent of total assets.

30. The banking market has been protected for many years largely because of concern over the potential impact of additional competition on the existing major banks, which are also substantial local employers. Until recently, all banks have been required to be local institutions, at least 60 percent owned by Bermudians. This restriction is now lifted on a case-by-case basis, opening the way to majority foreign-owned banks. However, the legislation still provides only for the licensing of local companies, not branches of foreign banks, and requires banks to provide certain core retail products to the domestic market.

31. BMA's supervision responsibilities have increased dramatically during the past few years. Its corporate governance structure has adapted to, and has been able to accommodate, the growing workload and maintain effective management oversight and control of its

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<sup>14</sup> The assessment was undertaken by Marcel Maes and Joel Shapiro (MFD Experts).

operations. Noteworthy is the initiation of a risk-focused on-site examination program, greater emphasis on corporate governance issues in its banks, and the issuance of policy statements describing BMA's approach to various aspects of the prudential manner licensing criterion.

## **Main findings**

32. Prudential regulations and powers are strong and the supervisory process, in general, is effective. This opinion is supported by the fact that all core principles were considered to be compliant or largely compliant.

33. There are two issues that predominate. The first issue relates to the independence of BMA. The MOF may give BMA general policy directions, which are not inconsistent with the provisions of the BDCA as to the performance of its functions. While this power has never been exercised in the past, its existence may create the impression that the BMA's independence is not fully established. The mandatory budget-approval process may reinforce this interpretation. Consideration should be given to a review of legislation dealing with the concern that the MOF's policy direction and budgetary approval powers may intrude on the performance of BMA's functions.

34. The second issue is that some further enhancements to on- and off-site supervision must be made, especially in specialized areas of on-site supervision and to fully exploit data collected in off-site supervision. An increase in supervisory resources will be necessary to accomplish this. Unless BMA staffing or use of outside expertise is expanded, the progress made to date will be difficult to sustain, and the Authority would not be able to address in an effective manner the mandate envisioned going forward. An in-depth analysis of the supervisory objectives should be undertaken to define the appropriate level of resources and a strategic plan should be developed to implement defined objectives.

## **Principle-by-principle findings**

### ***Objectives, autonomy, powers, and resources (CP 1)***

35. Prudential regulations are sound. CP 1 is divided into six principles with which there is a high degree of compliance. The BMA is to be commended for the actions taken to enhance Bermuda's regulatory regime and its commitment to meeting international standards.

36. The MOF's powers to give direction to the BMA and the MOF's required budgetary approval have the potential of intruding on the operational independence of the BMA. Consideration should be given to a review of legislation dealing with the concern over this issue.

37. The need for additional resources in the banking supervision function must also be addressed in light of further enhancements that are required.

***Licensing and structure (CPs 2–5)***

38. An effective licensing authority is in place supplemented by fair and equitable criteria to ensure a consistent approach, and is applied to permissible activities and ownership.

***Prudential regulations and requirements (CPs 6–15)***

39. BMA requires licensed banks to maintain an amount of capital commensurate with the nature and scale of their risks. In practice, all Bermudian banks are operating at capital adequacy levels well in excess of required limits, but BMA has not developed a specific market risk calculation to apply against capital to date. BMA reviews the extent to which banks are exposed to market risk as part of its review of bank systems and internal controls, and acknowledges that the current proxy system for market risk will have to be replaced.

40. For the past two years, BMA has devoted considerable attention to the review of banks' adherence to the requirements imposed on financial institutions under laws and regulations governing anti-money laundering initiatives, and it has been one of the aspects of on-site examinations scrutinized closely.

41. BMA is engaged actively in ensuring that the banks under its supervision have satisfactory policies and practices regarding the credit granting process and for investment decisions. On-site examinations are designed to assess the credit risk management program, including the credit granting program, overall asset quality and the adequacy of loan loss reserves, control of large exposures and connected lending. BMA relies principally on external auditors to assess asset quality and the level of loan loss reserves. BMA determines the adequacy of management controls on large exposures and connected lending through on-site visits and the review of prudential returns for compliance. Prudential reporting of connected lending by banks needs to be enhanced and further enhancements to corporate governance in this area are warranted. BMA examiners also should undertake independent reviews of the adequacy of the banks' internal loan rating systems.

42. The use of prudential returns to monitor the level of country risk carried by banks is under study by BMA at present, and movement to review these exposures more closely is under way.

43. BMA also should consider augmenting on-site examination techniques and practices pertaining to market risk, interest rate risk, financial derivative instruments, and information technology. With an increase in outsourcing of bank operations actively under consideration, there is a need for BMA to issue a policy statement outlining prudential safety and soundness standards banks must consider in their outsourcing initiatives.<sup>15</sup>

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<sup>15</sup> Subsequent to the mission the authorities developed a policy on outsourcing and report that the policy has been implemented.



44. BMA reviews internal control systems as part of the on-site examination program. BMA examiners test the efficacy with which they are performed and adherence to policy and procedure. External auditors, in connection with their annual audit and certification of a bank's financial statements, reach an opinion on whether the internal control system is adequate for the nature and scale of the bank's business.

***Methods of ongoing supervision (CPs16–20)***

45. BMA has established a risk-focused on-site supervision program. On-site examinations are based on BMA's analysis of risk in each institution derived from information analyzed from internal and external audit reports, meetings with management that are held at least three times per year, and data obtained from prudential reports. BMA conducts on-site examinations at branches and subsidiaries of its banks located overseas, promotes cooperative arrangements, and exchanges of information with host country supervisors.

46. While the off-site supervision function performs a degree of analysis of prudential returns, the available information has not been as fully exploited as possible in a proactive manner. An upgraded information technology platform would enable BMA staff to more readily analyze banking system performance, follow trends in individual banks, and compare the performance of the two larger banks as an informal peer group.

47. BMA supplements its on-site supervision program with a series of meetings held annually with senior management of each bank. The meetings are held to review financial performance, market conditions, supervisory issues, and strategic plans. Additional meetings are held with external auditors and with the officers in charge of overseas locations.

48. BDCA requires external auditors to certify the financial statements of each Bermudian bank on an annual basis and to verify the accuracy of data submitted on prudential returns on a sample basis.

***Information requirements (CP 21)***

49. BMA has established requirements for adequate accounting, records and internal control systems, and as part of its evaluation of risk management systems, determines whether each bank has satisfactory accounting processes and internal control systems. BMA also analyzes management's ability to identify, measure, monitor, and control risk.

***Formal powers of supervisors (CP 22)***

50. BMA has the legal authority to restrict bank activity, a license, or to revoke a bank license. BMA also has powers to object to potential controllers or shareholders of banks and to existing controllers or shareholders. In practice, BMA seeks remedial action through informal means, principally through the use of moral suasion.

51. An additional legal provision that BMA should have in its supervisory arsenal is direct intervention tools in the event of an impending bank failure. The enactment of such legislation by the government would provide for an important modern legal tool and would serve to safeguard the interests of depositors.

***Cross-border banking (CPs 23–25)***

52. BMA practices consolidated supervision globally by undertaking on-site examination of the branches and subsidiaries of Bermudian banks located overseas, engaging in on-going dialogues with host country supervisors on a range of issues related to Bermudian banks in the host country jurisdictions, requiring most prudential returns to be prepared and reported on a consolidated basis (incorporating the activities of overseas locations), and having financial statements of its banks audited on a consolidated basis.

53. The dialogue with host country supervisors concerns specific offices of Bermudian banks, the overall framework of supervision in which the banking group operates, and significant supervisory problems, if they occur. While the exchange of information can be governed by a memorandum of understanding, most dialogues are conducted informally.

Table 2. Recommended Action Plan to Improve Compliance the Basel Core Principles

Reference Principle	Recommended Action
CP 1.2 Independence	<p>The MOF’s powers to give directions to the BMA and the budgetary approval procedure have the potential of intruding on the operational independence of the latter. It is recommended that the law be reviewed to deal with the concern that the MOF’s policy direction and budgetary approval powers may intrude on the performance of BMA’s functions.</p> <p>An in-depth analysis of the resources required to fulfill the supervisory objectives is recommended, together with an action plan describing implementation of the objectives.</p>
CP 6 Capital adequacy and CP 12 Market risk	Envisage the replacement of the present proxy system for trading risk by a more appropriate capital requirement system.
CP 8 Loan Evaluation and Loan Loss Provisioning	BMA relies principally on external auditors to evaluate the quality of assets and the adequacy of provisioning. BMA should consider undertaking its own independent evaluation of a bank’s internal loan rating system to gain insight on implementation of credit risk management policies and, management’s ability to manage and monitor outstanding credit risk.
CP 10 Connected Lending	BMA should enhance its current policy addressing connected lending by ensuring that banks have satisfactory means to monitor and control these relationships. BMA examiners should routinely review these relationships as part of the on-site examination program.

Reference Principle	Recommended Action
CP 11 Country Risk	BMA should establish a formal reporting methodology to facilitate the monitoring of country risk exposure in its banks.
CP 13 Other Risks	BMA should consider augmenting on-site examination techniques and practices designed to confirm the existence and application of an effective and comprehensive risk management process for interest rate risk and financial derivative instruments, and the adequacy of information technology systems. Issuance of a policy on outsourcing of bank operations also should be considered. <sup>16</sup>
CP 16 On-site and Off-site Supervision	The maintenance of adequate staff resources remains critical in view of the bank supervision mandate assigned to BMA. Some further increase in the number of professionals and the breadth of their expertise should be considered. A comprehensive examination manual reflecting bank supervision policy and examination procedure is warranted to preserve current examination practice, reflect BMA bank supervision policy and ensure continuity in application of procedures as staffing changes. A more standardized regimen to document examination conclusions also is warranted by adopting a more formalized system of working papers reflecting the work performed during on-site examinations.
CP 18 Off-site Supervision	BMA should consider enhancing the off-site supervision function by analyzing the data obtained in prudential returns more fully, in addition to utilizing the data for checking compliance with law and regulation. The data can be used to compare performance of the banks in the system, analyze trends, and to create an early warning system.
CP 19 Validation of Supervisory Information	It would be useful for BMA to employ the provisions of Section 39 of BDCA more widely as a means to increase synergies with external auditors. BMA could request external auditors to perform additional work to complement BMA's examination regimen in capital markets activities, information technology, or in other predetermined areas. This would enable BMA to capitalize on strengths the auditing firms have in disciplines such as information technology, and permit BMA to allocate its examination resources still more efficiently.

<sup>16</sup> Subsequent to the mission the authorities developed a policy on outsourcing and report that the policy has been implemented.

Reference Principle	Recommended Action
CP 22 Remedial Measures	Legislation providing BMA with more direct intervention tools in the event of an impending bank failure should be enacted by the Bermuda government. BMA also should consider communicating examination results and efforts to enforce compliance with the prudential manner standards to each Bank's Board of Directors or its Audit Committee. <sup>17</sup>

### **Authorities' response**

The BMA welcomes the assessors' recognition of the quality of Bermuda's banking legislation, the effectiveness of the supervisory framework that has been put in place and the resulting high degree of compliance with the relevant international standards. Bermuda's provisions are kept under regular review to ensure that they remain adequate. Currently, the BMA (in common with banking regulators in many other jurisdictions) is engaged with the banking industry in a detailed review of aspects of the current approach as part of its preparations for implementing the Basel II capital accord framework on which international agreement has recently been reached. The assessors have endorsed the BMA's view that the present supervisory framework offers a strong foundation which can continue to be adapted and developed to provide the types of enhancements that will be required in the future. The BMA has reviewed with great interest the specific recommendations of the assessors for enhancements to current processes. As part of its consultation with industry on the continuing development of the supervisory framework, therefore, the BMA will be advancing particular proposals intended to deal with various of the matters identified by the assessors as warranting some further enhancement.

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<sup>17</sup> The authorities have reported that the practice of communicating exam findings and compliance actions to members of the banks' boards of directors was adopted subsequent to the mission.

## **B. FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism**

### **Introduction**

54. This report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations Combating the Financing of Terrorism* was prepared by a team composed of staff of the International Monetary Fund, an expert under the supervision of the Fund, and an expert not under the supervision of the Fund who was selected from a roster of experts in the assessment of criminal law enforcement.<sup>18</sup> The report provides a summary of the level of observance with the FATF 40+8 Recommendations, and provides recommendations to strengthen observance.

### **Information and Methodology used for the Assessment**

55. In preparing the detailed assessment, Fund staff and the expert under the supervision of the Fund reviewed the relevant AML/CFT laws and regulations, and supervisory and regulatory systems in place to deter money laundering and the financing of terrorism among prudentially regulated financial institutions. The expert not under the supervision of the Fund reviewed the capacity and implementation of criminal law enforcement systems. The assessment is based on the information available at the time it was completed on March 28, 2003.

### **Main Findings**

#### **Criminalization of ML and FT**

56. Bermuda has a generally adequate legal framework for addressing money laundering and the financing of terrorism (ML and FT). ML is criminalized on the basis of the Vienna Convention and the scope for predicate offenses extends to all indictable offenses. FT is criminalized as an offense by way of an Order in Council extended by the UK to its Overseas Territories, which gives effect to the provisions of the UN Security Council Resolution 1373. Whilst the Order is directly applicable in Bermuda, it was extended by the UK with a view to broader application to the Overseas Territories in relation to criminalizing FT and is less substantial than a domestic CFT legislation that seeks to give effect more fully to the requirements of international conventions and treaties for Bermuda. The Terrorism Order does not include provisions that deal with seizure and confiscation of property that is the proceeds of, or are to be used for terrorism, terrorist acts or acts by terrorist organizations. At

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<sup>18</sup> Ian Carrington (MFD), Cheong-Ann Png (Consultant LEG), Assistant Superintendent Erwin Boyce (IAE). The comments of the IAE appear in italics.

the time of the mission terrorism, per se, was not a criminal offense. However, work was underway with a view to introducing legislation in this regard.<sup>19</sup>

### **Confiscation of proceeds of crime or property used to finance terrorism**

57. The legal framework provides for a range of enforcement measures, such as confiscation and restraint orders as well as production and monitoring orders; although, there is less emphasis on non-criminal measures, such as civil forfeiture and penalties.

### **The Financial Investigation Unit (FIU) and processes for receiving, analyzing, and disseminating intelligence at the domestic and international levels**

58. The FIU is established as a part of the Police and is a member of the Egmont Group. The requirement under the PCMLR is for reporting officers (“MLROs”) of Regulated Institutions to file SARs to a police officer and not necessarily a police officer of the FIU. The Guidance Notes indicate that SARs should be filed with the FIU and that communication with respect to the SARs should also be undertaken with the unit.

59. *The FIU is a small unit and has a complement of four officers plus a constable on secondment from the United Kingdom. It has been given the responsibility not only to investigate money-laundering offenses and deal with proceeds of crime matters but also the responsibility to receive, collate, analyze, and investigate reports of suspicious activity made by regulated institutions in accordance with the Act. To this end, it also has the ability to obtain production and monitoring orders inter alia and is called upon to assist with the investigation of requests from international FIUs.*

60. *The FIU maintains the statistics to show inter alia the number of SARs received, investigations carried out, and cases realized. Since the creation of the unit, it has received in excess of ten thousand SARs according to the statistics and has developed nine money-laundering matters. Most of the SARs relate to small-scale money transmission cases. It can account for, trace, and show the status of all reports received.*

61. *The high level of SARs filed has resulted in a situation in which the focus within the unit has been skewed towards ensuring that the information is collated and entered into the data base. Presently, the situation at the FIU is not very effective as much of the time at the unit is spent in data entry activities and responding to the reporting institutions. Notwithstanding, there have been nine investigations for money-laundering offenses and four confiscation orders.*

62. *As presently constituted, the resources are inadequate to perform the roles of an intelligence and investigative unit. The head of the unit has recognized the dilemma and has*

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<sup>19</sup> Subsequent to the mission a bill which addresses a number of the above-mentioned deficiencies was laid before Parliament.

*tendered for consideration a model for an increase in staff. The model has been accepted and additional staff is forthcoming.*

63. *While all the members of the unit have been exposed to some training in financial investigation, further training is desirable. Consideration should be given to conducting awareness raising programs for prosecutors and the judiciary. There is the need for refresher training at the office of the DPP.*

#### **Law enforcement and prosecution authorities, powers and duties**

64. The legal framework supports information sharing, extradition, and limited mutual legal assistance. In the case of mutual legal assistance, the extent of assistance is more limited to the scope of serving of processes, calling of witnesses and obtaining evidence, and does not extend to facilitating the enforcement of measures such as search and seizure. The authorities work with foreign authorities in cooperative investigations and information sharing.

65. There is no general secrecy law in Bermuda and the common law on customer confidentiality does not limit disclosure of information where relevant, such as pursuant to the public interest. Regulations and guidance notes are in place, the scope of which could be extended further than the range of financial institutions that are currently regulated, such as in the case of those insurers that are presently excluded under the regulations and professionals such as accountants and lawyers.

#### **66. Principal Areas of Concern**

- A more substantial CFT legislation would be necessary for giving effect more fully to the requirements of international conventions and treaties.
- Establishing the FIU as the competent authority and stating its powers more explicitly, would strengthen its position and function.

#### **Preventive Measures for Financial Institutions**

67. Bermuda has a relatively well-developed infrastructure for the implementation of its AML/CFT framework. The National Anti-Money Laundering Committee (NAMLC) serves in an advisory capacity to the MOF on matters related to money laundering and issues relevant guidance from time to time. Its principal initiative has been the issuance of the Guidance Notes on the Prevention of Money Laundering (Notes) in January 1998. The Notes are applicable to most prudentially regulated institutions. Other guidance that has been issued includes notices urging that caution be exercised in conducting business with NCCT jurisdictions.

68. The Bermuda Monetary Authority has regulatory responsibility for licensed entities in the sectors of banking, insurance, investment, and trust activity. The BMA also plays a critical role in the registration of companies. It undertakes due diligence in respect of

beneficial owners of all entities seeking to be registered and, in the case of licensed institutions, extends its investigations to include directors and senior executives. These extensive processes represent an important first line of defense against the possible abuse of Bermuda financial institutions for the purposes of money laundering or terrorists financing.

69. Apart from its registration role, the BMA undertakes oversight in relation to AML/CFT through on-site surveillance mechanisms. A number of its staff have received specific training to assist them in undertaking these functions. The BMA is also represented on NAMLC. Over the last two years, the BMA's on-site visits to banks and investment firms have covered AML/CFT risks.

70. The BMA does not conduct on-site visits to insurance entities. Such visits are undertaken by auditors on behalf of the BMA. The authority does not give guidance to the auditors in respect of aspects of AML/CFT risk to be assessed during visits, and to date, no assessments of insurance entities have addressed this risk. This absence of any oversight of insurance entities in respect of AML/CFT risks is considered to be a weakness in the BMA's surveillance activities. While the initial due diligence undertaken by the BMA is comprehensive, it needs to be supplemented by on-going regulatory initiatives to create an effective AML/CFT regime.

71. Bermuda has in place a regime which allows licensed institutions to accept business from "reliable introducers." Such introducers are required to meet the definition of regulated institution/foreign regulated institution as defined in the Proceeds of Crime (Money Laundering) Regulations 1998, and must be from a country listed in Appendix A to the Notes. With the exception of Guernsey, the Isle of Man, and Jersey, all of the countries on the list are members of the FATF. The Notes indicate that institutions are not required to verify the identity of customers where the relationship originates through a reliable introducer. The introducer is, however, required to complete an introduction letter, which among other things requires confirmation that the customer's identity has been verified. The fact that verification documents may not at all times be immediately available to a Bermuda institution, represents a degree of vulnerability in customer-due-diligence arrangements. At the time of the mission a further concern was that an eligible introducer certificate appearing in an Appendix to the Notes offers an option in which the introducer does not have to assert that identity verification documents are held and will be available on demand. Subsequent to the mission, the authorities amended the sample certificate to address this concern. The introduced business regime is among a number of issues currently under review by the authorities.

72. Both the IBA and the BDCA include a definition of fit and proper which includes "a conviction or finding of guilt in respect of any criminal offence other than a minor traffic offence." Using this approach, the law sets out clearly the types of persons that are considered ineligible to participate in the ownership and management of licensed institutions. The concept of fit and proper is, however, not included in the IA, and this issue is therefore not addressed as clearly and unambiguously in this legislation.



### **Other Non-prudentially Regulated Sectors**

73. Bermuda's only money service business was run under an agency arrangement by a commercial bank. Since the activity was undertaken by a commercial bank, it came under the purview of the BMA. The agency arrangement was recently terminated, and there is currently no significant activity in this area. The agency was the principal source of the very large number of SAR's reported to the FIU.

74. Trust companies and other persons undertaking trust business under the Trusts (Regulation of Trust Business) Act 2001, are captured by the definition of regulated institution under the PCMLR. There are currently no regulatory arrangements in place for company service providers, nor are they captured by the PCMLR.

75. The PCMLR does not cover persons captured by the Investment Business (Exemption) Order. While this is acceptable in respect of persons who do not act as intermediaries or deal directly with client assets it is not clear that that all exempt persons fall into this category. The PCMLR should be reviewed to ensure that all persons who act as intermediaries or deal in client assets are captured by the legislation and the BMA's supervision in respect of AML/CFT.

76. **Principal Areas of Concern :**

- the lack of on-site surveillance of the insurance sector in respect of AML/CFT risk is unsatisfactory; and
- the regime for introduced business creates some potential vulnerability in the KYC arrangements.

77. The planned update of the notes should provide further guidance on the requirements set out in the law and regulations on a number of issues including the following:

- details of transaction records (other than those necessary to identify the customer ) that should be maintained by banks and deposit taking institutions for the purpose of assisting money laundering investigations; and
- guidance in relation to shell companies, charities, and not-for profit organizations.

### **Summary Assessment against FATF Recommendations**

78. Bermuda has a relatively comprehensive legal and institutional AML/CFT framework with good levels of compliance amongst regulated institutions. This assessment however, makes a number of recommendations for further strengthening of the framework. Table 1 summarizes actions required in relation to the FATF 40+8 Recommendations, while Table 2 highlights other recommendations arising from criteria of the AML/CFT Methodology.

Table 3. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
<b>40 Recommendations for AML</b>	
General framework of the Recommendations (FATF 1-3)	Authorities should incorporate more specific provisions for mutual legal assistance in enforcement matters, such as powers of search and seizure.
Scope of the criminal offense of money laundering (FATF 4-6)	The authorities may wish to consider whether to incorporate an objective test to the mens rea requirement for the money laundering offenses under Section 43(1) and 45(1) (and Section 44(1) offense).
Provisional measures and confiscation (FATF 7)	<p>Consideration should be given to introducing provisions for civil forfeiture.</p> <p>Consideration could be given to incorporating relevant provisions for rendering contracts void or unenforceable on the basis that parties to the contracts knew or should have known that authorities would, as a result of the contracts, be prejudiced in their ability to recover financial claims under the AML/CFT regime.</p>
General role of financial system in combating ML (FATF 8-9)	The authorities may also wish to revise the reference to insurers under Regulations 2(2)(a)(iv) of the PCMLR to clarify the category of insurers that is treated as regulated institutions and therefore subject to the PCMLR (and the Guidance Notes). The PCMLR should be reviewed to ensure that all persons conducting investment business who act as intermediaries or deal in client assets are captured by the legislation. Such persons should also be covered by the BMA's supervision in respect of AML/CFT.
Customer identification and record-keeping rules (FATF 10-13)	<p>The PCMLR should be amended to explicitly require that customer identification procedures be followed by the regulated institutions. Moreover the authorities should require financial institutions to (i) identify their customers on the basis of official or other identifying document; (ii) record their customers' identity when establishing business relations; (iii) identify and record the identity of their occasional customers when performing transactions over a specified threshold; and (iv) renew identification when doubts appear as to their identity in the course of the business relationship.</p> <p>Consideration could be given to amending the framework for introduced business to require that documentation pertaining to customer identity should be made available by the introducer to the financial institution without delay.</p> <p>The BMA should impose a requirement for originator information to remain with transfers or related messages through the payment chain within the deadline established by the FATF.</p>

Reference FATF Recommendation	Recommended Action
Increased diligence of financial institutions (FATF 14-19)	<i>There is need to assign adequate resources to the intelligence/investigative units, and there must be clearly defined roles; that is, a team for specific data entry and basic information gathering and a team of investigators for the sole purpose of investigating matters and enabling prosecutions.</i>
Measures to cope with countries with insufficient AML measures (FATF 20-21)	The Regulations should be revised to require that licensees should report to the BMA instances in which foreign branches or subsidiaries are unable to apply AML/CFT standards/requirements that are measures equivalent to those required in Bermuda.
Administrative Cooperation – Exchange of information relating to suspicious transactions (FATF 32)	The authorities should incorporate more specific provisions for mutual legal assistance in enforcement matters, such as powers of search and seizure.
Other forms of cooperation – Focus of improved mutual assistance on money laundering issues (FATF 36-40)	The authorities should consider introducing express provisions for the ML offense as an extraditable offense.
<b>8 Special recommendations on terrorist financing</b>	
II. Criminalizing the financing of terrorism and associated money laundering	Authorities should expedite current initiatives to introduce provisions for terrorist offenses per se and related matters.
IV. Reporting suspicious transactions related to terrorism	<p>The authorities should incorporate provisions pertaining to FT at appropriate aspects of the PCA, the PCMLR related laws and regulations and the NAMLC Guidance Notes. The Authorities should indicate that the FIU is the appropriate body for receiving SARs and dealing with financial information and intelligence in relation to ML and FT (as discussed under Criterion 17).</p> <p>The authorities should extend the scope of Section 46(1) of the PCA to include FT and specifying the disclosure to be made to the FIU.</p> <p>The authorities should extend the scope of Section 47 of the PCA to include FT.</p>
V. International Cooperation	<p>Authorities should incorporate more specific provisions for mutual legal assistance in enforcement matters, such as powers of search and seizure.</p> <p>The authorities should consider introducing express provisions for the FT offense as an extraditable offense.</p>
VII. Wire transfers	The BMA should impose a requirement for (i) originator information to remain with transfers or related messages through the payment chain within the deadline established by the FATF. and (ii) introduce a requirement to give enhanced scrutiny to wire transfers that do not contain complete originator information within the deadline established by the FATF.
VIII. Non-profit organizations	The revised notes should provide guidance in relation to charities and not-for profit organizations.

Table 4. Other Recommended Actions

Reference	Recommended Action
I—Criminalization of ML and FT	The authorities may wish to consider whether civil sanctions for ML and FT are suitable for the jurisdiction.
II—Confiscation of proceeds of crime or property used to finance terrorism	<p>The authorities may wish to consider whether to introduce provisions for civil forfeiture. The scope for the application of Section 39(1) of the PCA should extend to investigation of relevant offenses as defined under the PCA and not merely with regard to drug trafficking offenses, whether a person has benefited from criminal conduct and the whereabouts of any proceeds of criminal conduct.</p> <p><i>There is a need to limit access to the data base to FIU personnel only.</i></p> <p><i>There is the need for refresher training for the staff of the FIU. Consideration should also be given to awareness raising programs for prosecutors and the judiciary. There is the need for investigators to have relevant accreditation. Specific training plans ought to be included in the overall training program and accordingly budgeted for.</i></p>
III—The FIU and processes for receiving, analyzing, and disseminating financial information and other intelligence at the domestic and international levels	<p>The authorities may wish to consider amending the PCA or related legislation to require FIs to send SARs directly to the FIU.</p> <p>The authorities may wish to consider stating more explicitly the powers of the FIU.</p> <p><i>It is recommended that the FIU be allocated separate offices properly secured and in an accessible location to the commercial centre. Authorities indicated that efforts are ongoing to find appropriate accommodation.</i></p> <p><i>While careful dissemination of information is vital, the FIU should endeavor to publish information relating to trends and typologies.</i></p>
IV—Law enforcement and prosecution authorities, powers and duties	<p><i>The FIU needs to enhance its intelligence cell and continue to work with other units. It also needs to build and utilize informants more. The increase in staffing levels should assist in this regard.</i></p> <p><i>Separate provisions must be made in the budget for training.</i></p> <p><i>There is the need to intensify the Police’s awareness of the FIU in order to facilitate further exchange of information.</i></p> <p><i>There is need for clarification in respect of the role the offices of the DPP and the Attorney General play in relation to confiscation, restraining and monitoring orders.</i></p>

Reference	Recommended Action
V—International cooperation	
<b>Legal and Institutional Framework for Financial Institutions</b>	
I—General framework	<p>The limitation to the scope of the PCMLR and the NAMLC Guidance Notes has been recognized in the Consultation Paper; the authorities may wish to consider extending the scope of the PCMLR and the NAMLC Guidance Notes beyond the range of financial institutions that are currently regulated to cover company service providers and professionals, such as accountants and lawyers.</p> <p>The authorities should put in place suitable monitoring arrangements to ensure adequate monitoring of AML/CFT systems employed by these entities.</p>
II—Customer identification	<p>Wording in paragraphs 58 and 68 of the Notes “The relevance and usefulness of the following ... information should be considered” should be amended to more clearly indicate the practices that licensees are expected to follow.</p> <p>The notes should be amended to provide guidance in relation to reverification, PEPS, non face to face customers, and correspondent banking relationships.</p>
III—Ongoing monitoring of accounts and transactions	
IV—Record keeping	<p>The Guidance Notes should be amended to provide guidance in respect of transaction records (other than those necessary to identify the customer) that should be maintained by deposit taking institutions.</p> <p>The authorities could consider revisions to Regulation 5 (2) of the PCMLR to ensure that “business records” as specified in the Regulation is understood to mean all necessary records on transactions for the purpose of FATF Recommendation 12.</p>
V—Suspicious transactions reporting	
VI—Internal controls, compliance and audit	<p>The authorities may wish to consider incorporating provisions for FT at appropriate instances and for requiring Regulated Institutions to audit their compliance processes.</p> <p>The authorities may wish to consider incorporating provisions for the screening of employees under the PCA or the PCMLR.</p> <p>The revised Guidance Notes should provide more detailed guidance on the function of the MLRO.</p>

Reference	Recommended Action
VII—Integrity standards	<p>The authorities should consider incorporating provisions for prohibiting criminals from holding or controlling a significant investment, or holding a senior position, in a financial institution under the PCA or the PCMLR.</p> <p>The authorities should consider incorporating the concept of fit and proper in the Insurance Act to reinforce the vetting procedure that is currently in place and for consistency with the BDCA and the IBA.</p>
VIII—Enforcement powers and sanctions	<p>Whilst the approach seems to be for the respective authorities under the NAMLC (BMA, FIU) to have responsibility for their respective areas in the AML/CFT regime, for instance, the BMA is principally concerned with customer due diligence and record-keeping and the FIU principally concerned with SARs and investigation and dissemination of financial information and intelligence, the authorities may wish to consider empowering the BMA and the FIU with the appropriate powers for enforcement and sanction.</p>
IX—Co-operation between supervisors and other competent authorities	<p>The current initiative by the BMA to review its resources should ensure that resources are adequate to provide for sustained on-site surveillance in respect of AML/CFT as well as all other areas of risk.</p> <p>The BMA should provide specific directions to auditors of insurance entities indicating AML/CFT issues to be examined during on-site examinations.</p> <p>The current initiative to amend the IBA to provide for the exchange of information between the BMA and foreign regulatory authorities for the purposes of discharging the BMA's regulatory function should be expedited.<sup>20</sup></p>

<sup>20</sup> The new IBA came into effect in January 2004.

Reference	Recommended Action
<b>Preventive Measures For Financial Institutions</b>	
General framework	<p>Consideration should be given to extending the scope of the PCMLR and the Guidance Notes beyond the range of financial institutions that are currently regulated to cover company service providers and professionals, such as accountants and lawyers.</p> <p>The BMA should in place suitable monitoring arrangements to ensure adequate monitoring of AML/CFT systems employed by these entities.</p> <p>The BMA should provide specific directions to auditors of insurance entities indicating AML/CFT issues to be examined during on-site examinations.</p>
Customer identification	<p>Authorities should require financial institutions to (i) identify their customers on the basis of official or other identifying document; (ii) record their customers' identity when establishing business relations; (iii) identify and record the identity of their occasional customers when performing transactions over a specified threshold; and (iv) renew identification when doubts appear as to their identity in the course of their business relationship.</p>
On-going monitoring of accounts and transactions	<p>The authorities should require financial institutions to keep available for competent authorities, findings made in respect of complex, unusual large transactions or unusual patterns of transactions that have no apparent or visible economic or lawful purpose.</p>
Record keeping	<p>The authorities should require banks and deposit taking institutions to (i) maintain all necessary records concerning customer transactions, and accounts, for at least five years following completion of the transaction (or longer if requested by a competent authority upon proper authority), regardless of whether the account or business relationship is terminated; and (ii) have these documents should be available to a competent authority.</p>

### Authorities' response

Bermuda welcomes the fact that the assessment has confirmed the robustness of the measures in place to protect our institutions and markets from money laundering and terrorist financing abuses. As the assessment also notes, Bermuda is already engaged in taking steps to introduce further enhancements to its present arrangements, reflecting in particular the revised standards put in place by the FATF in its recent Revised Recommendations, together with the additional Special Recommendations on anti-terrorist financing measures. The necessary changes are being carried forward as a priority, illustrating Government's firm commitment to continuing to meet international standards in its international business and its determination to protect Bermuda's reputation as a high quality financial services centre.

## C. IAIS Insurance Core Principles

### General

79. The assessment of the insurance sector was performed as part of an OFC assessment for Bermuda. The main objectives of the assessment are to determine the levels of observance of the International Association of Insurance Supervisors (IAIS) Principles, and to suggest areas where further development may be appropriate.

80. The differences in focus between the IAIS Principles issued in October 2000, geared towards direct insurance, although in the process of being revised to include reinsurance, and the Bermudian industry, organized around captives, insurance of corporate accounts and reinsurance, have made the assessment more complex. However, the Bermudian legislation is identical for insurance and reinsurance companies. Statistics on the insurance companies (including reinsurance) are not wide-ranging and the Bermuda Monetary Authority (BMA) does not keep statistics on the actions it has undertaken to supervise these companies. However, the industry and the insurance supervision division, through numerous interviews, provided a significant amount of information orally.

81. The review of the IAIS Core Principles involved the analysis of the self-assessment prepared by the Bermuda Monetary Authority on its entire market, comparison with the Core Principles and the Core Principles Methodology, the Standards and Principles already adopted, and a review of the insurance laws and other relevant official documents.

### Institutional and macroprudential setting—Overview

82. In January 2002, the BMA became the regulator and supervisor for all financial services (the supervision of insurance companies was previously with the Ministry of Finance). The insurance industry comprises the largest sector of Bermuda's economy, followed by tourism. The regulatory regime enacted in 1978 was supplemented in 1995 by the introduction of four classes of general business companies (Classes 1 and 2 are captives and Class 4 contains the big commercial reinsurers, the residual being in Class 3). These classes do not distinguish between direct insurance and assumed business. Statistics seen by the mission, which make this distinction, only relate to 29 percent of companies by number and 58 percent by net premiums (in 2001).

83. Bermuda is predominantly an international insurance market that operates as a business-to-business market between sophisticated buyers and sellers of insurance and reinsurance. The industry includes 1,600 incorporated insurers (and reinsurers) (for comparison, there are four banks), with active companies having \$172 billion in assets, and writing over \$48 billion in annual gross premiums in 2001. Their total capital and surplus is \$66 billion. The industry has two main components, captives and reinsurance. Bermuda is the largest captive domicile in the world with approximately 900 active captives (but 1,200 registered) at December 31, 2002. Total gross premiums of captives are \$32.5 billion in 2001; premiums of \$10.2 billion are attributable to professional insurers and reinsurers.



## **General preconditions for effective insurance supervision**

84. The Bermudian insurance industry is supported by a well developed infrastructure that includes management talent, the presence on a large scale of the Big 4 auditing firms, actuaries, accountants, captive insurance company management firms, and legal professionals. Given the small domestic labor pool, many industry professionals are recruited from abroad, usually staying in Bermuda from one to five years. However, many key professionals stay for significantly longer periods. Various professional organizations and advocacy groups exist to support the industry. Since being transferred to the BMA, the insurance division has acquired more flexibility in establishing staff salaries and its budget.

85. Bermuda is a country with a population of 60,000 and 1,600 incorporated insurance companies (1 company per 38 persons) with gross insurance premiums amounting to twelve times the GDP in 2001. At the time of the mission the insurance supervisory staff consisted of 17 persons, 3 of whom were administrative. The authorities have aimed at employing market discipline, together with the use of financial ratios and outsourcing, to monitor the system. However, more effective outsourcing could be accomplished.

86. Subsequent to the mission the BMA has undertaken a number of initiatives to strengthen its regulatory regime for the insurance sector. It has drafted a number of guidance notes together with a supporting amendment to the insurance act, and has increased the staffing of the insurance division to 25 persons directly involved in the supervision of the sector with the recruitment of various skilled professionals including a consulting actuary and a regulatory consultant. In addition, this team is supported by the legal enforcement and policy units. These initiatives are positive steps towards strengthening the regime for insurance sector regulation.

87. In developing the guidance notes the BMA is seeking to provide additional clarity in relation to the roles played by persons who perform important functions in the context of a regulatory regime characterized by a high degree of outsourcing. These include auditors, inspectors, loss reserve specialists, and principal representatives. Bermuda will need to enact supporting legislation to give full effect to the Notes.<sup>21</sup>

## **Main findings**

88. The Bermuda Monetary Authority conducts its supervisory functions in close cooperation with the insurance industry and professionals with expertise in the market. This is especially clear in the licensing process and the reliance on actuaries and independent auditors employed by the insurance companies. The supervisory objectives include financial

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<sup>21</sup> The authorities have reported that the Insurance Amendment Act 2004, which gives the Authority the power to issue Guidance Notes was passed by the Bermudian Parliament 2004.

stability and soundness of financial institutions but do not mention the protection of the policyholder; although, given the nature of the industry, this is of limited materiality. The BMA has broad powers but limitations in staff resources at the time of the mission precluded their full utilization. As noted, previously staff resources have increased since the time of the mission.

89. The regulatory regime is largely reliant on a co-supervisory regime with the industry, employing an annual verification by actuaries and by independent auditors. The BMA should increase its level of oversight by introducing additional verification processes with regard to the data provided by the companies, setting stricter requirements on assets and liabilities, and requiring detailed information from the industry.

Main findings:

- Organization of an Insurance Supervisor—even if independence is not totally achieved, the insurance supervision department has globally adequate powers and is currently striving to raise its staff’s salaries to remain competitive with the private sector.
- Licensing and Changes in Control—the applications for licensing and changes in control are subject to an adequate fit and proper vetting procedure, in close coordination with the industry. However, this close coordination can potentially be a source of conflicts of interest.
- Corporate Governance and Internal Controls—the supervisor has no responsibility for setting corporate governance rules. The supervisor relies on the auditor’s review of internal controls, as part of the generally accepted audit process but does not provide the auditor with explicit terms of reference.<sup>22</sup>
- Prudential Rules—stricter prudential rules restricting assets (including derivatives) and liabilities (including the deduction of reinsurance recoverables) would be valuable. Capital adequacy and solvency appear more strictly regulated, but this is undermined by the deficiencies of asset and liability regulation.<sup>23</sup>

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<sup>22</sup> The authorities have reported that subsequent to the mission they have written guidance notes for corporate governance and internal controls for all insurance companies. As part of the Authority’s enhanced risk assessment framework, insurers’ compliance with these guidance notes will be assessed through off-site and on-site review work.

<sup>23</sup> The authorities have indicated that in order to incorporate the recently adopted IAIS standards for assets and liabilities, the Authority will publish in early 2005 additional guidance for investments, insurance underwriting, and the responsibilities of the actuary and the loss reserve specialist.

- Market Conduct—the approach in Bermuda, aimed at the large-scale international market, does not provide a differentiated treatment for domestic insurance, and does not, in particular, provide significant customer protection for the admittedly very small proportion of insured individuals.<sup>24</sup>
- Monitoring, Inspection, and Sanctions—monitoring and inspection are employed on a very limited scale. The sanction regime is generally sound; although, it should be expanded to include recovery powers and greater flexibility to correct deficiencies in industry conduct when they occur.
- Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality—a legal regime relating to information sharing among relevant agencies, both domestic and foreign, is in place, although it is procedurally complex. Confidentiality of information and legal protections are also in place, both domestic and foreign, is in place; although, it is procedurally complex. Confidentiality of information legal protections are also in place. However, they lack clarity despite strict criminal penalties that attach for their violation.

Table 5. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
<b>Organization of an Insurance Supervisor</b> CP 1	
The insurance supervisor of a jurisdiction must be organized so that it is able to accomplish its primary task, i.e., to maintain efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. It should, at any time, be able to carry out this task efficiently in accordance with the Insurance Core Principles.	The Minister should not have the possibility to give directions to the BMA.  The BMA should continue to improve to improve its IT system and to recruit staff, both of which are priorities. Knowledge of actuarial techniques should be developed in the staff.

<sup>24</sup> The authorities have reported that, with a view to explicitly addressing the IAIS core principle for consumer protection, the Authority has issued a guidance note for market conduct.

Reference Principle	Recommended Action
<p><b>Licensing and Changes in Control</b> CPs 2–3</p>	
<p>Companies wishing to underwrite insurance in the domestic insurance market should be licensed.</p> <p>The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs.</p>	<p>It is recommended that consideration be given to increasing the quorum requirements of the IAC Admissions Committee, completing the project to develop explicit fit-and-proper licensing criteria, and defining in detail the requirements of the business plan. The definition of long-term business should be more precise. Significant changes in ownership of public companies should be formally notified to the BMA.</p>
<p><b>Corporate Governance and Internal Controls</b> i.e., CPs 4–5</p>	
<p>It is desirable that standards be established in the jurisdictions which deal with corporate governance.</p> <p>The insurance supervisor should be able to review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary; and require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management.</p>	<p>In a regime largely dependent upon controls put in place by the companies themselves, the regulator must be able to depend on companies having detailed internal procedures ensuring that objectives are set, as well as procedures for monitoring and evaluating the progress made, that the respective accountabilities of the board and the management are clearly defined, and that the balance between executive and non-executive members of the board is kept.</p> <p>Internal controls should be mentioned explicitly as a regulatory imposition.</p> <p>The flow of information between the BMA and the auditor should be more frequent and, especially, more detailed. The supervisor should explicitly require the auditor to do specific checks (including the review of internal controls) and the auditor should systematically hand in a detailed written report.</p>
<p><b>Prudential Rules</b> i.e., CPs 6–10</p>	
<p>Standards should be established with respect to the assets of companies licensed to operate in the jurisdiction.</p> <p>Insurance supervisors should establish standards with respect to the liabilities of companies licensed to operate in their jurisdiction.</p> <p>The requirements regarding the capital to be maintained by companies which are licensed, or seeking a license, in the jurisdiction should be clearly defined and should address the minimum levels of capital or the levels of deposits that should be maintained. Capital adequacy requirements should reflect the size, complexity, and business risks of the company in the jurisdiction.</p> <p>The insurance supervisor should be able to set requirements with respect to the use of financial instruments that may not form a part of the financial report of a company licensed in the jurisdiction.</p> <p>Insurance companies use reinsurance as a means</p>	<p>The BMA should consider establishing provisions defining the diversification of asset by type, limiting the amounts that can be held by asset and requiring appropriate matching of assets and liabilities.</p> <p>Regulation should require that reasonably secure assets cover adequately calculated insurance reserves.</p> <p>The information in the annual statutory filings should be more detailed concerning the lines of business and reserves (gross and net reserves per line of business as well as specific information on recoveries, loss expenses reserves and liquidation of reserves).</p> <p>The accounting standard used by the company should be explicitly stated in the statutory filings.</p> <p>A general rule limiting reinsurance recoverables should be set (excluding not rated or below investment grade reinsurers, for example).</p> <p>Regulation should explicitly allow for a premium insufficiency reserve.</p>

Reference Principle	Recommended Action
<p>of risk containment. The insurance supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them.</p>	<p>The BMA should clarify the auditor’s responsibilities as to the reliability of the data, and require a final auditor report indicating precisely the checks made on the general data, and more specifically, on actuarial data.</p> <p>The actuary’s report should include detailed indications on the method used for reserving and the verifications conducted.</p> <p>The compulsory disclosure of off-balance sheet items would increase the accuracy of the financial statements.</p> <p>The appropriateness of the reinsurance program to cover the profile of the risks underwritten should be checked, either by the insurance supervisor or by outsourcing to the auditor.</p> <p>Auditors should systematically write management letters.</p>
<p><b>Market Conduct</b> i.e., CP 11</p>	
<p>Insurance supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills, and integrity in dealing with their customers.</p>	<p>It is recommended that market conduct customer-related issues be addressed for the individual or small corporate Bermudian policyholders (to receive meaningful and understandable information in a timely manner and to have access to an equitable treatment of their complaints).</p> <p>The existence of the Consumer Affairs Bureau could be mentioned in the new insurance policies to increase individual policyholders’ awareness that such possibilities are open, for example.</p>

Reference Principle	Recommended Action
<p><b>Monitoring, Inspection, and Sanctions</b> i.e., CPs 12–14</p>	
<p>It is important that insurance supervisors get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction.</p> <p>The information needed to carry out this review and analysis is obtained from the financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections, and communication with actuaries and external auditors.</p> <p>The insurance supervisor should be able to carry out on-site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. This may be limited to the operation of the company in the jurisdiction or, subject to the agreement of the respective supervisors, include other jurisdictions in which the company operates; and request and receive any information from companies licensed in its jurisdiction, whether this information be specific to a company or be requested of all companies.</p> <p>Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The insurance supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered.</p>	<p>In order to have a better understanding of the market, the financial reporting should be more detailed, and distinguish direct and assumed insurance, lines of business, and for reinsurance, type of contracts (for example, proportional treaties, non-proportional treaties, and facultatives). The information on losses should be considerably expanded to include, inter alia, data on the liquidation of the provisions.</p> <p>The BMA should require the actuary and/or the loss reserve specialist to give explicit written comments on reserving adequacy.</p> <p>The financial returns should be regularly updated. Consolidated information, where applicable, and quarterly accounts, at least for Classes 3 and 4 companies, could be required. Class 1 companies should file their financial statements with the Supervisor.</p> <p>The independent reviewers specifically mandated by the BMA should give the BMA access to their working papers. The BMA must have the capability, either directly or indirectly, of checking the reviewers' working papers.</p> <p>The number of appointed inspectors to conduct on-site inspections should be increased.</p> <p>It is essential that the supervisor be capable of verifying the information given by the company, directly or indirectly.</p> <p>To strengthen the authority to impose sanctions, it is recommended that:</p> <ol style="list-style-type: none"> <li>1) Explicit powers be given the BMA to intervene to require changes in the composition of the board and/or senior management if the insurer is found to be in a hazardous condition. Alternatively, it is recommended that the authority be able to vest temporary control and management powers in the inspector or other person with authority to act to rectify an insurer's hazardous condition short of initiating insolvency proceedings in court.</li> <li>2) Legislation be considered to allow the authority the express legal authority to require the submission of a written recovery plan within a relatively short time.</li> <li>3) An expanded range of civil penalties may be considered in instances where legal requirements are not met, but the failure to meet them does not rise to the level of criminal conduct.</li> </ol>

Reference Principle	Recommended Action
<p><b>Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality</b> i.e., CPs 15–17</p>	
<p>Insurance companies are becoming increasingly international in scope, establishing branches and subsidiaries outside their home jurisdiction, and sometimes conducting cross-border business on a services basis only.</p> <p>Increasingly, insurance supervisors liaise with each other to ensure that each is aware of the other’s concerns with respect to an insurance company that operates in more than one jurisdiction, either directly or through a separate corporate entity.</p> <p>In order to share relevant information with other insurance supervisors, adequate and effective communication should be developed and maintained.</p> <p>All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections.</p> <p>The insurance supervisor is required to hold confidential any information received from other insurance supervisors, except where constrained by law or in situations where the insurance supervisor who provided the information provides authorization for its release.</p>	<p>It is recommended that BMA’s ability to regulate cross-border business operations be strengthened by amending relevant statutory provisions relating to disclosure of information. “Fast track provisions” may be considered for inclusion to further facilitate the timely exchange of information between cooperating authorities. Such a provision can be conditioned on a pre-existing memorandum of understanding regarding information sharing executed between Bermuda and cooperating outside or foreign jurisdictions.</p> <p>Given the importance of protecting the confidentiality of certain information, the gravity of penalties that attach to the unlawful disclosure of information and the complexity of the statute in its present form, consideration should be given to a technical revision of sections of the Insurance Act along with the relevant parallel BMA Act, for purposes of clarity and organization.</p>

### **Authorities’ response**

We are pleased that the IMF Assessment has rightly recognized the strength and quality of the business to business market between sophisticated buyers and sellers of insurance and reinsurance that comprises the overwhelming portion of Bermuda’s regulated insurance business. The Report also recognized the effectiveness of the unique regulatory framework put in place in Bermuda under which reinsurance business has been long subject to effective regulation in the jurisdiction, while still being largely or wholly unregulated in many other major jurisdictions.

At the same time, the Report acknowledges the complexity of an attempt to apply the IAIS Principles in place at the time of the visit to an industry “organized around captives, insurance of corporate accounts and reinsurance” (paragraph 80), as was felt to be required by the terms of reference and the fact that Bermuda has developed a framework under which it regulates the full spectrum of insurance business conducted in the jurisdiction. It is, of

course, also the case that a significant proportion of Bermuda's insurance industry is made up of captives whose primary, and in many cases, sole activity involves the self-insuring of group risks, rather than any wider involvement in third party risk. We sympathize with difficulties clearly faced by the assessors in striving to apply Principles aimed essentially towards direct insurance business to a market for which the standards were evidently less than wholly appropriate.

Since the time of the IMF on-site visit, the IAIS Principles have been subject to extensive overhaul and enhancement, including through the development by a special Reinsurance Sub-Committee of standards geared directly towards reinsurers. Bermuda has been a full and active participant in this detailed review and in the development of new insurance (and particularly, reinsurance) standards in the various international fora and specialized working parties.

At the same time, in anticipation of the new international standards, which have now been adopted, Bermuda has moved swiftly to develop and enhance a number of aspects of its regulatory regime, consistently with the requirements of these new standards. This process is already well advanced, with numerous changes already introduced and others expected to be implemented during the first part of 2005. Certain amendments to the Insurance Act 1978 have been enacted, in particular underpinning the ability of the BMA to clarify aspects of the regulatory requirements and standards through guidance to the industry. Moreover, the BMA has taken a number of steps to further enhance the effectiveness of its insurance regime including: significant increases in qualified technical staff; development of a more sophisticated risk-based supervisory model and further enhancement of the on-site elements of the regulatory regime for insurers.

Arising out of the IMF Assessment, the Authority's Board has reviewed all the specific recommendations made, to determine what additional action might still be required in order to deal with any issues highlighted. This, again, reflects Bermuda's strong ongoing commitment to maintaining compliance with relevant international regulatory standards. Appropriate amendments, both to the Insurance Act and to aspects of the regulatory framework, have been identified, and the necessary action put in train. Some of these actions that have already been taken include increases in staff complement, the issuance of detailed guidance notes on critical matters related to supervision and an enhancement of our risk based supervisory model. Through these and other initiatives currently in preparation, the BMA is confident that it will continue to achieve a high degree of compliance with the relevant international standards.



## **D. IOSCO Objectives and Principles of Securities Regulation**

### **General**

90. An assessment of the *IOSCO Objectives and Principles of Securities Regulation* (2002) was undertaken in Bermuda as part of the Offshore Financial Centre assessment mission in March 2003.<sup>25</sup>

### **Information and methodology used for assessment**

91. The assessment was based on a review of Bermuda legislation, additional guidance and interpretation issued by the BMA, BSX rules and regulations, and interviews with BMA staff, interviews with Ministry of Finance staff, a review of documentation at the BMA, interviews with market participants, and with the BSX. The mission is grateful for the generous assistance of the authorities and the private sector. The assessment used as its methodology the *Bank/Fund Staff Guidance Note for the Assessment of the IOSCO Principles*, September 2002.

### **Institutional and macroprudential setting, market structure**

92. Bermuda is a small jurisdiction with a stock exchange, a limited number of full service brokerage firms, and a large and active investment fund and investment funds services sector. The jurisdiction serves as a hub or offshore conduit for a number of multinational financial services organizations. As well as serving a relatively affluent resident population, the securities sector serves institutional clients from a variety of onshore and offshore jurisdictions. Bermuda is home to a large number of hedge funds, investment managers, and portfolio managers as well as internationally active fund administrators.

93. There are 54 firms licensed to carry on business under the *Investment Business Act* (IBA). The majority of firms act as investment advisers and portfolio managers; although, there is also a small full-service industry. As of end-December 2002, there were 1,426 collective investment schemes in Bermuda with \$68 billion assets under management. Firms relying on exemptions under the IBA are required to file an exemption notice with the BMA—there are a large number of these businesses located in the jurisdiction including portfolio managers, and investment advisers.

94. There are both listed and unlisted registered companies in Bermuda. The BSX serves as a domestic market for local companies and as a venue for recording trades in internationally listed companies. There are 393 listings on the BSX with a total market capitalization, as of December 31, 2002, of \$150 billion. Of these, 359 are domestic listed companies (including 263 listed investment funds) with a total market capitalization of \$1.3 billion. The remaining 34 international companies listed on the BSX are cross-listed on

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<sup>25</sup> The assessment was undertaken by Jennifer Elliot (MFD).

onshore exchanges. The bulk of trading volume on the exchange takes place in the after hours crossing market which allows execution of orders at or between the closing bid/offer spread. This feature allows institutional or fund investors to execute basket trades or value weighted average price trades once the onshore exchange has closed.

95. Trading volume in domestic securities is thin, and the exchange has suffered from the cross listing of a major stock, the Bank of Bermuda, on Nasdaq in 2001. Investment funds and insurance companies dominate the domestic market. The BSX produces a BSX Index and the Bermuda Insurance Index. Like many small exchanges, the BSX is facing a challenging future as liquidity moves to more established large exchanges in Europe and North America. The BSX also hosts trading in a pre-public offering mezzanine market—currently there are 13 companies traded on this market.

96. There are 16 trading members on the BSX—some of these are remote access, non-Bermudian residents and are not licensed by the BMA. The BSX also operates a clearing and settlement system and a depository (BSD). All systems are fully automated.

### **Description of regulatory structure and practices**

97. The *Bermuda Monetary Authority Act* (BMA Act) establishes the BMA and charges it with responsibility for the regulation of financial institutions including investment firms, collective investment schemes, and the BSX. Under the IBA, the BMA is given authority and responsibility for licensing and supervision of market intermediaries, and under the *Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations* (CIS Regulations) the BMA is given authority and responsibility for classification and supervision of collective investment schemes. The BMA also plays a role in the registration of companies by vetting registration filings for all companies in the jurisdictions. Companies are registered by the Registrar of Companies, located in the Ministry of Finance. The BSX is responsible under the *Bermuda Stock Exchange Act* for regulation of its listed companies, trading members, and for surveillance of trading on the exchange.

98. Securities regulation is a relatively new development in Bermuda. The *CIS Regulations* were adopted in February 1998—collective investment schemes were given a transition period of one year following which they were expected to be in compliance with the *CIS Regulations*. The IBA came into effect January 2000—investment businesses were given six months to make an application or file an exemption with the BMA. Subsequent to the inspection a new IBA has come into force. The authorities are preparing a new CIS Act, and amendments to the *CIS Regulations* which will grant the BMA, among other things, greater licensing and inspection authority. As a reflection of the unique industry structure in Bermuda, the BMA is seeking authority to license and inspect mutual fund administrators (which may not now fall within licensing requirements unless the activity of a licensed bank or investment business).

## **General preconditions for effective securities regulation**

99. IOSCO has identified a number of preconditions for effective securities regulation, including, no unreasonable barriers to entry and exit from markets and products; adequate development of regulatory policy and the impact of the regulatory requirements; appropriateness of legal, tax, and accounting framework within which the securities markets operate, and the effectiveness of procedures for the efficient resolution of problems in the securities market; and soundness of macroeconomic policies (those aspects that could affect the operations of the securities market). These preconditions appear to be in place in Bermuda.

## **Principle-by-principle assessment**

### ***Regulator***

100. The BMA operates independently and is publicly accountable for its undertakings. Authority over all issuers, trading systems, and clearing and settlement systems should be more clearly established in law.<sup>26</sup> Independence would be enhanced with changes to the MOF's ability to give direction to the BMA (following a discussion with the BMA board) and greater budgetary autonomy.<sup>27</sup> There are a number of weaknesses in legal authority over investment firms and collective investment schemes such as the right to inspect without notice.<sup>28</sup> The ability to share information on individual clients requires clarification. These are generally recognized and various planned amendments to the IBA, development of a CIS Act, and amendments to the *CIS Regulations* will remedy any problems.<sup>29</sup> The BMA is currently able to attract high quality staff—however, there is some concern that in-depth technical skills required in this sophisticated market may be undermined by difficulty in retaining staff who are drawn to industry by better salaries. This is, of course, an on-going problem for many regulators, but a particular challenge in Bermuda because this small authority is responsible for oversight of a highly sophisticated sector.

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<sup>26</sup> Part IV of IBA/03 establishes a framework for the regulation of recognized investment exchanges and clearing houses by the BMA.

<sup>27</sup> Section 11 of IBA/03 provides that the Minister may give the BMA policy directions that are not inconsistent with the provisions of the Act.

<sup>28</sup> IBA/03 addresses these issues in relation to investment firms.

<sup>29</sup> Sections 78–81 of IBA/03 sets out a framework for the sharing of information.

### ***Cooperation and information sharing***

101. The BMA relies on authority under the BMAA to obtain and share information from investment firms.<sup>30</sup> In practice, the BMA shares information with a number of foreign counterparts including the United States, Canada, and the United Kingdom. In addition, it has formal agreements in place with its counterparts in Jersey and the Isle of Man.

### ***Issues***

102. Regulation of public companies is split between listed companies, regulated by the BSX and subject to prospectus and continuous disclosure obligations; and unlisted companies, subject to prospectus and some continuous disclosure requirements but not to regulatory oversight. The BMA should be given authority to regulate all public companies—including, greater oversight of the BSX listing function. New rules instituting insider reporting requirements and public disclosure of these reports, and takeover bid, change of control, and related party transaction requirements would improve protection of shareholders. The BSX and BMA should coordinate efforts in this regard.

### ***Collective investment schemes***

103. The BMA has a comprehensive classification system in place covering collective investment schemes in the form of mutual funds and unit trusts, although, it requires additional inspection authority. The classification process could be supplemented with further guidance to industry in the form of guidance notes and interpretation—this would provide greater transparency to requirements currently imposed in the licensing process and develop additional rules regarding handling of conflicts of interest, calculation and publication of net asset value, segregation of client assets, and securities lending. The BMA should have the authority to override a suspension of redemptions.

### ***Market intermediaries***

104. Licensing requirements and the licensing process are also comprehensive in the case of market intermediaries. The use of guidance notes and codes of conduct developed by the BMA are helpful in providing the industry greater guidance. The BMA has a full inspection program in place but would benefit from enhanced depth of technical skill amongst inspection staff. Market intermediaries are subject to capital requirements; but, on-site prudential examinations are carried out solely by audit firms, together with annual and quarterly reporting by intermediaries to the BMA. There are no on-site examinations undertaken by the BMA—the authority could consider enhancing its surveillance with its own staff inspections of investment firms' financial conditions. The BMA should develop a contingency plan for potential failure of an intermediary.

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<sup>30</sup> See footnote 29.

### ***Secondary markets***

105. The BMA is responsible for oversight of the BSX, both in its role as a trading system and clearing and settlement system. The new IBA will create a full licensing regime for trading systems and clearing and settlement systems and give the BMA broader powers over the BSX. At present, the BSX is not subject to a licensing regime and is not subject to inspections; although, it is subject to prudential requirements.<sup>31</sup> While the exchange appears to be operating well and has sound regulatory practices in place, supervision of the BSX could be strengthened, and the BMA should give some attention to develop staff skills in this specialized area. Insider trading and market manipulation rules should be developed for general application—currently, the government is considering bringing in related criminal-code provisions.<sup>32</sup>

### **Comments**

106. The securities regulatory system in Bermuda is largely sound. The BMA has, in a short period of a few years, brought into place a credible licensing and supervision system for market intermediaries and collective investment schemes. There are a number of legislative issues that should be addressed to provide the BMA with additional required authority—these have been acknowledged; some have been addressed in the new IBA and others will be addressed in upcoming CIS legislation. Given the nature of the market, which is dominated by investment advisers and collective investment schemes, the regulation of issuers and trading systems has been somewhat neglected. As the BMA completes its reforms in intermediary and collective investment scheme regulation, it should turn its attention to some regulation of issuers and closer supervision of the BSX.

107. The BMA staff are qualified, professional, and committed. The BMA is able to provide competitive salaries but still has some difficulty in retaining staff. The consequent lack of depth of technical skill is a challenge that should be addressed, particularly in the area of trading system oversight and inspections.

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<sup>31</sup> Part IV of IBA/03 establishes a framework for the regulation of recognized investment exchanges and clearing houses by the BMA.

<sup>32</sup> The authorities have reported that subsequent to the mission amendments to the criminal code have criminalized insider trading and market manipulation.

Recommended Plan of Actions to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principles Relating to the Regulator (P 1–5)	<ul style="list-style-type: none"> <li>• remove BMAA authority given to the MOF to direct BMA;</li> <li>• grant BMA budgetary autonomy; and</li> <li>• create a separate internal process for reporting under the employee code of conduct.</li> </ul>
Principles for the Enforcement of Securities Regulation (P 8–10)	<ul style="list-style-type: none"> <li>• improve authority to inspect collective investment schemes; and</li> <li>• create authority to sanction issuers and trading systems.</li> </ul>
Principles for Issuers (P 14–16)	<ul style="list-style-type: none"> <li>• grant BMA authority and responsibility for regulating all public issuers including review of prospectuses and on-going monitoring of continuous disclosure;</li> <li>• develop insider trade reporting requirements and system of transparency for insider activity; and</li> <li>• develop rules related to take-over bids, mergers, changes of control and related party transactions.</li> </ul>
Principles for Collective Investment Schemes (P 17–20)	<ul style="list-style-type: none"> <li>• further develop staff technical skills for inspections; and</li> <li>• develop additional guidance for collective investment schemes with respect to licensing and conduct requirements, securities lending, segregation of assets, calculation and publication of net asset value, and redemptions.</li> </ul>