Insights

Banking in Bermuda Magazine

Summer 2014

The Roundtable

Discussions with the CEOs of Bermuda's banks

KPMG

cutting through complexity

2014 KPMG in Bermuda

BANKING SURVEY

INTRODUCTION

By
Craig Bridgewater
Head of Investments
& Banking

Welcome to our fourth edition of *Insights* where we discuss the continuation of significant change in the banking industry. Globally we have observed:

- Unprecedented change to business models including cost optimisation, and the reevaluation of product offerings and sources of revenue streams;
- A continuing increase in regulation and the requirement for more information and more precision in information reported, and increased capital requirements;
- A focus on customer centricity with customers looking to engage in new ways with their banks. This includes the desire for tailored banking services, and new channels to interact with their bank (e.g. mobile applications);
- Shareholders continuing to seek acceptable returns on equity, less reputational risk, and the effective identification and management of significant risks; and
- An increased IT agenda including the increased harnessing of data to understand trends in client behaviours and needs, irregularities, to drive new revenue opportunities. This is commonly referred to as Data & Analytics.

In addition, low interest rates and challenges within loan and mortgage portfolios continue to prevail in Bermuda.

We discussed these matters with representatives of the Bermuda banking sector including the CEO's, the Chairmen of each of the banks, and representatives of the Bermuda Monetary Authority, to obtain their insight into these trends and how they apply to the Bermuda marketplace. KPMG professionals have also provided insights into these trends in the Bermuda banking sector.

We are once again thankful to the CEO's, Chairmen and the BMA for their willingness to take part in our annual survey. Specifically, we would like to acknowledge the involvement of Mr. Michael Collier and Mr. Peter Horton (Bermuda Commercial Bank), Mr. Brendan McDonagh (Butterfield Bank), Mr. Zoran Fotak (Clarien Bank), Mr. Phil Butterfield and Mr. Richard Moseley (HSBC) and Mrs. Marcia Woolridge-Allwood, Mr. Craig Swan and Mr. Tom O'Rourke (Bermuda Monetary Authority).

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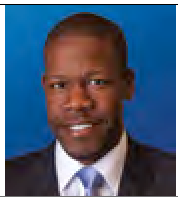
On the cover: Brendan McDonagh (Butterfield Executive Chairman and CEO), Peter Horton (BCB CEO), Zoran Fotak (Clarien Co-CEO) and Richard Moseley (HSBC CEO)

The Roundtable:
Discussions with the CEOs of Bermuda's banks

By
Craig Bridgewater
Head of Investments & Banking
Valerie Robshaw
Manager, Banking



Our roundtable discussion focused on future opportunities for growth, new ways to access customers, using data to understand customers' needs and behaviours, and the various challenges to the banking sector that are currently on the minds of the CEOs in Bermuda.

Key areas of discussion were:

1. How the banks were considering future business models and the growth agenda;
2. Cost optimisation;
3. Operating models that have customer centricity at their heart;
4. How banks can use data to better understand their customers;
5. Delivery channels and mobile banking; and
6. The increasing regulatory burden.

Top, from left: Charles Thresh (Managing Director, KPMG in Bermuda), Neil Patterson (Chairman, KPMG in Bermuda), Brendan McDonagh (Butterfield Executive Chairman and CEO), Peter Horton (BCB CEO), Craig Bridgewater (Head of Investments & Banking, KPMG in Bermuda) and James Berry (Managing Director, KPMG in Bermuda). ***Bottom, from left:*** David Harper (Senior Manager, KPMG in Bermuda), Zoran Fotak (Clarien Co-CEO), Richard Moseley (HSBC CEO) and Valerie Robshaw (Manager, KPMG in Bermuda).

AT THE TABLE:

PETER HORTON
CEO, Bermuda Commercial Bank

BRENDAN MCDONAGH
Executive Chairman & CEO, Butterfield Bank

ZORAN FOTAK
Co-CEO, Clarien Bank

RICHARD MOSELEY
CEO, HSBC Bank Bermuda Limited

NEIL PATTERSON
Chairman, KPMG in Bermuda

CRAIG BRIDGEWATER
Head of Investments & Banking, KPMG in Bermuda

JAMES BERRY
Managing Director, KPMG in Bermuda

CHARLES THRESH
Managing Director, KPMG in Bermuda

DAVID HARPER
Senior Manager, KPMG in Bermuda

VALERIE ROBSHAW
Manager, KPMG in Bermuda

Future Business Models and the Growth Agenda

Over the last few years since the financial crisis, there has been a redefining of business models in order to maintain or increase profits and shareholder returns. This has included cost optimisation or reduction, the search for new revenue streams and increased targets for cost efficiency ratios.

KPMG: Do you think the Bermuda banking industry can maintain its historical levels of profitability and return on equity? If so, how might this be achieved?

Fotak: Levels of profitability and return on equity post 2008 do not offer a compelling value proposition for risk capital or equity holders. Operating efficiency improvements alone will not be sufficient to enhance returns to requisite levels; as such, growth areas need to be identified where Bermuda has comparative advantages to other jurisdictions.

Horton: The dynamics of the banking sector have changed over recent years and I see there being two key factors impacting the ability to sustain profits at historical levels: Firstly, the increased capital costs and capital requirements post the global financial crisis. Secondly, the continued low interest rate environment. The challenge then facing banks is to realign their business models and manage costs of capital and alternative income lines much more effectively going forward.

McDonagh: A range of 15-20% return on equity in the banking sector performance will be achievable with a reasonable improvement in the economy. To achieve a return on equity in excess of 20%, a combination of higher interest rates and a lower cost base is needed.

Moseley: The industry as a whole is facing increased regulatory and financial compliance costs, increased regulatory capital costs and demand headwinds. The industry is reforming itself by optimising cost structures, using risk based pricing mechanisms as well as value based customer segmentation. This means becoming selective in customer acquisition and educating stakeholders of the increased costs of doing business. Overall, this will enable the industry to return to an acceptable level of sustainable risk and reward balance; however, it is unlikely to lead to a return to historical levels.

KPMG: What initiatives are ongoing or planned in relation to cost optimisation and identifying new sources of revenues other than interest income?

Fotak: Technological change is relentless and is requiring continuous improvements in work flows to achieve both cost efficiencies as well as shortened lead times in bringing new products to market. Interest income is the least compelling revenue stream in the current global environment of governmental monetary easing.

Horton: BCB is undertaking significant work around its technology infrastructure, which will be a significant driver in terms of increasing productivity. We see technology as a platform which will allow us to bring greater access to existing banking services and products and, at the same time, provide a broader range of services to our clients.

McDonagh: We are going through a period of continued process improvement to optimise our cost base. In terms of new sources of revenue other than interest income, we continue to expand our wealth management franchise, particularly in the trust division.

Moseley: Cost optimisation involves streamlining processes and reducing layers of bureaucracy in the organisation, including looking at outsourcing non-value added functions and reducing the footprint of operations. These initiatives are ongoing and have become business-as-usual. In terms of new revenue sources, we look at changing customer preferences; including rapid expansion to alternative channels e.g. Mobile Banking.

KPMG: In what areas is cost not considered as highly as other factors involved in doing business (e.g. compliance with regulation, development of new products or enhancing the quality of customer service)?

Fotak: Cost is always considered but, most importantly, the frame of reference is economic value add. Compliance and AML can be positioned as a key differentiator if effectively implemented.

Horton: Cost is always considered, regardless of the area. The challenge is to ensure that we are investing in the business in the right way, to achieve the balance between shareholder return and building a sustainable business.

McDonagh: Cost is considered less in specialist areas that are highly regulated, including Trust and Fiduciary Services and Asset Management.

Moseley: The costs of compliance and regulation, including customer onboarding and due diligence, as well as risk management, have now become part of the cost of doing business, just like most other functional costs.

KPMG: How much emphasis is being placed on technology or automation of processes to reduce costs and generate increases in revenue? What initiatives are ongoing or planned in relation to technology driven cost optimisation and revenue streams? How successful have these been?

Fotak: Technology implementation without the corresponding updates to work flows can lead to disappointment. New processes can be threatening to people, so considerable time needs to be spent on appropriate training and development.

Horton: Significant emphasis is being placed on technology. A critical success factor of any bank going forward will be the extent to which they successfully leverage technology. I see technology as one of the most exciting things happening in our industry and we are fully embracing the opportunities this presents to us.

McDonagh: There is a significant emphasis being placed on technology, including increasing the functionality in direct banking channels, which makes it easier for customers to access our products and services. The biggest challenge to this new way of interacting with our customers is their willingness to participate in this manner; we need to influence our customers to change their behaviours.

Moseley: Providing straight through processing through online channels and mobile apps for transaction banking remains a key component of cost optimisation. Allowing our customers to interact in a secure manner for an increasing array of products and services with the Bank on that basis has been a key component of success in this area.

There is a significant emphasis being placed on technology, including increasing the functionality in direct banking channels, which makes it easier for customers to access our products and services." —Brendan McDonagh, Executive Chairman & CEO, Butterfield Bank

Customer Centricity

KPMG: Many customers are now asking for tailored banking products and for their bank to be more responsive to their individual needs (i.e. more customer centric). What does customer centricity mean to your organisation?

Fotak: We view banking products as fairly homogenous, therefore differentiation happens when needs are identified and met with seamless and consistent execution.

Horton: Customer centricity to me means putting the customer right at the heart of our business and aligning our business around delivering a great customer proposition. I see it as critically important to provide a combination of easy access and a consistent quality service to our clients, if we are to be a truly customer centric business.

"A critical success factor of any bank going forward, will be the extent to which they successfully leverage technology." —Peter Horton, BCB CEO

McDonagh: We have found that this translates into better access to well functioning technology for our customers.

Moseley: It is becoming increasingly important that we understand how customer information can benefit both the customer and the Bank by ensuring that the customer receives the appropriate products and services throughout the relationship lifecycle. Certain products will remain homogenous but the improved understanding of our customers will also assist in differentiating the needs of customers and therefore enable us to tailor products and services better, leveraging the strength of our global capabilities.

Regulation

Banks continue to face an increasing regulatory burden including an increase in the amount and precision of reporting and an increase in capital requirements. Much of this has been enshrined in regulation and statutory instruments such as FATCA, enhanced KYC and AML standards, and the advent of Basel III and its related capital adequacy requirements and liquidity coverage ratios.

KPMG: What is your state of readiness for new regulations such as FATCA? For Basel III? What is your view on the jurisdiction's and the Bermuda banking industry's response to FATCA? To Basel III?

Fotak: We are prepared for the new FATCA regulations. Banks should be mindful of ways they can protect themselves when dealing with dual residents, including making updates to on boarding procedures. Our goal is to early adopt Basel III and we are on track.

"HSBC has adopted all new digital channels, including online, Mobile apps, smart ATMs and near field, which have been readily and rapidly adopted by our customers as their preferred channels and we believe this trend will continue due to the relative sophistication of the market as well as the wide availability of internet access in Bermuda." —Richard Moseley, HSBC CEO

Horton: We are ready and I think the response has been an extremely positive one. I have been impressed by the high levels of collaboration within the industry and with the Regulator.

McDonagh: We consider our organisation to be ready for FATCA. Bermuda and the financial services industry here had no other option than to be ready for FATCA, given its compulsory nature and Bermuda's location.

Moseley: The make-up of the Bermuda resident population include an exceptionally high proportion of dual (or more) residents, which will require enhanced documentation and reporting requirements under the regulations. In terms of Basel III, all Bermuda banks have been involved in extensive consultation with the BMA around the potential impact of the new rules. This has been extremely productive and we are confident that we are ready for implementation.

KPMG: What areas of regulatory compliance are currently the most challenging in your business and why?

Horton: We have to accept continued regulatory change as a fact of life, so I don't see that as a challenge in itself. The challenge is essentially one of continually striving to achieve commercial success and to therefore view regulatory change in a positive rather than a negative way.

McDonagh: Financial Crime Compliance (including Anti-Money Laundering) is a focus for us. The criteria are principle and broad based, meaning that we are required to have significant and sufficient information on file for our customers.

Moseley: As compliance expectations of Banks increase, the demands and costs for sophisticated screening and reporting mechanism increase significantly. In addition, it is difficult to explain the process to the customer, which could involve delaying and reporting payments for further investigation.

KPMG: Is the Bermuda banking industry working together with the BMA to ensure the regulatory requirements are appropriate for the industry? What would you like to see more of? What would you like to see less of?

Fotak: We have found that the BMA has been working on these issues very cooperatively and constructively.

Horton: Yes, there is substantial consultation ongoing between the banks and the BMA.

Moseley: Yes, the Bermuda Banker's Association is actively working with the BMA to ensure appropriateness and relevance of regulation. The consultation process around Basel III is an excellent example of that and we believe the results will be that Bermuda banks will be well positioned to retain and grow following the implementation.

Customer Channels

Recent trends have seen a disruption in traditional customer channels such as branches. Examples of new and emerging banking channels include mobile banking and less card based transactions, and digital banking experience using the web, and mobile apps and devices.

KPMG: What, if any, of the new customer channels has your bank adopted or are looking to adopt? Do you think the rate of adoption of these disruptive technologies is set to increase in the Bermuda banking industry? What barriers do you see to the adoption of such channels?

Fotak: Disruptive technologies by definition break down barriers to entry. So long as security issues can be addressed, this trend is unlikely to slow.

Horton: To me, this is about developing mobile banking channels to the fullest. The biggest barriers to adoption will be customer uptake and managing the cyber security issues. The security of these new and emerging banking channels remains a key focus.

McDonagh: We have concentrated on the mobile banking app to compliment our internet banking offering. We have seen good uptake in this channel, however we have found that barriers are customers' willingness to use our offering and their ability to access the new technology.

Moseley: HSBC has adopted all new digital channels, including online, Mobile apps, smart ATMs and near field, which have been readily and rapidly adopted by our customers as their preferred channels and we believe this trend will continue due to the relative sophistication of the market as well as the wide availability of internet access in Bermuda.

KPMG: Bank branches have traditionally been an important service feature of the banking industry. In more recent times, the trend has been moving away from traditional branches and banking halls. Are there plans to change the way your branches are used to service your customers?

Fotak: Expansion of the ATM network and our electronic banking offering is the most efficient way to deliver a significant component of banking services. There will always be a need to have a physical presence for the higher level banking services.

McDonagh: We currently have no plans to change the way in which branches are used to service customers, however we are augmenting this service with other ways for our customers to access our services. Bermuda is too small a market to warrant an extensive branch network.

Moseley: This is an area that continuously develops as customer preferences change. We find our customers now come to a face to face meeting with a specific purpose, such as opening an account, discussing a mortgage or to seek financial advice and will no longer use our branches for transactions or payroll services. We have changed our branch capabilities to match these preferences and also changed the working hours of some of our staff to meet client needs.

Risk Management and the Management of Reputational Risk

Given the increasing pressure to use and leverage technology in business delivery models and to meet the needs of significant stakeholders, including customers, shareholders and regulators, cyber security and the resultant business and reputational risk has made its way onto the Board, Audit Committee and C-level executive agendas. Regulators are also concerned. Investment needs to be focused in the right places in order to protect reputations, systems and trust.

"Banks are becoming increasingly prepared for cyber attacks from outside their organizations, but they should also be mindful of attacks from inside their organisations."
—Zoran Fotak, Clarien CEO

KPMG: Many boards have cyber security high up on their agenda. How do you assess the cyber security risk of your organisation? Have cyber security strategies been integrated into business operations and your entity's risk appetite?

Fotak: This is a hot topic in the industry and among regulators, directors, clients and insurance carriers. Banks are becoming increasingly prepared for cyber attacks from outside their organisations, but they should also be mindful of attacks from inside their organisations. We consider this to be the principal overlooked risk in relation to cyber security.

Horton: This is a key reputational risk faced by banks globally. It is vital to maintain the trust of customers, and banks need to do what they can to ensure this. Even small banks must be aware and be prepared for attacks that happen on a daily basis.

McDonagh: We consider it to be of critical importance and it has been integrated into our operations and risk appetite. To mitigate the risk, we have executives who are dedicated to ensuring we are ready for threats we are inevitably going to experience. We continue to upgrade our defenses in line with industry best practices.

Moseley: These areas are high up on our agenda, working closely with the resources in our Group. Each cyber risk is classified, assessed and controls, monitoring and mitigation strategies have an assigned owner.

KPMG: How prepared are you to act in the event of a cyber attack or insider threat? Considerations include having robust defence capabilities, having the ability to detect and respond to breaches and having the ability to remediate vulnerabilities?

Fotak: We are as prepared as we can be. The problem is that even a 1% penetration incidence can have significant negative consequences and a 100% defense is just not possible. As such, we also focus on the responses to incidents—because they do occur.

McDonagh: We consider ourselves as prepared as we can be, but there will always be unforeseen attacks.

Moseley: We use our global frameworks and capabilities and are as well prepared as the rest of the HSBC global network.

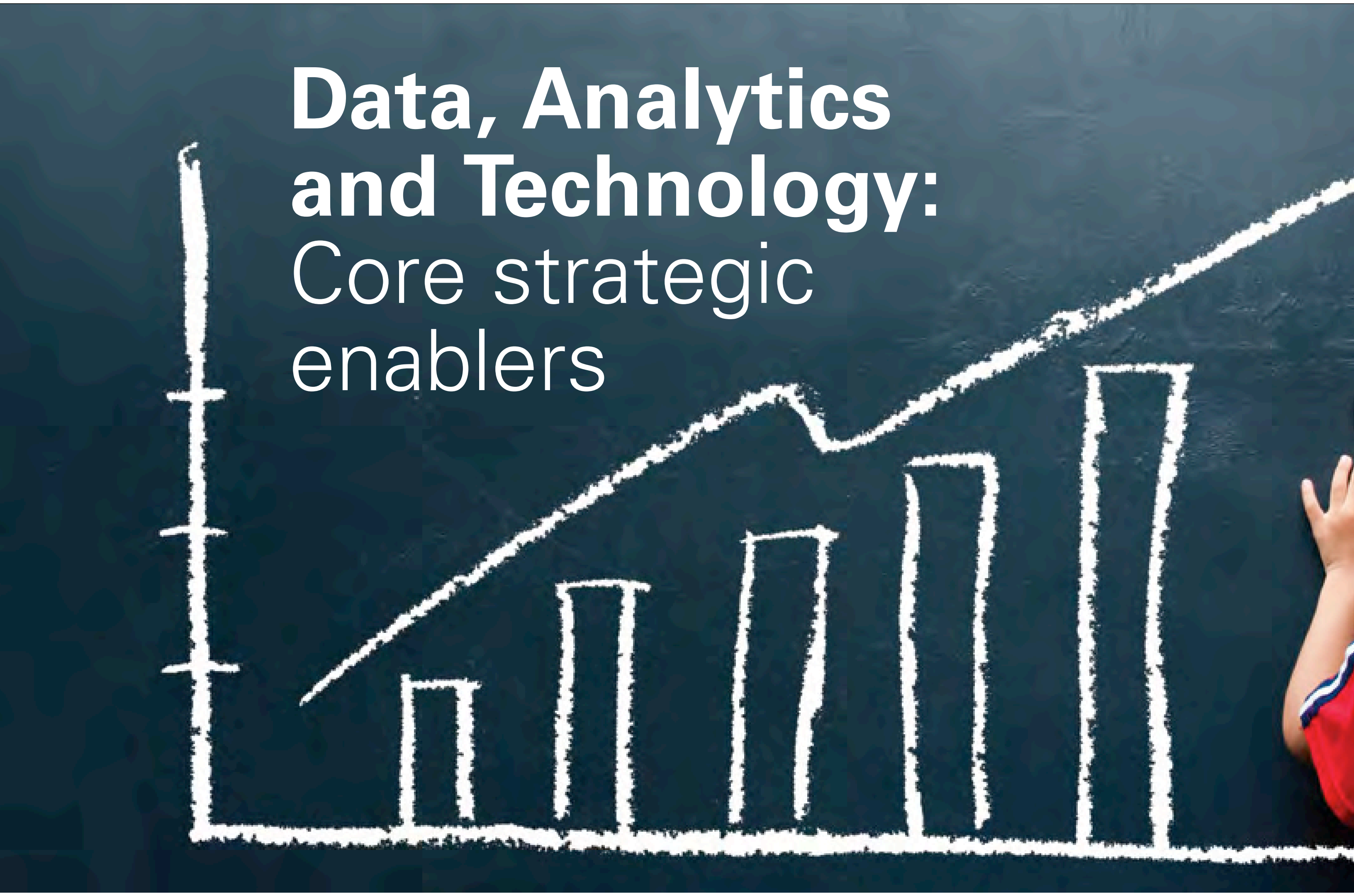
Data Analytics and Competitive Advantage

In general, it was found that the Bermuda banking industry is at the infancy stage with regards to warehousing data on customer needs and behaviours. However, the CEO's all acknowledged that this is a growing area of focus in Bermuda which has been historically underinvested in and, if appropriately harnessed, can provide a competitive strategic advantage to each of the respective organisations and to the industry as a whole.

In conclusion, the Bermuda banking industry and its participants are well aware of the significant issues and opportunities available to the industry and are very focused on taking advantage of them. The industry works well with the BMA in regards to the appropriateness of regulation for the Bermuda marketplace and to ensure that the respective regulations are implemented, reported on and monitored. There continues to be an effective relationship between the industry and the regulator.

The Bermuda banking industry will continue to evolve the products offered to customers and the channels by which such products are delivered. We look forward to the continued developments in these areas over the next twelve months until the time of our next publication.

Data, Analytics and Technology: Core strategic enablers



The international banking sector is increasingly being characterised by rapid and transformational developments in data, information, and technology, and Bermuda is no exception. These developments present challenges and opportunities for Bermuda's banks. Managing and taking best advantage of this new data environment requires new approaches to systems, processes and governance. Rapid and accurate data collection needs to be complemented by ensuring its accessibility in real time to relevant decision-makers. New tools for data and analytics and business information can now radically simplify and streamline the task of extracting management data and creating timely and insightful reports.

The role of data and information

The role of data and information is now integral across the business, from back-office to marketing and sales, and from risk management to meeting stakeholder and regulators' expectations. Banks need to consider the strategic implications of their data management processes and view data and analytics in terms of:

Cost and efficiency: Banks need to become leaner, simpler and more cost-effective in their operations. As a key enabler of process and workflow efficiencies, technology has a huge role to play here.

Exploiting data: Mastering the massive increase in data flow and extracting the greatest value from it is fundamental to organisational health and success. The implications extend across the business operating model. At the front end, banks face real challenges in managing and making sense of the vast array of information which can now be made available about

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the attitudes, behaviour and needs of clients, prospects and targets. Technologies such as data mining and data analytics are increasingly important as a foundation for effective marketing, sales and cross-selling.

Gathering insights: Current management information systems often fail to measure up to expectations. They do not aggregate the right data at the right level quickly enough. Furthermore, they are often ineffective at gathering and reconciling data from multiple sources. As finance, operations and risk functions all have separate data systems, forming a coherent overview is often very challenging. Rapid and accurate data collection is only part of the challenge, however. Ensuring its accessibility in real time to the relevant decision-makers is also critical. Many senior users of management information spend substantial periods of time away from their desks, either travelling or in meetings, and solutions that offer mobile access to crucial data are essential.

Data integrity: When internal processes, business-to-business communications and delivery of customer services all depend so critically on data and information technology (IT) infrastructure, maintaining its integrity is a key requirement in sustaining institutional security. We see only too frequently that when critical technology, such as payments systems, fail, even for a few hours, the impact can be widespread and immensely disruptive. Leaks and loss of sensitive customer data breach the trust between institution and client and can carry significant financial penalties. Significant reputational damage can occur if these situations are not well handled.

Managing risk: The financial crisis and the wide-ranging regulatory response have placed increased emphasis on the need for effective management of risk in all contexts: reputational risk, operating risk, regulatory risk. Banks now face the twin challenges of sustaining improved risk management and furnishing evidence of its effectiveness to stakeholders: regulators, clients, shareholders. Collecting, analysing and presenting the relevant data is now indispensable to creating the foundation for strong stakeholder relationships.

Customer relationships: Information technology and data management are fundamental to maintaining stable and responsive relationships with clients who expect continuous access to their financial service providers on a range of online and mobile platforms. Integrating the different interface technologies and grounding them on consistent, high-quality data are essential elements in creating agile communications and decision-making.

Day-to-day operations: Fundamentally, optimising day-to-day operations means maximising the use of scarce resources and ensuring that people have the right information to make optimal decisions at the right time. This requires accurate and consistent data, which can serve both to underpin the operational health of the bank and satisfy internal and external requirements.

Safeguarding the institution: The exponential increase in the volume of data necessary to the operation of our banks, together with institutions' increasingly critical reliance on it, carry major dangers of their own. The banking sector is more and more vulnerable to the loss or corruption of mission critical data and at greater risk of reputational damage and regulatory sanction if these organisations misuse it. Data and cyber security has moved from being a peripheral and technical specialism to a central strategic concern.

Seizing the benefits

It is not all danger and defensiveness. The new technologies are the way of the future and, if properly developed, promise major improvements in internal efficiency, external reporting and, perhaps most significantly, customer relations and customer propositions. Whether it is further development of internet and mobile channels or innovative new technologies for payments, there are major potential benefits as well as risks. The role of the Chief Information Officer (CIO) is now to help define an institution's core strategy against this rapidly developing background and guide investment decision-making on the basis of a clear view of risk and reward.

The universal importance of good data and information management across the business operating model places a huge premium on the ability to collect, aggregate and analyse data to create a single view of the truth; one complete and internally consistent data and information resource which can satisfy all needs. Technology, data and information management have been a core part of financial services for many years. They have now become more important still. Boards and executive management need to ensure they are accorded the same priority as any other critical success factor. Whether it is a question of customer-facing operations, internal systems and procedures or external reporting, the winners will be those who can bring together data in a coherent way to serve these multiple needs most effectively.

Customer Centricity: Profitable growth through customers

Bermuda's banks have a long and important history in the community and have played a key role in shaping the island as it is today. The small number of banks and the size of the jurisdiction mean that the relationship between customer and bank is typically much closer than in other environments. Therefore, Bermuda's banks have customer focus as a key priority and seek to give all their customers a positive experience. If successful, this certainly benefits the customer but also the bank—relationships and customer loyalty will be strengthened and customers become advocates.

However, in an environment of continued low interest rates, increasing costs, higher capital and other regulatory requirements, it is important that banks not only treat all their customers well but also analyse their customer base to identify opportunities for profitable growth.

This requires a focused strategy, an actionable plan and rigorous execution of identification of existing customers whose relationship with the bank could be profitably developed further, and new customers that the bank wants to attract.

What are the characteristics of a customer centric bank?
There are four key attributes that institutions with successful customer centric models have: Focus, Efficiency, Agility and Trust. While each attribute is applicable to today's conditions, organisations may place greater focus on one over another, depending on their particular circumstances and priorities. Some companies may have highly developed strategies relating to individual attributes, but recognise the need to fortify their other capabilities.

Focus: Best-in-class institutions articulate a clear strategy that reflects their vision and focus. Top firms have charted a precise course focused on a long-term view of their customers' needs and how these relate back to profitable growth.

Efficiency: Successful institutions embrace a culture of continuous focus on efficiency. They invest in scalable systems, processes and delivery channels to resolve legacy inefficiencies.

Agility: Top institutions demonstrate the flexibility to adapt swiftly to a changing environment. An open mind-set characterises their people from the boardroom to the front line.

Trust: Top-performing institutions have built confidence and trust in the eyes of their customers, regulators, investors and the communities they serve.

Going beyond customer focus to customer centricity

Know your customer
The business model of a customer centric bank starts with better knowledge of its clients that gives genuine insight into the true "voice of the customer". Those institutions that understand their customers are better placed to offer products and services that customers have a higher propensity to buy, particularly if this is done on an institution-wide basis rather than in silos. Customer centric banks often seek insight from methods such as satisfaction surveys, net promoter analysis, and social media, frequently resourcing these efforts by positioning customer insight as a centre of excellence, thereby attracting talent, including from other sectors.

Know and use your data
Banks that are able to connect internal and external data are better positioned to create value and gain competitive advantage. To be able to do this, data must be accessible and easily analysed across products, brands, businesses and functions. Social media and internet tools can supplement in-house data to predict customer behaviour, with individual-specific or demographic lifestyle data. Successful institutions use statistics, modelling and data mining to

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Dynamic banks are consistently challenging the notion that customer relationships are owned by one particular bank. Focusing on customer centricity will help ensure that existing customer relationships are retained and that new ones are gained.

extract information from data, to analyse current and historical facts, and to predict trends and behaviour patterns of customers. Such predictive analytics is a critical part of meeting customer needs, and driving profitable growth in competitive markets.

Propositions based on customer needs

As with any service organisation, a bank that can develop ‘unique buying reasons’ as opposed to ‘unique selling propositions’ will be rewarded by customers through greater loyalty, referrals and retention. A strategy built on an analysis of customer needs can provide increased value from proposition and product alignment and a better allocation of resources focused on higher value segments. Insights into customer needs should drive propositions which are based on the key ‘moments of truth’ that wield the most influence on customer decision making. This focuses an institution on those incremental value areas for price-sensitive customers who otherwise see banking as a commodity.

Optimise your distribution and operations

The evolving preferences of the next generation of customers will change the way banks operate and distribute products—and constantly emerging technologies will be key to that process. There is evidence globally that there is no one effective strategy for channel optimisation—the right solution depends on the geography, regulatory environment and, most importantly, customer preferences. While Bermuda’s banks are considering developments in distribution channels, such as mobile banking, it may be that the size of the community and customer relationship history means retention of a strong face-to-face relationship is appropriate. Ultimately, banks need to adopt a distribution strategy that optimises return on investment and also meets customers’ needs—not only from a convenience perspective but providing transparency to customers regarding risk and return of products and services.

Create a positive end-to-end customer experience

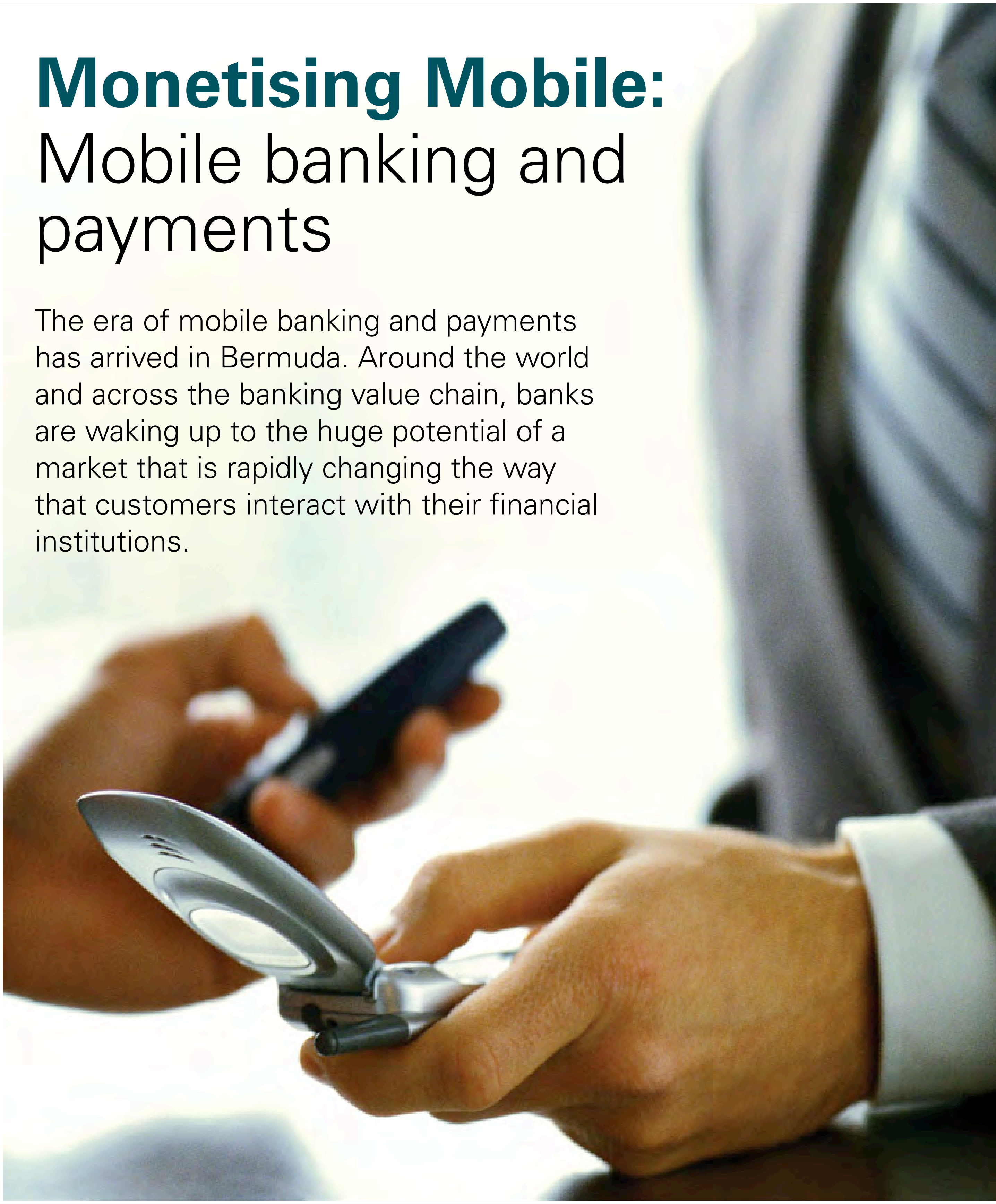
After the initial contact with the customer has been made, turning their expectations into reality requires efficient and effective operations organised around customers rather than products. The customer’s needs and expectations must be met across the organisation and not just in silos. In today’s banking world, customers are looking for consistent error- free processing regardless of service channel, working online one day, using the phone the next and increasingly using smart phones and tablets. However, while an agile digital strategy can be a game changing initiative to meeting customer needs and maintaining cost control, just as important in the service experience is ensuring that the bank’s people and processes are focused on the customer rather than individual products.

Customer preferences change, as must best-in-class banks

Moving from vision to action requires continual fine-tuning. Technology is changing at a fast pace, and customer demands are evolving. The traditional banking model is under pressure from low interest rates and high legacy cost bases. Shadow banking and niche products are also increasing their market share. Meanwhile, a carefully built brand is under pressure from adverse opinions on social media, and from advances by new entrants. The end-to-end execution of a clear customer strategy is critical for banks to generate profitable growth in these changing times.

Monetising Mobile: Mobile banking and payments

The era of mobile banking and payments has arrived in Bermuda. Around the world and across the banking value chain, banks are waking up to the huge potential of a market that is rapidly changing the way that customers interact with their financial institutions.



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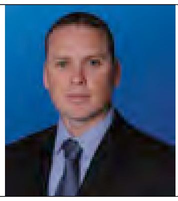

Late in 2013 mobile banking services were introduced to the Bermuda market by HSBC and Butterfield Bank. But those introductions are expected to be just the start of a number of mobile banking services innovations.

Terminology: Mobile banking vs. Mobile payments
Many consumers (and even a fair number of bankers) make the mistake of using these two terms interchangeably.

But there is a difference: Mobile Banking refers to platforms that enable customers to access financial services (such as transfers, bill payments, balance information and investment options).

Mobile Payments, on the other hand, is generally defined as the process of using a hand-held device to pay for a product or service, either remotely or at a point-of-sale.

Mobile payments gaining importance
Almost 85% of respondents to KPMG International's online survey of bank executives say that mobile payments will have significant importance to their business within the next one to four years.

Our survey shows that a select group of banks are quickly moving ahead of their peers to gain customer loyalty, reduce costs and—ultimately—secure their place in the mobile payment value chain. Others, however, are waiting for standards to be set and for customer demand to hit critical mass.

But Bermuda banks may quickly find that the spectre of new, nimble and highly effective competitors taking control of the mobile payments market represents a clear and present danger. In fact, the traditional hegemony of banks over the payment process is certainly not guaranteed and is more at risk today than ever before.

Challenges and opportunities of mobile payments
And while there are, as yet, very few certainties in the mobile payment arena, our survey illustrates a number of key challenges, considerations and opportunities that are universally critical to banks as they develop their mobile banking and payments strategies.

Monetising mobile: Innovator banks are taking the lead
In both mobile banking and mobile payments, a small number of banks are driving ahead with developing mobile payments to brandish their credentials as innovators and gain competitive advantage.

Mobile banking pilot programmes
Some institutions are already running small pilot programmes in local communities and within their own company facilities. For the innovators, these pilots are a critical step towards gaining a better understanding of customer preferences, trends and challenges. They also build awareness of the emerging service within the bank's employee base.

But, according to our research, some banks are still not convinced about the benefits of mobile payments. At the root of the debate is whether customers will see enough value in the new channel to push adoption rates to a level that offsets the investment costs. As one respondent insightfully pointed out, "Consumers don't always act as logically as you think they will in the marketplace."

"The introduction of Near Field Communications, being short-range wireless technologies, will change the traditional value chain for banks for low-value payments, bringing in new partners to manage devices and drive merchant adoption."
–James Berry, Managing Director, KPMG in Bermuda

In our opinion, if banks can roll out a safe, easy to use and ubiquitously accepted system, consumers will very quickly adopt mobile payment solutions in much the same way as they have adopted other mobile services.

Monetising mobile: The strategy for retail banks
Building a sustainable and achievable retail strategy in the face of a complex and uncertain technology environment is not easy. It requires banking executives to be decisive about the objectives they hope to achieve and the route by which they might travel to get there.

For example, organisations pursuing reputational benefits may want to focus on being first-to-market with mobile solutions in order to demonstrate their innovative nature and customer focus. Others may prefer to set more quantitative objectives around revenue generation and may therefore focus on developing high-value services that merit a premium fee. And those pursuing customer loyalty benefits will want to ensure they are focused on meeting and exceeding their customer expectations.

Central to any strategy for retail banks must of course be the customer. Indeed, the ability to accurately assess customer segments, trends, demands and concerns will be critical to creating a strong and valuable mobile payment strategy.

Monetising mobile: Scenario spectrum

The drive towards mobile banking and payments can take many forms and no two banks will approach the field in the same way.

However, the development of mobile solutions tends to follow an evolutionary pattern that starts with basic mobile banking and progresses towards mobile payments at the physical point-of-sale (POS).

The following scenarios examine some of the impacts, benefits, challenges and customer considerations facing banks at three distinct points in this evolution.

Conclusion

The banking value chain is rapidly changing and so are the ways that customers interact with their financial institutions. Mobile banking is one of those rapidly changing service areas that customers in Bermuda will seek and demand and is likely to represent a significant focus of innovation in the years ahead.

> "All mobile banking solutions must be created with the customer in mind. Banks cannot lose sight of their targeted end user segments as they develop their strategy."

	BASIC MOBILE BANKING	ENHANCED MOBILE BANKING & REMOTE MOBILE PAYMENTS	MOBILE PAYMENTS AT THE PHYSICAL POS
OVERVIEW	The basic mobile banking market consists of financial institutions that are focused on developing and refining their mobile banking platform	The enhanced mobile banking and remote payments market consists of players with mature mobile offerings, healthy adoption rates, and basic remote payment services	The physical POS mobile payments marketplace is composed of traditional and non-traditional players vying for early market share of mobile payment revenues
KEY FEATURES	Typically includes core service offerings such as account access, balance information and internal transfers and are usually on 1-2 technology platforms serviced by a vendor	Typically consists of market leading mobile banking features such as mobile deposit capture, mobile capture and bill pay, enhanced enrollment features, and some remote payment offerings such as person to person (P2P) payments	Features and functionality allow merchants to use mobile devices as point-of-sale terminals and facilitate payment transactions
BENEFITS	• Enhanced reputation and customer service • Reduced cost to serve (and therefore more flexible capital) • Can be straightforward to deploy • Easily integrated into existing internet banking services • Demonstrates innovation • Creates a base comfort level for consumers using mobile devices • Builds in-house experience and skills	• Reduces cost to serve and increases available capital • Streamlines processes and reduces manual intervention • Builds in-house experience and skills • Capitalises on 'first-to-market' opportunities • Provides new revenue streams	• Protects existing payments revenues • Creates new revenue opportunities • Responds to customer demands
CUSTOMER IMPACT	• Unfettered access to banking information and basic transactions • Convenience and ease of use • Integrated view of banking information and accounts • Higher customer loyalty and 'stickiness'	• Reduces branch and ATM visits • Delivers increased flexibility to customers • Builds comfort and acceptance of mobile payment solutions • Acts as a stepping stone to contactless and proximity payments	• Convenience and ease of use, particularly for low-value payments • Tighter security and privacy • Replaces traditional wallet or existing stored value accounts and electronic purse cards
KEY CONSIDERATIONS	• What is our mobile channel strategy? • What is our mobile commerce strategy? • What is our position on mobile payments? • What are our current mobile banking capabilities?	• Who is our mobile service vendor and are their capabilities sufficient? • What are leading practices in mobile commerce? • What should our mobile payments product look like? • What should our revenue sharing model look like?	• How should we plan for enhancements to our mobile platform? • How should we rollout our mobile payments pilot? • What are the estimated costs of the mobile payments initiative?

By
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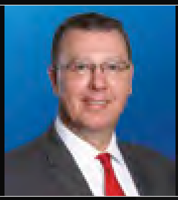

Cyber Security:
An evolving landscape

Cyber security is an important concern for every financial institution, including those located in Bermuda. Cyber is one of the fastest-growing areas of crime directed at banks. Cyber criminals, and indeed others such as "hacktivists", are exploiting the speed, convenience, and anonymity that modern technologies offer to invade bank information technology (IT) systems. The financial impact, coupled with reputational damage could be devastating.

Focusing on technology alone to address cyber security issues is not enough. Effectively managing cyber risk means putting in place the right governance and supporting control processes, along with appropriate enabling technology. It is essential that executive leadership take control of allocating resources to deal with cyber security, actively manage governance and decision making, and build an informed and knowledgeable organisational culture.

Cyber security threats faced by the banking industry

Whilst there is, rightly so, a lot of media attention focused on cyber security and the high profile breaches in recent years, the media often sketches an alarmist picture of cyber security, creating a culture of disproportionate fear. The reality is that cyber risks can be managed, and good security starts with developing a robust cyber defense capability and understanding the threat landscape. Some of the most significant threats include:

- **Account takeovers:** Cyber criminals target personal computers of online banking customers via phishing e-mails or text messages to gain access to their accounts. Fraudulent money transfers and counterfeiting of stored value cards are the most common exploits of account takeovers.
- **Third-party payment processor breaches:** Cyber criminals target computer networks of payment processors to hack personal data of customers.
- **Securities and market trading exploitation:** Cyber criminals access brokerage accounts in a similar manner as they access bank accounts to conduct market manipulation and unauthorised stock trading.
- **Mobile banking breaches:** Cyber criminals gain access to a user's credentials and account information by installing malware via a mobile application.
- **ATM skimming:** Cyber criminals fix a skimmer inside or outside the ATM to steal card number and the related personal identification number (PIN). They would then either sell the data or create fake cards to withdraw money.

The media often sketches an alarmist picture of cyber security, creating a culture of disproportionate fear. The reality is that cyber risks can be managed, and good security starts with developing a robust cyber defense capability and understanding the threat landscape.

- **Supply chain infiltration:** Cyber criminals attack suppliers of technology, software and hardware to the financial sector. Thus, when a financial institution installs the equipment or software impacted by a cyber crime it compromises its own security.
- **The human factor:** The human factor is and remains, for both IT professionals and the end user, the weakest link with respect to security. Cyber criminals target employees using "social engineering," a kind of con-game that manipulates employees into releasing valuable business information. Criminals may also use former bank employees who supply telephone access information to contact bank employees, who then unwittingly allow the criminal into the bank's internal computer portals.

Responding to cyber risks

Dealing with these threats is a complex task. The goal of being 100% protected against cyber risk is neither feasible nor realistic, especially when we consider the rate at which cyber attacks continue to evolve and diversify.

Banks can lower the risks to their business by developing capabilities in three critical areas—prevention, detection, and response.

Prevention

Prevention begins with governance and organisation. It is about installing fundamental measures, allocating responsibility for dealing with cyber crime within the organisation and developing awareness training for key staff.

Although this is generally led by the IT department, the knowledge and awareness of the end user is critical. Cyber security is often seen as the responsibility of a department of specialised professionals, however this mindset may result in a false sense of security and lead to the wider organisation not taking responsibility.

Detection

Through monitoring of critical events and incidents, an organisation can strengthen its technological detection measures. Monitoring and data mining together form an excellent instrument to detect strange patterns in data traffic, to find the location on which the attacks focus and to observe system performance.

Response

Response refers to activating a well-rehearsed plan as soon as evidence of a possible attack occurs. During an attack, the organisation should be able to directly deactivate all technology affected. When developing a response and recovery plan, an organisation should perceive cyber security as a continuous process and not as a one-off solution.

The emphasis must be on the detection of and response to cyber crime more than what has traditionally occurred. At a recent KPMG Audit Committee Institute (ACI) event, a board member from a large regional US bank suggested, "We don't know what we don't know." It was noted at the event that in 65% of the bank cyber attack cases handled by the FBI last year, the federal agency actually alerted the bank security teams because the bank did not know its systems had been breached.

A good defense is based on understanding organisational vulnerability, establishing mechanisms to detect an imminent or actual breach, and immediately confronting intruders to minimise loss. Organisations should develop an enterprise-wide method for assessing, prioritising, and reporting cyber security risks to appropriate stakeholders.

Management needs to collaboratively escalate efforts about threat awareness, timely discovery of incidents, risk assessments of vendors, and closer coordination with regulators about how cyber security risks are being identified and managed. Only an organisation that understands critical data and technology assets, external developments, and incident trends, and uses this insight to inform policy and strategy is likely to succeed in combating cyber crime in the long term.

Cyber security will become an even broader responsibility in the years ahead as banks, eager to expand their offerings and boost efficiency, partner with third-party vendors and service providers whose networks are connected in turn to other banks, subcontractors, and third parties—all boosting the risk that an attack on one could morph into an attack on many.

New technologies in mobile and cloud computing are also upping the ante. Banks will need to respond to these spreading threats on multiple fronts, building sound and secure IT infrastructures and vetting and monitoring vendors and other service providers for their own compliance with security protocols.

Cyber risks can be managed. Cyber criminals are not invincible geniuses, and while they can cause real damage to your business, you can take steps to protect yourself against them. You may not be able to achieve 100% security, but by treating cyber security as "business as usual" and balancing investment between risks and potential impacts, your organisation will be well prepared to combat cyber crime.

COST OPTIMISATION

By
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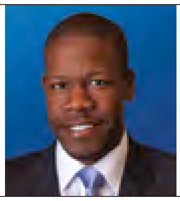

A Cost Optimised Operating Model

Changes are required to the current bank operating model to prepare for the challenges of the future as banks across the world must acclimatise to the negative or low growth environment.

The past number of years has been a time of unprecedented pressure in the banking sector. Customers have become ever more demanding; regulators' risk management expectations are more onerous than ever before; investment in new technology has become a business-critical decision; and new players into the market are providing more options for customers.

The consistent theme that underlies many of the challenges facing the banking model is the achievement of growth and/or maintenance of the return on equity, a major component of which is cost optimization. Many sources of cost optimisation are being explored by the banking sector, including:

- Greater efficiency of processes and data management through investment in IT systems;
- Closing branches and relying more on centralised and increasingly automated and industrialised front to back office processes;
- Focusing more on the overall profitability of products and services, and on where a bank has a competitive advantage, rather than justifying new or incremental products and services on the basis of their marginal contributions to net profit;
- Simplifying products and services, and taking a more risk-adjusted approach to costs and revenues;
- Greater automation of some controls functions, including compliance and internal audit, based on a re-assessment of risk tolerance in these areas;
- Simplifying legal entity and operating structures;
- Reducing staff numbers;
- Reducing variable remuneration, in response to weak economic conditions and regulatory constraints on remuneration; and
- Off-shoring and near-shoring.

Changes are required to the current bank operating model to prepare for the challenges of the future as banks across the world must acclimatise to the negative or low growth environment. Banks are compelled to cut costs, whilst at the same time to upgrade their IT architecture to accommodate their new operating model and handle greater demands for data.

To overcome inevitable loss of scale and cost issues, banks must devise innovative operating models. An imaginative approach is needed to cut costs and control a disintegrated value chain. Innovation can be encouraged by lateral thinking, based around preemptive rather than reactive processes. Furthermore, banks must introduce cost-reduction measures which are both long-term and sustainable. The following three strategies in particular could have a high impact on cost optimisation, while being versatile and scalable, and improving customer service.

Straight Through Processing (STP)
STP is about paring back to an absolute minimum the human input required to process transactions. For example, if a customer creates a standing order online, with STP the whole process is automated from start to finish and little or no human input is required. In preparing for the implementation of this strategy, banks should identify their STP throughput rates and try to dramatically increase them.

Self-service channel usage
By giving customers more power and responsibility for carrying out their own banking activities, there will be less need for human input from the bank, with obvious positive cost and error rate implications. However, banks should remember that moving a process to a self-service channel without adequate planning introduces the risk of inadvertently increasing the cost. Inviting customers to bank online increases the number of transactions carried out and reduces the related cost per transaction. If related processes are not automated, you will eventually need more people simply to handle the volume of transactions.

First-time resolution (FTR)
With FTR, processes are resolved immediately at the first point of contact with the customer, whether it is a branch or a contact centre. For example, if a customer wants to open an account, they are able to do it at once, without needing multiple contacts with a bank employee or contact centre to complete the transaction. This contrasts with the current centralised model, where the vast majority of transactions end up in central operations. Again, FTR will only work effectively if the underlying transactions abide to STP principles. Otherwise, the same strategy may increase costs.

By pursuing these three strategies or any combination thereof, the need for shared centres will fall, middle and back-offices will handle only exceptions, fewer people will be needed, customer service levels and the customer experience will increase, and costs will drop dramatically.

OECD – Global standard for automatic exchange of information

On 13 February, 2014 the Organisation for Economic Co-operation and Development (OECD), released the Common Reporting Standard (the CRS), which is intended to become the new global standard for automatic exchange of financial information (covering bank accounts and other financial assets held offshore).

Following in the wake of FATCA, this new proposed standard is intended to facilitate such information exchange between participating countries.

Automatic exchange of information (AEOI)
The legal basis for AEOI will either be the Multilateral Convention on Mutual Administrative Assistance in tax matters, or alternatively a bilateral treaty. In either case the OECD's standard then envisages a bilateral Competent Authority agreement providing for automatic exchange of information. Given Bermuda's numerous International Tax Agreements, the CRS is something Bermuda business need to be following.

Information exchange is envisaged to be reciprocal, but the same framework could in principle be used when there is no desire for reciprocity. In addition to the envisaged bilateral agreements implementing the exchange of information between tax administrations, the OECD document provides common reporting and due diligence rules that will need to be implemented into domestic law of participating countries.

The OECD document makes the point that this is intended to be a minimum standard—countries can ask for more information—and crucially, it is not intended to restrict other types of AEOI. This raises the prospect that financial institutions might be required to report under multiple AEOI regimes simultaneously, thus significantly increasing cost and complexity.

Like FATCA in some aspects
As with the U.S. FATCA regime, the scope will be broad to reduce the risk of circumvention. Thus, it will apply not just to banks, but also to certain brokers, investment firms, and some insurance companies.

Many aspects of the OECD proposals are consistent with the Model 1 IGA approach under FATCA. However, there are a number of areas where the standard deviates from the Model 1 IGA—such as the removal of minimum threshold limits and new account opening definitions. This will considerably increase the amount of work required.

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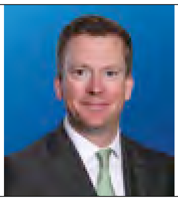

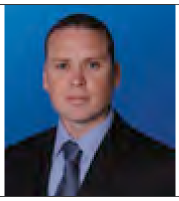

The CRS provides a common global approach for jurisdictions to obtain financial information from their financial institutions and to automatically exchange that information with other jurisdictions on an annual basis. The CRS outlines the financial account information to be exchanged, the financial institutions that need to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

The three key aspects of the CRS are:

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

It's on its way so start preparing

These initiatives were endorsed by the G20 at their recent meeting of Finance Ministers and Central Bank Governors in Sydney on 22-23 February 2014. There is overwhelming support for the CRS for the automatic exchange of tax information on a reciprocal basis. The G20 announced that it will work with all relevant parties, including their financial institutions, to detail an implementation plan at its meeting in September 2014. In parallel, the G20 expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015.

The G20 calls for the early adoption of the standard by those jurisdictions that are able to do so. The G20 urges all jurisdictions that have not yet complied with the existing standard for exchange of information on request to do so and sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters without further delay.

Basel III in Bermuda

In the aftermath of the financial crisis, the Basel Committee on Banking Supervision (BCBS) embarked on a programme to substantially revise its existing capital adequacy and liquidity guidelines. The resulting framework is known as 'Basel III'. Basel III is the third in the series of Basel Accords which deal with the risk management aspects of the banking sector.

According to the BCBS, "Basel III is a comprehensive set of reforms developed to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to: Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; Improve risk management and governance; and strengthen banks' transparency and disclosures."

The BCBS established a rather extensive timeline for the banks to adopt the necessary requirements of Basel III, so different components of the Accord have their specific deadlines and time frames for implementation. Although the transitional period appears long, the 2019 deadline to complete implementation should not distract institutions from the need to demonstrate capital and liquidity resilience much earlier and to meet interim deadlines along the way. In the medium term, most firms will be capital and liquidity constrained and so will need to focus on capital management, product and business pricing, capital inefficiencies that remain from Basel II, and the structure of their liabilities.

In November 2013, the Bermuda Monetary Authority ("BMA") released a consultation paper that makes proposals for the adoption of capital and liquidity regulatory requirements consistent with Basel 2.5

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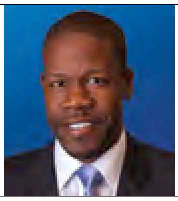

and Basel III for Bermuda from 2015. The BMA noted this should be viewed in the broader context of its efforts to promote high standards of risk management and corporate governance within Bermuda's banks. The consultation paper included the comments from Bermuda's banks and other stakeholders in response to a discussion paper that commenced the formal public consultation process on the adoption of the Basel III measures related to the quality, consistency and transparency of capital, the leverage ratio, capital buffers, and prudential liquidity standards. The consultation paper included, amongst others, the following key provisions:

Increased quality of capital: Basel III contains various measures aimed at improving the quality of capital, with the ultimate aim to obtain a higher loss-absorption capacity. The BMA proposed adopting the much stricter Basel III definition of capital where common equity and retained earnings would be the predominant component of tier 1 capital instead of debt-like instruments. These adoptions would likely require the raising of significant additional capital by Bermuda banks, along with increased retention of profits (e.g. through reduced dividends) and with the increased focus on loss absorbency criteria, less flexibility for the BMA to allow capital instruments to be included in tier 1 or 2 capital.

Increased quantity of capital: Basel III contains various measures aimed at increasing the level of capital held by banks, as well as providing counter cyclical measures. The BMA noted that the minimum common equity tier 1 capital will be increased from 2% to at least 4.5% of total risk weighted assets ("RWA") plus a capital conservation buffer of 2.5% bringing the total common equity requirements to 7.0% of RWA. The minimum total capital will increase from 8.0% to 10.5% of RWA, including the conservation buffer. Therefore banks will face a significant additional capital requirement and the bulk of this shortfall will need to be raised as common equity or otherwise by retaining earnings. These capital changes will gradually be phased in from 2015 to 2019.

Reduced leverage through introduction of a leverage ratio which acts as a non risk sensitive backstop measure to reduce the risk of buildup of excessive leverage in the institution and in the financial system as a whole. The leverage ratio will be calculated as tier 1 capital divided by total assets. The BMA noted that banks in Bermuda will be required to maintain a minimum leverage ratio limit of 6% in 2015 rising to 7% in 2016. The introduction of the leverage ratio could lead to reduced lending and is a clear incentive for banks to strengthen their capital position.

Increased short-term liquidity coverage: The BCBS has further strengthened its liquidity framework by developing two minimum standards for funding liquidity.

First, the 30 day liquidity coverage ratio ("LCR") aims at ensuring banks have enough funding resources available over the next 30 days thereby requiring banks to have sufficient liquid assets to cover 30 days of expected net liquidity outflows. The LCR is intended to promote short-term resilience to potential liquidity disruptions and will help ensure that banks have sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors. However, as the LCR requires banks to hold significantly more liquid, low yielding assets, this could have a negative impact on profitability and restrict investment activity and the use of cash. The BMA noted that this will be phased in gradually from 2015 to 2019.

> "The adoption of these new standards is important to protect the interests of depositors, the Bermuda financial system, and the reputation of Bermuda's banking market and its participants." –Bermuda Monetary Authority

Secondly, the Net Stable Funding Ratio ("NSFR") aims to ensure that banks have enough funding resources over the next 12 months to provide for the expected funding needs over the same period. The BMA has decided to delay the formal reporting of the NSFR in Bermuda.

Basel IV: Even before Basel III is fully implemented, 'Basel IV' may be emerging. Developments in recent months lay the groundwork as some countries are already beginning to impose requirements that go beyond Basel III; the US and Europe are requiring banks to meet minimum capital ratios even after the impact of severe stress; Switzerland, the US and the UK have set a minimum leverage ratio at above 3 percent; others (Australia and UK) are insisting that 'Pillar 2' capital add-ons are met through higher quality capital; and finally, countries such as the US and the UK are pushing for tougher liquidity standards.

Please note that at the time of publication, the Bermuda Basel III provisions continue to be developed.

Effective Governance, Driving Strategy

Banks must take a more strategic and forward-looking approach, shifting to a more customer-centric approach and taking a more outcomes-driven view of customer satisfaction.

By
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Chairman
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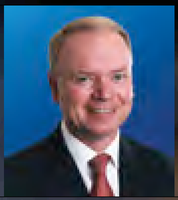

One of the key lessons learned from the financial crisis was that the governance of many banks was ineffective, resulting in poor quality decision-making and risk oversight by bank boards. This led to the conclusion that fundamental change is required across all aspects of risk governance. Regulators have begun to define what good risk governance looks like, while banks have begun to move towards higher governance standards.

Management, working with the board of directors, needs to redefine their business strategy and set the risk appetite and risk culture. They will need radically different management information to monitor progress against strategy and to manage the risks, which only significant investments in core and critical systems, as well as emerging analytic technologies, will provide.

Regulators are requiring banks to report an increasing amount and granularity of data. Every new regulation brings with it additional reporting requirements, as does the increase in supervisory intensity and coverage, and the growing emphasis on stress and scenario testing. This places considerable costs on banks in terms of the people, systems and quality assurance processes necessary to support this reporting.

In addition there is increased focus on individual responsibility for reported data, on banks' internal assurance processes (including the role of internal audit), and on governance (including how a bank's non-executive directors gain assurance about the quality of reported data), thereby resulting in significant pressure on management and the board to understand the drivers behind the results reported and to make sound decisions as a result of that understanding.

Banks therefore need to be able to produce and use high quality management information both routinely and in response to emerging risks as an input to high quality decision making.

Banks should be reviewing:

- The quality and harmonisation of the risk data they collect;
- Their ability to aggregate risk data effectively;
- The use of IT to streamline data management and to make it more efficient—it will be too expensive to rely on manual processes and workarounds; and
- The internal reporting of aggregated risk data, to both senior management and the Board, and the use of this information for decision-making.

Banks need to do more in the area of risk and governance. New risk management and risk reporting procedures are being introduced, but roles and responsibilities have not always been fully determined and documented. Most banks have not yet reached a stage where management and the risk management function together are strategic and forward-looking.

Strategy

In today's business environment, banks must take a more strategic and forward-looking approach, shifting to a more customer-centric approach and taking a more outcomes-driven view of customer satisfaction.

Banks face multiple pressures to reconsider their strategies, business models and operating structures. These range from structural separation requirements to bail-in liabilities, and from capital requirements to liquidity. For customers of banks the impact of these changes is stark – banking products and services are becoming more expensive, and in some cases the availability of products and services has been constrained.

Banks need to create a viable business model with a financial model that can support the costs of the new capital and liquidity requirements; and an operating model that delivers both efficiency and the flexibility to respond to the changing needs of customers and advancements in technology. Consideration should be given to those business activities that can succeed in the new financial and regulatory environment, and to which activities are 'non-core' or 'marginal' as a result.

The risk of not focusing on improvement and evolving is significant. The competition is assuredly moving ahead. Without a defined and well implemented strategy, a bank is likely to be left behind - in terms of efficiency, reputation and financial success.

The strategy must be in line with the company's vision. The vision is the aspiration. It should inspire all stakeholders and create a shared sense of purpose. The vision should define what the bank stands for and why it exists. It should also define what the bank aspires to become, to achieve and to create. A vision should be concise, direct and memorable so that all stakeholders are clear on the company's direction and aims.

The vision should then be supported by core values or guiding principles. These are deeply held beliefs that do not change. They outline what is sacred to the company and what must not change. Companies that enjoy enduring success have a strong vision and core values that remain fixed while their underlying strategy endlessly adapts to a changing world.

The strategy is then defined to describe how you will achieve your vision, in accordance with your guiding principles. For example, a strategy defines how the bank is going to be different from the competition; how the bank will deliver a unique mix of value to your customers; and how the bank will attract customers and how it will serve their needs. All decisions made by the company from this point must consider the strategy in order for alignment to be achieved. This will require management to make trade-offs and agree on what the bank will do, as well as what it will not do.

2014 KPMG in Bermuda BANKING SURVEY

2013 AT A GLANCE

Bermuda's banks were all profitable in 2013 for a third consecutive year despite a continuing economic recession in Bermuda, and a global low interest rate environment continuing to impact the ability to earn revenue.

BACKGROUND

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

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

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

- **HSBC** is part of a large global banking network. HSBC has a December 31 year end and prepares its financial statements in accordance with International Financial Reporting Standards ("IFRS").
- **Butterfield** is listed on the Bermuda Stock Exchange and has a December 31 year end. Butterfield prepares its financial statements in accordance with accounting principles generally accepted in the U.S..
- **Clarien** has largely had a residential lending focus to date and has a December 31 year end. Clarien prepares its financial statements in accordance with IFRS.
- **BCB**'s year end is September 30 and its financial statements are prepared in accordance with IFRS. BCB does not have a significant investment in loan assets.
- All amounts disclosed are in thousands (000's) of Bermuda dollars.

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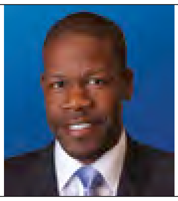
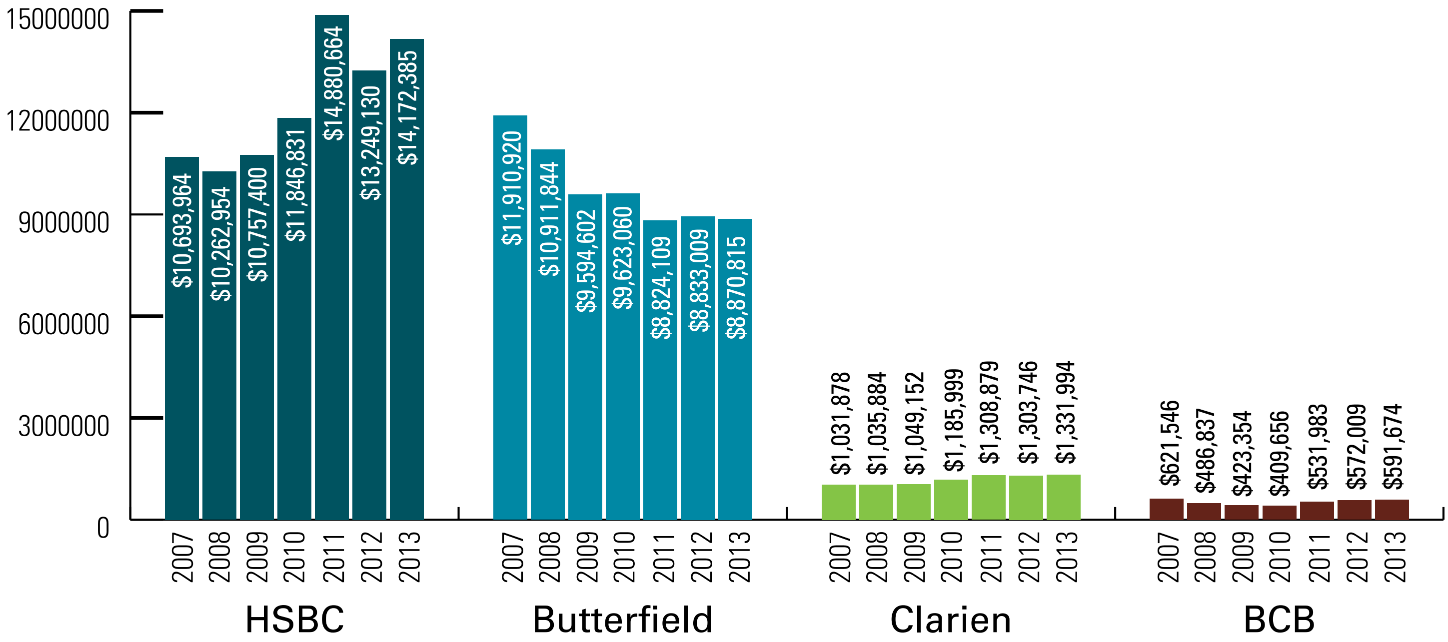


Figure 1: Total Assets



BALANCE SHEET

The balance sheets of the banks remained fairly consistent in size and composition, with the exception of HSBC's balance sheet, which grew by approximately $1 billion, or 7% since the end of 2012. The composition of HSBC's assets also shifted slightly. Loans and advances to customers reduced due to repayment of term loans during the year. These funds were re-invested in financial investments, along with the growth in deposits.

Clarien remained the most highly invested (77%) in loans to customers.

PROFITABILITY

Profitability of banks globally is under pressure due to the low interest rate environment, as well as a trend towards more liquid, lower risk, lower yield investments in the wake of the financial crisis, and in order to react to regulatory capital

Figure 2: Composition of Total Assets

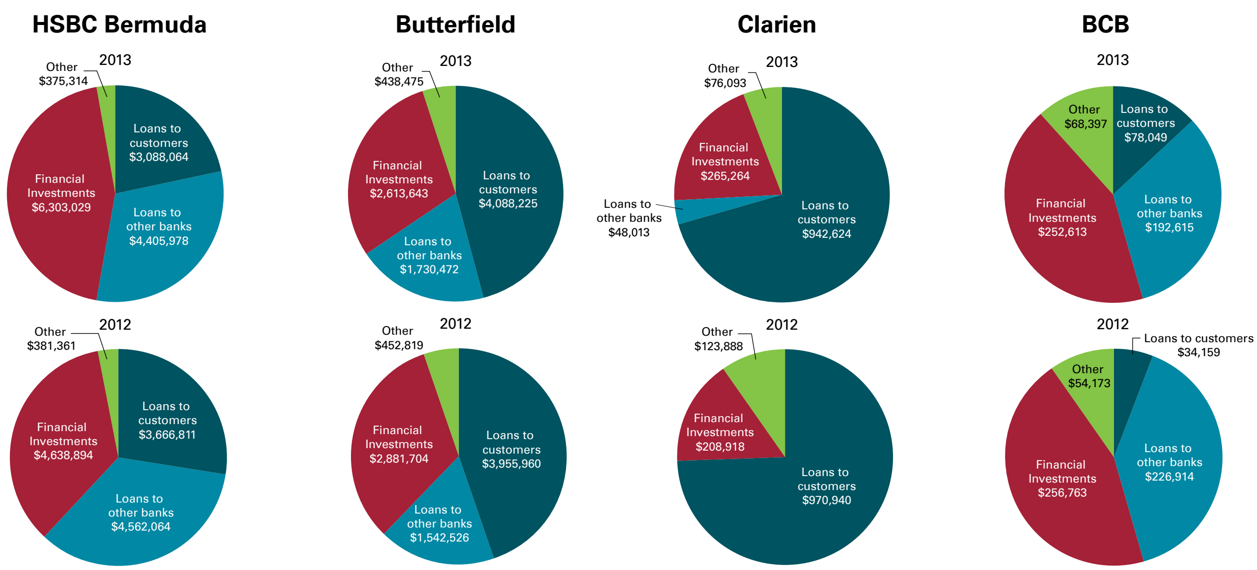


Figure 3: Net Profit as a Percentage of Equity

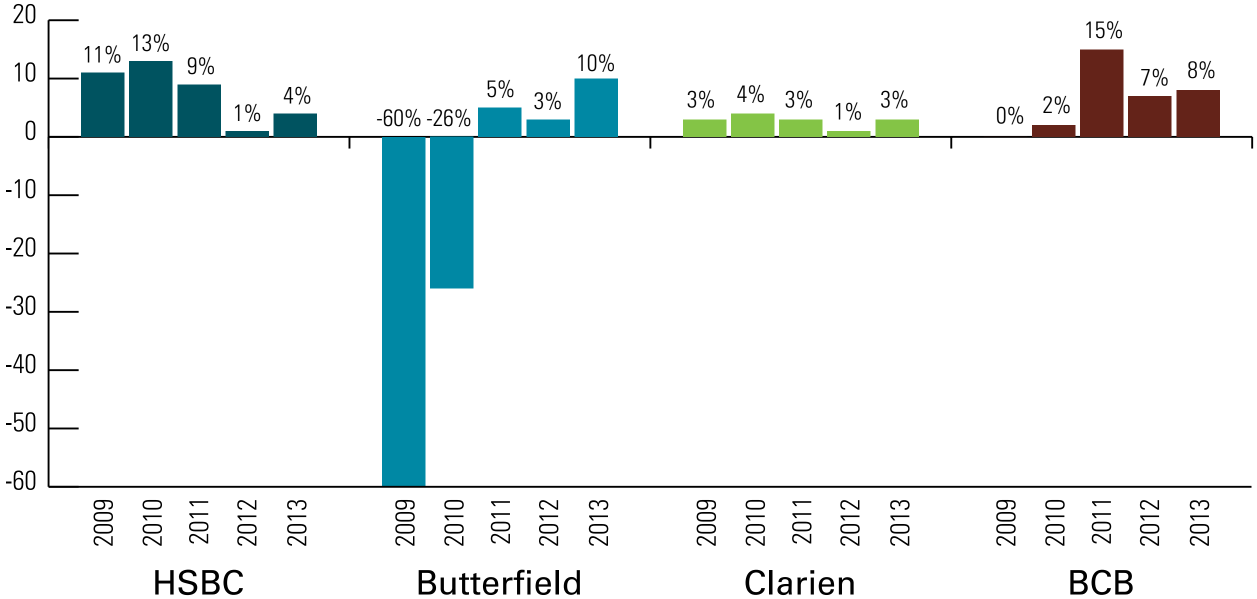


Figure 4: Total Interest Income as a Percentage of Net Interest Before Credit Losses

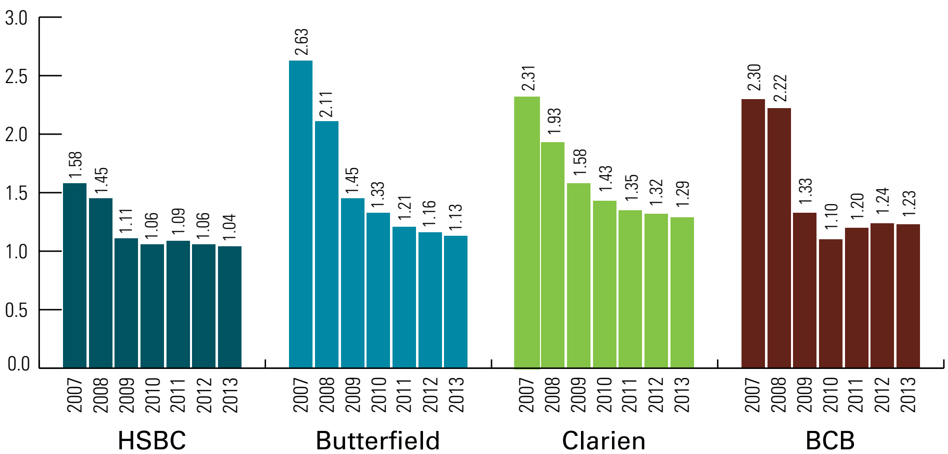
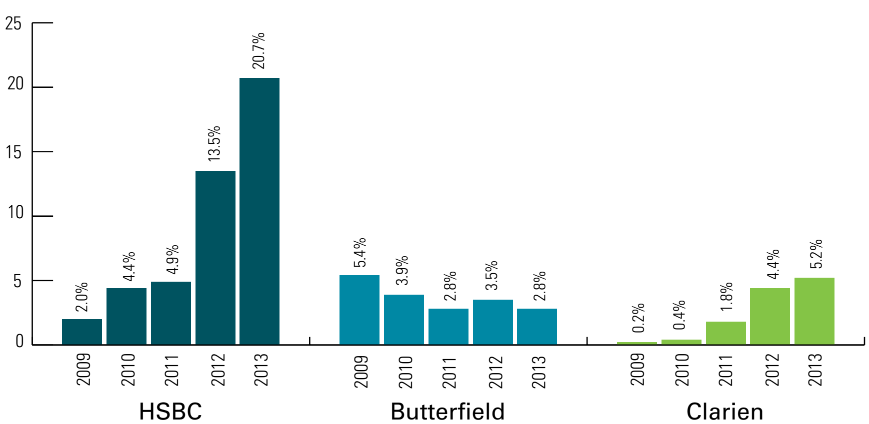


Figure 5: Impaired Loans as a Percentage of Gross Loans



pressures. The severe impact of the low interest rates is clearly evident in Figure 4, looking back to the sharp decline since the start of the financial crisis.

Bermuda's banks have been under additional pressure due to Bermuda's economic recession and the related impact on impaired loans and impairment charges. This is evidenced in the sharp increase in the percentage of impaired loans of those banks actively engaged in lending illustrated in Figure 5.

Despite this, all four of Bermuda's banks have managed to maintain profitability over the last three years.

With no real indication that interest rates are on the increase, or that the economic tides in Bermuda are changing, profitability will likely remain under pressure in the foreseeable future. The additional compliance costs associated with regulatory changes such as FATCA, Anti-Money Laundering, enhanced Know-Your-Customer regulations and Basel III, will also have an impact on profitability going forward.

To combat the lower net interest margin being earned, many of the banks have sought other sources of revenue, primarily fee income. In January 2014, Butterfield announced their purchase of a Guernsey-based trust and fiduciary services company. While BCB, did not make any direct acquisitions in 2013, its parent company, Somers Group did. This follows on from BCB's amalgamation with Paragon Trust Services Limited, and Charter Corporate Services Limited in 2012. These transactions are expected to have a positive impact on fee revenues.

Clarien was subject to a change of ownership early in 2014. The new owners have made it clear that they are focused on expansion into new lines of business and markets.

CAPITAL ADEQUACY

Despite the difficult times the capital ratios of the Banks remain strong, exceeding international industry standards. It should be noted, as it has been in prior years, that the BMA does require Bermuda based banks to maintain a premium above the international standards in order to compensate for the concentration risk associated with lending in the Bermuda market and the absence of a central bank.

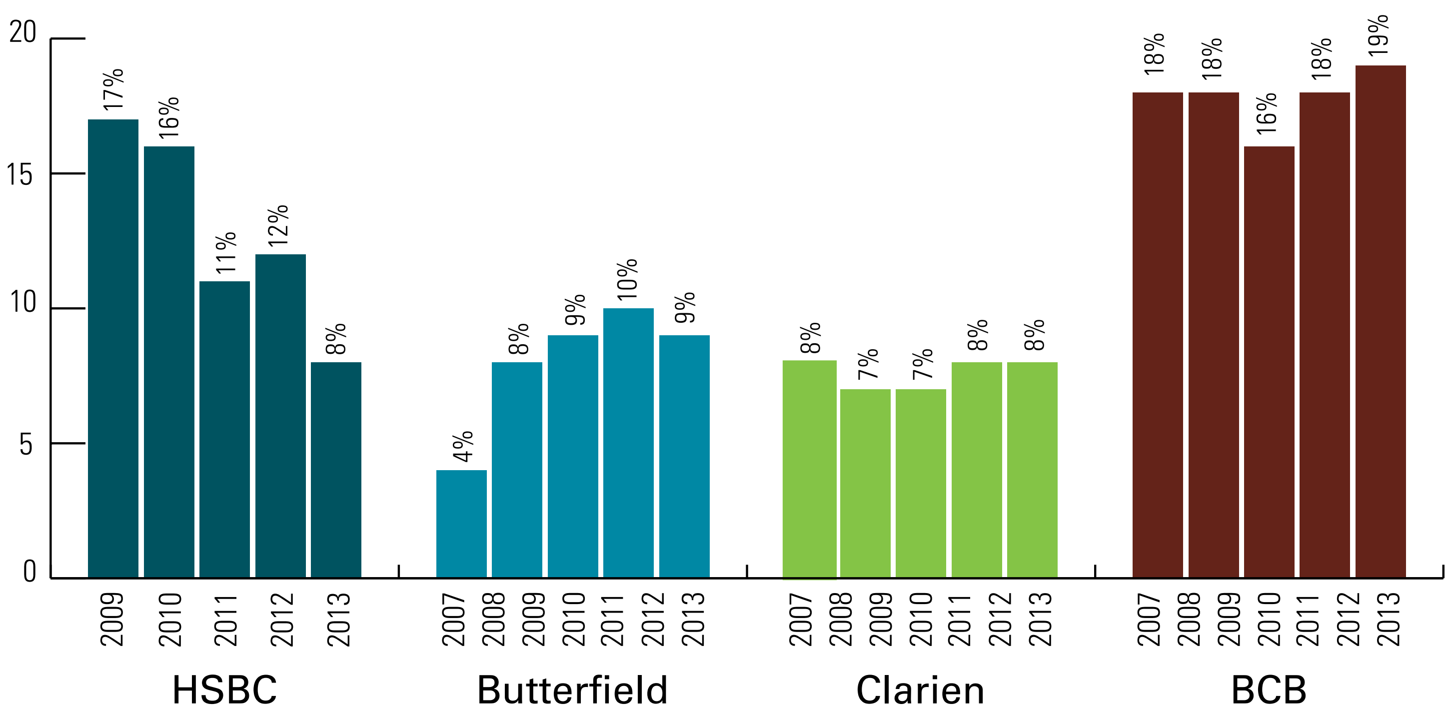
Banks are required to disclose information about their capital, risk exposures, risk assessment processes, and capital adequacy. These disclosures, known as the Capital and Risk Management Pillar III disclosures, allow informed market participant to gauge the capital adequacy of the banks, and are available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

Capital adequacy and risk management will continue to be closely monitored by regulators worldwide in the lead up to the implementation of Basel III, which is expected to increase bank capital requirements.

Figure 6: Basel II Tier 1 Capital Ratio

Bank	2010	2011	2012	2013
HSBC Bermuda	31%	33%	28%	21%
Butterfield	16%	18%	19%	20%
Clarien	17%	14%	13%	13%
BCB	27%	32%	26%	22%

Figure 7: Equity as Percentage of Total Assets

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