

The flight to quality

The beautiful island of Bermuda is just 21 square miles but is the domicile of choice for half of all Hong Kong listed companies, and does business with half the Fortune 500 companies. Sharon A Beesley, director and general counsel at ISIS Limited in Bermuda, discusses the island as an offshore fund centre

Bermuda, set in crystal clear aqua blue waters with soft white and pink sand, is without a doubt a small place, only 21 square miles, but from the perspective of business it is a giant by comparison. The Bermuda insurance and reinsurance market rivals New York in size and stature and is slightly larger than the London market. In addition to the insurance industry that is physically based in, and operated out of Bermuda, the financial services industry is rapidly expanding. Bermuda has been the domicile of choice for more than 50% of Hong Kong stock exchange listed companies since 1997, and it does business with more than 50% of the Fortune 500 companies. It has a first class trust sector with about 20 international institutions permitted to offer private client and trust services from a Bermuda base. As a result of the international business sector, Bermuda boasts one of the highest standards of living in the world. Not bad for a country with a population the size of a small European Village.

BERMUDA'S BUSINESS ETHOS

Much of Bermuda's success can be attributed to its selective approach to business. It has traditionally used a rigorous 'know your customer' approach in determining who will be allowed to come to the Island to do business in or from within

Bermuda. In the past this stance was felt to be a hindrance to using Bermuda and the development of its financial services industry. In today's climate, of course, such an approach is critical to an offshore centre's ability to maintain its status as well regulated jurisdiction in the eyes of the international regulatory bodies and governments such as OECD, FAFT, the UK and USA. In fact, the OECD KPMG Report highlighted Bermuda as an example of the way offshore centres should regulate themselves.

A major differentiation factor between Bermuda and other offshore domiciles is that it has chosen to subscribe to a view that quality is more important than quantity. In the past Bermuda has been perceived as slower and more expensive than other rival centres. Continuing 'vetting' of the direct and indirect beneficial ownership of entities wishing to do business in or from within Bermuda is now perceived internationally as the correct approach and is indeed being emulated in other jurisdictions. Bermuda is nowadays considered to be very competitive on fees.

The other distinguishing factor in the growth of Bermuda's financial services sector has been its past refusal to allow any foreign banks to establish in Bermuda. Similarly foreign investment management companies have not been allowed to carry

on such business locally. This approach has allowed Bermuda to control capital inflows carefully and avoid the major money-laundering or drug scandals that have plagued other offshore, and certain onshore, financial centres. Although there remains no offshore banking sector, the Bermuda government is giving signs of limited liberalisation of the rules, and has publicly stated that it is willing to open up bank licences to a handful of international players. At the same time, three of the existing locally owned Bermuda banks have been allowed to seek foreign investors in excess of the former restriction on foreigners owning an equity stake of more than 40%. Similarly, some foreign investment management groups have been permitted to carry on business locally.

THE REGULATORY ENVIRONMENT

The Bermuda Monetary Authority (BMA) was created over 30 years ago to provide an accountable but separate relationship with the Bermuda government. It has gone on to develop a well-recognised standard of effective regulatory oversight of Bermuda's financial sector in step with international regulators requirements. The BMA is now the sole licensor and regulator of all financial institutions, including the insurance and reinsurance sector. The Ministry of Finance continues to be involved in the process in its review of the impact of developments on economic issues affecting the island. Historically, the Bermuda international business community has worked in partnership with the government to design regulations, which encourage innovation while seeking to preserve the highest standards of conduct.

Bermuda is home to the thriving and well-regulated Bermuda Stock Exchange (BSX). The BSX provides regulated securities trading on a technologically advanced and secure trading platform. In

2001, daily trading value exceeded \$436 billion and there are over 385 listed securities (including 270 funds). The BSX has been approved by the US SEC as a designated offshore exchange, is a full member of the World Federation of International Exchanges and an affiliate member of IOSCO (the International Organization of Securities Commissions). One of the advantages of listing on the BSX is that institutional investors in Europe, Asia and Latin America are able to invest in a 'listed security' on a recognised exchange.

Bermuda's insurance and reinsurance market began with the establishment of a niche market, namely captives formed to insure or reinsure the risks of the captive's parent and affiliates. This self-insurance concept was then expanded to 'rent-a-captives' where third party risks are grouped together and managed with lower administration costs than traditional commercial insurers can provide. This product was followed by the development of 'speciality insurance markets', such as property catastrophe reinsurance, political risk insurance, and alternative risk transfer products. The latter product involves the use of insurance to help manage financial and business exposures of companies in the different areas of their business and results in the convergence of insurance, capital markets and banking techniques. One of the first leading insurers in the area of financial line products is the Bermuda-based Centre Solutions, a wholly owned subsidiary of the Zurich Group. Bermuda now sees many of its largest players working in this area, including XL Capital, Alliance, ACE, AXIS, Renaissance Re, Partner Re and others.

One of the most recent innovations in the Bermuda market place is the convergence of the insurance market and asset management. Examples of these convergent products over the past few years are the establishment of insurance

companies with a hedge fund investment component and the use of insurance guarantees for investment funds.

As a result of the foregoing innovations, Bermuda is now home to over 1,600 insurance and reinsurance companies and has some \$132 billion in insurance assets controlled on the island. Many of these companies are NYSE listed and have their home base and full senior management team on the island. Bermuda is now one of the largest excess liability markets in the world and is the largest private political risk market. Many of the Bermuda reinsurers own large onshore insurance companies, such as NAC Re, Winterthur, CIGNA and many Lloyd's syndicates. As further testimony to Bermuda's pre-eminent position following the events of September 11, Bermuda has seen an influx of over \$10 billion in new reinsurance capital.

OFFSHORE FUND MARKET

Bermuda is a leading centre for offshore funds, both as a domicile and as a base for fund administration services. Currently Bermuda regulates (as collective investment schemes) unit trust and open-ended investment companies, of which there are more than 1,300 schemes domiciled in Bermuda with approximately \$46 billion in assets. Bermuda is working on streamlining its existing funds regulation under a single comprehensive statute, which is expected to come into force in 2003. This new primary legislation will provide the BMA with an enhanced set of regulatory and intervention powers, in line with other regulatory statutes. Further developments will be:

- expansion of the definition of schemes to catch a wider range of pooled investment vehicles;
- exemptions for schemes which are private in nature; and

- provision for the licensing of fund administrators.

Under existing regulations, collective investment schemes may be classified under one of three classes. In the offshore context, the two classes are either institutional or standard schemes. As a result of recent changes, all collective investment schemes aimed at the sophisticated investor will be classified as institutional schemes. The test for institutional schemes is either a minimum investment of \$100,000 or compliance with a sophisticated investor test under Bermuda's investment business legislation. By contrast, standard schemes are aimed at retail investors and therefore have more regulation than is required for institutional schemes.

The island's sound regulatory framework was recognised as long ago as 1986 when Bermuda was awarded Designated Territory status for mutual funds by the UK. Bermuda continues to remain competitive as a jurisdiction for offshore fund because it has the flexibility to react to market challenges without sacrificing quality and integrity. The BMA's practice of examining the track record, expertise and integrity of all service providers to a fund rather than its actual structure ensures that the island is able to adapt to new products such as fund of funds, master/feeder funds and principal guaranteed notes (the return of which is linked to the performance of an underlying pool of funds).

Some recent developments increasing Bermuda's attractiveness as an offshore fund centre are:

- the ability of institutional schemes to use a non-Bermuda based custodian bank or prime broker;
- overseas funds can be administered from Bermuda without the need for any permit approval; and

- Bermuda funds can now be structured to have segmented (ie, ring fenced) accounts or portfolios. This is of particular benefit to the umbrella fund structure.

Bermuda enjoys the physical presence and accessibility of the world's largest accounting firms, as well as global service providers such as fund administrators. Among the major players currently based in Bermuda and in the business of adding real value to the operation of an offshore fund are the Bank of Bermuda, Hemisphere, IFS, CITCO and Olympia.

Because of Bermuda's excellent reputation, demonstrated innovation and wealth of experience in financial services, the island is well positioned to take advantage of the increasing 'flight to quality' in the use of offshore centres.