



Getting to the heart of Bermuda's asset servicing needs

Executives at BNY Mellon Asset Servicing give their views on the biggest asset servicing issues facing Bermuda's insurers and reinsurers.

What specific asset servicing needs do the Bermuda players have?

Christi Caperton, First Vice President – Head of Bermuda Insurance Relationship Management Group, US Asset Services:



Bermuda is a very sophisticated marketplace. Our clients are investment-management-driven in that they act as a “manager of managers” and also often manage a portion of their assets internally. From an asset-servicing perspective, these companies look to partners such as BNY Mellon for much more than just simple custody of their portfolios. They need key asset-level data and sophisticated reporting on that information to be able to assess and respond rapidly to changes in the global markets. Since these companies both invest in the global markets and are also marketing their products around the world, their service providers need to provide customized solutions to assist them in managing overall investment risk.

Peter Holland, Vice President - Head of Insurance Relationship Management Division, US Asset Services:



In addition to our ability to assist with our clients' unique reporting needs, we are strongly positioned to interface with our clients' chosen investment managers. As a leading custody service provider, BNY Mellon has fully automated links in place with virtually every leading investment manager. As new IM's are hired by our clients, trade and reporting work streams are easily activated. Many of our clients take advantage of our Performance Reporting and Transition Management services to assist in their monitoring and management of their IM's as well.

Jason Knight, Managing Director – Head of Insurance Industry Services Sales:

From a global bank perspective there was a particular focus in supporting the capital needs of the start-up entities

SPONSOR'S ROUNDTABLE



that emerged both after September 11th and hurricanes Katrina, Rita and Wilma. It was not just a matter of supporting our new clients in Bermuda from a credit perspective, but then also demonstrating an ability to understand their unique needs, including their infrastructure or lack thereof, in terms of back-office support in the domicile.

There is a tendency for Bermuda companies to outsource as much as their investment operations and back-office as they can, and that certainly includes the custody component of their business. Over the past four or five years there has been a stronger focus on doing the investment management oversight, so it is not just about selecting investment managers but also monitoring the performance of those managers through sophisticated tools which are designed to monitor risks from an investment perspective and ensure these risks are commensurate with their underwriting liabilities.

Peter Holland:

The Bermuda marketplace for BNY Mellon, when looked at as a combined organization, presents a broad scope of client profiles. As Jason mentioned earlier, we were fortunate to win a number of start-up mandates post September 11 and with the series of hurricanes that followed. Many of these firms began with tens of millions of dollars and initially utilized only our custody services. As these firms have expanded, many now with several billion dollars in assets, so have their needs. As a full service provider, we have been able to offer many additional services including accounting, performance measurement and risk analytics, asset management and securities lending. Today, we have relationships with more than 40 Bermuda based insurance companies with assets in excess of \$130 billion. The Bermuda marketplace represents a very significant and important growth segment of our overall insurance business.

Patrick Curtin, Executive Vice President - Head of US Asset Services:



Most non-Bermuda companies take on the majority of the middle-office responsibilities themselves and build proprietary analytical tools because, more often than not, they are acting in the capacity of portfolio managers and managing money themselves. This tends to not be the case in Bermuda, so they will look to their asset servicer or their custodian to provide a lot of those value-added services.

Joseph Keenan, Managing Director, Head of Relationship Management and Sales, US Asset Services:



In fact, the Bermudians seem to have been a harbinger of a trend toward the extension of middle-office outsourcing within the global insurance industry. In some ways they were way ahead of the curve. Historically, a number of the larger non-Bermudian firms were inclined to maintain or retain most of the middle-office responsibilities that many of the firms in the Bermuda market either didn't have the desire or

the wherewithal to perform. It is starting to become the model more broadly for global insurers. So in many ways Bermuda has set the tone for the broader insurance market.

What are the biggest issues facing Bermudian companies?

Christi:

The sub-prime market crisis is impacting them directly as a number of the Bermuda players have had exposure to mortgage-backed securities; tighter credit has further exacerbated their pain as many firms are also impacted by the expensive cost of commercial paper these days. Additionally, on the business side, there is a potential for D&O liability claims from the companies that created these structured products.

Insurers are also concerned about the two new Financial Accounting Standards Board (FASB) rules, FASB 157 and FASB 159, and they are now in the throes of dealing with them. BNY Mellon has done extensive research on what these regulations mean, and we have had many meetings with our customers to discuss how they are planning to respond and how we can help.



Christi Caperton, Vice President – Head of Bermuda Insurance Relationship Management Group, US Asset Services

What are the FASB rule changes and what will they mean for insurers?

Christi:

If a company is filing US GAAP financial statements with the SEC or is preparing financial statements under US GAAP, FASB 157 and FASB 159 may apply to them.

SPONSOR'S ROUNDTABLE

Patrick Curtin, Executive Vice President - Head of US Asset Services



FASB 157 defines fair value and establishes a framework for measuring fair value in US GAAP. Prior to FASB 157, there were different definitions of fair value and limited guidance for applying those definitions in US GAAP. Fair Value is defined as: “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” FASB 157 does not consider the price at which the asset would be bought, nor does it consider whether the company plans to hold or to sell the asset; it is based on exit price. Insurers can’t any longer just reflect the company impact – the strength of the company. Now they have to consider the market impact – what would the price be if I sold it today?

FASB159 gives entities the option (but not the requirement), under US GAAP, to choose to measure at fair value many financial instruments (stocks, bonds, loans, warranty obligations and interest rate hedges) and certain other items that are not currently required to be measured at fair value. With FASB 159, they may be treated the same as “trading” securities, and the unrealized gain/loss offset is posted directly to earnings. Insurers need to assess fair values and the internal controls that they will put in place around this process.

How big a change is this?

Patrick:

To sum up, we anticipate some investment decisions will be made that are driven by accounting conventions, as opposed to accounting conventions lining up behind investment decisions, and that’s potentially significant.

What assets will cause the biggest issues?

Patrick:

Any investment that doesn’t trade on an exchange at a very clear market price. Illiquid assets certainly, but in addition any security whose value is decided upon a buyer and a seller agreeing upon a price at that moment in time, or whose value is determined by a model or within a matrix pricing environment. That would include virtually any mortgage-backed securities, CDOs, and many of the structured credit products that have been put together in the past four or five years. This is not meant to pick on the Bermuda market. The insurance industry broadly holds a lot of these types of investments, as does the banking industry. This is not necessarily an issue with credit challenged paper, but more of a commentary on structured credit and structured note products. By its nature, the insurance industry has historically been heavy buyers of these structured instruments.

What will be the effect on results?

Patrick:

The general feeling is we definitely could see write downs in valuations. The principle of conservatism that governs all of the accounting promulgations are such that the more conservative market valuation will most likely hold sway in a market value context. The trend toward conservative valuations will be even more magnified during this period of market uncertainty and volatility.

In defense of FASB 157 and 159, if you take a longer-term view over multiple accounting cycles the effect should wash itself out, particularly as fixed income securities mature and pay off at their par value. The effects over a longer period of time should be muted.

SPONSOR'S ROUNDTABLE

How do you see the subprime crisis affecting the industry?

Patrick:

The insurance industry broadly, and the Bermuda industry specifically, enjoys a healthy shock absorber cushion with its strong capital base. The industry is entering this turbulent period from a position of strength, which is good news. We believe that in the grand scheme of financial upheavals, the history books will say this one won't have been all that terrible in hindsight.

The industry is faced more with a liquidity crisis than with a true credit crisis. There is clearly an element of credit deterioration, but what is really impacting our clients can primarily be explained by the rapid disappearance of market liquidity. This is why FASB 157 and 159 are so very important, if liquidity disappears and market values are what really matter there could be some misleading write downs in the short run.

But in the medium to long term we believe this crisis will largely blow over and will prove not to have been that big a deal in the grand scheme. There will be an impact as deeply subordinated investments do exist out there that are going to lose money. But that's no different than a property/casualty company that places its surplus capital in the equity markets taking a calculated risk with its decision to embrace equity exposure. Those kinds of losses happen in the normal course of capital market volatility, as of course do the gains that our clients many times enjoy as part of the ongoing investment process.

Joe:

A bit of a transition away from that point but not completely, it speaks to the role the BNY Mellon plays whether it is helping our clients address the new FASB Rules, or in general the impact of changing rules and regulations tied to market volatility. With this crisis, many of our clients are looking to us to help validate a consensus position, or to act as a clearinghouse of sorts. They are all getting introspective and saying 'We are looking at our investment portfolios, we are looking at what we are facing, and we think we know what the right course of actions is.' But they are also turning to us and saying either on an informal basis or a formal basis: 'What are the rest of your clients doing? What accepted practices are starting to emerge?' We see our obligation to be readily available to our clients during this period of uncertainty and alert the industry that we recognize our responsibility to act as a bellwether and to embrace this role aggressively.

How well are insurers placed to cope with the subprime crisis?

Patrick:

As previously noted we don't anticipate seeing any insurance company going out of business as a direct result of the subprime crisis; the industry is in a position of strength and has a great capital base. A large part of where losses are occurring is when the beneficial owner of the asset is forcing the sale because of a lack of liquidity. It is where they are seeing a bid that is well below the value that many believe should be enjoyed by the investments in question - fearing that the price will go even lower and forcing a sale when the asset will eventually be "money good" at maturity. So for many it is fear taking the place of rational behavior. As we all know, the insurance industry is not prone to knee jerk reactions as the beneficial owner of these recently illiquid assets.

Some pundits might say the financial contagion has the potential to be so severe that a disproportionate amount of claims will emerge within the insurance industry. While I imagine that this may be the case, we just don't see this as a calamity being big enough to create a significant capital drawdown within the insurance industry as a direct result of potential losses; we don't anticipate any major insurers hitting the skids as a direct result of the subprime crisis which again is more of an issue of liquidity than true credit quality.

It will, however, be interesting to see what the impact is on another niche part of the Bermuda market - the financial guarantor industry.

Jason:

Plus these investments aren't typically assets that insurers are normally looking to unload at bargain basement rates. Our clients are almost always inclined to hold them until maturity.



Jason Knight, Managing Director - Head of Insurance Industry Services Sales

What lessons can insurers take from this?

Patrick:

The lesson is probably the same takeaway that has come along with every financial upheaval throughout history: the next financial calamity will emerge from a place that no one has thought of yet. We should have learned our lesson from the tech bubble, but clearly the capital markets once again didn't see the storm on the horizon until we were all directly in the eye of the hurricane.

The risks that come along with any kind of major financial dislocation is over-regulation in every jurisdiction, with regulators believing they can regulate away bad decision making. However, the last I checked no one has even been able to regulate away stupidity! Our biggest concern, whether it is the insurance regulators, the banking regulators, the SEC or any of the European regulators, is that they will take things too far as was done with Sarbanes-Oxley. So let's hope the market can continue to regulate itself and manage its way through these choppy waters. ●