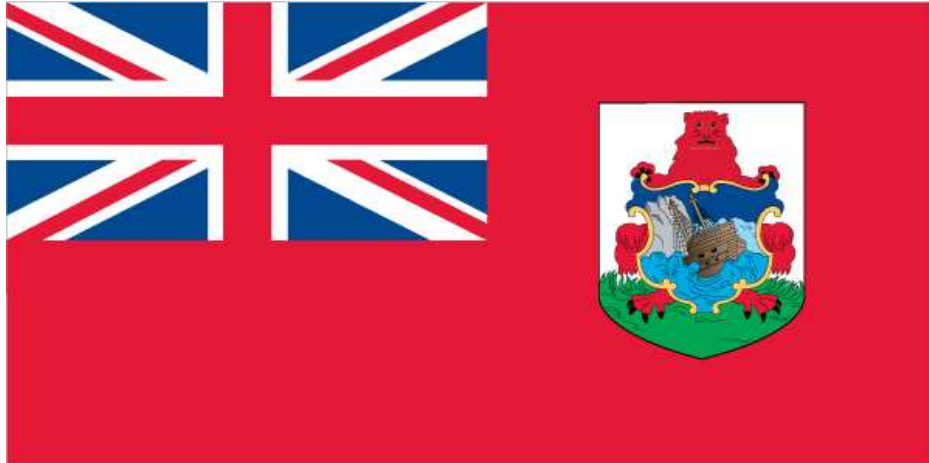


BERMUDA



Summary

Bermuda is a small British crown colony off the US eastern seaboard. The archipelago's small and undiversified economy is centred around the financial offshore sector, but also relies on its luxury tourism sector. Being renowned for its business-friendly tax climate and sophisticated financial infrastructure, the country has become the largest (re)insurance jurisdiction in the World after New York and London. Maintaining Bermuda's favourable operating environment for the financial sector is a key policy objective. Owing to its prominent international position in international (re)insurance markets, Bermuda, together with Japan and Switzerland, will be among the first non-EU countries whose compliance with the EU Solvency II directive will be assessed. As the country was hit hard by the global financial crisis, government finances deteriorated markedly, but the government has embarked on a sensible consolidation course that should restore government finances without choking Bermuda's sluggish economic recovery. Thanks to Bermuda's considerable net external creditor position, its relatively weak liquidity position should not pose any major problems in the coming year.

Things to watch:

- Economic recovery in the US
- Budgetary consolidation
- Progress in Solvency II implementation

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Bermuda			
National facts		Social and governance indicators rank / total	
Type of government	Parliamentary democracy	Human Development Index (rank)	n.a.
Capital	Hamilton	Ease of doing business (rank)	n.a.
Surface area (sq km)	54	Economic freedom index (rank)	n.a.
Population	68,679	Corruption perceptions index (rank)	n.a.
Main languages	English	Press freedom index (rank)	n.a.
Main religions	Angelican (23%)	Gini index (income distribution)	n.a.
	Roman Catholic (15%)	Population below \$1 per day (PPP)	n.a.
Chief of State (Queen)	Queen Elisabeth II	Foreign trade 1905	
Head of Government (premier)	Paula Cox	<i>Main export partners (%)</i>	<i>Main import partners (%)</i>
Monetary unit	Bermudian Dollar (BMD)	Spain 17	US 31
Economy 2010		India 10	South Korea 27
<i>Economic size</i>	<i>bn USD</i> <i>% world total</i>	Brazil 10	Brazil 7
Nominal GDP	6 0.01	Germany 7	Ireland 6
<i>Economic structure</i> 2010 5-year av.		<i>Main export products</i>	
Real GDP growth	0.5 1.7	Re-exports of pharmaceuticals	
Agriculture (% of GDP)	1 1	<i>Main import products</i>	
Industry (% of GDP)	10 10	Clothing	
Services (% of GDP)	89 89	Fuels	
<i>Standards of living</i> USD % world av.		Machinery and transport equipment	
Nominal GDP per head	96819 985	Construction materials	
		<i>Openness of the economy</i>	
		Export value of G&S (% of GDP)	23
		Import value of G&S (% of GDP)	36

Source: CIA World Factbook, Fitch

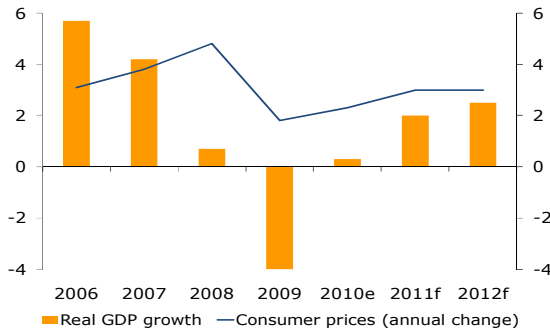
Economic structure and growth

Bermuda is a small British Overseas Territory in the Atlantic Ocean, approximately 1,000 km off the North Carolina coast. It is Britain's oldest crown colony and the United Kingdom retains significant powers on the islands, primarily in the fields of external and internal security and foreign affairs. It is also responsible for good governance. Self-government is modeled after the Westminster-system and the islands' two-party democracy has ensured considerable political stability. With a total population of about 69,000 and a nominal GDP of USD 6bn, Bermudians enjoy one of the world's highest incomes per capita (USD 96,819 in 2010). Most of the country's welfare is generated in Bermuda's large internationally-oriented financial services sector, which accounts for about 40% of GDP. Owing to Bermuda's benign tax climate, stable institutional settings and sound regulatory environment, the country has become a globally renowned offshore financial center. Bermuda is the third largest (re)insurance domicile in the World after New York and London. Luxury tourism primarily catering to US tourists constitutes the second most-important sector of the local economy. It is an important jobs generator and contributes about a quarter of total fiscal budget revenues. As business-related tourism is gradually gaining in importance, developments in the financial and tourism sector become increasingly intertwined. The small Bermudian economy is highly undiversified and vulnerable to external shocks, ranging from adverse economic developments in the US to financial market turbulences or commodity price fluctuations.

The global financial crisis and the ensuing economic downturn brought the vulnerability of the Bermudian economy to the fore as economic growth declined to 0.7% in 2008 from 4.2% in the previous year, before tumbling down to -4.0% in 2009. In 2010, a sluggish economic recovery set in, with GDP expanding by a meager 0.3%. Economic growth in the coming years will be tempered

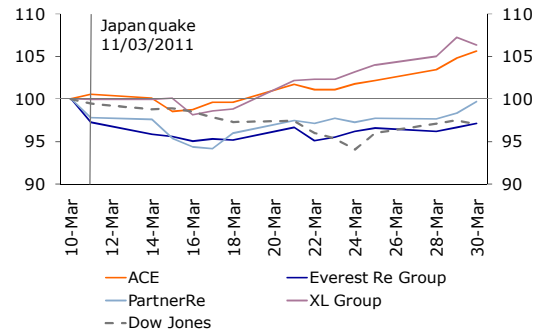
and depend on developments in the US, both in terms of financial market conditions and tourism demand. Owing to the relatively timid US recovery, Bermudian economic growth in 2011 and 2012 is estimated at 2.0% and 2.5%, respectively.

Graph 1: Economic growth and inflation



Source: Standard & Poor's

Graph 2: Stock price reaction of major Bermudan (re)-insurance companies to the Japanese earthquake



Source: NYSE

While reliable estimates as to the impact of the March 11, 2011, Japanese earthquake on Bermudian re-insurance companies are not yet available, stock price movements of Bermuda's main reinsurers suggest that insurance payouts could be limited. Despite major losses on US residential mortgages of one Bermudian bank that led to a partly government-guaranteed recapitalization, the capital adequacy ratio of Bermuda's banking system stood at a sound 21.0% in the first half of 2010.

Political and social situation

Bermuda's status as a British crown colony and the ensuing responsibility of the United Kingdom for external affairs and internal security broadly ensures political and social stability. Self-government is conducted on the basis of a Westminster-style system, which still reflects the racial divide on the island. While the governing centrist Progressive Labour Party (PLP) predominantly leans on the islands' black majority, the moderate United Bermuda Party (UBP) is supported by more affluent white Bermudians. This divide is also reflected in the parties' stance towards the question of independence from the UK. The UBP remains a staunch supporter of the status quo, since its electorate perceives the United Kingdom as a guarantor of stability on the islands, while PLP voters are generally more pro-independence. The Bermuda Democratic Alliance (BDA), which spun off from the UBP in 2009, attempts to bridge the racial divide in Bermudian politics. Headed by Ewart Brown, the PLP defended its parliamentary majority in the 2007 elections, gaining 22 out of 36 seats. In 2010, Mr. Brown lost internal party elections to Ms. Paula Cox, a UK-trained lawyer and former finance minister, which led to her appointment as Bermudian premier. Ms. Cox, a veteran of Bermuda's international business sector, is expected to adopt a less-confrontational policy approach than her predecessor. With Bermuda's income inequality ranking high among the PLP electorate's main concerns, Ms. Cox will focus on the party's social agenda, while the goal of independence from the UK should receive minor attention. Given elevated unemployment levels, particularly among the relatively less-educated, this policy mix should prove valuable in containing social tensions and protect Bermuda's reputation as a socially and politically stable country.

Economic policy

Maintaining a highly business-friendly operating environment remains the Bermudian government's overarching economic policy rationale and particular attention is paid to ensuring Bermuda's reputation as a jurisdiction of choice for financial service providers. The local financial supervisor, the Bermuda Monetary Authority (BMA), therefore intensified its efforts to keep up with the latest trends in supervision and capital adequacy. It is currently implementing the European Commission's Solvency II directive and expects to achieve regulatory equivalence¹ with the European Union before the end of 2012, when Solvency II becomes effective. Owing to regulatory equivalence, Bermudian reinsurance companies operating in the European Union will face the same collateral requirements as their EU peers, which should provide them with a competitive advantage with respect to non-European insurers. Together with Japan and Switzerland, Bermuda will be among the first non-EU countries whose full Solvency II compliance will be assessed.

The BMA has also signed various tax information exchange agreements in order to enhance the transparency of the Bermudian financial sector. Bermuda's efforts have been recognized by the OECD, which placed the islands on a list of countries that are meeting the organization's transparency and regulatory standards. Yet, Bermuda's financial sector remains exposed to possible tax increases as a consequence of international pressure on low-tax jurisdictions to adjust their tax regimes.

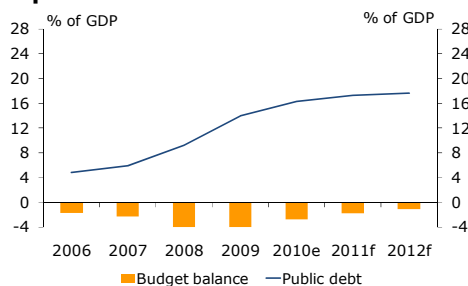
Bermuda does not conduct its own monetary policy, as there is no central bank and the domestic currency, the Bermudian dollar, is pegged to the US dollar at parity. In combination with the country's open financial account, Bermuda's monetary policy is consequently determined by the US Federal Reserve. Owing to the absence of a central bank, the local banking sector maintains the currency peg. Bermudian inflation, which generally follows US trends, strongly declined in 2009 on the back of declining domestic demand and tumbling oil prices. In 2011 and 2012, inflation will likely increase to 3% on average amidst rising food and fuel prices. Yet, owing to spiking oil prices as a consequence of tensions in the Middle-East, inflation rates could increase above this level, especially during the first half of 2011. Austerity measures will exert some limited downward pressure on domestic inflation, but this effect should not be overestimated.

Despite Bermuda's traditionally conservative fiscal stance, government finances have gradually deteriorated since the midst of the previous decade. Budget deficits widened markedly ahead of the 2007 parliamentary elections as the PLP focused on boosting social spending, which increased the deficit from 1.7% of GDP in 2006 to 3.7% of GDP in the next year. The 2009 recession led to a further deterioration of government finances as revenues from Bermuda's narrow tax base declined markedly, pushing the budget deficit to 6% of GDP. This forced the PLP government to cut back on its promises as government debt approached the constitutional debt limit of USD 1bn. In order to address the country's recent fiscal difficulties, the 2010 budget introduced various tax increases as well as measures to increase efficiency of government operations. While exempting the country's tourism sector from tax hikes, the budget identifies certain core initiatives in the fields of education, health and public safety, for which financing should be ensured by redirecting funds that were initially intended for capital expenditure projects. The fiscal consolidation should gradually reduce Bermuda's budget deficits from 4.0% of GDP in 2009 to 1.1% of GDP by 2012. We expect the 2010 budget to strike a sound balance between the need to consolidate government finances while sparing the still ailing tourism sector and meeting the PLP electorate's expectations for increased social spending.

¹ Regulatory equivalence implies that the Solvency II regulations will be adjusted to local circumstances as the Bermudian financial sector is predominantly wholesale-oriented, while the European insurance market caters relatively more to retail clients.

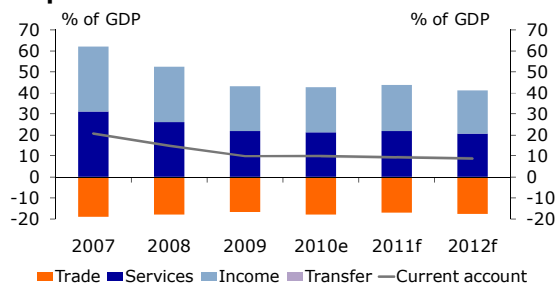
Bermuda's large budget deficits have led to a considerable deterioration of the country's traditionally low gross public debt level, which is expected to quadruple with respect to its pre-crisis level by 2012, reaching a level of 17.6% of GDP. Further debt increases beyond 2012 are rather unlikely, as the self-imposed public debt ceiling, set at 20% of GDP (net of sinking fund² assets which are estimated at 1.3% of GDP), forces the government to reduce its budget deficit. Despite the recent increase, Bermuda's debt levels are still relatively low compared to similarly rated countries. Bermuda's public debt is primarily external, USD-denominated and privately issued.

Graph 3: Government finances



Standard & Poor's

Graph 4: Current account balance



Source: Fitch

Balance of Payments and External Position

Bermuda's large current account surplus decreased markedly since the onset of the financial crisis, declining from 17.5% of GDP in 2007 to 10% of GDP in 2010. While the structural trade balance deficit was hardly affected by the crisis, Bermuda's services and income surpluses, which are primarily generated in the financial sector, decreased strongly on the back of cooling demand for international business services and falling returns on investments abroad. Declining employee compensation in the financial sector, which is largely paid from abroad, also contributed to the shrinking current account surplus. Owing to sluggish growth of financial services exports, the current account surplus is expected to remain steady at about 10% of GDP in the coming years. Though data on Bermuda's net foreign asset position is scarce, its large current account surpluses suggest that the country should be a sizeable net external creditor. External liquidity, however, is relatively weak and depends on the strength of the banking sector. Estimates based on available data for the public, banking and non-banking sector gauge net external assets at 24%, 185% and 300% of current account receipts, respectively. The strong net external creditor position of the banking sector hides possible vulnerabilities arising from large gross debt amounts, which explain part of Bermuda's considerable gross external debt levels. Most of the banking sector's gross external debt consists of short-term deposits of non-residents, exposing the banking sector to a possible sudden withdrawal of funds if investor confidence were to deteriorate. Since Bermuda's foreign exchange reserves are too small compared to the banking sector's large external financing requirement and the domestic currency is only traded in Bermuda, sudden large-scale deposit withdrawals could trigger balance of payments difficulties for Bermuda. Yet, this risk is mitigated by the banking sector's external asset base, which primarily consist of highly liquid investments that can be quickly liquidated to meet possible deposit outflows.

² Funds accumulated in the sinking fund are intended to increase government flexibility in debt servicing.

Bermuda							
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
<i>Key country risk indicators</i>							
GDP (% real change)	5.7	4.2	0.7	-4.0	0.3	2.0	2.5
Consumer price index growth	3.1	3.8	4.8	1.8	2.3	3.0	3.0
Current account balance (% of GDP)	23.4	21.0	15.0	10.3	14.2	10.2	16.2
Total foreign exchange reserves (mln USD)	18707	19412	17470	15960	16368	16841	17369
<i>Economic policy</i>							
Budget balance (% of GDP)	-1.7	-2.3	-4.0	-4.0	-2.8	-1.8	-1.1
General government debt (% of GDP)	4.8	5.9	9.2	13.9	16.3	17.3	17.6
Exchange rate LCU to USD (average)	1.00	1.00	1.00	1.00	1.00	1.00	1.00
<i>Balance of payments (bn USD)</i>							
Current account balance	1.0	1.2	0.9	0.6	0.6	0.6	0.6
Trade balance	-1.1	-1.1	-1.1	-1.0	-1.1	-1.1	-1.2
Export value of goods and services	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Import value of goods and services	1.1	1.2	1.1	1.1	1.1	1.1	1.2
Services balance	0.6	0.5	0.4	0.3	0.4	0.4	0.4
Income balance	1.4	1.8	1.6	1.3	1.3	1.4	1.4
Transfer balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net direct investment flows	-0.3	0.6	-0.4	-0.1	n.a.	n.a.	n.a.
Net portfolio investment flows	0.4	0.5	2.9	-1.7	n.a.	n.a.	n.a.
Change in international reserves	-6.8	0.7	-1.9	-1.5	0.4	0.5	0.5
<i>External position</i>							
Gross external debt (% of XGSIT)	274	264	265	344	331	341	305
Narrow net external debt (% of XGSIT)	-238	-207	-182	-154	-155	-150	-137
Net public sector external debt (% of XGSIT)	-41	-37	-27	-32	-24	-15	-11
Net banking sector external debt (% of XGSIT)	-228	-202	-193	-175	-185	-190	-175
Total foreign exchange reserves (mln USD)	18707	19412	17470	15960	16368	16841	17369
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	-19.9	-19.6	-18.6	-17.3	-12.9	-13.8	-13.4
Current account balance (% of GDP)	23.4	21.0	15.0	10.3	14.2	10.2	16.2
Debt service ratio (% of XGSIT)	412	389	443	530	n.a.	n.a.	n.a.
Interest service ratio incl. arrears (% of XGSIT)	129	133	65	10	n.a.	n.a.	n.a.
Liquidity ratio	27	25	21	23	n.a.	n.a.	n.a.

Source: Fitch, S&P, Global Insight

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