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Financial Services Briefings

Issue 01 / January 2011

Foreword

It certainly is an exciting time to be in the financial services sector.

The aftermath of the recent financial crisis is creating new opportunities across Asia, and at the same time the ascent of China, India and the Asian economies is helping to shape Singapore as one of the world's key financial centres.

Seizing these opportunities and capitalising on the region's growth is one of the major goals announced last year by Singapore's Economic Strategies Committee. The aim is to strengthen Singapore's position as a centre for financial services.

In this light, we bring you the first in a series of quarterly newsletters titled "Financial Services Briefings". We hope that the insights these newsletters contain will help you navigate more efficiently through the complexities of the local and regional financial services sector.

Each issue will highlight the opportunities, risks and issues that confront businesses in the region today, as well as our thoughts about how to capitalise on them. There will be an anchor analysis by KPMG's professionals that dives into a particular topic in depth.

Each issue will also detail some of the key regulatory updates, accounting and tax changes that have an impact on the financial services sector, and news reports and publications by KPMG professionals worldwide that may be useful to you as you go about your business.

In this first issue, our anchor topic focuses on domiciled fund vehicles in Singapore – the tax incentives and operational benefits they enjoy, local standards of professionalism and their impact on the cost of doing business, and some of the benefits that funds accrue when they use independent directors.

I hope you find our insights of interest. Should you wish to discuss any of these topics further, or if you have any questions, don't hesitate to get in touch with me or with one of my partners.

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Funds & Asia

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The evidence is compelling. Asia has become a very attractive place to locate tax-exempt funds. Taxes here are generally low and the regulatory environment is 'fund friendly'. There are also lots of institutional and individual investors looking for a productive home for their money.

A quick 'desktop' search indicates that 18 of the 30 world's largest pensions, wealth and reserve funds are in Asia. In Singapore, alone, there are currently more than 500 exempt fund managers. And, this number is growing rapidly.

What exactly makes Asia so attractive to fund managers?

On the one hand, investors and managers are increasingly leery of the deep-rooted structural problems embedded in the major economies of North America and Europe. They are also discouraged by tax and regulatory policies in these markets that seem to target funds in an almost punitive way.

On the other hand, most Asian economies are booming. And while markets like Singapore and Hong Kong comply with the relevant international standards on financial regulation, tax transparency and anti-money laundering, they have also created a comfortable, stable and operationally efficient environment in which funds can operate. Governments in these markets are generally cash positive and they have not been timid about using their surplus positions to attract and retain fund managers and capital pools.

Looking at the specific situation in Singapore as an example, we see that the Lion State offers a tax-free status to funds setting up in the country, and the profits from fund management operations that qualify for the 'Financial Sector Incentive Scheme' are taxed at 10 percent as opposed to the corporate rate of17 percent.

Locally registered funds in Singapore can also recover Goods and Services Tax (GST) payments on expenses incurred for the purpose of fund investment activities. The recovery rate is established annually by the tax authority and for the period 1 January 2011 to 31 December 2011, recovery has been set at 91 percent.

We also see fund managers attracted to Singapore because interest payments and payments connected with loans and indebtedness made by a fund in Singapore or a Singapore Permanent Establishment enjoy a withholding tax exemption. This is an important consideration for funds that employ multiple leverage strategies.

And yet another attraction is the effective tax rate in Singapore. For an individual income level of USD $300,000 the rate of 13.9 percent is one of the most attractive in the world (based on KPMG's Individual Income Tax and Social Security Rate Survey 2010).

Beyond Taxes

But low taxes is not the only reason that fund managers are locating to the region. After all, tax rates can vary and there are instances where tax exemptions are not certain.

Light touch regulations also have positive non-tax impacts on the cost of doing business. Our conversations with fund managers reveal that a minimum of USD $50 million is needed to break even in current market conditions[1]. Under this kind of pressure, funds that operate with a lean two or three man team need to be focusing the time and

[1] Yet, interestingly, we see a number of funds starting from as low as USD 15 million.

effort of their employees on managing and gathering money, not on paperwork. The approach taken by markets like Singapore ensures that regulatory matters do not pose a major distraction to employees as they do their job.

We believe a regulatory focus on systemic risks should be tied to size. The tiered levels of regulation that the Singapore's MAS has proposed are a welcome development in this respect.

The Cost of Professionalism

As funds go about their business, it is important that they operate with the highest standards of professionalism. While requirements for good business conduct already exist in the financial industry, compliance should be stressed and encouraged at every level.

Funds should adhere to industry standards in hiring and staffing, they should operate from suitable offices, they should be adequately capitalised and maintain a sound financial standing, they should be appropriately insured, and they should adhere to sound anti-money-laundering practices.

Adhering to these requirements, of course, adds to the cost of doing business and this, in turn, affects the attractiveness of a fund to investors. Lock up periods, redemption notices, fee structures and re-hypothecation arrangements are also cost and risk issues that investors look at.

Fund managers must operate astutely if they are going to successfully maintain high operating standards and at the same time offer attractive costs to investors. It isn't an easy job.

Size and Strategy

Investor allocations tend to gravitate towards larger funds, while a 'fund of funds' has traditionally provided an avenue for smaller funds to capture capital. This makes for a complex situation in which investors sometimes approach managers directly to better understand risks and negotiate prices. With the increased regulatory and costs pressures, and changing investor behaviour, smaller managers might consider giving up equity positions to pool resources and gather quantum. Managers who deal with Asian clients may also wish to note that many such clients prefer to keep a low profile.

Competition in the marketplace will only get tougher with the launch of European and US based UCITS[2] approved funds in their respective jurisdictions. Capital flows will be diverted to these funds, and while it is often claimed that there is no substitute for locally based managers, this may not hold true for investors who have not experienced or who do not have access to Asian based managers.

Conversely, Asian based managers face regulatory restrictions and hurdles when they try to access capital pools in the West.

Independent Directors

Qualified experienced independent directors are another strength we believe the region offers. Asia's financial

Scheme	Offshore Funds/Trusts	Onshore Trusts	Resident Fund Incentives	Enhanced Tier Incentive
Fund Structure	S13CA Trusts or Company	S13C Trusts only	S13R Company	S13X Onshore or Offshore Trust, Company or Limited Partnership
Filing of Returns	No	Yes	Yes	Yes
Incentive Detail	The offshore fund incentive provides tax exemption on specified income[3] derived by offshore funds managed in Singapore in respect of designated investments. The offshore funds can be in the form of non-resident foreign companies or trusts (with non-resident trustee). Funds of non-Singapore citizens nor residents in Singapore can also be regarded as offshore funds.	The Prescribed Trust Fund Incentive provides tax exemption coverage to foreign investors. Under this incentive, specified income from designated investments derived by a trustee of a trust fund managed in Singapore by a fund manager is exempted from Singapore income tax. This is on the condition that the trust fund does not have more than 20 percent of its value beneficially held directly or indirectly by Singapore investors (including one with a Permanent Establishment in Singapore).	The Resident Fund Exemption Incentive (RFE) was introduced in 2006. The onshore fund has to be tax resident and incorporated in Singapore to qualify. The RFE achieves tax exemption by sheltering specified income derived by the resident fund from Singapore income tax. Profit distributions by way of dividends are also not subject to withholding tax in Singapore. To deter tax avoidance, a financial penalty is imposed on resident non-individual investors whose holdings are above 30 or 50 percent[4].	The Enhanced Tier Fund Incentive (ETF) implemented in 2009 has no restrictions on residence status of the fund vehicle and investor. The incentive is applicable to funds constituted as limited partnerships, trusts or companies. The incentive grants tax exemption for specified income derived in respect of designated investments. The incentive applies if certain conditions are met one of which includes start-up capital of amounts exceeding S$50 million (USD$38 million).

[2] Undertakings for Collective Investment in Transferable Securities (UCITS).
[3] Examples of specified income include gains or profits from the disposal of securities, interest and foreign dividends received in Singapore.
[4] Depending on the number of investors in the fund.

hubs abound in independent directors who can offer credibility, a valuable network, and thoughtful dialogue on key issues. We see the desirability of hiring independent directors increasing as investors more frequently request meetings with them.

Offshore Jurisdictions

Many fund managers continue to use offshore structures, with only a handful adopting a patriotic approach.

The informal feedback we receive about this anomaly indicates that fund managers' familiarity with established offshore jurisdictions, such as the Cayman Islands, is an important consideration for negotiating private placement memorandums despite often attractive tax incentives that are available for onshore vehicles.

Other important considerations are the ease with which a manager can explain an offshore fund structure to potential investors, and the speed with which agreement can be reached about terms and conditions with prime brokers. The fact that most of the documentation for off-shore structures is tried and tested with all of the concerned compliance departments is also an important factor, as is the lead-time required to set up and register a fund.

Given the favorable financial and regulatory environment that now exist in Asia, the region is fast growing in importance as an onsite centre for the fund management industry.

Singapore, in particular, withstands any test of substance as a destination for funds. With a well respected regulator[5], clearly defined income tax rules, and compliance with OECD[6] requirements, it should be seriously considered as a location for domiciled funds.

[5] The Monetary Authority of Singapore (MAS).
[6] Organisation for European Economic Co-operation (OECD).

Regulatory, accounting and tax updates

Regulatory Updates

Deposit Insurance Scheme

In February 2010, The MAS conducted a public consultation on proposed enhancements to Singapore's Deposit Insurance (DI) Scheme. Responses to feedback received during the consultation were released in early September 2010.

While the DI Scheme previously covered only deposits by individuals and charities, in line with its primary objective of protecting small depositors, MAS decided to expand the coverage to all non-bank depositors in general, including small businesses such as sole proprietorships and partnerships.

Another key enhancement is to raise the DI coverage limit from S$20,000 to S$50,000 per depositor per Scheme member. This is a reasonably high level of coverage and under the Scheme it would fully insure 91 percent of depositors. To mitigate the cost impact on Scheme members, MAS will look at lowering annual premium rates and extending the build-up period for the DI Fund.

Other proposals that MAS will implement include insuring pledged deposits in addition to normal deposits, up to the DI coverage limit, and adopting a gross DI payout. Although most respondents were not in favour of gross payout, MAS decided that such an approach would generate greater confidence and stability in a distressed situation, and make it easier for depositors to quickly access the full amount of the insured deposits.

New Representative Notification Framework

Since 26 November 2010, customers of financial institutions in Singapore have been able to better examine the professional background of their relationship managers, sales representatives and fund managers. The MAS introduced the new representative framework to improve disclosure.

Revisions have been made to the licensing and business conduct requirements the Securities and Futures Act (SFA) and the Financial Advisers Act (FAA). These changes affect licensed capital markets entities, licensed financial advisers, banks and other financial institutions that carry out capital markets and financial advisory activities. The changes were introduced to provide customers with more information and enhance market discipline.

Public Register of Representatives

The new representative notification framework requires that information about all representatives who provide financial advice or capital market services to be listed in a public register maintained by the MAS. Financial institutions must notify the MAS about the permanent and provisional appointment of representatives under the SFA or FAA and certify that appointed individuals

meet all requirements for competency, financial soundness, and integrity.

Information about each representative, including name, regulated activities, previous regulatory actions such as suspensions, revocations and prohibition orders, if any, is published in register. At the launch of the framework, the MAS indicated that more than 30,000 representatives would be listed in the register.

The new representative notification framework requires that information about all representatives who provide financial advice or capital market services to be listed in a public register maintained by the MAS.

If the MAS believes that a financial institution has not conducted sufficient due diligence on a proposed representative, it may ask for further checks or refuse to include the name of the individual in the register. The MAS can also initiate regulatory actions against a financial institutions that has improperly provided 'fit and proper' certification for a proposed representative.

Accounting Updates

New FRSs not yet effective

Improvements to FRSs for 2010 are the result of the third annual improvement project. It contains 11 amendments to seven FRSs that result in accounting changes for presentation, recognition, measurement or disclosure purposes. Some of these amendments are generally only effective for annual periods beginning on or after 1 January 2011. One amendment that may be worth early adopting in 2010 is:

Amendments to disclosure requirements under FRS 107 *Financial Instruments: Disclosures*

These amendments reduce the amount of disclosures previously required by entities. Entities are no longer required to disclose the:

- financial asset's maximum exposure to credit risk if the carrying amount of the financial asset already best represents its maximum exposure.
- carrying amount of financial assets that would have been past due or impaired if their terms had not been renegotiated.
- description and fair value of collateral held as security and other credit enhancements in respect of financial assets that are past due but not impaired and in respect of financial assets that are individually determined to be impaired. However, the entity will be required to disclose the financial effect of any collaterals and other credit enhancements held against a financial asset.
- relevant information about the collaterals foreclosed during the year need only be disclosed if that collateral is still held at the reporting date.

For entities adopting these amendments early, appropriate disclosures should be made in the financial statements.

Recently issued IFRSs not yet adopted in Singapore and an exposure draft on *Hedge Accounting*

IFRS 9 *Financial Instruments*

On 12 November 2009, the IASB[7] issued IFRS 9 (2009) as part of its comprehensive review of financial instruments accounting.

IFRS 9 (2009) deals with classification and measurement of financial assets only. It retains, but simplifies, the mixed measurement model and establishes two primary measurement categories for financial assets – amortised cost and fair value.

The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset.

On 28 October 2010, the IASB issued a new version of IFRS 9 (IFRS 9 (2010)). IFRS 9 (2010) includes all the requirements of IFRS 9 (2009) without amendment.

However, the new version of IFRS 9 also incorporates requirements with respect to the classification and measurement of financial liabilities and the derecognition of financial assets and financial liabilities.

There are two substantive changes from the requirements in IAS 39 for classification and measurement of liabilities. These generally relate to:

- requiring the fair value changes in the credit risk of a financial liability measured under the fair value option to be presented in other comprehensive income
- removing exceptions for derivatives linked to and settled via unquoted equity instruments from being measured at fair value (similarly for the unquoted equity instruments and its related derivative assets).

[7] International Accounting and Standards Board (IASB)

The exposure draft on hedge accounting represents a major milestone on the road to improving the financial instruments accounting model as called for by the G-20. The changes proposed to the general hedge accounting model respond to significant criticisms of the complexity and burden of hedge accounting.

The guidance in IAS 39 *Financial Instruments: Recognition and Measurement* on impairment of financial assets, and on hedge accounting continues to apply until all the requirements of IAS 39 have been replaced. The IASB expects this to occur during 2011.

Amendments to IFRS 7 *Financial Instruments: Disclosures – Transfers of Financial Assets*

The amendments to IFRS 7 introduce new disclosure requirements about transfers of financial assets including disclosures for:

- Financial assets that are not derecognised in their entirety;
- Financial assets that are derecognised in their entirety but for which the entity retains continuing involvement

Exposure draft on *Hedge Accounting*

On 9 December 2010 the IASB issued a new *Hedge Accounting* ED which represents the first installment of the third phase of the IAS 39 replacement project. The exposure draft on hedge accounting represents a major milestone on the road to improving the financial instruments accounting model as called for by the G-20. The changes proposed to the general hedge accounting model respond to significant criticisms of the complexity and burden of hedge accounting.

The changes also aim to address the artificial mismatch in specific scenarios between risk management and hedging strategies under the current requirements. The proposed changes will:

- alleviate some of the more operationally onerous requirements including quantitative threshold and retrospective assessment for hedge effectiveness testing.
- allow entities to rebalance and continue certain existing hedging relationships that have fallen out of alignment instead of having to restart the hedge in a new relationship; however voluntarily discontinuing certain hedge relationships will be prohibited.
- make the use of purchased options as hedging instruments more attractive and broadening the scope of eligible hedging instruments and hedged items.

One key issue for financial institutions is the pending proposals on portfolio hedging as many institutions utilise this approach in their hedge accounting strategies.

Tax Updates

Recovery of GST for Qualifying Funds

The GST remission scheme has been enhanced to enable qualifying funds to recover GST incurred on all expenses. Previously, the scheme enabled funds that meet the qualifying conditions to only recover GST incurred on prescribed expenses based on a fixed recovery rate, if they were not registered for GST.

The enhancement takes effect retroactively from 22 January 2009 and will apply to all expenses (except disallowed expenses under the GST Regulations 26 and 27) incurred from 22 January 2009 to 31 March 2014. The fixed recovery rate for 1 January 2011 to 31 December 2011 is 91 percent.

In addition, with retrospective effect from 22 January 2009, the GST remission scheme has been extended to unit trusts that are approved under the Singapore Central Provident Fund (CPF) Scheme. To qualify for GST remission in the current year, the fund must be a CPF-approved unit trust as at the last day of its preceding financial year.

Withholding tax exemption for specified payments made by relevant funds managed in Singapore by prescribed fund managers

Under Section 12(6) of the Singapore Income Tax Act (SITA), interest, commission, fee and any other payments made in connection with a loan or indebtedness (herein referred to as '*interest payments*') are deemed to be derived in Singapore under certain circumstances. Correspondingly, where the payments to a non-resident fall within the ambit of Section 12(6) of the SITA, such payments are subject to withholding tax under section 45 of the SITA, unless exemptions are available under the SITA or relief is provided for under a relevant tax treaty.

In support of the goal to make Singapore a leading Asian hub for fund management, the Minister for Finance has introduced a withholding tax exemption for specified funds.

The withholding tax exemption only applies to interest payments made by funds that satisfy the conditions for specified fund vehicle tax incentive schemes under the SITA. In addition, such interest payments must be made for the purposes of the trade or business of the fund.

Global topics

Basel 3 Pressure is building

With the endorsement of Basel 3 at the recent G20 summit, the focus has now shifted to implementation. Although the finish line is still a way off, this report highlights the business implications and the need for clients to act now. *December 2010*

Evolving Banking Regulation: A marathon or a sprint?

Policy makers in every region have sprinted ahead with new rules for banks, while the G20 is still working towards a goal of coordinated global regulation. What does this mean for large global banks? *November 2010*

New on the Horizon: Insurance Contracts

This edition considers the proposed requirements of ED/2010/8 Insurance Contracts. It provides a high level overview of some changes to current practice expected in accounting for insurance contracts if the proposals in the ED are finalised as a new IFRS. *September 2010*

Breaking the gridlock: Strategies for managing distressed real estate issues

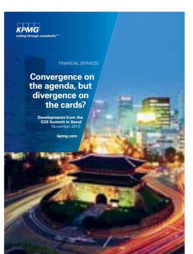
This paper suggests strategies for achieving a successful loan workout and addresses the issues and challenges associated with distressed or maturing real estate loans. The paper can help borrowers and lenders navigate a solution acceptable to both sides. *December 2010*

Dodd Frank Foreign Banks

Will the competitiveness of US banks really be undermined by Dodd-Frank? Signed into law on 21 July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act will have implications for foreign banks with operations in the US. *October 2010*

Financial Services Executive Survey: Executives Bullish on Recovery

This survey focuses on the current business conditions in the banking and financial services sector. It identifies the most significant revenue growth areas and factors that might hinder or accelerate the sector's recovery. *September 2010*



G20 Summit Seoul 2010

Progress on financial reforms was made in Seoul, but diverging national approaches are becoming evident. *November 2010*

Islamic Finance – A new agenda

As Islamic Finance enters the next stage of development, a new agenda is being defined. KPMG believes that issues should be re-positioned focusing on continued improvement in governance, better asset and liability management and product appropriateness. *October 2010*

Creating a new mould for banking

Banks' business models are continually evolving, as they are constantly having to review and revise their strategy in light of new market conditions, new competition, changing customer expectations and the evolution of technology. *September 2010*

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