Financial Services Briefings
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KPMG
cutting through complexity

Foreword

A "sea change" quarter for the financial services sector.

Policymakers and regulators are coming to grips with the challenges – and dilemmas – of framing new rules for the global financial system.

In recent weeks, we have witnessed Greek sovereign debt being lowered to a CCC rating by Standard and Poors following findings of a bilateral EU-IMF audit. The tightening or introduction of new regulations stemming from the Greek debt crisis is now imminent.

More recently, we have witnessed the US sovereign credit rating being lowered to AA+ by Standard and Poors, after the US Government narrowly averted a debt default through a political deal made at the eleventh hour.

On their part, institutions in the financial services industries are realising that while upcoming regulatory change means increases in compliance cost, these can represent opportunities as well.

In this issue, we discuss the results of a recent analysis conducted by KPMG in Singapore looking at the significance of fair value disclosure for financial institutions as required under Singapore FRS 107. A total of 77 banking, insurance and other financial institutions were analysed.

While the analysis reveals inconsistencies in the way financial institutions categorise their fair value disclosures, it nevertheless concludes that the SFRS 107 provides a good basis for reporting critical information about certain financial assets and liabilities.

As in the past issues, we highlight pertinent accounting, regulatory and tax changes of relevance to the financial services industry.

Leong Kok Keong
Partner, Head of Financial Services
KPMG LLP

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What level is fair?

Fair value disclosure challenges

In the current economic crisis, the issue of fair value in financial reporting is a matter of much discussion and some controversy.

Financial institutions measure some of their assets and liabilities at fair value either because they are required to do so (for example, a trading asset or a derivative without hedge accounting) or because they elect to do so (if certain conditions are met). In this case, significant additional disclosures are required in the financial statements.

Under SFRS 107 Financial Instruments disclosures, entities are required to assign such an asset or liability to one of the 3 levels in a fair value hierarchy and to disclose the basis for the fair value measurement they report.

The accounting standard requires, whenever possible, that an entity use quoted prices to measure the fair value of financial assets or financial liabilities which are traded on an active market as these are the best evidence of fair value.

However, if the market for a financial instrument is not active, an entity must establish fair value by using one or more valuation techniques.

An Analysis of Current Practice

To assess the significance of the fair value measurement and disclosure requirements for financial institutions in Singapore, we conducted an analysis of 77 banking, insurance and finance and financial holding companies in Singapore using recent publicly available financial statements issued as of June 2011.

Our analysis found that the relative use of the different categories of financial assets and liabilities measured at fair value varies significantly among the institutions analysed. This use is influenced by the business model and the chosen accounting designation. By assessing the financial statements. alone, it is not clear how each financial institution applies the definitions used to classify their financial instruments on an individual basis. While each financial institution provides general definitions for how financial instruments are classified within their fair value hierarchy disclosures, there is little detail as to how the definitions are applied in practice.

Among the institutions analysed, the ratio of financial assets measured at fair value as a percentage of total financial assets ranged widely from 1.84 percent to 95.92 percent depending on their business model. We noted that the institutions analysed with significant investment banking activities had a higher proportion of financial assets measured at fair value.

For 37 of the institutions analysed, 'available for sale' assets formed the largest group of financial assets.

The ratio of financial liabilities measured at fair value as a percentage of total financial liabilities ranged from 0.03 percent to 30.81 percent. The main fair value categories on the liability side of the balance sheet are in the non-hedging derivatives category.

The analysis also found that most financial institutions in Singapore classified Singapore Government Securities as Level 1 on the basis that the market price for such securities is publicly available from the Monetary Authority of Singapore's website and are transactable. However, some preparers classified these as Level 2 investments.

See accompanying charts for additional analysis results.

Establishing Boundaries

As noted in our analysis results, there

are inconsistencies in how institutions categorise their fair value disclosures. We believe that this is due to a degree of subjectivity and various challenges embedded in this process.

While the boundary between 'level 1' and 'level 2' is usually clear, there are challenges in determining the boundary between 'level 2' and 'level 3'.

Whether a fair value measurement is categorised as 'level 2' or 'level 3' depends on whether the inputs used in the valuation techniques are observable or unobservable and the degree of influence these inputs have on the resulting fair value measurement.

The Role of Judgement

Judgement is required in determining whether an adjustment is significant to a fair value measurement, including a consideration of factors specific to the asset or liability.

When inputs from multiple levels of the fair value hierarchy are employed, the inclusion of a lower level input may indicate that this input is significant because its use provides evidence that the entity considers the input to be an important element in the overall fair value measurement.

In our view, for the purpose of determining the significance of the unobservable inputs when multiple unobservable inputs are used, the unobservable inputs should be considered as a whole relative to the fair value of the asset or liability.

For example, a discount for lack of marketability calculated on the basis of an academic study rather than on direct observation is likely to be significant, both because of its size and because of the range of possible alternative assumptions.

When determining which level in the fair value hierarchy a financial instrument measured at fair value should be assigned, care should be taken with respect to the following sources of fair value information:

Pricing Services

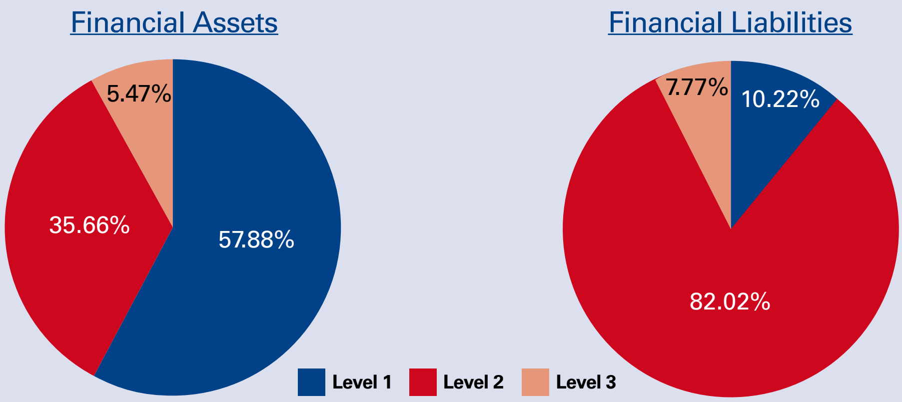
The use of a pricing service to obtain fair value measurements does not change the analysis of the categorisation of the inputs in the fair value hierarchy. Prices obtained from a pricing service are not considered observable simply because they were obtained from a third party. When using a pricing service an entity should clearly understand the source of the inputs used by the service as a basis for assigning an asset or liability into the fair value hierarchy. For example, if a pricing service provides an unadjusted quoted price from an active market for an identical instrument, then a fair value measurement based only on that price would be a 'level 1' measurement. Alternatively, if the pricing service provides prices generated by its own internal financial modeling, then any resulting fair value measurement would either be a 'level 2' or 'level 3' measurement depending on the observability and significance of the inputs used.

Result of the survey — Fair value measurement of financial instruments using unobservable parameters

The percentage of financial assets and liabilities measured using observable parameters and non-observable parameters, compared with instruments measured using quoted prices varies significantly.

The majority of financial institutions in this analysis possess Level 1 and Level 2 financial assets and liabilities measured at fair value, only 36 and 24 financial institutions had Level 3 financial assets or liabilities respectively in their books.

The analysis revealed the following statistics:



The graphs indicate that on average across the 77 financial institutions analysed, less than 6% of the financial assets at fair value at individual institution level are measured using unobservable parameters (level 3 inputs). Similarly, on average, only less than 8% of the financial liabilities at fair value at individual institution level are measured using unobservable parameters.

Consensus Pricing Services

Consensus-derived prices are based on data received from a pool of subscribers who each submit prices to the pricing service. When assessing consensus data it is important to understand what the consensus prices represent. If the estimates provided to the service by one or more subscribers do not represent executable quotes or are not based on observable prices, then a fair value measurement derived from the consensus price would be a Level 3 measurement. If, however, the inputs submitted to the pricing service are 'level 1' or 'level 2' inputs, then the use of those prices may result in a 'level 2' measurement.

Broker Prices

Similar considerations apply to prices obtained from brokers. A broker quote is generally not a binding offer. Even if it is, it may not represent the price at which an orderly transaction would take place between market participants. When a broker quote reflects actual current market transactions in an identical instrument, it may represent a 'level 1' or 'level 2' input. However, when a broker quote is an indicative price based on the broker's valuation models, then it may represent a 'level 2' or 'level 3' input.

Conclusion

SFRS 107 requires financial institutions to assign certain assets and liabilities to one of 3 levels in a fair value hierarchy and to disclose the basis for the fair value measurement they report. The ultimate objective of this requirement is to render the processes and criteria used to make these determinations clear and transparent in financial statements.

However, a significant degree of subjectivity still remains in the process of establishing 'fair value' and in assigning assets and liabilities to one of the 3 levels in the fair value hierarchy.

Whilst our analysis of major financial institutions in Singapore reveals some inconsistencies in how these institutions categorise their fair value disclosures, the SFRS 107 fair value reporting structure nonetheless provides a good basis for reporting critical information about certain financial assets and liabilities.

Regulatory, accounting and tax updates

Regulatory Updates

Enhanced Capital Adequacy Requirements for Singapore-incorporated Banks

On 28 June 2011, the Monetary Authority of Singapore (MAS) announced the capital requirements for locally incorporated banks under Basel III requirements, which are also higher than Basel III global standards.

Currently, Singapore-incorporated banks are required to maintain a minimum of 6 percent Tier 1 and 10 percent Total capital adequacy ratio (CAR). From 1 January 2015, MAS will require Singapore-incorporated banks to meet a minimum Common Equity Tier 1 (CET1) capital adequacy ratio (CAR) of 6.5 percent, Tier 1 CAR of 8 percent and Total CAR of 10 percent. These standards are higher than the Basel III minimum requirements of 4.5 percent, 6 percent and 8 percent for CET1 CAR, Tier 1 CAR and Total CAR, respectively.

While the Basel Committee on Banking Supervision (BCBS) has set 2015 as the timeline for banks to meet the Basel III minimum capital adequacy requirements, MAS will require the locally-incorporated banks to meet the minimum CET1 CAR of 4.5 percent and Tier 1 CAR of 6 percent from 1 January 2013, 2 years ahead of BCBS' set timeline. Total CAR will remain unchanged at 10 percent.

In line with Basel III requirements, MAS will also introduce a capital conservation buffer of 2.5 percent above the minimum capital adequacy requirement. This will be met fully with CET1 capital and phased in on 1 January each year, from 2016 to 2019. Including the capital conservation buffer, Singapore-incorporated banks will be required to meet a CET1 CAR of 9 percent, which is higher than the Basel III requirement of 7 percent.

Revisions to the Code on Collective Investment Schemes

The MAS has issued a revised code on Collective Investment Schemes under the Securities and Futures Act, that will become effective on 1 October 2011. The code applies to authorised schemes available to the public.

The revisions are designed to provide greater clarity and to increase flexibility for fund managers in managing their funds, while also enhancing safeguards for retail investors.

The changes strengthen safeguards on the use of financial derivatives, set new guidelines for funds which track an index, and require fund managers to standardise the methods they use to calculate any performance fees imposed. They also prohibit the use of simulated past performance data.

Revisions to the Notice on Recommendation on Investment Products

On 19 April 2011, the MAS revised the notice on recommendation on Investment Products under the Financial Advisors Act.
Under the revisions, advisors should

furnish and maintain certain documentation and records when making recommendations on investment products, such as collective investment schemes, debentures and life policies to clients.

For collective investment schemes and debentures, the following documents should be furnished and maintained: a copy of the prospectus or profile statement and product highlight sheet and other offer documents as may be prescribed by the relevant laws. Any other offer documents in this case would constitute a supplementary prospectus or supplementary profile statement and replacement prospectus or replacement profile statement issued in respect of the collective investment scheme or debenture. Similarly for life policies the following documents should be furnished and maintained: a copy of the product summary, benefit illustration and product highlights sheet.

Accounting Updates

Entities are required to disclose information under FRS 107 Financial Instruments Disclosures for transferred financial assets that remain on their books (i.e. on-balance sheet exposures).

However, there were no requirements to disclose information about transferred financial assets that were derecognised, but for which the entity (transferor) still retained some form of continuing involvement in that asset (i.e. off-balance sheet exposures). This raised some concerns in the wake of the global financial crisis.

To address these concerns, the IASB (International Accounting Standards Board) published the amendments to IFRS 7 Disclosures – Transfers of Financial Assets on 7 October 2010 to increase the amount of disclosures on transfer activities. They also mandate certain specified disclosures for off-balance exposures.

In Singapore, the equivalent amendments were issued on 23 February 2011.

Existing Disclosure Requirements

Before the amendments, FRS 107 required disclosures about transferred financial assets only when they fail to qualify for derecognition due to:

- retention of substantial risks and rewards (e.g. sale of listed shares with an obligation to repurchase at a fixed price)
- retention of control in the case where substantial risks and rewards have neither been retained nor transferred (e.g. sale of unlisted shares with a repurchase option that is at the money).

New Disclosure Requirements

The amendments expand the scope of transferred financial assets to encompass the following transactions:

- transactions that do not meet all the pass-through requirements of FRS 39.19(a)-(c)
- transfers where substantial risks and rewards have been transferred (e.g. sale with an option to repurchase where the exercise price is deeply out of the money)
- transfers where substantial risks and rewards have neither been transferred nor retained and control is lost (e.g. sale of listed shares with an option to repurchase at the money).

The intent of the disclosure requirements is to address the lack of disclosure of information on off-balance sheet exposures faced by entities. We expect financial services entities to be most affected by these new disclosure requirements.
Affected entities should take note:

1. The above disclosures are required at every reporting date so long as the entities have continuing involvement in the transferred asset at the reporting date. Disclosures are required even if the related transfer transaction occurred many years ago. This means that the current financial reporting system and processes have to be reviewed to ensure that the system is capable of collating relevant and reliable information to comply with the new disclosure requirements.
2. The maturity analysis required is in addition to the existing maturity analysis for financial liabilities required under FRS 107.39.

Effective date

Entities are required to apply the amendments for annual periods beginning on or after 1 July 2011. They are not required to provide the disclosures for any period presented that begins before the date of initial application of the amendments. Earlier application is permitted.

Historical Information

Although comparative information is not required, entities should take note that on first time implementation, historical information - gain or loss at the date of transfer of financial assets is required if the entity has derecognised the financial assets in their entirety in prior years but retains continuing involvement at the reporting date.

An entity is required to disclose whether the gain or loss at the date of transfer is due to the difference in the fair value of components of previously recognised financial assets and the fair value of the previously recognised assets as a whole. In addition, the application guidance requires the disclosure of whether these fair value measurements included significant inputs that were not based on observable market data (i.e. level 3 inputs).

Given that certain historical information is still required, affected entities are encouraged to start assessing their information requirements prior to the effective date.

Tax Updates

Enhancement to the Tax Incentive Scheme for Trustee Company

New applicants that wish to apply for the tax incentive scheme for Trustee Companies must meet the following conditions to qualify for the 10-year award under the Scheme:

- employ a minimum of three qualifying professionals in Singapore; and
- incur total business spending of at least $250,000 per annum.

Extension of Tax Incentive Schemes for Project and Infrastructure Finance

Companies approved as a Financial Sector Incentive (Project Finance) (FSI-PF) company on or before 31 December 2011 (i.e. the expiry date of the FSU-PF incentive) can continue to enjoy tax concessions under the FSI-PF award up to the expiry of their respective FSI-PF award.

Amendments to qualifying condition for exemption of interest income from offshore qualifying infrastructure projects / assets (OQIP)

Currently, one of the qualifying conditions for the tax exemption on foreign sourced interest income from OQIP received by approved resident entities listed on the Singapore Exchange is that the ownership of or investment in the OQIP has to be substantially advised and structured by ("investment advisory / structuring role"):

- an FSI-PF company; or
- a financial institution in Singapore where the Singapore-based staff of the financial institution have a leading and substantial role in advising and structuring the investment.

With the expiry of the FSI-PF scheme on 31 December 2011, the option of an FSI-PF company undertaking the investment advisory / structuring role will be removed. Remaining conditions under this tax exemption scheme for foreign sourced interest income are unchanged.

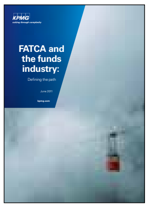
Global topics

The Bank Statement Issue 1

'The Bank Statement', examines new standard IFRS 9 Financial Instruments and discusses recent IASB activities relevant to banks.

The Bank Statement 2

Beside other topics this issue looks at the Dodd-Frank Act and its potential accounting consequences, asking whether you are ready for the challenges.



FATCA and the funds industry: Defining the path (June 2011)

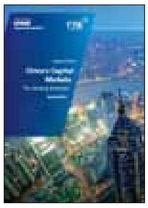
KPMG surveyed leading fund promoters in 12 countries to look at the key challenges the industry urgently needs to address to prepare for FATCA implementations.

IFRS - Insurance Newsletter (June 2011)

This edition of IFRS – Insurance Newsletter highlights the results of recent IASB1 and FASB2 discussions relating to the joint insurance contracts project.

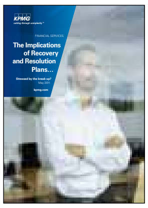
KPMG's Global Investment Management Practice (June 2011)

This issue highlights professional services that KPMG offers to a wide range of industry participants at a local, national and global level through its Global Investment Management practice.



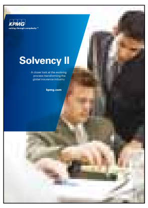
China's Capital Markets

This report provides an overview of the current state of China's capital markets.



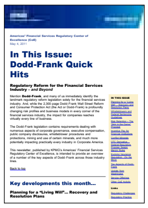
The Implications of Recovery and Resolution Plans… Stressed by the break-up? (May 2011)

The process of developing Recovery and Resolution Plans (RRPs) requires management to look at its business in a new and strategic way, assessing the priorities and practicalities that must be addressed both now and in case an RRP should be triggered.



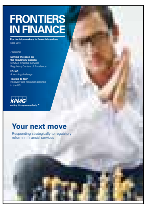
Solvency II- A closer look at the evolving process transforming the global insurance industry

This paper provides an overview of the Solvency II regime, highlights its strategic benefits, and draws attention to the regime's implications for the global insurance industry and its direct and indirect impacts on the U.S. insurance industry.



Dodd-Frank Quick Hits

This newsletter, released by KPMG's Americas' Financial Services Regulatory Centre of Excellence offers an overview of key aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act across virtually all industry lines.



Frontiers in Finance (April 2011)

How can institutions identify opportunities emerging out of new post-crisis regulatory environments?

Independent Commission on Banking: Adding to the complexity and challenges facing UK banks (April 2011)

If the proposed recommendations in the 11 May 2011 Interim Report issued by the Independent Commission on Banking (ICB) are implemented, this will lead to significant changes in the structure of UK banking.

Contributors to this issue

Leong Kok Keong
Partner, Head of Financial Services
T: +65 6213 2008
E: kokkeongleong@kpmg.com.sg

Ho Wah Lee
Partner,
Head of Advisory
T: +65 6411 8008
E: wahleeho@kpmg.com.sg

Tay Hong Beng
Partner,
Head of Tax
T: +65 6213 2565
E: hongbengtay@kpmg.com.sg

Yvonne Chiu
Partner,
Chief Editor
T: +65 6213 2323
E: yvonnechiu@kpmg.com.sg

David Waller
Partner, Financial Services - Audit
T: +65 6213 3007
E: davidwaller@kpmg.com.sg

Alan Lau
Partner, Financial Services - Tax
T: +65 6213 2027
E: alanlau@kpmg.com.sg

Reinhard Klemmer
Partner, Accounting Advisory Services
T: +65 6213 2333
E: rklemmer2@kpmg.com.sg

Gary Chia
Partner,
Risk & Compliance
T: +65 6411 8288
E: garydanielchia@kpmg.com.sg

If you would like more technical information on any of the issues discussed in this publication, please contact us.