Financial Services Briefings
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Foreword

Compliance moves to centre stage

Financial regulators around the world are enforcing existing rules and regulations with a renewed vigour, and are issuing new regulatory directives with increasing frequency.

As regulatory regimes become more demanding, the cost of compliance is rapidly escalating.

Penalties are also ballooning and being imposed more swiftly. Media attention is increasing, and the ensuing public reaction can stop careers and even sink a company.

In this environment, the role of the compliance function is taking on a new and added importance.

It is no longer sufficient for a compliance pepartment to simply communicate rules and regulations. Compliance must now play a lead role in managing behavior.

The stakes are high. Is your organisation's compliance department up to the task?

In this issue, we discuss the role that compliance should play in organisations. Our insights could help you address many of the challenges faced by compliance in light of the many new regulations.

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Practical issues in compliance functions in financial institutions

Compliance has traditionally been an important function but one of low profile within financial institutions. However, the global financial crisis and new regulations that have been implemented in response to it, have recently pushed compliance in the limelight.

Although the compliance function is expected to keep up with, manage and even anticipate regulatory developments, in some financial institutions there is a mismatch between this expectation and the key organisational elements and resources that are needed to make the function effective.

This article outlines some of the practical issues involved in creating and maintaining an effective compliance function in financial institutions.

Tone from the top

An effective compliance function requires that management set the tone for and support a strong compliance culture in their institution's front-to-back operations, and that the Board and senior management visibly and convincingly affirm that compliance is an integral component of their institutions' DNA.

Unfortunately this kind of support can be lacking in some financial institutions, and even when senior management understand the importance of compliance, they often fail to "walk the talk".

The most obvious indication of lack of support is when senior compliance officers are denied independent access to the Board or to senior management, or when senior compliance officers are not given the clout they need to ensure that appropriate compliance controls are put in place and satisfactorily executed. Another red flag is when the Board and senior management fail to require that compliance matters be reported directly to them in a timely manner.

Structure of compliance

Financial institutions should organise their compliance function in a way that is congruent with their risk management strategy. In every case, independence must take priority.

Appraisal of the compliance function should be conducted by top executive management. Such appraisals should be independent of other functions and remuneration of compliance personnel should not be related to the financial performance of any business lines. To avoid conflict of interest, compliance function staff should only be assigned compliance responsibilities, even though this can be a challenge for smaller institutions because of human resource constraints.

Organisational status of and attitude towards compliance

One direct consequence of the lack of strong support from the Board and senior management is the inability of the compliance function to enforce compliance throughout the organisation. This is one of the biggest issues faced by the compliance function in many financial institutions.

Without a clear and strong mandate from senior management, the earnings pressure will often take precedence over the prudential concerns raised by the function. The compliance function must be recognised as a critical function in the organisation and it must possess the authority required to function effectively.

A lack of top management support, coupled with the perception that the compliance function is a cost centre often compromises the adequacy of staffing and quality of personnel. It is not uncommon to find that the head of compliance is the only staff member in the department and that this person must manage compliance issues across many business lines. In addition, this person is often less senior in the executive hierarchy compared with other department heads in the organisation.

For example, we observed that the head of the compliance function in one medium size financial institution was the only compliance person in that organisation, and that he lacked both the management experience and business knowledge to work effectively with his peers in other departments. Unsurprisingly, this person was unable to establish credibility in the organisation and this impaired the function's effectiveness in influencing compliance activities in other departments.

It is also important that a financial institution's compliance function be provided with adequate resources to effectively carry out its responsibilities. This goes beyond providing adequate headcount. Staff must also possess the relevant qualifications and experience to carry out their jobs. For this reason, financial institutions should continually upgrade compliance staff skills through training programmes and seminars that keep them up to date with laws, rules and industry standards.

Given that the compliance department is a key gatekeeper for regulatory compliance, it is inevitable that tension may arise between this function and business lines. Some would even say that such tension is necessary for establishing a balance between the responsibilities of the compliance function and the priorities of the businesses.

As it turns out, achieving this balance can be elusive. In some financial institutions, the business lines are unfamiliar with the roles and responsibilities of the compliance function, or have had negative experiences with it. As a result, they may perceive the function to be an impediment or may even view it with outright contempt. In these situations, consultation with the compliance function about new, changed or existing regulatory matters could be selective or inconsistent. Rather than seeing the value that can be added by the compliance function, the business lines may approach compliance only when absolutely necessary and then only as a rubber-stamping exercise.

Compliance work plan

To carry out its duties effectively, the compliance function must command respect.

As with any credible and effective risk management function, it behoves the compliance function to have an annual work plan that sets out priorities and responsibilities, including those associated with providing advice, identifying and assessing regulatory risks, and surveillance.

Even though there is a compelling case for creating an annual compliance work plan, we have observed that some financial institutions still do not have one. As a result, the compliance work in these financial institutions is below par and performed haphazardly.

Common deficiencies include the failure to evaluate new or modified regulations or to escalate these to senior management, failure to update internal policies, failure to monitor and assess corrective action plans relating to regulatory and audit findings, and failure to train compliance and line staff in a timely manner.

Compliance as collective responsibility

More often than not, compliance is performed at a departmental level at financial institutions, rather than seamlessly across the whole institution. This is not an ideal arrangement because, under such a fragmented structure, not all of the information required to make informed compliance-related assessments or decisions will be available from the compliance department.

Indeed, the implementation of an effective compliance programme requires the involvement of staff from across the entire organisation - from the front line, which has contact with customers and is expected to be familiar with anti-money laundering requirements, to the back office which is responsible for mapping system control limits.

To ensure that compliance is a genuinely collective responsibility, it is critical that the work flow is analysed and that the allocation of compliance-related responsibilities is clearly communicated to staff in all concerned departments, and that final workplan is documented for accountability.

Training

While few people would argue against the merits of compliance training, more than a few financial institutions are not reaping the full benefits of such training.

As the principal provider of compliance training, the onus is on the compliance department to ensure that its own staff are up to date on the latest regulations, guidelines, circulars, and developments pertaining to the financial services sector. If compliance function staff are unfamiliar with the rules and regulations, the business units cannot expect to receive accurate and practical compliance advice.

Unfortunately, much of the training provided to business and operational units by compliance departments falls short in terms of substance and scope. Most financial institutions limit themselves to one-size-fits-all e-learning or to formally structured one-to-many seminar style presentations.

Given that personnel from different business and operational units have different compliance related responsibilities and varying levels of work-related compliance knowledge, other less formalised types of compliance training could be more valuable. For example, the sharing of relevant compliance knowledge at business unit and operations meetings, or through periodic one-on-one sharing.

Getting the scope of the training right is very important. Rather than covering all relevant regulatory requirements, the compliance departments at some financial institutions may prefer to focus on "hot topics" such as anti-money laundering and banking secrecy, and neglect more "mundane" topics.

Some areas that are often neglected by compliance training include the preparation of regulatory returns, fair dealing guidelines, and fit and proper guidelines.

A financial institution's defence against compliance infringement is only as strong as its weakest link.

Care should be taken to avoid scoping compliance training too narrowly.

Future outlook of compliance

Financial institutions must prepare themselves for the future regulatory landscape by ensuring the ongoing development and enhancement of their compliance functions.

As the future unfolds, there will be an increasing need to engage compliance officers who are not only knowledgeable in their field of business but who also possess the analytical and lateral thinking skills required to steer their institutions through the changing regulatory landscape.

Financial institutions must gain and hold the trust of their customers, shareholders, and regulators if they are going to be successful through these uncertain times. The ability to earn this trust will require consistent and high standards of compliance with rules and regulations. As the institution's principal steward of compliance, the compliance function should be empowered to build and safeguard this trust.

Regulatory, accounting and tax updates

Regulatory Updates

Changes in the regulations concerning Banks & Merchant Banks

- Monentary Authority of Singapore (MAS) Notice 637 - Risk Based Captial Adequacy Requirements for Banks Incorporated in Singapore
  This Notice establishes the minimum capital adequacy ratios for a bank incorporated in Singapore (Reporting Bank) and the methodology a Reporting Bank shall use for calculating these ratios (Pillar 1). It also sets out the expectations of the Authority in respect of the internal capital adequacy assessment process of a Reporting Bank under the supervisory review process (Pillar 2). In addition, this Notice specifies the minimum disclosure requirements for a Reporting Bank in relation to its capital adequacy, with a view to enhancing market discipline (Pillar 3).

  On 28 June 2011, the MAS announced that Singapore-incorporated banks will meet capital adequacy requirements that are higher than the Basel III global capital standards. MAS will require Singapore-incorporated banks to meet a minimum Common Equity Tier 1 (CET1) capital adequacy ratio (CAR) of 6.5%, Tier 1 CAR of 8% and Total CAR of 10% from 1 January 2015. These standards are higher than the Basel III minimum requirements of 4.5%, 6% and 8% for CET1 CAR, Tier 1 CAR and Total CAR, respectively.

  In addition, MAS will require Singapore-incorporated banks to meet the Basel III minimum capital adequacy requirements from 1 January 2013, two years ahead of the Basel Committee on Banking Supervision's 2015 timeline. This means that from 1 January 2013, Singapore-incorporated banks will meet a minimum CET1 CAR of 4.5% and Tier 1 CAR of 6%. MAS' existing requirement for Total CAR will remain unchanged at 10%. In line with Basel III requirements, MAS will introduce a capital conservation buffer of 2.5% 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%, which is higher than the Basel III requirement of 7%. As such, the notice will be amended accordingly.

  On 5 July 2011, amendments were made to the notice and these amendments shall be effective from 31 December 2011.

- Residential Property Loans
  The revised notice includes amendments which came into effect on 27 July 2011. The amendments largely pertains to the addition of credit facilities granted by moneylenders and credit facilities otherwise secured by residential property to be regulated under the current requirements.

- **MAS (Sanctions and Freezing of Assets of Persons – Libya) Regulations 2011**
  These regulations mainly set out the requirements for financial institutions to freeze the funds, financial assets or economic resources of any designated person. Financial institutions are also required to ensure that such funds, financial assets or economic resources are not made available to or for the benefit of the designated person. Exceptions to the above are set out in paragraph 3 under the section "Assets of certain persons to be frozen".

  These regulations came into effect on 8 July 2011.

- **SRD Cir TR 01/2011: Circular on Information Technology Outsourcing**
  This circular reminds financial institutions that the responsibilities for effective due diligence, oversight and management of outsourcing and accountability for all outsourcing decisions continue to rest with the institution, its board and senior management. The financial institution should put in place proper framework, policies and procedures to evaluate, approve, review, control and monitor the risks and materiality of all its outsourcing activities.

  In particular, the circular discussed about the unique attributes and risks of cloud computing, especially in the areas of data integrity, recoverability and confidentiality as well as legal issues such as regulatory compliance and auditing.

- **Consultation Paper on Proposed Amendments to MAS Notice 637 on Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore**
  On 1 July 2011, the Basel Committee on Banking Supervision (BCBS) issued the "Pillar 3 Disclosure Requirements for Remuneration" to support the disclosure of clear, timely and easily comparable information on compensation practices in banks. This consultation paper sets out proposed amendments to MAS Notice 637, incorporating the BCBS' Pillar 3 disclosure requirements on remuneration.

  The proposed amendments will require Singapore-incorporated banks to disclose qualitative and quantitative information about their remuneration practices and policies covering the following areas:

  1. governance structures overseeing remuneration;
  2. design/operation of remuneration structure and frequency of review;
  3. independence of remuneration for staff in risk and compliance functions;
  4. risk adjustment methodologies;
  5. the link between remuneration and performance;
  6. long-term performance measures (i.e. deferral, malus, clawback); and
  7. types of remuneration (i.e. cash or equity; fixed or variable remuneration)

Guidelines for Financial Institutions to Safeguard the Integrity of Singapore's Financial System

These guidelines reiterate Singapore's commitment to safeguard Singapore's financial system from being used as a haven to harbour illegitimate funds or as a conduit to disguise the flow of such funds. Financial institutions must continuously assess the legal, regulatory and reputational risks associated with their business. In particular, they should be alert to agreements between countries to resolve tax issues and undertake a more critical review of any asset transfers into Singapore from such countries. The risks should be evaluated and the bona fides of customers established before the acceptance of such assets. If they have reason to suspect that the assets are illegitimate, they should file Suspicious Transaction Reports and where appropriate, discontinue the business relationship.

Intermediaries will need to assess investment knowledge and experience of retail customers

Come 1st January 2012, the new Notice on the Sale of Investment Products under the Securities and Futures Act (SFA) and a new Notice on Recommendations on Investment Products under the Financial Advisers Act (FAA) will come into effect, a five months transition period will be provided for intermediaries to put in place the necessary processes to meet the requirements. The new requirements will apply to the sale of Specified Investment Products (SIPs). The new measures will require intermediaries to conduct a Customer Knowledge Assessment to assess whether a customer has the relevant knowledge or experience to understand the risks and features of an unlisted SIP. Intermediaries are also required to conduct a Customer Account Review to ascertain whether the customer has the relevant knowledge or experience to understand the risks and features of complex structures or derivatives, before approving the customer's account to trade such products. Intermediaries are required to comply with the new requirements in their dealings with all customers, new and existing.

The MAS has introduced stronger measures and enhanced requirements, with the aim to further safeguard customers' interests. The main objective is to ensure that intermediaries recommend suitable investment products to customers, particularly those who may not have the relevant investment knowledge or experience.

Accounting Updates

ED/2011/4 Investment Entities

On 25 August 2011, the International Accounting Standards Board (IASB) issued Exposure Draft ED/2011/4 Investment Entities (ED).

This ED proposes to amend IFRS 10 Consolidated Financial Statements to require investment entities to measure their investments in controlled entities at fair value through profit or loss in accordance with IFRS 9 Financial Instruments, rather than consolidating such investments.

This measurement exception would not be carried through to a parent of an investment entity that is not itself an investment entity, i.e. the parent is required to consolidate all entities that are controlled through an investment entity.

The proposals include additional disclosures, in addition to those required by IFRS 7 Financial Instruments: Disclosures, IFRS 12 Disclosure of Interests in Other Entities and IFRS 13 Fair Value Measurement. The ED also proposes prospective application, with effects of applying the amendments at the date of adoption recognised as an adjustment to retained earnings at the beginning of that period, i.e. comparatives would not be restated.

Consequential amendments would be made to IAS 28 (2011) Investments in Associates and Joint Ventures, to similarly require investment entities to measure their investments in associates and joint ventures at fair value through profit or loss. Unlike subsidiaries, this measurement exception will be carried through to the parent's consolidated financial statements.

The IASB has invited comments on the proposals contained in the ED by 5 January 2012. In Singapore, the Accounting Standards Council (ASC) issued the equivalent consultation paper and the comment period will close on 28 October 2011.

ED/2011/3 Mandatory Effective Date of IFRS 9

On 4 August 2011, the IASB issued Exposure Draft ED/2011/3 Mandatory Effective Date of IFRS 9. IFRS 9 (2009) and IFRS 9 (2010) on Financial Instruments: Classification & Measurement as issued by IASB currently are mandatorily effective for annual periods beginning on or after 1 January 2013.

Since the issue of the standard (Phase I) above, IASB has extended its timeline for completion of the remaining phases of the IAS 39 replacement project beyond its previous target of June 2011. Therefore, in order to allow entities adequate lead time to implement the requirements of all phases of the IAS 39 replacement project at the same time, this Exposure Draft proposes to postpone the mandatory effective date of IFRS 9 (2009) and IFRS 9 (2010) to annual periods beginning on or after 1 January 2015.

The IASB has further requested feedback as to whether entities that adopted IFRS 9 for reporting periods beginning before 1 January 2012 should continue to be given exemptions from restating comparative information for prior periods.

The IASB has invited comments on the proposals contained in this Exposure Draft by 21 October 2011. In Singapore, the ASC issued the equivalent consultation paper and the comment period had closed on 26 August 2011.

Amendments to IAS 1 Presentation of Items of other Comprehensive Income

On 16 June 2011, the IASB issued amendments to IAS 1 Presentation of Financial Statements.

The amendments require companies to present separately items of Other Comprehensive Income (OCI) that may be reclassified to profit or loss in the future from those that would never be reclassified to profit or loss. Consequently, an entity that presents items of OCI before related tax effects will also have to allocate the aggregated tax amount between these sections. The existing requirements that items in OCI and profit or loss could be presented as either a single statement or two consecutive statements is reaffirmed.

The title of the Statement of Comprehensive Income is changed to Statement of Profit or Loss and Other Comprehensive Income. However, an entity is still allowed to use other titles. The amendments to IAS 1 are effective for financial periods beginning on or after 1 July 2012, and are to be applied retrospectively. In Singapore, the ASC has issued the equivalent amendments.

Tax Updates

General Tax Update for Financial Institutions in Asia Pacific Template for September 2011 Issue 41 - Singapore

Islamic Financing

Under Section 43Q of the Income Tax Act, a concessionary tax rate of five per cent is accorded to income derived by a Financial Sector Incentive – Islamic Finance ("FSI-IF") company from prescribed Shariah-compliant activities in key areas of the finance sector, namely: (i) lending and related activities, and (ii) fund management and investment advisory services rendered in relation to funds.

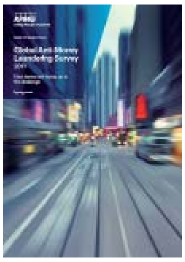
In order to enjoy the five per cent concessionary tax rate for lending and related activities, one of the requirements is for the qualifying Islamic activities to be structured according to one of the following Shariah-compliant concepts:

- Murabaha
- Mudaraba
- Ijara Wa Igtina
- Musharaka
- Istisna; or
- Salam

The MAS has issued a circular on 8 June 2011 to elaborate further the Murabaha concept. The circular also touches on the detailed workings of the following prescribed Islamic financing activities and the corresponding direct and indirect tax incentives that would apply to these qualifying prescribed Islamic transactions:

- Musharaka
- Istisna
- Wakalah

Global topics

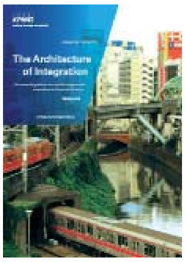


Global Anti-Money Laundering Survey 2011: How banks are facing up to the challenge (September 2011)

Our latest survey explores how AML fits into the changing risk and regulatory landscape. It reports the views of the survey participants on their areas of focus and challenge, and contains commentary from KPMG based on our work with clients.

The Dodd-Frank Act - Could there be Accounting Consequences?

This publication analyses some of the key aspects of the Dodd-Frank Act that may affect accounting and reporting for companies. It is aimed at helping these companies evaluate and address the new requirements that they may face.



The Architecture of Integration: An Essential Guide to Successful Mergers and Acquisitions in Financial Services (September 2011)

The report is based on the bi-annual M&A study from Advisory and includes KPMG FS insight on how different drivers may have contributed to the success or failure of global M&A transactions.

New on the Horizon Investment Entities

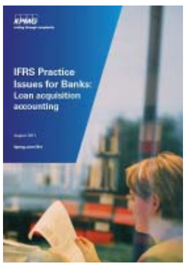
On 25 August 2011 the International Accounting Standards Board issued ED/2011/4 Investment Entities. This ED serves as an amendment to the recently issued IFRS 10: Consolidated Financial Statements.

KPMG Insurance Briefing - Achieving Profitability and Performance Through a Soft Insurance Market - Sep 2011

This edition of KPMG Insurance Briefing examines the question of property and casualty pricing by analysing three main points that drove a change to a hard market ten years ago.

Solvency II: A closer look at the evolving process transforming the global insurance industry (August 2011)

This paper provides an outline of the Solvency II framework. It begins with an overview of the regime, recognises the strategic benefits of the regime and highlights the directive's implications for the global insurance industry.



IFRS Practice Issues for Banks: Loan acquisition accounting (August 2011)

Market conditions over the last few years have changed the level and nature of loan portfolio sales and acquisitions. This edition of IFRS Practice Issues for Banks provides guidance and examples on accounting for acquired loans.

Focus on Transparency: Financial reporting of European banks in 2010 (July 2011)

This report analyses the 2010 annual reports of 15 European banks: Barclays, BBVA, BNP Paribas, Commerzbank, Deutsche Bank, HSBC, ING, LBG, Nordea, RBS, Santander, Société Générale, Standard Chartered, UBS and Unicredit.

Insurance Industry Pulse: Executives Consider M&A for Growth

KPMG LLP surveyed C-suite and other top-level executives in the insurance industry during the second quarter of 2011.

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