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Financial Services Briefings

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Foreword

Late last year, regulators in the United States and Britain launched an investigation into London's interbank lending system.

The concerns over LIBOR (London Interbank Offered Rate) have prompted scrutiny of lending benchmark rates in many parts of the world. Closer to home, Hong Kong, Japan and Singapore announced reviews of the way interbank benchmark rates were set. In South Korea, the anti-trust agency widened a probe into possible rate-fixing.

As banks assess their roles in a global rate setting system under heavy scrutiny, they will also need to understand the weaknesses in their current processes and identify any potential breaches.

In this issue, we discuss the potential consequences which banks could face should they be found to be involved in any form of manipulation of benchmark rates. Updates on regulatory, accounting and tax changes are also provided.

Leong Kok Keong
Partner, Head of Financial Services
KPMG LLP

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LIBOR and SIBOR: Conflict of Interest Rates

By: Lem Chin Kok

Background

Sometime this past June 2012, a global financial storm erupted over allegations involving major UK banks' attempts to manipulate the important London Interbank Offered Rate (LIBOR). At least a dozen banks came under scrutiny as regulators on both sides of the Atlantic, British and U.S. authorities commenced criminal investigations.

As the storm gathered momentum, senior banking executives lost or may lose their jobs, and fines running into the hundreds of million dollars were levied or may be levied against the offending banks.

Going beyond these record fines, the U.S. Department of Justice (DOJ) and the U.K. Serious Fraud Office (SFO) also began considering criminal charges against the banks and its employees for misconduct in relation to the submission of the LIBOR and the Euro Interbank Offered Rate (EURIBOR).

While banking systems in other geographic areas of the world remained on the sidelines, this incident nevertheless cast doubt on other benchmark rates from around the world. In July 2012, regulators in Canada, South Korea, Hong Kong and Denmark initiated probes into the benchmark rate setting process in their jurisdictions.

In Singapore, the Monetary Authority of Singapore (MAS) announced on 25 July 2012 that banks are to perform an independent review of their processes for setting benchmark interbank borrowing rates, with the focus to be placed on the Singapore Interbank Offered Rate (SIBOR) and the Swap Offer Rate (SOR).

Calculation of SIBOR

The SIBOR setting process is not dissimilar to that of LIBOR. As of 20 July 2012, there are 12 banks which submit rates to Thomson Reuters daily. The rates are typically submitted by designated traders of the contributing banks. The rates are ranked in order and the lowest three and highest three are removed. The six remaining submissions are averaged to obtain the day's SIBOR.

The rates submitted are non-binding and reflect the trader's perception of the rate at which the bank could borrow. As the trader, who is reporting the rates of those trades sits in the front office, potential conflict of interests arise when the rates quoted could affect transactions executed by the front office.

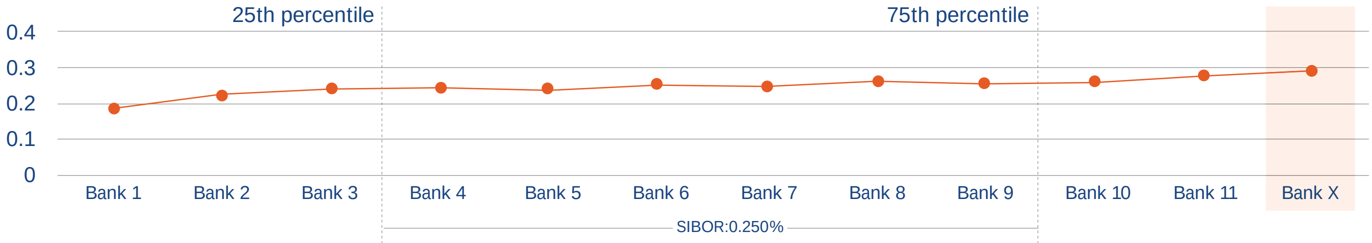
The decrease in interbank lending following the global financial crisis also limits the available reference data for the rates quoted by the traders, which makes verification of their quotes that much harder.

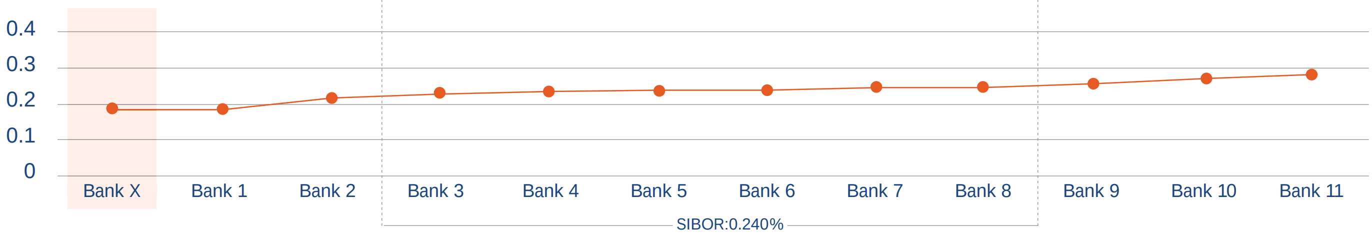
The Allegations

Globally, some of the contributing banks are alleged to have colluded to depress LIBOR for two main reasons.

First, an understated cost of borrowing would imply that the bank is economically healthier than it really is, as interbank lending rates reflect the credit risk of the borrower. Second, a suppressed LIBOR meant that a bank would pay lower interest rates for LIBOR-based financial instruments. The ability to influence LIBOR would also mean that the prices of LIBOR-based derivatives could be influenced, which would have advantages for bank traders dealing in such derivatives.

While the allegations to date have been of collusion between two or more banks, it is possible for a rogue trader to influence benchmark rates without colluding with other banks by persuading the rate reporter in his own bank to change the rate it reports. The illustration on the facing page shows a hypothetical scenario in





which significant change in the interday submissions for Bank X could result in a lower SIBOR.

Potential Consequences

Banks found to be involved in the manipulation of benchmark rates potentially face a multitude of consequences.

- Regulatory sanctions: the quantum of fines imposed to date underlines the severity with which the authorities view this kind of market misconduct and manipulation.

- Criminal liability: the authorities are willing to pursue criminal actions against banks and individuals. As the ongoing SFO enquiry demonstrates, the matter no longer ends with the resignation of senior management or return of bonuses.

- Civil liability: customers of banks have already commenced class action suits for losses they suffered in trading and borrowing with various banks. Other parties to contracts that rely on interbank rates may not even have direct relationships with the offending institutions but could have been affected. The Berkshire Bank, based in New York, recently issued a class action suit against 21 banks for damages on behalf of all New York financial institutions that "originated, purchased outright or purchased a participation in" loans paying interest rates pegged to LIBOR because if LIBOR was manipulated downwards, they would have lost interest revenue. However, if LIBOR was manipulated upwards at any stage – perhaps by traders involved in derivative trades – borrowers would also have suffered losses and the universe of potential plaintiffs grows exponentially.

- Increased scrutiny: financial institutions implicated in the LIBOR allegations may become subject to increased oversight in other areas as a result of reduced regulator confidence in their risk management and reporting.

- Damage to reputation: monetary sanctions may be significant but it may also impact the already shaky trust and confidence of investors, governments and the public. The recent turn of events could serve to fuel a consumer revolt against their banking system, such as the Move Your Money campaign - to spread the message that consumers can help to build a better banking system through their collective buying power, to strengthen the ethical banking sector, and to enhance the debate on financial reform.

Next steps

Given the scrutiny of historic interbank rate setting by both regulators and potential plaintiffs and the potentially severe responses to perceived misconduct, participating banks may wish to take steps to ascertain their exposure and contain the consequences.

Banks will need to understand weaknesses in their current process to identify potential breaches. Regulators will want to know whether any adverse findings are due to individual malpractice or are pervasive in nature. A process review will also enable remediation steps to be taken to ensure that the process is robust enough to prevent commercial interests influencing submissions.

Analysis of trends can provide useful indicators to focus the review and highlight anomalies requiring further investigation. Unusual trends should be identified and the underlying reasons identified.

The next step is to review email, web-based or proprietary messaging and voice records of potentially involved staff members. Keyword search engines and phonetic search technology can be employed to accelerate such reviews and cut down the cost in time and manpower required to perform this analysis. Interviews with involved staff members should be conducted with, where appropriate, legal supervision or involvement.

Conclusion

This issue is likely to escalate further in the coming months as more banks disclose findings from their preliminary reviews. It is important for affected banks to be on the front foot in dealing with this issue. Otherwise, regulatory or civil action may catch them off-guard and unprepared.

Regulatory, accounting and tax updates

Regulatory Updates

Consultation Paper on Notice on Technology Risk Management dated 13 June 2012

The Monetary Authority of Singapore (MAS) has issued various guidelines and circulars to the financial industry over the years to promote sound technology risk management and security practices.

To further this effort, MAS is proposing to issue a Notice on Technology Risk Management that sets out the obligations of the financial institutions which include requirements relating to system recoverability and reliability, IT security incidents and major systems failure notification, as well as security of customer information.

The following requirements are proposed.

1. Financial institutions shall put in place a framework and process to identify crucial systems.
2. Financial institutions shall maintain high availability for critical systems where maximum allowable unscheduled downtime within 12 months shall not exceed four hours. To achieve high availability, financial institutions will have to enhance the resiliency of critical systems by building sufficient fault tolerance and redundancies in the IT infrastructures that support these systems.
3. Financial institutions shall recover critical systems in four hours or less, in the event of a disaster. The recovery time objectives shall be documented and verified once every 12 months.
4. Financial institutions shall inform MAS about all IT security incidents and major systems malfunction within 30 minutes upon discovery of the incidents. Financial institutions shall also submit a root cause and impact analysis report to MAS within one month from the occurrence of any IT security incident and major systems malfunction. This is to provide MAS with timely information on disruptive events relating to IT security as well as critical systems and IT infrastructure.

In addition, data which are stored and processed electronically are susceptible to data loss, leakage or other forms of compromise through mishandling and other poor data protection practices. To maintain the integrity of customer information, MAS proposes that financial institutions implement IT controls to protect customer information from unauthorised access or disclosure. The consultation paper closed on 16 July 2012.

Consultation Paper on Technology Risk Management Guidelines dated 13 June 2012

The MAS Internet Banking and Technology Risk Management Guidelines have been updated to enhance financial institutions' oversight of technology risk management and security practices. The new guidelines include guidance on existing and emerging technology trends and security concerns in the financial industry. In addition, the circulars on IT outsourcing, endpoint security and data protection, information systems reliability, resiliency and recoverability have been amalgamated into the guidelines to facilitate ease of reference by users. The name of the new guidelines has been changed to "Technology Risk Management Guidelines".

The key additions and changes made are summarised below:

1. Data Centres Protection and Controls
   Financial institutions' critical data, applications, systems and network devices are maintained in data centres. Chapter 10 of the Technology Risk Management Guidelines provides guidance on the scope of assessment which financial institutions should perform to identify security and operational weaknesses in their data centres. This section also describes measures which should be implemented so that data centres are resilient and physically secured against internal and external sabotage.

2. Mobile Banking and Payment Security
   Mobile banking and payments are extensions of online financial services and payments on mobile devices. Whilst mobile banking and payments face similar threats as those of internet banking and payments, Section 12.2 of the Technology Risk Management Guidelines covers specific risks confronting the mobile security landscape and the importance of educating customers on security measures to protect their mobile devices from theft and loss as well as viruses and other malicious software.

3. Payment Card System and ATM Security
   Financial institutions, providing payment card services, should institute various measures to combat the increase in payment card fraud. Chapter 13 of the Technology Risk Management Guidelines covers a suite of measures that should be adopted to enhance the security of payments cards, card acceptance

terminals and processing systems, as well as guidance on fraud detection mechanisms. This section also recommends certain detective measures that financial institutions should take to mitigate this threat.

4. Combating Cyber Threats
   A multi-layered security strategy should be implemented to protect financial systems offered via the internet platform. Appendix E of the Technology Risk Management Guidelines addresses security measures for online systems. In particular, to address man-in-the-middle attack (MITMA), financial institutions are advised to implement transaction-signing for high risk transactions (e.g. payments, fund transfer limits or changes to personal details) performed by customers.

5. Customer Protection and Education
   Customer protection and education requirements are updated in Appendix F of the Technology Risk Management Guidelines to include new guidance for financial institutions to protect customers' login credentials for online systems. Financial institutions are also advised to educate customers on features and risks of different payment cards as well as measures to secure their cards.

The consultation paper closed on 16 July 2012.

Enhanced regulatory regime for fund management companies

Enhanced regulatory regime for fund management companies (FMCs) came into effect on 7 August 2012. These regulations were based on the two consultation papers dated 27 September 2010 and 27 April 2011.

Amendments have been made to the Securities and Futures (Licensing and Conduct of Business) Regulations, Securities and Futures (Financial and Margin Requirements) Regulations to include new requirements applicable to FMCs. To facilitate a smooth transition for the current Exempt Fund Managers, fund managers will need to apply for a licence or to register with MAS. MAS has allowed a six months transition period to register online via the Corporate e-Lodgement system.

Notice on Prohibition on Transactions with the Iranian Government and with Iranian Financial Institutions [MA-N-EXT 1/2012]

This Notice is issued pursuant to section 27B of the Monetary Authority of Singapore Act (Cap. 186) (the "MAS Act"), and applies to all financial institutions, as defined in section 27A(6) read with section 27A(7) of the MAS Act.

No financial institution in Singapore shall, directly or indirectly:

a. enter into;
b. continue to participate in;
c. arrange or facilitate the entering into or continued participation in; or
d. continue to arrange or facilitate the entering into or continued participation in,

any transaction or business relationship:

i. with; or
ii. for the benefit of, whether directly or indirectly,

a designated person as defined within this Notice.

This Notice has taken effect from 18 June 2012.

Accounting Updates

International developments

On April 2012, the IASB (International Accounting Standard Board) and FASB (Financial Accounting Standard Board) (the 'Boards') issued a joint progress report on the Boards' convergence activities, for consideration at the April 2012 meeting of G20 Finance Ministers and Central Bank Governors. The progress report:

- identifies mid-2013 as the new target for completion of major work on convergence
- explains how the Boards plan to pursue convergence; and
- summarises convergence efforts to date.

The Boards remain focused on their four major convergence projects listed below.

1) Financial instruments
- With the IASB's decision to reconsider some classification and measurement requirements, the prospects for closer alignment in this area have improved.
- The Boards are reaching agreement on nearly all key impairment issues, and plan to issue exposure drafts in the second half of 2012.
- The Boards have still not agreed on hedge accounting.

2) Revenue recognition
- The Boards' deliberations to date have resulted in agreement on all key issues.

3) Leases
- The Boards' current focus is on the profit or loss profile over the life of a lease, and whether all leases should be accounted for in the same way.

4) Insurance contracts
- The Boards are making further efforts to narrow differences before they issue their next due process documents.

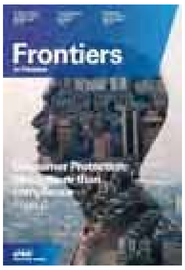
Tax Updates

Tax certainty on gains on disposals of equity investments

Concerning the safe harbour rule announced by the Finance Minister in the Budget 2012 to provide upfront tax certainty on gains derived from disposal of shares, the Inland Revenue Authority of Singapore has released further information on the qualifying criteria:-

- The exemption on gains from disposal of equity investments (the "exemption") would apply regardless of whether the investee company is:
  i. incorporated in Singapore or overseas; or
  ii. listed in any stock exchange or unlisted.
- The exemption would not be applicable to:
  i. disposal of shares in an unlisted company that is in the business of trading or holding Singapore immovable properties; and
  ii. a divesting company whose gains from the disposal of shares are included as part of its income as an insurer under Section 26 of the Singapore Income Tax Act.
- The exemption is only applicable to disposal of ordinary shares. It would not be applicable to a disposal of shares of a preferential nature or shares with redeemable or convertible features.
- The tax exemption would apply to qualifying disposals made during the 5-year period from 1 June 2012 to 31 May 2017.

Global topics

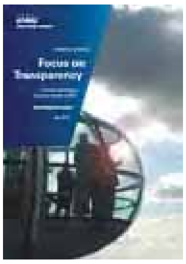


Frontiers in Finance (July 2012)

The business environment for financial services remains challenging. In this economic environment it is more important that financial services companies focus attention on customers. This theme underpins most of the articles in this edition of frontiers.

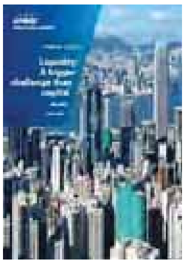
The Bank Statement Q2 2012 (July 2012)

Our quarterly banking newsletter – The Bank Statement – in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.



Focus on Transparency: Financial reporting of European banks in 2011 (Full report) (July 2012)

The report provides analysis of 15 of the largest European banks and discusses their priorities, as set out in their annual review, against their financial results and the wider economy.



Liquidity: A bigger challenge than capital (May 2012)

The Basel Committee has introduced two new liquidity ratios for banks. The Committee aims to strengthen banks against adverse shocks; eliminate structural mismatches; and encourage more stable sources of funding than short-term options.

Accessing Islamic financing and Sukuk markets

KPMG's Global Islamic Finance & Investments Group works closely with corporate finance & debt advisory colleagues to help clients implement Islamic financing strategies: aligning their balance sheets or to strategic objectives of their business.

Time to grow up: Perspectives on customer insight and analytics in retail banking (June 2012)

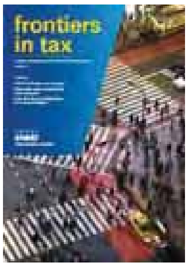
A report asserting that the time has come for customer insight and analytics teams to transform themselves from a fragmented set of cottage industries within retail banks to a centre of value, opportunity and innovation.

Insurance Reporting Round-Up (June 2012)

This edition reviews the 2011 financial information published by Europe's largest insurers, seeking to identify trends in performance and the way in which performance is reported.

Evolving Investment Management Regulation: A clear path ahead? (June 2012)

This report aims to address the practical challenges that investment managers will face as they strive toward global compliance.



Frontiers in Tax (July 2012)

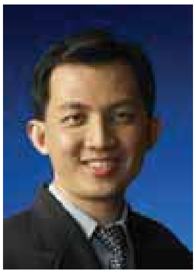
The biannual magazine from KPMG's Global FS Tax Practice. Articles in this edition include: * EURO-FTT: Politics over principle * Deferred tax assets * India: New tax law poses several challenges

To obtain any of the reports, please send a request to sg-marketing@kpmg.com.sg.

Contributors to this issue

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

Tony Rawlinson
Partner, Head of Financial
Services Advisory
T: +65 6411 8101
E: trawlinson@kpmg.com.sg



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

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

Lem Chin Kok
Partner,
Forensic Practice
T: +65 6213 2495
E: clem@kpmg.com.sg

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

Lyon Poh
Partner,
IT Assurance
T: +65 6411 8899
E: lpoh@kpmg.com.sg

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