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Financial Services Briefings

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Foreword

Recent enhancements proposed by the Monetary Authority of Singapore (MAS) to the tax and regulatory framework of the Islamic finance sector in Singapore demonstrate that the authorities have renewed their commitment to developing Islamic finance services.

Signalling a shift towards exploring non-fiscal means to boost the industry, the authorities have included proposals to shorten the approval processes and provide greater clarity and certainty for the regulatory and tax treatment of Islamic finance products.

With the global Islamic finance industry reaching US$1.3 trillion in total asset size and the Sukuk issuance reaching a record level in 2012, it is evident that there is a growing demand for Islamic financial products. The decisive moves by the authorities on both the tax and regulatory fronts offer great promise for Islamic Finance to become a new pillar of growth for the Singapore financial sector.

In this issue, we offer our thoughts on how some of the issues impacting the Singapore Islamic finance sector could be addressed.

I trust you find this information useful.

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A non-fiscal boost for Islamic finance

By: Alan Lau

Approximately 25 percent of the global population are Muslims. With global Islamic Finance growth reaching US$1.3 trillion in asset size and Sukuk issuance reaching a record level in 2012, the Islamic Finance sector has seen good growth and has significant new opportunities ahead. The demand for these Islamic financial products are from both the Muslim and non-Muslim communities.

Dedicated tax incentives for Islamic finance were first introduced in 2008 to encourage more Shariah-compliant financial activities to be carried out in Singapore. These incentives accorded a highly favourable five percent concessionary rate of tax for taxpayers engaged in qualifying Islamic financing transactions and offshore Islamic takaful (insurance) and retakaful (reinsurance) activities. The 2008 Budget also announced the broadening of the scope of tax exemption currently enjoyed by non-resident investors and resident individual investors of Islamic debt securities to include all investors, albeit subject to conditions. This gives Islamic debt securities a leg-up over their conventional cousins as resident non-individual investors (i.e. corporate taxpayers) are subject to tax at 10 percent on their returns on conventional qualifying debt securities. The incentives mentioned above have an initial tenure of five years. Unfortunately, the response and take-up by financial institutions and insurers to this tax incentive had been rather tepid. Against this backdrop, the subsequent decision by the authorities to allow these incentives to lapse in 2013 was understandable, albeit disappointing to the Islamic finance market players.

The Monetary Authority of Singapore (MAS) remains committed to supporting the growth of Islamic financing despite the expiry of tax incentives. At the Islamic Finance News Singapore road show held in April this year, the MAS commented that the lapsing of the incentives is no reflection of the MAS's continuing commitment to develop Islamic financial services in Singapore. It is worth noting that Islamic insurance and banking activities will continue to enjoy concessionary tax rates of 10 and 12 percent respectively. The returns from Islamic debt securities derived by non-resident investors and resident individual investors remain exempt from tax. More recently, the MAS announced that the enhancements to the tax and regulatory framework for Islamic financing are in the pipeline. The proposed enhancements seek to shorten the approval process and provide greater clarity and certainty in the regulatory and tax treatment of Islamic finance products. This marks a change in tack by the authorities towards incentivising the Islamic finance sector.

In this issue, we offer our thoughts on how some of the issues currently affecting the Islamic finance sector can be resolved.

Moving towards a principle-based regulatory system

Islamic finance is a relatively new sector, and the authorities have strived to ensure that the neutrality of rules insofar as Islamic financing is similar to conventional financing in economic substance and risks.

In this regard, an understandably measured approach have been adopted by the authorities in defining, albeit narrowly, a growing but still modest number of Islamic financial transactions in the income tax legislation qualifying for tax certainty.

However, industry experience has demonstrated that a prescriptive legislative approach towards characterising Islamic finance transactions is unwieldy; as such transactions evolve constantly and in some cases grow increasingly sophisticated.

On this note, KPMG, along with other industry observers, have been advocating for a migration of the Islamic finance tax legislation from a rule-based framework to one founded on broad guiding principles. This could entail, for example, allowing all Islamic financing transactions deemed Shari'ah-compliant being accorded certainty of tax treatment.

One of the first steps in the move to a new framework would be the redrafting of existing tax regulations to describe the essence of various Islamic finance transactions, rather than prescribing and dictating individual steps required for a transaction.

A source for much angst among taxpayers undertaking Islamic finance transactions is that any deviation from the prescribed steps had required approval of the tax authorities on a case-by-case basis, no matter how minor. This had resulted in transactional delays, slowing the time to market for Islamic finance products.

The transition to a principle-based Islamic tax framework should go some way towards meeting the authorities' twin aims of shortening the approval process and providing certainty of tax treatment.

Defraying the higher costs of Islamic financing via enhanced tax deductions

Beyond the regulatory tweaks

according upfront tax certainty for Islamic finance products, additional measures to mitigate the higher transactional costs associated with Islamic finance transactions in Singapore would certainly be welcome.

One reason for higher costs can be attributed to the shortage of skilled Islamic finance professionals required to deal with the complexities of Shari'ah law. In some cases, these higher costs have been passed on to customers. Islamic finance transactions in Singapore are therefore less attractive when compared to conventional finance equivalents. This is in contrast with Malaysia, which has a comprehensive tax incentive regime providing tax exemption on the income derived by financial institutions from qualifying Islamic banking, fund management and insurance activities. Some financial institutions in Malaysia have passed on the tax savings to their customers, putting Islamic financing on an extremely competitive footing relative to conventional financing.

Singapore has strived to ensure the neutrality of rules insofar as Islamic financing is similar to conventional financing in economic substance and risks. However, the rationalisation of tax incentives may have inadvertently tilted the balance away from Islamic finance.

As an interim measure, borrowers utilising Islamic financial products could be provided enhanced tax deductions for financing costs. This should help put Islamic financial products on an even keel with their conventional cousins in Singapore.

Cultivating a deep pool of Islamic finance professionals

In the longer term, a strong local network of lawyers, accountants and tax advisers is a critical component of a vibrant local Islamic finance industry.

To strengthen local expertise the Islamic finance sector, the Singapore Government can, for a start, consider awarding grants or subsidies to foreign Islamic scholars and renowned academics visiting our shores.

Such support from the authorities can help the local professionals narrow the knowledge gap with their foreign counterparts. It would encourage the knowledge transfer of expertise and market intelligence to local Islamic finance professionals.

Conclusion

The rationalisation of tax incentives for the Islamic finance sector and recently proposed enhancements to the tax and regulatory framework signals a positive shift by the authorities towards exploring non-fiscal means to boost the industry. KPMG looks forward to the release of additional details by the authorities and are confident that the Government will act decisively on the tax and regulatory fronts to establish Islamic finance as one of the new pillars of growth for the Singapore financial sector.

Regulatory, accounting and tax updates

Regulatory Updates

Financial Institutions

MAS Notice and Guidelines on Technology Risk Management (June 2013)

On 21 June 2013, MAS issued the Technology Risk Management (TRM) Notice and Guidelines.

The TRM Guidelines aim to provide comprehensive guidance on the establishment of sound technology risk management and security practices to address existing and emerging technology risks within the financial industry. This set of enhanced Guidelines replaces the existing MAS Internet Banking and Technology Guidelines as well as past circulars on IT risk management, and applies to all financial institutions (FIs) with immediate effect.

The TRM Notice defines a set of legal requirements relating to technology risk management for FIs. These include requirements for a high level of reliability, availability and recoverability of critical IT systems and for FIs to implement IT controls to protect customer information from unauthorised access or disclosure.

The new MAS Notice shall take effect on 1 July 2014.

MAS Notice on Prevention of Money Laundering and Countering the Financing of Terrorism

Under the revised Notice, amendments include the prohibition of a bank in Singapore from entering into or continuing correspondent banking relationships with banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities.

The amendments have taken effect from 23 January 2013.

Banks

MAS Notice 637 (Amendment No. 2) 2012

On 28 December 2012, this Notice was revised to incorporate the proposed amendments from the MAS Consultation Paper – Proposed Amendments to MAS Notice 637 to Implement Composition of Capital Disclosure Requirements dated 5 November 2012. The amendments will require Singapore-incorporated banks to disclose their capital positions through the following:

- breakdown of the full list of regulatory capital items and regulatory adjustments
- reconciliation of all regulatory capital elements back to the audited financial statements
- description of the main features of regulatory capital instruments issued; and
- provision of the full terms and conditions of regulatory capital instruments and the calculation of any ratios involving components of regulatory capital.

The amendments take effect in two phases on 1 January 2013 and 31 March 2013.

Banks/Merchant Banks

MAS Notice 645 / 1115 Computation of Total Debt Servicing Ratio for Property Loans (June 2013)

Guidelines on the Application of Total Debt Servicing Ratio for Property Loans under MAS Notice 645/1115 (June 2013)

MAS has introduced a Total Debt Servicing Ratio (TDSR) framework for all property loans granted by FIs.The TDSR framework will facilitate FIs' assessment of the debt servicing ability of borrowers applying for property loans, taking into consideration their other outstanding debt obligations. FIs will be required to compute the TDSR, or the percentage of total monthly debt obligations to gross monthly income, on a consistent basis. The TDSR will apply to loans for the purchase of all types of property, loans secured on property, and the re-financing of all such loans. MAS expects FIs to have internal policies and procedures in place to implement the Notices, including verifying and obtaining relevant documentation on a borrower's debt obligations and income used in the computation of the TDSR.

The Guidelines set out MAS' further expectations regarding an FI's application of the TDSR.

The MAS Notices and Guidelines took effect on 29 June 2013.

MAS Notice 632 / 1106 Residential Property Loans (June 2013)

MAS has revised the regulations on Residential Property Loans to include the following key amendments:

- Checks with Credit Bureaus and HDB
  Prior to the grant of a credit facility for the purchase of Residential Property, a bank shall conduct checks with one or more credit bureaus and the HDB, which includes verifying whether the Borrower has any outstanding credit facility for the purchase of any other Residential Property, and to assess the credit worthiness of the Borrower.
- Tenure of Credit and Refinancing Facilities
  The tenure of credit and re-financing facilities for the purchase of or secured by a Residential Property shall not exceed 35 years.
- Borrower to be a Mortgagor
  A borrower of a Residential Property loan must also be the mortgagor of the residential property which is used to secure that credit facility.
- Loan-to-Value Ratios (LTV ratio) for a Borrower which is a vehicle

set up by any Individual solely to purchase Residential Property

For a Borrower whose application date for the credit facility is on or after 27 July 2011, and does not have any outstanding credit facility for the purchase of another Residential Property, the maximum LTV ratio is 80 percent. In the case where the Borrower has any outstanding credit facility for the purchase of another Residential Property, the maximum LTV ratio is 60 percent.

The amendments took effect from 29 June 2013.

MAS Notice 646 / 1116 Foreign Exchange Conversion in China via the Renminbi Clearing Bank for the Settlement of Eligible Cross-Border Trade (July 2013)

The Notice sets out the regulatory requirements which all participating banks and merchant banks in Singapore must comply with when conducting foreign exchange conversion in China via the Renminbi Clearing Bank in Singapore for the settlement of eligible cross-border trade.

Under this new Notice, a participating bank or merchant bank -

- shall not conduct foreign exchange conversion in China via a Renminbi Clearing Bank, other than for any payment to settle an eligible cross-border trade in accordance with paragraph (ii) below, and the payment for insurance and freight charges, if any, for an eligible cross-border trade;
- may only conduct foreign exchange conversion in China via a Renminbi Clearing Bank for any payment to settle an eligible cross-border trade
  - I. in the case of a purchase of goods, not more than three months before the payment is due by the participating bank or merchant bank; and
  - II. in the case of a sale of goods, not more than three months after payment of the goods is due to be received by the participating bank or merchant bank.

In addition, the new Notice also stipulates requirements to verify an eligible cross-border trade and retain relevant verification documents, as well as the quarterly and annual reporting requirements.

The MAS Notices took effect on 9 July 2013.

Securities, Futures and Fund Management and Financial Advisers

Securities and Futures (Trade Repositories) Regulations 2013 (July 2013)

Securities and Futures (Clearing Facilities) Regulations 2013 (July 2013)

Securities and Futures (Clearing Facilities) (Savings and Transitional Provisions) Regulations 2013 (July 2013)

Pursuant to the Securities and Futures (Amendment) Act 2012 (SF(A)A) as part of its move to regulate over-the-counter (OTC) derivatives, MAS has issued new Regulations which have come into operation on 1 August 2013.

The Securities and Futures (Trade Repositories) Regulations 2013 and the Securities and Futures (Clearing Facilities) Regulations 2013 set out requirements on the admission as well as the ongoing requirements of trade repositories and persons operating clearing facilities respectively.

The Securities and Futures (Clearing Facilities) (Savings and Transitional Provisions) Regulations 2013 provides for the transition of existing persons operating clearing facilities to the new regulatory regime. An existing person operating a clearing facility before 1 August 2013 shall be deemed to have been approved as an approved clearing house under section 51(1)(a) of the SFA, and every condition or restriction imposed by MAS under Part III of the SFA. The existing persons in force immediately before 1st August 2013 shall, on and after that date, continue to be in force as if that condition or restriction had been imposed by the Authority under section 51(4) of the SFA.

Accounting Updates

Insurance contracts

The International Accounting Standards Board (IASB) has issued its targeted re-exposure draft on insurance contracts, marking a major step forward towards implementing a common insurance reporting framework across much of the world.

The proposals apply to all insurance contracts, including certain financial guarantees, rather than insurance entities, and to investment contracts with a discretionary participation feature (DPF) issued by insurance companies.

The re-exposure draft introduces a revised current value measurement model, which would go some of the way towards addressing concerns over increased volatility in profit or loss. It also introduces a new presentation approach, which would significantly change the way insurers – especially life insurers – report performance. The proposals are likely to have a profound impact across an organisation, affecting asset-liability management and decisions over product design, features and pricing. Capital management and regulatory requirements may also be affected in some jurisdictions. The new data collection and retention requirements could necessitate systems upgrades, increased demand for resources and additional training.

Comments are due to the IASB by 25 October 2013, and comments to the Singapore Accounting Standards Act closes on 12 September 2013. The Financial Accounting Standards Board is expected to publish its own exposure draft shortly.

Tax Updates

The Monetary Authority of Singapore (MAS) has released further details on the tax changes announced during Budget 2013 in relation to the Financial Sector Incentive Scheme (FSI) and Qualifying Debt Securities (QDS) and QDS Plus Schemes:

1. Extension and refinements to the FSI scheme

Under the FSI Scheme, income derived by the FSI awardholders from qualifying activities are subject to Singapore income tax at the concessionary rates of 5%, 10% or 12%, depending on the awards granted.

Extension of the FSI Scheme

The following awards under the FSI Scheme will be extended for another five years to 31 December 2018. These awards are originally due to expire on 31 December 2013.

- FSI-Standard Tier (FSI-ST)
- FSI-Headquarters (FSI-HQ)
- FSI-Fund Management (FSI-FM)
- FSI-Bond Markets (FSI-BM)
- FSI-Equities Markets (FSI-EM)
- FSI-Credit Facilities Syndication (FSI-CFS)
- FSI-Derivatives Markets (FSI-DM)

The FSI-BM and the FSI-EM awards will be merged to form a new FSI-CM award with effect from 1 January 2014. Under the FSI scheme, the individual awards would be broadly enhanced and refined.

The FSI-Islamic Finance (FSI-IF) Scheme expired on 31 March 2013. Existing FSI-IF award recipients will continue to enjoy the concessionary tax rates under their existing awards till the end of their award tenures, as long as they meet the conditions of the award. Thereafter, the existing FSI-IF award recipients can apply for the relevant incentives available under the FSI scheme for Islamic finance transactions if they meet the requirements and conditions of the awards.

2. Extension and redefinement of the QDS and Qualifying Debt Securities Plus (QDS+) Incentive Schemes

The QDS and QDS Plus schemes were introduced to promote the development of Singapore's debt market. Qualifying income derived by investors from debt securities that qualifies under the QDS or QDS Plus schemes may be tax exempt or enjoy a concessionary tax rate.

Both the QDS and QDS Plus schemes, which are due to expire on 31 December 2013, will be extended for another 5 years to 31 December 2018.

Rationalisation of the 'substantially arranged ' condition under QDS scheme

To qualify as a QDS, one of the current conditions of the QDS Scheme requires debt securities whether issued under a programme or otherwise, to be substantially arranged by FIs in Singapore. With effect from 1 January 2014, the 'substantially arranged' condition will be rationalised to certain conditions.

Enhancement under the QDS Plus scheme

Currently, to qualify under the QDS Plus scheme, debt securities with original maturity of not less than 10 years cannot be redeemed, called, exchanged or converted within 10 years from the date of their issue. Such debt securities also cannot be re-opened with a resulting tenure of less than 10 years to their original maturity date.

With effect from 28 June 2013, the QDS Plus scheme will be refined to allow debt securities with certain standard early termination clauses to qualify under the QDS Plus scheme at the point of issuance.

However, where the debt securities with the standard early termination clauses are redeemed prematurely (i.e. before the 10th year) subsequently and not covered under the above refinements, the tax benefits granted on qualifying income accrued prior to such early redemption will not be clawed back.

Instead, the QDS Plus status will be revoked prospectively for any outstanding debt securities. The outstanding debt securities may still enjoy QDS tax benefits if the QDS conditions continue to be met.

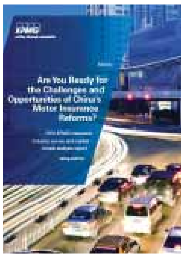
Submission of Return on Debt Securities (RODS)

With effect from 28 June 2013, the lead manager or arranger of debt securities under the QDS or QDS Plus Schemes only needs to submit the RODS to the MAS instead of to both the MAS and Inland Revenue Authority of Singapore presently.

Global topics

Private Equity Mook - AIFMD: Back to basics (August 2013)

The publication provides a whole range of insights on present and future challenges for the private equity industry, with a special focus on AIFMD.

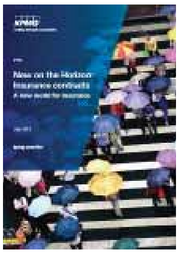


2013 KPMG insurance industry survey and market trends analysis (English)

This recent industry survey with input from 90% of the non-life market reveals that the industry is investing more in risk segmentation, new distribution, product innovation, and customer services.

Evolving Investment Management Regulation - Light at the end of the tunnel? (June 2013)

This report cuts through the complexity of global regulatory landscape for investment management industry, providing an overview of current & upcoming regulations, the challenges & opportunities they present & the implications on investment business.



New on the Horizon - Insurance contracts (July 2013)

The publication “New on the Horizon - Insurance contracts” considers the exposure drafts’ proposals and provides KPMG’s insight.

New on the Horizon - Leases for Banks (July 2013)

The IASB’s & FASB’s joint leases project continues to be a hot topic for banks. The Boards published revised proposals in May 2013. This publication looks at the potential impact of the revised proposals on banks & highlights the issues relevant to banks.

IFRS Banking Newsletter - The Bank Statement Q2 2013 (July 2013)

This is a quarterly publication that provides updates on IFRS developments directly impacting banks, considers accounting issues affecting the sector, and discusses potential accounting implications of regulatory developments.

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

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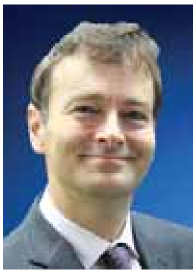

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