FSI Review

Deloitte Southeast Asia
Financial Services Newsletter
Issue 9, April 2015

Diversity in Asia
Rapid growth, diverse challenges

In this issue:

Deloitte.

In this issue

Foreword

Asia is a continent of contrasts, with huge variations in natural resources, business environments, and cultures. Made up of a mix of mature, emerging and frontier markets, Asia's economies are uniquely diverse, which inevitably has resulted in a variety of growth opportunities and challenges for the financial services industry.

In this issue, we outline a number of recent developments in the Asian market that may have an impact on our clients' businesses in the near future. We begin by exploring the current state of capital markets in Asia and assessing how the region compares to the rest of the world. To better understand the developments in Asia, we have identified five mega trends for discussion. In this evolving market, it is imperative for capital markets players to keep abreast of not only industry-specific trends but also the mega consumer and institutional trends shaping the region.

In Japan, the Government Pension Investment Fund (GPIF), one of the largest investment funds in the world, has announced changes in its policy asset mix, governance and other key aspects. This reform will impact the Japanese market and asset management industry. Closer to the region, Singapore's Inland Revenue Authority of Singapore (IRAS) released revised transfer pricing (TP) guidelines. We review the details of these changes and share our perspectives on the expected impact to the financial services industry. We round things off with our Asia Pacific Economic Outlook for the first quarter, which provides a near-term outlook for China, Japan, Malaysia, and Singapore.

As the industry continues to evolve, Deloitte's Financial Services Industry Group is committed to providing insights on the issues most important to global financial institutions. Deloitte Southeast Asia's FSI practice aims to help guide our clients through challenging times and provide the insights that are required for success.

We hope you enjoy this edition of the FSI*Review*.

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Decisions at the crossroads
Capital market trends and their implications on Asia

The following is an extract from a Deloitte Southeast Asia point-of-view report on the capital market trends and their implications on Asia.

"In 2014, capital markets institutions finally inched toward steadier ground as global investment banking fees reached US$ 69 billion during the first nine months of 2014. Yet this upbeat narrative was tempered by a lower than expected growth in emerging markets, declining commodity prices and the strengthening dollar with the spectre of rising rates."

Mohit Mehrotra, Executive Director, Deloitte Consulting

The current state of capital markets in Asia

Asia lags in capital market development with the Asian equity, debt and derivatives markets relatively smaller in size when compared to other markets such as the US or Europe. With the exception of Hong Kong, Malaysia and Singapore, most other countries in Asia have fewer listed companies and lower market capitalisation relative to GDP as compared to developed market benchmarks.

Furthermore, the Asian corporate bond market is only a fraction of that in the US or Europe as Asian corporates continue to rely heavily on bank funding, resulting in limited demand for corporate bonds. In the derivatives market, over-the-counter (OTC) trading accounts for the largest component in Asia, but its value is significantly smaller when compared to other global markets.

The figure below illustrates the disproportionate distribution of banking fees across the regions. With a less developed capital market, Asia Pacific excluding Japan only captured 13% of the global investment banking fees.

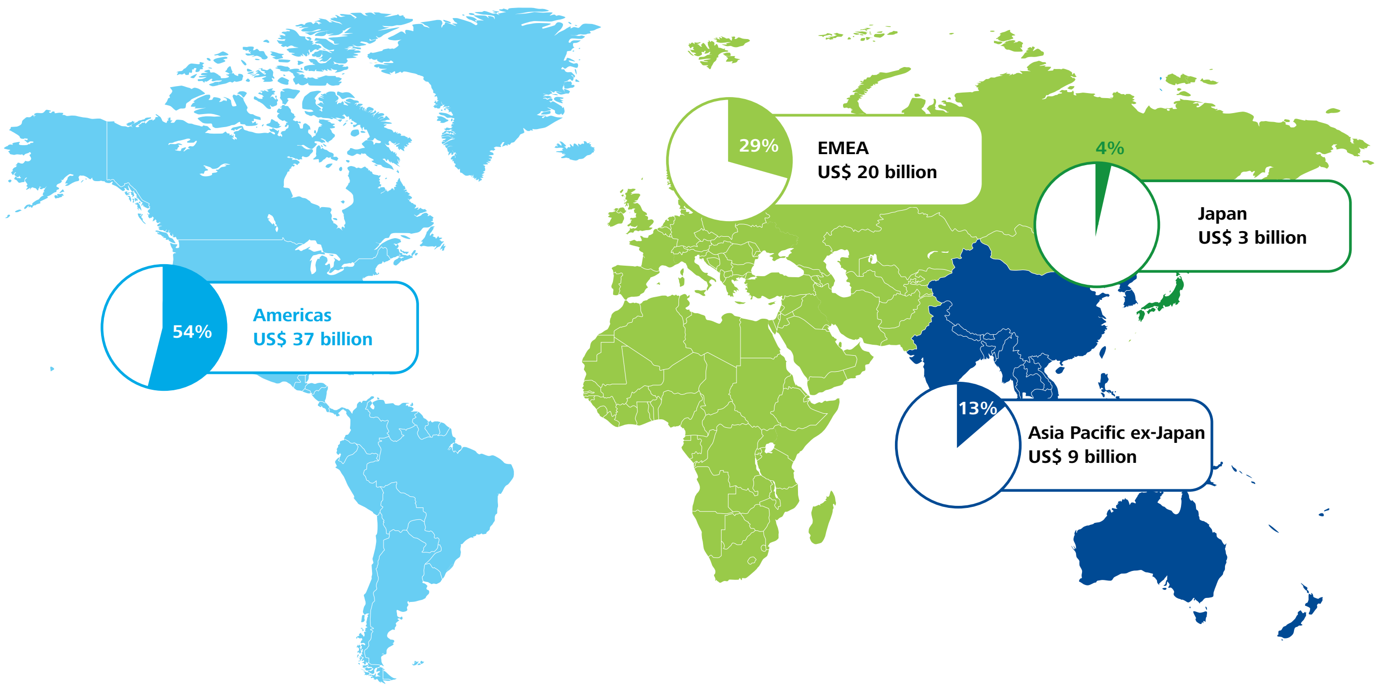
Although Asia's share of the pie in capital markets is significantly smaller when compared to other regions, it is important to acknowledge the growth potential of the Asian market. While the US and UK dominates capital market investments, there seems to be increasing attention on the developments of capital markets in Asia as the region is home to many emerging economies that are growing at unprecedented rates.

Consequently, many companies are attracted to invest in Asia with some businesses relocating their headquarters to this part of the world. The onus is on the governments to set up sustainable infrastructure to support the growth. When done right, enormous opportunities are available.

Many Asian governments have recognised the opportunities and introduced various initiatives to further capital markets developments. In the equity markets, stock exchanges were established in the growing economies while initiatives in the bond markets are focused on fostering regional integration.

As a result of such initiatives, Asian capital markets across asset classes have been rapidly developing. Equity issuance in Asia has grown at an impressive pace since the financial crisis and bond issuances repeatedly broke record highs over the past couple of years. In the derivatives market, the growth in Asia is evident with increased trading volumes.

Investment banking fees (Q1-Q3 2014)



Source: Thomson Reuters

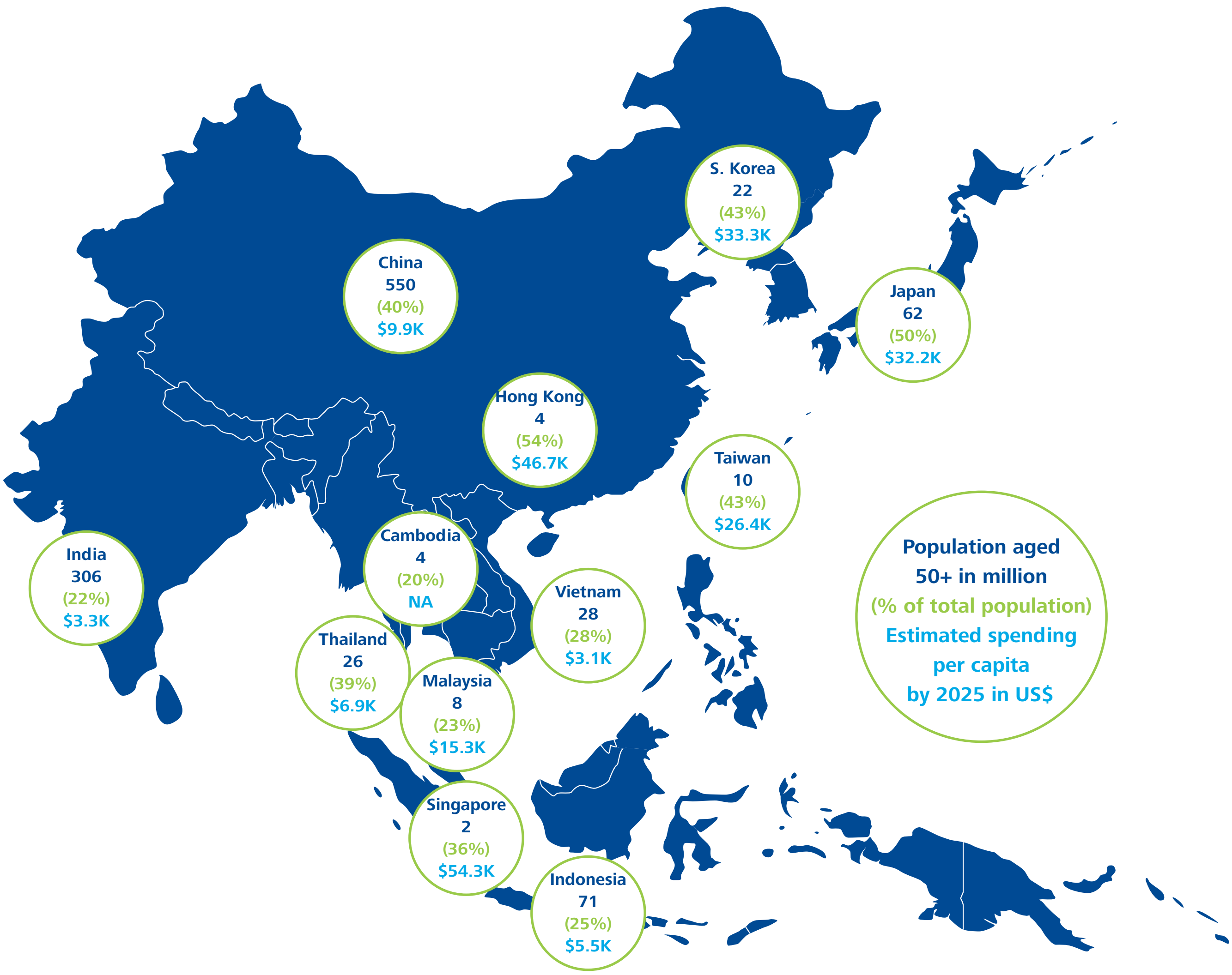
Mega trends and opportunities

While the global economic recovery lent some stability to the capital markets, they continue to be complex and dynamic in nature, making it essential to keep a constant watch on developments in order to gain insight into some of the most important trends shaping these markets. Asia in particular is set to witness a significant transition with changes in population demographics, the rise of digital natives, proliferation of a sharing economy, and localisation.

Ageing Asia

In Asia, the number of people aged 50 years old and above is expected to grow dramatically over the next 10 years. Across all 12 of its key markets, this group is expected to grow 42% between 2014 and 2025 to reach over 1 billion people, and with significant purchasing power. The map below illustrates the estimated spending per capita across the different markets in Asia.

Ageing population statistics in Asia projected till 2025



Source: United Nations, EIU, OECD, Deloitte Analysis

Working women

As society progresses, it experiences greater gender equality and increased employment opportunities for women. With more women in Asia entering the workforce, there will be a narrowing of gender gaps in labour force participation between men and women. Notably, the number of working women in Asia is growing at a faster rate as compared to other regions such as Europe and North America. The gender gaps in labour force participation are expected to decrease by 75% by 2027.

Digital natives

We are now living in an era of digitisation, inhabited by the digital natives of Generations Y and Z. As they come of age, these two demographic cohorts are likely to demand ubiquitous access to digital products and services. With Generation X becoming increasingly digitally-savvy as well, the majority of the population is expected to be technologically-adept by 2025. Generation Y has a projected population of 1.2 billion people by 2020, the largest segment in Asia. They are also estimated to account for US$ 3.5 trillion of total spending. However, Generation Y is found to be sceptical of and lacking trust in the financial services sector, posing a unique set of challenges in serving them.

Sharing economy

The sharing economy refers to an ecosystem built around the sharing of resources. It includes the shared creation, production and consumption of goods and services by different people and organisations. The sharing economy is disrupting traditional business models, with 78% of consumers in Asia willing to participate in it. With the help of technology and sharing platforms, consumers are increasingly looking to fulfill their needs by purchasing good and services from other consumers, cutting traditional businesses out of the equation in most instances.

Localisation

As smaller cities grow at a faster rate than big cities, there will be over 240 cities in Asia with more than 1 million people each by 2020, with China and India accounting for 83% them. The estimated number of cities excludes the 100 new 'smart cities' that India plans to build by 2022.

Capturing opportunities

To prepare for the evolution, capital markets firms need to assess their abilities to respond to opportunities emerging from these mega trends. The following are some focus areas that firms should consider evaluating:

Technology dynamics

Technology will enable a new era and investments in it will support growth, customer experience and security. Firms will start to recognise the benefits of integrating fragmented platforms and leveraging on unstructured data for real-time insights. Specifically, a fully integrated mobile solution may be the key retail differentiator.

Competition and markets

Mergers and acquisitions could be spurred by the need for new capabilities and network with large firms requiring specialisation and new solutions, as well as small firms facing compliance pressure. Moreover, the change in geographical focus may also require network ramp up.

Clients and products

A shift in the consumer landscape provides opportunities for firms to differentiate. For instance, the emergence of new segments such as the elderly and working women will likely require firms to explore new ways to serve them. Firms can also leverage on analytics to improve segmentation and highlight cross selling opportunities. It is expected that fee-based products, especially in the wealth management sector, will remain a focus moving forward.

Policy, regulations and risks

The policy-driven market is now the new norm. We have seen several policies been introduced in recent years such as the Bank of Japan's increase in asset purchase amidst the end of the US Federal Reserve's quantitative easing programme, as well as the mega-pension to ramp up investments in stocks and foreign bonds. The highly correlated equities returns, driven by government support, have seen investors moving from active to passive investments. Firms are also increasing their efforts to push for higher regulatory ratings and enhance management and governance of cyber threats.

Financial management

Chief Financial Officers are seen taking on a more strategic role in improving capital efficiency as corporates are under pressure to "unstash" record levels of cash equivalent to 9% of GDP in Japan. One way to do so is to deploy capital management tools at the business and transaction levels.

Organisational effectiveness

In view of the uncertain and rapidly changing environment, it is important that organisations foster agility in order to respond. Firms can do so by focusing on strategies, ecosystem and minds. Furthermore, it may be worthwhile to explore the industrialisation of processes to unlock new sources of efficiency.

Potential implications for consideration

Having identified the key trends impacting Asia, capital market firms should consider the implications that they pose and review their readiness to address these challenges. The following are some actionable takeaways for consideration:

- Firms need to reassess their abilities to concurrently serve the four generations of end-consumers and develop capabilities if required. The focus should be on the development of "investor continuum" plays given that many markets are undergoing inter-generational wealth transfer;
- With the rise of women and the roles they play in the Asian workforce, firms must develop capabilities to serve a diversified investor base. This will help develop a segmented play to allow greater participation of women in the retail investor community;
- The small and medium enterprises (SMEs) group is a significant market in Asia with more than 50 million SMEs accounting for up to 60% of GDP in selected Asian countries. It is important that firms develop solutions for this specific sector, as well as greater capital market access in order for them to play a key role in Asia's growth story;
- Opportunities from intra-Asia trades of over US$ 3 trillion have surpassed trade flows between Asia and the west. This results in increased demand for local currency-based capital market solutions to facilitate and streamline intraregional trade; and
- With the growth in population of digital natives, there is a need for firms to invest in solutions and new technology platforms to be ahead in the digital era.

Firms that are able to find a firm footing by positioning themselves ahead of these trends will enjoy a significant head start in this dynamic and fast evolving region. After all, success always comes to those who prepare for the opportunity.

For full versions of our point-of-view, please visit our Financial Services Industry pages at www2.deloitte.com/sg.

Japan's Government Pension Investment Fund (GPIF) and its reform

This article, written by Mitoshi Yamamoto, Deloitte Financial Services Partner based in Tokyo, Japan, first appeared in the January 2015 issue of Perform*ance* Magazine, Deloitte's digest for asset management professionals.

The GPIF and policy asset mix

The GPIF is an independent administrative institution with the objective of managing and investing the Reserve Funds of the Employees' Pension Insurance and the National Pension. The GPIF also manages and invests the Reserve Funds of the Government Pension Plans entrusted by the Minister of Health, Labour and Welfare, in accordance with the provisions of the Employees' Pension Insurance Act (Law No. 115 of 1954) and the National Pension Act (Law No. 141 of 1959). It is responsible for contributing to the financial stability of both plans by remitting investment profits to the Special Accounts for the Government Pension Plans.

The policy asset mix of GPIF has been changed (see Matrix 1). The new policy asset mix will be applied from 1 April 2015. Meanwhile, the proportion of equities held under the GPIF will increase at the expense of bonds—a shift that is likely to impact the market. Japanese equity indices such as the Nikkei 225 and TOPIX have gradually been moving upward.

Matrix 1: Policy asset mix

	Japanese bonds	Foreign bonds	Japanese equities	Foreign equities	Cash etc.
Old asset mix	60%	11%	12%	12%	5%
New asset mix	35%	15%	25%	25%	-

In the new asset mix, the GPIF's exposure to equities will rise from 24% to 50% (both Japanese and foreign equities will increase from 12% to 25%). Exposure to foreign currencies will also rise, from 23% to 40% (foreign bonds will increase from 11% to 15%, and foreign equities from 15% to 25%). Exposure to safer assets such as Japanese bonds will therefore decrease, from 60% to 35%.

So far, so good. The return from the portfolio has been almost ¥3 billion since the third quarter of the 2012 financial year, when Shinzo Abe became Prime Minister of Japan. The GPIF enjoys returns that make up for the risks that the GPIF has been taking during the period of 'Abenomics'.

Some professionals point out that the GPIF needs to be careful with respect to risks in view of these exposures to the equity and foreign exchange markets. The largest US pension fund, known as CalPERS (California Public Employees' Retirement System), allocates 61% of its assets to equities and has an advanced risk management system and organisation. There may be many points that GPIF can learn from CalPERS or other leading institutional investors in risk management of equity in its asset portfolio.

On the other hand, market participants have welcomed this change in view of the strong impact of the GPIF, particularly on the Japanese equity market. It is said that a 1% increase by the GPIF in its allocation of the Japanese equity market will bring ¥1 trillion into the market.

Some may wonder whether the GPIF will have any exposure to alternative assets. It was announced that the GPIF will allocate a maximum of 5% of its assets to alternatives such as real estate, infrastructure and private equity. These alternatives will be recognised as equity or bonds according to their characteristics.

Governance

The GPIF reform strengthens three areas, with the aim of improving governance: (1) internal control, (2) risk management capabilities and (3) human resource management.

Regarding internal control, GPIF managers will appoint a compliance officer, bolster the internal audit system by expanding the role of the internal auditor, review and develop its disclosure policy to enable effective investment management and upgrade its IT security management system.

With regard to risk management, the GPIF's macroeconomic and market analysis capabilities will be strengthened. It has hired external consultants and installed an IT system to analyse both investment assets and expected payouts in 2014, and is in the process of developing a sophisticated risk management system.

In order to strengthen internal control and risk management, the human resources function also needs reform. The remuneration system has been changed so that external experts can be hired, and the GPIF has already announced that, in January 2015, it will appoint Hiromichi Mizuno, a partner from Coller Capital, as executive managing director and Chief Investment Officer (CIO).

Before these changes, the policy asset mix of the GPIF had been decided under its internal rules by its president, without requiring the agreement of other GPIF members. This past summer, GPIF changed that system and set up an investment committee to establish pre-clearance of essential decisions made by the president. The reform of the GPIF's governance is still in progress.

"GPIF is the largest pension fund in the world and any reforms to its focus and actions can have a significant impact on the structure of the Japanese economy and on markets. With its reform, GPIF's ability to potentially invest directly into companies will elevate shareholder status, motivate companies to generate greater earnings and returns, and boost Japan's overall competitiveness."

Kazumasa Momose, Partner, Japanese Services Group, Deloitte Southeast Asia

The seven principles of Japanese 'stewardship' are reproduced below:

1	Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it.
2	Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities, and publicly disclose it.
3	Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
4	Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
5	Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.
6	Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.
7	To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

Japan’s Stewardship Code

The Principles for Responsible Institutional Investors, referred to as ‘Japan’s Stewardship Code’ were published by the Japanese FSA in 2014. So far, 160 institutional investors, including the GPIF, have complied with these principles. The main purpose of the principles is to promote the sustainable growth of companies through the ‘engagement’ of asset managers (investment companies) or asset owners (pension funds, etc.). Engagement is defined as a dialogue between investors and companies, and such engagement is supposed to promote mutual understanding between investors and companies.

The Japanese FSA will soon publish a code for a higher level of corporate governance for Japanese companies. These two codes are seen as essential for achieving sustainable growth of the Japanese equity market. The GPIF must, in this context, have better governance.

Secure Japanese pension system

It is not appropriate to classify the GPIF as a Sovereign Wealth Fund (SWF), as it has the liability of pension payments. When we look at the size of the GPIF, it is clear that it needs to have the same or even a higher level of governance through a clear decision-making system, strong internal auditing, a sophisticated risk management system and a secure IT system. The GPIF is on the path toward being a better organisation, and this progress will affect not only the Japanese market but other markets too.

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The future is now
Digital Financial Services in Indonesia

The following is an extract from a Deloitte Southeast Asia point-of-view report on the potential of digital banking in Indonesia.

"As the economy continues to prosper, Indonesia's promising projected growth is anticipated to encourage the development of DFS at an unprecedented rate. The emergence of DFS provides significant benefits to the national economy, resulting in job growth and additional government revenue."

Chairil Tarunajaya, Indonesia FSI Leader

For Indonesia, Digital Financial Services (DFS) may well be the next big thing, combining existing mobile phone usage and the country's increasing appetite for financial services. The prospective entry of millions of unbanked and underbanked consumers into the financial system is the result of the increasing prevalence of mobile devices. DFS not only promises accelerated economic growth in Indonesia, but also will yield significant changes in business practices and replace traditional methods of financing. Most importantly, DFS will likely extend its reach beyond major city centres and into the provincial hinterland, where the bulk of unbanked and underbanked consumers reside.

Globally, approximately 2.5 billion people do not have formal accounts at a financial institution, with 65% and 58% of the population in Latin America and South Asia considered unbanked respectively. While the DFS market is nascent in Indonesia, it is well-developed in other countries with large unbanked populations. A full appreciation of the market opportunity for DFS in Indonesia requires an understanding of successful models in other countries, DFS' national and local impact across Indonesia, and critical success factors for DFS deployment in the country.

Learnings from other markets

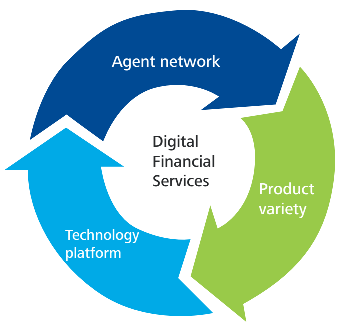
To examine what is achievable in Indonesia, we examined case studies from comparable markets to evaluate successful models of DFS implementation of which one of them was Kenya. The country's Safaricom's M-Pesa arguably represents the most successful DFS model, boasting more than 14 million users and providing services to over 70% of Kenya's adult population.

Case Study: Kenya

At the end of 2013, Kenya had more mobile money accounts than bank accounts. Launched in 2007 by Safaricom, the country's largest mobile-network operator, it is now used by over 17 million people, which is equivalent to more than two-thirds of the adult population and 54% of all bankable unbanked population. In terms of the total amount of transactions, around 25% of the country's GDP flows through M-Pesa.

According to a World Bank study, it is anticipated that a 20% increase in financial inclusion could lead to employment growth of 1.4%. Assuming a 20% incremental change in financial inclusion in Kenya in the next 5 years, DFS alone could accelerate GDP growth rate in the country by 7%.

Overview of M-Pesa, Kenya (2013)

<table>
<tr><td>GDP</td><td colspan="3">US$ 44.8 billion</td></tr>
<tr><td>Population</td><td colspan="3">44 million</td></tr>
<tr><td>% Unbanked</td><td colspan="3">71.6%</td></tr>
<tr><td>Background</td><td colspan="3">In March 2007, the leading cell phone company in Kenya, Safaricom, launched M-Pesa, a SMS-based money transfer system that allowed users to deposit, transfer and withdraw funds using their cell phones. M-Pesa has grown rapidly, and currently serves over 17 million users in Kenya via over 65,000 agents.</td></tr>
<tr><td></td><td>Strong agent network</td><td>Limited product variety</td><td>Robust technology platform</td></tr>
<tr><td>
</td><td>Safaricom effectively leveraged its extensive network of airtime sellers to build a reliable and consistent store network that serves customers' needs.</td><td>Safaricom leveraged its strong service brand for M-Pesa to drive a sense of trust and affinity in the products and services provided by M-Pesa.</td><td>Being the leading mobile operator, Safaricom capitalised on its existing customer base to highlight the value of M-Pesa. Mobile penetration in Kenya is over 80%, signifying a strong space for growth.</td></tr>
</table>

There are three main reasons why mobile money has grown rapidly in Kenya, while facing challenges in other countries. Firstly, Kenya's regulators enabled this service to be launched quickly. The Central Bank especially played a key role in facilitation of mobile money development. Furthermore, the regulator introduced restrictions on potential agents entering this business, as they were not providing banking services. Secondly, Safaricom has a strong position and national presence, which helped them achieve great scale and dominate the market. Lastly, while many other DFS providers focus on the technology aspect of the services, Safaricom focused on the management of the agent network. The table above provides an overview of M-Pesa in Kenya and an analysis of their best practices.

In Indonesia, DFS offers opportunities for an estimated110 million bankable unbanked citizens in the country to access banking services and products. With the increase in mobile phone usage, Internet penetration in Indonesia is expected to grow rapidly and reach 100 million users in the next three years. These developments will present enormous prospects for market participants in the DFS market space. Understanding the DFS' impact on the Indonesian economy, especially at the provincial level, will enable market participants to develop tailored DFS strategies in Indonesia.

Critical success factors

Local Indonesian insights and knowledge of DFS paradigms in other markets help establish a better understanding of the key success factors needed to implement DFS in Indonesia. These factors vary for the private and public sectors. Private sector participants such as financial services institutions and telecommunications companies have a direct role to play in driving DFS adoption and promoting financial literacy for the unbanked. Meanwhile, the public sector can help build the infrastructure to make the DFS eco-system possible. The partnership between the private and public sectors is critical to the success of Indonesia's digital revolution in financial services.

For full versions of our point-of-view, please visit our Financial Services Industry pages at www2.deloitte.com/sg.

Staying ahead of the curve
Singapore transfer pricing developments

This article was contributed by Michael Velten (mvelten@deloitte.com), Partner, Tax, Deloitte Southeast Asia

The Inland Revenue Authority of Singapore ("IRAS") on 6 January 2015 released the revised transfer pricing ("TP") guidelines replacing guidelines issued in 2006, and three supplementary guidelines/circulars issued in 2008 and 2009.

The major change in the revised guidelines is that taxpayers are now required to prepare and maintain TP documentation on a contemporaneous basis to substantiate that their related party dealings are at arm's length.

TP documentation requirement

The new guidelines are explicit in requiring taxpayers to "prepare and keep contemporaneous records" and this is to be "part of the record-keeping requirements for tax". The new requirements also call for the preparation of group level and entity level documentation.

Contemporaneous documentation

IRAS requires taxpayers to prepare TP documentation on a timely basis, which specifically is no later than the tax return filing date for the financial year in which the transaction takes place. The guidelines require that "the date of creation or update of each document should be stated in the document"[1].

Group level documentation

The new guidelines contain an expanded list of information required, particularly pertaining to information at the group level, which will provide "a good overview of the group's businesses". However, the guidelines do not require or advocate that documentation be prepared in a "master file and local file" format. Nor is there is a no country-by-country reporting requirement.

Specifically, under the new guidelines, some of the information to be included as group level documentation include:

- Worldwide organisational structure chart, showing the location and ownership linkages among all related parties;
- Description of the group's business, including the group's lines of business, products and services; geographic markets and key competitors; the group's business models and strategies, including any recent restructuring, acquisition or divestiture; important drivers of business profits and a list of intangibles and the related parties which legally own them; charts showing the supply chains of products and services; etc.
- Group's financial information – financial statements of the group relating to the lines of business involving the Singapore taxpayer.

Entity level documentation

The new guidelines require the entity level documentation to "provide sufficient details of the subject taxpayer's business and the transactions with its related parties". Most of the items required as entity level documentation are already covered under the former Singapore TP guidelines, except that a description of the management structure of the Singapore taxpayer and an organisational chart of the Singapore taxpayer, showing the number of employees in each department, has specifically been mentioned in the revised guidelines. While presenting these information taxpayers should ensure consistency with the functional analysis write up.

[1] *The guidelines are applicable from financial year ended 2014 and onwards.*

Exemptions from, and safe-harbour threshold for, TP documentation preparation

The new guidelines provide exemption from maintaining TP documentation in certain situations as follows:

a) Where the taxpayer transacts with a related party in Singapore and such local transactions (excluding related party loans) are subject to the same Singapore tax rates for both parties;
b) Where a related domestic loan is provided between the taxpayer and a related party in Singapore and the lender is not in the business of borrowing and lending;
c) Where the taxpayer applies the 5% cost mark-up for services that qualifies as "routine" services defined in the guidelines;
d) Where the related party transactions are covered by an agreement under an APA; and
e) An exemption also applies if the value or amount of the related party transactions per financial year [excluding the value or amount in sub-paragraphs (a) to (d) above] does not exceed the following, as illustrated in the table below:

Thresholds for each transaction category

<table>
<tr><th>Transaction categories</th><th>Types</th><th>Threshold: Each category with each type on aggregate basis</th></tr>
<tr><td>Transaction relating to goods with all related parties</td><td>• Purchases
• Sales</td><td rowspan="2">S$ 15 million</td></tr>
<tr><td>Loans with related parties</td><td>• Advanced
• Borrowed</td></tr>
<tr><td>All other categories of related party transactions, including service, royalty and rental</td><td>• Income
• Payments</td><td>S$ 1 million</td></tr>
</table>

Maintenance and updating of TP documentation

Taxpayers are not required to submit their transfer pricing documentation when the tax returns are filed. The documentation should be kept by taxpayers and submitted to IRAS within 30 days when requested to do so. The new guidelines also recommend that transfer pricing documentation be reviewed periodically to ensure that the functional and economic analyses are still accurate and valid. Taxpayers should update their TP documentation when there are "material changes" and in the absence of such a change, TP documentation should be updated "at least once every three years". Further, taxpayers are advised to update financial statements of accepted comparable companies (obtained from initial benchmarking analysis carried out for first year) with their latest available financial statements during the second and the third years.

Consequence of not preparing contemporaneous documentation

Failure to prepare and maintain contemporaneous documentation has "adverse consequences" and it increases the chances of TP adjustments during an audit conducted by the IRAS. IRAS may not also support a taxpayer's mutual agreement procedure application and there is a high possibility of IRAS declining any APA requests made by the taxpayer. Moreover, a penalty not exceeding S$1,000 or a jail term not exceeding 6 months in lieu of payment is also liveable.

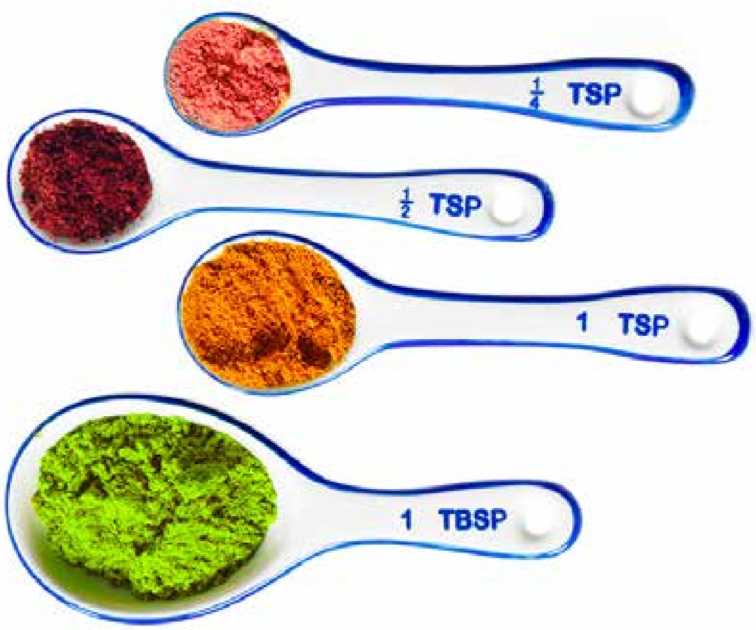
It has been stated in the guidelines that "IRAS is monitoring the compliance level and may, if necessary, consider more stringent measures including specific record-keeping regulations for transfer pricing."

Other highlights

Selection of comparables

The new guidelines state an explicit preference for local companies as comparables. A taxpayer may use suitable regional comparables, but only if an attempt has been made to identify local comparables and sufficient number of such comparables is not available. It also provides guidance on the admission and rejection of loss making comparables stating that a comparable with weighted average loss for the tested period or loss for more than half of the tested period is considered unreliable as a benchmark.

Use of Arm's Length Range and Testing of Results
The new guidelines affirm the use of the inter-quartile range as a reliable approach to ascertain the arm's length range. In terms of testing of financial results, the guidelines provide explicit mention of testing of annual results of the tested party as the appropriate approach, and that a multi-year testing may only be accepted under "exceptional" circumstances upon consultation with the IRAS.



Year end adjustments

The guidelines require taxpayers to test the financial results of the tested party annually, and to make appropriate year-end adjustments at the year-end closing of financial statements. Such year-end adjustments will be recognised for Singapore tax and TP purposes only if the taxpayer has in place contemporaneous TP documentation, makes year-end adjustments symmetrically in the accounts of the affected related parties and makes these adjustments before filing their tax returns.

Related party loans

The new guidelines incorporate the existing guidance provided on related party loans, and one notable addition is the discussion on the issue of credit worthiness. The new guidelines state that IRAS' preference is to evaluate credit worthiness on a "stand alone" basis (i.e. of the borrower), but leaves the possibility of using the group's credit standing, if "it can be substantiated that an independent lender will similarly accept such group credit rating."

What's next?

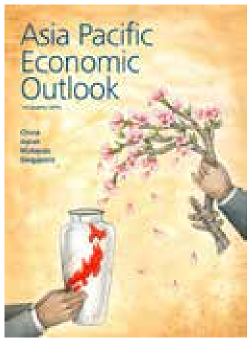
Transfer pricing will continue to be a focal point for IRAS. The new guidelines represents a significant milestone in Singapore's TP regime, and is continuing affirmation of IRAS' intent in ensuring that taxpayers maintain sufficient transfer pricing documentation and comply with the arm's length principle.

With the release of the new guidelines, it now becomes mandatory for taxpayers to conduct TP analysis and maintain contemporaneous documentation. Taxpayers with existing TP documentation should revisit these documents to understand how the revised guidelines will affect the current contents, disclosures and analysis contained therein.

Asia Pacific Economic Outlook
Focus on China, Japan, Malaysia and Singapore

This edition of the quarterly Asia Pacific Economic Outlook provides a near-term outlook for China, Japan, Malaysia and Singapore. China continues to implement short-term fixes to the economic slowdown. Japan is starting to ease policies to boost growth. Malaysia is on the path of fiscal reform and Singapore faces subdued growth due to global volatility.

The following is an extract from a Deloitte global point-of-view report on the more mature markets within the region.



China: Close to deflation? China's government is taking a number of steps to stabilise growth while not allowing too much credit creation. The government will accelerate spending on infrastructure projects this year to prevent economic growth from dipping below 7.0%. The problem with this policy is that it fails to attack the imbalance in the Chinese economy. China already spends excessively on investment and inadequately on consumer spending. Efforts to reverse this have not yet seen success, hence the decision to boost public investment.

In response to the government's announcement, the Australian dollar increased in value. Australia's currency is heavily influenced by China's perceived demand for Australia's iron ore and other commodities. Indeed, the price of iron ore rose as well. The increased spending on infrastructure will come from central and regional governments, state-run companies and the private sector. Much of it will be financed by debt, which is a concern given that China's economy has accumulated a large amount of debt. While China continues to implement short-term fixes to the economic slowdown, it has so far failed to implement major reforms aimed at shifting the structure of the economy.

In an effort to boost banks' lending ability and hopefully stem economic deceleration, the Chinese government has broadened the definition of a bank deposit. Banks are required to hold cash reserves equivalent to 25% of bank deposits. The government has simply changed the definition of deposits and waived the requirement for reserves for certain types of deposits. The end result will be the release of $800 billion in funds that banks will now be able to use for lending.

Japan: New hopes in 2015 as policymakers spring into action. As 2014 came to an end, it was clear that the impact of the April 2014 tax hike was harder on economic activity than initially expected. Annualised real GDP growth for the third quarter was revised down by 0.3% to -1.9% due to weaker fixed investment. Earlier, the economy had shrunk by an annualised rate of 6.7% in real terms in Q2 2014, which implies that the economy fell into a technical recession by Q3 2014.

Ongoing efforts to get the economy out of deflation that has lasted a decade-and-a-half have been adversely affected by the recent sharp drop in oil prices. Consumer price inflation slipped to a 17-month low of 0.4% in November, after accounting for the effect of April's tax increase (which added 2% to inflation from May onward). Core consumer price inflation was merely 0.7% in November, down from 0.9% in October 2014. While the Bank of Japan expects inflation to reach the 2% target rate in the next six months, its quarterly survey showed that most companies forecast a weaker rise in output prices in December than they expected in October.[2]

Poor economic performance and falling investors' confidence in Japan's ability to pull itself out of deflation have raised several questions about the success of Japan's much-heralded, three-pronged Abenomics. Until Q2 2014, the economy responded positively to the first two arrows of Abenomics, which involved easy monetary and fiscal policies to boost the economy. However, post the tax hike in April, the economy started faltering. Although recent monthly data on retail sales, the industrial production, and exports suggest that the economy may exit recession in Q4, the growth outlook for the quarter remains grim.

2 *Ben McLannahan, "Japan inflation slips to 14-month low," Financial Times, December 26, 2014, http://www.ft.com/cms/s/0/fbef12ae-8ca9-11e4-ad27-00144feabdc0.html#axzz3O1w7wBpa; Bank of Japan, "Tankan summary of inflation outlook of enterprises," December 2014*

Malaysia: On the path of fiscal reform. In November 2014, Malaysia's government announced that it will stop fuel subsidies from December. Domestic fuel prices will now track average international prices, and the move likely will save the government about $6 billion annually. The fuel subsidy removal was not the only move that the government has made recently in reforming public finances. Beginning in April 2015, a new goods and services tax (GST) is set to come into effect. While the GST is aimed at increasing revenues, it is also an attempt to diversify revenue sources, which are currently dominated by income tax and hydrocarbons. The latter, in particular, renders government revenues volatile. Arguably, the sharp drop in crude prices since 2013 is the best argument for implementing GST.

These measures, however, have not come without criticism. For example, there are concerns that the government will reinstate fuel subsidies if global fuel prices rise sharply. At 6%, the GST rate is lower than desired while the list of exemptions appears to be increasing. There are also worries about the tax's impact on low-income households. Interestingly, despite these measures, the government could miss its fiscal deficit target this year (3.0% of GDP). Such concerns notwithstanding, the government needs to continue on its fiscal reform path. A logical next step could be to overhaul the country's income tax regime. Currently, only about 1.7 million workers pay income tax out of a total workforce of 12 million. This is unsustainable in the long run. Moreover, continuing with reforms will not only offer greater fiscal legroom, but will also boost the country's structural fundamentals and hence, investor attractiveness.

Singapore: Subdued growth due to global volatility. Singapore's near-term growth prospects have been curbed by an uneven recovery in the global economy. The city-state's economic engine is fuelled by export earnings: In 2013, non-oil domestic exports accounted for 45% of Singapore's GDP. Currently, however three factors are weighing upon trade in Singapore. They are a slowdown in China, a recession in Japan, and near-zero growth in the Eurozone. An overvalued housing sector and high household debt are also on the country's list of concerns. Moreover, Singapore's monetary policy continues to grapple with above-average core inflation due to higher wages and an anticipated hike in interest rates in the United States later in 2015.

Singapore's economy grew 2.8% year over year in Q3 2014, accelerating from a 2.3% expansion in Q2. There was positive news from both services and manufacturing in Q3. Growth in services was driven by a surge in the finance and insurance subsector. Business services also picked up in Q3. Manufacturing grew 1.9% year over year in Q3, a modest improvement from 1.5% in the previous quarter. However, growth in manufacturing was driven by biomedical manufacturing clusters, which tend to be volatile. Manufacturing in the electronics subsector, which performed better in Q3 than in Q2, will continue to remain under pressure due to weakness in the global market as well as restrictions on the influx of foreign labour, as evidenced by Singapore's export data. Electronics exports continued downward, contracting 6.3% in Q3. Total merchandise trade declined 3.5% from a year earlier, but net exports remained positive due to a sharp slowdown in imports, primarily on account of lower oil prices.

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