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KPMG IN RUSSIA

Financial Services InFocus

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New IFRS Standards and IFRS Update Seminar

New IFRS Standards and Amendments

We set out below a snapshot of key updates in IFRS that are relevant in the Financial Services sector.

IFRS 7 Financial Instruments: Disclosures

Background

The Standard is effective for annual periods beginning on or after 1 January 2007. The IFRS supersedes IAS 30 and the disclosure requirements of IAS 32. The IFRS requires disclosure of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk.

What This Means to You

IFRS 7 requires entities to disclose:

- the significance of financial instruments for an entities financial position and performance
- qualitative and quantitative information about the nature and extent of risks arising from financial instruments.

Significance of financial instruments new disclosures include:

- the carrying amount for each category of financial asset and liability
- the impact of credit risk on financial liabilities designated at fair value through profit and loss
- additional information on loans designated at fair value through profit and loss
- net gains and losses on held to maturity investments, loans and receivables, available for sale financial assets, financial liabilities subsequently measured at amortized cost, financial instruments held for trading and financial instruments designated as at fair value through profit and loss. The net gain for each category must be disclosed separately
- More detailed disclosures in respect of hedge accounting.

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Qualitative Disclosure Requirements

Disclosures related to the nature and extent of risks arising from financial instruments are required for each type of risk (e.g. credit risk, liquidity risk) and include:

- the exposures to risks and how they arise
- the entity's objectives, policies, processes and methods used for managing and measuring the risks.

Quantitative Disclosure Requirements

The level of detail of quantitative disclosure should be based on the information provided internally to key management of the entity (e.g., board of directors, CEO). Quantitative disclosures are required at a minimum in respect of credit risk, liquidity risk and market risk.

Required credit risk disclosures include:

- the reporting entity's maximum exposure without taking account of collateral or credit enhancements and a description of any collateral and credit enhancements
- the credit quality of financial assets that are neither past due nor impaired
- the carrying amount of financial assets with renegotiated terms that otherwise would be past due.

Required liquidity risk disclosures include a contractual maturity analysis for financial liabilities.

Required market risk disclosures include:

- a sensitivity analysis for each type of market risk (i.e., currency risk, interest rate risk and other price risk) showing how profit or loss and equity would have been affected by changes in he relevant risk variables, and methods and assumptions used in preparing such sensitivity analyses
- for entities that prepare sensitivity analyses reflecting interdependencies between risk variables, such as value-at-risk, and use such sensitivity analyses to provide the disclosures required by IFRS 7, the standard requires the entity to provide an explanation of the method used in preparing the analysis, its objectives and limitations, and the main parameters and assumptions used.

If the quantitative disclosures do not result in providing the information representative of an entity's exposure to risk, then an entity has to provide further information that is representative.

Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures

Background

The Amendment is effective for annual periods beginning on or after 1 January 2007. The entity should disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

What This Means to You

Increased disclosure in respect of the entity's capital should be disclosed in the financial statements as follows:

- qualitative information: a description of what it manages as capital, when an entity is subject to externally imposed capital requirements with the details about the nature of

Information provided on this page should be read in conjunction with the explanation given on page 12.

those requirements and how those are incorporated into the management of capital, how entity is meeting its objectives for managing capital

- quantitative data: a description of what it manages as capital, any changes from the previous period, whether during the period it complied with any externally imposed capital requirements and when entity has not complied, the consequences of such non-compliance.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement - The Fair Value Option

Background

The Amendment is effective for annual periods beginning on or after 1 January 2006. The Amendment restricts the designation of financial instruments as "at fair value through profit or loss" to situations that meet a certain criteria.

What This Means to You

The Amendment restricts the extent to which entities can designate a financial asset or financial liability as at fair value through profit or loss only to situations when:

- the designation eliminates or significantly reduces an "accounting mismatch" arising from measuring assets and liabilities or recognizing gains and losses on them on different bases; or
- a group of financial assets and/or financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information provided internally to key management personnel is on a fair value basis; or
- a contract contains an embedded derivative, unless the embedded derivative does not significantly modify the cash flows of the host contract or it is clear with little or no analysis that separation of the embedded derivative would be prohibited.

An entity that adopts the Amendment in its annual period beginning on or after 1 January 2006 should de-designate the financial assets and financial liabilities that previously had been designated at fair value through profit or loss only if these financial assets or liabilities do not qualify for such designation under the Amendment. At the date adoption of the Amendment such an entity may not designate as at fair value through profit or loss any previously recognized financial assets or financial liabilities.

IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts

Background

The Amendment is effective for annual periods beginning on or after

1 January 2006. The Amendment requires financial guarantee contracts that are not insurance contracts to be measured at fair value upon initial recognition.

What are Financial Guarantees

The Amendment defines a financial guarantee contract as one that requires the issuer of the contract to make specific payments to reimburse the

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holder of the contract for a loss that holder incurs because a specified debtor fails to make payment when due under the terms of a debt instrument. A typical example of a financial guarantee is where a parent company ("the issuer") provides a guarantee to a third party lender ("the holder") in respect of amounts lent to a subsidiary of the parent ("the specified debtor"). In order to qualify as financial guarantee contracts, contracts have to provide for reimbursement of actual losses.

What This Means to You

For a financial guarantee contracts (which is not an insurance contract) issued on or after 1 January 2006 fair value measurement upon initial recognition should be applied with the following concession. If the issuer of a financial guarantee contract issued before 1 January 2006 has previously asserted explicitly that it regards such contracts as insurance contracts and had accounted for them as such, the issuer may elect irrevocably to continue accounting for such financial guarantee contracts under IFRS 4 as insurance contracts.

Guidance in the Amendment states that these assertions are normally found in business documentation, financial statements and communications with customers and regulators.

In our view, this election applies to previously existing contracts as well as to similar contracts that an entity may enter into in the future.

The above concession means that for the time being there is little impact for those issuers in the insurance business. However, for issuers not in the insurance business, the new requirements may introduce changes, for example in the separate financial statements of a parent (or subsidiary) that issues financial guarantee contracts in respect of other group companies, as these are typically not regarded by such entities as insurance contracts, but rather an efficient way to reduce funding costs within the group. In such cases, the issuer would need to consider the new requirement to measure the financial guarantee initially at fair value.

How KPMG Can Help

KPMG can provide training and assistance in the implementation of the above topics and IFRS in the Financial Services industry in general.

IFRS Update Seminar

KPMG will be holding an IFRS update seminar for Banks, Insurers and other Financial Services companies this Autumn 2006.

For further information on this seminar please contact Natasha Sorokina, Markets, KPMG
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Information provided on this page should be read in conjunction with the explanation given on page 12.

Russian M&A in the Financial Services Industry

There are challenges in executing deals in the Russian financial services industry, but the desire of companies to obtain cheaper financing and improve corporate governance and transparency is going hand in hand with the growing M&A market.

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The way in which deals are executed in Russia today reflects the evolution of Russia's corporations since the privatizations of the 1990s and the impacts of the recent growth in Russian M&A activity. In the early days of Russian M&A the approach to doing deals reflected a lack of corporate governance and the dominance over decision making in many organisations by powerful individual shareholders. Corporate transactions were typically executed through secret negotiations between these principal individuals, with little or no access to information or due diligence, and very little transparency over value or price.

Competition Is Driving More Sophisticated Approaches to Due Diligence

The past few years, however, have seen the volume of Russian M&A grow rapidly, particularly of late in the financial services industry. An increasing proportion of deals are now conducted along western lines involving a structured timetable of information and management access, due diligence and international standard sale & purchase agreements, often governed by international or English law. The financial services sector in Russia is a high priority for many foreign companies and ripe for consolidation, especially due to:

- remarkable recovery from the financial crisis in 1998, since which total assets of credit organisations operating in Russia have increased from USD59bn in 2000 to USD257bn in 2005;
- high margins;
- rapid growth in the corporate lending sector (average growth rate circa 50% p.a. between 2000 and 2005), due to decreasing interest rates and greater general economic stability;
- increasing demand by second-tier corporates and SMEs for credit and rapidly growing demand for consumer lending (average growth rate in lending to individuals circa 90% p.a. between 2000 and 2005);
- the introduction of a mandatory deposit insurance scheme should increase the volume of consumer deposits. Currently, about half of Russian savings (USD40-100bn) are still kept "under the mattress";
- next phase of development of products, regions and markets requiring additional capital;
- the existence of circa 1,200 licensed banks in Russia, which leads to a high degree of fragmentation. The top 5 banks in Russia have 47% of the lending with the next 45 having 30% and the remainder only 23%.

Information provided on this page should be read in conjunction with the explanation given on page 12.

Up until a few years ago Russian companies had no experience or knowledge of western-style due diligence processes. However, a growing number became subject to such processes as they were either bought or invested in by strategic western buyers, or they sought to raise finance in western capital markets. Moreover, since the late 1990s corporate governance has been gradually improving; many companies have recruited and engaged accountants in M&A. These developments have contributed to a more sophisticated approach being adopted in the execution of Russian deals.

Maturing but not Mature

Despite the steady developments in corporate governance and reporting there remain some aspects of the Russian corporate environment and financial services industry which make due diligence somewhat different and more challenging than in western environments – in respect to dealing with acquisition targets, the process and the market itself.

The whole perception of the banking industry and the role of financial reporting and accountants, though much developed over recent years, still partly reflects the orientations and attitudes of the past.

- In the days of the USSR, there was no competitive banking industry or large private Russian corporate banks. Presently, many of Russia's banks are still controlled or influenced by single key shareholders, who often use the deposit base to lend to their own businesses; therefore the customer base is often a maze of related parties and affiliates. Western investors often look at the corporate loan book in potential acquisition targets as a negative and ascribe it little value in their bid, or seek alternative measures to mitigate exposure to the corporate loan book.
- It is only in recent times that Russian banks have invested in systems and controls that approach international standards and have developed their branch network. The banks that prioritized development in these areas are most likely to capture the growth in the retail and SME segment. We often see that a target bank's future growth and profitability is underpinned by the retail and SME market, but their products, credit processes and procedures, and IT systems are not currently adequate to achieve the business plan objectives. We also see business plans totally focused towards the retail market, with high interest margins and large customer number assumptions without detailed implementation plans, low brand recognition and little experience at present.
- The emphasis of financial reporting until recently has been on the achievement of the minimal level of compliance reporting required and financial reporting for select users. Most Russian companies do now have integrated accounting functions and are improving financial reporting systems. According to the Russian Ministry of Finance, around 90% of Russia's top 100 companies now issue audited financial statements under IFRS or US GAAP; banks are already required to prepare IFRS financial statements in addition to those in accordance with Russian accounting practices ("RAP").
- Perceptions of accountants and their role among some of the older generation of management are still rather dated. It can be a challenge to convince senior management of the insights and value that accountants can provide during the M&A process. There is a lack of familiarity with the accountant's role in due diligence and a tendency in some quarters to consider due diligence as more of a compliance process than a valuable exercise. This is gradually changing as Russian companies gain experience of M&A and the value of due diligence.

Many Promises but a General Reluctance to Provide Detailed Information

The current corporate environment in Russia presents some particular challenges for those undertaking due diligence on Russian targets.

- Gaining access to the target can be difficult, as its management can be suspicious that the process may only serve to inform a competitor (or the authorities) about their business. Often the target will justify the lack of information "as due to confidentially".
- There is relatively little reliable publicly available information, but better intelligence on individuals and companies can sometimes be obtained with access to private networks of tried and trusted contacts with credible connections.
- The prevalence of legally unrelated but effectively controlled related entities, often offshore, which may be used to implement transfer pricing or royalty schemes in order to move profits and minimize tax,

also serve to obscure the beneficial ownership of businesses. These schemes typically involve various apparent "third parties" and allow the target company and its affiliates to reduce VAT, labour related taxes and corporate taxes.

Once access is gained, a general reluctance to provide information or explanations again stems partly from a lack of familiarity with, or misconceptions of, the purpose of due diligence. As we undertake due diligence engagements, our opening dialogue with the target's management is often to emphasize that we are not auditors, we are not there in any sort of compliance role and our findings, both negative and positive, will only be made available to our client, not regulators or the tax authorities. Information gathering can be a difficult and time-consuming process. It helps if senior management fully brief and authorize those with whom we work; otherwise fear and caution can cause middle management (who usually have not previously been through such a process) to stall the provision of information and continually refer us back to senior management.

Kick the Tyres Hard

Assessing the risks and opportunities arising from a target bank is usually complicated by:

- the existence of more than one set of accounts, which may not be reconciled to one another. All Russian companies prepare accounts under RAP as required by local law and mainly as the basis for tax accounts. These RAP accounts, however, often do not provide a complete or representative picture of the company's trading as they can be impacted by various tax minimization schemes, and inclusion or exclusion of other related businesses and operations. The Russian Central Bank now requires banks to prepare IFRS financial statements. This has enhanced the quality of banks' financial information, however, as with other industries in Russia, the application of the said policies is the issue, not the policies themselves. Some banks maintain a separate set of internal management accounts which may include unofficial transactions, but these will often not be reconciled to the audited financial statements;
- relationships with related parties that influence the financial results and position of the bank due to the issuing of loans at non-market rates of interest, arbitrary assessment of credit risk and provisioning rates, and the use of specially formed entities that lease key intellectual property and tangible assets. Transfer pricing arrangements set up within groups to manage profits (either between different tax authorities or in accordance with other legal, finance or ownership related factors) can also obscure the "true" profitability of targets;
- the generally low level of sophistication in asset and liquidity management processes with significant intervention from stakeholders or key management to override commercial judgments. Shareholder or management self interest also distorts the true operations of the bank and its earnings capability;
- the quality of the asset base, specifically a lack of transparency of the loan portfolio. Russian banks often have legacy clients and customers of the Bank that for various reasons, such as previous relationships with shareholders or management, are still maintained but are not necessarily the type of customers the bank or potential Western bank acquirers would like to continue to do business with. These customers are also not immediately identifiable due to complex group structures, such as shareholdings through affiliate companies and individuals. Assessing the value to ascribe to such customers and understanding the risks for the potential purchaser are key challenges;
- the top banks in Russia have clear strategies that are supported by business plans and forecasts. However, the vast majority may have clear visions of the bank's future but limited, if any, track record or detailed plans of the ways to achieve such visions. Often these banks have everything in the future, for example capital expenditures, product developments, new and expanded customer base, credit control policies and branch network. For this reason alone it is critical that a potential purchaser knows exactly where the value is and will be derived from; in the worst case the only value to the acquirer may be the banking license;
- due diligence on a Russian company's tax position also brings its own challenges. The Russian taxation system has undergone massive reform over the last few years and has become more transparent and easier to interpret. However, it is still subject to fairly frequent changes in legislation, and

official pronouncements and court decisions are not always clear, sometimes contradictory, and are open to differing interpretations by the various tax authorities. Russian companies use a spectrum of techniques to reduce taxes, ranging from tax planning of varying degrees of aggressiveness to avoidance schemes, sometimes of questionable legality. These include arguable interpretations of legislation which can be challenged by the tax authorities in court and schemes which involve complex and opaque ownership and organisational structures. Assessing the risks attached to such tax schemes is hard, because the risk of discovery and the likelihood of a challenge by the tax authorities are difficult to gauge. Having started with Yukos, the tax authorities are taking a more aggressive approach in their interpretation and enforcement of tax legislation. There are also signs that this more assertive approach is having an effect: we are seeing a growing number of companies reviewing their tax positions and exiting the more aggressive schemes.

Can You Bank on Russia?

Developments should also be seen in the context of a potentially more powerful influencing factor which is helping to drive the gradual improvement in governance, financial reporting and general business transparency across corporate Russia. The growing proportion of Russian companies that expect to participate in sell-side M&A at some point in the not-too-distant future, either to raise finance or to exit investments or non core businesses, means that many banks in the near future will be subject to some sort of transaction.

Many Russian banks are experiencing rapid growth and need to seek finance to remain competitive and capture a stake in the growing market. Western banks' desire to establish a presence in the Russian financial services sector and local banks' regional expansion strategies being pursued through acquisitions, as well as an increasing awareness of M&A as an exit strategy, will further boost Russian M&A activity levels. The outlook for the Russian M&A market in the financial services sector, and the environment in which it is practiced, is therefore very promising.

Key Points:

- Plan and prepare for the transaction.
- Ensure the timetable for the transaction is adequate: access to information to assess the bid may be slow in coming.
- Investigate the vendor and its key management and customers thoroughly.
- Understand exactly the value of the target bank versus the value you are providing.
- Assess risks and rewards in the specific context of the Russian business environment.

How KPMG Can Help

KPMG Transaction Services in Russia and CIS has a dedicated financial services team providing financial due diligences services in Russia. Together with our M&A tax, Corporate Finance and Forensic teams we can assist you in identifying and assessing potential acquisition target and structuring transactions in Russia and CIS.

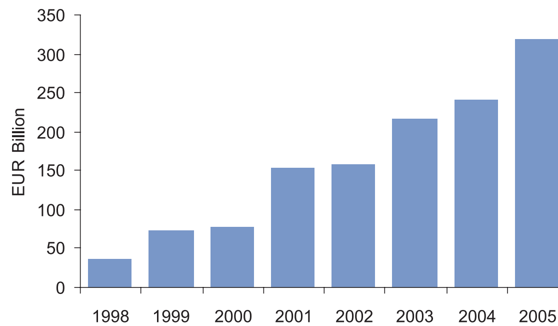
Information provided on this page should be read in conjunction with the explanation given on page 12.

Securitisation - Should You Go for It?

Background on securitisation market developments

Securitisation has become a common funding alternative in recent years and has shown a dramatic surge. Totalling barely EUR 40 billion in 1998, the European securitized issuance reached EUR 320 billion in 2005. Each year, during the period from 1998 to 2005, topped the previous year. The growth remained high with a 35.5 percent increase in the first quarter of 2006 compared to the same period in 2005[1].

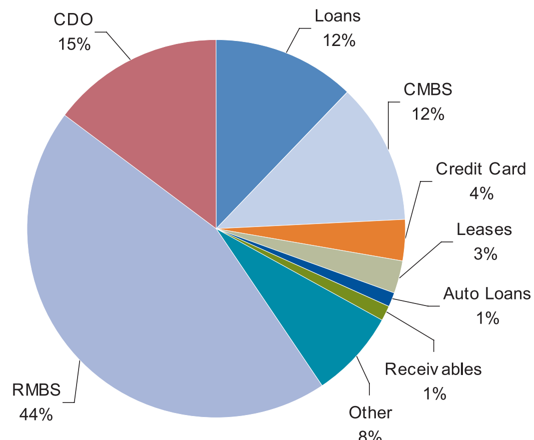
Figure 1: European Securitisation Issuance



Source: European Securitisation Forum

While the majority of securitised assets (EUR 142.6 billion in 2005) is accounted for by residential mortgages (RMBS) it is expected by market participants that Commercial Mortgage Backed Securities (CMBS) and Collateralised Debt Obligations (CDO) will dominate future growth.

Figure 2: European Securitisation by Collateral Type in 2005



Source: European Securitisation Forum

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[1] Source: European Securitisation Forum

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Compared to other low risk investments, asset backed securities return a higher yield for investors. On the other hand, demand from the capital market may enable attracting funding at a more favourable rate with a securitisation compared to other means of funding. Take for example the financial services company of General Moters (GMAC) a company rated Ba1[2]. GMAC is despite the rating downgrade of its parent company General Motors (Caa1), still able to attract low cost funding with its securitisation program. By the end of 2005 over 30 percent of GMAC's net funding consisted of off-balance sheet securitisations[3] totalling USD 115 billion.

In Emerging Markets securitisations has also taken off. Several factors fuel the fast pace growth of securitisations in these markets. The Emerging Markets currently experience a period of economic growth and stability. In addition, an improving legal environment gives investors comfort. These factors combined result in a recipe for both borrowers' as well as lenders' appetite for securitisations in Emerging Markets.

Securitisation Deals in Russia

Following a number of pilot deals (Bank Soyuz, Home Credit and Finance Bank, Russian Standard Bank etc), securitisation is becoming a fashionable funding technique among Russian companies because of a number of clear advantages it can provide, such as:

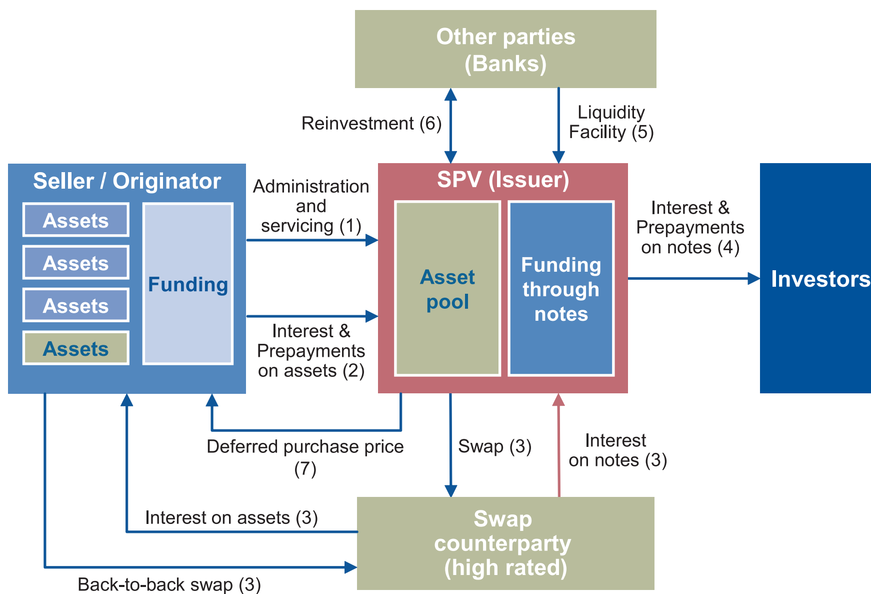
- Differentiating funding sources and attracting a different investor base;
- Increasing funding capabilities;
- Attracting long term funding;
- Possibly reducing funding costs by decreasing credit risk on asset portfolio (the rating for senior secu-ritisation tranches could be several notches above the originator's);
- In some cases - reducing solvency requirements (capital relief for banks);
- Still benefiting from the excess margins (difference between interest received and coupon paid) on the assets that are used for securitisation;
- Creating market recognition by using an innovative funding structure.

At the same time, upfront costs of securitization are relatively high. A feasibility study could be performed before embarking on the securitisation route in order to analyse the costs and benefits of a securitisation.

Possible Securitisation Structure

In a securitisation the Seller/Originator transfers assets to a Special Purpose Vehicle (SPV). The SPV funds this transfer by issuing several tranches of notes to investors. These tranches are different in size and risk profile, and therefore have different ratings. Interest and amortisation is first paid to the senior notes (highest rated notes) and then to the lower rated notes. Losses are first accounted to the junior notes (lowest rated notes).

Figure 3: Possible Securitisation Structure



[2] Moody's credit rating for senior unsecured debt as of July 2006 (source: Bloomberg)
[3] Source: GMAC Financial Services Annual Review 2005

Information provided on this page should be read in conjunction with the explanation given on page 12.

1. Originator will perform servicing on behalf of SPV.
2. Interest and prepayments on assets will be passed through to the SPV.
3. The SPV will swap interest received - after deduction of certain costs and (possibly) excess spread - with interest to be paid on the notes. The swap counterparty can swap (back-to-back) these flows with the originator, whereby the originator keeps interest- and prepayment risks.
4. The SPV will pay interest and prepayments to note holders (Investors).
5. A third party will provide a liquidity facility to support the SPV if interest received is temporarily not suffici- ent to pay interest under the swap.
6. The SPV could reinvest proceeds from the assigned assets between interest payments to investors, in a Guaranteed Investment Contract (GIC).
7. The possible excess spread not used to compensate losses will be paid back to the originator as Deferred Purchase Price.

As this article demonstrates, securitisation is a complex structured transaction, involving many parties and instruments. Careful structuring, coordination and control (including control over costs) are crucial for successful implementation of a securitisation transaction. While consumer and mortgage loan portfolios (most popular assets for securitisation) are growing quickly, it is important to put contractual terms of the loans, as well as the servicing systems, right to facilitate future securitisation. It may also be worth considering "warehousing" as an intermediate technique to obtain funding for growth if your portfolio is still not large enough to be securitised.

How KPMG Can Help

Financial advisors to originators are globally very common. The financial advisor assists the originator in:

- Analysing the structural alternatives of a transaction and the possible impact on economics;
- Assessing and selecting the involved parties in a securitisation, such as for instance legal advisors, underwriting investment banks and service providers;
- Assisting in the structuring and execution of the securitisation transaction.

The financial advisor can either be a Big Four firm or an investment bank.

The specialised Securitisation Team within KPMG Corporate Finance can act as financial advisor to originators in securitisation transaction. Beside the standard activities of a financial advisor in a securitisation transaction, such as acting as arranger, advising at all stages of a securitisation transaction - from initial feasibility study, structuring the deal, negotiating it with any third parties (most importantly - rating agencies) and taking part in the execution alongside the appointed lead manager(s), KPMG Corporate Finance can also advise originators in preparing the organisation for future securitisation. In that case, KPMG Corporate Finance can advise on loan documentation, preferred loan characteristics, IT necessities and internal processes.

As a professional advisory firm, we do not act as underwriters or lead managers and do not have any financial products to sell. Our only objective is to arrange for the best deal for the client, keeping all parties in the process fair and competitive and advising on potential pitfalls and hidden costs of securitisation.

In recent years, our specialised Securitisation Team advised 8 first time issuers on a total of EUR 7.4 billion transaction size. In total KPMG Corporate Finance acted as advisor on more than 20 securitisation transactions (funded and synthetic), totalling over EUR 40 billion.

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