



BANKING & FINANCE

The State of the Banking Industry

Banking and Investment Banking & Securities

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FINANCIAL SERVICES

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Market Forces

Consolidation and Convergence

- Capital One Financial Corporation and North Fork Bancorporation, Inc. announced that on November 8, 2006, the Board of Governors of the Federal Reserve System approved their proposed merger. The companies expect the merger to occur in December. As announced in March, Capital One will acquire North Fork in a stock and cash transaction valued at approximately \$14.6 billion. The combined company will be one of the 10 largest banks in the United States, based on deposits and managed loans, and the sixth-largest depository institution in the New York region, the nation's largest deposit market. North Fork stockholders may elect to receive cash, shares of Capital One common stock, or a combination of both, in exchange for each of their shares of North Fork common stock. *(Capital One and North Fork Joint Press Release, March 12 and November 9, 2006)*
- The PNC Financial Services Group, Inc. and Mercantile Bankshares Corporation announced that they have signed a definitive agreement for PNC to acquire Mercantile for \$47.24 per share, or approximately \$6.0 billion in stock and cash. According to the announcement, Mercantile is a \$17 billion asset banking company that provides banking and investment and wealth management services in Maryland, Virginia, the District of Columbia, Delaware and Southeastern Pennsylvania. *(PNC Financial Services and Mercantile Bankshares Joint Press Release, October 9, 2006)*
- Citigroup announced that it has reached a definitive agreement to acquire Grupo Financiero Uno (GFU), the largest credit card issuer in Central America, and its affiliates. According to the announcement, the acquisition of GFU, with \$2.1 billion in assets, will significantly expand the presence of Citigroup's Latin America consumer franchise, enhancing its credit card business in the region, and establishing a strong platform for regional growth in consumer finance and retail banking. The financial terms of the transaction are not being disclosed. *(Citigroup Press Release, October 27, 2006)*
- U.S. Bank Canada, a division of U.S. Bank, announced it has acquired CIBC's Visa purchasing and Visa corporate credit card portfolio. Financial terms were not disclosed. CIBC Visa corporate and purchasing cards will become U.S. Bank cards and will be managed by a dedicated sales and relationship management force located across Canada. *(CIBC Press Release, October 31, 2006)*
- Scotiabank announced the acquisition of Travelers Leasing Corporation (TLC), a Canadian automobile financing company. Terms of the transaction were not disclosed. TLC is one of three business units operated by Travelers Financial Group, British Columbia. *(Scotiabank Press Release, November 14, 2006)*
- Morgan Stanley announced that it has acquired Nan Tung Bank, a Zhuhai-based foreign funded bank formerly owned by Nam Tung (Macao) Investment Limited, a full subsidiary of Bank of China. Nan Tung Bank, which is now a wholly owned subsidiary of Morgan Stanley Bank International, offers a comprehensive set of commercial banking products and services, including deposits, home mortgage loans, corporate loans, foreign currency exchange and remittances, trade finance and credit facilities to individuals as well as corporate customers based primarily in the Pearl River Delta region of Guangdong Province. *(Morgan Stanley Press Release, October 2, 2006)*
- Merrill Lynch announced an agreement to acquire Petrie Parkman & Co., an investment bank specializing in mergers and acquisitions, asset and private company divestitures, corporate finance, and equity research for the North American oil and gas industry. According to the announcement, the proposed transaction will combine Merrill Lynch's investment banking capabilities with the specialized exploration and production energy expertise of Petrie Parkman, and leverage the commodities trading business of Merrill Lynch Commodities, Inc. (MLCI). Financial terms were not disclosed. *(Merrill Lynch Press Release, October 23, 2006)*
- U.S. Bancorp announced that its lead bank, U.S. Bank National Association, has entered into a definitive agreement to purchase the municipal bond trustee business of LaSalle Bank National Association, the United States subsidiary of ABN AMRO Bank N.V. As a result of this transaction, U.S. Bank Corporate Trust Services will acquire approximately 2,875 new client

issuances and assets under administration of \$30 billion represented by principal outstanding. Upon completion of this transaction, U.S. Bank's corporate trust division will have \$2.5 trillion in assets under administration, 725,000 bondholders and more than 95,500 client issuances.

Additionally, U.S. Bancorp and United Financial Corp. announced the signing of a definitive agreement for U.S. Bancorp to acquire United Financial Corp., the parent company of Heritage Bank. According to the announcement, this acquisition will nearly double the branch presence in Montana for U.S. Bancorp's lead bank, U.S. Bank National Association, and give the bank a deposit base exceeding \$1 billion. (*U.S. Bancorp (Business Wire) Press Releases, November 6 and 10, 2006*)

Risk Management

- Families near or in retirement are falling deeper in debt, and the nation's oldest families—those with family heads age 75 or older—have substantially increased their debt levels, potentially putting their ability to finance their remaining retirement at risk, according to a study released today by the nonpartisan Employee Benefit Research Institute (EBRI). Both housing debt and consumer debt levels are rising for elderly families. In the oldest age group, the study found that percentage of income that debt payments represented more than doubled from 2001 to 2004. Additionally, rising debt could be the first sign that older Americans are not able to maintain their

current standard of living and are taking on debt to do so. (*Employee Benefit Research Institute Press Release, September 14, 2006*)

- Hennessee Group LLC notes that hedge funds have continued to increase their exposure to credit derivatives. According to a report issued by the International Swaps and Derivatives Association (ISDA) in September 2006, the total notional value of credit derivatives outstanding globally grew 52 percent in the first six months of 2006 to an estimated \$26 trillion. Hennessee notes that the use of credit default swaps (CDS) by credit-oriented hedge funds has been commonplace and effectively used over the past five years. However, it also notes that the use of CDS has become more prominent among long/short equity funds over the past year. Equity funds have been using CDS in several ways, including: purchasing CDS on corporate bonds designed to profit from a widening in corporate credit spreads; purchasing CDS on sub-prime mortgage backed fixed income securities and indices intended to profit from deterioration in credit quality among mortgage borrowers; and purchasing CDS on emerging market government debt designed to profit from a decline in the country's credit quality. Instead of being used as a speculative investment, CDS have often been purchased as a hedge to portfolios of securities that funds currently own. (*Hennessee Group LLC Press Release, October 30, 2006*)
- New research from TowerGroup finds that although credit cards remain the

most profitable product for banks, an overall decline in bank cards is signaling the need for banks to evolve their rewards strategies. Since 2000, the bank card industry's dependence on rewards programs has increased significantly. While rewards have become an essential aspect of bank card business strategy and help increase card usage, customer retention and margins, they come with a cost to the institution in terms of overall profitability. In 2005, general purpose cards (GPC) produced 75 percent of the bank card industry's sales volume. Even with a greater number of solicitations mailed by bank card issuers in 2005, only 3 percent of target consumers responded. TowerGroup says that as customer acquisition costs continue to rise, the industry's dependence on card designs that include a rewards feature will increase. It is expected that within five years, 90 percent of consumers holding GPC will have some form of rewards, yet these rewards will place increased financial burdens on the profitability of bank card programs. (*TowerGroup Press Release, October 3, 2006*)

- Ninety-three percent of Americans are well aware of the growing crime of identity theft. Yet despite free access to credit reports and numerous educational efforts, a new survey from Capital One and national advocacy group Consumer Action finds that many consumers are still unaware of the financial damage that can result from the crime and the steps to take if they fall victim. The survey also suggests that older and younger

generations are particularly vulnerable. Key findings of the survey indicate that almost half of the respondents do not realize that their personal information can be used to obtain a mortgage, or that thieves can obtain a drivers license or photo ID card with such information. Additionally, Americans are putting themselves at risk for identity theft simply by carrying their Social Security Cards on their possession. Despite educational efforts, many consumers are still uninformed about the crime. (*Capital One Press Release, October 30, 2006*)

International Focus and Globalization

- The Investment Dealers Association of Canada (IDA) said it welcomed the release of the final report of the Task Force to Modernize Securities Legislation in Canada. On June 27, 2005, the IDA announced the establishment of an independent task force of business leaders, securities lawyers, industry professionals and academics to recommend changes to Canadian securities legislation to achieve a dynamic, fair, efficient and competitive capital market. The Task Force was asked to undertake comprehensive and expert research in Canada and internationally to generate data and analysis to support informed and innovative reform of regulatory content including issues related to investor protection, access to capital, enforcement, governance and regulatory burden. Its mandate did not include issues of regulatory structure. (*Investment Dealers Association of Canada Press Release, October 4, 2006*)
- On October 11, Visa announced that it intends to restructure its organization in order to create a new public global corporation called Visa Inc. As a part of this restructuring, Visa Europe will remain a membership association, owned and governed by its European member banks, and become a licensee of Visa Inc. Under the proposed restructuring, Visa Inc. will be created through a series of mergers involving Visa Canada, Visa USA and Visa International, which includes the operating regions of Asia Pacific, Latin America and the Caribbean, Central and Eastern Europe, the Middle East, and Africa. According to the announcement, the reorganization will result in a new stock corporation owned by Visa members. After the mergers are complete, the global corporation intends to begin the IPO process and list its shares on a major stock exchange. (*Visa Press Release, October 11, 2006*)
- Lehman Brothers announced that it plans to conduct its securities business in Japan as a Japanese corporation. The Firm will change its corporate structure and conduct its business through Lehman Brothers Japan Inc., a newly incorporated Japanese company. The Firm will transfer its business and rights and obligations to the new entity which was to commence business in Japan on December 16, 2006. (*Lehman Brothers Press Release, November 9, 2006*)
- On November 8, Citibank announced the introduction of a new cardless biometric payment service in Singapore. Offered in partnership with U.S. based Pay By Touch, this new service provided under the new Citibank Clear Platinum Card will enable cardholders to pay for goods and services with the touch of their finger. According to the announcement, this is the first of its kind in the world. The service, powered by Pay By Touch, will eradicate the need for cardholders to present their credit card when paying for purchases. Instead, cardholders simply need to press their finger to a biometric scanner located at participating merchant outlets. The announcement notes that besides greater payment convenience, consumers will also enjoy added protection against card fraud. (*Citigroup Press Release, November 8, 2006*)
- Celent indicates in a press release that the Chinese banking sector will be opened to foreign competition at the end of 2006, threatening the independence of small and medium-sized Chinese banks. After December 11, 2006, foreign banks will be able to compete with domestic banks with virtually no barriers. Celent's new report, "Corporate Banking in China: History, Opportunities and Challenges," indicates that the Chinese banking monopoly will be replaced by stiff competition with foreign banks. With their huge funding, mature operational, service models, global sales, and marketing networks, foreign banks will have the upper hand against smaller domestic players, Celent says. According to Celent, domestic banks

have used the past five-years—the transition period from China’s accession to the WTO—to reform the banking system and improve asset quality, the scope of services, and service standards to become more competitive. However, some overseas financial institutions are enjoying a share of the profits from the growth of the banking industry in China or accelerating the expansion of their service networks in China by buying into the equity of domestic banks. *(Celent Press Release, November 1, 2006)*

- TowerGroup reports that transaction volumes for foreign exchange (FX) trading have continued to rise over the past five years, returning to levels not seen since the late 1990s. New business models and changing motivations for trading FX products as an asset class have fostered greater buy-side participation—and have given rise to an increasingly diverse selection of execution venues with a focus on electronic foreign exchange (e-FX). New research from TowerGroup finds that by 2007, global FX daily average volumes will exceed \$3 trillion, with more than 44 percent of transactional volume conducted electronically. FX trading is still dominated by the large dealing banks, yet exchange-like models fueling a bid-and-offer market are challenging the traditional request for quotes. With the appearance of new execution venues, TowerGroup says it has become easier for traders to enter the FX market and reduce the risks associated with these transactions. *(TowerGroup Press Release, October 4, 2006)*

- According to the “Asia-Pacific Wealth Report” released on October 10 by Merrill Lynch and Capgemini, in 2005 Asia-Pacific represented 27.1 percent of the world’s High-Net-Worth Individuals (HNWI), those with net financial assets of at least \$1 million excluding their primary residence and consumables. The report is a regional extension of the firms’ annual “World Wealth Report” and provides an in-depth view of the changing Asia-Pacific wealth management market. In addition, it was reported that the region was home to 5 of the 10 fastest-growing HNWI populations in the world, and the number of HNWIs grew by 7.3 percent to 2.4 million from 2004. The number of Ultra-HNWIs, those having net financial assets of more than \$30 million, grew by 12.1 percent, to 15,600. The total wealth of the Asia-Pacific high-net-worth population was \$7.6 trillion in 2005, growing at an 8.0 percent pace over 2004. *(Merrill Lynch Press Release, October 10, 2006)*
- In October, the NASDAQ Stock Market LLC announced the signing of three Memorandums of Understanding, entering into agreements to provide an ongoing exchange of information and to explore mutually beneficial areas of interest in order to maintain fair and orderly markets. These include:
 - JASDAQ – the largest IPO market with nearly 1,000 listed companies in Japan.
 - The Korea Exchange, Inc. (KRX) – established in January 2005 through the merger of Korea Stock Exchange, Korea Futures Exchange and

KOSDAQ Market and is the sole exchange in the Republic of Korea.

- The Shanghai Stock Exchange (SSE) – for the benefit of investors in the U.S. and the People’s Republic of China.

(NASDAQ Press Releases, October 13 and 23, 2006)

e-Business and Technology

- Results from a survey released by Visa USA indicate that 68 percent of the financial executives and cash managers surveyed plan to reduce their reliance on checks for commercial payments. At the same time, the survey shows that 63 percent plan to increase their use of corporate payment cards which executives view as a more efficient payment method due to enhanced transaction data reporting and visibility into cash position. The survey identified lack of streamlined operational processes as a key challenge to cash management efficiency. The survey also measured the opinions and practices of financial executives toward the integration of corporate payment cards with e-procurement and enterprise resource planning (ERP) processes. Achieving more streamlined processes and cost savings were the primary reasons cited for payment card integration. *(Visa Press Release, October 17, 2006)*
- According to a new report from Celent, “Contactless and the Dawn of a New Payment Era,” the number of contactless payment devices has nearly doubled in the past year. After years of

testing contactless payment devices, many financial institutions are now offering these devices to their customers nationwide. Three years have passed since American Express launched the first pilot in July 2002. Today, contactless devices are being issued by a number of banks. Celent says that this is proving to be a big year for the contactless payment industry with over 30,000 merchant locations in the U.S. now capable of handling a contactless transaction and over 13 million contactless devices in the hands of consumers. While some hurdles must still be cleared before mass deployment is successful (e.g., the average consumer may be uncomfortable with new technology or may have security concerns; and merchants must also be convinced of the benefits of accepting contactless payments), the report indicates that the benefits of this technology will be realized by the market. Based on the trends in the electronic payment space and advances in contactless technology, Celent predicts that contactless payments will capture 15 percent of the market by 2011. Much of the growth is attributed to issuers being most likely to equip existing cards with contactless capabilities rather than require consumers to sign up for a new credit or debit account. (*Celent Press Release, September 5, 2006*)

- A new Celent report, "IT Spending Trends: A Global Financial Services Review," analyzes IT spending trends across different industries (banking, insurance, and securities and investments) and different regions

(North America, Europe, and the Asia-Pacific region) in addition to an overview of Latin America and Africa. Celent estimates that global information technology spending by financial services institutions stands at \$317.7 billion, representing an increase of 8 percent over 2005. Celent indicates that although the U.S. economic forecast is relatively upbeat, the growth in IT spending by financial services firms is expected to curtail starting in 2007. The financial services community is anticipated to spend \$351.2 billion on global IT products and services in 2008, or a growth rate of 5.1 percent per annum. Financial services institutions in Asia-Pacific are expected to increase their investments in IT at a significantly faster rate compared to firms in other parts of the world from 2006 to 2008, a compound annual growth rate of 11.4 percent. (*Celent Press Release, November 13, 2006*)

- In another announcement, Celent reports that spending on anti-money laundering (AML) software globally will increase to \$375 million by 2009, a compound annual growth rate of 5.9 percent. Celent indicates that technology has become an essential tool for complying with AML and counterterrorist funding legislation. Regulators in the United States and the EU are emphasizing the importance of effective AML analytics as a cornerstone of compliance. Financial institutions and regulators are demanding enhanced functionalities from AML solutions, driving the development of improvements to these systems. In the three years since

Celent's first AML vendor report, "Ranking the Vendors of Anti-Money Laundering Solutions," July 2003, the vendor landscape has gelled. According to Celent, vendors have significantly upgraded their systems, enhancing usability with web-based interfaces, improving workflow efficiency with advanced case management features, and plugging gaps in features and functionality. (*Celent Press Release, August 29, 2006*)

- TowerGroup says that the piecemeal development of banking systems over the last 30 years has left many banks with a combination of technologies that are difficult to integrate or nearly impossible to change quickly enough to maintain a competitive edge. New research from TowerGroup finds that service-oriented architecture (SOA) is poised to deliver the near-seamless integration of business functionality retail banks have been seeking to respond more nimbly to market opportunities and pressures. According to TowerGroup, SOA can be viewed as the coordinated use of new and existing technologies to increase the reusability of business components and processes. This would speed up development of new applications and products, decrease maintenance costs, and more efficiently leverage legacy systems. (*TowerGroup Press Release, October 25, 2006*)
- TowerGroup further reports that the use of technology by investment banks has lagged the trading side of the business due to the culture and regulatory landscape governing the industry. New research from TowerGroup finds that

investment banks are now beginning to increase their focus on leveraging “deal management” technology and automation, spending IT dollars on improving their ability to win deals—the key driver of investment banking revenues. The research indicates that there is ample opportunity for investment banks to maximize their effectiveness while minimizing the cost of their suite of IT tools through a tactical redesign of their infrastructure. TowerGroup estimates that investment banks will spend \$1.53 billion in the U.S. on investment banking suites of IT applications, with another \$1.48 billion being spent outside the U.S. (*TowerGroup Press Release, September 27, 2006*)

- On September 25, SEC Chairman Christopher Cox announced that the Securities and Exchange Commission (SEC) has awarded three separate contracts totaling \$54 million to transform the agency’s 1980s-vintage public company disclosure system from a form-based electronic filing cabinet to a dynamic real-time search tool with interactive capabilities. According to the SEC, the major investment in an “interactive data” system signals the agency’s commitment to move away from the model of its current EDGAR database. It also presages widespread adoption of interactive data filing by companies that report their financial information to the SEC—a development that until now has only been a voluntary pilot program. By moving to interactive data using the XBRL computer language, the SEC will be joining the Federal Deposit Insurance Corp. (FDIC),

the Federal Reserve, and the Comptroller of the Currency (OCC), which already require banks to use it. ICI President Paul Schott Stevens said that the ICI applauds the SEC’s plans for the new technology that will put enhanced disclosure within the grasp of millions of American investors, including mutual fund shareholders. In June, the ICI announced the start of a project to develop a system to use XBRL to link the power of interactive data to the information that mutual fund investors most need and use when deciding which funds to buy. (*Press Releases: Securities and Exchange Commission and ICI, September 25, 2006; ICI, June 12, 2006*)

Changes & Trends

General Highlights

- According to the latest economic forecast released on October 24 by the Mortgage Bankers Association (MBA), total residential mortgage production in 2006 will be \$2.46 trillion, the fifth-highest level ever, but will drop 14 percent in 2007 to \$2.1 trillion and remain unchanged at that level in 2008. Some of the key points of the MBA forecast indicate that:
 - Fixed mortgage rates should remain at about today's 6.3-6.4 percent through the rest of the year. Rates are expected to rise to about 6.7 percent by the end of 2007 and to about 6.8 percent by the end of 2008.
 - Total existing-home sales for 2006 will decline by about 9 percent relative to a record level in 2005, and will pull back by about another 8 percent in 2007. New-home sales will decline by nearly 18 percent from a record high in 2005 but will slip by about 8 percent in 2007. Both new- and existing-home sales will increase modestly in 2008.
 - Existing home price appreciation is expected to slow significantly this year, with median price gains decelerating to about 2.5 percent. Price gains for both existing and new homes in 2007 are expected to be similar to those in 2006. Home price appreciation should strengthen modestly in 2008.
 - Residential mortgage originations for purchase loans will reach \$1.39 trillion in 2006 and will edge down to

\$1.32 trillion in 2007. Residential refinance loans will total \$1.07 trillion in 2006 and then decline to \$807 billion in 2007. For 2008, both purchase and refinance originations should remain relatively flat to their 2007 levels.

(Mortgage Bankers Association Press Release, October 26, 2006)

- TowerGroup reports that financial institutions are on the cusp of a multi-trillion-dollar opportunity to gain assets by providing efficient and effective retirement income planning services for the growing percentage of the population in or near retirement. New research from TowerGroup predicts that the challenges inherent in retirement income planning and asset decumulation will soon prompt many U.S. households to consolidate assets with a single advisor. TowerGroup says that the opportunity for financial services institutions to gain or lose assets is significant. Retirement assets in various plan types under the control of individual investors in the United States total \$9 trillion, with business liquidation over the next decade potentially resulting in another \$10 trillion in assets. Yet the retiree market is far from monolithic with regard to income planning. TowerGroup's research underscores the importance of defining both the unique requirements and opportunities of each of the three major segments: mass market, affluent market, and the high net-worth segment. *(TowerGroup Press Release, October 24, 2006)*
- The American Bankers Association (ABA) expressed disappointment with

the FDIC's decision to set deposit insurance premiums at much higher than necessary levels, and reiterated its position that low and steady premiums are the most effective strategy for maintaining a strong Deposit Insurance Fund. The FDIC set the premiums at 5 to 7 basis points—or 5 to 7 cents per \$100 of deposits—for well-capitalized banks with no supervisory concerns. Banks with supervisory concerns could pay up to 43 basis points. According to the ABA, the Deposit Insurance Fund, which is fully funded by the banking industry, has assets of \$50 billion and is growing by \$300 million each quarter from interest income—even without any new premium income. The Fund exists to reimburse insured depositors in the event of a bank failure. There has not been a bank failure in more than two years—the longest period in the FDIC's history.

Additionally, the ABA reported that it was pleased that the FDIC made some important changes to the risk-based premium assessment system. These include eliminating the penalty premium assessed to new banks—those chartered after 1999—and excluding large time deposits from the risk calculator. As requested, Federal Home Loan Bank advances are excluded from the risk-assessment model. *(ABA Press Release, November 2, 2006)*

- A study that was conducted October 2006, by Harris Interactive® for Countrywide Home Loans, Inc. found that nearly half of Americans may be overlooking a significant financial asset. Many Americans consider their home equity as the largest financial asset, yet

they do not actually manage their mortgage—indicating a gap in Americans’ understanding of how to make the best use of a new or existing mortgage. While many Americans closely monitor and manage other investments within their portfolios, some are not using their mortgages as a viable financial tool. Many homeowners feel that they are tied to their original loan and underestimate their ability to use changes in their home loan strategies to meet short-term or long-term goals and match their current life stage. These homeowners may think of their mortgage as something they are stuck with until they sell their home. However, depending on their future plans and expected financial situation, there may be various mortgage solutions that, in fact, help them manage and achieve their changing financial goals. (*Countrywide Financial Press Release, November 6, 2006*)

“Harris Interactive®” is a registered trademark of Harris Interactive, Inc.

- On November 6, Mellon Financial Corporation reported that the funded status of a typical U.S. pension plan improved 1.5 percent in October as the value of its assets rose 2.5 percent, which was faster than the one percent increase in liabilities. (Mellon tracks the financial health of U.S. pension plans through its Mellon Pension Liability Indexes.) Powered by a double-digit return in equities in 2006 and interest rate hikes during the first five months of the year, the funded status of a typical plan was 7.8 percent better at the end of October than it was at the beginning of the year. According to Mellon, the assets of a typical plan

were 9.3 percent higher at the end of October than they were at the beginning of the year, while liabilities were 1.5 percent higher. (*Mellon Financial Press Release, November 6, 2006*)

Accounting Standards and Developments

Agencies Issue Final Guidance for Nontraditional Mortgage Product Risk

On September 29, the Federal financial regulatory agencies issued final “Interagency Guidance on Nontraditional Mortgage Product Risks.” The guidance addresses the risks posed by residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest. These products include “interest-only” mortgages and “payment option” adjustable-rate mortgages and generally allow borrowers to exchange lower payments during an initial period for higher payments later.

The final guidance discusses the importance of carefully managing the potential heightened risk levels created by these loans. These agencies indicate that management should ensure loan terms and underwriting standards are consistent with prudent lending practices, recognize that many nontraditional mortgage loans are untested in a stressed environment, and ensure that customers have sufficient information to clearly understand loan terms and associated prior risks to making a product or payment choice. (*KPMG’s The Washington Report (WR), October 2, 2006*)

Fair Value Measurements

FASB Statement No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute.

Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

Prior to this Statement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that require fair value measurements. Differences in that guidance created inconsistencies that added to the complexity in applying GAAP. In developing this Statement, the FASB considered the need for increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements. The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. (FASB at www.fasb.org)

Associated with Split-Dollar Life Insurance

At the September 7, 2006 EITF meeting, the Task Force affirmed as a consensus the tentative conclusion that for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with Statement 106 or Opinion 12 (depending on whether a substantive plan is deemed to exist) based on the substantive agreement with the employee. For example, if the employer has effectively agreed to maintain a life insurance policy during the employee's retirement, the cost of the insurance policy during the postretirement periods should be accrued in accordance with either Statement 106 or Opinion 12. Similarly, if the employer has effectively agreed to provide the employee with a death benefit, the employer should recognize a liability for the future death benefit in accordance with either Statement 106 or Opinion 12. The FASB considered and ratified this consensus at its September 20, 2006 meeting. (FASB at www.fasb.org)

Purchases of Life Insurance

At the September 7, 2006 EITF meeting, the Task Force affirmed as a consensus the tentative conclusion that a policyholder should consider any additional amounts included in the contractual terms

of the policy in determining the amount that could be realized under the insurance contract. When it is probable (as defined in FASB Statement No. 5, *Accounting for Contingencies*) that contractual restrictions would limit the amount that could be realized, the Task Force agreed that these contractual limitations should be considered when determining the realizable amounts. Amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. The Task Force observed that amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*. The Task Force affirmed as a consensus the tentative conclusion that a policyholder should determine the amount that could be realized under the insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The Task Force noted that any amount that would be ultimately realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. The Task Force also affirmed as a consensus the tentative conclusion that a policyholder should not discount the cash surrender value component of the amount that could be realized when contractual restrictions on the ability to surrender a policy exist. However, the Task Force observed that if the contractual limitations prescribe that the cash surrender value component of the amount that could be

realized is a fixed amount, then the amount that could be realized should be discounted in accordance with Opinion 21. The FASB considered and ratified this consensus at its September 20, 2006 meeting. (FASB at www.fasb.org)

Regulatory and Legislative Matters

Legislative Actions

- On September 29, President Bush signed the *Credit Rating Agency Reform Act* into law. The new law will improve the quality of credit ratings to protect investors by fostering accountability, transparency, and competition in the industry. It will allow all credit rating agencies meeting certain criteria to register as Nationally Recognized Statistical Rating Organizations (NRSROs) and give the SEC examination and enforcement authority over the NRSROs. (WR, October 2, 2006)
- Also on September 29, the President signed into law the *Military Personnel Financial Services Protection Act*. The law shields military personnel from abusive sale practices, bans the sales of inferior investment products, and ensures regulatory oversight of financial services sales on military installations. (WR, October 2, 2006)
- The House and the Senate passed legislation containing the *Unlawful Internet Gambling Enforcement Act*, which will cut off the flow of money to Internet gambling Web sites by regulating payment systems and will authorize state and Federal law

enforcement authorities to seek injunctions against persons who facilitate Internet gambling. The President is expected to sign the bill during October. (*WVR, October 9, 2006*)

- During the third quarter of 2006, the Senate and the House of Representatives and/or their respective Committees on banking and financial services held hearings and considered legislation on a variety of topics, including:
 - Nontraditional mortgage products
 - Implementation of Basel II
 - Bank Secrecy Act reporting
 - Industrial Loan Corporations
 - Pandemic Influenza preparedness

Regulatory Issues

- The Board, Office of the Comptroller of the Currency (OCC), FDIC, and Office of Thrift Supervision (OTS) jointly published their notice of proposed rulemaking (NPR) concerning the domestic application of the Basel II capital framework on September 25. Comments will be due to the individual agencies by January 23, 2007. Also on September 25, the agencies jointly published an NPR on possible modifications to the risk-based capital standards for market risk. The proposed rule would incorporate improvements to the current trading book regime as proposed by the Basel Committee on Bank Supervision and the International Organization of Securities Commissions in the joint document "The Application of Basel II to Trading Activities and the

Treatment of Double Default Effects," which was published in July 2005. (*WVR, October 2, 2006*)

- The FDIC released Financial Institution Letter (FIL) 83-2006 on September 18 to announce that it had adopted a final rule implementing provisions of the *Federal Deposit Insurance Reform Act of 2005* related to deposit insurance coverage for certain retirement plan deposits including Individual Retirement Accounts (IRAs), "Section 457" plan accounts and self-directed defined contribution plan accounts. The coverage was increased to \$250,000 effective April 1, 2006. (*WVR, September 25, 2006*)
- On August 24, the Board announced the approval of a final rule amending its Regulation E, which implements the *Electronic Fund Transfer Act*, and to the official staff commentary, which interprets the requirements of Regulation E. Generally, the amendments provide that payroll card accounts will be covered by Regulation E beginning July 1, 2007. (*WVR, August 28, 2006*)
- On September 13, the OCC issued a revised "Depository Services" handbook, which is part of the "Comptroller's Handbook for Consumer Compliance." The booklet contains background information and optional expanded examination procedures for consumer protection regulations. (*WVR, September 18, 2006*)
- In August, the member agencies of the Federal Financial Institutions Examination Council (FFIEC) released Frequently Asked Questions (FAQs) to

aid in the implementation of the interagency guidance on "Authentication in an Internet Banking Environment," which was issued in October 2005. In a related action, the OCC released Alert 2006-50 on September 8 to caution national banks about the potential for increased fraudulent activity associated with the December 31, 2006 effective date of the FFIEC guidance. (*WVR, August 21 and September 11, 2006*)

- On September 8, the FFIEC announced the availability of data for the year 2005 on mortgage lending transactions at financial institutions covered by the *Home Mortgage Disclosure Act* (HMDA) in metropolitan statistical areas throughout the nation. The FFIEC indicates that the aggregate 2005 data show that the incidence of higher-priced lending (the proportion of loans where the spread between the rate on the loan and the yield on comparable Treasury securities exceeds specified thresholds) was significantly higher overall in 2005 than in 2004. (*WVR, September 11, 2006*)
- On September 1, the OCC released OCC Bulletin 2006-39 to address risk management guidance on automated clearing house (ACH) activities. The OCC notes that the guidance is timely because advances in technology have brought about significant changes in the nature and volume of ACH activity, primarily as the result of fundamental changes in payment methods used by consumers and businesses. (*WVR, September 5, 2006*)

- **Short Sale Regulation**

Broker-dealers face myriad challenges in meeting their responsibilities under Regulation SHO (Reg SHO) under the Securities Exchange Act of 1934. Reg SHO was adopted on July 28, 2004 to modernize the regulation of short sales and require broker-dealers to establish internal controls to detect and deter abusive short selling practices. Beginning on the compliance effective date, January 3, 2005, firms were subject to many new requirements relative to their short sale business activities. Since then, many firms have encountered common issues in working to achieve compliance with the rule and applicable regulatory guidance. In its publications, KPMG has explored these and other current related topics, and identified various issues for consideration and steps that firms may undertake in order to address and resolve the various problems. (*KPMG's Compliance & Regulatory Focus (CRF), August 2006; KPMG's Regulatory Practice Letter 06-02*)

Related regulatory developments include the following:

- On September 15, the SEC convened a roundtable discussion group to explore issues related to the current short sale pilot in effect under Reg SHO. Participants discussed the efficacy of SEC and self-regulatory organization rules that limit the execution prices of short sales, including the Tick Test (Rule 10a-1 under the Securities Exchange Act of 1934) and the Bid Test (NASD Rule 3350). Pilot data was also considered, and several research papers were presented at the roundtable. Also at

this meeting, the SEC presented a report entitled "Economic Analysis of the Short Sale Price Restrictions under the Regulation SHO Pilot," which was prepared by its Office of Economic Analysis (OEA). In the report, the OEA concluded "that price restrictions constitute an economically relevant constraint on short selling. [Further, the] evidence suggests that removing price restrictions for the pilot stocks has had an effect on the mechanics of short selling, order routing decisions, displayed depth, and intraday volatility, but on balance has not had a deleterious impact on market quality or liquidity." The agency noted that tick test was found to have been "a more binding constraint" than the bid test. In closing, however, the OEA stated that "while the Pilot study was designed to facilitate a natural experiment in a controlled environment, the results might not be entirely representative of removing the rule permanently for all stocks." (*CRF, July and October 2006; WR, September 11 and 18, 2006*)

- On July 12, the SEC proposed amendments to Regulation SHO in order to further modernize the regulatory framework for short sales. In particular, the changes are intended to further reduce the number of persistent fails to deliver associated with the grandfather provision contained in Rule 203(b)(3)(i) and the options market maker exemption set forth in Rule 203(b)(3)(ii). The proposal also contains a technical amendment to the market decline limitation in Rule 200(e)(3). (*WR, July 17, 2006; CRF, August 2006*)

- **Soft Dollars**

On July 12, the SEC issued interpretive guidance to address money manager usage of client commissions to pay for brokerage and research services, a practice known as "soft dollars," under the existing safe harbor in Section 28(e) of the Securities Exchange Act of 1934. The agency noted that it would supplement the guidance as necessary. Generally, the guidance:

- Sets forth a three-part analysis to aid managers in evaluating the value of the services received relative to the commission paid to ensure that they satisfied their fiduciary duties in instances where an account, over which they exercised discretion, paid above the lowest available commission;
- Clarifies that client commissions may only be utilized to pay for eligible brokerage and research services. The release includes a discussion of services deemed to satisfy this definition;
- Addresses situations where money managers obtain brokerage and research services from broker-dealers and other research providers; and
- Provides that money managers relying on the safe harbor must use eligible brokerage and research services in an appropriate and lawful manner. (*WR, July 17, 2006; CRF, August 2006*)

- **Executive Compensation Disclosure**

On July 26, the SEC voted to adopt rule and form amendments to provide for the enhanced disclosure of executive and director compensation, related person

transactions, director independence and other corporate governance matters, and the security ownership of officers and directors. The changes will impact the current paradigm for reporting executive and director compensation arrangements to require information about the total compensation of these individuals, including options grants. The new rules also address the presentation of the data, including the requirement to affect all disclosures in "plain English." They will impact disclosure in proxy statements, annual reports and registration statements. The changes are intended to improve disclosure of executive compensation and facilitate investor understanding of the disclosed data. The SEC established December 15 as the compliance date for new filings, with the exception of Forms 8-K. (*WR*, July 31 2006; *CRF*, August 2006)

Self-Regulatory Organizations

Research Analyst Conflicts of Interest

NASD and the NYSE issued examination results collected from staff reviews of certain member firms' activities with respect to research analyst conflicts of interest and fixed income research. The self-regulatory organizations (SROs) assessed the extent to which broker-dealers have implemented the Bond Market Association's (BMA) "Guiding Principles to Promote the Integrity of Fixed-Income Research." These consist of guidelines promulgated by an industry trade organization that are implemented by firms on a voluntary basis. They are intended to assist firms in the management of potential conflicts of interest that may arise when conducting fixed income research activities. The

regulatory agencies are interested in this information to help "inform consideration of whether more definitive rules are needed to regulate fixed income research." Current regulations only address analyst conflicts relative to equity research reports.

Generally in their findings, NASD and the NYSE noted that multiple instances were found in which firms failed to adhere to the BMA's Guiding Principles. Further, many firms were found to have had deficient written supervisory procedures regarding their fixed income activities, and failed to achieve compliance with Regulation Analyst Certification (Regulation AC), an SEC rule. For more information, please see NASD Notice to Members 06-36 and NYSE Information Memo 06-55. (*WR*, August 7, 2006; *CRF*, September 2006)

Anti-Money Laundering

- On October 4, the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) published Frequently Asked Questions to provide additional guidance that supplements a final rule requiring mutual funds to file Suspicious Activity Reports (SARs) on suspicious transactions beginning October 31, 2006. (*WR*, October 9, 2006)
- FinCEN released an update to its Frequently Asked Questions about the *Bank Secrecy Act* that included five questions addressing how money services businesses should conduct independent reviews of their anti-money laundering programs. (*WR*, September 25, 2006)

(Sources: *The Federal Register* and Web sites of the issuing agencies including: www.sec.gov, www.nasd.com, www.nyse.com, www.federalreserve.gov, www.occ.treas.gov, www.fdic.gov, www.ots.treas.gov, www.ncua.gov, www.fincen.com)

Taxation

Seventh Circuit Addresses Standard to Be Used Concerning Valuation of Interest Swaps

On August 9, 2006, the U.S. Court of Appeals for the Seventh Circuit issued a decision affirming in part, vacating in part, and remanding to the Tax Court a case concerning the proper calculation of the fair market value of interest swaps. *JPMorgan Chase & Co. v. United States*, Nos. 05-3730 & 05-3742 (*7th Cir.* August 9, 2006)

Background – The case concerns the taxation of income derived from interest swaps. The Tax Court rejected both the taxpayer's and the IRS's methods for determining the fair market value of interest swaps. Instead, it crafted its own method of determining the value of the interest swaps and ordered the parties to provide calculations based on its method. Subsequently, the Tax Court adopted the IRS's computations and decided the taxpayer owed over \$7 million in income tax.

Seventh Circuit – The Seventh Circuit noted that the IRS's determination regarding an appropriate accounting method is not to be set aside unless it is clearly unlawful or plainly arbitrary—the "deferential standard." In other words, the Tax Court simply had to determine whether the IRS's method was arbitrary or unlawful. Because the Tax Court did not use this standard, the Seventh Circuit

rejected the Tax Court's determination that the IRS's method did not clearly reflect income, and remanded the case for the Tax Court to conduct this analysis using the appropriate deferential standard.

KPMG Observation – The court's interpretation that a valuation method is a method of accounting gives significant discretion to the IRS if it challenges a taxpayer's method of valuing securities. Proposed regulations would provide an election to follow book valuations in certain limited circumstances. For many securities, however, such an election could not be applied. Accordingly, the IRS may begin aggressively challenging valuations using an accounting method approach. (*KPMG's TaxNewsFlash No. 2006-216, August 9, 2006*)

Proposed Regulations Intend to Clarify When Accounts or Notes Receivable Are "Acquired for Services Rendered"

On August 4, 2006, the Treasury Department and IRS released for publication in the *Federal Register* proposed regulations (REG-109367-06) that clarify the circumstances in which accounts or notes receivable are "acquired...for services rendered" under section 1221(a)(4).

Reason for Proposed Regulations – Section 1221(a)(4) generally treats accounts or notes receivable as ordinary assets if they are acquired in the ordinary course of trade or business for services rendered or from the sale of certain property (i.e., property described in section 1221(a)(1)). The preamble to the proposed regulations states that courts have applied the provisions of section 1221(a)(4) more expansively, such as: (1)

to notes obtained in loan originations and (2) to notes that were purchased in transactions considered by the court to be closely associated with the process of origination. According to today's release, the "expansion of section 1221(a)(4) cannot be reconciled with Congress' stated purpose for enacting the statute" because such notes generally are issued by the borrower to the lender in exchange for money—not services rendered".

Proposed Regulations – The proposed regulations clarify that an account or note receivable is not one for purposes of section 1221(a)(4) if—in exchange for the account or note receivable—the taxpayer provides more than *de minimis* consideration (other than certain services or property) or if the account or note receivable is not issued by a party other than the party acquiring the services or property.

Treasury and the IRS believe that section 1221(a)(4) should not extend to loan origination and similar notes because borrowers do not issue such notes solely or even predominantly for services rendered. Rather, they issue such notes to the lender for money. Thus, to counter the case law, the proposed rules provide that a note is not acquired for services within the meaning of section 1221(a)(4) even if the taxpayer's act of acquiring (including originating) the account or note receivable constitutes or includes the provision of a service(s) to the issuer of the account or note receivable, to a secondary market, or to participants in the secondary market.

These changes are proposed to apply to accounts or notes receivable acquired

after the date final regulations are published in the *Federal Register*. A hearing on the proposed regulations was scheduled for November 7, 2006; comments were due by November 6, 2006. REG-109367-06 appeared in the *Federal Register* on Monday, August 7, 2006.

KPMG Observation – If the regulations are finalized in their current form, they will have a significant impact on the treatment of receivables acquired in factoring and conduit financing transactions regularly engaged in by banks and finance companies. (*KPMG's TaxNewsFlash No. 2006-207, August 4, 2006*)

Proposed Regulations Clarifying Bank's S Corporation Status Does Not Affect the Applicability of the Code's "Special Bank Rules"

On August 23, 2006 the Treasury Department and IRS released for publication in the *Federal Register* proposed regulations (REG-158677-05) clarifying that if a bank is an S corporation (within the meaning of section 1361(a)(1)), its status as an S corporation does not affect the applicability of the Code's "special bank rules" to the bank.

Proposed Regulations – The proposed regulations are intended to address issues concerning the application of the "special bank rules"—which includes certain provisions under sections 291, 265, 581, 582, and 585—to banks that are S corporations. According to the preamble, the only special bank rule that does not apply to banks that elect S corporation status is the section 585 reserve method for bad debts.

Comments and requests for a public hearing with respect to the proposed

regulations must be received by November 22, 2006.

KPMG Observation – If finalized as proposed, the regulations are likely to have a negative impact on many S corporation banks that had been taking the position that the interest expense disallowance rules applicable to banks holding tax-exempt securities did not apply once a bank had filed as an S corporation for three years. REG-158677-05 appeared in the *Federal Register* on August 24, 2006. (*KPMG's TaxNewsFlash No. 2006-230, August 23, 2006*)

Final Regulations Concerning Dividends Paid Deduction for Stock Held in ESOPs

On August 29, 2006, the Treasury Department and IRS released for publication in the *Federal Register* final regulations (T.D. 9282) providing guidance for employee stock ownership plans (ESOPs)—specifically, rules as to which corporation is entitled to a deduction for dividends under section 404(k). The final regulations adopt “without material change” regulations that were proposed in 2005.

Background – Regulations proposed in 2005 were intended to address two questions concerning the application of sections 162(k) and 404(k):

- Which corporation is entitled to the deduction under section 404(k) for certain dividends paid concerning the ESOP-held stock?
- Are payments in redemption of stock held by an ESOP deductible?

As proposed, the regulations clarified that a payment in redemption of employer

securities held by an ESOP is not deductible. The proposed regulations provided that, under section 404(k), only the payor of the dividend is entitled to the deduction—regardless of whether the employees actually work for another corporation. Thus, when a subsidiary maintains an ESOP for its own employees, but the ESOP holds stock of the parent company, the parent company is entitled to the deduction under section 404(k).

T.D. 9282 was published in the *Federal Register* on Wednesday, August 30, 2006. (*KPMG's TaxNewsFlash No. 2006-240, August 29, 2006*)

UK Branches of Overseas Banks Under Scrutiny by HMRC

Following a decision by the UK High Court earlier this year, HMRC is now taking active steps to identify and inquire into the VAT affairs of the UK branches of non-EU headquartered banks, insurance companies and other financial institutions. This is with a view to levying UK VAT on the value of third party professional services received by the UK branches via their non-EU head offices or other non-EU branches. Institutions with a non-EU headquartered business with a UK branch which cannot fully recover any VAT incurred may be affected by the UK High Court decision. (*KPMG's UK VAT Alert 4, September 2006*)

Securitization – UK High Court Judgment Delivered

The High Court released its judgment in the securitization appeal of a major financial institution concerning the recovery of residual input tax by a credit card company that securitizes its credit card receivables.

The Court considered that when viewed in the context of the securitization process, the assignment of receivables was “no more than the necessary precondition to the supply of securitization” and does not result in a supply for UK VAT purposes by the institution. Therefore, the vast cash throughput arising from the assignment of receivables will not give rise to VAT recoveries but the servicing of the debt will. The judgment was complex and detailed, and there remain a number of unanswered questions and outstanding issues.

It is important to remember that businesses may need to agree with HMRC in the UK individually on how much VAT is recoverable with reference to an individual securitization or an ongoing program. This decision could impact not only those businesses that have one or more securitizations already in place, but also those businesses considering the economic and cost impact of securitization going forward, together with the risk and compliance issues. (*KPMG's UK VAT Alert 22, September 2006*)

Management of Special Investment Funds – ECJ Judgment Released

The European Court of Justice has released its decision in a case referred to it by the UK VAT Tribunal. The case concerned the scope of the VAT exemption for the ‘management of special investment funds’ as defined by EU Member States. Specifically, it looked at whether Member States have the power to define the activities comprising ‘management’, and if not, what services properly fall within the scope of ‘management’ of special investment

funds. The ECJ decided that, broadly speaking, fund administration services should qualify for exemption.

Interestingly, it held that the exemption does not extend to the functions of depository.

As a result of this ruling, services previously classified as taxable fund administration in the UK now fall within the 'management' exemption where they form a 'distinct whole' and are specific and essential to the fund management. Such fund administration services should be exempted from 1 October 2006. Those affected include administrators of special investment funds who currently treat their services as wholly or partly taxable.

Management companies of special investment funds that outsource the administration to third parties will also be affected. (*KPMG's UK VAT Alert 5, May 2006*)

Reduced Canada GST Rate

The Canadian federal goods and services tax (GST) rate has been reduced to 6 percent (from 7 percent), effective from July 1, 2006, resulting in one of the most significant changes to Canadian GST in the last decade. Companies with operations in Canada will need to change their systems to reflect the rate reduction for both competitive and compliance reasons.

The harmonized sales tax (HST), a blended federal and provincial sales tax, was also reduced to 14 percent (from 15 percent). However, because of the limited ability for financial institutions to recover the tax, the HST rate reduction has actually resulted in an increase in financial institutions' HST liability, by about

17 percent. The increased rate applies to reporting periods that end after June 30, 2006.

In addition, on November 17, 2005, proposed changes were announced for financial institutions regarding imported services and intangibles, which may require self-assessment of GST on expenditure previously not subject to the self-assessment rules. The transitional rules provided for the GST rate change describe how financial institutions must allocate these proposed self-assessment rules between the previous 7 percent and the new 6 percent GST rate. (*KPMG Global VAT Brief Issue 5, September 2006*)

Tax Fairness Plan for Canadians

A statement by the Honorable Jim Flaherty, Minister of Finance, Ottawa, Canada on October 31, announced the "new Tax Fairness Plan for Canadians," which he said "is designed to level the playing field between income trusts and corporations" and "to restore balance and fairness to Canada's tax system." Additionally, Minister Flaherty indicated the Plan would bring Canada's approach to income trusts "in line with other jurisdictions throughout the world." According to Minister Flaherty's statement, there has been "a growing trend toward Canadian corporations converting to income trusts," resulting in "almost CAD 70 billion in new trust announcements in 2006." Prior to Minister Flaherty's announcement of the new Plan, income trusts were able to distribute all or substantially all of their earnings, thus avoiding income tax at the trust level. Income tax was paid by the beneficiary to the extent that the beneficiary was subject to tax.

With the Plan the government is proposing to:

- "Apply a distribution tax on distributions from publicly traded income trusts.
 - For income trusts that begin trading after [October 31], these measures will apply beginning with the 2007 taxation year.
 - Existing income trusts will not be subject to the new measures until their 2011 taxation year.
- Reduce the general corporate income tax rate one-half percent as of January 1, 2011.
- Increase the age credit amount by \$1,000 from \$4,066 to \$5,066 effective January 1, 2006. This measure will provide tax relief for low and middle income seniors.
- Introduce a major positive change in tax policy for pensioners, permitting income splitting for pensioners beginning in 2007. This is expected to enhance the incentives to save and invest for retirement security.

According to the statement, these measures represent a major tax reduction and will deliver more than a billion dollars of new tax relief annually for Canadians." (*Canadian Department of Finance Press Release, October 31, 2006*)

Contacts

Christopher S. Lynch
National Line of Business Leader
Financial Services
San Francisco, CA
clynch@kpmg.com

Editorial Production

Mary Ann Bramer
Marketing
Montvale, NJ
mabramer@kpmg.com

Contributing Authors:

Accounting

Elias Lambros
Audit
New York, NY
elambros@kpmg.com

Legislation and Regulation

Laura Haywood-Leigh
Financial Risk Management
Washington, D.C.
lhleigh@kpmg.com

Karen Staines
National Regulatory Advisory
Services Group
Washington, D.C.
kstaines@kpmg.com

Taxation

Denise Schwieger
Tax
New York, NY
dschwieger@kpmg.com

For additional information on KPMG,
please visit our Web site at
www.us.kpmg.com.

To submit changes to our mailing list,
please contact Rosemary Blum at
rblum@kpmg.com.

