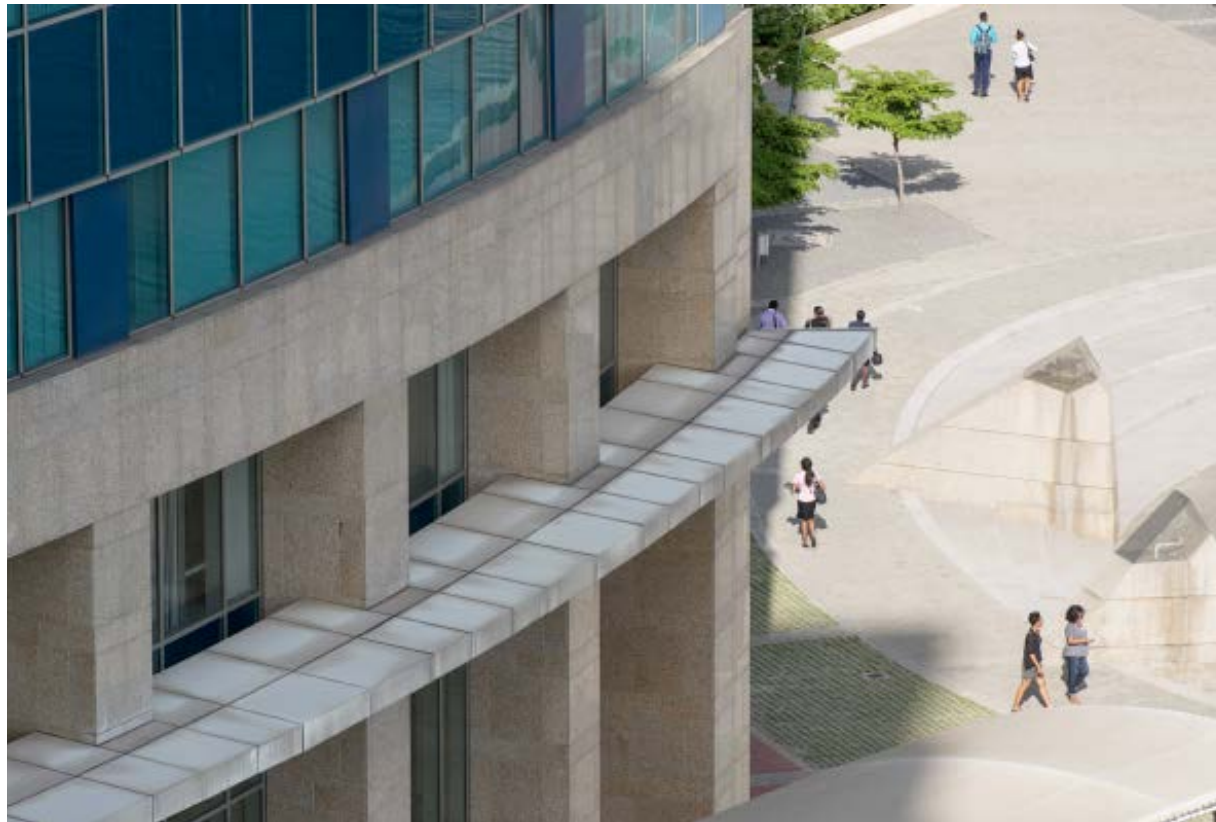


Being better informed

FS regulatory, accounting and audit bulletin



PwC FS Risk and Regulation Centre of Excellence

April 2015

In this edition:

- Strategic and operational challenges impacting the financial sector
- Twin Peaks: A complete system for financial sector regulation?
- Treating customers fairly
- Guidance on application of the in duplum rule
- Tax free savings and investment accounts
- New governance, risk management and internal control requirements for insurers
- Life tax reform process and changes

Executive summary



Irwin Lim Ah Tock
Banking and Capital
Markets – Regulatory
Practice Leader

Welcome to the first edition of 'Being better informed', our new quarterly FS regulatory, accounting and audit bulletin, which aims to keep you up to speed with significant developments and their implications across all financial services sectors.

The launch of this bulletin comes at a particularly interesting time, both locally and globally, when regulation and the impact of regulatory developments has never been more top of mind for FS executives.

In January, *PwC's 18th Annual Global CEO Survey* of business leaders from around the world was launched at the World Economic Forum in Davos, Switzerland. The overwhelming majority of CEOs surveyed believe that regulation is still the biggest threat to their companies' growth prospects in 2015. CEOs see regulation creating upheaval and more costs on the one hand, while diverting attention from other strategic challenges on the other. In conversations, our financial service clients tell us they have three major priorities:

- Finding growth in a challenging environment;
- Driving productivity; and
- Getting ahead in risk and regulatory management.

Fewer CEOs than last year believe global economic growth will improve over the next 12 months, but confidence in their own ability to achieve revenue growth in their companies remains stable.

The situation in Europe is particularly concerning, with the economic austerity/stimulation debate gaining more attention in January. But while debate continues about the optimal fiscal path to recovery, the necessity of having a well-functioning financial system remains sacrosanct.

As 2015 started, many opened the year with the Basel Committee on Banking Supervision consultations on five revisions to measuring risk issued in Q4 of 2014. It consulted on revisions to the standardised approach to credit, counterparty credit and operational risk. This is in addition to its consultation on standardised capital floors and its fundamental review of the trading book. Each consultation is significant in its own right, but considered as a whole they represent a substantial revision to the core of risk measurement. It's starting to feel like the Committee is working on replacing today's implementation projects with tomorrow's regulations and we feel these consultations could be setting the foundations for 'Basel IV'.

At home, a range of new and amended regulations and supervisory guidance have recently been issued across all FS sectors and we summarise many of these in this bulletin. What is clear is that as South Africa moves determinedly towards a Twin Peaks framework of financial regulation, market conduct issues will continue to gain prominence in the minds of both regulators and FS institutions.

We hope you will find this publication an insightful read and would welcome any thoughts or comments you may have about how we can add to its relevance.

Irwin Lim Ah Tock
Banking and Capital Markets – Regulatory
Practice Leader
PwC South Africa

Contents

How to read this bulletin?

Review the Table of Contents in the relevant Sector sections to identify the news of interest. We recommend you go directly to the topic/article of interest by clicking on the active links within the table of contents.

Executive summary	2	Taxation	14
Strategic and operational challenges impacting the financial sector	4	Life tax reform process and changes	14
Cross-sector regulations	6	Accounting updates	15
Twin Peaks: A complete system for financial sector regulation?	6	Financial accounting	15
Treating customers fairly	6	Other	17
Banking regulation	7	International announcements	17
SARB directives, circulars and guidance notes	7	Key dates	18
Guidance on application of the in duplum rule	9	Glossary	19
Regulation: International announcements	10	Contacts	20
Insurance and investment management	12		
Tax free savings and investment accounts	12		
New governance, risk management and internal control requirements for insurers	12		

Strategic and operational challenges impacting the financial sector

summarised by Rivaan Roopnarain

In 2015 firms need to focus on meeting practical implementation challenges in an evolving economic and regulatory environment.

For global financial services firms 2014 will be remembered as a year full of strategic and operational challenges. Regulators globally issued reams of new rules, significantly changed their supervisory approaches and imposed significant penalties for market abuse and other misbehaviour causing detriment to customers. In challenging economic conditions, firms sought to evolve their business models and product offerings, realign their cultures, improve their operations and invest in new technologies. For many, this was an uphill battle given the costs and difficulties of implementing new regulation against very tight deadlines while simultaneously seeking to optimise costs and execute on their growth ambitions.

This year offers a mixed global economic outlook. The UK economy is improving, but the upcoming UK general election creates uncertainties. Across the Atlantic, the US economy is also improving, but some commentators suggest that Congress may reverse some post-financial crisis regulation ahead of the 2016 US Presidential election. For firms with international operations the global economy continues to pose a range of uncertainties. Eurozone stagnation, recession in Russia and dramatic drops in oil prices will hit many countries and businesses. As a result, firms will need to closely monitor how these factors impact their businesses throughout the year ahead.

What is clear is that effective implementation of new regulation will continue to be a strong theme throughout 2015. Firms will continue their efforts to implement multiple large-scale, complex regulatory changes arising on various fronts. Regulators will focus on firm's cultures, their prudential soundness and whether the firm always puts the customer

first. Meeting these challenges will require stamina and fortitude – firms will need to think strategically, plan carefully and make significant investments in personnel and technology.

Regulators' ongoing emphasis on conduct and culture will put even more onus on firms to take control of their own destiny. As global regulators' demonstrate a more intrusive supervisory approach and larger penalties for regulatory failures become the norm, firms need to fully understand regulators' expectations and take a hard look at how their businesses stack up. Firms that can demonstrate their strong customer focus and proactive efforts to improve their risk management and operations are likely to have an easier path to success.

To succeed in 2015, firms need to put the customer at the heart of their culture, reflecting that ethos in all they do. They must also improve their infrastructure and digitalise their customer offerings by using new technology effectively, while embedding significant regulatory

change effectively and efficiently. Firms that do so can dramatically improve their relationships with customers and regulators, while enhancing their profitability.

From a South African perspective, responding to the challenges associated with the scale of current regulatory change will require a focused and proactive approach by firms to ensure that compliance can be turned into strategic advantage. Below are just some of the key regulatory developments that we believe will have significant strategic and operational implications for local firms:

- **BCBS 239** *Principles for effective risk data aggregation and risk reporting*: The principles set out in this BCBS paper will require banks to assess and evidence their risk data and reporting capabilities as well as establishing ongoing governance, monitoring and assurance processes, all of which will require a concerted response across all business units within banking groups;

- **BCBS Standardised Approach consultations:** In each area that the BCBS consulted during 2014 including revisions to the standardised approach to credit risk, counterparty credit risk and operational risk substantial changes have been proposed. Viewed collectively, the revisions measuring risk appear so significant that we may have witnessed the Committee laying foundations for Basel IV.

In 2015 we will see the consultations close, QIS exercises completed and new recommendations revised. Next in the cross hairs will be the models-based approaches. There is still some way to go before Basel's consultations become final proposals. So while firms do not need to think about implementation in the short term, the time to influence the proposals and assess readiness levels is now. The exception to this long-term horizon is the fundamental review of the trading book.

We expect to see the market risk proposals finalised by the end of 2015 with potential implementation in 2016. Firms should begin considering the changes they need to make as soon as final version of the fundamental review becomes available. Firms will find that some of the changes pose

strategic opportunities and challenges, as the trading market evolves. Other changes may require long lead-times to implement, particularly in areas where firms' systems have to be modified. Beginning to plan for these changes now will help ensure a smooth transition.

- **Stress testing:** The stress tests carried out by the European Banking Authority and the Bank of England's Prudential Regulation Authority in 2014 placed much tougher operational, logistical and governance demands on organisations than in the past, bringing the expectations closer to the high bar set by the US Federal Reserve.

With the 2014 tests still fresh in their memories, our UK practice invited organisations from the UK and continental Europe to assess how ready they were to meet the demands of this latest round of tests and whether they are equipped for the more exacting expectations to come. It is telling that while most respondents in the earlier survey were confident about their ability to perform the tests, most of those taking part in this latest survey reported that the demands on their businesses proved to be much greater than they had anticipated.

While stress testing is not yet a formal regulatory requirement in South Africa, we believe that it represents a key supervisory tool that is likely to feature on the regulatory agenda in the not too distant future.

We believe that firms should approach 2015 with a sense of optimism. While they shouldn't underestimate the regulatory challenges ahead, the economic growth agenda, new regulatory initiatives and innovative technologies will bring abundant opportunities. This promises to be a great year for those firms that focus on getting their culture right, innovate in ways that benefit their customers, steer a steady course on implementing known regulatory change and keep an eye on the horizon.

Cross-sector regulations

In this section:

Twin Peaks: A complete system for financial sector regulation?

Treating customers fairly

Banking regulation

SARB directives, circulars and guidance notes

Guidance on application of the in duplum rule

Regulation: International announcements

Twin Peaks: A complete system for financial sector regulation?

Roy Melnick (CAMS), Associate Director

The revised (second) draft of the Twin Peaks regulation, known as the *Financial Sector Regulation Bill (FSRB)* was distributed for public comment and concluded by 2 March 2015. Following this, a third draft will be tabled in Parliament. The second draft of the Bill addresses some of the concerns raised in the original draft such as:

- **Widening the scope of application** to minimise potential for regulatory gaps;
- **Empowering regulators to best achieve their mandate** by providing powers in addition to sectoral law so they are able to supervise and enforce the law in pursuit of their objectives;
- **Improving legal enforceability of the Bill.** In particular, many definitions have been reconsidered e.g. ‘financial customer’ and ‘systemic risk’/‘systemic event’ and additional areas have been added to improve legal application; and

- **Addressing inconsistencies and confusion** associated with the concepts of ‘mono-regulated’ and ‘dual-regulated’ entities. The new draft does not distinguish between these two concepts. The approach to licensing and supervising all institutions on a full dual basis is set out in further detail.

This draft is accompanied by the publication of a discussion document, *Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework for South Africa*, which seeks to establish a streamlined market conduct framework.

The Twin Peaks reform process is likely to take place over a number of years with the enactment of the FSRB being part thereof.

Treating customers fairly

Rachelle Best, Associate Director

The discussion paper, *Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework for South Africa*, was issued in January 2015.

The market conduct policy framework forms part of the Twin Peaks reform process. It proposes a regulatory and supervisory framework for the new FSCA.

This discussion paper is the first attempt to develop a comprehensive framework to govern how the market conduct regulator will operate in order to ensure that financial institutions treat their customers fairly.

Poor customer outcomes in South Africa’s financial services sector have highlighted the need for stronger oversight of how financial institutions conduct their business and treat their customers. To better protect customers, the financial sector must be held to higher standards than generic consumer protection, and standards must be applied consistently across the sector.

The following is proposed in the policy document:

- The consolidation of various pieces of market conduct legislation applicable to the financial sector;

- Empowerment of the FSCA to supervise institutions more intensively, monitor compliance with rules and take strict corrective actions against financial institutions in breach of conduct requirements.
- Supporting improved market conduct by better empowering financial customers. This includes improving the ombud system so customers can easily and effectively lodge disputes against financial institutions, and refining financial education initiatives.

Banking regulation

Banks Act Amendment Bill

Irwin Lim Ah Tock, Director

In November 2014, the *Banks Amendment Bill* was published by the Minister of Finance for tabling in the National Assembly. The Bill seeks to amend the powers of a curator by revising provisions of the current Banks Act that are considered ‘unnecessarily stifling’ to the curator’s efforts to rehabilitate banks under curatorship.

In brief, the bill provides greater power to the curator to transfer the assets of a bank under curatorship than previously allowed. It also provides for the curator

to make decisions on behalf of the bank’s corporate shareholders, while previously this was only possible on behalf of individual shareholders. Finally, the amendment would enable the curator to raise funds and provide such security over the assets as necessary. Previously, the Act was silent on this issue.

The bill is expected to be tabled in parliament in Q2.

SARB directives, circulars and guidance notes

Directive 9: Restructured exposures

Ryno Swart, Associate Director

The SARB published *Directive 9/2014* in December 2014 to provide banks with reporting directions regarding the treatment of advances subject to distressed restructuring. It does not change any of the existing requirements in the Banks Act Regulations.

Although the Directive is aimed at regulatory capital calculations, it makes it clear that it is only intended to emphasise the requirements of IAS 39 with regard to impairment and not contradict them

in any way. If the Directive results in a significant divergence between accounting and regulatory treatment, banks will have to reassess the appropriateness of their accounting policies in terms of IAS 39.

The Directive provides guidance on how to identify distressed restructures. It then sets minimum requirements for the classification and treatment of these restructured advances in the regulatory capital calculations and related disclosures. It further sets out specific requirements that have to be met before these advances can be regarded as being rehabilitated.

Some of the potential challenges that banks may face include:

- Systems are often not designed to keep an accurate history of restructured accounts. A further challenge could be for existing systems to track the length of time an account has been performing in line with the restructure or whether it was a distressed restructure.
- The requirements of the Directive could result in significantly more conservative treatment than current practice in some cases. For example, for a restructured loan to be classified as performing, all arrears at the time of going into the restructure have to have been caught up. Also, the Directive requires that

restructured exposure should remain in ‘default’ for as long as the restructure is impaired, which makes it unlikely that they will emerge from the default bucket.

- The Directive is likely to result in further divergence between accounting impairments and regulatory capital calculations.
- Banks may face challenges in determining exactly when a restructure has taken place, specifically at which stage during the debt review application process a loan would be regarded as a distressed restructure.

The Directive is effective as from 1 December 2014.

Directive 4/2015 – Amendments to the Regulations relating to Banks

Lindy Riphagen, Senior Manager

The SARB issued *Directive 4/2015* on the recent RCAP review findings on 25 March 2015.

As a member of the Basel Committee, South Africa’s legal framework in terms of which the SARB regulates and supervises banks is subject to ongoing international assessments and reviews, which include matters related to completeness and

comparability. Any identified area of incompleteness or non-comparability results in the implementation of an appropriate amendment.

This Directive accordingly specifies 40 such areas requiring amendment. In most cases, amendments merely represent changes to fully align the wording of the Regulations with the various Basel frameworks on which they are based. However, the most significant changes arising from the RCAP are addressed in separate circulars relating to credit valuation adjustment and minority interest as indicated below.

The Directive is applicable from the date of issue.

Directive 5/2015 on the capital requirements for over-the-counter derivatives not transacted through a central counterparty

Dennis Musau, Senior manager

In terms of *Directive 5/2015*, issued on 26 March 2015, banks are required to treat both ZAR-OTC and local-OTC derivatives that are not cleared through either a domestic or non-domestic central counterparty (CCP) as bilateral trades.

Banks are also required to treat all OTC derivatives that are transacted through a CCP that has not been declared a licensed clearing house under the Financial Markets Act 19 of 2012 as transactions through a non-qualifying CCP.

Banks are required to report and calculate the capital requirement for the default risk component of CCR on the basis of the capital requirements for trades through non-qualifying CCPs, as specified in the Regulations.

These OTC derivatives will carry a CVA capital charge. This proposed Directive therefore removes the previous CVA exemption applied to such trades.

The directive is effective from 1 April 2015.

Directive 3/2015 on matters related to the composition of Pillar 3 capital disclosure requirements

Dennis Musau, Senior manager

The *Directive* specifies the application of the composition of Pillar 3 capital disclosure requirements relating to:

1

The location and archive period: Banks and controlling companies are to publish the composition of their capital disclosures on their websites as part of their disclosures either in the financial statements, or on a website. If on a website, the financial statements to provide a link to the site. Banks should also provide on their websites an archive of all their Basel III capital disclosures, for not less than five years.

2

Capital disclosure template: Banks are required to use a capital disclosure template to provide a breakdown of the composition of their regulatory capital. No alterations may be made to the template. The template is to be disclosed on a semi-annual basis or as often as the financial statements are published.

3

Reconciliation requirements: Banks should prepare a full reconciliation between all instruments and reserves qualifying as capital and reserve funds, and the balance sheet in the financial statements using the three-step approach outlined in the rules text, paragraphs 10-26. This reconciliation is to be disclosed on a semi-annual basis or as often as the financial statements are published.

4

Main features template: Banks are to use a template to disclose the main features, terms and conditions of all relevant capital instruments issued. The required main features template report shall be disclosed (a) semi-annually; or (b) whenever capital instruments are issued and included in qualifying capital and reserve funds; or (c) whenever there is redemption, conversion, write-down, or any other material change in the nature of an existing capital instrument.

The Directive is effective from the first financial statements published after 30 June 2013.

Matters related to specified minority interests, that is, non-controlling interests, in shares and/or instruments qualifying as capital

Dennis Musau, Senior manager

In calculating the surplus capital related to minority interest, *Circular 2/2015* requires the capital requirement of the subsidiary to be based on the relevant minimum requirement for CET1, AT1 and T2 of the bank for which the consolidation is performed, plus the relevant capital conservation buffer.

The relevant minimum capital requirement referred to above for CET1, AT1 and T2 shall be the relevant South African base minima specified from time to time, which includes the Pillar 2A requirement but now excludes the Pillar 2B or bank-specific individual capital requirement (ICR) add-on. The capital conservation buffer, countercyclical buffer and domestic systemically important bank (D-SIB) capital add-ons are specifically included in the relevant minimum requirements, as imposed on the registered controlling company or registered local bank.

During the transitional phase-in period of the South African base minima and certain buffer requirements, the relevant percentage referred to above shall be the minimum requirements as at 1 January 2019.

The Circular is effective as from 1 April 2015.

Application process to adopt the advanced measurement approach for measuring banks' operational risk exposure

Stephen Owuyo, Associate Director

On 9 February 2015, the SARB issued Guidance Note 3/2015, titled *Application process to adopt the advanced measurement approach for measuring banks' operational risk exposure*. This guidance note replaces Guidance Note 7/2014. The purpose of this note is to inform all banks of the process to be followed and information to be submitted when applying to adopt the *advanced measurement approach*.

The guidance is prospective and sets out the information to be submitted by a bank wishing to make an application to adopt the AMA approach. The application process has two stages:

1

Stage 1: Submission of a high-level summary of the bank's AMA implementation plan (similar to what would be presented to the board of directors of the bank);

2

Stage 2: Providing the detail supporting the summary in Stage 1.

Banks are required to notify the Registrar of Banks of their intention to adopt AMA at least six months prior to submission of formal written application and the office requires 18 months to consider the application.

Key to the application process is for the bank to demonstrate that management have applied their minds in the application process and that the bank is ready and able to meet the more demanding requirements of the AMA approach.

Guidance on application of the in duplum rule

Proposed guidance on S103(5) of the National Credit Act – Government Gazette No. 38419, 30 January 2015

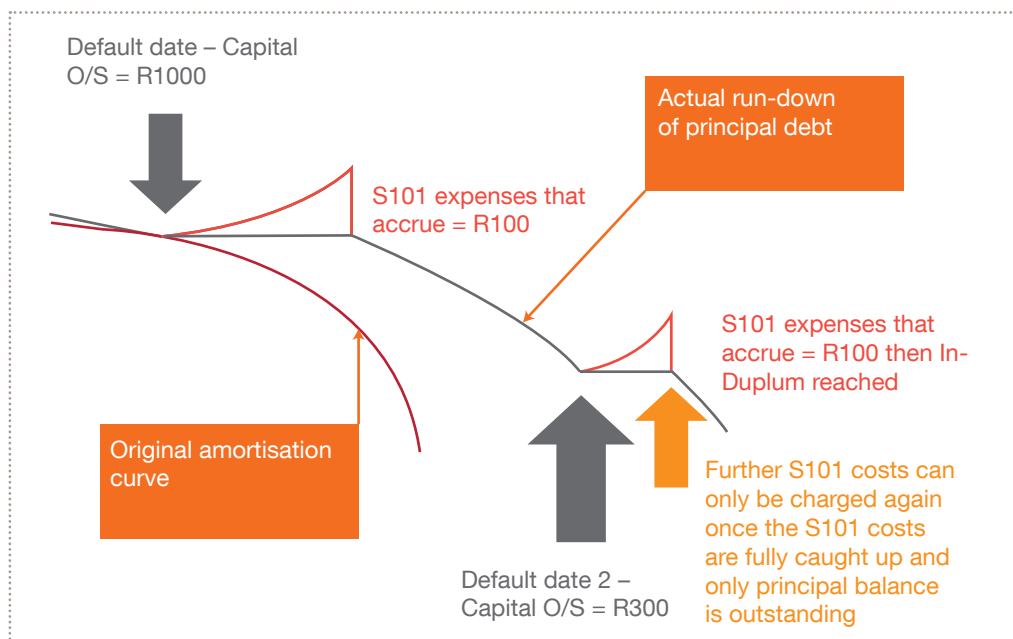
Ryno Swart, Associate Director

New proposed guidance has been issued with regards to the application of the *in duplum rule*. The guidance stems from uncertainty in the credit industry about how to apply the rules and closed for comment on 27 February 2015. The *in duplum rule*, as outlined in Section 103 (5) of the National Credit Act (NCA), states that:

Despite any provision of the common law or a credit agreement to the contrary, the amounts contemplated in section 101(1)(b) to (g) that accrue during the time that a consumer is in default under a credit agreement may not, in aggregate, exceed the unpaid balance of the principal debt under that credit agreement as at the time that the default occurs.

The amounts set out in sections 101(1) (b) to (g) are initiation fees, service fees, interest, cost of credit, insurance, default administration charge and collection costs.

The requirements of the proposed guidance are summarised on the following page.



- S101(1) expenses are measured from the point of any default on a loan (first or subsequent). Therefore, if a loan defaults close to maturity, the principal against which *in duplum* is measured is likely to be small regardless of whether the loan has defaulted previously.
- When a loan defaults for a second time expenses that accrued in terms of S101(1) during previous periods of default are also taken into account. Aggregated expenses accumulated during all previous periods of default therefore have to be taken into account.

- The operation of section 103(5) is not affected by the commencement of legal proceedings by the credit provider or debt collector against the consumer. This means that costs relating to legal proceedings will speed up the accumulation of S101(1) costs and the point at which *in duplum* is reached.

Credit providers will need to consider:

- Whether their systems are sufficiently customised to:
 - Keep track of defaults and cures as set out in the guidance;

- Accurately allocate payments received to S101(1) costs versus principle debt;
- Keep track of aggregate accumulated S101(1) costs over multiple periods of default; and
- Purge the charging of further costs once in duplum is reached.
- Whether it is worthwhile to pursue smaller amounts outstanding since accumulated S101(1) costs would reach their S103(5) limit fairly quickly with no possibility of recovery.

Regulation: International announcements

Capital and liquidity

Basel Committee revising Pillar 3

The Basel Committee published *Revised Pillar 3 disclosure requirements* on 28 January 2015. The most significant changes relate to the use of templates for quantitative disclosure. The Basel Committee wants to enhance the comparability of banks' disclosures, both between banks and over time for an individual bank. It also focuses on improving the transparency of internal model-based approaches that banks use to calculate minimum regulatory capital requirements.

Firms will have to disclosure and attest that disclosures have been prepared in accordance with board-agreed internal control processes. The revised requirements take effect from the end of 2016.

Restoring confidence in capital

The Basel Committee published its *Work Programme for 2015 and 2016* on 21 January 2015. Much of its work will be geared towards reviewing existing methods of measuring risk-weighted assets. It will consider the use of simple, transparent and comparable criteria for securitisations, the fundamental review of the trading book and interest rate, credit and operational risk in the banking book.

The Basel Committee also plans new initiatives to:

- Review the regulatory treatment of sovereign risk;
- Assess the interaction, coherence and overall calibration of the reform policies; and
- Assess the role of stress testing in the regulatory framework in light of national developments.

The Basel Committee will continue to monitor its members' implementation of the Basel framework via the RCAP. This year the RCAP will be expanded to also cover liquidity standards and the frameworks for G-SIBs and D-SIBs.

Banks struggle with risk management principles

The Basel Committee published its second report on *Progress in adopting the principles for effective risk data aggregation and risk reporting* ('Principles') on 23 January 2015. The 2013 Principles strengthen risk data aggregation and risk reporting at banks to improve risk management practices and decision-making processes. Firms designated as a G-SIB are required to implement the Principles in full by 2016.

The Basel Committee outlines the measures G-SIBs took to improve their overall preparedness for compliance with the Principles during 2014. While G-SIBs are increasingly aware of the importance of implementing the Principles, 14 of the 31 participating banks reported that they will be unable to fully comply by the 2016 deadline, compared with 10 G-SIBs in 2013.

Securities and derivatives

IOSCO promotes derivative certainty

IOSCO outlined nine standards to reduce uncertainties in derivatives markets in its final report on *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* on 28 January 2015. It published these to support the *margin requirements for non-centrally cleared OTC derivatives* published jointly with the Basel Committee in 2013.

IOSCO's recommendations cover all major players in the non-centrally cleared OTC derivatives market. Financial entities and systemically important non-financial entities that use non-centrally cleared OTC derivatives should employ the risk mitigation techniques IOSCO recommends. It proposes these firms establish policies and procedures to:

- Document the trading relationship with their counterparties before executing a non-centrally cleared OTC derivatives transaction, including all material terms governing the relationship;
- Ensure the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practical;

- Reconcile with counterparties the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio; and
- Regularly assess and engage in portfolio compression.

Firms must agree and document the process for determining the value of each transaction at any time, and the process for determining when discrepancies in material terms or valuations should be considered disputes. IOSCO wants regulatory authorities to collaborate to minimise inconsistencies in risk mitigation requirements across jurisdictions, and to implement the standards as soon as possible.

LEI goes online

On 26 January 2015 the GLEIF launched its new *website* in a further step to make LEI information available. The GLEIF, established by the FSB in 2014, manages the worldwide development of LEIs.

The site enables communication with the GLEIF and sets out instructions for obtaining an LEI from local operating units. In late 2015, the GLEIF expects the website functionality will allow LEI participants to access the database of all LEIs issued globally and their associated reference data.

Insurance and investment management

In this section:

Tax free savings and investment accounts

New governance, risk management and internal control requirements for insurers

Tax free savings and investment accounts

Julanie Basson, Associate Director

Draft Legislation: Final Notice and Regulations for Tax Free Savings and Investment Accounts (TFSAs) with effect from 1 March 2015 (the start of the new tax year) has been approved by the Minister of Finance and was gazetted in February 2015.

This incentive is an important initiative of Government to create a culture of savings and to encourage South Africans to reduce household indebtedness and vulnerability. It complements initiatives and incentives to promote retirement savings and will also support long-term economic growth in South Africa.

Such a vehicle should be comprised of interest bearing and equity accounts. Earnings (interest and dividends) and growth (capital gains) will be exempted from income, dividend and capital gains tax.

Contributions will be made from after-tax income, and will be capped at an annual limit of R30 000 and a lifetime limit of R500 000 per individual. These limits are expected to be adjusted over time to take account of inflation.

The compounding effect of this savings vehicle is quite clear if we look at the maximum annual investment spread monthly into even instalments.

Value at maturity

Monthly saving	Lump sum after 16 years 8 months	Lump sum after 16 years 8 months
	6% return	15% return
R2 500	R800 000	R2 200 000

The success of this proposed tax-free vehicle is arguably dependent on affordability. Recent press articles suggest that consumer credit levels are at their highest since 2006, which raises further concerns about individuals' ability to adopt a culture of saving.

New governance, risk management and internal control requirements for insurers

Gerda Burger, Senior Manager

The FSB released Board Notice 158 of 2014 in December 2014, which became effective on 1 April 2015. The Board Notice introduces a corporate governance, risk management and internal control framework for South African insurers.

The framework forms part of the interim measures of the FSB's SAM regime and aligns the South African insurance market with the principles of the IAIS for insurance supervision and regulation.

The framework follows a principles-based approach, which is intended to be proportionate to the nature, scale and complexity of insurers' businesses and risks, but sets out certain minimum requirements in respect of the governance, risk management and internal controls of insurers.

Key proposals of the Board Notice:

- Insurers are required to adopt, implement and document an effective governance framework to ensure the prudent management and oversight of insurers and to adequately protect the interests of policyholders;
- The insurer's board of directors are responsible for the effective governance and risk management of the insurer;
- Each director of an insurer must at all times comply with the fit and proper policy of the insurer, act in the best interest of the insurer and policyholders, and exercise independent judgement and objectivity in decision-making;
- Insurers must establish risk and remuneration committees and the chairpersons of these as well as the board must be an independent director;
- Insurers must establish and maintain an effective risk management system, comprising strategies, policies and procedures for identifying, assessing, monitoring, managing and reporting of all material risks to which the insurer may be exposed. The risk management system should include an adequate written overall risk management policy and specific prescribed component policies; and

- Insurers must establish, maintain and operate within an adequate and effective internal control system. The internal control system should consist of strategies, policies, procedures and controls to provide the board of directors with reasonable assurance from a control perspective that the insurance business is operated in line with the insurer's strategy, objectives, policies and procedures, while also complying with applicable legislative requirements.

The Board Notice also requires insurers to establish and maintain the following control functions:

- A risk management function;
- A compliance function;
- An internal audit function; and
- In the case of a long-term insurer, an actuarial function.

These functions must be structured to ensure that they each have the necessary authority, independence, resources, expertise and access to the board of directors. These functions may be outsourced.

The Board Notice sets out the minimum requirements for each of the control functions and an insurer needs to appoint a person as the head of each control function to ensure the performance and responsibilities of the control function is achieved.

The risk management, compliance and actuarial control functions must be regularly reviewed by an insurer's internal audit function or an objective external reviewer and the internal audit function must be regularly reviewed by an objective external reviewer.

The corporate governance, risk management and internal control requirements as set out in the Board Notice will have an impact on insurer's existing business structures. Although certain of the required structures, policies and processes are in place in various forms at insurers, there are now more onerous and specific requirements set out in the legislation.

Insurers will have to assess their current governance structures and practices. They also need to formalise and document their policies, procedures and controls to meet the requirements of the Board Notice.

As the Board Notice is principles based, in many instances insurers will have to define for themselves and be able to motivate their approach to apply these new regulatory principles.

Once the Board Notice is effective, insurers will also be expected to be able to evidence compliance with the principles of the Board Notice to the regulator.

Taxation

In this section:

Life tax reform process and changes

Life tax reform process and changes

Seema Ranchhoojee, Associate Director

Since the 2013 Budget and continuing into the most recent budget, the minister announced that there would be changes to the corporate tax regime for life insurance companies in South Africa. There were a number of factors motivating these changes, some of the most important being:

- The implementation of the SAM, effective 1 January 2016. As a result of this implementation, the current regulatory measurement basis for policyholders will require change;
- An outdated tax regime that required modernisation compared to other jurisdictions and a simplification of some elements of the four-funds tax system, as well as assessing the adequacy of the total tax contributed to the fiscus by long-term insurers was also needed; and
- A refinement of the tax framework to be equitable between industries and also different players within the same industry.

There was some uncertainty as to whether the reform would be a complete overall of the existing regime and a move to a totally new regime. This has not been the case and only changes to certain aspects of the legislation, focusing on the areas where uncertainty existed, or where the legislation was open to exploitation, have been applied. These amendments encompass the following:

- The change to the expense ratio applicable to policyholder funds was introduced in 2013 and anomalies relating to this expense ratio were refined in 2014;
- The introduction of the taxation of risk business and foundation of the RPF was established in 2014, effective 1 January 2016; and
- The taxation of foreign reinsurance on investment products was introduced effective 1 December 2014.

Life tax reforms are likely to continue and expectations for future consideration and planning as well as changes already seen include:

- Valuation of liabilities on an IFRS adjusted basis as announced by the minister during the 2015 Budget;
- Possibility of refinements to section 29A of the Income Tax Act No.58 of 1962 coming through when IFRS 4 Phase II is introduced; and
- Further clarification of probable uncertainties pertaining to the RPF to be considered, some which are pre-empted:
 - Definition of the RPF;
 - What the meaning of IFRS 'adjusted' for purposes of the valuation of liabilities is; and
 - The interpretation of what policies would fall into the new RPF.

Accounting updates

In this section:

Financial accounting

Financial accounting

Bruce Thomas, Associate Director - Accounting Consulting Services

Consolidated financial statements Q&As

IFRS 10 'Consolidated financial statements' and IFRS 12 'Disclosure of interests in other entities' were issued in May 2011. IFRS 10 retains the key principle of IAS 27 and SIC 12: all entities that are controlled by a parent are consolidated. But some of the detailed guidance is new and may result in changes in the scope of consolidation for some parent companies.

Experience suggests that the new requirements will have the greatest impact on consolidation decisions for structured entities (i.e. SPVs) and for pooled funds managed by a third party.

PwC's *In depth* series publication, [*IFRS 10 and 12 – Questions and answers*](#), sets out our views on some of the most common issues that arise during the implementation of the new standards. For further guidance on IFRS 10, see our [*Practical guide to IFRS: Consolidated financial statements – redefining control and IFRS 10 for asset managers*](#).

Hedging in practice

Many companies are now considering IFRS 9 the new accounting standard for financial instruments. IFRS 9 addresses all the relevant aspects of the accounting for financial instruments, including classification and measurement, impairment of financial assets and general hedge accounting.

Our [*IFRS 9 Hedging in Practice – Frequently asked questions*](#) focuses on general hedge accounting under IFRS 9.

IASB Investor Update - January 2015

[*IASB Investor Update - Our newsletter for the investment community - January 2015*](#) includes discussion of judgements and estimates in revenue recognition.

IFRS for SMEs – January 2015

Our January 2015 [*IFRS for SMEs Update*](#) includes the following discussions:

- IASB meetings on the comprehensive review of the IFRS for SMEs;
- Adopting the IFRS for SMEs in Uruguay;
- Upcoming 'train the trainers' workshops;

- IFRS for SMEs translations: status report; and
- Where to obtain IFRS for SMEs materials.

Expected credit loss disclosures

IFRS 9 introduces significant additional disclosure requirements relating to credit risk and expected credit loss allowances. Understanding the data and systems needed to meet these new requirements will be critical to ensuring the completeness of IFRS 9 project scopes, thereby avoiding revisions later in the project that could be costly and jeopardise project timings.

Simply replicating the illustrative disclosures included in IFRS 9 risks missing key information requirements. Considering these disclosure requirements as part of the broader consideration of internal management reporting and investor communications will also likely deliver significant benefits. Our *In depth* series publication [*IFRS 9: Expected credit loss disclosures for banking*](#) sets out key considerations and what they will mean in practice.

Basel Committee guidance on accounting for expected credit losses

On 2 February 2015, the Basel Committee issued for consultation 'Guidance on accounting for expected credit losses'. The guidance will impact banks implementing IFRS 9 and is designed to drive consistent interpretations and practice. The consultation period ends on 30 April 2015.

The new guidance will replace supervisory guidance on Sound Credit Risk Assessment and Valuation for Loans (SCRAVL) issued in 2006. The guidance was prompted by the International Accounting Standards Board (IASB) issuing IFRS 9 'Financial Instruments' in July 2014 with its requirement to adopt an expected credit loss (ECL) model for impairment, as well as the FASB project to develop a new US GAAP accounting standard that will also include an ECL accounting model.

As well as setting out 11 principles for supervisory requirements for sound credit risk practices and the supervisory evaluation of credit risk practices, the guidance also contains an appendix relating specifically to IFRS 9 covering:

- 12-month ECL allowances;
- Assessment of significant increases in credit risk; and
- The use of practical expedients.

The guidance only covers credit risk practices for lending exposures, with other bank exposures such as debt securities being outside the scope of the guidance.

Impact

The impact of the proposed guidance will require detailed consideration and depend on the specific circumstances of individual banks. As the guidance is principles based, its impact will also depend on territory supervisor interpretation and application. Nevertheless, key aspects of the guidance likely to have the greatest impact if implemented, as well as other areas respondents may want to comment on, include:

- **Increased expectations**

The Committee has significantly heightened supervisory expectations that internationally active banks, and those banks more sophisticated in the business of lending, will have the highest-quality implementation of an ECL accounting framework.

- **Cost**

The objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses. This will potentially require costly upfront investments in new systems and processes that should not be considered 'undue cost or effort'.

- **Less complex banks**

Supervisors may adopt a proportionate approach that will allow less complex banks to adopt approaches commensurate with the size, nature and complexity of their lending exposures.

- **Practical expedients**

Use of practical expedients, such as a 30-days-past-due criterion for a significant increase in credit risk, should rarely be used given the potential to introduce significant bias in ECL calculations.

- **Significant increase in credit risk**

It is necessary to look beyond how many 'notches' a rating downgrade entails because the change in default probability for a one-notch movement is not linear and a significant increase in credit risk could occur before even a one-notch downgrade.

- **Dynamic groupings**

Lending exposures should be dynamically grouped and regrouped to ensure they remain homogenous in their response to credit risk drivers.

- **More disclosure**

A number of additional disclosures are expected, including details of differences between regulatory and accounting data and assumptions, as well as sensitivities to changes in the main assumptions.

- **Interaction with IFRS 9**

The guidance is not intended to conflict with IFRS 9, but to narrow different interpretations and practices through the application of consistent and sound credit risk practices.

Our In Brief publication 'Basel Committee guidance on accounting for expected credit losses – first impressions' summarises the key aspects of the guidance likely to have the greatest impact if implemented, as well as other areas respondents may want to comment on.

Other

In this section:

International announcements

Key dates

International announcements

IOSCO published its *Comparison and Analysis of Prudential Standards in the Securities Sector* final report on 24 February 2015. It highlights similarities, differences and gaps among the different international frameworks for securities commissions with a view to updating its 1989 report on *Capital Adequacy Standards for Securities Firms* in light of the identified issues.

In 2014 IOSCO consulted on two regulatory and supervisory areas that might be considered in an update of its 1989 report: regulatory arbitrage opportunities created by differences across jurisdictions and the use of internal risk models that may leave the system undercapitalised.

IOSCO concluded that it was not possible to determine whether the capital requirements in one jurisdiction are more onerous than another, chiefly because supervisory discretion and the use of internal models makes numerical comparisons misleading. But if felt it did not need to make any further amendments to the 2014 or 1989 reports because it felt that overall prudential standards were sufficient to address its concerns.

IOSCO published its *Review of the Implementation of IOSCO's Principles for Financial Benchmarks* on 25 February 2015. It assesses the voluntary market adoption of its principles and covers 36 separate benchmarks. The Review found that only a third of benchmark administrators considered themselves to be fully compliant with the principles.

Almost half of administrators are in the process of either implementing procedures to comply with the Principles or are still addressing their compliance requirements. It found the biggest improvement was in governance arrangements, including the introduction or strengthening of oversight committees, new or formalised policies and training on conflict of interest management and whistleblowing. Boards were reported to have heightened levels of interest in the benchmark setting process.

IOSCO concluded that further steps may be necessary, but concedes that it is too early to say what those steps should be. It does not have the power to enforce implementation of its Principles, but encourages its members to implement them as well as they can.

On 4 March 2015 the Financial Stability Board and IOSCO published a second public *Consultative Document* on its assessment methodology for identifying global systemically important financial institutions that are neither banks nor insurers (NBNI G-SIFIs).

As most of the original responses highlighted disagreements around assessing asset management systemic risk, the revised guidelines present separate methodologies for investment funds and asset managers. Upon receipt of responses, the FSB and IOSCO look to finalise the methodologies by the end of 2015.

The proposed methodologies seek to identify NBNI financial entities whose distress or disorderly failure, because of their size, complexity and market interconnectedness, could lead to larger financial instability. Because most NBNI are primarily regulated from a conduct as opposed to prudential perspective, IOSCO and the FSB hope that a universally accepted set of methodological principles can help address some of the data and information gaps that currently exist around systemic risk.

The process of identifying NBNI G-SIFIs requires looking at different types of entities from different industries with differing legal forms, business models and risk dynamics. Consequently, the proposed methodology combines cross-sector risk factors along with sector-specific criteria.

The basic set of impact factors include:

- Size;
- Interconnectedness;
- Substitutability;
- Complexity; and
- Cross-jurisdictional activities.

One notable difference between the initially proposed methodology and the current version is that leverage is now a bigger consideration for determining whether investment funds meet the size criteria thresholds.

As the proposed methodologies will not only inform international data gathering and systemic risk monitoring, but will also potentially shape national initiatives to apply prudential regulation to NBNI financial entities, firms should carefully assess whether they could potentially be labelled as systemically important under the proposed methodology.

The consultation will end on 28 May, 2015.

Key dates

1 January 2014	Official opening date to register FFIs and obtain Global Intermediary Identification Number (GIIN).
9 June 2014	The Government of the Republic of South Africa and the Government of the United States of America signed an intergovernmental agreement to improve international tax compliance and to implement the provisions of FATCA.
1 July 2014	Reporting South African Financial Institutions (Foreign Financial Institutions under FATCA) are required to obtain information on reportable accounts.
1 July 2014	Enhanced account opening procedures must be in place to establish the FATCA status of new individual accounts.
1 January 2015	Enhanced account opening procedures and systems must be in place to establish the FATCA status of new entity accounts.
30 June 2015	Information required for the first reporting period must be submitted to SARS. Thereafter the required information must be submitted annually at the end of May for the reporting period ending February.

Glossary

FS	Financial services	D-SIB	Domestic Systemically Important Bank
BCBS	Basel Committee on Banking Supervision	AMA	Advanced Measurement Approach
EBA	European Banking Authority	IOSCO	International Organization of Securities Commissions
BoE	Bank of England	GLEIF	Global Legal Entity Identifier Foundation
PRA	Prudential Regulation Authority	RCAP	Regulatory Consistency Assessment Programme
FSRB	Financial Sector Regulation Bill	TFsAs	Tax Free Savings and Investment Accounts
SARB	South African Reserve Bank	SAM	Solvency Assessment and Management
FSCA	Financial Sector Conduct Authority	RPF	Risk Policy Fund
IAS	International Accounting Standards	SCRAVL	Sound Credit Risk Assessment and Valuation for Loans
RCAP	Regulatory Capital Assessment Programme	IASB	International Accounting Standards Board
CCP	Central counterparty	ECL	Expected credit loss
OTC	Over the counter	FATCA	Foreign Account Tax Compliance Act
CVA	Credit valuation adjustment	FFIs	Foreign Financial Institutions – foreign to the USA
ICR	Individual capital requirement	GIIN	Global Intermediary Identification Number

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