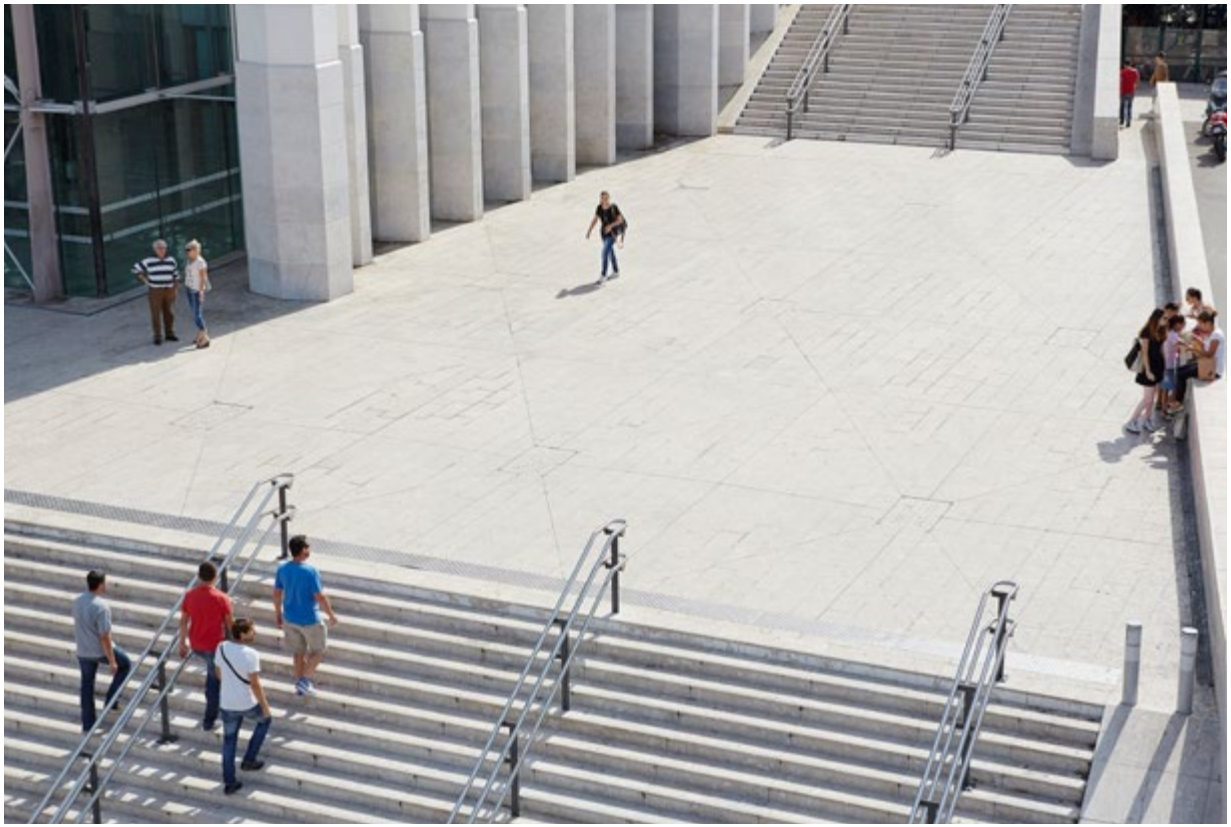
Being better informed

FS regulatory, accounting and audit bulletin



September 2016

- Financial Crime in the Spotlight
- Summary of the 2016 Retirement Fund Strategic Matters and Remuneration Survey
- Blockchain – disrupting central banks?
- Basel III monitoring gets going
- SARB Circular 4 of 2016: Implementation of the capital conservation buffer
- Insurance contracts project update
- Tax implications of the proposed TLAB amendments affecting banking institutions

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Executive Summary

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

The period since our previous publication in May 2016 has been eventful, with the outcome of the UK's EU referendum taking centre stage on the news agenda globally and across the FS industry in particular.

While it is still too early to meaningfully predict the longer-term consequences for emerging market economies, including South Africa, there are clearly many details to be worked through at a European level given the referendum result.

The significant financial market volatility experienced in the immediate aftermath of the referendum result in some ways serves as a reminder of the highly interconnected nature of the global financial system.

At the same time, these events underscore the need for financial institutions and regulators to maintain focus on the continued resilience of the global financial system. If anything, this means that the pace of delivering an already busy FS regulatory agenda is more than likely to continue – if not accelerate.

Beyond economic risks, financial crime has become a greater focus as a number of recent high-profile cyber attacks highlighted why cybercrime, and technology risk more broadly, ranks as a critical cross-industry risk globally.

These incidents remind us why FS institutions and banks in particular need to already be proactively dealing with the sinister implications of cybercrime. Failure to adequately manage them have direct consequences that range from outright financial losses and possible regulatory non-compliance to potentially severe reputational damage. Our anchor article in this edition summarises the results of our *Global Economic Crime Survey* and unpacks these important topics in more detail. Among other areas, the survey provides insight into the importance of firms maintaining a robust system of controls aimed at anti-money laundering (AML) and combating the financing of terrorism (CFT), and the challenges this poses. In light of recent supervisory sanctions for some South African banks, AML/CFT control weaknesses remain topical and high on the supervisory agenda.

In terms of global regulatory activity, the EBA published the results of its 2016 stress test at the end of July. The authority gave most EU lenders a relatively clean bill of health, concluding that they were in a better position than a year ago. However, stresses remain within the European banking sector to different degrees across individual jurisdications.

Italian banks were again in the spotlight, with one bank seeing its capital ratio drop to a negative figure under the adverse stress scenario, while there were also some concerning results for Irish and Austrian banks.

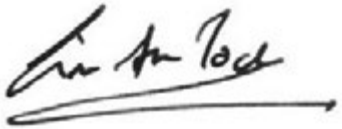
Looking at the prudential regulatory agenda, the Basel Committee has been busy as well, most recently updating the securitisation framework regarding the capital treatment for simple, transparent and comparable (STC) securitisations. Earlier in the year, the Committee consulted on topical revisions to the IRB approach towards calculating credit risk-weighted assets. The proposals aim to address variability in the capital requirements for credit risks through prohibiting the use of the IRB approach for certain portfolios and the implementation of model-parameter floors. Given the significance of the changes, it will be interesting to follow industry comments to the consultation. Depending on the form of the final rules, these floors may likely create a need for banks to maintain simultaneous calculations of standardised and model-based approaches for credit risk purposes.

The changes proposed by the Committee to the standardised approaches for credit, market and operational risks – together with numerous other revisions – will impact on banks' capital management processes and could have material implications for systems and data requirements and individual product lines.

Meanwhile, the SARB has issued final amendments to the Banks Act Regulations, effective 1 July 2016. These amendments are an important part of maintaining a domestic legal framework that remains reflective of market developments and aligns with the evolving international regulatory framework and supervisory best practices.

From a tax perspective, the Taxation Laws Amendment Bill (TLAB) has a wide impact on FS institutions. As an example, refinements made to provisions for collateral and securities lending arrangements will impact the banking and pension fund industries directly. Additonally, the implementation of SAM in 2017 for insurers also received specific consideration within the TLAB.

We trust you will find our latest edition of *Being Better Informed* an insightful read. Any thoughts you may have on how we can further enhance the publication are welcomed.



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Content

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.

Financial Crime in the Spotlight

The results of PwC's 2016 Global Economic Crime Survey give a clear indicator that financial crime is rapidly evolving. Combating fraud is no longer the only financial crime at the top of the agenda. Today's line-up of financial crimes includes an array of 'newcomers' that were unknown or not previously considered a threat.

Summarised by Bela Carvalho

Financial crime has grown to the point where it now includes, among others, asset misappropriation, cybercrime, bribery and corruption, money laundering, to intellectual property infringement, insider trading, competition law infringement and corporate espionage.

Criminal methodologies, and therefore the risks associated with financial crime, are evolving. Banks and other FS institutions are now finding it difficult to keep up to date not only with the increasing pace of regulatory change but also with managing financial crime risk.

This is especially the case with cybercrime – the second most reported crime in PwC's *2016 Global Economic Crime Survey*.

Although many banks have benefited from the rapid development of technology, using it to streamline and expedite their day-to-day operations, they also face a series of new risks associated with their dependence on these technologies. The introduction of internet and mobile banking, and the emergence of virtual currencies have undoubtedly aggravated the challenges banks already face in managing financial crime risk. The anonymous nature of these activities has allowed criminals to manoeuvre criminal proceeds across the globe with little fear of detection.

Of greater concern, however, is that very often these 'new age' financial crimes do not occur in isolation. A cyber attack is often followed by a fraudulent act and the subsequent laundering of funds.

There have been a spate of high-profile cybercrime incidents involving victims ranging from international payment networks to central banks which have highlighted the boldness and sophistication of financial crime threats. Incidentally, one of the more publicised incidents would have gone down in history as one of the largest online cash heists, but for a spelling mistake made by the hackers. Hackers misspelled "foundation" as "fandation", prompting a routing bank to request clarification and ultimately stopping the settlement of the majority of the transaction.

Closer to home, instances of financial crime within the South African FS industry have also become more prominent in recent periods through certain high-profile, well-publicised incidents. At the same time, weaknesses in AML/CFT controls have been highlighted by South African regulators by means of recent supervisory sanctions. Our survey identifies that only approximately 50% of money-laundering and terrorist-financing incidents in FS firms are being detected by system alerts, while almost one in three SA firms experiences difficulty in sourcing personnel with skills in the areas of AML/CFT.

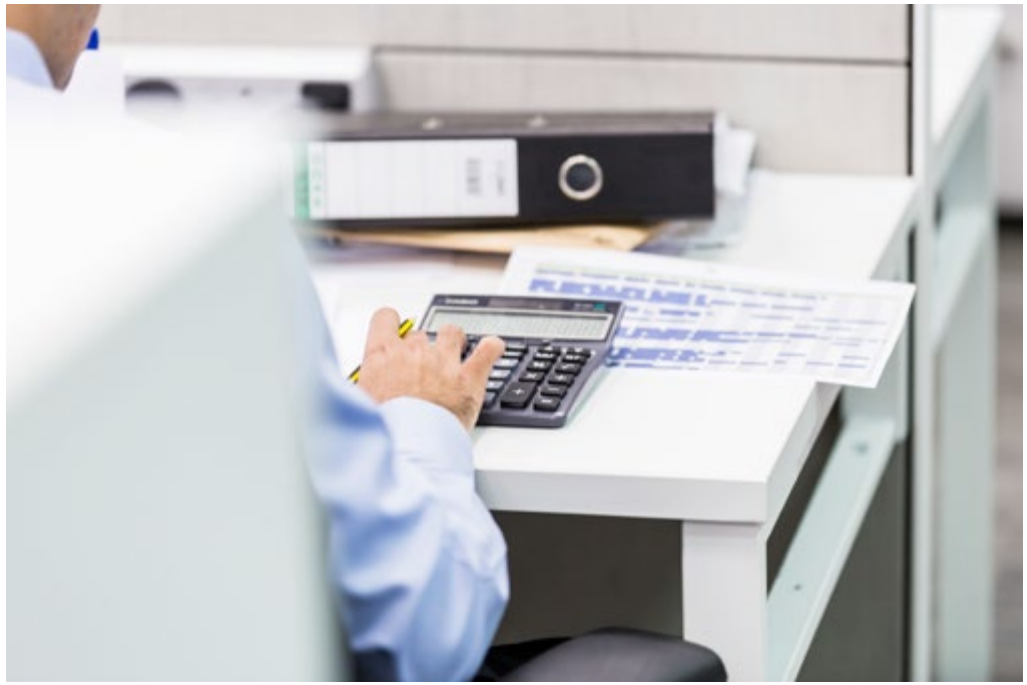
Both globally and domestically, where high-profile incidents of cybercrime occur the root cause can usually be traced back to a breach in the protection of personal data. Although advancements

in monitoring services may give FS institutions the ability to detect anomalies early on, they do little to prevent data theft.

The Financial Intelligence Centre (FIC) Amendment Act, currently being finalised, will place more responsibility on senior management, compliance functions and boards to ensure that their organisations and employees comply with the new requirements. The legislation requires accountable institutions to adopt a risk-based approach by implementing a comprehensive risk management and compliance programme. New client identification and verification measures have also been introduced, requiring accountable institutions to take a closer look at clients that pose a 'higher risk'. Penalties of up to R10 million may be imposed on individuals who have failed to ensure compliance with the provisions of the Act; in addition, these individuals may be 'named and shamed'. The FIC's powers will also be enhanced to gather information from a range of local investigating authorities, supervisory bodies, intelligence services and SARS, as well as bodies in other countries with similar objectives and activities. This essentially means that an accountable institution could now be faced with a situation where information from a range of sources can be analysed to show money flows, and the schemes and accounts behind these flows, before the accountable institution is requested to provide the information or becomes subject to inspection by local regulators. In other words, the accountable institution may be penalised for not having reported information, going forward.

In August 2015, the Department of Justice and Constitutional Development published the Cybercrimes and Cybersecurity Bill for comment. The Bill seeks to put in place a comprehensive legislative cybersecurity framework and address shortcomings which presently exist in dealing with cybercrime. The Bill has, however, since been substantially amended following public submissions, and an expert panel has been formed to revise the new version of the Bill. It is expected that this will be published later this year. The introduction of the proposed legislation is significant – it is estimated that cyber-related offences are increasing at an alarming rate and currently exceed R1 billion annually, based on government estimates noted publically.

As our Global Survey highlights, 'economic crimes fundamentally threaten the basic processes common to all businesses: buying and selling, paying and collecting, importing and exporting, growing and expanding.' While 'no sector or region is immune', the risks and consequences are acute for FS institutions and banks in particular, given their central role in financial intermediation. Plans are good, but practice and implementation are key to adequately facing up to the challenge.



Application of good corporate governance principles is key to SA's retirement fund industry: PwC survey

South Africa's retirement funds face significant challenges in the light of recent reform proposals and market uncertainty, with much stronger regulation and supervision expected in the near future. Boards of funds have to embrace change, set clear strategic objectives, and address the needs and well-being of their members. In turn, members have to ensure they have an outcome-based solution for their retirement plan. These are some of the highlights of PwC's 2016 Retirement Fund Strategic Matters and Remuneration Survey, released in June.

Summarised by Julanie Basson

Good corporate governance is at the heart of any organisation's well-being. Principles of the King III Report on Corporate Governance and consideration of the draft King IV Code recommendations, with the specific retirement funds industry supplement, would assist boards to better position themselves for the many challenges they face, which include regulatory change, turbulent investment markets and member expectations, among others.

The *survey* places its focus on three broad areas: fund officials' activities and their remuneration; board member education; and retirement fund reform.

Retirement fund reform has been on the agenda for a number of years. Although the final implementation of all aspects seems to remain elusive, there has been a fair amount of progress with the implementation of the amendments envisioned by the Taxation Laws Amendment Act.

It is not surprising that survey participants feel that the tax harmonisation and retirement reforms are creating additional costs for funds and employers. However, based on the survey results it would seem that the industry believes the reforms are overdue and will compel members to take a closer look at their retirement plans.

According to the survey results, 62% of respondents indicated that less than 5% of their members will be affected by the new maximum contribution limit of 27.5% of all contributions to retirement saving vehicles, capped at R350 000 per annum.

About two-thirds of respondents consider the threshold to be unreasonable; of these, the majority suggest that members should be encouraged to save more and that no contribution limits should be imposed. The majority of respondents further noted that the 'one-third cash, two-thirds preservation' principle should be legislated.

A positive message arising from the survey is that boards have been proactive regarding the reform proposals. The results show that 80% of boards have considered a default investment portfolio for active members, and 48% for paid-up members. The least consideration was given to in-fund preservation. It is open to speculation whether more board effort to administer 'in-fund' annuities and preservation is the reason some would rather wait for guidance or legislation before they act.

The two reform aspects at the top of the agenda were the consideration of passive investment options and the communication of default options to members. In addition, the majority of funds believe that the reforms will have a positive outcome and will result in cost savings, better preservation and enhanced replacement ratios.

Fund officials and remuneration

The survey indicated that 55% of funds remunerate some or all of their board members and the majority of large funds (58%) remunerate their principal officer. Small and medium stand-alone funds tend not to remunerate their principal officer, as this position is often filled by an employee of the participating employer. Boards or board subcommittees are still responsible, in the majority of cases, for setting the level of board member remuneration.

Respondents are of the opinion that it seems workload rather than qualification is more directly related to remuneration, and that more hours are being spent by chairpersons and board members on fund affairs. Given the increased complexities and ever-changing legislative requirements of the environment in which funds operate this may be seen as being expected by some.

Board member education

Being in a fit and proper state as a board member is critical to protect members' interest. The majority of boards have a formal policy that deals with the learning and education requirements of board members, who typically spend, according to survey respondents, 18 hours a year on training and attending industry events. With increased regulatory changes and emphasis by the Registrar of Pension Funds on the boards' duties to protect fund members, it was expected by industry that more time would be allocated to the education of board members.

The areas in which boards have received most training are fund governance and circular *PF 130 on good governance of retirement funds*. It was encouraging to see that risk management is receiving more attention.

The retirement fund industry has undergone significant changes, including ones of a regulatory nature. Board members will need to assess and review their governance strategies in order to manage them in accordance with the new regulations and legislation.

Cross-sector announcements

Financial market infrastructure

FSB re-uses collateral

The FSB *outlined possible measures of non-cash collateral re-use* on 23 February 2016, as part of its *work to transform shadow banking* into resilient market-based finance.

The FSB describes possible measures of non-cash collateral re-use, and the related data elements, that could be included in its *global securities financing data standards*. Authorities will report national and regional aggregates of these measures to the FSB. The FSB intends to use the report as a starting point for discussions with market participants and researchers to create a meaningful measure of collateral re-use for evaluating global trends and assessing risks to financial stability.

Collateral re-use increases the availability of collateral, which reduces transaction, liquidity and funding costs for market participants. But it is important for authorities to improve their understanding of collateral re-use practices and the potential impact of collateral re-use on financial stability.

Comment period closed on 22 April 2016.

IOSCO updates central clearing repository information

IOSCO published *updates* to its *Information repository for central clearing requirements for OTC derivatives by jurisdiction* on 1 April 2016. These changes capture the EC's determination to require central clearing of certain classes of interest rate swaps under EMIR. The repository sets out clearing requirements on a product level, as well as any relevant exemptions. It also identifies eligible CCPs.

The future of LIBOR

The IBA outlined future plans for LIBOR in a *roadmap* published on 18 March 2016. Over the past year and a half, IBA has consulted on how LIBOR should evolve to meet the needs of those who use it and enhanced regulatory standards. IBA hopes the measures it outlines for LIBOR will make it robust and sustainable in the long term. The roadmap sets out the IBA's plan to implement a uniform submission methodology for LIBOR panel banks.

The FSB has made it clear that it wants LIBOR to be transaction-based as far as possible. To ensure this is the case, IBA has designed a waterfall of submission methodologies. The waterfall comprises three levels:

- Level 1: The VWAP of eligible transactions
- Level 2: Submissions derived from transactions (including adjusted and historical transactions, interpolation and parallel shift)
- Level 3: Expert judgement, appropriately framed.

Looking to the future, IBA is examining the feasibility of evolving LIBOR to a centralised calculation using an algorithm to calculate the benchmark in diverse market circumstances. It expects to complete this feasibility study before Q3 2016. If the study results are positive, IBA expects to liaise with the FCA to gain regulatory non-objection to the algorithm, processes and controls during Q3 2016. It should then enable panel banks to connect with IBA for real-time transmission of transaction data, which is currently received by a daily file transfer.

If these steps are followed, IBA anticipates it will have full centralised responsibility for the formulation of LIBOR by 2017.

CCPs face up to responsibilities

On 5 February 2016, IOSCO published a *policy statement* on clearing FX instruments. The statement clarified that CCPs retain responsibility under the PFMI for the effectiveness of clearing despite the operational flexibility afforded to them for this instrument class.

Because deliverable FX instruments involve the simultaneous settlement of obligations in more than one currency, IOSCO recognises that CCPs may use 'paired settlement' arrangements which assign bilateral delivery obligations between the participants. But under the PFMI, CCPs are still responsible for ensuring they maintain sufficient qualifying, highly reliable and liquid resources to cover substantial liquidity shortfalls in extreme but plausible market conditions. Such resources can include agreements whereby participants lend or sell to the CCP the currencies necessary to ensure same-day settlement of currency exchanges.

More broadly, IOSCO emphasises that CCPs must ensure the same level of confidence regarding same-day settlement of obligations, irrespective of whether the obligations run to the CCP or to the counterparties under paired settlement arrangements.

Ending the CCP standoff

Bringing an end to the debate on mutual CCP recognition, the EC and US regulators agreed on a '*common approach*' to recognise each other's CCPs on 10 February 2016. Their agreement is designed to protect the transatlantic derivatives markets. For years, each jurisdiction had granted (and extended) time-limited exemptions and no-action relief while failing to reach a compromise. Their substantive disagreements were mainly about US margin rules that the EU deemed too lax and the EU's hesitancy to submit to the US' extensive registration requirements.

The regulators have agreed that US CCPs seeking EU recognition will ensure they collect sufficient margins to withstand a two-day liquidation period. US CCPs will also need to have initial margin models that mitigate the risk of procyclicality, which will likely lead to higher overall margin requirements. The US has also agreed to lighten the registration requirements for non-US CCPs.

In the absence of such an agreement, US CCPs would have been off-limits to market participants entering into transactions subject to the EMIR mandatory clearing requirements. EU firms would have also faced higher capital requirements for all of their transactions cleared by US CCPs.

Both EU and US authorities plan to announce formal equivalency determinations shortly. As a result of the agreement, we also expect the regulators will expedite the review of substituted compliance determinations over many non-EU swap dealers' obligations.

IOSCO reviews benchmark administrators

IOSCO published its *Second Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of EURIBOR, LIBOR and TIBOR* on 26 February 2016. Overall, it found administrators were making stronger progress in governance than design quality.

On the governance front, administrators have developed their conflicts frameworks and internal benchmark oversight comprehensively. But they need to work on ensuring their conflicts policies cover relevant individuals and the way in which oversight committees function is clear.

IOSCO also highlighted that adopting its design principles had been more difficult for administrators to achieve. It noted administrators had worked toward ensuring pricing reflected market transactions, but their efforts were hampered by a lack of data. Administrators also struggled to develop transparency around their benchmark determinations, but IOSCO expects this to improve when firms have dealt with the design issues.

IOSCO gave administrators individual feedback but is not planning further reviews.

Reporting on commodity price integrity

IOSCO published its *Final Report – The Impact of Storage and Delivery Infrastructure on Commodity Derivatives Market Pricing* on 9 May 2016. It identifies certain practices that could potentially cause market disruption, affect market efficiency and impair the price convergence process. But it concludes that the existing IOSCO principles set out in its *Final Report – Principles for the Regulation and Supervision of Commodity Derivatives Markets* provide an adequate framework in the context of its application to commodities storage infrastructure.

IOSCO believes the credible possibility of delivery is the market force that drives convergence of the prices in the physical and derivatives markets at the expiration of the contract. Anything that distorts the price of physical delivery correspondingly distorts prices in the futures markets. For example, stakeholders expressed concern that excessively long physical delivery times decrease the available supply in certain metal commodities, thereby altering the pricing of related futures contracts. IOSCO identifies the following areas as meriting further review and the development of guidance and industry good practices:

- Circumstances when the delivery maker chooses delivery location;
- Impact of higher storage fees for commodities stored for delivery against a derivative contract;
- Unequal treatment of customers through divergent use of discounts; and
- Conflicts of interest where traders, exchanges and warehouses all have the same corporate parent.

As impediments to physical delivery are likely to receive increased regulatory scrutiny, firms should proactively assess their inventory management practices, and exchanges should review the adequacy of their supervision of commodity warehouses and other facilities.

Blockchain – disrupting central banks?

Ben Broadbent, Deputy Governor of Monetary Policy of the Bank of England, spoke about the impact of blockchain technology on central banks on 2 March 2016. He highlighted three potential outcomes for central banks:

- Blockchain could eradicate the need for a central bank as a trusted third party or settlement agent.
- Central banks might issue their own digital currency.
- Blockchain could reduce funds to central banks, and hence their ability to supply credit.

Distributed ledger systems such as blockchain allow financial transactions to be verified and recorded without the need for a trusted third party, in a role that central banks currently perform for commercial banks.

Broadbent said while clearing payments through a distributed ledger rather than a central bank may not have any significant macroeconomic effects in itself, what would prove significant is how the technology could be used to widen access to the central bank's balance sheet beyond the commercial banks it currently serves.

According to him, any shift towards a widely accessible central bank digital currency would make commercial banks safer. This is because deposits are backed mainly by illiquid loans. But he said taking deposits away from banks could impair their ability to grant loans, as they would be more reliant on wholesale markets. He added that banks considering whether to issue digital currencies to meet the competitive threat posed by private sector rivals should consider what doing so might mean for banks' funding and the supply of credit.

Banking and capital markets

Capital and liquidity

Slow demise of model approaches

The Basel Committee consulted on *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* on 24 March 2016.

Proposed changes to the advanced and foundation IRB approaches are in three areas. The first is to remove the option to use IRB approaches for certain exposures where the Committee judges that banks cannot estimate model parameters with sufficient reliability. This includes exposures to banks and other financial institutions, large corporates and equity exposures. The second is to adopt exposure-level, model parameter floors to ensure a minimum level of prudence for IRB approaches that remain available. And the third is to limit the range of estimation practices applied to model parameters. The affected parameters include probability of default, loss given default, exposure at default, maturity and credit risk mitigation.

The Committee has already consulted on, and is still considering, the related issue of the design of aggregate capital floors based on the revised standardised approaches – a replacement for the Basel I floor. The treatment of sovereign exposures is subject to a separate ongoing review. The consultation closed on 24 June 2016.

Is RWA consistency unachievable?

The Basel Committee assessed the variability of RWA among banks using the IRB approach to calculate RWA. In *Regulatory Consistency Assessment Programme (RCAP) - Analysis of risk-weighted asets for credit risk in the banking book* published on 1 April 2016, it noted two primary themes: variation in retail and SME exposures, and exposure at default estimation. After comparing estimated values with the actual default and loss, the Committee found the estimated probability of default values is close to actual default. But the results were mixed for other factors. For instance, the analysis found wide variation in the average values of exposure at default. The Committee believes this is due to differences in estimation practices.

The Committee outlines the likely policy implications based on the results, which include better definitions for various calculation factors and using empirical evidence for estimations.

Recognising simple, transparent and comparable securitisations

The Basel Committee updated *Revisions to the securitisation framework* on 11 July 2016, incorporating the regulatory capital treatment for 'simple, transparent and comparable' (STC) securitisations. This builds on the joint Basel Committee-IOSCO criteria for identifying STC transactions published in July 2015 and amends the December 2014 standard revisions to the securitisation framework.

Compliance with the expanded set of STC criteria should provide additional confidence in the performance of the transactions, so the Basel Committee recommends a modest reduction in minimum capital requirements for STC transactions. The update sets out additional criteria for differentiating the preferential capital treatment of STC transactions from that of other securitisations. The additional criteria, for example, exclude transactions in which the standardised risk weights for the underlying assets exceed certain levels.

The Committee is currently reviewing similar issues related to short-term securitisations. It expects to consult on proposals for this at the end of 2016. This securitisation framework comes into effect in January 2018.

Calls for guidance on TLAC

The FMLC wrote to the FSB regarding *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* on 8 February 2016. The Committee cautions that the FSB Term Sheet on TLAC includes requirements expressed in terms that are high-level and could lead to differences in the implementation of TLAC by national governments and regulatory authorities. A uniform approach is vital to ensure the confidence of resolution authorities in the other jurisdictions where a G-SIB operates. The FMLC encourages the FSB to provide guidance on areas of uncertainty, particularly the internal TLAC requirement and the possibility of grandfathering until rules are finalised by the relevant authorities. Until rules are in place, the issuers of financial instruments will be unclear whether they are eligible for TLAC, which will compromise the ability of G-SIBs to meet their TLAC requirement.

Basel III monitoring gets going

The Basel Committee published a *Basel III monitoring workbook* along with *instructions* and *frequently asked questions documents* on 1 February 2016. This workbook relates to the semi-annual exercise the Committee plans to undertake to monitor the impact of Basel III. While participation is voluntary, the Basel Committee expects both large internationally active banks and smaller institutions to participate in the study.

The Committee asks banks to report the data as of end of December or end of June, as applicable. The prescribed workbook provides the structure for the monitoring exercise. But the instructions document proposes banks obtain the workbook from their respective national supervisory agencies to submit their returns. The Basel Committee also advises banks to consider the frequently asked questions when providing the data.

It has set a tentative deadline of early April 2016 for firms to submit their end-December 2015 data to national supervisors. The Committee plans to review the data between April and mid-May and publish the results by September 2016.

Basel adds to FAQs

The Basel Committee updated its *Frequently asked questions on Basel III monitoring* on 23 February 2016. New questions relate to:

- defaulted assets in the definition of capital worksheet, and
- the form of netting to be reported for certain cash receivables.
- The Basel Committee also amended the revised operational risk instructions.

More Basel III guidance for supervisors

The Basel Committee published the *Regulatory Consistency Assessment Programme (RCAP) Handbook for jurisdictional assessments* on 17 March 2016. To facilitate the implementation of Basel III, the Basel Committee adopted RCAP in 2012. Based on experience to date, the Basel Committee updated its procedures and processes for conducting jurisdictional assessments into one document – this handbook. The Committee also considered that the handbook and associated questionnaires will help all supervisory authorities evaluate their own progress on the implementation of Basel III and identify areas for improvement.

Possible simple NSFR for small banks

The EBA published the minutes of its *Banking Stakeholder Group meeting* on 24 February 2016. The meeting took place on 15 December 2015. The stakeholders discussed forthcoming publications and the risks and vulnerabilities in the EU banking system.

An important future report on the impact assessment and calibration of NSFR was highlighted. There is a possibility that a simplified ratio calculation and different reporting for small banks may be introduced. The EBA also noted a future publication on proportionality, linked to prudential requirements for risk takers and remuneration. The EBA plans to publish an opinion on the application of proportionality principles to remuneration with this.

The EBA recognised that EU banks strengthened their capital ratios in 2015, but it remains concerned about the quality of assets.

Pillar 3 keeps expanding

The Basel Committee published consultative document *Pillar 3 disclosure requirements – consolidated and enhanced framework* on 11 March 2016. The disclosure requirements apply to all internationally active banks. Banks must disclose information on their regulatory capital and risk exposures to enable market participants to gain transparent information and compare the risk profiles. This is the second phase of the review and it covered:

- enhancements to the revised framework,
- revisions and additions based on ongoing reforms, and
- consolidation of existing and prospective disclosure requirements.

There are three enhancements to Pillar 3 disclosures. The Committee proposed a set of key regulatory metrics that banks need to disclose, including metrics on TLAC. Originally, banks had to disclose hypothetical capital requirements for credit risk calculated according to the standardised approach. But the Committee now expanded this requirement for counterparty credit risk, market risk and the securitisation framework. Banks will need to provide an additional breakdown of the prudential valuation adjustments.

Further revisions and additions relate to TLAC, operational risk, market risk and interest rate risk in the banking book. The Committee proposed new templates in line with regulatory developments in these four areas.

To facilitate access to comprehensive regulatory information, a single and coherent Pillar 3 framework was introduced. Banks will need to disclose capital requirements, capital and liquidity ratios and remuneration as per this framework. Apart from minor stylistic changes, the Committee largely retained the existing templates in the consolidated framework. The consultation closed on 10 June 2016.

Leverage ratio gets a makeover

The Basel Committee proposed changes that will impact all banks in *consultative document revisions to the Basel III leverage ratio framework* on 6 April 2016. Significant changes include revisions for treating derivative exposures, financial asset sales and regular-way purchases. There are additional requirements for G-SIBs too.

The changes to the treatment of derivative exposures reflect the approach the Basel Committee took in March 2014 when it published the *standardised approach for measuring counterparty credit risk*.

For G-SIBs, the Basel Committee welcomes feedback on the characteristics it proposed for the additional requirement. It is considering applying a limit on additional tier 1 capital and making the requirement fixed for all G-SIBs. It may also suggest a higher minimum or a buffer requirement.

For financial assets and regular-way purchases, the Basel Committee outlines two options. The first proposes a 100% credit conversion factor for off-balance sheet items. The second option is to allow banks to offset cash receivables and cash payables. This will be subject to certain conditions, however.

The proposals also cover the treatment of pooling transactions, credit conversion factors for off-balance sheet exposures and provisions. The consultation closed on 6 July 2016.

More leverage questions answered

The Basel Committee published an update to *Frequently asked questions (FAQs) on the Basel III leverage ratio framework* on 6 April 2016. This updates the July 2015 version of these FAQs. The Basel Committee added 15 new FAQs addressing issues that include written credit derivatives, on- balance sheet cash-pooling positions, and securities and financing transaction exposures.

Basel Committee defines problem loans

The Basel Committee published a consultative document, *Guidelines – Prudential treatment of problem assets – definitions of non-performing exposures and forbearance*, on 14 April 2016.

The global financial crisis revealed difficulties in identifying and comparing information reported and disclosed by banks across jurisdictions. In the absence of a current international standard for the categorisation of problem loans, the Basel Committee developed these definitions to promote consistency in the measurement and application of these two important measures of asset quality.

The definition of non-performing loans centres around delinquency status (90 days past due) or the unlikeliness of repayment. The Basel Committee defines forbearance by reference to concessions granted to counterparties as a result of financial difficulties. The definitions also address the criteria for the upgrading of non-performing loans to performing loans and for the declassification of exposures as forborne exposures.

The Committee intends that the guidelines should complement the existing and regulatory frameworks relating to asset categorisation. It wants banks to use the guidelines in the context of supervisory asset quality monitoring, Pillar 3 disclosures and banks' internal credit categorisation systems. The consultation closed on 15 July 2016.

Basel Committee makes data request

The Basel Committee issued *Instructions for Basel III monitoring ad hoc exercise* on 26 April 2016. It is collecting data on TLAC which it intends to include in its semi-annual exercise going forward. The Basel Committee is also collecting data for two ongoing policy initiatives that include:

- proposed revisions to the Basel III leverage ratio exposure measure, and
- changes to the IRB approaches to credit risk.

The Committee requires all banks to fill out the general information on credit risk because proposed changes to the IRB approach will have an impact on exposures under the standardised approach.

Participation in this exercise is limited to banks which also participate in the regular exercise, as the data from both exercises will be used together. The Committee expects both large internationally active banks and smaller institutions to participate in the study.

Interest rate risk stays in Pillar 2

The Basel Committee published *Standards – Interest rate risk in the banking book (IRRBB)* on 21 April 2016. This publication updates the principles and methods for banks to identify, measure, manage, monitor and control interest rate risk in the IRRBB.

The Basel Committee decided to retain this risk in the Pillar 2 capital framework against the alternative of a standardised Pillar 1 approach. Key changes include:

- More extensive guidance on the expectations for a bank's IRRBB management process in areas such as the development of stress scenarios, as well as key behavioural and modelling assumptions to be considered by banks in their measurement of IRRBB;
- Enhanced disclosure requirements, in line with revised Pillar 3 requirements, to promote greater consistency, transparency and comparability in the measurement of IRRBB. This includes quantitative disclosure based on prescribed interest rate shock scenarios;
- An updated standardised framework, which supervisors could mandate their banks to follow or banks could choose to adopt; and
- A stricter threshold for identifying outlier banks, reduced from 20% of a bank's total capital to 15% of a bank's tier 1 capital, when comparing the maximum change in economic value of equity under prescribed interest rate shock scenarios.

These standards will come into effect in 2018. For banks with financial year ends on 31 December, the relevant disclosures in 2018 should be based on information as at 31 December 2017.

Good progress in adopting Basel regulations

The Basel Committee set out where each of its members were in adopting the Basel regulations in *tenth progress report on adoption of the Basel regulatory framework* on 11 April 2016. All 27 member jurisdictions have adopted the final rules on risk-based capital, LCR and capital conservation buffers. They are now focusing on implementing other rules such as leverage ratio and the NSFR. These rules will be effective by 2019.

Reports on the consistency of regulatory implementation in 24 member jurisdictions are also available on the Committee's website. It aims to complete the assessment for the remaining three members by end 2016.

Calculating operational risk capital

The Basel Committee published its second consulation on the *Standardised Measurement Approach for operational risk* on 4 March 2016. The most significant change is the introduction of historical operational loss data for calculating operational risk capital.

In the first consultation, the Committee proposed ending the advanced models approach. Instead, banks will need to use a single non-model-based standardised measurement approach for calculating operational risk capital. This position remains unchanged in the second consultative document.

To enhance risk sensitivity in the new approach, banks would have to use ten years of good-quality historical operational loss data. On an exceptional basis, banks could use five years of historical loss data in the operational risk capital calculation. But this provision would be available only during the transition period.

Firms argued that the previous proposal could result in disproportionate capital treatment for certain business models. The latest proposal aims to address this issue by calculating capital based on income or expenses, whichever is higher. Banks would not need to include both income and expenses in the calculation.

The Committee will now be finalising its approach, including deciding the implementation timeframe, with the consultation having closed on 3 June 2016.

SARB Circular 4 of 2016: Implementation of the capital conservation buffer

The *Circular* was issued to provide information relating to the phases of implementation of the capital conservation buffer (CCB). It also provides information relating to the regulatory capital framework in South Africa over the Basel III implementation period to the end-state in 2019 and the interaction of the CCB with Pillar 2A requirements.

The capital conservation buffer was introduced with effect from 1 January 2016 and will be phased in evenly until 1 January 2019, to 2.5%. The CCB will be required to be met, in full, with CET 1 capital.

From 1 January 2016, where a bank's regulatory capital position drops to within the CCB range (i.e. where its capital has fallen below the minimum required ratio), the SARB will impose restrictions on capital distributions until the required minimum capital adequacy ratio has been restored.

In line with the implementation of Basel III in South Africa and to adhere to the internationally agreed timelines, the Basel III capital buffers – comprising the CCB, the countercyclical capital buffer (CCyB) and D-SIB buffers – will be phased in between 2016 and 2019. The Pillar 2A add-on will be gradually reduced to 0.5% at a CET 1 level and to 1% at a total capital level by 2019. This is to ensure that the sum of the Pillar 2A add-on and the higher loss absorbency requirement for D-SIBs does not at any point exceed 3.5%.

SARB Circular 5 of 2016: Matters of Interpretation relating to the LCR

This *circular* replaces Circular 2 of 2016 dated 9 February 2016 and deals with matters of interpretation which have arose since the implementation of the LCR in 2015.

Directive 7 of 2014 – National discretion related to LCR

The directive allowed banks to hold HQLA in a currency that does not match the currency of the associated liquidity risk. Investments in foreign-currency-denominated level 1 HQLA to cover expected denominated currency net cash outflows will be limited to 5% of the total ZAR HQLA requirement of the relevant bank, subject to an 8% haircut.

For the purposes of consolidated reporting, the SARB will allow the inclusion of net foreign-currency-denominated inflows provided that a bank has a framework to attest the fungibility and transferability of the currency cash flows. The framework should:

- define the criteria used to determine the fungibility and transferability of the currency during periods of stress and its inclusion in the LCR;
- be sufficiently agile and dynamic to respond in a timely manner to any new developments in the global economy;
- be monitored on an on-going basis, at a minimum monthly; and
- be subject to all appropriate and applicable governance processes.

Currencies have been limited to the top ten most liquid currencies determined in the *Triennial Central Banks Survey on Economic Exchange Turnover*, published by the BIS.

Directive 8 of 2014 – Matters related to compliance with LCR

The directive addresses compliance with LCR on a daily basis and related reporting in the form BA 325. The SARB recognised that daily LCR on the last day of the month may differ from the LCR on the BA 300, as the BA 300 is submitted on the 20th working day after month-end.

As long as the difference between the BA 325 and the BA 300 is immaterial, the BA 325 does not have to be resubmitted. No specific guidance on materiality has, however, been provided.

Directive 11 of 2014 – LCR: Scope of application and related disclosure requirements

The directive addresses the calculation of average balances and related disclosure for the LCR. For the calculation of consolidated LCR, an aggregation of the relevant individual net cash outflows and the individual HQLA portfolios of all the relevant banking and/or deposit-taking entities is to be performed.

In the aggregation process, the circular clarifies that the HQLA of the relevant banking and/or deposit-taking entities is to be restricted to 100% of the HQLA of the minimum LCR requirement in each relevant jurisdiction. Excess HQLA will be allowed in only two circumstances, i.e. where excess HQLA will qualify as HQLA in the home jurisdiction, and where it can be demonstrated that the HQLA is easily transferable across jurisdictions.

In addition, the restriction of 100% will be limited to the minimum LCR requirement for a particular year during the phase-in period, until the LCR has been fully phased in. For example, in 2016 the requirement is 70 per cent, therefore all HQLA above the minimum requirement needs to be evaluated for fungibility and transferability.

Directive 1 of 2016

This directive confirms that the R12.5 million threshold to determine 'small and medium enterprises (SMEs)' should be applied to each small-business customer independently for deposits and credit exposures, and the classification should be re-evaluated at least quarterly.

Regulation 23(12)(d)(xxv)

The Regulation dealing with LCR outflows indicates that relevant outflows related to 'operating' costs should be excluded from the provisions of the LCR. Clarification was provided that operating leases and capital expenditure are considered 'operating' costs for LCR purposes.

SARB Directive 1 of 2016: Matters relating to the exposure limits imposed in the classification of deposits and credit exposures to SMEs

When determining the classification of exposures to retail, SME retail and qualifying retail revolving credit, specific limits are specified by the Regulations to enable classification of exposures as 'retail exposures'. *This directive* was issued to amend the limit thresholds, effective 1 July 2016.

The amendments apply to various categories of retail exposure, including individual and small businesses, and effectively raise the R7.5 million classification threshold that came in during the Basel II framework implementation in South Africa to R12.5 million to better reflect market conditions.

However, the other qualifying quantitative threshold relating to retail revolving exposures – maximum counterparty exposure of R1 million – was maintained.

To ensure consistency between credit and liquidity risk requirements, the qualifying classification threshold applicable to liquidity risk for non-financial small-business customers has also been amended. To qualify for classification, total funding raised from a small-business customer and its relevant affiliates, on a gross consolidated basis, should be less than R12.5 million.

SARB Directive 2 of 2016: D-SIBs to submit group consolidated information on six-monthly basis

This directive was issued to provide information on the submission of regulatory returns relating to credit risk (BA 200 and BA 210) at both solo and group levels. The submission will be applicable to D-SIBs, with an expected implementation date of June 2017. The credit regulatory returns must be submitted six-monthly, based on a calendar year (i.e. end-June and end-December data of each year), with the first required submission being based on December 2016 data on a parallel-run basis. Certain line items within the returns will not be mandatory in the submission of group credit returns.

The consolidated credit returns at a solo and group level, irrespective of year-end dates, will be required to be audited in line with current requirements for returns submitted other than year-end.

SARB Guidance Note 3 of 2016: Credit risk and accounting for expected credit losses and Guidance Note 5 of 2016: Corporate governance principles for banks

In order to remain up to date with the latest international supervisory best practices, the SARB is currently reviewing its regulatory and supervisory framework and will review banks' progress to incorporate the principles and guidance set out in Basel Committee Guidelines relating to *Corporate governance principles for banks* and *credit risk and accounting for expected credit losses*.

Guidance notes 5 and *3* were issued to request banks to assess their current policies, processess and practices in terms of the Basel Committee Guidelines after taking into account the nature, size, complexity and risk profile of their activities.

SARB Guidance Note 4 of 2016: Instruments qualifying as HQLA

The *SARB recognised* that various banks are in the process of developing policy frameworks regarding investments in instruments qualifying as HQLA in order to comply with the LCR. It noted that a document, *Guidance for supervisors on market-based indicators of liquidity*, has been released by the Basel Committee and recommends that it should be incorporated in the internal framework that governs investments in assets eligible for HQLA, and in particular level 2 HQLA.

SARB Guidance Note 6 of 2016: Provision of a CLF by the SARB

The *guidance note* replaces Guidance Note 5 of 2015 and was issued to provide revised guidelines in respect of eligible collateral, pricing and other requirements for the CLF for the period 1 December 2016 to 30 November 2017.

Key features of the guidance note include:

- **Size of the facility –** The level 1 HQLA requirement of LCR is to be met prior to the recognition of a CLF. The CLF is to be capped at 40 per cent of the total HQLA amount a bank is required to hold in ZAR. The CLF amount that can be recognised for LCR and drawn down during periods of stress will be limited based on criteria specified in the note.
- **Eligible collateral –** No changes were made to the proposed eligible collateral previously published by the SARB. However, revisions have been made to the haircuts applied that are reflective of the SARB's exposure to credit and liquidity risks if it were to take ownership of the collateral and needs to dispose of it.
- **Pricing –** Election to use the CLF will attract a commitment fee equal to 58 basis points for 2017, revised on an annual basis. In the event of a drawdown, a rate equal to the repo rate plus 100 basis points will be applied.
- **Operational arrangements –** The CLF will be granted from 1 December to 30 November for a 12-month period. Re-applications have to be made by 30 September annually. Where application for the CLF is made for the first time, this has to be completed by 31 August in the year preceding the facility date.

Financial stability

China focuses on structural reform

Details of the *First G20 Finance Ministers and Central Bank Governors meeting in 2016 held in Shanghai* were released on 1 March 2016. Ministers and governors agreed that while the global recovery continues, downside risks have increased, stressing the use of individual but also collective monetary, fiscal and structural tools. They agreed to improve the structural reform agenda by developing priorities and guiding principles and creating an indicator system to enhance the assessment and monitoring of the progress of structural reforms.

The Finance Minister of China, Lou Jiwei, emphasised the importance of structural reforms that correct distortions and improve resource allocation. As an example he referred to the reduction in China's reliance on investment to power growth in 2015, replaced by the increased contribution of consumption. But he also welcomed the increase in technology and equipment investment, because it has improved the allocation of resources. Zhou Xiaochuan, Governor of the People's Bank of China, stated that China had entered a period of 'new normal', where growth has decelerated from high to medium speed. China restored the International Financial Architecture Working Group under its G20 Presidency, with discussions expected to focus on the IMF's governance reform, sovereign debt restructuring, debt sustainability, capital flows, the global and financial safety net, and an increased role for special drawing rights.

The second G20 Finance Ministers and Central Bank Governors Meeting is expected to be held in Washington D.C. on 14 and 15 April 2016.

IOSCO scans for emerging risks

On 2 March 2016, IOSCO released its *2016 Securities Markets Risk Outlook on emerging risks threatening the securities market*.

The key risks for the coming year are as follows:

- Unlike in the primary bond market, liquidity in the secondary market for corporate bonds is being negatively affected by regulatory changes. Long-term global data is not available to assess the risks effectively.
- The increase in regulatory requirements for high-quality collateral to mitigate credit and counterparty risks may result in a high concentration among providers of collateral management services. This merely substitutes credit and counterparty risk for increased liquidity risk and asset encumbrances.
- Mis-selling of unsuitable complex investments is the most prevalent risk to retail investors. Survey respondents cited examples of investment advisers selling bundled products on commission and misleading pricing of structured products.
- The increased interconnectedness within financial services has spawned an increase in cyber attacks.
- The low interest rate environment may lead unit investors to redeem en masse, increasing liquidity risks for asset managers.

IOSCO's forward-looking report informs the risk identification processes of the G20, FSB, IMF and other global standard-setting bodies.

FSB reviews shadow-banking supervision

The FSB published its *Thematic Review on the Implementation of the FSB Policy Framework for Shadow Banking Entities* on 25 May 2016. Its policy framework sets guidelines for authorities supervising shadow-banking entities. The FSB reviewed how well authorities are implementing this framework.

The FSB states implementation efforts are in their infancy, but notes that:

- most shadow-banking firms are within regulatory boundaries;
- authorities are classifying shadow-banking activities inconsistently; and
- data quality on shadow banking is in need of improvement.

It suggests implementation efforts could be enhanced by greater supervisory collaboration at a national level. The FSB also recommends that authorities should enhance the quality of data on shadow-banking activity. Finally, it advises authorities to develop stricter disclosure requirements for shadow-banking firms.

Operational resilience

Best practice in cyber resilience

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, elaborated on *cybersecurity recommendations for financial institutions* on 11 February 2016.

Dombret stated that the financial sector is both a main target of cyber threats and also vulnerable to almost every type of cyber risk. These include phishing attacks, malware, distributed denial of service, and 'man-in-the-middle' attacks in which communication is secretly taped and manipulated.

Financial institutions face three main types of threat: personal information theft, information integrity breach (i.e. data manipulation), and availability breach, in which the reputation and capital liquidity of a bank are placed in a negative light through false information.

Best practice to minimise cyber risk includes:

- Utilising two-factor authentication for clients when signing on to online banking applications;
- Applying appropriate security solutions at all layers of the network and information systems; and
- Rehearsing contingency and recovery plans in the event of data loss and/or service disruption.

Dombret commented that the human factor remains the largest vulnerability in a firm's cybersecurity. Providing training for employees, assigning responsibility and having a clear governance structure for IT systems and processes, as well as a robust risk governance programme, are all important steps to build cyber resilience. Sharing best practice and notification of threats among financial institutions is also a positive step towards a mutually resilient financial sector.

Asset management

Capital and liquidity

Pinpointing asset managers' systemic risk

The FSB released a summary of its *Meeting of the Financial Stability Board in Tokyo on 30 - 31 March* on 31 March 2016. At the meeting the FSB agreed on the elements of a public consultation to take place in the middle of 2016 on policy recommendations to address structural vulnerabilities from asset managers' activities. These include:

- Funds' liquidity mismatches;
- Leveraging within funds;
- Operational risk and challenges in transferring investment mandates in a stressed situation; and
- Securities-lending activities of asset managers and funds.

The FSB encouraged authorities to consider the use of stress testing to assess the individual and collective ability of funds to meet their redemption under stressed market conditions. It described information on liquidity and the leveraging of risk across asset managers as an 'essential tool' for understanding systemic risk.

The FSB intends to finalise its recommendations by the end of the year.

Financial stability

FSB turns its gaze to asset management

On 29 February 2016 the FSB published its *Chair's Letter to G20 Ministers and Governors on Financial Reforms – Progress on the Work Plan for the Hangzhou Summit*. The FSB has prioritised work to analyse structural vulnerabilities in asset management activities which may merit policy responses. These areas include:

- Liquidity mismatches in funds;
- Leveraging within funds;
- Operational risks in transferring investment mandates; and
- Securities-lending activities of asset managers and funds.

Once work on these areas is completed the FSB, jointly with IOSCO, intends to finalise the assessment methodology for asset management under the G-SIFI framework. The FSB intends to publish a consultative document with the assessment of structural vulnerabilities and policy recommendations to address them in time for the Hangzhou Summit in September 2016.

The FSB is also looking at the financial stability implications of FinTech and will report on issues for authorities and next steps by the G20's meeting in April 2016. In response to a request from the Chinese Presidency, the G20 has also asked for a review of international experiences and lessons learnt on macro-prudential policy frameworks and tools.

The FSB also noted that the BCBS will continue to address elements of the Basel III framework to ensure its coherence and maximise its effectiveness. In doing so, the FSB highlighted that authorities are focused on not significantly increasing overall capital requirements across the banking sector and therefore does not currently adopt 'Basel IV' as official terminology.

Insurance

Insurance contracts project update

In February 2016, the IASB reviewed and confirmed that to date all the necessary *due process* steps have been completed. It instructed staff to commence with the drafting process.

The IASB published a podcast titled *Discussion on the decisions from the February 2016 IASB meeting* on 18 February 2016. It looks at the start of the balloting process for the final standard on insurance contracts and the next steps in the project.

In March 2016, the IASB discussed the proposed amendments to IFRS 4 in respect of transitional reliefs on the application of IFRS 9. The board confirmed that the eligibility assessment for the temporary exemption is performed at 'the reporting entity level' only; there should be a temporary exemption and an overlay approach, and both approaches should be optional; and the temporary exemption has a fixed expiry date. The board plans to be in a position to issue the amendments to IFRS 4 in September 2016.

See our *Insurance Alert - IASB meeting on 15 March 2016* for a summary of the meeting.

IASB April meeting notes

Our *Insurance Alert – IASB meeting on 19 April 2016* summarises the discussions at the IASB's April 2016 meeting. It continued its re-deliberations on the proposed amendments to IFRS 4 Insurance Contracts (IFRS 4), Applying IFRS 9 Financial Instruments (IFRS 9) with IFRS 4. The board decided to revise the eligibility criteria for meeting the temporary exemption from applying IFRS 9, so more entities would be eligible for it. The board also changed the assessment date for eligibility to an earlier period than the initial application date of IFRS 9.

The board made decisions relating to application, presentation and disclosure of the overlay approach, disclosures relating to the application of the temporary exemption, and disclosure of other information when the temporary exemption is applied.

At the IASB meeting in May 2016, the board plans to complete its re-deliberations relating to the proposed amendments to IFRS 4, including the expiry date and whether first-time adopters should be prohibited from applying the temporary exemption or overlay approaches. The board expects to issue final amendments to IFRS 4 in September 2016.

IFRS developments

Amending IFRS 15

The IASB has amended IFRS 15 to clarify the guidance on identifying performance obligations, licences to intellectual property and principal versus agent assessment. The amendments also provide additional practical expedients on transition. In our *In Brief - IASB issues amendment to IFRS 15 'Revenue from contracts with customers'* we provide insight on the issues and impact of these amendments. The amendments are effective for annual reporting periods beginning on or after 1 January 2018, with early application.

Offsetting and cash-pooling arrangements

Our *In brief – Immediate impact on cash pooling arrangements of IFRS IC decision* looks at the wide-ranging implications for financial institutions, particularly banks which offer cash-pooling arrangements, and for corporate entities, of the IFRS IC's recent decision on offsetting and cash-pooling arrangements under IAS 32. The IC notes that, to the extent to which a group does not expect to settle its subsidiaries' period-end account balances on a net basis, it would not be appropriate for the group to assert that it had the intention to settle the entire period-end balances on a net basis at the reporting date. Hence such balances cannot be offset under IAS 32.

Taxation

Tax implications of the proposed TLAB amendments affecting banking institutions

Background

With the publication of the TLAB on 8 July 2016, numerous amendments have been proposed in respect of the Income Tax Act, No. 58 of 1962.

The following is a summary of key proposals facing FS, and in particular banking, institutions:

Sections 8F and 8FA

Cross-border hybrid debt instruments

The anti-avoidance rules denying the interest deduction are to be limited to resident company issuers and issuers with a permanent establishment in South Africa only in order to curb arbitrage opportunities that could potentially arise from non-resident issuers of debt instruments.

This amendment is proposed to be applied retrospectively on 24 February 2016 and apply to transactions from that date.

Third-party-backed instruments

Third-party-backed instruments are to be excluded from the application of these sections in order to ensure that they only fall within the ambit of section 8EA, i.e. re-characterising dividends to income.

Hybrid debt instruments subject to subordination agreements

Where an issuer owes an amount to a company that forms part of the same group of companies and the payment in respect of such amount is suspended due to financial difficulties (subordination agreement), the anti-avoidance rules contained in section 8F should not apply in order to grant financial relief to the distressed issuing company.

Sections 8E and 8EA

Addressing circumvention of anti-avoidance rules dealing with third-party-backed shares

To curtail certain transactions which circumvent the hybrid equity anti-avoidance rules, the definitions of "*hybrid equity instrument*" and "*preference share*" are to be amended.

Amendments are to include any right or interest where the value of that right or interest is directly or indirectly determined with reference to an underlying share that is a share other than an equity share or an equity share where the amount of any dividend is based on or determined with reference to a specified rate of interest or time value of money.

Refinement of third-party-backed shares: Pre-2012 legitimate transactions

To provide relief for historic transactions entered into (pre-2012) which included guarantees and obligations that would now fall foul of section 8EA, it is proposed that:

- Parties be allowed to cancel any enforcement obligation or right;
- The cancellation must be made within a proposed window period, i.e. from the introduction of the TLAB to 31 December 2017; and
- Relief will only be prospective.

Sections 1 and 22, paragraph 11 of the Eighth Schedule and section 1 of the Securities Transfer Tax Act, No. 25 of 2007

Refining the implications of outright transfer of collateral provisions

The following amendments have been proposed:

- Extending the allowable period within which the identical shares may be returned to the borrower by the lender from the date on which the collateral arrangement was entered into from 12 to 24 months;
- Broadening the definition of 'identical share' to cater for other specified corporate actions as well, i.e. situations outside the control of a party, to a securities lending or collateral arrangement that could result in an identical share being unable to be returned in terms of the initial securities arrangement; and
- Extending the provisions of collateral arrangements to include listed government bonds as allowable instruments.

Sections 8C, 8CA (new section) and 10(1)(k)

Addressing the circumvention of rules dealing with employee-based share incentive schemes

The current requirements regarding dividends relating to REIs that are exempt from normal tax do not adequately deal with dividends consisting of or derived from:

- the proceeds from the disposal or redemption of:
  - the underlying equity shares, and
  - shares from which those REIs derive their value; and
- the liquidation of a company from which those REIs derive their value.

Therefore, the following are proposed:

- The inclusion in the income of a holder of an REI in respect of a return or foreign return of capital of any amount received or accrued if that amount is not:
  - a return of capital or foreign capital by way of a distribution;
  - subject to the provisions with respect to a dividend; and
  - taken into account in determining the gain or loss in respect of that REI.
- Clarity will be provided in section 10(i)(k)(i) whereby dividends will only be exempt after the restrictions fall away and the equity instrument vests in the employee (section 8C) or when the marketable security is held by an employee (section 8A).
- Paragraph (dd) of the proviso to section 10(1)(k)(i) will be deleted.
- More certainty is to be provided on how the employer should treat the contributions in respect of REIs, as follows:
  - The historic cost actually incurred and paid by the employer to provide its employees with REI will be regarded as being in the production of income and will qualify for a deduction in terms of the new section 8CA.
  - This deduction will be spread over the period during which the restriction relating to the equity instrument applies.
  - In instances where an employee leaves the employee share scheme, the current recoupment provisions in section 8(4)(a) will apply.

Proposed amendments to the taxation of long-term insurance

Background

With the publication of the TLAB on 8 July 2016, numerous amendments have been proposed in respect of the Income Tax Act, No. 58 of 1962.

Long-term insurers should take note of the draft amendments that may have a significant impact on their businesses.

The TLAB saw on-going changes contributing to life tax reform in anticipation of SAM, IFRS 4 Phase II, as well as the general modernisation of the current four funds tax regime.

Sections 29A and 29B

The following proposed changes are worth taking note of:

The definition of adjusted IFRS value is amended

- The tax basis to be used for policyholder liabilities when SAM is introduced will be the IFRS basis, with certain adjustments for deferred tax. Negative liabilities are to be excluded from these adjustments and will be phased out (or in) over six years in cases where the recognition thereof is different on the IFRS basis in comparison to the statutory (and tax) basis.
- The first year of phase-in will commence in the first year of assessment ending on or after the date on which the new Insurance Act comes into operation. Subsection 14 of section 29A explains the percentage-based phasing over the six-year period.

The definition of the valuation basis of liabilities is amended

- The tax basis for the liabilities of the RPF will no longer be 'IFRS adjusted', but aligned to policyholder funds, i.e. the 'value of liabilities' (in other words, the statutory valuation of liabilities will apply for tax purposes), until SAM is introduced.
- This retrospective alignment is to apply for years of assessment commencing from 1 January 2016.

Capital allowances on assets

- A technical correction is proposed to allow the corporate fund and RPF to deduct capital allowances on assets previously disallowed.
- This amendment is not retrospective, but is only applicable for years of assessment commencing from 1 January 2016.

Life insurers should be aware of these changes and understand how they may have an impact on their business.

Glossary

BIS	Bank Of International Settlements
CCP	Central Counterparties
CLF	Committed Liquidity Facility
D-SIB	Domestic Systemically Important Bank
EBA	European Banking Authority
EC	European Commission
EMIR	Regulation On Otc Derivatives, Central Counterparties And Trade Repositories (Ec) No 648/2012
ESMA	European Securities And Markets Authority
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FinTech	Financial Technology
FIC	Financial Intelligence Centre
FMLC	Financial Markets Law Committee
FSB	Financial Stability Board
FX	Foreign Exchange
G20	Group Of 20
G-SIBs	Global Systemically Important Banks
G-SIFI	Global Systemically Important Financial Institutions
HQLA	High-Quality Liquid Assets
IASB	International Accounting Standards Board
IBA	Ce Benchmark Administration
IC	Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organisations Of Securities Commissions
IRB	Internal Ratings-Based
IRRBB	Interest Rate Risk In The Banking Book
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank-Offered Rate
NSFR	Net Stable Funding Ratio
OTC	Over-The-Counter
PFMI	Principles For Financial Market Instruments
QIS	Quantitative Impact Study
RCAP	Regulatory Consistency Assessment Programme
REI	Restricted-Equity Instruments
RPF	Risk Policy Fund
RWA	Risk-Weighted Assets
SAM	Solvency Assessment And Management
SME	Small And Medium Enterprises
SPI	Special-Purpose Institution
TIBOR	Tokyo Interbank-Offered Rate
TLAB	Draft Taxation Laws Amendment Bill
TLAC	Total Loss-Absorbing Capacity
VWAP	Volume-Weighted Average Price

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