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Financial Services NewsFlash

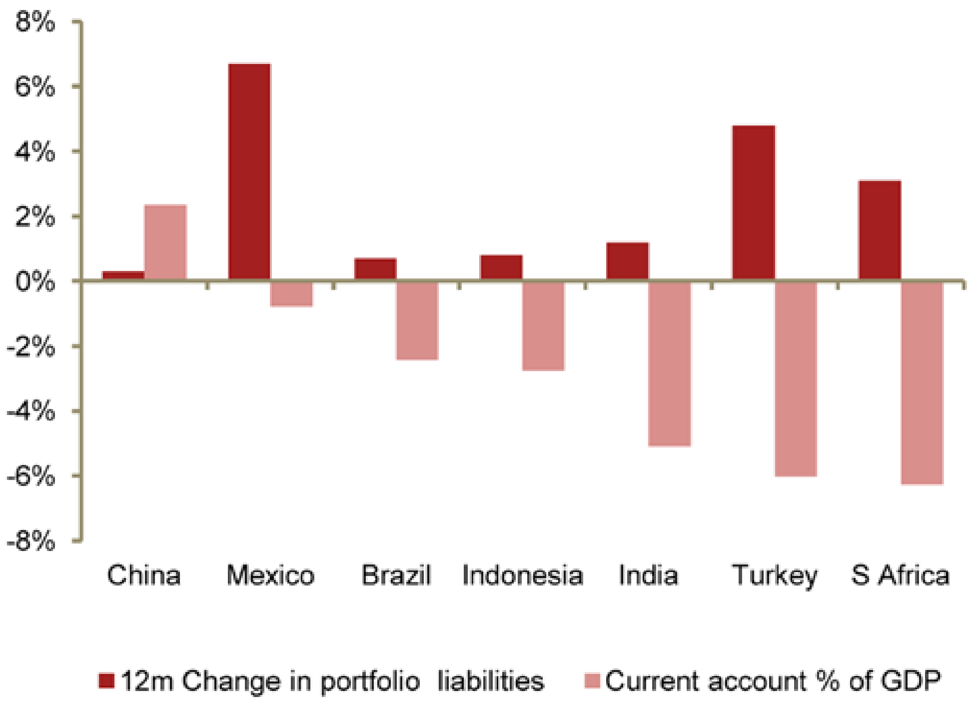
Economic update: tapering fears cause impact on emerging markets

Improving economic conditions in the US, and remarks made by Ben Bernanke, the Federal Reserve (Fed) Chairman, have stoked expectations that the monthly Quantitative Easing (QE) purchase of assets could be tapered by the end of 2013. One of the consequences of the extra loose monetary policy by central banks (such as QE in the US and UK) has been an inflow of foreign capital into debt, equities and currencies of emerging markets over the past two years. As investors searched for a higher return, this capital was increasingly invested into a number of emerging markets with a higher risk profile than the traditional BRIC countries (Brazil, Russia, India and China). Following the Fed's announcement on 20 June 2013 that it will start to "taper" bond purchases, the yield on benchmark ten-year Treasury notes jumped by around 40 basis points. The Fed's move marked the start of investors paring back from emerging markets, a tendency which was encouraged by political unrest in countries such as Turkey, Egypt and Brazil.

The average Country Risk Premium (CRP) increased by 0.2 percentage points over the last quarter in the BRIC countries. The N11 (Next Eleven) countries which include fast-growing economies such as Turkey, South Africa and Mexico also experienced a rise in its average CRP, increasing by 0.6 percentage points between Q1 and Q2 of 2013.

Emerging market currencies have been affected by such tapering fears, particularly where current account deficits are high (see Figure 1 below).

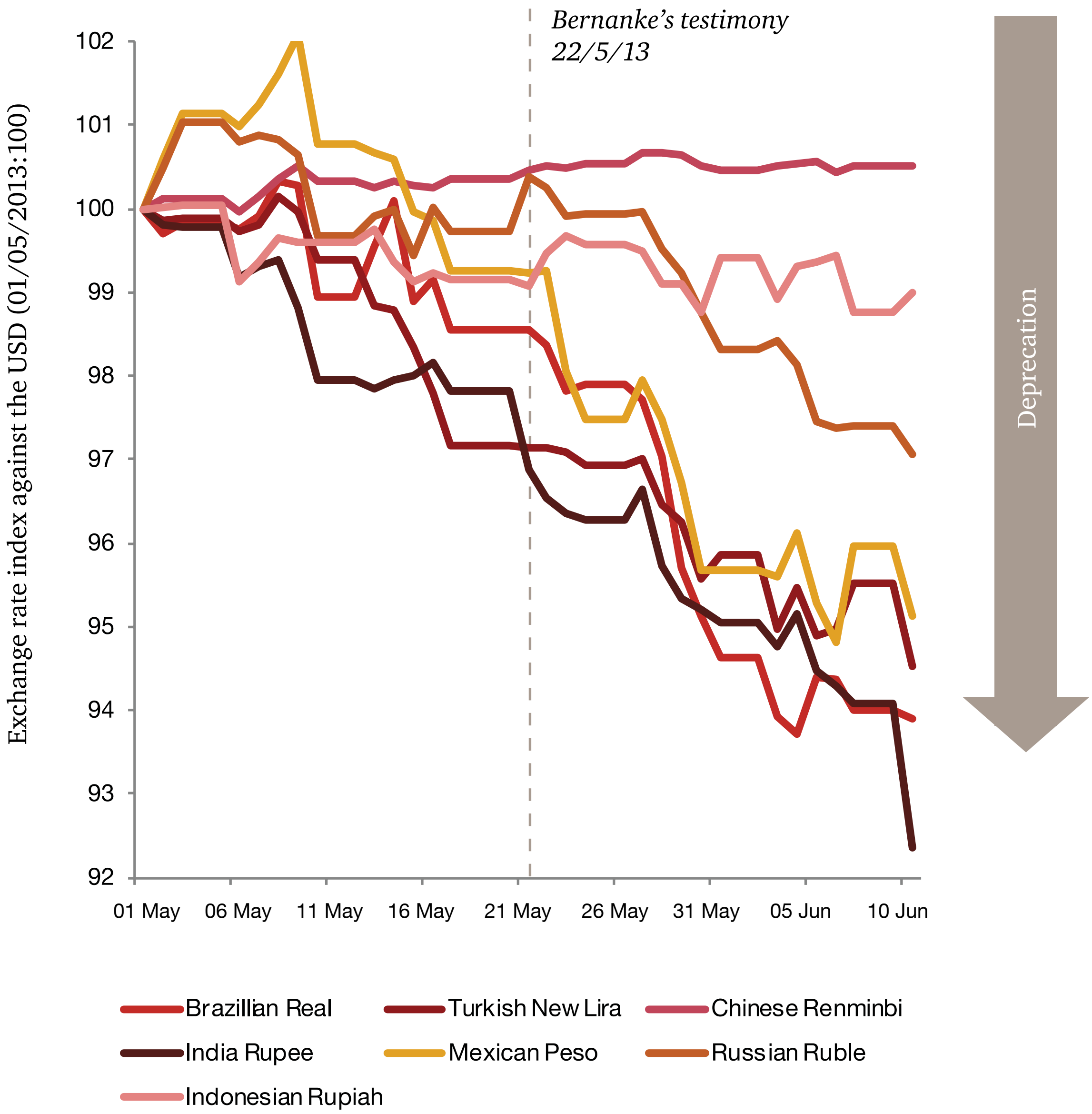
***Figure 1** – Some emergingmarkets are increasingly depending on foreign portfolio flows to fund their current accounts*



Source: OECD (using latest available 2012 data)

The Indian Rupee, for example, hit an all-time low in June. Policymakers across the emerging world have reacted promptly to their sliding currencies: in Brazil, the government abolished a tax on foreign bond investments to encourage capital inflows, and in Indonesia the central bank, Bank Indonesia, increased its benchmark rate by 25 basis points in June followed by a further rise of 50 basis points in July to 6.5% to support the Rupiah currency. Figure 2 shows emerging market currencies came under significant pressure.

Figure 2 – Currencies in emergingmarkets came under significant stress in May and June



Source: Datastream, PwC analysis

So, is this the end of cheap money? It may still be too early to say. A reduction in the pace of asset purchases by the Fed should be evaluated in the context of the nearly $3.5 trillion of assets already held on the Fed's balance sheet and its 'forward guidance' on the main reserve rate. The Fed has consistently said that interest rates will not rise if unemployment is above 6.5%, provided inflation remains under control. At its current pace the unemployment target is unlikely to be reached until early 2015; and inflation in the US remains low and stable. However, it does look like the Fed is at the beginning of a path back toward operating normal monetary policy – that could take as long as five years.

Final enhanced prudential standards and Basel III rules in US

The word “soon” has been used often by regulators to describe when delayed rulemakings would be released under the Dodd-Frank Act. Despite expectations that by this juncture banks would finally gain some needed regulatory clarity, the fog still has not lifted. Key US rulemakings remain outstanding, including the elusive final Volcker Rule and several other rules pertaining to risk retention, affiliate transactions, and broker-dealer duties.

However, 2013 has brought some important regulatory developments so far, if not enough. Regulators finalized several key mortgage rules early this year, and provided some important derivative specifications with respect to swap execution facilities, block trading, and the swap push-out rule. It is anticipated that the second half of 2013 will see far more regulatory development. Not just because of the additional derivatives guidance we expect, but because we believe that a host of rules will be finalized, implementing outstanding prudential standards in the US – namely, Basel III quantitative capital and liquidity rules, and enhanced prudential standards affecting systemically important financial institutions.

On 2 July, the Board of Governors of the Federal Reserve System voted in favor of what had been billed as the most significant revisions to regulatory capital for banking organizations in years. This final Basel III capital rule (Rule) and its Preamble total some 970 pages. There remain a number of significant questions still to be answered for the largest organizations. These institutions, at the center of the “too big to fail” debate, are seeing the bar continue to rise beyond the Rule. It appears that the lobbying on behalf of community and regional banks had some success given the outcomes for those firms including: an additional year for implementation, maintenance of the current capital approach for risk weighting residential mortgages, the elimination of phase-out provisions for certain capital instruments (e.g., trust preferred securities), and the one time opportunity to opt out of Accumulated Other Comprehensive Income (AOCI).

US government announces six-month extension to FATCA effective dates

The Internal Revenue Service (IRS) and the US Department of the Treasury (Treasury) issued Notice 2013-43 (Notice) on 12 July announcing revised timelines for implementing various provisions under the Foreign Account Tax Compliance Act (FATCA). The Notice also provides additional guidance concerning financial institutions in jurisdictions that have signed an intergovernmental agreement (IGA) but have not yet enacted legislation bringing it into force. By extending the timelines, the Notice also provides (1) the IRS with more time to issue the necessary forms, guidance, clarification, and interpretation, (2) the Treasury and potential FATCA partners with more time to agree to and sign IGAs and (3) entities around the world with more time to implement changes in order to be FATCA / IGA compliant.

The Treasury and the IRS continue to listen and respond to stakeholders and to make adjustments to the provisions of FATCA while keeping their primary policy objectives intact. Although the relief provided is welcome, without additional guidance many of the substantive questions regarding the application of the final FATCA regulations and IGAs remain. As a result of the Notice, companies should adjust their project plans accordingly.

Capital Requirements Directive CRD IV package adopted in Europe

There is much about CRD IV that is critical for banks to understand and for financial services to take note of. On 27 June 2013 the CRD IV Directive (2013/36/EU) was published in the EU's Official Journal. Publication confirms the timetable for application of its key provisions, including the provision for country-by-country tax reporting for banks. The CRD IV package was primarily developed to introduce "Basel III" into EU law and applies to credit institutions and investment firms (i.e. retail and investment banks) which fall within the scope of the EU MIFID Directive. The CRD IV regulation establishes new prudential requirements and applies directly to all member states. The Directive must be transposed into the national laws of the member states by 31 December 2013 (except for certain provisions). Some have pointed out that under their legal systems it will require at least 12 months (not six) to transpose this directive, so some transitional measures may still be negotiated.

We understand that a preliminary discussion among member states in a formal Council working group meeting was held on this topic. It remains to be seen if country-by-country reporting will be proposed as part of the non-financial and diversity paragraphs of the Accounting or Transparency Directives or whether a new proposal for a Directive will be launched by the Commission to introduce financial data and tax country-by-country reporting for all large companies and groups. The new EU rules on country-by-country reporting reflect the EU's commitment to promoting transparency in the context of G8 activities and a common global reporting standard. Importantly, G8 Leaders called for the global introduction of financial and tax country-by-country reporting by major multinational enterprises based on a common OECD template to be developed, and taking account of concerns regarding non-cooperative jurisdictions. Banks and others affected by CRD IV need to be thinking now about how they will assemble the data and how they will want to disclose the tax footprint that they have in the main operating countries. In particular, do they want to present a more balanced picture of the total tax contributed as well as taxes on income (which can give a highly misleading picture of the overall tax contribution)? Our prediction is that country-by-country reporting will likely spread over time.

Revised proposals for insurance contracts will have a significant impact

Following the 2010 exposure draft (ED), the IASB has published a targeted revised ED that will fundamentally change the accounting by all entities that issue insurance contracts. The IASB has attempted to address concerns expressed by stakeholders regarding perceived 'artificial' volatility resulting from the proposals in the previous ED. The revised ED will replace IFRS 4, which currently permits a wide variety of practices in accounting for insurance contracts. While this is not a joint project, the IASB and FASB have been working together in their deliberations. However, the EDs will have a number of differences. The FASB expects to publish its comprehensive ED on insurance contracts in the near future.

The revised ED will significantly affect all entities that issue insurance contracts, including recognition of profits and presentation in the statement of comprehensive income. Compared to the previous ED, income statement volatility will be reduced to some extent. But the new proposals add significant complexity and create extra demands on resources, data and modelling systems, and stakeholders need to understand the changes. The impact of the proposals will vary from one territory to another, depending on current accounting and regulatory requirements. Given the likely significant impact of this revised ED, management should assess the implications and consider commenting on the new proposals to ensure its views are taken into account. The comment period ends on 25 October 2013, and the effective date is expected to be approximately three years from the date of publication of the final standard.

FATCA: Be prepared. Deadlines are approaching fast

FATCA, the Foreign Account Tax Compliance Act, was enacted in 2010 with the primary goal of providing the Internal Revenue Service ("IRS") with an increased ability to detect U.S. tax evaders concealing their assets directly in foreign accounts or indirectly through off-shore entities. It aims to accomplish this goal by requiring U.S. and non-U.S. entities to comply with a new set of tax information reporting and withholding rules as well as investor due diligence and documentation requirements. The consequences of non-compliance include being subject to or liable for a 30% withholding tax on income from U.S. sources and eventually on the gross proceeds from the sale of securities that could produce U.S. sourced interest and dividends.

On 12 July 2013 IRS issued the latest time line for FATCA implementation. By as early as April 2014, legal entities that qualify as Non-U.S. or Foreign Financial Institutions ("FFI") must determine whether they should register with the IRS to enter the FATCA agreement; and no later than 1 July 2014, FFIs must ensure the required new account due diligence have been in place. FATCA compliance is a present challenge, and companies need to assess how FATCA affect their business. Some practical steps companies can take to assess FATCA's impact on their organizations should at a minimum cover:

- **Legal entity analysis**
  A group or multinational companies should examine their ownership structure, treasury centers, retirement funds, branches location, and holding companies, just to name a few examples, to ensure their definition and classification under FATCA.

- **Initial assessment on U.S. source income and assets**

  Obligations are imposed on the payer of U.S. source fixed or determinable, annual or periodic (FDAP) income, which includes many multinational companies. Companies must assess U.S.-related assets and payments happening within the companies to identify the potential impact.

- **Customer or counterparty analysis**
  FATCA requires certain minimum due diligence on FFIs customers and counterparties, one of the examples is necessary procedures on know-your-customer ("KYC") in knowing whether a person is categorized as a U.S. person or not. The regulations also extend to the procedures to classify counterparties to FATCA classification and acknowledge them through certain tax forms.

Some actions to think about

FATCA deadlines are approaching fast. Companies need to start assessing how FATCA has an impact on their business and make strategic decisions.

To comply with FATCA, companies need a FATCA compliance program to ensure all necessary FATCA classifications, documentation, monitoring and reporting are undertaken. This process ought to be documented in a series of policies and procedures ensuring that the process has controls that can be replicated and tested. Furthermore, the program should highlight changes in business practices that may be necessary for FATCA compliance and is intended to provide comfort to senior management that all areas of the organization have been reviewed according to requirements.

Becoming a leading bank through branchless banking

The rise of the digital consumer and the high-cost infrastructure of physical banking locations are leading to a declining return on investment (ROI) for branches. If the branch model stays on its current course, it will become a financial burden to banks, cutting deep into cross-channel profitability. The branch of the future has a critical place in banks' overall channel strategy. But branches cannot survive in their traditional form. Evolving the branch network to align with changing consumer and economic realities can help banks boost revenues and ROI and position themselves for the future.

A time for change

Decreased traffic and cost inefficiencies shouldn't signal the demise of the branch which still remains an important interaction point, playing an essential role in complex product sales and relationship building for both retail and small-business customers. Instead, these factors should be a warning that urges banks to take the next step in their branch channel evolution. Those that don't are likely to experience:

- A continued decline in branch traffic and sales.
- Loss of wallet share to innovative competitors whose branch transformation efforts better address consumer needs.

Bank Indonesia's view on branchless banking

Bank Indonesia (BI) introduced branchless banking as an activity of payment system and limited banking services through agents (Unit Perantara Layanan Keuangan / UPLK), focusing on unbanked and under banked people. BI has not introduced any regulation specifically on branchless banking. However, BI has introduced guidance on the trial period of the payment system and limited banking system through the agents.

Business models that are allowed in this trial period are:

- Bank led model, where banks are the responsible party for end to end banking services;
- Telco led model, where telecommunication companies are the responsible party for end to end activities;
- Hybrid model, which is the combination of both. Specifically for the hybrid model, the allowed business models in the trial period are:
    - The Bank works together with the Telco as e-money seller which is published by the Telco and sold by agents;
    - The Bank works together with the Telco as e-money seller which is published by the Telco and sold by agents and contains the name of the bank;
    - Connecting e-money and savings to allow transactions between the two accounts, such as top up or withdrawal.

The trial period is projected to run from May 2013 to November 2013, and banks are allowed to continue the service upon submitting the permit request to BI two months before the trial ends.

The result of this trial period will be used as an input for BI in composing the regulation and policies related to the branchless banking activities.

Updates of COSO Internal Control – Integrated Framework: It's the right time to look at your internal control framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its Internal Control-Integrated Framework in 1992. This has been widely adopted as the leading framework for designing, implementing, and conducting internal controls and assessing internal control effectiveness. In 20 years, business and operating environments have changed significantly, becoming increasingly global, complex and technology driven. COSO decided it was time to refresh.

The Updated Internal Control-Integrated Framework (the "Updated Framework"), authored by PwC, was released in May 2013 and is designed to address reporting, compliance, and operational objectives in the current business and regulatory environments. This provides businesses and their stakeholders with a common vocabulary for getting a handle on the ever-changing environment.

As business evolves, leading companies evolve their internal control systems. The release of the Updated Framework provides the perfect opportunity for both internal and external stakeholders to consider: Are the existing internal controls really keeping up in response to the evolving business activities and risks? Do you have problems or potential problems, such as:

- Hidden exposures in business that existing internal controls cannot help uncover
- Blind spots lurk in your business

The COSO Internal Control Framework was updated in three important ways to make it easier for internal controls to evolve to align with the businesses and meet operations, reporting and compliance objectives.

1. Clarifying the requirements of effective internal controls

The Updated Framework reflects how doing business has changed and provides guidance to assess risk and keep related controls current. It also helps you apply internal controls to your growing list of objectives. It now addresses internal reporting, which can satisfy requirements set by senior management and boards as well as covering external non-financial reporting requirements driven by laws, regulations, or even heightened stakeholder expectations.

The Updated Framework is principles-based, making it more flexible, adaptable, and broadly applicable than a rules-based framework. It provides 17 principles that formalize fundamental concepts in the original framework with aims to help you specify objectives, assess risks, and deploy controls that you can adapt to meet your unique requirements.

2. Removes the blind spots

The Updated Framework helps you focus on objectives, related risks, and controls in all reaches of your business—its legal entities, divisions, operating units, and functions. The Updated Framework includes principles for specifying objectives and assessing risks across the business, and for establishing structures, authorities, and responsibilities. In the current continuously changing business environment, the Updated Framework has included principles for identifying and assessing the impact of significant changes on internal controls.

3. Take control through people, technology, information and processes

The Updated Framework helps you address people at all levels of the organization. It includes a principle for attracting, developing, and retaining competent personnel. Managers with key roles in operating units and functions, like the supply chain, IT security, and portfolio management, are closest to the risks and changes that could have an impact on them. They are well-positioned to spot new risks, identify when issues are likely to occur, and design proper controls to mitigate risks.

The Updated Framework also includes several principles for using relevant information and communicating the right information to the right people.

Why it is relevant to you?

Local regulators (OJK, Bank Indonesia, IDX, and others) have kept emphasizing the importance of robust and effective governance and internal controls framework. There is a strong regulatory expectation that key stakeholders, including boards of commissioners, directors and senior management apply a robust internal control framework to ensure risks are mitigated.

The following items are increasingly becoming more relevant to companies and financial institutions in Indonesia:

- Accurate and relevant information reporting to stakeholders
- Timely and proper assessment of risk profiles
- Change management to respond to business needs
- People and technology
- Vendor management in supporting business needs such as IT vendors and outsourced activities

We are of the view that the updates to the COSO Internal Control Framework have come at the right time and for the right reasons to commission a review of your internal controls systems and see how well they are aligned with the Updated Framework in order to further enhance the design and effectiveness of the internal controls, thus meeting the needs arising from the current dynamic business environment.

New guidelines on transfer pricing audits

The Indonesian tax audit landscape is moving towards a more mature environment and the scrutiny on transfer pricing (TP) is increasing. On 30 May 2013, the Indonesia Directorate General of Tax (DGT) issued regulation No. PER-22/PJ/2013 (PER-22) regarding the updated tax audit guidelines for taxpayers with related parties. PER-22 is effective from 1 July 2013 and is applicable to ongoing and prospective tax audits.

More clarity from ITO

PER-22 provides more certainty to taxpayers, including the following:

- **Median point as basis of correction** – The regulation provides an illustration whereby a taxpayer's Transactional Net Margin Method result is below the inter-quartile range and the correction is made by reference to the median point. This provides more clarity on the fact that the median result of the comparables is more appropriate to compute the transfer pricing correction.
- **Use of multiple year data** – One of the positive features of PER-22 is that it emphasizes the need to use multiple year data in economic analysis. This may lead to a more consistent approach taken by the tax auditor for the selected comparables, even though the practical application of this approach to the tested party is not clear.
- **Transactional or aggregated approach** – PER-22 confirms that an aggregated approach can be applied particularly where the transactions are closely linked and interconnected.
- The Comparable Uncontrolled Price method is prescribed for certain transactions including royalty payments and interest on loans.

Key considerations for taxpayers

The key highlights of PER-22 that need to be considered by taxpayers are the following:

- **Intragroup charges require more documentation from the service provider** In addition to the "service is actually rendered" test and the "benefits" test, PER-22 also requires further details such as the cost base and actual amount of costs incurred to provide the service. This will require taxpayers to obtain cost base information from the service provider and maintain supporting evidence such as global transfer pricing policy, calculation and allocation driver of service charge, email correspondence, and deliverable.

- **Timely preparation of TP documentation is critical** - In conducting a TP audit, tax auditors need to consider taxpayers' documents, which form the basis for applying the arm's length principle. In this context, the primary document reviewed by the tax auditor will be the taxpayer's formal TP documentation. Other relevant supporting documents, such as inter-company agreements and invoices should be readily available as these are likely to be requested during an audit.

- **Comprehensive audit questionnaire to be completed during tax audit** - part of TP audit procedures, taxpayers will be required to complete extensive forms within seven working days. Considering the limited timeline and the fact that some forms require information from overseas, it is recommended that the taxpayer complete the relevant forms in advance. The forms should include the following:

    1. Related party transactions
    2. Segmented financial data
    3. Supply chain management analysis, including identifying the value chain, name and net of operating profit of the companies that perform each function
    4. Functions, assets, and risks (FAR) analysis, including the affiliates' FAR analyses
    5. Business characteristics
    6. Comparability analysis

- **Intellectual property** - This new regulation introduces the income based approach, cost based approach, and market based approach as valuation methods for the transfer of intangible property. However, there is no further guidance on the application of the new valuation methods.

In anticipating the tax auditors' expectations during a TP audit, taxpayers should re-examine their existing TP documentation which may not be reflective of PER-22.

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