Financial Action Task Force Grey List

The Financial Action Task Force Grey List is fast approaching… are you prepared for it?

How close are we to the Grey List?

The Financial Action Task Force (FATF) is the global money laundering and terrorist financing watchdog that sets international standards aimed at preventing these illegal activities. The FATF has developed the **FATF Recommendations**, or FATF standards, with more than 200 countries and jurisdictions committed to their implementation. The FATF monitors countries through ongoing rounds of peer reviews called Mutual Evaluations, to ensure that FATF Standards are implemented appropriately and holds countries that do not comply accountable.

In October 2021 the FATF published the long-awaited Mutual Evaluation Report (MER) on South Africa which showed poor results. In respect of technical compliance, South Africa is fully compliant with three and largely compliant with seventeen of the forty FATF recommendations, with twenty negative ratings achieved on the remaining recommendations. When it comes to effectiveness of compliance, South Africa did not achieve any positive scores in the eleven immediate outcomes. Due to the severity of deficiencies detected in this Mutual Evaluation (ME), South Africa has now been placed in the FATF enhanced follow-up review category, which means that three follow-up assessments over a five-year period will be performed by the FATF post the publishing of the initial MER.

For its first follow-up assessment, the FATF committee will be coming to South Africa in October 2022 to reassess, from a technical compliance perspective, the progress that has been made to remediate strategic anti-money laundering (AML) and counter-terrorist financing (CTF) deficiencies. This will assist the FATF in deciding on whether South Africa should be included in the FATF list of "jurisdictions under increased monitoring", also commonly known as the **FATF Grey List**. The effectiveness rating would only be reassessed after five years since the Mutual Evaluation.

South Africa's ratings are deficient even when compared to other grey-listed jurisdictions set out in the diagram below. Most grey-listed jurisdictions produced better results than South Africa in their Mutual Evaluation, such as Turkey and Zimbabwe which both had eleven compliant ratings while South Africa had three compliant ratings in terms of technical compliance. If we look at the ratings in the FATF's follow-up review, Turkey achieved only nine negative ratings (partially compliant and non-compliant ratings) while Zimbabwe achieved ten negative ratings. Such results were not good enough to avoid a greylisting of these countries. South Africa will be subject to FATF follow-up review in this coming October and currently South Africa still has twenty negative ratings.

		Gibraltar	Malta	Turkey	Botswana	Zimbabwe	Mauritius	South Africa
	Year	**2019**	**2019**	**2019**	**2017**	**2017**	**2018**	2021
Mutual Evaluation	Technical Compliance	15 C	10 C	11 C	0 C	11 C	3 C	3 C
		15 LLC	21 LC	17 LC	2 LC	9 LC	11 LC	17 LC
		10 PC	9 PC	10 PC	14 PC	14 PC	13 PC	15 PC
		0 NC	0 NC	2 NC	23 NC	6 NC	13 NC	5 NC
		--	--	--	1 N/A	--	--	--
	Effectiveness rating	0 HE	0 HE	0 HE	0 HE	0 HE	0 HE	0 HE
		1 SE	2 SE	2 SE	0 SE	0 SE	0 SE	0 SE
		7 ME	6 ME	7 ME	2 ME	2 ME	4 ME	8 ME
		3 LE	3 LE	2 LE	9 LE	9 LE	7 LE	3 LE
Follow-up	Technical Compliance	22 C	12 C	11 C	--	18 C	10 C	
		17 LC	28 LC	20 LC	--	12 LC	13 LC	
		1 PC	0 PC	7 PC	--	6 PC	10 PC	
		0 NC	0 NC	2 NC	--	4 NC	7 NC	
	Decision	Grey Listed after follow up	Grey Listed after follow up	Remain in Grey List	Grey Listed after Mutual Evaluation	Grey Listed after follow up	Grey Listed after follow up	
	Current Status	Grey-Listed	Removed in 2022	Grey-Listed	Removed in 2021	Removed in 2022	Removed in 2021	

* There are four possible levels of technical compliance: Compliant (C), Largely Compliant (LC), Partially Compliant (PC) and Non-Compliant (NC)
** Effectiveness ratings can be either: High (HE), Substantial (SE), Moderate (ME) or Low (LE) level of effectiveness
*** Source: FATF Mutual Evaluations reports and Follow-up Reports on different jurisdictions

In order to avoid the greylisting, various actions have been taken to remediate the findings. Since December 2021, many supervisory authorities have submitted notifications asking accountable institutions to proceed with remedial actions according to the FATF requirements, and strengthened the extent of their supervision on said accountable institutions. In recent weeks we have observed more regular activity in the AML/CTF space, such as:

- Cabinet approving the General Laws (Anti-Money Laundering and Combating Terrorism Financing) Amendment Bill of 2022 for submission to Parliament;
- the establishment of the new draft list of accountable institutions; and
- the Financial Sector Conduct Authority (FSCA) requesting financial institutions to provide information on their ownership structure.

However, technical compliance re-ratings will not be considered where the FATF determines that the legal, institutional, or operational framework has not changed since the country's MER. Additionally, such changes need to be presented to the FATF at least six months before the Plenary, which is scheduled to take place mid-February 2023. At this stage, many deficiencies have not yet been addressed or are still in the planning or approval process. These deficiencies can therefore not be considered for re-assessment by the FATF.

Based on the above, it is highly probable that South Africa will enter the FATF Grey List.

Therefore, instead of asking whether South Africa will be included in the FATF Grey List, the question we now need to ask is: How will South Africa be impacted by the FATF grey-listing and what can we do to prepare for this?

How will the FATF grey-listing impact South Africa from a regulatory and economic perspective?

To answer this question we need to analyse the cases of other grey-listed jurisdictions and understand the cause-and-effect relationship of subsequent events that took place in their regulatory and economic spaces, to attempt to predict the impact of the grey-listing on South Africa.

Below are some of the jurisdictions that were grey-listed in recent years that may be used as a reference for South Africa to consider in the event of a grey-listing.

Botswana

- Asset Managers could not transact directly with pension funds with offshore portfolio
- FDI in diamond sector was affected as the repatriation of profits from Botswana to the origin was affected.

(Information provided by KPMG Botswana)

Pakistan

- The paper titled, "Bearing the cost of global politics -- the impact of FATF grey-listing on Pakistan's economy", authored by Naafey Sardar, suggest that FATF grey-listing, starting in 2008 and till 2019, may have resulted in cumulative real GDP losses of approximately $38 billion.

Malta

- Number of active Correspondent Banking relationships fell by 20% between 2011 and 2019.
- Banks and supervisory authorities prepared contingency plans to ensure that the payment infrastructure remains uninterrupted.

(Source: www.fitchratings.com: No immediate Impact on Malta's Ratings from Greylisting)

Turkey

- Decline in foreign investments: from 2007 to 2020, foreign direct investment declined from $19 billion to $5.7 billion; foreign ownership of bonds is down to about 5% in 2021 from 25% in 2016.
- The decline in foreign investment and economic activity further exacerbates Turkey's currency crisis and high inflation. Turkey's central bank cut interest rates by 2% in October 2021, causing the value of the Turkish Lira to fall to new lows after already shedding 20% of its value in 2021.

(Source: www.ft.com: Turkey faces threat of "grey-listing" by global finance watchdog; www.reuters: Finance watchdog "grey lists' Turkey in threat to investment)

Mauritius

- Soon after its inclusion, one of the large foreign custodians operating in India had put a halt on trades from Mauritius.
- The Reserve Bank of India had rejected a few applications for Non Banking Financial Company licences as the investments were routed through Mauritius. Any foreign portfolio investor from Mauritius could only acquire voting rights of an Non Banking Financial Company not exceeding 20 per cent of the total shareholding.

(Source: www.business-standard.com: Mauritius exits FATF grey list, Pakistan remains on the list: http://timesofindia.Indiatimes.com: RBI blocks NBFC plans of Mauritius-funded startups; https://economictimes.indiatimes.com: RBI tightens screws around Mauritius based investments into NBFCs

The impact of the FATF grey-listing is not only limited to accountable and reporting institutions, but will be a struggle for all private institutions, including both financial and non-financial entities operating in the South African economy.

Impacts in the event of FATF grey-listing from an economic perspective

The inclusion of a country in the FATF grey list would lead to a number of international and domestic economic impacts. According to the International Monetary Fund (IMF), a grey-listed country can expect an average decline in capital inflow of 7.6% of gross domestic product (GDP), a decrease in foreign direct investment (FDI) of 3% of GDP, and a decrease in portfolio inflow of 2.9% of GDP.

However, this might worsen in jurisdictions that already had trouble attracting investments, such as Turkey, whose foreign ownership of bonds is down to about 5% in 2021 from 25% in 2016. The extent of capital inflow and outflow is expected to decline as a result of reduced investments and business activity. Interestingly, in many grey-listed jurisdictions it was observed that ahead of the grey-listing announcement, a surge in capital outflow took place where advantage was taken of the information asymmetry.

The grey-listing would also lead to a direct domestic economic impact: due to increased compliance requirements and restrictions imposed, there would be a significant increase in the cost of doing business and in the cost of capital. These obstacles would decrease South Africa's competitiveness in doing business and in obtaining investment.

There would also be macroeconomic impacts, such as on the exchange rate and interest rate, inflation, and negative effects on economic growth and employment. The reputational damage goes without saying.

Impacts in the event of FATF grey-listing from a regulatory perspective

The starting point of all events is the decision and announcement of a grey-listing. This status officially recognises the failure of a jurisdiction to address its financial crime risks. Following the announcement, an action plan would be developed by the FATF with South Africa to address its strategic deficiencies. As part of the enhanced follow-up review, South Africa would go through two more follow-up sessions that aim to monitor the progress of the country in executing the action plan, until the fifth year post the Mutual Evaluation. Thereafter, an evaluation on the effectiveness of the implementation of the action plan would be performed.

The enhanced supervision of the FATF on South Africa would lead to a significant regulatory impact at a jurisdiction level. Major AML/CTF legal and regulatory changes would take place following the FATF requirements; operational changes and government actions would be taken with the purpose of ensuring the appropriate implementation of the legal and regulatory changes. This would lead to more frequent and stricter supervisory actions on various institutions, as well as the imposition of more significant fines and penalties as required by the FATF.

The negative reputational effect of the grey-listing would lead foreign counterparties to impose scrutiny on any business relationship or investment with South African entities, including the performance of additional due diligence and control measures or the performance of an AML/CTF audit based on international standards. In extreme cases we might observe what is called "de-risking", which is a process through which existing relationships with South African entities might be terminated.

We have performed a study on the impact suffered by other grey-listed jurisdictions with a number of our KPMG member firms located in such jurisdictions and based on publicly available information. Included below is a summary of the possible scenarios that South African entities might face in the event of the FATF grey-listing:

SA entities not be recognised as equivalent regulated entities

- South African entities **not** be recognised as **equivalent regulated entities**.
- Subject to **limitation** and **scrutiny**
- SA international branches might not be able to establish new relationships

De-risking and disinvestment in South African entities and investment vehicles

- Institutions **reluctant** to keep **relationships** or to start new relationships.
- Investors may sell their current investment for **redomiciling** their **funds**.
- Entities will need to **prove** that **sufficient AML/CTF controls** are in place to restrain the effect of de-risking.

Imposition of AML/CFT audits, following national and international standards

- **AML/CTF audit** may be imposed as **precondition** for relationships, applying **international standards**.
- In the event of **unfavourable** audit **results**, remedial actions need to be implemented within a short space of time.
- **Mandatory annual AML/CTF audit** was adopted in different grey-listed jurisdictions.
- SA entities need perform **self-examination** and **remediation** according to FATF standards and international best practice.

Delays in payment settlements

- For **payments** in **foreign currency**, additional **due diligence** may be requested.
- This would affect **any type of transfer** of funds.
- This would lead to significant **delays** of the transaction value day.
- Institutions need to prepare and **train** their **operations units** to shorten the process.

Reluctancy to establish relationships related to PEPs

- Current definition of **PEP** in FIC Act is **deficient** and in amendment process
- Investors would be reluctant to establish relationships with **entities related to PEPs**.
- Additional **controls to identify PEPs** according to international standards.
- Some grey-listed countries applied controls to limit the entry of PEPs in private entities

Extensive KYC performance & remediation

- Current **sources** of corporate information are **not reliable** (legal changes in process).
- **Reliance of KYC** on third parties such as intermediaries, or agents might be **limited**.
- Where reliance is still possible, entities need to **enhance** their **controls on third parties**.
- Entities need to **perform and remediate KYC** in accordance to new requirements, changes in official sources and where reliance is limited.

Next steps for the South African financial services sector

Regardless of whether South Africa is grey-listed or not, it is obvious that the country faces huge financial and proceed-generating crime risks. In order to reduce crime effectively, private entities, supervisory authorities and law enforcement bodies need to work together in cohesion. Many financial institutions may not have the right attitude or skills to identify the risks or the necessary controls to effectively address them on a timely basis.

It does happen that some financial institutions are to limit their controls to the minimum requirements or are still applying a rules-based compliance mindset, despite the enforcement of a risk-based approach that is required through the amended Financial Intelligence Centre (FIC) Act in 2017.

How should South African institutions fight financial crime? Once again, we would look to the lessons learnt by other jurisdictions which were in the same position as we are now, but are currently more advanced in their implementation of **industry best practice**. In most advanced jurisdictions, the implementation of industry best practice by accountable institutions is considered to be mandatory.

Set out below are the key areas where we believe the South African financial institutions will be subject to substantial remediation:

1. Better understanding of the threat landscape to address risks

In order to address financial crime risks effectively, it is necessary to have a comprehensive understanding of the threats and vulnerabilities from a sector and institutional perspective. Only when an institution understands the different schemes used by criminals to abuse the products and services offered, and the vulnerabilities of this institution when facing these threats, can effective measures be designed and implemented. In order to achieve this, different types of institutions need to understand the existing financial crime threats that may be relevant to the sector and quantify each risk factor taking into consideration the business context, such as volume of business, types of products and services distributed, types and number of business relationships, etc. The quantification of such risk factors should enable the design of risk mitigating measures to be able to address each risk effectively, leading to a limited residual risk that should also be quantified and monitored by the institution.

At current stage, most financial institution's business-wide risk assessment is yet a general and one-dimensional description of risk per business area. Institutions may expand their business risk assessment beyond a incorporate best practice activities such as:

- the inclusion of a comprehensive consideration of all relevant risk factors that the institution might be exposed to;
- considering the business context to quantify risk exposure; and
- addressing each emerging risk with effective risk mitigating measures.

2. Better understanding of risk through know-your-client (KYC) and customer risk assessment

The purpose of performing KYC and customer risk assessments is to better understand each client, which enables financial institutions to predict the behaviour of the customer during the course of the business relationship and detect activities that do not make economic sense. The information collected through the KYC process serves as a baseline for such knowledge whereas the risk rating predicts the potential threat of the customer. For any activity performed by the customer or any relevant change or update in the customer's background, the KYC information should be consulted in order to ensure that the activities performed continue to make sense.

The starting point for financial institutions in ensuring an effective KYC and customer risk assessment check is to collect information and documentation as required by the amended FIC Act and archive it for recording keeping purposes and in line with documentation retention requirements. In order to enhance the effectiveness and robustness of this process, institutions shall consider the following practices:

- Consideration as to whether the product need and the transactions performed are aligned with the nature of the business relationship with the client along with other potential risk factors associated with the client, and not simply limiting the assessment to the product the client has purchased.
- A framework is implemented that provides for a robust weighting of risk factors, ensuring that all relevant risk factors are taken into consideration and have an appropriate impact on the final risk rating. The framework provides for a single client risk view across the suite of entities and business divisions that may be offering products to the same customer.

3. **Effective enhanced due diligence measures**

When onboarding high risk customers, South African institutions usually apply the following enhanced due diligence measures: approval by senior management or performing more frequent KYC assessments. The usefulness of this assessment increases where the due diligence is not seen as a formality and where real value is extracted from this process that can provide better protection to the institutions against the potential increased risks of such customers.

Enhanced due diligence practices should ensure that more information is gathered and further verification procedures are performed. This should take place not only at onboarding but for any activity that may have higher risk associated, and therefore request additional due diligence measures to have a better understanding of the risks and be in a better position to mitigate them. As an example, international best practice requires a more in-depth examination of the client's shareholding structure; a better understanding of the source of income by requesting documentation such as financial statements, salary slips and tax declaration records; and requesting additional information for each relevant transaction to understand whether this deviates from the expected behaviour of the customer.

4. **Investment in technology**

The implementation of technology is critical for financial institutions, particularly as many have large client bases and sell a high volume of products and services. Included below are examples of how financial institutions are able to make the best use of effective technology platforms or enablers to mitigate potential financial crime risks:

- The first example is KYC technology. Extracting information contained in KYC documentation for further processing and analysis assists in the detection of relevant changes in the KYC assessment that may impact on the risk profile of the customer. This also assists in detecting possible activities that may deviate from the knowledge that institutions have of their customer and monitoring possible suspicious activities to ensure the timely detection of and analysis of such scenarios. A risk-based monitoring model is suitable for customers of different risk profiles as well as different product offerings.
- In keeping with the sophistication of financial crime schemes, the importance of implementing automated monitoring mechanisms to identify red flags is now more pronounced. A risk-based transaction monitoring system should not be limited to thresholds-related controls but be able to detect deviations in the behaviour of customers having different risk profiles (peer profiling). This would request the implementation of machine learning, data analytics and artificial intelligence technologies.

5. **Effective prevention and reduction of suspicious transactions**

Most financial institutions, when detecting possible suspicious transactions, proceed to the investigation and reporting of such transactions to the Financial Intelligence Centre (FIC) as required in the section 29 of the FIC Act. However, there is no further action taken by such institutions after the reporting, as most of them would still maintain the business relationship with parties involved in the reported transactions, while suspicious transactions are still being accepted and processed. As consequence, the underlying predicate crimes would still continue profiting criminal organisations and damaging our society.

In order to effectively stop or at least reduce crime, financial institutions should consider the following practices that are widely extended in other jurisdictions:

- Have procedures in place to interrupt the execution suspicious transactions and perform enhanced due diligence measures to collect further information about the purpose and nature of such transactions, and allow the blocking or cancellation of such transactions when there is doubt about its legitimacy or economic sense.
- Have a procedure in place to have event-triggering risk assessments for those clients presenting multiple suspicious transactions, or other types of higher risks, and consider the exit of such clients.

Conclusion

There is still uncertainty as to whether South Africa will be grey-listed by the FATF. However, we do not need to wait to be included on the list to realise that South Africa has material financial crime shortcomings that need to be addressed.

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