



Déan Friedman

**Partner
Forensics**

Tel: +27 82 719 0336

Email: dean.friedman@kpmg.co.za



Monica Wu Yu

**Manager
Forensics**

Tel: +27 72 446 7281

Email: monica.wuyu@kpmg.co.za

The Financial Action Task Force Grey Listing is possible... 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 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 non-compliant 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, 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 Mutual Evaluation Report (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 five years after the publishing of the Mutual Evaluation Report.

South Africa’s ratings are deficient even when compared to other grey-listed jurisdictions set out in the diagram on the next page. 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 nine negative ratings (partially compliant and non-compliant ratings) while Zimbabwe achieved ten negative ratings. Such results were not good enough to avoid a grey listing of these countries. Zimbabwe subsequently achieved satisfactory progress and was removed from the Grey List in 2022.

		Gibraltar	Malta	Turkey	Botswana	Zimbabwe	Mauritius
Mutual Evaluation	Year	2019	2019	2019	2017	2017	2018
	Technical Compliance	15 C	10 C	11 C	0 C	11 C	3 C
		15 LLC	21 LC	17 LC	2 LC	9 LC	11 LC
		10 PC	9 PC	10 PC	14 PC	14 PC	13 PC
		0 NC	0 NC	2 NC	23 NC	6 NC	13 NC
		--	--	--	1 N/A	--	--
	Effectiveness rating	0 HE	0 HE	0 HE	0 HE	0 HE	0 HE
		1 SE	2 SE	2 SE	0 SE	0 SE	0 SE
		7 ME	6 ME	7 ME	2 ME	2 ME	4 ME
		3 LE	3 LE	2 LE	9 LE	9 LE	7 LE
Follow-up	Year	2021	2021	2021	--	2019	2019
	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

South Africa
2021
3 C
17 LC
15 PC
5 NC
--
0 HE
0 SE
8 ME
3 LE

* 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 grey-listing, various actions have been taken to remediate the findings. Since December 2021, many South African 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.

Requests for 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, with less than two months left before the FATF reassessment, 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 information 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.

On the following page 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.

Impact observed on other grey-listed jurisdictions



Botswana

- Asset managers were not able to transact directly with pension funds with an offshore portfolio.
- Foreign direct investment in the 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, suggests that the FATF grey-listing, which began in 2008 and ended in 2019, may have resulted in cumulative real GDP losses of approximately \$38 billion.



Malta

- The 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 was down to 5% in 2021 from 25% in 2016.
- The decline in foreign investment and economic activity further exacerbated 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.com: Finance watchdog "grey lists" Turkey in threat to investment)



Mauritius

- Soon after its inclusion in the grey list, a large foreign custodian 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 a non-banking financial company not exceeding twenty 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 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.



In the event that South Africa is included in the FATF grey list, in addition to the enhanced follow-up reviews by the FATF, South Africa may also face restrictions imposed by other jurisdictions, leading to barriers to doing business or investing in South Africa. The international economic impacts may include: increase in the regulatory burden imposed on both South African entities and their foreign counterparties, economic restrictions from international funders such as the IMF or World Bank, or restrictions imposed by individual banks and businesses in doing business with South African entities. This would lead to a loss of trading and business partners as well as loss of financial flows. According to National Treasury, it will take a number of years for South Africa to fall off the FATF Grey List which may mean that the international economic impact may have long-lasting effects on the South African economy.

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 hamper South Africa's ability to remain competitive 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.

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 legal and regulatory AML/CTF 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:

South African entities may not be recognised as equivalent regulated entities

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

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

- Institutions may be **reluctant** to maintain current or start new business **relationships**.
- Investors may sell their current investments in South Africa and **redomicile** their **funds**.
- South African entities will need to **prove** that **sufficient AML/CTF controls** are in place to limit the effect of de-risking.

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

- **AML/CTF audits** may be imposed as a **precondition** for new and existing business relationships, applying **international standards** and regulations.
- In the event of **unfavourable** audit **results**, remedial actions need to be implemented within a short space of time.
- **Mandatory annual AML/CTF audits** were adopted across many grey-listed jurisdictions.
- South African entities need to perform **self-examination** and **remediation** assessments 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 be relevant to **any type of transfer** of funds.
- This would lead to significant **delays** of the payment process of transactions.
- South African institutions need to prepare and **train** their **operations units** to shorten the process.

Reluctancy to establish relationships related to PEPs

- The current definition of a politically exposed person (**PEP**) in the FIC Act is **deficient** and is in the process of being amended.
- Investors would be reluctant to establish relationships with **entities related to PEPs**.
- Additional **controls to identify PEPs** according to international standards may be requested.
- Some grey-listed countries applied controls to limit the entry of PEPs in private entities.

Extensive KYC performance and remediation

- Current **sources** of corporate information are **not reliable** (legal changes to this process in progress).
- **The extent of reliance on KYC** performed by third parties such as intermediaries or agents may be **limited**.
- Where reliance is still possible, entities need to **enhance their controls over third parties**.
- Entities need to **perform and remediate KYC** assessments in accordance with 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. Many financial institutions may not have the right skills to identify the risks or the necessary controls to effectively address them on a timely basis.

There is a possibility that some financial institutions may be limiting 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 of 2017.

How should South African life insurers 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 which 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 life insurance industry 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 insurer understands the different schemes used by criminals to abuse the life insurance system, and the vulnerabilities of an institution when facing these threats, can effective measures be designed and implemented. In order to achieve this, insurers 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, amongst other risk factors. 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. Those insurers that expand their business risk assessment beyond a general and one-dimensional description of risk per business area, 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 insurers 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 life insurers 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 record keeping purposes and in line with documentation retention requirements. In order to enhance the effectiveness and robustness of this process, insurers consider the following factors:

- Consideration as to whether the product need is 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. Third party risk

Many life insurance companies work with a large amount of third parties and intermediaries such as brokers and agents who distribute products to or perform risk assessment procedures in respect of clients on the insurer's behalf. Those life insurers that have succeeded in ensuring that such third parties comply with AML/CTF requirements have implemented effective controls. For example, implementing periodic controls to ensure that brokers follow the policies set out by the insurer. These practices will mitigate against the possibility of brokers or intermediaries acting as frontmen for financial crime schemes.

4. Effective enhanced due diligence measures

When onboarding high risk customers, life insurers usually apply enhanced due diligence measures, such as 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 insurer 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. 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.

5. Investment in technology

The implementation of technology is critical for life insurers, particularly as many have large client bases and sell a high volume of products and services. Included below are examples of how life insurers 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 insurers 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 more pronounced. For example, mechanisms can be put in place to detect whether a payment made by a customer to purchase an insurance policy comes from an account that belongs to the customer, or whether the early surrender of such policy and the return of the premium is paid into the policyholder's account.

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.

