UNITED NATIONS
SOUTH AFRICA

GREY LISTING IN SOUTH AFRICA:
A Note on Possible Socioeconomic Implications

AUGUST 2023

Grey listing in South Africa: A Note on Possible Socioeconomic Implications

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I. Introduction

On 24 February 2023, the Financial Action Task Force (FATF), a global body that sets standards and policies on money laundering, terrorist financing, and the financing of the proliferation of weapons of mass destruction, placed South Africa as a "jurisdiction under increased monitoring". This is also known as "grey listing" and takes place when a jurisdiction is found to have insufficient compliance with FATF standards. Among analysts' responses, many emphasised that the consequences for South Africa could be far reaching and that higher compliance costs would imply less foreign investments flowing in, higher costs of borrowing for national entities and companies, and more transaction, administrative and other costs for doing business. This would happen at a time when the South African economy is already underperforming and facing both external and internal shocks.

This note examines the possible adverse effects of grey listing highlighted in the media and by expert/commissioned reports. It takes into consideration the factors that led to the FATF decision as well as the characteristics of the South African economy. It also considers the duration of grey listing to understand its possible implications. The position of the South African National Treasury (NT) is that South African grey listing is motivated by specific shortcomings in the country's attempt to respond to FATF recommendations for action in 2021, rather than a generalised dissatisfaction with the levels of compliance with FATF's recommendations.[2] Whilst this may be true, there is a common understanding that, no matter its specific causes, grey listing is likely to cause adverse economic consequences due to a generalised perception that the risk of doing business in South Africa has increased.

II. What the FATF does, how it works and reasons for grey listing South Africa[3]

The FATF standards on anti-money laundering and counter financing of terrorism (AML/CFT) comprise 40 recommendations and 11 effective immediate outcomes. They cover a broad range of issues including the regulation of financial institutions and nonfinancial businesses and professions, cross-border currency movements, the transparency of legal entities, criminal law, institutional capacity, sanctions, as well as domestic and international cooperation. The FATF conducts "mutual evaluations", publish their results and follow-up on the progress countries make on addressing the main deficiencies identified by the evaluations.

South Africa's mutual evaluation report was published in 2021and revealed various deficiencies in its AML/CFT infrastructure, including in its legal framework. It was considered as only partially compliant with 17 of FATF's standards and totally non-compliant with three of them (Perumall, 2023). In October 2021, South Africa was given one year to address all recommended actions (67 in total) that FATF had made. During that time, South Africa made significant progress and passed two major legislative amendments in 2022.[4] A further assessment conducted in January 2023 noted that South Africa had made significant and positive progress, reducing the 67 Recommended Actions to eight strategic deficiencies, on which more progress is required. As a result, South Africa was grey listed and will remain on the list until FATF notes substantive progress in addressing the identified deficiencies.

In order to exit the grey list, South Africa is expected to: increase mutual legal assistance requests to help facilitate AML/CFT investigations; strengthen risk-based supervision of non-financial and professions;

1 Comments from Max Alier, IMF Resident Representative in South Africa, are greatly acknowledged.

2 See National Treasury (2023).

3 This section draws heavily on National Treasury (2023), except otherwise mentioned.

4 These are: the Anti-Money Laundering and Combating Terrorism Financing Amendment Act and the Protection of Constitutional Democracy Against Terrorist and Related Activities Amendment Act (Perumall, 2023).

ensure timely provision of authorities' requests for up-to-date beneficial owner (BO) information; apply sanctions for breaches of violations by legal persons to BO obligations; demonstrate a sustained increase in requests by law enforcement agencies for financial intelligence from the Financial Intelligence Centre (FIC) for their AML/CFT investigations; show sustained increase in investigations and prosecutions of serious crimes; enhance confiscation of proceeds of such crimes; update its terrorism financing risk assessment; implement a national counter financing of terrorism strategy; and have in place financial sanctions and mechanisms to identify individuals and entities that support terrorist financing.

It is important to note from the above that the issues South Africa should address refer to the information sharing of information, particularly on investigation of crimes, and strengthening its law enforcement and prosecution agencies – a major challenge for South Africa. In the Media Statement issued by the National Treasury following South Africa's grey listing, the Treasury noted that "there are no items on the action plan that relate directly to the preventive measures in respect of the financial sector. This reflects the significant progress in the application of a risk-based approach to the supervision of banks and insurers."[5]FATF[6] as well as the South African government, recognize that South Africa experienced deliberate attempts to erode the state's ability to detect, investigate and prosecute money laundering and terrorism financing related crimes during the state capture era. Moreover, the FATF in its October 2021 report states that South Africa has a "solid legal framework for combating money laundering"[7] and it does not foresee de-risking as a result of grey listing in the South African case. What is needed is a more effective implementation of its AML/CFT framework.

5 Media Statement Issued by the National Treasury on 24 February 2023, p.3 (National Treasury, 2023). See also Statement by President South African

6 President at Ramaphosa (2023).

7 South Africa FATF Mutual Evaluation Report, p. 19, p. 61.
Quote from the FATF report extracted from Perumall (2023).

III. Possible implications according to the analysts and the literature on grey listing

Possible implications of grey listing can be grouped as:

i) Impacts on foreign capital flowing into and out of the country: all categories of foreign capital may be affected, including foreign direct investment (FDI), portfolio flows and other flows (which include interest-bearing bank lending, trade credit and other). A key reason is the due diligence procedures international investors and lenders are subject to when considering dealing with a grey listed country. This may have an impact both on the volume and cost of capital flowing into the country. The cost is essentially of compliance nature and will depend on the regulatory regime applying to them – and, more generally, increased perceived risk. Compliance costs will vary from country to country and to different categories of capital. In some countries, pension funds and other institutional investors may face internal and/or regulatory rules that set upper limits or even totally prohibit investment in grey listed countries (Moonstone, 2023a).

The empirical literature on the impacts of grey listing on capital flows is inconclusive. According to a recent IMF study (see Kida and Paetzold, 2021) that reviews the literature, the effects are at best weak. The exception is the IMF study itself which finds that the effects of different types of flows are statistically significant and can be quite sizeable: of 7.6 per cent of GDP for total inflows, 3.0 per cent for FDI, 2.9 per cent for portfolio flows and 2.0 per cent for bank flows.

ii) Impact on the cost of doing business: the most affected will be firms operating in the foreign trade sector, exporting and importing goods and services, due to higher transaction and administrative costs they will face in trying to respond to information requests from foreign counterparts having to comply with stricter requirements in dealing with them; correspondent banking services such as foreign exchange, money transfers and business transactions by foreign banks dealing with respondent banks may be affected; insurance companies may face higher costs for their reinsurance programmes with foreign reinsurers programmes with foreign reinsurers (Moonstone, 2023b); and business opportunities may dwindle in case foreign partners decide to no longer trade with their South African counterparts.

iii) Impact on borrowing costs for the government, business and individuals: inevitably, the government and companies raising capital abroad may have to pay for higher risk premium/interest rates or may simply fall out of favour by potential investors/lenders. This is due to increased perceived risk, which may be reinforced if credit rating agencies downgrade South Africa on account of grey listing (which to date has not happened). Furthermore, it should be noted that the costs of grey listing increase the longer it takes to resolve the issues. Another important consequence is that, although FATF grey listing does not have binding implications for international financial institutions, it leads to blacklisting by the EU and higher risk listing by the UK and those do have binding implications for financial institutions in their jurisdictions.

In addition, there is the reputational damage grey listing may cause, which is more subjective and therefore harder to gauge – but also more diffuse. The ultimate consequences of all factors combined may be lower GDP growth and worsened socio-economic conditions for business and people in South Africa. Factors affecting levels of economic activity and thus GDP include less investment in productive activities, lower levels of net exports and income generated by different sectors including financial services (due to loss of trading and other revenues) – which may cause second-round effects such as reduced consumption levels and lower government revenues and hence budgetary pressures to spend less. Other factors may include the exchange rate, which may depreciate due to less capital flowing in. A depreciated exchange rate may cause an increase in inflation and lead to higher interest rates by the South African Reserve Bank. The exchange rate may also turn out to become more volatile, which increases uncertainty for businesses in general – and particularly for exporters and importers. A further indirect effect is through the balance of payments. In case the country witnesses an enlarged current account deficit, the government may increase interest rates, this time not to fight inflation – but, rather, to attract more foreign capital to help close the external financing gap and protect the country's level of foreign reserves.

The Business Leadership South Africa (BLSA) published a report by Intellidex back in October 2022 – thus before grey listing was announced – highlighting possible impact such as higher transaction costs for cross-border payment and reputational risks, which, if actions by the government were not seen as effective in redressing the shortcomings pointed out by FATF, could lead to reduced appetite for investing in South Africa. The notion that the longer grey listing lasts the greater the effects will be, has been alluded above and is in line with IMF view that the effects can be cumulative over time. The report also remarked that there was a risk of grey listing making access to bilateral and multilateral development funding more difficult, which could affect in particular funding for energy transition. The Just Energy Transition Partnership itself could be affected, according to the report (Intellidex, 2022).

All the possible adverse effects just mentioned, no matter how small they in the end turn out to be, will add to the effects arising from the multiple shocks South Africa has suffered in the recent past. These include the reduced risk appetite by international investors for emerging market assets due to greater international uncertainty and tightening financing conditions; the ongoing energy crisis; and higher domestic interest rates in response to the volatile external economic-political environment and to domestic inflation. A consequence is that grey listing combined with all these shocks complicates further a socio-economic reality characterised by deep structural issues that has kept South Africa in a low growth trap for over a decade. Of course, it is also possible that grey listing may result in some positive outcomes. A clear government response to redress issues highlighted by the FATF may help turn the tide against a generalised perception that little is done to fight money laundering, other criminal activities and corruption, in this way increasing the levels of confidence in the country and encouraging greater levels of investment, both foreign and domestic. Furthermore, in order to address the deficiencies outlined in the mutual evaluation report and FATF Action Plan, State institutions may benefit from an increase in human and financial resources.[8]

Grey listing of South Africa may also potentially affect the southern Africa region and Africa more generally, with feedback effects on South Africa. This is because South Africa is an important regional financial centre[9] and economic hub in Africa.[10] The country serves as an important gateway for inter-regional trade, destination for African immigrants, and foreign direct investment and capital flowing to different countries.[11] Therefore, any negative consequences to South Africa's grey listing will likely resonate throughout the African continent. In addition, the currencies of some countries are pegged to the South African Rand (e.g Eswatini, Namibia and Lesotho), meaning that any long-term currency fluctuations may further impact these countries.

iv) How big will be the impact of grey listing in South Africa?

In South Africa, it is still early to identify possible effects as the country was grey listed in the final week of February 2023. Some of the effects may have already been priced because the event was widely anticipated with a reasonable level of certainty that it would happen. The problem is that, looking back to the past 6-8 months when reporting and analysis about the prospect of grey listing in South Africa became more frequent, the country has been impacted by various shocks. As mentioned above, these include growing economic uncertainty and political tensions at the international level, the tightening of financial conditions (both globally and domestically) and the intensification of loadshedding (i.e., scheduled power cuts). The negative GDP growth in the fourth quarter of 2022 and the depreciation of the exchange rate since last year have been associated with these factors – and possibly grey listing too, but it is difficult to disentangle their effects to know exactly to what extent or by how much each factor may contribute to such macroeconomic trends.

Reported impacts of grey listing in selected countries

Many grey listed countries that cooperated with FATF to address deficiencies succeeded to exit the list in between 2 to 4 years. Much of their grey listing had to do with the need to strengthen supervision of financial institutions and beneficial ownership reporting, in addition to strengthening of legislation. Reported consequences were similar between them.

Mauritius was grey listed by the FATF in February 2020 and was removed from the list in January 2022. The consequences the country suffered reportedly included payment delays by banks, negative impacts on trade and higher transaction costs for cross-border businesses. Some investors changed the domicile of their business while new investors opted for other jurisdictions. The European Union blacklisted Mauritius and the UK included it on the list of high risk third countries (Calcutteea, 2022). In both cases, these measures imply the need for enhanced due diligence. In Botswana (grey listed between October 2018 and October 2021), local financial institutions faced higher costs dealing with foreign banks and cross-border transactions were impacted – including donor transfers to NGOs (Dinar, 2021), as well as FDI in the diamond sector. Pakistan, which was grey listed between 2012 and 2015, saw GDP growth reduced between 1-2 per cent, according to findings from Intellidex (Lexology, 2022). In Zimbabwe (grey listed between October 2019 and March 2022), the greatest impact was on correspondent banking relationships and FDI (Sibanda and Chingwere, 2022).

[8] See, for example, statement by the South African President (Ramaphosa, 2023). In that statement, the President mentioned that that additional funds will be allocated to the police, NPA, SIU and Financial Intelligence Centre (FIC) to strengthen the fight against crime and corruption. He further added that “One of our most effective tools for combating money laundering and other financial crimes is the multidisciplinary Fusion Centre we established in 2020. The Fusion Centre brings together bodies like the NPA, SIU, SARS, the Hawks, Crime Intelligence, State Security Agency and the FIC. Since its inception, the work of the Fusion Centre has led to the preservation and recovery of approximately R1.75 billion in criminal assets.”

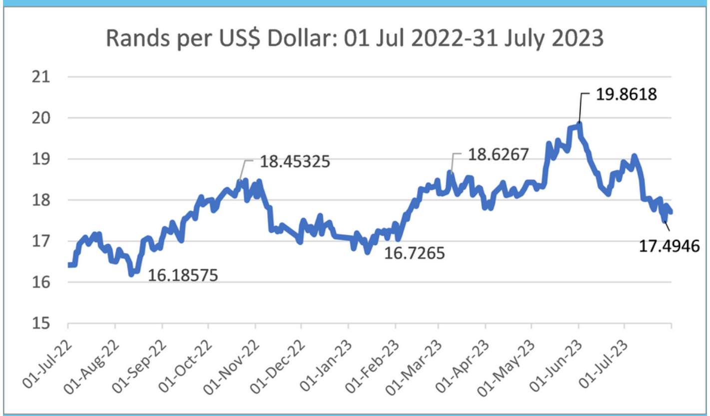
[9] South Africa FATF Mutual Evaluation Report, 2021, para. 414.

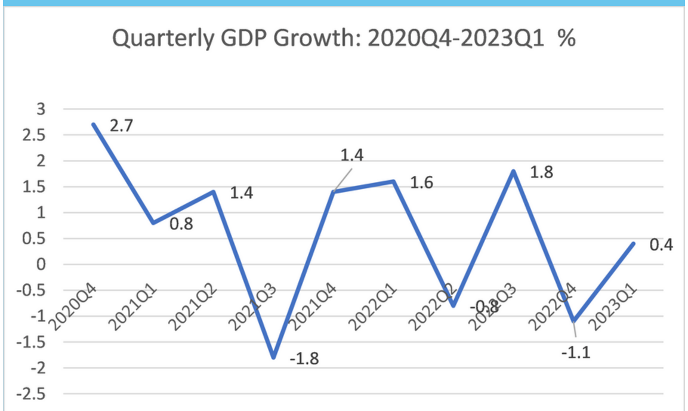
[10] Cenfri (2020, pages 8 and 12).

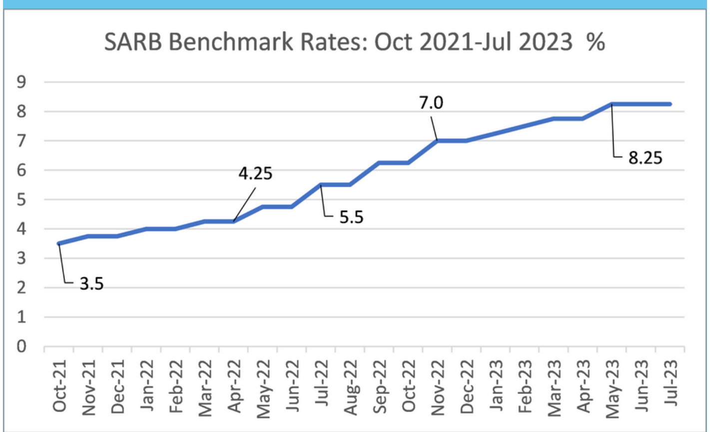
[11] Ibid.

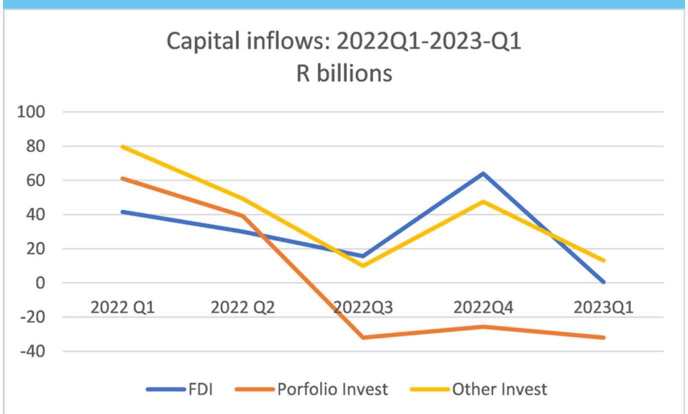
Figure 1 below shows recent trends in the country's nominal exchange rate and GDP growth, as well as the domestic benchmark rates (as a possible underlying factor) and capital inflows (which itself could be reflecting grey listing while also having an impact on both the exchange rate and GDP growth). Of course, some of the consequences of grey listing have a long-term effect.

Figure 1: Selected Macroeconomic Indicators









Sources: IMF, Stats SA and SARB.

However, even if the economic situation deteriorates further in the future, it will be difficult to identify the exact contribution of grey listing, given that there are so many confounding factors simultaneously at play.

Yet, however difficult it may be to gauge impacts, the fact is that grey listing is a signal to countries of the perceived risk of doing business with a particular jurisdiction – regardless of the action points because they all signal weaknesses in the country's AML/CFT framework.

Because of that perceived risk, there is likely to be an increase in compliance costs. Correspondent banks and the international business community will still be wary of doing businesses with jurisdictions like SA with high financial crime. The international banks will have to exercise enhanced due diligence, for example when they are aware of the large amounts of funds that have been looted from South Africa.[12] As a result, both trade and the financial sector will continue to be impacted.

The Banking Association South Africa (BASA) recognises that doing business may become "more onerous and costly," although they remark that South African banks "will not be shut out of international markets", as they are already aligned with international best practices, and due diligence is already the case among international correspondent banks dealing with South Africa (BASA, 2023).

The South African government clearly acknowledges that state institutions that are necessary to fight money laundering, terrorism and other forms of crime have had their ability to perform their tasks

[12] See also Adshade (2023).

with effectiveness eroded during the years of state capture. Moreover, recent reports indicate that the National Prosecuting Authority (NPA) has a severe backlog of cases, meaning that the timeframes indicated by the NT for compliance may be optimistic. Additionally, the NPA has recently (see Sunday Times of 30 April) lost key 'state capture' cases, meaning that in fact institutions to fight AML are rather not up to the task. On this basis, and given other reports of potential financial leakages, NT's optimism could be misplaced.

v) Policy Messages

It is therefore important that South Africa remains firmly on the path to redress the shortcomings highlighted by the FATF. A recent event that brought together FIC, the NPA and development partners to the same room highlighted the need for greater coordination among stakeholders assisting South Africa in redressing the issues highlighted by the FATF, and that it is crucial to avoid duplication and to provide better, more tailored technical assistance.[13]

In addition, there is a general perception that:

- There seems to be a lack of cooperation within the government. Different government sectors are not sufficiently communicating and working with each other. It is important that the FIC and the National Treasury improve their communication with each other. Budgetary issues may be an issue that creates frictions in the relationship.

- The various working groups the government has established still work in silos; these silos need to be broken and greater collaboration fostered.

- South Africa may not always be welcoming to technical assistance (TA) provided from outside. TA may be seen as with some suspicion. Building trust is therefore critical. In a recent event on an unrelated matter, a South African Government Minister said: "Trust is built through action".

An early exit from grey listing is important, since the longer the country remains listed, a sense of despondency may settle in and effects may take greater proportion, causing visible and sizeable harm to the economy. What the experience from other countries which succeeded in exiting the grey list in a short period of time indicates is that government's strong commitment and close cooperation between the different stakeholders – government, business, others – are vital ingredients to ensure that laws and regulations are implemented.

The UN in South Africa through its United Nations Sustainable Development Cooperation Framework 2020-2025 addresses many of these issues, which fall under its priority area of effective, efficient and transformative governance and mobilises efforts including by convening and leveraging support to help the government of South Africa to redress this and other obstacles in its path towards inclusive and sustainable development.

[13] The event was co-organised by the Canada embassy in Pretoria, South Africa, and the German Cooperation, and facilitated by the United Nations Office on Drugs and Crime. It took place on 13 April 2023, Pretoria, South Africa.

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SUSTAINABLE DEVELOPMENT GOALS

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