Q&A ON

South Africa's grey-listing

28 February 2023

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Q. What has happened?

On 24 February South Africa was placed on a global financial watchdog's "grey list" comprising countries that are deemed to be inadequately identifying and halting illicit international financial flows including money laundering, terrorist financing and proceeds from crime. This means that the country has been classified as a jurisdiction subject to increased monitoring, along with 25 other countries including Nigeria, South Sudan, Cambodia and Syria.

The decision was announced by the Financial Action Task Force (FATF), a global intergovernmental organisation which is essentially an auditing group that reviews and evaluates countries based on 40 technical compliance ratings. It had been widely expected, having been considered a serious risk by the SA government, financial market participants and regulators for some time now, despite the government having actively sought to address the deficiencies over the past two years.

In 2021, the FATF published its evaluation report highlighting vulnerabilities in the country's anti-money laundering system, as shown in the accompanying table. Subsequently, progress had been made in addressing these weaknesses, including the enactment of two laws to address the technical deficiencies in the legislative framework (the General Laws Amendment Act of 2022 and the Protection of Constitutional Democracy Against Terrorist and Related Activities Amendment Act). In his 2023 Budget Speech on 22 February, the Minister of Finance said the remaining deficiencies would be addressed through regulations and practices that do not require legislation. "We recognise the need to be more effective in implementing our laws, particularly in fighting organised and sophisticated crimes," he noted, while warning that the country should be prepared for the possibility of being grey-listed.

FATF 40 Recommendations	Rating	FATF 40 Recommendations	Rating
1. Assessing risk & applying risk-based approach	Partially compliant	21. Tipping-off and confidentiality	Compliant
2. National co-operation and co-ordination	Partially compliant	22. DNFBPs: Customer due diligence	Partially compliant
3. Money laundering offence	Largely compliant	23. DNFBPs: Other measures	Partially compliant
4. Confiscation & provisional measures	Largely compliant	24. Transparency & BO of legal persons	Partially compliant
5. Terrorist financing offence	Partially compliant	25. Transparency & BO of legal arrangements	Partially compliant
6. Targeted financial sanctions – terrorism & terrorist financing	Non-compliant	26. Regulation and supervision of financial institutions	Partially compliant
7. Targeted financial sanctions - proliferation	Partially compliant	27. Powers of supervision	Partially compliant
8. Non-profit organisations	Non-compliant	28. Regulation and supervision of DNFBPs	Partially compliant
9. Financial institution secrecy laws	Largely compliant	29. Financial intelligence units	Largely compliant
10. Customer due diligence	Partially compliant	30. Responsibilities of law enforcement and investigative authorities	Compliant
11. Record keeping	Largely compliant	31. Powers of law enforcement and investigative authorities	Compliant
12. Politically exposed persons	Non-compliant	32. Cash couriers	Partially compliant
13. Correspondent banking	Largely compliant	33. Statistics	Largely compliant
14. Money or value transfer services	Partially compliant	34. Guidance and feedback	Largely compliant
15. New technologies	Non-compliant	35. Sanctions	Largely compliant
16. Wire transfers	Largely compliant	36. International instruments	Largely compliant
17. Reliance on third parties	Non-compliant	37. Mutual legal assistance	Largely compliant
18. Internal controls and foreign branches and subsidiaries	Partially compliant	38. Mutual legal assistance: freezing and confiscation	Largely compliant
19. Higher-risk countries	Largely compliant	39. Extradition	Largely compliant
20. Reporting of suspicious transactions	Largely compliant	40. Other forms of international co-operation	Largely compliant

Source: FTAF October 2021

Q. What does research and history tell us about the impact of grey-listing?

There have been a number of academic papers that have investigated the impacts on capital flows of grey- and black-listing, and these results have been inconsistent. The much-cited 2021 IMF paper highlighted a substantial drop in capital inflows, across all categories of flow at the time of grey-listing, but these generally quickly reversed in the quarter or two following the announcement. This would be largely consistent with our hypothesis that markets anticipate effectively, leading to limited longer-term effects.

Mauritius was grey-listed in February 2020. Many South African banks have operations there, resulting in them having to manage and navigate the additional risk oversight that correspondent banks would have required as a result. Yet Mauritius is seen as having favourable capital and tax frameworks and the country has an investment-grade credit rating, and it was removed from the grey list 18 months later. This has effectively provided South African banks with a good learning experience in managing a grey-listing.

We would also suggest that countries that implement changes in laws and policies to address identified deficiencies are likely to spend the least time on the grey list. South Africa has done so, as noted above, and in 2022 there was much publicity around actions taken to combat fraud and state capture. These included some high-profile arrests and, notably, the extradition application to the UAE for the Gupta brothers.

Q. What about the impact on the Rand?

Our analysis indicates that the Rand is fundamentally cheap relative to the US Dollar. This is less the case vs the Euro, Sterling or the Yen, which have also been very weak vs the Dollar. We would expect limited long-term effects from the grey-listing on the currency given this valuation support. US monetary policy will likely remain the main dynamic at work in foreign exchange markets, and its direction remains very uncertain at present. Our portfolios have recently reduced exposure to hard currency given the valuation support for the Rand and, as noted, our view is that the present is an unattractive time to enter offshore markets given the attractive valuations on offer in SA.

Q. What is M&G Investments' view on the potential impact on the SA economy, financial markets and investment returns?

Following the FATF announcement on 24 February, there appeared to be very little bond market reaction. SA bonds ended the day stronger and the yield curve flattened, the opposite of what one would expect to see following a typical bad news headline. The rand did weaken somewhat versus the US dollar on the day and again the following day, but the release of worse-than-expected

In-country experience following grey-list inclusion – Morgan Stanley

Country	Grey list Inclusion	Empirical observations
Argentina	2011 - 2014	Argentina was already outside the main channels of international capital flows with no market access, so this event was not very impactful. This was just another negative development, but not very relevant given other factors limiting inward FDI.
Hungary	2001 - 2002	Hungary's inclusion in the list was short-lived, clouding the effect in the data. However we do observe a significant reduction in capital flows, from c.10% of GDP to just 2% of GDP within that period. The reduction was mostly in portfolio and other investment flows.
Philippines	2000 - 2005: 2010 - 2013; 2021-	Regular public statements from officials/legislators suggest strong commitments to meeting FATF standards. BoP data show weaker net portfolio and/or net FDI flows to varying degrees, however these periods overlap with the aftermath of 2001 TMT correction and the GFC.
Russia	2000 - 2002	In those early years foreign capital presence in Russia debt and equity markets was insignificant, so the BoP data doesn't show any corresponding outflow of capital.
Thailand	2010 - 2013	Policymakers take inclusion seriously and the list itself appears to have had some deterrence value by prompting legislative changes to meet FTAF's recommendations and best practices. BoP data are somewhat inconclusive as to the effect of the inclusion.
Turkey	2010 - 2014; 2021-	Inclusion in 2010 was taken seriously by the authorities at the time, who took a series of steps to satisfy FATF's criteria. The 2021 inclusion occurred when the Lira was already weakening. The quality of external finance deteriorated, with continued portfolio outflows and large inflows through net errors and omissions as well as a reserve drawdown.
Ukraine	2001 - 2004; 2010 - 2011	Given shallow capital markets during the period of the first inclusion and the political volatility throughout the period of the second inclusion it is hard to identify outflows specifically driven by the FATF decisions.
Venezuela	2010 - 2013	Similar experience to Argentina, with already low liquidity on the trading of treasury bonds and the national oil company PDVSA at the time. Marginal impact of grey list inclusion was low.

Source: Morgan Stanley.
Note: Country selection based on Macro Research coverage.

US inflation data on the day played a role in strengthening the US dollar, and one cannot distinguish between these two factors and others at work as well. As such, these reactions are supportive of our view that the bond and currency markets had already priced in the FATF decision.

In equity markets, financial sector shares weakened approximately 2% after the new – losses possibly related to the grey-listing. However, we see this as a short-term move, with other more important factors driving our equity markets.

The academic evidence, especially for countries that take policy action in response to being grey-listed, is that the effects on capital flows are short-lived. Our interaction with the South African banks also corroborates the broad notion that they are well prepared to manage this development.

Among emerging markets, South Africa has deep and liquid equity, bond and foreign exchange markets. The evidence to hand, and included the various academic literature, is highly suggestive of limited effects in anything other than the very short term. Even over that horizon, the Mauritius experience is likely to have provided a useful learning ground for the SA banks, which will substantially ameliorate any effects.

That effects are likely to be limited was echoed in a research paper by Morgan Stanley, which focused on the financial market effects of grey-listing. The findings are summarised in the accompanying table. Only Turkey demonstrated a material underperformance, and many other factors were at play in that market at the time. In the example of Mauritius, bond yields weakened by around 30 basis points a month before the announcement, but quickly recovered and then proceeded to track global bond market developments.

Global credit ratings agency S&P Global Ratings said last year that South Africa's sovereign credit rating was unlikely to be hurt by a grey-listing, although some state-owned enterprises with high debt levels like Eskom and Transnet might see credit costs rise.

The lack of general significant market impacts may be explained by the prior observation that the deterioration in fundamentals that led to the grey-listing were already discounted. Morgan Stanley did find some evidence of market outperformance when countries exited the grey list.

Q. What about the reaction from offshore investors?

The 2021 IMF Paper indicated private investment flows dipped materially around the time of grey-listing, before rapidly recovering. There was a substantial variation around the mean of this result; however. It is our contention that financial markets are driven by a great number of factors, and many of these probably have a bigger impact on global investor sentiment. The most important of these over the longer term, in our view, is valuation. In the short term, important local issues would include loadshedding and the state of the South African economy and fiscus. Globally, concerns about the pace of interest rate increases, the peak and start of easing of US interest rates, the rate of improvement in global inflation, the path of energy and food prices and the state of (deteriorating) geopolitics will doubtless dominate price action. The focus on grey-listing is at best useful in a ceteris paribus world, which feels a far cry from the prevailing uncertainty today.

Q. What is M&G Investments' view on the impact on SA banks and the banking system?

In our view, the risk that South Africa might be grey-listed had been known to the banking sector (both locally and internationally) for many years, and they have effectively had advance warning. Many SA banks and correspondent banks have therefore already put measures in place to improve risk oversight and confirm arrangements should a grey-listing be put in place. Specifically, banks have termed out their debt in many cases, firmed up on arrangements with correspondent banks and put in place additional risk and compliance oversight.

We also think that the insight the grey-listing of Mauritius has provided to the SA banking sector and the "advance warning" that the SA banking sector and international banks and investors have had, should mean that there will likely be minimal impact on international transactions and flows.

Q. What is M&G Investments' view of the broad impact on the financial services industry?

In our view it is difficult to draw a clear conclusion about the potential impact of grey-listing, as markets are driven by a plethora of factors and there is good reason to believe that they have already anticipated a grey-listing announcement. The announcement itself is essentially backward looking, as the fundamental factors driving it will have been more or less in plain sight for some time. In South Africa's case, State Capture, credit rating downgrades, deteriorating rankings in the WEF Global Competitiveness Survey, weak potential growth, low productivity, limited fiscal capacity and other factors, have all been known for years. We would suggest that internal and external agents will have been responding to these themes in their risk pricing, and that the resulting elevated risk premium is already reflected in the current cheap valuations of South African bonds and equities.

Q. What is the Impact on M&G Investments' fund positioning?

Challenging South African fundamentals, which have led us to this very place, have ensured that our risk positioning is moderate. Our portfolios are moderately overweight both local equities and bonds. Offshore, we held an underweight position in global bonds for many years, although in the past year we gradually added to our position to be much less underweight as yields rose around the world. For global equity, our exposures were pared back in late 2021. In aggregate, asset allocation risk is modest. Our SA overweights are largely informed by extremely cheap levels of valuation, which in our view more than factor in the potential risks in the current environment, of which a potential grey-listing has been only one (likely temporary) component. Within equities, we see many attractive opportunities in South Africa, and prefer companies with pricing power and strong balance sheets and those that can weather difficult economic environments.

Despite the relaxation of the Regulation 28 rules to allow greater foreign exposure, we view the Rand and SA assets as favourably priced against global peers and believe the timing is suboptimal to take any further funds offshore given the valuations on offer.

We anticipate ongoing elevated global volatility for all the reasons already highlighted elsewhere in this note, and expect to be able to take advantage of this both in our stock selection and asset allocation in line with our proven investment philosophy and process. Despite this volatility, given the attractive valuations in South Africa and our current holdings, we believe our overweights in SA equities and bonds will add further value to client portfolios over time, as has been the case during the past two years.

Q. What are the concerns around grey-listing for SA investors?

South Africa's grey-listing has flagged the higher risks of international transactions into and out of the country being illicit, and these transactions will now require much greater scrutiny by bank administrators and other regulatory authorities. This higher risk and additional administrative burden are likely to bring extra costs for offshore transactions, including banking and investing. The SA Reserve Bank has previously warned that it could increase transactional, administrative and funding costs for banks and investment managers, as well as triggering capital outflows.

SA investors may therefore experience more difficulties in investing offshore directly in foreign currency, in terms of more documentation being required, and perhaps additional costs and transaction delays, as long as the country remains on the FATF grey list.

Q. How can M&G Investments help investors to invest offshore during the grey-listing?

As a global investment manager, M&G Investments offers our clients Rand-denominated feeder funds that invest into M&G's range of Irish-domiciled, US Dollar-denominated global funds, including the M&G Global Equity, M&G Global Balanced and M&G Global Bond funds. Investments into these feeder funds will not incur extra scrutiny, additional paperwork or increased costs and transaction delays because they are SA domiciled and rand-based, while still offering clients global investment exposure via attractive global portfolios managed by our long-experienced global investment team.