

**G:ENESIS**



**Access to Financial Services in South Africa:  
A brief case study of the effect of the  
implementation of the Financial Action Task  
Force Recommendations**

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## **EXECUTIVE SUMMARY**

This case study highlights the need for appropriate interpretation and enforcement of FATF recommendations in developing and middle income countries using the example of South Africa. The study shows that there is a clear potential contradiction between inappropriate and strict rules-based enforcement of FATF recommendations, and access to financial services for the majority of a developing country's population.

South Africa implemented the FATF AML standards in June 2003 when the Financial Intelligence Centre Act (FICA) came into force. In line with international practice on customer identification and verification FICA requires financial institutions to obtain and verify the residential address of a client before they enter into a business relationship with the client or process a transaction for the client.

To date financial institutions could not comply fully with this requirement. The reason is that one third of the population live in informal dwellings without formal address whilst up to half of the population lack the documents to verify their residential addresses. These are primarily low income persons. The Banking Council responded by issuing a Practice Note suggesting that banks dispense with the verification requirement when the client cannot prove his or her address. The banks face a similar difficulty with the requirement to re-identify existing clients.

South Africa has not yet implemented the FATF Recommendations on Combating the Financing of Terrorism. Despite the presence of a large immigrant community, originating primarily from countries in the Southern African region, the levels of formal remittances are very low. Early evidence therefore suggests the presence of an extensive informal remittances sector, most of it in the form of cash remittances using cross-border transport. This corresponds with the large informal cash-based economy in which most poor South Africans and immigrants operate.

The case of South Africa offers the following positive recommendations for reducing the contradiction between the need to include the poor in the formal financial sector and – at the same time – more effective FATF outcomes:

- The implementation of FATF AML Recommendations should be sensitive to the particular circumstances of developing and middle income countries. A cost-benefit analysis should be done before legislation is passed. Clarity must be obtained regarding the measure of latitude that countries have to formulate context-sensitive regulations to meet the FATF Recommendations;
- AML and CFT risks are very different things and have different faces in different societies. An internationally acceptable yardstick to determine AML and CFT risks should be designed to enable developing countries to follow a risk-based approach in respect those who are financially and socially vulnerable;
- The imposition of regulation by itself will not force the users of informal financial services to suddenly use formal services. It may have the opposite effect. The provision of low-cost, user-friendly products that require minimal administration will achieve more; and
- International AML practice on client identification and verification should not follow a universal template. Developing and middle income countries may have national identification systems that will be equally effective to identify clients.

# 1.INTRODUCTION<sup>1</sup>

The Financial Action Task Force (FATF) recommendations on anti-money laundering (AML) and combating financing of terrorism (CFT) are increasingly being applied within middle income and developing countries. Early experience suggests that the manner in which they are being implemented may put at risk the goal of increased inclusion of the low income earners into the financial sector. The success of the related drive to formalise remittance flows, and whether this process promotes or reduces financial inclusion, will be determined in part on how appropriately the FATF recommendations are applied to developing country and informal sector realities. South Africa has been actively implementing FATF recommendations for long enough to offer valuable insights and lessons in the context of financial inclusion and access to financial services.

The UK's Department for International Development (DFID) has requested the FinMark Trust, which is based in Johannesburg, South Africa and funded by DFID, to prepare a short case study on the impact, actual and potential, of FAFT AML and CFT standards on access to financial services in South Africa. This report will also feed into the policy process in the UK, which is currently preparing its submission on remittances to the G7, and which actively supports the implementations of the FATF recommendations as well as financial access programmes worldwide.

FinMark's mission is to make financial markets work for the poor and it has worked extensively on regulatory obstacles to the extension of financial services to low income individuals in South Africa. Although much of this work focused on transaction banking services, many of the same issues apply to remittances. And indeed little research and analysis have been done on the impact of the implementation of the FATF Recommendations on development. The South African experience on the transaction banking side coupled with fairly realistic projections of the likely impact on remittances provides useful evidence to inform FATF implementation in developing countries.

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<sup>1</sup> The authors acknowledge with appreciation the comments from the South African National Treasury on an earlier draft of this paper.

## 2.PROBLEM STATEMENT

AML and CFT regulation is no different from other regulation applicable to the financial sector. It imposes either absolute barriers or costs on the usage of the financial services concerned. The costs are two-fold – compliance costs for the financial institutions and direct costs for the client. Jointly they increase the transaction costs for the client of using a service.

Absolute barriers prevent persons from using a service. For example, if the regulation requires certain formal documents to be presented, persons without the documents are effectively excluded from the service. Transaction costs, when unaffordable, can also prevent persons from using a service. If the transaction costs imposed on utilising formal sector services are too high, clients are likely to abandon the formal sector and turn to informal sector provision (the informal sector is by definition beyond the reach of regulation and the incremental transaction costs imposed by it). This defeats the very object of imposing the regulation in the first instance, and has negative consequences for the development of the society.

Within this framework, what is the likely impact of the implementation of AML and CFT standards in developing countries? We look at this question drawing on recent experience with AML implementation in South Africa.

## 3.SOUTH AFRICAN CONTEXT

Broad-based black economic empowerment (BEE) is a key policy objective of South Africa's government. The purpose of BEE is to correct the racially skewed economic development of the country caused by apartheid. An essential plank of this is the government's objective to extend access to basic financial services to low income households. The scale of this task is daunting, since recent research<sup>2</sup> shows that 50% of the 27 million adult South Africans do not have bank accounts.

To meet this challenge, the South African financial sector has negotiated a Financial Sector BEE Charter, endorsed by the government, in which financial institutions commit

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<sup>2</sup> FinScope 2003, a FinMark Trust initiative, <http://www.finscope.co.za>



themselves to the achievement, over a period of 5 years, of specific targets for the extension of access to financial services to low income households (defined as households earning less than approximately US\$340 per month). One of the Charter targets is that 80% of these low income households should have access to transaction banking services by 2008. A financial institution's failure to meet its Charter and other BEE commitments will affect its ability to secure government contracts.

To give effect to this obligation under the Charter, banks have formed a joint initiative to develop a branded National Bank Account that would provide low-income individuals with low-cost basic savings and transactions services.

The South African government also seeks to integrate South Africa into the international community following the isolation of the apartheid years. This includes integrating the country into international capital and financial markets, as well as compliance with international standards including financial regulation and safety measures. As part of this policy the government has committed itself to combating money laundering and the funding of terrorism. Following implementation of its AML system, South Africa was admitted as a member of the FATF in June 2003.

## 4. INTERNATIONAL FRAMEWORK

The international AML and CFT standards are embodied in the Forty plus Eight Recommendations of the Financial Action Task Force ("FATF").<sup>3</sup>

The Forty Recommendations were first formulated in 1990 to address the laundering of proceeds of crime, in particular the proceeds of drug trafficking. In October 2001, following the terror attacks of 9/11, a strategic decision was taken by the FATF to broaden its scope and that of the money laundering control framework to combat the funding of terrorism. Eight Special Recommendations on Terrorist Financing were therefore adopted to supplement the Forty Recommendations. The Forty Recommendations were substantially revised in 2003. In their current form they provide detailed standards that countries and financial institutions must meet to combat money laundering and financing of terrorism.

Non-compliance with the Recommendations can impact negatively on the economy of a country. Financial institutions are required to give special attention to transactions and clients that are linked to non-compliant countries. These due diligence procedures slow down and, in certain cases, hamper the relevant transactions and clients. Non-compliant countries may also be subjected to appropriate countermeasures by other countries.

### 4.1. CUSTOMER IDENTIFICATION AND VERIFICATION

The 2003 Forty Recommendations require financial institutions to identify their customers and to verify a customer's identity using reliable, independent source documents, data or information. These procedures form part of general customer due diligence ("CDD") procedures.

Whilst the current FATF CDD requirements are more detailed and strict than the pre-2003 requirements, they also allow countries to follow a risk-based approach in respect of CDD. It works like this. The general rule is that customers must be subject to the full range of CDD measures. Nevertheless it is recognised that there are

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<sup>3</sup> The pre-2003 Recommendations were endorsed by more than 130 countries. These standards were also recognized by the World Bank and the IMF as the international standards for combating money laundering and the financing of terrorism. The Recommendations are reinforced by international instruments such as the 2000 United Nations Convention against Transnational Organized Crime and the 2003 United Nations Convention against Corruption.

circumstances where (i) the risk of money laundering or terrorist financing is lower, (ii) information on the identity of the customer and the beneficial owner of a customer is publicly available, or (iii) where adequate checks and controls exist elsewhere in national systems. In such circumstances a country may allow its financial institutions to apply simplified or reduced CDD measures with respect to identification and verification. For higher risk categories of customers or transactions, on the other hand, financial institutions are expected to perform enhanced due diligence.

The Recommendations must be read in conjunction with other relevant international standards. Two publications of the Basel Committee on Banking Supervision<sup>4</sup> provide an important CDD benchmark for banks. The 2003 publication (the “Basel Guide”) requires specific information to be obtained from clients and for it to be verified as set out in the Guide (see **Appendix A**). The guidelines are strict, but also allow a risk-based approach.

## 4.2.RESIDENTIAL ADDRESS REQUIREMENTS

The 2003 FATF Recommendations do not explicitly require information to be gathered about a client’s residential address and for this information to be verified. The Recommendations simply require as a general principle that a client’s identity should be established and verified using independent, reliable source documents, data or information (referred to as “identification data”). However, international best practice is that the client’s residential address should be obtained and preferably verified.<sup>5</sup> Certain *advanced* jurisdictions such as the UK and the USA require residential addresses to be obtained and verified but allow institutions to accept non-standard verification documentation (for instance, a letter of a person in a position of responsibility or information relating to the address of next of kin) when persons are reasonably believed to be incapable of producing standard documentation or where they do not have a

<sup>4</sup> The 2001 paper entitled “Customer due diligence for banks” as supplemented by the 2003 annexure entitled “General guide to account opening and customer identification”. The Interpretative Notes to the 2003 FATF Recommendations incorporate certain portions of the guide by reference.

<sup>5</sup> See, for instance, Commonwealth Secretariat *A model of best practice for combating money laundering in the financial sector* (2000) 69-70: “An individual’s identity comprises her/his name and all other names used, the address at which s/he can be located, date of birth and nationality.” See also the reference to address in Special Recommendation VII as an element of “accurate and meaningful originator information” (a requirement subsequently softened by the relevant interpretative note). Note the relevance of the correct permanent address in the Basel Committee on Banking Supervision’s “General guide to account opening and customer identification” (see **Appendix A**), the UK approach to the verification of clients’ addresses (especially the guidance issued by the UK Joint Money Laundering Steering Group) and the US residential address verification requirements in the final regulation under section 326 of the USA Patriot Act 2001 (Customer Identification Program for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks).

residential address. We now turn to how this key issue is dealt with in one FATF-compliant developing country, South Africa.

## **5.FATF IMPLEMENTATION IN SOUTH AFRICA**

### **5.1.BRIEF OVERVIEW**

South Africa first criminalised drug-related money laundering in 1992 and in 1996 broadened the scope of its money laundering laws to the proceeds of all types of crime. The current money laundering offences are mainly created by the Prevention of Organised Crime Act of 1998 and the money laundering control provisions are mainly set out in the Financial Intelligence Centre Act of 2001 ("FICA"). The latter should be read in conjunction with its attendant regulations and exemptions. Funding of terrorism has not yet been criminalised but relevant legislation is in the final stages of adoption pending completion of the April 2004 general election.

### **5.2.MONEY LAUNDERING CONTROL**

FICA requires all businesses, all persons in charge of businesses and any employee of a business to report suspicious and unusual transactions to the Financial Intelligence Centre ("FIC"). The FIC is South Africa's Financial Intelligence Unit. It receives the FICA reports and shares the intelligence with law enforcement units.

FICA also creates a range of money laundering control obligations for "accountable institutions". These institutions include banks, insurance companies, money remitters, casinos, attorneys and bureau de change. They are required to identify and verify the identities of their customers, keep the relevant records, report specified transactions to the FIC and generally to have the necessary compliance procedures in place. The control obligations are detailed in the regulations under FICA (the Money Laundering Control Regulations) and are tempered by a set of Exemptions issued by the Minister of Finance. The supervisory powers in relation to money laundering control are entrusted to the existing regulatory authorities. The main financial supervisory bodies for purpose of FICA are the South African Reserve Bank, which supervises compliance by banks, and the Financial Services Board, which performs the same functions in relation to non-bank financial institutions.

### 5.3.CUSTOMER IDENTIFICATION AND VERIFICATION

FICA's control framework follows international best practice, particularly in relation to identification and verification. Detailed information about these requirements is set out in **Appendix B**. In respect of natural persons, financial institutions are required to obtain the client's full names, date of birth, identity number and residential address. Provision is also made for the income tax number (if issued) to be obtained, but this requirement is not currently in force.

The regulations require that names, dates of birth and identity numbers be verified by comparing it the person's official South African identity document or another equivalent and acceptable document. Where necessary these particulars must also be compared with information obtained from any other independent source. The residential address must be compared to information that can reasonably be expected to achieve verification of the particulars and can be obtained by reasonably practical means.

Identification and verification procedures must be followed before a single once-off transaction is concluded or any transaction is carried out in the course of a business relationship. These procedures must therefore also be followed in respect of money remittance through an accountable institution. Accountable institutions were given a year (ending on 30 June 2004) to implement the same identification and verification procedures in respect of all their existing clients.

To an extent, exemptions temper the strict regime. The exemptions relate mainly to smaller transactions and low-risk customers. Provision was also made for smaller clients (defined as clients whose bank balance does not exceed US\$3800, whose rights to deposit and withdraw funds are limited to specified amounts and who are not entitled to transfer funds out of their accounts internationally.) In practice, though, this exemption has proved to be of little value, since a number of the conditions imposed by the exemption either run counter to needs of the low income market, or conflict with the optimal product design of low cost products.<sup>6</sup> For example, most mass market products utilise internationally branded debit cards with cross-border functionality. The exemption prohibits this. The exemption also requires a 180 day dormancy cut-off – an unrealistic requirement for seasonal and other workers without a regular income. In any event, the whole scheme of exemptions has now come under fire. In its June 2003 evaluation, FATF criticised South Africa for its "large number of exemptions from the customer identification and record-keeping requirement, some of which seem to unduly limit the

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<sup>6</sup>See Genesis Analytics, 2003, *Legislative and regulatory obstacles to mass banking* parrr 6.6 and 9.1.

effectiveness of the law.” FATF therefore advised that these exemptions should be amended or their number lessened. In response, government officials apparently undertook not to increase the reach of the current exemptions.

## **6.IMPACT ON ACCESS TO FINANCIAL SERVICES**

The implementation of the FATF AML standards in South Africa has placed the domestic financial sector under great pressure. FICA came into force on 30 June 2003. All the major financial institutions undertook extensive projects to prepare for implementation. These included the creation of FICA compliance functions, training of staff (an estimated 80 000 staff members underwent an initial standardised 8 hour AML training programme in 2003 with more to undergo training in 2004) and the design and modification of systems.

## **6.1.PRACTICAL PROBLEMS RELATING TO RESIDENTIAL ADDRESSES**

Once it came to implementing the CDD requirements of FICA, financial institutions ran into insurmountable problems. The most important of these relate to the fact that at least one-third of South African households do not have formal addresses: according to the most recent census (2001) 30% of the approximately 9.1 million households in South Africa live in either traditional dwellings or informal structures. The statistics from the South African Post Office (“SAPO”) are also telling. The SAPO maintain a database of formal addresses in the country. They have just more than 4 million addresses, these include business addresses, on their database, compared to 9.1 million households.

When financial institutions requested existing and prospective clients to produce documentary proof of residential address, which is normally taken to be utility bills or other accounts containing both the name and physical address of the individual, most low income clients could not deliver such proof.

## **6.2.THE BANKS’ RESPONSE**

To deal with this challenge, the Banking Council issued a Practice Note to its members giving guidelines on the implementation of FICA. Regarding residential address verification for clients in the so-called mass market (which they define as account holders with a net monthly income into the account of less than US\$770) the Practice Note requires banks to request proof of residential address. However, if the client responds that he or she does not have any “and the bank is reasonably satisfied with that answer, i.e. the physical address details are consistent with such and answer, the answer should be noted and the account opened or transaction concluded”. This is the approach currently followed by all banks.

FICA requires banks to obtain proof of address before an account is opened or a transaction concluded. The current banking practice is to attempt to comply with this legislative requirement, but to not do so if the bank reasonably believes that it is impractical to comply with the law. The banks’ approach received the backing of the South African Registrar of Banks when, with reference to this particular aspect, he was reported as acknowledging that banks were not fully complying with FICA, saying that the Act was proving impossible to implement.<sup>7</sup>

In essence, banks are required to give effect to two conflicting government policies:

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<sup>7</sup>Rose, R., 2003 (12 December), *Money laundering laws ‘impossible’*, Business Day.

- facilitating access to banking by those who are financially and socially vulnerable; and
- implementing strict money laundering controls.

Banks opted to comply with their obligations in terms of the Financial Charter and to give precedence to the first policy. However, they have not totally abandoned attempts to comply with the second policy objective.

Both government and the banking industry are working hard to resolve this issue. The matter is urgent as financial institutions are required by FICA to have re-identified and verified all their existing clients before 30 June 2004.<sup>8</sup> No transactions may be performed after that date in respect of clients who have not been identified and verified in accordance with FICA. This looming deadline for the re-identification of existing clients has intensified the concerns of the banks who are obviously not keen to lose millions of their current clients due to the clients' inability to produce formal proof of residential address. The extent of the problem faced by banks is evident from the fact that seven million of the 18.5 million bank accounts in South Africa fall within the mass market affected here. To date the government has not changed the relevant regulation, neither has guidance notes been issued on this matter. The acting director of the FIC has also been reported as saying that no exemption to the laws was likely.<sup>9</sup>

A companion problem for financial institutions relate to the requirement to maintain up-to-date records of residential address. South Africa, in common with many developing countries with relatively low levels of urbanisation, has a very mobile population. A recent (2003) study on internal migration showed that between 1992 and 1996, 38 percent of South Africans moved house at least once<sup>10</sup>. These high levels of internal migration have had a fascinating impact on the domestic telecoms industry. This is illustrated by the fact that, although mobile telephony was introduced in South Africa as recent as 1997, mobile telephones now exceed landlines by a factor of more than 3 to 1 (13.8 million versus 4.2 million). People living in the burgeoning urban and peri-urban townships have little use for landlines if they are constantly on the move. Under such circumstances maintaining up to date residential addresses for clients in this section of

<sup>8</sup> See, in general, Du Preez, L., 2004 (3 April), *Identify yourself or your money may be frozen*, Personal Finance; Naidu, E., 2004 (4 April) *Banks rush to avoid ID chaos* The Sunday Independent; Khangale, N., 2004 (6 April), *Bank law could see customers lose their accounts* The Star.

<sup>9</sup> Rose, R., 2003 (12 December), *Money laundering laws 'impossible'*, Business Day.

<sup>10</sup> Source: Kok, Pieter, O'Donovan, Michael, Bouare, Oumar & Van Zyl, Johan, 2003, *Post-Apartheid Patterns of Internal Migration in South Africa*, Cape Town: HSRC Publishers (Full details, initials etc)



the population has very little meaning, whilst imposing significant costs on financial institutions.

### **6.3.COMPLIANCE COSTS**

Regulatory compliance imposes costs, both for financial institutions and clients. FATF rules are no exception. One major South African bank estimated the initial cost of AML compliance at US\$18.5 million with a recurring cost of at least US\$1 million per annum. Financial institutions absorb some of these costs, but inevitably some costs are passed on to the users of the services. In addition clients themselves bear direct compliance costs in terms of time spent, document acquiring and understanding a set of complex rules. Low income clients are far more vulnerable to such costs than higher income clients. According to a recent FinMark survey, the main reason that a large segment of the mass-market is unbanked is that they cannot afford banking services<sup>11</sup>.

## **7.IMPACT ON REMITTANCES**

South Africa's AML legislation, FICA, covers money remittances through formal financial institutions, including dedicated money remitters. As indicated, South Africa has undertaken to implement the CFT standards, but has yet to give full effect to that undertaking.

The actual profile of money remittances in South Africa is heavily under-researched. What is clear though, is that a vibrant informal money remittance system exists side-by-side with the formal money remittance system. In relation to cross-border remittances this is apparent from comparing the number of formal sector remittance transactions with the number of foreign migrants present in the country.

<sup>11</sup>

The FinScope survey shows that the main reason given by the unbanked for why people don't have bank accounts is that "people do not have enough money". 27% of unbanked respondents, the highest proportion, gave this reply. A further 24% replied that "people are not regularly employed". When asked what the greatest problems with banks are, 19% of unbanked respondents, the highest proportion, replied that bank charges are too high.

A study conducted in 2003<sup>12</sup> compared the costs of transferring US\$40 cross-border within the Southern African region, utilising different remittance systems. The results showed a clear distinction between formal and informal systems. It found that whereas the cost of utilising an informal cash courier system amounted to between 10 and 20 % of the amount transferred, utilising banks and formal transfer agents such as MoneyGram cost between 50 and 64% of the amount transferred (the percentage is reduced for larger transfer amounts). The cheapest formal sector option was the SAPO which charged about 19% of the amount for a telegraphic money order. However, in 2003 the SAPO intermediated only 46 000 overseas remittances with an average value of US\$82.

How does this compare with the number of foreign migrants in South Africa? Formal statistics<sup>13</sup> suggest that South Africa had 942 000 foreign immigrants in 2001. However, this is unlikely to include illegal immigrants working in the country. In 1996, between 2.5 and 4.1 million illegal immigrants were estimated to be in South Africa<sup>14</sup>, and it is unlikely that the number would have reduced since then.

Therefore the bulk of remittances from South Africa to neighbouring countries flows via the informal rather than the formal remittance system. One reason is that illegal immigrants find it difficult to access formal remittance systems, unless they can do it through a third party with the necessary documentation. Although particular South African cultural communities familiar with such systems do use hawala-type remittance processes, this is suspected to be very limited. The majority of informal remittances flow via cash couriers who move cross-border. These are either friends or family going “home”, or taxi-drivers in South Africa’s vibrant minibus taxi industry. Anecdotal evidence suggests that informal remittances are generally very cheap and simple to achieve<sup>15</sup>, and have a number of other advantages<sup>16</sup>, even though they are generally

<sup>12</sup> Genesis Analytics, 2003, *African families, African money: The money transfer system in South Africa*, prepared for the FinMark Trust, [www.finmark.org.za](http://www.finmark.org.za)

<sup>13</sup> Statistics South Africa, Census 2001, <http://www.statssa.gov.za>.

<sup>14</sup> Estimated by the Human Sciences Research Council from a study completed in 1996. It is important to note that it is difficult to estimate these numbers accurately. The HSRC has since retracted this estimate. It is still quoted by the SA Dept. of Home Affairs (<http://home-affairs.pwv.gov.za/faq.asp>).

<sup>15</sup> Source: Genesis Analytics, 2003, *African families, African money: The money transfer system in South Africa*, prepared for the FinMark Trust, [www.finmark.org.za](http://www.finmark.org.za)

<sup>16</sup> Other benefits of transmitting money informally include: cheap service for transfer of small amounts, relative to the banking industry that charges high minimum fees; no monthly charges; based on familiar communal networks (cultural inertia); avoidance of currency controls; avoidance of distorted exchange valuations (in the case of Zimbabwe, for instance); avoidance of government taxes; avoidance of uncertain receiving end charges; non-reliance on formal infrastructure; non-reliance on documentation (no literacy constraints) ; and transfers from illegal persons can be facilitated.

more risky. This greater use of informal rather than formal money remittance mechanisms is in line with trends elsewhere in the world. It is estimated that, globally, informal remittances are 1.5 times the value of formal remittances.<sup>17</sup> However, it is also a result of the exchange control regime applicable in South Africa. Exchange control regulations cause formal international money transfers<sup>18</sup> to be far more costly and more complex to achieve than informal remittances.

The use of informal as opposed to formal means of remitting money is also consistent with the number of people in South Africa who depend on the informal sector for their income. According to the 2003 Labour Force Survey, 42 percent of the South African labour force is currently unemployed, and a further 9.5 percent are employed in the informal sector. This is reflected in the fact that 54 percent of South Africans receive their income in cash<sup>19</sup>. The majority of South Africans therefore live and conduct their financial transactions in an informal cash-based society. To the extent that these transactions do not pass through the formal financial sector, they are beyond the reach of FICA and other regulations for implementing FATF standards in South Africa. On the remittances side it would be practically impossible to register the persons and institutions undertaking informal remittance services, simply because of the dispersed and fragmented nature of the process and the limited capacity of regulators.

**Implementation of CFT / AML standards in the money transfer environment in a manner that does not take into account the need for simplicity and low-cost products, and the number of residents who conduct their affairs entirely within the informal cash-based economy, risks having little effect.**

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<sup>17</sup> Source: Sander, Cerstin, 2003, *Capturing a market share? Migrant remittance transfers & commercialization of microfinance in Africa*, Paper prepared for the conference on Current Issues in Microfinance, Johannesburg 12-14 August 2003

<sup>18</sup> All South African citizens and residents (temporary and permanent) can send up to US\$4600 per annum abroad as a "gift". They may remit these funds only through "Authorised Dealers", and must complete a number of documents and fulfil several requirements in order to achieve this.

<sup>19</sup> Source: FinScope, 2003, published by the FinMark Trust, [www.finmark.org.za](http://www.finmark.org.za).

## 8.OBSERVATIONS AND SUGGESTIONS

### 8.1.CONTEXT-SENSITIVE REGULATION

AML legislation presupposes the existence of formal systems and documents that financial institutions can use to verify client details. The international AML standards were clearly formulated with developed countries in mind. However, developing countries often lack the systems and the documentation required. Developing countries forced to adopt legislation based on first world models are put in an invidious position: their financial institutions may contravene the law (often with tacit approval of regulators and law enforcers); or they comply, with severe consequences in respect of financial exclusion of particularly the poor.

In South Africa this is exactly what happened following the AML requirement to provide a residential address and documentary proof to verify the address. On the one hand, financial institutions wish to comply with the law. On the other hand, strict compliance with the requirements would exclude millions of South Africans from financial services and undermine their social commitments, for example as agreed to in the Financial Sector Charter. Simply put the requirement to record and verify a client's residential address does not match well with the fact that a third of the population do not have formal residential addresses, and that close to half of the population do not have the means to verify whatever address they may have cited. At the same time, the value of recording a residential address is limited in a society with high levels of internal migration.

A full cost/benefit analysis of this requirement may have assisted South Africa to formulate context-sensitive regulations that would still meet the objectives of the international AML standards. It would also have been helpful to have clarity about the degree of latitude that a country has to formulate context-sensitive regulations within the broader international AML framework. South Africa drafted its laws to meet the 1996 FATF Recommendations. In this process it made assumptions about the strictness of the standards and international expectations. However, the lack of clarity resulted in some of the rules exceeding the international standards while others were criticized as falling short. The 2003 Recommendations are more detailed, but still do not provide developing and middle-income countries with sufficient guidance to confidently follow a context-sensitive approach when implementing the Recommendations.

## **8.2.YARDSTICK TO DETERMINE RISK**

The 2003 FATF Recommendations introduced the principle of a risk-based approach, but have not provided sufficient guidance on how to apply this approach. Admittedly, the interpretative notes to the Recommendations provide some examples of lower risk clients and transactions, but they do not allow developing countries to confidently classify transactions and accounts of the financially and socially vulnerable as low risk.

These uncertainties are mainly caused by the lack of a proper yardstick with which to measure risk. Prior to 2001, risk in terms of AML was often determined by using monetary value. Indeed, elements of this approach are still evident in the current Recommendations. However, given the fairly small amounts required to fund terrorism, monetary value is not necessarily an adequate gauge with which to measure the funding of terrorism risk.

AML and CFT risks are very different things and have different faces in different communities and geographies. For example, the CFT risks associated with intra-regional cross-border transfers between developing countries are in all likelihood different from the CFT risks involved in cross-border transfers between developing countries on the one hand, and developed countries subject to terrorism risk, on the other. The question arises whether it is wise to enforce the same standards in respect of transfers in both cases.

More generally, a risk-based approach to either supervision or compliance requires a keen understanding of the risks involved. Currently, very little information is available on especially funding of terrorism risks and its indicators in developing countries. The uncertainties around risk are potentially costly to developing countries. An incorrect or even disputed classification of clients or transactions as low risk, may expose a country to international censure. Given the lack of certainty, developing countries may therefore err on the side of caution, choosing to classify even the most innocuous financially excluded and their transactions as high risk.

## **8.3.FORMALISING THE INFORMAL SECTOR**

In South Africa about half of the population conduct their financial transactions beyond the reach of the formal financial sector and thus substantially beyond the reach of AML and CFT regulation. It is in the interest of economic development and AML/CFT enforcement that these transactions should be drawn into the formal sector.

A standard approach to do so, and one evident in the FATF Recommendations, is to formulate regulations to formalise the informal sector. However, if the enforcement of regulation of the informal sector could be achieved with ease, surely governments would have done so a long time ago. International regulators and governments should therefore be more sensitive to the actual reach of their powers into the informal sector. Just as South African exchange control regulations have contributed to much of the cross-border remittances of low income migrants being out of the formal sector, the strict and inappropriate enforcement of AML/CFT regulations could achieve the same.

Citizens should be enticed rather than bludgeoned into the formal sector. The most effective approach may be to provide low-cost, user-friendly products that require minimal administration from clients and that utilise existing identification systems. Coercive financial regulation risks having the perverse effect of forcing people into the informal, unregulated system. The disappearance of transactions into the informal sector without formal records or paper trails undermines the key object of AML and CFT regulation, i.e. more efficient law enforcement against money launders and potential terrorists.

#### **8.4.NATIONAL AND REGIONAL IDENTIFICATION DIFFERENCES**

International client identification and verification standards must ensure that financial institutions are able to identify their clients. However, the information that is required to do so differs from country to country. The example of South Africa is again instructive. South Africa has a national identification system and its citizens are issued with national identification numbers and identification books. At the beginning of 2004 28.5 million South Africans over the age of 18 years had national identification documents.<sup>20</sup> This covers virtually the entire adult population. The system links the ID number to the citizen and to information such as fingerprints and the citizen's address at the time of application. The first six digits of the identity number reflect the person's date of birth. In a country without such a system, information relating to a person's permanent residential address, date of birth, place of birth, occupation etc may be vital elements of a procedure to identify that person. This information is not as crucial from a South African perspective where a person's identity is comprehensively expressed in his or her identity number.

In view of the importance and prevalence of the identity number in South Africa, and the relative unimportance of a formal residential address for many citizens, South Africa

<sup>20</sup> According to figures supplied by the Department of Home Affairs.

might be best served with a less complicated client identification and verification system. The system could focus on a person's name, identity number and, where applicable, income tax number. This information could be verified as currently required. The system could dispense with the requirements relating to the residential address. In the majority of cases businesses could ask this information as a matter of course to maintain contact with the client. However, financial institutions would not be burdened with the task of verifying residential addresses before they can open an account or conclude a transaction. This approach, albeit more relaxed, will still be effective and would satisfy the AML objectives of ensuring identification of the client.

## 9.CONCLUSION

This case study clearly highlights the need for appropriate interpretation and enforcement of the FATF recommendations, and the potentially negative impacts on the large section of the population that is socially and financially vulnerable, and dependent on the informal sector.

Developing and middle-income countries need to first have a clear understanding of the operation and the positive and negative effects of AML/CFT regulation and enforcement before designing appropriate regulation. At the international level there also needs to be an explicit recognition that a standard global template for FATF enforcement does not allow for developing country realities. The international community needs to allow countries a reasonable measure of leeway to design unique, context-sensitive, and risk-based systems to meet the international objectives in an effective and reasonable manner.

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## **APPENDIX A: BASEL CDD REQUIREMENTS**

### **BASEL COMMITTEE ON BANKING SUPERVISION**

The Basel Committee on Banking Supervision published a paper entitled “Customer due diligence for banks” in October 2001. The aim of the paper was to provide a customer identification and so-called know-your customer (“KYC”) framework that may serve as a benchmark for banking supervisors to establish national practices and for banks to design their own KYC programmes.

The guidance provided in the paper enjoys broad international support from banking regulators. Participants in the 2002 International Conference of Banking Supervisors in Cape Town in September 2002 recognised the paper as the agreed standard on CDD. The participants represented banking regulators from more than 120 countries.

### **CUSTOMER ACCEPTANCE POLICY**

The Basel paper requires banks to develop clear customer acceptance policies and procedures, including a description of the types of customer that are likely to pose a higher than average risk to a bank. In preparing such policies, factors such as a customer’s background, country of origin, public or high profile position, linked accounts and business activities should be considered. These policies and procedures should be graduated to require more extensive due diligence for higher risk customers.

The paper is sensitive to the needs of the financially or socially disadvantaged. It allows client acceptance policies that may require the most basic account-opening requirements for a working individual with a small account balance. The paper also stresses that “[i]t is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged.”

## **CUSTOMER IDENTIFICATION**

The paper lays down a number of general principles regarding client identification. The principles include the following:

- Banks should establish a systematic procedure for identifying new customers and should not establish a banking relationship until the identity of a new customer is satisfactorily verified;
- The best documents for verifying the identity of customers are those most difficult to obtain illicitly and to counterfeit.
- The customer identification process applies naturally at the outset of the relationship.
- To ensure that records remain up-to-date and relevant, there is a need for banks to undertake regular reviews of existing records.
- Banks need to obtain all information necessary to establish to their full satisfaction the identity of each new customer and the purpose and intended nature of the business relationship. The extent and nature of the information depends on the type of applicant (personal, corporate, etc.) and the expected size of the account.

The paper was not specific on general identification requirements as the Working Group on Cross-Border Banking intended to develop guidelines on essential elements of customer identification requirements. These guidelines were published in February 2003 as an attachment to the paper. The attachment is entitled “General guide to account opening and customer identification”.

The guide deals with the identification requirements in respect of a host of customers. In respect of natural persons it requires the following information to be obtained, where applicable:

- legal name and any other names used (such as maiden name);

- correct permanent address (the full address should be obtained; a Post Office box number is not sufficient);
- telephone number, fax number, and e-mail address;
- date and place of birth;
- nationality;
- occupation, public position held and/or name of employer;
- an official personal identification number or other unique identifier contained in an unexpired official document (e.g. passport, identification card, residence permit, social security records, driving licence) that bears a photograph of the customer;
- type of account and nature of the banking relationship; and
- signature.

The guide requires banks to verify this information by at least one of the following methods:

- confirming the date of birth by comparing it to an official document such as a birth certificate, passport or identity document;
- confirming the permanent address by comparing it to a document such as a utility bill, tax assessment, bank statement or a letter from a public authority;
- contacting the customer by telephone, by letter or by e-mail to confirm the information supplied after an account has been opened (e.g. a disconnected phone, returned mail, or incorrect e-mail address should warrant further investigation);
- confirming the validity of the official documentation provided through certification by an authorised person (e.g. embassy official).

The guide also formulated the following principles that are relevant to this study:

- The examples of verification documents quoted in the guide are not the only possibilities. In particular jurisdictions there may be other documents of an equivalent nature which may be produced as satisfactory evidence of customers' identity.
- Financial institutions should apply equally effective customer identification procedures for non-face-to-face customers as for those available for interview.
- For one-off or occasional transactions where the amount of the transaction or series of linked transactions does not exceed an established minimum monetary value, it might be sufficient to require and record only the name and address of the customer.

It is important to note from the perspective of this study that the guide produced in February 2003 is as concerned with the protection of the financially and socially vulnerable as the main paper was in October 2001. Paragraph 16 provides the following guidance:

“It is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged.”

The Basel principles and guidelines in this regard were formulated before 2003 FATF Forty Recommendations were finalised. They influenced the drafting of the Recommendations, but unfortunately the Recommendations did not follow their lead by expressly providing safeguards for the interests of the financially and socially vulnerable.

## **APPENDIX B: SOUTH AFRICAN CLIENT IDENTIFICATION AND VERIFICATION REQUIREMENTS**

From the perspective of low income banking, the statutory identification and verification requirements relating to natural South African citizens and residents are of importance. These requirements are set out in Regulations 3 and 4 of the Money Laundering Control Regulations.

### **BASIC IDENTIFICATION AND VERIFICATION REQUIREMENTS**

In short, the scheme requires the following information to be obtained in respect of a customer who is a South African citizen or resident and who does not require legal assistance and is not providing assistance to another:

- Full names
- Date of birth
- Identity number
- Income tax number if issued to the client (accountable institutions are currently exempted from this duty)
- Residential address.

The information must be verified in the following way:

- The full names, date of birth and identity number must be compared with:

- an identification document of the person (defined in relation to a South African citizen or resident as an official identity document); or
- if the person is, for a reason which is acceptable to the bank, unable to produce a identity document, another document which is acceptable to the bank (taking into regard any guidance notes that may be applicable) and which bears:
- a photograph of the person;
- the person's full names or initials and surname;
- the person's date of birth; and
- the person's identity number.
- If it is believed to be necessary, taking into account any relevant guidance notes, any of these particulars must be compared with information which is obtained from any other independent source.
- The income tax number must be compared to a document issued by SARS bearing such a number and the name of the person.
- The residential address must be compared to information that can reasonably be expected to achieve verification of the particulars and can be obtained by reasonably practical means (taking into regard any relevant guidance notes).

#### **ADDITIONAL REQUIREMENTS FOR HIGH RISK CUSTOMERS AND TRANSACTIONS**

Regulation 21 compels the bank to obtain further information concerning a business relationship or single transaction which poses a particularly high risk of facilitating money laundering activities or to enable the accountable institution to identify the proceeds of unlawful activity or money laundering activities. The information which the bank must obtain in these circumstances must be adequate to reasonably enable the institution to determine whether the relevant transactions are consistent with the bank's knowledge of



that client and that client's business activities and must include particulars concerning the source of that client's income; and the source of the funds which that client expects to use in concluding the single transaction or transactions in the course of the business relationship.

## **EXISTING CLIENTS**

These requirements came into effect on 30 June 2003 in respect of new customers. FICA gave accountable institutions until 30 June 2004 to identify their existing clients and to verify their particulars in accordance with FICA. After 30 June 2004 they are not allowed to do business with such clients before they have been identified and verified.

## **UPDATING OF INFORMATION**

Regulation 19 compels an accountable institution to take reasonable steps in respect of an existing business relationship, to maintain the correctness of particulars which are susceptible to change and are obtained as part of the identification and verification procedures

## **EXEMPTIONS**

The Minister of Finance published a number of exemptions from the money laundering control obligations when the regulations were published. These exemptions relate mainly to low risk customers and transactions, for instance specific insurance products with annual premiums below US\$ 3000 per year, verification of details of clients in FATF-compliant jurisdictions, companies listed on recognised exchanges etc. The set of exemptions also includes an exemption in respect of mass banking clients (clients whose bank balance do not exceed US\$ 3800, whose rights to deposit and withdraw funds are limited to specified amounts and who are not entitled to transfer funds out of their accounts internationally.) Unfortunately the mass banking exemption is unworkable in practice and the whole scheme of exemption has come under fire. In its June 2003 FATF evaluation South Africa was criticised for its "large number of exemptions from the customer identification and record-keeping requirement, some of which seem to unduly

limit the effectiveness of the law.” FATF therefore found that these exemptions should be amended or their number lessened.