



Financial
Intelligence Centre

Assessment of the inherent money
laundering and terrorist financing risks

LENDER OF MONEY AGAINST THE SECURITY OF SECURITIES SECTOR

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1. INTRODUCTION

Money laundering can be described as the process whereby criminals attempt to conceal the proceeds of their criminal activities from their actual crimes, thereby giving the proceeds an appearance of legitimacy. These criminals may be done by investing in different immovable and movable assets. The provision of services such as banking and making available credit are some of the activities that have been identified internationally as being potentially vulnerable for the laundering of money from illegitimate sources. Terrorist financing is the process by which individual terrorists and terrorist organisations obtain funds to commit acts of terrorism.

The Financial Intelligence Centre (FIC) conducted a preliminary risk assessment of the inherent risks of money laundering and terror financing (ML and TF) for Money Lenders against the Security of Securities, as described in item 11 of Schedule 1 (item 11 institutions) of the Financial Intelligence Centre Act, 2001 (Act 38 of 2001)(FIC Act).

This report is based on open-source information on potential national and international ML risks faced by money lenders in general, the FIC's regulatory knowledge of the sector and the analysis of the financial intelligence reports submitted by Item 11 institutions to the FIC.

While it is understood that the ML and TF environment may change over time, the ML and TF risks associated with money lenders that have been incorporated into this inherent risk assessment report are nonetheless important for Item 11 institutions and for the FIC to understand.

It must be noted that some of the institutions that are included in the definition and description of Item 11 institutions are also registered with the FIC under other Items of Schedule 1 such as Financial Services Providers, authorised users of an exchange or banks.

2. SCOPE, LIMITATIONS AND METHODOLOGY OF THE RISK ASSESSMENT

This risk assessment report addresses principally the inherent money laundering risk factors of Item 11 institutions, pertaining to products and services, clients, transactions, delivery channels, and geographical areas. The risk factors are not exhaustive. Terrorist financing risks were addressed to a limited extent.

Although it is recognised that the ML and TF risks could be mitigated by introducing compliance controls in accordance with the requirements of the FIC Act, such mitigation factors were not included in this report, as the sector risk assessment report focuses on the inherent ML and TF risks.

3. OVERVIEW OF THE SECTOR

- 3.1. Item 11 of Schedule 1 of the FIC Act defines that “A person who carries on the business of lending money against the security of securities” is an accountable institution. All the obligations under the FIC Act are applicable to such an institution. These providers essentially extend secured loans as explained in paragraph 3.2 below.

- 3.2. Item 11 institutions are credit providers and are, in most instances, registered with the National Credit Regulator under the National Credit Act, 2005 (Act 34 of 2005) . However, the current description of these credit providers is limited to those credit providers who, as collateral for the credit, accept assets that are included in the definition of “securities” as defined in the Financial Markets Act, 2012 (Act 19 of 2012). This definition of securities includes listed and unlisted instruments such as shares, derivatives, debentures, notes, participation in foreign and local collective investment schemes, instruments that are based on an index, certain securities based on a foreign exchange, similar instruments and rights in these securities.

Money market instruments, shares in the South African Reserve Bank and any security prescribed by the Registrar of Financial Markets are excluded from this definition. Credit providers that do not accept assets as collateral for any of the loans

provided by them, are not included within the description of Item 11 institutions, and do not need to register with the FIC, unless they fall under one of the other categories of accountable institutions.

- 3.3. There are approximately 84 Item 11 institutions registered with the FIC as accountable institutions. These registrations include banks, stockbrokers, and other institutions that provide credit to individuals and entities in accordance with the description of Item 11. Included in these institutions are some of the large development institutions that provide structured finance to new and existing businesses with the aim of developing the economy in a specific geographic area or in a specific industry. Security for loans provided by these institutions is often in the form of shares in the borrower or another entity, which shares are then redeemed when the loan has been repaid.

4. INTERNATIONAL MONEY LAUNDERING RISKS ASSOCIATED WITH CREDIT PROVIDERS

- 4.1. Credit providers are internationally recognised as being vulnerable to money laundering as loans can be repaid with illicit funds. This money laundering technique sometimes results in loans being paid back in advance or with cash. Although control measures, such as a limitation on early repayment or on the use of cash, have been introduced in some instances. However, a real inherent risk involved in this practice still remains.
- 4.2. Internationally, money launderers also use the “loan-back” method to launder the proceeds of crime. With this method, funds are transferred from a credit provider to lender. These two parties are often established and controlled by the same entity which then “borrows and repays its own funds”, thereby concluding transactions that provide an appearance of legitimacy to these funds. In South Africa, the provision of collateral for cross-border loan agreements are subject to the rules of the Financial Surveillance Department of the South African Reserve Bank in respect of reporting and the nature of the collateral that may be used.

5. REPORTING BY ITEM 11 INSTITUTIONS

5.1. The volume of reports received from Item 11 institutions

Between From April 2016 to March 2021, a total of 2 768 cash threshold reports (CTRs¹) were filed by Item 11 institutions at an average of 554 per year. During the same period, Item 11 institutions filed only 58 suspicious and unusual transaction reports (STRs²) at an average of 12 per year.

The number of regulatory reports filed by Item 11 institutions with the FIC for each reporting period from 1 April to 31 March for each year is depicted below.

Table 1: Regulatory Reports filed by Lenders of Money against the Security of Securities

Reports filed by industry	2016/17	2017/18	2018/19	2019/20	2020/21	Average number of reports
CTRs	91	339	966	690	682	2 768
STRs	5	8	8	19	18	58
TPRs	0	0	0	0	0	0
Total reports	96	347	974	709	700	2826
Registered number of Item 11 institutions	63	73	79	75	72	362
Average number of reports per Item 11 institution per year	96 / 63 =2	347 / 73 =5	974 / 79 =12	709 / 75 =9	700 / 72 =10	2826 / 362 =8

¹ Reports on cash transactions exceeding R24 999.99

² Reports on transactions that are regarded as unusual or suspicious, as explained in section 29(1) of the FIC Act

5.2. Types of reports filed

Item 11 institutions file regulatory reports in terms of section 28, 28A and 29 of the FIC Act. The vast majority of regulatory reports submitted in any year to the FIC have been CTRs, filed in terms of section 28 of the FIC Act, as evidenced from the information in Table 1 above. This indicates that cash is still being received by Item 11 institutions and the use of cash as a repayment mechanism, either directly to an accountable institution or paid into the bank account of the accountable institution, makes these loans potentially more vulnerable for possible abuse by money launderers.

The number of financial intelligence reports submitted per registered institution can be regarded as relatively low in comparison to other sectors. It is possible that some Item 11 institutions may also be registered under other Items in Schedule 1 of the FIC Act and may possibly report transactions under the other registered entities. In this regard it must be noted that an institution that is registered as more than one accountable institution is required to submit reports under the institution in respect of where the reportable transaction originated.

6. RISK BASED ON REGULATORY REPORTS SUBMITTED AND RESEARCH

The risk factors used in this sector risk assessment report align with those contained in Guidance Note 7 issued by the FIC (refer to paragraph 37 of Guidance Note 7) with the addition of risks associated with transactions and terrorist financing.

The risk factors mentioned below represent the factors that Item 11 institutions need to consider when conducting daily business. These risk factors were also derived from information obtained from research and from regulatory reports submitted to the FIC.

6.1. Products and Services Risks

6.1.1. The products provided by credit providers in general, being loans and finance, are internationally recognised as being vulnerable for ML and TF. An example of how illicit funds could be laundered in this industry is the early repayment of loans or the use of the funds from the loans for illicit purposes.

- 6.1.2. Certain loan products and services are regarded as having a higher risk for money laundering. The range of products offered by credit providers include long-term and short-term loans, structured finance and micro loans. The ML and TF risks associated with the types of loans vary significantly and credit providers, including the lenders of money against the security of securities, must understand the ML and TF risks posed by such different products. It must be stated that the loans covered in this report is restricted to those in terms of which collateral, specifically in the form of “securities” as described in the Financial Markets Act, 2012 (Act 19 of 2012) is required.
- 6.1.3. Cross-border transactions involving clients from high-risk jurisdictions must also be considered as possible high-risk areas and institutions are required to apply additional measures to ensure that such transactions are not being abused for money laundering or terrorist financing.
- 6.1.4. Factors that could increase the ML risks of the products provided may arise from the process and conditions for repayment of the funds e.g. to what extent the loan or repayment thereof is cash intensive and the ease with which loans may be obtained. Other factors that can be considered is the use of “cooling off periods”, penalties for early repayment and the possibility of over payment with a resultant repayment of funds already provided to the borrower.

6.2. Client Risks

- 6.2.1. The client of an institution plays an important role in determining the ML and TF risks associated with that institution. As accountable institutions under the FIC Act, Item 11 institutions are required to assess, identify, understand and then risk rate the inherent money laundering risks associated with their clients. Some clients, such as foreign prominent public officials (FPPOs), complex legal structures or foreigners potentially pose a higher risk for money laundering. Domestic prominent influential persons (DPIPs) may also pose a higher risk for money laundering depending on the identified circumstances. The establishment of complex structures, involving legal persons (companies) and legal arrangements such as trusts and partnerships – including where such structures are named as beneficiaries for a trust – could possibly be aimed at concealing the identities of the ultimate beneficial owners of such legal persons and arrangements.

- 6.2.2. In addition to DPIPS and FPPOs, lenders of money against the security of securities, must also be aware of the potential risks associated with non-profit organisations (NPOs) and non-government organisations (NGOs), including potential terrorist financing risks. Clients that are NPOs or NGOs could be registered as companies or trusts and institutions are required to obtain information on the nature and purpose of their business to ensure that its status is verified.
- 6.2.3. Risks associated with any client type are not static and the expectation is that the client risk should be monitored throughout a business relationship. Within a client type, based on a variety of factors, individual clients could also be classified into risk categories, such as low, medium, medium, or high risk. Measures to mitigate ML and TF risks should be applied accordingly.
- 6.2.4. Included in Item 11 institutions registered under the FIC Act, are state-owned enterprises, some of which were established in terms of their own legislation. The chances of DPIPs and FPPOs being involved in such institutions, either as directors or other office bearers or as clients or representatives of clients, are potentially high. Item 11 institutions must be aware of and understand the increased ML and TF risks associated with such clients.

6.3. Transaction risk

- 6.3.1. The type of transactions and the manner in which it is executed, can have an impact on the money laundering risks of the entities involved. Where a transaction occurs through legal entities and trusts, criminals can potentially hide their identity by using the legal entity or trust as a front company. Such criminals then become directly or indirectly, the beneficiaries of such trusts. Monitoring of the nature and purpose of transactions, their values and the means of payments involved, would contribute to understanding and monitoring the ML risks associated with such transactions.
- 6.3.2. Examples of transactions that are potentially high risk for money laundering in the business of credit providers, include the accelerated settlement of loans, if possible, the “reversing” of transactions with a request to repay loans already received and transactions that do not make economic sense as well as the involvement of third

parties in the transaction. Item 11 institutions should be aware of the potential money laundering risks associated with such transactions and take the necessary steps to mitigate such risks.

6.3.3. In South Africa, cash is still used to a large extent. It is evident by the number of CTRs submitted by Item 11 institutions, that cash is still received by these institutions. Special care should be taken when dealing with cash transactions to determine the source thereof. Where applicable, institutions should also make sure that its subsidiaries follow the necessary additional steps to mitigate the ML risks associated with cash transactions.

6.4. Risks relating to delivery channels

6.4.1. Item 11 institutions must be aware of the delivery channels used to attract and deal with clients. Delivery channels that may obscure or conceal the true identity of the client or clients not being on-boarded on a face-to-face basis, may increase the risk of the institution being abused by criminals to launder the proceeds of crime. Where an intermediary is used to on-board clients, or where shell companies or nominee companies are used, an institution must do proper due diligence on these entities and their business and be familiar with the risk mitigation processes and procedures that the intermediary or entity may have in place.

6.4.2. Modern technology is also, to a large extent, used to advertise services and to conduct business. Where social media platforms and third-party service providers are used to share information on products or services or to on-board clients, an institution must ensure that such clients are properly identified and verified and that all the relevant information pertaining to the risks posed by such clients are obtained.

6.5. Geographical Risk

6.5.1. Because some foreign jurisdictions pose a higher risk for money laundering, it is important that an institution be aware of the risks posed by clients from such foreign geographic areas and that the necessary risk mitigation processes are implemented. This risk is exacerbated as modern day transactions can take place electronically across provincial and international borders.

6.5.2. Item 11 institutions must be aware of the potential higher risks posed by clients from the following areas:

- Countries that are subject to a travel ban or other international sanctions and countries in close proximity to sanctioned jurisdictions
- Countries the Financial Action Task Force³ regards as a high ML risk
- Countries that are regarded as high secrecy jurisdictions
- Countries or jurisdictions regarded as “tax havens”
- Countries known to have high levels of organised crime, corruption or from which terrorist organisations are known to operate
- Countries in conflict zones or in close proximity to such countries.

6.5.3. In addition to foreign jurisdictions, Item 11 institutions must also be aware that their local clients may also pose a geographic ML and TF risk. Factors to be considered include clients that acquire funds in an area that is different from where they reside or clients that make payments from areas different to where the original transaction was entered into.

6.6. Terrorist Financing Risk

6.6.1. Where business is conducted with NPOs and NGOs, entities should verify the registration details of the organisation and ensure that the use of funds and properties involved are in accordance with the stated objectives of these organisations. The FIC has issued public compliance communication (PCC) 41 to provide guidance and advice to NPOs and to institutions conducting business with such NGOs and NPOs.

6.6.2. Item 11 institutions must also be aware of the appropriate compliance obligations in section 28A of the FIC Act as well as section 26A of the FIC Act. Item 11 institutions must know how to access the referenced lists and determine whether they are conducting business with individuals and institutions on such lists.

³ The Financial Action Task Force is the international standard setting body for combating money laundering and the financing of terrorism and proliferation. South Africa is a member of the Financial Action Task Force and has to comply with its Standards.

7. INDICATORS OF MONEY LAUNDERING AND TERRORIST FINANCING ACTIVITY FOR THE SECTOR

Possible indicators of money laundering in the provision of credit facilities to businesses and individuals, include the following:

- The use of the funds for illicit activities
- Reversing of transactions before repayments of a loan have started, resulting in the borrowed funds being repaid within a short space of time
- Repayment amounts for loans are higher or within a shorter time frame than originally agreed upon with no reasonable explanation or an explanation of the source of funds used
- Multiple cash repayments without plausible explanation for source of funds
- Clients hesitant to provide personal information and information on their proposed business
- The business that is being established does not make economic sense and does not fit into the profile of the borrower
- A change in the business or the business strategy of the borrower that does not make economic sense
- The client is part of a complex structure or group or is a trust established in a foreign jurisdiction
- The loan is serviced by a third party that was not part of the original transaction
- Multiple loans are taken out which do not make sense or do not fit the economic profile of the client.

8. CONCLUSIONS

The business conducted by Item 11 institutions is recognised as posing an inherent, medium to low risk for money laundering. Furthermore, registered Item 11 institutions include entities that may potentially conduct business with clients vulnerable to money laundering such as legal entities, trusts, NPOs, NGOs, FPPOs and DPIP's as well as their family members and associates. Many of the institutions registered under this category are small lenders where the risks are relatively low. In instances where larger state-owned enterprises are involved,

the loans are usually backed by security and the use of cash for repayment is evident but tends to be minimal.

The inherent ML and risks of Item 11 institutions in South Africa is generally medium but at the lower end. There is potentially also a TF risk associated with Item 11 institutions.

However, the extent of TF risk is regarded as unknown due to a lack of information, and as the TF vulnerability and threat assessment is ongoing. It is incumbent on each item 11 entity to thoroughly and adequately assess and scrutinise the risk profile of every client on a case-by-case basis, to ensure the ML and TF risks are well understood and then managed.

Overall money laundering risk factors for Item 11 Institutions

Money laundering risk factor	Likelihood	Consequence	Overall risk rating	Priority
Compliance: Lack of mitigating circumstances through compliance – e.g. CDD, training, record-keeping	3	4	18	2
Products and services /delivery channels – Use of cash, online platforms, transaction size	3	3	13	2
Risk/threats associated with clients – PEPS, source of funds, complex structures	4	4	21	1
Risk/threat associated with geographical area – sales to clients outside geographic area, sales to clients in restricted area	2	3	9	3

Overall money laundering risk of Item 11 institutions – Rating heat map

LIKELIHOOD SCALE (PROBABILITY)	5 Almost certain likelihood/probability	11	16	20	23	25
	4 Highly probable likelihood	7	12	17	21 Client risks	24
	3 Possible likelihood	4	8	13 Products/Services (e.g. cash)	18 Lack of compliance	22
	2 Unlikely probability	3	5	9 Geographic risk	14	19
	1 Improbable likelihood	1	2	6	10	15
		1 Low impact	2 Minor impact	3 Moderate impact	4 Major impact significant	5 Severe impact
	CONSEQUENCE SCALE (IMPACT)					