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Hawala: criminal haven or vital financial network?

Within days of the 9/11 attacks, American authorities prepared to wage war on terror on both financial and military fronts. As the Taliban fled Kabul in the face of advancing American forces, U.S. Treasury Secretary Paul O'Neill announced he was forging a global alliance through which 'we are going to pursue the financiers of terrorism like they've never been pursued before'. His target, however, was as shadowy as al-Qaida itself: the informal system of international money transfer known as Hawala.

Roger Ballard

Well before the events of 9/11, a modernised version of the ancient system of value transfer known in Arabic as *hawala* (exchange, especially of debt) had begun to play a significant role in financial transactions throughout the Islamic world. Widely used by migrant workers of Muslim origin as a cheap and convenient means of remitting their savings to their families back home, Hawaladars – most of whom identify themselves as running money transmission businesses – can be found operating at the heart of virtually every ethnic colony which Asian migrant workers have established in Europe, North America and the oil-rich parts of the Middle East. Equipped with little more than a telephone, computer and fax machine, often in the corner of an inner-city store selling anything from cheap tickets to groceries to a largely migrant clientele, Hawaladars guaranteed delivery to recipients within 48 hours, no matter how remote the destination at a fraction of the cost charged by more fomally constituted agencies such as Western Union, and to a far wider range of destinations. Cash deliveries to remote valleys in the Pir Panjal, the mountains of the North West Frontier Province, let alone to war-torn Afghanistan and Somalia cause no problems. A similar system used by Chinese migrants is called *fei-chien*, 'flying money' – an apt description of Hawala's wonders.

'Underground banking'

Hawala is big business: millions of dollars a day flow through this global value transfer system. Prior to 9/11 few outsiders were even aware of the existence of the system; fewer still knew how it worked. Hence when there was an instant panic about all things Islamic in the aftermath of the assault on the twin towers, Hawala was suddenly outed as a form of 'underground banking'. But this was clearly banking with a difference. For those accustomed to the clerical procedures of formally constituted banks and their mounds of documentation – cheques, deposit receipts, account statements, transaction summaries – Hawala operations appeared to operate on an impossibly casual basis, and hence to be wide open to exploitation by terrorists and other malefactors.

Hawala is indeed an 'informal' system by contemporary Euro-American standards. Relying wherever possible on trust rather than written contracts to guarantee the security of their transactions, and only transmitting the data needed to implement the transaction in question, hawaladars deploy conventional banking procedures of consolidation, settlement, and deconsolidation. But they do so in such a way that record-keeping is reduced to the bare minimum, thereby saving whole forests of paper as well as huge amounts of

clerical and administrative effort. Whilst this 'lean and mean' approach to business practice dramatically reduces overheads, and hence the cost of transactions, it also has an alarming consequence as afar as regulators are concerned. Such operations appear to be un-auditable, at least by conventional standards: hence in the moral panic which followed 9/11, Hawala was routinely described as 'a system without records'.

Much of this was empty hype. Careful inspection reveals that Hawaladars do keep records of amounts to be delivered and of recipient names and addresses: there is no way in which Hawaladar could reliably run their huge and complex operation without recording such essential data. However it was not the store-front Hawaladars' front-office practices which stumped outside observers, but rather the back-office procedures they utilised to engineer the transfer of funds to remote destinations, culminating in physical cash deliveries. Making funds available overseas by conventional means is normally a fairly complex financial operation, which is why banks charge a substantial commission for their services. How could 'backstreet' Hawaladars implement such an operations so much more cheaply? Many sceptical observers promptly smelled a rat.

Terrorist finance?

Whilst the American military began to round up 'illegitimate combatants' in Afghanistan and elsewhere as post-9/11 hysteria took off, the US Treasury Department took aim at the illegitimate financial networks by means of which terrorists were believed to support terrorists. When the American embassies in Nairobi and Dar es Salaam were bombed three years earlier, the US authorities alleged that al-Qaida operatives responsible had received funds through local Hawaladars. On the grounds that those responsible for the 9/11 atrocities must surely have done the same, American authorities soon found a target: the al-Barakaat network, the principal means through which members of the Somali global diaspora supported their kinsfolk back home. The network was promptly closed down, and all its identifiable assets were confiscated, despite vociferous protests by those involved, to the effect that al-Barakaat had a wholly legitimate function, and that the cash remitted by émigrés had kept the entire Somali economy afloat for the past decade. Much later, it emerged that suggestions that al-Barakaat was the underground banking arm of al-Qaida turned out to be largely specious. The 9/11 Commission eventually revealed that the bulk of funds used to finance the Twin Towers operation were channelled through the Suntrust Bank in Venice, Florida, where two of the perpetrators opened an account on an entirely conventional basis.[i]

The PATRIOT Act and KYC

However in no way did absence of concrete evidence preclude either legal or executive action in heated post 9/11 political climate. Within six months Congress passed the Patriot Act, fully entitled: *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism*. Among its many draconian measures it introduced was a requirement for all US-based financial institutions to bring practices into compliance with reinforced Anti-Money Laundering and Countering Terrorist Finance (AML/CFT) regulations promulgated by yet another US-sponsored agency, the Financial Crimes Enforcement Network (FinCEN). These not only required US financial institutions to monitor the financial transactions of all their own customers, but also to ensure that every other financial institution with which they did business – *including those operating elsewhere in the world* – had taken similar steps to comply with AML/CFT requirements.[ii]

The purpose of the whole exercise was quite clear. In pursuing their self-declared 'war on terror', US strategists aimed not only to detect and sweep up terrorists wherever in the globe they might seek to conceal themselves, but to perform exactly the same operation with respect to the financial flows which were deemed to support their terroristic activities. Given the status of the U.S. dollar as the globally-preferred unit of exchange, no major financial institution in the world could afford to ignore the new provisions if they wanted to continue routing transactions through New York's markets – as they had to be able to do in order to stay in business.[iii] The U.S. Treasury clearly felt it had the enemy cornered.

In achieving this goal, a key feature of the whole exercise was Know Your Customer (KYC) requirements, which required all front-line institutions to check out the identity of all their customers to ensure that they were neither criminals nor terrorists, and that any funds they deposited were 'clean' rather than 'dirty', on pain of the imposition of multi-million dollar fines. FinCEN's main objective was to firewall the global financial system. If all institutions complied with its new requirements, of which KYC was the key, criminally acquired funds would be unable to penetrate the legitimate financial marketplace. 'Clean' money would consequently continue to circulate freely, while the 'dirty' money generated by drug smugglers, criminals and terrorists would stagnate outside the firewall, from where it could at least in principle be mopped up by authorities.[iv]

At least in principle, the new regulations did not ban Hawala networks. They simply demanded conformity to AML/CFT, KYC and other financial services industry regulations. Hence the US authorities have had great success in closing down 'terrorist' networks on the grounds that they had operated in breach of regulatory requirements. Many European Governments took the same sceptical view of Hawala networks.[v]

At first these initiatives appeared to have the desired effect. Faced with the possible sequestration of informal sector transfers, many migrants switched to the more expensive services of formally constituted banks and Western Union to send money home. The results were spectacular: in Pakistan, for example, the formally recorded annual inflow of migrant remittances rose from US$1.1 billion in 2001 to US$4.2 billion in 2004.[vi] Since then, however, formal channel inflow has slackened, and no evidence suggests the end of informal networks. The latest World Bank estimates suggest the annual global flow of migrant remittances through formal channels in 2005 exceeded $233 billion worldwide, of which developing countries received $167 billion. Unrecorded flows moving through informal channels push the total far higher, as they are conservatively estimated to amount to at least 50% percent of recorded flows.[vii]

It follows that Informal Value Transfer Systems – of which Hawala is best regarded as the Indian Ocean exemplar of an even more global phenomenon are still very much in business. Wherever possible they have adjusted their practices – or at least the way in which they represent them – to comply with AML/CFT regulations. In doing so they have taken every possible advantage of local variations, given that different countries have interpreted AML requirements in varying ways. In Britain, for example, Customs inspectors have confined their attention to front-office KYC compliance proceduresviii in keeping with FinCEN's 'firewall' policy. However inspectors rarely, if ever, consider the back-office procedures deployed by those engaged in trans-national and trans-currency value transmission; as a result most hawaladars have now registered as licensed Money Service Businesses. In France, Germany and Holland those seeking to operate such businesses are required to register as banks, with all the associated regulatory consequences. Hence those engaged in the business have no alternative but to keep their heads well below the parapet. In other words the Patriot Act has certainly not killed off Hawala: having made suitable adjustments to the requirements of specific local circumstances, the whole operation continues to thrive.

The operation of contemporary hawala networks

In a post-9/11 climate of fear and suspicion, news of the existence of a system which supports a multi-billion dollar flow of funds through informal channels on a global scale precipitates instant paranoia, especially in the form of alarmist stories about the way in which the system enables criminals, drug smugglers and terrorists to run wild. But before jumping to conclusions, it is worth examining the evidence. Does it necessarily follow that the excellent terms which hawaladars offer their migrant-worker customers is solely the result of the large premiums which criminal and terrorists are prepared to pay to get their hands on 'clean' dollars? Or is it because hawaladars have devised a highly efficient means of long-distance value transfers with which more formally constituted institutions find themselves unable to compete?

From their customers' perspective, the most attractive dimension of Hawala-style delivery systems is their capacity to respond to their requirements for financial services swiftly and cheaply, and at a fraction of the cost charged by Western Union or Travelex. Using hawala, customers depositing cash in any one country and currency can expect a sum of similar value in local currency to reach the specified destination in another country, including remote rural locations, within 48 hours. How do Hawaladars pull this off? Above all as a result of the efficiency of their back-office procedures, such that their overhead costs are dramatically lower than those of their formal sector rivals.

These costs have two major components. Firstly that of moving raw cash from place to place; Hawaladars seek to reduce these costs in the same way as all other financial operators, by turning cash it into value – financial instruments that can be consolidated, traded and de-consolidated at will. But whilst information can be transmitted far more cheaply than cash, information processing also costs money: this is the second source of overheads. As we shall see, hawaladars, like banks, still sometimes find it necessary to implement the physical transfer currency notes between themselves. However just as in the formal banking sector, the greater part of hawala is conducted at a more abstract level, since it involves the transfer of value rather than of cash from one location to another. The more efficiently these transfers can be implemented, the lower the overheads.

The implementation of value transmission is not a matter of physical logistics, but rather of the transmission and processing of information – which is one reason why recent developments in communications technology have had such a far-reaching impact on the global financial services industry. In a comprehensively wired world, digital data can be instantly transmitted to anyone with access to a telephone, whether a land-line, mobile phone or satellite link. Hawaladars have been no slouches in making the most of these developments. Indeed they owe their competitiveness in the field of transnational value transmission precisely to their success in marrying their ancient commercial art with the potentiality of modern communications technology.

Hawala began life, it will be remembered, as an 'exchange of debt', most usually between hawaladars providing financial services to traders moving between spatially separated markets. Cooperating hawaladars formed a coalition of reciprocity, such that they routinely honoured each other's *hundi* – Bills of Exchange in conventional banking terminology. To long distance traders, the hawaladars' services were of great utility, since a hundi could be encashed with no fuss by a hawaladar belonging to the same coalition in any other market which they might visit. This obviated to need for them to carry bullion – always vulnerable to depredations of thieves and pirates – to finance their activities. However the encashment of such hundis generated a complex network of debt between the many partners within the coalition, which were in due course settled in a series of swaps – hawala.

Much has changed since the system originally emerged. After European powers finally established hegemony over the Indian Ocean region, Western-style banking houses came to dominate the greater part of mainline trade, such that hawala systems were pressed out to the economic periphery. However following the collapse of colonial power, a huge upsurge in long-distance migration from below, and above all radical improvements in communication technology, hawala networks have gained a new lease of life, especially since they have turned out to be particularly well suited to cope with the logistical challenge of delivering migrant remittances. [ix]

Most migrants remit relatively small sums: rarely much more than a few hundred dollars. Their central requirement is that recipients should receive cash deliveries swiftly and reliably, even if they live in remote villages far beyond the banking frontier. For formally constituted banks, meeting the demands of such customers is an extremely challenging task. Their procedures are cumbersome and overheads substantial. Hence for small sums, migrants frequently find that between 15 and 20% of their hard-earned cash disappears in transfer and delivery costs. Hawaladars use just the same system of consolidation, settlement (hawala) and deconsolidation as do mainstream banks. But by substituting the mainstream banks' expensive formal procedures with 'informal' reciprocities of trust, and by using a distributed system of information-exchange (rather storing huger masses of date in expensive central registries) to implement long-distance value transfers, Hawaladars are able to respond to migrants' financial services requirements far more cheaply than can their formally constituted rivals. Given that hawala networks offer a first class service at a low cost, the fact that labour migrants flock to use them should not be a cause of any surprise.[x]

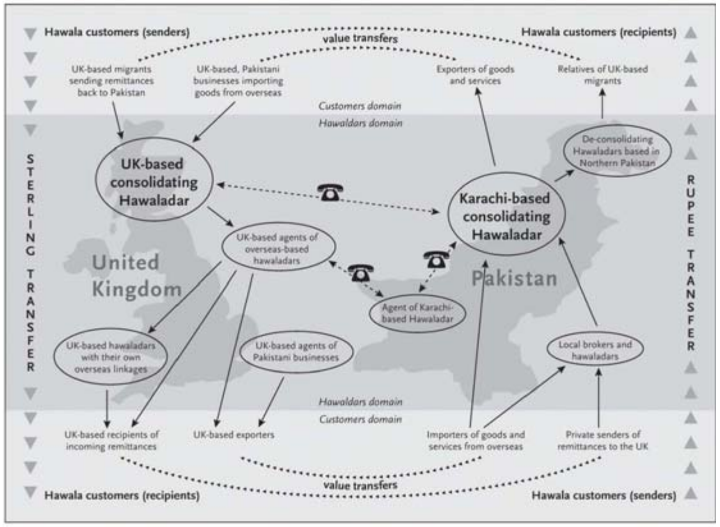
'Informality' and relationships of absolute trust

To set the scene still further, it is worth emphasising that whilst Hawala and other similarly constituted IVTS networks are conventionally identified as 'informal', they are anything bit small-scale. The hawala swaps brokered on a daily basis in Dubai use tranches of value worth $100,000 as their minimum unit of account substantial multiples of which are exchanged in the process of brokering each hawala swap. Moreover it goes without saying that at this level physical settlement is not implemented through exchanges of currency notes: multi-million-dollar transfers are settled using just the same facilities as those used by mainstream banks, up to and including the Swift network.

The mega-deals of this kind brokered in Dubai, in which multiple tranches of £100,000 are exchanged between global hawaladars, are the highest level of consolidation within the hawala system. Each of these tranches of value is normally assembled by a consolidator operating at a local (national) level, at which the physical dimensions of hawala – including the physical transfer of currency notes – become much more readily compre-

hensible. Hence these more local swaps provide a convenient arena within which to set out a (highly simplified) model of how coalitions of mutual trust provide hawaladar with the means of constructing dynamic alliances within which to implement some bewilderingly complex financial transactions. Hence the diagram in Figure 1 is a simplified (and anonym-ised) illustration of how two parallel sets of consolidation and deconsolidation of funds in both Britain and Pakistan, together with a back-to-back swap of value between consolidating hawaladars can, amongst other things, facilitate transfer of funds from Pakistani settlers in Britain to their kinsfolk in Pakistan.

The core of the operation – which is executed on a daily basis – is an agreement between two hawaladars to swap tranches of cash of the same value, one in Pounds sterling and the other in Pakistani rupees, as a means of implementing a multitude of smaller deals on behalf of their respective clients.[xi] Having agreed on an exchange rate (e.g. GBP 1 = PKR 100), the Britain-based Hawaladar is in a position to swap £100,000 worth of orders from British based Pakistanis to deliver an equivalent sum of Rupees to their kinsfolk in northern Pakistan for 10 million rupees which his Karachi-based partner has accumulated from local businessmen in Pakistan, in return for and agreement to settle £100,000 worth of invoices for goods they have imported from British suppliers. In these circumstances they implement a two-way international and inter-currency value-swap by means of two parallel cash-swaps, in one of which £100,000 is physically transferred to the Karachi Hawaladar's UK agent, which he uses to settle the Karachi businessmen's invoices, whilst in the other the UK Hawaladar's agent in Karachi arranges the despatch of the 10 million rupees in cash of which he has taken delivery the villages in northern Pakistan where most UK migrant workers' relatives live.



Transactions precipitated by a Britain/Pakistan exchange of debt between two consolidating hawaladars

As Figure 1 illustrates, a large number of actors are involved in the transactions which lead up to, as well as those which are precipitated by this swap. The tranches of value which the two consolidators exchange are invariably the product of a myriad independently brokered deals and sub-deals negotiated by networks of agents and sub-agents, of which Figure 1 is a highly simplified model, which effectively 'pulses' on a daily basis. Each time a deal is reached, *information flows* passing back and forth along the horizontal axis between UK and Pakistan gives rise to two matched, simultaneous and *local* flows of hard cash: in physical terms pounds sterling reflecting value transmitted to Pakistan flow down along the vertical axis to recipients elsewhere in the UK, for whom it represents value transmitted from Pakistan; whilst on the other side of the diagram a movement of rupees of similar value moves from senders to recipients in Pakistan. However neither senders nor recipients are aware of just how this outcome has been achieved – anymore than customers extracting notes from ATMs have any idea as to just where the cash so delivered has actually come from. In both cases value transfer and cash delivery are handled at a back-office level, using techniques which are structurally similar in both cases. It is just that the hawaladars' 'informal' procedures enable them to implement such exercises in financial engineering more efficiently and hence more cheaply than can mainstream banks.

Should we be alarmed?

That depends on the perspective which one adopts. What looks like a godsend from the viewpoint of migrant workers is indeed a cause for alarm for mainstream banks: the success of hawala networks cuts them out from a large volume of potentially profitable business. However that is not the principal focus of public concern: here the focus is whether such networks provide a financial haven for terrorists and drugs smugglers. That they could do in principle is quite clear. We already know that huge volumes of dirty money are currently being transmitted to through the formal banking system on a regular basis, regardless of AML/CFT requirements;[xii] it would be idle to suggest that IVTS networks are not open to similar forms of malfeasance. However this issue is not whether they *might* be being used for such purposes, but whether they are being used, and if so on what scale?

As far as conspiracy theorists are concerned, such questions are hardly worth asking. The answer seems quite self evident. Uninterested in exploring just how it is that hawala networks actually operate, and bemused by suggestions that they might constitute a highly effective entrepreneurial initiative in the increasingly competitive global market-place for financial services, they leap instead for easy answers. Hence, for example, FATF website unequivocally asserts that cash deliveries of the kind shown in the bottom left-hand quadrant of Figure 1 is are a classic example of process it describes as 'cuckoo smurfing', and goes on to identify as *prima facie* evidence of money laundering.[xiii] No other possible explanations are even considered.

None of this is to suggest that money launderers do not or cannot utilise the services of hawala networks. It is certainly not beyond the bounds of possibility that *some* of those tranches of $100,000 are the proceeds of the sale of heroin. But is there any likelihood that all, or even the majority of them, are so generated? That seems unlikely in the extreme. No matter how great the profits of international drug-smuggling may be, they are dwarfed by the scale of migrant remittances; and in any event is it at all likely that UK-based drug smugglers would wish to shelter the profits of the malfeasance in Pakistani rupees? All serious commentators appear to agree that they much prefer US dollars in formally constituted banks located in well-sheltered jurisdictions in the Caribbean.

That said, one cannot exclude the possibility that criminals, terrorists and drug smugglers will take advantage of those jurisdictions where no formally constituted banks currently operate. In Somalia and Afghanistan, for example, financial transactions of all kinds, from the most innocent to the most criminal, can indeed pass through Hawala networks. In more normal circumstances, however, Hawaladars would appear to have a direct interest in avoiding criminal activity. Coalitions of absolute trust depend on the reliability of their members and everyone their members do business with. Violated trust imperils the stability of the whole coalition and invites severe sanctions. Precisely because Hawaladars expect to maintain a *personal* relationship with their customers, and most especially those with whom they engage in large-scale transactions, they effectively maintain their own 'know your customer' scheme. They also have a personal interest in excluding dodgy dealers: failure to do so would inevitably imperils their position within the entire coalition.

Ill-focussed blunderbusses or targeted stilettos?

Nobody denies the need for authorities to do everything in their power to contain the activities of terrorism's financiers and drug traffickers. However the results have not been impressive so far. Having impounded consignments of cash passing through Hawala networks, it is easy to generate headline-grabbing reports about the destruction of the financial sinews of terrorist and drug-smuggling operations. But if no terrorists or drug-smugglers are apprehended as the outcome of such interventions, and if heroin becomes so plentiful that its street price declines, shaking down Hawaladars begins to look more like a public relations exercise.

If my analysis is correct, most transactions routed through Hawala networks provide a much needed financial service to millions of migrant workers who need a cheap and reliable means of sending money back home. It may well be that some 'dirty money' gets inserted into the huge flows of value passing through the hawala system, but the same is also undoubtedly true of the mainstream banking system. The challenge here is to find an effective means of separating the sheep from the goats. In their efforts to do so the regulatory authorities, under pressure from the US Treasury, appear to have armed those who guard the gates of financial rectitude with blunderbusses rather than stilettos. In these circumstances it should come as no surprise that whist their blunderbusses are inflicting considerable collateral damage, the goats have become yet more skilled at evading surveillance and for the most part slip though undetected.

The authorities' chances of success would have been greater had they formulated their strategies with a better appreciation of the character, location and *modus operandi* of their targets. Merely driving the system underground – the currently preferred tactic – favours criminals much more than their pursuers, providing we remember that the real targets here are terrorists and drug smugglers, rather than those alleged to be providing them with financial services. Rather than succumbing to mindless moral panic, might not the authorities make much greater progress if they sought the cooperation of hawaladars, rather than subjecting them to random prosecution on specious grounds? If some 'dirty money' does indeed seek to pass through the system – as is manifestly a possibility – no-one is better placed than Hawaladars to point intelligent investigators to its source; however there is little chance of them volunteering such information if their normal commercial business places them in constant danger of arrest.

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i Public Affairs Commission. 2004. *The 9/11 Commission Report*. New York: Public Affairs.

ii Amongst other things this initiative led to the emergence of expensive AML/CFT compliance consultants. www.moneylaundering.com gives constant updates on the additional spheres of financial activity into which the regulatory regime has spread, and offers ever more detailed training programmes which enable participants to become certified anti-money laundering consultants.

iii It is precisely these provisions which have facilitated the shut-down in the financial sinews of the Palestinian economy since the election of Hamas. Once labelled as a terrorist regime, no international banks have dared to transfer funds into Palestine for fear of having their facilities in New York withdrawn.

iv This strategy was based on a largely illusory premise. As Raymond Baker demonstrates in great and illuminating detail in *Capitalism's Achilles Heel: Dirty Money and how to renew the Free-Market System* (Wiley 2005), trillions of shadily acquired dollars already circulate freely within the firewalls FinCEN is so desperately seeking to erect.

v The USA Patriot Act - A Proven Homeland Security Tool <www.dhs.gov/dhspublic/display?content=5077>

vi The State Bank of Pakistan's best estimate of the annual total inflow of remittance funds during this period was US$8 billion. In other words, despite the massive post-9/11 switch into the formal sector, around 50% of the inflow was still being channelled through the informal sector. <www.sbp.org.pk/publications/wpapers/wp03.pdf>.

vii (World Bank, Global Development Finance 2006:3)

viii Anyone who has recently opened a bank account will be familiar with KYC regulations, which require two independent forms of personal and financial identification before the transaction can proceed.

ix Ballard, Roger. 2004. 'Delivering migrant remittances: the logistical challenge'. *Journal of Financial Transformation* 12.

x A full analysis of how such relationships of reciprocity are constructed and maintained can be found in: Ballard, Roger. 2005. 'Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems: the operational dynamics of contemporary hawala networks'. *Journal of Banking Regulation* 6-4.

xi In this example I am assuming that the two hawaladars are acting independently. In practice these localised swaps are often part of much larger global swaps brokered elsewhere, most usually in Dubai.

xii See Baker in footnote 4.

xiii Money Laundering and Terrorist Financing Typologies 2004-2005, p.18 ff, <www.fatf-gafi.org/dataoecd/16/8/35003256.pdf >.