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Financial intermediaries – Anti-money laundering allies in cash-based societies?

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Financial intermediaries
– Anti-money laundering allies in cash-based societies?

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Abstract

Many informal cash-based economies run parallel financial systems that are very different to the Western banking concept. Such countries are perceived to have a high risk of money laundering. Looking at Afghanistan, Somalia, and India – where anti-money laundering efforts have yielded mixed results – this paper draws lessons from the operations of financial intermediaries. These countries are considered high risk not only for money laundering and terrorism financing, but also for corruption and political and legal concerns. The issues at hand – risk assessments for remittances, strategies of engaging on the ground, resource management, and alternatives to the existing financial networks – are also valid for other cash-based, low-income societies. In fact, informal remittance channels may provide opportunities to strengthen regulatory and governance capacities.

Introduction

Illicit flows adversely affect all countries, but especially developing ones where economies are fragile and controls comparatively weak. At the same time, formal and informal remittance flows in cash-based societies – as well as regulation of these flows – powerfully impact access to financial services and development. Financial intermediaries, especially in the informal sector, play a crucial role in enabling these remittance flows and facilitating or controlling money laundering and other related misconduct. Societies and communities with large volumes of cash transactions are a high policy and research priority, given their vulnerability to illicit flows and money laundering.

Concerns have been voiced over the effectiveness of anti-money laundering/counter-financing of terrorism (AML/CFT) measures, which in some countries may be mere window dressing to avoid stigmatization or sanction from the international community. They can influence the power illegal actors have over an economy, the criminalization of certain economic sectors, corruption, and the volume and utilization of remittance flows.

The ongoing implementation of international standards against financial misconduct in both transition and comparatively stable developing countries has brought about a series of new or amended laws, processes, and institutions dealing with the control of money laundering.[2] The literature has not kept up with the impact of these changes on the activities of financial service providers and money launderers. This study illustrates the benefits and adverse consequences of changes to the legal frameworks and actual practices of informal remittance intermediaries in three cash-based societies: Afghanistan, India, and Somalia.

Implementing AML/CFT measures entails costs and investment on the part of all countries. Some have argued that the costs are higher than perceived or real benefits. For instance, countries with international financial centers (IFCs) have had to examine the potential loss of customers and negative impact on their economies. However, such an impact has been neither uniform nor universally accepted (Sharman and Mistry 2008; Vlcek 2009, 2010). The main concerns that enter into cost and benefit analyses in cash-based societies include the risks of capital flight, interference with economic/monetary policy, terrorism finance, money laundering, tax evasion, illicit flows, criminalization of legitimate flows, financial exclusion, and an inability to oversee the in-flow of migrant remittances (Bester et al. 2008; FATF 2013c; Maimbo and Passas 2005; Vaccani 2010). All these issues are even more relevant in countries with capacity challenges and porous borders (Mynhardt and Marx 2013; Tagliacozzo 2005; Thachuk 2007).

Efforts to formalize remittance services[3], combined with AML/CFT measures, are a double-edged sword: they raise awareness of issues, but also of the costs of compliance, thus pushing many intermediaries underground and effectively increasing the risk of financial misconduct. In addition, such efforts can reduce the monitoring capacity of authorities because informal intermediaries often have good knowledge of their clients and can provide useful information about irregularities that underlie corrupt and illicit payments. Recent AML failures at global banks show that the formal sector is not risk free and point to the need for a good balance of formalization and context-sensitive controls in order to maximize compliance and collaboration by all financial intermediaries in cash-based societies. Donors could be more effective and instrumental in guiding and assisting with the implementation of best practices and related capacity building.

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[2] Some of these international standards are the UN Convention against Corruption, the UN Convention against Transnational Organized Crime, and Financial Action Task Force (FATF) recommendations.

[3] According to the World Bank (2013), "Remittance flows to developing countries are expected to reach $414 billion in 2013 (up 6.3 percent over 2012), and $540 billion by 2016."

1. Cash-based societies and money laundering

The toughest money laundering challenges are often associated with developing countries, most of which are characterized as *cash-based* and have extensive informal economies (Moshi 2012; Mynhardt and Marx 2013). In fact, much of the literature treats cash dominance and informality as almost interchangeable terms. Some go even further to associate *cash society* with illegality (Hepburn 1992). In short, two issues must be clarified. Firstly, what would represent a cash-based society? Secondly, in what ways are such societies vulnerable to money laundering and other financial misconduct?

There is no consensus on what precisely *cash-based society* means. *Unrecorded, hidden, underground, shadow, grey,* and *cash economy* are terms generally taken to signal substantial economic activity that is not officially registered, but these different terms do not always cover the same issues (Reinhart, Job, and Braithwaite 2004). Some focus on the economic aspects of such activities: "all economic activities that contribute to the officially calculated (or observed) gross national product but are currently unregistered" (Schneider and Enste 2000, 78). According to a simpler definition, "a cash-based economy is one in which more than 50 per cent of the economic transactions in all sectors are conducted in cash, and in which the majority of the population are unbankable" (Moshi 2012, 2).

We rely on this definition in this study. While these transactions are not likely to be fully reported, officially recorded, measured, or taxed, these issues are not of concern to this study. What matters for this study is the means used in a given social group for economic exchanges. Notably, one may encounter cash economies also *within* a given country. Particular communities, groups, or regions may prefer operating in cash, even when formal financial services are available.[4] This suggests the need to prioritize risk assessments for specific sectors or areas.

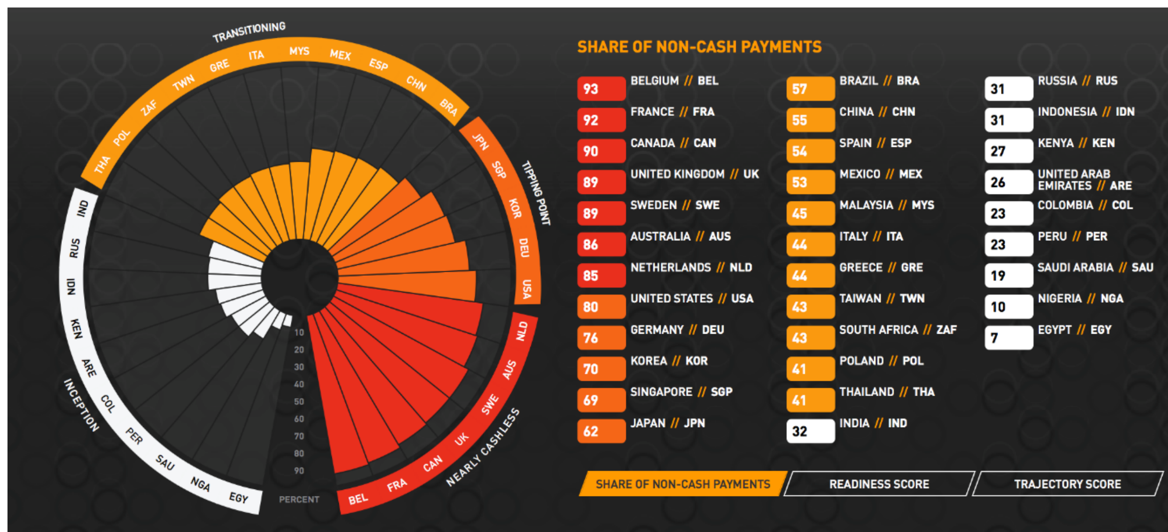
The dominance of cash is overwhelming in many countries, but it is important to note that the world in general is far from cashless. A study by MasterCard Advisors found that 85% of global retail payment transactions are currently made in cash (Thomas, n.d.). Cash dominance may result from cultural resistance to banks, low confidence in the banking sector, a lack of financial literacy, the absence of efficient and low-cost banking infrastructure, ineffective banking supervision and regulation, or financial exclusion. More than 2.5 billion people are *unbanked*, mostly in developing countries. Exclusion and marginalization of large populations from financial services is unfair and has negative effects on economic development and growth, as well as causal links with modern slavery (Walk Free Foundation 2013). Especially victimized are the disadvantaged and poor. Financial inclusion − access to financial services at affordable prices delivered by sound, sustainable and well-

[4] This occurs in relation to a good deal of ethnic community transactions in the US (Kotkin 2008). For example, the City of Miami explained, "Miami has a strong cash economy that is unaccounted for by most traditional research and attributable to cultural influences, including the spending patterns of immigrant populations" (City of Miami, n.d.).

regulated institutions – is therefore a high priority policy concern (FATF 2013a; Maxima 2010; Shehu 2012).[5]

The three countries selected for this study easily fall within the cash-based society category. India was included in the MasterCard Advisors study and found to have only 32% non-cash payments (see below).

Figure 1.



Source: MasterCard Advisors (2014)

Afghanistan and Somalia are cash-based societies by any yardstick. In Afghanistan, in particular, less than 5% of the population has bank accounts and 90% are using hawala (Schwellenbach 2012).[6]

Cash-based societies are commonly considered a high risk for money laundering because "the dominance of cash transactions, coupled with the narrowness of the financial sector (low levels of penetration), makes it easier for the proceeds of crime to be integrated into the rest of [the] economy, without the involvement of the financial system in the initial stages" (Moshi 2012, 3). However, the problem may be not as much with the volume of cash transactions as with the traceability of these transactions. Traceability is poor when overall controls and governance in a country are weak. As the same author notes, "most cash-based economies tend to have very limited law enforcement capacity and are under pressure to address numerous other law enforcement priorities" (ibid, 6). The challenge may be law enforcement rather than cash dominance.

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[5] Financial inclusion, as defined by the FATF (2013a), refers to access to formal financial institutions rather than financial services. However, financial inclusion could be defined in a way that also captures instances where communities are deprived of any financial services (whether formal or informal) for necessary and essential transactions. This definition accounts for cases in which poor communities can theoretically access to expensive, exploitative, slow, or culturally insensitive formal financial services, but cannot as a practical matter use those services. In China, for example, many have access to informal and illegal banking services (Passas, Hsu, and Li 2012).

[6] See U4 Expert Answer: Hawala remittance system and money laundering (http://www.u4.no/publications/hawala-remittance-system-and-money-laundering/) for details on hawalas.

With respect to money laundering, two points must be clarified at the outset. Firstly, there is no need to launder crime proceeds if they are recycled into another illegal business: crooks require no receipts or certificates of origin. Secondly, there is no need to engage in money laundering techniques aimed at tricking financial institutions if the authorities do not enforce AML and related laws. When enforcement is lacking, offenders can enjoy the fruits of their crime with impunity and fear no sanctions or losses. This means (a) the volume of money laundering will be extremely low (and thus additional AML controls will not have a strong impact on serious crime) and (b) even if financial institutions perform their AML functions as desired, they will be unable to detect suspicious transactions, since known money laundering methods may not be used.

These reflections apply to both formal and informal transactions and operators[7] and to credit as well as cash-based economies. The bulk of organized crime money is made when illegal goods and services are sold to retail clients. The largest illegal markets – from drugs and sex to stolen antiquities – are mostly in credit-based economies, which means that the money laundering cycle starts there. This raises a couple of key issues. Firstly, if these countries have better AML controls than the developing world (Yepes 2011) and yet continue to struggle against serious crime and money laundering practices, how much success can be expected by much poorer countries with fewer resources? Secondly, the size of illegal transactions and how well the corresponding legal framework handles them may be just as important as – if not more important than – whether an economy is cash or credit dominated. In other words, vulnerability to money laundering does not come from cash alone and *per se*. For instance, if cash transactions are recorded and transparent, there is traceability; controllers can follow the money, ask relevant questions, conduct effective investigations, and reveal misconduct.

Informal and unofficially conducted money transfers through hawala networks are not by themselves an impediment to controls. For example, terrorist and drug trafficking operations have been discovered in India and the UAE, thanks to the cooperation of hawaladars. Funds sent from Yemen to Kenya to finance the bombing of the US embassy were recorded in hawala ledgers that were kept for years and produced in New York courts as evidence. This traceability was possible well before the post-9/11 regulation and record maintenance obligations. When properly approached, hawala networks can be a great asset against money laundering and terrorism financing, rather than the obstacle they are often considered to be (Passas 2008). Controllers can follow the money, ask relevant questions, conduct effectively investigations, reveal misconduct, and seize and recover assets.

[7] Formal–informal differentiations based on whether a remitter is regulated or not or based on its size or range of services offered do not matter or make sense. Hawala operators may serve as “wealth managers”, distributing remittances to members of the family and investing a portion of the funds until the repatriation of migrants (which is often the case in Yemen). In addition, neighborhood or small social circles may save funds and lend them to those in need (as is the case with committees in Pakistan). Thus, it is wrong to assume that hawala is unregulated. Even when operated without observing local laws, self-regulatory mechanisms address mistakes, delays, or fraud (conclusion based on interviews with Indian and Pakistani hawaladars in the UK). For this reason, the formal–informal distinction may not usefully apply to remitters (Committee on Payment and Settlement Systems 2006).

2. Legal and institutional AML changes in Afghanistan, India and Somalia

UN and OECD conventions on transnational crime, terrorism, and corruption; UN Security Council Resolutions on sanctions; and the FATF recommendations have generated a regulatory tsunami. These standards contain extensive AML provisions applicable to financial institutions, including money remitters, who are extremely active in cash-based societies.

In all three countries under study, strong efforts have been made with assistance from the international community to implement these standards through legislative and regulatory reforms. As will been seen, these efforts have not produced the desired practices and effects. The phases of implementation range from very early standard design and introduction stages (Somalia) to efforts of initial implementation (Afghanistan) to the establishment of a full-scale legal and institutional framework that still needs to demonstrate effectiveness (India).

a. Afghanistan

Afghanistan has established a Financial Intelligence Unit (FIU), the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA), and passed the Anti-Money Laundering and Proceeds of Crime Law in 2004. FinTRACA has analytical responsibilities based on reports filed by private entities and data from other government agencies. Reporting entities from the private sector must file reports on suspicious transactions[8] and on large or structured cash transactions[9]. The FIU is tasked with collaborating with other government entities and cooperating with foreign counterparts.

However, even FinTRACA's stated goals do not appear to have been met. As stated on FinTRACA's website, its main objective is to "deny the use of the Afghan financial system to those who obtained funds as the result of illegal activity, and to those who would use it to support terrorist activities"[10]. Despite high-level political statements and commitments, Afghanistan has not convinced the FATF that it is making sufficient progress. In January 2014 the FATF listed it under "Jurisdictions not making sufficient progress."

In Afghanistan, hawala is well established as a reliable institution and for a long time it has been the only option for both legitimate and illegal fund transfers (Maimbo 2002; Passas 1999; Thompson 2011). As a result of significant vulnerabilities and challenges, the US Bureau of International Narcotics and Law Enforcement Affairs considers Afghanistan a "jurisdiction of primary concern". The most important problems that undermine security and development in the country include terrorist finance, drugs and other criminal enterprises, corruption, fraud, and the abuse of hawala (which is used for 90% of financial transactions)[11]. The strong preference for hawala is due to corruption and weakness in the financial sector. The same report suggests that both banks and hawala operatives turn a blind eye to illicit flows that end up in the financial system – as illustrated by the

[8] See guidance on what constitutes "suspicious" transactions at http://www.fintraca.gov.af/STR.aspx.

[9] See guidance on large cash transactions at http://www.fintraca.gov.af/LCTR.aspx.

[10] See http://www.fintraca.gov.af/Overview.aspx.

[11] According to the 2014 International Narcotics Control Strategy Report (INCSR), "Approximately 90 percent of financial transactions run through the hawala system, including foreign exchange transactions, funds transfers, trade and microfinance, as well as some deposit-taking activities" (DOS 2014, 55).

massive Kabul Bank fraud and corruption scandal (Strand 2014) − while US dollar cash smuggling to Iran rose in the aftermath of the Iranian rial depreciation in 2012.

Overall, new AML laws and institutions do not appear to be satisfactory, effective, or consistently enforced. Afghan banks and state institutions cannot be relied upon for the production of records and evidence in support of money laundering investigations (SIGAR 2013). In this light, it is impossible to assess the impact of AML measures on the remittance sector, not only because the data are not there, but also simply because it is enforcement *practices* rather than *announced changes* that affect the cost, routing, and behavior of those involved in formal and informal remittances.

b. India

Even though India has been concerned about illicit flows for some time, legal and institutional reforms have only recently focused on bringing the country in line with international AML standards. It adopted a revised action plan to strengthen its AML/CFT systems and was granted FATF membership in 2010. Until 2013, it was subject to annual reviews to ensure implementation of the action plan, fulfillment of all FATF membership criteria, and satisfactory compliance with other FATF recommendations. In 2013, the FATF concluded that "India rectified nearly all of the technical deficiencies identified with respect to the criminalisation of money laundering (ML) and terrorist financing (TF) and the implementation of effective confiscation and provisional measures through amendments to the Prevention of Money Laundering Act (PMLA) […] the Unlawful Activities (Prevention) Act (UAPA)," and the Banking Laws Act (FATF 2013d, 7).

While India is a very important emerging market (and part of the BRICS[12]), it remains largely a cash-based society that heavily uses hawala channels for both honest and criminal fund transfers.[13] The frequent media reports of hawala arrests, money laundering, terrorism finance, and other crimes detected in India indicate that there is significant room for improving preventive and control measures against such offenses. The FATF has noted also that the low number of convictions on money laundering and terrorism finance charges should be addressed, especially as the new legal instruments are implemented more effectively in the near future (ibid., 17, 26).

Another interesting gap in FATF's evaluation was the absence of any mention of laws that outlaw hawala, such as the Foreign Exchange Regulation Act of 1973, which was replaced by the Foreign Exchange Management Act of 1999 and subsequent amendments and regulations. India's national press is replete with references to these laws and the role hawala continues to play in India's economic life, although the emphasis is on the additional offenses involved, such as tax and duty evasion, bribery, money laundering, and terrorism finance.[14] Given the frequent combination of hawala and trade mis-invoicing, enforcing these laws is the responsibility of the Indian Enforcement

[12] The term "BRICS" refers to five emerging economies – Brazil, Russia, India, China, and South Africa – all which are distinguished as being newly industrialized, fast-growing economies.

[13] As noted by the 2014 INCSR,

India's extensive informal economy and remittance systems, persistent corruption, onerous tax administration, and currency controls contribute to its vulnerability to economic crimes, including fraud, cybercrime, identity theft, money laundering, and terrorism financing. India's porous borders and location between heroin-producing countries in the Golden Triangle of Southeast Asia and Golden Crescent of Central Asia make it a frequent transit point for narcotics trafficking. Proceeds from Indian-based heroin traffickers is widely known to re-enter the country via bank accounts, the hawala system, and money transfer companies. (DOS 2014, 123)

[14] Some of these are mentioned in a different FATF report on informal remitters, which includes information received from Indian authorities (FATF 2013c).

Directorate and the Central Board of Excise and Customs. Because of the long prohibition of hawala, recent AML laws are not expected to have significant impact on these practices, which are influenced by cultural remitting traditions, commodity (especially gold) prices, capital controls, tax rules, trade subsidies, and the operation of criminal enterprises.

India also faces serious capacity, governance, and corruption challenges. The problem of formally establishing a client's identity was highlighted after a move by the prime minister to provide bank accounts and insurance to masses of the unbanked. For this to happen, customers must be identified through birth certificates and proof of address. This is anything but given, as pointed out by the chief manager of Andhra Bank: "For the common man, the opening of a bank account is a Herculean task" (BBC 2014).

On the other hand, India has a developed financial sector. As a result, financial misconduct is not entirely concentrated in hawala networks, but is spread out:

> The high degree of corruption in Indian society both generates and conceals criminal proceeds. Illicit funds are often laundered through real estate, educational programs, charities, and election campaigns. The most common money laundering methods include opening multiple bank accounts, intermingling criminal proceeds with assets of legal origin, purchasing bank checks with cash, and routing funds through complex legal structures. Transnational criminal organizations use offshore corporations and trade-based money laundering (TBML) to disguise the criminal origin of funds; and companies use TBML to evade capital controls. Laundered funds are derived from narcotics trafficking, trafficking in persons, and illegal trade, as well as tax avoidance and economic crimes. (DOS 2014, 123)

This, together with the widespread money laundering and corrupt practices revealed by Cobrapost's Red Spider investigations (Cobrapost 2013, 2014), shows again that cashlessness does not mean freedom from financial crime risk.

As bitcoin[15] established exchanges in India and the UAE (where about a million Indian expatriates live), the remittance market has been directly targeted as an inexpensive way of sending money home.[16] This conversion can be done instantly from dirhams to rupees, so that anyone concerned about the volatility in the value of bitcoin itself will not have to worry about it all (Maierbrugger 2014).

The combination of ethnic conflicts, nominee practices, and hawala networks brings about terrorist finance risks as well: "Terrorist groups often use hawalas and currency smuggling to move funds from external sources to finance their activities in India. Indian authorities report they have seized drugs for sale in India purchased by India-based extremist elements from producers and/or trafficking groups in neighboring countries" (DOS 2014, 123).

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[15] "Bitcoin" is an open-source, peer-to-peer digital currency that allows instant funds transfer to users worldwide without intermediaries (or their associated cost). Recipients can either make further payments by bitcoin or convert it into the local currency. Because there are currently not many bitcoin users in cash-based societies, registered remittance companies may use bitcoin themselves to keep fund transfer and currency conversion costs low. In such instances, remitters and beneficiaries may not even know that this method is used as they send and receive local currencies. A Canada–India corridor is served this way at a cost lower than 1% (Brustein 2013).

[16] There is no cost for the transfer and only a 1% fee for the currency conversion.

c. Somalia

Somalia has been in turmoil for more than two decades and continues to confront security, political, and economic challenges. There are ongoing reforms and strong donor involvement in peace- and state-building initiatives, and new laws have been introduced, but security and governance continue to be weak.

Government capacity is minimal and reliance on external funds and hawala for the legitimate economic and humanitarian purposes is high, with remittance recipients dependent on these flows for survival: a third of them are unable to meet basic food, medicine and school expenses without remittances (FSNAU 2013; Hammond 2010; Hammond et al. 2011; Orozco and Yansura 2013). Fifty-one percent of recipients are women, and remittances account for 64% of their income. More generally, remittances account for 60% of the incomes of Somalis (which average US$ 3,000) (Orozco and Yansura 2013).

The Somali AML/CFT system is slowly coming into place with donor assistance, but (as in other cash-based societies with large populations in poverty) these reforms are not effectively, productively, and consistently implemented. The financial sector remains essentially informal "operating almost completely outside of government oversight, either via the black market or unsupervised remitters and hawaladars" (DOS 2014, 183). An estimated US$ 1.5 billion every year is remitted from the Somali diaspora to their families via Arabian Gulf financial centers, especially Dubai, a topic covered from the perspectives of academia, donors, and international organizations (Hamza 2006; Lindley 2006, 2010; Omer 2003; Orozco and Yansura 2013; Passas 2006b; Rodima-Taylor and Estey 2013; Twyman-Ghoshal 2013; Warsame 2011).

As the authorities struggle to control piracy, smuggling, and al Shabaab terrorism, criminal and legitimate economies intersect and multiple types of illicit flows go through Somalian territories, many of which are totally outside the control of the government (World Bank 2013; DOS 2014). Even in areas the government controls, oversight and law enforcement are wanting. For example, financial institutions' efforts at due diligence on client criminal records and the issuing of passports are hampered by the inability of the government to create accurate and usable databases on such information (Moalim 2014). Corruption, official participation in illegal networks, and ineffective law enforcement mean that criminal assets can be enjoyed without prior laundering (see DOS 2014). The mixing of legal and illegal business further undermines reforms and the legitimacy of the government and its institutions.

All these risks – along with UN sanctions – have led to Somali-specific measures in countries where diaspora members reside and remit from. Regulatory alerts, sanctions, adverse media stories, and a risk-based approach called for by FATF and national governments have resulted in what some consider overly cautious practices by US and UK banks servicing Somali remittance companies. Account closings in these two countries have caused concerns about the survival and livelihoods of large Somali communities. With the active involvement of donors and NGOs, remittance flows have not been completely blocked, but remitters are threatened with the loss of the few remaining bank accounts they have.

Thus, it is mostly AML/CFT actions overseas (rather than domestic actions) that have contributed to crises for remitters and needy beneficiaries. A similar pattern of efforts to introduce international AML standards without much success or effectiveness can be observed in many other cash-based societies as well. In most of Africa, attempts to comply with FATF standards have resulted in hard-to-assess implementation and compliance. With respect to the remittance sector, compliance is much more challenging partly because of the higher cost:

Meeting these legal requirements poses a challenge in opening the remittance marketplace to payers outside the traditional banking sector. Extra compliance staff, record-keeping costs and training of employees significantly increase the cost of doing business. Smaller, non-banking financial institutions generally lack this kind of capacity and the funds to develop it. (IFAD 2009, 11)

d. Risk overview

In sum, implementation of AML in cash-based societies remains a challenge. This is confirmed by data obtained from the Basel Institute on Governance AML Index.[17] All three countries under study here are considered high risk not only for money laundering/terrorism financing (ML/TF) but also for corruption and political and legal concerns (10 is the maximum risk score):

Country	Listed	Overall Score	ML/TF Risk	Corruption Risk	Political & Legal Risk
Somalia*		9.85	10	9.2	9.23
India		5.62	6.36	6.4	3.31
Afghanistan		8.53	8.8	9.2	7.49

Country	Listed	Overall Score	ML/TF Risk
Afghanistan		8.53	8.8
India		5.62	6.36
Somalia*		9.85	10

Country	Listed	ML/TF Risk	US INCSR	FSI	FATF
Afghanistan		8.8	10	n/a	8.4
India		6.36	10	8.11	3.68
Somalia*		10	10	n/a	n/a

Country	Listed	ML/TF Risk	US INCSR	FSI	FATF	WB Business Disclosure Index	WEF GCR Strength of auditing and reporting standards	WB IDA IRAI Financial Sector Regulations
Afghanistan		8.8	10	n/a	8.4	9	n/a	8
India		6.36	10	8.11	3.68	3	3.5	4
Somalia*		10	10	n/a	n/a	n/a	n/a	n/a

*More than 50% of the data is not available for Somalia. Please consider results with care.

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[17] See Basel Institute on Governance (2014). Many thanks to the Basel Institute for giving the author access to this database.

3. Common features and risks in cash-based societies

The challenges confronted by the three countries are similar to those of other cash-based societies, most of which are low-income, developing countries (Goredema 2011; Shehu 2012; Trausolt and Johnson 2012; Zerzan 2011). These challenges can be summarized as follows:

- All three case studies presented here share a lack of genuine political will to engage in necessary reforms. This is clearly the case in Afghanistan, and until recently in India. Many government leaders remain unconvinced about the negative effects of money laundering in their countries, resist pressures to implement AML standards, and do not regard these standards as a high policy priority (Sharman and Chaikin 2009; Yepes 2011).

- Low capacity is a major problem, even where there is political will. Governments typically have their hands full, and policy priorities compete for limited resources. Legal and private sector institutions are weak, while unrecorded economic activities thrive. Human capital is low, as people with the requisite skills, experience, and training are not available to help plan and implement effective controls. Also, many cash-based societies have porous borders that cannot easily be controlled; this is a challenge in all three of the countries this study deals with. In addition, the sort of documents, data, and information systems upon which FATF recommendations rely are lacking.[18]

- Countries are expected to implement rather complex AML regimes. Multiple agencies and processes must be coordinated. Success can be expected when all interdependent elements are in place: "If one part of the system is missing, it is likely to greatly hinder effectiveness of the rest" (Zerzan 2011, 3).

- Cultural and other resistance slows down progress and reveals disparities between what the law mandates and what many people consider acceptable. For example, some have argued that in Afghanistan and the UAE informal remitters resist state regulation (see Trautsolt and Johnson 2012). Alternative ways of customer identification and due diligence include biometrics solutions (Makin and Clark 2014) and the use of telephones (Orozco and Yansura 2013), but these are not popular or trusted by Somalis (Thompson et al. 2013).[19]

- The cost of compliance is prohibitive for small players (Passas 2006b; Watkins and Quattri 2014). Even big financial institutions have complained about the burden of new rules. Between 2008 and 2011, compliance costs rose 45%, and they are still underestimated in 2014 (KPMG 2011, 2014).

- Donors support AML efforts, but often neither co-ordinate technical assistance and capacity-building programs nor engage in systematic quality control. In some cash-based societies (particularly those with small financial sectors and limited exposure to international finance) these efforts lag behind (Shehu 2012).

[18] A systematic assessment of how FATF data-driven AML can work in low capacity countries is needed but has not yet been done (Zerzan 2011).

[19] In addition, these methods also come with their own sets of risks and technology challenges (Shetty 2014).

- Corruption and governance challenges mean that both the public and private sectors are affected. In other words, *all* financial institutions are vulnerable to misconduct.[20] Banks do not always do their job, and when they do, the authorities may not do theirs. Money launderers try to hide illegal proceeds wherever there are large volumes and a lot of traffic. In such a context, dominant financial institutions, whether formal or informal, will be equally vulnerable to abuse.[21] Weak anti-corruption controls go hand in hand with lower AML compliance (Kyriakos-Saad, Esposito, and Schwarz 2012), which is generally low in developing countries (Yepes 2011). In cash-based societies, illegal proceeds are likely to be invested in legal businesses, and clean profits may then be entered into the bank system (Goredema 2011).

In many cash-based societies AML efforts are tentative and slow, but in the global North similar efforts can be decisive, fast, and impactful. This does not mean that northern efforts adequately address risks or do not have negative externalities on the remittance industry and its users. For example, one of the main negative externalities of these efforts is that when countries impose severe penalties for non-compliance, banks may become more risk averse and close down accounts of legitimate operators. This is a challenge Somali remittance companies have confronted since 9/11 when banks closed down accounts of legitimate companies in the US and the UK (Lindley 2006; Orozco and Yansura 2013; Pantuliano et al. 2011; Passas 2006b; Thompson et al. 2013).

In sum, the AML/CFT practices of credit-based societies (where remitters reside and remittance companies operate) are also relevant to cash-based societies. These practices raise the cost of doing business due to enhanced compliance duties (Horst and Hear 2002; Todoroki et al. 2014; Vaccani 2010; Yepes 2011). They also are sometimes unnecessary or ill-conceived, as they apply formal controls to informal institutions (Passas 2003a, 2005).

4. The effects and drivers of money laundering and related illicit practices

Money laundering and other financial crimes have numerous negative consequences in developing economies. One goal of AML efforts is to remove the profit motive from criminal enterprises. When crime appears to pay, dirty funds fuel additional crime and corruption, and ultimately undermines security (e.g. by incentivizing terrorism finance, sanctions violations, and cross-border organized crime). Economic power shifts to dishonest and criminal actors, which torpedoes the legitimacy of national governments and institutions.

a. Effects of money laundering and similar serious crimes

Illicit *outflows* have negative consequences for cash-based and developing countries: the deprivation of desperately needed revenue and investment as well as an inability to build necessary infrastructure, to develop and implement public policy, and to provide even basic social services.

Precise estimates of money laundering in cash-based societies are impossible because data are unreliable or non-existent. Detected cases, however, indicate that the volume is significant and reveal structural factors warranting attention. Often, illicit funds are commingled in the legitimate economy.

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[20] See Basel Institute on Governance data (2014).

[21] This is the case in India, where the more developed formal financial sector has been found to be vulnerable.

Money laundering and illicit flows may go through both trade and barter transactions, and criminal enterprises and extremist groups may operate in both the formal and informal parts of the economy (Baker et al. 2014; Goredema 2010; Naylor 2004; Passas 2011; Passas and Jones 2006; Tagliacozzo 2005; Thompson 2006, 2011; Zdanowicz 2009; Zdanowicz, Welch, and Pak 1996).

Financial misconduct can occur in banks and intermediaries of all types (depending on a country's financial infrastructure). In India, for example, where there are diverse intermediaries, misconduct is found in both informal hawala networks and formal financial institutions. In Somalia, where the banking sector is still underdeveloped, misconduct is detected primarily in remittance companies (Monitoring Group on Somalia and Eritrea 2013). This is not because these institutions are problematic per se, but because they are the only institutions functioning (and thus both legitimate and illegal transactions go through them). The same applies to Afghanistan (Passas 2004a, 2004b, 2006b; Rodima-Taylor and Estey 2013; Thompson 2006, 2011), where hawala has been the sole reliable financial intermediary for some time (Maimbo 2002).

The mixing of legitimate with illegitimate transactions and actors is a serious challenge and policy concern, even in OECD countries, compliance with respect to establishing beneficial ownership and AML by non-financial businesses and professions are still "problematic areas" (OECD 2014). The extent and nature of serious misconduct and the methods of operation in each country depend on the specific circumstances. For instance, all three countries have an extensive diaspora and large unregistered economic activities. All three have porous borders, corruption, poverty, and extremism. Afghanistan and Somalia have been in a state of conflict for decades, and Somalia faces the additional problem of piracy.

b. Drivers of money laundering and similar serious crimes

What drives financial misconduct in cash-based societies, and what shapes their patterns over time? This question is important because demand side approaches to controlling crime must supplement supply side controls (such as AML). Understanding the demand side of money laundering will add value to donor interventions in cash-based societies.

In case of Afghanistan, new laws drafted with foreign assistance constitute another layer in need of harmonization. However, efforts to fight financial crime and corruption in the country are inconsistent, ad hoc, and discriminatory (de Lauri 2013; Meininghaus 2007). The normative dissonance resulting from this lack of coordination – along with the judicial exclusion of certain groups, dysfunctional governance, corruption, turmoil, and insecurity in the midst of foreign involvement – have given rise to continued drug trafficking and terrorism.

Similar to Afghanistan,[22] Somalia has experienced decades of war, conflict, insecurity, poverty, weak infrastructure, foreign involvement, and successive regimes. In the aftermath of 9/11, al Barakaat (the most successful Somali remittance company and business model, combining security and telecommunications) was destroyed by US-led sanctions following a baseless assumption that it lent support to al Qaeda and bin Laden (9/11 Commission 2004; Passas 2006b). Even though the ensuing crisis was alleviated by donor community efforts (especially from DFID and UNDP), this incident caused a "trust deficit" between regulators and remittance companies (Cockayne and Shetret 2012).

[22] The same theoretical framework has been applied to India as well (Passas 2000; Thiel 2011).

For a brief period in 2006, the Islamic Courts Union (ICU) was able to improve governance, services, and security in Somalia; during the ICU regime the number of piracy incidents fell drastically (Twyman-Ghoshal 2013). Yet, the ICU was violently undermined and overthrown by the US and Eritrea. Hence, Somalis have good reasons to mistrust foreign influence, whether it be through private companies new technologies, or other types of outside "assistance" (including that revolving around financial regulation reform and formal controls). This mistrust renders diaspora remittances even more critical to local communities. Yet, AML/CFT policies within and beyond Somalia affect the cost, patterns, and channels through which remittances flow. Fighting illicit flows is a governance issue (OECD 2014), particularly when one considers the conception and implementation of reforms, coordination of government agencies, involvement of private sector actors, and cooperation with overseas counterparts (Yepes 2011).[23]

This analysis points to the importance of finding local solutions, while calling donor attention to the negative externalities of home-based interventions on cash-based societies:

- AML/CFT efforts cause the cost of doing business to rise.
- Because compliance costs are not affordable for small companies, they are eliminated from competition.
- In places with limited competition, the "big players" left in the market underserve or offer no service in many geographic locations.
- The cost to individual remittance is high – even the target of 5% set by the G8 is too high, but the cost is even higher in many markets and cash-based societies.
- Administrative and operational processes slow down.
- Humanitarian and other aid efforts are hampered.
- Innocent parties (including charitable organizations) may be unnecessarily and unfairly targeted.
- Remittances services may be pushed underground or legitimate clients and transactions may be criminalized.
- Ethnic communities may be less trusting and willing partners in AML/CFT efforts.
- Grievances fuel anti-globalization or anti-western rhetoric.

[23] The drivers for hawala services are linked to drivers of broader governance challenges. For example, a country may discourage hawala through prohibition, strict regulation, or preferential treatment of formal institutions, but may at the same time inadvertently promote hawala due to poor governance, corruption, capital and currency controls, trade restrictions, protectionist programs (such as subsidies), lack of affordable and accessible banking infrastructure, economic instability, perceived or objective heavy taxation, and sanctions regimes.

Contrary to conventional wisdom, hawala and similar informal remittance channels in cash-based societies could be a blessing in disguise. Although these bring in risks and uncertainties, they also create practical and useful opportunities that could be leveraged in parallel with the international community's efforts to gradually build regulatory and governance capacity in cash-based societies.

5. Recommendations for donors

Given the general governance challenges to which regulating hawala and money laundering in cash-based societies are tied, any approach taken must be patient, gradual, locally inspired and maintained, and progressive. Donors and local partners must temper their expectations. Specific policy implications relate to areas which donors may distribute and coordinate amongst themselves: (a) risk and capacity assessments; (b) strategies, outreach, and managing expectations; (c) maximizing resources; (d) exploring alternative options; (e) performance indicators; and (f) direct donor initiatives.

a. Capacity and risk assessments

The risk assessment should give attention to specific sectors, including remittance services and intermediaries (e.g. DNFB). Studies indicate that remittances are equally or less vulnerable to abuse than other institutions, contrary to regulator and bank assumptions (Orozco and Yansura 2013; Passas 1999; Todoroki et al. 2014), and informal remitters may even contribute to AML/CFT efforts.

A risk assessment may conclude that in some areas problems are exaggerated or over-controlled. For instance, there may be no need for enhanced customer due diligence for *de minimis* amounts. According to a recent survey, Somali expatriates remit an average US$ 2,040 per annum (FSNAU 2013). The average Somali remittance is GB£ 25 in the UK and US$ 170 in the US (Thompson et al. 2013). Minimal verification is appropriate for trivial amounts, which appear to be the overwhelming majority of remittances to cash-based societies (Shehu 2012).

If a risk-based approach is applied to transactions lower than US$ 200 (a threshold informally discussed in FATF and regulatory circles[24]) it could be that most transactions to Somalia, Afghanistan, and other societies worry authorities and banks needlessly, while adding unnecessary compliance costs. Thus, any risk assessment should determine how much of the volume of remittances falls under such a threshold. Enhanced due diligence efforts can then focus on large transactions, which may be a comparatively small and more manageable number.

At the same time, low volume transaction flows can be checked by connecting sending and delivery remittance agents and comparing their respective records on clients and amounts. Inconsistencies between the two sides could then be investigated and followed up. If no irregularities appear in the volumes of small transactions (e.g. signs of structuring, nominee arrangements, or amount discrepancies), authorities could focus on larger transactions. Donors may wish to consider sponsoring and supporting the creation of a clearinghouse that allows the consolidation and analysis of sending and delivery data for this purpose.[25]

[24] There is no recommendation, guidance, or consensus on this yet (personal interviews).

[25] In Somalia, the current Given remitter willingness to collaborate has created a current window of opportunity to introduce a tool for such data collection and analysis of data.

b. Strategies, outreach, and managing expectations

Given the multiple moving parts in the design and construction of an AML/CFT framework, donors should strive for a collaborative and collective approach that seeks to improve governance as well as address the sources of crime. Such an approach could include the following elements:

- *Genuine outreach* – that is, two-way communication channels (rather than the sort of "dialogue" where authorities tell audiences what the law and its requirements are[26] – will maximize local buy in, the creation of shared stakes in the successful outcome of the policies and measures, and, ultimately, better compliance with the mechanisms implemented. In particular, it is worth exploring ways to foster public-private partnerships, including collaborations between financial intermediaries and authorities, in order to maximize the positive impact of remittances and reduce the risk of crime.

- *The creation and sharing of consensual knowledge* can result from risk and capacity assessments and will create a common language and communication bridge between contributors and constituents.

- *Involving public and private sector stakeholders from other key areas* of public policy can help facilitate synergies and cost savings. For example, AML/CFT policies can be connected and coordinated with security, due process, rule of law, justice, public procurement, and economic policy objectives.

- *An inclusive multi-stakeholder process* will make the approach context-sensitive and enhance the credibility and legitimacy of the initiatives. Stakeholders consulted should include financial service providers, law enforcement agencies, financial regulators, the FIU, and private sector, civil society, and academic stakeholders.

- *Pragmatic policy targets* should be consistent with capacity and priorities, as identified in the risk and capacity assessments. Such prioritization, sequencing, and planning will allow authorities to consider local effects of AML/CFT measures, especially on the population groups most susceptible to negative consequences of controls (e.g. loss or reduction of remittances or financial exclusion).

- *A consideration of public interest effects* will allow authorities to identify and address disparities between legally mandated practices and what is regarded as "the right thing to do". A cost-benefit analysis may help determine the point of diminishing returns (Pantuliano et al. 2011; Rodima-Taylor and Estey 2013). In particular, donors should consider the interplay between AML/CFT measures, financial inclusion, humanitarian needs, security, and other impacts on communities, livelihoods, and the overall economy.

- *Legal transplantation from other jurisdictions should be avoided* unless the potential impact and appropriateness of those measures has been examined carefully.

[26] As has been observed, "dialogue is often overly formal, confrontational, and characterised by inflexibility and an unwillingness or inability to consider alternative points of view" (Thompson et al. 2013, 47).

These steps will render strategies more effective, viable, and sustainable. As well, they will pave the way for well-informed communications that avoid raising local and international expectations to unrealistic levels. Evidence based and consensus maximizing approaches support pragmatic planning, progressive implementation, and continuing successes that build momentum, credibility, and legitimacy.

c. Build on what you have: Maximizing resources

Maximizing the use of existing resources means that biometrics and other new customer due diligence (CDD) solutions (Makin and Clark 2014) need not be introduced before low technology alternatives are considered[27]. In particular, it is worth considering ways to leverage hawala information nodes and the willingness of participants to collaborate with authorities.

Donors can help leverage local agents' knowledge of their clients, ability to "smell a rat", and willingness to collaborate. Despite arguments that informal agents in the UAE and Afghanistan resist state regulation (Trautsolt and Johnson 2012), most participants desire to collaborate and contribute to AML efforts (Todoroki et al. 2014; Vacanni 2010). Hawala is the only reliable means to investigate AML assets in Afghanistan (SIGAR 2013). Donors can raise awareness on this and promote a data linkage with the sending and settlement parts of the hawala process.

In addition, existing networks, institutions, and arrangements – including traditional and informal justice and conflict resolution systems at local and regional levels – might serve rule of law, fairness, and justice goals.

This all suggests that there might be advantages to informality – or at least that money laundering risks in informal economies could be managed better. Thus, donors and technical assistance providers should not indiscriminately pursue formalization in cash-based societies, but rather should carefully consider the potential costs and benefits.

d. Considering alternatives to banks and hawala

While building financial integrity and stability through AML controls and collaborating with private and informal actors, donors and their local partners should also explore alternative remittance channels. One successful example is provided by the Kenyan company Mamamikes.com: a website where users can use their credit card to send gifts to relatives and friends throughout Kenya. Users can send anything from birthday presents, flowers, and chocolate boxes to electronics and supermarket vouchers.[28] This is a traceable and transparent way of providing an in kind remittance that has social and economic benefits similar to cash.

Another popular option used increasingly in cash-based societies, including Somalia, is mobile banking. While this can be effective and should be encouraged (it leverages the wide availability of mobile phones even among the unbanked), at the same time donors ought to raise awareness about the risks and the need for a proper institutional and regulatory framework for this option, too. The successful experience of the Philippines (Vlcek 2011) contrasts with Kenya where regulatory arrangements for remittances through mobile telephone money channels were found non-compliant with FATF standards as of September 2011.

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[27] Importantly, such new and expensive technologies may not be easily accepted or implemented in cash-based societies.

[28] See http://www.mamamikes.co.ke/en/58-shopping-vouchers.

Bitcoin use for remittances in cash-based societies is also growing. Low cost, fast, and accessible ways of using bitcoin in cash machines should be studied carefully. It is quite possible that, just as in hawala networks, information-rich nodes exist (the bitcoin exchanges) and many of them are prepared to collaborate on crime control. As even PayPal is opening up to bitcoin exchanges, a study examining the advantages and risks of bitcoin use for laborer remittances in cash-based societies would be useful and could result in spectacular benefits to labor remitters and their families, especially in Africa.

e. Direct donor initiatives

Donors can directly facilitate positive change in a number of ways. They can pursue initiatives within their home countries. Policies and measures in the global North can have serious effects and undermine donor work in cash-based, developing societies. Awareness raising and advocacy at home for policy coherence, coordination, and the provision of effective assistance are vital components of any donor's agenda. Political and foreign policy interests will inevitably shape donor activities, but projects with local buy-in that reflect domestic priorities and needs will be more cost-effective and sustainable. A good example of this type of domestic advocacy and initiative is furnished by the UK efforts toward safer remittance corridors for Somalia (Thompson et al. 2013).

Donors also can assist with enabling communities' access to bank accounts as appropriate. They can lend a hand to banks that need to better understand remittance operations and do fact-based risk assessment. Policy makers need to bear in mind that, if banks block access to legitimate remittance flows, these will be diverted to other channels that are harder to monitor and control, thus defeating crime control policy objectives.

Importantly, regardless of what actions donors themselves take, they need to go beyond low-hanging fruits and think strategically about long-term goals. Inexpensive projects that appear to constitute successes and steps in the right direction (e.g. new laws and institutions) may be ineffective if laws remain unenforced and institutions under-resourced and unsupported. Coordination and quality control for donor projects that center on one or more of the tasks discussed in this paper would foster transparency and accountability while setting a good example for national administrations on how to seek out synergies, collaborate, harmonize, and integrate governance tasks and projects.

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Many informal cash-based economies run parallel financial systems that are very different to the Western banking concept. Such countries are perceived to have a high risk of money laundering. Looking at Afghanistan, Somalia, and India – where anti-money laundering efforts have yielded mixed results – this paper draws lessons from the operations of financial intermediaries. These countries are considered high risk not only for money laundering and terrorism financing, but also for corruption and political and legal concerns. The issues at hand – risk assessments for remittances, strategies of engaging on the ground, resource management, and alternatives to the existing financial networks – are also valid for other cash-based, low-income societies. In fact, informal remittance channels may provide opportunities to strengthen regulatory and governance capacities.

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