

# The Implementation of Value Transfers in an Era of Financial Volatility: meeting the logistical challenge

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Opportunities*

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# Value transfers in a globalised world

- Globalisation has transformed the operation of wholesale money markets
  - value can now be transferred instantly on the click of a mouse
    - provided that one has access to SWIFT
    - and the transfer is implemented on a wholesale basis between major financial centres
- By contrast values transfer facilities for personal customers and SMEs are ill-developed
  - even within single currency zones, fully electronic real-time inter-bank payments systems for non-corporate customers are still under construction
  - but the moment one seeks to transfer value across national boundaries
    - and above all as between differing currencies
  - the whole process becomes as expensive as it is sclerotic
- If one also throws in the prospect of making transfers involving 'exotic' currencies
  - the problems, and the costs, redouble
  - especially in the light of current levels exchange rate volatility
    - let alone the plummeting value of the global unit account
- Whilst globalisation is precipitating an exponential growth in the level of customer demand for value transfers in all conceivable directions
  - why is it that although goods and information now move with such ease around the globe
  - Value transfer on anything other than a corporate basis remains so sclerotic?

# The logistics of cross-currency value transfers <sup>3</sup>

- An audience such as this needs no reminding that there is no such thing as a value transfer in forex contexts
  - all such transactions are ultimately part of a zero-sum exchange
    - in which there is an equivalent transfer of value in the reverse direction
- It is equally self-evident that efforts to line up separate settlements for each and every retail exchange would be hopelessly inefficient
  - since the consolidation of individual transactions to facilitate bulk settlements generates massive economies of scale
- But to implement this task all viable cross-currency payments systems must also include
  - i. facilities to consolidate and de-consolidate value in numerous currencies/locations
  - ii. facilities to broker value exchanges (i.e. settlements) as between them
- Implementing these processes reliably is a complex logistical task
  - doing this can easily high levels of clerical activity, and hence of overheads
    - however these can readily be offset against the income generated by the funds held in transit
  - hence established operators in the forex field have a strong interest in holding onto their clients funds for as long as possible
- On top of this overhead costs not significantly affected by the size of the transfer
  - hence they have little interest in meeting the needs of low net worth customers
    - and most especially those who make small transfers to obscure destinations

## Hawala networks: an alternative value transfer system

- In recent years IVTS/Hawala networks have emerged as significant players in the global value transfer market
  - above all as a cheap and convenient means for migrant to remit their savings to their kinsfolk back home
    - no matter how remote and rural that destination might be
- But in the aftermath of 9/11 these networks became the focus of intense suspicion
  - on the grounds they were merely a 'front' used by criminals and terrorists to conceal their nefarious activities
    - even though very little concrete evidence has ever been produced to support these assertions
- All of which has diverted attention from key issues
  - how did such systems originate?
  - how do they manage to operate with such logistical efficiency?
  - how are they responding to efforts to drive them out of business?
  - what lessons can be learned from their success?
  - what role does/should regulation play in this sphere?

## The logistics of Hawala

- The term Hawala is of Arabic origin
  - meaning both 'a transfer' and ' an exchange'
- The key feature of every contemporary hawala operation is a pair of back-back to back swaps
  - a settlement, in other words
- Hawaladars are those who engage in the implementation of such settlements
  - whilst hawala networks are the arenas within which they are brokered
- Which they utilise to address precisely the logistical challenges which I've just been describing market
  - including the delivery of penny-packet consignments of value to remote destinations
  - much more swiftly and cheaply, yet just as reliably as their formally constituted competitors
- So just how do they manage to pull off such a feat?

## Origins and growth

- Hawala networks did not appear out of the blue
  - they are the heirs of system developed to facilitated long-distance trade around Indian Ocean long before the arrival of Europeans
- Which have reached out into the global value transfer market as a result of three parallel developments
  - i. the burgeoning growth of national, international, and intercontinental labour migration from rural to urban areas
    - and the consequent reverse flow of remittances
  - ii. a dramatic fall in the cost of long distance messaging systems, and the a global extension of their reach
  - iii. the rapid growth in South-South inter-regional trade
    - generating a demand for all manner of cross-currency settlements
- Creating a niche in the market which Hawaladars begun to fill in steadily more sophisticated ways
  - by skilfully combining ancient and modern methodologies to meet the underlying logistical challenges of transnational value delivery

# Sorting out the back office

- No financial operation can hope to be successful in the absence of procedures to ensure that data is accurately recorded and transmitted
  - and all the more so when distance increases the risk that administrative laxity will provide opportunities for criminal malfeasance
- Which is one reason why conventional modes of value transfer generate an exceptional volume of paperwork
  - checking, and confirming every detail at each and every stage of the transaction is labour-intensive, and yet further inflates overheads
- But if risk could be contained on a less labour intensive basis
  - back-office costs could be slashed
  - transactions more speedily processed
    - and charges to customers greatly reduced
- This is the secret of the success of contemporary Hawala networks
  - by developing sophisticated multi-layered settlement strategies
  - by reducing data transmission solely to that required accurately to implement the component of the transaction immediately to hand
  - and by utilising *coalitions of mutual trust* as a backstop against the risk of malfeasance
- Contemporary Hawaladars have devised a 'lean and mean' solution to the logistical challenge of remittance delivery right through to the last mile
  - giving them a huge competitive advantage over their rivals in the formal sector

## The Hawaladars' key asset: Coalitions of Reciprocity<sup>8</sup>

- No financial system can operate smoothly in the absence of confidence that agreements with one's partners will be honoured
  - and as the credit crunch has reminded us, trust is a fragile commodity
    - and once lost, is incredibly difficult to restore
- Hawala networks serve to remind us that trust is not only an immensely valuable asset, but also one which is most easily sustained in the context of a tight-knit *moral* community
  - within which betrayal of trust precipitates an exceptionally powerful sanction
    - comprehensive exclusion, not just from business activity, but from the entire community to which the malfeasant and his family belongs
- In the absence of such a moral community fully documented formal contracts become a necessary bastion against the risk of malfeasance
  - thereby inflating overhead costs
  - and even then my no means necessarily overcome the corrosive impact of mistrust
- However in those parts of the world where moral communities are still in good shape
  - as is still the case in much of the Indian Ocean region
  - and also within migrant workers' tight-knit ethnic colonies
- Coalitions of reciprocity, and hence of mutual trust continue to underpin a great deal of commercial and business activity
  - Hence they have not only provided fertile arenas within which to construct and maintain trust-based value transfer networks
  - but have also provided them with a key source of competitive advantage

## Delivering remittances: the financial and logistical challenges

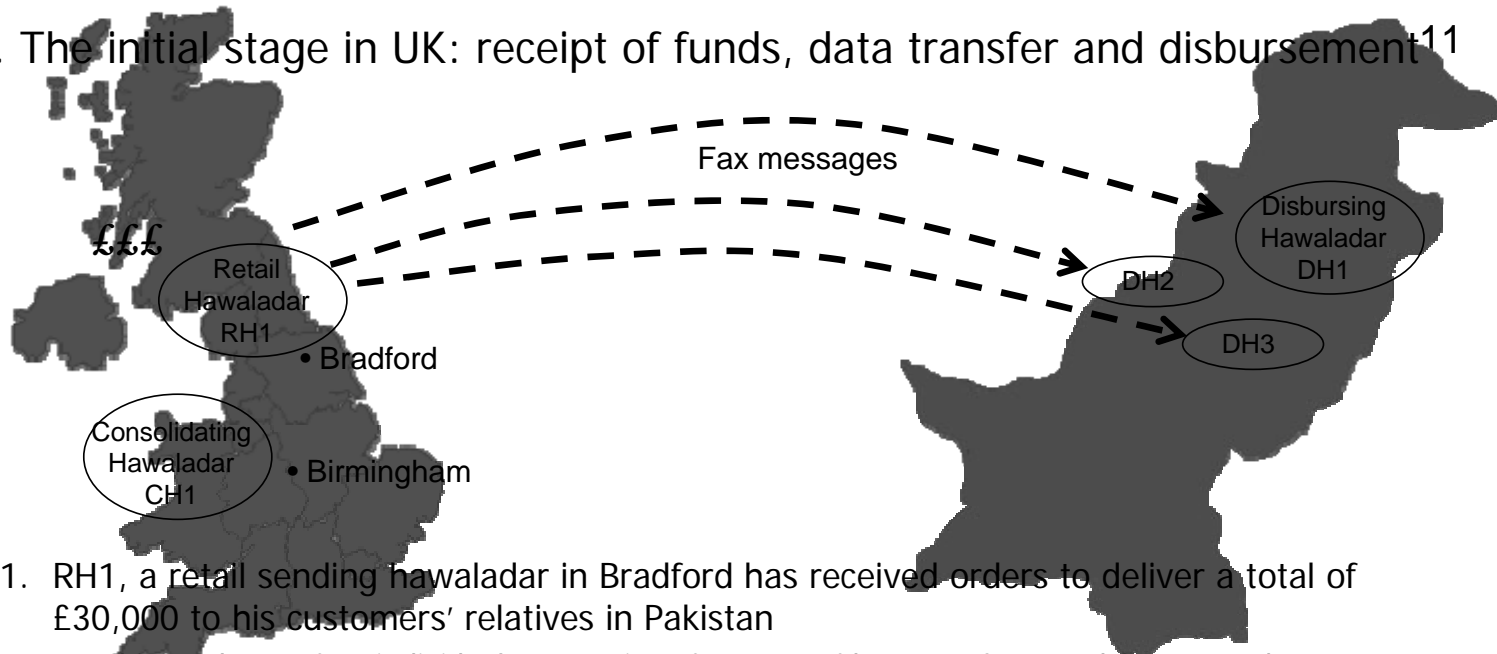
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- All those providing remittance services find themselves confronted by two parallel challenges:
  - i. A *financial* challenge: converting customer's funds from one currency into another
  - ii. A *logistical* challenge: delivering those re-denominated funds into the hands of distant
- Whilst currency-conversion is readily achieved on wholesale basis in forex markets
  - the marginal cost of converting small sums is prohibitive
    - hence economies of scale are a prerequisite for commercial efficiency
  - so arrangements to consolidate innumerable penny packets into commercially negotiable tranches need to be put in place
  - moreover costs can be further reduced by brokering back-to-back settlement swaps
    - such that the negative spread on forex market transactions can be avoided
    - and even reversed if swaps are brokered at unofficial rates
- Meanwhile the logistics of value-delivery are yet more challenging still, especially over the last mile:
  - even when large tranches of value have been converted into foreign currencies
  - they still need to be accurately disaggregated
  - and then delivered at speed, to recipients largely resident in obscure rural destinations
- How, then, do Hawaladars crack these challenges?

# The Hawala solution

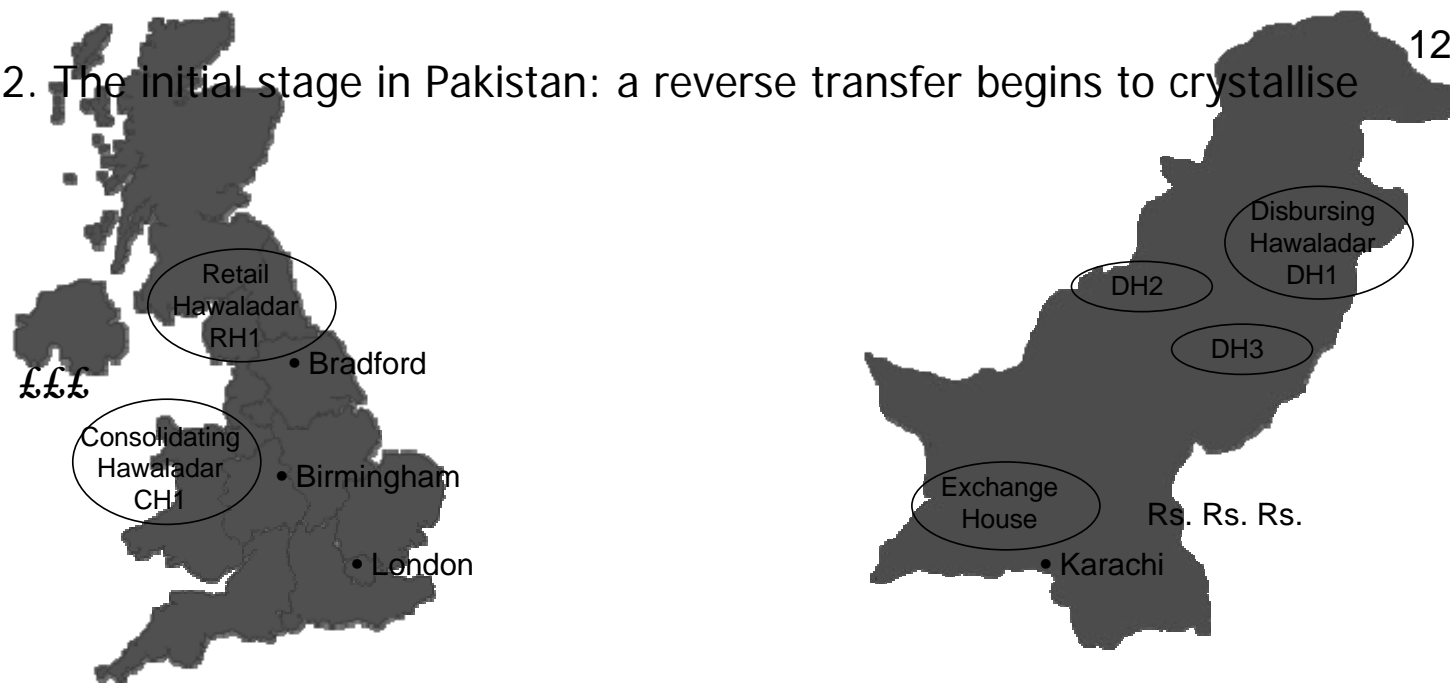
- Besides their capacity to implement their transactions within the context of coalitions of reciprocity, the solutions to these logistical challenges developed by contemporary hawaladars display two key features:
  1. Their capacity to separate the *messaging* dimension of transfer processes from their *settlement* dimensions
  2. Their ability to construct a hierarchy of mutually cooperating Hawaladars within which to layer the various dimensions of the settlement process within the context of a distributed system
    - such that they are in a position to execute an inter-related series of individually brokered transnational *pas-des-deux* between themselves on a daily basis
      - during the course of which large tranches of value are consolidated and deconsolidated
      - mixed, matched and swapped on a global basis
      - in such a way as to precipitate cross-currency transfers which meet host of globally distributed customers' forex requirements on a daily basis
- Before proceeding further several further distinctive features of this system are also worth noting
  - i. since the system operates in real time, no-one holds customers' assets for long enough to make extract investment benefits from them
  - ii. foreign exchange risks are minimised since all deals are contracted at spot rates
  - iii. since this is a distributed system without a central registry, no-one has a comprehensive view of all elements of the global settlement

# 1. The initial stage in UK: receipt of funds, data transfer and disbursement<sup>11</sup>



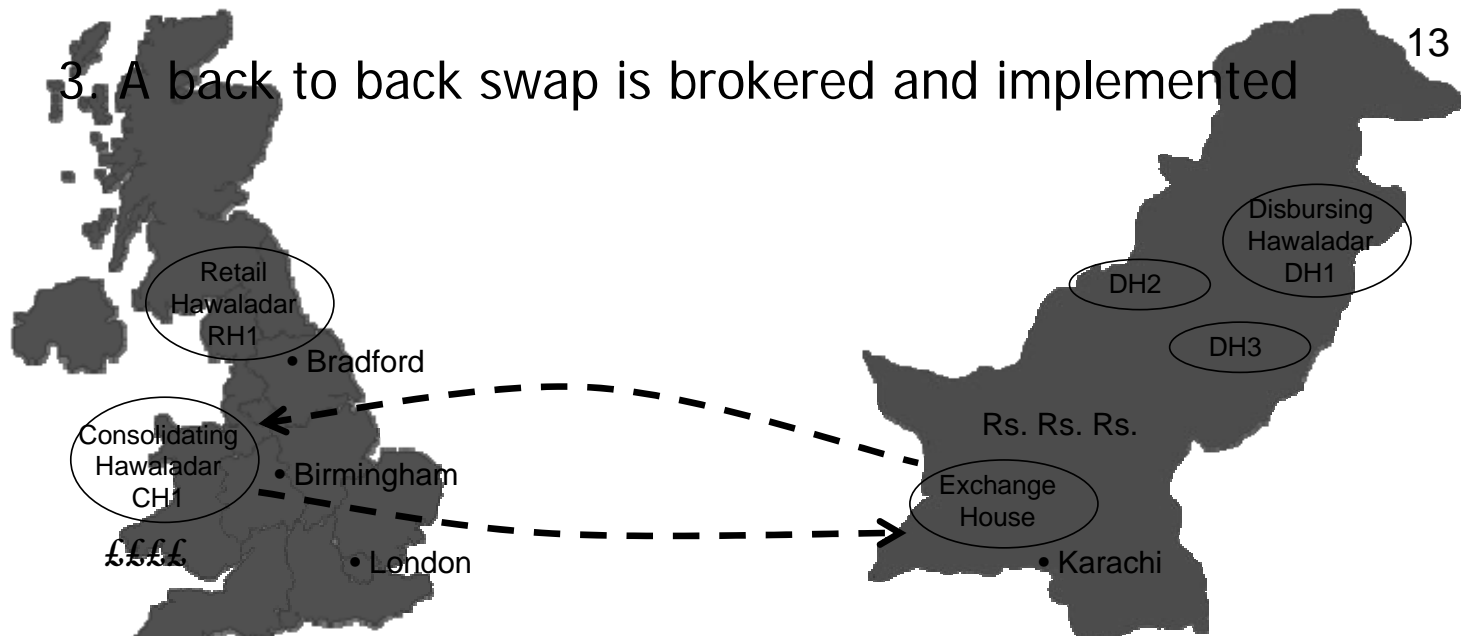
1. RH1, a retail sending hawaladar in Bradford has received orders to deliver a total of £30,000 to his customers' relatives in Pakistan
  - this made up of 35 individual transactions for sums of between £200 and £2,000, to be converted at the rate of £1 = Rs. 130
    - a rate agreed with his consolidating hawaladar CH1 in Birmingham that morning
  - as well as to several more in others localities in Northern Pakistan with whom he does business
2. At close of business he faxes a list of delivery instructions to his disbursing partners DH1, DH 2 and DH3 in Northern Pakistan
  - which they will set about implementing the following day
3. And make arrangements to send £30,000 in cash to CH1
  - together with instructions to arrange appropriate cash deliveries in rupees to DH1, DH 2 and DH3 etc in Pakistan

## 2. The initial stage in Pakistan: a reverse transfer begins to crystallise



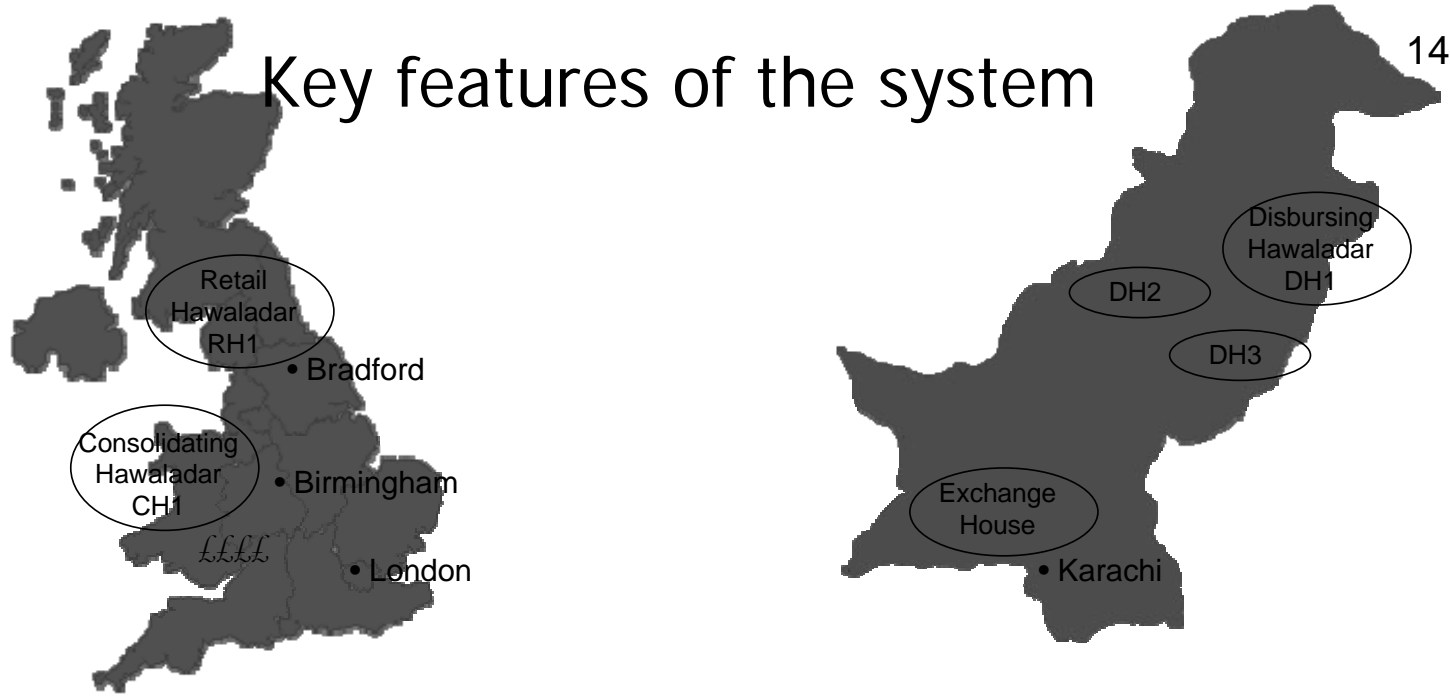
- Meanwhile in Karachi three businessmen have invoices to settle to a total £100 K for goods imported from the UK
- Having checked the rates on offer at several Exchange Houses in Karachi
  - they hand over a total of Rs 14 million to an agent of their selected Exchange house
  - together with details of their suppliers' bank accounts in the UK into which a total of £100 K is to be deposited

### 3. A back to back swap is brokered and implemented



- The Exchange House in Karachi phones CH1 in Birmingham, indicating that he is seeking to place £100 K in Exchange for rupees, and they agree on a deal @ Rs 135 to the Pound, to be implemented later that day, whereupon:
  - i. The Exchange House faxes its local agent in London to signal the impending arrival of £100k, along with details of the bank accounts into which the funds are to be deposited
  - ii. Hawaladar CH1 faxes delivery instructions to the Exchange House in Karachi, such the a total of Rs. 13.5 million are physically transferred to DH1, DH2, DH3, DH4 and DH5
    - since CH1 is providing transfers services for RH 2, RH 3, and RH 4 as well as RH1
  - iii. CH1 then phones RH1, RH 2, RH 3, and RH 4 to inform that delivery is in train
  - iv. Later that day the settlement is implemented, and the deal is complete

# Key features of the system



- Several key features in this system are worth noting
  - i. All the elements of this complex deal are executed on the basis of reciprocities of mutual trust
  - ii. Information is transmitted on a need to know basis; CH1 will have no information about the precise identify of the ultimate retail beneficiaries of the transfers he has brokered
  - iii. But this is not a 'system without records': it could not work reliably without the accurate transfer of delivery information
  - iv. Rather it is a 'lean and mean' operation in which unnecessary (and hence redundant) information transfers are avoided
  - v. Such that the whole operation is vigorously competitive
  - vi. And can also readily be spatially and geographically extended

# Global Hawala

- So far I have presented you with a highly simplified model
  - in which I have hugely shrunk the number of hawaladars
  - and assumed that settlements are straightforward GBP/PKR exchanges
- In reality
  - Pakistani migrants are to be found in large numbers in the Gulf, throughout Western Europe and in North America
  - only a very small portion of Pakistani imports are priced in sterling
  - hawala networks also facilitate value transfers to and from East Africa, throughout the Middle East and across the rest of South Asia
- All these networks are interconnected, and are ultimately brokered through the Exchange Houses of Dubai
  - such that the units of account in global hawala settlements are tranches of value stacked up in multiples of \$100,000

# Formal or Informal?

- Whilst frequently described as Informal Value Transfer Systems (IVTS), contemporary transfer systems constituted on this basis are in no sense
  - small scale
  - operationally and logistically unsophisticated
  - or low-tech
- Nor are they disengaged from the international banking system
  - to be sure they normally operate on a cash basis over the first and last miles
  - but top-level consolidated swaps such as those brokered in Dubai have long been settled via US\$ accounts held in Wall Street Banks
  - and as the impact of post 9/11 AML/CFT regulations became steadily more draconian
    - so and ever greater portions of the processes of consolidation and deconsolidation have also been implemented within the formal sector
- As this has happened the formally Exchange Houses have extended their reach
  - recruiting consolidating and the retail hawaladars as their formally registered agents
    - with the result that large parts of their formerly independent operations were relocated in the Exchange Houses' back-offices
    - as a result the distinction between 'formal' and 'informal'
  - so much so that Hawala networks willing to identify themselves as such have evaporated
  - since no-one wishes to be tarred with the suggestion that they are, or ever have been, engaged in activities which are labelled as 'criminal' in a post-9/11 world

# AML/CFT

- Given the disastrous consequences of toxic debt, no-one needs to be reminded of the crucial role of regulation in maintaining the integrity of financial systems
- But in this sphere we meet a major contradiction
  - whilst loose regulation and globalisation have unleashed an escalating series of speculative bubbles
  - value transfers have been subject to intense and regulatory scrutiny
    - not to secure the integrity of the financial system
    - nor to secure customer's funds against malfeasance
    - but instead to counter money laundering and finance for terrorists
- However there is little sign that this costly regulatory exercise has achieved its announced purposes
  - trillions of tax- and regulation-evading dollars are still stashed away offshore
  - terrorists and drugs smugglers remain as active as ever
  - and despite its nominal evaporation, the 'informal' sector remains in business
    - not so much as an arena for AML/CFT evaders
    - but rather because it offers a highly efficient means of implement transnational value transfers on behalf of migrant workers, SMEs and so forth

# Value transfer and the management of risk

- Whilst anyone who places assets in the hands of someone else puts them at risk, funds placed with a value transfer agent have a very different status from those deposited in a bank:
  - whilst banks are entitled to utilise such deposits for money-making purposes
    - whilst making provisions to return them to customers as and when required
  - value transfer agents only take brief custody of their customers' assets during the delivery process
    - and if delivery does not take place, feed-back is swift
- Since system-failure is much more difficult to conceal, risks far smaller than those to which bank depositors must of necessity expose themselves
  - and diminished yet further when constrained by reciprocities of mutual trust
- Hence regulatory initiatives which demand that every transaction remains identifiable throughout the transfer process
  - satisfying, amongst other things the audit trail demands of AML/CFT
    - overheads would be substantially ramped up, but bringing few if any benefits to customers
- So if AML/CFT does not catch criminals
  - and there are few signs that it does
- Can there be any justification for the criminalisation of Hawala-style networks?
  - given the intrinsic financial efficiency of their methodologies
  - the incorporation of their methodologies into above-ground systems makes far better sense
    - especially when such developments are already in train

## Some concluding queries

- In a globalised world, large corporations maintain their own self-constructed international value transfer systems
- Whilst individuals and SMEs buy in specific financial services, including facilities for
  - i. value storage in each of the financial jurisdictions within which they operate
  - ii. value transfers within each such jurisdiction
  - iii. value transfers as between those jurisdictions
- If so
  - can a single service provider hope to provide customers access to all these services with equal efficiency?
  - or is there a role for specialist agencies to broker low-cost forex transactions independently of local value storage and transfer operators?