

Risk, regulation and the challenge of compliance in the operation of contemporary transjurisdictional Informal Value Transfer Systems

Update of a presentation delivered at *The International Money Transfer and Migrant Remittances Summit*, Rome, 2nd – 3rd July 2009

Why do customers choose to use informal/Hawala methods?

Before answering this question directly, it is worth exploring prior question. Just how do 'informal methods' differ from their 'formal' counterparts?

Looked at from the perspective of migrants from the Global South working in the Global North, 'informal value transfer systems' are simply alternative modes of transferring funds to their kinsfolk back home. Having discovered that executing such transfers through the formally constituted banking system were as slow as they were slow, costly, wrapped in alien bureaucratic procedures, and in any event unable to deliver to their largely unbanked kinsfolk began to explore alternative solutions of their own.

At the outset those 'informal' alternatives were relatively crude. For example when someone was making a home visit, all his friends would ask him to take along packets of cash to deliver to their own relatives as well. But besides being hit and miss, hand delivery did not address the forex issues: relatives who received currency notes in pounds sterling, US dollars or Deutschmarks still had to convert them into local currency before they could make use of their inherent value

Hence virtually every group of migrants gradually began to develop their own more sophisticated alternatives to hand delivery.

In the 1970s and 80's a very specific solution to this challenge began to emerge throughout the Indian Ocean region. In doing so the transactional hub which emerges in Dubai during the course of the 1970's and 80's, largely to facilitate the transfer of remittances from migrant workers in Saudi Arabia and the UAE back to their kinsfolk in India and Pakistan. The methodology which developed in this context was largely based on the ancient system of Hawala transfers, in which transjurisdictional settlements were regularly brokered through pairs of back-to-back swaps.

The result – as I explained in some detail in the presentation which I made at last year's conference in Berlin (www.casas.org.uk/papers/pdfpapers/globaltransfers.pdf) contemporary hawala networks have two key features. Firstly they routinely separate the *messaging* dimension of the transfer process whereby sending agents transmit delivery instructions to their disbursing partners from the settlement dimension, by means of which arrangements are made to deliver the necessary funds to the disbursers; and secondly their use of a hierarchically organised network of mutually cooperating Hawaladars to broker an inter-related series of transnationally executed *pas-des-deux* during the course of which large tranches of value are consolidated and subsequently deconsolidated after having been mixed,

matched and swapped on a global basis in such a way that a multiplicity of disbursing agents are provided with the funds which enable them to fulfil their disbursement instructions in the relevant local currencies.

It follows that Hawala deals are complex processes of clearing and settlement, each of which serve to implement a multiplicity of transjurisdictional value transfers which vary widely in size, run in a multiplicity of directions, and are readily delivering value in a wide range of currencies. Moreover provided that the flow of value back and forth along each of the many channels to which these transactions gave rise are broadly in balance large, relatively little recourse has to be made to the forex market.

It also followed that the whole exercise had to be backed up – as I explained in my presentation in Berlin last year – by a complex system messaging between cooperating agents to ensure that the processes of consolidation and deconsolidation as well as the payouts to the local beneficiaries are implemented smoothly and efficiently. This is normally within 48 hours, and something close to door to door basis as and when this is required

So the initial answer to the question “Why use Hawaladars” is quite straightforward. They deploy well-established banking procedures such as consolidation, value-swaps and deconsolidation to provide a highly efficient cash-based solution to the logistical challenges encountered by those engaged in facilitating transjurisdictional value transfers, including those in the \$100 -\$200 dollar range, which is largely (although by no means wholly) external to global inter-bank value transfer system.

As such the transjurisdictional value transfer networks which Hawaladars have constructed – or rather reconstructed – during the course of the course of the past three decades can in my view best be described as *an alternative global payments system* which attracts a wide range of customers *because the service on offer provides are exceptionally good value for money.*

To what extent is the competitive advantage of IVTS/Hawala derived from their evasion of the costs of compliance?

Whilst a relatively relaxed approach to compliance issues may well be a *component* in the secret of the success of contemporary Hawala-style systems, I can see no reason for concluding that compliance evasion is their *primary* source of competitive advantage. In my view other dimensions of their operations are far more important.

Contemporary systems with ‘informal’ roots have by now come of age. Most major Exchange Houses – such as those who form a settlement and clearing hub in Dubai – are now LLCs, from where they facilitate tens of millions of dollars of business around the Indian Ocean region on a daily basis. By maintaining

- i. A lean and mean approach to information processing, in which replication and redundancy is systematically eliminated
- ii. Highly effective utilisation of IT systems as a means of information transmission
- iii. Globally distributed networks of local agents and sub-agents operating within a distributed system, in which relationships mutual trust are deployed to generate coalitions of reciprocity on the basis of which to sustain system security

The Exchange Houses of Dubai are in a position to offer a highly competitive product.

In contemplating their activities – as well as the efficiency – it is vital to remember that migrant remittances make up only half the picture. Migrant remittances are vital to the whole operation, in the sense that they provide huge and reliable flows of hard-currency liquidity; Hawala networks are also fully integrated payments systems, which work most effectively when there are balanced flows of value in *both* directions within each transmission channels which they serve. Hence in contemplating the Hawaladars' source of competitive advantage as much attention must be paid to the services which they are in a position to offer to their customers (mostly, although not exclusively, SMEs) in the countries to which they deliver remittances as those which they offer to migrant workers themselves.

Viewed from this perspective Hawala-style systems are best understood as a niche-specific global payments system which has emerged to serve non-corporate customers. It is not so much compliance avoidance which is the secret of their success, but rather their capacity to provide an attractive alternative to the cumbersome, sclerotic and expensive retail facilities which the greater part of the international banking system offers to non-corporate customers.

It is also worth noting that their implementation of clearing and settlement processes within and between currency-specific pools of value are in way a unique feature of Hawala networks. Multinational corporations of any size invariably run their transjurisdictional Treasury operations on exactly the same basis, as the specialist Forex/Money Transfer businesses which currently provide services for higher-end private customers as well as for SMEs in most of the financial hubs in the Global North

From this perspective the most distinctive feature of 'informal' Hawala-style operations is not so much their logistical procedures, but rather their routine use of extensive networks of semi-autonomous agents and sub-agents, who underpin the systematic security of their activities not so much in terms of formal legal contracts, but in terms of relationships of personal trust which are ordered and utilised in such a way that they are able to construct robust transjurisdictionally extended coalitions of mutual reciprocity.

But if Hawala networks continue to operate in this way how can they possibly conform to the demands of AML, let alone the move towards a requirement for payments systems to offer end-to-end transparency of each and every transaction?

Whilst 'informal' systems have undoubtedly begun develop a steadily greater degree of transparency in this sense – especially when customers are in a position to instruct them in such a way that payments in, and above all disbursements, can be made to a an electronically identifiable bank account, the vast majority of customers still prefer to make cash-to cash transfers. Cash-to-cash remains the default mode in the majority of Hawala style networks.

If the much trumpeted move towards formalisation/compliance is ever to be achieved on a comprehensive basis, a necessary corollary is that customers will have to become both willing and able to implement bank-to-bank transfers. However the prospect of reaching that goal still seems far off: amongst other things the holding of personal bank accounts have to

be rendered virtually mandatory on a global scale before there would be any prospect of reaching such a goal, and in all probability the use of cash to settle all but the most trivial transactions would almost certainly have to be rendered illegitimate. Steps in that direction have already been taken in the Global North, and further steps are in the pipeline.

How far the further limitation of cash as a vehicle for completing transactions would be found acceptable, feasible or practicable amongst the public at large remains an open question; the same questions would also appear to be even more open in the context of the Global South.

Whilst regulators, those responsible for the collections of taxes, and those investigating fraud, crime, terrorism and so forth inevitably regard the anonymity (and hence the lack of transparency) of cash transfers with both alarm and concern, the ability to spend one's money as one chooses without external scrutiny is viewed by many as a key aspect of personal freedom. Over and above such concerns money provides an exceptionally flexible vehicle for value transfer, not just within financial jurisdictions, but also across them.

Individually negotiated value swaps will invariably offer those in a position to transact them invariably offer both parties a much better deal than those which are implemented through elaborately constructed, ordered, audited and archived payments systems – even when the payments system in question only crosses national boundaries, but the unit of value remains the same, as in the case of the Euro. The same conclusion will inevitably hold good in spades in the transactions in question are made as between currencies whose relative value is subject to daily and even hourly volatility.

With such considerations in mind it would appear that efforts to drive all payments into the formal sector, thereby steadily reducing the legitimacy of currency notes as a vehicle for legal tender, will only have one outcome. Barter will become popular again, and as settlement becomes steadily more difficult as a result of lack of flexibility, the use of IOUs will become steadily more widespread as we start to invent currency notes all over again. Or will we all end up in prison on the grounds that such activities only serve to undermine the integrity of the properly regulated financial order.

Is AML/CFT fit for purpose?

All this also raises a wider question: just what is the purpose of the regulatory initiatives which those in the payments services sector are expected to conform to? Given the credit crunch, we have all become acutely aware of the value of regulation as a backstop against the prospect of systemic failure. But it is also equally clear that all such regulatory structures should be fit for purpose. Hence besides underpinning the security of depositor's funds, a key feature of a viable system of financial regulation is that it should provide a backstop against systemic failure of the financial system as a whole.

But just as the activities of retail banks differ sharply from those of investment banks (so much so that many argue that a key source of the collapse in the Euro-American financial

system arose when these two very different kinds of institutions were allowed to merge) it is also worth distinguishing Value Transfer Agencies from Banks. Unlike Banks, value transfer agencies do not take deposits nor offer loans: indeed if they are doing their job properly they are not in a position to do so, since they are only acting as agents on their customers' behalf, and in that role shifting value from point *a* to point *b* as quickly as possible. In an age of electronic communication that transfer can often be instant – but in any event should not take longer than twenty four hours.

Such is the speed of cash flow through such businesses that neither insolvency nor the misappropriation/misdirection of customers' funds can be hidden for more than a few days: since customer confidence is crucial in the sphere of value transfer, any business which fails deliver will swiftly witness a collapse of its business. In this sense at least both systemic risk and customer risk is by definition both relatively limited and hard to conceal in this sphere, even when the daily flow of value through any such business is very substantial.

However the objectives of AML/CFT – the principal source of regulation in the field of value transfer – have nothing to do with provision of backstops against prospect of systemic failure, or even with underpinning the security of clients' funds. Rather their central objective of AML is to prevent illegitimately acquired funds from entering the regulated – and in that sense 'clean' – global financial system, and/or of otherwise legitimately acquired funds being used for illegitimate purposes.

But whilst catching fraudsters, tax-dodgers, drugs smugglers and terrorists is an entirely legitimate – and indeed a *necessary* objective – it is surely time to ask whether AML/CFT compliance is actually *fit for purpose*, most especially when the cost of compliance for the global financial services system can only be described as astronomical. If this is so the key question to ask – to paraphrase Deng Xiao Ping – is whether this cat is capable of catching mice, or whether it is merely an expensive costly but empty gesture which all manner of fraudsters, tax-dodgers, drugs smugglers and terrorists evade with ease?

In considering this question it is worth remembering that AML/CFT is quite unlike other forms of financial regulation, since it has nothing to do with guarding against systemic failure, rigging the market, or the misuse of investors' funds. Rather it requires all those involved in value transfers to systematically police the identity of their customers, the provenance of their funds and the uses to which they put them. If their suspicions are aroused two options are available: either they can refuse to accept such business, or in the case of existing customers are required to report their suspicions to the authorities; those who fail adequately to perform these requirements can find themselves facing substantial fines.

A central consequence of this regulatory initiative is that it has effectively out-sourced the task of policing the transactions passing through global financial system to the providers of financial services themselves, thereby generating considerable increase in compliance costs for all concerned. But just how effective has its impact been? Given that those involved in the provision of financial services little experience when it comes to fulfilling the role of proxy

policemen, let alone that of proxy detectives, the criminal-catching capabilities are extremely limited. Such tasks are much better addressed by experts with the relevant skills. In these circumstances it should come as no surprise that the central response to AML/CFT has been to ensure that all the required processes and procedures have been completed, but next to no malfeasance has been identified. It follows that expensive exercises in this dimension of compliance have very little impact on anything but the cost of providing financial services, and that in relative terms those costs are particularly heavily in the case of small-scale value transfers, with respect which many providers are happy to price themselves out of the market.

In these circumstances compliance evasion will indeed place ‘informal’ operators in a position of substantial competitive advantage, especially if they choose to avoid complying with this expensive but largely ineffective regulatory regime. This is not to argue that there is no need to seek to constrain the activities of fraudsters, tax-dodgers, drugs smugglers and terrorists; it is simply to argue that such activities are best carried out by those with the relevant skills and training, and whose central priority is to track down such malfeasance, rather than to get on with implementing value transfers on behalf of their customers.

Are there any lessons that formal businesses can learn from IVTS/Hawala?

Perhaps the first question to ask on that front is how far Hawala style value transfer systems differ from those routinely implemented in the formal sector. Considered in logistical terms the answer appears to be not much. Rather all those operating in this sphere invariably adopt one version or another of established financial practices, including consolidation, deconsolidation, settlements and swaps.

By contrast the human and organisational contexts within which these operations are conducted can vary a great deal. In the respect the principal difference between formal and informal systems can be spelt out with some ease. Whilst the former are overwhelmingly (although not exclusively) Euro-American in origin, corporate in character, such that all relationships both within and between such corporate bodies are (at least in principal) formal and hence contractual in character, the latter are much more explicitly grounded in informal relationships of mutual reciprocity, largely (although by no means exclusively) articulated with bodies of people who share a strong sense of conceptual and cultural commonalities.

Those operating within the latter framework are much more likely to be of non-European rather than European origin, and their characteristic operational base is much more like to take the form of inter-connected networks as opposed to formally structured corporations.

Hence it is to their networking capabilities, and their capacity to construct transjurisdictional coalitions of reciprocity as between chains of collaborating but otherwise autonomous local agents and sub-agents that Hawaladars have been able to build value transfer systems which not only deal with the first and last mile issues with a level of efficiency which can hardly be surpassed, but also to plug these into large-scale global settlement operations such as those

brokered through wholesale Exchange Houses, such as those which form a major hub in Dubai.

However a central consequence of their methodology is that they have created a distributed system which works smoothly and reliably – as does the internet – without having to have recourse to a registry in which details of each and every retail transaction facilitated are the operation of the entire system are systematically recorded. This does not mean that it is a system without records. No financial operation of this scale and sophistication could possibly operate reliably in the absence of cooperating partners being in a position to transmit detailed instruction to one another – most usually by fax or email. However in keeping with a commitment to remaining lean and mean, redundancy in information transmission and storage is recorded: it follows that detailed records of *local* activity can invariably be found at each local node.

Encounters with such a *modus operandi* may well be a frustrating experience for auditors who expect to be able to track all transactions with a single central registry. But it would be a great mistake to assume that the failure to maintain such registries (leading to suggestions that hawala-style networks are ‘systems without records’) is simply a ploy to confound all efforts to monitor their activities, and hence to conceal the illegitimate transfer of funds; rather the absence of such registries has a *commercial* logic. The use of “informal” methods (or in other words, the construction of coalitions of reciprocity) to maintain the operational security of *distributed* systems renders the expensive process of maintaining centralised registries and archives redundant, and in doing so makes for a significant reduction in overheads.

This brings us back to the structural and operational differences between banks and value transfer agencies. Retail banks not only store value on behalf of their customers, but also have the right to put a substantial portion of those funds to financial use, so long as they keep a sufficiently large buffer to repay customers as and when they seek to withdraw their deposits. By contrast the primary role of value transfer agencies is to facilitate the cheap delivery of (often very small) packets of value in local currencies at the earliest possible opportunity to recipients, many of whom are resident in remote destinations, where they often prefer cash disbursements.

Given that the latter are primarily involved in the speedy *transfer* of value, rather than in its *storage* (with the consequent prospect of being able to make loans and other investments by making use of the standing balance), both the scale of the prudential risk and the systemic risk generated in the value transfer sector is dramatically lower than that potentially present in the banking sector.

It is also worth noting that whilst banks are invariably in a position to facilitate transjurisdictional/transcurrency transfers on behalf of their retail/SME account holders, in the vast majority of banks the implementation of such transfers is at best marginal to their core business. Since the pressure to cut costs in areas marginal to their core activities will

always be low, let alone that such transactions normally have to be processed through a chain of correspondent banks, it should come as no surprise that the banks' overhead costs in this sphere – particularly for relatively small packets of value which are relatively small in size – are invariably substantially higher than those incurred by specialist value transfer agencies.

Conclusion

- i. If levels of prudential and systemic risk are indeed dramatically lower in the value transfer than the retail banking sphere, it would appear to be inappropriate to render both subject to the same regulatory regime.
- ii. Compliance is never a cost-free exercise, and all such costs are ultimately borne by clients and customers.
- iii. Imposing unnecessary/inappropriate regulatory requirements on value transfer agencies will of necessity cause them to raise their charges
- iv. In a low margin business such as value transfer, a significant increase in charges which bring customers no meaningful benefits is most likely to lead to a flight of business to unregulated/underground agencies.
- v. If so it follows that out-sourcing the policing of transjurisdictional value transfers is a wholly counter-productive strategy.

Roger Ballard
Centre for Applied South Asian Studies

9th July 2009