

I Overview

Since the September 11, 2001, terrorist attacks in the United States, there has been renewed public interest in informal funds transfer (IFT) systems. Press coverage, which often focused on the putative connection between the IFT systems and terrorist financing activities, helped to increase the level of official concern about IFT systems' potential susceptibility to financial abuse. Some national financial regulators began examining existing regulations and, in some cases, designing, developing, and implementing new financial sector policies, including those that address IFT systems.¹ Such actions led to a need to better understand the historical context within which IFT systems have evolved, the operational features that make the systems attractive, the fiscal and monetary implications for remitting and recipient countries, and the regulatory and supervisory responses to its current usage.

Background, Definitions, and Recommendations

This paper presents the findings, analyses, and conclusions of a study on the operational characteristics of informal "hawala," which is used predominantly in the Middle East and South Asia. Recognizing that in some of the countries in these regions, the term "hawala" is also used to refer to money transfers in the formal financial sector, the study used the term "informal hawala system" to refer broadly to money transfers that occur in the absence of, or are parallel to, formal banking sector channels. Specifically, the study examined the (1) historical and socioeconomic context within which hawala has evolved; (2) operational features that make the system attractive for both legitimate and illegitimate uses; (3) fiscal and monetary implica-

¹In October 2001, the Financial Action Task Force on Money Laundering (FATF) agreed to adopting "Special Recommendations on Terrorist Financing," which included extending anti-money-laundering requirements to alternative remittance systems. Report available via the Internet: http://www1.oecd.org/fatf/40RecsTF_entm.

tions for informal-hawala-remitting and hawala-recipient countries; and (4) current regulatory and supervisory responses.

Recognizing that the reasons for the development of informal financial systems are many and varied, the study conducted qualitative and quantitative analyses to describe the informal hawala system and reach conclusions about its practice. The key themes of the paper are as follows:

Historical perspective. Despite the different terminology ascribed to IFT systems—*fei-ch'ien* (China), *hui kuan* (Hong Kong), *hundi* (India), *hawala* (Middle East), *padala*² (Philippines), and *phai kwan* (Thailand)—their initial growth was primarily rooted in facilitating trade between distant regions at a time when conventional banking instruments were either absent or weak.

Operational characteristics. At present, the operational characteristics ascribed to IFT mechanisms, namely, speed, lower transactions costs, cultural convenience, versatility, and potential anonymity, contribute to their widespread legal and illegal use.

Linkages with formal sector. Generally, the growth of IFT systems seems to be negatively correlated with the level of development of the formal financial sector. Hawala-type operations appear to have prospered in countries with inefficient financial institutions and restrictive financial policies. However, in cases where the user's intent is of an illegal or criminal nature, he or she will use informal financial systems irrespective of the level of financial sector development.

IFTs have important implications for designing and implementing monetary, fiscal, and financial sector regulatory and supervisory policies. Drawing on the experience of selected countries in Asia, Europe, and the Middle East, the study found that

- IFTs reduce the reliability of statistical information available to policymakers. This effec-

²Although often applied to informal fund transfers, the term "padala" can also refer to formal transfers. It is a generic word, which means "to send" anything. Derivations of the word can be applied to transfers through a courier, a bank, a relative, or door-to-door transactions.

tively limits the significance of economic data by underestimating the factors that affect certain economic aggregates, including national accounts.

- IFT transactions can affect the composition of broad money and thus have indirect effects on monetary policy.
- IFT transactions may influence exchange rate operations because they can affect the supply and demand for foreign currency. Whereas informal hawala and other IFT transactions are conceptually a part of national balance of payments (BOP) accounts, accurate compilation is highly unlikely. Published BOP accounts contain little numerical—and certainly no identifiable—traces of this system and, thus, their consequences are difficult to explore.
- IFT systems have negative fiscal implications for both remitting and receiving countries. Since informal funds transfers are conducted outside the formal banking system activity, they are not subject to taxes on income and services. Like any underground economic activity, IFT systems also entail a loss of business for the formal financial sector and thereby of potential government income.

Estimating the size of hawala and other similar transactions cannot be undertaken with any reliability. Despite the difficulty of this task, certain judgments can be made about the possible dimensions of hawala, and some approaches to quantification can give indicative results. Using a select sample of 15 countries, a simulation model in the paper suggests that informal transfers declined over time in those countries that liberalized their financial systems. The use of IFTs for criminal purposes is not taken into consideration in the simulation.

Individual country regulatory and supervisory responses to this phenomenon have been varied. Overall, the study found distinct differences in the regulatory and supervisory responses to the IFT systems between “recipient” and “remitting” countries. In recipient countries, concerns over foreign exchange regimes, the quality of the formal financial sector, and the level of political stability have been important influences on the regulatory attitude toward the systems. However, remitting countries generally have fairly liberal foreign exchange policies and mature financial sectors. The key issue in these countries is the potential abuse of IFT systems by criminals. In the recipient countries, the regulatory response has varied from outright prohibition to benign neglect. In the remitting countries, recent regulatory measures include registration or licensing and customer-reporting and record-keeping requirements.

In the wake of the recently heightened concerns that money launderers and terrorist groups use informal transfer systems, the number of national and international regulatory initiatives to license or regulate IFT activities has increased. Many countries consider benign neglect of the IFT industry as no longer an acceptable policy option. The potential anonymity that characterizes these systems is believed to present risks of money laundering and terrorist financing and therefore needs to be addressed. As national authorities develop and implement enhanced regulatory and supervisory frameworks, the paper

- *Encourages* the following two-pronged approach toward regulation in the context of long-term financial sector development.

—In countries where an informal hawala system exists alongside a well-functioning conventional banking sector, it is recommended that hawala dealers be registered and keep adequate records in line with the Financial Action Task Force (FATF) recommendations. Efforts should be made to improve the level of transparency in these systems by bringing them closer to the formal financial sector without altering their specific nature. In conflict-torn countries without a functioning banking system, requirements beyond basic registration may not be feasible because of inadequate supervisory capacity.

—Simultaneously, the regulatory response should address weaknesses that may exist in the formal sector. The formal and informal financial systems tend to benefit from each other’s deficiencies. Policymakers should address economic and structural weaknesses that encourage transactions outside the formal financial systems as well as the weaknesses in the formal financial sector itself.

- *Emphasizes* that prescribing regulations alone will not ensure compliance. Regulators need to possess the appropriate supervisory capacity to enforce the regulations, and there need to be incentives to comply with the regulations. Compliance is likely to be weaker where there are major restrictions on transactions through the formal financial system.
- *Cautions* that the application of international standards needs to pay due regard to specific domestic circumstances and legal systems.
- *Concludes* that policymakers should acknowledge the existence of practical reasons, from the customer’s point of view, for resorting to these methods rather than to formal banks for interna-

tional payment purposes. As long as such reasons exist, the hawala and other IFT systems will continue to operate, and thus addressing these systems will require a broader response, including well-conceived economic policies and financial reforms, a well-developed and efficient payments system, and effective regulatory and supervisory frameworks.

Implications for Work of the World Bank and the IMF

Regarding the possible implications of IFT for the work of the World Bank and the IMF, missions may need to survey or compile information on the importance of these systems and on regulations governing them in various countries. This objective could be achieved as part of Fund surveillance work, to the extent that relevant macroeconomic issues arise,³ conducted in the context of the Bank-Fund Financial Sector Assessment Program (FSAP), or on fact-finding or technical assistance missions. The Bank and the Fund missions could also advise authorities on how to upgrade and enhance regulatory frameworks in the area of IFT systems, allowing countries to benefit from experiences developed elsewhere. The Bank and the IMF advice in this respect would need to take into consideration the reasons underlying the development of IFTs and the specific circumstances of the member countries.

The Bank and the Fund would also review compliance of IFT systems with anti-money laundering and combating the financing of terrorism (AML/CFT) standards in the context of AML/CFT

assessments, where IFT systems are considered macrorelevant or pose a serious AML/CFT risk.

At the same time, the World Bank and the IMF technical advice should focus on the developmental benefits of financial reforms and liberalization. In this respect, technical assistance would aim at strengthening payment systems, enhancing competitiveness of formal sectors in the area of funds transfer, and disseminating lessons learned from experiences in countries that succeeded in increasing the share of the formal sector in remittance business. It could emphasize the need to reduce the cost, improve the speed, and simplify the procedures of the formal funds transfer system. In countries with impediments to establishing formal money changers or opening bank branches for fund remittances, technical assistance could be aimed at how best to phase out these hurdles and provide advice on how to design an adequate legal and regulatory framework.

There is increasing recognition that remittances from migrant workers are very important to both the national economy of developing countries and the individual households as a means to escape poverty. Therefore, while remittance systems have recently come under close scrutiny as part of the international efforts to counteract crime financing, there is need to ensure that tighter controls do not negatively affect the availability and the cost of these services for the poor. Better regulation and transparency, improved technology, and greater outreach to rural areas offer big developmental gains. There is increasing demand from donors to draw together emerging knowledge and best practices on remittances; define strategic priorities; and strengthen collaboration between governments, banks, nonbank financial institutions, and nongovernmental organizations (NGOs) to realize these benefits.⁴

³As indicated in the 2002 IMF paper, "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview," for surveillance to be effective, individual Article IV consultations need to retain a clear focus on the key issues in each country. The paper is available via the Internet: www.imf.org/external/np/pdr/surv/2002/031302.pdf.

⁴In this context, an international conference on remittances, organized by the World Bank and the U.K. Department for International Development, is planned for September 2003.