BOX 6

The Impact of Informal Money Transfers on Financial Markets and the Economy

Introduction

Efficient and safe movement of funds within a country and across the borders is an important component of the financial system of a country. This is more important for cross border transfers where foreign exchange is involved. Usually, a vast majority of these transactions occur through formal channels. However, in any economy, in varying sizes, there exist informal money transfer channels mainly for cross border transactions. The extent of informal channels and the use of formal channels by money remitters depends on the characteristics of a particular economy and financial market and the legitimacy of such transactions. Formal channels consist of the services provided by licensed and regulated entities such as financial institutions. Informal channels consist of participants of the unregulated markets such as Hawala, Hundi or Undiyal (in South Asia), Fei Qian or Chit (in South East Asia) and Black-market Peso (in European countries) service providers who have not been licensed to perform money remittance services in several countries. However, at present, certain countries with informal money transfer channels such as Germany, United Kingdom and United States of America pursue regulatory approaches in registration and licensing such service providers along with imposing anti-money laundering requirements. Hawala channels have been continuously used in moving the value of money from one place to another, without the physical movement of funds, since ancient times, when there were no formal banking channels. However, such informal channels still exist today, even though banking transactions have been made ultra-easy, as convenient as effecting by using a mobile app. These informal remitting services are used for legitimate as well as illegitimate purposes by various individuals, groups and entities. Such services are heavily exploited for criminal activities, even including laundering of money and financing of terrorism. For instance, Hawala channels were used to finance the activities that led to the deadly terrorist attack on the US World Trade Centre in 2001. Some favourable characteristics such as low cost of transactions, easy access, less paperwork, and quick transfers make these channels popular among remitters. However, being an informal business with the involvement of possible criminal activities, the possibility of losing money makes them a risky channel. Most importantly, these channels are highly vulnerable to misuse by money launderers and terrorist financiers. These types of informal and illegitimate payment channels could be detrimental to the smooth functioning of financial systems and economic activity of a country, as they move economic resources from the formal sector to the informal sector of an economy. This article intends to shed light on the adverse impacts of informal money remittance channels on financial systems and the economy of a country. Since all these informal remittance channels have more or less the same characteristics, the article will focus on the mainly used channel in Sri Lanka, namely Hawala, and refer to it as Hawala channels or informal channels alternatively.

Introduction to Hawala Transactions

These remitting channels work as network arrangements and can be sometimes found within a particular community in the society. In these arrangements, the value transfers are facilitated by agents belonging to these networks who are located all over the world. In the Hawala channels, the Hawala agents or dealers (also known as Hawala Dars) live in different countries and settlements of transactions occur completely based on trust. An agent in one country collects money from people who need to send money to another country and the agent in that particular country settles those amounts to the intended recipients in the currency they desire. Accordingly, there is no physical cash movement across the borders, no financial institutions are involved in cross border transactions, and no transactions are properly recorded under these channels. However, financial institutions may be involved in the event domestic fund transfers are required.

Users of Hawala Channels

Hawala is used for both legitimate as well as illegitimate purposes by different economic agents. These include, a) foreign workers remitting money for families in their native countries, b) traders paying funds for goods imported and receiving funds for goods exported, c) parents transferring funds for their children's foreign education, d) people who live in areas with less developed banking channels that provide remittance services, e) migrants without proper visa remitting funds and, f) illegitimate users such as money launderers and terrorist financiers.

Main Features of Hawala Channels

Hawala and informal channels have special features, which make these remitting channels attractive for users. Some of those features are as follows. ***Accessibility***: informal channels have subtly penetrated every corner of the world and made their way into most economic activities including remote areas where formal banking facilities are limited or not available. ***Affordability***: charges associated with fund remittances through formal banking channels are expensive when compared to the commissions involved in Hawala. Also, usually, the exchange rate offered by Hawala agents is more attractive than that of authorised dealers in foreign exchange. ***Speed:*** there are no cross border movements of currency in these informal channels and the amount equivalent to the foreign currency value is locally settled either by depositing funds to an account of the recipient or by settling in cash. In some instances, the recipients receive the money within a couple of hours and some have the option to receive money to their doorstep upon revealing the password to the respective Hawala agent. ***Convenience:*** these informal arrangements are

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convenient from the remitter's perspective as in countries where there are many expatriate Sri Lankan workers, such as Kuwait, South Korea and the Maldives, these agents possess mechanisms to collect salaries from the workers at the work premises itself, for the purpose of sending it to their families. ***Possible anonymity:*** this is the most appealing feature of Hawala. No paper or documentary proof is required for these arrangements. Hence, it is an indirect invitation for people who need to maintain secrecy in their transactions. Further, the legitimacy of the source of funds is not questioned by service providers since these agents are not subject to any regulatory supervision. In general, the more exchange and monetary restrictions and controls, the higher would be Hawala and Undial activities as customers in the formal sector also tend to patronize these services.

Money Laundering and Terrorist Financing Through Hawala Channels

Informal money remitting channels provide a convenient platform for illegal money transfers through money laundering and terrorist financing activities. *Money laundering* is simply the conversion of money generated from illicit crimes into legally accepted money. The process of money laundering involves the following three steps. The first step is the *placement* where proceeds of the illicit crime are placed in the financial channel, i.e., in bank accounts. The second step is *layering*, which involves a series of transactions involved to conceal the origin of the proceeds of the illicit crime. The final step is *integration* where proceeds of the illicit crime are absorbed into the economy. *Terrorist financing* is the act of funding terrorist activities and/or organisations. The source of financing terrorism can be legal or illegal. Continuous inflows to backup terrorist activities are a must to continue the agendas of terrorist groups. Hence, different avenues are misused by terrorists for their funding needs.

There are several ways in which Hawala channels support money laundering and terrorist financing. The absence of a regulatory framework to control and identify any drawbacks and negative consequences of these channels is one of the key factors making them vulnerable to money laundering and terrorist financing. The absence of proper record retention procedures by these agents is another supportive factor. Compared to the banking sector, the lack of attention to the source and use of funds during these transactions also encourage money launderers and terrorist financiers. The difficulty to initiate legal proceedings is another notable feature.

Risks of Using Informal Channels

Many innocent people get caught in law enforcement investigations as a result of their choice to use Hawala channels to transfer funds arising from otherwise lawful and legitimate transactions. Hawala does not often utilise any sort of negotiable instrument or wire transfer. Instead, transfers of money take place based on communications between members of Hawala dealers. Hence, there is no way to prove the transaction and there is a high possibility of losing all the hard earned money that needs to be transferred. Sometimes Hawala dealers are directly or indirectly involved in criminal activities such as fraud and drug trafficking to balance books. Hence, there is a high possibility of law enforcement agencies investigating Hawala dealers. In such an instance, people who innocently or unknowingly use Hawala channels may also be inquired by authorities.

Impact of Hawala on Financial Markets, the Economy and the Country

Informal cross border transactions could have negative impacts on financial markets, the economy and the national security of a country. Following are some of the main areas that could have an impact by having sizeable informal cross border channels:

Lower Tax Income

Hawala channels allow individuals or entities to transfer money through informal channels, thus facilitating tax evasion. The government incurs losses from direct taxes in the form of income, taxes as well as indirect taxes related to such transactions. Since the transactions carried out through Hawala channels are not being recorded, and due to the unavailability of such information to the local tax authorities, the income of the parties involved in the transactions along with the income of Hawala agents are excluded from the tax income of a country. Further, indirect taxes relating to transactions carried out through formal systems, such as registration fees and other service taxes are avoided, thereby negatively affecting government income. Hawala transactions are also used by importers and exporters of a country for the purpose of avoiding taxation on goods. For example, an importer could request the overseas exporter to underquote the invoices thereby reducing the tax to be paid to the government by the importer. The difference between the actual cost and the invoiced cost could then be settled through Hawala channels, which would be unnoticed by the tax authorities.

Impact on Balance of Payments (BOP) and Foreign Reserves of a Country

Workers' remittances have become a significant component in foreign inflows and the balance of payments in emerging economies like Sri Lanka. When workers remit foreign earnings through informal channels such as Hawala, such earnings are not reflected in the calculation of BOP. This is relevant to several other components reported in BOP, such as merchandise trade. Accordingly, BOP statistics will not reflect the true position of the external sector of a country. Further, since foreign reserves of a country are accumulated through the transfer of funds via formal channels, Hawala transfers will not help in building up foreign reserves of a country, in fact, it could deplete reserves due to the possible switch between formal and informal channels.

Impact on Money Supply

The direct effect on broad money of an economy is almost zero for Hawala transactions as there is no physical movement of cash. However, the composition of broad money of the recipient country can be affected by Hawala transactions due to the cash centric nature

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of the transactions as there could be a decline in bank deposit accounts (savings and time deposits) in favor of cash transactions. The negative impact of Hawala channels on the banking sector and the development of a cash economy which could create instability of demand for money would limit financial intermediation and affect monetary transmission mechanisms causing inefficiency in monetary policy.

Impact on Financial Intermediation

The leakage of money from the banking system could constrain the availability of banking resources. It could also cause an increase in market interest rates when banks attempt to attract deposits by offering higher interest rates. Further, the essential functions of financial intermediation are threatened by alternative informal money transfer channels. Banks may also lose their market share due to an increase in the Hawala network.

Impact on National Security

The existence of informal channels is a challenge for national security agencies since several large terrorist attacks in the world have been partially funded by such channels. Hawala is a form of underground banking method, which is considered a threat to the effectiveness of the fight against terrorist financing since certain sources of terrorist financing are channeled through informal mechanisms. Accordingly, every effort should be made to stop expanding these channels and to stop terrorists using Hawala channels.

Sri Lanka and Hawala Channels

The Growth of Informal Money Transfer Channels

It has been observed that workers' remittances in Sri Lanka fell notably in 2021 mainly due to fewer worker departures for foreign countries during the pandemic and the expansion of Hawala channels due to large exchange rate differentials between the formal market and the grey market. Migrant workers have been incentivised to switch to Hawala channels by the premium paid on the foreign exchange conversion rate by Hawala agents. The drastic drop in workers' remittances in 2021 negatively affected the BOP position in Sri Lanka. It has been reported that Sri Lankan importers too use Hawala channels to pay their import bills because of the shortage of foreign currency supply in formal channels arising from exchange rate differentials even though the use of Hawala channels to obtain foreign currency is expensive. Overall, the popularity of Hawala channels in recent times has deprived the country from receiving crucial flows of foreign currency through formal channels, thus dampening the supply of foreign exchange, and shrinking foreign currency reserves creating BOP concerns. Thus, the expansion of Hawala channels poses a significant threat to the BOP position in Sri Lanka. However, if formal channels can continuously maintain a competitive exchange rate based on market demand and supply, the demand for informal remittance channels is expected to be contained, as the exchange rate differential is expected to reduce substantially.

Recent Actions Taken against the Hawala Channels

Efforts to contain the expansion of Hawala channels in the island were strengthened in 2021, in view of the severe threats they pose to the economy, as discussed earlier. Public awareness sessions, including newspaper advertisements and articles, to increase the level of understanding of the public on the risk of Hawala type transactions, were conducted. Funds of accounts involved in such transactions were seized until investigations into their possible connections with unlawful activities are concluded. Further, financial incentives such as offering extra rupees to encourage foreign workers to remit their earnings through formal channels such as banks and other financial institutions were introduced. Moreover, other incentives such as retirement benefits and loan facilities for foreign remitters were also proposed with a view to promoting formal remittance channels and discouraging the use of informal channels.

Way Forward

The existence of Hawala channels poses a great risk to the global economy and the threat of vast expansion of these channels has been addressed by different countries by employing varied tactics. In India, Hawala transactions are restricted by prohibiting the making of any payment to any person outside India without conditional approval from the Reserve Bank of India (RBI). In addition, the RBI has implemented actions to enhance the quality of formal financial services such as establishing branches of commercial banks in rural areas to access the formal financial sector and permitted the non-bank financial sector to access Money Transfer Service Schemes to contain the impact of Hawala channels. Subsequently, the Indian Government enacted The *Financial Exchange Management Act* in the 1970s. Pakistan took steps towards the transformation of money changers to foreign exchange companies in which they were given a two year period to register and comply. The publication made by the Financial Action Task Force titled *The Role of Hawala and other Similar Service Providers in ML/TF* in 2013, clearly explains strategies to identify unregulated Hawala and other similar service providers and possible avenues to create incentives to formalise their business. At present, authorities plan to pursue steps to implement an appropriate legal framework to monitor and legalise Hawala channels in Sri Lanka.

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