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Beating the Banks: Hawala's Place in the Global Financial Environment and its Potential Links to Piracy

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ABSTRACT

Hawala is an informal system that allows its users to transfer money quickly, reliably, and inexpensively. It is prevalent in countries where infrastructure is lacking and political corruption is widespread. As such, it is able to fill a major gap in citizens' access to financial services. In Somalia, for example, hawala is the only reliable way of moving money into the country. Hence, it is used by members of the Somali diaspora to send remittances to their families, as well as by United Nations agencies and non-governmental organizations to get aid money to those in need. Its contribution to these societies is vital. However, all of this takes place under the radar of formal financial institutions and regulatory bodies. This makes it an attractive channel for criminal groups that wish to fund or launder proceeds of illegal activities. Money can be transferred anonymously, and transaction records are scant or nonexistent. It is important to note, however, that illicit users make up only a small percentage of total clients, overall. For example, even using the highest estimate, Somali piracy proceeds could have made up only 6% of total money transferred out of the country through hawala in 2010.

Viable alternatives are needed to draw users away from hawala and new developments in mobile money transfer technology could represent a promising first step. This SMS-based service allows individuals to deposit money into an account that they can access through their cell phones, using it for personal transfers or purchases. This innovation addresses many of the gaps in formal banking services that keep hawala in demand; mobile transfers are cheap, instant, and accessible to all segments of society. Through the use of new technology and strategic partnerships, legitimate users of hawala may begin to move away from informal transfer channels, leaving the system a weaker tool for the criminals left behind.

1. INTRODUCTION

This report will examine the characteristics of hawala, an informal system used for transferring money worldwide, and seeks to understand its role in the global financial landscape. While other types of informal value transfer systems (IVTS) will be touched upon, this report's focus will be hawala, particularly its Somali network.

Hawala is a complex topic to address. It is a vital and positive influence in the countries where it is prevalent, such as Somalia, Afghanistan, and Pakistan, and has deep cultural roots. However, the system lacks regulation, does not adhere to record-keeping standards, and allows clients to remain anonymous. This opens it up to abuse by criminals who use it to fund and launder the proceeds of illegal activity. The system is under surveillance by international financial regulatory bodies, yet it remains notoriously difficult to track. This has led to widespread demand for a deeper understanding of hawala operations and, by some parties, a call for its eradication.

This paper will begin with an overview of hawala's historical origins, followed by a description of the mechanics of its operations. Its success and societal impact will be considered through its broad range of applications, both legitimate and illegal. The size of the business will be assessed from financial and geographic perspectives and, of hawala's illicit uses, particular consideration will be given to its possible relationship with marine piracy in the Horn of Africa. Finally, new developments in the money-transfer business will be reviewed and hawala's influence in that shifting environment will be evaluated.

2. OVERVIEW OF HAWALA

In order to understand the success of hawala, it is necessary to begin with an overview of its defining characteristics and historical origins. While this report is focused on the hawala system, it should be noted that many of the general characteristics discussed in this section apply to other informal value transfer systems (IVTS), as well. Although its exact origins are unclear, it is generally accepted that hawala was used in South Asia and the Middle East by the early Middle Ages (Razavy, 2005). As migration became more common amongst these populations, the need to send and receive money over long distances became apparent. In this way, value transfer networks began to evolve, expand and become entrenched in the cultural fabric. Exact dates are unknown, but hawala is mentioned as early as the 8th century in Islamic jurisprudence texts (Feldman, 2006).

One commonly used definition of the system is "money transfer without money movement" (Jost & Sandhu, 2000). While accurate, this phrase also applies to other forms of transfer, including those between formal banks where transfers can take place immediately without any corresponding physical movement of cash. The real differentiating feature of hawala is its reliance on trust as a control mechanism rather than the use of contracts and legal regulation. Hawala networks are based on strong regional, ethnic, or familial relationships (Pathak, 2003). It is through these shared values that self-regulation becomes possible and, in fact, it is very effective (Schaeffer, 2008).

The second defining characteristic of hawala is its informality. There are no standard practices associated with the transfer of funds, the means of settling debt, or record-keeping. This makes for a network that can easily adapt to changing regulatory, political, and business environments. It also makes hawala an attractive channel for unlawful money transfers. However, despite its potential for negative use, hawala's informality should not be confused with illegality. In large part, the system is being used by honest individuals for legitimate purposes (Viles, 2008).

Given its deep roots in South Asia and the Middle East, it is unsurprising that IVTS continues to survive. Its adherence to Sharia law adds even greater appeal for Muslim societies (Razavy, 2006). However, hawala offers benefits that go beyond adherence to cultural norms and fills a major gap in available banking services. As such, much of its success can be attributed to the lack of accessible, affordable financial institutions in the regions where it thrives. Hawala transfers are extremely fast, often completed within a single day, thanks to the lack of regulatory work required and the extensive range of the networks. Speed is of particular value when funds are being moved into or out of remote areas where, in some cases, it would be not only slow but impossible to send or receive cash. In comparison to formal transfer methods, which can have fees of up to 20%, charges associated with hawala transactions are a mere 2-4% (Sharma, 2006). Anonymity is yet another of the system's perks. This is obviously attractive to criminal users, but many law-abiding citizens lack trust in business and government, as well. Keeping in mind that hawala is most prevalent in countries with lacking infrastructure and widespread corruption, a preference for anonymity is easy to understand. Equally justifiable is a greater confidence in local hawala brokers, with whom users have a personal relationship, when handing over hard-earned funds. Hawala serves very real needs in the market, and it does the job very well.

3. THE MECHANICS OF HAWALA

A basic hawala transfer can be illustrated in a fairly straight-forward way. The transaction will be initiated when a customer deposits money with a hawala broker in country A. This broker then contacts another in the recipient country and gives transaction instructions. A promise to settle the debt a later time is established and, finally, the hawala broker in country B delivers the original deposit amount, less a small brokerage fee, to the intended recipient. Note that no money actually changes hands in this scenario; rather, the broker in country A now has a surplus and the broker in country B now has deficit of cash. In its most simple form, this debt will be balanced when another transfer takes place with funds being transferred back from country B to country A. The exchange of transaction information can be made via telephone, email, or fax.

Of course, transactions can be much more complex. While the basic function remains the same, multiple brokers may be involved in one deal. This could be to settle several debts at once or to split a lump sum into smaller amounts that will be delivered through multiple brokers. In larger operations, funds may be moved to a clearinghouse prior to distribution, as well. Finally, the means of debt settlement is not always as simple as the balancing of incoming and outgoing transfers. Many brokers offer money transfer services in addition to other, legitimate businesses. In this way, hawala discrepancies can be covered through the under- or over-invoicing of unrelated business deals. In some cases physical goods, such as electronics, will be received as payment although this is much less common in practice (Thompson, 2006).

It should be noted that hawala operations vary in size. Many are small-scale and adhere very closely to the means of transfer described above. However, there are some very large scale remittance companies in existence that make use of more official channels, such as banks, wire transfer services, and online credit card payment. These large-scale firms will be discussed in greater detail later in this report.

4. MAJOR FUNCTIONS OF HAWALA

The hawala system is used for a wide variety of purposes and one must be mindful of the distinction between those that serve illicit ends and those that do not. This section will begin by discussing some of the decidedly positive roles played by hawala and will move on to address its involvement in criminal activities.

Remittance is one of the most common uses of hawala. High rates of immigration continue to occur and as of 2009 there were 215 million migrants worldwide (World Bank, 2011). A large number of these individuals continue to help their families by sending a portion of their earnings back home and, for many, hawala is an attractive option for this task. Low brokerage fees are important for expatriate workers that may be making only minimum wage and anonymity is essential for illegal immigrants. In countries such as Somalia, Afghanistan, and Pakistan, hawala is sometimes the only reliable channel available to get much-needed support to loved ones. The critical importance of remittance income is demonstrated by the fact that developing countries received $351 billion in remittances in 2011, an amount that is three times the size of official development funds (World Bank, 2011).

Somalia is a prime example of this phenomenon. It is estimated that up to 70% of the population relies on money received through hawala channels for subsistence, particularly in urban areas (Razavy, 2005). A 2008 U.K. survey of Somali remittance patterns found that 58% of Somalis in the country send remittances home on a monthly basis and 87% do so at least twice a year. Aside from supporting one's family, a common purpose of remittance is for investment in the private sector. This money funds an estimated 80% of startup capital for businesses in the country, where external financing through other means is not an option (Chalmers & Hassan, 2008). Overall, to put things in perspective, estimates suggest that up to $1.6 billion is handled annually by remittance companies; it is big business. In comparison, total imports in 2006 amounted to $798 million and total exports to only $300 million (CIA, 2012). Hawala channels play an undeniably vital role in Somalia, and interrupting their operations without careful consideration will have dire consequences on the society.

Hawala channels are also used by United Nations agencies and non-governmental organizations (NGOs) to get emergency and humanitarian funds into countries that lack reliable banking infrastructure. This has been documented in Afghanistan (Maimbo, 2003) and Somalia (Dahabshiil, 2012), among others. In 2011, over $1.3 billion of official donations flowed into Somalia, predominantly through hawala networks. Large Somali remittance companies take their stewardship role in the community seriously, with many charging no fee for charity transfers. The largest company, Dahabshiil, also reinvests 5% of its profits into community regeneration projects (Dahabshiil, 2012).

However, like anything else, people have found ways to abuse the hawala system. While accounting for a relatively small amount of hawala usage overall, these illegal applications have dominated media coverage of the system. Tax evasion and fraud are among the ways that hawala can be exploited (Passas, 2006); however these infractions are relatively minor in comparison to other potential abuses of the system.

Broadly speaking, hawala can facilitate the funding of illegal activities or the laundering of those activities' proceeds. In the Kandahar and Helmand regions of Afghanistan where the drug trade is booming, it is suggested that 80-90% of hawala brokers are involved in the transfer of narcotics-related funds (Thompson, 2006). This is a staggering percentage, but when considering that the opium trade is equivalent to 53% of the country's GDP (UNODC, 2007) and that hawala plays a major role in the country's economy, the number becomes less surprising. This example is demonstrative of the system's capacity for involvement in large scale criminal operations.

Another illicit connection that has attracted a great deal of scrutiny is hawala's role in terrorist activity. Investigations became especially rigorous following the al-Qaeda attacks on the United States on September 11, 2001, when it was alleged by the U.S. government that hawala played a major facilitating role. Specifically, a 2001 White House press release stated that Al Taqwa and Al Barakaat, a Somali remittance company, were used to: raise, manage, invest, and distribute funds for al-Qaida; provide terrorist supporters with Internet service and secure telephone communications; and arrange for the shipment of weapons. Al Barakaat was effectively shut down by the U.S., resulting in economic and humanitarian emergencies in Somalia as assets were frozen and remittances blocked (Ballard, 2006). Yet, little was gained from anti-hawala initiatives such as this one. Other remittance companies quickly filled the void left by Al Barakaat and, in fact, it was later reported that $300,000 of the estimated $400,000-500,000 required to carry out the Al Qaeda attacks went through formal U.S. bank accounts. Additional investigations turned up no evidence of a connection between al-Barakaat and al-Qaeda (Terrorist Financing Staff Monograph, 2004). That being said, it is inevitable that hawala is involved in the movement of terrorist-related funds; however, it is not the only channel in use and may play a smaller role than has been previously reported.

Allegations exist that hawala is also used in funding and laundering proceeds of human trafficking, arms trafficking, and piracy. The relationship between hawala and marine piracy in the Horn of Africa will be discussed in greater detail below.

5. HAWALA'S MARKET

There is tremendous demand for the services provided by hawala. It fills a gap in the offerings of formal banking institutions while remaining fast, reliable, and inexpensive. The numbers speak for themselves; $100-300 billion passes through informal value transfer systems annually[1] (Maimbo, 2003). Former Pakistani Finance Minister Shaukat Aziz claimed that only about one sixth of the money transferred within Pakistan in 2000 went through a formal banking channel (Razavy, 2006) and, in 2003, Interpol estimated that the amount of money moving through Indian hawala systems equated to nearly 40% of India's Gross Domestic Product (GDP).

Somali remittance companies move $1.6 billion into the country each year (UNDP, 2009). This is made up of a variety of types of transactions. Remittances to families from workers abroad average in size, between $100 and $500 (UNDP, 2003). This type of transaction is reoccurring, as the remitting family member will often send money home each month. As mentioned in the preceding section, some remittances are also sent as investment capital. These transactions are typically greater than $100,000. Finally, remittance transactions for the purpose of trade in the international markets are usually over $500,000 (UNDP, 2003). This final example would have funds flowing out of, rather than into, Somalia. While a great deal of transactions consist of small dollar amounts, it is clear that large lump sums of cash are also being moved around. It is impossible to determine the size of transactions involved in the laundering of illicit funds. However, based on the amount of capital being transferred into the country, all of which creates an imbalance in debt between hawala brokers, the capacity certainly exists for significant amounts of illegal money to be flowing out of Somalia, as well.

The biggest Somali remittance companies take the business of hawala to another level, functioning as major international operations. Dahabshiil, the largest of these, has upwards of 2000 employees spread out across 400 branches in 144 countries. In addition, they have 24,000 agent locations worldwide (Dahabshiil, 2012). Responsibility for most business rests with the local branch, though transfer funds go through central clearinghouses and the company is still entirely family owned. Headquarters are located in London, U.K., and Dubai, U.A.E, both of which are major hawala centers, in general. The company provides service to United Nations agencies, Oxfam, and Save the

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1 Includes other informal value transfer systems in addition to hawala.

Children, among other well-recognized NGOs. Dahabshiil branches are legally registered in the countries they operate in, transfer funds through formal bank accounts, and have money-laundering procedures in place. It is interesting to note, however, that they do not allow transfers of more than $9,000 (Dahabshiil, 2012), falling just below the $10,000 mark that is used by many financial regulatory bodies as the threshold for suspicious activity. This could be a useful tool for preventing its involvement in illicit transfers; although, this could also serve to protect criminal users from detection by regulatory agencies.

6. GEOGRAPHIC REACH

Hawala networks are extensive and reach nearly everywhere in the world. This is thanks in large part to increasing global migration rates and technological advances in the telecommunications sector. Since each network is based on shared ethnic or regional identity, a hawala network can be spread as far as its diaspora community and, with increased access to the Internet and cell phones, it is easier than ever to stay connected.

Major hawala networks operate out of Afghanistan, Pakistan, and Somalia. For the most part, these networks serve clients of their respective nationalities. However, crossover between Afghan and Pakistani networks has been documented and seems to be on the rise. For example, Afghan brokers are making use of Pakistani networks in the United Kingdom, where the latter has greater reach (Thompson, 2006). This crossover is unsurprising considering the close proximity of the two countries, the movement of refugees from Afghanistan to Pakistan during recent conflict, and increased trade between the countries, in general. In contrast, the Somali network does not appear to be experiencing any such crossover. However, the client base does extend beyond nationality to include others from northeastern African. For example, it is not uncommon for Kenyans, Ethiopians, or Sudanese clients to make use of Somali remittance companies (Maimbo, 2006).

The map found in Figure 1[2] illustrates the Somali diaspora geographically, based on the size of the population. Darker colours indicate larger Somali populations and lighter colours indicate smaller populations. This image shows that Somalis are represented on all continents, extensively so in North America, Australasia, Western Europe, North Africa, and the Middle East. This gives Somali remittance companies access to very large economies and the ability to disperse funds across far distances. Agent branches of hawala companies do, in fact, exist in all of the populated areas identified below.

[2] Source: http://www.search.com/reference/Somali_people

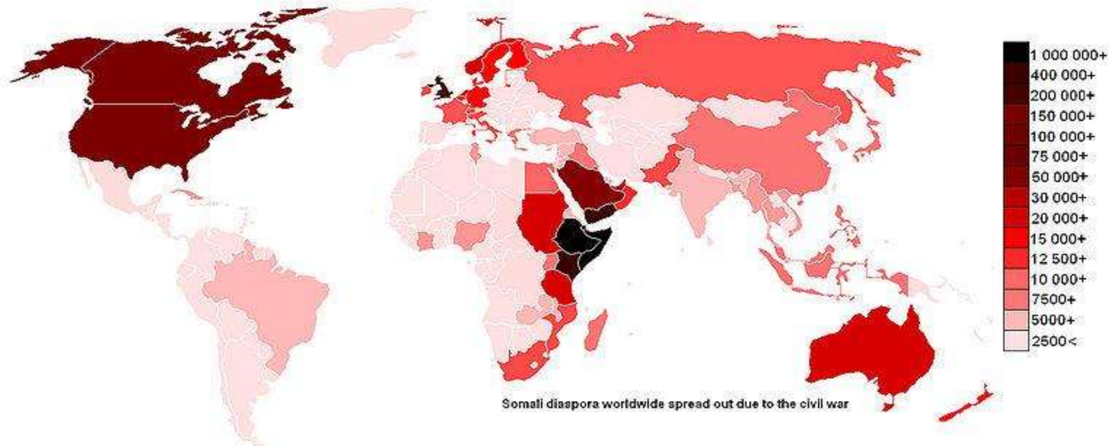

Figure 1: Map of Somali Diaspora

It should be noted, as well, that IVTS networks, similar to hawala, exist in parallel throughout Asia. Tamil communities of Sri Lanka (undival), India (hundi), China (fei ch'ien), the Philippines (padala), Hong Kong (hui kuan), and Thailand (phei kwan), all operate comparable value transfer systems (Viles, 2008). However, many of these systems are experiencing a decline in power as accessible banking institutions move in to take their place. Only hawala and India's hundi continue to garner attention as serious threats to formal banking systems.

7. POTENTIAL LINKS TO PIRACY

Given how strongly entrenched hawala is in Somali society, the question arises as to what role it plays in the funding of Somali piracy and the laundering of its proceeds. It is impossible to obtain definite statistics on any aspect of the Somali economy, let alone statistics regarding its criminal activities, given its lack of infrastructure and governance. However, some broad points about the relationship can be drawn.

Piracy is an attractive option to many Somalis as it provides significantly higher income than other job opportunities in the country. Although ill-gotten, the proceeds of piracy arguably have some favourable effects in the community, such as job creation, investment capital, and increased indirect spending. That being said, the negative consequences far outweigh the positive and the business shows no signs of slowing. A Geopolicity study (2011) predicted that piracy income could increase to $200-400 million by 2015. Based on Somalia's GDP of roughly $5.9 billion, that would put piracy proceeds at almost 7% of total GDP. This is almost on par with the contribution of industry, which was only 7.4% of the total as of 2008 (CIA, 2010). It is alleged that members of the Somali diaspora are investing in pirate enterprises through hawala channels, although other reports suggest that there is no evidence for this (International Expert Group on Piracy off the Somali Coast, 2008). On the other end, estimates suggest that approximately 40-50% of ransom proceeds are moving out of the country using hawala, with the rest being reinvested back into the business and redistributed within the community (Geopolicity, 2011).

In 2010 a total of $238 million was paid in ransoms off the coast of the country. Therefore, if 40% of this entire amount moved back through Somali hawala networks, it would account for roughly $95 million. This amount is undoubtedly high as it is impossible to say what percentage of the ransom money actually enters the country. However, even funds that end up in neighbouring nations are not precluded from movement through hawala, thanks to the network's strong presence in these regions. Nonetheless, even using the high $95 million estimate quoted above, piracy revenue would account for only about 6% of the expected annual hawala outflows[3]. These numbers suggests that, although piracy-related money is certainly being moved through hawala channels, these users make up a small percentage of the total client base. The movement of ransom proceeds is facilitated by, rather than driving, the existence of hawala.

3 Based on the debt owed to hawala brokers abroad for the $1.6 billion entering the country annually.

8. DEVELOPMENTS IN THE MONEY TRANSFER BUSINESS

New technology is revolutionizing the movement of funds in developing nations. Mobile money transfer services have been introduced in a number of countries where they are quickly gaining popularity. These services allow any person with a cell phone to register for an account and, after depositing money, have access to those funds through his or her mobile device. The service is SMS-based and allows users to transfer money to friends or family, even those that are not registered users. In addition, bills can be paid through the account and, where merchants are registered users, items can be purchased at the store via SMS-transactions. Agent locations are available to withdraw cash from the account at any time. Currently, most providers do not offer international transfers.

This concept was first seen in Kenya when M-PESA was launched in 2007 (Safaricom, 2012)**.** The idea was developed by Vodafone employees in Britain and was launched by its affiliate provider, Safaricom. The concept came out of a desire to improve micro-finance operations and lower the cost of financial services access for the country's poor. For this reason, the United Kingdom's Department for International Development (DfID) providing seed funding to get the project off the ground. The results have been exceptional; as of 2010, 40% of Kenyan adults were registered users (Mas & Radcliffe, 2010). M-PESA has since been successfully launched in Tanzania, Afghanistan, and South Africa and similar models are springing up all over the developing world.

In Somalia, all of the major telecommunications companies offer mobile transfer capabilities. One of these, Somtel, is owned by Dahabshiil, the largest Somali remittance company in operation, and dubs its transfer service E-Dahab (Somtel, 2012). Mobile transfers are not yet competing with traditional hawala channels for international remittance. However, hawala is also used regularly for transfers within the country's borders. In this market, mobile transfers have moved in as direct competition to traditional hawala channels, offering users safety, speed, and low costs. Of course, whether mobile transfers are more or less susceptible to abuse is up for debate. In February, 2012, Ali Ahmed Nur (Jim'ale) was accused by the UN Security Council of acting as a chief financier of Al Shabaab, an Islamist militant organization. Interestingly, Jim'ale is the head of Hormuud, a large telecommunications firm in Somalia, and it is alleged that the mobile transfer function was being used to launder Al Shabaab's money anonymously (Garowe Online, 2012).

Still, the service has great potential. Kenya's M-PESA announced in 2011 that it was partnering with

Western Union to allow money to be sent to Kenyan cell phones from around the world (Western Union, 2012). Kenyans wishing to remit money back home will be able to visit any Western Union location and have the money sent directly to the SMS account of their family member. It is inexpensive, the transfer takes place immediately, and the recipient's access to a formal bank is not required. Additionally, Western Union will follow regulations and maintain record-keeping practices that adhere to formal standards. The use of new technology and strategic partnerships could have the impact of enticing legitimate hawala users to move away from that model, ultimately decreasing the overall strength of the network for criminal use. Regardless, mobile transfer services are a positive step forward in giving financial power to those who have typically been excluded from formal banking institutions.

What began as a way for developing nations to address issues of corruption and lack of infrastructure is now starting to be seen as the way of the future. In the U.K., where the original idea was conceived, Barclays bank is introducing an SMS money transfer service for its clients in 2012. It is being dubbed a revolutionary app, though the service was, in reality, introduced five years earlier in Kenya (Telegraph, 2012). Sweden's largest banks are planning to launch a joint SMS transfer service in 2012, as well, tying in with a current push by some in the country to become a cashless society (Basulto, 2012). It is inevitable that the money transfer business will be hugely impacted by these developments, but there will also be repercussions for the banking landscape, in general. The $100-300 billion informal transfer market represents an enormous source of lost revenue for banks. In order to begin making gains there, the industry as a whole needs to see a paradigm shift take place. The right of the world's poor to have affordable access to financial services must be balanced with the typical profit-seeking mandates of formal banking institutions. This is a win/win situation. After all, helping to develop the economic power of a large part of the population is going to, in the long term, benefit a bank's bottom line, as well.

9. CONCLUSION

The issues surrounding hawala are extremely complex. While hawala channels are known to play a role in the movement of illicit funds, and have the capacity to move even greater amounts, that is only one aspect of the business. In many countries, hawala is a mainstay of society and cannot simply be shut down. It fills a gap left by formal banking institutions and gives people access to financial services that they would otherwise be excluded from. In fact, it is the only reliable option for money transfers in countries, such as Somalia, that lack infrastructure and have extreme political corruption. This makes hawala channels a lifeline, vital for getting remittances and emergency/humanitarian aid to those that need it. Furthermore, it has deep cultural roots. An attack on the system could be construed as yet another attack on non-Western culture. However, it is also clear that hawala channels are being used for illegal purposes, from evading taxes to facilitating the trafficking of drugs, arms, and humans, as well as piracy in the Horn of Africa. It is no wonder that hawala is an attractive channel for these groups; it provides anonymity, is unregulated, and does not adhere to record-keeping processes. All in all, it is extremely difficult to track. Though the majority of users are legitimate, the criminal minority is still a significant size. In light of this, developing ways to better monitor hawala networks is a valuable pursuit but, in doing so, the multi-faceted nature of the issue must be taken into account. It is clear that hawala use will not decline unless viable alternatives are offered.

With $100-300 billion traversing the globe annually, the informal transfer market represents a huge source of potential income that conventional banks are missing out on. In order to make gains in that market, the banking industry will need to undergo a paradigm shift, taking on a role in the development of economic power amongst the world's poor. Advancements in mobile transfer services are a hopeful first step in providing legal alternatives to formal banking institutions for those that need them the most. Perhaps through this type of initiative, legitimate users of hawala will begin to move away from informal transfer systems, leaving the system a weaker tool for the criminals left behind.

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