# Hawala – The "Western Union of the East"

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Informal funds transfer (IFT) systems continue to puzzle the west and provide unfortunate loopholes in the world banking system. A very widely acknowledged example of these systems is Western Union. But not many are aware of another one of these IFTS, 'Hawala' which has existed in South East Asia and the Middle East since the 8th century. Supported by data made available by global financial institutions and think-tanks we will present studies, analyses and conclusions in our report on the so-called "Western Union of The East" value transfer system, how does it function and the sheer volume of this huge operation - estimated by some to be over 500 billion USD per year, and why so many people still continue to use it by examining the socioeconomic context in which it has evolved and the features that make it attractive for legal and illegal purposes.

We will also study why governments across the world consider it to be illegal, how it leads to tax evasion and other illegal activities like money laundering and terror financing and the current regulatory and supervisory responses. Also, we would like to draw parallels between Hawala and cryptocurrencies like Bitcoin, in the sense that they both help common man prevent high transfer fees, offering anonymity and sidestepping banks' centralized control and overhead. Only a handful of western countries have fully developed banking systems. An operation of this scale that helps the majority of the world population move their funds, helps migrants send money back home and impacts international trade can't be stopped just by law and regulations as we will see with examples of unsuccessful attempts in India and the USA. We would close by giving out a broader view to tackle the problems Hawala poses to world governments by putting in place developed and efficient international payments policies and removing inefficiencies by financial reforms in the existing banking framework, and how cryptocurrencies can bridge this gap.

## An insight into Hawala

The word 'Hawala' in Arabic, simply means "transfer". In many countries it refers to the money transfers in the formal financial sector. However, we are more interested in Hawala as an informal funds transfer (IFT) system, found predominantly in the Middle East and South Asian countries [The World Bank and The International Monetary Fund 2003]. We will be using the term 'Hawala' to refer broadly to any money transfer that occurs in absence of, or parallelly to formal banking sector channels. Hawala is different to other well-known IFT systems in respect that:

- In some jurisdictions, it is the dominant means by which financial transfers are conducted, hence it is not just an alternative remittance system;
- In many countries it operates openly, with or without government recognition, hence it is not an underground banking system;
- Despite following Islamic traditions, its use is often cross-cultural and multi-ethnic hence it is unlike ethnic banking [Thompson 2007].

This definition describes it as an apparently harmless process, nonetheless it hides a few drawbacks that affect the global economy. To better understand these drawbacks, let us see how such hawala transactions look like.

Let us take an example of Hussain and his son, Amir. Hussain works as an expatriate construction worker at a site in Saudi Arabia whereas Amir lives back home in Bangladesh along with his mother and grandparents.

As the sole breadwinner of the family Hussain sends a substantial part of his income each month back home. Since what he is left with is barely enough to go by, he can't maintain the minimum balance on a bank account to keep it open. Hence, he does not have one. Also, being illiterate, he doesn't understand English and other procedures banks require to fulfill for an international money transfer. Therefore, he decides to do what most other migrant workers do. He goes to a certain Asif Bhai, a respected member amongst the migrant Bangladeshi community in Saudi Arabia who is a hawala service provider, also known as a 'Hawaladar'. Hussain hands over the money to the hawaladar, who gives him a code which Amir will need in order to receive the money. Of course, money is handed in Saudi Riyals and delivered in Bangladeshi Takas, hence a currency exchange is performed too.

Then, Asif Bhai calls up Ra Him, his partner hawaladar in Bangladesh and asks him to give an equal amount to Amir promising him either payment at a later date or simply returning the favor in the future, and then instructs Hussain to send his son Amir to go and collect money from the hawaladar in Bangladesh. Amir just has to communicate the code to Ra Him if he wants to collect the money. (Figure 1.)

In under an hour money is transferred overseas without even actually changing hands. Thus begins a relationship between a customer and a service provider. In fact, for the first transfer Asif didn't charge any commission as well.

Now, this is the story of just one customer using the Hawala system for the inherent benefit it provides of keeping no minimum balance. This hawaladar partakes in hundreds of such transactions every week and he has no problems finding customers for his service.

If somebody wants to send money home quickly, or maybe doesn't want to pay heavy transaction fees or other bank charges, they will come to Asif Bhai. The reason he is able to offer such a service is because the Hawala system is basically a network constituted of hawaladars operating in all major nations on a concept of respect and trust. By offering this service at almost no commission, hawaladars gain respect of the migrant community and their word is respected and revered. Hawaladars mutually settle their balances usually by receiving the same favor when the need arises or sometimes by making payments too at a later date. Since hawaladars come from communities where defaulting on a promise is worthy of death and pride themselves on honoring their words, usually this system runs itself efficiently without the need of any formal contracts.

Governments have long been wary of IFT systems like Hawala because of its relation to obvious problems such as money laundering and tax evasion, but preferred to look "the other way" because it forms a large chunk of international money transfers, hence banning it would simply negatively affect international trade. It has often been linked to facilitating proceeds from drug trafficking, corruption and disguise of other criminal activities. But its sheer size always deterred any small steps taken to tackle it [Passas 2003].

Hawala transfers form a substantial part of global funds transfers. Many poor economies depend on money they receive from their citizens living abroad, hence it has a huge supportive lobby as well. In fact, in many countries it is the only option for legitimate fund transfers. For example, in Somalia, Afghanistan and other war-torn countries it is the only institution aid organizations can rely upon [The World Bank and The International Monetary Fund, 2003]. However, it all changed after 9/11. Governments started looking into IFTs in a different light, as the backbone of terror financing, and they decided to break it, and eliminate it completely.

Now, let's observe what are the advantages of performing money transfers through Hawala. Firstly, Hawala moves money without actually moving it; as we have seen in the previous example, the money didn't travel, neither virtually nor physically, as Hussain gave it to the first hawaladar, while the other hawaladar gave the settled amount of money to Amir. Also, there was a currency exchange between the two hawaladars, as money was handed in a particular currency, yet delivered in a different one. Typically exchange rates settled by hawaladars are better than the "official" exchange rates [Association of Certified Fraud Examiners 2020]. Moreover, the transaction is generally much faster than a conventional one; a regulated international wire transfer always takes at least 1 day, and can take up to 5 working days, depending on the countries where the bank accounts are held. A hawala transaction, on the other hand, is usually carried out immediately, and can take up to 24 hours, only if the recipient is located in a rural or particularly distant area [The World Bank and The International Monetary Fund 2003].

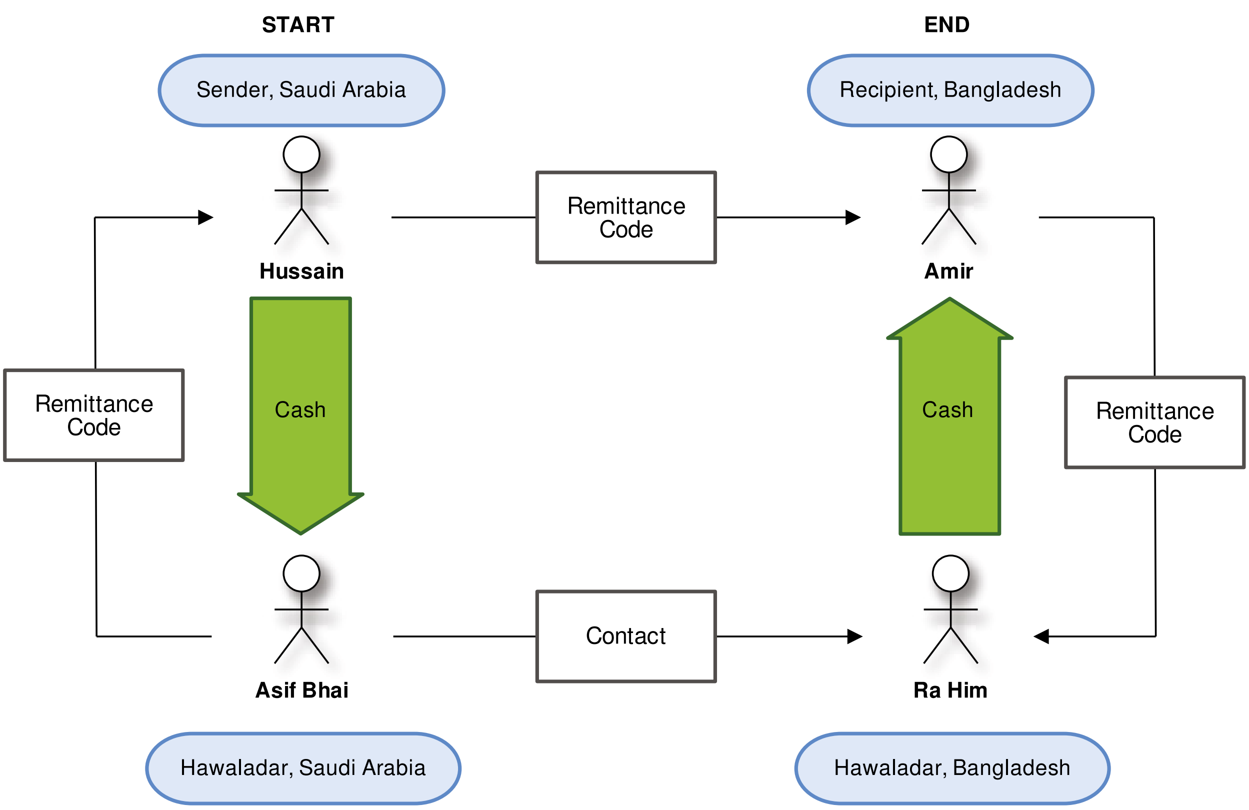


***Figure 1.*** ***An example of Hawala Transaction.***

*Source: Own elaboration*

Last, but not least, when performing a hawala transfer there is no bureaucracy involvement; apart from recording issues, this means that no one else apart from the hawaladars, the sender and the recipient, knows about the transaction.

Where hawaladars keep records, they will do show a date, some initials or a number which will identify the customer, but this almost surely won't reveal the customer's identity to a third party, as well as the amount of the transaction, exchange rate and identification of the partner hawaladar. Unlike banks with their huge apparatus of working tools, hawaladars simply rely on a phone and a diary for their day to day operations [The World Bank and The International Monetary Fund 2003].

Hawala transactions cannot be reliably quantified because the only records, held by hawaladars, are virtually inaccessible. This holds true for both sides of the transactions. Hawala transactions from developing countries are sometimes driven by capital flight motivations; they may also be driven by a desire to circumvent exchange control regulations and the like, leaving no traceable records [El Qorchi 2002]. Although it would be impossible to provide a precise figure, the amounts involved in hawala transactions are likely to entail billions of dollars. The authorities of some countries have sporadically made estimates of hawala activity based on their expatriate populations and balance of payments data. Based on such data, Interpol estimates the size of Hawala in India to be at 40% of the country's GDP. According to world bank estimates, in the years between 2006 and 2015 Indian diaspora formally remitted approximately $558 billion to India. In Pakistan, officials estimate that more than $7 billion flow into the country through hawala transfers every year. Iran, which was locked out of the international financial system because of multiple sanctions imposed on it has had to rely on Hawala for decades.

Conservative global hawala transfers volume estimates range between $100 billion and $300 billion per year [Henry 2017], other sources estimate such volume to be above $500 billion yearly.

In any case, all crude estimates should take into account both hawala and reverse hawala transactions as well as transactions driven by illicit activities.

## Why do governments struggle against it?

The Hawala IFT system has direct and indirect macroeconomic implications, for financial activity as well as for fiscal performance. First, hawala transactions do not reflect in official statistics, the remittance of funds from one country to another is not recorded either as an increase in the recipient country's foreign assets or as a liability increase in the remitting country, unlike funds transferred through regulated systems. Therefore, values do change hands, but the amount of money in the countries remains unaltered. Remember, moving money, without actually moving it.

However, hawala transactions may affect the composition of broad money in a recipient country [The World Bank and The International Monetary Fund 2003]. In the remitting country, such transactions are conducted mainly in cash, even though hawaladars may use the banking system for other purposes. Individuals from developing countries who transfer funds abroad through the Hawala system for investment or other purposes are usually members of wealthy groups. They supply local hawaladars with cash by making withdrawals from their bank accounts. As a consequence, hawala-type transactions tend to increase the amount of cash in circulation. Furthermore, IFT systems have fiscal implications for both remitting and receiving countries because no direct or indirect tax is paid on hawala transactions. The negative impact on government revenue applies equally to both legitimate and illegitimate activities that involve the Hawala system [El Qorchi 2002].

Serving as a perfectly legal means of money transfer in many countries for millions of migrants it didn't raise as many concerns as it did after 9/11. After that date, the American government suspected that it was through means of hawala transactions that terrorist organizations like Al-Qaeda were being financed and that the handlers of 9/11 received money through hawala operators in Afghanistan and Pakistan [ACAMS].

Therefore, as a result of intense pressure against it, several hawala networks' activities were stopped, and many hawaladars were arrested. Hawala system was thus made illegal and banned in many countries. However, there was no evidence of the relation between Hawala and terrorism itself.

The Hawala system has been made illegal in several countries like USA, India and some European countries as well, not only because of its linkage to terrorism financing and money-laundering [Passas 2007], but also due to other illegitimate uses that should be discussed and analyzed.

The first of such uses, relates to countries facing shortages of foreign exchange reserves which often impose capital controls and tax barriers on imports. Individuals but also firms seek alternative means to circumvent authorities and perform international funds transfers through the application of the so-called reverse Hawala route, from countries under the cited exchange controls to other countries (typically economically more developed), without documentary requirements or controls [The World Bank and The International Monetary Fund, 2003].

Other illegitimate uses may concern customs, excise, and income tax evasion. Often, importers wish to make partial payments to an overseas exporter through IFT systems, especially in such situations where customs, excise and income taxes are high. In order not to pay custom duties, importers may request the overseas exporter to under-invoice the goods. Then, the difference between actual price and invoiced amount is remitted to the overseas exporter through a hawala transfer [The World Bank and The International Monetary Fund 2003]. (Figure 2.)

The opposite can happen when governments guarantee grants subsidies depending on export receipts, so as to encourage them; exporters may then have their goods over-invoiced, consequently obtaining the mentioned grants, maximizing their profits [The World Bank and The International Monetary Fund, 2003]. (Figure 3.)

## Present regulations against Hawala

Current regulatory and supervisory practices vary between recipient and remitting countries.

Generally, in hawala-recipient countries, concerns over foreign exchange management, capital movements, the quality of the formal financial sector, and the level of political stability have important influences on the regulatory attitude towards the system [The World Bank and The International Monetary Fund 2003].

For instance, in India, Hawala has been banned, as remittances of Indians living abroad are allowed only through normal banking channels [Jost and Harjit]. India has long suffered with terror financing in the Kashmir valley and has enforced multiple regulatory reforms. As a member of the Financial Action Task force (FATF, a 37 member states inter-governmental body that combats money-laundering), it has cracked down on the Hawala network forcing it to go underground, hence making it even more difficult to combat. In Pakistan, exchange houses are authorized to perform currency exchange, not to serve as a channel for net inward remittances. Hawala is banned, despite the official rate for the Pakistani rupee has often been subject to large discounts, which is favorable to several types of informal transactions, such as Hawala [Jost and Harjit]. Pakistan has been on FATFs grey list for a long time in connection with terror funding and in October 2019 was given an ultimatum to bring reforms or face black listing which would deteriorate its already fragile economy [FATF 2020].

In the Philippines there are no regulatory or supervisory requirements for hawala operators. On the other hand, the Central Bank has encouraged banks to innovate and replicate the advantages offered by the informal sector [The World Bank and The International Monetary Fund 2003].

However, hawala-remitting countries generally have fairly liberal foreign exchange policies and developed financial sectors. In these countries, the regulatory and supervisory interest primarily stems

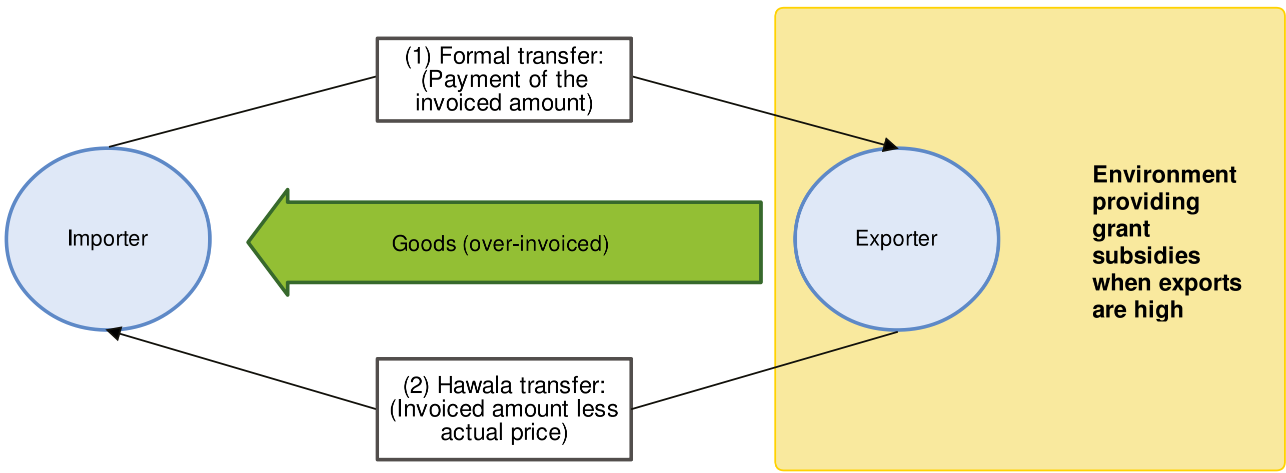


***Figure 2.** An example of illegitimate use of Hawala transfer involving under-invoicing of goods and consequent tax evasion.*

*Source: Own elaboration on the basis of The World Bank and The International Monetary Fund, 2003* from concerns about their potential criminal abuse and terrorist financing. Because of its anonymity and untraceability, a hawala transaction is typically used to fund criminal activities without alerting the authorities.

For example, in Germany IFT systems are strictly regulated. Persons operating remittance services without a license from the German Financial Services Authority are liable to prosecution. Also, licensed remittance service providers are subject to regular supervision, just as other financial service providers are. They must comply with the same requirements too.

In the United Kingdom, hawala transfers are not directly declared illegal, however, authorities' efforts are aimed at strengthening registration and record keeping among participants in these activities [The World Bank and The International Monetary Fund 2003].

In Saudi Arabia and UAE, Hawala is banned; moreover, the countries have taken steps to improve the quality of services offered by the formal financial sector. Today it offers one of the most sophisticated and regulated financial frameworks but it still remains the Hawala hub of the world due to Dubai trade free zone policies allowing anybody to convert black money to "legal" money.

We believe that regulations will only push Hawala further underground, (see India's example) as it is a system that serves legitimate needs that cannot be met in other ways. The Hawala system offers financial services to people who would otherwise be excluded from the system or would have to bear excessive costs to access it.

Moreover, Hawala is actually self-regulated through trust-built networks [Henry 2017]. And while Hawala is based on such trust formed between hawaladars and customers, formal banking is based on the opposite.

In the US, for example, trust is enforced through regulation and litigation. Financial institutions are expected to keep the pace with ever-changing regulations, which average about 200 revisions and modifications a day. Such institutions are periodically audited by regulators to ensure their compliance. Naturally, warnings and fines are distributed when non-compliances are found and the global increase in such penalties represents a continued loss of trust between governments and its financial institutions.

Hawala is simply successful due to the reputation of a network of people working together to transfer value across the globe.

The responses received to the regulatory framework for money exchange and money remittance business in many countries have been inadequate in combating informal money transfers. The world banking system needs to focus

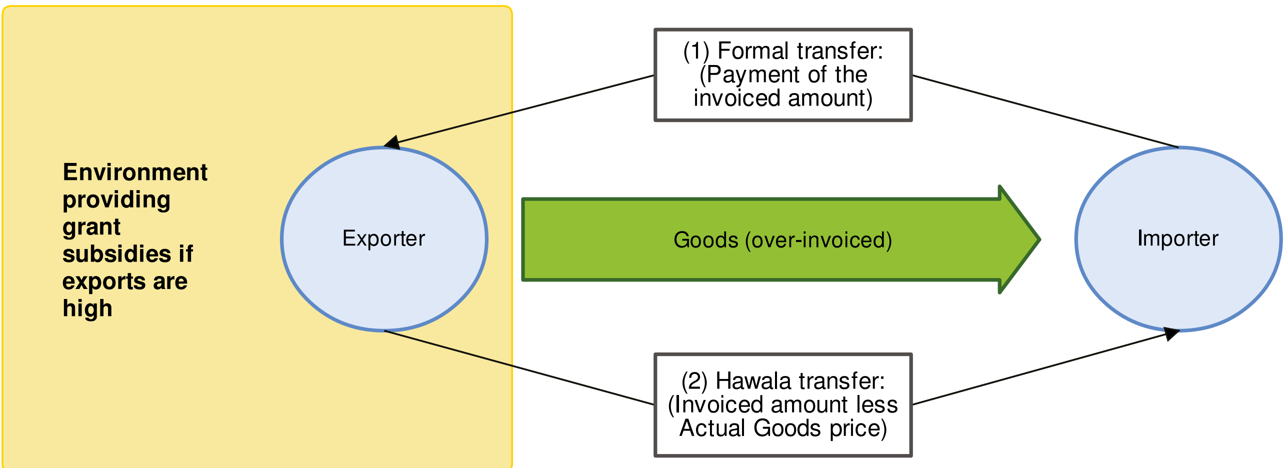


***Figure 3.*** ***An example of illegitimate use of Hawala transfer involving over-invoicing of goods and consequent subsidies fraud.***

*Source: Own elaboration on the basis of The World Bank and The International Monetary Fund, 2003* on financial inclusion, that would be bringing more people into the formal banking sector by removing hurdles they face (i.e. high remittance charges, delayed transactions, minimum balance requirements, etc...). In September 2015, the United Nations Sustainable Development Goals committee for the first time put this issue on its agenda by agreeing to reduce to less than 3% the transaction costs of migrant remittances and eliminate the remittance corridors with costs higher than 5%.

## Bitcoin – The new Hawala?

Quite recently Bitcoin has been riding a high of all new popularity. Especially after the mammoth exercise of Demonetisation conducted by India on 8th November 2016 we saw a surge of Bitcoin prices in the Indian market and elsewhere. From $757 of that day in the Indian market, it rose to $2096 as of 27th May 2017. Since Bitcoin and other forms of cryptocurrencies are mostly considered a parallel form of currency, many nations consider it illegal, whereas countries like Japan and many major multinational corporations are examining it further for the potential use cases it can offer [BitcoinWiki].

Digital money is often considered as the new Hawala (or Hawala 2.0) because it also provides anonymity, and carries a greater risk of deception, fraud and terror financing. Its prominent use on the silk route, an underground dark web drug delivery market, enforces this claim.

The idea of Bitcoin was raised in October 2008 by a paper published by an unidentified person or group, under the pseudonym "Satoshi Nakamoto". Bitcoin is a decentralized currency with no central authority to charge any transaction fees or commission. Each bitcoin transaction is verified and then put onto a digital ledger that is stored on each node in the network, thus making it virtually impossible to hack the system as that would require altering the entire ledger of transactions in all of the network's nodes. It provides some form of digital accounting where a money transfer can be seen and verified but identities of sender and receiver are anonymous and can never be confirmed with certainty. It operates on the concept of private and public key using a SHA-256 hash function.

Offering few of the same advantages and disadvantages as Hawala, Bitcoin lies somewhere in between the informal and formal banking sector. Unlike the two, where trust is embedded in the system (Hawala is based on trust and Formal Banking is based on no trust between parties), Bitcoin offers the market a channel where the need for trust is entirely eliminated. Customer A doesn't need to know or trust client B for a bitcoin transaction to happen. Since cryptocurrencies eliminate the need of trust between two transacting parties, there's no need for a central authority to regulate and mediate over transactions. And thus being decentralized just like Hawala, it has done away with any prohibitive exchange fees or commissions while maintaining the identity of parties untraceable and requiring no minimum balance.

In the past, like Hawala, it has also been looked down upon by governments as a possible means of illicit drug trafficking and terror financing. US, EU, Japan, Singapore and India along with FATF have been dealing with creation of laws that bring digital money under the purview of anti-money laundering and anti-terrorism laws. Governments found proof of use of Bitcoin in 2015 Paris attacks [Security Council, Counter-Terrorism Committee 2016]. Also, the Islamic State (ISIS) is well known to promote donations in Bitcoin [Fanusie 2016].

In the past, countries facing American sanctions like Venezuela, Iran and Russia have taken steps to float their own cryptocurrencies to circumvent the sanctions [The Law Library of Congress, 2018]. This only goes on to prove that money will always find a way.

We would like to conclude by underlining that increased regulatory reforms in the past have not proved adequate to curb Hawala. Any system that is more desirable to the customer than the legal one will always find its takers. The task is to make these alternative, and more desirable channels compliant with governments' needs. The aim is to keep providing the customers the benefits of less commission, no minimum balance, reduced transaction fees and timeline while also providing governments enough data using stricter but easier to implement 'Know-your-customer' rules to keep a track of and to stop any illicit transactions in place [Henry 2017].

With the rise of cryptocurrencies, challenges for governments would only get harder as we witness mass adoption of alternative transaction systems. Governments around the world are working already to find a solution to regulate and further legitimize the use of Bitcoin. This is expected too, since cryptocurrencies work on the concept of blockchain, and the technology of blockchain allows regulators to record (but not track) transactions better than any other payment system ever made. All transactions are recorded in a ledger and the ledger can't possibly be tampered. Customers of businesses dealing in cryptocurrencies in developed financial economies like the US and EU are verified not only by the digital exchanges operating in these countries but also by the banks these currency owners use for deposits and withdrawals in fiat money. This, compared to Hawala, leaves a track of records to verify and authorize legitimate payments made. Ensuring that proper "Know-Your-Customer" policies are followed represents a substantial challenge for financial market authorities and compliance officers at financial institutions, especially nowadays, when an individual can transfer money without any institutional oversight at all. Bitcoin in essence is a decentralized system that does not require any third parties to interact with, and hence can't be controlled or directly regulated by any central authority. At best, only the exchanges can be monitored. However, for Bitcoin and other currencies to grow and become accepted means of international value transfer, they too need a greater level of governance around them which seems quite likely to happen, especially with countries like Japan and South Korea legalizing and bending rules to accommodate the booming crypto industry [The Law Library of Congress, 2018]. Because of customer friendly and liberal laws they have been able to bring Bitcoin exchanges in the legal framework and provide a legitimate way for its citizens to deal with cryptocurrency.

For those who refer to Hawala for their remittances, cryptocurrencies represent a valid alternative as the transaction costs are limited (negligible or non-existent for some currencies) and speed of the transactions is guaranteed (in most cases instant). Ripple (see ripple.com) is an example of such a real time currency exchange and remittance network that charges negligible transaction fees. The network employs use of its native decentralized cryptocurrency called XRP, which stands second largest globally in terms of market capitalization.

Offering secure, instant and nearly free global financial transactions of any size Ripple's XRP token has quickly found its supporters in the international banking arena. It is much favored by banks and financial intermediaries and is expected to replace SWIFT (Society for Worldwide Interbank Financial Transactions) for secure global financial transactions. Quite arguably, it will be through the means of cryptocurrencies like Ripple's XRP that it would be possible to bridge the gap between providing better services to customers and fulfilling the requirements of monitoring by the governments at the same time.

## Summary

Hawala can't ever be completely regulated. It is not possible. And a system that is said to be dealing with trade of over $500 billion annually can't be simply shut down or banned as well. Our best bet is to provide customers with an alternative that finds a middle ground between privacy and the needs of governments and is attractive to customers from all income groups. And quite possibly, cryptocurrencies of the future will pave the way for a tradeoff that finds the perfect balance between the benefits of decentralization and that of regulation.

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