

SENATE LEGAL AND CONSTITUTIONAL LEGISLATION COMMITTEE
AUSTRALIAN INSTITUTE OF CRIMINOLOGY

Question No. 175

Senator Ludwig asked the following question at the hearing on 14 February 2006:

Please provide a copy of project number 0092, the study into the regulation of money laundering in Australia. If not, why not?

The answer to the honourable senator's question is as follows:

Project No 0092: "The Regulation of Money Laundering in Australia" resulted in the publication of "Underground banking: legitimate remittance network or money laundering system?" in the series *Trends and Issues in Crime and Criminal Justice* (No 300, July 2005). A copy of the publication is attached.

Underground Banking: Legitimate Remittance Network or Money Laundering System?

Rob McCusker

Underground banking, where money is transferred through informal rather than formal banking sectors, is a recognised method by which legitimate remittances from overseas workers are routinely transferred. However, underground banking has also long been regarded as a conduit for money laundering by criminal organisations and arguably by terrorist networks. It is important to achieve a balance between regulating the underground banking sector in an attempt to reduce the flow of illicit funds, and permitting its continued use as a legitimate, alternative remittance system. This paper provides policy makers and others with an interest in underground banking matters with a concise overview of how underground banking systems work, along with the potential associated with such systems for criminal activity and the various regulatory responses that governments have employed to date.

Toni Makkai
Director

Definition

Underground banking is a generic term used to describe any informal banking arrangements which run parallel to, but generally independent of, the formal banking system. Underground banking systems are also referred to as alternative remittance systems (FATF 1999), informal funds transfer systems (World Bank & IMF 2003) and informal value transfer systems (FinCEN 2003). Particular types of underground banking systems are also used to describe the underground banking process. These include *hawala* (India), *hundi* (Pakistan) and *fei ch'ien* (China) (Passas 1999). Underground banking takes place in many parts of the world ranging from Hong Kong and Paraguay to Canada and Nepal (Passas 1999). The combination of the geographic diversity and varied typology of underground banking systems makes them attractive for illegal activities and difficult for regulators to control.

Process

Whatever term is used, the basic principle of underground banking remains the same – it involves the transfer of the value of currency without necessarily physically relocating it. A typical *hawala* procedure serves to illustrate the basic process (Figure 1). Value may be transferred to and from both jurisdictions. In either case, the *hawaladars* need to be paid for their services. *Hawaladars* may utilise a range of settlement methods (Secretary of US Department of Treasury 2002) but those commonly used include under- and over-invoicing (Figures 2 and 3).

Context

Underground banking predates the formal banking system. Chinese funds transfer systems, for example, were in evidence during the Tang Dynasty (618–907 AD) (Wucker 2004) and that historical longevity alone makes the continued use of underground banking unsurprising. Underground banking is a rational choice for the transfer of money because it has the same structure and operational characteristics as the formal banking sector without any of its attendant bureaucracy or external regulatory scrutiny (Wilson 2002).

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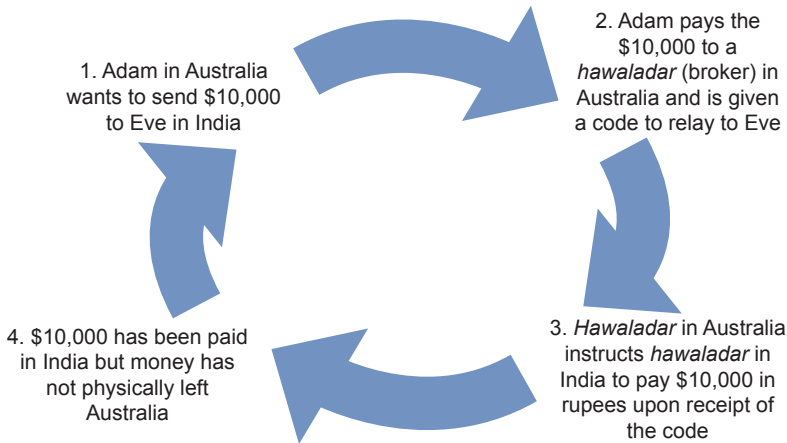
GPO Box 2944
Canberra ACT 2601
Australia
Tel: 02 6260 9221
Fax: 02 6260 9201

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Project no. 0105

Figure 1: Hawala process



Globalisation has created demand for a cheap and mobile labour force and there is often a cultural expectation that members of that labour force will dispatch a proportion of their earnings to their families in their home countries (Passas 1999). In 2002, US\$80 billion was remitted through the formal banking sector by workers from developing countries (Sander 2003), constituting the second largest capital inflow to developing countries behind foreign direct investment (Ratha 2003). Allowing for unreported and informal remittance flows, the total remittance figure might be in the order of US\$200 billion per annum (Sander 2003). Although the total level of funds is significant, it usually comprises a large number of small transactions which the formal financial sector does not generally facilitate (Buencamino & Gorbunov 2002). The economic situation of the workers and their families makes it necessary for earnings to be dispatched rapidly, efficiently and as cheaply as possible.

Advantages

Underground banking transactions in the *hawala* system require no identification from either the remitter or receiver of the funds save for the exchange (via telephone, fax or similar) of a simple password between the remitter and recipient of the funds. This anonymity serves illegal immigrants, who might fear that using a formal financial institution could lead to their discovery by

immigration authorities and legal immigrants who, because of language, limited education or illiteracy, may experience difficulties with formal institutions because of language issues, limited education or illiteracy (World Bank & IMF 2003). Other advantages of underground banking include that its systems are highly accessible, resilient and versatile. They are able to withstand sudden and dramatic economic, political and social upheaval as evidenced by their presence in war-ravaged nations such as Afghanistan, Iraq, Kosovo and Somalia (World Bank & IMF 2003). In addition, transactions are rapid, with authorisation and completion of transfers occurring within minutes or hours by telephone, fax, email or similar. Finally, although the formal banking sector is usually bound by an official or market exchange rate, underground bankers are under no such constraint and, as they

often speculate in currency exchange rates, are able to charge far lower fees.

Initial concern

Underground banking systems have been used to facilitate a range of disparate crimes, involving intellectual property, arms and drugs trafficking, tax evasion and the smuggling of illegal immigrants (Passas 1999). It is, however, the potential for money laundering activity which has heightened the importance of underground banking. Money laundering involves disguising the source of illicit profits and is achieved through a basic process (although money laundering typologies differ in complexity):

1. placement – illicit proceeds are placed within the formal banking sector;
2. layering – illicit proceeds are redistributed through a series of accounts in small amounts so as to disguise the origin of the funds; and
3. integration – the once-illicit proceeds are now licit and are used to purchase property, stocks and bonds so that they can be deposited legally into client bank accounts.

The Financial Action Task Force on Money Laundering (FATF) has long maintained that underground banking systems are important conduits for laundering proceeds of crime (FATF 1999). It is arguable that the formal banking sector, professional service providers, correspondent banks and off-shore banks continue to serve transnational criminal organisations well enough for underground

Figure 2: Under-invoicing

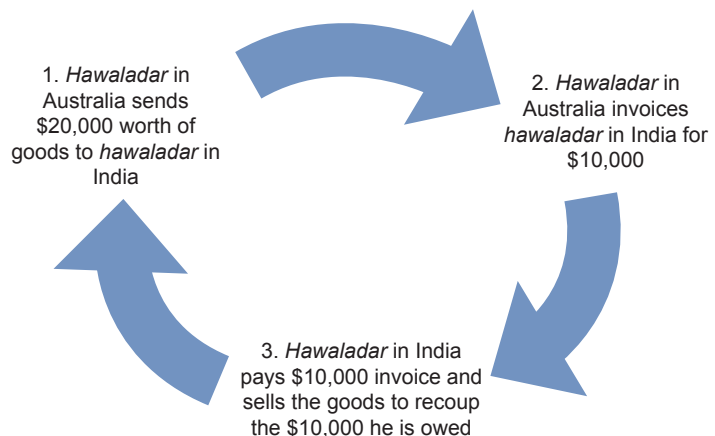
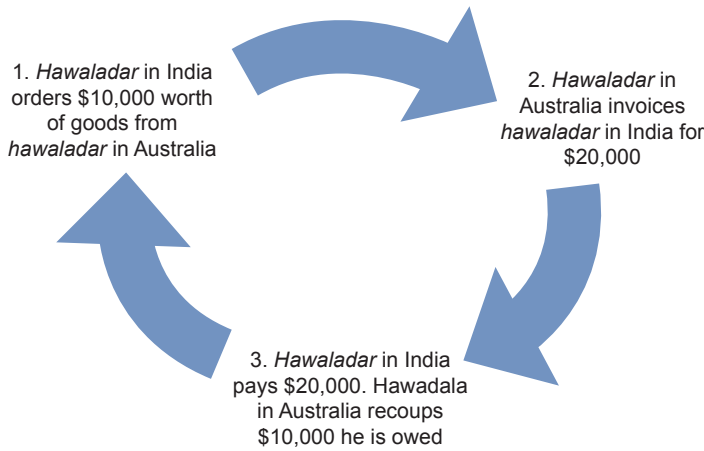


Figure 3: Over-invoicing



banking to be largely unnecessary (FATF 1999; Permanent Subcommittee on Investigations 2001). Indeed, recognition of the capacity of the formal financial sector to facilitate money laundering has led to an increased focus on what might be termed 'non-traditional' business sectors such as real estate, dealers in precious metals/stones, and the gambling industry (Attorney-General's Department 2004a, 2004b, 2004c).

Ironically, heightened scrutiny and increased oversight of the formal sector may increase the propensity for transnational criminals to try laundering their profits via the less regulated underground banking sector. However, it has been argued that if a member of an underground banking network engaged in money laundering, this might impact so negatively upon the network as a whole that it would provoke social and commercial ostracism of the member, which might deter such activity (Ballard 2003). There has of course been a long-standing underground banking practice in respect of Colombian drugs traffickers through the black market peso exchange (Figure 4).

Growing concern

The terrorist attacks on 11 September 2001 drew formal attention to the possibilities of funds transfer by terrorists through informal banking systems. The bulk of funding for the 9/11 attacks was transferred through the formal banking

system via wire transfers and credit cards (Passas 2003) but the 9/11 Commission's report (2004) maintained that Osama Bin Laden relied generally on established *hawala* networks operating in Pakistan, Dubai and throughout the Middle East. Equally, the US Treasury (Aufhauser 2003) recently blocked the assets of the al-Barakaat network, a global money remitting company being used by Bin Laden to support al Qaeda's activities. The fact that terrorist groups may be using underground banking systems is arguably a sign that the attention being paid to the formal financial system (for example, in terms of customer identification and suspicious transaction reporting) is becoming more effective (Lehmkuhler 2003). Nevertheless, the US General Accounting Office (2003) has urged US

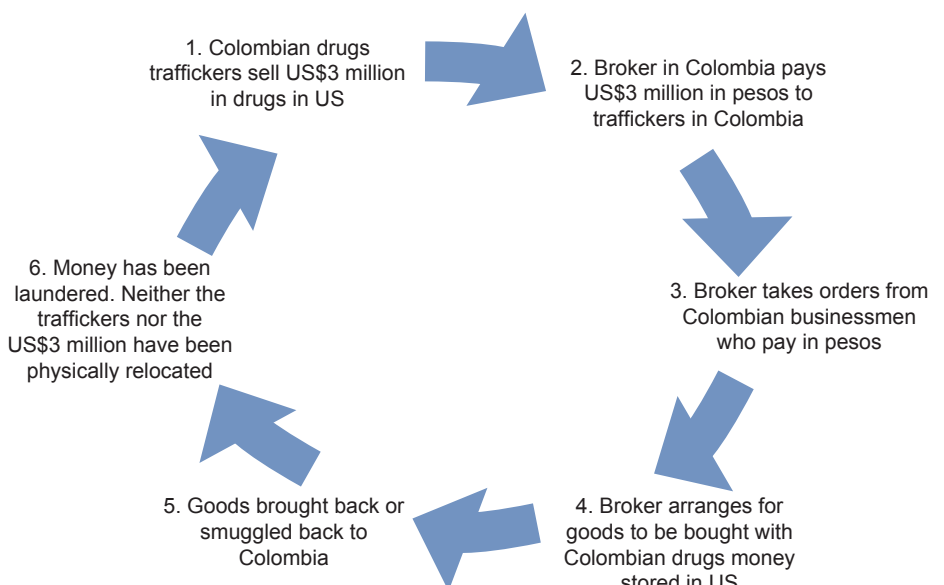
agencies to systematically assess terrorists' use of underground banking systems.

Reducing the level of underground banking has become increasingly important. The overriding purpose of anti-money laundering activities in general, and anti-terrorist financing strategies in particular, is to increase the level of transparency of the underground banking sector and to bring underground banking within the scope of the current anti-money laundering legislation that applies to the formal sector (Buencamino & Gorbunov 2002). This might in turn remove the camouflage surrounding illegitimate remittances.

Regulatory problems

The nature and complexity of underground banking systems varies between and within jurisdictions, and any policy vehicle would need to be aware of this fact (El-Quorchi 2002; IMF 2005). Underground bankers are still difficult to identify or locate. Even if it were possible to identify them, their transactions are so varied and secretive it would be difficult to regulate them. Although records are kept in order that the *hawaladar* is able to maintain control of his numerous transactions (Ballard 2003) such records are unlikely to be systematic, will illustrate perhaps only one transmission stage among the several that might occur within an underground

Figure 4: Black market peso exchange



banking network, and will be written in idiosyncratic and indecipherable codes. Even if it were possible to regulate them, it would be difficult in many countries to establish the necessary infrastructure to implement such regulation (Maimbo 2003). In addition, formalising an informal system simply removes its advantages. The net result might be that the whole system is driven yet further underground so as to avoid infiltration (Maimbo 2003).

Regulatory solutions

It has been suggested (Committee on Banking, Housing and Urban Affairs 2001) that the bulk of underground bankers would be willing to cooperate with regulatory measures. The FATF (2003a), in special recommendation VI, requires that measures be taken to ensure those who transmit money or value are licensed or registered and subject to all of the FATF guidelines that apply to banks and other financial institutions as well as to administrative, civil or criminal sanctions.

The FATF (2003b) also requires jurisdictions to ensure underground banking services are subject to FATF recommendations 4–16 and 21–25, and also to seven other special recommendations on terrorist financing. Essentially, these recommendations require law enforcement agencies to obtain certain information about customers, their transactions, suspicious transactions, the underground banking service's location and the accounts used.

The FATF recognises that the increased focus on money laundering within the formal banking and financial sectors may lead to an increased displacement of such activity into the informal underground sector. In order that recommendation VI is instituted, the FATF suggests:

- licensing or registration with a designated competent authority such as a financial intelligence unit or financial sector regulatory body, of persons that provide underground banking;
- carrying out background checks on the operators, owners, directors and shareholders of underground banking systems;

- identifying underground banking services by examining the full range of utilised media (including newspapers, radio and the internet) to detect advertising and informing operators of their registration and/or licensing obligations;
- liaising with the formal banking and financial sector to identify suggestive underground banking activities (given that many underground bankers may use formal banking accounts as part of their primary businesses);
- making law enforcement agencies aware of the compliance requirements for underground banking services and of the methods by which illegal use of those services is achieved;
- advising businesses which may be operating underground banking services of their licensing or registration and reporting obligations; and
- requiring entities to display their registration/licence to customers in the hope that legitimate clients will seek out licensed/registered operators.

Legislative solutions

A number of countries have introduced legislation in an attempt to curb underground banking (Passas 2003: 53–64). In Australia, the *Financial Transactions Report (FTR) Act 1988* requires 'cash dealers' (which includes remittance dealers) to submit financial transaction reports to AUSTRAC (the Australian Transaction Reports and Analysis Centre) which is Australia's anti-money laundering regulator and specialist financial intelligence unit. AUSTRAC operates a cash dealer education program which is supported by industry meetings, information circulars and high-level consultation with individual cash dealers (AUSTRAC 2004). In 2003–04, AUSTRAC focused specifically upon the remittance sector, for example through campaigns in ethnic newspapers, to promote compliance with the FTR Act (AUSTRAC 2004). In the United States, the USA PATRIOT Act requires money remitters, including the informal banking sector, to register as money services businesses (MSBs). The US Bank Secrecy Act provides that all

MSBs must:

- register with FinCEN;
- file a suspicious activity report with FinCEN if it knows, suspects or has any reason to suspect that any transaction is suspicious and involves or aggregates funds or other assets of US\$2,000 or more;
- develop an anti-money laundering program;
- file a currency transaction report if it provides cash transactions (whether payment or receipt) to the same customer in a day of more than US\$10,000;
- keep a record if it provides money orders or traveller's cheques for cash of between US\$3,000 and \$10,000 to the same customer in a day;
- keep a record if it transfers US\$3,000 or more to the same customer in a day; and
- keep a record if it provides currency exchanges of more than US\$10,000 to the same customer in a day.

Aside from the fact that the requirements generally only apply if the same customer engages in multiple transactions on the same day (leading to the possibility of multiple transactions on behalf of one person by a number of people), this approach presumably seeks to reduce underground banking activity within the US in the hope that a decline in remittances from migrant workers will reduce the viability of underground banks in receiving countries. However, legislative reforms which are not accompanied by behaviour and service changes are unlikely to have the desired effect. If the reason for remitting through the informal sector is cultural or economic, underground bankers will navigate their way through the regulatory net.

General economic solutions

In order to remove underground banking, the economic incentives of systems such as *hawala* need to be removed (Wilson 2002). This might be achieved by providing cheap, fast and efficient outlets for money transfers so there is less economic dependence on *hawala* remittances (Hayaud-Din 2003).

Perhaps increased focus needs to be applied to issues such as financial policies, taxation, currency and trade restrictions. The mistrust of banking systems within developing countries and the arguably anti-competitive global presence of formal money service providers (such as Western Union) should perhaps also be addressed (Buencamino & Gorbunov 2002). One of the key determinants of increased underground banking activity is the difference between the official and the black market exchange rates (Buencamino & Gorbunov 2002). Foreign exchange restrictions not only provide incentives for underground banking but also increase capital flight (Schneider 2003) from the developing country. In light of this, China, for example, while maintaining currency controls, also has regard for the black market rate when setting the official rate of exchange. In this way, the disparity between official and non-official rates is reduced and in turn the propensity for using underground banking may decline.

Specific economic solutions

Policies could be drawn up which recognise the financial importance of migrant remittances to the development of the economies of the receiving countries. First, mandatory remittance limits could be introduced in which a proportion of the migrants' earnings would have to be transferred through formal channels. This was attempted in Bangladesh, the Republic of Korea, Pakistan and the Philippines. It was only truly effective in the Republic of Korea because nearly all of their migrant workers overseas were employed by Korean businesses operating in the Middle East. It was therefore relatively easy to persuade the companies to deposit migrant earnings in designated accounts.

Secondly, governments might attempt to disrupt the underground banking system. In Pakistan, the government has focused attention upon *hundi* systems with a resulting increase in formal remittances of 64 per cent between January 2001 and January 2002. However, achieving a long-term and meaningful shift from informal to

formal banking systems requires improving the alternatives to informal banking (Buencamino & Gorbunov 2002).

Thirdly, governments might provide incentives rather than creating and enforcing regulations. In Bangladesh, India, Pakistan, Sri Lanka and Vietnam, foreign currency accounts pay above-market interest rates. In these countries, as well as Egypt, Poland and Turkey, premium exchange rates are offered for those wishing to convert foreign currency into local currency. The disadvantage of this incentive approach is that foreign currency accounts are really only attractive to professional and higher skilled workers whose earning capacity provides sufficient funds to render the transfer meaningful. The bulk of workers will not fit into this narrow category (Buencamino & Gorbunov 2002).

Fourthly, developing nations might liberalise their economies. Arguably, if a government restricts imports and places limits on foreign exchange, underground banking systems will seek to fill the void. For example, if goods are smuggled into a country because of high import tariffs, the money to pay for those goods still has to leave the country, and is likely to do so via informal networks (Buencamino & Gorbunov 2002). In 1995, when the Philippines abolished foreign exchange controls and unified the exchange rate, remittances through formal banking channels quadrupled in that year. Conversely, in Pakistan in 1998 the government created strict currency controls which included a restriction on withdrawals from foreign currency accounts such that money could only be withdrawn at a government rate of 46 rupees compared to a *hawala* rate of 58 rupees. In consequence, foreign remittances via the formal banking sector fell from US\$150 million to US\$50 million per month (Buencamino & Gorbunov 2002).

Fifthly, improving the financial infrastructure of developing countries so as to render underground banking less attractive is likely to reap rewards. A number of companies in Egypt, Jordan, Lebanon and countries in the Persian Gulf

have undertaken to deliver money door to door, thus compensating for their lack of physical presence, which historically has provided succour to the underground bankers. In the US, many banks are working with Latin American countries to allow migrant workers' families the ability to access money from ATMs in their home countries (Buencamino & Gorbunov 2002).

Finally, currency transfers might be facilitated by micro-finance institutions (MFIs). These organisations, evolving largely from NGOs, provide credit and other financial services to those of low income. Funds which are currently remitted via informal means deprive the developing economies of much needed capital. MFIs '...are more and more identified as potentially critical for the mobilization and transformation of remittances' (International Labour Office 2000).

Conclusion

The use of underground banking for transferring legitimate remittances has been overshadowed by its potential use by criminal and terrorist groups. The decision to regulate or licence brokers who operate within the underground banking system must carefully evaluate the practicalities and consequences of doing so. An unregulated system in which illicit funds might be transferred with licit ones is doubtless dangerous. A regulated system driven further underground is more dangerous still. Australia has recognised the existence of remittance dealers as a constituent of cash dealers generally and AUSTRAC has in consequence proactively targeted such people via multi-lingual advertisement campaigns. Persuading remittance dealers to register and to submit financial transaction reports to AUSTRAC is arguably a sound means by which the impact of those who might elect to launder money or finance terrorist groups could be mitigated. The most pragmatic solution, however, might entail altering the economic conditions which currently render underground banking a viable alternative to the formal banking sector.

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