



# **THE MONEY EXCHANGE DEALERS OF KABUL**

**A Study of the *Hawala* System in Afghanistan**

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## ABSTRACT

Money exchange dealers, or *hawaladars*, have long provided their customers with a reliable, convenient, and inexpensive means of transferring funds into Afghanistan and among its provinces. They offer a diverse range of financial and non-financial business services at the local, regional, and international level. More recently, they have been instrumental in providing financial services for the delivery of emergency relief and humanitarian and developmental aid into Afghanistan for the majority of international and domestic NGOs, donor organizations, and development aid agencies.

This study was undertaken to: (1) determine the current practice of *hawala*<sup>1</sup> in Afghanistan; (2) verify the assertions regarding the convenience, speed, and cost-effectiveness of *hawala* transactions in comparison with formal financial institutions such as the central bank and the remaining state banks; (3) evaluate the use of money exchange dealers to remit development funds to regions that are not served by formal financial institutions; (4) identify the operational characteristics that make the *hawala* system vulnerable to financial abuse; and (5) consider the appropriate regulatory and supervisory options for informal funds transfer systems in Afghanistan.

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<sup>1</sup> In Arabic, *hawala* simply means “transfer.” For analytical purposes, the author designated the term to refer broadly to money transfer mechanisms that exist in the absence of, or parallel to, conventional banking channels. In some countries, commercial banks use the term *hawala* to refer to formal-sector money transfers. That definition is not used in this paper.

## **PREFACE**

This paper was written after three field visits to Afghanistan—two in 2002 (May and August), and one in 2003 (February). The second field trip, in August 2002, involved visits to the provincial cities of Jalalabad and Herat; and on all three missions extensive interviews were conducted with staff in the Ministry of Finance, Central Bank, the Ministry of Rural Development, the Ministry of Planning, the Afghan Chamber of Commerce, other government ministries and departments and several international aid institutions and nongovernmental organizations (NGOs). This paper details the results of these meetings. Most significant for the present study, discussions were held with numerous money exchange dealers, including the chairperson of the informal, Kabul-based Money Exchange Dealers Association and a Jalalabad-based member of the association's executive committee.

# CHAPTER 1

## INTRODUCTION

After more than 20 years of conflict in the country, Afghanistan's formal financial sector is virtually non-operational. The conflict has resulted in the complete disruption of domestic and international payments system, the virtual cessation of all lending activities within the country, significantly reduced deposit taking activities, and a stoppage of most international banking relationships. The disruption to the provision of financial services was most acute during the reign of the Taliban government when Afghanistan was subjected to international sanctions.

Financial institutions in Afghanistan, including the Central Bank – Da Afghanistan Bank (DAB), face four key constraints, namely: an outdated legal, regulatory and operational framework for banking activities; unskilled managerial and technical staff; nonexistent banking hardware and software, and poor payments telecommunications networks. These constraints severely limit the formal financial sector's ability to provide efficient and reliable financial services, particularly domestic and international payment systems for the public, non-governmental organizations, commercial entities, bilateral and multilateral agencies, and government institutions. The specialized financial institutions, namely Agricultural and Development Bank; Mortgage and Construction Bank; Export Promotion Bank; and the Industrial Development Bank are moribund.<sup>2</sup>

In the absence of any real formal banking system, a large and vibrant informal market has developed. Money exchange dealers, or *hawaladars*, provide a well-organized, convenient, and cost-effective means of making international and domestic payments. They have had lots of practice, for the Afghan population has relied on the informal sector to access financial services for hundreds of years. For many years, operating primarily from open-air markets, *hawala* has provided the most reliable, convenient, safe, and inexpensive means of transferring funds to far-flung regions.

The quality and utility of the *hawala* service have led some observers to suggest that the Afghan financial authorities should consider encouraging some of the *hawaladars* to convert their thriving enterprises into formal banking enterprises. With such suggestions in mind, this study was conducted in order to:

- determine the current usage of the *hawala* system in Afghanistan;

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<sup>2</sup> At the time of publication, financial sector reforms were underway. Some of the weaknesses listed in this paragraph may have been partially or completely addressed.

- verify the assertions of convenience, cost-effectiveness, and speed of *hawala* transactions,<sup>4</sup> in comparison with transactions done through formal financial institutions such as the Central Bank and the state banks;
- evaluate the use of money exchange dealers to remit development funds to regions that are not served by formal financial institutions<sup>5</sup>;
- identify the operational characteristics that make the *hawala* system vulnerable to financial abuse; and
- consider the appropriate regulatory and supervisory options for informal funds transfer systems in Afghanistan<sup>6</sup>.

This paper was written after three field visits to Afghanistan—two in 2002 (May and August), and one in 2003 (February). The second field trip, in August 2002, involved visits to the provincial cities of Jalalabad and Herat; and on all three missions extensive interviews were conducted with staff in the Ministry of Finance, Central Bank, the Ministry of Rural Development, the Ministry of Planning, the Afghan Chamber of Commerce, other government ministries and departments and several international aid institutions and nongovernmental organizations (NGOs). This paper details the results of these meetings. Most significant for the present study, discussions were held with numerous money exchange dealers, including the chairperson of the informal, Kabul-based Money Exchange Dealers Association and a Jalalabad-based member of the association’s executive committee.

The operational characteristics of *hawala* in Afghanistan are discussed in Chapter 2. It describes the system’s geographic characteristics, convenience, effectiveness, cost, and

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<sup>4</sup> A *hawala* transaction, as defined in this paper, encompasses financial transfers made by principals, or customers (Customer A, or CA, and Customer B, or CB) located in countries A and B, through *hawala* service providers in their respective countries. These providers (designated *hawaladars* HA and HB) operate outside the formal financial sector, regardless of the use or purpose of the transaction and the country of remittance or destination. Typically, HA receives funds from CA and asks HB to advance the amount to CB in the local currency equivalent. In a prototype *hawala* transaction (figure 1), an expatriate worker (CA) uses a *hawaladar* (HA) to arrange a remittance to his home country. He makes payment in dollars or another convertible currency to this intermediary. This individual contacts a *hawaladar* counterparty (HB) in the receiving country, who arranges payment in local currency to the remitter’s family or other beneficiary (CB). Obviously, some network of family or connections among *hawaladars* is required to make such a system work consistently and on a large scale.

<sup>5</sup> Throughout the paper the operations of money exchange dealers and *hawaladars* are considered together. In Afghanistan, a registered money exchange dealer can provide *hawala* remittance services without complying with any additional requirements. It must be borne in mind, however, that the buying and selling of currencies by a money exchange dealer can be done without intermediating remittances at all; and intermediating remittances by a *hawala* operator can be done without engaging in any kind of foreign exchange transaction.

<sup>6</sup> The regulatory and supervisory options presented in this paper are based on the suggestions made by respondents and do not necessarily represent the views of the Ministry of Finance, Central Bank or World Bank.

<sup>7</sup> Throughout the paper the operations of “money exchange dealers” and “*hawala* operators” are considered together. In Afghanistan, a registered money exchange dealer can provide *hawala* remittance services without complying to any additional requirements. It must be bourn in mind, however, that the buying and selling of currencies by a Money Exchange Dealer can be done without intermediating remittances at all; and intermediating remittances by a *hawala* Operator can be done without engaging in any kind of foreign exchange transaction.

its relationship with the formal financial system. Chapter 3 presents case studies of the domestic transfer of development funds by international aid institutions and nongovernmental organizations. It discusses the *hawala* system's benefits as well as the operational characteristics that make it vulnerable to abuse. Chapter 4 presents regulatory and supervisory options. Finally, Chapter 5 presents research conclusions and policy advice on the developmental role of informal financial institutions in the Afghan financial system; the implications for financial management practices of donor-financed development programs; and the regulatory and supervisory options for DAB.

## CHAPTER 2

### OPERATIONAL CHARACTERISTICS

The Kabul money exchange market, where most of the city's *hawaladars* operate, has an eighty-year-old history. Established along the Kabul River, it is near the gold and silver bazaars and financial service offices used by the precious-metal traders; Kabul's other specialized markets all are within walking distance. The money exchange dealers have traditionally provided traders with a range of banking conveniences, including currency conversions, international and domestic money transfers, deposit-taking services, and more recently communication facilities—for example, satellite telephone, fax, and e-mail.

Before Afghanistan's communist revolution in the 1970s, *hawaladars* from India and Pakistan dominated the Afghan money market. Following the revolution, though, and the flight of most foreigners, the market became almost solely dominated by the local Afghan money exchange dealers who had previously operated from Kabul, but outside the traditional market.

Presently, the more than 300 registered<sup>8</sup> money exchange dealers in the market have organized themselves into a self-regulating market. Estimates of the number of unregistered money exchange dealers in Kabul and around Afghanistan vary widely from 500 to 2,000.<sup>9</sup>

#### *Scope*

The money exchange dealers provide a diverse range of financial and nonfinancial business services in local, regional, and international markets. Financial activities include money exchange transactions, funds transfers, micro-finance, trade finance, and deposit taking. Nonfinancial activities may include telephone and fax services, regional and international trade assistance, and, more recently, internet services. No clear delineations exist among any of these business activities, nor are there distinct geographic and business classifications. The classifications below are meant to help identify general patterns and trends rather than set out consistent, ongoing operational realities.

Local money exchange dealers can be found in almost every community in Afghanistan. Traditionally, these dealers provide the community with numerous financial services in addition to funds transfers, for which they have attracted much attention. They also

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<sup>8</sup> Presently, money exchange dealers are required to register their businesses with the Central Bank's international affairs department. As at December 2002, the registration process includes making a deposit with the Central Bank of 20 million Afghanis (US\$526). Thereafter, annual license fees are 1 million Afghanis (US\$26).

<sup>9</sup> In the absence of regional records, and given the open nature of the Kabul money exchange market, these estimates must be viewed as speculative. There is no basis upon which to accept them with any measure of confidence.

provide deposit-taking facilities for those who want to save<sup>10</sup>; microfinance for informal entrepreneurs; trade finance for wholesalers and retailers; and currency exchange services for international business and personal transactions. *Hawala* tends to be some of the cheaper financial services provided by local money exchange dealers.

Regional money exchange dealers tend to be located in a regional rather than a provincial village, town, or city and serve more than one province. For example, Kandahar-based dealers may concentrate on the southern Afghan regions of Helmand, Oruzgan, and Zabol; Herat-based dealers may cover the western regions of Badghis, Farah, Faryab, and Ghowr. Apart from serving the eastern regions of Vardak, Parvan, Kapisa, Laghman, and others, Kabul-based dealers may serve the national market through the regional dealers in Kandahar (south), Herat (west), and Mazar-e-Sharif (north).

Regional dealers may offer the usual types of auxiliary financial services provided by local dealers, their principal clients are traditionally regional traders. In some instances they may engage in trade themselves, or they may be retired traders who have chosen to settle in one community but retain valuable regional contacts and counterparts.

### ***International***

International dealers, most of whom are based in Kabul, connect the domestic financial system to the rest of the world. Their counterparts are found in traditional trading cities on the Asian subcontinent: Tehran (Iran), Islamabad (Pakistan), and New Delhi (India); and in the Gulf cities and states of Riyadh (Saudi Arabia), Doha (Qatar), Abu Dhabi and Dubai (United Arab Emirates), and Muscat (Oman). These dealers target international traders and investors, and more recently, international aid institutions and NGOs disbursing development funds for rebuilding Afghanistan.

### ***Transaction Volumes***

There is no limit on the volume of funds transfers the money exchange dealers can transfer; individually or severally. Since the fall of the Taliban regime, the volume of financial flows through the *hawala* system has grown significantly. NGOs alone are estimated to have channeled at least US\$200 million in emergency, relief, and development funding through the *hawala* system. Single transactions in excess of US\$500,000, especially between Peshawar in Pakistan and Kabul, are not uncommon. The larger international aid institutions and NGOs have made individual transactions of US\$1,000,000. Because there are limited storage facilities in Kabul for large sums of money, however, the majority of organizations included in this study remit funds through the *hawala* system in smaller amounts of US\$100,000 to \$200,000. The smaller organizations regularly remit US\$20,000 to \$30,000 to meet operational expenses.

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<sup>10</sup> Deposit facilities are unlikely to include an accumulation of interest—often because *hawala* dealers view this as contrary to the principles of the Muslim faith, but also because such facilities are usually used for safekeeping rather than as investment tools.

Internally, the funds remitted to the provinces tend to be smaller, ranging from US\$10,000 to \$20,000. Owing to security concerns, these *hawala* transactions are made only when the regional offices have ready invoices for payment. This minimizes the volume of cash the regional offices have to store on their premises. The regional offices keep minimum cash reserves to meet their daily operating expenses.

### *Speed*

Transferring funds to Kabul from Peshawar, Dubai, and London usually takes 6 to 12 hours. Less time is required if both the sender and recipient are in the dealers' respective offices at the same time. Then confirmation and payment are instantaneous, and the entire transaction can be concluded in minutes. Commonly 24 hours are required for transfers between Kabul and any of the regional centers. Slightly more time is usually required for payments in the more remote regions or villages where the money exchange dealer has no local office or representative.

### *Cost*

The cost of making funds transfers into and around Afghanistan averages 1 to 2 percent. As is common with every bazaar in South Asia, however, the final quotation depends on the negotiating skills of both parties and their understanding of how the market operates. Some money exchange dealers quote a flat fee of 2 percent on both international and domestic transactions. Yet this is usually only a starting point for discussion. Discounts and premiums are offered and charged depending on the volume of the transaction, the relationship between the client and the *hawala* dealer, the currency of exchange, the security environment in Kabul, and the destination of the funds. The larger international aid institutions transferring US\$200,000 or more per month pay less in fees than local NGOs transferring US\$7,000 or less per month for their administrative expenses.

Under the Taliban regime, *hawaladars* charged higher fees among the different regions, and few dealers were willing to transfer funds within the country. Trade itself was difficult and even dangerous. Presently, however, there are so many dealers in the market that the fee structure has come down significantly to the stated average of 1–2 percent. In rare circumstances the fee may exceed 2 percent of the transaction amount, typically when the customer is new and fails to comparison-shop among the other dealers first. Rates also climb in provinces, where the security situation remains tenuous (as in Khor, Paktika, Nimroz, and Badaksan). The fee structure might also change if the customer requires additional services not normally provided—for example, an emergency transaction that must be expedited.

## Box 1. Hawaladar Operations in Afghanistan

### Hajji Mustafa, Jalalabad

**Background:** Hajji Mustafa (not his real name) has been a money exchange dealer for 14 years. His shop is located in the Jalalabad *hawala* market in the midst of 180 other dealers. Like the central *hawala* market in the capital city, Kabul, the market is located in the center of the city near the major trading markets and the customs office. The 180 money exchange dealers have an association that looks after its members' affairs. Mustafa's father was primarily a trader of goods from and to China, Azerbaijan, Turkmenistan, India, and Pakistan. Alongside his trading activities, he provided financial services to his colleagues, using his excess cash reserves. Mustafa chose to concentrate on providing financial services while occasionally investing in trade.

**Financial services:** Besides facilitating money transfers, Mustafa provides loans, takes deposits, and cashes checks. Loans are available to traders for trade finance, to NGOs for emergency relief activities, and to shop owners for paying customs duties and taxes on imported goods.

**Geographical coverage:** Mustafa has a brother in Kabul, a cousin in the commercial hub, Herat, and a brother in Melbourne, Australia. He also has partners in Tokyo, London, Peshawar, and Dubai. Although he occasionally conducts money transfers to other cities, this is exceptional. Barring communication problems, money transfers are completed within 24 hours.

**Settlement:** In most cases, end-of-month outstanding balances are between Mustafa and his brother in Melbourne, with whom he conducts the most business. If his brother owes Mustafa money, he uses his bank account in Japan to purchase second-hand cars for export to Afghanistan. Once the cars reach Afghanistan, Mustafa sells them and keeps the proceeds. If Mustafa owes his brother money, he uses his bank account in Peshawar to remit the money to his brother's account in Japan. Occasionally, he may export some Afghani products, such as carpets, for sale abroad.

### Amanullah Mohammed, Kabul

**Background:** Amanullah Mohammed (not his real name) has been a money exchange dealer in the Shahzada market for 25 years. He started the business after retiring from a career as a road construction engineer in the government and is now one of the largest money exchange dealers.

**Financial services and geographic coverage:** Apart from currency exchange, Mohammed's main business is money transfers. Recently, this business has received a significant boost with the influx of foreign nongovernmental organizations. Occasionally, he will provide safekeeping facilities for businessmen with excess currency. He does not pay interest on these cash holdings. Neither does he charge interest on the loans he makes, owing to his adherence to the Islamic proscription against charging or receiving interest on loans and deposits.

**International coverage:** Mohammed has a well-established international network of correspondent partners in all the major financial centers in the world—among them Tokyo, London, and New York—and regional contacts in every South Asian country. He maintains bank accounts in Dubai and London for making transfers to cities and countries where he lacks local contacts.

**Domestic coverage:** Within Afghanistan, Mohammed is able to make transfers to all major cities—Herat, Jalalabad, Konduz, Mazar-e-Sharif, and Kandahar. Domestic transfers usually include at least two currencies, even if both the transferor and the transferee are dealing in afghanis. By moving, for example, from afghani to Pakistani rupee to afghani, Mohammed can make gains on the foreign exchange differences between the cities.

**Expectations:** Mohammed is keen to receive approval for his bank license application. He is confident that he can provide good financial services to the Afghan population. He recognizes that local Afghan banks can not match international banking standards and recommends that international banks be invited into the country as soon as possible.

Source: Author research interviews.

## ***Reliability***

The *hawala* system is reliable. Dealers seldom fail to effect payment. Beside the expected high standard of adherence to unwritten but nevertheless well-established codes of business practice, default risk is eliminated through a variety of *hawala* dealer selection criteria adopted by users (see Annex 1 for select criteria), and operational usage procedures (see Annex 2 for select procedures), particularly the “confirmation before payment” procedure. In all cases reviewed in the study, the remitter pays the *hawala* dealer the value of the funds remitted only after the recipient has confirmed receipt of the money. Because of the large sums involved, NGOs typically make bank transfers into the *hawaladars*’ accounts in either Pakistan or Dubai. When interviewed, the international agencies and NGOs expressed general satisfaction with the delivery of funds. The rare incidents of client dissatisfaction were limited to occasions when the customer paid a slightly higher fee than that offered by competitors for that particular route or region.

## ***Documentation***

There are no standard documentary requirements for conducting *hawala* transactions, and the *hawala* association does not require its members to open their books for external inspection, nor does it require periodic financial reports. Standardized documentation and reporting are considered unnecessary because of the high level of trust that makes the system viable. Dealers know that any failure to honor contracts will result in immediate blacklisting, and possible expulsion, from the market.

Each *hawaladar* designs, develops, and maintains independent documentary policies and procedures. Some of the procedures have been in use for many years and adapted to the changing business environment. Each business develops its own system for keeping track of transactions and balancing their accounts with international and domestic business partners. The study found that some dealers maintain detailed records for each *hawala* transaction for purposes of remittance and settlement. Dealers know exactly how much cash they have, how much has been transferred, and how much is owed them. During the research, the money exchange dealers routinely provided the following documents in varying combinations:

- *Hawala slips*: Each customer is provided with a *hawala* slip, which indicates a *hawala* number or code. The dealers use the code to identify customers and for payment and settlement purposes. Although this is the primary bill of exchange, some dealers require the holder to produce a secondary identification document when presenting the note for cashing.
- *Customer identification documents and records*: Some *hawaladars* implement rudimentary due diligence, “know your customer” banking procedures. Dealers maintain photocopies of customer passports or identity cards from hospitals, the army, and other institutions that issue such cards. Some of the data collected for records are: (1) date of transaction; (2) name and address of sender and recipient; (3) passport number or other identification number; (4)

*hawala* number; and, (4) name of counterpart dealer. The last piece of information is important because there are so many players in the market. The customer must be able to identify the correspondent party at the other end of the transaction.

- *Accounting records:* For established organizations such as NGOs and international aid institutions, the dealers maintain files with invoices and quotations, copies of receipts, and transaction contracts and agreements. The accounts between the organization and the dealers are reconciled periodically. For their correspondents, *hawaladars* maintain debit and credit columns in an accounting ledger book or computer. Each transaction is meticulously recorded, with columns for the date, *hawala* number, currency, amount, destination, fee, and the date of settlement. Dealers maintain a separate book that customers at both ends sign when a transaction is completed and funds received. Separate receipts for the sender and payment confirmation documents can also be arranged if the customer so desires.

### ***Settlement***

The study found that outstanding accounts between *hawaladars* are balanced weekly or monthly. When the volume of transactions is high, dealers have been known to settle their accounts daily. The nature of the relationship between dealers appears to determine how frequently accounts are settled.

The many settlement options include simple monetary settlement (cash transfers), trade in licit and illicit goods, smuggling, and other forms of bilateral or multilateral settlement. In the past, when the banking system in Kabul was operational, dealers settled their accounts through the exchange of checks. Now, if dealers need to transfer cash from one region to another, it is moved over traditional trading routes that have been in existence for years. A good many international settlements, however, appear to be done either through cash or bank accounts in Peshawar or Dubai.

All international *hawala* dealers maintain one or two accounts with formal financial institutions. The usual locations used by Kabul money exchange dealers are Peshawar, Islamabad, Dubai, London, and New York. These accounts are used for effecting funds transfers for customers and for settling with other *hawaladars*. Many of the dealers in Kabul use their Peshawar-based bank accounts to receive dollars from NGOs that want afghani payments made in Afghanistan. Also, to avoid having to carry cash within Afghanistan to settle accounts, dealers credit and debit each other's Peshawar or Dubai accounts via satellite communication. The London and New York accounts are also used to make normal bank transfers to cities where the *hawaladar* has no correspondent relationships with another nonbank institution or partner. Conventional money transfers from that account are made for customers, who are then charged the normal banking fees and subjected to formal-sector documentation, procedures, and delays.

The recent surge in the volume of foreign currency entering Afghanistan through international aid institutions and NGOs presents researchers with a number of unique questions. How are the regional counterparts able to finance payments on behalf of the international aid institutions? What is the source of the afghani equivalent paid out in the regions? In the last 12 months, for example, international aid institutions have individually transferred amounts in excess of US\$10 million. Where is the afghani equivalent coming from?

If the afghanis, for example, are being generated by, for example, legitimate trade in legitimate goods among regions then there is no legal reason for suppressing the *hawala* system of funds transfers. Yet if the settlement process is in part completed with funds from illegal activities such as the smuggling of gold or weapons, drug trafficking, or trafficking in girls and women, or if the process involves international terrorist financing then users carry a high reputational risk of inadvertently aiding in laundering the proceeds of criminal activities. This risk is particularly acute because of the difficulty of separating legal from illegal money flows.

### ***Potential for Financial Abuse***

Like the formal banking system, the *hawala* system is vulnerable to abuse by money launderers and those seeking to finance terrorism. The number and variety of methods used to launder the proceeds of criminal activities, especially opium production, continues to become increasingly complex. Money launderers employ diverse methods that employ both banking and nonbanking channels. Recently, the abuse of informal remittance systems by those who would finance terrorism has received a great deal of attention in the press.

Criminals use similar techniques to launder the proceeds of crime through the formal and informal financial systems. First, neither formal nor informal financial systems necessarily transfer funds from one jurisdiction to another. Instead they depend on a sequence of accounting debits and credits among accounts kept by a network of individuals, companies, accountants, lawyers, and other partnerships and companies. Second, much as banking-secrecy laws have been implicated in money laundering crimes, the anonymity built into *hawala* means that it, too, is vulnerable to charges that criminals or terrorists use this traditional, informal system to move or launder money and commit crimes.

The primary difference between the formal and informal systems lies in the amount of documentation required of each. Laundering money through the formal financial system leaves a paper trail, making it vulnerable to detection by law enforcement agencies during an investigation. Placing funds (from criminal activities) into a bank results in deposit documentation; transferring funds from one account to another requires transfer-request forms that provide details about the transferor and the transferee. Finally, financial investments require the signing of deposit and withdrawal records such as checks by the withdrawer or his nominee.

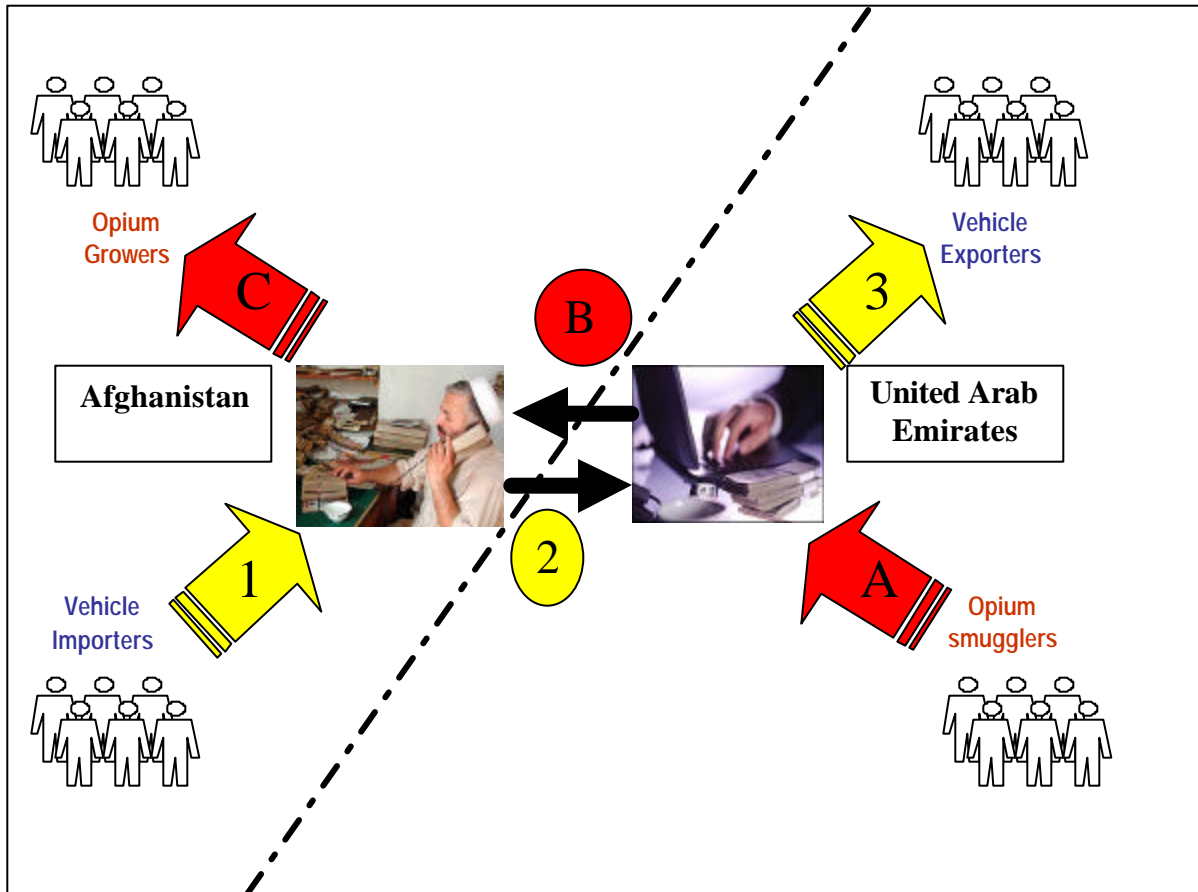
*Hawaladars* minimize detection by limiting external access to or oversight of their records. Where documents *are* maintained, and money exchange dealers often noted this during interviews, they are rarely accessible to third parties, especially to law enforcement agents. Funds can be placed anonymously when a money exchange dealer accepts funds for remittance without establishing either the identity of the remitter or the source of the funds. The recipient can receive monies without producing identity documents other than a previously agreed code. Thereafter, a money exchange dealer can initiate or facilitate a number of transfers, all of which conceal the original source of funds through a network of *hawaladars* operating in many different jurisdictions; with each dealer requiring little or no formal documentation. Finally, the recipient of funds can reintegrate the funds into the formal, legitimate financial system by making a “legitimate” business investment on behalf of the funds’ owner. Or the funds can be reintegrated into the formal financial system through imports and exports by transferor and transferee, or even by third parties. Once the transaction is complete, there is no regulatory requirement for customer identification documents, nor are codes or references preserved for a specified period. Consequently, *hawala* transactions leave no audit trail for law enforcement agencies to establish predicate offenses for money laundering, tax evasion, corruption, or other related activity. The absence of financial transactions records and business documents could therefore make the use of the *hawala* system attractive for laundering the proceeds of criminal activities.

Is *hawala* used to launder money in Afghanistan? If so, to what extent? The lack of documentation makes both questions difficult to answer. Illegal money flows are difficult to track. It is also difficult to separate legal from criminal money flows and to establish, as law enforcement agencies must, actual financial links to actual criminal activities. Further, law enforcement agencies face significant cultural and linguistic barriers when investigating the informal financial systems; business, tribal, or kinship ties among the participants also complicate investigations. Additional constraints in Afghanistan include:

- lack of effective monitoring of cross-border currency movements;
- lack of reporting requirements for large cash transactions or a pattern of inconsistent reporting under a voluntary system;
- lack of uniform guidelines from which to identify suspicious transactions;
- parallel black-market economies;
- little ability to share financial information with foreign law enforcement authorities.

Afghanistan meets many of the above characteristics and will continue to do so for many years. While the *hawala* system in Afghanistan is convenient and appears to serve a legitimate remittance purpose, its potential for anonymity and its tendency to avoid record-keeping, particularly in the reverse transactions, make it vulnerable to those seeking to launder the proceeds of criminal activities. As Figure 1 on the next page shows, it is possible that by remitting funds through *Hawaladars*, a legitimate second hand car import business, for example, may find itself aiding opium merchants purchase heroin from Kabul.

Figure 1. The *Hawala* Transactions Combining Legitimate and Illegal Activities



*Legitimate Transaction*

1. Vehicle importer in Afghanistan approaches a *hawala* dealer in Kabul with afghanis for the import of vehicles from a Dubai based car exporter.
2. *Hawala* dealer in Kabul communicates payments instructions to a Dubai based *hawala* Dealer.
3. Dubai based *hawala* dealer gives the vehicle exporter US\$ equivalent as requested by the vehicle importer in Kabul.

*Illegal Transaction*

- A. Drug Dealers approach a *hawala* dealer in Dubai with US\$ for the purchase of opium from Kabul based opium dealers/growers
- B. *Hawala* dealer in Dubai communicates payment instructions to a Kabul based *hawala* dealer.
- C. Kabul based *hawala* dealer gives the opium dealers/growers afghani equivalent as requested by the opium smugglers in Dubai.

*Settlement of Accounts between Hawala Dealers*

- The *hawala* dealers use the cash they receive from domestic clients to execute payment instructions on behalf of their foreign counterparts.
- When differences arise that can not be matched by reciprocal transactions, *hawala* dealers may use formal transfers between their bank accounts.

The diagram above offers a possible, yet still speculative, network. The field research did not find evidence that *hawala* transactions facilitate opium transactions —nor for that matter that the formal banking sector does *not* handle illicit proceeds. The diagram merely highlights possibilities that law enforcement groups might ponder in the absence of clear information about the *hawala* transaction process. In both transactions, it is important to remember that neither hawala dealer need necessarily know the purpose for the financial transfers to execute them.

Interestingly, before the national currency change in January 2003 the study found substantial volumes of freshly printed, shrink-wrapped afghani notes. When questioned about the source of the new notes, the *hawala* dealers said the monies were printed in Russia and were available to dealers selling dollars. It was not possible to determine the legality of the notes. Distinguishing between genuine and counterfeit notes was complicated by the presence of three legal versions of the afghani then in circulation. One version of the note found in northern Afghanistan was worth just half the currency used elsewhere in the country. Another currency was also in use in a small corner of northeastern Afghanistan; it dated to when the region remained in the hands of the Northern Alliance while the Taliban regime held sway over the rest of the country. The possibility of organized criminals printing the old afghanis and purchasing genuine foreign currency in the money exchange market was real at that time.

## CHAPTER 3

### INTERNATIONAL AND DOMESTIC USE OF THE HAWALA SYSTEM

#### *By International Aid Institutions*

Most international aid institutions operating in Afghanistan use *hawalas* to move funds into and around the country. Only the largest organizations can manage the costs and logistics involved in physically transferring cash around the country. Occasionally, some agencies bring cash when staff members fly into the country, but the amounts involved are usually small and are meant to cover overhead expenses not program needs. For larger sums of money, the *hawala* system is often the only option.

International aid institutions now work with several dealers. Under the Taliban regime, agencies worked with perhaps one or two *hawaladars*, with whom they established long-term relationships. But the competition is now such that the *hawaladars* regularly send agencies dealing in large volumes of cash periodic bids for their services. With each round of bids, rates and services become more competitive. Responding to these inducements, agencies are working with a number of different dealers on different routes. In some cases, the dealer may provide the service at no charge on one route on the understanding that he will receive the contract for another route (See Annex 3 for a sample of a contract. The cases below illustrate a few aspects of the *hawala* system that institutions and NGOs must deal with. Those issues include the volume of cash, the confirmation process, concerns about counterfeit cash, and the security of the cash when the local *hawala* operator gives the transferee cash in response to instructions from his counterpart in Pakistan or Dubai.

#### **Box 2 International Aid Agencies and the Hawala System**

*Agency A:* Agency A's policy is to make payments only through official banking channels. Where these do not exist, it physically transfers cash to places where payment is required. To pay salaries and expenses for staff based in Afghanistan, the staff physically transfer cash from Pakistan to Kabul. The monthly transfers from Pakistan now average US\$23 million. Within the country, cash transfers are made, especially for large sums of money. In one instance, as much as US\$7 million was transferred from Kabul to Kandahar for project financing. Agency A does not, however, monitor the remittance methods used by the Kabul-based recipients of its funds.

*Agency B:* Agency B would prefer to operate through normal banking channels for its international and domestic funds transfers. However, given the current situation, it is compelled to use the *hawala* operators based in Islamabad and Peshawar. When Agency B needs money for salaries, it instructs the *hawaladar* to make a payment to one of its offices in Kabul. The *hawaladar* in Islamabad instructs his counterpart in Kabul, to make payment in afghanis. The Islamabad office credits the account of the *hawala* operator in Islamabad only when the Kabul office confirms by fax that it has received the money. Because of growing concerns about counterfeit currency in the market, Agency B's *hawala* operators now stamp the notes with special seals. If the note is later determined to be counterfeit, the organization can return it to the dealer for full compensation. The monthly transfers from Pakistan are significant, but the money exchange dealers have not had any difficulty in sourcing the required amount of afghanis, dollars, or Pakistani rupees. Recently, the organization remitted US\$900,000 to pay rent for office and living space, as well as other overhead expenses. The cost of doing business through the *hawala* dealers has come down significantly in recent times.

Source: Author research interviews.

## Box 2 International Aid Agencies and the Hawala System cont...

*Agency C:* When Agency C requires US\$1 million for use in Kabul, the *hawala* remittances are divided into tranches of US\$200,000 to \$300,000. Occasionally, remittances of US\$500,000 are made. Agency C asks its local suppliers and contractors to collect their money as soon as the Kabul-based *hawaladar* is ready to make payment. Internally, funds transfers average US\$20,000 to \$30,000. For security reasons, all transactions take place on Agency C premises. The entire process is well documented. The recipient sends e-mail confirmation to the sender before the money is given to the money exchange dealer. No payment is made until the e-mail or fax is received, even where oral communication has taken place and confirmation given. Receipts are issued to money exchange dealers when they deliver cash. The receipts act as settlement documents for the dealer. Each receipt states clearly that the transfer has been made through the informal market because of security concerns and the absence of a functioning banking system in the country.

*Agency D:* Agency D uses the *hawala* system for all its international and domestic transactions. International transactions between Pakistan and Kabul average US\$20,000–30,000 weekly. The *hawala* dealer delivers the monies directly to Agency D's office. He is given a receipt, which he faxes to his counterpart in Islamabad for settlement with Agency D's office there. The mechanism used to deal with counterfeit notes is the same as that used at Agency B. The fee for transactions is 1.5 percent if the settlement is made after confirmation that the transfer has been made, and 1 percent if Agency D pays in advance. Within Afghanistan, the *hawala* system is used to make payments to staff operating in the provinces. Physical transfers of cash are considered too dangerous for staff members. Airlifting cash or arranging armored vehicles to escort cash deliveries is costly and attracts too much attention. The agency is considering using the *hawala* system to make local payments to suppliers. Presently, suppliers collect cash from the Agency D office, or cash is delivered to the supplier. Cash deliveries within Kabul of US\$10,000 have taken place. Documentation has not been a problem. The money exchange dealers are willing to provide the documents the organization requires. However, as a security measure, cash balances at the head office are minimized.

Source: Author research interviews.

The transfer arrangements of the four agencies reflect their size and area of operation. Generally, funds are remitted from Pakistan (Peshawar or Islamabad) in tranches that meet the organizations' periodic program requirements. Smaller amounts are then remitted to the provinces using the same or a different dealer. In each case, the agency pays the dealer only upon confirmation that the transfer has been made.

### **By NGOs**

Approximately 127 international and 467 local NGOs are now operating in Afghanistan. Government officials in the estimate that more than US\$200 million was channeled through these NGOs in the form of humanitarian relief, emergency aid, and development financing for the Afghan people within the first year of the fall of the Taliban regime. The *hawala* system has been used to facilitate the movement of these funds into and around the country. *Hawala* is particularly well suited for NGOs operating in rural Afghanistan, where the formal banking system is absent. Some of the less well funded NGOs are especially grateful for the low costs associated with the system. Although they lack the resources of international aid institutions, these NGOs are still able to implement life-saving relief and emergency assistance programs. The two cases below show the similarities and differences in NGO use of *hawala*.

### Box 3 NGOs and the Hawala system

*NGO A:* NGO A uses the local money exchange market to conduct banking business with its regionally based groups. Most of its community development programs involve regional representatives purchasing equipment from local markets and handing them over to the community. No cash is given to the community directly. The NGO's regional representatives collect cash from local money exchange dealers who may be shopkeepers or traders, depending on the community in which the NGO is working. The commissions are minimal, and the organization has never had a problem with money exchange dealers. The volume of funds remitted through the system depends on the number and type of programs the NGO is implementing in a given region. For example, the eight agricultural cooperatives NGO A works with have approximately 800 members who borrow an average of US\$100 per person. In 115 communities, individual loans average between US\$250 and \$450.

*NGO B:* Every month NGO B receives competitive bids from three or four large money exchange dealers. It accepts the best offers that come in each month. The fees range from 2 to 4 percent for rural areas and 0.7 to 1.5 percent for urban areas. In all cases, NGO B pays the *hawala* dealer only upon receipt of confirmation that the transfer has been made.

Source: Author research interviews.

A foreign bank in Peshawar is the bank of choice for many NGOs. A second foreign bank plans to open a branch there soon. The volume of transactions ranges from US\$100,000 to \$300,000 for international transactions and US\$20,000 to 30,000 for domestic transactions. Transfers are completed quickly and efficiently. Most problems have to do with delays by the Peshawar bank in making the transfer to the *hawala* dealer's account. *Hawaladars* are frustrated by such delays, but they understand that paper-based conventional banking systems are laboriously slow.

Money exchange dealers provide NGOs with liquidity they otherwise might not have. NGOs are able to cash checks with *hawala* dealers and are discussing with a few dealers ways to make the check system more widespread. Should the discussions succeed, NGOs will be able to issue checks to local suppliers, who will present them to money exchange dealers for cash.

## CHAPTER 4

### REGULATORY AND SUPERVISORY OPTIONS

Since the terrorist attacks of September 11, 2001 on the United States, there has been renewed public interest in the regulation of *hawala* systems. Press coverage, which often focused on the putative connection between the *hawala* systems and terrorist financing activities, increased the level of official concern about its potential susceptibility to financial abuse. Some national financial regulators began the process of examining existing regulations, and in some cases, designing, developing, and implementing new financial sector policies, including those that address *hawala* systems.

In October 2001, the Financial Action Task Force (FATF) agreed to Special Recommendations on Terrorist Financing, which included extending anti-money laundering requirements to alternative remittance systems (See Annex 4). At a conference on *hawala* in the UAE in May 2002, a number of governments agreed to adopt the FATF recommendation and shortly thereafter the UAE government announced it would soon impose a licensing requirement on *hawalas*. Participants at the UAE meeting drafted and agreed upon the Abu Dhabi Declaration on *Hawala* which set forth five complimentary principles (See Annex 5).

The fundamental question for the Afghan Central Bank is whether money exchange dealers require regulation and supervision. Do they pose such systemic risks as to require formal regulatory and supervisory regimes similar to those being developed for the banking sector? Can they be left alone without endangering the long-term stability of the financial sector and monetary policy?

Afghanistan can choose one of four options. It can prescribe no regulatory or supervisory standard. It can extend formal banking-sector regulations to the money exchange market and establish formal on- and off-site supervisory mechanisms. It can allow self-regulation and supervision among dealers; or it can establish special regulatory and supervisory standards for the informal sector. Each policy approach presents specific administrative and institutional challenges.

#### ***No Regulation or Supervision***

In the course of the study, various parties, particularly the *hawala* dealers, argued against regulation or supervision. First, they noted that except for dealers with shops at the market, *hawaladars* are difficult to identify or locate for regulatory and enforcement purposes. Grocers, merchants, individuals, and a host of other individuals conduct *hawala* transactions. Second, the money exchange dealers have no incentives to declare their activities for external monitoring and supervision. Third, even if it were possible to identify, register, or license *hawaladars*, their transactions are so varied and multifarious it would be impossible to develop a consistent set of regulations for the sector. Fourth, even if it were possible to develop regulations, guidelines, and standards for the sector, the Central Bank simply does not have the resources to implement them. Finally, attempts

to regulate an informal financial system will alter the system's original characteristics and push it farther away from the formal sector, especially as long as the primary reasons for its existence—foreign exchange arbitrage opportunities and poor banking services—have not been addressed.

Yet in the wake the events of September 11 2001, and the subsequent international efforts to combat money laundering and the financing of terrorism, abstaining from regulation or supervision of the informal financial system is no longer a tenable option. Instead, the regulatory authorities will need to begin considering how the current practices of the *hawala* dealers can be brought into closer compliance with international regulatory and supervisory standards. Can the current registration process be strengthened? Can the client information the *hawaladars* already collect be standardized? Can *hawaladars* begin to report suspicious activity to their own association or directly to the Central Bank? What about the records *hawaladars* keep? Can agreement be reached about external oversight and access to these records?

In addressing these questions and others, the Central Bank can introduce notions about formal banking-style regulations and supervision practices, pursue a self-regulatory model, or develop special regulations. Selecting the appropriate regulatory and supervisory responses requires a realistic and practical assessment and understanding of Afghanistan's circumstances and of the environment in which the money exchange dealers operate.

### ***Formal Banking-Style Regulation and Supervision***

Given the country's socioeconomic and political conditions, a comprehensive extension of existing banking regulations and supervision practices to the money exchange dealers is not a realistic option—such practices affect (i) licensing requirements,<sup>11</sup> (ii) customer identification,<sup>12</sup> (iii) suspicious activity reporting,<sup>13</sup> and (iii) recordkeeping.<sup>14</sup>

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<sup>11</sup> Bank licensing requirements are designed to prevent the control or significant ownership of financial institutions by criminals or their associates. In determining the suitability of applicants, regulators need to consider: (i) skills and experience commensurate with the intended activities; and (ii) records of criminal activities and adverse regulatory judgments.

<sup>12</sup> Effective customer identification and due diligence enforcement require two complementary activities. First, in cases where money remitters are registered or licensed, the authorities must regularly communicate new legislation, regulations, and other guidance on customer identification, and provide appropriate training. Second, the regulators need to ensure that money remitters accurately record the transaction details of their clients, namely, the name and address of remitter and recipient, type of remittance, amount and currency involved, and other relevant details. The records must be properly maintained and made available for inspection by regulators.

<sup>13</sup> Requirements for reporting suspicious activity compel banks to have procedures in place for recognizing, recording, and reporting potentially suspicious transactions. The procedures ensure that staff pay special attention to all complex, unusually large transactions, and all unusual patterns of transactions that have no apparent economic or lawful purpose, especially where funds are suspected to proceed from criminal activity or to be intended for the financing of terrorism. Often the law requires banks not to inform clients of their actions but instead to cooperate with the regulators or law enforcement agencies, who may be required to further investigate the transactions' background and purpose.

<sup>14</sup> Record-keeping requirements make it mandatory for banks to maintain records regarding customer identification and individual transactions for a reasonable period, typically not less than five years. For this

Regulatory requirements beyond basic registration are not feasible in countries that have inadequate or nonexistent supervisory capacity. Afghanistan's Central Bank faces several basic but fundamental challenges—all of which makes the matter of regulating the *hawaladars* less urgent by comparison. The bank has lost key personnel, and the reporting framework, both in the Central Bank itself and between the bank and other institutions, has completely broken down. Office automation is absent, and the physical infrastructure in serious disrepair. Even when compared with other conflict-afflicted countries, Afghanistan's authorities face great challenges.

### ***Self-Regulation and Supervision***

At this time it may be most feasible for Afghanistan to implement a self-regulatory and supervisory framework instead of pursuing a banking-style model for the sector. Self-regulation and supervision at least offer an interim solution. The *hawala* dealers' association has an executive committee responsible for enforcing the tacit rules and business codes of the market; code violations bring serious consequences. The executive committee is also responsible for the amicable settlement of disputes. The police and the committee rarely intervene in the day-to-day affairs of *hawaladars*; the committee charges no fees for its services, and its appointed members are not salaried or otherwise compensated.

Yet formal, written rules and regulations offer four advantages. First, if money exchange dealers perceived a tangible value from registering with the association, more might volunteer to register and be identified. Second, dealers operating under formal rules might be better equipped (better equipped than external authorities in any event) to identify the *hawala* practices in particular need of regulation and supervision. Third, under formal rules regional or local association committees might be in a better position to share the administrative and financial burdens of checking compliance. Finally, regulations and standards designed and administered by the *hawala* dealers themselves might work to bring them closer to the formal financial system (whereas rules imposed by external authorities might push the system further underground). As with all self-regulating bodies, however, there is a high risk of self-serving regulations, perverse incentive structures, and regulatory forbearance.

### ***Special Regulations and Supervision Techniques***

A fourth option is to create special regulations and supervision practices that render business practices more transparent without sacrificing *hawala*'s most valuable attributes: cost-effectiveness, convenience, and regional reach. Such regulations might have some or all of the following characteristics:

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requirement to be enforceable, the legislation, regulations or guidance notes should define which identifying documents are to be maintained and the minimum period the records are to be maintained. At a minimum, the records should be such that regulators and law enforcement agencies will be able to reconstruct individual transactions.

- *Hawala* dealers would be registered, but not licensed. The Central Bank could continue its current policy of registering dealers in Kabul. Beside normal business registration procedures, money exchange dealers would not have to comply with further legal and institutional requirements. Registration could be extended to the provinces, and the Central Bank could refuse registration only if an applicant provided false information, failed to produce the documentation required by law, or did not pay the registration fee. The bank would not conduct fitness and probity tests of applicants. Nor would it seek to determine the reasonableness of the applicant's business plan or the adequacy of the capital proposed for the business.
- Dealers would be required to identify customers and record or copy evidence of identity and address. The Central Bank would ask in particular that dealers bear the responsibility for determining suspicious activity regardless of the funds involved, and for keeping sufficient documentation to ensure customer identification. The Central Bank would not prescribe, however, the type and form of documents that dealers must maintain or the minimum amount above which a suspicious-activity report must be prepared.
- Dealers would adhere to a mechanism for facilitating investigations when the need arose. The regulations should not require ongoing regulatory and supervisory oversight from the Central Bank. Instead, authorities would retain the right to obtain access to records whenever reasonable grounds existed for believing that an offense had been, was being, or was about to be committed.

Overall, regulatory and supervisory requirements for *hawaladars* would be introduced gradually, in coordinated steps, and in close collaboration with the Money Exchange Dealers Association.

## CHAPTER 5

### CONCLUSION

#### *Developmental Role of Money Exchange Dealers*

With the decline of Afghanistan's financial services over the past decade—at least those offered by the formal banking system—the *hawala* business has grown to fill an enormous void. The money exchange dealers of Afghanistan are providing an invaluable channel through which family members, NGOs, and bilateral and multilateral donors are sending humanitarian assistance and development aid into the country. In addition, they are cementing rudimentary but still important commercial business relationships. Both commerce and industry in the country rely on the *hawala* system for the purchase of goods and services and for receiving revenues.

The recent growth in *hawala* transactions presents financial sector reformers with a dilemma. The burgeoning *hawala* market operates without any external regulatory or supervisory oversight—and that lack of regulation poses serious macroeconomic management problems for the country. First, the Central Bank lacks control over financial or monetary policy because most monetary activity in the country occurs outside its realm of influence. Conventional Central Bank prudential and open-market operations cannot function effectively when financial institutions and currency reserves fall outside the formal system. These conditions are fundamentally destabilizing. Second, a large informal financial system, with the potential to facilitate large anonymous financial transactions—particularly for the settlement process—makes the system itself and the country as a whole particularly vulnerable to money launderers and those seeking to finance terrorism.

#### *Hawala Regulation and Supervision*

Selecting the appropriate regulatory and supervisory response requires a realistic, practical assessment of the environment in which the money exchange dealers of Afghanistan operate. In addressing Afghanistan's unique circumstances—a nonexistent formal banking system, no regulatory and supervisory capacity, and an overactive informal sector—the Central Bank should consider how its relationship with the *hawala* dealers can be brought into closer compliance with international regulatory and supervisory standards.

Working with the informal Money Exchange Dealers Association, the Central Bank could consider exploring the benefits of a self-regulatory and supervisory framework as an interim solution. Dealers are well placed to assist in detailing the different *hawala* typologies that require regulation and supervision. Most important, regional or local association committees can share the administrative and financial burden of ensuring compliance. Suitable incentives to the dealers are probably the key to the success of self-regulation.

At the same time, the Central Bank could move towards developing more sophisticated regulations for money exchange dealers, ones that accommodate external oversight. Although it may be premature and impractical to introduce formal banking-style regulatory and supervisory requirements at this stage, authorities could take pains to introduce these in coordination with practices employed by money exchange dealers for identifying customers, reporting suspicious activities, and keeping records.

The Central Bank might also begin to set out the benefits of, for example, extending and standardizing current, formal record-keeping practices into the informal sector, and seek to explain the advantages of protecting market integrity by having the *hawaladars* report suspicious transactions—perhaps in the first instance to their own dealers’ association and then to the Central Bank or another external body. Special regulations could suggest that although an external oversight body may eventually take responsibility for such matters, for the time being dealers bear the responsibility for determining what constitutes suspicious activity and for keeping sufficient documentation to ensure customer identification.

### ***Formal Financial Sector Reforms***

Ideally, comprehensive financial reforms would include establishing a rudimentary banking system in Afghanistan. Such reforms, which are consistent with the recently published World Bank-International Monetary Fund conclusions on the hawala system (see Annex 6), would seek to strengthen the Central Bank’s regulation and supervision of monetary policy and banking practices, and develop and strengthen the commercial banking system.

In the immediate future, the Central Bank may wish to concentrate on creating a functioning payment system. The Central Bank branches require better communications, technology, and transportation capacity to be able to transport physical cash when required. The larger international aid institutions cannot provide program funds through the informal market without exerting a negative effect on financial and monetary stability. Each time they send large amounts of dollars to be sold on the market, money exchange dealers have an equally large incentive to resort to illicit sources to meet the massive demand for afghanis.

In the medium to long term, developing and strengthening commercial banking will be one of Afghanistan’s greatest challenges. The existing commercial banks offer inadequate financial services. An attractive possibility is to encourage the entry of foreign banks and to create new local banks. Obvious international candidates are banks operating in South Asia with long-standing ties to Afghan businesses and Afghanistan-based international aid institutions and NGOs. Afghanistan will not be an entirely new banking environment for them. Other banks based in Dubai, Pakistan, India, and Iran are also potential candidates for entry into the country’s banking sector. Decisions to enter will depend, of course, on the investment climate in the country in the coming months.

In the long term, the Central Bank may then consider encouraging some of the larger money exchange dealers to make the transition into the formal banking sector. Such a transition would have three advantages. From a business perspective, the *hawala* dealers already know the business of banking. In fact, most of them already operate as miniature banks. Licensing them as banks would merely confirm the status quo. By making the transition to formal bank practice, *hawala* dealers would need only to scale up their activities and institutional structures. *Hawaladars* already enjoy a tremendous reservoir of customer goodwill, ensuring public confidence. From a regulatory perspective, bank licensing would come with conventional banking regulation and supervision requirements. Greater openness would follow as a matter of course as the money exchange dealers came closer to the formal banking sector.

## ANNEXES

*Annex 1 Sample Selection Criteria for Hawala Dealers*<sup>15</sup>

**In selecting financially sound *hawala* dealers to work with, users apply a variety of selection criteria, some of which include the following:**

- **Be registered with the Central Bank, Da Afghanistan:** The registration process includes making a deposit with the central bank and paying an annual license fee. There are no further legal and institutional requirements with which money exchange dealers must comply. Although the central bank currently does not conduct fitness and probity tests of applicants, determine the reasonableness of the applicants business plan or assess the adequacy of the capital proposed for the business, this is an important first step at ensuring the operators legitimacy.
- **Recognized by the Money Exchange Dealers Association:** The market has an informal eight member Executive Committee that meets regularly to discuss its member's affairs. The Committee's Executive Director and his three assistants direct the activities of the Money Exchange Dealers Association and ensure that each member adheres to the Association's unwritten rules of conduct and practices. Membership to the association is voluntary and there are no subscription fees. Membership is also a additional indicator the operator legitimacy
- **Maintain a physical presence at the Sari Shahzada in Kabul:** The physical money exchange market, where the majority of Kabul's money exchange dealers are currently located has an eighty-year-old history. Established along side the Kabul River, it is situated close to the gold and silver bazaars and financial service to the metal traders. Kabul's other specialized markets are all within walking distance of the market, from which traders conduct and conclude their financial transactions. Operators with a physical presence at the market are likely to have a longer operational history than those that do not.
- **Authorized to deal in foreign currencies:** New central bank and banking laws have been drafted and rare expected to be passed soon. It is important that all transactions conducted through informal financial institutions are in compliance with these laws.
- **Be able to execute promptly a large number and volume of transactions :** There is no limit on the volume of funds transfers the money exchange dealers of Kabul can transfer; individually or severally. The NGO's alone are estimated to have channeled at least US\$200 million in emergency, relief and development funding through the hawala system. Single transactions in excess of US\$500,000, especially between Peshawar in Pakistan and Kabul, are not uncommon. The larger international organizations and NGO's have made individual transactions of US\$1,000,000. A basic assessment of the operators operational capacity needs to be done before being contracted.

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<sup>15</sup> Source: Author interviews.

- **Agree to issue promptly a detailed monthly statement of funds transfer transactions:** Contrary to common belief, money exchange dealers maintain comprehensive records for each hawala transaction. The financial records the money exchange dealers maintain are detailed, and the entire process of remittance and settlement is very well documented. There are records of everything. Dealers know exactly how much cash they have, how much has been transferred and how much is owed to them. It is important that the accessibility of these documents for users is improved through an agreed financial statement review process.
- **Have established a satisfactory domestic and international correspondent funds transfer network:** Regional money exchange dealers are generally situated located in a regional rather and village or provincial town or city and service more than one province. For example, Kandahar based dealers may concentrate on the southern Afghan regions of Helman, Oruzgan, and Zabol; The international dealers are mainly based in Kabul. They connect the domestic financial system to the rest of the world. Their counterparts are found in traditional trading cities on the Asian sub-continent: Tehran (Iran), Islamabad (Pakistan), and New Delhi (India); and in the Gulf cities and states of: Riyadh (Saudi Arabia), Doha (Qatar) Abu Dhabi and Dubai (United Arab Emirates), and Muscat (Oman). The government needs to determine which operators are able to serve its regions of interest.
- **Must have maintained an account in a formal commercial bank for at least five years:** A relationship with a formal financial institution provides some measure of comfort about the probity of the money exchange dealer. Also, because banks are mandate to report any suspicious transactions involving client accounts, this measure provides additional oversight criteria. The money exchange dealer must provide the bank the authority to communicate with the central bank directly when providing the reference letter.
- **Charge reasonable fees for its services:** The cost of making funds transfers into and around Afghanistan average 0 to 2 percent. However, as is common with every bazaar in South Asia, the final quotation depends on the negotiating skills of both parties and their understanding of how the market operates. Some money exchange dealers quote a flat fee of 2 percent on both international and domestic transactions. Yet, this is usually only a starting point for discussion. Discounts and premiums are offered and charged depending on the volume of the transaction, the financial relationship with the relationship, currency of exchange, security environment in Kabul and the destination of funds. The larger international organizations transferring US\$200,000 or more per month pay less in fees than the local NGOs transferring US\$7000 or less per month for their administrative expenses.

## *Annex 2 Sample Operational Procedures for Conducting hawala Transactions*<sup>16</sup>

Non-governmental organizations and international agencies that use the *hawala* system are keen to ensure that all hawala transactions include sufficient information to ensure an effective ex post field review of documentation. Adequate documentation is often required be maintained to permit verification and comparison of the financial services provided and payments made by the operator. To that effect, users apply a variety of operational procedures, some of which include the following:

- **Obtain a written document stating the following: (1) amount to be transferred; (2) funds transfer destination; (3) currency or currencies used for the transaction; (3) expected date of payment, and; (4) fee chargeable for the transaction:** Each hawala dealer designs, develops and maintains their own documentary policies and procedures. Some of the procedures have been in use for many years and adapted to the changing business environment. Each business develops adequate systems that are sufficient for keeping track of transactions and balancing their accounts with international and domestic correspondent partners.
- **Establish monetary limits for individual transactions which reflect: (1) capacity of the money exchange dealer; (2) security situation at the origin and the intended destination of the funds, and; (3) capacity of the recipient to maintain cash holdings on their premises:** Because there are limited storage facilities in Kabul for large sums of money, most organizations remit funds through the hawala system in smaller amounts of US\$100,000–US\$200,000. The smaller organizations regularly remit US\$20,000 – US\$30,000 to meet operational expenses.
- **Agree that the remitter will only pay the Hawala service provider after (1) the correspondent hawala service provider has made payment of the agreed amount to the intended recipient, and; (2) The recipient has acknowledged receipt of the funds. The confirmation of receipt must be both verbal *and* in writing (Fax or e-mail):** The hawala system is extremely reliable. Seldom do dealers fail to effect payment. Besides the expected high standard of adherence to codes, default risk has been eliminated through the “confirmation-before-payment” process. In all cases reviewed during the study, the remitter is only paid the hawala dealer the value of the funds remitted after the recipient had confirmed receipt of the money. There was 100 percent satisfaction rate with the delivery of funds. The isolated incidents of client dissatisfaction were limited to occasions when the customer paid a slightly higher fee than competitors were offering.
- **Agree that, with the exception of small transactions, all financial transactions must be conducted in a secure location, preferably on the premises of the remitting and recipient organization.** Carrying large amounts of cash around Kabul is not advisable, especially in a busy open market. Hawala dealers are often willing to come to the premises of the use to collect/pay funds from/to the user/recipient.

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<sup>16</sup> Source: Author interviews

## **Agreement between Ismail Zaman Relief Fund Afghanistan And Hassan Radwan Money Exchange**<sup>18</sup>

This contract is drawn up between Ismail Zaman Relief Fund and Hassan Radwan Money Exchange desiring to set forth the following understanding that will govern supplying of US\$, Pakistan rupees and afghanis to Ismail Zaman Relief Fund. As crossing the border is still an unresolved issue, it was agreed through both sides that the payment will be done in Peshawar office based on electronic communication system, that is fax plus password file for confirmation.

### **Responsibilities of Hassan Radwan Money Exchange**

1. To provide Ismail Zaman Relief Fund offices with afghanis, Pakistani rupees and USD in 6 hours from Kabul and within 12 hours for the respected provinces after requisition through Ismail Zaman Relief Fund as:
  - For Kabul office: a) by faxing through Ismail Zaman Relief Fund, with commission of 0.65 percent.
  - For Ghazni office: a) by faxing through Ismail Zaman Relief Fund, with commission of 2.0 percent
  - For Logar office: a) by faxing through Ismail Zaman Relief Fund, with commission of 1.0 percent
  - For Gardez office: a) by faxing through Ismail Zaman Relief Fund, with commission of 2.0 percent
2. To provide Ismail Zaman Relief Fund with exchange rate of afghanis/Pakistan rupees equal or higher than the Money Changers in the open currency exchange market. Hassan Radwan will be requested to observe collection of exchange rate quotations through Ismail Zaman Relief Fund key staff.
3. To inform Ismail Zaman Relief Fund about any problem, which may cause delay in, the cash being delivered beyond 24 hours of the time of requisition.
4. In the case of cash being provided late (i.e., more than 24 hours after being requested despite Hassan Radwan signing that he will provide the money), than, the exchange rate offered will be revised again (at the time of delivery). If the second exchange rate is unfavorable to Ismail Zaman Relief Fund, then Hassan Radwan should agree to provide at the original agreed rate.
5. The bank notes that are provided must be legal tender and must not be damaged.

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<sup>17</sup> Source: NGO in Afghanistan.

<sup>18</sup> Names of parties have been changed for reasons of confidentiality.

6. Invalid/damaged notes of all types of currencies should be changed with newer ones.
7. In case Hassan Radwan can not provide the amount Ismail Zaman Relief Fund wants, he should submit something in writing to care stating his excuse based on which Ismail Zaman Relief Fund can ask the second money dealer to provide the needed amount onwards.

**Responsibilities for Ismail Zaman Relief Fund**

1. To request money from Hassan Radwan 6 hours in advance for Kabul and 12 hours in advance for different provinces of the time being required informing Hassan Radwan of the exchange rate to be used.
2. Reimbursement of the same amount plus commission charge as mentioned in the first item of Hassan Radwan’s responsibilities.
3. IF the money paid to Ismail Zaman Relief Fund is in Rupees and Afghanis, then the refund will be in Pakistani rupees and if the money paid to Ismail Zaman Relief Fund is in USD, then the refund will be in USD.
4. Ismail Zaman Relief Fund faxes the receipt documents to its main office in Peshawar and it bears the fax charge too.
5. Ismail Zaman Relief Fund will undertake to count the money it received as quickly as possible.

**General**

This contract will remain valid for three months effective from signing date onward. If either party wishes to change the contract, then, they must inform each other in written notice at least three weeks in advance by either side. This contract will be extended with the same terms and conditions when both sides agree after the validation of the contract.

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**For Ismail Zaman Relief Fund Afghanistan**

**Name:**  
**Title:**  
**Date:**

**For Hassan Radwan**

**Name:**  
**Title:**  
**Date:**

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***Annex 4 Financial Action Task Force on Money Laundering Special Recommendations on Terrorist Financing<sup>19</sup>***

Recognizing the vital importance of taking action to combat the financing of terrorism, the FATF has agreed these Recommendations, which, when combined with the FATF Forty Recommendations on money laundering, set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts.

***I. Ratification and implementation of UN instruments***

Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.

Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.

***II. Criminalizing the financing of terrorism and associated money laundering***

Each country should criminalize the financing of terrorism, terrorist acts and terrorist organizations. Countries should ensure that such offences are designated as money laundering predicate offences.

***III. Freezing and confiscating terrorist assets***

Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism and terrorist organizations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.

Each country should also adopt and implement measures, including legislative ones, which would enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organizations.

***IV. Reporting suspicious transactions related to terrorism***

If financial institutions, or other businesses or entities subject to anti-money laundering obligations, suspect or have reasonable grounds to suspect that funds are linked or related to, or are to be used for terrorism, terrorist acts or by terrorist organizations, they should be required to report promptly their suspicions to the competent authorities.

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<sup>19</sup> Source: <http://www.fatf.org>

## ***V. International co-operation***

Each country should afford another country, on the basis of a treaty, arrangement or other mechanism for mutual legal assistance or information exchange, the greatest possible measure of assistance in connection with criminal, civil enforcement, and administrative investigations, inquiries and proceedings relating to the financing of terrorism, terrorist acts and terrorist organizations.

Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts or terrorist organizations, and should have procedures in place to extradite, where possible, such individuals.

## ***VI. Alternative remittance***

Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

## ***VII. Wire transfers***

Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain.

Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).

## ***VIII. Non-profit organisations***

Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Non-profit organizations are particularly vulnerable, and countries should ensure that they cannot be misused:

- i. by terrorist organizations posing as legitimate entities;
- ii. to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; and
- iii. to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations.

*Annex 5 Abu Dhabi Declaration on Hawala (May 2002)*<sup>20</sup>

At a conference on hawala in the UAE in May 2002, a number of governments agreed to adopt the FATF recommendation and shortly thereafter the UAE government announced it would soon impose a licensing requirement on hawalas. Participants at the UAE meeting drafted and agreed upon the Abu Dhabi Declaration on Hawala which set forth the following principles:

- Countries should adopt the 40 Recommendations of the Financial Action Task Force (FATF) on Money Laundering and the 8 Special Recommendations on Terrorist Financing in relation to remitters, including Hawalas and other alternative remittance providers.
- Countries should designate competent supervisory authorities to monitor and enforce the application of these recommendations to Hawalas and other alternative remittance providers.
- Regulations should be effective but not overly restrictive.
- The continued success in strengthening the international financial system and combating money laundering and terrorist financing requires the close support and unwavering commitment of the international community.
- The international community should work individually and collectively to regulate the Hawala System for legitimate commerce and to prevent its exploitation or misuse by criminals and others.

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<sup>20</sup> Source: Conference proceedings.

*Annex 6 World Bank-IMF Conclusions on Hawala Systems*<sup>21</sup>

- **Historically, Informal Funds Transfer (IFT) systems are relatively commonplace.** Despite the different terminology ascribed to IFT systems—fei-ch'ien (China), hui kuan (Hong Kong), hundi (India), hawala (Middle East), pedal (Philippines), and phi khan (Thailand)—their growth is primarily found in the monetary facilitation of trade between distant regions at a time when conventional banking instruments were either absent or weak. Over time, the operational features of speed, low cost, and cultural convenience, versatility, and potential anonymity led to their use for various legal and illegitimate remittance purposes.
- **Informal hawala systems have typically thrived in jurisdictions where the formal banking sector is either absent or weak, or where significant distortions exist in payment systems as well as foreign exchange and other financial markets.** Generally, except for cases where the purpose for using the informal sector is of an illegal or criminal nature, the growth of informal funds transfer systems seems to be negatively correlated to the level of development and liberalization of the formal financial sector. The study found that these systems are more likely to be prevalent in jurisdictions where the formal banking sector is either virtually absent or not functioning, as is sometimes the case in conflict afflicted countries, or does not provide a reliable, cost effective and convenient mechanism for the transfer of funds. Where these conditions exist in recipient countries, the system can be particularly used for migrant labor remittances, humanitarian, emergency, and relief aid in countries experiencing conflict. The attraction of informal operators is also likely to be heightened in countries where inefficient banking institutions operate in an environment of financial policies that include foreign exchange controls.
- **Illegitimate use of the informal hawala system could occur regardless of the level of development of the financial sector.** In cases where the intent of the user is of an illegal or criminal nature, the use of informal financial systems will occur irrespective of the level of financial sector development in the country. While both the formal and informal financial sectors are vulnerable to abuse, the potential anonymity that the system offers the users renders it susceptible to smuggling activities, capital control circumvention, customs, excise and income tax evasion, money laundering, and terrorist financing operations. These crimes are not new and law enforcement agencies have long been concerned about informal financial mechanisms. For financial sector regulators, however, legislation against financial crimes is a relatively recent phenomenon. In drafting new international standards against financial crimes—registration, licensing, reporting and record keeping requirements—financial authorities also need to consider the settlement process between hawala operators and the economic and regulatory implications of hawala-type systems.
- **The nature of the settlement process of hawala transfers has implications for economic and regulatory policies.** Developing appropriate responses to IFT systems requires a clear understanding of both the remittance and settlement analytics.

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<sup>21</sup> Source: El Qorchi, M., Maimbo, S., & Wilson, J. (2003).

Essentially, the accounting details of these informal transactions are similar to other kinds of international payments, including those that go through the banking system. Like the informal hawala system, banks do not necessarily move physical cash between branches or correspondent banks when effecting transfers. The main difference between hawala and formal institutions is that the subsequent settlement of hawala accounts usually remains outside formal operating channels that are regulated by national authorities.

- **Because informal hawala transactions are unrecorded in national accounts and other statistics, the data available to policymakers would not offer an accurate description of the economic and monetary situation of a country and would tend to limit the effectiveness of their policies.** A hawala transaction is a balance of payment transaction, not because “money is sent” across borders or there is any recorded purchase or sale of foreign exchange, but because the transaction is intrinsically linked to changes in international assets and liabilities. However, while hawala and other IFT transactions are conceptually part of national BOP accounts, accurate compilation is almost impossible. Nevertheless, even though national authorities are unable to directly maintain records of informal financial transfers, the indirect effects of these transactions on monetary aggregates and operations, as well as on the balance of payments, should be taken into consideration. The system reduces the amount of statistical information available to policymakers on the level of economic activity in the country.
- **IFT systems have fiscal implications for both remitting and recipient countries.** First, hawala operators are typically not taxed. The revenue collection structures required for informal financial business do not exist. Second, the business activities of IFT users are also likely to evade direct and indirect taxation. Third, since the settlement of accounts between hawala operators may include under-invoicing and smuggling of goods and services, the government may also incur losses in its customs and excise duty income.
- **IFT transactions cannot be reliably quantified** since accessible records are scarcely available for statistical or BOP purposes. Despite this limitation, certain considerations can be made of the dimensions of IFT transactions, and there are some approaches to quantification that can give indicative results. While these results are rough simulations, they indicate that the monetary and fiscal implications of IFT systems remain significant.
- **Current regulatory and supervisory practices vary between hawala-recipient and hawala-remitting countries.** Overall, the study found distinct differences in the regulatory and supervisory responses toward the informal hawala system between recipient and remitting countries. In recipient countries, concerns over foreign exchange management, capital movements, the quality of the formal financial sector, and the level of political stability have been important influences on the regulatory attitude towards the system. 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 from concerns about their potential criminal abuse and terrorist financing.

- **Emerging approaches to international standards need to sufficiently take into account specific domestic circumstances.** In the wake of the recently heightened concerns that money launderers and terrorist groups use IFT systems, the number of national and international regulatory initiatives to license or regulate their activities has increased. A number of countries have decided that the potential anonymity characterizing these systems presents risks of money laundering, terrorist financing, and other law enforcement concerns, which preclude a policy of benign neglect. This said, the paper cautions against the application of emerging international standards without due regard to specific domestic circumstances. Developing international regulatory and supervisory standards for informal funds transfer systems is a complex process. Differences in the stages of economic development in general, and the financial sector in particular, imply that national regulators need to give careful consideration to country-specific circumstances and national legal systems.
- **Regulators must bear in mind that prescribing regulations alone will not ensure compliance.** Regulations are not a panacea for possible abuse of the IFT systems. Specifically, regulators need to possess the appropriate supervisory capacity to enforce the regulations. Also, they must bear in mind that experience shows that restrictive methods will not drive out all businesses involved in unlicensed financial transfer activity from the market. The informal banking system can not be completely eliminated by means of criminal proceedings and prohibition orders. Policy-makers should acknowledge the existence of practical reasons, from the customer's point of view, to resort to these methods rather than formal banks for international payment purposes. As long as such reasons exist, the hawala and other IFT systems will continue to exist.
- **For purposes of long-term financial sector development, addressing the potential risks of financial abuse and criminal activity requires a two-pronged approach.** In the majority of countries, where IFT systems exist alongside a functioning conventional banking sector, it is recommended that hawala dealers be registered. In these systems, additional efforts should be made to improve the level of transparency by bringing them closer to the formal financial sector without altering their specific nature. Simultaneously, the regulatory response must address the weaknesses that may exist in the formal sector. The formal and informal financial systems benefit from their mutual deficiencies and each tends to expand when the condition of the other is impaired. High transaction costs, long delays in effecting money remittances, exchange controls and overly bureaucratic policies and procedures for simple money transfers in the formal system are major incentives for the existence of the informal financial system. To face the challenge, the formal sector should tackle its deficiencies and enhance its competitiveness. In conflict-afflicted countries with no functioning banking system, imposing requirements beyond basic registration may not be feasible because of the lack of supervisory capacity.

- Clearly, the development of various informal funds transfer systems over many years and across many countries points to the important role that these systems can play in the absence of a robust and efficient formal financial sector. However, risks of misuse exist considering the informal nature of these systems, particularly anonymity and lack of records. The development of the ability of the formal financial sector to respond to the legitimate market demand for hawala-type transactions, coupled with prudent regulatory policies for hawala operators, requires sound and sustainable macroeconomic policies, a well-developed payments system, and a healthy financial sector. Notwithstanding the progress apparently made by the formal sector in expanding its activity at the expense of informal activity, these gains are not definitive and can easily be reversed. Poorly functioning financial systems or just the deterioration in financial or macroeconomic conditions could pave the way for greater recourse to informal payment systems. A setback in financial and exchange liberalization or the rise in the exchange spread between official and parallel market exchanges can always induce a greater use of the IFT activity.
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