



# Regulatory Frameworks For Hawala and Other Remittance Systems

Monetary and Financial Systems Department

The background of the cover features a collage of various international banknotes, including Euro, Indonesian Rupiah, and Swedish Kroner, overlaid with a world map. The map is rendered in a textured, golden-brown style with white lines indicating flight paths or remittance routes.

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## Foreword

**H**awala and other remittance systems have gained attention in past years with the substantial growth of remittance flows from countries with large migrant labor forces and with increased focus on combating both money laundering and the financing of terrorism.

In May 2002, the government of the United Arab Emirates, under the leadership of the Central Bank of the U.A.E., pioneered this area with the First International Conference on Hawala. The International Monetary Fund welcomed that the government of the U.A.E., again with the leadership of the Central Bank, organized a second conference in April 2004, and that the IMF has been able to collaborate with the U.A.E. in its organization.

The IMF and the World Bank have been researching hawala and other remittance systems since 2002 to better understand the significance of informal remittance systems and the interplay of historical, cultural, and economic factors that promote such systems. The IMF especially has been working on developing operational guidance for regulating both the formal and informal remittance sectors.

The Second International Conference on Hawala resulted in a conference statement that identified the challenges of implementing a regulatory framework for remittance systems. The conference participants concluded that there was a need to gather and analyze information on remittance systems and their operations and to conduct outreach to raise the regulated community's and the public's awareness of remittance issues.

The Monetary and Financial Systems Department of the IMF developed these proceedings of the Second International Conference on Hawala to promote outreach. Readers will find several articles on regulatory frameworks in remitting and receiving countries and some general articles on the problems that can arise when regulating remittance systems. I hope that this collection of articles will function as a survey of regulatory practices and an overview of experiences in different countries.

Stefan Ingves

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*Monetary and Financial Systems Department, IMF*



# 1

## Work of the IMF in Informal Funds Transfer Systems

R. BARRY JOHNSTON

### Background

The First International Conference on Hawala, hosted by the government of the United Arab Emirates under the leadership of the Central Bank of the U.A.E. in May 2002, was a groundbreaking event that produced the Abu Dhabi Declaration on Hawala. The IMF was very pleased that the government of the U.A.E., again with the leadership of the Central Bank, collaborated with the IMF to organize this second conference.

The IMF has been working on enhancing the integrity of the financial system for some time now. However, like many other organizations, we have turned our attention to informal funds transfer (IFT) systems relatively recently. In 2002, we began a research project with the World Bank to better understand IFT systems. The results were published in early 2003 as *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*.<sup>1</sup> This work helped us to better understand the significance of the informal hawala system and the complexity of historical, cultural, and economic factors that promote such systems. The following are some highlights of that analysis.

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<sup>1</sup>Mohammed El Qorchi, Samuel Munzele Maimbo, and John Wilson, 2003, *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, IMF Occasional Paper No. 222 (Washington: International Monetary Fund).



- In countries where financial capacity is limited, IFT systems fill a critical gap.
- IFT systems can have economic implications. In countries where large volumes of transactions are channeled through such systems, they could have macroeconomic consequences.
- Certain characteristics of IFT systems, including anonymity and lack of official scrutiny, make them susceptible to use by criminals for money laundering and terrorist financing.

These features make such systems relevant to the work of the IMF as part of our macroeconomic and financial sector surveillance, and as part of technical assistance to help strengthen countries' economic systems. The IMF is compiling additional information on the significance and operation of IFT systems to understand the systems better and to be ready to advise countries, where needed, on how to upgrade and enhance regulatory and supervisory frameworks for IFT systems.

## IMF Goals

The Second International Hawala Conference provided a unique opportunity to document the regulatory practices and procedures adopted by various countries, to discuss their merits, and to begin to develop a statement of good regulatory practices for IFT systems. Following broader consultation and outreach, the IMF will develop operational guidance on regulating the informal sector, which will be used in discussions with members and to inform our technical assistance and advice. This publication of the hawala conference proceedings will promote outreach and function as a survey on the regulatory practices in a number of countries.

Important work in developing the approach to regulating IFT systems has already been done. The Abu Dhabi Declaration on Hawala of May 2002 provided a road map on how to proceed. The Financial Action Task Force (FATF) on money laundering adopted a recommendation on alternative remittance systems. Special Recommendation VI is one of the eight special recommendations on terrorist financing that were adopted in October 2001. The FATF subsequently developed an *Interpretative Note to Special Recommendation VI: Alternative Remittance Systems* (February 2003) and a best practices paper, *Combating the Abuse of Alternative Remittance Systems: International Best Practices* (June 2003), based on the findings of the Asia/Pacific Group on Money Laundering. The Asia/Pacific Group also produced an implementation package for the regulation of

alternative remittance systems. The IMF has adopted FATF's 40 recommendations plus the 8 special recommendations as standards important to our operational work.

The IMF is aware that countries have adopted a variety of approaches to supervising and regulating informal funds transfer systems and that, in developing effective responses and advice, it must understand local circumstances. In short, there is a very practical issue to confront: how to implement the international standards, which are to some extent aspirational, in ways that take account of local circumstances and can result in more effective oversight. The 2002 Abu Dhabi Declaration on Hawala highlighted the undesirable consequence of overregulation—that it could drive the IFT providers further underground. The task before us is no mean challenge, made more difficult by the imperfect knowledge of the operation of the IFT systems. Therefore, the IMF places a high premium on consulting and cooperating with countries to learn from their experiences, which can guide the implementing practices and procedures.

## **Perspective on Regulation**

From the IMF's perspective, the following are some factors the international community should reflect on when designing regulatory and supervisory systems.

First, the regulatory structure should be appropriate and commensurate to the risks. These risks have been difficult to quantify in view of our limited knowledge of IFT systems and the extent to which those systems are exploited by criminals.

Second, although in past years IFT systems have come under scrutiny for terrorist financing and money laundering, we must not lose sight of the reality that remittances are very important to migrant workers who send money home and that IFT systems represent an important source of income for some countries.

Third, informal systems are very difficult to regulate without driving the systems further underground. The international community will need to demonstrate to those who operate and participate in such systems that the benefits of regulation will outweigh the costs. In the jargon of economics, the regulations will need to be incentive-compatible, and their design will require engagement with the private sector.

Fourth, the international community needs information to design good supervisory and regulatory practices that can take account of local circum-

stances. The regulatory frameworks that are already in place in some countries should help generate such information.

Fifth, regulation should not be considered the panacea that will prevent the misuse of IFT systems. The international community will need to use multiple approaches, including promoting the formal sector in fund transfers, as several countries have done successfully.

Sixth, we need to specifically acknowledge the difficulties of implementing effective regulation in conflict-afflicted countries.

## Structure of the Conference Panels

At the Second International Conference on Hawala, we were very fortunate to have an internationally diverse and knowledgeable group of panelists: standard setters and representatives from the international organizations, hawala remitting and hawala receiving countries, academia, law enforcement, and the private sector. In addition to the panelists, the audience included many distinguished experts and practitioners from whose comments and questions we all learned.

Three panels discussed the experiences of countries that receive funds predominantly by means of the IFT systems. In recipient countries, concerns over foreign exchange management, capital movements, and the quality of the formal financial sector have been important influences on the regulatory attitude toward IFT systems. These countries' experiences in regulating and in promoting the formal sector were critical. In addition, it was interesting to hear views on the approach to regulation in conflict-afflicted countries such as Afghanistan and Somalia.

One panel discussed the experience of hawala remitting countries. Such countries generally have fairly liberal foreign exchange policies and developed financial sectors. In those countries, the regulatory and supervisory interest primarily stems from concerns about the funds' potential criminal misuse and about terrorist financing.

The conference also had panels for law enforcement and the private sector. The private sector is in the best position to advise on the commercial effects of different approaches to regulation and on the likely response of the IFT systems. It was interesting to hear that some business associations represent the collective views of the hawaladars (hawala dealers) from certain regions or ethnic communities and could be partners in future discussions. From law enforcement representatives, it was interesting to hear to what extent hawala is used for criminal purposes in their own countries and their perspective on the effect of the regulations in place in their countries.

## Elements That Will Need to Be Considered

The Abu Dhabi Declaration of the First International Conference on Hawala and the best practices paper on FATF Special Recommendation VI already outline the elements that need to be considered in designing a regulatory framework for IFT systems. However, some issues remain to be studied.

- *Licensing or registration requirements.* What is the rationale for choosing either a registration or a licensing regime, or for following a policy of prohibition of IFT systems? What are the practical experiences relating to the merits of choosing one regulatory regime over another?
- *Due diligence of owners and managers.* One of the goals of regulating IFT systems is to ensure that criminals do not own or manage an IFT agency. A competent authority should be designated to perform a fit-and-proper test. The question is, what should constitute the minimum elements of a fit-and-proper test that could have wide application for diverse country circumstances? For example, to what extent should a registration system also involve elements of due diligence?
- *Implementation of anti-money laundering regulations for customer identification, record keeping, and reporting of suspicious transactions and counterterrorist finance regulations.* It is important to identify practical approaches to implementing regulations to combat money laundering and the financing of terrorism in IFT systems, whether direct or phased in as a country's overall anti-money laundering capacity develops. What "second best" approaches could be followed that address the critical risks while the broader capacity to implement the international standards is being developed?
- *Compliance monitoring and sanctions.* How have countries gone about monitoring compliance with IFT regulatory systems? What are the merits and costs of having continuous compliance monitoring compared with reactive monitoring when specific problems are identified? Are there any pointers on where it is best to locate the compliance monitor (e.g., in the central bank or supervisory body or in law enforcement)? What has been the experience with self-regulatory compliance systems? Is there experience with adopting risk-based approaches to supervision of IFT systems? What has been the experience with sanctioning IFT systems; have transactions been driven underground?
- *Consumer protection.* What are the public sector's obligations to consumers once IFT systems are regulated, and how should those obligations be discharged? Should the authorities require transparency with

regard to the list of licensed and registered IFT systems and to fees and exchange rates?

- *Awareness-raising and training.* What has been the experience in building acceptance of the regulatory frameworks for IFT systems and in creating the capacity to implement the regulation?

This conference identified the challenges in implementing a regulatory framework for IFT systems and recommended steps to advance the work. It also advanced the participants' knowledge, the level of international collaboration, and the way forward on regulating IFT systems, and began to answer some of these and other questions.

The IMF already started developing operational guidance on how to supervise and regulate IFT systems. However, this will be an ongoing process in which we will collaborate with regulatory agencies and the private sector to gather information and identify good practices for a regulatory framework. Furthermore, the IMF will look into the specific problems facing developing countries in complying with supervisory and regulatory requirements for the IFT sector to combat money laundering and the financing of terrorism. We will present the results of our studies and hope to reach consensus on operational guidance on the best ways to regulate remittances in a Third International Conference on Hawala.