Seminar on Current Developments in
Monetary and Financial Law

THE REGULATION AND SUPERVISION OF INFORMAL REMITTANCE SYSTEMS: Emerging Oversight Strategies

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Introduction

Since October 2001, there has been a plethora of new laws, regulations, recommendations and best practice statements on the regulation and supervision of informal remittance systems. The text of most of these initiatives has been prepared in the context of prevailing anti-money laundering and terrorist financing concerns and thus contain provisions for the licensing or registration of remittance service providers, customer identification, suspicious transactions reporting and record keeping.

At the same time, there is growing recognition that in and of themselves, the emerging regulations are an insufficient tool for addressing with the phenomenon of informal remittance systems in both developed and developing countries. Recent research draws attention to the legitimate economic reasons for the existence of these systems. In the absence of formal financial systems in countries such as Afghanistan, and even the absence of government structures in Somalia, for example, leave migrant workers with little option but to resort to alternative means of supporting their family and relatives.

In the wake of the dual perspectives on the benefits and risks of informal remittance systems, the challenge for the development community, regulators and law enforcement agencies is to identify a way in which to design, develop and implement more effective regulatory and supervisory regimes that deal with the equally legitimate money laundering and terrorist financing concerns while at the same time facilitating and enhancing the development impact of informal remittances.

This paper is a review of the recent regulatory and supervisory economic literature on informal remittance systems and discusses the emerging differences in approach to dealing with this phenomenon. It gives examples of the different approaches, considers the rationale for them, and concludes by contending that a synthesis of the four approaches discussed in the paper is essential for the effective regulation and supervision of informal remittance systems.

Informal Remittance Systems

There are many terms used to describe informal remittance systems including, "alternative remittance systems," "underground banking," "ethnic banking," and "informal value transfer system." Geographically, the terms used to describe informal remittance systems include: —*fei-ch'ien* (China), *hundi* (Pakistan, Bangladesh), *hawala* (India and Middle East), *padala* (Philippines), *hui kuan* (Hong Kong), and *phei kwan* (Thailand).

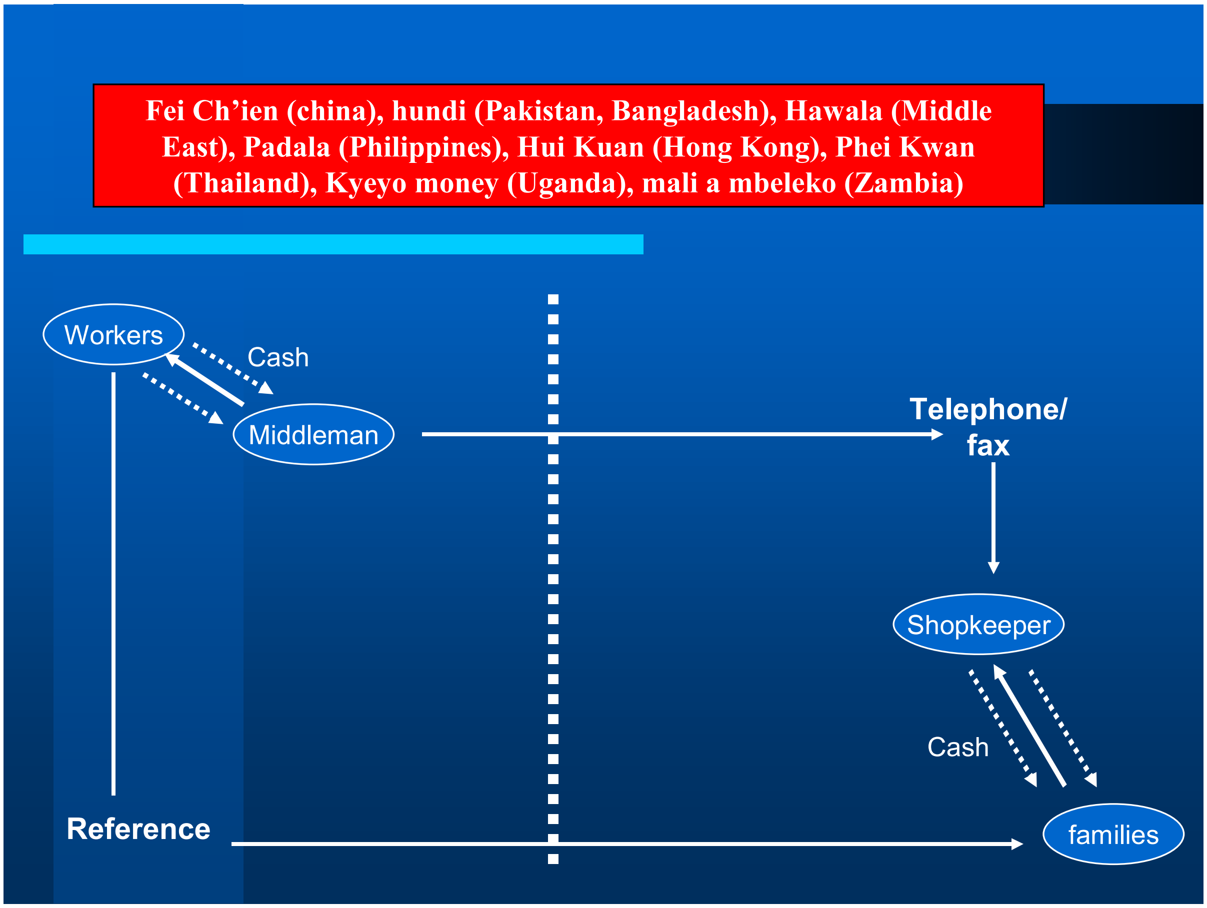
Despite the differences in terminology, the operational mechanisms of the various systems are fundamentally the same. For a basic informal remittance transaction to take place there needs to be a remitting party, two remittance service providers and a recipient (see Figure 1). When the remitting party, for example, a Somali migrant worker in Italy, wants to send money to Mogadishu, he makes payment in Euro or another convertible currency to a remittance agent or middleman in Rome. The service provider contacts a partner service provider counter party (who might be a shopkeeper in the receiving country, who arranges payment in local (or other) currency to the remitter's family or other beneficiary on the production of a pre-agreed reference.

As a form of identification for the transaction, the agent in the remitting country provides the remitter a code or reference which must be passed onto to his designated beneficiary for presentation to the agent in the recipient country (increasingly, a passport or national identification card is used by beneficiaries).

Once the funds have been paid to the recipient, the agent in the remitting country is indebted to the agent in the recipient country. The principals to the initial transaction do not play any role in subsequent clearing and balancing of this position. The agents can settle their positions in various ways; including simple transactions going in the opposite direction, cash deliveries, and settlement by cheques into the relevant accounts. Their positions can also be transferred to other intermediaries. These other entities can assume and consolidate the initial positions and settle at wholesale or multilateral levels, also by various means[2].

[2] For more details on informal remittance systems and how they work, including their economic and legal implications see Passas N. (2000), El Qorchi et al (2003), and Maimbo S. (2003)

Figure 1: The Basic informal remittance transaction



Highly trust-based, informal remittance systems have a long history of being reliable, inexpensive, speedy, accessible and a convenient way of transferring funds in Asia, where they are thought to have originated, and many other parts of the world following waves of immigration, using minimal or no documentary requirements. The element of trust is a defining characteristic of most informal remittance systems. Trust has ensured that rarely, if ever, customers lose their money. Informal dispute resolution processes among service providers have also made it an efficient payments system that attracted little interest or attention by regulators in developed countries until recently.

Unfortunately, the systems success – speedy transactions with minimal or no documentation has also been in undoing. The anonymity that is possible with transactions of this kind has long raised concern in the law enforcement community, in general. In some countries such as India, governments have been so concerned about the command abuse of these systems as to ban them completely. Concerned about the evasion of currency controls, developing countries in particular, have long been worried about informal remittance systems, but only worries about terrorist finance brought it to international regulatory focus after the September 11, 2001 terrorist attacks in New York and Washington.

It was inevitable that once journalists and others had made putative connections between the financing of terrorism and informal remittance systems, that calls for more effective regulatory and supervisory frameworks would follow.

Emerging Regulatory and Supervisory Strategies

The literature on regulating and supervising informal remittance systems is still in its infancy, and any categorization of that literature at this stage is necessarily for analytical purposes only. Practice is yet to confirm if this categorization is indeed a fair reflection of international and domestic experience. However, the more detailed analytical research must start somewhere. This paper is a contribution in that direction.

Legal and Prudential Regulation Strategy

In response to the concerns of linkages between terrorism and informal remittance systems spurned on by the events of September 11, 2001, the Financial Action Task Force (FATF) issued eight special recommendations aimed at combating terrorist financing, including one specifically addressing informal remittance systems. In Special Recommendation VI (FATF SP.IV), the FATF called on countries to either license or register informal remittance business and to subject them to all FATF recommendations that apply to banks and non-Banks.

"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".

Arguing that money or value transfer systems had shown themselves vulnerable to misuse for money laundering and terrorist financing purposes, the FATF issued FATF SP.IV with the objective of increasing the transparency of payment flows by recommending that jurisdictions impose consistent anti-money laundering and counter-terrorist financing measures on all forms of money/value transfer systems. Financial regulators began the process of re-examining existing regulations, and in some cases, designing, developing and implementing new financial regulations.

In June 2003, the FATF issued a Best Practices Paper for combating the abuse of alternative remittance systems in which it adopted a broad definition to transfer systems by adopting the term *Money or value transfer service* (MVT service), which refers to:

"a financial service that accepts cash, checks, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the MVT service belongs. Transactions performed by such services can involve one or more intermediaries and a third party final payment."

In a deliberate attempt to be inclusive of as many possibilities as possible, the paper also noted: that a MVT service may be provided by persons (natural or legal) formally through the regulated financial system or informally through entities that operate outside the regulated system; that in some jurisdictions, informal systems are frequently referred to as alternative remittance services or underground (or parallel) banking systems, and; that often these systems have ties to particular geographic regions and are therefore described using a variety of specific terms which include *hawala*, *hundi*, *fei-chien*, and the *black market peso exchange*.

The FATF further recommended that to maintain consistency with the obligations imposed on other financial institutions, jurisdictions should introduce transaction reporting in line with their current reporting requirements for financial institutions. Specifically, it recommended that:

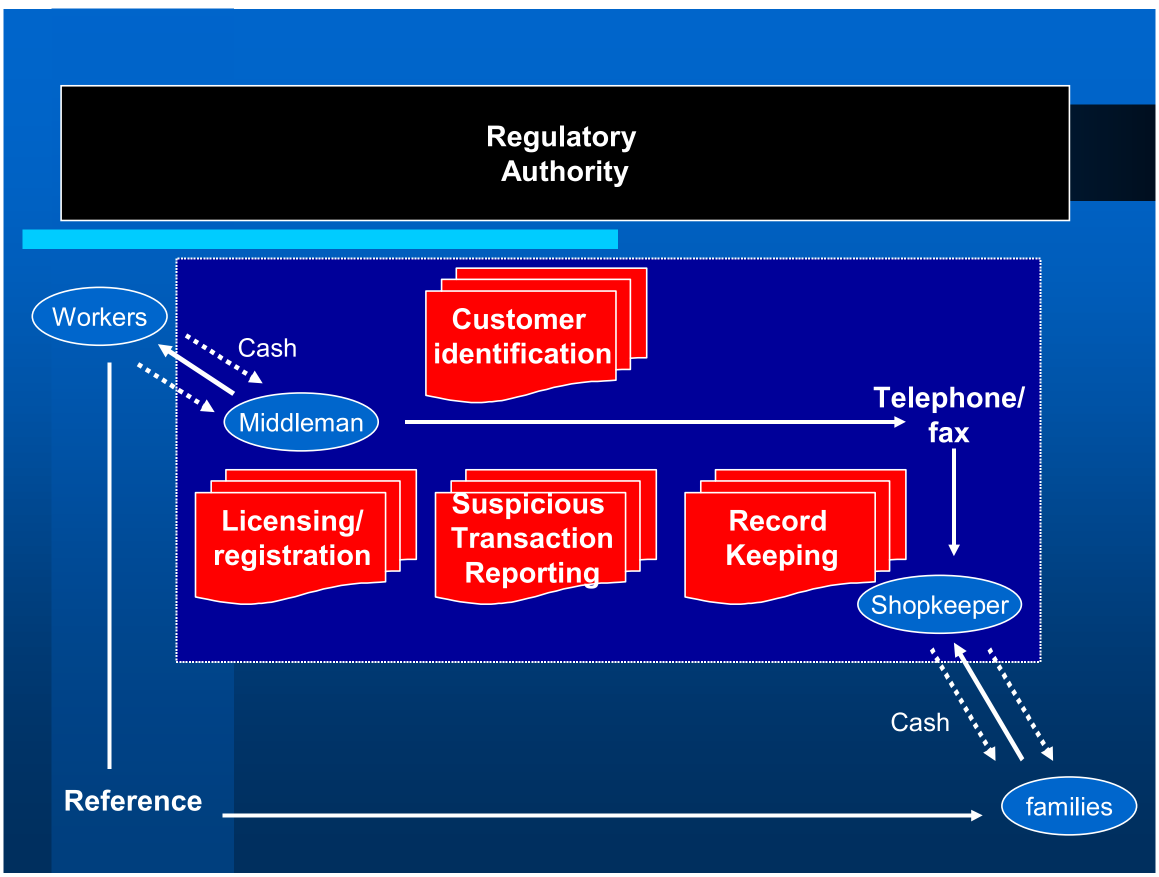
"Jurisdictions may consider issuing specific guidance as to what may constitute a suspicious transaction to the MVT service industry. Some currently used indicators of suspicious financial activity, such as those found in the FATF's Guidance for Financial Institutions in Detecting Terrorist Financing, are likely to be relevant for money/value transfer service activity. However, particular activities and indicators that are unique to this sector should be further developed.

The second half of FATF's Special Recommendation VII on Wire Transfers should also be taken into account when developing guidance in this area. For example, operators that receive funds/value should ensure that the necessary originator information is included. The lack of complete originator information may be considered as a factor in assessing whether a transaction is suspicious and, as appropriate, whether it is thus required to be reported to the Financial Intelligence Unit or other competent authorities. If this information is not included, the operator should report suspicious activity to the local FIU or other competent authority if appropriate."

The underlying rationale for recommending the regulatory instruments noted above is that licensing and registration will help isolate legal from illegal remittance service providers; that those who operate legally will report suspicious transactions enabling regulators to report terrorist financing activities, and other financial abuses, to law enforcement agencies.

As Figure 2 indicates, the legal approach to regulating and supervising informal remittance systems, seeks to superimpose existing formal financial sector regulatory and supervisory practices on an informal system. To its credit, the FATF has made it clear that in the application of its recommendations, supervisory agencies must be mindful of their own domestic circumstances. The objectives of the recommendations and best practices are to introduce a measure of transparency in the operation of these financial systems. Customer identification guidelines, licensing or registration requirements, suspicious transaction reporting procedures and record keeping standards are all aimed at reducing the financial abuse of systems that, rightly used can provide a valuable service to migrant workers.

Figure 2: The Legal and Supervisory Approach



This rationale begs the question – Can we target illegal acts perpetrated through informal remittance without affecting the numerous innocent customers who remit honest money back home to their family or unduly disrupting trade or harming legitimate enterprises?

Regulating informal remittance systems, it has been argued, may not be a solution as it does not address the primary apprehensions and concerns regarding its use for terrorist financing and assisting money launderers in the countries where it is intended to be 'regulated'. There is no guarantee that even after regulation, illegal transactions would not continue through other unlicensed operators. The legal approach may not even be practical as informal transfers involves cross-border transactions between two jurisdictions and while it may not be illegal in one country, it may be so in the other country and this would be a bar on regulation.

Further, there is often a complex web of transactions in the settlement of informal remittance deals between the originating and recipient countries unlike official bank to bank transactions and such settlements may not be amenable to 'regulation' in all the countries concerned. In view of these facts, some have argued that it may not be advisable to prescribe international standards for regulating and supervising remittance systems. Rather, that what was more important was a sector wide approach to the development of the financial sector as a whole.

Financial Sector Development Strategy

In their study of informal remittance systems El Qorchi, Maimbo and Wilson (2003) argued that the emerging legal approach to informal remittance systems needed to sufficiently take into account specific domestic circumstances. They cautioned against the application of the FATF Recommendations without due regard to specific domestic circumstances. Recognizing that Developing international regulatory and supervisory standards for informal funds transfer systems is a complex process, they called on regulators to note the differences in the stages of national economic development in general, and the financial sector in particular.

Regulators, they argued, had to bear in mind that prescribing regulations alone would not ensure compliance. Regulations were not a panacea for possible abuse of the informal remittance system. Specifically, regulators needed to possess the appropriate supervisory capacity to enforce the regulations. Further, El Qorchi et al (2003) emphasized that regulators had to 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 could not be eliminated by means of criminal proceedings and prohibition orders. Policy-makers had 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, informal remittance systems will continue to exist.

For purposes of long-term financial sector development, they therefore recommended that in the majority of countries, where informal remittance systems existed alongside a functioning conventional banking sector, it is recommended that informal remittance dealers be registered. In these systems, additional efforts should be made to improve the level of transparency by bringing the informal remittance systems 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 are major incentives for the existence of the informal financial system. To face the challenge, the formal sector had to 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 lack of supervisory capacity.

This strategy was not new. Buencamino and Gorbunov (2002) had earlier observed that over the years governments were introducing a number of incentive based and mandatory measures to encourage migrants to remit more through formal channels.

Commenting on the mandatory minimum remittance requirements introduced in Bangladesh, Republic of Korea, Pakistan and the Philippines they observed that mandatory measures were only successful where the government played an active role in the process by directly assisting local companies win contracts abroad. In turn, the local company deposited the all or portion of the employees earnings abroad in local banks.

Incentives rather than mandatory regulations had higher chances of success. Migrant foreign currency accounts and bands that are not subject to foreign exchange regulations, and, offering above market interest rate have been successful in Bangladesh, India, Pakistan and Vietnam. In other country such as Egypt, Poland and Turkey, premium exchange rates are for conversion of foreign currency into local currency.

Yet this approach to encouraging a shift from informal to formal, they conclude, has had mixed results. Primarily because these instruments largely attract professional and higher-skill categories of migrants who earn relatively high incomes and have funds for investments – A category of employees who are usually a minority of migrant workers.

It has been argued, Buencamino and Gorbunov (2002) note, that the best way to significantly reductive volume of informal transactions is the liberation of the economy. Social and economic stability, a low rate of inflation, positive interest rates, a stable and realistic exchange rate and reliable financial institutions are important elements in a migrants decision to remit through the formal channels than informal remittance systems. Referring to the O'Neill (2001) study of six major labor-exporting countries in NA and Europe, they make the case that a rise in black market premium by 10% results in a decline in official remittances by three percent. Doing away with dual and parallel exchange market they contend, is an effective strategy for diverting remittances into formal channels.

Institutional/Payments Systems Strategy

Buencamino and Gorbunov (2002) rightly argue that an effective strategy for attracting funds into the formal financial sector cannot be limited to macroeconomic and financial sector development strategy issues. Improving the ability of formal financial institutions to compete with the informal market is a requisite component.

Efficiency, costs, reliability, outreach, products offered and convenience are critical factors that migrants consider in determining a preferred remittance channels. Unless viable former sector options are available, exchange and interest rate based incentives are inadequate motives for formal sector remittance usage.

They conclude that reducing entry barriers proves a convenient means through which the increase private sector participation in the sector; increase competition, and ultimately the quality for formal sector remittance services. Banks and remittance companies have recently introduced new materials of settlement and delivery of-funds including: door-to-door services, language translation offers; money transfer services to undocumented workers; additional bank for recipients to allow ATM withdrawals.

This approach recognizes that the choice of remittance channel is fundamentally a payment systems issue. At it most basic level, a payment system is merely an agreed upon way to transfer value between buyers and sellers in a transaction. In developed economies, currency, checks and some electronic are used simultaneously (Humphey, 1995:4). In less developed economies, commodities and currency are dominant.

The key strategy here, is to expand the model distribution points for the payment system network – expanding bank/financial institution branches or at least money recipient points by partnering with other banks, postal services, microfinance institutions institutions and money transfer and exchange agencies (Buencamino and Gorbunov, 2002:10).
Technology has facilitated this approach by increasing the capacity of banks to offer ATM services and orphans. Referring to a recent study, B&G, 2002 contend that by 2006 ATM will likely 11 percent market share in global remittances against 0.2 percent in 2002. And critically, the pre of ATM in developing countries may lead to the emergence of a new generation of remittance companies competing with card based products a global level in order to benefit from economy of scale.

In an innovative study of the US-Mexico Remittance Corridor, the World Bank adopted this approach to improving the regulatory and supervisory environment for remittances. Having framed the study under the three operational stages of remittance transactions (Origination, System Operation and Distribution), the study concluded with a set of policy lessons and recommendations that have been discussed during the preparation of the paper with the countries involved.

In the Origination phase, the study noted that Mexican migrants have had better access to formal mechanisms, mainly through banks. This has been a key factor for the integration of Mexican migrants into the formal financial sector. The use of the Mexican consular identification card as a tool to access financial services, combined with higher levels of financial education among migrants, have also been key factors in facilitating an increased use of formal channels to remit funds.

At the Intermediary stage, (System Operation) increased competition, technology and innovative products have created a true market for system operators and transaction facilitators. Finally, at the Last stage (distribution), the study observed that distribution networks have expanded in urban and rural areas, streamlining remittance delivery and contributing to lower prices for remitters, and, more importantly, reliable delivery of funds to the recipient, which is a critical factor in the decision making process of the sender.

Further, in a country like Somalia, where there is no government and the regulatory and supervisory capacity is absent, both the institutional approach has to include empowering the private remittance institutions with self regulatory powers. Indeed, the Somali Remittance Association, with the aide of the United Nations Development Programme (UNDP) has already embarked on this path with the establishment of the Somali Financial Services Association on September 28, 2003 (KPMG, 2003). The UNDP has been engaged with the Somali Remittance sector to ensure the crucial flow of money remains open to Somalia despite the absence of a government and the closure of the largest remittance agency in November 2001.

Anthropological Approach

An interesting, but unexplored approach of regulating and supervising informal remittance system is the anthropological dimension. Reading the economic literature to date leaves one to conclude the choice between formal and informal channels is primarily and only an economic one – with adequate financial incentives, migrants will choose to remit through a bank instead of the local informal remittance system service provider. This might not always be the case.

Monsutti (2004), in his study of cooperation, remittances, and kinship among the hazarus, argues that economic funds transfer do not occur in an isolated sore, but rather are embedded in social relations. Funds transfers are both a means of survival and a way of structuring transnational Afghan society – a very efficient tool to reproduce social despite the war and dispersion of members of each domestic and solitary group.

Much is written about the levels of 'trust' associated with informal payment systems trust and ethnic culture are discussed in-. But there is little in the deconstruction of this trust. Efforts to understand this 'trust' in the economic literature are superficially attributed to kinship and ethnicity. In the anthropological literature, the sources of trust are not only examined in detailed and better explained, but also associated with the equally powerful emotions of rivalry, competition and jealousy with the same realm of kinship.

Monsutti (2004) for example, compares between multilateral kinship cross cousins (sons of a brother and sister) who are the persons of choice for borrowing money and for setting up joint , and multilateral parallel cousins (sons of two sisters) which are more , but seem to rarely be the basis for building commercial partnership, with patrilateral kinships. The later, he argues are structurally opposed to friendship and to some degree, to kinship and alliances. Through cooperative the level of trust is not the same.

Cooperation and trust, he explains do not automatically emerge from a given social tie. Rather one has to consider the social constructs surrounding matriarchal and patriarchal relocations, friends and external agents. And so it is with the remittance system (Figure 3). "The channels of migration and of funds transfers include four types of actors: (1) close relatives among whom solitarily and conflict are possible but along predictable lines; (2) distant relatives and friends who represent the people of choice for lending money or becoming business partners; (3) people from the same circle, or same ethnic or social background, who may be linked by the informal remittance system but who may not be engaged in a close economic partnership; (4) people from the host society with whom it is often to be in touch (smugglers, forgers and middlemen, etc.)

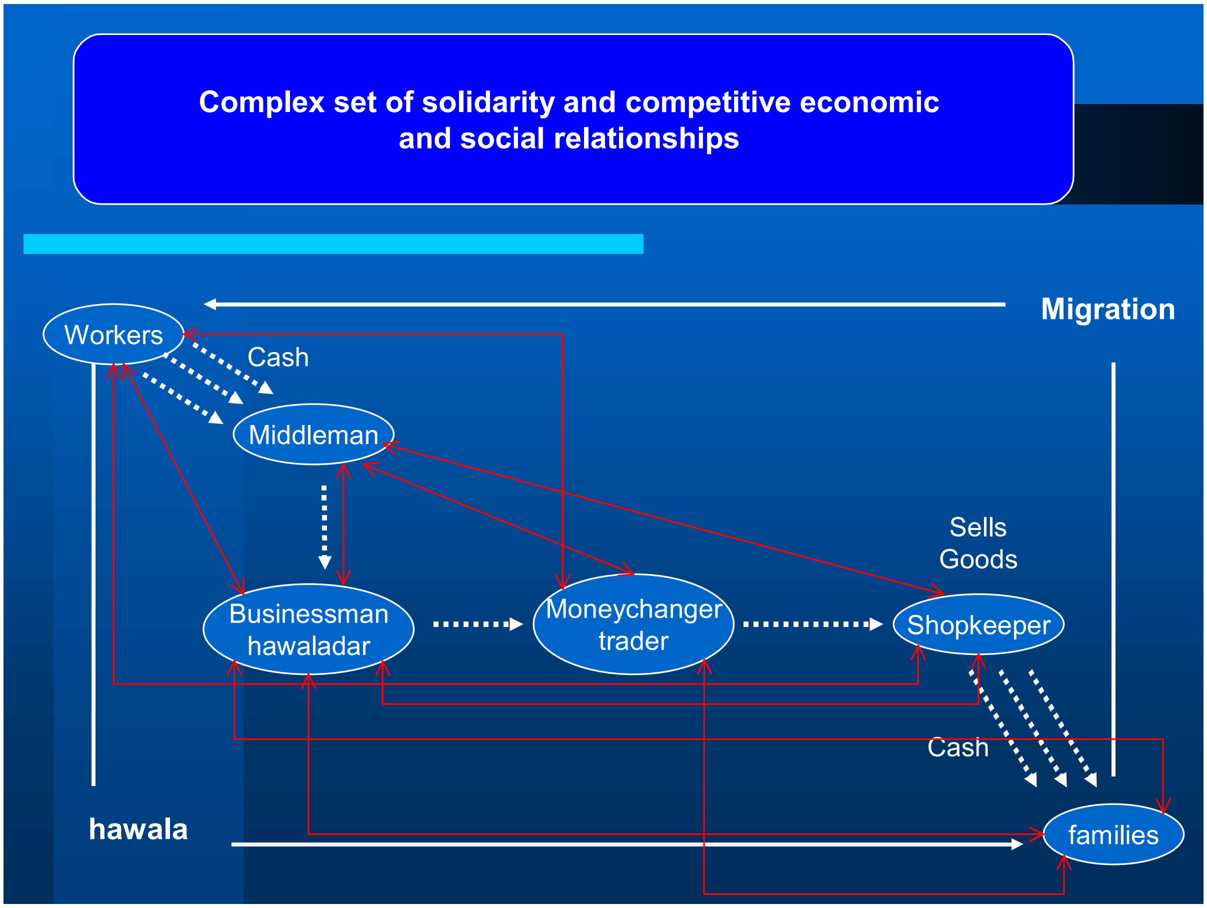
In his study of the Hazaru's, M (2004) that besides its economic significance the local remittance system has an even more important social dimension – it allows the reproduction of social ties despite insecurity and dispersion. The exchanges taking place through the circulation of people, documents, and money bring together religious, judicial, political, economic and family ties. The exchanges do not only satisfy material needs, but also produce and reproduce social ties. The relationship between material ties and social ties is reciprocal. He concludes, "The hawala system, a complex set of solidarity and completion relationships, explains how Afghan society, despite war and migration, has not collapsed into a hobbesian chaos."

In the Mexican context, social relations play a significant role in facilitating informal remittance transactions. Hernandez-Coss (2004) observed the decision to use and informal remittance channel over a formal one was influenced by personal relations, notably the following:

- Personal contacts are a key aspect of the informal remittance channels from Mexican migrants because they represent a personal social link back home as do Home Town Associations (HTA).
- The informal funds transfer systems operating between Mexico and the United States are primarily an extension of the larger cross-border social connections between migrants and their home communities in Mexico.
- Unlike IFT systems in other parts of the world that developed as result of facilitating trade, for example the *Hawala* system in the Middle East, the IFT systems between the United States and Mexico facilitate the movement of funds, as well as letters, food, and other nostalgic goods. Sometimes the channel through which funds are remitted informally involves the same contacts and people who facilitated the migration of the worker.
- Many of the HTAs are representative of a particular region of Mexico that has, over time, sent migrant workers into a particular U.S. city, where migrants have organized themselves into an expatriate community. Therefore, we observed "regional corridors" within the U.S.-Mexico corridor.
- The HTA represents a concerted effort to organize remittances in the United States for small-scale development projects in the home community in Mexico. According to Federation of Michoacan Clubs in Illinois, the personal and social link developed through the HTA gives migrants a way to stay involved in their hometowns, and, as a result, the HTAs have had some notable success stories.
- The *Michoacanos* that are in the US are still very connected with their community in Mexico, and in their minds, there is the hope to return to Mexico one day. They raise money among the immigrants to build public services in their communities in Mexico. The main public services that they build are: water pipes, collecting pipes, pantheons, churches, streets, etc. The funds for these building projects are normally transported to Mexico by hand, when someone from the community goes to Mexico to visit the family.

Regulatory and supervisory efforts need to take into account the social relations between individual families and the broader social communities. Well organized communities with clear objectives and money transfer mechanisms should be invited to discuss their regulatory and supervisory mechanisms, and if deemed adequate, invited to complement the efforts of an external regulatory agency.

Figure 3: Anthropological Strategy



Conclusion

Given the insufficient theoretical and practical experience with formal and informal remittance regulation and supervision warranted an incentive based regulatory approach rather than one based solely on direct-external regulatory interventions[3]

Now that the initial rush to regulate informal remittance system, with practice preceding a comprehensive theoretical debate and empirical research, is being balances by a boarder assessments of the regulatory implications, perhaps more effective strategies for dealing with the regulatory and supervisory challenges of informal remittance systems - the absence of transparent audit trails, difficulties in interpreting informal remittance records, and the practice of conducting remittance business as par of the other cash rich business – will emerge.

The regulatory community does not have an adequate understanding of these issues. There needs to be a concerted and systematic evaluation of the regulatory objectives and supervisory strategies, tools and mechanisms applicable to informal remittance systems. Consistent with my earlier work, regulators need to consider the legal, macroeconomic, institutional/payments systems and anthropological approach to regulating and supervising informal payment systems.

[3] This conclusion is explored in greater detail in Maimbo and Passas (2004)

The Hernandez-Coss (2004) study on the remittance channel between the United States and Mexico is best practice in this regard. Its recommendations cover the broad spectrum of the preferred combinations of policy actions. For example, three of the study recommendations include the following:

- **Legal**: The role that IFT systems play in filling a vacuum of financial services to the underserved should be appreciated and imitated by formal channels. IFT systems, by registering and licensing, can then move closer to "formalization" and experience the benefits of operating in a transparent market.
- **Institutional/Payments systems**: "Cajas", microfinance institutions and the BANSEFI network are important links in the chain for formal remittance systems to reach rural regions, and authorities should foster the development of these institutions. They act as a rural remittance distribution network that brings financial services to communities that have been disconnected from mainstream services.
- **Anthropological**: Formal channels would benefit from market strategies that consider the social nature of remittances for Mexican migrants, and adapt their products, services and branches to these considerations. These market strategies should consider "the corridors within the corridor": specific regions in the US where the remittances originate and those regions in Mexico where they are received.

Many central banks are making the effort. Often times, the central banks with a large volume of remittance activities are the very same ones with limited resources to meet the challenge. In some jurisdictions, such as Afghanistan and Somalia, the reforming the formal financial sector immediately offer active conflict is difficult enough; that undertaking to regulate the informal sector under such circumstances is doubly daunting.

In Afghanistan, for example, the challenge of regulating an informal system with a long history of independence and self-regulation in an environment where incentives for compliance are weakened by weakness of the legal and judicial framework for the prosecution of financial crimes; is self-evident. The challenge is further compounded by the complexity of investigating money laundering and terrorist financing crimes in a country with a significant economy and the emerging risk of a nexus of drug trafficking with terrorist/militant groups.

To these challenges, applying all three strategies discussed in this paper – legal, financial sector development, institutional/payments system and anthropological - is the most sensible approach. The markets simplicity, cost-effectiveness and convenience will ensure its survival for years to come. Informal remittance systems cost effectiveness and speed cannot, nor should they be regulated away. Instead, their transparency should be enhanced through the creative application of regulatory and supervisory standards that minimize the risk of financial abuse.

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