

THE HAWALA SYSTEM

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Abstract

The authors in their article review a well-known money transfer system in Middle-East and Asia. There is an alternative remittance channel that exists outside of traditional banking systems. The main focus of the article is why and how does the systems work in practice? Hawala or hundi is a method of transferring money without any real movement. Transactions between hawaladars or hawala operators are done without promissory notes because the system is heavily based on trust. One definition from Interpol is that Hawala is “money transfer without money movement.” Hawala originated in Asia during ancient times, and is used in many regions in the world today, especially in the Islamic community.

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What is hawala?

Informal funds transfer (IFT) systems are in use in many regions for transferring funds, both domestically and internationally. The hawala system is one of the IFT systems that exist under different names in various regions of the world. Hawala is a traditional and alternative Asian Remittance System in the Middle East, North Africa, South Asia and the Horn of Africa. Known as *hawala* in India, *hundi* in

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Pakistan, *fei qian* in China², *padala* in Philippines, *hui kuan* in Hong Kong, and *phei kwan* in Thailand.

The FATF³ (*Financial Action Task Force*) uses the following definition:

„Alternative remittance systems cover any system used for transferring money from one location to another and generally operating outside the banking channels. The services encompassed by this broad definition range from those managed by large multinational companies to small local networks. They can be of a legal or illegal nature and make use of a variety of methods and tools to transfer the money”.⁴

Origins of the word of hawala and hundi

The words hawala and hundi are both used, interchangeably and correctly. There is only one system, the usage “the hawala and hundi system” is incorrect. The correct usage is “hawala or hundi system”.

The word comes from the Arabic root *h-w-l*, which has the basic meaning “change” and “transform”. The word of hawala is defined as a bill of exchange or a promissory note. When the word came into Hindi⁵ and Urdu⁶ languages it retained the meanings, but it also gained the additional meanings “trust” and “reference”, which reflect the manner in which the system operates. The hawala operator is the *hawaladar* or *hawala operator*⁷.

The word hundi comes from the Sanskriti⁸ root meaning “collect”. In addition to this, it also has the same meanings as hawala. The hundi operator is the *hundiwala*.

Both terms are used.

² In China has another well-known system:” the „chop” or „chit” or flying money”, and also used around the world.

³ The Financial Action Task Force is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is therefore a ‘policy-making body’ that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas.

⁴ <http://www.fatf-gafi.org/dataoecd/16/8/35003256.pdf>

⁵ Hindi is one of the national language of India.

⁶ Urdu is the national language of Pakistan.

⁷ The term of „Hawala dealers „are used, too.

⁸ The liturgical language of Hinduism and the Persian of the Mughals, the Islamic rulers of India.

The history of hawala

Hawala is an ancient system originating in South Asia. Its origins in the classical Islamic law (Sh'aria) and is mentioned in texts of Islamic jurisprudence in early 8th century. Hawala itself later influenced the development of the operation in civil law.

Hawala is believed to have arisen in the financing of long-distance trade around the emerging capital trade centres in the early medieval period.

In early 20th century the hawala appears to have developed into a fully-fledged money market instrument, which was only gradually replaced by the instruments of the formal banking system. Today, hawala and "traditional" banking exist as parallel, but intertwined economic systems in India and Pakistan.

How does the system work?

Hawala systems involve the transfer of the value of currency without physically moving it. In fact "money transfer without money movement" is a definition of hawala that was used, successfully, in a hawala money laundering case.

An effective way to understand hawala is by examining a single hawala transfer:

"An initial transaction can be a remittance from a customer (CA) from country A, or a payment arising from some prior obligation, to another customer (CB) in country B. A hawaladar from country A (HA) receives funds in one currency from CA and, in return, gives CA a code for authentication purposes. He then instructs his country B correspondent (HB) to deliver an equivalent amount in the local currency to a designated beneficiary (CB), who needs to disclose the code to receive the funds. HA can be remunerated by charging a fee or through an exchange rate spread. After the remittance, HA has a liability to HB, and the settlement of their positions is made by various means, either financial or goods and services. Their positions can also be transferred to other intermediaries, who can assume and consolidate the initial positions and settle at wholesale or multilateral levels.

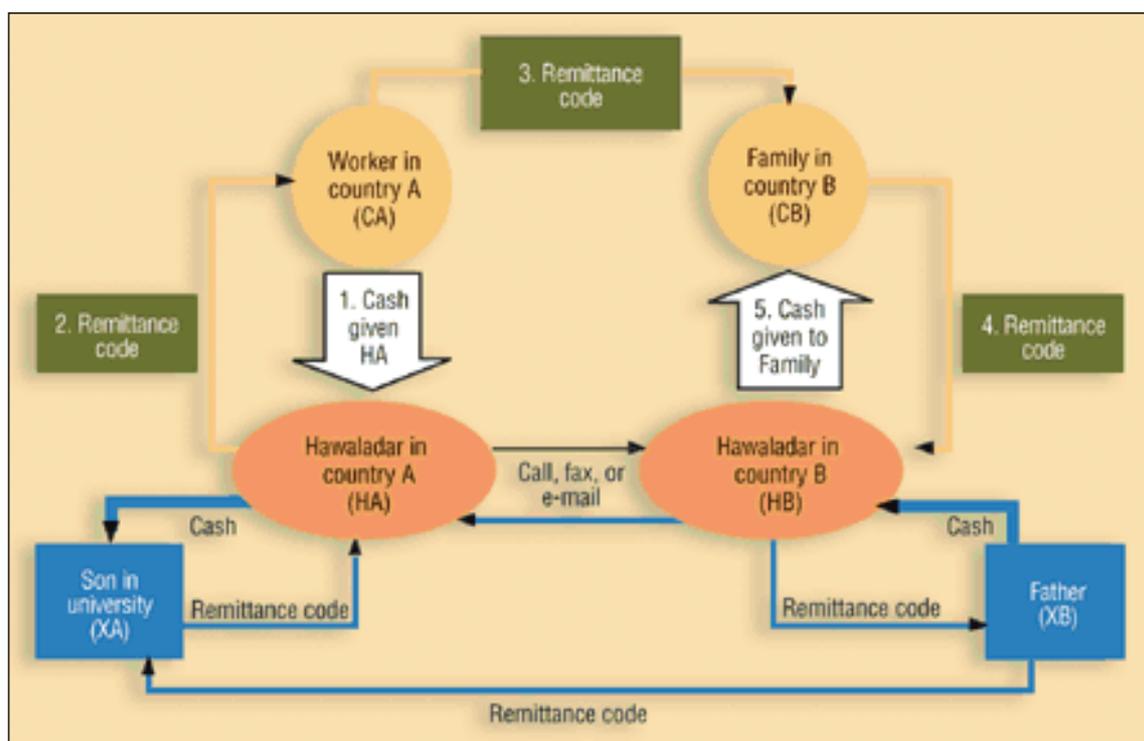
The settlement of the liability position of HA vis-à-vis HB that was created by the initial transaction can be done through imports of goods or "reverse hawala." A reverse hawala transaction is often used for investment purposes or to cover travel, medical, or education expenses from a developing country. In a country subject to foreign exchange and capital controls, a customer (XB) interested in transferring funds abroad for, in this case, university tuition fees, provides local currency to HB

and requests that the equivalent amount be made available to the customer's son (XA) in another country (A).

Customers are not aware if the transaction they initiate is a hawala or a reverse hawala transaction. HB may use HA directly if funds are needed by XB in country A or indirectly by asking him to use another correspondent in another country, where funds are expected to be delivered.

A reverse hawala transaction does not necessarily imply that the settlement transaction has to involve the same hawaladars; it could involve other hawaladars and be tied to a different transaction. Therefore, it can be simple or complex. Furthermore, the settlement can also take place through import transactions. For instance, HA would settle his debt by financing exports to country B, where HB could be the importer or an intermediary".⁹

Fig.1. The Hawala system¹⁰



⁹ El-Qorchi, Mohammed: Hawala

¹⁰ <http://www.imf.org/external/pubs/ft/fandd/2002/12/elqorchi.htm>

Why does hawala work?

Hawala „works” because of its cost effectiveness. The secondary consideration is that there is often related or even integral to existing business dealings.

One reason for hawala’s cost effectiveness is low overhead. The second reason is exchange rate speculation. In addition, since many hawaladars are involved in businesses where money transfers are necessary, providing remittance services fits well into these businesses’ existing activities. Monies from remittances and business transfers are processed through the same bank accounts, and few, if any, additional operational costs are incurred by a business that offers hawala remittance services.

Finally, one of the most important movement is trust. Hawala dealers are almost always honest in their dealings with clients and fellow hawaladars. Breaches of confidence are very rare. It can be note that one of the most important meanings attached to this word hawala is “trust”.

Everybody knows that Hawala hurts the national economies of developing countries desperate for foreign exchange deposits, but every individual in the chain has the incentive of earning a commission.

” ‘People know that salaries cannot buy the goo things says one of thousands of operatives in an underground banking world that stretches from New York to Tokyo. ‘You need a little extra’. Even at a cost of enabling crime and terrorism”¹¹

There is an array of advantages for users:¹²

- The system is cost effective. Hawala brokers take a small commission and usually practice more advantageous exchange rates than the official rates. Hawala operators low overheads, and generate profit through small commissions and exchange rate speculations.
- The system is safe. In countries plagued by political insecurity such as Afghanistan, it is one of the most convenient, safe, reliable and inexpensive ways to move funds within the country.
- The system is efficient. A Hawala remittance transaction takes place within one or two days.

¹¹ <http://content.time.com/time/world/article/0,8599,178227,00.html>; A Banking System Built for Terrorism

¹² www.U4.no

- The system is reliable. The system is based on trust and there are no reported instances of customers being cheated in the literature. A breach of trust would keep the customers away.
- The system is flexible and not bureaucratic. The informal nature of the transactions makes them very attractive to users with tax, immigration or other legal concerns. For example, illegal migrants do not have adequate identification and couldn't use the formal banking system to send money home.
- The system is anonymous. It facilitates transfer of money without records or documentation.
- The system doesn't leave a paper trail. As it is rare that Hawala brokers keep records after the transaction is completed, it is unlikely that the transaction will be identified or detected.
- The system is culture friendly. For migrant workers, ethnic or kinship ties with the Hawala brokers make this system particularly convenient and easy to use.

Is hawala legal?

All authors consulted agree on the advantages of using hawala both for legal and illegal purposes. Hawala is attractive to customers as it provides a fast, safe and convenient way to transfer funds, usually with a far lower commission than that charged by the banks. In countries where there are strict regulations governing domestic and international money transfers, Hawala can be driven by capital flight motivations, by customers concerned with internal security and stability using alternative remittance systems to place money abroad, or pay for education or medical treatment.

Hawala has been made illegal in some U.S. states and some other countries but there is a legal and effective system in many countries across the world (UAE, Pakistan, Afghanistan, India etc.)

In South Asia the situation is more complicated. Hawala is traditionally associated with South Asia and the Middle East. Its primary users are members of the expatriate populations from the Indian sub continent, East Asia, Africa, Eastern Europe who migrated to Northern America, Europe and the Persian Gulf region and send remittances to their family who remained in their country of origin.

These migrant labours have reinvigorated the system's role and importance. While hawala is used for the legitimate transfer of funds, its anonymity and minimal documentation have also made it vulnerable to abuse by individuals and groups transferring funds to finance illegal activities.

Economic and cultural factors¹³

As we declared before hawala is less expensive, swifter, more reliable, more convenient, and less bureaucratic than the formal financial sector. Hawaldars charge fees or sometimes use the exchange rate spread to generate income. The fees charged by hawaladars on the transfer of funds are lower than those charged by banks and other remitting companies, thanks mainly to minimal overhead expenses and the absence of regulatory costs to the hawaladars, who often operate other small businesses.

The structure is swifter than formal financial transfer systems partly because of the lack of administration and the simplicity of its operating method; instructions are given to correspondents by phone, facsimile, or e-mail; and funds are often delivered door to door within 24 hours by a correspondent who has quick access to villages even in remote areas.

The minimal documentation and accounting requirements, the simple management, and the lack of bureaucratic procedures help reduce the time needed for transfer operations. In addition to economic factors, kinship, ethnic ties, and personal relations between hawaladars and expatriate workers make this system convenient and easy to use.

Summary¹⁴

Hawala system is an informal banking arrangement that allow the transfer of funds both domestically and internationally without using formal financial institutions. As a *cheap, fast, and reliable money transfer system*, they are primarily used by itinerant workers overseas sending remittance to support their families in their home countries.

¹³ EL-QORCHI, Mohammed: Hawala

¹⁴ www.U4.no

Although it is difficult to quantify accurately the volume of funds transferred every year to the developing world through such channels, remittances are very important sources of income for many impoverished households and may play an important role in promoting growth and development.

Like any other remittance system, hawala can and does, play a role in money laundering. As they are anonymous and require minimal documentation, they can be easily misused by criminal organisations, including terrorist groups to conceal the proceeds of criminal activities or corrupt officials to launder the proceeds of corruption.

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