U4 Expert Answer

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Hawala remittance system and money laundering

Query:

Please can you send resources on the Hawala remittance system? In particular, is it more predominantly used by poor people? What are the risks of corruption and how far is it thought to be connected with money laundering? I am interested primarily in the Middle East and North Africa but this might include outgoing remittances (i.e. from migrant workers in the gulf to South East Asia) or remittances going into the region from elsewhere.

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Date:
23 May 2008

Purpose:

We are discussing a MENA UNCAC implementation programme. I need to better understand how Hawala works in the MENA region. What its risks are and also what its benefits are for poor people and how these might be balanced.

Content:

- Part 1: Overview of Hawala Remittance Systems
- Part 2: The Role of Hawala Remittance Systems in Money Laundering
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Summary:

Hawala remittance systems - also referred to by the Financial Action Task Force as alternative remittance systems – are informal banking arrangements 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 migrant workers overseas sending remittance to support their families in their home countries. 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. However, in the aftermath of 9/11, there has been growing concern on their potential 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.

Part 1: Overview of Hawala Remittance Systems

In the aftermath of 9/11, there has been renewed interest in Hawala remittance systems and their potential role in facilitating illegal or terrorist activities. There is still limited knowledge on informal funds transfer systems and the extent to which they are misused for illegal purposes, including for both money laundering and terrorist financing.

What is Hawala?

Hawala remittance systems are a fast, safe and cost-effective way to transfer funds both domestically and internationally without using formal financial institutions. As such, it is an informal fund transfer system that runs in parallel to – and usually independently from – the formal banking system. Such systems were originally developed to facilitate trade between distant regions at a time or in regions where conventional banking instruments were either absent, weak or unsafe.

The FATF uses the following definition of alternative remittance systems:

"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 legal or illegal nature and make use of a variety of methods and tools to transfer the money". (Please see: http://www.fatf-gafi.org/dataoecd/16/8/35003256.pdf).

Hawala remittance systems are not per se illegal. As a remittance system, Hawala is submitted to the national regulations governing remittance services. In some countries, Hawala is illegal from a regulatory perspective, although enforcement is difficult as such services are usually advertised in ethnic media or via internet in vernacular languages. In addition, Hawala brokers often run legitimate businesses alongside the remittance services that they offer, which further challenges potential detection. In South Asian countries such as India or Pakistan, there are laws that prohibit speculation in the local currency and foreign exchange transactions at another rate than the official exchange rate, which makes Hawala systems as they currently operate illegal. Some countries also impose registration/licensing requirements to money remitters or strict regulations over domestic and international remittance.

How does Hawala Operate?

Hawala remittance systems involve the transfer of the value of currency without physically moving it.

A customer – usually a migrant worker- approaches a Hawala broker and gives him a sum of money to be transferred to a beneficiary – usually a relative - in another city or country. The Hawala broker often runs a legitimate business in addition to the financial services he offers and has a business contact, a friend or a relative in this city/country. The Hawala operator contacts their Hawala partner – usually a contact from their personal or business network - in the recipient city/country by phone, fax or e-mail. The operator instructs the partner to deliver the funds to the beneficiary, providing amount, name, address and telephone number of the recipient and promises to settle the debt at a later stage. The customer does not necessarily receive a receipt but is given an identification code for the transaction. The Hawala broker in the recipient city/country contacts the beneficiary and delivers the funds. The recipient can receive the funds without producing identity documents other than the previously agreed code.

There is no recorded agreement or written contract for the transaction. The deal is secured by the trust between the parties with no legal means of reclamation.

Such systems suppose that the Hawala broker is connected to a network of other brokers to arrange the payments or knows people who can access such networks in the recipient city/country. Hawala networks are therefore often (but not only) based on kinship or family ties, as the closer the relationship, the easier the settlement process will be. They usually advertise services for countries/cities where such connections exist.

Each time the Hawala broker gives payment instructions, an informal debt is created. The Hawala broker that delivered the funds to the beneficiary needs to recover the money from the first broker. In some cases, predominantly in the Middle East, a courier brings the money from one party to the other. The formal banking system can also be used to settle alternative remittance debts, but the system more typically relies on alternative methods, using a mix of legal and illegal means of settlement.

Hawala partners may be business partners, typically involved in import/export activities. In such case, transferring money is one of the activities they are regularly engaged in as part of their normal dealings with one another. The debt settlement can be done by "manipulating" invoices to conceal money transfers, for example by under-invoicing or over-invoicing shipment of goods.

The Hawalla broker delivering the money to the end beneficiary may also owe the other money, repaying his debt by paying the Hawala customers. The first broker may also have entrusted the second one with money for Hawala activities. In such cases, there is no need for the second broker to recover any money.

Once the transaction is complete, there is no need for record keeping and neither for reporting nor regulatory requirements for customer identification. Hawala transactions leave no paper trail, business documentation or financial records for law enforcement agencies to track the origins of the transfers.

Extent of Hawala Remittance Systems

Hawala brokers operate more or less openly in all parts of the world and the system has global reach. The only limits to the transaction are the risk involved for the remitter to carry cash and the capacity of the receiving broker to cover the transaction. The United Arab Emirates, especially Dubai, are believed to handle the largest volume of transactions, but the system is widespread in countries such as Pakistan, Indian and the Persian Gulf states.

The extent of Hawala systems has been little explored in the literature and cannot be quantified reliably and accurately given the informal nature of the transactions. It is impossible to provide a precise figure, but it is likely that it ranges to billions of USD. Some countries make estimates based on their expatriate community and balance of payment data. In Pakistan, officials estimate that more than USD 5 to 7 billions enters into the country every year through Hawala channels. (Please see: http://www.treas.gov/offices/enforcement/key-issues/hawala/) In the case of India, Interpol estimates the size of Hawala at possibly 40% of the country's gross domestic product. It is estimated that globally between USD 100 billions and USD 300 billions flow through informal remittance systems every year. (Please see: http://www.un.org/esa/desa/papers/2002/esa02dp26.pdf).

In spite of its informal nature, alternative remittance systems may have direct and indirect macroeconomic implications and have a potential impact on monetary accounts of both remitting and receiving countries. Informal financial transactions are neither reflected in official statistics nor recorded in the foreign assets of the recipient country or liabilities of the remitting countries. At the same time, such transactions are believed to increase the circulation of cash in the recipient countries and affect the composition of broad money. Alternative remittance systems may also have an indirect effect on monetary policies as they influence the demand and supply for foreign currencies. Alternative remittance systems also have negative fiscal implications for both remitting and receiving countries. As the funds circulate outside the official system, they are not subject to tax and represent a loss of business both for the formal financial system and government income.

The literature points to the need to survey and compile information on the importance of these alternative remittance systems as well as on the regulations governing them in the various countries.

The Profile of Hawala Users

Advantage for users

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. There is an array of advantages for users:

- The system is cost effective. Hawala brokers take a small commission and usually practice more advantageous exchange rates than the official rates. Hawala operators have 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.
- 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.

Profile of Users

The speed, cost-effectiveness, safety and potential anonymity of Hawala transactions contribute to widespread use (for both legal and illegal purposes) and make them a rational choice for the poorest segments of the population.

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 funds represent important sources of income for some countries. In 2005, the World Bank estimated that remittances to developing countries from overseas workers amounted to USD 126 billions in 2004, representing twice the amount of Official Development Assistance. A study by the Inter-American Development Bank concludes that Latin America and the Caribbean are the main recipient areas of remittance in the world (31%), followed by South Asia (20 %) and the Middle East and North Africa (18%). (Please see: http://tcdc1.undp.org/Remittances_Oct102005B.pdf).

Remittance from migrant workers- whether transferred through formal or informal channels- are very important to both the national economy and individual households as a means to escape poverty. In a 2005 background note, UNDP explores the potential role of remittance in achieving the Millennium Development Goals, including the goal of reducing the proportion of people living in absolute poverty and suggests that remittance to developing countries can play an instrumental role in reducing poverty and promoting growth and development. (Please see: http://tcdc1.undp.org/Remittances_Oct102005B.pdf). The following data and information are mostly drawn from this background note.

In countries in post-conflict states or affected by economic hardships, remittance are a very important part of family maintenance and economic survival for millions of impoverished households. For example, in Haiti, remittances represented 17 % of the GDP in 2001 and accounted for up to 40 % of the GDP in Somalia in the late 1990s. A 2003 UNDP survey estimates that more than 25 % of families in Somalia receive remittance from abroad. According to a survey conducted in Armenia, remittances make up to 80 % of household incomes on average and appear to go to the most vulnerable households, keeping families above the poverty line. Similar trends have been observed in Tajikistan, Eritrea or the Comoros, suggesting high dependence on remittance per capita.

Informal channels are the most commonly used systems of remittance transfer for less developing countries as well as economies in transition, as there are considerable price differences between the formal and the informal systems. The average cost of transferring remittances to Central and South America can be as high as 20 %. There are cases in which low income customers are not charged at all for the transfer when using alternative remittance systems.

The system is particularly convenient for populations that are out of reach of the formal financial sector because they live in poor and remote areas, where it is not profitable to open local branches of formal banking institutions. In a context of political insecurity, this may be the only option to reach isolated segments of the population. In conflict affected countries such as Afghanistan for example, the Hawala system constitutes the safest way to circulate money in the provinces and the population uses it to transfer funds around the country. More recently, they have also been used by the majority of international and domestic NGOs and development agencies to provide financial services for the delivery of emergency relief and humanitarian aid.

Remittance can also be used for investment and play a key role in developing small businesses. More information would be needed on the use of remittance, but it is believed that a substantial portion is re-invested in land and housing, vehicles purchase and education services. Some remittances are also spent on machinery and shops to start up an income generating activity. One can also reasonably assume that, even when spent on consumer goods, remittance can stimulate growth. A study of Mexico suggests that each dollar of remittance generates three dollars of spending power.

Part 2: Hawala Remittance System and its Role in Money Laundering

The many above-mentioned advantages of Hawala remittance systems don't make them attractive only for "legitimate" users. In the wake of 9/11, there has been renewed interest for Hawala systems and growing concern about its potential role in facilitating serious crimes including money laundering and terrorism financing.

Potential for Abuse

While Hawala system may serve legitimate purposes for migrant workers or poor people, its specific characteristics make it vulnerable to those wanting to launder the proceeds of criminal activity. As they are anonymous and require minimal documentation, external oversight of Hawala transactions is limited and detection risks are minimised. This makes them susceptible to abuse by individuals and groups transferring proceeds of crimes or funds to finance illegal activities. There is, for example, a long-standing tradition among Columbian drug traffickers to use informal "underground" banking systems.

In addition, the formal financial sector has been subject to increased oversight in recent years, which may provide criminals with additional incentives to launder their profits via less regulated systems such as the Hawala systems. Money laundering through the formal financial system involves a series of risks that have increased with recent know-your-customer campaigns and heightened scrutiny over suspicious transactions. Smuggling large amounts of cash in low regulated areas also carries a high risk of losses. Alternative remittance systems can minimise transaction risks and allow placing the money in the banking system while avoiding the reporting requirements of the formal banking system.

As adopted in the general assembly in 1995, Interpol defines money-laundering as "*any act or attempted act to conceal or disguise the identity of illegally obtained proceeds so that they appear to have originated from legitimate sources*". More specifically, money laundering methods seek to hide the source of the income through a series of financial transactions, either through the formal or informal financial system. Money laundering activities typically involves three major steps, namely the placement, layering and integration stages. There is a consensus in the literature on the fact that Halawa remittance systems have the potential to facilitate all stages of the money laundering process:

- Placement of criminal proceeds. At this stage of the process, illicit proceeds are placed within the legitimate financial system. The risk for money launderers is to raise suspicions about the size and source of income, as some regulations require reporting over a certain amount of cash handled. Large deposits can be split into smaller deposits in different financial institutions or accounts, or mingled with the deposits of a legitimate business. The Hawala system provides an effective means of placement, as in most cases, the Hawala broker can make deposits at the bank that are justified by its other legitimate business activities. He/she may also use the cash received to meet business related costs, thus reducing cash deposits at the bank.

- Layering of criminal proceeds. This stage involves a series of financial transactions where the money is moved by electronic or wire transfers through the financial system to make it impossible to track its origins. Funds are typically moved through a combination of front companies or shell corporations operating from financial tax havens and/or redistributed through a series of accounts in smaller amounts. Multiple remittances can occur in the layering process. Alternative remittances such as Hawala systems constitute a relatively safe layering alternative in a money laundering scheme. In the absence of paper trails or record-keeping of the transactions, Hawala transfers are difficult to trace and tie to the original source of money. Layering can be done by using Hawala brokers in several countries and distributing the transfers over time.

- Integration of criminal proceeds. At this stage, funds are finally made available for use and return to the money launderer in the form of a legitimate income, such as profit from a shell company or mixed with the profit of a legitimate business. Integration shares common features with the Hawala debt settlement process and can be accomplished through investment in a legitimate business, the purchase of bonds or property, or an import/export invoice.

Evidence or Lack of Evidence

Illegal flows of moneys are difficult to track or separate from legal money flows, as criminals develop new and more sophisticated methods to avoid detection. Empirical evidence and information on the extent and use of alternative remittance systems for money laundering activities remain thin, anecdotal or non-existent.

In 2005, the Financial Action Task Force (FATF) acknowledged the potential misuse of alternative remittance systems by including a full section on such systems in its money laundering and terrorist financing typologies. The reports states "*Although the alternative remittance sector is largely* *composed of legitimate operators, some categories of alternative remittance systems have nevertheless been involved in the transfer of funds related to illegal activities. (…). Experience over the last decade has shown that alternative remittance systems can be misused for illegal purposes, including for both money laundering and terrorist financing*".(Please see: http://www.fatf-gafi.org/dataoecd/16/8/35003256.pdf).

Other authors argue that Hawala networks are neither the only nor the main vehicle of illegal fund transfer. In an article published in 2003 in Risk Management, Nikos Passas argues that evidence from the 9-11 attacks shows that most of the funds received by hijackers reached the US through formal financial institutions. (Please see: http://www.palgrave-journals.com/rm/journal/v5/n2/abs/8240148a.html). However, the 9/11 commission report in 2004 still maintains that Osama Bin Laden relied generally on established Hawala networks operating in Pakistan, Dubai and throughout the Middle East.

There have been some established cases where Hawala or Hawala-like techniques were used to launder proceeds of criminal activities. In a report published in 2000, Interpol provides a brief description of such cases in its appendix. They involve cases of narcotics trafficking, terrorism, alien smuggling, welfare fraud, insider trading, custom and tax violations, and gambling. (Please see: http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/Hawala/default.asp). The link between corruption and alternative remittance systems has not been specifically documented in the literature, but most authors implicitly connect Hawala to the laundering of corruption proceeds.

In 1998 Interpol also conducted a study to determine the structure and operations of alternative remittance systems in the Asia and Pacific region, through a review of existing literature on alternative remittance system and a survey of 31 Interpol member countries in the region. Response to the survey provided a working sample of 25 Interpol member countries of which 21 reported some form of alternative remittance system operating within their borders. 13 of the 21 countries experiencing alternative remittance systems found that they operate as a money laundering tool, including Hong Kong, China, India, Indonesia, Japan, Nepal, Pakistan, Sri Lanka, Philippines, Turkey and Vietnam. Interpol records a variety of criminal proceeds laundered through such systems in the region, including profits from the drug trade, arms, gold and gem smuggling, terrorism, and corruption.

Interpol countries in the Gulf and the Middle East observed that alternative remittance systems tend to launder profits of drug trade, gold smuggling, extortion and terrorism. Information regarding specific operational aspects of the system is not available for this region. Experts in neighbouring countries also report that alternative remittance systems are used in the Gulf as a conduit and financing mechanisms for the gold trade in the Indian subcontinent. (Please see: http://www.interpol.com/Public/FinancialCrime/MoneyLaundering/EthnicMoney/default.asp).

Recommendations by International Organisations

The FATF released in October 2001 eight special recommendations on terrorist financing, which combined with the forty recommendations on money laundering outlines a comprehensive framework to detect, prevent and combat money laundering. Special recommendation VI focuses explicitly on alternative remittance, outlining three core elements. The objective of these elements is to bring all money transfer services, whether formal or informal, within minimum legal and regulatory requirements, in accordance with the relevant FATF recommendations. These recommendations focus on key areas such as licensing/registration, due diligence, customer identification, record keeping, suspicious transaction reporting, compliance monitoring, sanctions and awareness raising. The sixth recommendation targets alternative remittance systems and include three major aspects: (Please see FATF's interpretative note to special recommendation VI: http://www.oecd.org/document/34/0,3343,en_32250379_32236947_34261877_1_1_1_1,00.html#INSRVI).

- Jurisdictions should require licensing or registration of persons or legal entities providing value/money transfer services, including through informal systems or networks;
- Jurisdictions should ensure that money/value transfer services, including informal systems or networks, are subject to the applicable FATF forty recommendations and the eight special recommendations;
- Jurisdictions should be able to impose sanctions on money/value transfer services, including informal systems networks that fail to obtain a licence/register and fail to comply with relevant FATF recommendations.

The IMF highlights differences in regulatory and supervisory responses to alternative remittance systems between remitting and receiving countries. In recipient countries, the key issues include foreign exchange regimes, the quality of the formal financial system and the level of political stability. Regulations tend to be influenced by these concerns. In remitting countries, there are concerns about the potential abuse of such remittance systems by criminals. Regulatory measures include registration/licensing, customer reporting and record keeping requirements. (Please see: http://www.oecd.org/document/34/0,3343,en_32250379_32236947_34261877_1_1_1_1,00.html#INSRVI).

The IMF encourages a two-pronged approach toward regulation:

- In countries where an informal Hawala system exists alongside a well-functioning formal sector, it is recommended that Hawala dealers be registered and keep adequate records in line with the FAFT recommendations. Efforts should focus on improving the level of transparency in these systems by bringing them closer to the formal financial sector. In countries torn by conflicts, such registration may not be feasible.
- The regulatory response should simultaneously address weaknesses that may exist in the formal sector.

Efforts to regulate Hawala remittance systems are challenged by the limited knowledge of those systems and the extent to which they are exploited by criminal organisations. Too strict regulations may push such systems underground or deprive poor people from legitimate sources of income and survival in many countries. Regulatory concerns should therefore strive to balance the prevention of misuse with the need to ensure that flows of legitimate funds continue to reach the developing world.

Part 3: Further Reading

Money Laundering and Terrorist Financing Typologies 2004-2005 (2005)
This report from the FATF dedicates a full section to alternative remittance systems and describes how these networks work in practice, with the view to identifying areas of vulnerability and risks of misuse for illegal purposes. http://www.fatf-gafi.org/dataoecd/16/8/35003256.pdf

Regulatory Frameworks for Hawala and Other Remittance Systems (2005)
This report prepared by the IMF presents the proceedings of the second International Conference on Hawala. The conference resulted in a statement identifying the challenges of implementing a regulatory framework for Hawala remittance systems. Participants agreed that there is a need to gather and analyse more data and knowledge on those systems.
http://www.apgml.org/frameworks/docs/8/Regulatory%20Frameworks%20for%20Hawala%20and%20Other%20ARS%20-%20IMF%202005.pdf

The Potential Role of Remittances in Achieving the Millennium Development Goals (2005)
In this Background note, UNDP explores the potential role that remittances can play in promoting growth and development in developing countries. Although the issues involved are complex, remittances are important for developing countries as they provide access to substantial additional

financial resources and support the sustainability of livelihoods. http://tcdc1.undp.org/Remittances_Oct102005B.pdf

Informal Funds Transfer Systems (2003)
This joint IMF-World Bank paper provides an analysis of the Informal Hawala System, presenting its major features, its uses as well as an economic analysis of Hawala transactions. It concludes by outlining legal and regulatory aspects of Hawala remittance systems.
http://www.imf.org/external/pubs/nft/op/222/

Combating the Abuse of Alternative Remittance Systems: International Best Practices (2003)
This best practice paper prepared by the FATF is intended to provide additional details to the Interpretative Note on Recommendation VI that addresses risks associated with alternative remittance systems. It provides guidance on how to detect those systems outside the formal banking system and focuses on practical issues such as identification of money transfer services, procedures for registration/licensing and customer due diligence procedures.
http://www.fatf-gafi.org/dataoecd/32/15/34255005.pdf

Hawala and Other Informal Value Transfer Systems: How to Regulate Them? (2003)
This article summarises the findings of an 18 month study of the mechanics and settlement processes in Hawala networks and concludes with some policy implications. http://www.palgrave-journals.com/rm/journal/v5/n2/abs/8240148a.html (available for purchase).

The Money Exchange Dealers of Kabul (2003)
This study of the Hawala system in Afghanistan was undertaken to determine current practices of Hawala in Afghanistan, verify assertions regarding convenience, speed, cost-effectiveness, identify characteristics that make Hawala vulnerable to abuse and consider appropriate regulatory and supervisory options.
http://www1.worldbank.org/finance/html/amlcft/docs/ARS/The%20Money%20Exchange%20Dealers%20of%20Kabul.pdf

Informal Money Transfer Systems: Opportunities and Challenges for Development Finance (2002)
This paper reviews the main types of informal money transfer systems (IMTS). IMTS remain today the preferred remittance vehicle among migrant communities. Characteristics such as low transaction costs, speed and little paperwork render them more attractive than banking institutions. The paper proposes measures to make those systems less prone to potential abuse by criminals and encourage the development of formal sector alternatives.
http://www.un.org/esa/desa/papers/2002/esa02dp26.pdf

Alternative Remittance Systems Distinguishing Sub-systems of Ethnic Money Laundering in INTERPOL Member Countries on the Asian Continent (2000)
A study of 31 INTERPOL member countries in Asia/Pacific was conducted in 1998 by questionnaire and telephone interview to test the hypothesis that two dominant and distinct alternative remittance systems prevail in the region; the first encompassing the Asian-oriental countries and the second covering the Indian sub-continent. The data set is comprised of the 21 INTERPOL countries reporting the presence of ethnic banking inside their borders. Observational trends in operational aspects within each system lend support to the hypothesized existence of two distinct ethnic banking systems in the region.
http://www.interpol.com/Public/FinancialCrime/MoneyLaundering/EthnicMoney/default.asp

The Hawala Alternative Remittance System and its Role in Money Laundering (2000)
This paper presents a description of the Hawala remittance system. Hawala is an ancient system originating in South Asia; today it is used around the world to conduct legitimate remittances. Hawala can and does play a role in money laundering. In addition to serving as a "tutorial" on Hawala

transaction, this paper will also discuss the way in which Hawala is used to facilitate money laundering. http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/Hawala/default.asp