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Iqbal, S. et.al. pp.65-71

Global anti-money laundering mechanisms and classifications

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Abstract

The objective of this paper is to explore various ways in which criminals attempt to subvert financial institutions to enjoy the profits of their illicit activities. Occurrences of money laundering methods such as hawala, hundi and chop-shops have origins based in cultural demography. Terms such as hawala have been overused in industry, and an ambiguity has arisen to the classifications of these methods. This ongoing study reclassifies mechanisms that criminals use as an alternative to regulated financial transactions in an attempt to demystify these terms. To this end, the research will enable financial watchdogs to increase sensitivity of illicit activities and become more robust in their countermeasures against money laundering and terrorist financing.

Keywords: knowledge management, anti-money laundering, money laundering mechanisms.

Jel Codes: F13, F1, F10

1. Introduction

According to the OECD (2009), money laundering is the processing of illicit funds to disguise their illegal origin. This process is of critical importance to criminals, as it enables them to enjoy these profits without jeopardising their sources. Illegal arms sales, smuggling, and the activities of organized crime, including for example drug trafficking and prostitution rings, can generate huge amounts of proceeds. Embezzlement, insider trading, bribery and computer fraud schemes can also produce large profits and create the incentive to attempt to effectively legitimise gains through money laundering. When criminal activities generate substantial profits, the individual or group involved often attempt to find ways to control the funds without attracting attention to the underlying activity or the persons involved. Criminals do this by disguising the sources, changing the form, or moving the funds to a place where they are more inconspicuous. In simple terms, money laundering is the conversion of black money into white proceeds, or in other words from criminal proceeds into legal funds (Mahajan, and Karthik, 2014). It is also important to take into consideration types of corruption which enable money laundering to occur.

Banking and financial services depend heavily on the belief that they operate with integrity and within legal and professional frameworks (Isern and de Koker, 2009; FATF, 2010; International Finance Corporation, 2019). Financial institutions value their reputations for integrity and as such complicity in unregulated fund transfers has a damaging effect on the attitudes of other financial intermediaries and regulatory authorities, as well as ordinary customers (Lannoo and Parlour, 2021).

The consequences of unchecked money laundering can include potentially negative or harmful effects such as a loss of consumer trust in financial institutions, financial institution instability, artificial price growth, effects on growth rates, and an increase in volatility of both international capital flows and exchange rates. This may occur because of unanticipated cross-border asset transfers (Asian Development Bank, 2003; Gjoni, et al. 2015). Achim, and Borlea (2020) further states that corruption and shadow economy are destructive activities which undermine democratic governing and the rule of law which has the effect of negatively influencing economic growth.

Criminals continuously search for innovative ways in which to subvert systems to launder their funds (OECD, 2019). Countries with growing economies or developing financial centers are considered more at risk than countries with more established financial centers, as they have less comprehensive anti-money laundering systems (Grigaite, et al., 2021). National anti-money laundering systems can be exploited by criminals, who can move their networks to countries with weak or ineffective countermeasures. It has been suggested that developing economies have less motivation to be highly selective about the sources of capital that they attract. However, lack of action can be high risk, as organized crime can become deeply entrenched (Nunnenkamp, 2001; Dermirhan and Masca, 2008; The World Bank, 2012).

2. Literature Review

According to the Basel AML Index (Basel Institute on Governance, 2019), the highest risk of money laundering occurs in Mozambique, Laos and Myanmar. Associated scores were 8.22, 8.21 and 7.93 respectively, with an average risk of 5.39 out of 125 countries assessed. In 2018, the average risk represented 5.63 indicating a marginal improvement against money laundering and terrorist financing. However, the results of the study indicated that some countries' resilience is deteriorating. For example, Latvia with a risk score of 4.89 represented an increase in risk of 0.91, Finland at 3.17 increased by 0.60 and China at 6.59 increased by 0.57 since the previous year.

While money laundering can be defined as the process which attempts to hide illicit assets as legitimate assets (Singh and Best, 2019), Levi and Reuter (2006) suggest that money laundering is a difficult subject to study due to its inherently elusive nature. For example, professional money launderers (PMLs) represent specialists who help criminals to evade anti-money laundering detection (FATF, 2018). Since they themselves are not involved with the activities which generate illicit proceeds, and criminals attempt to disguise their identities, the complexity of identifying the crime can greatly increase. Money laundering has been categorised as having three elements; placement, layering and integration. However, van Duyne, et al. (2018) indicates that not all money laundering transactions have all three phases. An additional complexity occurs as individuals engaged in illicit activities attempt to disguise their identities. This complexity can be increased by the ability to hide within the net, such as through the dark web, use of technology such as cryptocurrencies, encryption software and secure browser technologies (Weber and Kruisbergen, 2019).

The Financial Crimes Enforcement Network (FinCEN) classifies systems and mechanisms which enable the transaction of funds to a third party in another geographical location as an informal value transfer system (IVTS). These funds may or may not be in their original form (FinCEN, 2003). IVTS in themselves are not necessarily illicit such as the introduction of licensed dual currency exchanges by governments. Several mechanisms are associated with IVTS and underground banking such as hawala, door-to-door (also known as padala), Black Market Peso Exchanges, phoe'kuan, fei-ch'ien (flying money), ch'iao hui, chop-shop, and chiti banking as represented in figure 1. (FinCEN, 2003; International Monetary Fund 2008). Nonetheless, this research postulates that many of these mechanism types can be grouped under collective mechanisms such as hawala. Unlike IVTS, informal fund transfer systems (IFTS) exist. These can be classified as physical transport methods such as self-carry and courier services (Passas, 2003).

Type of Transfer	Transfer Mechanism	Where It Is Popular	Cash Flow Between Countries at Time of Transfer
Hawala	"Transfer": payment instruction transmitted	Middle East, South Asia	No
Fei Ch'ien	"Flying money": payment instruction transmitted	Asia	No
Hundi	"Collect": payment instruction transmitted	Asia, Middle East	No
Chits and chops	"Notes, seals": payment instruction transmitted	Asia	No
Black market peso exchange	Asset exchange	Latin America	No
Cross-border transport operators/drivers	Physical transfers	Africa	Yes
Relatives, friends, migrants, and short-term workers traveling home	Physical transfers	Middle East, Asia, Europe, Africa, Latin America	Yes

Figure 1. A representation of Informal Value Transfer Systems by transfer mechanism and regional popularity. Source: International Monetary Fund (2008). p13.

Adoption of these methods tend to be influenced directly by ethnic demography, for example; hawala originated in Middle Eastern societies such as Afghanistan and Pakistan, hundi and chiti banking from India, and fei ch'ien and chop-shop banking from Chinese societies. Additional mechanisms such as phoe'kuan can be found in Thailand, and Black-Market Peso Exchange in South America (FinCEN, 2003). This may be due largely or in part to trust issues, such as a Chinese group may struggle to accept transactions with a non-Chinese intermediary. The National Crime Agency (NCA, 2019) suggests that the ethnic-demographic occurrence may also be heavily influenced by resources as IVTS providers need to have entrenched and established resources within that country. For example, a Chinese national wishing to move funds from China to a foreign country, may use an intermediary with a legitimate method of remittance. The legitimate method may be only available to people who have legal residency in that country. Communication with the intermediary and language barrier must be overcome (Passas, 2003).

3. Data & Methodology

This research holds to the premise that modern money laundering schemes are actually derivatives of older schemes which take into consideration new technological capabilities. Such capabilities include decentralised financing technologies such as mixers and cryptocurrency un-hosted wallets (HM Treasury, 2020; Fletcher, et al., 2021). Researchers have attempted to categorise mechanisms before. Trehan (2002) suggests that hundi and hawala, or chop-shop and chiti banking are interchangeable expressions. However, Passas (2003) suggests that the term hawala has been overused such that any unusual or suspicious transaction has been denigrated to the expression hawala. Equally, distinctions exist between chop-shop and chiti banking. Buchanan (2004) on the other hand, categorises money laundering into 7 areas of common techniques and tools. These are structuring, front companies, mis-invoicing, shell companies, wire transfers, mirror-image trading and parallel systems. This research aims to clarify distinctions between categories of underground banking and to establish types of underground banking mechanisms.

As a result, our primary research questions are:

1. What are key differences between mechanism models?
2. Which mechanisms are derivatives of others?

This paper represents an-ongoing research which utilizes a systematic analysis of literature. Since it was our intention to gather a wide range of views and perspectives, literature sources included white papers from consulting groups, reports from AML institutions and organizations, as well as peer reviewed articles. A thematic coding approach was taken to categorize similarities between mechanisms and enable us to produce diagrammatic representations.

4. Discussion & Findings

An examination of the hundi and hawala mechanisms which can be seen in figures 2 and 3, support Passas' opinion that these terms are not interchangeable, however it also supports the concept that hundi is a derivative or variation on the fundamental model of hawala. Figure 2 depicts a conventional model of the hawala mechanism. Business clients (BC) wishing to remit funds from Locality A to B utilise financial intermediaries with their own networks and resources (Schramm and Taube, 2003).

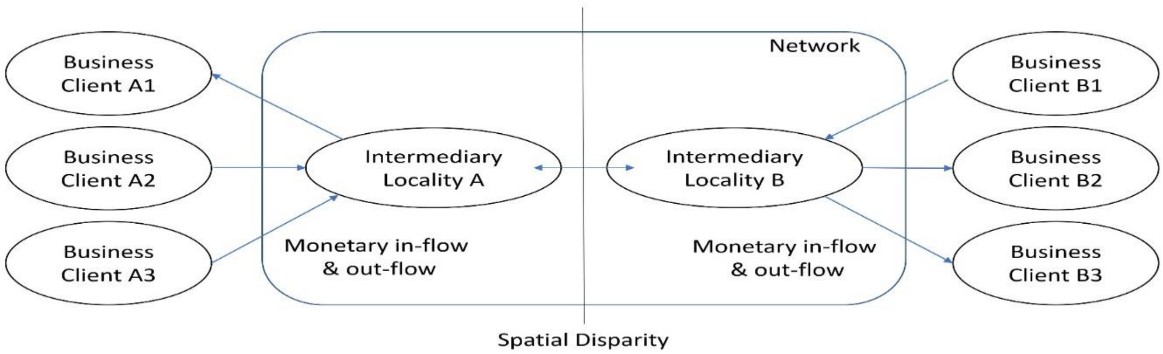

Figure 2. The hawala mechanism
Source: Based on the hawala mechanism by Schramm and Taube (2003)

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Whereas the hawala mechanism tends to involve illicit cash remittance, the hundi mechanism as shown in figure 3, can realise money laundering efforts by the trading of goods. In this case, the hundi traders launder money by pricing goods at a higher rate, and take the margin of these goods as the laundered amount (FATF, 2010; US Government Accountability Office, 2019). Similarities exist between hawala and hundi, as both mechanisms require the use of an intermediary. These intermediaries have established networks of their own in other localities (Schramm and Taube, 2003; Passas, 2003).

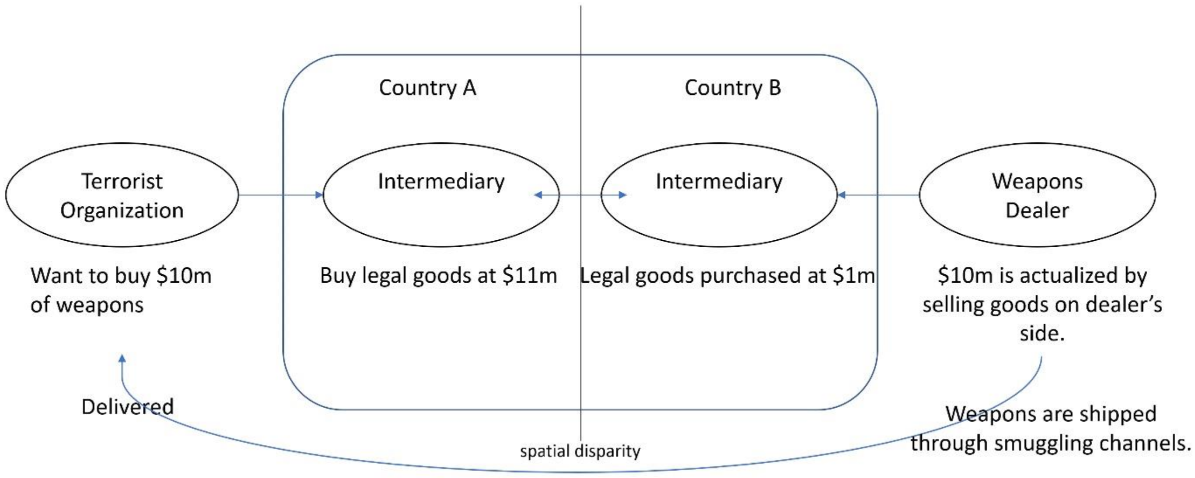

Figure 3. Hundi, a trade-based underground banking model.
Source: Authors' representation

One of the primary differences between door-to-door and other forms of unregulated fund transfers, is the perception that this mechanism does not necessarily represent a predicated criminal activity.

Figure 4 depicts a scenario where an overseas student needs to pay fees in the university's domestic locality using a payment method, that the student has no access to. Asking a friend or acquaintance who has the means to actualize the payment, as a favour may seem a rational solution. Intermediaries in this case, offer a courtesy, by leveraging their own networks and resources to resolve what they may see as a simple matter. Similar to hundi and hawala, padala represents an unregulated transfer of funds by use of an intermediary who enables their resources to secure a successful solution.

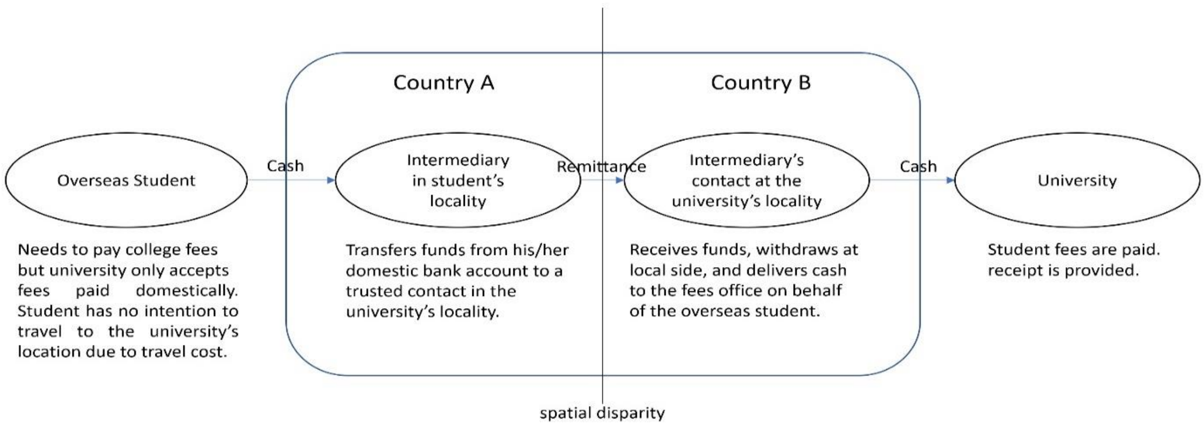

Figure 4. Door to door (padala), an informal fund transfer system.
Source: Authors' representation

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Figure 5 depicts the chop-shop mechanism which utilises a front. In this case, a dry-cleaning business which appears completely legitimate. The front handles standard legal activities with regular customers, but also handles illicit transactions by under-reporting actual amounts transacted. Chop-shop may be construed as a core mechanism-type as it is dissimilar to other types of mechanisms that were examined in our study.

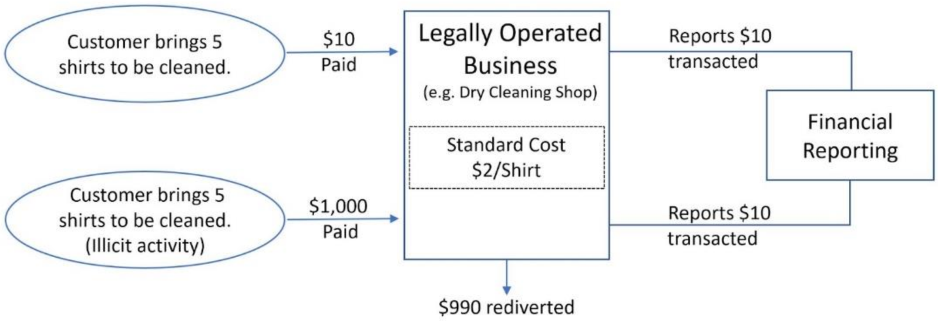

Figure 5. Chop-shop, a front-based underground banking model.
Source: Authors' representation

Figure 6 depicts chiti banking which represents a mechanism where both illicit and legitimate funds can be mixed. A legitimate fund manager who has control of a fund, works on behalf of criminals to enable the transforming of monies into other forms of money. While the fund manager may be considered a type of intermediary, this model represents a transformation of funds from form A, into form B, rather than a transfer of funds such as in the mechanisms of hawala, hundi or padala.

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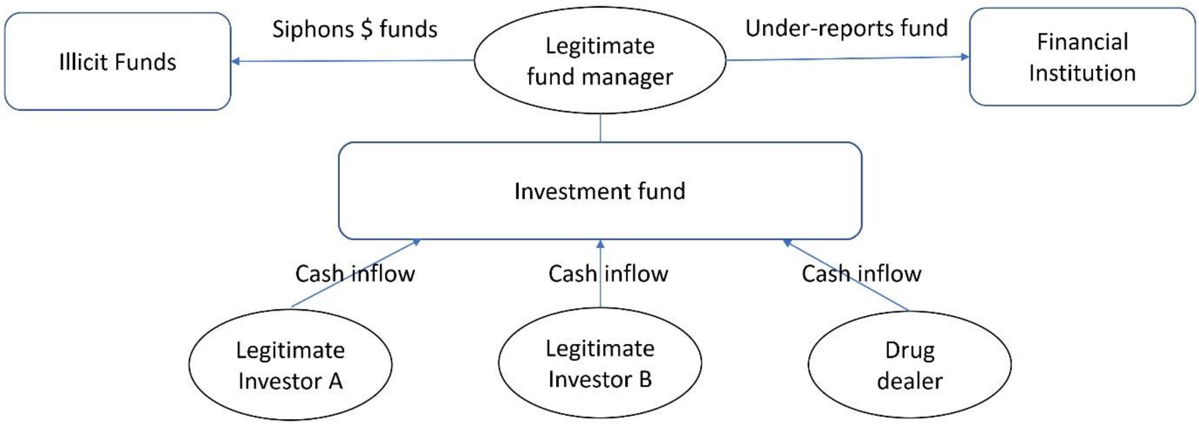

Figure 6. Chiti banking, a method of fraud for avoiding money laundering detection
Source: Authors' representation

5. Conclusions

In this article we attempt to analyse fundamental examples of mechanisms used in money laundering by constructing diagrammatic models. Through a clearer understanding of hawala, hundi, door-to-door, chop-shop and chiti banking, enables AML practitioners to be more specific when classifying occurrences of money laundering. Through an analysis of the mechanisms we examined, we construed that hawala, chop-shop and chiti banking may be considered mechanisms in their own rights, but hundi and padala are derivatives of hawala. Principle differences in mechanisms are the functions excluding motive. Such as, hawala uses intermediaries with their own networks and resources and transacts varieties of monies from different localities. On the other hand, chop-shop uses established fronts and avoids detection by under-reporting payments for services. Chiti banking uses legitimate access to funds by bribing or employing fund managers. Unlike chop-shops, money is not transacted but instead transformed from one form into another. Chiti banking introduces another level of complexity as the original illicit proceeds are mixed with innocent investment, and the outflowing cash is no longer in its original form.

The researchers acknowledge that this paper represents early findings of our ongoing study. In the future, we will continue to investigate a wider range of mechanisms such as the Black-Market Peso Exchange and newer developments such as the abuse of blockchain technologies, and un-hosted wallets.

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