

Informal Funds Transfer systems as a target of customs enforcement¹

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Abstract

Informal Funds Transfer (IFT) systems entail the movement of money without using formal financial institutions. People use IFT systems for several reasons, such as migrants remitting their income to relatives in home countries. While IFT can have legitimate purposes, it can also be exploited for criminal activities. In addition to being swifter, less expensive, and more convenient than some formal banking systems, IFT has some criminogenic advantages, including increased anonymity, weak recordkeeping, and non-transparent settlements. IFT systems are frequently used by informal traders and smugglers and, consequently, can help to evade compliance with customs regulations. This paper offers a preliminary examination of the implications for Customs of IFT systems and advocates that customs administrations increase their knowledge and enforcement activities with respect to IFT.

1. Introduction

In open economies, people, goods, services, money, and information flow freely over borders. Customs administrations are responsible for facilitating the legitimate flow of ‘goods’ and ‘people’³ and for controlling illegitimate ones. Even though they collect ‘money’ as a form of custom duties and taxes from goods, the ‘flow’ of money between countries has not been a major issue for many customs administrations as long as the flow of money runs separately to the flow of goods. That is because while goods and people cross borders, in most cases money does not physically move from one country to another (El Qorchi, Maimbo & Wilson 2003), even if the value of money is transferred abroad.

As international trade volumes increase and regional trade agreements add further complexities, Customs faces challenges in effectively discovering illegal activities in international trade because of the current enforcement approach of concentrating on the flow of goods. This is especially the case because, as more customs administrations have adopted risk management as their core philosophy, they need better information and intelligence to tackle risks to the global trade environment, compensating for the discard of 100% verification. In this respect, greater awareness about the flow of money can benefit customs administrations.

Money crosses borders in several ways. Some people use formal financial institutions to transfer money electronically to other countries. Some carry cash with them when crossing borders. Some conceal cash in parcels or cargo in order to transport money across borders. Others, however, transfer money to other countries without relying on these well-known methods. They ask someone to remit money to another country then the agent transfers the value of the money to the destination country without using the formal banking system. In the literature, this approach has several names, including *informal money transfer systems* (Buencamino & Gorbunov 2002), *informal fund transfer systems* (El-Qorchi 2002), and *alternative remittance systems* (FATF 2003; McCusker 2005). This paper uses the term Informal Funds Transfer (IFT) systems.

IFT systems have longer historical backgrounds than conventional banking systems and, recently, they have been examined in the light of financial regulations to prevent unregulated banking systems from being abused for criminal purposes, such as money laundering. After the 9/11 attacks, however, law enforcement agencies as well as financial authorities have taken heightened interest in IFT systems because of concerns⁴ that IFT systems are being used for illegal and terrorist activities (El-Qorchi 2002; United States General Accounting Office [USGAO] 2003; Rees 2010; United States Department of State [USDS] 2012).

Some analysts contend that many IFT systems have a self-regulating mechanism based on trust between operators and users, and thus are not likely to be involved in financing illegal and terrorist activities (Buencamino & Gorbunov 2002). Compared to conventional financial systems that have established safeguards against money laundering, IFT systems have a heightened vulnerability to exploitation by criminal syndicates (*The Economist* 2001). Many law enforcement and financial authorities are devising regulations to control IFT systems. Most customs administrations,⁵ however, believe that IFT systems are not a domain of Customs, and have not sought methods to investigate their use in violating customs laws. The reasoning is that because IFT systems are primarily used by migrant workers to transfer their remittances to their families in home countries (Buencamino & Gorbunov 2002), they are considered *capital trades*, not *commodity trades*. IFT systems, however, are not only used by traders for trade payments in order to avoid trails but also for under- or over-invoicing or smuggling gold and bulk cash to settle balances between IFT brokers. This paper advocates that Customs should take an increased interest in the use of IFT systems for non-compliance with customs laws and describes mechanisms for doing so.

2. Informal Funds Transfer systems

To analyse the implications of applying customs controls to IFT systems, it is necessary to understand their basic characteristics. This paper illustrates how IFT systems work from the Customs' point of view, taking into account the rich body of existing research on IFT's historical background and mechanisms.

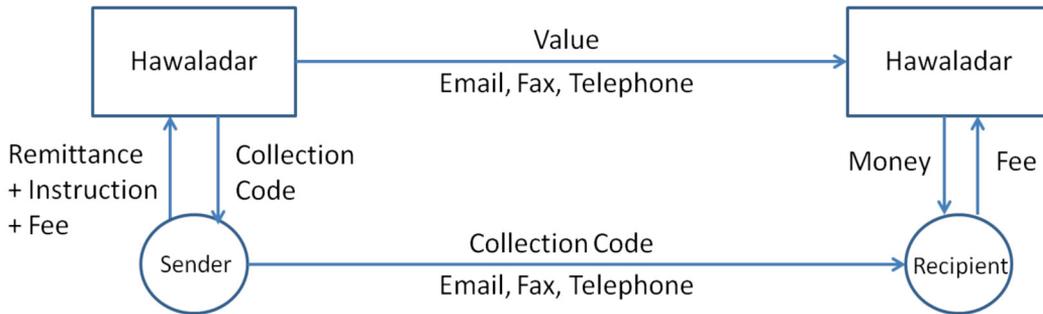
2.1 Types of IFT systems

IFT systems have several variants with different terms (Hernandez-Coss 2005), but they can be categorised into three general types: hawala⁶ in South Asia, Fei qian in China, and Black Market Peso Exchange (BMPE) in North and Central America.

Several hundred years ago, hawala was created to support trade financing in South Asia. In particular, hawala was attractive to traders who wanted to avoid the dangers of travelling with gold and other forms of payment on routes beset with highwaymen. At present, the primary users of the system are migrant workers in Europe, the Persian Gulf region, and North America who send remittances to relatives, especially in South Asia, the Middle East, and the Sub-Saharan Africa region (El-Qorchi 2002; Hernandez-Coss 2005; Hernandez-Coss & Bun 2007; Passas 1999; Rees 2010).

Hawala is based on trust between hawaladars (brokers) and users within the same ethnic group. In a sending country, a client hands over a sum of money to a hawaladar and requests that the equivalent amount (usually in the local currency of a receiving country) be sent to a designated recipient in a destination country. The sending hawaladar relays all the necessary information concerning the transaction to a counterpart hawaladar in the destination country either by telephone, facsimile or email. The client receives from the hawaladar of the sending country a 'collection code' that is agreed in advance between the two hawaladars. The client informs the recipient of the code that is necessary to present to the hawaladar of the destination country in order to collect the money (Buencamino & Gorbunov 2002).

Figure 1: Informal Funds Transfer system



Source: Developed by Han & Ireland.

Under hawala, each transaction does not involve the physical movement of money. A hawaladar in a sending country owes their counterpart the equivalent of the amount given to a designated recipient because the hawaladar in the destination country gives money to the recipient out of their own cash reserves. The debt of the sending hawaladar is cleared in several ways (El Qorchi, Maimbo & Wilson 2003). Some financial experts contend that there are many bilateral transactions (that is, hawala and reverse hawala) between two hawaladars and the reciprocal debts between them are cleared from their books (Buencamino & Gorbunov 2002). However, there are other ways of clearing the debts between them: this is the link to Customs which will be explained later in this paper.

The Chinese devised a system known as Fei qian, or flying money, more than a thousand years ago. It was a way for southern Chinese provinces to pay tax to the imperial capital without the risk of travelling and being robbed on the way (*The Economist* 2011). The basic mechanism of Fei qian is similar to that of hawala. The difference between the two systems is that a Fei qian broker gives their client a token necessary to collect the money requested for transfer. The client travels with the token and receives the money transferred through presentation of the token to a designated broker in another place.

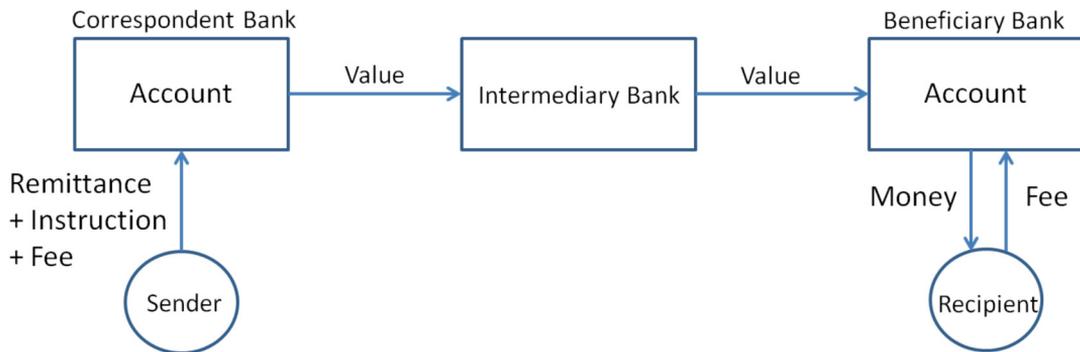
Unlike the other two systems with long historical backgrounds, the Colombian BMPE was developed in the 1970s as a vehicle for the movement of money across borders, especially to serve the needs of Colombian importers. Government exchange controls during the period made it difficult for Colombian importers to obtain the hard currencies (for example, United States dollars [US dollars]) needed to pay for their trades. The importers were willing to purchase US dollars at a premium over the official rate. The importers' demand for the hard currency was met by Colombian drug cartels which earned a number of US dollars in their drug sales in the US but needed to convert their criminal proceeds into Colombian pesos without relying on formal financial institutions. As a result, the Colombian BMPE began to be used as a vehicle to launder drug money and other illegally acquired wealth (Buencamino & Gorbunov 2002).

2.2 Advantages of IFT systems

Relying on IFT systems is a rational choice for the transfer of money because they have the same function as the formal banking sector; in addition, they are less expensive, swifter, and more convenient than the formal financial sector (El-Qorchi 2002). Due to their mainly minimal overhead expenses, IFT systems charge lower fees (for example, 0.25 to 1.25 per cent of the amount transferred) for their money transfer service than the formal banking sector with high minimum surcharges. IFT systems provide better exchange rates for their clients than conventional bank institutions. Recipients can collect money from IFT brokers in destination countries two or three hours after correspondents ask IFT brokers to transfer remittances to recipients, whereas it takes two or three days for the formal banking sector to send remittances. In cases of sending money to developing countries where financial institutions are barely

stationed at each town and governments strictly control the supply and demand of foreign exchanges, it takes more than a week to receive money through the formal banking sector. In addition, whereas the formal banking sector checks senders' identifications and requires recipients to have appropriate bank accounts, IFT systems do not (Buencamino & Gorbunov 2002; Hernandez-Coss 2005; USDS 2012).

Figure 2: Transferring money through the formal banking sector



Source: Developed by Han & Ireland.

2.3 Concerns with IFT systems

The merits of IFT are attributed to the absence of bureaucracy; the advantages, on the other hand, play a role in drawing and supporting illegal activities. The formal banking sector is obliged to screen their clients and transactions according to the due diligence process (USGAO 2003). If they detect suspicious transactions, they are generally required to report their findings to the government. However, IFT systems do not face similar regulatory requirements. The characteristics of IFT systems, such as anonymous transactions, weak recordkeeping, non-transparent settlement systems, and the absence of regulatory oversight,⁷ are of great use in laundering criminal proceeds by covertly moving and integrating criminal proceeds (for example, drug money) into legitimate business earnings.⁸ This makes IFT an attractive vehicle for illicit activities (IMF 2005; McGusker 2005; Passas 2003; Rees 2010; USDS 2012).

Policymakers have addressed the problem from a financial perspective in that IFT systems are a kind of unregulated financial system. International organisations and finance experts contend the improvement in the quality of service in the formal banking sector (for example, lowering official exchange rates and transaction fees) is needed in order to divert the clients of IFT systems to formal financial institutions. Another option that has been implemented in some countries is to legalise⁹ IFT systems by getting them registered or licensed (Rees 2010). As in the formal banking sector, financial regulation alone, however, has not controlled illegal movement of funds through IFT systems (El Qorchi, Maimbo & Wilson 2003).

3. IFT systems and Customs

3.1 Relevance of Customs to IFT systems

Transferring money of migrant workers to their families in home countries through IFT is not an issue for customs administrations. If traders settle their payments through IFT systems, however, this is a different story: IFT systems would thus enter into the domain of customs law. Even though customs tariff rates have decreased in recent decades, traders in many countries still need to pay considerable amounts of customs duties and taxes for importing or exporting goods. To evade customs duties and

taxes, some importers and exporters collude to manipulate their invoices. Some traders conduct their illegal businesses in a more sophisticated fashion: they settle their payment through IFT systems rather than formal financial institutions in order to evade customs regulatory requirements¹⁰ (Passas 2003; Rees 2010).

Table 1: Trade payment and IFT systems

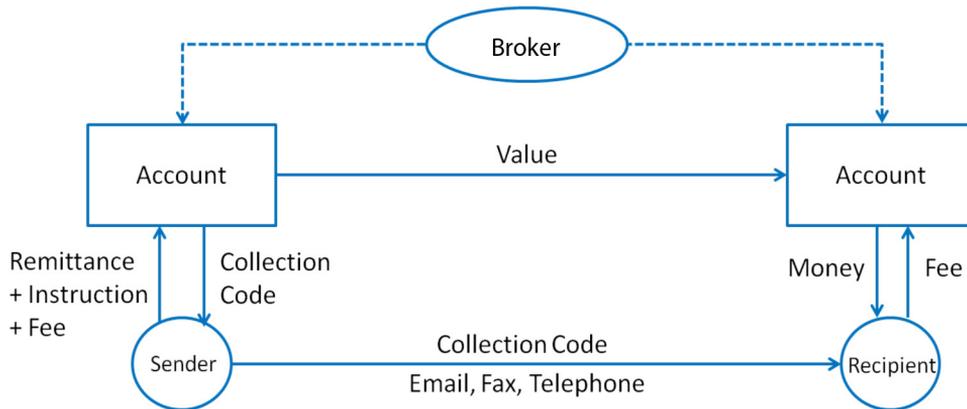
Player	Balance	Possible Offence	Role of IFT systems
Importer	Value declared < Value paid	Customs duty evasion, Capital flight	Transferring part of payment to the exporter
	Invoiced price > Actual price	Bogus trade, Tax evasion	Retrieving over-payment from the exporter
Exporter	Invoiced price < Actual price	Tax evasion	Receiving part of debt from the importer

Some traders exploit IFT systems to siphon their taxable or tax-evaded funds¹¹ overseas as well. They devise a motive to remit their funds with bogus trade and flee their funds (UNDP 2011) through IFT systems. In other words, the importers place orders for worthless goods, such as books or CDs, colluding with exporters for over-invoicing and send payment based on over-valued invoices. They covertly retrieve the over-payment from the exporter via IFT systems (Passas 2003). Of course, tax evasion through IFT systems and the transfer of tax-evaded funds *per se* are not the business of Customs. Customs administrations, however, need to have a heightened interest in bogus trade in the sense that that trade can be exploited as a channel for money laundering. The exporter also employs IFT systems to evade a tax on their sales. The exporter pays a corporate income tax in proportion to their profit which is closely related to their sales. To hide their sales, the exporter issues under-valued invoices, colluding with the importer, and receives invoiced payment via formal banks and retrieves the difference between the invoiced price and actual price via IFT systems.

IFT systems should be of interest to customs administrations because they may be related to informal cross-border trade (Pohit & Taneja 2003; Taneja 2004). Informal cross-border traders¹² have difficulty in collecting their debts through formal financial institutions. The traders do not want to take risks coming back with huge quantities of cash. Thus, the informal traders (exporters) either ask importers to send the money that they should collect from them through IFT systems or collect their debt in person in an importing country and transfer the money to themselves through IFT systems. Thus, when it comes to controlling informal cross-border trade, it is efficient to start locating IFT systems rather than tracing individual informal traders.

Conventional wisdom holds that IFT systems are completely separated from the formal banking sector and that their role is to satisfy the needs of the poor who have difficulty in using bureaucratic and high-end services of formal financial institutions. However, as IFT systems are gradually employing information technology for their services,¹³ they are becoming connected to the formal banking sector. This makes IFT systems more attractive to traders who need both the formal banking sector's high-end service and the IFT systems' anonymity.¹⁴ In other words, an IFT client does not need to hand over their money to an IFT broker in person in order to transfer their remittance to a recipient; the client wire transfers their money to the broker's bank account. Because the broker has many bank accounts in several countries, they do not need to contact a counterpart broker (Passas 2003). After making sure how much money a client deposited in their bank account, the broker merely transfers the same amount of money that they were asked to transfer to the recipient's bank account. The broker does not move their money from a bank account to another bank account. What they do is to take money (for example, Korean Won) into a bank account and take the same amount of money (for example, Chinese Yuan Renminbi) out of another bank account in order to give the money to a recipient.

Figure 3: A variant model of IFT systems



Source: Developed by Han & Ireland.

The evolution of IFT systems is thus not just influenced by development of an online banking system but also facilitated by a liberalised policy of the formal banking sector. Many countries allow foreigners to easily open bank accounts (for example, non-resident accounts) as far as they meet some criteria (for example, identification and residential address).

Customs administrations’ attention to IFT systems should not be confined to payment through IFT systems. IFT systems draw the attention of Customs to the process of settling each IFT broker’s debts. Even though both IFT brokers bilaterally reiterate their money transferring transactions, if the amounts of money transacted are not exactly the same between two brokers, the process of restoring a balance between the two parties is necessary (El Qorchi, Maimbo & Wilson 2003; Passas 2003). A wire transfer through the formal banking sector is the simplest and easiest way. Some brokers settle their debts through smuggling gold and bulk cash (Passas 2003). Smuggling gold and bulk cash itself is illegitimate but this can lead customs officers to IFT systems that are spawning more illegal activities. Manipulation of invoices is also employed to clear debts between IFT brokers (McCusker 2005). If the two brokers have been involved in regular trade as well, they can restore their balances through manipulation of export and import invoices. Given that customs duty rates for some commodities are zero, over-invoicing can be used as a way of restoring balance (Passas 2003). Over-shipment (actually under-invoicing) is also employed to settle debt, which means that IFT brokers owed by other brokers receive goods for their credits instead of money.

3.2 Customs’ approach to IFT systems

IFT systems generally have not been a consideration of customs enforcement. Thus, many customs officers may not have expertise on how to access and detect IFT. However, although in many countries IFT systems are not *per se* targets of customs enforcement, customs administrations should increase their interest in what occurs in IFT systems because illegal international trade activities supported by IFT should be controlled by those administrations.

Many customs administrations do not have authority to examine IFT systems directly. Thus, customs administrations need to develop methods to consider IFT systems. One of the methods is to trace the ‘flow’ of money paid to import goods rather than to discover the static value of imported goods in terms of valuation. When customs officers conduct post-clearance audits on importers, they need to examine what kinds of methods are used for their payments (for example, Letter of Credit or Telegraphic Transfer¹⁵) and whether there are discrepancies between the invoiced amount and the actual payment. When analysing the relationships between recipients and importers, customs officers can identify that several

importers' funds converge on a certain 'domestic' bank account which does not have normal business relationships with importers, even though transactions for the payment are related to 'international' trade.¹⁶ The domestic bank accounts are likely to be IFT brokers' bank accounts.

Clues leading to IFT systems can be obtained at ports as well. Many customs administrations pay attention to the detection of undeclared cash smuggling but are not interested in discovering the motives for the importation of bulk cash, or the origin and destination of cash. Customs are supposed to tackle money laundering in which cash couriers are involved. Paradoxically, Customs are likely to legitimise suspicious money if customs administrations simply accept the declaration of import of cash. When customs officers take declarations of large amounts of cash,¹⁷ they should suspect several possibilities. For instance, the declared money may be imported to clear debts between IFT brokers and those brokers may be involved in the settlement of illicit trade. In addition, when customs officers detect bulk cash smuggling, they may tend to close the case after imposing fines on smugglers. Deeper investigation, however, may identify IFT brokers to whom the smugglers are supposed to deliver the money.

4. Conclusions

Although IFT systems can be used for legitimate purposes, they also have characteristics applicable to conducting illicit trade. Moreover, it is apparent that IFT systems have under some circumstances been used to avoid compliance with customs laws. Because most IFT systems operate in the black market, they have been largely beyond the reach of customs enforcement. Thus, it will take time for customs administrations to build up expertise on enforcement against non-compliance where IFT systems are used. Cooperation with tax agencies and financial supervisory authorities that have experience and intelligence regarding IFT systems will enable better understanding by Customs and strengthen the ability to investigate.

The primary objective of customs enforcement of IFT systems should not be to crack down on IFT systems *per se* but to investigate how they buttress illegitimate trade and non-compliance with customs regulations. That is because targeting criminogenic opportunities where illegitimate trade can spawn and thrive can have a wider impact than controlling individual illegitimate traders.

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Notes

- 1 This article should not be reported as representing the views of the World Customs Organization (WCO). The views expressed in this article are those of the authors and do not necessarily represent those of the WCO or WCO policy.
- 2 The authors are grateful to Thomas Cantens, Mariya Polner, Norbert Steilen, and Tadashi Yasui of the WCO, Michael Weeding of HM Revenue and Customs, and Youngho Joo of the Korea Customs Service for their input.
- 3 Most customs administrations regulate people only with respect to the goods and money they carry across borders. A small but growing number of customs administrations regulate people as a matter of immigration and security.
- 4 While Al-Qaeda transferred funds to the 9/11 operatives using the formal banking sector, for other plots it funnelled funds through IFT systems (*The Economist*, 22 November 2001).
- 5 The UK's HM Customs and Excise is a notable exception. The UK government requires money service businesses to register with UK Customs and provide UK Customs with authority to audit such businesses (IMF 2005).
- 6 The term 'hawala' originated in India; IFT systems are called 'hundi' in Pakistan.
- 7 In return for taking risk, some hawaladars charge higher transaction fees for seemingly criminal proceeds (El Qorchi, Maimbo & Wilson 2003; Rees 2010).

- 8 Money laundering is an operation that converts criminal proceeds into assets to evade the attention of law enforcement authorities. It generally involves the three sequential elements of placement, layering, and integration, in order to conceal the source and existence of criminal proceeds (Reuter & Truman 2004).
- 9 The Financial Action Task Force on Money Laundering (FATF) recommends every country penalise IFT and IFT systems as long as IFT systems are not registered or licensed (FAFT 2003).
- 10 Some importers pay only the invoiced price to exporters through the formal banking sector; then they use IFT systems to remit the difference between the actual price and the invoiced amount to exporters (El Qorchi, Maimbo & Wilson 2003).
- 11 When someone transfers their funds to a third party (for example, to their family members), they need to pay transfer tax or gift tax. Some traders evade gift tax on their funds transfer by exploiting bogus trade and IFT systems.
- 12 The connotation of informal trade includes not only illegal trading (for example, the smuggling of goods) to circumvent tariff and non-tariff barriers but also extra-legal trading (for example, trading by unregistered or unlicensed traders) that is tolerated in practice even if it is technically illegal (Pohit & Taneja 2003).
- 13 Many hawaladars operating in Korea and China use online banking services of the formal banking sector to deposit money and remit it to either China or Korea.
- 14 Even though transaction trails between hawaladars and traders (importers or remitters) may be left, monetary relations between importers and exporters are not observable.
- 15 Telegraphic Transfer is easier than Letter of Credit to employ IFT systems for customs duty evasion in the sense that the importer can decide the number and extent of payments without the interference of formal banks, compared to Letter of Credit where formal banks assure invoices and send the payments which the invoices indicate. However, if invoices are manipulated, the Letter of Credit method is also involved in customs duty evasion with IFT systems.
- 16 In order to identify IFT systems' bank accounts, customs administrations need to conduct regular post-clearance audits on traders and establish a database that contains information of remitters and recipients.
- 17 Customs' role in anti-money laundering has been confined to controlling cash couriers according to the FATF Recommendations, which are international standards on combating money laundering.

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