# The Implementation of Value Transfers in an Era of Financial Volatility:

## meeting the logistical challenge

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# Value transfers in a globalised world

- Globalisation has transformed the operation of wholesale money markets
  - value can now be transferred instantly on the click of a mouse
    - provided that one has access to SWIFT
    - and the transfer is implemented on a wholesale basis between major financial centres
- By contrast values transfer facilities for personal customers and SMEs are ill-developed
  - even within single currency zones, fully electronic real-time inter-bank payments systems for non-corporate customers are still under construction
  - but the moment one seeks to transfer value across national boundaries
    - and above all as between differing currencies
  - the whole process becomes as expensive as it is sclerotic
- If one also throws in the prospect of making transfers involving ‘exotic’ currencies
  - the problems, and the costs, redouble
  - especially in the light of current levels exchange rate volatility
    - let alone the plummeting value of the global unit account
- Whilst globalisation is precipitating an exponential growth in the level of customer demand for value transfers in all conceivable directions
  - why is it that although goods and information now move with such ease around the globe
  - Value transfer on anything other than a corporate basis remains so sclerotic?

# The logistics of cross-currency value transfers

- An audience such as this needs no reminding that there is no such thing as a value transfer in forex contexts
  - all such transactions are ultimately part of a zero-sum exchange
    - in which there is an equivalent transfer of value in the reverse direction
- It is equally self-evident that efforts to line up separate settlements for each and every retail exchange would be hopelessly inefficient
  - since the consolidation of individual transactions to facilitate bulk settlements generates massive economies of scale
- But to implement this task all viable cross-currency payments systems must also include
  i. facilities to consolidate and de-consolidate value in numerous currencies/locations
  ii. facilities to broker value exchanges (i.e. settlements) as between them
- Implementing these processes reliably is a complex logistical task
  - doing this can easily high levels of clerical activity, and hence of overheads
    - however these can readily be offset against the income generated by the funds held in transit
  - hence established operators in the forex field have a strong interest in holding onto their clients funds for as long as possible
- On top of this overhead costs not significantly affected by the size of the transfer
  - hence they have little interest in meeting the needs of low net worth customers
    - and most especially those who make small transfers to obscure destinations

# Hawala networks: an alternative value transfer system

- In recent years IVTS/Hawala networks have emerged as significant players in the global value transfer market
  - above all as a cheap and convenient means for migrant to remit their savings to their kinsfolk back home
    - ➢ no matter how remote and rural that destination might be
- But in the aftermath of 9/11 these networks became the focus of intense suspicion
  - on the grounds they were merely a ‘front’ used by criminals and terrorists to conceal their nefarious activities
    - ➢ even though very little concrete evidence has ever been produced to support these assertions
- All of which has diverted attention from key issues
  - how did such systems originate?
  - how do they manage to operate with such logistical efficiency?
  - how are they responding to efforts to drive them out of business?
  - what lessons can be learned from their success?
  - what role does/should regulation play in this sphere?

# The logistics of Hawala

- The term Hawala is of Arabic origin
  - meaning both ‘a transfer’ and ‘ an exchange’
- The key feature of every contemporary hawala operation is a pair of back-back to back swaps
  - a settlement, in other words
- Hawaladars are those who engage in the implementation of such settlements
  - whilst hawala networks are the arenas within which they are brokered
- Which they utilise to address precisely the logistical challenges which I’ve just been describing market
  - including the delivery of penny-packet consignments of value to remote destinations
  - much more swiftly and cheaply, yet just as reliably as their formally constituted competitors
- So just how do they manage to pull off such a feat?

# Origins and growth

- Hawala networks did not appear out of the blue
  - they are the heirs of system developed to facilitated long-distance trade around Indian Ocean long before the arrival of Europeans
- Which have reached out into the global value transfer market as a result of three parallel developments
  1. the burgeoning growth of national, international, and intercontinental labour migration from rural to urban areas
     - and the consequent reverse flow of remittances
  2. a dramatic fall in the cost of long distance messaging systems, and the a global extension of their reach
  3. the rapid growth in South-South inter-regional trade
     - generating a demand for all manner of cross-currency settlements
- Creating a niche in the market which Hawaladars begun to fill in steadily more sophisticated ways
  - by skilfully combining  ancient and modern methodologies to meet the underlying logistical challenges of transnational value delivery

# Sorting out the back office

- No financial operation can hope to be successful in the absence of procedures to ensure that data is accurately recorded and transmitted
  - and all the more so when distance increases the risk that administrative laxity will provide opportunities for criminal malfeasance
- Which is one reason why conventional modes of value transfer generate an exceptional volume of paperwork
  - checking, and confirming every detail at each and every stage of the transaction is labour-intensive, and yet further inflates overheads
- But if risk could be contained on a less labour intensive basis
  - back-office costs could be slashed
  - transactions more speedily processed
    - and charges to customers greatly reduced
- This is the secret of the success of contemporary Hawala networks
  - by developing sophisticated multi-layered settlement strategies
  - by reducing data transmission solely to that required accurately to implement the component of the transaction immediately to hand
  - and by utilising *coalitions of mutual trust* as a backstop against the risk of malfeasance
- Contemporary Hawaladars have devised a ‘lean and mean’ solution to the logistical challenge of remittance delivery right through to the last mile
  - giving them a huge competitive advantage over their rivals in the formal sector

# The Hawaladars' key asset: Coalitions of Reciprocity

- No financial system can operate smoothly in the absence of confidence that agreements with one's partners will be honoured
  - and as the credit crunch has reminded us, trust is a fragile commodity
    - and once lost, is incredibly difficult to restore
- Hawala networks serve to remind us that trust is not only an immensely valuable asset, but also one which is most easily sustained in the context of a tight-knit *moral* community
  - within which betrayal of trust precipitates an exceptionally powerful sanction
    - comprehensive exclusion, not just from business activity, but from the entire community to which the malfeasant and his family belongs
- In the absence of such a moral community fully documented formal contracts become a necessary bastion against the risk of malfeasance
  - thereby inflating overhead costs
  - and even then my no means necessarily overcome the corrosive impact of mistrust
- However in those parts of the world where moral communities are still in good shape
  - as is still the case in much of the Indian Ocean region
  - and also within migrant workers' tight-knit ethnic colonies
- Coalitions of reciprocity, and hence of mutual trust continue to underpin a great deal of commercial and business activity
  - Hence they have not only provided fertile arenas within which to construct and maintain trust-based value transfer networks
  - but have also provided them with a key source of competitive advantage

# Delivering remittances: the financial and logistical challenges

- All those providing remittance services find themselves confronted by two parallel challenges:
  i. A *financial* challenge: converting customer's funds from one currency into another
  ii. A *logistical* challenge: delivering those re-denominated funds into the hands of distant
- Whilst currency-conversion is readily achieved on wholesale basis in forex markets
  - the marginal cost of converting small sums is prohibitive
    - ➢ hence economies of scale are a prerequisite for commercial efficiency
  - so arrangements to consolidate innumerable penny packets into commercially negotiable tranches need to be put in place
  - moreover costs can be further reduced by brokering back-to-back settlement swaps
    - ➢ such that the negative spread on forex market transactions can be avoided
    - ➢ and even reversed if swaps are brokered at unofficial rates
- Meanwhile the logistics of value-delivery are yet more challenging still, especially over the last mile:
  - even when large tranches of value have been converted into foreign currencies
  - they still need to be accurately disaggregated
  - and then delivered at speed, to recipients largely resident in obscure rural destinations
- How, then, do Hawaladars crack these challenges?

# The Hawala solution

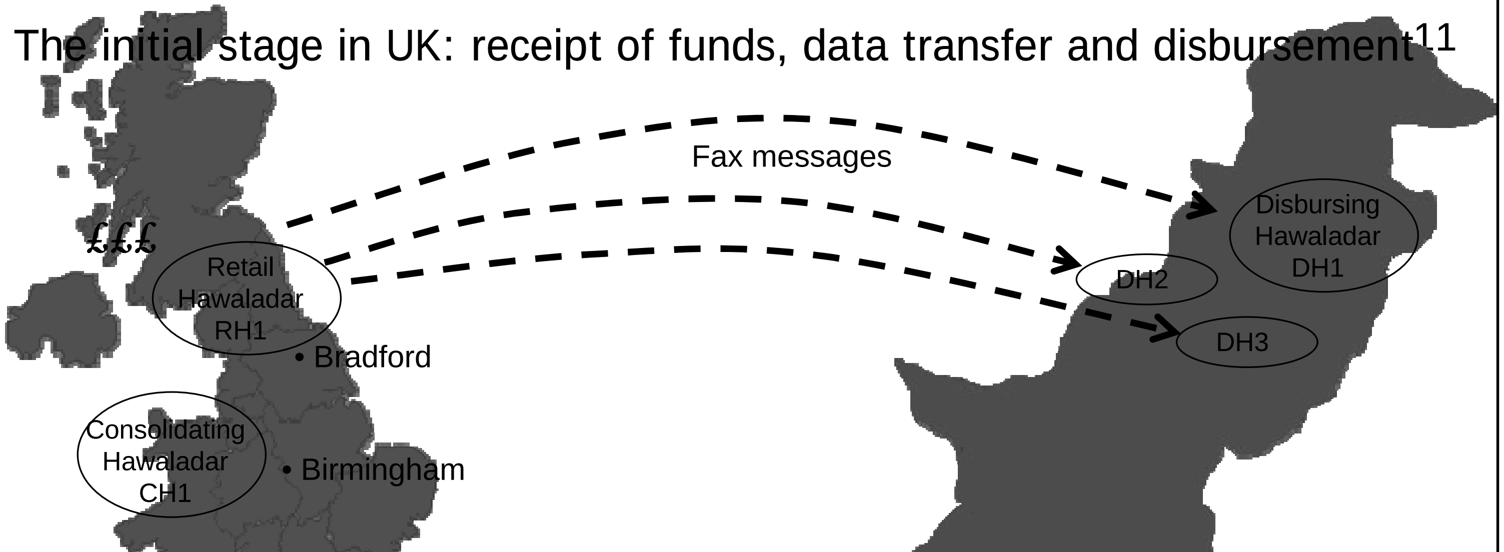
- Besides their capacity to implement their transactions within the context of coalitions of reciprocity, the solutions to these logistical challenges developed by contemporary hawaladars display two key features:

1. Their capacity to separate the *messaging* dimension of transfer processes from their *settlement* dimensions
2. Their ability to construct a hierarchy of mutually cooperating Hawaladars within which to layer the various dimensions of the settlement process within the context of a distributed system
   – such that they are in a position to execute an inter-related series of individually brokered transnational *pas-des-deux* between themselves on a daily basis
     ➢ during the course of which large tranches of value are consolidated and deconsolidated
     ➢ mixed, matched and swapped on a global basis
     ➢ in such a way as to precipitate cross-currency transfers which meet host of globally distributed customers' forex requirements on a daily basis

- Before proceeding further several further distinctive features of this system are also worth noting
  i. since the system operates in real time, no-one holds customers' assets for long enough to make extract investment benefits from them
  ii. foreign exchange risks are minimised since all deals are contracted at spot rates
  iii. since this is a distributed system without a central registry, no-one has a comprehensive view of all elements of the global settlement

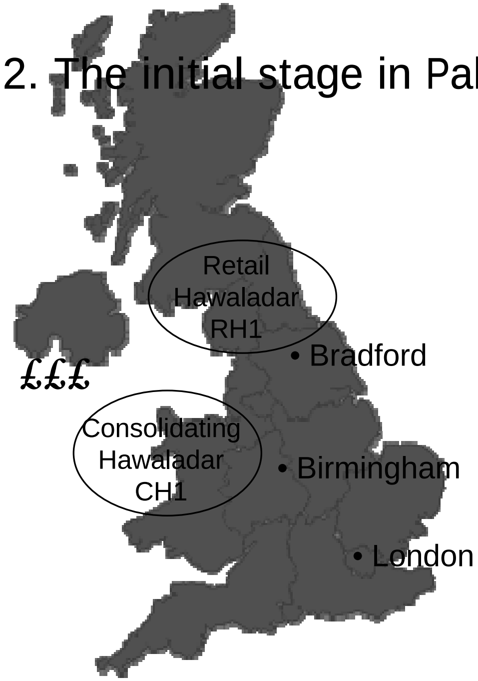
## 1. The initial stage in UK: receipt of funds, data transfer and disbursement

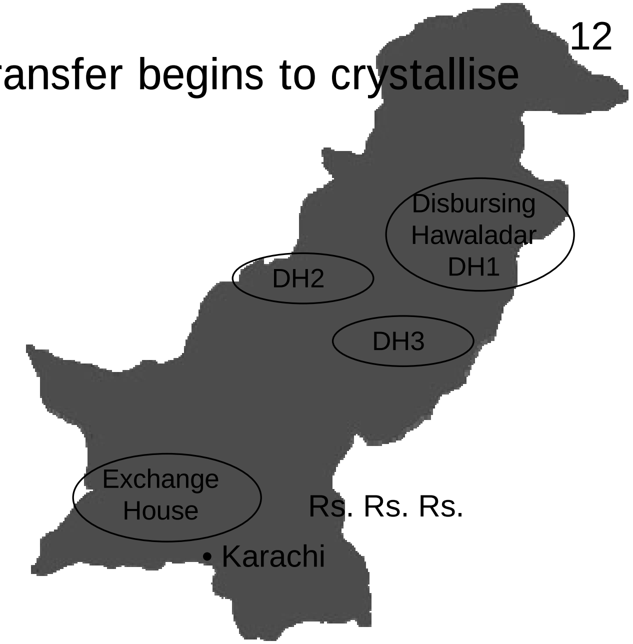





1. RH1, a retail sending hawaladar in Bradford has received orders to deliver a total of £30,000 to his customers' relatives in Pakistan
   - this made up of 35 individual transactions for sums of between £200 and £2,000, to be converted at the rate of £1 = Rs. 130
     - a rate agreed with his consolidating hawaladar CH1 in Birmingham that morning
   - as well as to several more in others localities in Northern Pakistan with whom he does business
2. At close of business he faxes a list of delivery instructions to his disbursing partners DH1, DH 2 and DH3 in Northern Pakistan
   - which they will set about implementing the following day
3. And make arrangements to send £30,000 in cash to CH1
   - together with instructions to arrange appropriate cash deliveries in rupees to DH1, DH 2 and DH3 etc in Pakistan

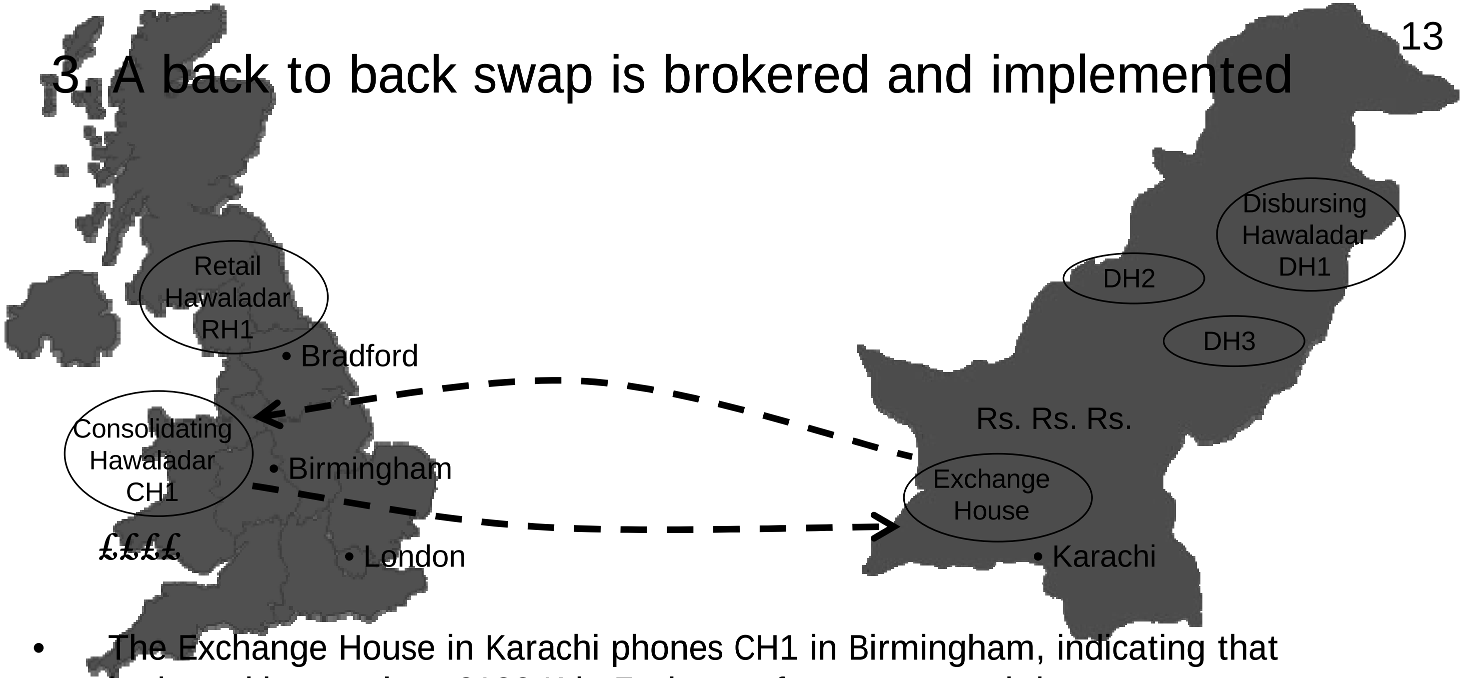
## 2. The initial stage in Pakistan: a reverse transfer begins to crystallise



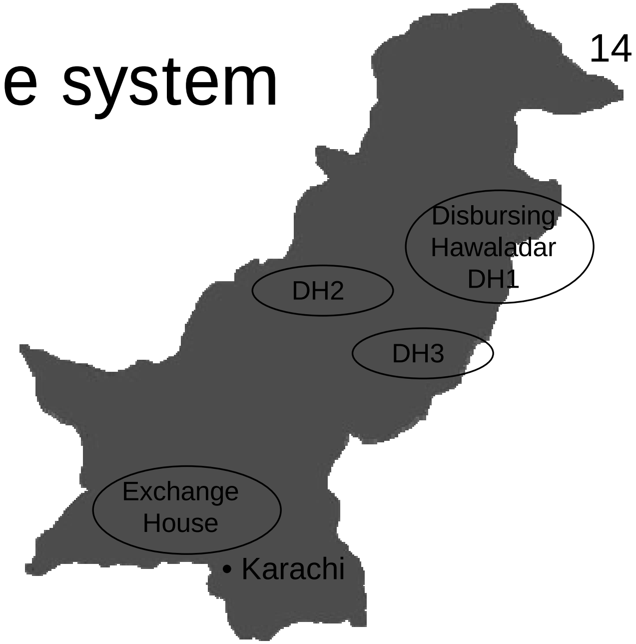

- Meanwhile in Karachi three businessmen have invoices to settle to a total £100 K for goods imported from the UK
- Having checked the rates on offer at several Exchange Houses in Karachi
  - they hand over a total of Rs 14 million to an agent of their selected Exchange house
  - together with details of their suppliers' bank accounts in the UK into which a total of £100 K is to be deposited

# 3. A back to back swap is brokered and implemented




- The Exchange House in Karachi phones CH1 in Birmingham, indicating that he is seeking to place £100 K in Exchange for rupees, and they agree on a deal @ Rs 135 to the Pound, to be implemented later that day, whereupon:
  i. The Exchange House faxes its local agent in London to signal the impending arrival of £100k, along with details of the bank accounts into which the funds are to be deposited
  ii. Hawaladar CH1 faxes delivery instructions to the Exchange House in Karachi, such the a total of Rs. 13.5 million are physically transferred to DH1, DH2, DH3, DH4 and DH5
     - since CH1 is providing transfers services for RH 2, RH 3, and RH 4 as well as RH1
  iii. CH1 then phones RH1, RH 2, RH 3, and RH 4 to inform that delivery is in train
  iv. Later that day the settlement is implemented, and the deal is complete

# Key features of the system


- Several key features in this system are worth noting
  1. All the elements of this complex deal are executed on the basis of reciprocities of mutual trust
  2. Information is transmitted on a need to know basis; CH1 will have no information about the precise identify of the ultimate retail beneficiaries of the transfers he has brokered
  3. But this is not a 'system without records': it could not work reliably without the accurate transfer of delivery information
  4. Rather it is a 'lean and mean' operation in which unnecessary (and hence redundant) information transfers are avoided
  5. Such that the whole operation is vigorously competitive
  6. And can also readily be spatially and geographically extended

# Global Hawala

- So far I have presented you with a highly simplified model
  - in which I have hugely shrunk the number of hawaladars
  - and assumed that settlements are straightforward GBP/PKR exchanges
- In reality
  - Pakistani migrants are to be found in large numbers in the Gulf, throughout Western Europe and in North America
  - only a very small portion of Pakistani imports are priced in sterling
  - hawala networks also facilitate value transfers to and from East Africa, throughout the Middle East and across the rest of South Asia
- All these networks are interconnected, and are ultimately brokered through the Exchange Houses of Dubai
  - such that the units of account in global hawala settlements are tranches of value stacked up in multiples of $100,000

# Formal or Informal?

- Whilst frequently described as Informal Value Transfer Systems (IVTS), contemporary transfer systems constituted on this basis are in no sense
  - small scale
  - operationally and logistically unsophisticated
  - or low-tech
- Nor are they disengaged from the international banking system
  - to be sure they normally operate on a cash basis over the first and last miles
  - but top-level consolidated swaps such as those brokered in Dubai have long been settled via US$ accounts held in Wall Street Banks
  - and as the impact of post 9/11 AML/CFT regulations became steadily more draconian
    - ➢ so and ever greater portions of the processes of consolidation and deconsolidation have also been implemented within the formal sector
- As this has happened the formally Exchange Houses have extended their reach
  - recruiting consolidating and the retail hawaladars as their formally registered agents
    - ➢ with the result that large parts of their formerly independent operations were relocated in the Exchange Houses' back-offices
    - ➢ as a result the distinction between 'formal' and 'informal
  - so much so that Hawala networks willing to identify themselves as such have evaporated
  - since no-one wishes to be tarred with the suggestion that they are, or ever have been, engaged in activities which are labelled as 'criminal' in a post-9/11 world

# AML/CFT

- Given the disastrous consequences of toxic debt, no-one needs to be reminded of the crucial role of regulation in maintaining the integrity of financial systems
- But in this sphere we meet a major contradiction
  - whilst loose regulation and globalisation have unleashed an escalating series of speculative bubbles
  - value transfers have been subject to intense and regulatory scrutiny
    - ➢ not to secure the integrity of the financial system
    - ➢ nor to secure customer’s funds against malfeasance
    - ➢ but instead to counter money laundering and finance for terrorists
- However there is little sign that this costly regulatory exercise has achieved its announced purposes
  - trillions of tax- and regulation-evading dollars are still stashed away offshore
  - terrorists and drugs smugglers remain as active as ever
  - and despite its nominal evaporation, the ‘informal’ sector remains in business
    - ➢ not so much as an arena for AML/CFT evaders
    - ➢ but rather because it offers a highly efficient means of implement transnational value transfers on behalf of migrant workers, SMEs and so forth

# Value transfer and the management of risk

- Whilst anyone who places assets in the hands of someone else puts them at risk, funds placed with a value transfer agent have a very different status from those deposited in a bank:
  - whilst banks are entitled to utilise such deposits for money-making purposes
    - whilst making provisions to return them to customers as and when required
  - value transfer agents only take brief custody of their customers' assets during the delivery process
    - and if delivery does not take place, feed-back is swift
- Since system-failure is much more difficult to conceal, risks far smaller than those to which bank depositors must of necessity expose themselves
  - and diminished yet further when constrained by reciprocities of mutual trust
- Hence regulatory initiatives which demand that every transaction remains identifiable throughout the transfer process
  - satisfying, amongst other things the audit trail demands of AML/CFT
    - overheads would be substantially ramped up, but bringing few if any benefits to customers
- So if AML/CFT does not catch criminals
  - and there are few signs that it does
- Can there be any justification for the criminalisation of Hawala-style networks?
  - given the intrinsic financial efficiency of their methodologies
  - the incorporation of their methodologies into above-ground systems makes far better sense
    - especially when such developments are already in train

# Some concluding queries

- In a globalised world, large corporations maintain their own self-constructed international value transfer systems
- Whilst individuals and SMEs buy in specific financial services, including facilities for
  1. value storage in each of the financial jurisdictions within which they operate
  2. value transfers within each such jurisdiction
  3. value transfers as between those jurisdictions
- If so
  - can a single service provider hope to provide customers access to all these services with equal efficiency?
  - or is there a role for specialist agencies to broker low-cost forex transactions independently of local value storage and transfer operators?