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Afghan Narcotrafficking Illicit Financial Flows

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**Joint U.S.-Russia
Working Group on
Afghan Narcotrafficking**

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Money
changers in
the bazaar of
Mazar-I-Sharif,
Afghanistan.



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The Afghan Narcotics Industry: A Contextual Framework

With Afghanistan's weak and poorly functioning government and public administration institutions, high levels of corruption (kleptocracy), a huge outflow of citizens (including young and educated people), an almost total lack of ability to enforce the rule of law and a worsening security situation, the stage is set for the growth of illicit finance and financial flows, especially in view of the expansion of drug cultivation, production and trafficking in Afghanistan and the surrounding region. These factors position today's Afghanistan as a multibillion-dollar narcotics enterprise vulnerable to exploitation by terrorist groups, drug traffickers and all those looking to enrich themselves through corrupt practices. Interactions and collaborations among these actors can potentially lead to further growth in narcoterror-

ism activity inside and through Afghanistan's territory and financial systems.

Afghanistan is an impoverished country with a population of some 30 million people located in Southwest Asia. In 2015, Afghanistan's gross domestic product (GDP) per capita was 594 USD, ranked 214 out of 228 countries by the World Bank. That same year, its total GDP was estimated by the World Bank to be 19.3 billion USD, but this figure does not include profits from illicit drugs and weapons or other trafficking. From 2007 to 2015, the Afghan GDP increased significantly (figure 1).

Agriculture, which was by far the most active sector before 2001, decreased to 26 percent of the GDP in 2015, while the services sector—including wholesale, retail trade, restaurants,



Figure 1. Afghan GDP in USD billions

SOURCE: WWW.TRADINGECONOMICS.COM | WORLD BANK

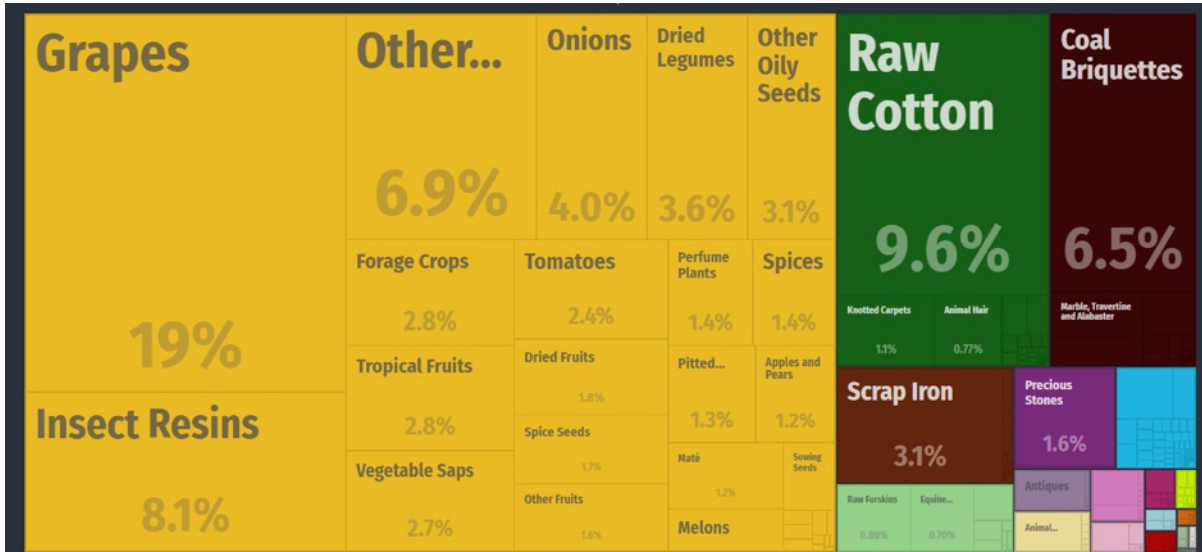


Figure 2. Afghan exports (Source: The Observatory of Economic Complexity)

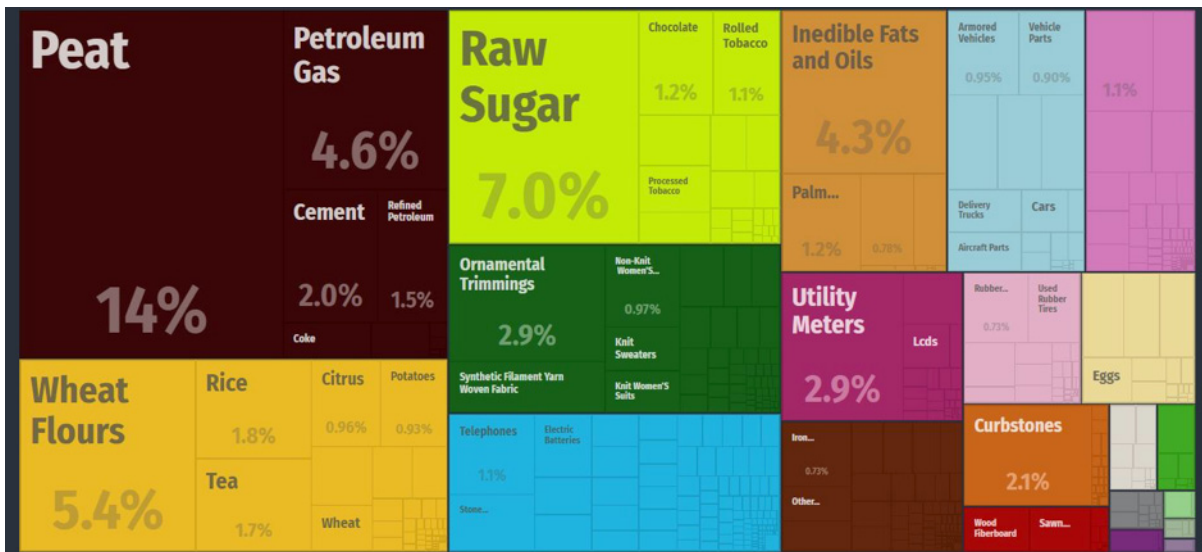


Figure 3. Afghan imports (Source: The Observatory of Economic Complexity)

hotels, transports, storage, communication, finance, insurance and real estate, as well as community, personal, social and governmental services—accounted for 49 percent of the total GDP that year. Manufacturing and mining industries made up 13 percent, with construction representing 12 percent of the GDP.

Total exports out of Afghanistan in 2015 amounted to 866 million USD and total imports came to 7.63 billion USD (figures 2 and 3).¹

In 2015, the main destination countries for Afghan exports were Pakistan (45 percent), India (32 percent), Iran (3 percent), Turkey (2.7 percent) and United Arab Emirates (2.4 percent). An estimated 2.1 percent of exports went to Russia and 2.1 percent to the

United States. The main countries exporting to Afghanistan in 2015 were Pakistan (26 percent), Iran (13 percent), China (7.7 percent), India (7.3 percent), Turkmenistan (7.2 percent), Kazakhstan (5.4 percent), Malaysia (4.1%) and Azerbaijan (2.9 percent).

Since the North Atlantic Treaty Organization (NATO) intervention in 2002, the Afghan economy has become extremely dependent on the spending of foreign military forces present in the country. In early 2016, the Afghan economy collapsed primarily due to the withdrawal of U.S. troops and, to a lesser extent, foreign NATO troops in Afghanistan. From 2002 to 2016, the United States alone invested more than 113 billion USD in the Afghan economy, but the results have been rather disappointing. According to the Spe-

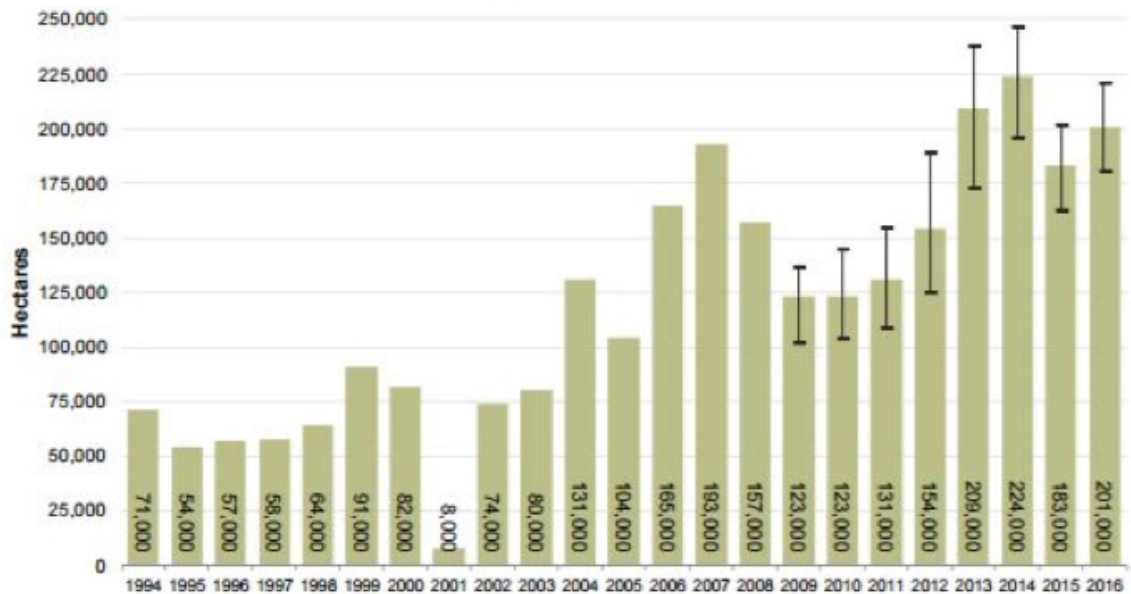


Figure 4. Opium poppy cultivation in Afghanistan, 1994-2016 (hectares) (Source: UNODC, *Afghanistan Opium Survey*, 2016)

Sources: MCN/UNODC opium surveys 1994-2016. The vertical lines represent the upper and lower bounds of the 95% confidence interval.

cial Inspector General for Afghanistan Reconstruction (SIGAR) report of January 2016,² President Ashraf Ghani stated that the draw-down of coalition troops led to the loss of at least 100,000 jobs in the transport sector alone, which had contributed to roughly 22 percent of Afghanistan's GDP. The construction sector and connected services driven by U.S. military contracts accounted for 40 percent of the country's GDP.³

Consequently, foreign lending to Afghanistan more than doubled between 2015 to 2016, from 270 million USD to 717 million USD.⁴ However, this can hardly compensate for the loss of the infusion of U.S. dollars by NATO and U.S. agencies.

The refugee crisis of 2015 that involved a flood of migrants leaving Syria for Europe also included refugees fleeing Afghanistan. As of November 2015, the United Nations (UN) Refugee Agency estimates that 23 percent of the approximately 660,698 people who fled to Europe by sea have been Afghans.⁵ In fact, only Syria has had more refugees and immigrants flee to Europe than Afghanistan. The UN Refugee Agency also estimated that approximately 197,000 people had been displaced within Afghanistan in 2015.⁶

Refugee flows out of Afghanistan and back also provide potential channels for drug and financial flows. Afghan migrants to Iran have reportedly been the agents bringing drug abuse from Iran to Afghanistan.⁷ However,

reports of such flows have been scarce so far due to the lack of evidence and poor intelligence, and as such, it is difficult to estimate the scope of the problem. Additional research and reports on this issue are required.

On the other hand, what makes Afghanistan stand out in the international community is its unique place in the global opiate market, which was estimated to be worth 2.84 billion USD in 2014. Approximately 85 percent of global opium production came from Afghanistan;⁸ however, these figures are considered to be largely conservative. Approximately four billion USD of these funds benefit Afghans, with approximately one billion USD going to Afghan opium poppy farmers and the remaining funds going to district officials, insurgents, warlords and drug traffickers.⁹

Drug-related financial flows bear serious consequences for Afghanistan, including activities ranging from funding terrorism and supporting criminal enterprises to nurturing corruption, undermining the rule of law, impeding economic development and depriving the state of desperately needed revenue and resources, among others. Transgressing various division lines, these financial flows bring together in a single network state officials and insurgents, poor farmers and rich landlords, the fighters of competing insurgent groups and residents of competing regional and non-regional states. Thus, they form part of the Afghan and regional shadow economy, which remains non-transparent and poorly studied.

Report Objectives

The main objective of this report is to assist policymakers and scholars to better understand the nature of illicit flows of goods and services from and into Afghanistan that relate to drug smuggling. Given the dearth of recent and in-depth research on this topic, a key aim of this report is to provide an analysis of what information is missing, how it could be obtained or generated and for what purpose, in order to facilitate future assessments and policy advice to decision-makers regarding Afghanistan.

At the outset, it is important to note that for any policy to gain traction in Afghanistan, it would need to be adopted and enforced by the Afghan people rather than by foreign agencies, states or non-governmental organizations (NGOs), as the latter can offer only knowledge, skills, ideas, analyses or advice. As the world's largest producer of opiates, Afghanistan has an impact on the rest of the world and cannot be ignored. A significant portion of Afghanistan's population relies on the black market and is directly or indirectly involved in the narcotics economy. These proceeds are sometimes the only source of income, as legal alternatives are absent.

The world reacts when it is victimized. Afghanistan was heavily bombed and invaded in large part because the 9/11 terrorists were allegedly directed from an al-Qaeda base in the country. Thus, it is in the interest of the Afghan community to address the drug issue in an effective way. If Afghanistan does nothing to counter this threat to other countries, it might face another set of retaliatory actions that will render the country even poorer and more desperate than it is now. On the other hand, Afghanistan's opiate economy is not only a significant part of the national and regional economy, but it is also an economy that allows the country to import goods and services for its own survival. As has been

witnessed over the last 10 or more years, it would be a serious mistake to assume that a military invasion of Afghanistan would stop opiate trafficking.

The objective of this report is to provide a state-of-the-art review of what is known about the opiate trafficking economy to provide recommendations and strategies to counter, control and reduce the supply side of opiate narcotics around the world by reducing the Afghan economy's dependency on this industry. This report can pave the way for an evidence-based and thoughtful strategy for Afghanistan's development, starting with its main economic component: opiate trade. The challenge is quite serious. It could be compared to healing an entire body knowing that the heart is seriously damaged. Yet, there is no way to reform Afghanistan without addressing the dominant narco-industry.

Information about the illicit financial flows stemming from Afghan drugs is extremely important yet very scarce. This paradox stems from the techniques, interests and focus of researchers, which concentrate mostly on narcotics trafficking and are segmented from the banking sector. This relatively focused research and segmentation does not allow for a broad picture on the overall implications of the narcotics trade in and out of Afghanistan.

This report is intended to be a tool for all stakeholders in the efforts to counter Afghan narcotrafficking, from Afghans themselves to foreign stakeholders, both regional and international. For the purposes of this report, the principal authors conducted an extensive desk review including numerous studies, which are listed as references, but focused on those published after 2012. The report also includes information from personal interviews and field research.¹⁰

Regulatory and Policy Framework

The Afghan government's turbulent and insufficient presence over the past few years has severely hampered support for citizens' security, the promotion of counternarcotics, legitimate industries and general nation-building. Today, Afghanistan's post-Karzai government is struggling to function and legitimize itself. After more than a year in office, President Ashraf Ghani, Chief Executive Officer Abdullah Abdullah and their respective teams have been unable to establish a National Unity Government operating anywhere near the level required for proper governance. Many ministerial positions have yet to be filled and approved by Parliament.

This is a serious problem given the deteriorating security situation in Afghanistan, including in Kabul. In mid-2015, the U.S. Embassy in Kabul determined that it was no longer safe to travel by road from the embassy to Hamid Karzai International Airport in Kabul, authorizing its diplomats and U.S. employees to travel this route only via helicopter. Additionally, the U.S. Department of State issued a warning in November 2015 to American citizens against travel to Afghanistan, citing a number of recent incidents throughout the country in which Americans and other foreigners were targeted.¹¹

NATO and U.S. troops in Afghanistan were reduced to fewer than 12,000 soldiers in 2015, as responsibility for security operations was transferred from NATO to the Afghan National Security Forces (ANSF). This transition resulted in a spike in Taliban operations in several areas of the country, including the Taliban taking and holding the city of Kunduz in northern Afghanistan in October 2015. U.S. and NATO forces were required to assist ANSF in reclaiming and securing the city.

Anti-Money Laundering and Terrorism Finance

With substantial assistance from the international community, strong efforts have been made to align Afghanistan's national law with international standards on anti-money laundering and combating the financing of terrorism (AML/CFT). Yet, legal reforms and institutional efforts have not produced effective and acceptable practices.

Inter alia, Afghanistan passed the 2004 Anti-Money Laundering and Proceeds of Crime Law, on which the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA), a financial intelligence unit (FIU), was created. Following long delays due to parliamentary inaction, suggesting weak rather than genuine political will, Afghanistan passed new AML/CFT laws in 2014, but the process of implementing regulations and actual enforcement practices remains slow. The notable progress made with this legislation is that money laundering is properly criminalized and adequate provisions regarding the seizure and confiscation of crime proceeds are included. Finally, in 2015, a new banking law was enacted; this law is expected to strengthen bank reporting and governance while also incorporating a framework for the declaration of cross-border cash transactions and bearer instruments.¹² It is hoped that this law will improve the regulatory environment when it goes into effect.

FinTRACA is a semi-independent body administratively housed within the Central Bank of Afghanistan (Da Afghanistan Bank) and responsible for analyzing reports filed by private entities and data from other government agencies. Private sector entities are required to file reports on suspicious transac-

tions and on large single or structured cash transactions.¹³ This FIU is tasked with collaborating with other government entities, as well as foreign counterparts for international cooperation. Afghanistan is a member of the Egmont Group and the Asia/Pacific Group on Money Laundering (APG), a Financial Action Task Force (FATF)-style regional body.¹⁴

FinTRACA's principal objective is to "deny the use of the Afghani financial system to those who obtained funds as the result of illegal activity, and to those who would use it to support terrorist activities."¹⁵ Although this objective is laudable and consistent with international standards, only meeting this goal may be counterproductive. Does the goal assist in the pursuit of other policy objectives, such as monitoring illegal transactions, facilitating investigations and prosecutions and improving asset tracing, freezing and recovery, among others? What if illicit flows are merely displaced to other channels less familiar or accessible to banks and government officials? These include informal value transfer systems such as hawala, import/export manipulation, digital payments and even abuse of correspondent accounts.¹⁶ If a primary goal is to equally seek traceability and effective implementation of governance reforms aimed at improving the capacity of revenue collection, reducing financial crime and confiscating criminal assets from criminal offenders, then simply shifting illicit flows from one relatively transparent sector to an opaque one is unhelpful. Arguably, these goals are more critical than successfully denying access to the formal financial sector of illicit flows, which may get diverted to routes less amenable to surveillance and regulation.

FinTRACA's website describes its role and responsibilities in terms that appear promising: "In order to meet its objectives, FinTRACA

collects and analyzes information from a variety of sources. These sources include entities with legal obligations to submit reports to the FinTRACA when a suspicious transaction is detected, as well as reports of cash transactions above a threshold amount specified by regulation. When the analysis of this information supports the supposition of illegal use of the financial system, FinTRACA works closely with law enforcement and/or Attorney General's Office to support their investigation of the illegal activity." FinTRACA cooperates internationally to support its own analyses and investigations, as well as those of its foreign counterparts, as permissible by law. In addition to these responsibilities, FinTRACA also provides training for reporting entities and develops laws and regulations to further national AML objectives.¹⁷

Unfortunately, it does not appear that FinTRACA is meeting these stated responsibilities. Despite political statements and commitments made at very high levels, Afghanistan has still not convinced the FATF that its progress is adequate. In January 2014, the FATF listed Afghanistan in the category, "jurisdictions not making sufficient progress." The FATF has repeatedly noted Afghanistan's need to address serious deficiencies by "(1) adequately criminalising money laundering and terrorist financing; (2) establishing and implementing an adequate legal framework for identifying, tracing and freezing terrorist assets; (3) implementing an adequate AML/CFT supervisory and oversight programme for all financial sectors; (4) establishing and implementing adequate procedures for the confiscation of assets related to money laundering; (5) establishing a fully operational and effectively functioning financial intelligence unit; and (6) establishing and implementing effective controls for cross-border cash transactions."¹⁸ Per a U.S. Department of

State report, the Afghan jurisdiction in 2014 prosecuted and convicted four cases of money laundering.¹⁹ The same report also stated that “less than 10 percent of the Afghan population uses banks, depending instead on the traditional hawala system, which provides a range of financial and non-financial business services in local, regional, and international markets. Approximately 90 percent of financial transactions run through the hawala system, including foreign exchange transactions, funds transfers, trade and microfinance, as well as some deposit-taking activities.”²⁰

As of October 2016, the FATF continued to list Afghanistan as a jurisdiction with strategic deficiencies: “In June 2012, Afghanistan made a high-level political commitment to work with the FATF and APG to address its strategic AML/CFT deficiencies. Afghanistan has taken significant steps to improve its AML/CFT regime, including issuance of a freeze order that automatically requires the implementation of changes to the UNSCR 1267 list. However, Afghanistan should provide additional information regarding the implementation of its legal framework for identifying, tracing and freezing terrorist assets. The FATF encourages Afghanistan to continue implementing its action plan to address the remaining AML/CFT deficiency.”²¹

In an environment where unpaid police sell their arms to the Taliban to make ends meet,²² FinTRACA has benefited from a strong donor investment and relationship with the U.S. FIU, the Financial Crimes Enforcement Network (FinCEN), but it continues to face serious challenges: illiterate employees or managers, ongoing security problems, lack of cooperation from other agencies and reporting entities that are still not reporting consistently or reliably.²³

The investigation of money laundering cases is also extremely difficult. As SIGAR has pointed out, attempts to obtain certified records from Afghan banks that can serve as evidence typically fail; police and court records often do not exist; and some government offices lack computerized records, computers or even electricity. Thus, investigators must resort to Western Union and hawala records or even prosecutors for evidence.²⁴

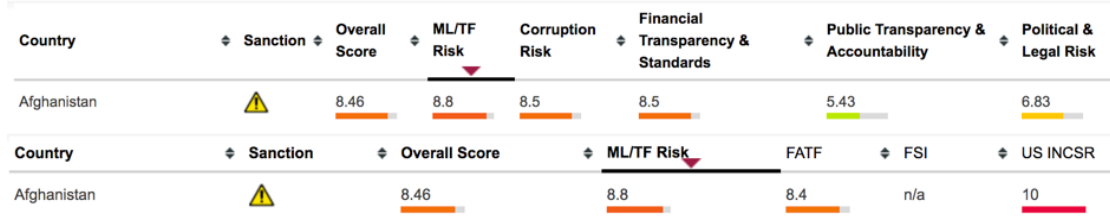
The informal economy is thriving, and the hawala remittance system is well established as a reliable institution. In fact, hawala has been

the only viable option for both legitimate and illegal transactions within and throughout the country for a long time.²⁵ Banks often use hawala for their own transactions.²⁶ Yet at the same time, it is noteworthy that no hawaladar—a broker in the hawala system—has submitted a suspicious transaction report to FinTRACA. When it comes to dealers of precious metals and stones, lawyers, accountants and real estate agents, supervision is poor.

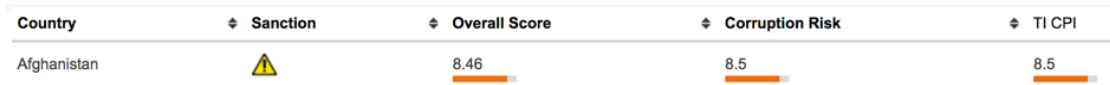
Finally, all sorts of cash and other flows take place unmonitored and unchecked due to geography (especially the Afghanistan-Pakistan border), resource constraints, unclear customs rules on dealing with suspicious transactions and the country’s porous international borders. Even Kabul’s international airport does not have proper controls for all passengers: “In 2011, the Afghanistan-Pakistan Transit Trade Agreement (APTTA) expanded trade cooperation between the two countries and attempted to minimize smuggling by maximizing oversight and technical monitoring. Yet the designated trade routes pass through key locations where insurgent and terrorist groups operate. It appears insurgents are finding creative ways to utilize APTTA’s new rule of being able to maintain control of a cargo truck from country of origin to cross-border destinations without having to risk unloading trucks at border crossings. In addition, since the initiation of the new APTTA agreement, it appears organized smuggling groups have increased their use of Iranian ports of entry. With the phasing-out of Iranian sanctions, this trend will continue to grow. The Afghan transit trade is used in trade-based money laundering, value transfer, and in counter-valuation or the process of settling accounts between hawaladars.”²⁷

In light of this, the U.S. Department of State’s Bureau of International Narcotics and Law Enforcement Affairs (INL) also continues to list Afghanistan as a “major money laundering” country and a “jurisdiction of primary concern.”²⁸ INL’s most recent report notes: “Terrorist and insurgent financing, money laundering, bulk cash smuggling, abuse of informal value transfer systems, and other illicit activities designed to finance organized criminal activity continue to pose serious threats to the security and development of Afghanistan. Afghanistan remains a major narcotics trafficking and producing country, and is the world’s largest opium producer

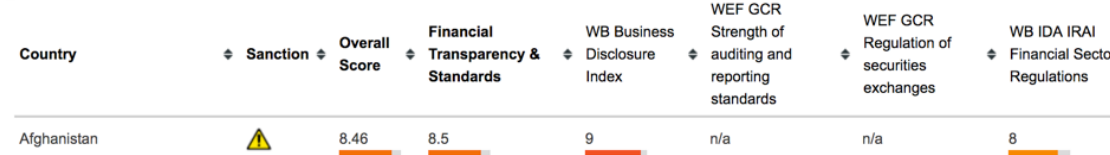
Money Laundering/Terrorist Financing (ML/TF)



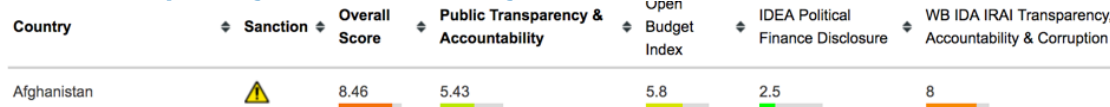
Corruption Risk



Financial Transparency and Standards



Public Transparency and Accountability



Political and Legal Risk



Figure 5. Risk of money laundering and terrorist financing (Source: Basel Institute on Governance AML Index)

and exporter. The narcotics trade, corruption, and contract fraud are major sources of illicit revenue and laundered funds. Corruption permeates all levels of Afghan government and society.”²⁹ The report further points out that 90 percent of financial transactions go through hawala, with only the remainder employing the formal financial sector. The same report goes on to add: “Corruption and weaknesses in the banking sector incentivize the use of informal mechanisms and exacerbate the difficulty of developing a transparent formal financial sector in Afghanistan. The unlicensed and unregulated hawaladars in major drug areas, such as Helmand, likely account for a substantial portion of the illicit proceeds being moved in the financial system. Afghan business consortiums that control both hawaladars and banks allow criminal elements within these consortiums to manipulate domestic and international financial networks to send, receive, and launder illicitly-derived monies or funds intended for criminal, insurgent, or terrorism activities.”³⁰

An earlier U.S. Department of State report suggested that, especially in drug-trade areas, both banks and hawala operatives turn a blind eye to illicit flows that end up in the financial system, with U.S. dollars smuggled in cash to Iran rising in the aftermath of the Iranian rial depreciation in 2012.³¹

Lack of implementation of AML in Afghanistan is confirmed by data obtained from the Basel Institute on Governance AML Index and database (figure 5), which assigns an overall risk score (the maximum is 10) in addition to individual weights for the following indicators: Money Laundering/Terrorist Financing (ML/TF) Risk; Corruption Risk; Financial Transparency and Standards; Public Transparency and Accountability; and Political and Legal Risk.³²

In short, new laws and institutions to control money laundering, terrorism finance and other illicit flows have been introduced, but they are ineffective. As Nikos Passas has pointed out, “new laws drafted with foreign

Figure 6. Overall risk scores for Afghanistan (Source: Basel Institute on Governance AML Index Expert Edition)

Country	ISO Code	Sanction	Overall Score	ML/TF Risk	Corruption Risk	Financial Transparency & Standards	Public Transparency & Accountability	Political & Legal Risk	Expert Edition updated on
Afghanistan	AF		8.46	8.8	8.5	8.5	5.43	6.83	27-Feb-17

assistance constitute another layer in need of harmonization. However, efforts to fight financial crime and corruption in the country are inconsistent, ad hoc, and discriminatory. The normative dissonance resulting from this lack of coordination—along with the judicial exclusion of certain groups, dysfunctional governance, corruption, turmoil and insecurity in the midst of foreign involvement—have given rise to continued drug trafficking and terrorism.”³³

Rule of Law and Governance Program Outcomes

The lack of effective rule-of-law strategies or programs introduced by U.S. agencies between 2003 and 2015 has exacerbated this crisis, despite the good intentions of these agencies. In July 2015 SIGAR reported that the development of rule-of-law programs had been largely unsuccessful during the past 10-plus years.³⁴ The report identified two significant contributing factors for that lack of

success, both at present and in the foreseeable future: (a) pervasive corruption in Afghanistan’s justice sector and (b) uncertainty within the country and internationally about the government’s ability and willingness to sustain U.S. programs and reforms for rule of law.

SIGAR also noted that since 2003, the U.S. Department of Defense, the U.S. Department of State and the U.S. Agency for International Development (USAID) had spent more than 1 billion USD on the development of rule of law in Afghanistan. However, this figure was not wholly representative of total spending on rule-of-law initiatives, because the Department of Defense was unable to provide complete funding figures.³⁵ Both the Defense and State Departments similarly have been unable to accurately measure the performance of many, if not all, of the rule-of-law programs funded by the U.S. government over the same time period.

The lack of rule of law, strategic approaches

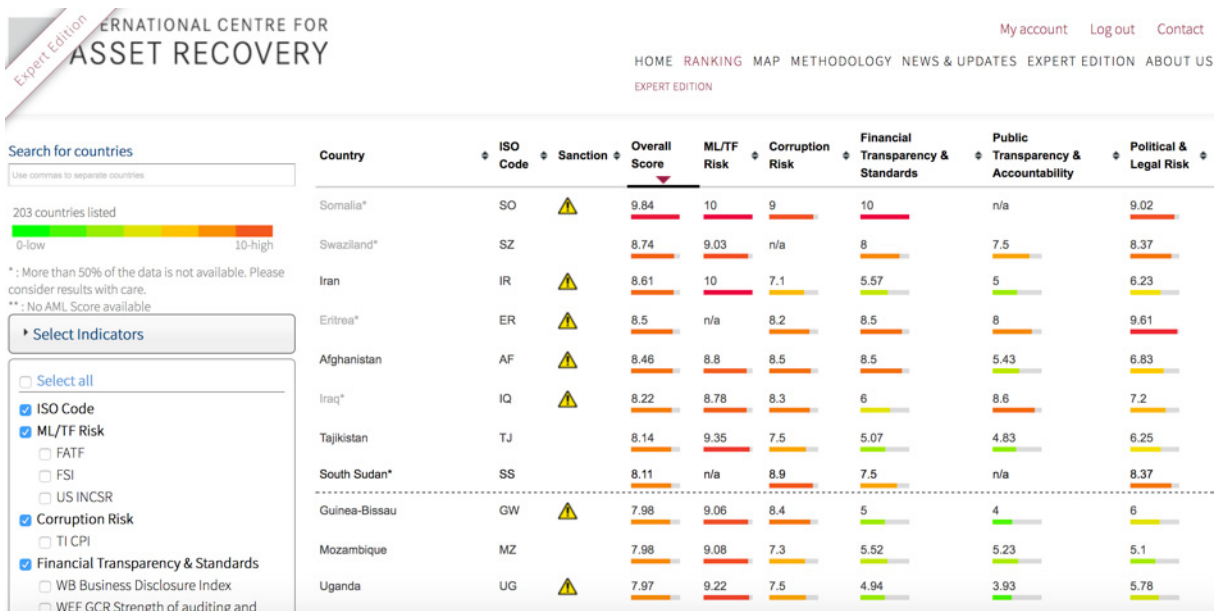


Figure 7. Country rankings by overall risk score (Source: Basel Institute on Governance AML Index Expert Edition)

	Scale	Afghanistan
Units		percentile rank, 0 (lowest) to 100(highest)
2005	units	13.46
2006	units	14.42
2007	units	16.83
2008	units	13.46
2009	units	8.53
2010	units	7.58
2011	units	9.39
2012	units	11.27
2013	units	12.68
2014	units	14.78
2015	units	16.26

	Scale	Afghanistan
Units		range, -2.5 (weak) to 2.5 (strong)
2005	units	-2.084
2006	units	-2.227
2007	units	-2.392
2008	units	-2.684
2009	units	-2.704
2010	units	-2.545
2011	units	-2.478
2012	units	-2.392
2013	units	-2.504
2014	units	-2.424
2015	units	-2.502

Figure 8. (left) Afghanistan's voice and accountability percentile ranks, 2005-2015 (Source: The World Bank Worldwide Governance Indicators)

Figure 9. (right) Afghanistan's scores for political stability and the absence of violence/terrorism, 2005-2015 (Source: The World Bank Worldwide Governance Indicators)

and effective governance, along with the deteriorating security situation, have had a serious impact on Afghanistan and its partner countries in their efforts to counter the opiate trade, criminal and terrorist activities and illicit financial flows in and through the country.

Corruption

Afghanistan's governance and corruption rankings are very low by any standard. Transparency International lists it as one of the most corrupt countries in the world: 169 out of 176 countries, with only Libya, Sudan, Yemen, Syria, North Korea, South Sudan and Somalia ranked lower.³⁶ In the Basel AML Index, Afghanistan is ranked the second highest risk country out of 149 countries assessed by the FATF.³⁷

As the expert edition of the Basel Institute of Governance AML Index and database in-

dicates (figure 6), Afghanistan is considered high risk not only for money laundering but also more broadly (10 is the maximum risk score).³⁸

Afghanistan's overall score is fifth from the last out of 203 countries listed (figure 7).³⁹

According to the World Bank's Worldwide Governance Indicators, the country's percentile rankings pertaining to voice and accountability throughout the 2005 to 2015 period are extremely low, but they have at least been improving slightly from 2012 to 2015 (figure 8).⁴⁰

On political stability and the absence of violence/terrorism, Afghanistan's scores are extremely low (figure 9).⁴¹

On government effectiveness and control of corruption, Afghanistan is doing poorly as well (figure 10).⁴²

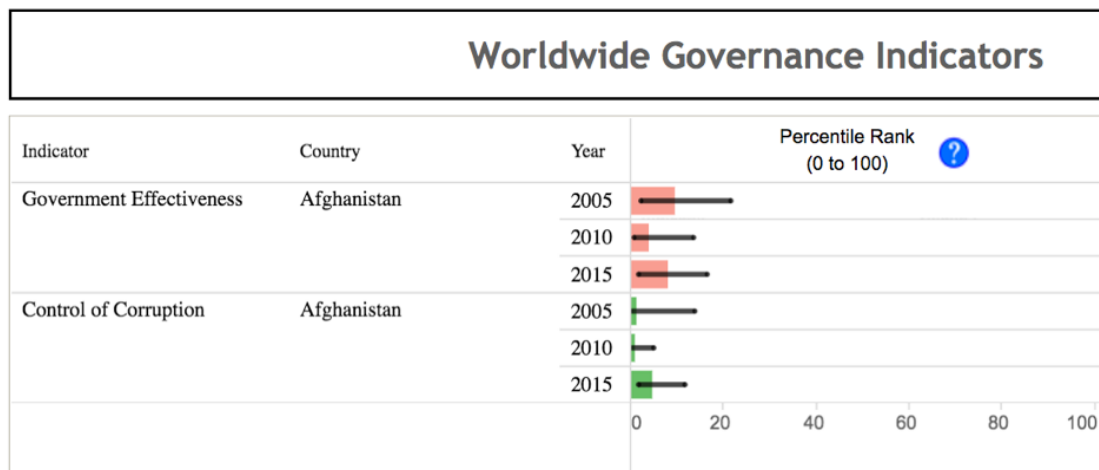


Figure 10. Afghan government's effectiveness and control of corruption percentile rank, 2005/2010/2015 (Source: The World Bank Worldwide Governance Indicators)

Topics	DB 2017 Rank	DB 2016 Rank ①	Change in Rank	DB 2017 DTF (% points) ①	DB 2016 DTF (% points) ①	Change in DTF (% points) ①
Overall	183	182	↓ 1	38.10	38.42	↓ 0.32
Starting a Business	42	38	↓ 4	92.08	92.19	↓ 0.11
Dealing with Construction Permits	186	185	↓ 1	22.39	22.39	-
Getting Electricity	159	157	↓ 2	45.04	45.51	↓ 0.47
Registering Property	186	185	↓ 1	27.50	27.50	-
Getting Credit	101	97	↓ 4	45.00	45.00	-
Protecting Minority Investors	189	189	-	11.67	11.67	-
Paying Taxes x	163	150	↓ 13	51.29	55.64	↓ 4.35
Trading across Borders ✓	175	176	↑ 1	30.63	28.90	↑ 1.73
Enforcing Contracts	180	180	-	31.76	31.76	-
Resolving Insolvency	159	161	↑ 2	23.62	23.62	-

✓=Doing Business reform making it easier to do business. x=Change making it more difficult to do business.

Figure 11. Afghanistan's "Doing Business" ranking 2016-2017 (Source: The World Bank Worldwide Governance Indicators)

With regards to the "Doing Business"⁴³ ranking, the indicators are not only disappointing, but most of them have also been in a downward trend in the last year (figure 11).

At this time, governance and corruption remain critical challenges, as the government of Afghanistan has not implemented any meaningful policies or measures to combat them. In October 2015, Drago Kos, the chair of the Independent Joint Anti-Corruption Monitoring and Evaluation Committee—the main international corruption watchdog in Afghanistan—resigned, stating that he did not think the government of Afghanistan was serious in its anti-corruption efforts. "With the exception of some sporadic activities, in [the] one year since the new President and the CEO [chief executive officer] took [their] positions, I could not see any systemic action against [the] endemic corruption in the country," said Mr. Kos. "All we've needed was some good political will and support, which never came and in such circumstances, I do not see the point to go on."⁴⁴

The Karzai government's corruption has been documented many times; in some reports, the government has been referred to as a "kleptocracy,"⁴⁵ a government that has a particularly severe and systemic problem with its officials or ruling class employing

corrupt practices to extend their personal wealth and political power. Illustrative of the situation was the arrest of ANSF Brigadier General Abdul Sama,⁴⁶ who was accused of smuggling nearly 20 kilograms of heroin. Yet, there are grounds to believe that this case and other investigations are only a small part of the drug-related corruption problem. Afghan officials' complicity with drug production and trade, as well as their ties with insurgents and other criminal groups, is one part of the problem, while their inability to enforce drug production and trafficking bans is another. The year 2015 saw a steady and rapid contraction of government-controlled territory, which contributed to the growth of the shadow economy.

The Afghan Narcotics Industry

In opiate production (poppy), Afghanistan clearly stands out, as it accounted for more than 50 percent of the world's total production, reaching an apex of 70 to 80 percent at one point. The opiate trade in Afghanistan has been scrutinized for decades by many organizations, among them the United Nations Office on Drugs and Crime (UNODC), which provides historical trends in poppy cultivation and trade, with the most recent report published in December 2016.⁴⁷ The goal of this report is not to replicate such UNODC surveys but rather, to alert the reader to the magnitude and trends of the problem of the narcotics economy in Afghanistan.

In 2015, the gross value of the Afghan opiate economy was estimated to be about 1.56 billion USD, dropping by 45 percent from 2014. The opiate market is estimated to correspond to 7 percent of the entire Afghan GDP.⁴⁸ However, the net value of opiates, including base morphine and heroine, available for export is about 1.48 billion USD. This figure assumes that the product coming out of Afghan laboratories may be further processed before reaching final destination markets in Europe, the United States and elsewhere. However, this figure, which the authors of this report deem very conservative, represents two times the value of the total of all other exports from Afghanistan in 2014.

In the meantime, the UNODC suggests that the value of the internal Afghan market went down to 80 million USD in 2015, as the value of imported precursors needed for heroin manufacturing was about 70 million USD.

Production of Opiates in Afghanistan

The UNODC Afghanistan Opium Survey of December 2016 shows a 10 percent increase in cultivated areas from 2015 to 2016.⁴⁹ It also noted an increase of 30 percent in average opium yield (18.3 kilograms/hectare in 2015 to 23.8 kilograms/hectare in 2016) and a 43 percent increase in the potential opium production (oven-dry equivalent opium).⁵⁰ Thus, the UNODC calculated that the farm-gate value of opium increased by 57 percent from 2015 to 2016 (570 million USD to 900 million USD).⁵¹ At the same time, poppy cultivation surface eradication fell by 91 percent, from 3,760 hectares in 2015 to 355 hectares in 2016.⁵² These figures can be compared with the general cultivated areas for poppy cultivation, estimated in 2016 to be between 182,000 and 221,000 hectares.⁵³

The UNODC also stated that the number of "poppy-free" provinces (provinces with less than 100 hectares of cultivation) has dropped from 14 in 2015 to 13 in 2016. The number of provinces affected by poppy cultivation (provinces with more than 100 hectares of cultivation) grew from 20 in 2015 to 21 in 2016. At the same time, the average farm-gate price of fresh opium at harvest increased by 18 percent (129 USD/kilogram to 152 USD/kilogram) while the price of dry opium at farm gate rose by 10 percent in the same period (171 USD/kilogram in 2015 to 187 USD/kilogram in 2016). The UNODC pointed out that the massive production in the years 2012 t



Figure 12. Map of Afghan opium poppy cultivation (by province), 2016 (Source: UNODC, *Afghanistan Opium Survey, 2016*)

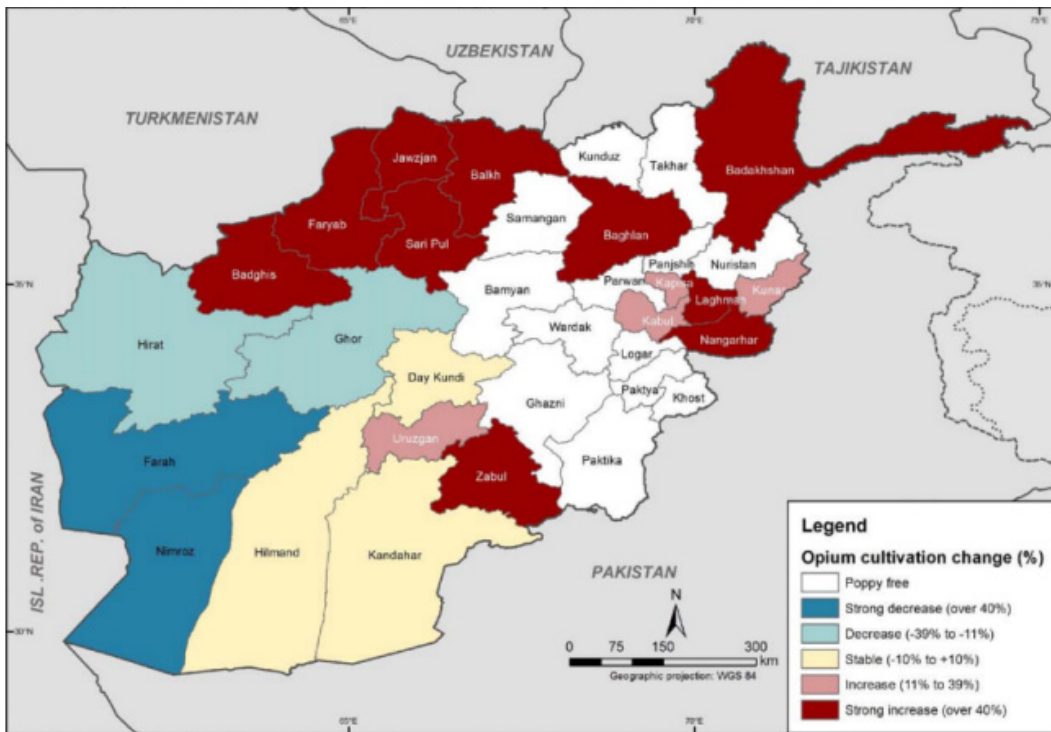


Figure 13. Opium poppy cultivation change in Afghanistan (by province), 2015-2016 (Source: UNODC, *Afghanistan Opium Survey, 2016*)

Figure 15. (opposite page, left) Opium poppy cultivation in Hilmand, Kandahar and Uruzgan provinces, 2004-2010 (hectares) (Source: UNODC, *Afghanistan Opium Survey, 2016*)

Figure 16. (opposite page, right) Farm-gate prices of dry opium at harvest time, weighted by production and annual opium production, 1994-2016 (tons, USD/kg) (Source: UNODC, *Afghanistan Opium Survey, 2016*)



The high-low lines represent

Province	2010	2011	2012	2013	2014	2015	2016	Change 2015-2016	2016(ha) as % of total
Hilmand	65,045	63,307	75,176	100,693	103,240	86,443	80,273	-7%	40%
Badghis	2,958	1,990	2,363	3,596	5,721	12,391	35,234	+184%	18%
Kandahar	25,835	27,213	24,341	28,335	33,713	21,020	20,475	-3%	10%
Uruzgan	7,337	10,620	10,508	9,880	9,277	11,277	15,503	+37%	8%
Nangarhar	719	2,700	3,151	15,719	18,227	10,016	14,344	+43%	7%
Farah	14,552	17,499	27,733	24,492	27,513	21,106	9,101	-57%	5%
Badakhshan	1,100	1,705	1,927	2,374	4,204	4,056	6,298	+55%	3%
Nimroz	2,039	2,493	3,808	16,252	14,584	8,805	5,303	-40%	3%
Rest of the country	2,930	3,538	5,475	8,121	7,858	7,453	14,779	+98%	7%
Rounded Total	123,000	131,000	154,000	209,000	224,000	183,000	201,000	+10%	100%

Figure 14. Main opium-poppy-cultivating provinces, 2010-2016 (hectares) (Source: UNODC, *Afghanistan Opium Survey, 2016*)

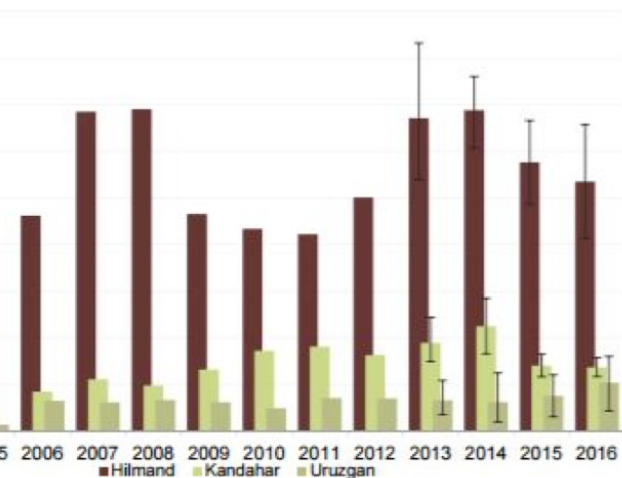
2014 may have forced cultivators to reduce their production to elevate prices.

Figure 12 shows a map of Afghan opiate cultivation. By contrast, figure 13 shows where poppy cultivation decreased or increased between 2015 and 2016.

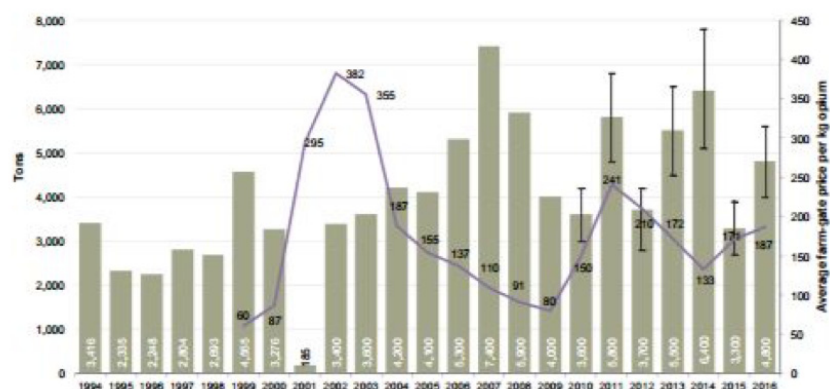
Despite the massive increase in poppy cultivation in Badghis province, Helmand province remains the main location for cultivation, and the southern region of Afghanistan still accounts for more than half of the country's total poppy cultivation (figure 14). Interestingly, though, this increase shows that cultivation can "migrate" around the country. Further in-depth analysis of the factors driving these changes in cultivation location is needed. Due to the many efforts of NATO and coalition forces in the province of Kandahar, which is considered to be Taliban territory, 40 percent

(as of 2016) of poppy cultivation takes place in Helmand province. It was in this province that an alternative eradication program—called the "Food Zone"—was implemented between 2009 and 2012. The farmers in this zone were provided with fertilizers, certified seeds and high-value horticulture seeds during the poppy planting seasons for the 2009 to 2011 harvests. Tests show that the decrease in and out of the "Food Zone" is significant, with an 11 percent increase of hectares of poppy cultivation inside the zone compared to an 18 percent decrease outside of the zone. However, these results remain rather marginal, as we can see the number of hectares cultivated in the different provinces (figure 15).

As expected, there is a strong negative correlation between production volumes and farm-gate prices (figure 16).



at the upper and lower bounds of the 95% confidence interval.



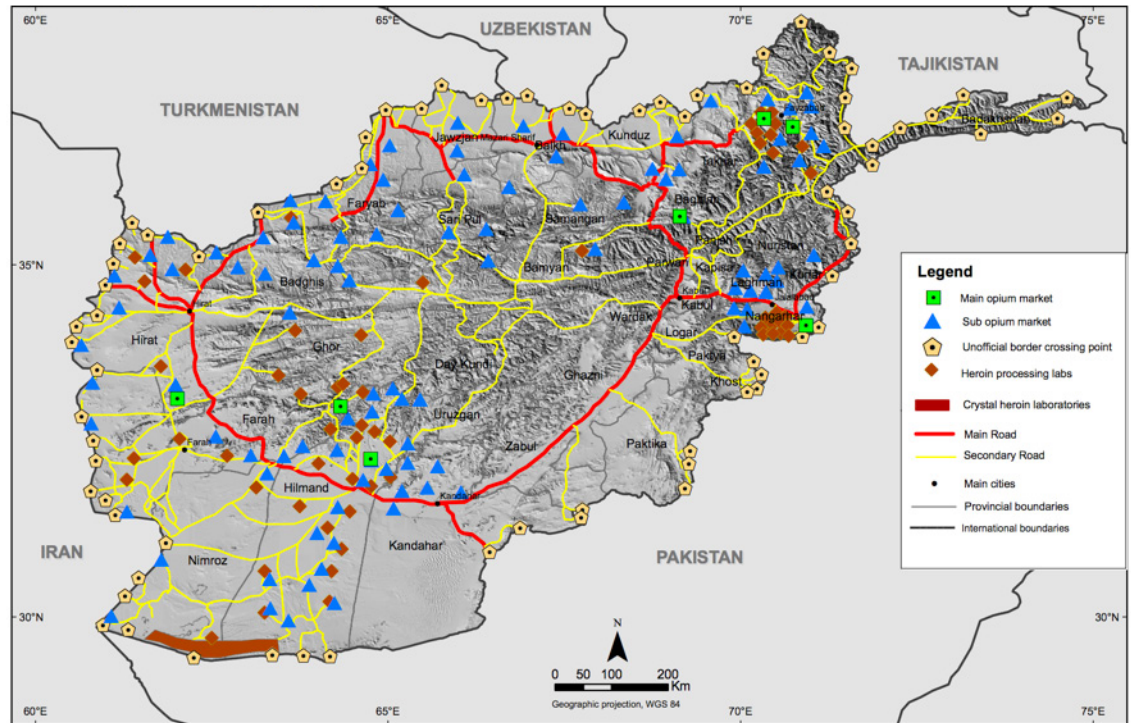


Figure 17. Heroin and opium trafficking in Afghanistan (Source: UNODC, *Monitoring of Drug Flow in Afghanistan*, 2007)

The Routes and Trade in the Region

In 2007, the UNODC established a monitoring mechanism to map the different locations of opium markets, laboratories and export routes of drugs (figure 17). So far, such detailed work has unfortunately not been repeated (at least not in published form).⁵⁴ Based on the information collected, the UNODC identified 90 laboratories within the country.⁵⁵ Twenty-six out of the ninety laboratories were in Helmand province. Twenty-five of them, exclusively local, were identified in Nangarhar province, fourteen in Badakhshan province, one in Kunduz province, two in Takhar province and one in Logar province.

The mapped structure of the trade was as shown in figure 18. The UNODC also mapped the entry points for chemical precursors (figure 19). As of 2014, the routes seemed to remain unchanged, as reported by the U.S. Congressional Research Service (figure 20).

Border controls seem to continue to be very inefficient, and the challenges are growing because of the intensification of the northern routes serving the countries of the Commonwealth of Independent States (CIS) and the European Union (EU).

Terrorist Groups and Drug Trade

There is a long history of terrorist groups, in Afghanistan as well as in other countries, taxing or using drug production and trafficking to fund their operations. As reported by the FATF, out of the Taliban's total 400 million USD estimated budget in 2011 and 2012,⁵⁶ approximately 133 million USD was derived from the poppy/opiate trade.⁵⁷ In 2014, the Analytical Support and Sanctions Monitoring Team, which assists the United Nations ISIL (Da'esh) & Al-Qaida Sanctions Committee, suggested that opiate financing was about to become the leading source of income for the Afghan Taliban, thus enabling a major threat to Afghanistan's national security as well as to broader regional stability.⁵⁸ A number of former United States Drug Enforcement Administration (DEA) directors of financial operations have stated that there is intelligence indicating that terrorist financing in Afghanistan from drug trafficking proceeds rose significantly between 2012 and 2015. A major concern and strong possibility is that the relationship between drug criminal organizations and terrorist groups has grown closer and in some instances, they might have merged. As Yury Fedotov, executive director of the UNODC, noted, "Illicit drugs are

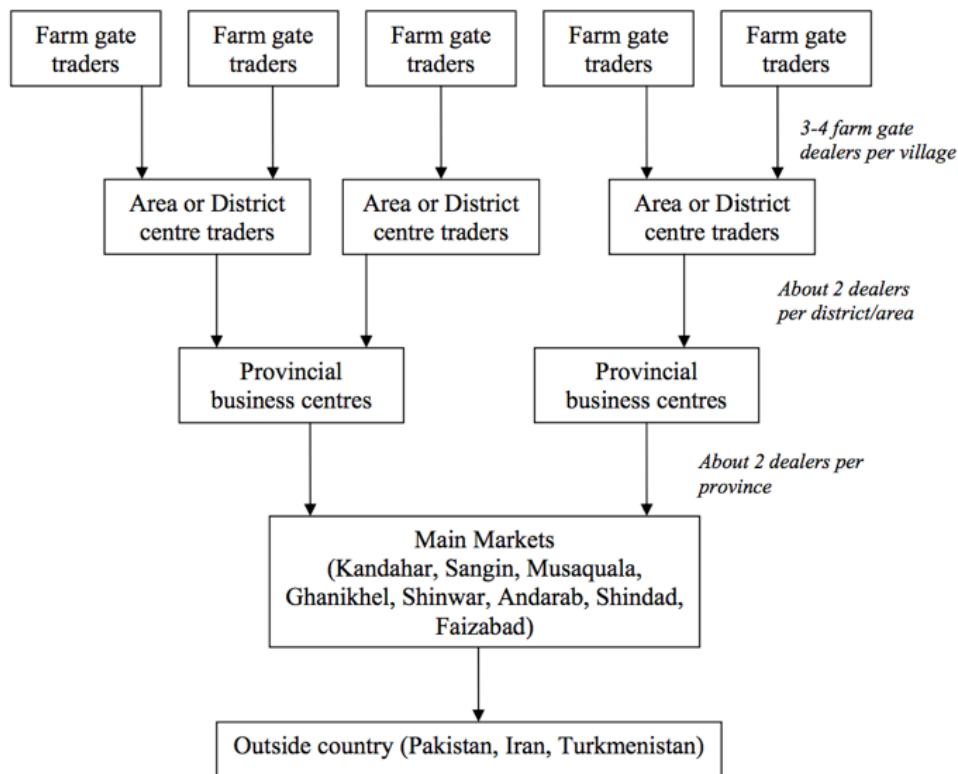


Figure 18. Structure of the drug trade in Afghanistan (Source: UNODC, *Monitoring of Drug Flow in Afghanistan*, 2007)

supporting instability, insurgency, corruption and organized crime.”⁵⁹ This likelihood would be similar to the situation in Colombia during the 1990s when it was reported that the terrorist organization, Revolutionary Armed Forces of Colombia (FARC), became involved in drug production and trafficking.

A development in the past few years in Afghanistan and neighboring countries is the establishment and growth of the Islamic State of Iraq and Syria (ISIS) and its operations. Within Afghanistan, ISIS has been documented and reported as established and growing primarily in Nangarhar province. However, as of 2015, there were also reports of ISIS’ presence in at least 25 of Afghanistan’s 34 provinces.⁶⁰ Some experts believe that a central goal of ISIS is expansion;⁶¹ as such, Afghanistan is an attractive new frontier, especially given its geographic proximity to large Muslim populations north of the country. This includes a huge swath of territories and countries that encompass the south-central part of the Russian Federation.⁶²

From ISIS’ vantage point, Afghanistan would likely constitute fertile ground for its activities, given the vast cash resources it could extract from drug cultivation, production and trafficking within and outside of Afghanistan. Some experts believe that competition for il-

licit drug proceeds has become the primary source of conflict between ISIS and the Taliban: “The raw narcotics material is produced in a number of Afghan provinces. First among them is Helmand, where 80 percent is cultivated; then this product goes abroad, either to Russia and CIS countries through Tajikistan or via Iran to Turkey. This latter route by sea makes its way via Nangarhar province, where militants are operating today on behalf of ISIS. In Nangarhar, there is a large factory that used to be controlled by criminal authorities loyal to the central government in Kabul. During the last year, ISIS militants engaged in fighting with the Taliban, who also oversaw the business. [Illicit drug] deliveries from Afghanistan to Turkey, by the way, has been underway for a long time. ISIS is trying to gain control of this traffic, and indeed, its efforts have been partly successful. In fact, the struggle in Afghanistan between the Taliban and the ‘Islamic State’ is reduced to mercantile interests—who will control this [drug] traffic.”⁶³

Although recent analysis of ISIS and the Al-Nusra Front for the People of the Levant has shown that they have not diversified into new revenue streams (current ones include extortion, crude oil smuggling, illicit trafficking of cultural Syrian and Iraqi antiquities, ransomed kidnapping and external donations),

Zone Name	Country	Cross border locations	Province	District	Village
Central and Eastern	Pakistan	Sasobai	Nangarhar	Dur Baba	Dur Baba
	Pakistan	Torkham	Nangarhar	Lal Pur	Tourkham
North-eastern	China	Turkham	Nangarhar	Turkham	Turkham
	India	Turkham	Nangarhar	Turkham	Turkham
	Pakistan	Turkham	Nangarhar	Turkham	Turkham
	Tajikistan	Sherkhan Bandar	Kunduz	Imam Sahib	Sherkhan bandar
Northern	Pakistan	Turkham	Nangarhar	Shinwari	Bander
Southern	Pakistan	Baram Cha and Chatu	Hilmand	Dishu	Barm Cha
	Pakistan	Spin Buldak	Hilmand	Dishu	Buldak
Western	Germany	Turghundi	Hirat	Kohsan	Khushki rabati sangi
	Pakistan	Gala Chah	Hilmand	Dishu	Gala Cha
	Pakistan	Rabati Jahli	Nimroz	Chahar Burjak	Afzal Khan villeg
	Pakistan	Spin Boldak	Kabul	Spin Boldak	Chaman

Figure 19. Entry points of precursor chemicals in Afghanistan (Source: UNODC, *Monitoring of Drug Flow in Afghanistan*, 2007)

many countries are actively working to cut off these income sources, making income source diversification a necessity for their survival.⁶⁴ A Western contract consultant to the National Security Council (NSC) of the National Unity Government of Afghanistan detailed the NSC's concern for the coming of ISIS and the group's potential as a significant additional security threat to Afghanistan. Nicholas Haysom, head of the United Nations Assistance Mission in Afghanistan (UNAMA), recently noted that there is considerable concern that ISIS was seeking to establish itself there, while also raising a concern over foreign fighters entering Afghanistan from the north.⁶⁵

Although reports identify ISIS' primary goal in Afghanistan as being "to recruit sympathizers and followers and establish a network of contacts,"⁶⁶ ISIS is a growing—if presently largely dormant—threat in Afghanistan and will likely continue to be such as long as the country remains a potential source of illicit cash. This trend may grow as anti-ISIS activities elsewhere cause it to lose ground and space under its control.

ISIS has branded itself as a more radical fundamentalist terror group than the Taliban in Afghanistan. Although it is a relatively new presence there, approximately 10 percent of ISIS personnel in Afghanistan in 2015 were former Taliban sympathizers and defectors.⁶⁷ Although ISIS and the Taliban are likely competing for the same recruits within Afghanistan, ISIS may receive many recruits in the form of both disenchanted Taliban fighters and foreign fighters residing in Afghanistan and seems certain to pose a significant prob-

lem for Afghanistan and many of its neighboring countries.

ISIS' presence is largely focused in the Nangarhar districts of Achin, Deh Bala and Chaparhar, where it alienated many locals due to its brutality and extortion, although it may be recruiting at a faster pace than it is alienating.⁶⁸ Beyond Nangarhar province, ISIS' presence is very limited, and the Taliban has been fairly efficient at squashing recruitment attempts in provinces like Farah. Thus, technically, there might be ISIS representatives in 25 provinces,⁶⁹ but it is important to add the huge qualification that ISIS' numerical presence is largely in Nangarhar for now. There is scant knowledge of ISIS' sources of funding in Khorasan province. Pakistanis largely lead the core leadership, and there does not seem to be a significant funding link with ISIS in the Middle East yet. There were initial assertions that the Islamic State in Khorasan province derived revenue from narcotics, but now some international officials in Afghanistan explain in private conversations that this was not accurate and that ISIS may even be promoting eradication. This is no doubt a move of expediency, partly to appear Islamic and partly to cut lucrative drug funds that are otherwise going to their enemies (Afghan officials, criminal networks and Taliban, among others).⁷⁰

Since January 2016, ISIS lost some of its ground in Nangarhar province but gained a secondary foothold in Kunar and Nuristan provinces and has been largely restricted to the remote southern belt in the Nangarhar districts of Achin, Deh Bala, Kot and Nazyan, thanks to the difficult terrain. The group's

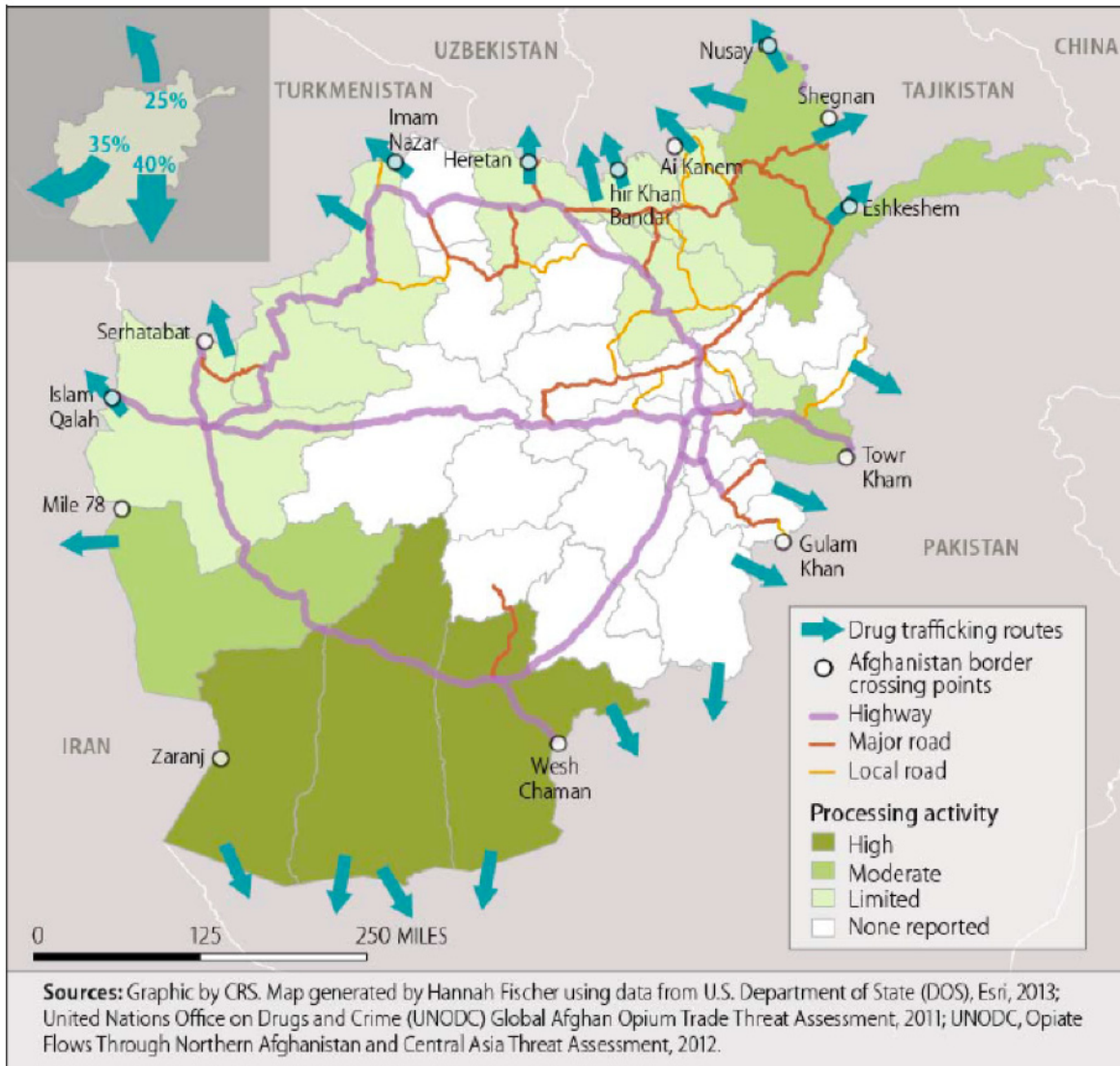


Figure 20. Heroin processing activity and trafficking routes in Afghanistan (Source: Congressional Research Service, 2014)

main stronghold, according to data provided in 2015 by non-public UN sources, is in Mohmand Valley in Achin district. Throughout 2016, the Afghan army, with U.S. help, scaled up operations against ISIS, and some people on the ground reported that the group has been diminished substantially in Achin. At the same time, the Taliban resorted to attacks on ISIS in these areas, as it did not welcome its presence.⁷¹

Recent reports have suggested that deals have been brokered between the Taliban and ISIS to “live and let live,” but these should not be exaggerated because they are very localized and do not reflect a change in the Taliban’s overall hostility towards ISIS. It must be noted that the ranks of ISIS are dominated by Pakistanis, although Afghans may comprise about 40 percent or so of ISIS ranks in Kunar province.⁷²

In April 2016, security officials reported two financial transactions totaling 1.1 million USD from Iraq to a bank account in Kabul via Turkey. This was the first confirmed evidence of a money link between the Islamic State in Syria/Iraq and the Islamic State in Afghanistan. The group also had a presence along some border passes with Pakistan.⁷³

Imagery and fieldwork has shown that the Islamic State “stronghold” of upper Achin and, in particular, the Mohmand valley does not have any poppy cultivation at all following the ban imposed by the Islamic State in July 2015 when it first occupied the valley. Fieldwork reports suggest that the vast majority of the Islamic State in this area are in fact Orakzai from Tirah and that there are few Afghans amongst them. Sources of funding are speculative—locals often point to Pakistan—but there are few obvious links to the drug trade given the imposition of a ban on cultivation

and trade. The Shadaal, a major drug bazaar, was shut down almost immediately upon the Islamic State's occupation of the area.⁷⁴

With regard to the Taliban's links to the drug trade, this is often overstated when it comes to rural taxation. "Control" over the trade itself is often more about local commanders and their histories of involvement and networks rather than the political party/group per se. Regarding Nangarhar province, it would be safe to say that the tax-raising opportunities for Taliban-affiliated groups have increased given the rise in opium poppy cultivation. However, this pertains more to the rise in levels of disposable income than opium.

The Flows

Regarding financial flows related to Afghanistan's opium market, one must remember that dry opium itself is often used as a currency in Afghanistan itself and in the border zones. The other important fact to bear in mind is that a large part of money flows simply do not occur at all but are replaced by a barter trade of opium against goods. This obviously raises questions about the quantity of goods that are smuggled across Afghanistan's borders with Iran, Pakistan, Tajikistan and Uzbekistan.

As a landlocked country, Afghanistan has reached trade agreements with several neighboring countries. The 1965 Afghan Transit Trade Agreement (ATTA) is a bilateral treaty with Pakistan allowing Afghan imports and exports to transit free of customs duties through the port of Karachi. In 1974, Iran agreed to allow free transit through its port of Bandar Abbas. In 2003, the same status was

granted for the port of Chabahar. Given that these ports have road and railway access, they dramatically improved Afghanistan's capacities for importing and exporting commodities, including opium.

The 2011 Afghanistan-Pakistan Transit Trade Agreement (APTTA), referred to earlier in this report, expanded these arrangements and included attempts to tackle the drug trade by installing tracking devices on transport units, in turn allowing for better use of "custom-to-custom" information sharing through data transfer technology. As noted earlier, the enforcement of this agreement is still problematic. As John Cassara has noted, "Many of the trade goods that enter the transit trade are broken down into smaller shipments to be distributed in Afghanistan or smuggled back into Pakistan, Iran and other countries for resale on the black market."⁷⁵ Some shipments that appear to be declared for Afghan markets only exist on paper. In other cases, the same shipment is declared many times, yet none of the goods actually cross the border into Afghanistan but instead are illegally smuggled directly into Pakistan.⁷⁶

Most of these commercial flows, as well as payments for them, are conducted through Dubai, which was a "lifeline of the Iranian regime" during the sanctions period. With the economic sanctions against Iran being lifted piece-by-piece, the trade flows in and out of Iran have started to inflate and will continue to grow.

The role of Dubai and, more generally, the United Arab Emirates (UAE) in the trade flows between Afghanistan, Iran and Pakistan arise from ancient ties that long ago transformed Dubai into a regional commercial and finan-

cial hub.⁷⁷ The ties between the UAE and Iran go back 150 years but grew dramatically after the Iranian revolution in 1979. In the 1960s and the 1970s, the Iranian working class started to emigrate to Dubai and Abu Dhabi. Today, several Iranian families are among the UAE's most influential families. During the Iran-Iraq and the Afghan wars, the UAE officially remained neutral but allowed a good deal of trade, despite sanctions regimes. In 2003, when Sheikh Mohammad lifted restrictions on the real estate market to foreign nationals, Dubai boomed with a massive influx of money in which Iranians played a substantial part.

In 2010, the re-export of goods to Iran from the UAE amounted to 8.5 billion USD, representing almost 17 percent of the total re-exports from the UAE free zones. From 2001 to 2009, the volume of re-exports from the UAE to Iran grew almost 900 percent.

However, to balance the powers between two powerful neighbors, Saudi Arabia and Iran, the UAE became part of an ever-growing partnership with the United States. In 1971, when the UAE declared independence from Britain, the United States was the third country to recognize it. Since then, cooperation between the U.S. and the UAE has grown in stages: first with the Iranian revolution; then with the Iran-Iraq War; the war in Afghanistan; the invasion of Kuwait by Saddam Hussein and the first Gulf War; tensions with Iran regarding its "Gulf imperialism" over Bahrain and some islands; and finally, tensions over the Iranian nuclear program. When NATO troops invaded Afghanistan in 2002, the UAE was ready to serve as a base for the troops and logistics.⁷⁸ From 2003 to 2009, the UAE was one of the largest weapon importers of

U.S. and French military devices and the first country to receive U.S. clearance to install the most advanced air defense system, the Terminal High Altitude Area Defense (THAAD) system. As a result, the import balance from the United States and the UAE grew by 900 percent between 2004 and 2009.

When the UN issued sanctions against Iran in 2010, the United States pressed the UAE to enforce financial controls, if not goods export controls. The UAE was always reluctant to be too invasive in business, especially with Iran, because of the power and influence of Iranian businesses and communities in Dubai. However, the introduction of financial sanctions against Iranian businesses in Dubai and Abu Dhabi led to more financial transactions shifting to the hawala networks and to Pakistani communities, especially with respect to trade with Afghanistan.

Today, we know that the Ras al-Khaimah (RAK) free-trade zone and the storage facilities in the UAE free-trade zone ports are playing a very important role in the trade flow in and out of Afghanistan. This importance seems to be balanced with the growth of the Chabahar port on one side and the Karachi port of the other side. The balance of the volume of trade with Afghanistan is subject to investments made in the facilities, changing regulations and the political situation in each of these zones. Unfortunately, almost no information and statistics on the Afghan import and export trade have been produced recently on the balance of the trade volume of these three port facilities.

The Financials

When one mentions the Afghan banking system, the hawala system quickly comes to mind. This is mostly because the banking system as it is usually understood and used especially in the Western world is not commonly used by the Afghan population.

The World Bank's financial inclusion data report for Afghanistan shows that 10 percent of adults (+15 years old) had an account at the country's financial institution in 2014, compared to only 9 percent in 2011 (figure 21). Only 1.7 percent owned a debit card in 2014, compared to 4.7 percent in 2011. However, money transfers were very active, as 13.3 percent sent remittances in 2014 with only 16 percent of senders using a financial institution and 6 percent using other money transfer operators. The figures are similar for the receipt of remittances: 13.1 percent of recipients received remittances from financial institutions, 10.5 percent via money transfer operators and 1.4 percent via mobile phones. Credit is also very personal: 22.3 percent of the adult population had borrowed money from family and friends in 2014, compared to 3.6 percent who borrowed from a financial institution and 34.6 percent who have simply "borrowed money" but did not specify from whom.⁷⁹

There are several major explanations why the banking sector in Afghanistan is not widely used by the local population. The banking

system is too complicated for the common illiterate Afghan who ends up waiting hours to set up an account and receive basic service; the paperwork sometimes seems excruciating for this population. For more educated Afghans and for businesses, they do not feel that banks are safe, for a variety of reasons. First, the Ministry of Finance can easily freeze bank accounts over simple tax disputes. There are many cases of the Ministry of Finance's Revenue Department freezing bank accounts in order to extort businessmen to pay bribes for false tax claims by the ministry. Also, banks have disclosed bank account information to media and others, thus creating significant concern about the trustworthiness of banks. In addition, it has become virtually impossible to transfer money from Afghanistan.⁸⁰

A 2005 World Bank report stated that 80 to 90 percent of the narcotics-related financial flows were handled by the hawala system. This is unsurprising given that hawala is the main system for all financial flows. NATO and U.S. interventions after September 11, 2001, started to re-establish a formal banking sector in the country. Nonetheless, both the FATF and the World Bank estimated that a huge percentage (a mean of 70 percent, according to different estimates) of drug money is moved through hawala to Pakistan, Iran, Dubai and Saudi Arabia.⁸¹ It is also reported that between 80 to 90 percent of the hawaladars—hawala brokers—in the provinces of

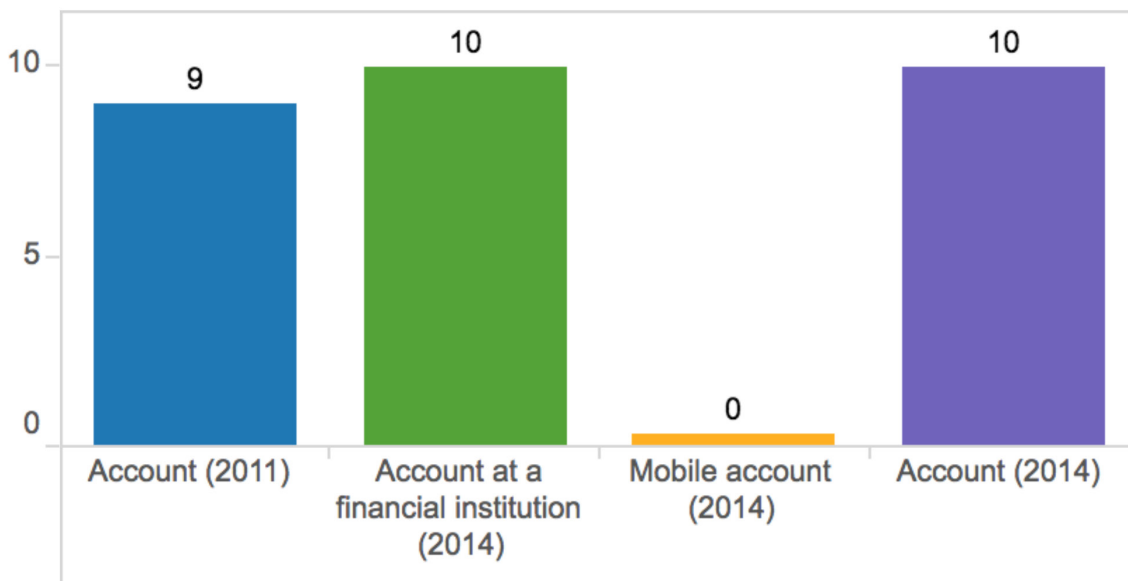


Figure 21. Percentage of account ownership in Afghanistan, 2011/2014 (Source: The World Bank)

Kandahar and Helmand are involved in the financial flows of narcotics. *Newsweek* reported an interview with a local hawaladar, who stated that he was moving an average of 500,000 USD per day in 2015, all clients included.⁸² The Afghan government in 2014 imposed an obligation to report applications to all hawala centers and other cash-collecting entities, but this rule is rarely implemented.

As noted earlier, FinTRACA still lacks resources, skills and implementation powers. In 2014, the FATF threatened Afghanistan with blacklisting but did not act on this. Under U.S. pressure, foreign governments involved in Afghanistan—NATO countries—preferred to encourage, rather than discourage, the efforts of the Karzai government to implement financial controls. Blacklisting could have had the effect of setting the whole system back and handing all transactions to hawaladars or organized crime systems and related middlemen. But even the most visible institutions do not follow the implementation of financial vigilance rules. For example, the regulation mandating the declaration of any sum above 20,000 USD to customs is not widely observed. Even at the Hamid Karzai International Airport in Kabul, corruption of public servants allows people to circumvent this rule easily, depriving FinTRACA of useful data on the financial flows in and out of the country.

The U.S. government has actively engaged in

finance control operations since 2008, with the aim of identifying and disrupting sources of insurgent and terrorist funding from the narcotics trade.⁸³ The Afghan Threat Finance Cell (ATFC) implemented by the United States through a joint cooperation between the DEA, the Department of Defense and the Department of Treasury reportedly played a key role in the implementation of targeted financial sanctions against narcotics traffickers pursuant to the Foreign Narcotics Kingpin Designation Act (PL 106-120) and “played a significant role in revealing high level corruption and illicit financial networks behind the Kabul Bank investigation.”⁸⁴

In recent years, there have emerged several companies that have won large infrastructure projects from the government of Afghanistan or have been engaged in other legitimate businesses. Some of the most successful companies have direct or indirect ties to circles that in turn have direct or indirect ties to the narcotics industry. For example, a construction company that bids on every project and consistently offers the lowest price is widely believed to be a front for the owner’s drug business. Similar companies exist in other sectors.⁸⁵

Kabul real estate has long been recognized as a major investment sector for drug dealers. Over the past several years, Afghanistan’s economy has tanked, but the Kabul real estate market has remained quite stable.

Dozens of large properties sit vacant, and it is widely believed that a great deal of black money goes into the real estate sector in Kabul and other cities.⁸⁶

The Case of Kabul Bank

In 2010, Kabul Bank, the largest bank in Afghanistan, became a prime example of the country's public sector corruption when, as noted in numerous news articles, a "giant pyramid scheme" to loot money from the bank was revealed.⁸⁷ Kabul Bank lost some 910 million USD in funds provided by U.S. taxpayer-funded foreign assistance to Afghanistan, primarily in the form of U.S.-supplied Afghan government, military and police salaries. Kabul Bank itself played a role in "a crony capitalism that enriches politically-connected insiders and dismays the Afghan populace."⁸⁸ One of former President Karzai's brothers, Mahmood Karzai, and then First Vice President Mohammad Fahim's brother, Haseen Fahim, were named in the scheme. Khalilullah Ferozi, the CEO of Kabul Bank, was a principal defendant in the fraud case. He was found guilty by the Afghan courts, sentenced to a 15-year prison term and ordered to make restitution to Kabul Bank in the amount of 196 million USD.⁸⁹

Although this major incident illustrated how corrupt practices are pervasive in Afghanistan, it unfortunately did not end there. On November 4, 2015, Ferozi appeared in public with Afghan government officials to sign a contract for a new township in Kabul: 33 acres of prime real estate on which 8,800 homes would be built and sold to the Afghan government for more than 95 million USD.⁹⁰ In a telephone interview immediately afterwards, Ferozi said he had reached a deal with the government of Afghanistan to serve his sentence at night while going to his office during the day to invest in projects that would eventually pay back the 137 million USD owed. Ferozi said he had paid back 17 percent of his debt up front and would be paying off the remainder in installments over the next seven years.

Within days, President Ghani called off the Afghan government's business partnership with Ferozi. "All parts of the court's verdict on conviction of Khalilullah Ferozi and his liability to pay back the loans are unalterable and binding," President Ghani said in a statement.

He also ordered a review of ways to transfer Ferozi's 33 acres of land, upon which the township was to be built, to Kabul Bank "as a compensation for [Ferozi's] outstanding debts."⁹¹

Clearly, challenges remain in attempting to create a government-financial system relationship in Afghanistan built on auditable, ethical practices and transactions.

The Hawala System

Hawala is a system of informal money transfer, based in part on trust and in part on self-regulation, that is practiced throughout the world (figure 22). An estimated 90 percent of all financial transactions in Afghanistan are conducted via money or value transfer services (MVTs)⁹²—of which hawala is a subset—with no more than 10 percent of Afghanistan's population using the formal banking system.⁹³ Money transfer services within Afghanistan and its region are conducted almost exclusively via the hawala system, according to all available sources. MVTs and hawala have come under considerable suspicion, especially in the last 15 to 20 years, because they can be used to transfer funds without a paper trail that can be audited or easily investigated without a deeper understanding of hawala mechanics and context.⁹⁴ Details on the mechanics, traditions, variations and risk of abuse in these informal networks have been provided since the 1990s by Nikos Passas and FinCEN. A detailed description of methods, risks, ways of monitoring and policy suggestions regarding hawala networks can be found in Appendices A and B of this report.

Hawala is the primary method of legitimate money transfer, but it is also a method vulnerable to abuse by drug traffickers who wish to return crime proceeds to Afghanistan. Although there is evidence of large cash transfers from international traffickers back into Afghanistan as payment for drugs that have been shipped out, it is also common practice for these individuals to instead ship commodities into Afghanistan as payment, in lieu of cash.⁹⁵

Several countries have recently identified the expansion of illicit activities perpetrated by import/export companies registered in China.⁹⁶ A primary concern is that cer-

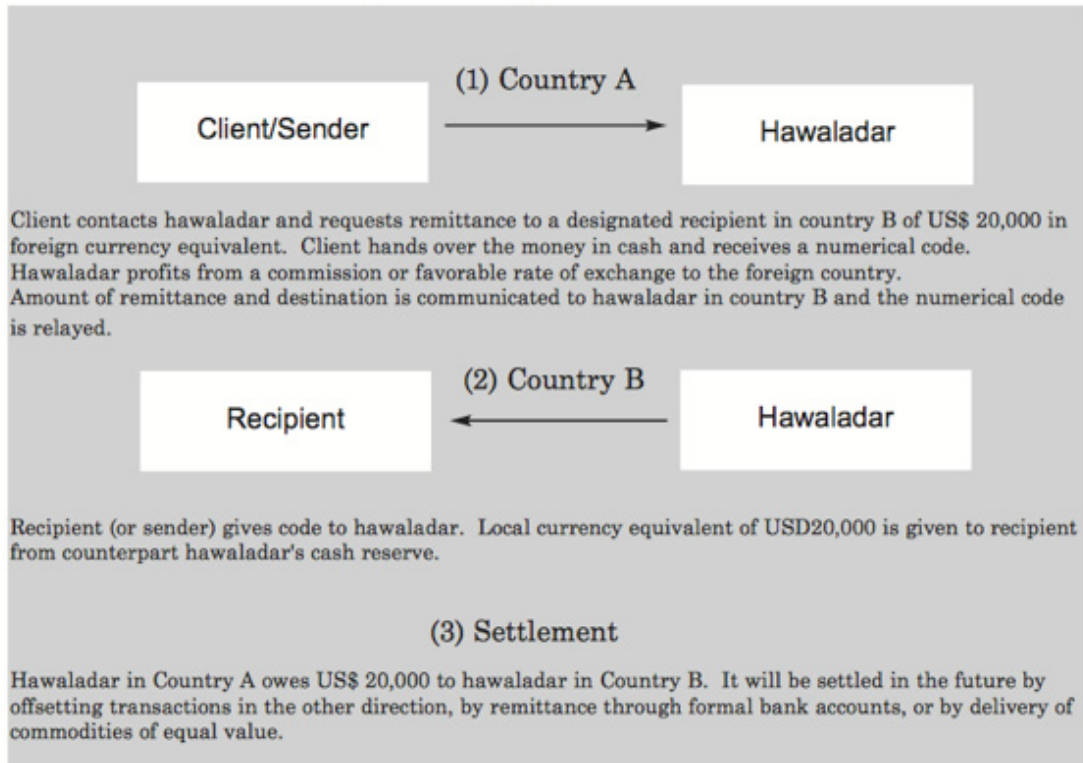


Figure 22. Stages in a typical hawala transaction (Source: The World Bank and UNODC, *Afghanistan's Drug Industry*, 2006)

tain Chinese-registered companies transfer funds into Afghanistan. Many hawaladars in Afghanistan also reportedly control or have an interest in these trading companies, including transferring monies to recipients in China. A strong policy recommendation in this arena is for U.S. and Russian law enforcement authorities to work more closely with their Chinese counterparts to combat these illicit financial flows.⁹⁷

Although China is a relatively new illicit financial flows hub for Afghanistan, a long-time hub of growing concern is the UAE. In April 2008, the UAE and FATF determined that UAE laws criminalize money laundering but do not do so fully in accordance with FATF recommendations.⁹⁸ A basic legal framework for combatting money laundering and terrorist financing is in place in the UAE but needs extensive strengthening in several areas.⁹⁹

For several years, Dubai has been considered a global center for terrorism funding, money laundering, drug money and mafia cash.¹⁰⁰ The UAE is consistently deemed each year as a jurisdiction of primary concern by the U.S. Department of State.¹⁰¹ However, the UAE has thus far not been included on the FATF's high-risk jurisdiction list.

More broadly, Pakistan and the United Arab Emirates are the main transaction centers for the "financial flows linked to production and trafficking of Afghan opiates" and the Afghanistan MVTs markets.¹⁰² Studies by Edwina A. Thompson, Samuel M. Maimbo and Nikos Passas on hawala in Afghanistan form the basis for much of our understanding of Afghanistan's informal financial flows. A more updated study of today's hawala informal markets and financial flows would benefit both the understanding of and potential policy actions intended to stem illicit financial flows while still supporting legitimate economic transactions.¹⁰³

As the demographics of hawaladars change, new methods of payment—including virtual currencies—are now being used at both the consumer and international distribution stages of Afghan opiate enterprises, although at much lower volumes than hawala methods.¹⁰⁴ More thorough study and intelligence is needed to better determine the prospective volume and types of virtual currencies used in Afghan financial flows, as well as the destinations of the virtual currencies being transferred into and out of the country.

Conclusion and Recommendations

In conclusion, there is not a lack of information about the financial flows stemming from the Afghan drug trade, but there is certainly a lack of integration of existing information. The drug trade in Afghanistan is relatively well understood; however, the routes, the dedicated trade structure and the financial structure behind it is not well documented. The most important element to highlight is the magnitude and impact of the narcotics opiate trade on the Afghan economy. Thus, it is necessary to consider this reality, the importance of it in all dimensions of the drug trade and its impact before considering any policy towards improved control of the narcotics trade in Afghanistan.

1. All involved countries should undertake an updated, systematic and comprehensive study of financial flows in and around Afghanistan, as well as worldwide (covering all continents and financial centers), to present a more complete picture of how financial flows from the Afghan drug trade are generated, what channels are used for transmission (including import/export transactions) and what is the final destination and investment. This would place the Afghan challenge in the proper context, showing how it interfaces with the global financial and commercial environment. Afghan authorities should describe the typical financial patterns and financial behaviors of different actors involved in Afghan narcotrafficking, which would assist in raising red flags and producing risk profiles (e.g., for ISIS and Taliban fighters, hawaladars, gatekeepers, intermediaries, etc.). The international community—especially the United States, Russia and other Commonwealth of Independent States countries, Iran, Pakistan and

China, as well as international organizations such as UNODC—should provide support for such research and risk management activities that could in turn benefit policy development.

2. All affected countries (e.g. the United States, Russia, Afghanistan, China, India and others) should start a focused and systematic inquiry into Afghan-related drug trafficking financials—including Western banking systems, informal value transfer systems (IVTS) and informal fund transfer systems—to assess vulnerabilities, risks, volumes, routes, actors involved or benefiting and modus operandi employed. Each country's investigators legally should be able to build investigations leading to successful prosecutions within their own country, including the ability to seize illicit funds and assets,¹⁰⁵ in order to combat narcotrafficking and terrorist groups and to provide resources for the additional funding of counternarcotics financial investigations.
3. A special development fund should be established—if possible, under the United Nations Security Council, UN Development Programme (UNDP) or another UN agency—where all narcotrafficking-related assets seized and confiscated in Afghanistan will be managed by an international supervisory and transparent UN-affiliated body (including strong U.S. and Russian bilateral control). All such funds should be dedicated to financing alternative farming, education, rehabilitation programs for local drug addicts and healthcare in Afghanistan or in other

countries identified as recipients, under a regulatory framework such as the Italian regulation framework on organized crime asset seizures and re-utilization.¹⁰⁶ This could be created pursuant to a special convention or UN Security Council Resolution making it mandatory for all State parties.

4. Leading countries (the United States, Russia, etc.) should jointly develop a common international approach to the management and use of confiscated assets, via a special UN convention on the disposal of seized assets (related to narcotrafficking). Such a convention should be developed on a consensus basis with the aim of providing a common approach to the distribution and disposal of seized and confiscated assets. This convention should be mandatory for all UN members.
5. All international financial centers that currently serve as major transit points and hubs for cash and other assets flowing out of Afghanistan, including Dubai, should implement policies to enable their own, other countries' and/or international regulating bodies' counternarcotics financial investigators to audit cash and assets and the individuals conducting these transactions in a manner consistent with international AML/CFT standards (e.g. FATF recommendations and best practices guidance).
6. All countries in which hawala networks are active should implement policies to identify and study such financial intermediaries to assess the possibility of enhancing their transparency and traceability and seek to develop more collaborative relations between authorities and financial operators (see Appendix B). FATF, in concert with research institutions and the international development community, could expand and support its best practices aimed at making positive contributions to the financial inclusion and support of livelihoods, small businesses and other legitimate customers, while being instrumental in countering illegal financial flows within hawala networks. Afghan authorities should promote and encourage best practices to identify intermediate and ultimate beneficiaries of money transfer service operators (owners), as well as general compliance with know-your-customer (KYC) policies and due diligence requirements, especially for cross-border operations.
7. All countries hosting Afghan migrants, legal or illegal, should closely monitor and raise awareness of Afghan drug trafficking and money laundering activities and how legitimate businesses or networks might be abused. Additional research and reports based on reliable sources are needed to illustrate how refugee flows from Afghanistan and back also provide potential channels for drug and financial flows. Such vulnerability analyses will shed light on the situation and risks in each country, and the evidence can be used to counter the growth of populist tendencies or views.
8. Customs, transit and port authorities in Pakistan, Iran and the UAE should develop stronger cooperation with each other, as well as other

involved actors, to gather documentation on goods to and from Afghanistan and to assemble high-quality trade data on volumes, types of goods and services, values, end use and destination, etc. This move would help furnish good information about Afghanistan's trade partners and would facilitate the identification of payment routes and types.

9. The United States and Russia should support tri-partite cooperation and information sharing between Afghan, Pakistani and Iranian drug law enforcement officials to gather data and identify routes, actors and means directly connected with drug trafficking. Given the common interests of the three countries and consensus against drug-related problems, the chances of tri-partite cooperation are high.
10. U.S., Russian and Chinese counter-narcotics investigators should increase international cooperative efforts with each other as well as with Afghanistan's neighboring countries, regardless of other diplomatic challenges, to prevent Afghan-origin heroin and opium from reaching national, regional and international markets worldwide and to stem the flows of illicit assets to criminal and terrorist groups.
11. NATO countries fighting against ISIS should devote considerable attention to Afghan drug trafficking when considering ISIS' funding sources and formulating strategies to reduce such funding. In particular, these countries should seek to develop and implement a joint program (action plan) aimed at identifying and reducing the proceeds of Afghan drug trafficking as a source of funding for ISIS as well as other terrorists and insurgents—possibly even funding the joint program with seized assets from Afghan drug trafficking.
12. New global trends should be taken into account. Outside Afghanistan, activities to counter ISIS have caused it to lose territory previously under its control; however, ISIS will continue to pose a threat within Afghanistan as it becomes a more important actor. Because ISIS enjoys support from individuals in different parts of the world, it will also continue to receive various forms of financial support—legal and illegal, including via hawala. Governments all over the world should take this trend into account and engage all money transfer actors in the global AML/CFT regime to prevent ISIS financing, as well as the financing of other rebels and insurgents in Afghanistan and worldwide.
13. Afghan authorities should prioritize drug trafficking and related legal and illegal financial flows and flows of goods (opium, etc.) as an important part of the national assessment of AML/CFT risks. The private sector (national and international, including the local branches of international companies in Afghanistan) as well as all government bodies should take an active part in an Afghan AML/CFT national risk assessment.
14. The international community should enhance coordination, transparency and supervision of international development aid projects and programs carried out in Afghanistan so that they cease to be a source of corruption. The international community should establish quality controls and context-reflective, results-oriented best practices with local buy-in, as well as a wide range of educational and technical assistance for all Afghan AML/CFT system participants (governmental and non-governmental), especially in the financial sector (formal and informal, including hawaladars), to promote a spirit of community policing and effective compliance with AML/CFT rules.

ACRONYMS

AML/CFT	Anti-money laundering and combating the financing of terrorism
ANSF	Afghan National Security Forces
APG	Asia/Pacific Group on Money Laundering
APTTA	Afghanistan-Pakistan Transit Trade Agreement (2010)
ATFC	Afghanistan Threat Finance Cell
ATTA	Afghanistan Transit Trade Agreement (1965)
CEO	Chief executive officer
DEA	United States Drug Enforcement Administration
EU	European Union
FARC	Revolutionary Armed Forces of Colombia
FATF	Financial Action Task Force
FinCEN	Financial Crimes Enforcement Network
FinTRACA	Financial Transactions and Reports Analysis Center of Afghanistan
FIU	Financial Intelligence Unit
GDP	Gross domestic product
INL	United States Department of State Bureau of International Narcotics and Law Enforcement Affairs
ISIL	Islamic State of Iraq and the Levant
ISIS	Islamic State of Iraq and Syria
IVTS	Informal value transfer service
KYC	Know your customer
ML/TF	Money laundering/terrorist financing
MVTS	Money or value transfer services
NATO	North Atlantic Treaty Organization
NGO	Non-governmental organization
NSC	National Security Council
OECD	Organisation for Economic Co-operation and Development
RAK	Ras al-Khaimah
SIGAR	Special Inspector General for Afghanistan Reconstruction
THAAD	Terminal High Altitude Area Defense
UAE	United Arab Emirates
UN	United Nations
UNAMA	United Nations Assistance Mission in Afghanistan
UNDP	United Nations Development Programme
UNODC	United Nations Office of Drugs and Crime
UNSCR	United Nations Security Council Resolution
USD	United States dollar

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Hawala Mechanics and Control Opportunities¹⁰⁷

Contrary to conventional wisdom, hawala and similar informal remittance channels could be a blessing in disguise. Although informal value transfer systems bring in risks and uncertainties, they also create practical and useful opportunities that could be leveraged in parallel with the international community's efforts to gradually build regulatory and governance capacity in fragile environments. In order to appreciate these opportunities, it is helpful to take a closer look at hawala and its modus operandi.

1. The mechanics and operations of informal financial intermediaries (hawala)

The word "hawala" refers to money transfer in Arabic. The operations of informal value and fund transfer systems, including hawala, have been described in works freely available online (Passas, 1999, 2003c, 2004b). More recent details on hawala routes and transactions of Pakistani and Indian networks (Passas, 2006; Razavy, 2005) apply to Somali and Afghani hawala as well (Maimbo, 2003; Orozco & Yansura, 2013; Thompson, 2011).

Hawala is a hierarchical network and market in which funds transfers for retail clients are tangential. The intermediaries (hawaladars) – active in different occupations and economic sectors – trade and speculate in currency in parallel to their main business. The basic way it works is as follows: migrants or donor organizations wish to send money from point A (e.g. the UK) to point B (e.g. Afghanistan). Importers and other customers want to send money from B to A. Intermediaries collect the money, organize and send payment instructions from each end and execute payment instructions received on a daily basis. Payment instructions contain a reference point for each transaction, as well as data on amount, payer, beneficiary, so if there is a delay or error, hawaladars go back to their records and sort it out.

Delivery can be made at the hawaladar's office, in a bank account or at the beneficiary's doorstep in local or foreign currency. The exchange rate they offer is much better than that of banks, Western Union or money changers.

Efficient hawala operates with pools of funds on both ends of transactions: one cash pool in a labor-importing country like the USA on one side (pool A) and another cash pool in a remittance-receiving country such as India on the other (pool B). Each hawaladar makes payments for the counterpart's clients and minimizes the need to move money. Asymmetric flows are balanced through transfers to and from accounts held in large financial centers.

Example of fax record keeping

F.A.O. GURU 22/05/01 PAGE 1

492 SENDER : - HARJIT SINGH RECEIVER : - R.K. GUPTA W / O SANJOY SINGH
128/6 PREET NAGAR LADOWALI ROAD JULLUNDHUR TEL : - 181 12345
DISTT. JULLUNDHUR 1400//=

493 SENDER : - JOHANDER PARTHA RECEIVER : - BHAGWANT SHARMA WIFE OF
LATE SEN SINGH SON JOGINDER SINGH HOUSE NEAR THE GURUDWARA
VILLAGE DALEWAL P.O. GORAYAN TEL : - 1826 12345 DISTT.
JULLUNDHUR 1000//=

494 SENDER : - KANG RECEIVER : - ARJINDER SINGH DEFENCE COLONY MOBILE
NO.98141-12345 OR 981 55 123456 JULLUNDHUR
18000//= TOKEN NO. 4AS 689122 (50 INR)

URGENT MESSAGE

**THE ORDER NO 494 ABOVE
MUST BE DELIVERED BY WEDNESDAY 23RD MAY
2001 OR THE LATEST 24TH MAY 2001 IT IS
EXTREMELY URGENT**

Comparative amounts received in Pakistan for 100 USD from Dubai

Method of remittance	Charges	Total paid	PK Rupees received
Draft (exchange house)	1.36 - 2.722	101.36 - 102.722	5901 - 5910
Draft (Bank)	2.722 - 6.80	102.722 - 106.80	5890
TT (exchange house)	9.52 - 16.33	109.52 - 116.33	5901 - 5910
TT (Bank)	12.25 - 27.22	112.25 - 127.22	5890
Western Union	9.52	109.52	5858
Hawala	NIL	100	5920

If the amounts pooled together in each jurisdiction were the same, there would be no need for either physical or other cross-border funds transfers or currency conversions. The British pounds of expatriates would cover exporters to Afghanistan, for example, while the afghanis of importers could be distributed to family recipients in Afghanistan. However, these pools are asymmetrical because people may remit in multiple directions or wish to receive funds in a third country (sometimes on behalf of another client).

Account reconciliation between hawaladars occurs at regular intervals and depends on their relationship. If they are family, this may happen on an irregular basis. If they do not know each other well, they may balance accounts weekly. US dollar accounts in big financial centers (e.g., New York, London, Dubai, Hong Kong, or Singapore)¹⁰⁸ are typically used for this purpose.

So, the generic hawala modus operandi involves three components: (i) sending funds, (ii) delivering funds, and (iii) account consolidation and balancing. As networks evolve and grow, hawaladars engage in arbitrage and shop around for the best dollar, pound, rupee, or other currency exchange rates. Consequently, multiple intermediaries become involved adding to the complexity of hawala networks of operators, agents, sub-agents, clients, and clients of clients. These counterparties and clients may be traders or service providers. Travel agencies, money changers, corner shops, delicatessen shops, music stores, and import/export businesses are all often involved in hawala.

The service is fast, reliable, convenient, cheap and, in some locations, the only option. Recipients can get their money at the speed of a fax and receive their funds even when police confiscate hawala assets. Delivery at the recipient's home benefits women who in some parts of the world do not leave their house unaccompanied. Illiteracy and lack of formal ID cards do not block access to this service, which yields more cash to the recipient than any alternative. Even small savings on the transaction cost represent significant amounts to those dependent on these flows for survival and basic expenses.

The more intermediaries join in, the less transparent transactions become to outsiders or government authorities, even in countries where hawala is authorized. **On the other hand, traceability is not lost.** On the contrary, because each node of these networks maintains records and knows its immediate counterparts, it is feasible and possibly easier to follow transactions and the money in these networks than in Western financial institutional systems.¹⁰⁹ Despite the mythology of paperlessness in hawala, operators create and keep records (Passas, 2006). The reason is simple: as retail, payment instruction, delivery and reconciliation transactions take place constantly, there is no other way they can keep track of what they are doing and with whom. It is a commonsense, necessary business routine. At least for the legitimate side of their business, they maintain their records for some time. Illegitimate deals may be entered

Figure 23. (left) Payment instructions (Source: A case of South Asian hawala. Names and numbers have been altered)

Figure 24. (right) Exchange rates and fees (Source: Nikos Passas' field research in 2005)

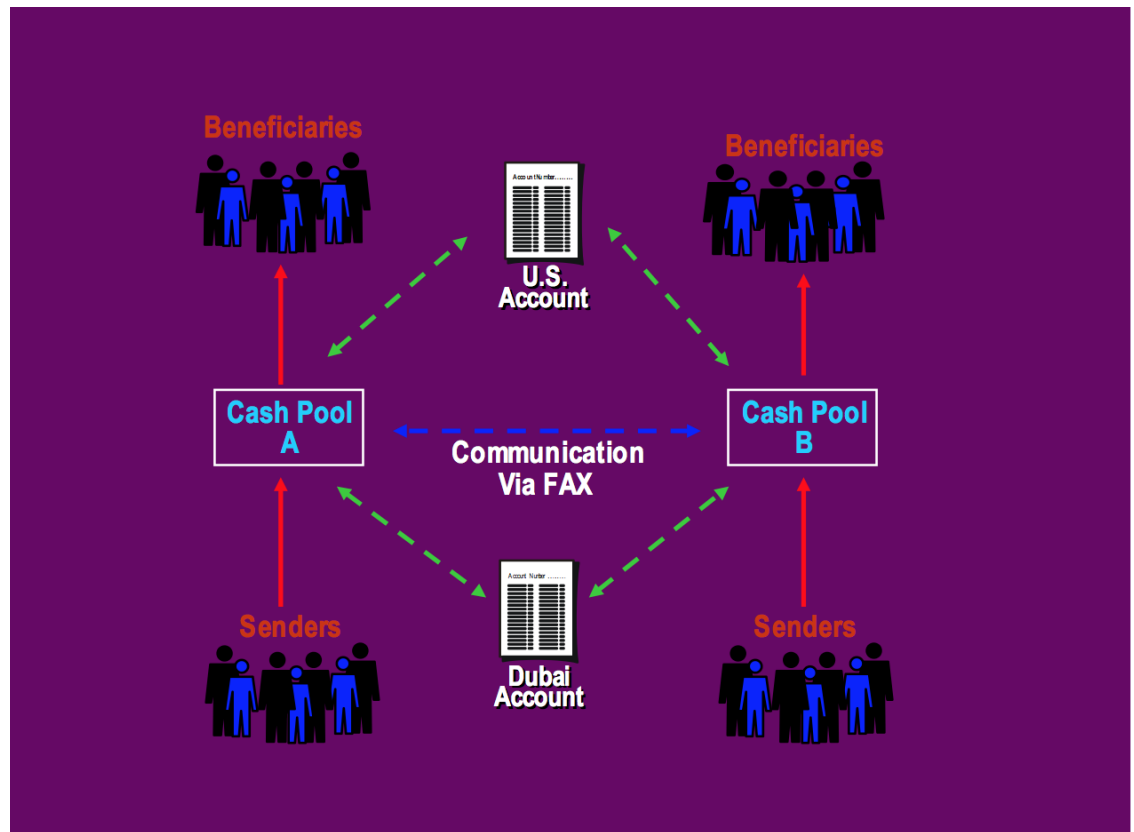


Figure 25. The mechanics of hawala (Source: Passas, 2003c)

in a different way or records destroyed after reconciliation is done, but this would create a red flag (Passas, 2004a).

For this reason, we need to **stress the distinction between transparency (that is, easy access to comparatively mechanized data) and traceability (the ability to find answers to investigative questions by contacting the information-rich nodes of these networks).** To the extent these nodes are open to collaboration, this is a great opportunity and low-tech tool for investigators and intelligence collectors, who can trace funds and intermediaries (Cockayne & Shetret, 2012; SIGAR, 2013) and solve important money laundering and terrorism cases.

If hawaladars do not wish to collaborate, they can obscure transactions or information about their clients. Blanket prohibitions of hawala for decades in South Asia and the Middle East (indeed, in any country with capital controls) have strengthened these networks and made them remarkably resilient and adaptable. The state neither can nor should try to abolish hawala – the question is rather how to handle and regulate it (Passas, 2003b). This is why it is helpful to engage in outreach and build communication and collaboration bridges in networks not overseen by government authorities. Such outreach can take place both in countries where hawala is legal (e.g. UAE) and where it is not (e.g. India). A FATF study reported that hawala is per se illegal in 18 out of 33 reviewed countries – 12 of the countries outlawing hawala are in the developing world (FATF, 2013). The outreach and handling of hawala players in different cash societies will necessarily vary and would need to be based on an assessment of risk, capacity and local practices.

Absence of formal oversight does not mean that hawala is not regulated for integrity (Ballard, 2005). While trust may no longer be the most salient feature and condition sine qua non for hawala networks (Joint Narcotics Analysis Centre, 2008), there are in-built self-regulatory processes and mechanisms for dispute resolution and compliance with their own set of rules. One cannot over-estimate the significance of potential loss of reputation, honor and economic viability, as well as collective shame or ostracism suffered by dishonest participants. Violence is very rare, but has occurred in some instances in the past (Passas, 1999, 2004b).

When disputes arise, hawaladars from different locations meet and consult with each other. In some instances, there are also special bodies, such as a commission of elders in Afghanistan who assist with conflict resolution. Costs resulting from fraud or law enforcement action are usually absorbed in a shared and fair way, so individual remitters do not run a risk in established (“mature”) hawala networks, esp. in S. Asia.

2. Recommendations

The first and most basic step is to establish the facts and the particular problems to be addressed in a given country, a thorough risk assessment for money laundering and related serious crimes. Well-designed research, solid data and thoughtful analysis will help produce a proper diagnosis and uncover the most serious vulnerabilities, risks and top priorities.

This is not a one-off process. Risks and vulnerabilities identified for each country need to be monitored and updated regularly with the active participation of all shareholders whose insights on irregularities and changes in the socio-political, economic and business environment are invaluable.

Attention thus should be paid to specific sectors, including remittance services and intermediaries. An open mind and shunning of misperceptions will lead to effective measures. Studies indicate that remittances are equally or less vulnerable to abuse than other institutions, contrary to regulator and bank assumptions (Orozco & Yansura, 2013; Passas, 1999; Todoroki, Noor, Celik, & Kulathunga, 2014). Informal remitters may even provide an advantage in fighting terrorism and other crimes. This becomes even clearer when we distinguish between transparency and traceability of transactions.

Risk assessments may show that in some areas we are exaggerating the problem or overshooting with controls. For instance, there is no need for enhanced customer due diligence for de minimis amounts. According to a recent survey, Somali expatriates remit an average \$2,040 per annum (FSNAU, 2013). The average Somali remittance is £25 in the UK and \$170 in the USA (Thompson et al., 2013). Minimal verification is appropriate for trivial amounts, which appear to be the overwhelming majority of remittances to cash societies (Shehu, 2012).

If a risk-based approach is applied to transactions lower than \$200, a threshold informally discussed in FATF and regulatory circles, it could be that most transactions to Somalia, Afghanistan and other societies worry authorities and banks needlessly, while adding unnecessary compliance costs. The risk assessment should determine how much of the volume falls into this category. Enhanced due diligence efforts can then focus on large transactions, which may be a comparatively small and more manageable number.

This does not mean that low transaction flows would be left unchecked. A systematic effort could be made to connect sending and delivery actors and to compare their respective data (on clients and amounts). Inconsistencies between the two sides would be investigated and followed up. If no irregularities appear in the volumes of small transactions (i.e., no signs of structuring, nominee arrangements, amount discrepancies, etc.), then the bulk of attention would center on larger transactions. Congress should consider sponsoring and supporting the creation of a clearinghouse that allows the consolidation and analysis of sending and delivery data.

At the same time, it is worth considering ways to leverage hawala information nodes and willingness of participants to collaborate with authorities. Hawala is a headache for controllers and bank compliance officers, but it is also a resource for risk analysis, monitoring, intelligence gathering and investigations. Outreach and good connections within hawala networks provide unique and valuable insights into otherwise non-observable shady networks and operations. It is a problem but also a solution.

The international community can help leverage the local agents’ good knowledge of their clients, the ability to “smell a rat” and willingness to collaborate. Despite some arguments that

informals in the UAE and Afghanistan resist state regulation, most participants desire to collaborate and contribute to AML/CFT (Todoroki et al., 2014; Vaccani, 2010). Hawala is the only reliable means to investigate AML assets in Afghanistan, for example (SIGAR, 2013). We can raise awareness on this and promote a data linkage with the sending and settlement parts of the hawala process.

This suggests that there might be advantages to informality or at least that money laundering and terror finance risks in cash economies can be managed better. As pointed out elsewhere, "Informal remittance providers are not riskier than other financial intermediaries, while they may extend a helping hand with better governance and control in financial sectors especially in challenging environments. Hawala is a very good business model that helps communities and can foster development and humanitarian support. When traceability is possible, authorities and banks should take advantage of it rather than squander the opportunity to use such a strategic and operational tool" (Passas, 2016).

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Hawala-related Recommendations¹¹⁰

1. Recommendations for donor organizations

Given the general governance challenges with which the regulation of hawala and AML in cash societies are tied, the approach to be taken will have to be patient, locally inspired and maintained, gradual and progressive. So, expectations need to be tempered and better managed. The policy implications relate to the following areas which donors may distribute and coordinate among them: risk and capacity assessment, strategy and outreach, maximization of existing resources, smart collaboration with hawala operators, management of expectations, exploration of alternative options, donor tasks at home and overseas, and performance indicators.

a. Risk assessment

The first and most basic step is to establish the facts and the particular problems to be addressed in a given country, a thorough risk assessment for money laundering and related serious crimes. This may have been done or delegated to a different donor, but it is essential to start with an understanding of the extent and factors making for informal sectors, as well as the socio-economic, cultural and political context, local specificities, resistances and vested interests, facilitative conditions and potential allies or partners. Well-designed research, solid data and thoughtful analysis will help produce a proper diagnosis and uncover the most serious vulnerabilities, risks and top priorities.

This is not a one-off process. Risks and vulnerabilities identified for each country will need to be monitored and updated regularly with the active participation of all shareholders whose insights on irregularities and changes in the socio-political, economic and business environment are invaluable.

Attention thus should be paid to specific sectors, including remittance services and intermediaries (e.g., DNFB). An open mind and shunning of misperceptions will lead to effective measures. Studies indicate that remittances are equally or less vulnerable to abuse than other institutions, contrary to regulator and bank assumptions. Informal remitters may even provide an advantage in fighting ML and TF. This becomes even clearer when we distinguish between transparency and traceability of transactions.

Risk assessments may show that in some areas we are exaggerating the problem or overshooting with controls. For instance, there is no need for enhanced customer due diligence for de minimis amounts. Minimal verification is appropriate for trivial amounts, which appear to be the overwhelming majority of remittances to cash societies.

If a risk-based approach is applied to transactions lower than \$200, a threshold informally discussed in FATF and regulatory circles,¹¹¹ it could be that most transactions to Somalia, Afghanistan and other societies worry authorities and banks needlessly, while adding unnecessary compliance costs. The risk assessment should determine how much of the volume falls into this category. Enhanced due diligence efforts can then focus on large transactions, which may be a comparatively small and more manageable number.

This does not mean that low transaction flows would be left unchecked. A systematic effort could be made to connect sending and delivery actors and to compare their respective data (on clients and amounts). Inconsistencies between the two sides would be investigated and followed up. If no irregularities appear in the volumes of small transactions (i.e., no signs of structuring, nominee arrangements, amount discrepancies, etc.), then the bulk of attention would center on larger transactions. Donors may wish to consider sponsoring and support-

ing the creation of a clearinghouse that allows the consolidation and analysis of sending and delivery data. Given the current Somali remitter willingness to collaborate, there is a window of opportunity to introduce a tool for the collection and analysis of data in order to detect suspicious activities.

b. Capacity assessment

Once risks and priorities are established, a (review of existing) capacity assessment before launching projects and making medium or long-term commitments is essential for the optimal use of available resources, laws and institutions. Risk and capacity assessments create consensual knowledge, a baseline and shared understanding of problems, causes, possible solutions and program formulation. The AML capacity assessment would also look into the provision of financial services, oversight and fair law enforcement. This is instrumental to a) a realistic planning and expectations management (internally and externally); b) the listing of needs where donors assist and c) a multi-stakeholder debate and strategy.

c. Strategy

Given the multiple moving parts in the design and construction of an AML/CFT framework, while also seeking to improve governance and address the sources of crime problems, a strategic approach provides the best basis and promise, the elements of which include:

- Genuine outreach, that is a two-way communication channels rather than the sort of 'dialogue' where authorities tell audiences what the law and its requirements are. This will maximize local buy-in, creation of shared stakes in the successful outcome of the policies and measures, and better compliance. It is worth exploring ways to foster public-private partnerships, collaborations between financial intermediaries and authorities to maximize the positive impact of remittances and reduce crime risks.
- Creation and sharing of consensual knowledge, such as the results of the risk and capacity assessments, diagnostic on causes, etc., will serve as common language and bridge of communications among contributors and constituents.
- Involve public and private sector stakeholders from other key areas of public policy to achieve synergies and cost savings. AML/CFT policies can be connected and coordinated with security, due process, rule of law, justice, public procurement, economic policy objectives, etc.
- Set pragmatic policy targets consistent with capacity and priorities. The risk assessment, prioritization, sequencing and planning will consider local specificities and identify the population groups most susceptible to any negative consequences of controls (loss or reduction of remittances, financial exclusion, etc.)
- The process must be inclusive: financial service providers, law enforcement agencies, financial regulators, the FIU, and other private sector, civil society, academia. A multi-stakeholder approach to policy construction and implementation will make the approach context-sensitive and enhance the credibility and legitimacy of the initiatives.
- Consider public interest effects and do a cost-benefit analysis to determine the point of diminishing returns. Disparities between legally mandated practices and what is regarded as the right thing to do can thus be identified and addressed. Donors should consider the interplay between AML/CFT, financial inclusion, humanitarian needs, security and other impact on communities, livelihoods and the economy.
- Legal transplantation from other jurisdictions should be avoided unless the potential impact and appropriateness of those measures are examined carefully.

d. Manage expectations

The above steps will render strategies more effective, viable and sustainable, and will also pave the way for well-informed communications that avoid raising expectations to unrealistic levels. Evidence-based and consensus maximizing approaches support pragmatic planning,

progressive implementation, and continuing successes that build momentum, credibility and legitimacy.

e. Build-on-what-you-have

Maximum use of existing resources means that biometrics and other new CDD solutions need not be introduced before low-technology alternatives are considered. New and expensive technologies may not be easily accepted in cash societies. At the same time, it is worth considering ways to leverage hawala information nodes and willingness of participants to collaborate with authorities. Hawala constitutes a headache for controllers and private sector compliance officers, but it is also a resource for risk analysis, monitoring, intelligence gathering and investigations. Outreach and good connections within hawala networks provide unique and valuable insights into otherwise non-observable shady networks and operations. It is a problem but also a solution.

Donors can help leverage the local agents' good knowledge of their clients, ability to smell a rat and willingness to collaborate. Despite arguments that informals in the UAE and Afghanistan resist state regulation, most participants desire to collaborate and contribute to AML. Hawala is the only reliable means to investigate AML assets in Afghanistan (SIGAR, 2013). Donors can raise awareness on this and promote a data linkage with the sending and settlement parts of the hawala process.

This suggests that there might be advantages to informality or at least that ML risks in informal economies can be managed better. Donors and TA providers, thus, should not indiscriminately pursue formalization in cash economies, but may wish to consider the potential costs and benefits before deciding on the desirability, extent and speed of such efforts.

Finally, rule of law, fairness and justice goals might be served by existing networks, institutions and arrangements (eg, traditional and informal justice and conflict resolution models found at local and regional levels).

f. Consider alternatives to banks and hawala

While building financial integrity and stability through AML controls and collaborating with private and informal actors, alternative remittance channels must be explored. One successful example is provided by the Kenyan company Mamamikes.com – a website, where users can use their credit card and send gifts to relatives and friends throughout Kenya. Users can send anything from birthday presents, flowers and chocolate boxes to electronics and supermarket vouchers.¹¹² This is a traceable and transparent way of in-kind remittances that have similar social and economic benefits as cash.

Another popular option used increasingly in cash societies, including Somalia, is telephone and mobile banking. While these can be effective and should be encouraged (they leverage the wide availability of mobile phones even among the unbanked), but at the same time donors ought to raise awareness about remaining risks and the need for a proper institutional and regulatory framework for these options too. The successful experience of the Philippines contrasts with Kenya, where regulatory arrangements for remittances through telephone mobile money channels were found non-compliant with FATF standards as of September 2011.

Bitcoin use for remittances in cash societies is growing. Low cost, speed and accessible ways of using bitcoin in cash machines should be studied rather than dismissed out of hand without understanding the risks and advantages involved. It is quite possible that, just like in hawala networks, information-rich nodes exist (the bitcoin exchanges) and most of them are prepared to collaborate for crime control. As even Paypal is opening up to bitcoin exchanges, a study examining the advantages and risks of bitcoin use for laborer remittances in cash societies would be rather useful. Perhaps even stronger consideration should be given to other digital currencies, such as those back by gold deposits, that may be even more sustainable and less vulnerable to abuse than bitcoin. The benefits to labor remitters and their families could be spectacular.

g. Donor Tasks

Donors need to go beyond low-hanging fruits and think strategically with long-term goals. In-expensive projects that appear to constitute successes and steps in the right direction (e.g. new laws and institutions are in place) may be ineffective (e.g., laws remain unenforced and institutions under-resourced and unsupported).

Coordination and quality control for donor work in a given location would foster transparency and accountability on the one hand, while setting a good example for national administrations on how to seek out synergies, collaborate, harmonize and integrate governance tasks and projects.

There are initiatives that donors can pursue within their home countries as well. We have seen how policies and measures in the global North can have serious effects and undermine donor work in cash and developing economies. Awareness raising and advocacy at home for policy coherence, coordination, and the provision of effective assistance are vital components on donors' agenda. Political and foreign policy interests will inevitably shape donor activities, but it is always helpful to know that projects with local buy-in that reflect domestic priorities and needs will be more cost-effective and sustainable. A bright example of this type of domestic advocacy and initiative is furnished by the UK efforts toward safer remittance corridors for Somalia.¹¹³

Donors can assist with enabling communities' access to bank accounts as appropriate. They can also lend a hand to banks that need to better understand remittance operations and do fact-based risk assessment. Policy makers need to bear in mind that if banks block access to legitimate remittance flows, these will be diverted to other channels that are harder to monitor and control, thus defeating the crime control policy objectives.

h. Technical Assistance

Specific technical tasks for donors include:

- Training of public and private officials
- Assistance with introducing and strengthening a transparent and traceable payment infrastructure
- Assistance with oversight rules and capacity
- Enhancement of trade transparency to control illicit flows
- Mapping of illicit networks and their methods in order to facilitate law enforcement prioritization and control operations as well as to anticipate criminal networks' adjustments to reforms
- Guidance to private sector (e.g. manuals, best practices, etc.) on their role, duties and responsibilities

i. Performance indicators for monitoring and adjustment

AML and other regulatory reforms are often done for strictly compliance purposes – in order to avoid reputational damage sanctions and listing as non-cooperative. Such national efforts are also done in order to meet donor expectations or requirements, so that aid and assistance programs can continue. This is observable and confirmed through interviews in multiple countries. As the FATF increasingly pays attention to outcomes and not just outputs, donors should introduce, support and employ performance indicators that scratch beyond the surface of literal compliance and checklists. That is, having a law, institution or measure is one step, but insufficient when these are unenforced or inadequate. The same is being done in related reform efforts towards the implementation of anti-corruption standards, where formalism and legalism defeat the purpose of improving governance, containing serious crime, and enhancing economic development.

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On the cover: Money changers in the bazaar of Mazar-I-Sharif, Afghanistan.

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