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**"UNDERGROUND BANKING AND MONEY LAUNDERING: FOCUS**  
**ON CHINA"**

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# INTRODUCTION

Migration flows around the world are incredibly increasing. Many worker expatriates move abroad alone or with their families looking for job opportunities; since most of them come from very poor areas, those who choose to leave the family in their origin countries send home part of their income in order to provide their relatives with economic support. These money transfers are known as remittances and, very often, both the remittances' receivers and the national economy rely on those money transfers respectively to cover daily family expenses and the national trade deficit.

Remittances move through financial channels, such as banks, Money Transfer Companies, post offices and so on; however, migrants often address to informal financial channels, which are quite risky just because of their informality. Conversely from conventional banks, the Informal Value Transfer Systems (also known as underground banking, Alternative Remittance System, or ethnic banking) allow migrants to easily access financial services thanks to their vast network covering also remote areas. On the other hand, unofficial banks may be subject to abuses connected to money laundering and terrorism financing activities because they are not as regulated as official ones: they agree to use cash without limits and do not often even ask for customers' identification documents, which makes them attractive for irregular migrants. Hence, although Alternative Remittance Providers have been historically used for licit purposes, regulators have been trying to deter the use of informal channels for unlawful purposes since the amount of criminal activities have started increasing. As a result, authorities have encouraged formal operators to enter into the remittance market: some of them have launched mobile and online banking networks but, except for a few cases (e.g. Kenya and the Philippines), they are still far from succeeding as much as wished.

Recently, Italy has been recording huge migration inflows and banks operating in the country have signed partnership with the biggest Money Transfer Companies in order to attract as many migrants as possible and discourage the use of unofficial agents to accomplish money transfers transactions. Investigations by authorities have however revealed that there are still many informal agents operating in the national territory. The Chinese individuals living in Italy constitute the foreign community who makes the largest use of underground banks and the last investigations revealed that the Chinese often address to informal systems in order to carry out money laundering activities rather than remitting part of their income to their families. Stricter investigations were therefore put in place and, as a consequence, remittances

to China have been shrinking. It is still not clear whether the amount of money sent to China has been really decreasing or whether individuals have opted for even more informal operators.

The thesis will describe the role of remittances and underground banks and will link them to money laundering issues; it will finally focus on the money flows from Italy to China. The work is divided in five chapters. The first chapter gives a general definition of remittances and their main characteristics, as well as a description of their influence on the receivers countries' economy and about the general functioning of Remittance Service Providers. The second chapter starts with a short explanation of the European and international payment systems; it then reports details on the features of financial channels offering money transfer services and lists the characteristics of both formal and informal ones. It also contains a sketch of transactions carried out through Remittance Service Providers and explains the main reasons making underground banks more attractive than conventional ones. The third chapter introduces the concept of money laundering and the main forms of illicit activities related to it. I reported a few cases of money laundering through underground banks and the effects they have on the real economy. Moreover, I talked about the international regulation in place against money laundering and terrorism financing activities and I listed the role of the main international bodies. I also analyzed the regulation in place in the United Arab Emirates and Afghanistan and I listed their main drawbacks. I finally discussed the opportunities and threats faced by formal operators willing to enter the remittance market. In the fourth chapter, I started talking about China: I began with a brief outline of the Chinese economy and migration flows, and I added an analysis about the amount of remittances inflows in the last few years. Finally, in the last chapter, I talked about the most common money laundering activities in China and the respective regulation. After having described the Italian money laundering regulation and remittance market, I started analyzing the money transfers from Italy to China. I first reported the outcome of the last investigations by Italian authorities and I tried to demonstrate those results by computing the amount of remittances per Chinese individual and by comparing them with the average income declared by the Chinese living in Italy. To further confirm the results, I compared China with Pakistan and Morocco, which makes it clear that China is an exceptional case.



# CHAPTER 1: DEFINITION OF REMITTANCES AND THEIR ROLE

## I. DEFINITION AND MAIN CHARACTERISTICS OF REMITTANCES

“Remittance transfers are defined as cross-border person-to-person payments of relatively low value”, usually made by migrants sending money to their families still living in their origin country (The World Bank, 2007); hence, they are “a portion of the wages of migrant workers earned in foreign countries and sent back to their home country” (Maimbo and Ratha, 2005). The definition of remittance is quite recent: as the worldwide volume of money transfers have increased a lot since the 1990s, the G-8 was asked to articulate a description of these flows in order to provide guidance to governments willing to identify the phenomenon, its size and its effects. (Barajas et al., 2008)

Estimation of money transfers among countries have highlighted that remittances are a great source of financing for receiving countries, exceeding foreign aids and ranking just after Foreign Direct Investments.

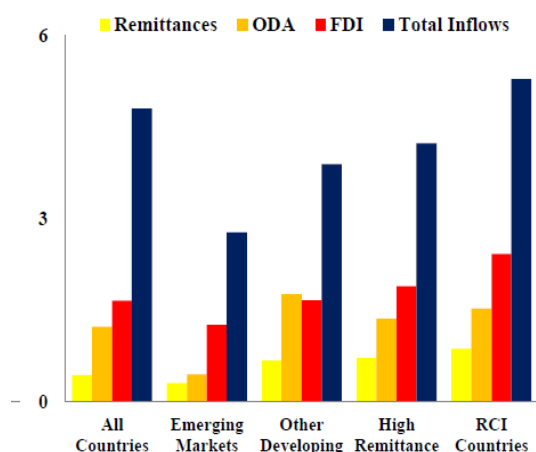
In many countries, remittances are the fundamental source of capital for rebalancing the balance of trade. Nepal case is emblematic: although its trade deficit has been significantly increasing in the last years, it succeeded in turning to a current account surplus thanks to the growing amount of remittance inflows (Gaudel, 2006). In fact, the association of the demographic increase and a weak economy environment have forced more and more workers to move abroad; as a result, money transfers have been raising and they have largely contributed to the contraction of the country’s deficit (Wagle, 2012).

However, the bulk of cash is carried by unofficial channels, so amounts are even higher than estimated. Given the huge volumes of these flows, they have been studied to detect their impact on the destination countries’ economies, i.e. macroeconomic effects and interactions among agents (firms, governments, households, financial intermediaries) (Barajas et al., 2008).

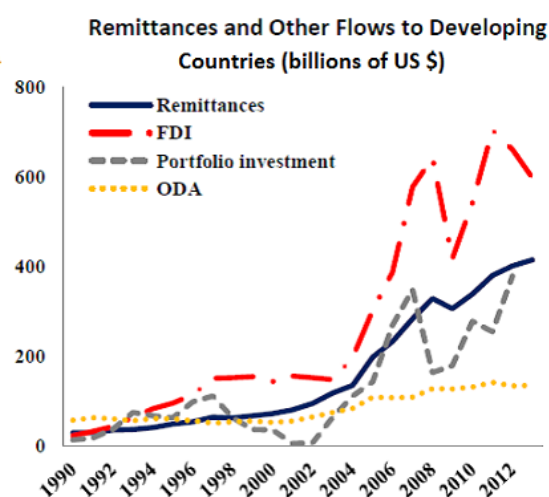
Remittances and Foreign Direct Investments have different characteristics, so their impact on the economy is not the same. Just to make some examples, the former are sent in small amounts but quite frequently, while the latter are sent occasionally but in great amounts; moreover, remittances flows have shown to be quite stable over time, while private capital inflows depend on the economic cycle (i.e. they move pro-cyclically). This happens because migrants are obviously willing to invest in their countries more than foreign investors are; hence “remittances can be viewed as a self-insurance mechanism for developing countries”, which is extremely useful in case of natural disasters, wars or state default, because they serve as a tool hedging from shocks. It is just because of the stability of remittances over cycles that some nations started using them as collateral when borrowing on the international capital markets (Maimbo and Ratha, 2005).

### Volatility of Inflows

(Mean standard deviation)



Source: De et al., 2016.

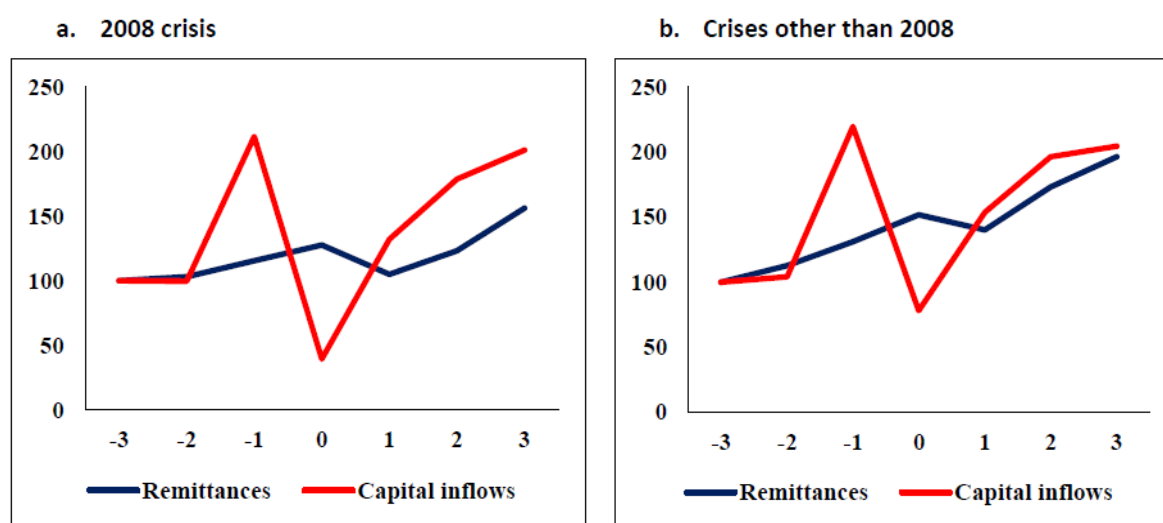


Source: Data from World Bank World Development indicators and IMF Balance of Payments – retrieved from De et al., 2016.

The left-side graph demonstrates that, regardless of the set of countries considered, remittances are much less volatile than other external financial sources, while the right-side graph shows the trend of different financial sources from the 90s onwards. Remittances have significantly increased over time and, notwithstanding a slight decline corresponding to the beginning of the crisis (probably due to migrants losing their jobs), the chart proves that they are much more stable than FDI and portfolio investments. The graph below confirms the results.

### Remittances and Capital inflows during sudden stops

(Index numbers)



Source: De et al., 2016. Authors' calculation on data from the World Bank World Development Indicators and Global Capital Flows  
 Note: Values are averages of remittances and net capital inflows for emerging market and developing economies that have experienced sudden stop episodes. Index numbers are calculated with a base of 100 for the period three years before the sudden stop year (-3). Capital inflows are net, that is, the difference between the amounts brought in by nonresidents and the amounts sent out by residents. The horizontal axis denotes years. Zero (0) refers to the year of the sudden stop episode.

Remittances flows amounts can be retrieved from the Balance of Payments of single countries. Estimations are not straight because they are made up of the sum of personal transfers, including all current transfers between resident and nonresident individuals, and compensation of employees, which refers to migrants' wages earned in countries other than their homelands. The World Bank has estimated that top sources countries in 2014 were the United States, Saudi Arabia, Russia, Switzerland and Germany, while top recipients were such big states as India, China, the Philippines, France and Mexico. Nonetheless, if we compare those amounts to the GDP of each country, we find that small nations (Tajikistan, Nepal, Moldova) receive more money transfers and are heavily dependent on remittances inflows (The World Bank, n.a., a).

<b>Migrant remittance inflows (US\$ million)</b>	<b>2014</b>	<b>Share of GDP in 2014</b>
<b>World</b>	591.968	3,4%
<b>India</b>	70.389	3,4%
<b>China</b>	62.332	0,6%
<b>Philippines</b>	27.273	9,6%
<b>France</b>	25.195	0,9%
<b>Mexico</b>	24.462	1,9%
<b>Nepal</b>	5.770	1,4%
<b>Tajikistan</b>	3.384	1,7%
<b>Moldova</b>	2.084	17,9%

<b>Migrant remittance outflows (US\$ million)</b>	<b>2014</b>
<b>United States</b>	56.311
<b>Saudi Arabia</b>	36.924
<b>Russian Federation</b>	32.640
<b>Switzerland</b>	24.693
<b>Germany</b>	20.836

*Source: World Bank staff calculation based on data from IMF Balance of Payments Statistics database and data releases from central banks, national statistical agencies, and World Bank country desks.*

The type of transfers that I am going to analyze later is cash remittances, but migrants may choose to make transfers in kind as well. Cash can be transferred both through formal or informal channels: the former category includes banks, credit unions and Money Transfer Operators (e.g. Western Union, MoneyGram International, Vigo), the latter consists of nonbank institutions (Hawala, Hundi, etc) (Yang, n.a.). The world's largest migration corridor is that from Mexico to the US, followed by Russia to Ukraine, Bangladesh to India, and Ukraine to Russia (The World Bank, 2015a).

Migration is a daily-discussed phenomenon and migration flows are massively increasing; as a result, remittances are expected to increase as well and policy makers should try to capture all the advantages deriving from these transfers. Thanks to globalization, it is very easy to move from one place to the other and people are attracted by higher labor demand and income levels of other countries: the greater the international labor mobility is, the higher remittance flows to poorer countries are (Maimbo and Ratha, 2005). Individuals commonly migrate just if benefits exceed costs, so economic considerations are fundamental; the wage differential between the origin and the destination country constitutes a great economic support for migrants' families (Cai, 2003). Recessions and economic crisis are other factors pushing people to migrate; nonetheless, in 2014, some events in Europe reduced migration inflows

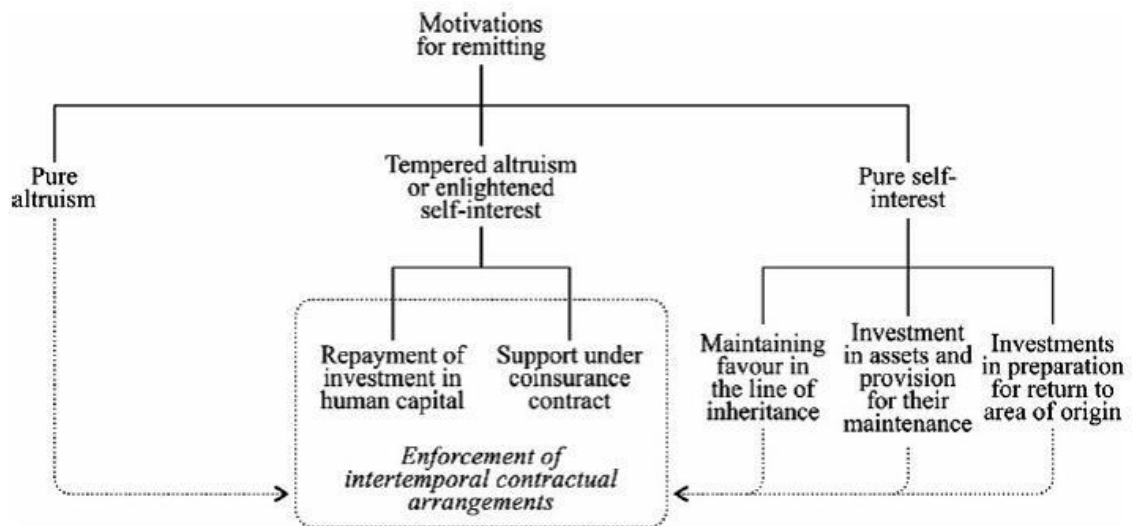
and hence remittance volumes to recipient countries. In particular, the tightening of immigration controls and the weak recovery of Europe implied a shrink in job opportunities for migrants; in addition, the slowdown in Russia made unemployment higher and led to the depreciation of its currency, causing a reduction of migrants' real income. Conversely, in the same period, the economic improvements in the US heightened money transfers inflows in Latin America and the Caribbean by 5.8%; South-Asian and Sub-Saharan countries recorded an increase in remittances as well (The World Bank, 2015a).

Remittances flows are positively related to the stock of migrants: a deep analysis of the level of international money transfers and their drivers is thus essential for setting up adequate migration policies aiming at attracting high-skilled immigrants and preventing undesirable flows by promoting and supporting economic development in poorer countries (Carling, 2008). Conversely, the receiving countries should formulate policies pointing to enhance the developmental effect of remittances on their economies (Barajas et al., 2008).

## II. DETERMINANTS OF REMITTANCES

The migrants' choice of transferring money home is due to many different factors, which can have huge impact both at micro and macro level in their origin country (Bartolini, 2015).

Incentives and restrictions to remit set up by governments definitely influence the level of international money transfers; however, the amount of money which migrants decide to transfer depends also on the ties that they have with their families and on whether they are going back home in the future (Maimbo and Ratha, 2005). If the latter is the case, they send money home in order to have some capital in their origin country and to maintain their relationships with natives, especially if they are illegal migrants, since their length of stay abroad is much more uncertain than for legal ones (Markova and Reilly, 2007). Migrants driven by altruistic reasons include the receivers' level of consumption in their utility function, so they transfer money to enhance the standards of living of their relatives and smooth their consumption level. The money that they send act then as a buffer hedging from negative shocks, i.e. as an insurance (Barajas et al., 2008).



Source: Carling, 2008.

Empirical studies on remittance behavior highlighted that men use to remit higher amounts of money, but women remit a larger share of their income (Posel, 2001). Obviously, migrants moving with their husbands or wives are less likely to send money to their countries (Carling, 2008).

Other factors influencing money transfers are the presence of other people coming from the same places in the areas where migrants move and the location of receivers. In fact, the existence of many immigrants having similar backgrounds translates into better networks intended for transferring money but also more intense relationships with the country of origin and hence, higher tendency to remit; farther, rural areas are usually poorer than urban ones, so migrants coming from those zones are more likely to send money home (Carling, 2008).

### III. IMPACT OF REMITTANCES ON RECEIVING COUNTRIES

Remittances have been deeply investigated by researchers because they can potentially have positive effects on the economy of poorer countries. Data on the amount of money transfers, origin and receiving countries and ways used for transferring that money are very useful to understand the impact that remittances have on the economies of the destination countries. The main aim of estimation of these flows is to find out what they are used for. Unfortunately, a large portion of money transfers pass through informal channels and even flows passing

through formal channels may not be accurate: some countries require to publish data only if money transfers pass a specific threshold; some other may incorporate those flows with other ones (e.g. tourism revenues, nonresident deposits) (Maimbo and Ratha, 2005).

Clearly, migrants are able to transfer money only if they manage to find a job in richer nations. Contrarily from money arriving through foreign aids, whose target are public entities, remittances are meant for households. They positively affect destination countries if they are spent in health or education because they help to accrue and improve those nations' human capital; this effect is significant in the long term only if natives receiving education thanks to remittances do not in turn migrate (Barajas et al., 2008). Increasing levels of consumptions is the consequence most contributing to growth because of its effect in stimulating demand. In this case, remittances contribute to soften poverty issues in receiving nations thanks to multiplier effects and the reduction of inequalities, which improve the standard of living (Maimbo and Ratha, 2005). However, Chami, Fullenkamp, and Jahjah (2003) claimed that money transfers may be used as labor income substitutes, causing receivers to reduce their labor effort. If these moral hazard issues arise, both firms' performance and the labor market participation rate will shrink.

Emigrants may be willing to invest the money earned abroad in their origin countries, both to build houses and setting up firms. Their investments function as start-up capital that in the medium-long term contribute to raise employment opportunities for their families and sustain their birthplaces' economic growth by providing liquidity that would not be otherwise available (Maimbo and Ratha, 2005). As they supplement banks' available funds, remittances are a great resource to ease the financial sector's constraints of countries having inefficient credit markets (Giuliano and Ruiz-Arranz, 2009); last but not least, greater availability of borrowing funds translates into lower borrowing costs and lower investments volatility (Barajas et al., 2008).

Summing up the effects analyzed up to now, we might conclude that remittances act as an insurance instrument allowing to hedge from negative shocks, therefore reducing uncertainty; they provide an additional source of income contributing to alleviate households' poverty and contribute to increase the level of investments (both in human capital through education and physical capital) by easing credit constraints. However, besides these growth-enhancing effects, it is important to point out some pitfalls as well. The danger of a decreasing labor supply adds to the risk of appreciation of the receiving countries' currencies: high amounts of money inflows involve higher inflation rates and a consequent real exchange appreciation. In

several countries, especially small ones, the annual total volume of remittances flows is even higher than the amount of foreign reserves (World Bank, 2015). The primary result is the decline of exports accompanied by a loss of competitiveness; nonetheless, the country would pay less for imports and thus may reduce its level of debt by improving the balance of payments (Maimbo and Ratha, 2005). Anyway, it must be noted that, where remittances are in kind rather than cash, the balance of trade improvement might not occur if residents change their consumption attitudes: they may start opting for foreign goods (i.e. increase in imports) and make the domestic level of production decrease (Mughal, 2013).

While it is real that higher amounts of remittances flowing to the country imply higher levels of sustainable deficit, it is also true that politicians may rely on remittances to support economic growth and improve their creditworthiness, therefore postponing essential reforms (Catrinescu et al., 2009). Empirical studies confirm that, in remittance receiving countries, governments use to deviate from fiscal discipline and increase public expenditure (Barajas et al., 2008). In the long term, this inefficient public behavior may cause a lower employment level and hence a surge of workers expatriations; remittances amounts would hence be higher and might lead residents and government to heavily depend on them. Increasing reliance on remittances may make the country experience serious crisis as soon as money transfers inflows fall (Mughal, 2013). In addition, a strong reliance on remittances may cause public moral hazard to translate into households' moral hazard: families may use remittances as "shock absorbers" and lose any incentive to press for reforms (Hubert Ebeke, 2012).

Thanks to their counter-cyclical behavior, money transfers have been used by some countries (e.g. Brazil, Mexico, and Turkey) as collateral when borrowing in international markets, permitting their governments to reduce debt costs and lengthen its maturity. In 2008, banks established in developing countries raised more than \$20 billion by securitizing remittances but, as these nations lack laws on securitization and bankruptcy procedures, it has been difficult to develop this business (Ketkar and Ratha, 2009). Anyway, in the last years remittances have been taken into account by rating agencies evaluating the countries' creditworthiness. This practice had great impact on countries recording high amounts of money transfers inflows (The World Bank, 2015a).



## A. POLICY IMPLICATIONS

In the single countries' balance of payments, remittances may be included in such other items as migrants' transfers or employee compensation; however, it is fundamental to have accurate estimates of the remittances volumes to get sufficiently precise predictions of their effects, and hence to put in place adequate policies.

We saw that money transfers may have great positive effects but they have drawbacks as well: the prevalence of ones on the others depends on the characteristics of each country. For example, some authors (Barajas et al. 2008) argued that the investment level may remain stable if capital mobility is high or if remittance receivers have no financial education and do not know how to invest that money; they also highlighted that investments are more productive if the financial system can take advantage of them because they can contribute to lower the costs of financing. As a result, governments should formulate policies encouraging remittances' receivers to devote that money to productive investments (Barajas et al., 2008). Catrinescu et al.(2009) pointed out that institutions determine the final output level by defining incentives for financial and business investments; Barajaset al. (2008) added that poor institutions might deviate households from putting pressure on governments for setting up new programs (i.e. households' moral hazard).

Even if remittances allow reducing the country level of debt, governments should maintain some fiscal discipline and avoid using freed-up resources in distortionary ways. Politicians of those countries should keep in mind that most inhabitants are remittances-dependent and cannot sustain any increase in taxes. Governments should rather opt for growth-enhancing choices benefitting the whole society (Barajas et al., 2008).

In the last years, some immigrants groups have decided to pool remittances and devote them to their origin countries' governments. The most relevant example is that of Hispanic communities living in the US who created hometown associations whose objective is to share experiences and fund public and private projects in their homelands (Maimbo and Ratha, 2005). In this way, money do not enrich only some households and families, but the society as a whole; furthermore, they promote their culture by sponsoring events in their residence towns, they help their members to find an accommodation when arriving in a new country and provide them with medical assistance (Milusheva, 2012).

## IV. REMITTANCE SERVICE PROVIDERS (RSPs)

The agents involved in a remittance transfer are the sender, the receiver and the provider of service (so-called capturing provider in the sending country and disbursing provider in the destination country). Remittance services are primarily offered by informal operators, but they are provided by some deposit-taking institutions as well (The World Bank, 2007). When deciding to remit, migrants can thus use different channels to transfer money: if they want to avoid the use of any intermediary, they may opt for bringing cash home when they visit their families; otherwise, they can choose among Money Transfer Operators (MTOs), informal intermediaries transferring cash (the most popular are “Hawala”, “Hundi”, “Feich’ien”) or traditional banks (Kosse and Vermeulen, 2014). Except for those located in developing countries, especially in India, Turkey and the Philippines, banks are not widely used because they consider remittances services only as a marginal activity (Ratha and Riedberg, 2005).

Remittances transactions usually consist of three main stages: first, the migrant asks an agent to transfer money through cash, checks, credit or debit cards; then the funds are settled and, finally, the receiver gets the money. Most remittances receivers are unbanked, so migrants use to transfer cash; however, some countries like the Philippines, Mexico, Haiti, Nepal, have developed remittance systems paying in kind and allowing receivers to buy goods in affiliated stores, whose price correspond to the money received. The greatest concern is that sellers may take advantage of this habit by raising the price of those goods (Ratha and Riedberg, 2005).

It is usually the sender who pays for the service; the amount charged depends on various factors: the level of competition, which in turn depends on entry barriers; the costs incurred by the providers, determined by the technology used; the location of both the sender and receiver. Since in most countries there are only a few Remittance Service Providers, the trivial number of competitors allow them to charge high commissions (Ratha and Riedberg, 2005).

Estimations say that the average cost per transaction is about 15% of the transferred amount and it is sometimes even higher if the remittance value is below a specific sum (Daly, 2010). Operators’ charges include the cost of sending money, the foreign exchange commission and the additional fee. The amount of foreign exchange commission depends on the source and destination countries of remittances: some countries have great discrepancies between the official and the unofficial exchange rates, while some other have tight exchange controls. The amount of the fee is instead always high (i.e. independently of the location and the provider)

because RPSs are not endangered by competition: it is not unusual that some RPSs ask to larger banks or to the postal network to sign contracts aiming at restricting competition. Many developing countries still suffer from many market failures in the financial field; the lack of competition is just one of the inefficiencies that policy maker are trying to solve (Maimbo and Ratha, 2005).

Unofficial providers were born because the traditional banking system do not operate in many rural areas of some countries, want their customers to be identified, and often requires a minimum amount of money to be held at the bank in order to enjoy some services, such as money transfer (Maimbo and Ratha, 2005); indeed, unofficial operators are mainly used by migrants having no bank accounts (Kosse and Vermeulen, 2014). Moreover, even if Remittance Service Providers' objective is just to offer money transfer services, many states want these agencies to conform to standards required to get the banking license.

Since having a mobile phone is much more easy and common than having a bank account, a new trend that is becoming popular is the mobile-based remittance service, which allows reducing the costs of transferring money (Watterson, 2012). As previously said, migrants use to repeatedly remit small amounts and this practice translates into very high commissions. A good solution might be to remit higher amounts and less frequently, but because of the risk of theft or loss of money and the liquidity constraints they are subject to, many migrants cannot change their habits (Yang, n.a.). Switching to mobile phone remittance may hence be the best solution to reduce the commission expenses paid by migrants and escape the danger of losing money. In addition, people living in rural and remote areas can also reach these services. Likewise, intermediaries may increase the number of customers without needing to be physically present. Mobile remittances are now offered by many companies all around the world; among them Travelex Money Transfer, Forex International Hong Kong, Dollar America Exchange in California, CBN Grupo, New York Bay Remittance, Banco de Oro Bank (Ratha and Riedberg, 2005). These intermediaries can choose to offer three kinds of services: mobile to cash or cash to mobile (depending on the party using cash and the one using electronic wallets), and mobile to mobile, which is the cheapest way of transferring money (Daly, 2010). The use of this technology is however still low. Plaza, Yousefi and Ratha (2016) estimated that in 2013 the value of international mobile-based remittances did not even reach the 2% of total remittances.

Informal RSPs do not usually ask for senders' identification: it is just because of the impossibility to recognize people transferring money that RSPs have been contested for their

potential risk of abuse (including money laundering, tax evasion and terrorism financing), which adds to the risk of theft. Educated and skilled migrants, who are more conscious of these risks, tend to prefer formal intermediaries to transfer their money (Kosse and Vermeulen, 2014); however, since remittances volumes are negatively related to transmission costs and lower-developed financial systems imply higher costs, migrants tend to opt for informal operators (Freund and Spatafora, 2008).

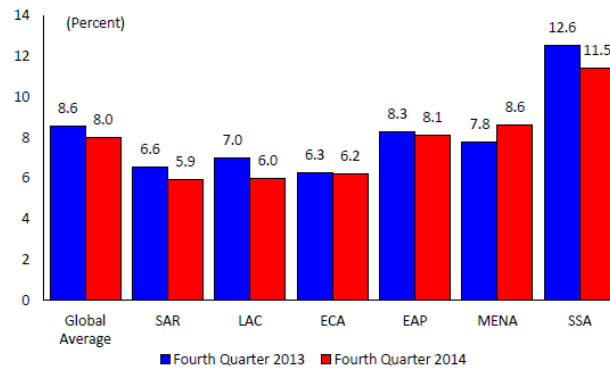
## A. POLICY IMPLICATIONS

It has been widely acknowledged that remittance providers do not correspond to banks and the level of competition in their industry is much lower than in the banking system (Ratha and Riedberg, 2005).

Providing access into the banking system for unbanked migrants might be a first step to reduce the use of unofficial channels. International banks may sign agreements with informal operators to create an integrated financial system, which would benefit both sides: large banks would attract new customers, and intermediaries of poorer countries would extend and develop their activities. Moreover, since competition in the traditional banking field is much higher, fees would be lower and transferring money would be cheaper (Maimbo and Ratha, 2005).

South-Asian and African countries have recorded a reduction in remittance costs thanks to the collaboration between MTOs, including mobile ones, and banks. In the fourth quarter of 2014, the worldwide average cost for transferring money decreased from 8.2% to 8%, while the weighted average cost (weighted by the extent of bilateral remittance volumes) stayed at 6%. The fact that the latter cost is lower than the former means that greater corridors are cheaper. The World Bank estimated that the cheapest corridors were the UAE and Singapore (The World Bank, 2015a).

**Sub-Saharan Africa is the costliest region to which to send \$200 (average costs)\***



\* Total average cost of sending about \$200 equivalent

*Source: Remittance Prices Worldwide, World Bank Retrieved from Dubey, 2015.*

Nevertheless, the enhancement of required standards set to limit money laundering does not help reducing costs and act as a barrier to the entry of new agents and cheaper technologies. The World Bank suggests reducing such barriers as mobile licensing and exclusiveness for incumbents in order to simplify the collaboration among different operators and the establishment of new technologies; it in fact reminds that new regulatory frameworks forced many banks to exit from remittance activities and caused the subsequent shutdown of those MTOs that were not able to operate without the support of banking accounts (World Bank, 2015).

# CHAPTER 2: INTRODUCTION TO THE PAYMENT SYSTEM AND THE UNDERGROUND BANKING SYSTEM

## I. MONEY TRANSFER ACTIVITIES

### A. INTRODUCTION TO THE PAYMENT SYSTEM

Any economic agent frequently engage in money transfer transactions for reasons ranging from bill payments to financial or educational support to relatives living elsewhere (i.e. remittances). Money transfers services are provided by different kinds of financial institutions, such as traditional banks, Money Transfer Operators, Alternative Remittance Systems; regardless of the intermediary chosen, they all make use of the payment system.

The payment system (or more properly, the *Payment, Clearing and Settlement System*) is an essential part of any financial system and includes all the instruments, rules, procedures, intermediaries and interbank funds transfer arrangements permitting money to circulate in a certain area (European Central Bank, 2010). After a bank receives a payment instruction by a client, the payer and the payee's banks exchange information about the order through the clearing process, consisting in "transmitting, reconciling, and in some cases, confirming transfer transactions before their final settlement. During clearing, the sending and receiving financial institutions exchange information about the payment, and the amount of funds to be settled by those institutions is calculated" (Isern, Donges and Smith, 2006). After having checked the availability of funds, settlement finally compensate the two accounts. The correct functioning of the Payment, Clearing and Settlement System is ensured by Central Banks, which must accurately manage financial, operational and legal risks in order to guarantee efficiency. Regulations and institutions have also a role in determining the structure of the systems, which hence differ among countries (European Central Bank, 2010).

The main purpose of payment systems is to allow agents (private and public individuals, firms) to make transactions and to make sure that resources are efficiently allocated. Reliable and efficient infrastructures constitute the fundamentals for preserving financial stability; moreover, an efficient system guarantees that transaction costs do not go over benefits, and hence encourages to trade. Factors like the integration of financial markets and financial innovation have posed new challenges because they have contributed to increase the worldwide volume of financial transactions; in addition, increasing levels of migration have caused a higher demand for cross-border transactions (European Central Bank, 2010).

## 1. PAYMENT SYSTEM IN THE EU

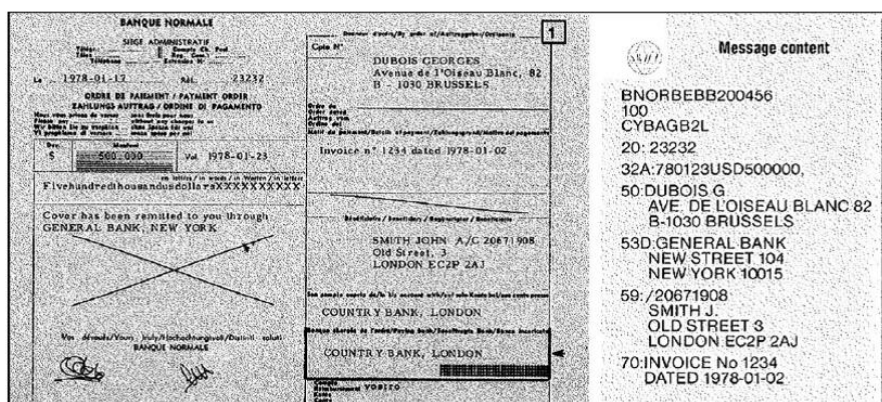
After the introduction of the unique currency, the European Central Bank and the European Commission promoted the creation of the so-called SEPA (Single Euro Payments Area) to launch a unique, integrated market for non-cash payments (in particular card payments, direct debits and credit transfers). The main objective was to increase competition, and hence efficiency, by promoting the use of the same payment instruments throughout the Union and by ensuring the same rights and obligations to any agents making or receiving payments (Virtanen, 2014). The Payment Services Directive defines the payment system as “a funds transfer system with formal and standardized arrangements and common rules for the processing, clearing and/or settlement of payment transactions” (Directive (EU) 2015/2366). Therefore, starting from SEPA introduction in 2008, international payments made within the area by any economic agent are treated as domestic ones.

The European Automated Clearing House Association (EACHA) includes 26 Automated Clearing Houses from 22 different countries (European Automated Clearing House Association). Automated Clearing Houses usually refer to US electronic networks for interbank clearing of fund transfer transactions and providing overnight transaction settlement; they are usually operated by the central bank or bank associations and may choose to provide services only to deposit-taking institutions or to any kind of financial institution (Isern, Donges and Smith, 2006). Within the EU, these entities are called PE-ACHs (Pan European ACHs) and consist of Clearing and Settlement Mechanisms (CSMs) arranging both clearing and settlement of SEPA-compliant wire transfers and direct debits; clearing and



settlement activities may be however carried out separately by different entities (SEPA Glossario).

Within SEPA, many Clearing and Settlement Mechanisms (CSMs) compete for the provision of these services; among them: ACH Finland, Banca d'Italia, EBA Clearing, Eurogiro, GSA, DIAS, SIBS, STET, TRANSFOND. Clearing and Settlement Mechanisms messaging services are instead provided by SIA and SWIFT SCRL by means of international arrangements (European Payment Council). SWIFT (Society for Worldwide Interbank Financial Telecommunication) is not a payment system but a messaging infrastructure permitting to transmit payment instructions for most international interbank transactions. It was created in the 70s by some major banks as a worldwide provider of secure financial messaging services and interface software for payment systems (European Central Bank, 2010). Each institution was given an exclusive identification code (i.e. BIC, Bank Identifier Code) and could transmit information through SWIFTNet thanks to a standard code system: SWIFT does not hold funds nor offer clearing and settlement services; it simply guarantees a reliable and confidential convey of instructions for wire transfers between institutions by providing a common language for international payments. The concrete exchange of funds occurs later through the payment system or correspondent banking relationships (SWIFT). Therefore, EURO1 participants (EURO1 is the unique Real-Time Gross Settlement European system for large value and urgent transactions to be made both within the same country and within cross-border) make use of SWIFTNet to send payment messages, which are usually credit or debit transfers; the network then processes those messages and forward them to receiving banks (European Payment Council).



Example of a payment instruction translated into a SWIFT message.  
 Note: This example illustrates a payment order translated into an MT100 message. The payment is being sent to the bank with SWIFT code CYBAGB2L. The separate fields with the payment information are also clear. This is a fake representation used by SWIFT in early brochures.

Source: Barclays Archive Groups. Retrieved from Scott and Zachariadis, 2010.



## 2. PAYMENT INSTRUMENTS

The first payment mechanism to be introduced was barter; it then developed to coins and, more recently, to sophisticated tools, such as cards and electronic or mobile instruments. “Payment instruments are the mechanisms that people, businesses, and governments use to transfer money in the settlement of exchange transactions. These instruments take many forms and have many uses”. The most commonly used money transfer instruments are currency, checks, money orders, traveler’s checks, debit cards, credit cards, and prepaid cards. These devices have been traditionally associated to banks as they are often offered as ancillary services to bank accounts; however, we will see that most residents of developing and underdeveloped countries are still unbanked and cannot enjoy these facilities. They therefore address to informal operators (e.g. *hawaladars*) which offer easy and fast clearing and settlement mechanisms (Isern, Donges and Smith, 2006).

### B. FUNDS TRANSFER

When funds transfers require transferring money between accounts held either in the same bank or different but connected banks, they are simple book transfers; if the two institutions are instead not related by any relationship, transactions involve the use of interbank funds transfers systems such as CHIPS and Fedwire which move money from one account to another (Madinger, 2011).

#### 1. WHOLESALE FUNDS TRANSFERS

The amazing growth of the banking industry has involved the development of Electronic Funds Transfers; most EFTs are handled by the wholesale payment system, which deal with large-value transactions between banks acting either on their own or their customers’ behalf. In the US, the two main wholesale payment systems for interbank funds transfers are the Fedwire Funds Service and the Clearing House Interbank Payments System (CHIPS); they arrange the settlement of interbank purchases and sales of federal funds, foreign exchange transactions, disbursement or repayment of loans, real estate transactions and other financial

market transactions (Federal Financial Institutions Examination Council, b). Fedwire takes care of Real-Time Gross Settlement transfers for US domestic funds, while CHIPS is a system for private electronic payments allowing transmitting and settling transactions denominated in US dollars among financial institutions; it hence includes some US banks and US branches of foreign banks. In order to distinguish the single accounts, each entity is given an Universal Identifier Number (Lim, 2008). Settlement may be both bilateral and multilateral: banks having positive closing positions get Fedwire payments, so CHIPS is both a customer and a competitor of Fedwire; for that reason, most of banks are members of both systems (Federal Reserve Bank of New York, 2002).

## 2. RETAIL WIRE TRANSFERS

“A wire transfer is an electronic transfer of funds across a network administered by hundreds of banks around the world. Wire transfers allow for individualized transfer of funds from single individuals or entities to other individuals or entities, while still maintaining efficiencies of fast and secure movement of funds.” (Investopedia). Since money is not actually moved, retail wire transfers involve just a virtual movement of funds between accounts; they differ from wholesale funds transfers because they usually have to do with low value payments originated by retail clients, including debit and credit card transactions at the Point Of Sale (POS), Automated Clearing Houses (ACH), Automated Teller Machines (ATM) and home banking systems (Federal Financial Institutions Examination Council, b).

Money transfer services provided by banks can generally be classified into three types: wire transfer via SWIFT; receivers’ accounts credit (even if held in a different bank); accounts credit followed by cash withdrawal. The typical wire transfer made through banks starts with a payment instruction by a bank, which provides the identification code of the receiving bank; messaging systems transmit both payment and settlement instructions and, after some time (might be some hours or some days), the recipient’s account is credited (Orozco, 2010). International money transfer companies (or nonbank money transmitters) provide comparable services but allow transferring money without passing it through bank accounts; they may be both large international companies and small local businesses. As most migrants are “unbanked”, these entities are commonly chosen by workers expatriates wanting to send home part of the money earned abroad: estimations say that about 2 billion of people are

unbanked and most of them live in Sub-Saharan countries, Latin America, South Asia and US (The Money Cloud Blog, 2015). ACE Money Transfer, RIA Financial Services, MoneyGram, Azimo, Dwolla, TransferGo, and TransferWise are the most common organizations providing wire transfers services to migrants, but Western Union remains the leading company in the field: it enjoys a 15% market share (30 transactions per second on average) and it operates in 200 countries (The Money Cloud Blog, 2015; DeParle (2007) stated that “migration is so central to Western Union that forecasts of border movements drive the company’s stock”.

## II. FINANCIAL CHANNELS FOR MONEY TRANSFERS

As I have just reported, effective and efficient payment systems are essential for the correct functioning of the economy. These systems have been traditionally associated to the formal banking system but, lately, several non-bank entities have emerged and have started providing payment services competing with traditional banks’ ones. The phenomenon has been particularly evident in developing countries whose majority of residents are unbanked (Awrey and van Zwieten, n.a.). I am therefore going to compare the features of the payment services provided by the two kinds of “banking” channels and to assess the potential risks associated to non-bank activities.

“A financial channel is any means by which money is transferred” (Isern, Donges and Smith, 2006). The global financial system has been evolving for many decades; during the last ones, the huge increase in competition in the banking sector deriving from the so-called *deregulation* made banks’ profits decrease and they have thus been trying to avoid taxes for long time. These factors gave rise to a process known as *financial innovation*, i.e. the creation and the marketing of new kinds of financial products and services in order to reduce the cost of credit and to widen the range of financial products and services available (Prates and Farhi, 2015). The process started in the US in 1930s with the born of investment banks, it went on with the introduction of Automated Teller Machine (ATM) in the 1960s, and progressed in the last few years with securitization practices, over-the-counter derivatives trade, collateral rehypothecation, repo market operations and the coinciding development of the *shadow banking system* (Palan and Nesvetailova, 2014). By renovating the way of conducting credit intermediation, financial innovation gave rise to new banking models and practices. Shadow

banks do engage in credit intermediation but do not have access to Central Bank liquidity or public sector credit guarantees; this means that they do not fall within regulation for usual banks (Pozsar, 2008). The shadow banking system has existed for a long time, but starting from the 2000s, it has been expanding so much that it overpassed the size of the regular banking system (Lysandrou and Nesvetailova, 2015): according to Federal Reserve data, in 2007 the US shadow banking system accounted for \$18 trillion, while traditional banks represented just \$12 trillion (Pozsar et al., 2010). Non-bank entities has developed all over the world but the level of their diffusion varies state by state. They widely spread in emerging countries, especially in China, probably because of a lower degree of ruling (Adrian, Ashcraft and Cetorelli, 2013). Some nonbank entities succeeded with respect to banks thanks to economies of scale and the provision of products and services that usual banks do not offer (Pozsar et al., 2010).

When selecting the Money Transfer Mechanism to use, people take into account such factors as the cost, the frequency and the amount of transfers, the level of urgency and the destination of those funds (short or long distance; domestic or international; the financial channels available at the end point).The three categories of financial intermediaries whom customers may address their money transfer needs are formal, semiformal and informal:

- Formal channels include entities such as commercial, agricultural, developmental and saving banks but also credit unions. The key difference with the other two categories is that they are subject to strict regulations and supervision of competent authorities and that they provide backstop against credit risk. Banks are able to provide remittance services through the SWIFT system or may act as agent for Money Transfer Operators; however, they do not operate in rural and remote areas, so either the sender or the receiver of the money transferred may not have access to them (Isern, Donges and Smith, 2006).
- Semiformal channels are authorized, non-deposit-taking institutions, also known as *shadow banks*. With the term shadow banks we include hedge funds (e.g. Black Rock), money market funds, mutual funds (e.g. Fidelity Investments), Structured Investment Vehicles (SIV), credit investment funds, exchange traded funds, credit hedge funds, private equity funds, securities broker dealers, credit insurance providers, securitization and finance companies (e.g. Household Finance Corporation), but also intermediaries such as Money Transfer Operators, mobile payment systems,

pawnshops, peer-to-peer lending websites and bond-trading platforms set up by technology firms (Labes, 2013; A.A.K., 2016).

Since non-bank entities are not allowed to take deposits from the public, a few years ago they started using deposits surrogates as a form of funding, including commercial papers, repo, brokerage accounts and MMMF shares. It is important to note that these substitutes offer higher return rates with respect to common deposits, but they are not protected by any insurance (Jackson, 2013).

The Financial Stability Board defined the phenomenon as “the system of credit intermediation that involves entities and activities outside the regular banking system”; “this implies focusing on credit intermediation that takes place in an environment where prudential regulatory standards and supervisory oversight are either not applied or are applied to a materially lesser or different degree than is the case for regular banks engaged in similar activities.” (FSB, 2011). Hence, their services are similar to those of traditional banks (*bank-like activities*), but they are not subject to financial regulations. As a consequence, they do not need any banking license to operate and can touch higher leverage ratios than traditional banks, thus exposing themselves to higher risk; indeed, they had a great role in causing the financial crisis since they engaged in risky activities like securitized lending and derivative operations (Plantin, 2014).

Shadow banks are not totally disconnected from traditional ones: the former may be backed by bank holding companies or by major nonbank financial institutions (nonbank-affiliated broker-dealers or insurance companies); some other are independent of any institution or they are sponsored by government (Adrian and Ashcraft, 2012). Consequently, various shadow banking activities (e.g. repos) were carried out within banks; securitization practices were carried out either by investment banks (Bear Stearns, Lehman Brothers, Morgan Stanley, Merrill Lynch) or commercial ones (Citigroup, J.P. Morgan, Bank of America) because both categories were looking for new sources of revenue (Gorton and Metrick, 2009). Similarly, Structured Investment Vehicles were sponsored by commercial or investment banks or even a combination of them; the latter case makes clear the reason why insolvency spread to different financial institutions (Lysandrou and Nesvetailova, 2015). The existence of shadow banks has been caused by such events as regulatory arbitrage and financial innovation. The last factor primarily derives from the very low interest rates paid on accounts held at banks and from the absence of a deposit insurance for

depositors (Adrian and Ashcraft, 2012); regulatory arbitrage instead refers to activity changes permitting to increase net cash flows by decreasing the costs of regulation (Adrian, Ashcraft and Cetorelli, 2013). The Financial Crisis Inquiry Commission stated that, in the years preceding the global financial crisis, “regulation and supervision of traditional banking had been weakened significantly, allowing commercial banks and thrifts to operate with fewer constraints and to engage in a wider range of financial activities, including activities in the shadow banking system.” The Commission also concluded that “[t]his deregulation made the financial system especially vulnerable to the financial crisis and exacerbated its effects” (Angelides, 2011).

- Informal channels: these intermediaries have widely expanded in places where traditional banks do not operate and offer cheap and fast services. Since they do not provide any guarantee against the risk of theft or loss, these networks are based on trust.

## A. FORMAL AND SEMIFORMAL CHANNELS

**Credit unions.** Credit unions are regulated financial institutions offering traditional banking services such as deposit accounts, loans and savings, which were born to provide access to financial services to unbanked individuals. Most migrants however still lack access to banks, so, since 2000, credit unions have offered remittance services through the *International Remittances Network (IRnet)*, i.e. an electronic platform launched by the World Council of Credit Unions (WOCCU), covering both developed countries (United States, Europe, Australia) and emerging ones (Latin America, Asia, Africa). In order to provide financial access to as many people as possible, the network allows transferring money also from/to non-credit unions and charge very low commission rates. Transfers are accomplished by three international Money Transfer Companies: MoneyGram, Travelex and Vigo Remittance Corporation (World Council of Credit Unions). Other categories of banks (e.g. commercial ones) provide remittance services as well but they require the receiver to hold a bank account and charge higher fees.

**Money Transfer Companies.** Money transfers represent a global growing business since it serves governments, firms and private individuals; besides credit unions, many pure Money

Transfer Operators have therefore tried to enter this potentially profitable market. Money Transfer Operators provide remittance services as primary business and may offer foreign currency exchange services in addition; the category hence includes exchange houses, money service businesses, payment institutions and mobile network operators (Todoriki et al., 2014). The biggest players are: AIB, Azimo, Bank of Ireland, Barclays, Halifax, HiFX, HSBC, Lloyds Bank, MoneyCorp, Nationwide, Natwest, PayPal, Permanent TSB, RBS (Royal Bank of Scotland), Skrill, The Co-operative Bank, Transferwise, Travelex, Western Union, UK Forex (part of the Oz Forex group), Ulster Bank, XE.com, Neteller, WorldFirst, WorldRemit, TransferGo (CurrencyFair, 2016); there exists also operators serving specific region or countries, e.g. RiaEnvia, Dolex, Siguue, Vigo, Delgado, Intermex, Nexar, GroupEx, Money Express, Telepay. They usually do not require opening accounts but they do ask for customers' identification; as for costs, fees have been shrinking as a result of the increasing competition, but MTCs are still more expensive than informal operators (Isern, Donges and Smith, 2006).

**Postal systems.** Post offices have traditionally offered money transfer services since they operate also in the countryside but, although they signed agreements with some of the above-listed MTCs, postal networks are generally used for domestic transfers rather than international ones. These entities thus entered in *Eurogiro*, which “is a unique payments network that connects different payments "ecosystems", e.g. postal organizations, post banks, commercial banks and other payment service providers, focusing on cross border high volume - low value payments” (Eurogiro). Eurogiro Network and the Universal Postal Union (UPU) have signed an agreement to connect their electronic networks and have created a new product called Tele Money Order (Isern, Donges and Smith, 2006).

**Digital Banks.** Some institutions have launched mobile financial services in order to provide access to banking services to unbanked individuals at lower cost; however, although a large share of its population uses mobile phones, interviews in sub-Saharan Africa highlighted that less than 20% of people did actually converted to mobile payments (Kendall, Schiff and Smadja, 2014). In India, the DBS have just launched a digital bank allowing holding deposits, withdrawing and transferring money very easily through an e-wallet, without signing any document. *Monese* is another operator offering similar digital banking services, targeted to worker expatriates living in the UK and not having the citizenship there (Smart Money, 2016).

## B. INFORMAL CHANNELS: UNDERGROUND BANKING

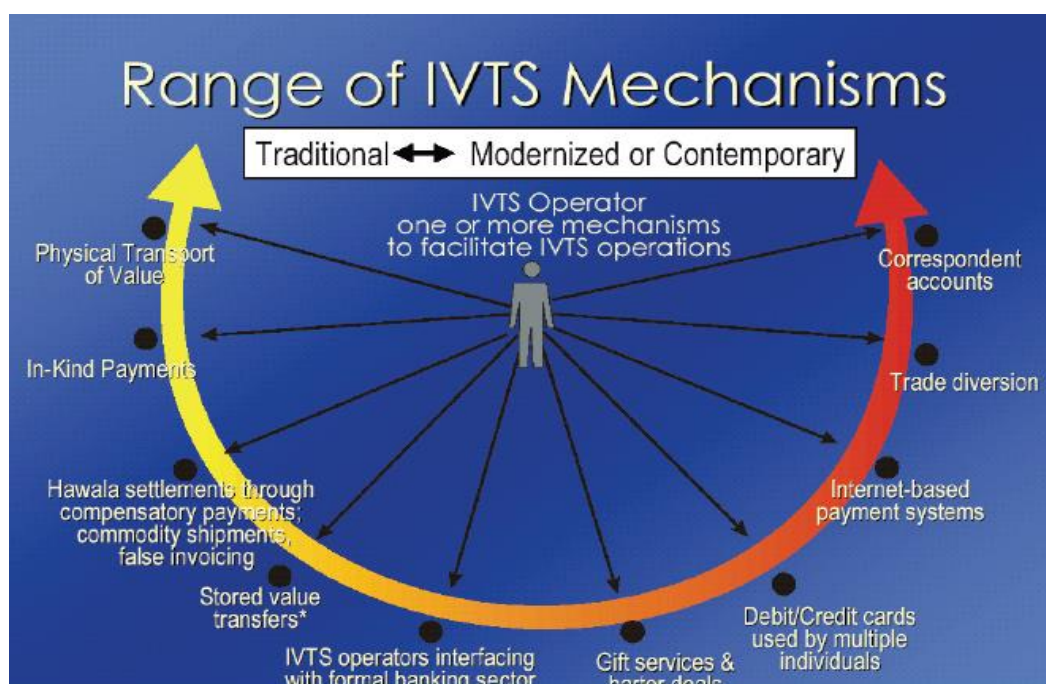
Informal Funds Transfer (IFTs) refers to “a currency or value transfer system that operates informally to transfer money as a business” (Federal Financial Institutions Examination Council, a), or more specifically “financial service that accepts cash, cheques, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the money/value transfer system belongs”; it hence covers “the full range of financial services involved in transferring money, including everything from banks to systems operating in full or in part outside conventional banking channels” (FATF, 2005). As they are mainly used by migrants who send part of their income earned abroad to their families, the Financial Action Task Force refers to these informal banks as *Alternative Remittance Systems*. They are cheap, fast and do not depend from the traditional banking system; they are not subject to specific rules but some countries require them to get the operating license and to register (Chene, 2008). They therefore provide financial services “outside the conventional, regulated financial institutional systems” (Passas, 1999). Where financial sector is not well developed and formal financial intermediaries do not operate in some areas, IFTS may represent the unique way for conducting financial transactions (Federal Financial Institutions Examination Council, a.). In the previous chapter, I have highlighted the great role that remittances have in sustaining the economic growth of recipient countries but I have also emphasized that Informal Transfer Systems have been blamed of contributing to money laundering because they allow people to transfer money anonymously.

Informal Funds Transfer Systems derives their name from the fact that they were born just as an informal and cheap method for transferring money and values targeted to people belonging to the same ethnic group and lacking access or confidence in the traditional banking system (Blum et al., 1999). They are also called *underground banks*, but, even if they operate in parallel to the traditional banking system, this appellative is not very appropriate: first, these offices do not operate secretly (not underground), rather they liberally work close to other stores and they are often advertised on newspapers; second, they do not carry out typical banking activities related to credit intermediation (Buencamino and Gorbunov, 2002). Their services do resemble some of those offered by traditional banks and by non-bank institutions



such as Western Union and MoneyGram, but underground bankers do not record transactions and remitters' identities (van de Bunt, H. 2008)

Informal banks may be divided into two main categories: Informal Funds Transfer Systems (IFTS) and Informal Value Transfer Methods (IVTM). IFTSs are much older because they include fund and value transfers activities first born in China and in the Indian region to satisfy immigrants' needs; they were hence originally used only for legitimate purposes and then evolved into forms of unofficial banking. Some key examples are *Hawala*, *Fei ch'ien*, *padala*, *black market for peso*. IVTMs instead refer to systems born with Internet and technological changes, which engage in informal high-value money transfers usually hiding illegal operations; they make use of the traditional banking system but do not record any transaction. Among IVTMs, there are: in-kind payments/transfers, invoice manipulation, trade diversion, e-payments, credit/debit cards used by multiple individuals, use of correspondent accounts and so on (Passas, 2003). The separation of the two groups is primarily used to make a distinction between licit and illicit transactions; I will anyway generally refer to them as a unique category.



Source: Shah, 2007.

## 1. MAIN IFVS AROUND THE WORLD

Informal Funds Transfers predate Western banks and operate in several countries; the biggest systems are Hawala and Fei ch'ien. Hawala is the most famous network, born in the Indian subcontinent, where it takes the name of Hundi. The name Hawala was given by the Arabics and derives from *hawalah*, i.e. a “transfer of money or information between two people using a third person” (Shehu, 2004); Hundi adds the connotations of 'trust' and 'reference' (Jost and Sandhu, 2003). The system was initially created to settle accounts within Indian rural communities; it recently extended to other areas because workers expatriate from India moving to Africa and South-East Asia needed to have a safe and efficient mean for settling accounts (Buencamino and Gorbunov, 2002). It operates autonomously, meaning that it does not depend on the formal financial system and makes use of codes and messages transferred by mail, telephone or fax (Shehu, 2004). Even if it has developed in Europe and America as well, Middle East, Africa and Asia are still the areas where Hawala is most used; nonetheless, statistics say that most Hawala transactions are carried out in the United Arab Emirates, where there are more than a hundred exchange houses (Wilson, 2002); Dubai is in fact considered as the central clearing house for Hawala transactions (Thompson, 2006).

The Chinese *Fei ch'ien* (that means “flying money or coin”, also known as *Chiao Hui* and *Nging Sing Kek*) is much older than Hawala since it dates back to the 6<sup>th</sup> century After Christ. Although it works similarly to Hawala, the fact that the latter is founded on trust and connections allows its broker to use less negotiable tools and is often used for money laundering objectives; on the contrary, Chinese systems often require to remit the money before the conclusion of transactions but they are less subject to abuse (Buencamino and Gorbunov, 2002). Depending on their security assessment, the two systems just described operate in different places, which may be both in private buildings and in grocery, jewels or textile shops (Shehu, 2004).

There exists many other Alternative Remittance Systems whose activities are similar to Hawala and Chop ones: among them, the *Phoe Kuan* in Thailandia, *Padala* in the Philippines, *Hui Kuan* in Hong Kong. Whatever their name, all these networks present some common features: they are normally located in countries having high shares of expatriate workers in order to provide them with remittance services and enjoy vast networks covering many countries; their core business is money transfer but they also engage in currency exchange and other activities.

The *Black Market Peso Exchange System* is instead a bit different. It was set up in the 70s by Colombian traders in order to get hard currencies without restrictions. At that time, the government used to do severe exchange controls by setting limits on the amount of foreign currency that could be purchased and importers did not often have enough money to settle their accounts (Buencamino and Gorbunov, 2002). Its objective is hence to simplify the exchange of currencies by selling dollars to Colombian entrepreneurs wanting to buy American goods for export. Later, the system however started being used to launder money coming from drug traffic: the peso brokers deposit dollars deriving from narcotics trafficking in the US accounts and then sell them to Colombian businessmen needing that currency to buy goods for export (Sloan, 1999). Similar black markets operate also in other countries; the one in Hong Kong is the most famous and it is mostly used to transfer money from Hong Kong to China, which exercises currency controls (Buencamino and Gorbunov, 2002).

Unofficial systems like Hawala operate similarly to other remittance providers but most of times they are not licensed and registered (Wilson, 2002). Since they are part of the informal channel, Alternative Remittance Systems are subject to specific regulations varying state by state. Hawala systems are even illegal in such countries as Pakistan and India where speculation practice in foreign exchange transactions (i.e. using rates other than the official ones when converting local to foreign currency and vice versa) are forbidden, and this is one of the reason why Hawala is banned (Chene, 2008). Since many workers coming from India and Pakistan migrate in the United Arab Emirates, and most of gold sent to these two countries comes from Dubai, a direct consequence of India and Pakistan strict regulations is the use of the UAE to make transactions through Hawala systems. To evade these two countries' rules it is hence sufficient to make money pass through brokers set up in Dubai, which enjoys a strategic position among the Gulf, South Asia and Africa (Jost and Sandhu, 2003). Jamwal (2002) reports the result of a U.S. Treasury Department study that denoted Pakistan, India, and Dubai as the *Hawala Triangle* to move money clandestinely. Pakistani financial authorities stated that almost \$3 million are carried every day from Karachi to Dubai, mainly to buy gold (Farah, 2002).

The growth of *ethnic banks* have shown to be negatively correlated to the expansion of formal financial sector, which means that countries having inefficient banking systems are exactly those where Informal Funds Transfers have most developed. Policymakers should carefully monitor the spreading out of these intermediaries because they may have striking monetary and fiscal effects: transferring money through underground banks definitely influence the composition of broad money (informal transactions increase cash circulation),but also money

demand for both domestic and foreign currency because they take foreign currency away from the formal sector and makes the spread wider. The usage of unofficial systems may also implicate a loss of revenue for governments (informal entities are not taxed on profits because money does not flow into the official system) and for traditional banks which may lose part of their business. Moreover, even if Hawala transactions involve changes in foreign asset and external debt positions, and should be hence included in the Balance of Payments, they are not recorded in official accounts since they flow through unofficial payment systems (El-Qorchi, Maimbo and Wilson, 2003).

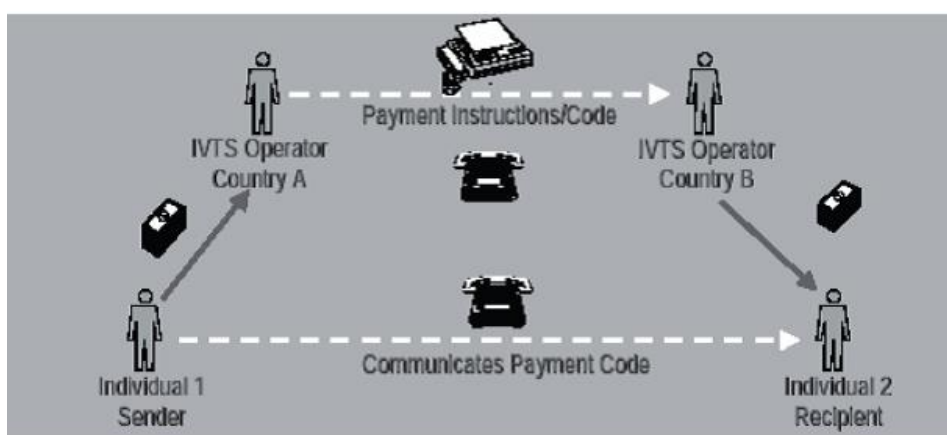
As parallel banking face new demand patterns and progressing Anti-Money Laundering regulations, operators are constantly evolving their services. Some credit card companies sell debit cards in exchange for cash, which can be withdrawn through any ATM by third people knowing the PIN; in this case, the card buyer is the only person subject to AML checks. Likewise, mobile phone companies allow remitting money by storing value in SIM cards and using it in countries with emerging mobile arrangements. Some African bus companies offer remittance services even by using cash from tickets. Internet-based remittance agencies are developing as well; the major one is set up in the US but works in Hong Kong. It makes use of the Global Integrated Funds Transfer System (GIFTS) to provide transfer of funds through ATM cards backed by accounts (FATF, 2005).

## 2. TRANSACTIONS FUNCTIONING

Alternative Remittance Systems are alleged to handle between 100 and 300 billion dollars per year (Chene, 2008) through virtual transfers of money, i.e. “money transfer without money movement” (Jost and Sandhu, 2003); most of times, transactions involve only an exchange of debt, so money does not pass through any Central Bank nor SWIFT (Fisher and Hills, 2002).

Underground bankers usually operate through legitimate businesses, gold or silver shops, remittance houses, moneychangers or unregulated financial houses (Trehan, 2003). Typical transactions in Hawala-like systems involve four agents (the sender, the receiver and two brokers) and they are carried out according to the following steps: the client first asks the broker to send money to a specific person (i.e. the beneficiary) living in another town or abroad; the broker sends the request to his partner (by mail or telephone) in that town/country, giving details allowing to identify the beneficiary, and he gives an identification code to the

sender, which must be exhibited by the receiver in order to get the money. The *Hawaladar* profits by charging an exchange rate spread or a fee: the former is usually computed on the basis of unofficial exchange rate because no foreign exchange transactions take actually place; the latter instead depends on such factors as the location of receiver's town (if he/she lives in remote areas and/or in countries lacking infrastructures, the commission is higher), the amount of money to remit (higher amounts may enjoy some discount), the frequency of transfers made by the same client, the ties between the Hawala dealer and the customer, the timing of transfer (if the transaction is urgent, Hawaladars charge higher fees) and the payment currency (local or foreign) (Passas, 2003).



Source: Shah, 2007.

The two partner brokers do not record the transaction by contracts or paper trails since the system is based on trust between parties. As stated by Chene (2008), “the system is culture friendly”, so migrants having strong ties with Hawala brokers can make transactions very easily. This practice makes it very difficult for authorities to recover the details of the transactions, including the identification of both senders and receivers. Connections are hence the basis on which Hawala networks are built up: the fact that in India the system is called *Hundi*, i.e. trust, confirms the importance of personal connection between users and brokers (Jost and Sandhu, 2003).

Gold is frequently used to balance the books of Hawaladars operating in different places, but settlement may even involve formal banking channels. As settlement operations are carried out periodically, Hawaladars must take into account foreign exchange rate fluctuations before settling. Depending on whether the provider carries out other businesses or not, settlement may be accomplished in several ways (FATF, 2005); some procedures examples are:

- Import transactions: HA (i.e. Hawaladar in country A, who is the debtor) may finance exports to HB (creditor) which acts as importer and accepts goods rather than cash;
- Simple *reverse Hawala* transaction: a payment in the opposite direction, i.e. if someone remitted from country A to B, HB gives local currency to the beneficiary but do not receive money from HA; later, when someone in country B asks to transfer money to country A, HA pays without getting the sum from HB. Net settlement through banking wire transfers occurs only if flows between A and B are very disproportionate.
- Complex *reverse Hawala* transaction: broker in country B (HB) gets money from a person wanting to have funds abroad but living in country C, which is subject to capital controls (e.g. countries in the Indian region and Africa). Settlement may be carried out in different ways: HB asks help to HA, which may suggest recurring to HC either because they are correspondent or because they still have to settle their accounts; alternatively, HA may order HC to make funds available for any receiver in country C; finally HB and HC may involve in a direct transaction and ask HA to settle their positions;
- Bilateral settlement: HA simply makes a payment into HB's accounts;
- Multilateral settlement: same as bilateral settlement, but HA deposit money in HB's foreign account, i.e. accounts held in countries with convertible currencies;
- International services: HA settle his debt by providing services like education, medical assistance or travel to HB or residents of country B;
- International investment transaction: HA buys financial products or services for HB (bonds, stocks but even real estate), whose country restrict foreign investments.
- Transfers through Conventional Banking Systems.
- Physical Cash Movement.

Except for the last two cases, cash does not materially move cross-borders; settlement simply consists in adjusting credit and debt positions among Hawala dealers (El-Qorchi, Maimbo and Wilson, 2003; FATF, 2005 and 2013).

**Balance Sheet Effects of Prototype Hawala Transaction(Dollar (\$) and local currency (LC) components, as indicated)**

**1. Hawala Customers: remittances sent home (\$ assumed)**

Remitter, Country A		Recipient, Country B	
Assets	Liabilities and NW	Assets	Liabilities and NW
- \$ (cash)		+ LC (cash)	
	- \$ (net worth)		+ LC (net worth)

Notes: Net worth of remitter declines. Net worth of recipient increases.  
Such transactions usually across international borders.

**2. Hawaladar intermediaries**

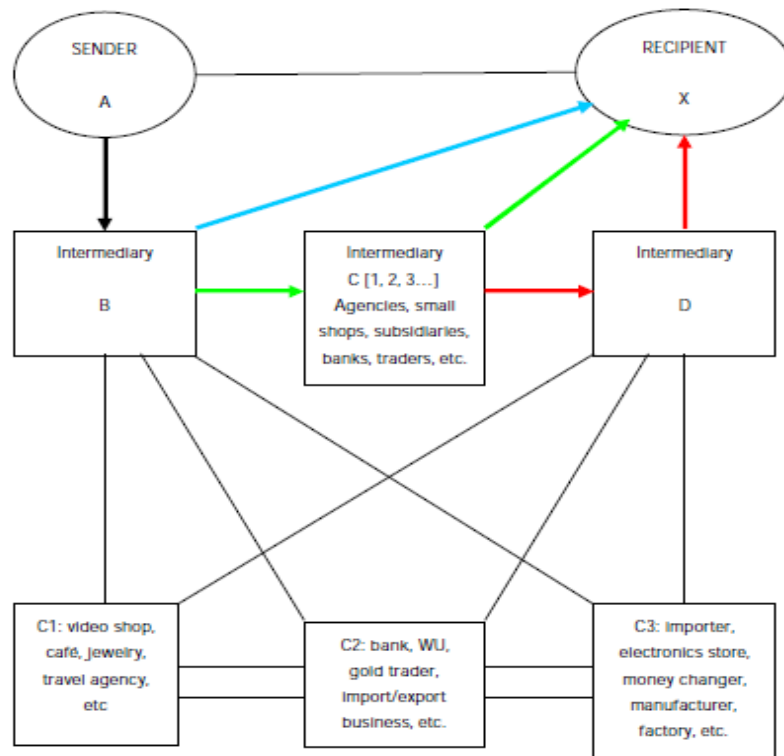
Hawaladar A (HA)		Hawaladar B (HB)	
Assets	Liabilities and NW	Assets	Liabilities and NW
+ \$ (cash)	+ \$ (HB)	- LC (cash)	
		+ \$ (HA)	

Notes: HB Pays out cash and acquires claim on HA.  
Both HA and HB: Change in balance sheet composition. Net worth unchanged;  
Settlement necessary to restore status quo ante.  
No actual foreign exchange transaction by any participant.

*Source: Wilson, 2002.*

Hawala dealers often have accounts in different places to make settlement process easier and to reduce their exposure to currency rate fluctuations. Anyway, if they do not have foreign accounts, a common practice is to settle positions by recurring to third-party intermediaries, usually located in other countries; by doing so, they can enjoy quicker settlement and lower costs in terms of fees and exchange rates. Most of these intermediaries are established in places offering economies of scale and more convenient foreign exchange rates, for example Dubai, New York, London, Hong Kong, Singapore and Switzerland (Passas, 2003).

## Mechanics of IVTS and Settlement Process in IVTS in view of Possibly Multiple Intermediaries C



- 1 A-X [physical transport; in-kind payment; pre-paid tel. cards and stored value]
- 2 A-B-X [courier, epayment, credit and debit card use]
- 3 A-B-C-X [hawala and other traditional IVTS; wire remitters, in-kind payment; gifts and vouchers]
- 4 A-B-C-D-X [trade diversion; correspondent banking; mixed IVTS, including sophisticated hawala]

*Source: Passas, 2003.*

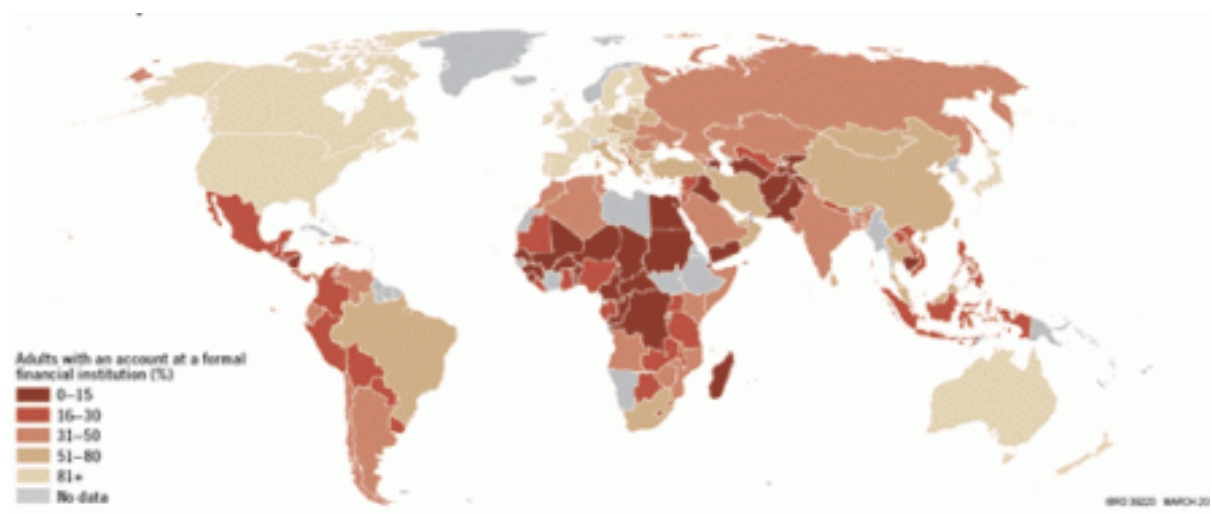
**Users' Profile.** Alternative Remittance Systems are generally used by migrants leaving poor families and moving abroad in order to get a job. Most of times both senders and receivers lack financial access because credit institutions do not operate in their areas or just because they are poor and they cannot afford those service; this is why underground banks are also called “the poor man’s banking system” (Buencamino and Gorbunov, 2002). Additionally, in case of wars and conflicts, IFTS are considered a safer means of transferring money; Afghanistan is an emblematic case because during the conflict and the Taliban regime, Hawala has completely substituted the formal sector. The most common origin countries of Hawala’s users are those having many worker expatriates, such as the Indian region, Middle East and East Asia. Some Non-Governmental Organizations have also started using underground banks in order to supply monetary aids to some populations (Chene, 2008).



### 3. WHY IVTS HAVE NOT BEEN SUBSTITUTED BY BANKS

Informal systems have developed because of the increasing migration flows to developed countries recorded in the 70s and the resulting increasing need of sending money home. Even though traditional banks have been intercontinentally expanding, these financial intermediaries did not arrange for efficient targeted services so most workers expatriates and families remained unbanked, meaning that they could not use the formal sector for their transactions (Buencamino and Gorbunov, 2002). Moreover, banking channels between some countries have not existed for long time; for example, between Kuwait and Pakistan or among Australia and some African states (Passas, 1999). Shortages in economic growth and institution development hence force people to use informal channels. Finally, underground banks may be the only available means of transferring funds in countries going through wars and conflicts such as Somalia and Afghanistan (FATF, 2013).

#### Account penetration around the world



Source: Demirgüç-Kunt and Klapper 2012.

The political and economic instability characterizing developing countries implies strict currency controls, inadequate payment systems, high levels of bureaucratic compliance and overvalued currencies, which act as taxes on remittances. High instability therefore translates into stricter regulations on trade, currency exchange and movement of money; all these facts in turn imply a growing need of circumventing rules by using alternative, less regulated

channels. Empirical studies found out that an increase by 10% in the black market premium causes a reduction of 3% in remittances made by recurring to official channels; hence, countries protecting their currencies may force residents to use informal ways to match supply and demand for foreign currency. Other facts causing the persistence of the informal banking system are the lack of financial access of poorer segments of population, the absence of bank branches in some remote rural areas, the lack of confidence in regular banks, and the high costs charged by traditional banks and major formal Money Transfer Operators (e.g. Western Union). Last but not least, the confidentiality ensured by underground banks have attracted people wanting to evade regulations and/or involving in criminal activities (Buencamino and Gorbunov, 2002).

### C. DIFFERENCES WITH TRADITIONAL BANKS/BENEFITS FOR USERS

Likewise traditional banks, Informal Funds Transfer Systems offer payment systems as well, but they make use of informal channels rather than formal ones. Some main features of underground banks differentiate them by traditional ones:

- Trust-based: ties and kinships are at the base of these systems; parties believe in each other. Hawaladars have rarely cheated their clients and this has implied fewer litigation cases. When defraud events take place, hawaldars are severely punished;
- No use of negotiable instruments: senders are not asked to use cheques or other kinds of instruments; they can simply transfer money by asking brokers to communicate the amount to his partner operating abroad or in another city. Moreover they require a very low level of technology;
- Cheaper services: fees are lower (usually ranging between 25 and 50% of those charged by banks) and offer more favorable currency exchange rates;
- Efficiency: transactions are concluded within a few hours or a couple of day at maximum thanks to the extension of their networks; wire transfers at banks take instead about a week because they work only on business days and do not operate in remote areas;

- Reliability: while transactions carried out by regular banks involve many agents (different branches of different banks), IVTS only involve two partner brokers and transactions are direct;
- No bureaucratic requirements: Alternative Remittance Systems do not ask for Identification Documents. This fact makes these operators attractive both for criminals and for illegal immigrants who cannot access traditional banking services;
- Anonymity: after the transactions take place, agents do not issue any paper trail so transactions are not recorded. Trust between participants hence guarantees secrecy and allows circumventing currency controls and tax payments;
- No language obstacle: Hawaladars usually speak immigrants' native language, while bankers do not.

(Jost and Sandhu, 2003).

All these aspects make Informal Funds Transfer Systems much more advantageous than banks, Money Transfer Operators and other kinds of agents offering remittance services. In addition, Hawala transactions may be valuable if remittances are sent from countries with convertible currencies to countries with inconvertible ones (Wilson, 2002). Buencamino and Gorbunov (2002) reported the point of view of some researchers who argued that “a business culture based on trust may prevent widespread use of formal financial systems. In the “modern” financial world, there is so much distrust that every letter has to be documented.”

# CHAPTER 3: MONEY LAUNDERING

## ACTIVITIES AND THEIR INFLUENCE ON THE REAL ECONOMY

### I. MONEY LAUNDERING CONCERNS

Financial and technological integration have made trading transactions cheaper and faster, leading to a surge in cross border transactions, which have become easier and easier; in addition, the globalization process and the introduction of a single currency in the EU have facilitated the integration of various financial markets. Money launderers have obviously benefitted from these improvements since dirty money can be easily diverted among different jurisdictions and illicit transactions are much less detectable (Buchanan, 2004). Both formal and informal financial institutions may well be involved in different kinds of crimes, such as credit card frauds or selling of fraudulent financial products. Money laundering is another very common form of crime (Ardizzi et al., 2014).

Even though in many states underground banks are considered as a legitimate substitute of traditional banks, criminals may use them for money laundering or terrorism financing purposes because these intermediaries are subject to a lower degree of regulation and do not record transactions (Rees, 2010). For this reason, Hawala transactions are denoted by two different terms depending on whether they are legal or not: in the former case we speak about *white Hawala*, while in the second case it is *black Hawala*. White Hawala transactions are standard remittances sent by migrants in order to help their families; black Hawala instead refers to such illicit operations as narcotics traffic, tax evasion, terrorism financing and so on (Jost and Sandhu, 2003). The UAE is one of the three countries that maintained relationships with the Talibans and authorities said that the majority of money used for the terrorist attack on 11<sup>th</sup> September 2001 did flow through Hawaladars operating in Dubai, which enjoys an almost unregulated gold market and open banking centers (Shehu, 2004).

The formal channels of the financial industry have been increasingly regulated and supervised by authorities, especially after the beginning of the financial crisis. Lawbreakers are therefore

forced to make use of networks where regulation is less strict, such as non-bank financial institutions (bureau de change, check cashing services, insurers, brokers and traders) (Buchanan, 2004). Many researchers agree that political instability may also act as an obstacle for people trying to escape controls (Buencamino and Gorbunov, 2002).

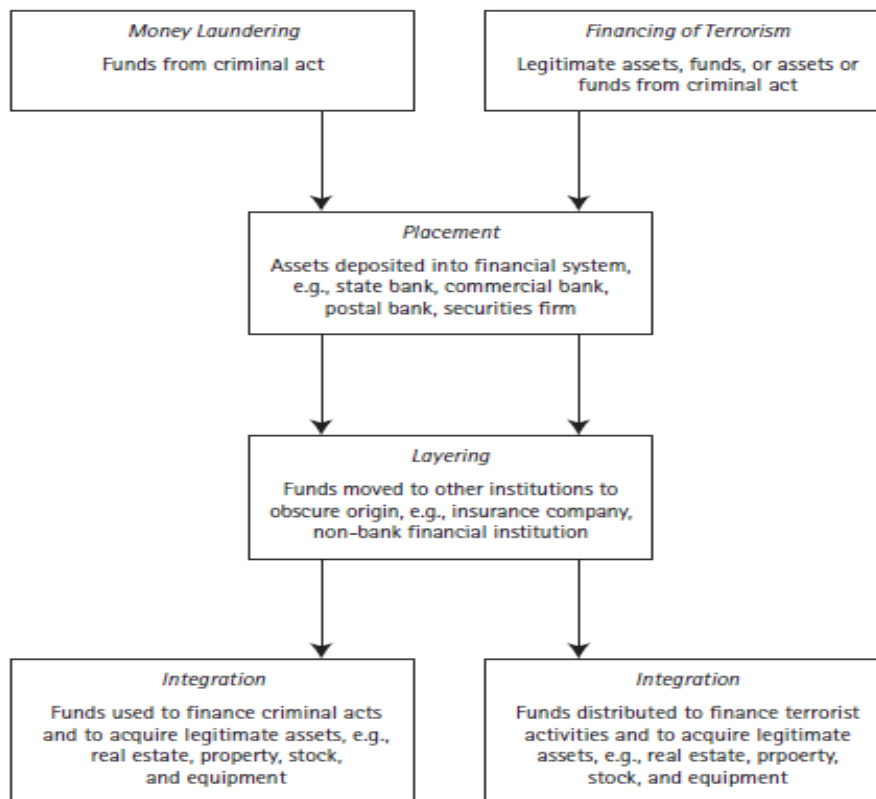
## A. MONEY LAUNDERING DEFINITION

The U.S. Department of Justice has defined money laundering as “the process by which criminals conceal or disguise the proceeds of their crimes or convert those proceeds into goods and services. It allows criminals to infuse their illegal money into the stream of commerce, thus corrupting financial institutions and the money supply, thereby giving criminals unwarranted economic power” (FBI, 2011).

Earnings from criminal businesses are usually in cash because this payment instrument ensures anonymity. Operations meant to launder money involve three different stages:

- Placement: launderers try to find a legitimate source for money having illicit origin; most of times money is passed through traditional banking accounts; if the amount to deposit is very large, they may opt for using different accounts held in different banks.
- Layering: black money is hidden through multiple transfers so it is hard to detect all the transactions; cash may be converted into monetary instruments or real assets, which are later sold. Since most of times dirty money is transferred to companies established in tax haven countries or to offshore accounts, this phase usually encompasses at least two jurisdictions.
- Integration: money is reintroduced in the formal economy through financial or real estate investments and goes back to launderers as legitimate (clean) money.

## Money Laundering and the Financing of Terrorism



Source: The World Bank, 2004.

Alternative Remittance Systems are suitable to launder money as they can make illicit money appear as licit and permit depositing it without having to comply with any legal requirement; money laundering practices made through these channels are hence very easy. Placement of money is particularly easy to accomplish since brokers can vindicate the deposited money as profits coming from the carrying out of their business. Layering of criminal proceeds does not present any obstacle because, as we saw before, Informal Transfers Systems do not record transactions and it is therefore difficult to recover and detect them; moreover, IVTs have partners in many countries and money can be distributed among them (Chene, 2008).

## B. FORMS OF MONEY LAUNDERING

Many different procedures are used to clean dirty money; depending on the kind chosen, it gets easier to understand whether the operation is a sporadic event or a regular practice (Blum et al., 1999).

These practices may involve both the financial and the real sector. As for the former, launderers can invest money in low-risk shares and bonds to get rid of cash; in alternative, they may opt for derivatives that are definitely riskier but still liquid. If they do not invest in financial securities, they can divide cash into many banking accounts below the reporting threshold in order to circumvent disclosure requirements (i.e. *smurfing*). Most of times they choose *offshore shell banks*, i.e. companies “that do not conduct any commercial or manufacturing business or any other form of commercial operation in the country where their registered office is located” (FATF): they do not pay any tax on profits, they can act anonymously (they generally provide services only to non-residents) and are not obliged to be physically present in the jurisdiction where they operate. Just because they are established in the so-called Non-Cooperative Countries and Territories (NCCTs), they guarantee banking secrecy and conceals the identity of the funds’ beneficial owner. The greatest offshore financial centers are the Cayman Islands, the Bahamas, Panama and The Netherlands Antilles. Multiple indirect relationships among banks make money laundering even easier: as described in the previous chapter, wire transfers involving interbank transactions are arranged by Fedwire, CHIPS and SWIFT; when different banks are not connected, these transfers require passing through many intermediaries which may not even know each other and simply assume that previous intermediaries have accomplished with customers documentation and identification requirements. Launderers may also buy travelers’ cheques to easily transfer money abroad or even an insurance policy on one or more assets: to get cash back, they will make periodic claims on the asset(s) covered. Finally, if they instead want to avoid depositing or moving large amounts of cash, launderers can make use of black markets for foreign currency, e-Cash or online banking (Utrecht, 2006).

Dirty money can be laundered through the real sector as well. Casinos cheques are probably the easiest way to turn illegal money into legal; however, launderers may opt for investing in consumer or luxury goods and real estate assets, which they will resell to get cash back; investing in gold is also very attractive since it is easily convertible into cash, ensures anonymity and it is exempt from international reporting requirements (Utrecht, 2006). A

senior US law enforcement official said that “gold is a huge factor in the moving of terrorist money because you can melt it, smelt it or deposit it on account with no questions asked” (Farah, 2002). Moreover, gold and other precious stones may be illegally traded through *smuggling* activities, which involve also drugs, human trafficking, women for prostitution, arms, stolen vehicles, cigarettes, medicines; these practices are commonly used to bypass restrictions, sanctions, embargo, taxes and duties (Passas, 2003). Smuggling activities involving gold are very common in India and Pakistan because demand for this metal is very high in these two countries; money and gold pass through money laundering centers such as Dubai, Singapore and Hong Kong (Farah, 2002; Trehan, 2003). Similarly to the above-mentioned shell companies, launderers may make use of *front companies* to layer dirty money; import-export businesses are also widely used for hiding illegal money through double invoicing (moving funds into or out of a country), misinvoicing (i.e. over-reporting of income through fake purchases and sales) and under- or over-valuation of goods (e.g. reporting higher import prices) (Utrecht, 2006).

## 1. HAWALA CASES OF MONEY LAUNDERING

Generally, suspects of money laundering activities arise in the following cases: low-income people present accounts with high turnover; money is wired out bank accounts, sent to companies carrying out their business in different sectors or to agents involved in illicit activities; local market suffers from foreign exchange fluctuations whose cause is not evident; agencies filled in some Suspicious Activity Reports (SARs); high volume of money is daily moved and/or there are no records of large transactions; some customers’ transactions differ from usual ones (Passas, 2003).

Hawala systems have been often used for money laundering purposes. Most of times they helped people to traffic narcotics, but they have been also used for terrorism financing, tax and currency controls evasion, violation of intellectual properties, gambling and alien smuggling. As for narcotics trafficking, authorities detected some cases of laundering of money coming from the sale of heroin, opium and hashish: money was deposited either in formal institutions (banks, foreign exchange offices) or in the Hawala system. There was a case in which money deriving from narcotics, after having been deposited in Hawala accounts, was used to buy weapons for terrorists; again, Hawala has been used to transfer



money from North America to South Asia to pay alien smuggling commissions (Jost and Sandhu, 2003). In the 90s, Hawala was involved in a big political scandal known as “the Hawala scandal” or “*Jain diaries*”, where Indian politicians got money from four Hawala brokers (the Jain brothers) who kept records of transactions in their diaries. From February 1988 to April 1991, those officials received US \$ 18 million bribery flowing from London and Dubai dealers to Indian ones. The money was sometimes passed through foreign banks’ accounts (Indian Mirror, 1999).

### C. EFFECTS ON THE ECONOMY

Money laundering activities implicate negative effects on the economy. Besides allowing avoiding taxes, thereby contracting government revenues, they make financial markets unstable and therefore reduce growth. As I reported above, launderers often use *front companies* which they fund through illicit money rather than by bank loans; the former form of funding is obviously much cheaper and may make competition very hard for existing companies (Schott, 2006). Resources may be misallocated and investments distorted because launderers do not look for investments maximizing returns but for those allowing to easily evade detection (e.g. real estate properties and luxury goods); as a consequence, other more productive sectors may suffer, especially if goods are imported (Utrecht, 2006). Moreover, as they are concerned only about a few kinds of assets, their high willingness to pay may lead to higher prices, which turn out to be excessive for other buyers; Keh (1996) reports an example about a Colombian group who bought a very large area of land, pushing prices four times higher.

Countries guaranteeing banking secrecy or not engaging much in money laundering detection are obviously more appealing for criminals, especially if their GDP is high and they enjoy a wide range of trading partners. On the other hand, if residents feel threatened by corruption in the financial sector, they lose trust in the system and opt for other means for conducting transactions, which results in a loss of customers and profits for formal institutions (Schott, 2006). However, high levels of corruption translates into higher risk of losing money, which discourage launderers to act in some countries (Utrecht, 2006). It is also worth noticing that laundered funds deposited at banks are often unexpectedly withdrawn and transferred, thus

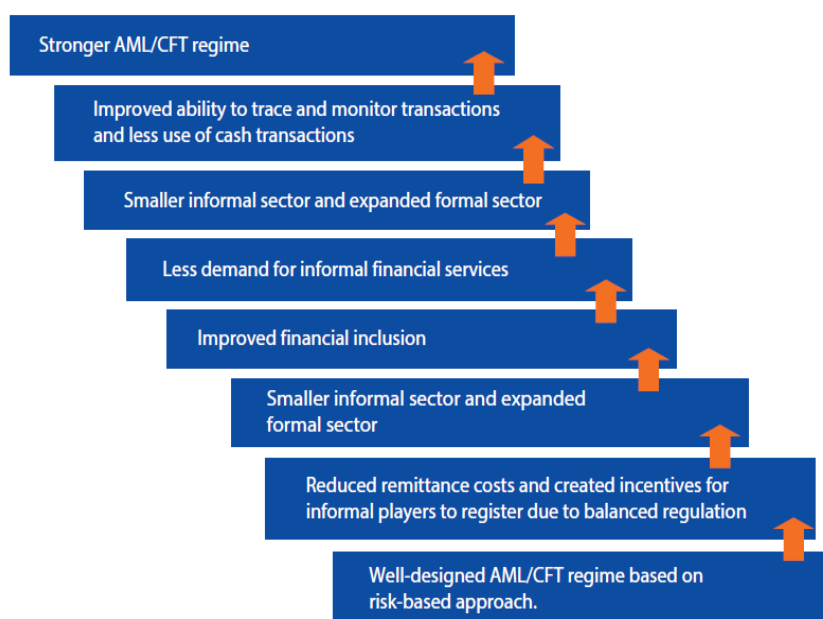
making banks vulnerable to liquidity issues; these problems may be exacerbated if investigations impose costs and penalties on the institution (Schott, 2006).

## II. MONEY LAUNDERING REGULATION

In the previous chapter I reported the most relevant factors driving people to use Informal Value Transfer Systems rather than formal banking channels when transferring money; however, we saw that, in countries with exchange currency controls, IFTS are illegal because they may allow circumventing those controls. Even though Alternative Remittance Systems have been historically used for legal practices (remittances from expatriate workers, humanitarian/emergency aids, personal expenses), they are often used also for illicit activities, such as circumvention of capital and currency controls, customs and tax evasion, corrupt payments, financing terrorism, money laundering. As remittance volumes increase, authorities get more and more concerned about those potential risks. Countries should thus guarantee accessible but safe remittance systems by deeply understanding the market risks and preventing them (Todoriki et al., 2014).

In 1996, the Financial Action Task Force recognized the potential misuse of the parallel banking system and included it in the list of ‘The money laundering techniques most frequently employed in the Asian region’ (FATF, 1996); these informal operators often carry out other business activities, which make it easier for them to engage in money laundering processes because it gets simpler to hide illegal money into lawful one. Moreover, increasing migration flows have contributed to the proliferation of underground bankers (both in terms of number and size) (Rees, 2010). Since terrorist attacks in 2001, regulatory authorities have started concerning about the use of Alternative Remittance Systems for financing terrorism as well.

## Complementary effects of strong AML/CFT Regime and improved financial inclusion



*Source: Todoriki et al., 2014.*

Terrorist financing had already been mentioned in FATF reports in 1999, as an extension of anti-money laundering laws; the ‘terrorist related money laundering’ has however been treated as a real issue since 2001 (Vlcek, 2008). Increasing regulation and supervision of the official sector have definitely led people to use informal channels for criminal activities, hence international authorities have been pressing for regulating Alternative Remittance Systems. Countries have reacted in two different ways: some states opted for licensing informal operators (e.g. UAE); others instead chose to forbid them (e.g. Pakistan, India). Johnston (2005) however warns about the potential counterproductive effects of overregulation of the underground bank system, which may lead parallel bankers to move even more underground and disincentive Remittance Service Providers and formal financial institutions to provide remittance services because of higher compliance costs. In addition, an excessive level of regulation may leave expatriates with fewer and more expensive alternatives for sending remittances, which may in turn reduce the positive effect of remittances and reduce the possibilities to send fund for humanitarian and development purposes. As a result, prohibiting ARS is not an effective solution; a much better way to deal with ML/FT associated to informal system would be to ensure access for legitimate uses while preventing abuses (Passas, 2005).

Financial inclusion and reliable financial institutions are mutually dependent and must be the primary policymakers' goals because they both contribute to economic progress. A reduced financial exclusion translates into lower money laundering and financing terrorism risks, but regulations imposed by certain countries makes financial inclusion a difficult goal to achieve (Todoriki et al., 2014).

## A. GENERAL ANTI-MONEY LAUNDERING REGULATION

Money laundering is a transnational crime concerning “a number of different jurisdictions with different legal standards” (Rider, Linklater and Bazley, 2009). Dirty money can have their origin or destination in any country, and the three stages to launder money may take place in three different states; countries having ineffective regulations are particularly subject to abuse and allow criminals intensifying their illicit activities. International authorities set standards and provisions but each country applies them in a different way: the different application of legislation and the presence of tax haven and banking secrecy countries exacerbate the defeat of illegal activities and make some nations more exposed to money laundering; effective and uniform regulation would thus have great advantages both at the country and at the international level (Schott, 2006).

Regulations against money laundering and terrorism financing activities have been developed in these years, but different authorities still disagree on the most effective form of ruling and find it difficult to reach an uniform binding ruling for all countries; Mugarura (2011) claimed that criminals have learnt to abuse of countries' different regulation to access new markets. Each country has its own ranking of legal sources to solve discrepancies and express supremacy among different laws; for example the US give supremacy of national law over international one, while France does the opposite (Keesoony, 2016). In 2014, FATF published a list of non-cooperative countries to warn institutions carrying out business in these jurisdictions to pay particular attention; the high-risk countries are Iran, Democratic People's Republic of Korea, Algeria, Ecuador, Indonesia, Myanmar (FATF, 2014a); other countries (Kenya, Kyrgyzstan, Mongolia, Tanzania, Nepal) are instead “no longer subject to the FATF's on-going global AML/CTF compliance process” thanks to their commitment to solve their deficiencies (FATF, 2014b).

Regulating informal operators is essential to respond to increasing money laundering and terrorism financing threats. The main goals of norms in this field are enhancing transparency by forcing record keeping and customer identification; it has been anyway emphasized that it is fundamental to prevent illicit use of informal intermediaries while still permitting their use for lawful purposes (e.g. remittances) (Rees, 2010). Indeed, FATF declared that “remittances are an important financial service for people in many developing countries and are a powerful enabler of financial inclusion. However, for AML/CFT purposes, it is important that financial products and services, including MVTS, are provided through financial institutions subject to adequate regulation in line with the FATF Recommendation. This will potentially reduce overall ML/TF risk in the financial system by bringing customers into the regulated sector. MVTS may be many customers’ first or only interaction with the financial sector. Therefore, a well-designed and functioning AML/CFT policy and supervisory framework for MVTS may foster greater financial inclusion.” (FATF, 2016). Hawala-like networks pose specific challenges to regulators: the main one is that transactions are not recorded and hence it is difficult to detect them (sometimes brokers give receipts with codes or symbols which may be hard to interpret); Hawaladars often carry out other business activities which must be analyzed separately from money transfer practices; cultural and social factors as well as traditions must be taken into account (Passas, 2005).

It has been widely acknowledged that launderers and terrorist financiers “take advantage of high speed international transfer mechanisms, such as wire transfers, to accomplish their goals”. International coordination is hence essential and many international bodies took part to the setting of standards (Schott, 2006). First, I will list some of the main international organizations which have been working on money laundering and terrorism financing prevention; then I will also report some regional bodies engaging in the same field.

## 1. INTERNATIONAL BODIES PROVISIONS

**The United Nations.** The United Nations was the first international entity to engage in money laundering prevention by setting up the so-called *Global Programme Against Money Laundering* (GPML) as part of its Drugs and Crime Office. It is worth noticing that this organization has the power to write down principles binding on all participant countries. In occasion of the *Vienna convention*, the United Nations initially included money laundering in

drug trafficking activities, but later deepened the subject in the *Palermo Convention*, whose article 18 requires mutual legal assistance among countries in cases of transnational crimes (Schott, 2006).

The UN requires countries to prevent money laundering in banks and non-bank financial institutions through “beneficial owner identification, record-keeping and the reporting of suspicious transactions”; in particular they are required “to maintain such information throughout the payment chain and to apply enhanced scrutiny to transfers of funds that do not contain complete information on the originator” (Art. 14). Moreover, article 58 suggests countries to “cooperate with one another for the purpose of preventing and combating the transfer of proceeds of offences” and “consider establishing a Financial Intelligence Unit (FIU) to be responsible for receiving, analyzing and disseminating to the competent authorities reports of suspicious financial transactions.” Financial Intelligence Units were first set up in 1995 and formed the Egmont Group (United Nations Office on Drugs and Crime, 2004).

As for countering terrorism financing, the UN created the Counter Terrorism Committee and adopted the *International Convention for the Suppression of the Financing Terrorism*, which required countries to defy any form of terrorism and promoted cooperation and information sharing among countries (Schott, 2006).

**The Financial Action Task Force.** The Task Force in fact stated that the *Forty Recommendations* on money laundering together with the *Nine Special Recommendations* on terrorism financing must be considered as the basis for preventing, identifying and defeating the two criminal activities. FATF stated that “countries should criminalize money laundering on the basis of the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988 (the Vienna Convention) and the United Nations Convention against Transnational Organized Crime, 2000 (the Palermo Convention).” (FATF, 2003).

FATF standards for AML/CFT prevention include: customer identification; ongoing monitoring of accounts and transactions; record-keeping and reporting of suspicious transactions; internal controls and audit; integrity standards; cooperation between supervisors and other competent authorities (The Joint Forum, 2003). FATF’s main goal is to detect new forms of money laundering, which it publishes in its periodic Reports, and monitor whether the single states comply with its standards through self-assessments and mutual evaluations;

the criteria for these procedures have been jointly agreed by the FATF, the World Bank and the International Monetary Fund. In case some countries do not act in accordance with the above-mentioned Recommendations, FATF includes them in the list of Non Cooperative Countries and Territories (NCCTs) (Schott, 2006). Compliance is assessed for each Recommendation; the table below lists the possible ratings which a country can get.

Compliant	The Recommendation is fully observed with respect to all essential criteria.
Largely compliant	There are only minor shortcomings, with a large majority of the essential criteria being fully met.
Partially compliant	The country has taken some substantive action and complies with some of the essential criteria.
Non-compliant	There are major shortcomings, with a large majority of the essential criteria not being met.
Not applicable	A requirement or part of a requirement does not apply, due to the structural, legal or institutional features of a country e.g. a particular type of financial institution does not exist in that country.

*Source: FATF, 2009.*

Depository institutions must suspend or terminate any relationship with entities or individuals posing money laundering concerns. Some money transmitters have been therefore denied access to formal banks and so have lost access to accounts that they use to settle their balances; at the same time, money laundering and terrorism financing risks have made conventional banks lose some clients (Lawrance, 2016). The Financial Action Task Force defines de-risking as the “phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk in line with the FATF’s risk-based approach. De-risking can be the result of various drivers, such as concerns about profitability, prudential requirements, anxiety after the global financial crisis, and reputational risk. It is a misconception to characterize de-risking exclusively as an anti-money laundering issue.” (FATF, 2014c). The World Bank analyzed the size of de-risking measures taken by banks and confirmed that some formal financial institutions are getting more and more reluctant to provide access to remittance providers. The de-risking trend has become more accentuated since 2010; the largest shares of MTOs account closures have been registered in Australia, Canada, France, Germany, Italy, Mexico, the UK and the US. The World Bank however warned that some banks seemed to be excessively risk-averse with respect to customers operating in certain countries (The World Bank, 2015b); those

institutions should rather adopt risk-based measures proportionate with their size and complexity, the risks they face and the kinds of customers that they serve (Todoriki et al., 2014)

### → **Customer identity verification**

Customers' identification is essential for ensuring safe and sound financial operations (Schott, 2006). Different international bodies (for instance the Basel Committee on Banking Supervision, the IOSCO and the International Association of Insurance Supervisors) have issued guidelines on Customer Due Diligence, which asks for more details than Know Your Customers (KYC) procedures (De Koker, 2006); however, financial institutions are mainly asked to comply with CDD standards provided by the FATF recommendations. These guidelines were first set in 1990 "as an initiative to combat the misuse of financial systems by persons laundering drug money", but they were later revised in 1996 to update with new money laundering methods and once again in 2003 when the Task Force added a glossary and interpretative notes to ensure a better understanding of the norms. Customer Due Diligence standards require financial institutions to verify both originator and beneficial owner's identities and documents; in case the latter is a legal person, they must get proofs about its ownership and control structure. Moreover, the institutions must verify that transactions are consistent with the customer's risk profile and business. The Task Force listed some circumstances in which institutions can apply simplified or reduced CDD measures, for example in situations presenting low risk of money laundering or terrorism financing or when the identity of the customer or beneficial owner is publicly available. As for record keeping, financial institutions are required to maintain trails about transactions for at least five years. (FATF, 2003).

### → **Suspicious Transaction Reporting**

Money transmitters must fill a suspicious transaction report whenever a transaction amounts to at least \$2,000 and operators suspect it involves ML or TF; depository institutions are instead required to report suspicious activities in case of suspicious transactions equal to or above \$5,000 (Lawrance, 2016).



## → Recommendations on terrorist financing

Terrorism financing consists of “encouraging, planning, assisting or engaging in acts of terrorism (...) to achieve economic and political destabilization and gain media attention” (Choo, 2013). Crain and Crain (2006) estimated that, if no terrorist attacks had taken place, the 2002 GDP of the 147 countries included in their survey might have been \$3.6 trillion higher.

Terrorists are often supported by money coming from legitimate sources such as donations and gifts; in case they are financed through dirty money, combating terrorism financing involves also anti-money laundering policies (Schott, 2006). In October 2001, FATF published eight special recommendations to counter terrorist financing and added the ninth three years later. It recommended that any bodies subject to AML obligations report suspicious transactions to authorities and asked countries to require Informal Operators to be licensed or registered, otherwise they should impose sanctions; moreover these intermediaries are required to report any available information about the money transfer originators. Countries must also make sure that non-profit organizations are not used for financing terrorism (FATF, 2001). The Interpretative Note to Special Recommendation VI states that “licensing means a requirement to obtain permission from a designated competent authority in order to operate a money/value transfer service legally. Registration (...) means a requirement to register with or declare to a designated competent authority the existence of a money/value transfer service in order for the business to operate legally.” (FATF, n.a.). According to Shah, “Licensing is the optimal method of assuring persons of dubious background and intentions are not allowed legal operating status, while the more minimalist registration approach at least allows regulatory and law enforcement agencies a straightforward way of contacting IFTS operators for both specific investigations and research opportunities.” (Shah, 2007).

**Basel Committee On Banking Supervision.** As I previously wrote, money laundering and terrorism financing generally involve various jurisdictions and this fact makes it difficult to detect them at national level. The Basel Committee on Banking Supervision was created just to ensure an international oversight on banks regulation, hence checking they maintain a good reputation while keeping their competitive position (Keesoony, 2016). In 1988, this Committee issued the *Statement on Prevention of Criminal Use of The Banking System for the Purpose of Money Laundering*, containing guidelines aimed at preventing

the abuse of the banking system for money laundering. It defined Know-Your-Customer procedures as the core principles for defeating money laundering, it strongly suggested cooperation with law enforcement authorities and required both to close accounts whose funds are supposed to derive from criminal proceeds and to deny any transaction which is suspected to be related to money laundering activities. In 2003, it focused on parallel-owned banks, defined as “banks licensed in different jurisdictions that, while not being part of the same financial group for regulatory consolidation purposes, have the same beneficial owner(s), and consequently, often share common management and interlinked businesses”. It suggested international cooperation in order to share “information cross-border on the conditions of the bank and its compliance with banking laws and regulations” and on-site examinations (Basel Committee on Banking Supervision, 2003).

**International Organization Of Securities Commissions.** In 1992, IOSCO published the *Resolution on Money Laundering*; in 2004, it issued the *CIBO Principles* (i.e. Client Identification and Beneficial Ownership) for the securities sector, requiring client or beneficial owner identification through Client Due Diligence method and the keeping of these data. Institutions dealing with securities must ask for financial background and business objectives of their customers in order to understand whether the transactions are consistent with their business profile (OICV-IOSCO, 2005).

**International Association Of Insurance Supervisors (Iais).** This association was founded in 1994 by insurance supervisors from more than 100 countries. Its *AML Guidance Notes*, requiring insurance companies to comply with Anti-Money Laundering rules, are close to provisions for banks by the Basel Committee and entirely comply with FATF Recommendations (Schott, 2006).

## 2. REGIONAL ASSOCIATIONS

As for bodies operating at regional level, among the most important there are the Wolfsberg Group of Banks, the Commonwealth Secretariat and the Organization of American States. FATF also created some more specific bodies called FATF-Style Regional Bodies (FSRB), which ensure compliance and harmonization at the regional level. Depending on the reference area, they have different names: Caribbean FATF; Asia/Pacific Group on Money Laundering; Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism ; Eastern and Southern Africa Anti-Money Laundering Group; FATF on Latin America; Middle East and North Africa FATF; Inter Governmental Action Group against Money Laundering in West Africa; Task Force on Money Laundering in Central Africa; Eurasian Group. Some of them have published specific guidelines applying to their competence region (FATF-GAFI).

### III. SPECIFIC REGULATION FOR NON-BANK INSTITUTIONS

Illegal activities through underground banks imply significant economic and social consequences, ranging from crime and corruption to the weakening of financial institutions (Liargovas and Repousis, 2011). Trehan (2003) reported the critical areas for action identified by the Indian working group: improvement of existing banking channels; cooperation in case of invoice manipulation; proper taxation laws; intelligence sharing; examination of existing law and use them in the best way to combat parallel banking use.

FATF have enacted specific provisions for Money Transfer Businesses, i.e. recommendation 1 on Risk-Based Approach, recommendation 14 on Money or Value Transfer Services, recommendation 16 on Wire Transfers, recommendation 10 on Customer Due Diligence, recommendation 11 on Record Keeping, recommendation 20 on Suspicious Transaction Reporting, recommendation 18 on Internal Controls and Foreign Branches and Subsidiaries, recommendation 35 on Sanctions (Todoroki et al., 2014). Specifically, the FATF recommends countries to adopt “measures to ensure that natural or legal persons that provide money or

value transfer services (MVTs) are licensed or registered, and subject to effective systems for monitoring and ensuring compliance with the relevant measures called for in the FATF Recommendations. Countries should take action to identify natural or legal persons that carry out MVTs without a license or registration, and to apply appropriate sanctions.” It however reminds that “MVTs play an important role in supporting financial inclusion [i.e.] providing access to an adequate range of safe, convenient and affordable financial services to disadvantaged and other vulnerable groups, including low income, rural and undocumented persons, who have been underserved or excluded from the regulated financial sector at an affordable cost in a fair and transparent manner. It is also about making a broader range of financial services available to individuals who currently may have access to only basic financial products.” (FATF, 2016). As for the Risk-Based Approach, MVTs agents have to assess money laundering and terrorism financing risk through some indicators, which take into account such factors as:

- The nature and the complexity of their activities, including the volume of transactions that they carry out
- Their target markets;
- The customers’ profiles and the share of those considered as high risk;
- The features of jurisdictions in which they provide services; in particular they shall analyze the frequency of crime and corruption, the level of regulation and law enforcement, the occurrence of anti-money laundering/counter financing terrorism controls;
- The distribution channels, together with the payment string, the settlement systems, the technology used.

In case of suspicious transactions, MVTs have to fill in a Suspicious Transaction Report. In 2012, FATF introduced a Risk-Based Approach (RBA) to assess the overall risk associated to specific transactions; the task force in fact primarily aims at deterring and preventing ML and TF rather than at imposing sanctions. Risk assessment is mandatory in order to be fully compliant with FATF Recommendations and makes MVTs operators aware of their exposure to money laundering or terrorism financing operations. The FATF Risk evaluation methodology takes into consideration various kinds of risks:

- geographic risk: transactions from/to countries particularly vulnerable to criminal activities or subject to sanctions for non-compliance with AML regulation;

- customer risk: transactions made by people or institutions which have been sanctioned by FATF or whose identity is uncertain, but also when they do not provide consistent information about the beneficiary or they are suspected doing transactions for third parties;
- product and service risk: when customers prefer anonymous payment instruments or choose products easily exchangeable in cash;
- agent risk: relates to distribution channels and include the risk associated to transactions from/to high-risk countries, to agents not willing to share and provide information, or whose profits do not correspond to their business profile and risk. (FATF, 2016).

General AML/CFT provisions include registration or licensing, Customer Due Diligence, record keeping and Suspicious Transaction Reporting; some countries impose additional requirements to Money Transfer System, ranging from prudential rules (capital or organizational requirements), to exchange controls and consumer protection provisions. Registration and licensing regime also imply some significant country differences. In countries which chose the former system, Remittance Service Providers must provide many information to authorities and requirements to get the authorization may often vary, but do not usually include AML/CFT compliance before the authorization is granted; RSPs are hence sometimes asked to renovate their registration, which is renewed only if operators have been complying with all the requirements. The registration procedure is hence faster and cheaper than that for licensing, but from the point of view of authorities, it may translate in higher supervisory costs. On the contrary, asking for a license means being subject to more restrictions: authorities examine due diligence process, suitability, structure of the business, operational context and operating systems, compliance with AML/CFT regulations. All these assessments impede some operators to enter the market because they have to show ex-ante their compliance with rules (Todoriki et al., 2014).

## CASE STUDIES

Passas (2006) argued that US “[fought] terror with error” because it imposed a too strict regulation on informal financial system, which then resulted in a greater exposure of those systems to abuse and made remittances more expensive to people really needing those funds. I will hence examine how some countries have reacted to pressure for increasing regulation of

the informal financial sector. Each jurisdiction implement its own policies concerning requirements, enforcement, sanctions and so on; these differences result in countries forbidding ARS, countries requiring licensing or registration and countries not regulating these systems (Rusten, 2011).

I will now focus on two countries that the US Department of State have defined as “Jurisdictions of primary concern” about money laundering and terrorist financing (US Department of State, 2015).

**United Arab Emirates.** The United Arab Emirates (UAE) has become an increasingly important regional hub for trade and financial activity thanks to its economic development, political stability and liberal business environment counting 36 Free Trade Zones; Dubai is a primary international banking and trading center and has been acknowledged to be part of the *Hawala Triangle*. Since most banks are branches of foreign financial institutions and immigrants constitute a large share of its labor force (about 80% of the population is made up by foreigners), informal networks are very popular. Hawala networks are often used to finance terrorists living in Afghanistan, Pakistan and Somalia or to traffic narcotics coming from Southwest Asia; however, the UAE are universally known for illegal activities involving gold and diamonds.

In 2002, the country organized the first *International Conference on Hawala* led by its Central Bank, which established AML rules requiring Hawaladars to register and comply with CDD, keeping records (including those of reverse transactions) and provide STR (Suspicious Transaction Reports); any transaction reports must be sent to the Central Bank on a quarterly basis (Trautsolt and Johnson, 2012). Registration allows them to make legal use of the traditional banking system; actually, only a small part of these brokers applied for the registration certificate but they anyway recur to the formal banking system without restrictions. The UAE Banking Supervision and Examination Department thinks that “the absence of any STRs reflects the fact that Hawaladars’ customers are typically people who are known personally to them through family or business contacts” and this fact make authorities think that suspicious transactions are privately solved, i.e. within the community, rather than through reporting to authorities (FATF, 2008, p. 106).

In 2004, the UAE government and Central Bank organized a second conference on Hawala, which involved also the International Monetary Fund. The three authorities once again concluded that they needed to gather information on Hawaladars’ operations and enhance regulation (Johnston, 2005). Trautsolt and Johnson (2012) claim that AML and CFT

provisions in the UAE do not seem to have reduced criminal activities because “the regulatory and supervisory approach seems to ignore the local context with its religious, cultural, and social characteristics”.

In 2014, the government issued new AML measures saying that people moving from/to the UAE must declare any convertible financial instrument or precious metal that they are carrying and the amount of money they have; moreover, the Central Bank was authorized to suspend suspicious bank accounts (US Department of State, 2015).

**Afghanistan.** Afghanistan has been increasingly threatened by terrorist financing, money laundering, cash smuggling, abuse of informal value transfer systems, and other illicit activities. It is among the biggest narcotics producing and trafficking country and the largest opium producer and exporter in the world. In the last few years, the increasing size of illegal activities and of corruption level have caused the contraction of the formal banking sector, which is used by less than 10% of the country’s population, meaning that about 90% of financial transactions is run through the informal sector, whose leader is the Hawala network; some NGOs and international aid institutions have also addressed to Hawaladars since the formal banking system is not entirely operational. Actually, the formal and informal sector are not well separated one from the other because Hawaladars have accounts at banks and settle their books through banks’ wire transfers, and banks send funds through Hawala when money must be sent to areas where they do not operate (US Department of State, 2015).

Spreading corruption makes the enforcement of AML provisions very hard; for instance, the country’s FIU stated that no operators submitted Suspicious Transaction Reports and many categories are not even supervised (e.g. dealers in precious metals and stones, lawyers, accountants, real estate agents). New rules impose \$20,000 as a threshold to amounts which can be transported outside the country, but they simultaneously abolished the requirement of outbound currency reporting and provide most of cargos with inspection exemptions. Regulation against terrorism financing allows the government to take hold of terrorist assets but there is no clear instructions on how these procedures work and no assets have been seized up to now. The lack of effective and clear regulation results in a large share of unregistered operators, since they are not threatened by sanctions (US Department of State, 2015).

Afghanistan experience demonstrates that regulation failed due to the government lacking capacity of implementing rules. UAE was more successful but did not take into account the

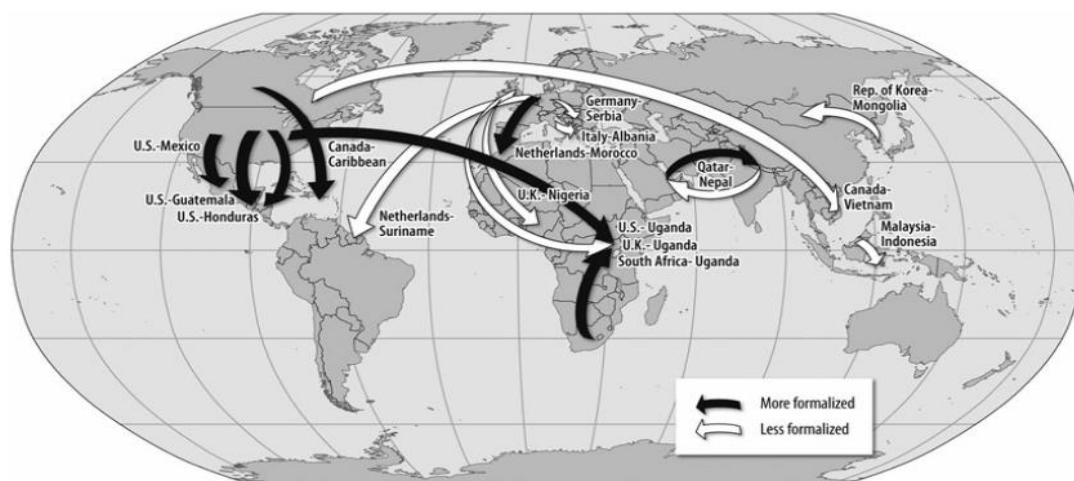
cultural and social factors related to the use of Hawala systems (Trautsolt and Johnson, 2012). Moreover, complying with new rules translates into higher costs because operators may need new technology or more employees taking care of reporting and identification procedures. Compliance costs are generally higher in countries where people are less used to comply with rules, such as Afghanistan; the best line of attack would hence be to make compliance easier and cheaper (Isern et al., 2005). Some studies found out that good quality of national regulation is the basis for encouraging compliance, while spreading corruption definitely discourage it. In a few words, we can say that compliance is strictly linked to the countries' economic development and to the strength of AML/CFT standards; these must be stricter the more the country is vulnerable to ML/FT (Verdugo Yepes, 2011).

#### IV. ENTERING IN THE REMITTANCE MARKET: THREATS AND OPPORTUNITIES

The total annual remittances volumes account for billions of dollars and, as migration flows are increasing, money transfers are likely to surge as well; remittance market is hence a growing, multi-billions dollars market. Individuals have historically chosen to remit money through money transmitters, but the formal financial sector should try to take part to this business both to reduce the usage of informal networks, and hence ML risks, and to expand the sources of revenues. Remittance industry however does not coincide with banking industry because the two businesses have different targets: the former addresses to low-income individuals, while the latter aims at providing services to high-net worth persons. The strict regulation previously imposed only to the formal sector have reduced the cases of abuse in the official system, so, if more transactions were made through traditional financial institutions, ML and FT risks would shrink (Todoroki et al., 2014). To achieve the goal of expanding into the remittance market, banks should first find out the facts causing the informal sector to continue to play a dominant role in the field and policymakers should analyze the reasons for choosing IVT systems from the customers' point of view.



## Degree of Formality of Remittances among Bilateral Remittance Corridor Analysis Case



Source: *The World Bank*. Retrieved from Todoriki et al., 2014.

Underground banks provide essential services on a global basis, and this is why outlawing them is not a desirable solution; informal banking networks should be rather incorporated in the formal system. Besides lacking transaction records, the main issue relating to the use of Alternative Remittance Systems is that money transfers are in cash, which facilitates criminal practices by ensuring anonymity. Payment instruments should be chosen on the basis of the competition level in the financial industry, but cash is the only tool providing hedging from crisis and working in absence of electronic networks (Passas, 2016).

While low charges and large accessibility seem to be the key advantages of informal operators with respect to banks, fees might not differ that much when comparing ARS with corporate remitters (i.e. Money Transfer Companies). Although the latter categories definitely has to incur in higher costs due to corporate expenses, most of them have been trying to contain those overheads to gain competitive positions; unfortunately, informal operators continue enjoying cost advantages because of the very simple technology required for their operations (internet/fax/telephone), enabling them to operate also in uncertain conditions. The main issues however are those related to cultural, social and religious characteristics of ethnic banks (Rees, 2010). Hariharan (2012) claimed that formal banks could learn how to serve poor communities and worker expatriates by imitating the features making the informal system so attractive for these individuals, but it is very difficult for Money Transfer Operators to get over social matters. We cannot forget that, in an Islamic community, whenever men migrate, their wives cannot have any contact with unfamiliar people, meaning that they cannot even go to banks; Hawaladars may therefore be a great alternative since they are usually known by people living in the area and are aware of local customs (Rees, 2010). Therefore,

provided that ARS maintain their characteristics, corporate remitters will have to struggle hard to take business away from informal operators (Rees, 2010).

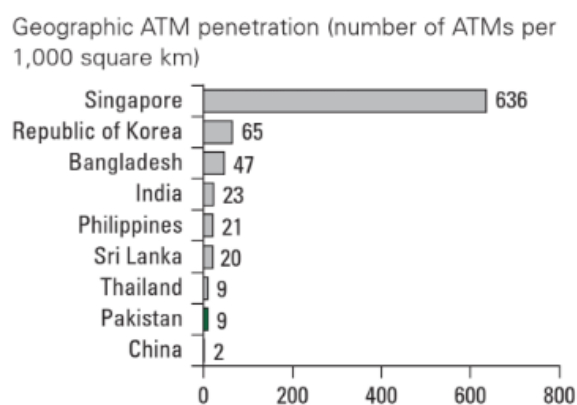
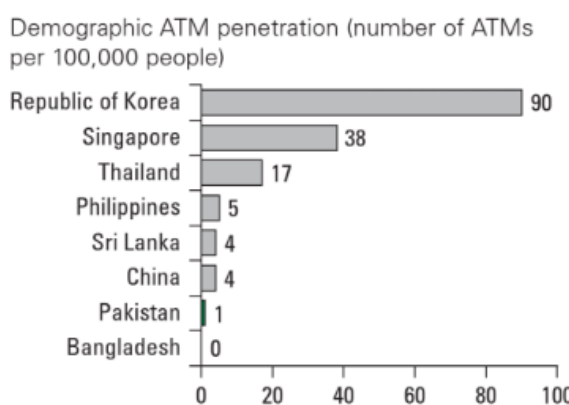
Shifting to official banking system definitely needs the support of governments, which should set up adequate policies providing incentives to both people and formal financial institutions; this would barely occur in underdeveloped or developing countries, since most of them are characterized by inefficient and corrupted classes of politicians, absence of regulatory frameworks for financial institutions and payment infrastructures, and may be affected by conflicts, natural catastrophes, economic crisis, economic sanctions and other unfavorable conditions (Rees, 2010). All these factors cause many individuals to be unbanked: taking Pakistan as an example, 50% of its residents have no access to any financial intermediary (neither formal nor informal), 30% have access to the informal system and 14.3% have access to the formal financial system. The high rates of unbanked individuals led to oblige Pakistani banks to offer *Basic Bank Account* for low-income people. Access to financial services (e.g. credit, insurance, remittances) allows people to reduce exposure to income fluctuations and promotes investments (Nenova, Niang and Ahmad, 2009); however many factors continue acting as barriers to financial services access for the population of poorest countries, e.g. limited literacy, lack of infrastructures, high commission charges, lack of knowledge of banking operations (Chatain et al., 2011).

Official financial intermediaries of many countries are not willing to expand in the remittance market mainly because of the lack of proper technology and financial products (Nenova, Niang and Ahmad, 2009). However, if informal players were integrated into the formal system, the level of competition would be much higher and would hence contribute to improve efficiency; enhanced efficiency would then translate into low charges for customers, new technologies and the introduction of new products and services (Todoroki et al., 2014). Maimbo (2007) analyzed the likely benefits of the integration of formal and informal financial sector in countries going through wars: although conflicts often imply deficiencies of both the payment system and of government regulation and oversight, countries may dispose of informal financial networks, including those of microfinance institutions, credit cooperatives and mobile Money Transfer Operators. Hariharan (2012) proposed to enter the financial industry of a post-conflict country by using its existing networks and imitating their operations; in a few words, he suggested to set up “Hawala-inspired techniques” to make formal sector remittances services easy to reach by a larger share of population. Conventional banks should hence provide more efficient and accessible services, adapt their banking

procedures, integrate informal operators and take into consideration cultural differences when setting up their business strategies.

Increasing competition has stimulated many Remittance Service Providers to expand their product and service range and to tailor them on migrants' needs; banks may enjoy of a wide range of technologies permitting to customize products and services as well, but each solution pose specific ML/FT risks which must be attentively analyzed and mitigated. In Pakistan, Western Union has entered into partnerships with various banks, exchange companies and the country postal network and, in 2006, it presented a remittance card (*Suriname*) containing all the information about the holders (Nenova, Niang and Ahmad, 2009).

Some American banks created partnerships with foreign ones and allow remittances between accounts of partner banks; examples of these agreement are those of Citizens Bank targeted to New England's Cape Verdean population, Wells Fargo Bank and Bank of America, whose main target is Mexican immigrants (Getter, 2015). Nigerian banks started paying out remittances both in foreign and local currency because many people want to withdraw funds in U.S. dollars, while many Mexican financial institutions have been considering accounting for clients' remittance history in risk assessments for loans. Likewise, Banco Industrial in Guatemala has started providing short-term credit for home restructuring asking for a guarantee based on future remittance flows. Other institutions set up Internet-Based Remittance Transfers, which allows using prepaid cards to withdraw money in any ATM. However, ATMs are usually present mainly in urban areas rather than in rural ones, so it won't help in attracting unbanked individuals living in remote areas and it also may imply higher ML/FT risks whenever providers do not investigate on both origin and destination of that money (Todoriki et al., 2014).



Source: Nenova, Niang, Ahmad, 2009.

Banks of other countries succeeded in entering the remittance market through mobile banking. Fathallah, Mino and Pickens (2011) report some data on the number of people having mobile phones in 2011, and he said that it was twice the amount of people having a bank account; therefore, banks may definitely exploit this growing opportunity, which can also be very helpful in countries experiencing conflicts, natural disasters etc. For example, after the earthquake hit Haiti in 2010, banks had to close; the Bill & Melinda Gates Foundation hence launched the *Haiti Mobile Money Initiative*, whose main goal was to encourage 241 banks and mobile operators to introduce mobile banking services (Bold, 2011). Mobile money transfer services include mobile banking services (i.e. self-service banking transactions such as checking account balance, transferring funds to other accounts, making payments using mobile phone), mobile payment services (allow using the value stored on the mobile for payments) and mobile remittance services (domestic or international money transfers via SMS) (Choo, 2013). Notwithstanding many successful cases, banks are still reluctant to expand their activity to mobile phone services because they think to them as a *plus* for existing customers, rather than a way for serving the unbanked and hence enlarging their clientele (Ivatury and Mas 2008).

In the Philippines, Globe launched the so-called G-Cash, which allows maintaining deposits and transferring money through mobile phones. Since October 2004, users have thus enjoyed a new and cheap method for making and receiving payments by using e-wallets via SMS without needing to have prepaid cards or bank accounts (Owens and Bantug-Herrera, 2006). In 2009, G-Cash enjoyed a market penetration in the Philippines equal to 82% and counted 65 million subscribers. According to Proenza (2007), G-Cash had such a great success because of the Philippines large urban population and text messaging culture. Any individual wanting to move money through G-Cash has to load his own mobile wallet by giving cash to the operator or one of its partners, who turn it into virtual money, or by transferring money from bank accounts. When remitting money through G-Cash, senders go to Globe partners, where they have to show their ID, fill in a form and pay the fee, which varies according to the amount transferred. It is not necessary that receivers are Globe customers: it is sufficient that senders provide recipients' phone number so that they get a SMS notifying about the transaction and giving them the Reference Code to show to operators in order to withdraw the money. Even individuals not owning a mobile phone can get remittances through G-Cash service (Globe Telecom website). In 2007, a similar m-payment product called M-Pesa was launched in Kenya by Safaricom (which is part of Vodafone): M stays for mobile, while Pesa is the Swahili for cash. The product was not part of Vodafone core business, neither it was

introduced in a core market but M-Pesa spread very quickly: 14 months after its introduction, it already counted almost 3 million users. This great success has corresponded to a coincident great increase of remittance (Flores-Roux and Mariscal, 2010). Through M-Pesa, Safaricom and its partners accept deposits to any subscriber owning its SIM card, which in turn get e-float (i.e. e-money); partner stores get a commission from Safaricom for every conversion of money into e-float. The electronic money can be transferred among M-Pesa accounts via SMS or sold back to Safaricom in exchange for money. Originally M-Pesa was born for remitters but later has extended its services to goods and services payments. Fees are charged both to senders and to receivers whenever they withdraw money (Jack and Suri, 2011). According to Fernandes (2015), M-Pesa success factors are the very high fees charged by any other kind of remittance/payment provider, the dominant market position of Safaricom, a successful slogan (“Send money home”), the inefficiency of the local banking system and, last but not least, the post-election violence in Kenya in 2008 which pushed people to use M-PESA both to send money to people stuck in Nairobi's shantytowns and to store money in a place other than banks, which were involved in disputes (Fernandes, 2015).

The Philippines experience with *G-Cash* and the Kenyan *M-Pesa* however witness that traditional banks may successfully offer financial service to the unbanked through mobile banking strategies; their success derives also from the very low costs that what Ivatury and Mas (2008) call *branchless banking* have to incur when deciding to serve the poorest segment of population: physical presence is not needed so they can easily reach large shares of population.

Equity Bank in Kenya, Tameer Bank in Pakistan, and XacBank in Mongolia have entered the mobile money market; evidence however shows that mobile banking strategies are often launched and led by mobile operators instead of banks (Ivatury and Mas 2008). The main difference between the two is that mobile operators enable customers to remit money through their mobile devices, while banks usually allow making payments which are debited from the customers' bank accounts or credit cards (Choo, 2013).

## Examples of Branchless Banking Projects

Country	Provider	Model
Afghanistan	Roshan (mobile operator)	M-banking
Brazil	Caixa Economica Federal (bank) Banco Bradesco (bank)	Card-based Card-based
Chile	BancoEstado (bank)	Card-based
Colombia	Banco Caja Social (bank)	Card-based
DR Congo	Celpay (bank)	M-banking
India	SKS Microfinance (MFI) State Bank of India (bank)	M-banking M-banking
Kenya	Safaricom (mobile operator) Equity Bank (bank)	M-banking M-banking
Malawi	Opportunity International (bank) First Merchant Bank (bank)	Card-based Card-based
Mexico	Banamex (bank)	Card-based
Mongolia	XacBank (bank)	M-banking
Pakistan	Tameer Bank (bank)	M-banking
Peru	Banco de Crédito (bank)	Card-based
Philippines	SMART (mobile operator) GXI (mobile operator)	M-banking M-banking
Russia	Tavrishesky Bank (bank)	M-Banking
Senegal	Ferlo (third-party)	Card-based
South Africa	MTN Banking (bank-mobile operator joint venture) WIZZIT (third-party)	M-banking M-banking
Tanzania	Vodacom (mobile operator)	M-banking
Uganda	Uganda Microfinance Ltd. (MFI)	Card-based

*Source: Ivatury and Mas, 2008.*

Introducing mobile payments in new markets may not be easy. Individuals living in developing countries look for the most convenient method to transfer and withdraw funds but ATMs and other basic elements may not be in place, hence requiring high initial sunk costs (Kendall, Schiff and Smadja, 2014). Besides, potential providers must take into account that mobile money is not ML/FT risk free, but it is still safer than cash because transactions are always recorded. Users are usually identified, but issues may arise whenever customers use false names (they do not have to show ID cards because the whole process is electronically carried out); whenever transactions involve non-identified clients, authorities can however make use of phone lists kept by providers. To overcome concerns related to the use of cash, mobile banking operators often impose caps on the frequency and the amount of money that can be transferred (Todoriki et al., 2014); indeed, ML and FT risks through mobile money is still low: evidence shows that criminals tend to choose other channels, also due to the high

costs of carrying out criminal activities through mobile devices (Chatain et al., 2011). Notwithstanding these proofs, Levya (2010) warned that *digital value smurfing* may take place if mobile operators permitted customers to use digital stored value: as criminals would not need to deposit cash, they could get digital value in exchange for illicit money and they could immediately and quickly transfer that value anywhere in the world.

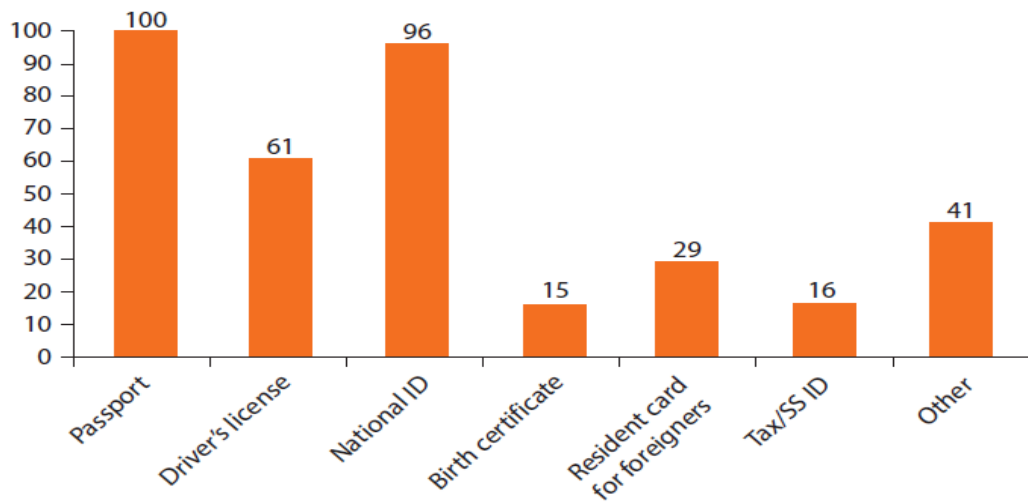
Financial institutions looking for expansion opportunities should consider extending to Sub-Saharan Africa, where most payments (including those of firms from government and customers, and to wholesalers and employees) are still in cash. These areas present features that are much different from those of other countries: first of all, most expenses are related to basic needs such as food, education, health and basic retail purchases; in addition, mobile phones are wide spreading (Kendall, Schiff and Smadja, 2014).

Since IFTS have never stopped operating even in case of unstable conditions (opposite to traditional banks), we can reasonably conclude that formal banks should continue investigating and imitating the modus operandi of informal networks. Remittances market may be definitely attractive for banks for various motives: remittances are usually stable over economic cycles, so fees deriving from providing remittance services are likely to be stable over time; in addition, banks may provide financial education programs to remitters who can then be potential customers for other financial products and services. Getter (2015) however argued that formal institutions have to fill some gaps before entering the remittance market:

- the trust gap: migrants frequently mistrust formal financial institutions; Watterson (2012) suggested filling this gap by directly promoting banks in places hosting large shares of immigrants and by accepting alternative forms of identification such as the *Matricula Consular* (i.e. an identity card given to undocumented workers living outside Mexico);
- the information and education gap: banks do not usually know immigrants' culture and hence cannot discriminate among different habits of different ethnic groups; likewise, immigrants lack knowledge of banking operations, products and services;
- the product gap: banks do not provide products and services specifically target to immigrants' needs.

### Acceptable Documents for Verification

(% of surveyed countries)



Source: Todoriki et al., 2014.

After having filled those gaps, conventional banks may enhance their competitiveness by introducing new financial inclusion methods, such as the above mentioned mobile banking, but also by presenting themselves as reliable institutions (Getter, 2015).



# CHAPTER 4: REMITTANCES TO CHINA AND THE COUNTRY'S FINANCIAL SYSTEM

*“Around the world, there is no other market like the market in  
China that highlights a convergence trend of Internet and  
mobility.”*

*- YuanKe Deng, Vice president of Nokia Global*

## I. CHINESE FACTS AND FIGURES

China has been a communist planned economy for long time but since the 70s it has been implementing economic reforms which have turned the country to a socialist market economy. Many state-owned firms are still present, but there are many private companies as well. The main economic changes due to Reforms were the reorganization of agriculture production, the distribution of land to households through the Household Responsibility System and the introduction of new and differentiated economic activities; all these factors caused the redistribution of rural population and the creation of new jobs, especially in the tertiary sector. Thanks to urban reforms, Chinese people had the possibility to carry out long distance trading activities and, as restrictions on population mobility were relaxed, they could move to cities and get temporary jobs there. Rural-to-urban flows started: the dramatic and quick surge in migration led to a huge increase in remittances that contributed to partially relocate wealth from cities to the countryside (Cai, 2003).

In the 80s the country was ready to open to the world economy; in 2005, more than 44,000 foreign invested enterprises were allowed to set up branches in China and the number quickly raised (FATF, 2007). In the same year, the Chinese government implemented the reform of the Renminbi (RMB) exchange rate formation mechanism and the country experienced a fast rise of its foreign exchange reserves; as a result, short-term speculative capital in the

international financial market (*hot money*) were destined to the Chinese capital and real estate markets with the goal of gaining from asset price increases (Li, Liu, and Ge, 2012).

Because of the widespread of the financial crisis consequences, in the last few years China has been suffering for the consequences of the worldwide economic downturn, which has impaired global trade and has caused amazing effects on stock market indexes. China has primarily suffered of FDIs and exports contraction and the government has responded with a \$586 billion stimulus package devoted to infrastructure improvement and similar programs. The government agenda has definitely boosted investments in fixed assets, especially by local governments, which borrowed from banks and shadow bank institutions (Hsu and Li, 2015). China's GDP growth has considerably slowed down due to a decreasing growth in industrial production, investment and imports; growth has however steadied in the last couple of years. The total level of debt in 2014 reached the 282% of its GDP.

China still exerts extensive capital controls but it is gradually losing them by allowing inflows and outflows of capital; these new arrangements aim at sustaining financial development and encouraging the free movement of capital; Shanghai Free Trade Zone was introduced in 2013, followed by those in Guangdong, Tianjin, and Fujian. China has tried to shift towards a flexible market-determined exchange rate; the RMB/US dollar exchange rate has hence been subject to market forces and has led to a lower pressure on RMB (Prasad, 2016). Expectations of Chinese currency appreciation have contributed to increase foreign debts well and, at some point, China reached the debt levels of countries hit by the crisis. The government reacted by enacting new policies requiring foreign-invested enterprises to manage only their own balance; this rule implies that multinational companies can declare to have extended their debt because of cash shortages and short-term debt can be easily recycled. Foreign-invested enterprises can therefore introduce *hot money* through transfer pricing, inflating profits, short-term debt and capital increases, which rule out any form of detection; likewise, Chinese-invested enterprises established abroad can transfer hot money to China by reporting higher income than actual. Most of this hot money flows through underground banks and harm the country: the most relevant effects are the rising inflation, asset price bubbles and the higher need of monetary policy actions. As these consequences exacerbated when the Fed started Quantitative Easing policies in 2010, Chinese authorities enacted stringent measures to restrain the size of hot money inflows, but they were not so effective because most of that money flowed through informal channels (i.e. ARS) (Li, Liu, and Ge, 2012). In fact, many residents wanted to transfer money offshore because they believed that their money was safer

abroad and they could get higher returns: in order to circumvent capital controls, people addressed to underground bankers, whose enhanced activities translated into a decrease in forex reserves and made it more difficult for the country to stimulate growth because it had less money for investments (Chuin-Wei, 2015).

The 2013 Annual Report of the State Administration of Foreign Exchange states that investigations led to the detection of “2,453 cases involving activities in violation of the regulations on foreign exchange administration” (SAFE, 2013). More recently, an article published by Bloomberg a few months ago reports that China imports from Hong Kong have significantly increased (+89% with respect to 2015); this fact has raised concerns about trade invoices manipulation aimed at routing capital out of the country because of fears of Yuan devaluation (Curran, 2016).

## II. CHINA MIGRATION FLOWS AND REMITTANCES

Nowadays, China is fourth in the ranking of source of immigrants and the amount of remittances sent to China has increased proportionately to the increase of expatriate workers.

Remittances of Chinese expatriates were fundamental in the years before and after the World Wars: besides providing economic support to poor families, remittances helped the country to reduce its trade deficit; in 1903, their amount corresponded to 168% of the trade deficit, so it is easy to understand the importance of remittances contribution to the fall of deficit. They played another important role during the Great Depression (1930s) because they did not drop as much as it was expected (as said in the previous chapters, remittances have a counter-cyclical behavior) (Cheong, Lee and Poh, 2013).

### Alternate estimates of Remittances to China and as shares of trade deficit, 1929-38

Year	Remittances ('000 yuan)	Remittances as share of trade deficit (%)	Remittances (Bank of China estimates) ('000 yuan)	Remittances as share of trade deficit (%)
1929			300,000	
1930			250,000	
1931	421,200	64.3	190,000	41.9
1932	323,500	39.4	320,000	36.3
1933	305,700	40.1	200,000	34.6
1934	250,000	46.7	250,000	38.5
1935	316,000	92.0	260,000	47.0
1936	320,000	136.2	320,000	73.4
1937	359,000	312		
1938	479,000	387		

Source: Cheong, Lee and Lee, 2014.

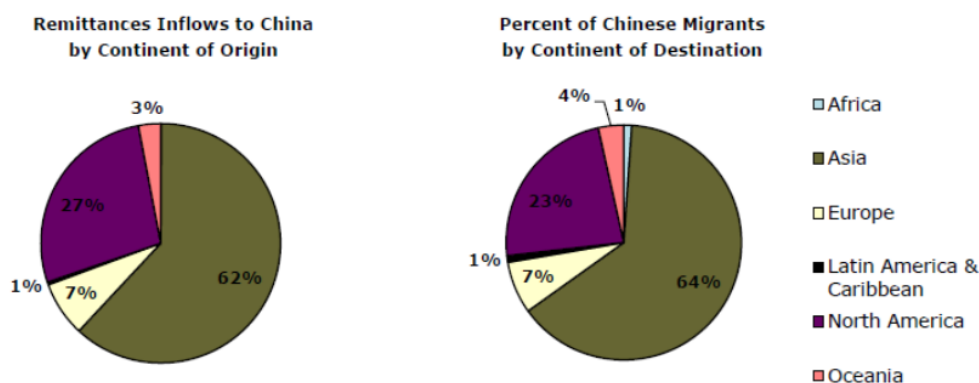
In the communist period after the Second World War (1950s), the government implemented strict controls on forex transactions, aiming at eliminating the foreign currencies' black market. People willing to remit money to relatives tried to find alternative ways of transferring that money because the official RMB exchange rate was much higher than the prevalent rate in the black market; however, to prevent these practices, the Bank of China required that all remittances passed through its branches (Shiroyama, 2006). To evade the BOC controls, Chinese overseas transmitted money through clan-based networks of individuals and institutions, in turn constituted by Chinese people. I will later give details about the Chinese Alternative Remittance System. Moreover, during the planned economy period, the Chinese inhabitants were not permitted to move within the country. The society was clearly divided into rural and urban population and they could not shift from one category to the other.

On the contrary, many residents were obliged to travel towards central and western China in the 60s and 70s, and towards cities during the Cultural Revolution (Cai, Du and Wang, 2009). Since the well-known rural-to-urban migration can be defined as a labor migration (it originated from Economic and Rural Reforms that caused labor surplus in the agricultural sector), workers were reallocated to higher productive sectors and those migration flows have therefore been the driver of China development. In the 80s, there were still some barriers to restrict labor mobility and the government encouraged rural Chinese to “leave the land without leaving the village (*litubulixiang*)”. A few years later, local farmers were given the right to move for business reasons for the first time and rural-to-urban migration became a huge phenomenon: the urban to rural income per capita ratio was above 2.5 in 1978, so rural inhabitants strongly desired to move to cities. Starting from the 90s, China experienced a great economic growth that stimulated even more migration flows because of the high number of job vacancies; in 2007, migrant workers constituted almost half of the individuals working in cities.

Migrant workers are still a fundamental source of income for their families staying in rural areas; remittances are therefore very important for making rural households a bit more wealthy and for reducing the income divergences within the society (Cai, Du and Wang, 2009). Luo (2008) stated that, among the Reforms implemented in China, labor reallocation to non-agricultural sectors was the factor most contributing to the country's growth, both because demand for land was lower (thus preventing land shortages and deterioration) and because of the great role of remittances in mitigating income fluctuations and in providing an

additional source of income that encouraged rural farmers to invest in more developed agricultural technologies.

### Remittances and Migration by Continent



Source: Human Development Report, 2009. Retrieved from Migration Policy Institute, 2011.

For these reasons, the People’s Bank of China has been engaging in developing innovative payment tools and in encouraging financial inclusion as well as financial education for migrants, including remittances literacy. The Central Bank, commercial banks, mobile network operators and payment service providers have therefore collaborated to extended financial infrastructures in order to be able to provide remittance services in rural and poorer areas. The 2015 Country Plan for decreasing remittance transfer costs included such goals as:

- increasing competition among remittance providers by lowering the regulatory barriers for inflows and outflows;
- improve financial infrastructures and introducing new technologies;
- enhancing transparency and consumers’ protection (G20, 2015).

### Top 10 Remittance Flows to mainland China in 2014

Corridor	Volume (\$US billion)	Corridor	Volume (\$US billion)
United States	16.3	Australia	2.9
Hong Kong SAR, China	15.6	Singapore	2.8
Japan	4.2	Macao SAR, China	2.2
Canada	4.2	Italy	1.1
Korea, Rep.	4.1	Spain	1.0

Source: World Bank Bilateral Remittance Data, 2014. Retrieved from G20, 2015.

### III. ALTERNATIVES FOR MONEY TRANSFERS

In 2012, remittances inflows to China exceed US \$66 billion and constitute about the 80% of total flows to Eastern Asia. However, China's remittance market is not adequately competitive and, as a result, it is the Asian country with the highest average transaction cost (9.83%) (IFAD, 2013).

Money transfer to and from China can be accomplished through several kinds of institutions.

**Remittance transfer cost as a percentage of total cost, by country and type of remittance provider**

Country	MTO	Bank	Credit card	Credit union	Post
Bangladesh	3.30	5.70			
China	9.10	14.20	15.10	19.60	12.00
Fiji	7.50	13.90	9.80		
India	6.20	13.30	15.10	19.60	12.90
Indonesia	5.40	7.90			
Kazakhstan	2.70				
Kyrgyzstan	2.00				
Lao People's Democratic Republic	7.00				
Malaysia	7.90	11.90			
Nepal	4.90	4.80			
Pakistan	4.50	9.10	15.90		4.00
Papua New Guinea	14.10				
Philippines	5.90	10.90	17.60		15.20
Samoa	9.20				
Sri Lanka	5.90				
Tajikistan	2.20				
Thailand	4.90				
Togo	6.50	18.60		19.60	9.60
Tonga	7.90	15.50	14.00		
Turkmenistan	5.00				
Uzbekistan	2.10				
Vanuatu	6.00	14.20	10.50		
Viet Nam	7.10	11.50	14.00	19.60	14.00

*Source: Orozco (2013). The Market for Money Transfers in Asia: Scorecard Report. Retrieved from IFAD, 2013.*

**Banks.** Chinese state-owned banks (e.g. Bank of China, Industrial and Commercial Bank of China (ICBC), Bank of Communications and Agricultural Bank of China) and some commercial banks (e.g. Merchants Bank of China, China Citic Bank and China Everbright Bank) provide money transfer services. Before concluding a bank transfer, banks ask for the receiver's name, his account number (IBAN) and the SWIFT code; the transfer requires from one to five business days to be concluded and the sender is charged commissions usually corresponding to 0.1% of the amount transferred. Banks add foreign currency exchange fees whenever money are transferred to foreign bank accounts. In case foreign receivers do not own bank accounts, banks provide demand drafts, which are much faster and have a restricted validity (generally one year) (Olson, 2015).

**Money Transfer Companies.** Besides banks, money transfers can be accomplished by international Money Transfer Companies. Western Union is one of them: it cooperates with many Chinese banks and those agreements allow people to move money via Western Union by simply addressing to their cooperative banks (Agricultural Bank of China, Bank of Jilin, Bank of Wenzhou, Bank of Yantai, Construction Bank of China, Everbright Bank of China, Postal Saving Bank of China,...). The service is definitely fast because money is immediately available to receivers, who must show the “MTCN” number and their ID card in order to withdraw the sum; fees vary depending on the amount moved. Money Gram offer services very similar to those of Western Union and it cooperates with banks as well. It is important to underline that both Western Union and Money Gram accepts only US dollars and do not allow to move amounts greater than \$9,999.99 (Olson, 2015).

**Post.** Post offices are active players in the Asian remittance market and are particularly strong in China (IFAD, 2013). The Universal Postal Union (UPU) provides international postal money orders with a daily threshold equal to \$1,500, which allow transferring money quickly among post offices in countries which signed UPU agreements. The information required are generally just the recipient’s name and his address (Olson, 2015).

**E-Transfers.** As for electronic money transfers, the most common payment system is Alipay that permits to move even very large sum of money from Alipay accounts to foreign bank accounts. It is a multi-function app for mobile phones allowing to make payments in stores and online, but also to transfer money abroad. The main drawback of this system is that Alipay accounts can be open just by people owning Chinese visas and green cards, which foreigners usually do not have. The transfer requires three to five working days and money is converted into foreign currency by default. PayPal is a very similar system providing a virtual wallet and it is much more diffused around the world; it provides immediate virtual transfers between PayPal accounts, while it takes a few days if they are transferred to bank accounts (Josh, 2016).

**Alternative Remittance System.** Finally, money transfers can be done via underground banks, which in China are called *Fei ch’ien*.

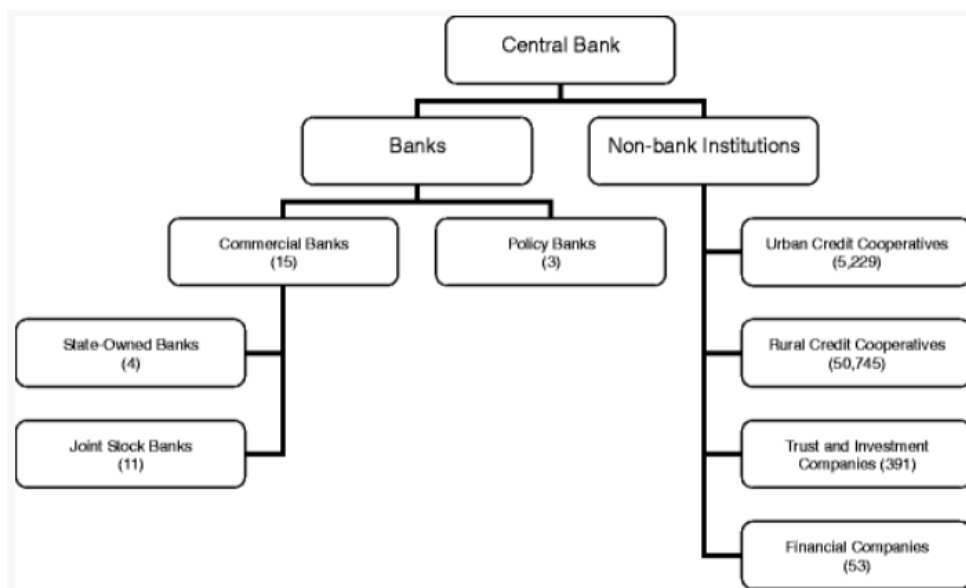
I will now sketch some characteristics of the first and the last category.

## A. THE CHINESE BANKING SYSTEM

The People's Bank of China (PBC) was set up at the end of 1948 after the consolidation of the Huabei Bank, the Beihai Bank and the Xibei Farmer Bank; it was appointed as Central Bank just in 1983 and was later given three main functions: the formulation and implementation of the monetary policy, the banking supervision and regulation and the provision of payment settlement services (Sappideen and He, 2008).

China's banking system has historically been both owned and controlled by the government, but since the economic reforms in 1978, the country has sought to renovate the system, which was isolated from the international market, and only four banks have been kept under the state control. All the other banks have been given incentives to act in a more competitive way and the system has been progressively converted into a competitive market counting various kinds of banks, including foreign ones; nevertheless, the government still represents a major equity holder in most banks and is hence able to restrict their autonomy by exercising a substantial influence on the investment choices and operations of the institutions (Martin, 2012). Starting from 2001, the Chinese banking system was made up of four wholly state-owned commercial banks, three policy-lending banks, more than one hundred commercial banks, three thousands urban credit cooperatives, almost two hundreds foreign banks (Schueller, 2003).

**Organization of Chinese Financial System at the end of 1994**



*Source: Almanac of China's Finance and Banking, 1995.*



Nowadays, China counts three main kinds of banks differing for operations and ownership structures: wholly state-owned banks (i.e. the Industry and Commercial Bank of China, the Agricultural Bank of China, the Bank of China and the Construction Bank of China), “equitized” commercial banks and local banks. The Chinese banking system has some specific features distinguishing it from foreign systems: first of all, loans constitute a large part of assets and are mostly granted to companies, while the liability side of the balance sheet is predominantly constituted by deposits; moreover, both assets and liabilities have very low ratings (Simwayi and Guohua, 2011).

China also counts many illegitimate banks (shadow banks and underground banks) that offer higher deposit rates but also allow hiding money, therefore constituting a privileged channel to transfer money abroad illegally (Martin, 2012). The shadow banking sector has been expanding because of the mismatch between demand and supply of credit and savings products, but also because of the strict regulations on the formal banking system imposing controlled interest rates and high levels of reserve requirements on deposits. Moody’s estimated that shadow banking assets correspond to 65% of Chinese GDP (Prasad, 2016).

The payment process is defined as “first-horizontal (interbank) and then-vertical (intrabank)” because payments are primarily cleared and settle through the local clearinghouse and then intrabank; the Chinese payment system in fact consists of three main sub-systems:

- the National Electronic Interbank System (NEIS): it takes care of clearing and settlement on a national basis and limit the credit and liquidity risk exposure of recipient banks by debiting the sender banks’ account before routing payments.
- local clearing houses (LCHS): they take care of such transactions as exchange, bill and cheque within the same region
- Commercial banks' intra-bank payment systems.

The PBC settles accounts only when net accounts equal zero (Sappideen and He, 2008).

#### **IV. UNDERGROUND BANKING IN CHINA**

The rising value of the Yuan, the growing economy and the stringent capital controls constitute the main elements for explaining the wide use of underground banks in China (Chen, 2007). Funds transfers within China indeed take place mainly through underground

banks or companies controlled by them: the most used informal and unregulated channels are cargo trade, service trade, and direct investment.

The main business of the underground banks is to provide remittance and currency exchange services and hence constitutes a network for secretly transferring money to the more developed regions and trade areas of China. In the country, there are different kinds of underground money houses:

- Underground agents operating as branches of overseas informal money transfer institutions providing remittance services;
- Underground banks operated by
  1. commercial companies, which make transactions with foreign commercial companies in order to transfer money by simulating trading activities
  2. foreign investment and foreign trade companies
  3. normal shops, such as grocery stores, cafe bars and restaurants; these are what we call *Fei chi'en* (Chu, 2008).

*Fei chi'en* (i.e. flying money) is also known *Ch'iaohui* (i.e. overseas remittance) and *Huik'uan* (to remit sums of money) in Mandarin, or *Nging Sing Kek* (i.e. money letter shop) in Cantonese. It has widely spread in China, Hong Kong and Thailand, where it takes the name *Phoe Kuan*. The network was probably born during the T'ang Dynasty (565-909 After Christ) as a payment tool for exchanging tea within the country, which was a commercial and trade center (Shehu, 2004). The network allowed transferring money without physically moving it, therefore avoiding the risk of theft or loss. In the 19<sup>th</sup> century, many Chinese people emigrated abroad (so-called *Chinese diaspora*) and the *Fei ch'ien* started being used as a remittance system (Buencamino and Gorbunov, 2002). As migrants moved abroad looking for a job, they belonged to a sort of “dual family” because they had one family in China and one in their new town. They regularly sent remittances back home in order to maintain ties with their origin families in case they had to go back to China because of unemployment (Purcell, 1951). Underground banking was particularly useful for people who opened “high-value” shops abroad, such as gold shops, because they could easily conceal their income (Cassidy, 1994).

The system is also well-known as *Chit banking* (deriving from *Chitty*, i.e. a Hindi word referring to a mark) because British Colonialists used to give servants a piece of paper containing symbols (usually animals) as a form of certificate. These documents are still used as receipts but they are conserved just until the conclusion of the transfer and then wasted

(Shehu, 2004). Lambert (2002) reported that, many years ago, a Hong Kong Police official told that “he found a piece of paper with the picture of an elephant on it that represented the collection of a receipt for U.S. \$3million at a Hong Kong gold shop”. Another common name for the Chinese underground banking is *Chop*: a chop is a seal stamped in a stone or wood indicating ownership of goods, goods or cash delivery, or goods acknowledgement (i.e. the chop is put on the invoice by the receiver as soon as goods are delivered). Finally, chops can be printed on banknotes to ascertain ownership (Cassidy, 1994).

Fei chi'en systems have the same trust-feature of Hawala networks: Fei chi'en operators usually belong to families that have been working in the banking field for generations and, since they have to maintain the good name of their families, they are considered as reliable people. Chinese society have in mind the idea of *guanxi*, which refers to the basic relationship in individuals' networks of influence (i.e. the relationships among individuals); the Confucian culture puts emphasis on the importance of trust and mutual obligations as basic factors for establishing *guanxi* networks. On the other hand, Chinese ARS presents also some differences from Hawala: when settling accounts, import or export manipulation is much less common in Fei chi'en; chit trails are more common in China rather than in Arabic countries, where underground bankers generally use codes; Fei chi'en is typically a one-way system (towards China), while Hawala moves funds both in and out each state (Shehu, 2004). Informal Value Transfer Systems operating in Hong Kong are similar to those operating in the whole China, but they are known as Unregulated (or Unlicensed) Remittance Centers (URCs). These centers are usually located in shops, trading companies, guest houses or even private houses, and provide money transfer services overseas through parent companies located in those jurisdictions (Passas, 1999).

Passas (1999) interviewed Willard Myers, Director of Center of Asian Studies, who described the two components of Chinese underground banking: one is obviously the customer who is willing to send money to another individual and needs to convert his money into foreign currency; the other component is the banker, who instead wants to get foreign exchange without being subject to government controls.

Addressing to underground banks is quite common in China. Fielding (1993) blamed discrimination against the Chinese population as a factor contributing to the popularity of informal systems in the Western countries: the British closed some of the Asian banks in the UK, so that the Asian population living there had to address to informal bankers. The reasons why the Chinese continue choosing Alternative Remittance Systems rather than traditional

banks are the same listed in the second chapter (i.e. speed, cost effectiveness, efficiency, anonymity..), but the primary motivation for using Fei chi'en is the mania of Chinese individuals to hide their wealth (Shehu, 2004). A post on Save on Send reports the result on investigations about the reasons why so many Chinese prefer remitting money by addressing to informal channels rather than licensed money transmitters. They found that this choice derives from a combination of historical background, cultural characteristics and current trends in China; more specifically:

- Trust is a key factor in Chinese culture and, since Chinese fear losing their wealth, non-Chinese companies are still considered as suspicious;
- Chinese government imposes restrictions on the amount of money that can be transferred every year, and has therefore set up a database of all incoming transactions. As a result, the Chinese formal financial sector is not able to satisfy all the foreign exchange requests because of the restrictions on foreign currency conversion; ethnic banks are instead able to easily match demand and supply for foreign exchange because they are not licensed by the government and can therefore circumvent capital controls (Shehu, 2004).
- Chinese citizens receiving money from abroad must pay taxes on it, so they pass money through unofficial channels; moreover, Chinese people tend to be very secretive about their income and wealth for safety and reputation reasons, so they choose channels allowing avoiding reporting their earnings (SaveOnSend, 2016).

An article published by Reuters reports that in 2015 “China underground banks did more than 1 trillion Yuan (\$152 billion) in transactions” deriving from the great amount of capital outflows due to the country’s stagnation and market volatility (Blanchard, 2016). Chinese Alternative Remittance Systems usually transfer money through various methods, mainly involving foreign exchange transactions (foreign currency smuggling, non-resident foreign exchange settlement, financial institutions’ business transactions), fake trading transactions (reporting higher export and lower import prices, advance export payments) or fraudulent foreign investment. Since, as I said before, ARS offer more convenient exchange rates, Chinese Informal Value Transfer Systems largely engage in foreign exchange transactions to transfer funds abroad on behalf of companies and private. Recently, China’s foreign trade has rapidly developed, implying a great increase in trade frauds; hence, the Alternative Remittance System has progressively increased to use false reporting of import and export prices, advance and delayed payments, and false trade contracts to send funds abroad (Li, Liu, and Ge, 2012).

The Chinese underground banking system has primarily expanded in Shantou and Chaozhou, that are coastal cities where many enterprises choose to set up; they are also close to Hong Kong and Macau, which enjoy more open financial systems. Large amounts of money are often distributed among several bank accounts controlled by underground bankers and then transferred out of mainland China. Another common practice by underground bankers is the matching of Yuan with corresponding amounts in foreign currency (Chuin-Wei, 2015).

## V. OTHER FORMS OF PAYMENTS AND MONEY TRANSFERS

In the last few years, China has experienced a great development of its mobile payment and clearing system; just to give an idea, in 2008, Chinese internet users exceeded the US ones and in 2014, the electronic payment services amounted to 33 million, corresponding to ¥140 billion. The constant economic growth has led to increasing business activities, including online trades (both business-to-business and retail). The rising use of this form of payments however alarmed the anti-money laundering organization, which enacted some guidelines about mobile payment and clearing (Wang and Ou, 2015; To and Lai, 2014).

In 2004, the Bank of Communications introduced a Wireless Application Protocol (WAP) mobile banking services and later, Chinese biggest banks did the same. Their systems allow accessing to usual banking services (such as inquiry, account information, money transfers and remittances, storing value, payments) through mobile phones. The success of mobile banking was also due to the surge in mobile commerce that has been registered since the moment in which the government granted 3G mobile network licenses to phone operators. At that time, the main issue was to set up systems ensuring network security, reliable electronic signatures and so on; hence, the government has been involved in enacting proper rulings since 2005. Online payment companies introduced Public-Key Infrastructure (PKI, i.e. digital certificates) and One-Time Passwords (OTPs).

Mobile payment services are based on an active cooperation between financial institutions and mobile operators. China has three main mobile payment models: mobile network operator centric (focusing on micropayments, i.e. mobile wallets and phone bills); financial institution centric (mainly arranging for macro-payments); and third-party operator centric, in which an intermediary (the third party) arranges for mobile payment services (both at micro and macro

level) by integrating the mobile communications network with the financial institutions' payment accounts. While the first model has succeeded in Japan and the second in Korea, the best model for China is the third one: both financial institutions and mobile operators operating in the country enjoy strong bargaining power and are willing to provide different kinds of services; by implementing the 'one connection, multiple services' concept, mobile network operators and banks are encouraged to collaborate. In China, there are two main categories of third-party payment providers, i.e. the non-independent ones (those that started with e-commerce platforms and later expanded their services) and the independent ones (those that were born as such). Among the firms belonging to the first category, the market leader is Alipay, with a market share touching the 80% (Lu et al., 2011; To and Lai, 2014). It is a third-party online payment platform introduced by Alibaba in 2004 and accounts for half of all online payment in China. It provides real time payment solutions and account settlement in many currencies. Among its products and services, Cross Border website payment is definitely the most relevant since it allows to move money worldwide (StockNewsDesk, 2014).

Corporation (website)	Type	Services domain	Market share
AliPay ( <a href="http://www.alipay.com">www.alipay.com</a> )	Non-independent	C2C; B2C; B2B	56%
Tenpay ( <a href="http://www.tenpay.com">www.tenpay.com</a> )	Non-independent	C2C; B2C; B2B	21.5%
Chinapay ( <a href="http://www.chinapay.com">www.chinapay.com</a> )	Independent	B2B; B2C	7.8%
99Bill ( <a href="http://www.99bill.com/">www.99bill.com/</a> )	Independent	B2B; B2C	4.9%

*Source: Lu et al., 2011.*

UnionPay was introduced in 2002 by the People's Bank of China and was founded by 85 Chinese banks, included the state-owned ones; it can hence be defined as the government-supported payment card network. It soon became a leader in the card and payment market: every transaction denominated in Yuan must pass through UnionPay's electronic payment network. Financial authorities however found out that shops allowed customers owning UnionPay cards to make fake purchases in order to circumvent currency exports controls by Chinese authorities. This practice obviously violates AML regulations as well as currency controls (Pomfret, 2014). In 2012, China UnionPay and China Mobile signed up an agreement aiming at sustaining the expansion of mobile payments. According to their contract, users could enjoy remote payment services (also called online payment, which includes: credit card

repayments, utilities payments, online shopping through SIM cards) and mobile contactless payments (To and Lai, 2014).

WeChat is a mobile communication service launched by Tencent in China in 2011. Besides text and voice messaging services, it allows making payments and transferring money; it has hence become a competitor of Alipay. Last year, Tencent started allowing making overseas transactions through WeChat Pay. Thanks to the partnership among WeChat and Chinese banks, users have just to scan their QR codes and RMB are automatically converted into foreign currency (British pound, Hong Kong dollar, U.S. dollar, Japanese yen, Canadian dollar, Australian dollar, Euro, New Zealand dollar and Korean won) (Liu, 2015).

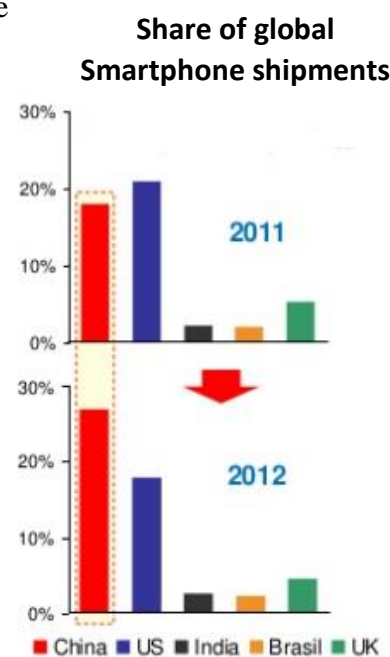
During spring 2016, Tencent invested RMB 100 million in the *Xinghua Jihua* project, whose main goal is to speed up the expansion of WeChat Payment (Sun, 2016).

## A. OPPORTUNITIES FOR GROWTH

Mobile and online banking experienced a great surge in China thanks to government policies discouraging the use of cash and the expansion of e-commerce. Mobile transactions are the cheapest way to move money: their cost correspond to the 2% of banking costs, 10% of ATM costs and 50% of internet banking costs; new players in the field would be therefore desirable (IFAD, 2013). Ken Research (2014) published a report saying that Chinese money transfer market will grow at a compounded average growth rate close to 7.4% thanks to higher acceptance rate of online transfers.

The mobile payment market size has significantly expanded in the last years; the biggest Chinese players in the mobile payment sector are Alipay, Lakala, Union Pay and Tenpay. Online money transfers have increased as well thanks to the extension of Internet penetration and to the lower charges with respect to money transfers through banks' branches.

Since the mobile banking market has just taken off, companies definitely have many growth opportunities; financial institutions, operators, and Third-Party Payment providers have been exploiting the market (To and Lai, 2014). A Deloitte research reports the statistics of the



Source: Van Den Dam, 2013.

Ministry of Industry and Information Technology of China saying that, in March 2012, the number of mobile subscribers in China was already over 1 billion, corresponding to “three [times] the mobile base in North America and [more] than the entire mobile subscriber in Europe”. The main concern is that 3G services have slowly spread, so there might be technological gap to fill; however, the government sought to increase the number of 3G users through its policies contained in the *12<sup>th</sup> Five-Year Plan for National Economic and Social Development of China* (Deloitte Consulting, 2012).

First of all, mobile companies could involve the poorest segment of population living in rural areas where banks have never operated or have closed their branches; mobile phones are instead more easily accessible and would constitute a great alternative to banks. Since a considerable portion of the Chinese population is not educated, another important factor to take into account is the ease of use of these services. In addition, mobile operators could concentrate in presenting themselves as reliable. I previously mentioned that trust is a greatly important factor in the Chinese culture; putting more efforts in increasing their trustworthiness would definitely attract more customers. Chinese people feel particularly exposed to technology risk (i.e. the risk that users choose unconfident technologies), information loss, and attacks (e.g. denial of service and malware) (To and Lai, 2014). China is indeed culturally different from Western countries, so both financial institutions and mobile operators willing to launch mobile or online payment networks must take into consideration its features. New technologies may be largely perceived as unsafe and risky because the Chinese are particularly risk-averse and reluctant to changes; in addition, a large part of the population lacks computer and mobile phone skills. The collectivist behavior may affect the willingness to adopt to technological changes by whole groups of individuals. Hence, before introducing new systems, banks and operators should try to increase consumers’ awareness and acceptance of new technologies and promote them as secure and reliable (Laforet and Li, 2005).

The 12<sup>th</sup> Five-Year Plan includes instructions to “actively develop e-commerce, improve e-commerce services for small and medium enterprises (SMEs), and promote the building of credit service, online payment, logistics and other supporting services for the public” (To and Lai, 2014). On the other hand, the Bank of China fears that the booming acceptance of mobile payments such as WeChat and Alipay will threaten the conventional banking system by taking business away from it. It has therefore started drafting policies setting a threshold on the amount of money that can be spent through mobile payment apps (Fin Tech, 2014).



Many Cross-border Payment Services have been launched in the last years. Alipay is probably the most famous one, but the same services are offered by Tenpay. PayEase provides SMS mobile payments, Internet banking, and point-of-sale (POS) terminals by supporting more than 60 kinds of credit and debit cards. AsiaPay offers payment services in 12 Asian countries (China included) via credit and debit cards issued by Visa, MasterCard, American Express, JCB, China UnionPay and others. NTT Com Asia provides e-Commerce and m-commerce through its platform for domestic and cross-border transactions in many currencies. Red Dot Payment allows payments with Visa, MasterCard and China UnionPay, but also with Alipay, Tenpay, and 99Bill. MOLPay offers payments with cards in more than 170 currencies but also national online banking for many Asian Pacific Caribbean banks and cash payments in different kinds of stores (Jiang, 2016).

In the next chapter, I will briefly analyze the Chinese Anti-Money laundering regulation as well as the Italian regulation and remittance market, as well as the specific regulation for Money Transfer Companies. I will then report data about the remittances outflows from Italy to China, which are huge with respect to those to other countries, and have been decreasing after the last investigations by Italian authorities. The detections have indeed revealed that money transfers to China are so high because most of money derives from illicit activities, especially from fake invoicing and the sale of counterfeited goods. My empirical analysis will demonstrate these facts, and the comparison with the Pakistani and the Moroccan community in Italy will further confirm the results.

# CHAPTER 5: MONEY LAUNDERING

## ACTIVITIES BY THE CHINESE: CASE STUDY

### ON REMITTANCES FLOWS FROM ITALY TO

### CHINA

#### I. MONEY LAUNDERING IN CHINA

For very long time, the Chinese population has preferred to make payments by using cash, which accounted for more than 80% of total payments up to 2005 (Tang and Yin, 2005). Cash was used even when purchasing cars or houses. However, since the origin of cash is difficult to determine, especially in places where underground banks are largely used, the government has gradually encouraged non-cash payments. As a result, the country has recently shifted to virtual payments made through debit or credit cards, and e-wallet mobile apps are becoming particularly popular. Some segments of the population still prefer using cash (i.e. the poor, who do not have access to credit cards, and the rich, who want to hide their wealth); anyway, a research made by Reuters demonstrated the huge increase in bankcards issuance, which exceeded 4.2 billion at the end of 2013. MasterCard has defined this change as “from cash to cashless” (Waldmeir and Rabinovitch, 2014).

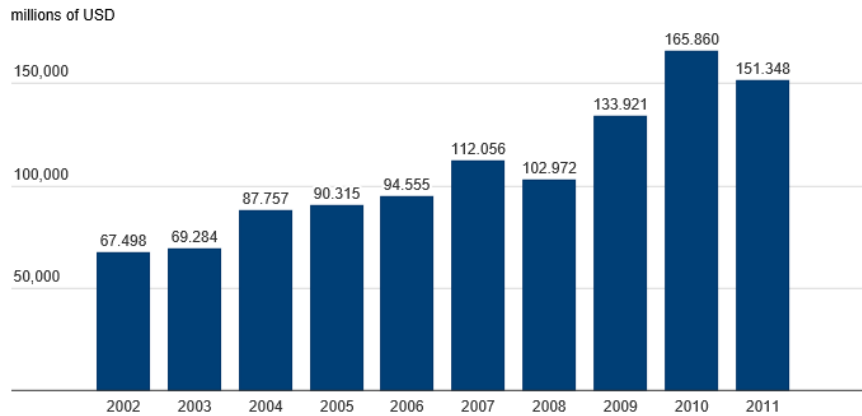
Contrarily from the neighboring Hong Kong and Singapore, China is not acknowledged as an offshore financial center; nonetheless, the country set up some development zones, many Special Economic Zones (e.g. Shenzhen, Shantou, Zhuhai, Xiamen), as well as the Shanghai Free Trade Zone (US Department of State, 2015). The development of the financial sector and of the technological devices has led the country to become the world leader in illicit capital flows, with more than \$1 trillion of illicit money outflows from China from 2003 to 2012 (Gascoigne, 2014).

Cleaning of dirty money by legal persons established in mainland China is often accomplished by exploiting their branches or financial institutions set up in Hong Kong Special Administrative Region (HKSAR) which enjoys specific and privileged conditions; physical persons may instead act as if they were remitting money to relatives living elsewhere

and get the amount back in the form of gifts or donations (US Department of State, 2015). In the years from 2000 to 2011, illicit financial flows from China (excluding the intra-regional trade with Hong Kong and Macao) summed to US \$3.79 trillion; a substantial part of those outflows went back to China in the form of Foreign Direct Investment (FDI). This is due to the advantages coming from FDI regulations, which make it easy to set up complex money laundering scheme: usually, much of legitimate money goes out of China in the form of FDI to Hong Kong and the British Virgin Islands (BVI), but is then laundered into another entity and reinvested in China as FDI from Hong Kong or the BVI (Kar and Freitas, 2013). Alternatively, launderers address to underground banks illegally operating inside China. These agents offer less expensive procedures to transfer dirty money abroad because underground bankers usually refer to the lowest price to determine the exchange rate to apply (Yang, 2002). Hence, notwithstanding the regulations restricting the amount of Chinese currency that can be converted into foreign currency and transferred abroad, many individuals use money laundering techniques to elude these limitations (US Department of State, 2015). The final outflows commonly support crime, corruption, and tax evasion, and consequently take capital away from the real economy (Gascoigne, 2014). The main methods used in order to elude Chinese currency controls are money transfers through Hong Kong money changers; transferring checks issued by underground bankers across the border to Hong Kong; operations through banks (cash transactions, account payments..) with fake ID cards; cash smuggling; trade-based money laundering or laundering through the underground banking system (FATF, 2007; Lee and Luo, 2015).

In the last years, Chinese authorities have also observed an increasing trend of criminal activities in cash-intensive sectors (real estate, securities, insurance, legal profession) and have found out that most of money deriving from these activities are moved abroad (FATF, 2007). As I explained in the previous chapter, the wealthiest Chinese individuals have invested their money in foreign assets since they believed that they could get higher returns. Fletcher (2014) reported that more than US \$50 billion have been transferred outside China in 20 years, giving rise to the phenomenon of *hot money outflows*. Bank of China and China Citic Bank were blamed to facilitate money outflows by providing underground banking services to their customers and they violated currency control laws.

### Illicit Financial Outflows from China (Mainland): 2002-2011



Source: Fletcher, 2014.

A Reuters analysis has found out that a “growing numbers of Chinese are using the country's state-backed bankcards to illegally spirit billions of dollars abroad” through Macau. The government-backed payment card system (i.e. China UnionPay) is used to make fake purchases allowing people to circumvent the severe currency-export control, i.e. *cash-back transactions*. UnionPay was set up to open up China’s capital account, but it has revealed as a major tool for channeling illicit money out of the country by rich Chinese as well as by corrupt individuals; therefore, foreign banks belonging to the UnionPay network were required to close accounts of merchants involved in illicit transactions (Pomfret, 2014).

Criminal activities in China mostly involve corruption, narcotics and human trafficking, smuggling, economic crimes, intellectual property theft, counterfeit goods, crimes against property, tax evasion. Money laundering often involves state-owned firms that clean dirty money through various methods, which are the same described in chapter three (cash smuggling, false trading, invoice manipulation, purchase of valuable assets, gambling). New methods are however wide spreading: among them, illegal fundraising activity, cross-border telecommunications fraud, and corruption in the banking, securities and transportation sectors are the most common (US Department of State, 2015).

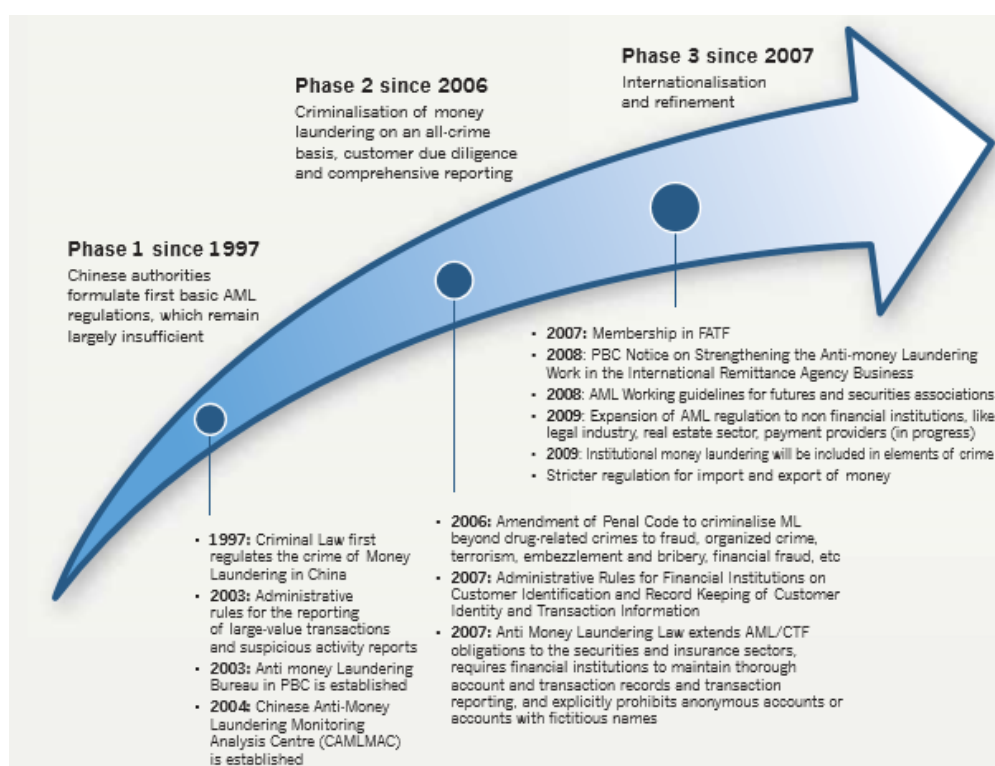
Evidence shows that criminal activities originate in the most developed areas (especially coastal ones) and spread to internal poorer zones (US Department of State, 2015). In 2007, more than half of financial crimes took place in coastal areas and those in Guangdong corresponded to one third of all detected cases; other places commonly subject to abuse are Shandong, Zhejiang, Liaoning, Yunnan and Shanghai. When investigating on money laundering cases, the People’s Bank of China (i.e. the Chinese Central Bank) pays particular

attention on excess cash, recurrent withdrawals or receipt of high amounts of cash, efforts to get foreign exchange, and frequent high value forex remittances (Passas, Hsu and Li, 2012).

## II. AML/CFT REGULATION IN CHINA

Since the People’s Republic of China is one of the major player in the worldwide economy, it is essential that it takes part in activities aimed at ensuring credible investment and trade frameworks and at guaranteeing the effectiveness of international anti-money laundering regulations; however it has been historically averse to outside influences (Heilmann and Schulte-Kulmann, 2011).

### Development of AML regulatory regime in China



Source: Asian Banker White Paper, 2009.

As shown in the picture published in the Asian Banker White Paper (2009), the country started implementing a national AML/CFT regime at the end of the 1990s. The first step was the introduction in the Criminal Code of specific articles concerning money laundering, according to which “whoever, while clearly knowing that the funds are proceeds illegally

obtained from drug-related crimes or from crimes committed by organizations in the nature of criminal syndicate, crimes of terrorism or crimes of smuggling and gains derived there from, commits any of the following acts in order to cover up or conceal the source or nature of the funds shall, in addition to being confiscated of the said proceeds and gains, be sentenced to fixed-term imprisonment of not more than 5 years or criminal detention and shall also, or shall only, be fined not less than 5 percent but not more than 20 percent of the amount of money laundered” (Criminal Law, 1997).

In 1998, the FATF put effort in trying to include China in the worldwide anti-money laundering framework, but China has been reluctant to join it until the most powerful economies started complying with FATF recommendations; since that moment, China experienced a radical conversion from a reluctant approach to an active involvement in the FATF. Despite its scarce experience in the field, in the last few years China has taken many actions aimed at combating money laundering thanks to the job of the National People’s Congress of China and the central government (Heilmann and Schulte-Kulkmann, 2011).

After 11 September 2001, the National People's Congress of China included terrorism as a money laundering-related crime and the country ratified the main international counter-terrorist treaties (EAG, 2010): these developments were primarily due to the fact that in that year the country joined the World Trade Organization (WTO) and started liberalizing its financial market. Nonetheless, China did not accurately regulate the tracing of large value transactions and money laundering became a huge problem, also due to the fact that developing countries are particularly attractive for launderers (Heilmann and Schulte-Kulkmann, 2011). For these reasons, the following year some representatives of the National People’s Congress proposed the drafting of anti-money laundering laws and the Budget Committee was given this task. Anyway, it was not an easy process because the country started introducing AML laws much later than many other jurisdictions and had to take into account all the previously enacted international laws.

Efforts for financial crime prevention were strengthen in 2004, when the country joined the Eurasian Group on Combating Money Laundering and Financing of Terrorism and later hosted some of the EAG Plenary meetings. In 2006, the Eurasian Group evaluated China’s AML and CFT framework based on the documents provided by Chinese authorities and the FATF found out that the People’s Bank of China (PBOC) had already detected 600 violations during the previous year: hence, by November 2006, more than 7,000 people were employed in AML division of the PBOC (FATF, 2007). One year later, China became a FATF member:

the country revised its anti-money laundering regulations and finally adopted the Anti-Money Laundering Law initiated by the Budget Committee. It includes more than 70 types of individual crimes and consists of seven chapters:

- i) General Provisions;
- ii) AML supervision and administration. These activities are carried out by the Administrative Department of Anti-Money Laundering of the State Council. The Chinese Financial Intelligence Unit is the AML information center that analyzes suspicious and large value transactions reports; the FIU is part of the People's Bank of China and it is therefore considered as the national supervisor (Ping, 2007). The Financial Intelligence Unit functions were allocated between two units: the Anti-Money Laundering Bureau (AMLB), which organizes and initiates investigations on Suspicious Transactions, and the China Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC) that carries out activities such as data collection and analysis through the Bank of China's branches. It is also the point of interaction with foreign Financial Intelligence Units (EAG, 2010).
- iii) AML obligations of financial institutions: they must establish identification and document preservation systems as well as large-value transaction reporting system.
- iv) Banks must report to the FIU any cash deposit or withdrawal exceeding RMB 200,000 or foreign-currency withdrawals of over \$10,000 in a single day, money transfers beyond RMB 2 million between companies or between an individual and a company above RMB 500,000. Monthly reports about suspicious activities are also required (Asian Banker White Paper, 2009).
- v) AML investigation, which is carried out by the Administrative Department of Anti-Money Laundering of the State Council; this body can take decisions about freezing actions.
- vi) International cooperation with foreign government and international organizations, which is based on Article 27. The rule however does not appoint which body should take care of judicial assistance nor provides mechanisms for confiscated assets sharing.
- vii) Legal liabilities. Financial institutions not complying with AML obligations are first suggested to adopt those provisions and then (if they do not comply within a certain time period), they are given disciplinary sanctions (Ping, 2007).

According to Ping (2007), the Law has many advantages: it imposes AML obligations also to non-financial institutions; it tries to protect individual and legal persons' rights; it incorporates

FATF Recommendation and imposes the supervision of funds likely to be involved in terrorism activities. However, the author outlined some drawbacks as well: the law does not regulate criminal suppression (for instance, confiscated asset sharing) and does not completely fill some gaps with international provisions. On the contrary, the main pitfall of this ruling is that an independent AML administrative department (supervising both financial and non-financial institutions) was not appointed; they rather engaged the People's Bank of China as the national body overseeing AML/CFT activities, including the monitoring of suspicious transactions and the implementation of international criteria.

On 23 November 2010, the Chinese Ministry of Public Security said that, since 2002, 500 underground banks had closed thanks to money laundering deterrence and detection (Xinhua, 2010). Nowadays, the PCAC (Payment & Clearing Association of China) and other industry associations support the People's Bank of China Anti-Money Laundering Office systems in the enactment of anti-money laundering guidelines (Wang and Ou, 2015).

China still lacks regulation for non-financial businesses and professions. The country has some confiscation laws but they are not frequently enforced. The US and China have arranged the Agreement on Mutual Legal Assistance in Criminal Matters but American authorities have been complaining about the scarce cooperation of the Chinese counterparties. The US suggested that "China should also cooperate with international law enforcement to investigate how indigenous Chinese underground financial systems and trade-based value transfer are used to circumvent capital restrictions for illicit outbound transfers and capital flight, and to receive inbound remittances and criminal proceeds for Chinese organized crime" (US Department of State, 2015).

As shown by the table, data referred to 2009 shows the divergence between China and other two countries' (UK and Australia) Anti-Money Laundering regime. Except for Customer Due Diligence, China demonstrated to be still very far from reaching the level of other countries' regulation and even lacked laws about a couple of matters.



## Assessment of China's regulatory AML regime

Customer Due Diligence	● ● ●	● ● ●	● ● ●
Disclosure protection safe heavens	● ● ●	● ● ●	○
Sanctioning of non-compliance	● ● ●	●	●
Criminalisation of terrorist funding	● ● ●	● ● ●	●
Criminalisation of self-laundering	● ● ●	● ● ●	○
Terrorist financing confiscation & seizure	● ● ●	● ● ●	● ●
Quality of FIU	● ● ●	● ●	● ●
Foreign PEP	● ● ●	● ● ●	●
Correspondent banking relationship with shell banks	● ●	● ●	●
	United Kingdom	Australia	China
	● ● ● International Standard	● ● Reasonable	● Weak ○ Nascent

Source: Asian Banker White Paper, 2009.

Nowadays, China's anti-money laundering and anti-terrorism financing regulatory framework consists of:

- i) Laws: the Criminal Law; Anti-money Laundering Law, Decisions of the National People's Congress on Strengthening Antiterrorism Work and Interpretations of the Supreme People's Court on Applicable Laws for Cases of Money Laundering and Other Criminal Cases;
- ii) Regulations: Anti-Money Laundering Regulations for Financial Institutions; Administrative Measures for Financial Institutions on the Reporting of Large-value or Suspicious Transactions; Administrative Measures for Financial Institutions on the Reporting of Transactions Suspicious of Terrorist Financing; Administrative Measures for Financial Institutions on Customer Identification and Preservation of Records on Customer Identification Information and Transactions; Administrative Measures for the Freezing of Assets Suspicious of Terrorist Activities;
- iii) Normative and policy documents: Administrative Measures for Payment Institutions on Anti-money Laundering and Antiterrorism Financing Issues; Measures for Financial Institutions on Anti-money Laundering Supervision and Administration (Trial) and other supporting systems (China, Sixth Meeting).

As I said above, the main supervisory body is the Anti-Money Laundering Bureau of the People's Bank of China, which collaborates with the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and China Securities Regulatory Commission (CSRC). Furthermore, the Ministry of Public Security has an AML Division and an Anti-Terrorism Bureau, which ensure the law enforcement (Asian Banker White Paper, 2009). Nevertheless, law compliance still poses some challenges. First of all, the great number of underground banks makes it very difficult to set up an effective AML/CFT framework; secondly, such mechanisms as suspicious transaction reporting and internal controls are still not very effective in many commercial banks, especially those located in rural areas, and financial institutions are not required to set up an audit unit examining compliance nor to provide employees training about this subject. In addition, there is a general lack of public information, and, since China presents significant differences among regions, each area is subject to specific money laundering activities and hence requires distinct provisions. Last but not least, China is well known for the great number of fake ID documents. This issue is exacerbated by the fact that many people in China have the same name and, given that there is not a direct correspondence between Chinese and Latin characters, Chinese names can be translated in many different ways, therefore making it easier to conceal real identities (Asian Banker White Paper, 2009).

### III. MONEY TRANSACTIONS BETWEEN ITALY AND CHINA THROUGH MONEY TRANSFERS

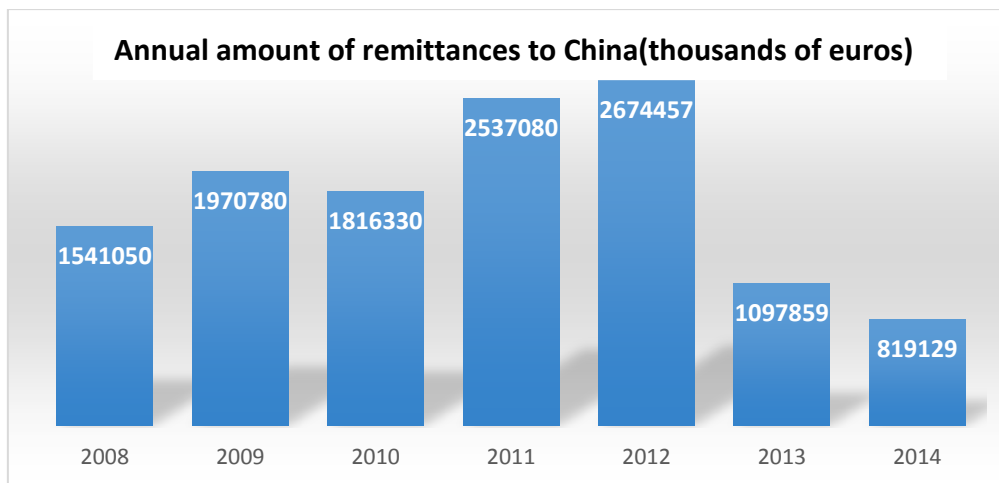
Starting from 2005, the Bank of Italy carries out controls on cross-border transactions not passing through bank current accounts but rather through licensed intermediaries. Data on remittances published by Bank of Italy highlighted that, among all the ethnic communities living in Italy, the Chinese are those sending the highest amount of money to their country. More than 90% of money directed to China are sent from Rome, Prato, Florence and Milan, which are the provinces where most of the Chinese population resides (Banca d'Italia).

The World Bank reported the price of sending remittances from Italy to China in 2013.

PROVIDER	PAYMENT INSTRUMENT	ACCESS POINT	SPEED	TAXES	EXCHANGE RATE MARGIN	TOTAL COST (%)	TOTAL COST (€)
SKRILL	credit/debit card	branch/ call center	3/5 days	1.40	3.82%	4,82	6.75
WESTERN UNION	cash	branch	<1 hour	12.00		08,57	12
MONEY GRAM	cash	branch	<1 hour	21.00	1.09%	16.09	22.53
POSTE ITALIANE (via Money Gram)	cash	branch	<1 hour	21.00	1.09%	16.10	22.54
SIGUE MONEY TRASNFER	cash	branch	<1 hour	10.00		07,14	10
<b>AVERAGE</b>				<b>14.40</b>	<b>1.07</b>	<b>11.36</b>	<b>15.91</b>
NOTE: Based on transfers of €140. The exchange rate of Sigue Money Transfer was not disclosed, so 0 does not mean that any margin is applied.							

Source: Adaptation from the World Bank, 2013.

While China has been for long time on the top of the received remittances ranking, money transfers from Italy have drastically shrunk since 2012: in 2011 the total amount was equal to € 2,537 million, but three years later the Chinese transferred “only” € 819 million, although the Chinese population in Italy had increased by 22.3%. The reasons behind this fact are still not clear, but it is likely that the anti-money laundering investigations by Italian authorities have led the Chinese to look for other ways to move money (Zanotti, 2015; Esposito, 2015).



Source: data from Banca d'Italia.

#### IV. OVERVIEW ON THE ITALIAN REMITTANCES MARKET

Outflows from Italy are much higher than inflows: the amount of money leaving the country through formal channels in the form of remittances has been incredibly increasing from 2005 to 2011 (+ €3.5 billions), but remittances have been dropping since the following year. The

fall seems to be in line with the fact that migrants families are less integrated than before and that more migrants are unemployed. The country recording the greatest reduction of remittances from Italy is China, while countries like Pakistan, Sri Lanka and Moldova have recorded an increase of inflows (Banca d'Italia, a).

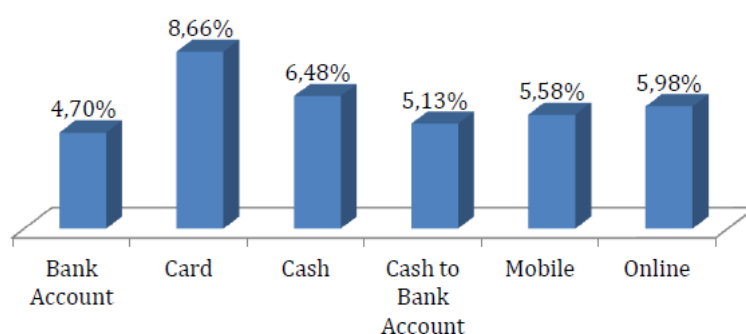
**Market structure.** The Italian money transfer industry is mostly constituted by EU-operators, while Italian ones are just a small portion. At the end of 2012, Italian Payment Institutions providing remittance services were nineteen, but just three years later they were nine; on the contrary, EU providers are almost 300.

As for market concentration, three operators own the 75% of the total market share (Camera Dei Deputati, 2016); the dominant players are Western Union and MoneyGram, but Ria Finacial and Coinstar are also common. In addition, there are some MTOs serving merely some corridors (e.g. remittances to Senegal are provided by Money Express and Choice Money; those to Rumenia by Smith & Smith, to India by ICICI Bank and Remit2India; to China by Money2money) (Giangaspero, 2009).

The Italian remittance market is continuously expanding: in 2009, 6,500 branches were open and the entrance of some online providers into the market (e.g. Skrill, World Remit, Transferwise, Xendpay) have led the “historical” operators to introduce cash-to-bank accounts and online transfer services. Poste Italiane signed an agreement with Money Gram; some banks tried to expand the *migrant banking* market (e.g. Mutual banks, Banca Popolare di Sondrio, Banca Popolare di Bergamo, Banca Sella); Western Union launched the so-called *Direct to bank* service and it has recently entered into partnerships with Intesa San Paolo and Unicredit. The former agreement allowed introducing remittance services via ATMs or internet banking, while the contract with Unicredit resulted in the setting up of the service *Unicredit - AgenziaTu* allowing customers to remit money from AgenziaTu branches via Western Union (Giangaspero, 2009 and 2014).

**Costs.** In 2014, Poste Italiane was the cheapest provider of remittances services. Remittances costs have been falling over time and the introduction of online services may contribute to further reductions of costs both for providers and for customers. On average, transfers to Asia are the most expensive, while those to Latin America are the cheapest. Cost analysis made in 2014 demonstrated that account-to-account and cash-to-account money transfers through banks are the cheapest tools for remitting money, while cards are the most expensive; online and mobile payments are not as expensive as cards, but still more costly than bank accounts. African corridor has recorded a significant cost reduction, except for Nigeria that, on the contrary, has become more costly (Frigeri, 2014).

### Average cost per product (October 2014)- computed on € 150



### Average cost for different providers (October 2014)- computed on €

	Banks	MTOs	Poste Italiane
average cost	4,55%	6,33%	3,96%

Source: elaboration by Frigeri, 2014 - based on data from [www.mandasoldiacasa.it](http://www.mandasoldiacasa.it)

**Amount of remittances.** Data on remittances published by the Bank of Italy show a constant increase of money outflows up to 2011; since then, remittances have started decreasing (Banca d'Italia, a), probably because of the effects of the economic crisis on migrants' income. However, except for China and a few other countries (Brasil, Philippines, Ecuador), the decline of money transfers was limited to 2012: we can hence confirm the counter-cyclical characteristic of remittances (Frigeri, 2014). In fact, the drop of remittances outflows in the last few years has been mainly due to a meaningful decrease of money transfers to China; since authorities were afraid that the decrease was due to the use of other (even more risky) channels to move money, they initiated some investigations which finally revealed that migrants addressed to EU-Payment Institutions that did not attentively record transactions and did not communicate their data about remittances (Camera Dei Deputati, 2016).

On 16 February 2016, the Bank of Italy published a new ruling (*Provvedimento recante disposizioni in materia di raccolta di informazioni statistiche per la bilancia dei pagamenti e la posizione patrimoniale verso l'estero*) according to which, from 1 March 2016 on, banks, Poste Italiane, Italian Electronic Money and Payment Institutions are no more subject to communication requirements about remittance services; EU-MTOs may instead communicate data on a voluntary basis (Banca d'Italia, 2016). This provision may however distort the assessment of remittances' impact on the country's economy; in fact, as I explained in the first chapter, remittances flows are recorded in the Balance of Payments of the country and

are fundamental to compute the real trade balance and the sustainable deficit. In the next years, the lack of information about remittances outflows and inflows may lead to distorted computations of the Balance of Payment.

**Money Transfer Operators regulation.** Money transfer agents' must be listed in the official list of financial activities agents because they are very vulnerable to abuses (Fondazione Icsa, 2012). According to d.lgs. 385/1993 (TUB), remittance services can be provided by Payment Institutions and Electronic Money Institutions authorized by the Bank of Italy; they must comply with rules on minimum capital, professional requirements for corporate executives as well as requirements about corporate organization and internal controls. Bank of Italy has supervisory, investigation and disciplinary powers (Camera Dei Deputati, 2016).

## V. CASE STUDY

### A. ANTI-MONEY LAUNDERING REGULATION IN ITALY

Italy enjoys a strategic location that facilitates the passing through of criminal proceeds from and to the whole Mediterranean area. Italy's biggest organized crime groups are Camorra, 'Ndrangheta, and Mafia and they constitute the main source of money laundering proceeds, which are estimated to account for 12.4% of the country's GDP. These groups largely engage in drug trafficking, tax evasion, smuggling and sale of counterfeit goods, extortion, corruption, and usury, but they also contribute to terrorism through document counterfeiting. They address to either formal or informal banking sector, but also to the offshore ones (US Department of State, 2015). In its 2014 Annual Report, the Italian Financial Intelligence Unit listed the three main types of behaviors which it normally faces whenever it investigates on suspicious transaction reports. Behaviors associated to corruption constitute a well-known phenomenon in Italy and are related to the embezzlement of public funds; the appropriative category instead includes transactions related to the illicit embezzlement of resources through telematics fraud, usury and buy-gold shops. Finally, the fiscal typology of money laundering includes transactions linked to fiscal evasion or fraud, which may be sometimes aimed at introducing dirty money in the real economy (e.g. through over invoicing practices). These money laundering practices are widely used in Italy and suspicious transactions are usually related to fake invoices, funds transfers between physical and legal persons related to each

other, and the use of personal current account to bring about commercial transactions (Banca d'Italia, 2015). Furthermore, data collected from the Finance Committee demonstrated that cash is used in the 91% of transactions in Italy. The great use of banknotes is quite risky because it allows hiding the purchase of goods or services and circumventing disclosure requirements; moreover it allows introducing in the economic system money deriving from illicit activities (Fondazione Icsa, 2012).

**European Legislation.** Italy is subject to European Regulations and Directives on the topic. The *Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime* of 1990 aimed at “facilitat[ing] international co-operation and mutual assistance in investigating crime and tracking down, seizing and confiscating the proceeds thereof [and hence] intended to assist States in attaining a similar degree of efficiency even in the absence of full legislative harmony.” (European Council, 1990). The Directive 91 /308/EEC states that “launderers could try to take advantage of the freedom of capital movement and freedom to supply financial services which the integrated financial area involves, if certain coordinating measures are not adopted at Community level”; the European Commission hence established that :states must consider money laundering as a crime; any financial institution must identify customers making transactions equal to or above €15,000; transactions records must be kept for at least five years; in case of suspicious transactions, financial institutions must refuse to transfer money and, if the transactions have been made, authorities must collaborate and hence restrict banking secrecy in order to facilitate cooperation.

After the terrorist attacks in New York, the Directive 2001/97/EC included terrorism financing as a possible destination of illicit money deriving from money laundering activities and other categories of intermediaries were subject to regulations. The Directive 91/308/EEC was finally abolished in 2005, when it was replaced by the Directive 2005/60/EC on preventing the use of the financial system for money laundering and terrorist financing. As said by its name, the directive aims at conforming to FATF standards and hence at preventing the use of the financial and non-financial sectors by launderers and terrorist financiers. By including also the non-financial sector, it addresses to lawyers, notaries, accountants, estate agents, providers of gambling services, trust and company service providers, and to all providers of goods accepting cash payments above €15,000. All these agents are required to verify the identity of both originator and beneficial owner, to report suspicious transactions and to train employees in order to make them aware of the standards they have to respect; enhanced due diligence must be applied in cases of higher money laundering and terrorism financing risk (EUR-Lex, 2016). Directive 2005/60/EC and the following 2006/70/EC were

substituted by Directive 2015/849, which requires applying Customer Due Diligence also to electronic money transactions; simplified CDD can be applied whenever an area of low risk is identified, while enhanced CDD must be applied with high risk countries.

The Payment Services Directive recognized new payment institutions to provide banking services, such as money remitters, retailers, and phone companies; depending on the license they apply for, some PSPs were also allowed to provide remittance services. The Directive hence provided a new regulatory framework which permitted non-bank bodies (including gas-stations and supermarkets) to act as money transfer agents. PSD provisions are in line with FATF recommendations as it recognizes the importance “to ensure that all persons providing remittance services are brought within the ambit of certain minimum legal and regulatory requirements. Thus, it is desirable to require the registration of the identity and whereabouts of all persons providing remittance services, including of persons which are unable to meet the full range of conditions for authorization as payment institutions. (...)For those purposes, Member States should enter such persons in the register of payment institutions while not applying all or part of the conditions for authorization. However, it is essential to make the possibility of waiver subject to strict requirements relating to the volume of payment transactions.” (Directive 2007/64/EC).

**Italian Legislation.** Money laundering was first introduced in the Italian Criminal Code with the Law No. 191 of 18 May 1978. However, it was just in 1991 that the banking system was actually involved in the prevention of money laundering with the Law No. 197, establishing urgent provisions to limit the use of cash and bearer securities and to prevent the use of the financial system for money laundering purposes. Transactions involving cash and bearer securities exceeding £20,000,000 were required to be executed only through specific financial intermediaries listed in the legislative decree and then recorded and kept in an electronic archive for at least ten years; moreover suspicious transactions had to be signaled (Dlgs. 5 luglio 1991, n. 197).

In 2013, the government issued new rules aiming to boost transparency of companies and to identify non-UE jurisdictions and it required entities to terminate business relationship with people or companies which cannot be completely identified. The following year, the Bank of Italy issued enhanced Customer Due Diligence provisions for Politically Exposed Persons and introduced the Electronic Data Base, on which financial intermediaries must register all significant transactions (US Department of State, 2015).



As for regulation on the use of cash, the threshold for cash payments was enhanced from € 999.99 to € 2,999.99 last January; traceable instruments of payment must be therefore used to move cash exceeding €3,000. The new threshold can be applied also to some currency exchange transactions made by exchange houses, which were previously allowed to handle cash transactions up to €2,499.99; on the contrary, since the Guardia di Finanza has found out some links between migration flows and financial transactions from and to Italy, money transfer businesses are still subject to the €999.99 and are therefore excluded from the new rules contained in the 2016 *Legge di Stabilità* (Camera Dei Deputati, 2016).

The regulatory framework about money laundering and money transfer includes:

- D.Lgs. 25 September 1999, n. 374: extension of provisions on laundering of capital with illicit sources and financial activities particularly susceptible to money laundering;
- D.M. 13 dicembre 2001, n. 485: agency in financial activity;
- Law No. 155, 31 July 2005: urgent measures for contrasting international terrorism;
- D.Lgs. 21 november 2007, n. 231: implementation of directive 2005/60/CE and 2006/70/CE (see above);
- Law 15 July 2009, n. 94: Dispositions on public security concerning new obligations for money transfers, if the originator is an extra-Community citizen (Palana, 2010).

**Competent authorities.** Article No. 2 of Regulation 1889/2005 set out that the competent authorities in the anti-money laundering field are: Agenzia delle Dogane, which controls the declarations of individuals carrying more than €10,000; Guardia di Finanza; the Ministry of Economics and Finance, which take decisions about disciplinary sanctions; the Financial Information Unit (FIU) of Bank of Italy, which collects information on money laundering and terrorism financing at the border (Fondazione Icsa, 2012).

Although the regulatory framework is quite complete, Italian authorities has recently found more than 400 abusive money transfer agents and they estimated that the 30% of the money transfer providers operating in Italy is illegal (Palana, 2010). Investigations on these operators have been therefore intensified. The first national Analysis on money laundering and terrorism financing risks was carried out in 2014; the Financial Security Committee reported that the money transfer activities are strictly related to the high number of immigrants remitting money to their families. The remittance service providers in Italy are subject to ML

and TF risk because they handle large amount of cash (which is often divided into low-value tranches to circumvent controls and then sent to countries with weak AML/CFT regulation), and they operate out of the regulated financial sector (most of them operate in bars, internet point centers, currency exchange offices etc); proofs of money laundering activities through money transfers are those of the Chinese community in Italy (e.g. Money2Money and Bank of China case) (Camera Dei Deputati, 2016).

**Suspicious Transaction Reporting by MTOs in Italy.** Except for some case, MTOs have been actively collaborating with authorities; just to have an idea, last year they reported 210,000 suspicious transactions executed by 30,000 individuals. STRs commonly make authorities aware of frequent transactions of amounting to the threshold allowed by the law and often executed by “risky” individuals. In the last two years, about the 10% of transactions deemed to be linked to terrorists have been concluded through MTOs; moreover, authorities found out that many people used to provide fake fiscal codes. Then, in order to ensure a better and prompter action, a specialized committee devoted to the examination of suspicious transactions was set up last year (Camera Dei Deputati, 2016). In fact, notifications made by money transfer agents generally present the same characteristics: the agents do not usually know their customers (the relationships between the agents and the customers are normally occasional rather than regular) and they are therefore able to provide information just about the frequency of transactions made or received by the same individuals and the amount of transactions (in particular, if they are lower or just equal to the cash transaction threshold). Hence, since this few information should be analyzed on an aggregate basis to understand whether transactions are related to illicit activities, the Italian Financial Unit Intelligence is developing new methods for investigating suspicious transactions carried out through money transfers (Banca d’Italia, 2015).

**AML regulation for MTOs.** Individuals transferring money abroad through money transfer agents (but also through banks and other financial entities) must pay stamp duties corresponding to the 2% of the sum, except for money sent towards EU countries and for individuals having INPS number and fiscal code (Fondazione Icsa, 2012). Law No. 94 of 15 July 2009 introduced the obligation for money transfer agents to ask for residence permit to customers willing to move money; that provision may have incentivized the use of informal channels by the irregular migrants. Recently, Italy has been discussing about the implementation of the fourth European Directive on anti-money laundering (directive EU 2015/849): new rules introduced communication obligations that will help authorities to get clearer and more detailed information in order to ensure prompt and effective actions;

furthermore, they extended regulation on online payments and reinforced the cooperation among European authorities (Camera Dei Deputati, 2016). European Financial Intelligence Units have been given the power of acquiring information by any obligated subject (none of them can refuse to provide information) and any FIU can ask for the suspension of the accomplishment of suspicious transactions (Banca d'Italia, 2016).

## B. THE CHINESE COMMUNITY IN ITALY

### 1. CHINESE ENTREPRENEURS IN ITALY

Chinese firms are typically family businesses in which both the husband and the wife bring in their economic resources and strictly respect the hierarchy. Any Chinese who is able to get the status of *laoban* (i.e. boss) has a reason of pride for him and his family thanks to his prestigious role (Campani, Carchedi and Tassinari, 1994; FIERI, 2011).

Caritas Migrantes (2011) reported that Chinese entrepreneurs, together with Moroccan, Romanian and Albanian, constituted the 56.9% of the total foreigner entrepreneurs in Italy. Researches made by Mestre CGIA in 2010 recorded an increase of Chinese entrepreneurs in Italy by 131.1% from 2002 to 2009, and the percentage continued raising notwithstanding the economic crisis made revenues decrease. Their businesses are concentrated in Lombardia, Veneto and Tuscany; as for the latter, FIERI (2011) said that the 11.5% of firms run by Chinese is located in Prato province. The organization also found out that Chinese firms are characterized by a higher female and youth participation with respect to other foreigners' firms. The table below demonstrates that the Chinese enterprises are concentrated in some industries and constitute a very high portion of the total firms owned by foreigners.

	MANUFACTURING ACTIVITIES		COMMERCE		ACCOMODATION AND RESTAURANTS		OTHER SERVICES ACTIVITIES	
1°	China	16,374	Morocco	46,052	China	5,342	China	2,761
2°	Morocco	1,533	China	19,160	Egypt	2,393	Switzerland	1,635
3°	Switzerland	1,398	Senegal	15,342	Switzerland	1,212	Albania	498

Source: data from Info Camere (2014).

In Milan, Chinese mainly set up accommodation activities, especially restaurants (Rapporto Camera di Commercio Padova, 2012), while Chinese manufacturing firms prevail in Tuscany (mainly textile, clothing and leather); these companies have subcontracting agreements with Italian firms for whom they produce components (Sacchetti, 2007). Footwear Chinese firms have been expanding in Riviera del Brenta and in Fermo (Marche) but Chinese enterprises have been spreading also in Southern Italy, especially in Rome and Naples (Ceccagno, 2004).

Chinese entrepreneurs are very tied to their homeland and they typically import products from China. The biggest Italian cities count many Chinese wholesalers who collect shoes, clothing, toys and other merchandise from China in order to gain from labor cost differentials. Some wholesalers are themselves the owners of production units in China; some others address to third firms in China that are specialized in the production of goods for Italy (Ceccagno, 2004). The high amount of imports from China to Italy is due to the low customs controls which have made Chinese wholesalers enjoy lower costs for long time; Naples custom is particularly easy to access and has allowed under-invoicing practices for many years.

## 2. MONEY LAUNDERING ACTIVITIES BY CHINESE IN ITALY

Concerns over illegal transfers of money by the Chinese living in Italy arose in 2007, when an anti-money laundering detection took place in a money transfer counter called *Sweet Point*, managed by Chinese (Petrella, 2013). The Guardia di Finanza investigations found out that money transfers to China are often used to move money having illicit origins and hence constituting the gains from the sale of illicit merchandise in the Italian market. More than four hundreds companies controlled by Chinese individuals were involved in money laundering transactions through money transfers (Fondazione Icsa, 2012).

Since the inspection ascertained the transmission of dirty money to China, more examinations were initiated. Money transfer bodies, travel agencies and other kinds of shops were attentively scrutinized and the authorities finally found out that, from October 2006 to June 2010, more than 4.5 billion euros were illegally transferred from Italy to China. The money transfer house *Money2Money* was managed by a Chinese and an Italian families (the Cai and the Bolzonaro), who played an active role in helping Chinese entrepreneurs or criminals to send laundered money to China without risking detections by the authorities (Petrella, 2013).

Money2Money had provided money transfer services for many years, but it was still small if compared to such competitors as Western Union and Money Gram. The huge increase of its business in 2006 derived from the agreement between the two families mentioned before, according to which the Cai initially acquired the 10% of the business; the Bolzonaro would have later dispose their stake in favor of the Cai in case the Chinese managed to achieve remittances flows equal to ten millions euros. Since the maximum threshold for money export is €1,999.99, the Chinese divided the amounts into tranches equal to that amount to evade examinations (*smurfing*). Moreover, since the Cai had previously founded the Tian Tian business (a mobile company providing SIM cards which allowed calling from Italy to China at very low costs), they transferred money by using the ID documents of the Tian Tian users, who were obviously unaware that somebody else was using their data to move illicit money (Talia, 2015). The Guardia di Finanza found out that some individuals sent money several times during the same day but providing different addresses and different Chinese bank account numbers for the same receiver or the same bank account number for different receivers (Fondazione Icsa, 2012). Data show that those money transfers were mainly made by employees (56% of times), self-employed professionals (32%), entrepreneurs (7%) and unemployed (4%). The entrepreneurs addressing to Money2Money declared almost no income to Italian fiscal authorities but were gaining profits through the sale of counterfeit goods, the exploitation of illegal labor and prostitution. Most receivers of those flows were Chinese export companies that supplied raw-materials to Chinese firms established in Italy, which could therefore avoid paying VAT. Bank of China participated in the illegal money transfer activities as well, by allowing depositing that money in their accounts before making it available to receivers' bank accounts in China. About half of the over 4 billion euros moved passed through Bank of China; none of the employees reported suspicious transactions to competent authorities because the bank gained €750,000 from this illegal business (Talia, 2015).

Most of the money was moved from Tuscany, and in particular from Prato, where Chinese firms account for more than 10% of the added-value of the whole area. Therefore, Prato is the province that originates a large portion of remittances: in only 7 years (2005-2012), money sent to China from Prato has recorded an increase of 930%, corresponding to about half million of euros per day. These capital flights are detrimental to the local economy, which loses money rather than benefitting from partnership with Chinese firms (Rete Sviluppo, 2014).

## C. EMPIRICAL STUDY

The following tables summarize data about the official Chinese population resident in Italy on the 1 January 2013. Although there are many Chinese in Italy who are not regular migrants, it is likely that irregular immigrants do not address to formal channels for remitting money and are not thus included in Bank of Italy's statistics on remittances outflows; however, they are not even included in statistics about official population, so I will not take them into consideration for the empirical study.

<b>Total number of Chinese in Italy (1/01/2013)</b>	<b>304,768</b>
women	48.9%
men	51.1%
population over 15 yearsold	110,610

<b>workers (per sector)</b>	<b>newcontracts</b>	<b>endedcontracts</b>
agriculture	3.1%	3.3%
industry	46.1%	47.9%
tertiary	50.8%	48.8%

*Source: data from Centro Studi e Ricerche IDOS, 2014.*

Below is the table reporting the amount remittances from Italy to China for the years 2008/2014. As I am analyzing data about the Chinese population on 1 January 2013, I will base my computations on remittances outflows recorded in 2012.

<b>Remittances per year (thousands of euros)</b>	
2008	1,541,050
2009	1,970,780
2010	1,816,330
2011	2,537,080
2012	2,674,457
2013	1,097,859
2014	819,129

*Source: Banca d'Italia.*

Total remittances in 2012 amounted to € 2,674,457 thousands. Officially, on 1 January 2013 there were 304,768 individuals from China living in Italy; therefore, by dividing the amount of remittances by the total Chinese population, I get that each Chinese individual sent € 8,686.79 to China in 2012. However, I will assume that people under 15 years old migrated with their families and therefore do not remit money home; in addition, I will assume that they go to school rather than to work (and hence are not taken into consideration when computing the average income for Chinese). I will also assume that only Chinese workers are able to remit money because the unemployed do not get any wage: since the employment rate for the Chinese is about 69.9%, I can divide the total amount of remittances by the 213,034 working individuals; the outcome suggests that the average remittance per head in 2012 was € 12,554.12.

<b>Total average wage</b>	<b>€ 959</b>
female average wage	€ 904
male average wage	€ 1,005
<b>employed</b>	<b>69.9% (42% women)</b>
looking for a job	2.9%
inactive	27.2%
<b>unemployment rate</b>	<b>4%</b>

*Source: data from Centro Studi e Ricerche IDOS, 2014.*

The data reported in the table above inform that, in 2012, the Chinese working in our country earned € 959 per month on average; as usually, the average for men was higher than that for women (€ 1,005 and € 904 respectively). I can hence easily figure out that the average annual wage for the Chinese employed in Italy was about € 11,508. With the available numbers, it is possible to determine the portion of wage that was moved to China in 2012: by subtracting the amount of remittances per head from the annual wage, I get a negative result, meaning that each Chinese transferred to China € 1,046.12 more than the amount earned. Moreover, since the data about remittances are computed only on transfers accomplished through formal channels, I can reasonably assume that the amount of money transfers is much higher than reported by statistics.

So, how is it possible for the Chinese to transfer such a high amount of money?

Adoc (2012) estimated the impact of daily expenses on a family living in Italy, composed by two adults who have one child and are both employees. The association computed an average monthly income per employee equal to € 1,410 (hence € 2,820 per family) and found that

each family spends about € 39.4 per day: it therefore realized that the life cost accounted for the 83.8% of an individual's earning. As it is likely that the Chinese have different preferences and their expenses may not exactly correspond to those of an Italian family, I looked at a research about expenses weights for an average Chinese individual:

- Tobacco, liquor, other 3%
- Food 32%
- Residence 17%
- Recreation/education/culture 14%
- Transportation/communication 10%
- Healthcare 10%
- Clothing 8%
- Household facilities/articles/services 6%

Confcommercio (2013) instead estimated weights for a medium Italian individual:

- Food 22.9%
- Residence: 30.2%
- Recreation: 7.8% (+2.8% for holidays)
- Transportation/communication 16.6%
- Healthcare 12.7%
- Clothing 7%

It seems like the preferences do not differ much: I may therefore assume that the Chinese living in Italy spend as much as the Italians to face daily expenses; anyway, whatever the consumption pattern of the Chinese is, it is clear that it is not possible for the Chinese to transfer money beyond their means. Then, I will try to investigate what is behind these huge money transfers.

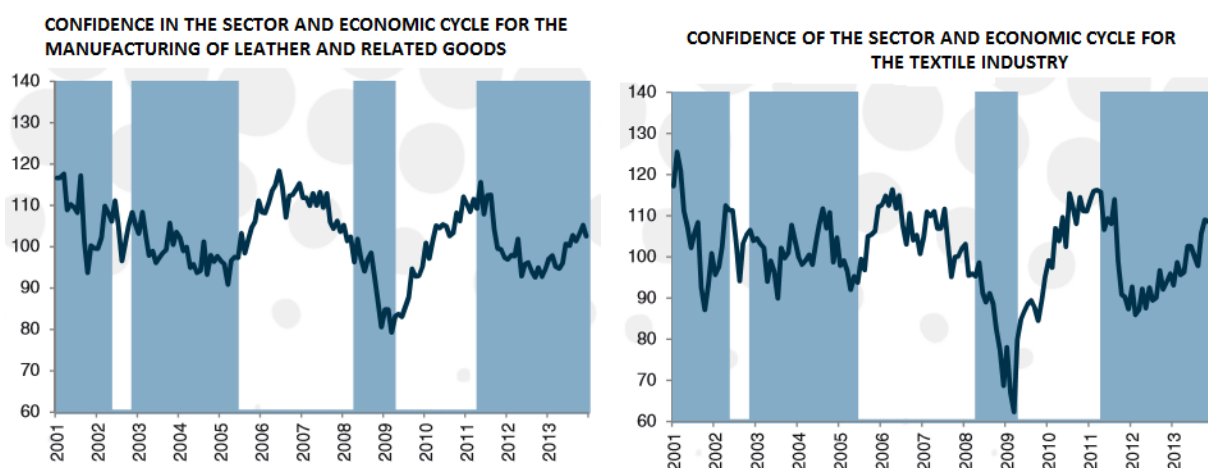
<b>Import from China (mln of euros)</b>	
2008	23,607
2009	19,334
2010	28,789
2011	29,574
2012	25,006
2013	23,071
2014	25,075

*Source: data from Istat, elaborated by Santonico (2016).*



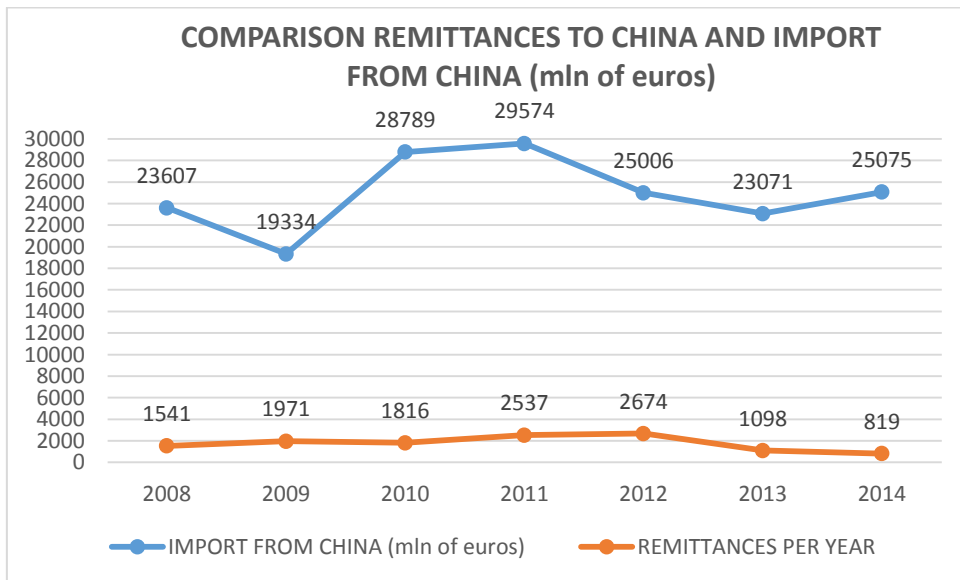
First of all, by looking at data about the Chinese population in Italy, I noticed that males and females are almost equally present: this may be a clear signal that men use to move to Italy with their wives and therefore they do not generally need to send money to their families. This hypothesis is confirmed by the fact that Chinese firms are mostly family businesses (see the paragraph “Chinese entrepreneurs in Italy”) and by interviews to Chinese who revealed that most of them do not send money home because their whole family moved to Italy (Fondazione Icsa, 2012). So, what is the final destination of remittances? Investigations on suspicious transactions revealed that some Italian but prevalently Chinese entrepreneurs (especially those operating in the textile sector who make cash payments to Chinese firms in China) were the originators of most money transfer transactions. Some studies in fact demonstrate that remittances of Chinese are frequently devoted to pay Chinese suppliers: estimations say that, in 2007, the 40% of total remittances was devoted to imports rather than to family supporting (Fondazione Icsa, 2012). Indeed, Italian imports from China are much higher than exports to China: textile, clothing and products for manufacturing firms are the main categories of imports (InfoMercatiEsteri), which I found to exactly correspond to the main industries operating in areas recording the greatest amount of remittances outflows: this may therefore be another sign confirming the fact that remittances are devoted to import payments.

By comparing the amount of imports from China with the revenues of a few sectors in which most of Chinese firms in Italy operate, I found a link between the two: this may be interpreted as a confirmation that a good trend in those industries was associated to higher production and hence, generally, to more imports.



Source: Istat, 2014.

After this assessment, I also compared imports from China with the amount of remittances from 2008 to 2014 but I did not find any link between them, meaning that just in those years in which the economic cycle was favorable for the analyzed sectors, the Chinese remitted less money to their origin country. If I assume that the increase in imports is a signal of a good economic trend (which is in fact confirmed by increasing revenues), I may in turn assume that in those years Chinese entrepreneurs resident in Italy paid part of those imports by remitting money through informal channels; on the contrary, in the years in which revenues were lower and imports decreased as well, the Chinese devoted more time to illicit activities in order to get extra money, which they finally remitted and hence generated an increase in money outflows. They may also have concealed part of their imports to avoid paying taxes on them, which would have exacerbated the decrease in revenues due to the crisis.



Consequently, I may reasonably conclude that it is likely that some Chinese have been involved in under and over-invoicing practices in order to import merchandise and raw materials from China while circumventing the payment of taxes and duties. Likewise, these practices have definitely allowed many Chinese entrepreneurs to declare lower profits.

In order to confirm these results, I will now compare remittances to China with those to Pakistan and to Morocco, whose communities are both numerous in Italy; similarly to the Chinese case, immigrants from Pakistan and Morocco have set up many enterprises in Italy but these two countries export much less to Italy with respect to China.

## 1. PAKISTANI COMMUNITY IN ITALY

Pakistani people started coming to Europe with the beginning of the Gulf war in the 90s. Migrants are mainly young men, who try to get a job before their families move as well. On 1 January 2014, the Pakistani living in Italy were more than 100 thousands and constituted the 13<sup>th</sup> most numerous foreign community in the country. The 76% of them lives in Northern Italy, mostly in Lombardia and Emilia-Romagna (Ministero del Lavoro e delle Politiche Sociali, 2014).

<b>Total number of Pakistani in Italy (1/01/2014)</b>	<b>106,485</b>
women	32%
men	68%
population under 18 years old	31,523
of which students	18,128
population under 30 years old	52%
of which do not go to school nor to work	7,521
unemployment rate	20,1%
<b>employment rate</b>	<b>43,30%</b>
of which employees	33,904
of which self-employed	9,523

*Source: data from Centro Studi e Ricerche IDOS, 2014b.*

The largest share of Pakistani entrepreneurs work in the manufacturing, accommodation and commerce industry. As reported by Infocamere (2014), they are among the foreign communities owning the highest number of firms: in 2014, they covered the tenth position for the manufacturing sector (397 firms) and the sixth position both for the commerce and the accommodation and restoration sectors (respectively 5,653 and 633 firms).

<b>Remittances per year (thousands of euros)</b>	
2008	63,980
2009	75,610
2010	82,210
2011	94,260
2012	81,322
2013	105,992
2014	125,495

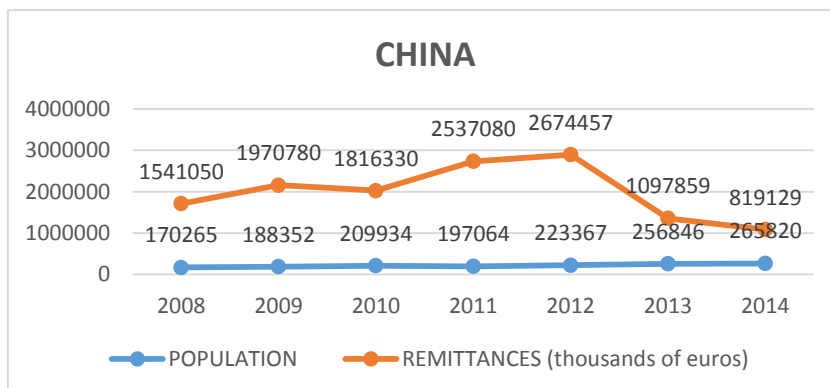
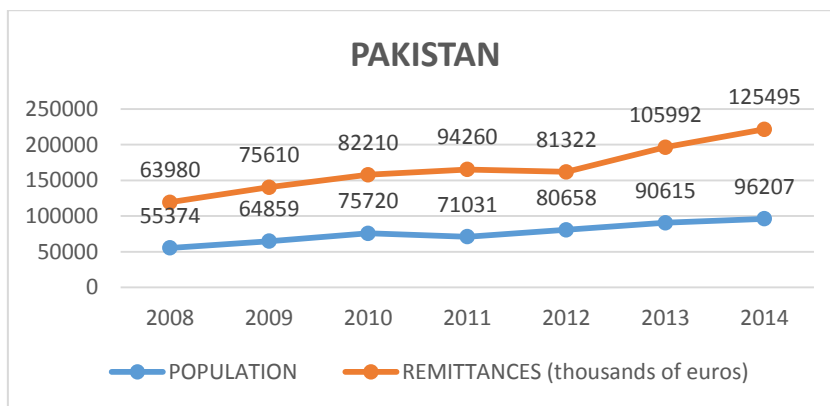
*Source: Banca d'Italia.*

Total remittances in 2013 amounted to € 105,992 thousands; by dividing them by the official Pakistani population in Italy, I get that each individual sent € 995.37 to Pakistan in 2013. Since the available data say that the 43.3% of Pakistani individuals living in Italy was employed in 2013, it means that about 46,108 people were able to remit money home. Therefore, I can say that, in 2013, the average remittance to Pakistan was about € 2,298.78 per head. The paper published by Ministero del Lavoro e delle Politiche Sociali (2014) reports that the Pakistani earnings are higher than those of extra-communitarian individuals working in Italy: the 60% earns more than €1,000 per month, and the 34,3% of them earns up to €1,250. Since there is no more specific information, I will assume that the 40% earns € 900 per month, the 34.3% earns € 1,125 and that the 25.7% earns € 1,300; with these assumptions, I get that the average wage for Pakistani was € 12,959.70 in 2013. By subtracting the amount of remittances per head in 2013 from the annual wage earned during the same year, I get that, on average, Pakistani remitters remained with € 10,660.92.

Conversely from the China's case, I got a positive result, meaning that Pakistani did not remitted more money than what they disposed: this is a clear signal that these individuals are much less likely to conduct illicit activities from which they earn extra money; in addition, there are some other differences between the Chinese and the Pakistani case:

- The table above shows that men immigrants are much more than women, meaning that Pakistani men are used to move abroad and leave the family in their native country. This fact leads to think that remittances to Pakistan are likely to be devoted to family supporting.
- Imports from Pakistan are very low: in 2013 the total amount of import corresponded to € 476.64 million, in 2014 to € 557.25 million and in 2015 to € 578.37 million (InfoMercatiEsteri). Devoting money transfers to import payments is probably not frequent and would anyway have a lower impact.

Furthermore, I took data on the Pakistani and Chinese population regularly residing in Italy from 2008 to 2014 and I compared them with the remittance outflows to those countries during the same years. The two graphs below demonstrate that remittances to Pakistan followed the population trend (whenever immigrants from Pakistan increased, remittances to their origin country increased as well), while remittances to China moved opposite to migration flows, except for 2011.



In order to get a uniform comparison between the two cases, I computed the ratio of remittances over regular population for the two countries.

<b>Remittances/population</b>	<i>China</i>	<i>Pakistan</i>
2008	9,85	1,16
2009	11,57	1,17
2010	9,64	1,09
2011	12,09	1,33
2012	13,57	1,01
2013	4,92	1,17
2014	3,19	1,30

*Source: data on population by Comuni-Italiani.it, computed on 31 December.*

The table clarifies the huge differences between the remittance flows to Pakistan and to China: while for the former country the ratio of remittances over population has been quite steady over time, the ratio for China has not been stable at all. Moreover, I also computed the

correlation ratio between remittances and population of the two countries for the time period considered: China's data present a negative correlation (-0,535), while Pakistan's data have a positive relationship (0,901).

By referring to those outcomes, I can make the following considerations:

- As I said above, Ministero del Lavoro e delle Politiche Sociali (2014) reported that, on average, Pakistani employees earn more than extra EU individuals in Italy; by comparing the data about the Chinese and the Pakistani's incomes, I found that Pakistani's wages are generally higher than those of the Chinese. Although the unemployment rate for the Pakistan is much higher than for the Chinese, how is it possible to that the Chinese can afford such a high amount of remittances with respect to the Pakistani?
- The graphs above displaying the economic cycle for some industries show that the economic crisis hit harder in 2009 and 2012, which are exactly the two years in which the ratios between the remittances to China and the resident Chinese population in Italy are highest and also higher than the preceding years (i.e. 2008 and 2011). Conversely, the ratio for Pakistani was the same in 2008 and 2009, and in 2012 it was lower than the preceding year.

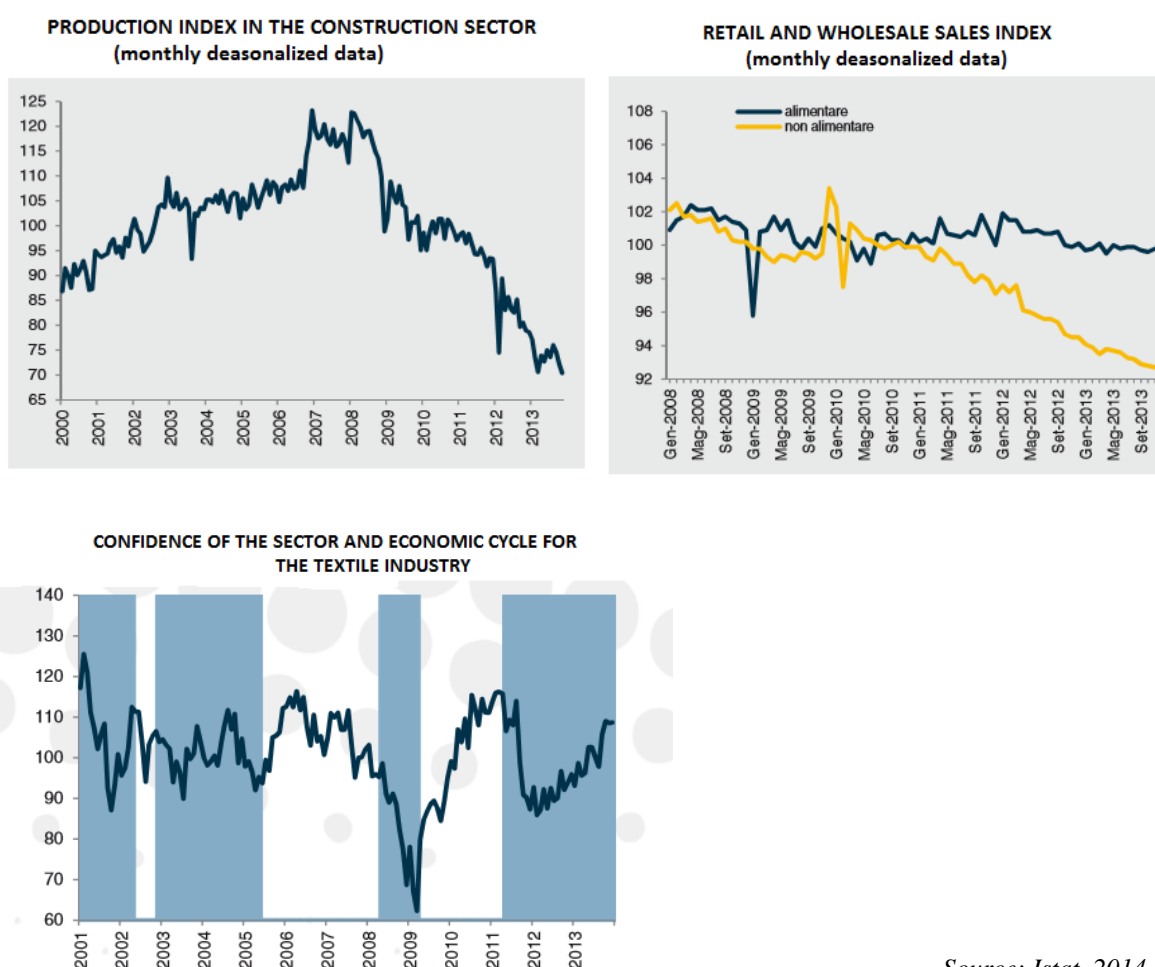
Before making final considerations, I will add the Morocco case.

## 2. MOROCCAN COMMUNITY IN ITALY

<b>Total number of Moroccans in Italy (1/01/2014)</b>	<b>454,773</b>
women	44%
men	56%
population under 18 years old	158,764
of which students	101,167
population under 30 years old	46.7%
of which do not go to school nor to work	28,553
unemployment rate	27%
<b>employment rate</b>	<b>44.1%</b>
of which employees	
of which self-employed	61,180

*Source: data from Ministero del Lavoro e delle Politiche Sociali, 2014b.*

In 2013, most migrants from Morocco were concentrated in Lombardia, followed by Emilia Romagna, Piemonte and Veneto. At the end of that year, the Moroccans were at the top of the ranking on the foreign communities with the highest number of individual enterprises. Many Moroccans set up enterprises in Lombardia (13.7%) and Piemonte (11.8%); Campania also counts many Moroccan firms (9.7%), although a very small portion of the Moroccan migrants live there (3.5%). Most enterprises are included in the following industries: wholesale and retail commerce; construction; rental, travel and enterprise support; manufacturing (Ministero del Lavoro e delle Politiche Sociali, 2014 b).



Source: Istat, 2014.

The above graphs show the trend of the three sectors in which most Moroccans are employed or self-employed; all of them were hardly hit by the crisis and, by looking at data on remittances from Italy to Morocco, I noticed that changes of the amount of money transfers correspond to changes in the economic cycle. Although the amount of remittances has not changed much over time, it has decreased in the last years.

<b>Remittances per year (thousands of euros)</b>	
2008	333,030
2009	279,070
2010	283,540
2011	299,900
2012	242,509
2013	240,940
2014	249,960

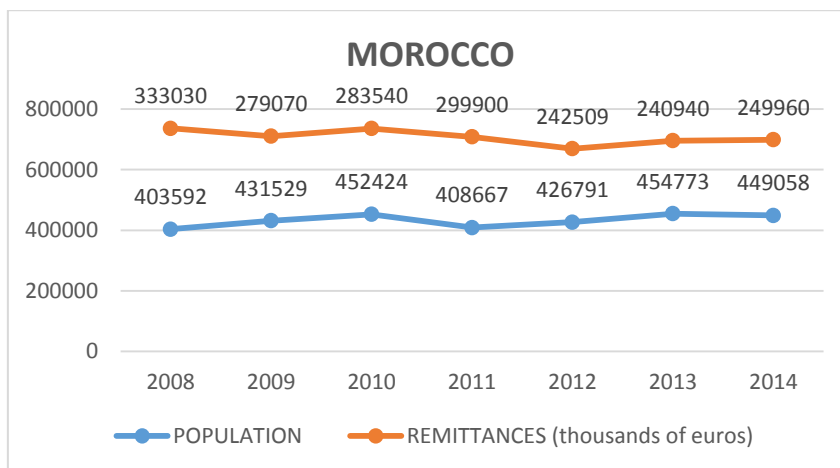
*Source: data on remittances from Banca d'Italia, elaborated by Papavero (2015).*

Total remittances in 2013 amounted to € 204,940 thousands; by dividing them by the official Moroccan population in Italy, I get that each individual sent € 529.80 to Morocco in 2013. Since the available data say that the 44.1% of Moroccan individuals living in Italy was employed in 2013, it means that about 200,555 people were able to remit money home. Therefore, I can say that, in 2013, the average remittance to Morocco was about € 1,021.86 per head. The paper published by Ministero del Lavoro e delle Politiche Sociali (2014b) reports that, as well as the Pakistani, Moroccan earnings are higher than those of extra-communitarian individuals working in Italy. More than half of them earns more than € 1,000 per month and, since there is no more specific information, I will assume that the average income per month is just € 1,000. By subtracting the amount of remittances per head in 2013 from the annual wage earned during the same year, I get that, on average, Moroccan remitters remained with € 10,978.14. Likewise the Pakistani and conversely from the Chinese, the Moroccan did not remitted more money than what they disposed. Moreover:

- The table above shows that men immigrants are more than women but the percentages do not differ much; this may mean that most Moroccan use to move abroad with their families but someone migrates alone;
- Imports from Morocco are quite low with respect to those from China: in 2013 the total amount of import corresponded to € 656.86 million, in 2014 to € 705 million and in 2015 to € 797 million (InfoMercatiEsteri; SACE).

By computing the ratios between the Moroccan population regularly residing in Italy and the remittance outflows to Morocco from 2008 to 2014, I noticed that after the beginning of the economic crisis, remittances have been decreasing and, conversely from China, lowered both in 2009 and 2012, when the crisis hit hard.





Source: data on population by Comuni-Italiani.it, computed on 31 December.

Remittances/population	China	Pakistan	Morocco
2008	9,05	1,16	0,83
2009	11,57	1,17	0,65
2010	9,64	1,09	0,63
2011	12,09	1,33	0,73
2012	13,57	1,01	0,57
2013	4,92	1,17	0,53
2014	3,19	1,30	0,56

Once again, the table demonstrates that China presents some differences. Summing up, the results obtained from the comparison among China, Pakistan and Morocco have highlighted that the Chinese living in Italy send huge amounts of remittances per head, which are even higher than their average annual wage, and the “curious thing” is that money transfers have increased just when the regular Chinese population in Italy has decreased. This trend is completely opposite to the other two cases: remittances to Pakistan and Morocco are much lower and the average amount per head does not exceed the average annual wage of Pakistani and Moroccans workers, even if these two communities have declared higher incomes than the Chinese in the last years.

Imports from China are huge with respect to those from Pakistan and Morocco, and the highest amounts of imports have been recorded in the textile, leather and clothing sector. Given that these three segments exactly correspond to the industries in which most of Chinese

firms established in Italy operates, this fact may suggest that Chinese entrepreneurs continue addressing to suppliers working in their origin country and that the two parties conclude commercial transactions through money transfer agents in order to conceal these relations and avoid paying taxes and duties on imports. The hypothesis may be confirmed by the fact that most remittances outflows originated from areas and cities recording the highest number of Chinese enterprises.

The most anomalous thing is that imports has changed proportionately to the economic cycle of those industries, but not to remittances. As I previously said, I may link this opposite trend to the fact that Chinese tried to get extra profits by conducting more illicit activities when the crisis hit harder and revenues were therefore lower. On the contrary, although remittances tend to move counter-cyclically, Pakistani and Moroccans lowered money transfers to their homelands in the years in which they suffered most from the economic crisis.

Finally, one more confirmation of the fact that remittances to China are not usually devoted to family supporting is that the percentages of Chinese men and women living in Italy are almost equal, suggesting that families migrate together. On the contrary, those percentages differ much more for the Pakistani and the Moroccan, whose men migrants are used to migrate alone in search for a job, and send part of their income to their wives in order to provide them with economic support.

In conclusion, it is quite evident that there is something more than family supporting behind remittances to China and it is very likely that at least part of the money remitted comes from illicit activities, which make the Chinese earn extra money. As confirmed by Guardia di Finanza investigations, money transfers are mainly related to commercial transactions with firms operating in China, which supply components to Chinese entrepreneurs operating in Italy; in addition, Bank of China's branch in Milan reported that the chief destinations of the Chinese remittances are cities located in the South-East of China, which is a wealthy area and enjoy strategic positions thanks to the short distance from Hong Kong and Shanghai. The South-Eastern area has rapidly grown in the last decades and has developed an industrial district in which firms manufacture goods to be exported to Italy. Fake invoices and the sale of counterfeited goods are probably the most common practices and they may help explaining why most of times the remittances receivers are firms established in China and supplying merchandise to those in Italy. However, the huge amount of remittances does not often raise money laundering concerns since Chinese remitters tend to use fake Identity Documents and transfer money in tranches not exceeding the cash threshold imposed by the government.

# CONCLUSION

This thesis addresses three main topics highly connected to each other indeed broadly studied - i.e. remittances, underground banking, and money laundering. The works started with a general overview on these topics and reported the main steps in regulation changes against money laundering.

Evidence shows that remittances are definitely vital for thousands of people and even for some countries' economy, so the provision of remittance services is essential for reducing poverty (Maimbo and Ratha, 2005). As I previously explained, most individuals living in poor countries (i.e. remittance receivers) do not have access to the conventional banking system because there are no branches in their area or they do not have ID documents; on the contrary, the parallel banking system allows those people to access financial services at low cost and it has therefore widely spread in countries recording high flows of worker expatriates and having inefficient financial sectors. On the other side, since the alternative banking channel is not subject to specific and strict regulation, it has been subject to abuses by criminals since long time (Buencamino and Gorbunov, 2002). Financial crime (i.e. money laundering) is the most common kind of offense carried out through the underground banking; therefore, in order to prevent money laundering practices through informal agents, authorities should promote the use of conventional banking systems to accomplish money transfers.

Indeed, summing up what I wrote in the previous chapters, traditional banks are forced to implement stricter controls on customers' identification and to record all the transactions, whose documentation is then preserved for some years. These rulings act as a deterrent for launderers, so, if banks played a greater role as remittance service providers, the negative effects of criminal activities on the real and financial economy would be much more restricted.

In order to encourage the use of formal channels, it may be useful to compute the threshold that makes migrants indifferent between using the formal or informal channel: the lower the threshold, the more likely is the use of formal channels:

- a) Formal channel:  $\text{Remittance}^f = \text{money sent} - \text{total cost}$
- b) Informal channel:  $\text{Remittance}^{\text{inf}} = \text{money sent} - \text{total cost}$

where total cost is a function of the exchange rate, the commission applied, the distance between the sender and the receiver, and the transportation costs related to the presence of branches in the receiver's location: in case the receiver lives in a remote area where banks do not have branches, transportation costs to get to the bank may be quite relevant.

By applying the formula above, money sent *ceteris paribus*,

$$\text{Remittances}^f > \text{remittances}^{\text{inf}} \quad \longleftrightarrow \quad \text{cost}^f < \text{cost}^{\text{inf}}.$$

Costs are therefore a prime factor in influencing the use of the formal or informal system. The economics literature always suggest to increase competition in order to reduce costs, so if more and more banks and Money Transfer Companies entered the remittance market, they would be forced to reduce costs and would therefore be more competitive with respect to Alternative Remittance Providers (Maimbo and Ratha, 2005). Banks should hence continue developing the *migrant banking* business and make the service more accessible to foreign people.

Besides offering cheaper services, underground bankers are normally chosen also for cultural reasons. Hawala and Fei ch'ien are the largest underground banking networks and were indeed born in areas having strong trust and network values, which lead them to address to people who they know. As migrants do not know banks' employees, who most of time do not even speak the local language, it is hard to convince worker expatriates to address to formal bankers when transferring money abroad.

The proposition above is confirmed by the description of money transfer activities from Italy to China reported in Chapter 5, which are accomplished by a network of agents mostly constituted by Chinese individuals. Authorities willing to reduce money laundering cases should take into account that the Chinese culture gives a high value to trust, and this is why the Chinese tend to address to people belonging to their network (*guangxi*); it would hence be very helpful to employ Chinese agents in formal Money Transfer Companies, and, in general, users' compatriots. As for the Italy-China corridor, credit risk is almost null because small money transfers provide cash-to-bank services (i.e. cash payments at the counter), which are then electronically transferred to the Bank of China branch in Milan, and the receiver's bank account is credited only when the money transfer agent gets the sum of money, which is transported to Milan by vans (Pieraccini, 2010). This mechanism definitely helps eliminating the credit risk but money transportation to the Bank of China's branch may be quite costly if the originator lives far from Milan. On the contrary, official operators do not incur in transportation costs and this may be a point in their advantage. Since most of money transfers

to China are accomplished for commercial purposes (e.g. pay for imports), money is sent to industrialized zones of China where banks are likely to operate; in these cases, transportation costs related to remittances would be almost null and banks would result more convenient. Indeed, besides explaining why the Chinese address to individuals coming from their country to carry out money transfers, the Chinese culture is also responsible for the strict relationships between firms in China and those managed by Chinese but established in Italy. Each Chinese individual establishes personal relationships and creates his own network made up of friends and relatives, from which he/she will never isolate. The collectivist behavior is one of the reasons why most of the Chinese living in Italy come from the same provinces, know each other and locate close one to the other when moving abroad (Shehu, 2004). Anyway, the main problem related to outflows to China remains that money transferred for commercial purposes comes from or is devoted to illicit activities (Fondazione Icsa, 2012). In order to appear more reliable, wholesale Italian firms should therefore try to establish partnership with Chinese firms established in China and become suppliers of the Chinese companies established in Italy; hiring one or more Chinese employees may also be very helpful to take care of interaction and relationships with Chinese partners, so that the latter would reduce their risk aversion towards foreigners' firms. The partnerships and supplying relationships between Italian and Chinese firms may help reducing the cases of money laundering involving the concealment of export payments. Still, as I mentioned in Chapter 5, customs controls in Italy have not been enough severe for long time, so it may be helpful to carry out stricter controls.

After comparing the remittances flows to China with those towards Pakistan and Morocco, it is clear that the money laundering issues arising in the Italy-China corridor are exacerbated by the recent and weak Anti-Money Laundering regulation in China. Indeed, China, Pakistan and Morocco are developing countries, and may hence experience the same matters in terms of corruption and so on; however, China presents some specific features which definitely incentivize money laundering practices; among them: the benefits enjoyed by the Hong Kong Special Administrative Region and the presence of many Free Trade Zones allow firms to circumvent taxes and other requirements which would negatively influence firms' profits. Moreover, the Chinese have always tended to conceal both their identities (fake passports have been traditionally used by this population) and their money, meaning that they try avoiding disclosing their wealth; these two habits make it even more difficult to solve the problem (Shehu, 2004; Asian Banker White Paper, 2009).

The Chinese case is a great example of criminal activities accomplished through the underground banking system. In conclusion, in order to make the formal banking system

prevail on the unofficial one, more actions are definitely needed; anyway, it would be desirable that those arrangements did not consist only in strict regulation on informal agents, but rather in imitating the way of operating of underground bankers while still trying to prevent and deter criminal activities. Besides increasing collaboration among international authorities aimed at achieving a better prevention of abuses, reducing the bureaucratic burden of official providers (while still allowing customers' identification and transactions recording) would translate into more efficient and quicker services that would result more attractive for users. Proper policies should also aim at helping potential Remittance Service Providers to enter the market by exploiting new technologies as well as helping potential and actual users to have a deeper knowledge of the functioning and the services that they can enjoy. In addition, since irregular migrants do not own any ID document and they are therefore denied to access to conventional bank and Money Transfer Companies, it is certainly necessary that MT providers set up an alternative identification systems for irregular migrants.

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