



# CURBING ILLICIT FINANCIAL FLOWS IN AFGHANISTAN

Money Laundering, Terrorist Financing, and *Hawala*

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Integrity Watch Afghanistan

2015

This (Message/publication/study/report/audio or visual product/communication or information material, etc.) was made possible by the generous support of the American people through the United States Agency for International Development (USAID) under the terms of its Associate Cooperative Agreement Number 306-A-14-00001 (Afghan Civic Engagement Program) implemented by Counterpart International and its partners. The contents and opinions expressed herein are not the responsibility of Counterpart International and do not necessarily reflect the views of USAID.



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Published by Integrity Watch Afghanistan

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## ACKNOWLEDGEMENT

The author expresses his gratitude to all the interviewees who graciously devoted their time to provide information about very sensitive topics. All respondents wished to remain anonymous. The author is grateful to internal IWA reviewers Sayed Ikram Afzali, Ezatullah Adib, and Kowsar Gowhari. The researcher is also thankful to Manija Gardizi, Neeti Biyani, and Daniel Gies for their insightful comments. Finally, many thanks to Abdul Naser Rahmani for his invaluable assistance throughout the research of this report.

Mehdi Hakimi

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## ACRONYMS

|         |   |
|---------|---|
| ACBR    | Afghanistan Central Business Registry                                 |
| Af      | Afghani—Afghanistan’s currency  |
| AGO     | Attorney General’s Office   |
| AISA    | Afghanistan Investment Support Agency                                 |
| AML/CFT | Anti-money laundering and combating the financing of terrorism        |
| APGML   | Asia/Pacific Group on Money Laundering                                |
| CDD     | Customer due diligence  |
| DAB     | Da Afghanistan Bank   |
| DNFBP   | Designated non-financial businesses and professions                   |
| FATF    | Financial Action Task Force   |
| FED     | Foreign Exchange Dealer   |
| FI      | Financial institution   |
| FIU     | Financial intelligence unit   |
| FSD     | Financial Supervision Department of Da Afghanistan Bank               |
| GFI     | Global Financial Integrity  |
| HOOAC   | High Office of Oversight and Anti-Corruption                          |
| IFFs    | Illicit financial flows   |
| IMF     | International Monetary Fund   |
| MEC     | Independent Joint Anti-Corruption Monitoring and Evaluation Committee |
| ML      | Money laundering  |
| MLA     | Mutual legal assistance   |
| ML/TF   | Money laundering and terrorism financing                              |
| MOF     | Ministry of Finance   |
| MOI     | Ministry of Interior  |
| MSP     | Money service provider  |
| NDS     | National Directorate of Security                                      |
| NPO     | Nonprofit organization  |
| PEP     | Politically exposed person  |
| SIGAR   | Special Inspector General for Afghanistan Reconstruction              |
| STR     | Suspicious transaction report   |
| TF      | Terrorist/terrorism financing   |
| UN      | United Nations Organization   |
| UNCAC   | United Nations Convention Against Corruption                          |
| UNTOC   | United Nations Convention against Transnational Organized Crime       |
| UNODC   | United Nations Office on Drugs and Crime                              |
| UNSCR   | United Nations Security Council Resolution                            |

## EXECUTIVE SUMMARY

Illicit financial flows (IFFs) are illegal movements of money or capital from one location to another. This movement is classified as an illicit flow when the funds are illegally obtained, transferred, or used. IFFs involve various practices, but a key aspect is money laundering. Money laundering is the process of disguising the proceeds of crime and integrating it into the legitimate financial system. Money laundering includes illicit financial flows linked to drug trade, tax evasion, corruption, and other criminal activities.

The actual volume of IFFs and their different components are extremely hard to measure accurately. IFFs from developing countries are estimated in the trillions of U.S. dollars. These illicit financial flows going out of the country are a multiple of what money comes in from official development assistance. The impacts of IFFs are unquestionably damaging, particularly for poor countries. IFFs strip resources from developing countries that could be used to finance much-needed public services, from security and justice to basic social services such as health and education, weakening their financial systems and economic potential.

Illicit financial flows allow criminals, corrupt politicians, and warlords to send the proceeds of their crimes throughout Afghanistan and the world to purchase elaborate houses, cars, and weapons, pay salaries for militias and criminal gangs, and buy their way to immunity for their crimes. All the while, the Afghan people as a whole are robbed of the funds to pay their teachers, supply their hospitals, and have their roads fixed. In this way, IFFs wreak havoc on the nation and ordinary Afghans' lives.

Afghanistan has an especially difficult problem with illicit financial flows. According to the Ministry of Finance, of all the financial flows in Afghanistan, approximately 65 percent of the funds are illicitly earned, transferred, or used. This total includes IFFs linked to money laundering, tax evasion, corruption and bribery, and lost Customs revenues. For this reason, curbing IFFs is a major challenge and priority for Afghanistan.

To begin to curb this problem, Afghanistan has taken a number of measures to combat IFFs. FinTRACA—the country's financial intelligence unit (FIU)—was established in 2004 to help track and investigate these flows and work with other countries to arrest criminals and try to get the money back. The parliament also recently approved the *Anti-Money Laundering Law* and the *Combating the Financing of Terrorism Law* (AML/CFT Law), as well as additional amendments in order to better comply with the international standards set out in the Financial Action Task Force (FATF) recommendations. The Afghan Central Bank, Da Afghanistan Bank (DAB), which is in charge of oversight of the Afghan financial system, has also published relevant regulations. Despite these improvements, much work still remains, particularly concerning the enforcement of AML/CFT law regulations.

In order to reduce the number of illicit financial flows, Integrity Watch Afghanistan recommends the following:

*New legislation and regulations and clarification of government roles:* There needs to be new and improved legislation and regulations, as well as greater coordination and cooperation among relevant ministries, agencies, and authorities to curb IFFs. The roles of FinTRACA and other agencies must be clarified to eliminate redundancies and improve cooperation. Moreover, AML/CFT laws and regulations need to be further amended to become fully compliant with international standards and best practices.

*Improve training and encourage greater political will to enforce AML/CFT laws and regulations within the Afghan government:* There is insufficient knowledge and understanding of AML/CFT laws and regulations by the courts, law enforcement, and other relevant authorities. Moreover, there is an alarming lack of measures and sense of urgency in key governmental institutions involved in curbing IFFs. A number of important ministries and institutions either do not view IFFs as a significant challenge or are unaware of the extent of the problem in the country. Raising awareness and training governmental institutions, agencies, and relevant authorities on IFF issues and related measures must be a priority. Additionally, corruption within these agencies must be rooted out, and those civil servants who have violated rules or engaged in criminal activity must be penalized and, where appropriate, referred to the Attorney General's Office (AGO).

*Enhance reporting of who really owns and controls money service providers (MSPs) and other important businesses:* The Afghanistan Central Business Registry (ACBR) does not collect information on who actually owns or controls a business (“beneficial owner”) in a systematic and adequate manner. The Afghan government, law enforcement, and the populace at large should be able to find out who actually owns a business, whether it is a bank, construction company, restaurant, or any other business so that people will know whether this is a company illegally tied to politicians or other corrupt people, involved with criminal networks, or are untrustworthy parties with whom to invest one’s money. With beneficial ownership information, the police can better track down criminals, attempt to prosecute them, and seize the illegal money they have earned.

*Better regulate money service providers:* Despite the growth of the formal banking system, money service providers or *hawaladars* continue to play a dominant role in Afghanistan’s financial system. Approximately 90 percent of financial transactions go through the informal *hawala* system. They are the preferred choice for ordinary Afghans, but also for criminals and terrorists. While Da Afghanistan Bank (DAB) has issued specific regulations governing these financial actors, the vast majority of *hawaladars* operate without licenses and do not comply with the relevant laws or regulations. In particular, they do not track down who the real owner of the money is or how they have received that money (“customer due diligence”), keep good records of their customers’ transactions, or report on suspicious customers or money. The Financial Supervision Department of DAB, which is charged with supervising *hawaladars*, lacks the resources, training, and expertise to do its job well. Supervision and enforcement must be dramatically improved, and *hawaladars* violating the rules must be penalized and, where appropriate, referred to the Attorney General’s Office (AGO). Due to high levels of corruption within DAB in previous years, the international community ceased to provide aid or training. The international community should be encouraged to again provide much-needed technical assistance to DAB and other government agencies.

*Enhance reporting and controls on cash crossing Afghanistan’s borders:* Under Afghan law, anyone carrying more than \$20,000 must declare where the cash has come from and where it is going. This needs to be enforced, and the law should be amended so that the level for reporting is \$10,000 rather than \$20,000. Because illicit financial flows like money from drug trafficking and other crimes usually travel through very large quantities of cash (“bulk cash”) and currently can be done anonymously, strictly enforcing the requirement to declare one’s cash at Afghan borders and airports would help decrease these illicit financial flows.

*Besides banks and MSPs, improve legislation, regulations, and enforcement of other types of businesses with a high threat of illicit financial flows:* While much illicit financial flows go through banks and *hawaladars*, there are many other businesses and groups where illicit financial flows are common. These include real estate agencies, import-export firms, procurement contracts, and non-profit organizations like charities. In order to curb illicit financial flows, legislation, regulations, and enforcement must be strengthened in these sectors as well.

*Improve training to banks, MSPs, and other businesses with a high threat of illicit financial flows:* There is a lack of adequate training provided to banks, *hawaladars*, real estate agencies, contractors, non-profits, and so forth on what illicit financial flows are, how to spot them, and what to do about them. Also, there is a lack of training and oversight on conducting due diligence of one’s customers and business. In order for businesses to do their part, they must be trained in illicit financial flows, proper record keeping, how to ensure their employees are not involved in illicit financial flows, and other important obligations.

Tackling illicit financial flows effectively requires genuine commitment by the government, businesses, and Afghan citizens. The government must improve the laws and regulations, as well as educate businesses and citizens on the danger of these financial flows and how to help stop them. Businesses and citizens must each do their part as well to recognize these financial flows and report them to the police. Only then can security within Afghanistan begin to improve.

## 1. INTRODUCTION

This section will provide an overview of the key issues presented by illicit financial flows (IFFs), particularly in the Afghan context. First, this portion will discuss the concept of IFFs and their various components, in particular, the issues of money laundering, tax evasion, and corruption. Next, this section will examine the volume of IFFs from developing countries, including estimates from Afghanistan. Finally, it will analyze the devastating impact of IFFs, particularly on nascent democracies and developing countries such as Afghanistan, as well as examining the case of Kabul Bank.

### 1.1. Illicit Financial Flows (IFFs)

According to Global Financial Integrity (GFI), IFFs are “illegal movements of money or capital from one country to another” (2015). GFI classifies this movement as an illicit flow when the funds are illegally earned, transferred, and/or utilized (2015).

As GFI explains, examples of illicit financial flows include:

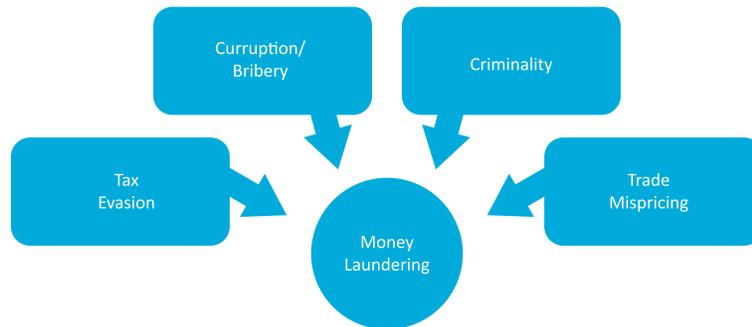
- An individual smuggling bulk cash into another country where there is greater bank secrecy or less stringent enforcement concerning money laundering and then depositing that cash into an offshore bank account;
- A drug cartel mixing legal money from the sale of a good or service (such as used cars) with illegal money from the sale of something illicit (such as drugs);
- An importer using trade mispricing to evade Customs duties or income taxes;
- A corrupt public official transferring dirty money to an offshore bank account through the use of a shell or front company; or
- A terrorist wiring money from the Middle East to an operative in Europe (2015).

### 1.2. Components of IFFs

Whether IFFs stem from licit and illicit sources, these flows typically involve the following practices: money laundering, tax evasion, trade mispricing, criminality, and corruption/bribery (Fontana and Hansen-Shino, 2012). Trade mispricing/misinvoicing is a form of trade-based money laundering<sup>1</sup>. Similarly, IFFs linked to a variety of criminal enterprises are also a type of money laundering. This includes the production and trafficking of drugs, which is a major contributor to IFFs in Afghanistan. GFI indicates that “money laundering is the process of disguising the proceeds of crime and integrating them into the legitimate financial system” (2015). Tax evasion and corruption/bribery are both crimes, the proceeds of which can be disguised and introduced into the legitimate financial system of a country. As such, money laundering is a key focus of this paper.

1 “Trade misinvoicing is a method of moving money illicitly across borders, which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to Customs” (GFI, 2015).

Figure 1: IFFs and Money Laundering



### 1.2.1. IFFs and Money Laundering

GFI explains the process of Money Laundering (ML) as follows:

Before proceeds of crime are laundered, it is problematic for criminals to use the illicit money because they cannot explain where it came from, and it is easier to trace it back to the crime. After being laundered, it becomes difficult to distinguish money from legitimate financial resources, and the funds can be used by criminals without detection. (2015)

Sometimes clean money—or money from an unknown source—can be used to commit future crimes (Cassella, 2003). This is known as reverse money laundering, and similar techniques can be used to conceal the ownership of money, as well as to conceal the purpose for which money will be used. Reverse money laundering can also be used to finance criminal operations and enterprises such as terrorism. The U.S. attacks of September 11, 2001 were financed with cash and wire transfers from abroad (Cassella, 2003). In his 2003 article, “Reverse Money Laundering,” Stefan D. Cassella details IFFs in one instance of the 9/11 attacks:

Money from a money exchange in the United Arab Emirates passed through a correspondent account at a New York bank before being credited to the accounts of the hijackers at another bank in Florida. In other instances, the hijackers or their supporters simply carried bundles of cash into the country. The money may have had a legitimate origin—it could have come from someone’s personal fortune, from funds raised for humanitarian aid, or from any other licit source—but its purpose was deadly.

Money laundering typically occurs in three phases: placement, layering, and integration. In the placement phase, money gained from criminal activities is introduced into the financial system. In the layering stage, the money launderer takes actions to manipulate the illicit funds and make them appear as though they were obtained from a legitimate source. Layering schemes often involve the transfer of money from one account to another. In the final stage of money laundering, integration, the launderer invests the money in other assets, thereby putting the illicit funds back into circulation. It’s in this third and final phase when money appears to become legitimate (Jost and Sandhu, 2013).

Figure 2: A simple money laundering scheme



Source: Kamala Harris (2014)

Money laundering can take many different forms, although most methods can be categorized into three main types. The first is through the use of the financial system, such as with checks or wire transfers<sup>2</sup>; the second involves the physical movement of banknotes, an action often carried out by cash couriers or bulk cash smuggling); and the third is through trade-based money laundering (TBML) or the movement of goods via the trade system. TBML involves disguising the proceeds of crime and moving value through trade transactions in an attempt to legitimize their illicit origins. In practice, this can be achieved by misrepresenting the price, quantity, or quality of imports or exports. TBML represents an important channel of criminal activity, and, as the Financial Action Task Force Group points out in a 2006 report, is an increasingly important money laundering and terrorist financing vulnerability, especially in light of the growth of world trade.

Figure 3: Money Laundering Process



2 "Money laundering can be facilitated through anonymous shell companies. An anonymous shell company is a corporate entity that has disguised its ownership in order to operate without scrutiny from law enforcement or the public. These 'phantom firms' can open bank accounts and wire money like any other company, making them a favorite tool for money launderers to hide their business and assets from authorities" (GFI, 2015).

Growing criminality in Afghanistan, including the country's rising transnational organized crime networks relating to narcotics, has presented a major challenge with regard to money laundering. As indicated by the United Nations Office on Drugs and Crime (UNODC), "Afghanistan has increased the area under poppy cultivation by 36 percent, from 154,000 hectares in 2012 to 209,000 hectares in 2013. With a crop yield of 5,500 tons, Afghanistan accounted for up to 80 percent of global opium production" (Yakovenko, 2014). As the global leader in the production and trafficking of opiates, the country is believed by the Asia-Pacific Group on Money Laundering (APGML) to be generating revenues as high as USD 70 billion (2014). Foreign policy experts such as Dr. Alexander Yakovenko, the Russian Ambassador to the UK, posit that "the increase in opium cultivation, trafficking, and consumption continues to cause serious harm to the stability, security, social and economic development, and governance of Afghanistan (2014). Consequences of the country's increased drug production include not only illegal-drug trafficking and money laundering but also the creation of a fertile hotbed for terrorist activity and transnational organized crime (Yakovenko, 2014).

Amid growing concerns from the UN Security Council and following threats from the international banking system that the country would be added to its blacklist unless measures were taken to prevent money laundering (Tolo News, 2014), Afghanistan's former president, Hamid Karzai, signed the Anti-Money Laundering Law (AML law) in 2014. In Afghanistan's parliament, the Meshrano Jirga added to these efforts with recent approval of the Counter-Financing of Terrorism Law (CFT law) as well (Tolo News, 2014).

### 1.2.2. IFFs and Tax Evasion

Another key contributor to IFFs is the illegal practice of tax evasion. It is estimated that USD 9.3 trillion of developing country assets are hidden offshore (Hearson, 2014). Tax evasion is facilitated by tax havens through the opacity of financial information. Tax havens are jurisdictions with a system of financial secrecy in place, often levying taxes at low rates. In these jurisdictions, financial institutions are often allowed to accept money from virtually anywhere without reporting it to the authorities in the country where it originated or from which it is controlled. For this reason, tax havens also easily facilitate money laundering. Laundering criminal proceeds through a tax haven is merely a matter of finding a bank in that jurisdiction to accept one's deposit without asking questions, shuffling the money around a bit, and then sending it to the next destination to be received or spent (GFI, 2015).

Tax-motivated IFFs are another major challenge facing Afghanistan. The International Monetary Fund (IMF) conducted a confidential assessment of Afghan finances which reportedly indicated the government's 2013 financial woes were caused by widespread tax evasion and smuggling abetted by government officials and the increasing theft of Customs revenues by provincial governors (Rosenberg, 2013).

The issue is more widespread than government corruption, however. As IWA addressed in an August 2015 policy brief, tax evasion in Afghanistan is rampant, including the large-scale misappropriation of revenue across sectors such as telecommunications, construction, and extractive industries; the concealment of staff withholding tax by businesses and organizations; and even underreporting of income at the individual level.

There are various reasons that tax evasion is such a significant problem in Afghanistan. Poor government standards, loopholes in the rules, weak enforcement mechanisms, and lack of resources and expertise are several key contributing factors. Furthermore, lack of familiarity with this legal custom<sup>3</sup>, lack of confidence or trust in the government<sup>4</sup>, and lack of awareness<sup>5</sup> are also notable causes. Corruption, bribery, and political influence are also relevant factors. All of these factors contribute to a pandemic tax evasion problem in a country where the wealthiest citizens are sometimes exempt from many tax laws to begin with. Plenty of Afghanistan's wealthy businessmen, who should be paying large tax bills, are closely linked to senior officials and political figures and are thus granted a type of "untouchable" status (New York Times, 2013).

Foreign firms are also complicit in IFFs linked to evasion of Afghan tax laws. According to recent investigations by the Afghanistan Investment Support Agency (AISA), some foreign companies owe billions of Afghani (Afs)

3 Generally speaking, the custom and culture of paying taxes is not entrenched in the Afghan society.

4 There is a general skepticism among the average Afghan regarding the appropriate use of taxpayers' money for public services.

5 Some Afghans are unaware of the legal obligation to pay taxes as well as the purpose of taxation.

as tax to the Afghan government, and some companies function without the requisite business license, taking the law into their own hands with willful disdain. As reported by AISA, one firm responsible for providing logistic support to American soldiers stationed in Afghanistan has continuously failed to clear its dues, despite repeated reminders. This firm owes the Afghan government Afs 4 billion in taxes. AISA officials suspect the firm might be working at the behest of powerful people in the government (Amanpoor, 2014)<sup>6</sup>.

Tax evasion provides fertile ground for corruption and bribery, as evidenced in the extractive industries. Corruption, in turn, is linked to IFFs, as discussed in the next section.

### 1.2.3. IFFs and Corruption/Bribery

The relationship between corruption and IFFs is symbiotic, and the incidence of one often incites the occurrence of the other. Corruption's enormous profits—estimated at more than \$1 trillion of illicit funds annually—are increasingly laundered in the international system (Chaikin and Sharman, 2009). Moreover, attempts to curb corruption through anti-money-laundering systems are frequently compromised by bribery, trading in influence, and embezzlement.

A recent case of bribery highlights this problem and corruption's link to IFFs in Afghanistan. *The New York Times* recently revealed that a leading Afghan opium trafficker on the United States' kingpin list, Haji Lal Jan Ishaqzai, was freed from prison by way of a USD 14 million bribe (Goldstein, 2014). Ishaqzai was a close friend of Ahmad Wali Karzai, the former president's brother. Following his arrest in 2012 and subsequent 20-year prison sentence, various ministers sought his release. However, it was ultimately the judges who arranged the drug kingpin's freedom in late 2014. Acts of bribery such as this one are far from the exception in Afghanistan. The top police investigator in Oruzgan Province, Gulab Khan, shared his insight: "We detain approximately 150 people annually who have committed murder and other heinous crimes, and I can say half of them are set free through means of corruption" (Goldstein, 2014). These instances of bribery are demonstrative of the relationship between corruption and IFFs.

In its 2014 Corruption Perceptions Index, Transparency International ranked Afghanistan 172 out of 175 countries surveyed (with 175 being the most corrupt). Afghanistan received a score of 12 out of 100 (with 0 being highly corrupt and 100 being very clean). According to Huguette Labelle, chair of Transparency International, Afghanistan "falls almost at the bottom of the list of the most corrupt and poorly governed countries" (2015). Corruption permeates all levels of the Afghan government and is a major source of illicit funds. By some estimates, including those from IMF, corruption may have generated up to USD 2.4 billion in 2009 (2011). To further highlight the gravity of the problem, international observers such as Al Jazeera and the Associated Press have stated that corruption, not the Taliban, is the worst threat to the future of Afghanistan (2014).

Table 1: Corruption Perceptions Index 2014

| Rank | Country       |
|------|---------------|
| 169  | Turkmenistan  |
| 170  | Iraq          |
| 171  | South Sudan   |
| 172  | Afghanistan   |
| 173  | Sudan         |
| 174  | Korea (North) |
| 174  | Somalia       |

Source: Transparency International (2015)

6 Under bilateral agreements, firms and organizations providing military supplies and development assistance are not subject to tax, provided that they do not engage in commercial activity.

While the prevalence of corruption in Afghanistan may not be a surprise, the problem is becoming worse. According to a UN report, the cost of paying bribes to public officials was USD 3.9 billion in 2012. This corresponds to a 40 percent increase in real terms between 2009 and 2012 (UN Office on Drugs and Crime, 2012).

As corruption grows, IFFs continue to be linked to the extractive and telecommunications industries, as well as to Customs. Equality for Peace and Democracy cite customs officials as having estimated that approximately 70 percent of border revenue is lost to corruption (2014). Additionally, the ability to generate domestic revenue is hampered by the fraud and corruption plaguing the extractive and mining sectors. One challenge contributing to lost revenue within the mining industry is the absence of a successful legal framework to protect private sector investments and promote transparency and accountability (Equality for Peace and Democracy, 2014).

### 1.3. Volume of IFFs from Developing Countries

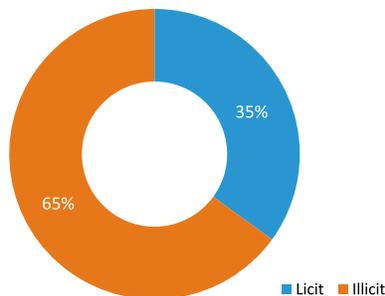
The actual volume of IFFs and their different components are extremely hard to measure, and estimates vary widely. IFFs from developing countries are estimated to be in the trillions of U.S. dollars (Henry, 2012). A Global Financial Integrity report from December 2014 details that “developing and emerging economies lost USD 6.6 trillion in illicit financial flows from 2003 through 2012, with illicit outflows increasing at an extraordinary average inflation-adjusted rate of 9.4 percent per year—almost twice as fast as global GDP.” Globally, illicit financial outflows averaged 3.9 percent of GDP, and in 2012, USD 991.2 billion flowed illicitly out of developing and emerging economies (GFI, 2014). These are conservative estimates, excluding movements of bulk cash, the mispricing of services, or many types of money laundering.

The illegal capital outflows stem from crime, corruption, tax evasion, and other illicit activity. The money that flowed illicitly out of developing countries in 2012 (USD 99.1 billion) was greater than the combined total of foreign direct investment (FDI) and net official development assistance received that year from these same economies (amounting to USD 879 billion) according to Kar and Spanjers (2014). Echoing these findings, the Organization for Economic Cooperation and Development (OECD) has stated that IFFs likely exceed aid flows and investment to developing countries in volume (OECD, 2014).

#### 1.3.1. IFFs in Afghanistan

Accurate estimates regarding the volume of Afghanistan’s IFFs are not provided by any relevant governmental authorities or other competent agencies. One reason for this is the difficulty of tracking this data, given that illicit financial flows are unreported. According to the Ministry of Finance (MOF), however, only about 35 percent of the country’s financial flows are legal.

Chart 1: Financial Flows in Afghanistan



As illustrated in the table below, Afghanistan’s cumulative illicit outflows from 2003-2012 totaled USD 2.22 billion, which is an average of USD 222 million per year. The total amount of IFFs from Afghanistan is likely significantly higher than GFI’s estimate, though, since from 2007 to 2012, GFI assigned a value of zero to annual illicit outflows<sup>7</sup>. IFFs linked to Afghanistan’s increased opium production and drug trafficking were also not captured in GFI’s 2014 estimate

Table 2: GFI’s estimation IFFs

| Country     | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Total | Avg |
|-------------|------|------|------|------|------|------|------|------|------|------|-------|-----|
| Afghanistan | 892  | 667  | 505  | 159  | 0    | 0    | 0    | 0    | 0    | 0    | 2,223 | 222 |

Source: GFI, *Illicit Financial Flows from Afghanistan (in millions of U.S. dollars, nominal) (2014)*

In 2011, an estimated USD 4.5 billion was reportedly taken out of the country through the Hamid Karzai International Airport (KIA). According to Special Inspector General for Afghanistan Reconstruction (SIGAR), bulk cash flows such as these increase the risk of money laundering and cash smuggling, which in turn heighten the incidence of terrorist activities, narcotics activity, and other illicit operations (2012). Despite the Afghan government’s pledge to implement regulations that would help govern bulk transfers of cash outside the country, especially given the country’s cash-based economy, the existing measures to monitor the outflow of currency have so far remained ineffective.

One such regulation was the installation of bulk currency counters at KIA<sup>8</sup> as a means to hinder money laundering and bulk cash smuggling; however, these machines are not used for their intended purposes and examinations by official observers<sup>9</sup> have revealed a number of serious deficiencies. First, the cash counters are located in an area of the international terminal of the airport that is not easily accessible to Customs and FinTRACA<sup>10</sup> officials. Second, the machines are rarely used. Third, the machines are not connected to the internet or computer servers—an essential component for sending relevant data to FinTRACA.

SIGAR reports that, additionally, no bulk currency counter has been made available for the counting or data collection of currency declared by Very Important Persons (VIPs), who are exempt from security screenings and processing by main customs. According to an official from the Department of Homeland Security (DHS), many of the individuals who traffic money through KIA leave from the VIP area of the airport (2012). The 2012 report from SIGAR also notes that “ a new Very Important Persons (VVIPs) lounge has been built to provide easier boarding access for high-ranking officials, again allowing transit without main Customs screenings or use of a bulk currency counter” (2012).

Similar problems likewise persist across Afghanistan’s porous border crossings. Cargo is often exempted from screening or inspection due to rampant corruption at official border crossings and Customs depots, and SIGAR reports that many border areas are under-policed or not policed at all (2015).

- 7 It appears impossible that Afghanistan had zero IFFs during 2007-2012. Indeed, as explained in the subsequent paragraphs, approximately USD 4.5 billion in bulk cash left the Hamid Karzai International Airport (KIA) in 2011 alone.
- 8 Bulk currency counters are important anti-money laundering tools because they can capture currency serial numbers and other important data useful for detecting and investigating financial crimes. These machines are also designed to transmit these data via an internet link to the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA). FinTRACA—part of Afghanistan’s Central Bank (Da Afghanistan Bank)—uses data on financial activity to identify financial crimes and assist law enforcement agencies in the investigation and prosecution of criminal activity.
- 9 As noted by officials from the Special Inspector General for Afghanistan Reconstruction (SIGAR) in their visit to KIA in 2012.
- 10 Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA) operates as Afghanistan’s financial intelligence unit. It serves as the national center responsible for the receipt and analysis of suspicious transaction reports and other information relevant to money laundering, associated predicate offenses and terrorist financing, and for the dissemination of the results of that analysis. This organization will be discussed in depth later in the report.

## 1.4. Impact of IFFs

The Organization for Economic Cooperation and Development (OECD) describes the impact of IFFs on a country as having substantial social and economic effects. The organization explains:

Every year huge sums of money are transferred out of developing countries illegally. IFFs facilitate transnational organized crime, foster corruption, undermine governance, and decrease tax revenues. The most immediate impact of IFFs is a reduction in domestic expenditure and investment, both public and private. These illicit financial flows strip resources from developing countries that could be used to finance much-needed public services, from security and justice to basic social services such as health and education, weakening their financial systems and economic potential. While such practices occur in all countries and are damaging everywhere, the social and economic impact on developing countries is more severe given their smaller resource base and markets. (2014)

For example, corruption diverts public funds from public use to private consumption. According to OECD, “Private consumption has much lower positive multiplier effects than public spending on social services” like health and education (2014). The World Bank agrees, noting that proceeds of corruption or criminal activities are often “spent on consumption of items such as luxury vehicles or invested in real estate, art, or precious metals” (2006). The social impact of a dollar spent on luxury goods is very different from that of a dollar spent on elementary education (OECD, 2014).

Moreover, IFFs can cause greater dependency on development assistance as a result of their negative effects on domestic revenue generation. IFFs can also worsen inequality, as citizens with a higher socioeconomic status incur a relatively smaller tax burden than poorer residents who do not have the same opportunities to hide their wealth abroad (UNDP, 2013).

The impact and consequences of IFFs are not restricted merely to developing countries; by their very nature, IFFs have transnational effects as well. Through globalization and international organized crime, the reverberations of IFFs in developing countries such as Afghanistan will be felt even in first-world countries. Failure to address IFFs in Afghanistan makes the task of addressing worldwide illicit proceedings—such as the drug trade, weapons and arms trade, and terrorist financing—much more daunting (The Global Initiative, 2015). As such, it is critical that the challenge of curbing IFFs remain a priority not only for developing countries such as Afghanistan, but also for developed counties that are serious about addressing these transnational illicit concerns.

### 1.4.1. Impact on Afghanistan

In addition to the consequences detailed above, potential failure to address the issue of IFFs have a number of other negative implications for Afghanistan.

Seeing out pallets of cash flow from a desperately poor country, along with the mansions of narcotics traffickers and politicians, severely degrades public trust and hurts the overall legitimacy of the Afghan government. IFFs allow criminals and the corrupt to move their fraudulent gains overseas, largely away from the reach of Afghan law. IFFs enable these criminals to purchase residency or even citizenship abroad and live in luxury, while average Afghan citizens are left behind to make a life in the mess the corrupt have created. In this way, IFFs are a form of “robbing the poor to give to the rich,” a practice which erodes the overall feelings and practice of justice in Afghan society. Moreover, illicit funds help empower various malign actors such as criminal groups and militias. Insurgent groups like the Taliban and ISIS use these illicit funds to arm themselves and to pay their members (Vittori, 2015), creating further instability and jeopardizing the quality of life for Afghan residents.

IFFs negatively impact development assistance and economic prosperity in Afghanistan as well. They erode donor confidence and willingness to support Afghanistan's future. IFFs significantly degrade the willingness of good companies to engage in foreign direct investment<sup>11</sup> in Afghanistan, which Afghanistan will need if it wants to legitimately exploit its mineral resources and strategic location in the heart of Asia to develop a sustainable economy (Vittori, 2015). Clearly, IFFs not only result in significant damage to the social and economic sectors of Afghanistan, but they are also responsible for extensive and lasting global effects as well as noxious consequences for the country's international relations.

#### 1.4.2. Kabul Bank Case

With regard to the financial sector, a general reputation of integrity is critical for success, and this is of course undermined by money laundering. Financial crimes impair long-term economic growth and harm the welfare of entire economies (OECD, 2014), and the Kabul Bank fraud case is a prime illustration of this principle.

Kabul Bank was established in 2004 and viewed as a step toward progress and modernization of the banking system in Afghanistan (Integrity Watch Afghanistan, 2015). However, the bank collapsed in 2010 after losing almost USD 1 billion, mostly deposited by international donors (BBC, 2014) and as the result of fraud perpetuated by the bank's administrators. According to the Independent Joint Anti-Corruption Monitoring and Evaluation Committee, a large portion of the embezzled funds was laundered from Afghanistan to overseas accounts for the benefit of related parties and politically exposed persons (PEPs<sup>12</sup>) (2014).

The reopening of the fraud case by the new government was perhaps the most serious, albeit unsuccessful, attempt on behalf of the government to address corruption in the financial system. Though the Supreme Court upheld convictions in the embezzlement case, this was a hollow victory for a number of reasons (Tolo News, 2014). Most of the USD 977 million embezzled has not been recovered, and recovery efforts were further impeded by difficulties in finding buyers for the seized assets, owing to issues relating to title and ownership deeds. Additionally, various high-ranking officials, possibly complicit in the fraud, were not tried or held accountable. Thus, the Kabul Bank case has been viewed as one example of the inadequacy of current efforts to tackle financial crimes and IFFs.

The Kabul Bank disaster has cost Afghanistan hundreds of millions of dollars. The bank's depositors are being paid out of the national budget, which means these scarce funds aren't instead being allocated to crucial priorities such as education, health, and employment. MEC reports that the Afghan government provided the bank with a USD 825 million lender-of-last-resort instrument funded from its central reserve (2014). Repayment of this instrument, a total of USD 67 million per year, comes from Afghanistan's annual budget and comprises 1.35 percent of the operating budget (MEC, 2014).

In short, the Kabul Bank corruption case adversely impacted the economy and development growth in Afghanistan by nearly collapsing the entire Afghan financial system, seriously damaged relationships with international donors, and eroded public trust and confidence in the financial system and the government.

11 A foreign direct investment is a controlling ownership in a business enterprise in one country by an entity based in another country.

12 PEPs refer to individuals who are or have been entrusted with prominent public functions, for example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials (FATF, 2013).

## 2. OBJECTIVES AND METHODOLOGY

### 2.1. Objectives and Scope of Research

The research aims to address three issues relating to IFFs in Afghanistan. First, the research will present an overview of the key measures undertaken by the Afghan government and quasi-governmental authorities to curb IFFs. These measures include establishing laws, regulations, agencies, and programs to prevent illicit financial transactions.

Second, the paper will evaluate Afghanistan's legal and regulatory framework in comparison with international standards on combatting IFFs. In particular, the Financial Action Task Force (FATF) recommendations—the international gold standard on curbing IFFs—will be examined, as well as Afghanistan's compliance with these benchmarks. The research will identify shortcomings in the Afghan regulatory measures, as well as issues relating to the enforcement of the rules. The report will provide recommendations for improving the authorities' ability to curb IFFs.

Third, the research will investigate the role of the *hawala* system in stymieing IFFs in Afghanistan. Relevant laws and regulations, including the *Money Service Providers Regulations* (MSP regulations), will be analyzed. The paper will evaluate the efficacy and appropriateness of existing anti-IFF measures relating to MSPs or *hawaladars* and provide recommendations for enhancing these measures.

The research does not attempt to assess the accuracy of existing estimates on the scale of IFFs in Afghanistan, nor does it investigate the relative importance of various forms or methods used for transferring funds. Moreover, the report does not aim to cover all aspects of the complex IFF picture. In particular, the key aspects of IFFs covered in this report are money laundering (which includes IFFs linked to drug trade, tax evasion, and corruption), terrorist financing, and the role of *hawaladars* or MSPs in curbing IFFs.

### 2.2. Methodology and Framework

This research is based on a literature review, legal research focusing on primary and secondary sources, and field research. The literature review examined research, analytical reports, and findings on curbing IFFs, particularly in Afghanistan and in other similar developing countries. In addition, legal research was conducted on primary sources (Afghan laws and regulations, as well as international laws and standards) and secondary sources analyzing legal aspects of IFFs.

The research is based on qualitative methods. The field research entailed valuable interviews and meetings with key stakeholders in Afghanistan, including government, private sector institutions, and non-governmental organizations. The interviews took place in Kabul. In addition, surveys were utilized to collect data and information from relevant stakeholders.

The research team also attended a workshop in New Delhi, India in December 2014, organized by the Centre for Budget and Governance Accountability (CBGA). The CBGA workshop entailed several presentations and discussions on the topic of IFFs in the region, allowing us to explore a number of key issues.

### 3. GOVERNMENTAL MEASURES CONCERNING ILLICIT FINANCIAL FLOWS

While some relevant governmental agencies and authorities view IFFs as a serious threat and significant challenge in Afghanistan, a number of key institutions do not share the same view. Moreover, some governmental authorities are unaware of the extent of the IFF problem in Afghanistan. According to some government officials, the drug trade and pervasive corruption produce large sums of illegal funds, a significant portion of which flow out of the country. A number of measures have been taken to combat IFFs in Afghanistan. Two important steps in addressing this problem have been the promulgation of rules and the establishment of a Financial Intelligence Unit (FIU).

This section will present an overview of the key governmental measures taken by the Afghan government to address IFFs. First, this section will provide a high-level overview of the Afghan financial system to contextualize the discussion. Second, it will explore regulatory measures specifically concerning money laundering and terrorist financing. Third, this section will examine the role of Afghanistan's financial intelligence unit, the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA). Finally, it will examine other key measures, including the adoption of important laws and regulations and the establishment of relevant institutions; it will also assess the efficacy and utility of these measures.

#### 3.1. Afghan Financial System and IFFs

The Afghan financial system is a work in progress and vulnerable to IFFs. The formal banking system is relatively underdeveloped, and the informal financial system remains the de facto and preferred method of conducting financial transactions.

Though the Afghan central bank, Da Afghanistan Bank (DAB), was established in 1939, the formal Afghan financial system was nearly nonexistent by the end of 2001. DAB's sole function at that point was printing currency. Various reforms have taken place since then to modernize the country's financial system, such as the revision of DAB's governing legislation in 2003 (SIGAR, 2014).

The central bank plays a key role in the Afghan economy by supporting the general economic policies of the government and by strengthening sustainable economic growth. The primary mission of the Da Afghanistan Bank is to foster domestic price stability and to build a robust financial system. To that end, DAB's other objectives include fostering the liquidity, solvency, and effective functioning of a stable market-based financial system and promoting a safe, sound, and efficient national payments system (Da Afghanistan Bank, 2015).

The Financial Supervision Department of DAB (DAB FSD) is responsible for ensuring the efficacy of the banking sector. DAB FSD oversees the issuance of licenses for banks and informal financial institutions, such as money service providers (MSPs) and foreign exchange dealers (FEDs) and also monitors compliance with applicable laws and regulations (SIGAR, 2014).

Another important actor in the Afghan financial system is the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA). FinTRACA functions as the country's financial intelligence unit (FIU) with the purpose of protecting the integrity of the Afghan financial system. As an FIU, FinTRACA is the national center responsible for gathering information on suspicious financial activity from both the financial industry and other entities required to report transactions suspicious of involving money laundering or terrorism financing (Egmont Group, 2015).

The aforementioned illustrates some measures undertaken to modernize and regulate the Afghan financial system. Furthering these efforts, the Afghanistan Banks Association (ABA) was established in 2004 to represent and meet the needs of the growing formal banking sector. Founded by nine banks, ABA has grown to a membership of 16 licensed operators, including government, private, and foreign commercial banks (Afghanistan Banks Association, 2015).

Despite the relative growth of the formal banking sector in recent years, the informal financial system remains influential, where MSPs or *hawaladars* continue to play a dominant role. Less than 10 percent of the Afghan population uses banks; approximately 90 percent of financial transactions go through the informal *hawala* system. There is no clear division between the *hawala* and formal banking systems—*hawaladars* keep bank accounts and use wire-transfer services, while banks use *hawalas* to transmit funds within Afghanistan (SIGAR, 2015).

Although there have been developments in modernizing and regulating the banking sector since 2001, the Afghan financial system is fragile and vulnerable to IFFs. The central bank's ability to supervise the banking sector remains weak. This is demonstrated by the Kabul Bank case that nearly caused the collapse of Afghanistan's largest bank and provider of government salaries (SIGAR, 2014). This report further explores, in greater depth, the functions and issues relating to these various institutions and actors in the Afghan financial system.

### 3.2. Regulatory Measures

The *Anti-Money Laundering Law* and the *Combatting the Financing of Terrorism Law* (AML/CFT)<sup>13</sup> are two important regulatory measures designed to address the IFF problem. Afghanistan's AML/CFT laws were enacted pursuant to the Financial Action Task Force (FATF) recommendations on combatting money laundering and the financing of terrorism<sup>14</sup>.

As detailed by FinTRACA, the purpose of Afghanistan's AML law, articulated in Article 2, is twofold: "(1) Protect and promote the financial integrity of Afghanistan; (2) Fight against use of financial institutions and designated non-financial businesses and professions (DNFBPs) for money laundering, proceeds of crime, and terrorism financing." The AML law applies to both financial institutions and DNFBPs, referred to as "reporting entities" under Article 5. Article 24 empowers FinTRACA to enforce compliance with respect to all "reporting entities".

The recent amendments to, and approval of, the AML/CFT laws in 2014 were in part due to international pressures and warnings by the Financial Action Task Force (FATF) to blacklist Afghanistan for failing to take measures against money laundering (Wadsam, 2014)<sup>15</sup>. The World Bank provided technical assistance to Afghanistan by reviewing and providing comments on the draft AML/CFT laws<sup>16</sup>. The World Bank has also assisted in raising awareness and providing technical training on AML/CFT issues to government officials.

The approval of the AML/CFT laws has been met with criticism. According to some agencies, the AML/CFT laws and regulations are unresponsive to the realities and needs of Afghanistan. Instead, critics maintain, these regulatory measures are Western standards being exported in their entirety to Afghanistan that do not, and will not, work.

Da Afghanistan Bank (DAB), Afghanistan's central bank, has also issued the *Regulations on Responsibilities of Financial Institutions in the Fight Against Money Laundering and Terrorist Financing* (AML/CFT regulations) as well as specific regulations governing money service providers (MSPs) and foreign exchange dealers (FEDs), designed to prevent IFFs.

Impediments in the enforcement and application of these regulatory measures hamper efforts in curbing IFFs in the country. These impediments include corruption and lack of training and knowledge by the relevant authorities on AML/CFT issues and standards. Bribes and political influence interfere with the appropriate handling of ML/TF cases. In many cases, in lieu of ML charges, the accused are convicted of lesser offenses (e.g. dishonesty) with very low penalties. Enforcement is especially haphazard and lax when high level authorities and individuals are involved.

13 Full texts of the AML/CFT laws are available at: <http://www.fintraca.gov.af/>.

14 Afghanistan is a member of the Asia/Pacific Group on Money Laundering (APG). An FATF Associate Member, APG's purpose is to ensure the adoption, implementation, and enforcement of FATF recommendations (APG, 2015).

15 Blacklisting would have put the Afghan economy in a major crisis. It would have cut off Afghan banks from the global financial system, disrupting up to USD 10 billion worth of annual imports by the time Karzai's successor would have taken over. If the blacklist were enforced, all sectors of the aid-dependent economy would have been put under further strain, seriously affecting traders, government revenue, and employment (Menon and Donati, 2014).

16 FinTRACA played an important role in this process as well.

### 3.3. Financial Transactions and Reports Analysis Center of Afghanistan

As per FATF Recommendations, Afghanistan is required to establish a Financial Intelligence Unit (FIU)<sup>17</sup>. As such, pursuant to Article 25 of the AML law, FinTRACA was established in 2004 to operate as an FIU. Under this article, FinTRACA serves as the national center responsible for the receipt and analysis of suspicious transaction reports and other information relevant to money laundering, associated predicate offenses and terrorist financing, and for the dissemination of the results of that analysis.

The law attempts to provide mechanisms to bolster FinTRACA's independence as an FIU. Article 25(3) states that FinTRACA "shall be independent in its operations for the purpose of enforcing its powers, duties, and functions, including full autonomy in decisions to receive, request, analyze, or disseminate information in the manner prescribed in this law." Under article 25(4), Da Afghanistan Bank (DAB) is to provide an adequate budget for FinTRACA. Moreover, under article 25(5), DAB is tasked with determining the FIU's "composition, organization, operation, and resources, consistent with international best practices, as reflected in the FATF Recommendations" (FinTRACA).

Since becoming operational in 2006, FinTRACA has led Afghanistan's AML/CFT efforts, joining the Egmont Group of Financial Intelligence Units as a member in 2010. The Egmont Group is an informal network of FIUs operating with the goal of enhanced international cooperation in reducing money laundering and terrorism financing. Egmont Group members meet regularly to advance the development of FIUs through information exchange, training, and the sharing of expertise (Egmont Group, 2015). According to FinTRACA, there is extensive collaboration with Egmont members and almost 11 MOUs have been signed with other FIUs. FinTRACA has received technical assistance from APG, IMF, UNODC, and the donor community. Canada recently donated USD 1 million for capacity building on the AML/CFT regime.

FinTRACA reports that the FIU is on the front lines of combatting IFFs in Afghanistan. FinTRACA has also attempted to increase cooperation with domestic partners, including the Ministry of Interior (MOI), AGO, and National Directorate of Security (NDS). Moreover, FinTRACA provides regular training to the AGO and other law enforcement agencies on IFF issues. Whistleblower policies under the AML/CFT laws and banking laws provide legal protection to FinTRACA's staff. Since its establishment, the FIU has reportedly submitted more than 20 cases of ML to law enforcement agencies.

Despite the reporting of such incidents, not many convictions have been entered in ML/TF cases. While progress has been made on several fronts, additional measures need to be taken to ensure that FinTRACA can effectively perform the functions of an FIU. Despite changes in FinTRACA's organizational structure and despite a human resource expansion, the FIU is not operationally independent, as it lacks technical resources; additionally, a significant portion of its budget, passed on by Da Afghanistan Bank, is dependent on dwindling foreign aid. Lack of IT facilities is cited as a significant challenge that prevents FinTRACA from proactively combatting IFFs. Various governmental institutions have pointed to the lack of "financial inclusion" as a key factor exacerbating the IFF problem in Afghanistan; ordinary Afghans do not use the formal banking system. Instead, they opt to use the informal hawala system, making it difficult to identify and prevent IFFs.

17 FIUs are national centers responsible for collecting information on suspicious or unusual financial activity from the financial industry and other entities required to report transactions suspicious of involving money laundering or terrorism financing (Egmont Group, 2015). Afghanistan's FIU is the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA).

### 3.4. Other Measures

Afghan authorities have undertaken a number of other measures to curb IFFs in the recent years. New laws, such as *Counter-Narcotics Law*<sup>18</sup> (2006) and *Anti-Bribery and Corruption Law*<sup>19</sup> (2004), have been promulgated. An overall anti-corruption strategy has been adopted, and an Anti-Corruption Unit has been created within the Attorney General's Office (AGO). New law enforcement agencies now exist, such as the Major Crime Task Force, the Sensitive Investigation Unit, the Intelligence and Investigation Unit, and the National Directorate of Security (NDS) (IMF, 2011).

Given the formidable challenge posed by pervasive corruption in Afghanistan, two important institutions have been established: the High Office of Oversight and Anti-Corruption (HOOAC) and the Independent Joint Anti-Corruption Monitoring and Evaluation Committee (MEC). HOOAC was established in 2008, pursuant to the Afghan constitution and in accordance with the United Nations Convention Against Corruption (UNCAC). HOOAC is the highest institution for the coordination and monitoring of the implementation of Afghanistan's anti-corruption strategy and for the implementation of administrative procedural reform in the country. An independent institution, HOOAC reports to the president (HOOAC, 2015).

The Independent Joint Anti-Corruption Monitoring and Evaluation Committee (MEC) independently monitors and evaluates national and international efforts to fight corruption in Afghanistan. It reports to the public, parliament, president, and international community. MEC is an independent agency, and is not subject to direction from either the Afghan government or from the international community. MEC's focus is threefold: (1) developing anti-corruption recommendations, (2) monitoring and evaluating the anti-corruption efforts of the Afghan government and the international community, and (3) reporting regularly about the state of the fight against corruption<sup>20</sup> (MEC, 2015).

The Financial Supervision Department (FSD) of Da Afghanistan Bank (DAB) supervises financial institutions (FIs) and their compliance with IFF-related regulations by conducting on-site and off-site supervision and reporting. DAB also regulates the activities of money service providers (MSPs) and foreign exchange dealers (FEDs) and imposes sanctions and penalties for non-compliance. According to DAB, there is extensive collaboration with governmental and non-governmental agencies in curbing IFFs. In DAB's view, some of the challenges in curbing IFFs relate to capacity building of FIs, difficulty raising awareness, outdated laws, off-the-record transactions, lack of transparency of beneficial ownership, and lack of political will to enforce regulatory measures.

There is an alarming dearth of measures and sense of urgency in several key governmental institutions involved in combatting IFFs. Relevant institutions do not have specific rules, guidelines, or policies designed to prevent IFFs. Moreover, vetting or background checks are often not conducted in these institutions to ensure non-involvement of prospective employees in previous IFF-related matters. In addition, no systematic trainings are offered to these employees to educate them on IFF issues. There is a shortage of specialists and experts who can train and raise awareness on IFF issues. Absence of whistleblower policies and insufficient cooperation with other relevant authorities are other shortcomings. Effective coordination and collaboration on anti-IFF measures are lacking among relevant governmental agencies and departments. Often, a particular ministry believes that it is the only entity responsible for preventing IFFs, which demonstrates the acute unawareness of, and lack of collaboration with, other institutions and agencies involved in this sphere. Other major obstacles to curbing IFFs include corruption and lack of political will from the national government, as well as the international community (particularly with respect to IFFs linked to drug trafficking).

18 Available at: <http://www.asianlii.org/af/legis/laws/clogn875p2006020413841115a474/>.

19 Available at: <http://www.asianlii.org/af/legis/laws/lotcabaacogn838p2004101113830720a846/>.

20 An example of this third focus is the reports on the Kabul Bank case. MEC completed its first public inquiry into the Kabul Bank crisis in November 2012 and issued a Follow-Up Report on this matter in October 2014.

## 4. STANDARDS AND COMPLIANCE

This section will provide an overview of the key international standards addressing IFFs. In addition to discussing the primary international instruments dealing with IFFs, this section will also explore in depth an important international standard: the Financial Action Task Force (FATF) Recommendations concerning money laundering and terrorist financing. Moreover, it will assess Afghanistan's compliance with the FATF standards. Additionally, this evaluation will focus on both the current regulatory measures *and* the enforcement and implementation of those measures in light of the FATF standards.

### 4.1. Background

There are a number of international instruments and standards designed to address IFFs. These measures include the United Nations Convention Against Corruption (UNCAC), the United Nations Convention against Transnational Organized Crime (the Palermo Convention), the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, and the Financial Action Task Force Recommendations regarding money laundering and terrorism financing. Afghanistan is a State Party<sup>21</sup> to these international instruments.

#### 4.1.1. International Measures Concerning IFFs

The United Nations Convention against Corruption (UNCAC)<sup>22</sup> is a historic, international anti-corruption treaty adopted by the UN General Assembly in October 2003. The convention was established on December 14, 2005 with 176 countries, including Afghanistan, as parties to the convention (UNODC, 2015). In a policy brief from the U4 Anti-Corruption Resource Centre, UNCAC is described as providing for both preventive and punitive measures in the fight against corruption, a major component of IFFs. Additionally:

[UNODC] addresses the transnational nature of corruption with provisions on international cooperation and on the return of the proceeds of corruption. States Parties (countries that have ratified the Convention) are also obliged to help each other to prevent and combat corruption through technical assistance (defined broadly to include financial and human resources, training, and research). The convention further calls for the participation of civil society organizations in accountability processes and underlines the importance of citizens' access to information. (2010)

Afghanistan became a signatory to UNCAC in 2004 and ratified it in 2008. As shared by an MEC news brief, "consequently, as a State Party to the convention, the Afghan government is required to comply with its provisions and conduct a two-phase review of their implementation" (2015). The Karzai government entrusted this task to the High Office of Oversight and Anti-Corruption (HOOAC). According to the Independent Joint Anti-Corruption Monitoring and Evaluation Committee (MEC), HOOAC's assessment of Afghanistan's compliance with UNCAC was deficient in myriad ways (MEC, 2015)<sup>23</sup>.

The United Nations Convention against Transnational Organized Crime (UNTOC)<sup>24</sup>, also known as the Palermo Convention, is the primary international instrument designed to curb IFFs linked to transnational organized crime. The Convention is further supplemented by three protocols, which target specific areas and manifestations of organized crime<sup>25</sup>. Afghanistan ratified the Palermo Convention on September 24, 2003. As a State Party to the Palermo Convention, Afghanistan has committed itself to taking a series of measures against transnational organized crime, including the creation of domestic criminal offenses (participation in an organized criminal group, money laundering, corruption, and obstruction of justice); the adoption of

21 State Parties are countries that have ratified a particular convention.

22 For more information on UNCAC, see: <https://www.unodc.org/unodc/en/treaties/CAC/>.

23 See: [http://www.mec.af/files/2015\\_02\\_15\\_UNCAC\\_Recommendations\\_Press\\_Release\\_\(English\).pdf](http://www.mec.af/files/2015_02_15_UNCAC_Recommendations_Press_Release_(English).pdf).

24 For more information on the Palermo Convention, see: <http://www.unodc.org/unodc/treaties/CTOC/>

25 These include the Protocol to Prevent, Suppress, and Punish Trafficking in Persons, Especially Women and Children; the Protocol against the Smuggling of Migrants by Land, Sea, and Air; and the Protocol against the Illicit Manufacturing of and Trafficking of Firearms, their Parts and Components, and Ammunition.

new and sweeping frameworks for extradition, mutual legal assistance and law enforcement cooperation; and the promotion of training and technical assistance for improving the capacity of national authorities (UNODC, 2015).

The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances is one of three major drug control treaties currently in place<sup>26</sup>. This convention, as UNODC explains, “provides comprehensive measures addressing drug trafficking, including provisions against money laundering and the diversion of precursor chemicals. It provides for international cooperation through, for example, extradition of drug traffickers, controlled deliveries, and transfer of proceedings” (2015). The convention was established on November 11, 1990 with 189 countries ratifying this important instrument. Afghanistan became a State Party to this convention on February 14, 1992 (UNODC, 2015).

These international instruments are important measures in curbing IFFs. A detailed and comprehensive analysis of these conventions, and Afghanistan’s compliance with them, are beyond the scope of this report. However, the report will investigate international standards relating to money laundering, a crucial aspect of IFFs. In particular, the report will explore, in depth, the Financial Action Task Force Recommendations on combatting money laundering and terrorism financing, along with Afghanistan’s compliance with these standards.

#### 4.1.2. Financial Action Task Force (FATF)

The Financial Action Task Force (FATF) is an intergovernmental body established in 1989 by the Ministers of its member states. A 2012 FATF mandate describes its objectives as follows: “to set standards and promote effective implementation of regulatory and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system”<sup>27</sup>. The FATF has developed a series of recommendations<sup>28</sup> that are recognized as the international standard for combating money laundering and the financing of terrorism (FATF, 2012).

Afghanistan is a member of the Asia/Pacific Group on Money Laundering (APG). As an FATF Associate Member, APG’s purpose is to ensure the adoption, implementation, and enforcement of FATF recommendations. The APG’s five primary functions are conducting mutual evaluations of its members’ compliance with the global AML/CFT standards, coordinating technical assistance and training to improve compliance with the FATF AML/CFT standards, typologies research, global policy development, and private sector engagement (APG, 2015).

The International Monetary Fund (IMF) conducted an analysis of Afghanistan’s compliance with the FATF standards in 2011. The IMF report found that the compliance of Afghan laws and measures with the FATF standards was deficient. On February 16, 2012, FATF revised its recommendations. Four years later, the Afghan government has had a chance to address the issues raised in the IMF report.

The next section of the report evaluates the compliance of Afghanistan’s laws and regulations on money laundering and terrorism financing (ML/TF) with the revised 2012 FATF standards. It will also explore the enforcement and implementation of these AML/CFT measures.

## 4.2. Afghan Compliance with FATF Standards

This section will examine the Afghan regulatory and enforcement mechanisms dealing with money laundering and terrorism financing (ML/TF) in light of the revised 2012 FATF standards. For ease of reference and comparative assessment purposes, this section is structured in accordance with the organization and sequence of topics and issues in the FATF Recommendations.

26 This treaty provides additional legal mechanisms for enforcing the 1961 Single Convention on Narcotic Drugs and the 1971 Convention on Psychotropic Substances. For information on these conventions see: <https://www.unodc.org/unodc/en/treaties/illicit-traffic.html>.

27 The objectives of the Afghan AML law, set out in article 2, are similar to those of the FATF standard: to protect and promote the financial integrity of Afghanistan and to prevent the use of financial institutions and designated non-financial businesses and professions (DNFBPS) for money laundering, proceeds of crime, and the financing of terrorism.

28 For more information on the FATF Recommendations see: <http://www.fatf-gafi.org/topics/fatfrecommendations/documents/fatf-recommendations.html>.

## 4.2.1. National AML/CFT Policies and Coordination

### 4.2.1.a. Assessing risks and applying a risk-based approach

Afghanistan is a high-risk country for money laundering and terrorist financing activities, both of which are linked to IFFs. Various factors—such as the substantial illicit narcotic industry and rampant corruption—make Afghanistan fertile ground for IFF-related activities. FATF standards require adoption of an appropriate AML/CFT regime that adequately addresses such risks. While recent amendments to the AML/CFT laws and regulations have enhanced the country’s compliance with international standards, much work still remains, particularly with respect to the implementation of the regulatory measures. Current efforts to enforce these measures fall short of the high level of ML/TF risk in the country, particularly with respect to Money Service Providers (MSPs).

### 4.2.1.b. National cooperation and coordination

As per FATF standards, Afghanistan has enacted AML/CFT legislation, and a financial intelligence unit (FinTRACA) has been established to combat money laundering and terrorist financing. While an informal AML/CFT committee was established in 2009 to foster collaboration and cooperation among FinTRACA, Da Afghanistan Bank (DAB), and relevant law enforcement authorities, the committee has not focused on operational matters (IMF, 2011). Proper domestic coordination<sup>29</sup> among the relevant authorities is lacking. For instance, with respect to supervision of MSPs or *hawaladars*, there is minimal cooperation among the relevant competent agencies. Corruption/bribery is a major obstacle, preventing the enforcement of regulatory measures relating to MSPs. In addition, various agencies and authorities have expressed mistrust of, and lack of confidence in, other key relevant institutions when it comes to combatting ML/TF. Moreover, there have not been many convictions in ML/TF cases brought before the courts, despite the high risk for money laundering and terrorist financing activities in Afghanistan.

## 4.2.2. Money Laundering and Confiscation

### 4.2.2.a. Money laundering offense

While Article 4 of Afghanistan’s AML law criminalizes money laundering (ML) in Afghanistan, FATF mandates that countries should apply the crime to all serious offenses, with the intention to include the widest range of predicate offenses<sup>30</sup>. ML criminalization in Afghanistan does not apply to the full range of FATF-designated categories of offenses. Several of the activities listed in the standard (such as participation in an organized criminal group, kidnapping, or illicit arms trafficking) remain outside of the purview of the ML offense (IMF, 2011).

### 4.2.2.b. Confiscation & provisional measures

Chapter V of Afghanistan’s AML law adequately addresses the FATF recommendations concerning confiscation and provisional measures. Article 40 provides for an order by a court, in the event of conviction, for confiscation of funds or property. Article 41 also authorizes courts to order confiscation,<sup>31</sup> without requiring a criminal conviction.

29 Such cooperation relates to both preventative and punitive measures and includes training, information sharing, appropriate collaboration on ML/TF cases from the investigation stage until the conclusion of the trial, and other relevant key areas.

30 Predicate offenses are crimes underlying money laundering or terrorist finance activity. A predicate offense is an offense whose proceeds may become the subject of any of the money-laundering offenses established under the law.

31 The term confiscation, which includes forfeiture where applicable, means the permanent deprivation of funds or other assets by order of a competent authority or a court.

### 4.2.3. Terrorist Financing and Nonprofit Organizations

#### 4.2.3.a. Terrorist financing offense

Terrorist financing involves the raising of assets to supply terrorists with resources to pursue their activities. As with money laundering, terrorist financing poses a significant threat to the economic and financial stability of Afghanistan. In their book, *Money Laundering Among Globalized World*, authors Hitesh Patel and Bharat S. Thakkar elaborate, noting that “terrorist financing can compromise the integrity and stability of financial institutions and systems, discourage foreign investment, and distort international capital flows. It may have negative consequences for a country’s financial stability and macroeconomic performance, resulting in welfare losses, draining resources from more productive economic activities,” and even destabilizing the economies of other countries (2012).

Afghanistan continues to be a hotbed of terrorist activities, with groups such as Al Qaeda, Taliban, and ISIS operating within the country. In accordance with a 2012 report of recommendations from FATF, Afghanistan’s *Combating the Financing of Terrorism* (CFT) law criminalizes terrorist financing. Article 4 of the legislation further criminalizes the financing of terrorist organizations and individual terrorists, even in the absence of a link to a specific terrorist act. Moreover, Article 4(6) makes terrorism financing a predicate offense for money laundering (FATF, 2012).

#### 4.2.3.b. Targeted financial sanctions related to terrorist financing

Afghanistan has made provisions for the implementation of United Nations Security Council Resolution (UNSCR) 1267 designed to freeze the funds or other assets of designated terrorist persons, entities, or organizations. Under Article 11 of the CFT law, the Afghanistan National Security Council shall immediately notify the AGO of any person, entity, and/or organizations designated under UNSCR 1267 (1999), UNSCR 1988<sup>32</sup> (2011), and any successor resolutions issued by the United Nations Security Council acting under Chapter VII of the United Nations Charter. Following such notification, the AGO must, without delay and without prior notice, freeze the funds or property of any person, entity, or organization deemed pursuant to Articles 10 and 11 of the CFT law.

However, despite the high risk of TF in the country and the number of persons and entities that have links with Afghanistan, actual enforcement of these provisions has been inadequate. In one instance, authorities ordered the freeze of an account held by a person designated under UNSCR 1267, but the order was lifted pursuant to the demand of a very high-level government official, thus “reportedly enabling the holder of the account to withdraw the funds and leave the country” (IMF, 2011).

#### 4.2.3.c. Non-profit organizations

Under FATF standards, non-profit organizations (NPOs) should also be closely regulated and monitored to prevent misuse for TF. NPOs play an important role in Afghanistan, with close to 2,000 organizations operating in the country. Under the CFT law, NPOs operating to collect or receive grants, gifts, or donations—or to transfer funds and property—are required to align their activities to comply with provisions of NPO law and other applicable laws (article 26). NPOs are also subject to obligations concerning record keeping and annual financial statements in order to demonstrate that gifts, donations, and transactions involving NPOs are not for illicit purposes (article 27). NPOs can also be penalized, banned, or dissolved for contravening the law (articles 22 and 28). Despite these regulatory provisions and the high of risk of NPO misuse for TF purposes, no cases have been brought before the courts. Moreover, according to law enforcement agencies, there have been instances of NPOs being used to fund terror activities. Relevant institutions responsible for monitoring NPOs lack the necessary resources to conduct their functions effectively and do not perceive the risk of misuse of NPOs for TF purposes.

32 UNSCR 1988 (2011) deals with sanctions relating to the Taliban.

## 4.2.4. Preventive Measures

### 4.2.4.a. Financial institution secrecy laws

Under FATF standards, financial institution secrecy laws must allow, and not inhibit, implementation of FATF recommendations. Afghan laws comply with the requirement to prohibit secrecy. Each reporting entity is obliged to adhere to the requirements under the AML law, notwithstanding any obligation as to banking or professional secrecy or other restriction on the disclosure of information imposed by any law or otherwise (AML law, article 8). Moreover, shell banks<sup>33</sup> are forbidden, as are anonymous accounts and accounts in false names (AML law, articles 9 and 10).

### 4.2.4.b. Customer due diligence

The customer due diligence (CDD) requirements meet those set out in the FATF standards. All reporting entities, including financial institutions and DNFBPs, must comply with the CDD measures which include identifying the customer and verifying the customer's identity, identifying the beneficial owner and verifying the beneficial owner's identity, understanding the ownership and control structure of the customer, and conducting ongoing due diligence on the business relationship and scrutiny of transactions (AML law, article 2). AML/CFT regulations also provide additional guidance on customer identification (regulation 1.1.3). The CDD requirements apply to both new and existing customers. Financial institutions, including MSPs, must also develop customer acceptance policies, must not open anonymous accounts or accounts with false names. They are also required to avoid occasional transactions in excess of Afs 500,000 on behalf of customers who refuse to identify themselves at all or who refuse to disclose and document the source of their funds (AML/CFT regulations 1.3.1, 1.3.2, 1.4.3).

### 4.2.4.c. Record keeping

The FATF requirements regarding recordkeeping measures are incorporated in the domestic rules. As per FATF standard, reporting entities are obliged to maintain all necessary records on transactions for at least five years. Other relevant obligations include keeping records on identification and verification data obtained through CDD measures and ensuring that all transaction records and CDD information are readily available to FinTRACA and other competent authorities (AML Law, article 16). Moreover, FIs with branches or sub-offices must establish and maintain a centralized database of information from their branches and sub-offices on the identity of customers, principals, beneficiaries, agents, and beneficial owners, and on all large cash transactions and suspicious transactions (AML/CFT regulation 1.3.8).

Despite these regulatory measures, implementation of the CDD and of records retention rules is weak. While banks are equipped with online compliance software, insufficient resources and corruption, particularly with respect to MSPs, impede enforcement efforts. According to authorities, individuals who use bank accounts can be traced, but tracing is nearly impossible for those who choose not to use bank accounts. Moreover, banks have acknowledged challenges faced in checking transactions and complying with CDD and recordkeeping requirements.

## 4.2.5. Additional Measures for Specific Customers and Activities

### 4.2.5.a. Politically exposed persons (PEPs)

Most of the CDD requirements with respect to Politically Exposed Persons (PEPs)<sup>34</sup> are reflected in the domestic law. Under the AML law, in addition to normal due diligence measures, reporting entities should have appropriate risk management systems to determine whether the customer or beneficial owner is a PEP, they should take reasonable measures to ascertain the source of funds, and they should conduct enhanced ongoing monitoring of the business relationship (article 15). Moreover, financial institutions must reject PEPs as customers, if they know or reasonably suspect that the wealth of the PEP may have resulted from bribery, extortion, or other illegal activities (AML/CFT regulation 1.4.1).

33 A shell bank is a bank that is incorporated or licensed in a country or jurisdiction in which it has no physical presence and that is not affiliated with a financial group subject to effective consolidated supervision (AML law, article 3).

34 A "politically exposed person" means any natural person who is or was entrusted with a prominent public function in the Islamic Republic of Afghanistan or a foreign country, or a person who is or has been entrusted with a prominent function in an international organization, or a key figure of political parties, including family members and close associates (AML Law, article 3).

An important measure in the FATF standard is not incorporated in the domestic rules. Unlike the FATF standard, there is no provision requiring the application of PEP measures to family members or close associates of PEPs. Considering the prevalence of corruption and the potential risk posed by PEPs, this is a significant regulatory omission. Moreover, banks interviewed have also expressed difficulties in implementing CDD measures for PEPs.

#### 4.2.5.b. Correspondent banking

The AML law and AML/CFT regulations meet the FATF requirements concerning correspondent banking<sup>35</sup>. Before entering into correspondent banking or other similar relationships with a foreign bank, in addition to performing normal CDD measures as prescribed under article 12 of the AML law, financial institutions must comply with a number of obligations. These obligations include gathering sufficient information about the respondent institution, evaluating its reputation, and assessing the AML/CFT controls implemented by the respondent institution (article 21). FIs must ensure that respondent institutions are in compliance with applicable AML/CFT laws and regulations, and they must not open correspondent accounts at financial institutions that are unlicensed or otherwise unregistered or domiciled in countries that have been designated by the FATF as non-cooperative in the fight against ML and TF (regulation 1.4.2).

#### 4.2.5.c. Money or value transfer services

The cash-based nature of the Afghan economy coupled with the strong cultural preference for using MSPs necessitates close regulation and supervision of *hawaladars* in order to curb IFFs linked to ML/TF.

Under FATF standards, MSPs must be licensed or registered and subject to effective systems for monitoring and ensuring compliance with the relevant measures in the FATF recommendations. Agents working for MSPs must also be licensed or registered by the competent authorities and comply with internal AML/CFT controls and programs. Under the Money Service Providers Regulations (MSP regulations)<sup>36</sup> issued by Da Afghanistan Bank, each MSP must hold a valid license issued by the Financial Supervision Department's Licensing Section of DAB. The MSP regulations further articulate the scope of permitted activities of MSPs and the obligations of *hawaladars* to prevent ML/TF. Despite these specific rules, many MSPs continue to operate outside the legal framework, even in large urban centers. Supervision and enforcement of MSP regulations are even more difficult in insecure and remote parts of the country<sup>37</sup>.

Issues concerning MSP regulations and enforcement are analyzed in detail under the next major section of the report.

#### 4.2.5.d. Wire transfers

FATF requires FIs to include accurate originator and beneficiary information on wire transfers. Outlined in a 2012 report, the interpretive note to FATF recommendation 16 in particular requires all cross-border wire transfers to contain information on "(a) the name of the originator; (b) the originator's account number; (c) one of the following: the originator's address, national identity number, customer identification number, or date and place of birth; (d) the name of the beneficiary; and (e) the beneficiary account number."

However, the Afghan AML law (article 6) and AML/CFT regulations (regulation 1.4.4) fall short of meeting this standard by omitting the requirement for information on beneficiary or recipient of the wire transfer. Article 6 of the AML law requires the beneficiary's name only when the value of the wire transfer is less than Afs 1,000,000. For transactions exceeding Afs 1,000,000, the sender must also provide documentation on the source of funds (regulation 1.4.4). Moreover, this monetary threshold for triggering verification of the originator's information is substantially higher than what is contemplated in the standard (USD/EUR 1,000). In practice, however, FIs (and in particular MSPs), do not generally comply with these requirements.

35 Correspondent banking means the provision of banking services by one bank to another bank (AML Law, article 3).

36 For more information on these regulations see: <http://www.fintraca.gov.af/>.

37 By way of example, FIU staff examined an MSP in Kandahar but the staff were beaten and threatened. Insurgents were actively operating in that area as well.

#### 4.2.6. Reliance and Internal AML Controls

As permitted by FATF, Afghan AML law has envisioned the possibility of relying on third parties for CDD (article 12(10)). Moreover, as mandated by the FATF standard, the AML law requires reporting entities to develop programs and internal controls to prevent ML and TF (article 19). These programs must include internal policies, procedures, and controls relating to CDD, reporting, and record keeping obligations, adequate screening procedures when hiring employees, ongoing training for employees, and the internal audit arrangements necessary to check compliance with, and effectiveness of, the program and internal control measures. The AML/CFT regulations also require financial institutions to designate one individual as an “AML officer” who has the primary responsibility for development and implementation of the AML program and internal controls (regulation 1.2.1).

In practice, there has been insufficient guidance provided to FIs in developing such internal programs and controls. The sample policies and procedures developed and used by FIs are inconsistent and, at times, noncompliant with the domestic rules. Some banks also refuse to provide samples of their internal policies. The overwhelming majority of MSPs or *hawaladars* do not have such internal AML programs and controls. Banks interviewed also did not have whistleblower policies in place to protect and encourage individuals to voice concerns relating to IFF matters.

#### 4.2.7. Reporting of Suspicious Transactions

Under FATF standards, if a financial institution has reasonable grounds to suspect that the funds are the proceeds of criminal activity, or related to TF, it must report the suspicious transaction to the financial intelligence unit (FIU). This requirement is incorporated in article 18 of the AML law. The specific details regarding the reporting obligations are found in the *Regulations on Responsibilities of Financial Institutions in the Fight Against Money Laundering and Terrorist Financing* (AML/CFT regulations), promulgated by Da Afghanistan Bank (DAB). Regulation 1.3.6 addresses issues concerning what to report, when to report, preparation, delivery, and validation of reports, as well as issuance of receipts.

Reporting entities<sup>38</sup> must report suspicious<sup>39</sup> and large cash transactions<sup>40</sup> to FinTRACA. A 2011 report from IMF stipulates that whenever there are reasonable grounds to suspect an offense of money laundering or the financing of terrorism has been committed, FinTRACA must immediately submit a report on the facts, together with its opinion, to the AGO, which will decide upon further action. That report shall be accompanied by any other relevant documents, including the actual suspicious transaction report (STR)<sup>41</sup>.

FinTRACA received around 400 STRs in 2014, and approximately 2,500 STRs overall since its establishment. Virtually all STRs have been submitted by banks. Indeed, according to a recent SIGAR report, to date, no Afghan money-service business or *hawaladar* has ever submitted a suspicious transaction report to the government, as required under Afghan law (SGIAR, 2015).

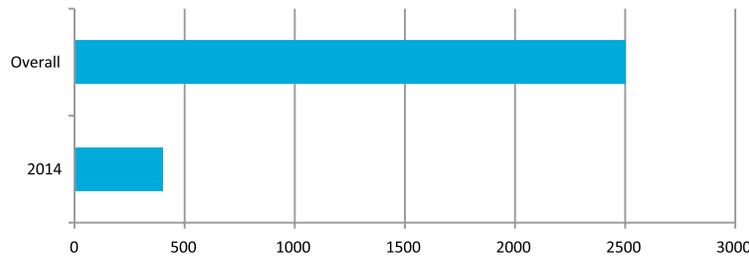
38 “Reporting entities” are financial institutions and designated non-financial businesses and professions (DNFBPs) that are subject to the Afghan AML law (article 5(1)).

39 A “suspicious transaction” is a transaction where any of the following circumstances exist: 1) there is no underlying legal or trade obligation, purpose, or economic justification; 2) the client is not properly identified; 3) the amount involved is not commensurate with the business or financial capacity of the client; 4) taking into account all known circumstances, it may be perceived that the client’s transaction is structured in order to avoid being the subject of reporting requirements under law and regulations; 5) there are circumstances relating to the transaction which are observed to deviate from the profile of the client and/or the client’s past transactions with the financial institution; 6) the transaction appears to be in any way related to an unlawful activity or offense that is about to be, is being, or has been committed; or 7) it is a transaction that is similar or analogous to any of the preceding conditions (Regulation 1.1.2(f), AML/CFT).

40 A “large cash transaction” is a transaction with value equal to, or exceeding, Afs 1,000,000 (approximately USD \$20,000). A large cash transaction also includes the completion of two or more such transactions by or on behalf of the same person during any two consecutive business days when the total value of the transactions is equal to, or exceeds, Afs 500,000 (Regulation 1.1.2(b), AML/CFT).

41 An STR is a report that reporting entities are obligated to submit to FinTRACA in the case of any “suspicious transactions”. An STR must be submitted even if it becomes clear only after the completion of a transaction that there are grounds for suspicion. Reporting entities are also required to submit, without delay, any additional information that might confirm or invalidate the suspicion. Furthermore, reporting entities, including their directors and employees, are prohibited from disclosing to a customer or any other person the fact that an STR has been made or any information has been submitted to FinTRACA or any competent authority in relation to any money laundering or terrorism financing investigation (AML Law, article 18).

Chart 2: Suspicious Transaction Reports Submitted to FinTRACA



AML/CFT regulations also comply with the FATF requirements relating to “tipping-off” and confidentiality. Reporting entities and their staff are required to maintain confidentiality, and not disclose information concerning their AML activities to their clients or to others, except to FinTRACA (regulation 1.3.7).

The scope of the reporting requirement, however, is narrow considering that not all FATF-designated categories of offenses, including the predicate crimes, have been criminalized. In practice, banks tend to be the only reporting entities that submit STRs—and only with respect to money laundering, not to terrorist financing. One particular bank confided that it submitted 77 STRs and around 1,000 large cash transaction reports (LCTRs) in 2014. According to the same bank, suspicious customers’ accounts are blocked and their transactions are rejected. As discussed later in the report, the level of compliance with reporting obligations is more lax when it comes to MSPs, making them the preferred vehicle for IFFs. Despite the high risk of ML/TF in Afghanistan, there have not been many convictions in such cases. Financial institutions and other stakeholders attribute this to corruption and political influence.

#### 4.2.8. Designated Non-Financial Businesses and Professions (DNFBPs)

FATF standards require the application of customer due diligence (CDD) and record-keeping measures to Designated Non-financial Businesses and Professions (DNFBPs). DNFBPs qualify as “reporting entities” and are hence subject to AML/CFT obligations concerning CDD and record keeping under articles 12 and 16 of the AML law. DNFBPs include lawyers, other independent legal professionals, accountants, real estate agents, rahnamai mamelaat (property dealers), Trust and Company Service Providers, and natural or legal persons dealing in precious metals and stones (article 5(3)).

As required by FATF, in addition to CDD and record keeping requirements, DNFBPs are also bound by the reporting obligations set out in article 18 of the AML law. DNFBPs are required to report any suspicious transactions that may be linked to ML/TF.

In practice, DNFBPs do not comply with these CDD, record keeping, and reporting obligations. Moreover, there is no supervisory framework for DNFBPs, many of whom operate without licenses or other legal authorizations.

#### 4.2.9. Transparency and Beneficial Ownership of Legal Persons

FATF requires countries to take measures to prevent the misuse of legal persons and arrangements for money laundering or terrorist financing. Under article 12 of the AML law dealing with identification and verification of customers, reporting entities<sup>42</sup> are required to identify beneficial owners<sup>43</sup> and verify their identities. With respect to legal persons and arrangements, reporting entities are obligated to “take reasonable measures to understand the ownership and control structure of the customer” (article 12(6)(b)).

Legal and beneficial ownership information can assist law enforcement and other competent authorities by identifying the individuals responsible for the underlying activity of concern, or by determining who may have relevant information to further an investigation. This allows the authorities to “follow the money” in

42 Reporting entities are financial institutions and designated non-financial businesses and professions (DNFBPs) that are subject to the Afghan AML law (article 5(1)).

43 “Beneficial owner” refers to the natural person(s) who ultimately own(s) or control(s) a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement.

investigations involving suspect accounts/assets held by corporate vehicles. In particular, beneficial ownership information can help locate a given person's assets within a jurisdiction (FATF, 2014).

Despite the regulatory stipulations, reporting entities—particularly MSPs and DNFBPs—tend not to investigate the beneficial ownership and control structure of the legal persons. In addition, legal persons must register with the Afghan Central Business Registry (ACBR), but information on beneficial ownership is not always collected, and general information in the registry is not updated frequently<sup>44</sup>.

#### 4.2.10. Regulation, Supervision, and Enforcement

While the establishment of FinTRACA and recent amendments to the AML/CFT laws and relevant regulations have enhanced the country's compliance with international standards, much work still remains, particularly with respect to the implementation of the regulatory measures. The regulations provide for on-site supervision and enforcement of the AML/CFT measures by the Financial Supervision Department of DAB, FinTRACA, and other competent authorities (AML regulations 1.5.1 and 1.5.2). Moreover, sanctions and penalties are available for noncompliance with the rules (articles 50-54 of AML law and articles 20-25 of the CFT law).

However, current efforts to enforce these measures fall short of the high level of ML/TF risk in the country, particularly with respect to MSPs, foreign exchange dealers, and DNFBPs. There have not been many convictions in ML/TF cases despite the high level of ML/TF risk in Afghanistan.

The central bank, Da Afghanistan Bank (DAB), is responsible for the supervision of financial institutions (FIs) including banks and MSPs, and the Ministry of Finance has the authority to regulate and supervise the insurance industry. However, according to relevant institutions, no measures are in place to ensure the fit and properness of beneficial owners and controllers of FIs, and no criminal background checks are conducted to prevent criminals from owning or controlling FIs.

There is insufficient cooperation and coordination among relevant ministries, agencies, and authorities in enforcing the regulatory measures, particularly with respect to MSPs and DNFBPs. Lack of cooperation among financial institutions also impedes curbing IFFs. Sharing information and other best practices among FIs could prevent IFFs.

According to government authorities, declaration systems and money laundering controls exist for cross-border transportation of currency into and out of the country at airports and borders. However, such declaration systems are only implemented at the Hamid Karzai International Airport at Kabul (KIA), and they are done so in a limited and insufficient way, as outlined earlier in this report.

Another issue that has further hampered the ability to monitor cash flow at border crossings is the 2012 presidential decree, which raised the limit of the amount of currency persons travelling outside of Afghanistan are required to declare from USD 10,000 to USD 20,000. This change has likely increased the risk of illicit bulk cash movement and further weakened controls for monitoring money movements at airports by making it easier to engage in a practice called "structuring." As explained by SIGAR, structuring occurs when "transactions such as money transfers or drug purchases are conducted repeatedly in small amounts to avoid suspicion. Under the current system, there is no requirement to report anything under USD 20,000" (2012).

44 Lack of resources, both human and technical, is cited as a major reason for this shortcoming.

Picture 1: Bulk Currency Centers at KIA



Source: SIGAR (2012)

Ineffective inspection controls at airports persist across Afghanistan's insecure and porous border crossings as well, affecting the screening of cargo and the policing of border crossings (SIGAR, 2015). Overall, the existing framework for supervision of financial institutions and implementation of the regulatory measures is weak, largely due to general lack of resources and expertise, as well as lack of vested interest and corruption.

Afghanistan's banking sector remains fragile and inadequately regulated by Da Afghanistan Bank (DAB). A 2014 SIGAR report indicates:

Audits of major commercial banks have identified systemic weaknesses in many areas of banking governance and operations, including personnel capacity, internal controls, accounting, credit analysis, and compliance with regulations. DAB's limitations and inability to conduct robust oversight allow such weaknesses in Afghan banks to remain unchecked, heightening the risk of another banking crisis.

#### 4.2.11. International Cooperation

In terms of international cooperation, article 55(1) of the AML law requires the competent authorities to provide the widest possible range of cooperation for the purposes of mutual legal assistance (MLA) in investigations and proceedings related to ML/TF. Article 55(4) makes ML and TF extraditable offenses for purposes of the *Law on Extradition and Legal Cooperation No. 1103* (2013). International cooperation is also addressed in chapter II of the CFT law. The scope of MLA by Afghan authorities, however, is limited, considering the number of FATF-designated offenses that have not been criminalized, as well as the lack of steps taken to implement the relevant UNSCRs. Another limitation is the inexperience of authorities in rendering assistance to foreign jurisdictions.

## 5. HAWALA AND ILLICIT FINANCIAL FLOWS

This section will explore the pivotal role played by the *hawala* system in curbing IFFs in Afghanistan. First, the concept of *hawala* will be discussed along with the preference for and importance of *hawala* in the Afghan financial system. Second, the nexus between *hawala* and IFFs will be examined. In particular, this section will explore the crucial function of *hawala* in facilitating money laundering and the Afghan drug trade. Third, it will evaluate the Afghan regulatory framework, supervision, and enforcement mechanisms for money services providers (MSPs). Finally, the section will explicate the fundamental reasons for the dangerously high level of noncompliance of MSPs with regulatory measures.

### 5.1. Background

*Hawala* remittance systems—also referred to by the Financial Action Task Force (FATF) as alternative remittance systems—are informal banking arrangements that facilitate the transfer of funds both domestically and internationally without using formal financial institutions (Chêne, 2008).

*Hawala* operates outside of, or parallel to, traditional banking or financial channels. Unlike traditional banking, *hawala* makes minimal or no use of negotiable instruments, instead relying on trust and the extensive use of connections such as family relationships or regional affiliations. There is often no recorded agreement or written contract for a transaction. The deal is secured by the trust between the parties with little legal means of enforcement. Money transfers are conducted through communications between members of a network of *hawaladars* or Money Service Providers (MSPs) (Jost and Sandhu, 2013). In this paper, the terms *hawaladars* and MSPs are used interchangeably. Undoubtedly, MSPs are key institutional players in the fight against IFFs.

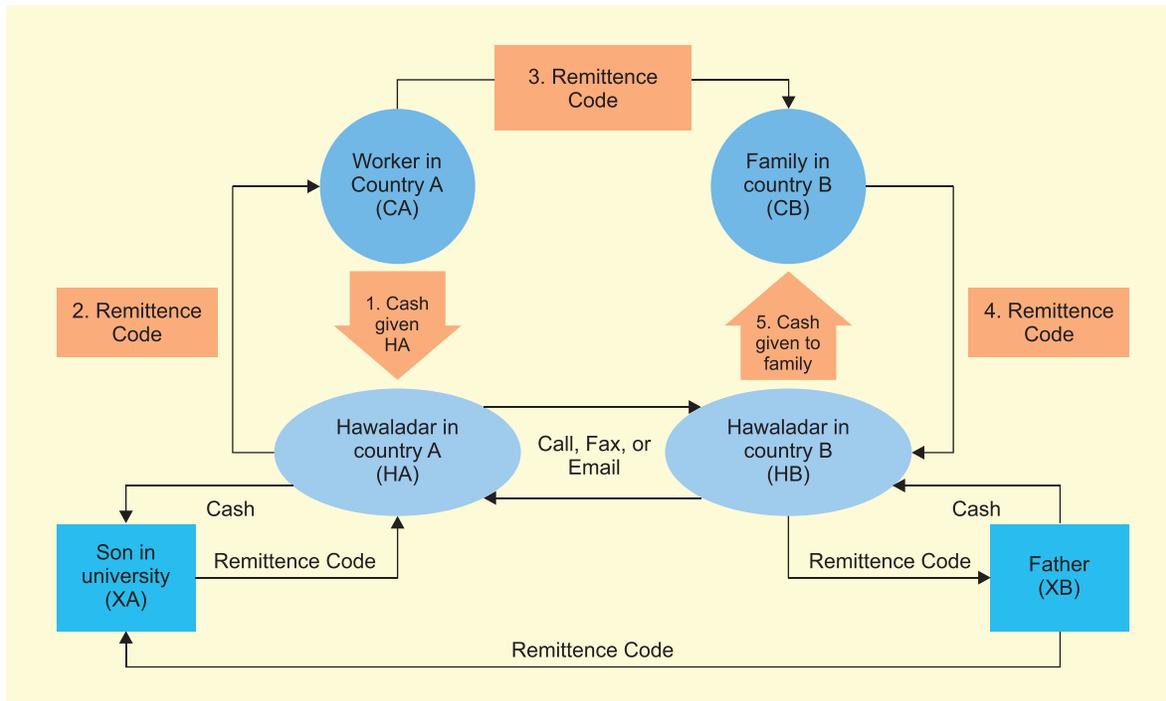
**The following scenario provides an illustration of a *hawala* transaction.**

In “The *Hawala* System,” Senior Economist for the Monetary and Exchange Affairs Department of the IMF, Mohammad El-Qorchi, provides the following illustration of a *hawala* transaction:

An initial transaction can be a remittance from a customer (CA) from country A, or a payment arising from some prior obligation, to another customer (CB) in country B. A *hawaladar* from country A (HA) receives funds in one currency from CA and, in return, gives CA a code for authentication purposes. He then instructs his country B correspondent (HB) to deliver an equivalent amount in the local currency to a designated beneficiary (CB) who needs to disclose the code to receive the funds. HA can be remunerated by charging a fee or through an exchange rate spread. After the remittance, HA has a liability to HB, and the settlement of their positions is made by various means, either financially or via goods and services. Their positions can also be transferred to other intermediaries, who can assume and consolidate the initial positions and settle at wholesale or multilateral levels.

The settlement of the liability position of HA through HB that was created by the initial transaction can be done through imports of goods or ‘reverse *hawala*.’ A reverse *hawala* transaction is often used for investment purposes or to cover travel, medical, or education expenses from a developing country. In a country subject to foreign exchange and capital controls, a customer (XB) interested in transferring funds abroad for, in this case, university tuition fees, provides local currency to HB and requests that the equivalent amount be made available to the customer’s son (XA) in another country (A). Customers are not aware if the transaction they initiate is a *hawala* or a reverse *hawala* transaction. HB may use HA directly if funds are needed by XB in country A, or he may use it indirectly by asking him to use another correspondent in another country, where funds are expected to be delivered. A reverse *hawala* transaction does not necessarily imply that the settlement transaction has to involve the same *hawaladars*; it could involve other *hawaladars* and be tied to a different transaction. Therefore, it can be simple or complex. Furthermore, the settlement can also take place through import transactions. For instance, HA would settle his debt by financing exports to country B, where HB could be the importer or an intermediary (2002).

Figure 4: Illustration of *Hawala* transition



Source: Mohammad El-Qorchi (2002)

## 5.2. Preference for Hawala

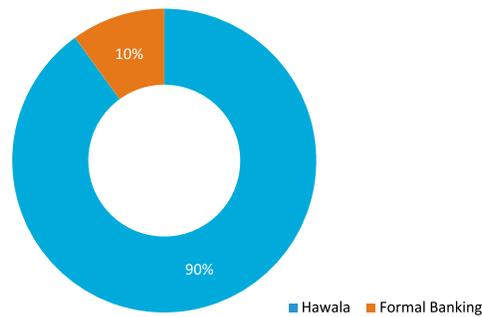
*Hawala* is the preferred method for money transfers and financial transactions in many jurisdictions for several reasons. First, *hawala* is cost-effective and efficient. A *hawala* remittance can take place in one or two days, as opposed to an international wire transfer, which involves at least one correspondent bank. The second reason is reliability. Traditional international transactions can be complex, time-consuming, and problematic, whereas the same transfer using *hawala* is completed in significantly less time and without as much hassle. The third reason is the lack of bureaucracy. Unlike international wire transfers, *hawala* does not require opening bank account(s) in other locations, nor does it require the accompanying customer due diligence (CDD) conducted at banks (Jost and Sandhu, 2013).

The fourth reason *hawala* is the preferred method for transferring money is the lack of a paper trail. *Hawaladars* tend not to keep detailed transaction records, and individuals can remain anonymous. This makes MSPs an ideal tool for illicit financial transactions. A fifth reason is tax evasion. Money transferred through formal banking systems might invite scrutiny from tax authorities; *hawala* provides a scrutiny-free remittance channel (Jost and Sandhu, 2013).

## 5.3. Importance of Hawala to the Afghan Financial System

Despite the relative growth of the formal banking sector in recent years, MSPs or *hawaladars* continue to play a dominant role in Afghanistan’s financial system, with approximately 90 percent of financial transactions still conducted through the informal *hawala* system. Moreover, according to a study by the World Bank, 80 to 90 percent of Afghanistan’s economic activity was facilitated by *hawala* in 2005 (IMF, 2011).

Chart 3: Financial Transactions in Afghanistan



Afghans generally prefer using MSPs to conduct financial transactions. As with other conflict regions, *hawaladars* are often the only channel through which funds can be transmitted in Afghanistan. *Hawaladars* are the safest, easiest, and cheapest way to transfer funds in the country (FATF, 2013). Other reasons behind the preference for *hawaladars* include cultural preference, an underdeveloped financial system, lack of banking services in large parts of the country (cash-based economy), higher confidence in *hawala* and similar service providers than in the banking system<sup>45</sup>, the desire to evade currency controls and international sanctions, tax evasion, and the need to transfer or conceal criminal proceeds (FATF, 2013).

According to MSPs, Afghans generally do not trust the formal banking system, making it more difficult to identify and prevent IFFs. Moreover, Afghan banks have also emphasized the “heavy reliance on the *hawala* system,” characterizing *hawala* as the “primary source of transferring illicit funds” in Afghanistan (FinTRACA).

These facts necessitate close regulation and supervision of these important financial actors to curb IFFs linked to ML/TF. However, enforcement and implementation of the rules governing MSPs are deficient, posing a major risk to the integrity of the Afghan financial system through proliferation of ML/TF activities and, in turn, IFFs.

## 5.4. Link between Hawala and IFFs

### 5.4.1. Hawala and Money Laundering

Money laundering is the process of disguising the proceeds of crime and integrating it into the financial system. These illicit proceeds could come from many different sources, such as drug trade, tax evasion, bribery, and corruption. Money laundering allows these illicit financial flows to be introduced into the financial system under a legitimate guise. As such, money laundering is central to IFF (GFI, 2015). A recent study by FATF concluded that MSPs continue to pose money laundering and terrorist financing vulnerabilities (2013).

As stated previously, money laundering consists of three phases: placement, layering, and integration. *Hawala* can be used at any phase, since it is a remittance system (GFI, 2015). In the placement phase, the illicit money is introduced into the financial system. In many ML cases, the biggest problem is handling cash. FIs must comply with CDD, recordkeeping, and reporting requirements. Enforcement of these requirements are lax, and often nonexistent, in the *hawala* system.

In the layering stage, the criminal manipulates illicit funds to make them appear as though they were derived from a legitimate source, often times transferring the money from one account to another. Doing this through the traditional banking system will likely result in a suspicious transaction report (STR) and leave a paper trail. Paper trails generated by financial transactions are important in stopping IFFs. The paper trail is a key factor connecting the three stages of the money laundering process<sup>46</sup>. By contrast, *hawala* will leave a sparse

45 The embezzlement and fraud in the Kabul Bank case has not helped with improving Afghans’ trust in the banking system.

46 Criminals try to avoid leaving this “paper trail” by avoiding reporting and recordkeeping requirements imposed on financial institutions. Through reporting and recordkeeping requirements, paper trails of transactions are created, and law enforcement and others can use them in criminal and regulatory investigations, and, ultimately, prevent illicit transactions (Financial Crimes Enforcement Network, 2015).

or confusing paper trail, if any. Research on *hawala* money laundering demonstrates that even basic *hawala* transfers can be difficult to trace and tie to the original (and in these cases, also criminal) source of money, making it an ideal monetary transmission mechanism for criminals.

Figure 5: Money Laundering Process



In the final phase, integration, the money seems to become legitimate, and *hawala* techniques offer many possibilities for establishing an appearance of legitimacy due to the absence of a paper trail and the ease with which the history of *hawala* transactions can be manipulated. (Jost and Sandhu, 2013).

According to several *hawaladars* operating in Saraye Shah Zada (Shah Zada market), the hub of the country's informal financial system, *hawaladars* play an instrumental role in IFFs. MSPs directly or indirectly assist terrorist networks, drug dealers, and other criminals in conducting financial transactions domestically and internationally. The MSPs interviewed insist that any serious attempt at curbing IFFs in Afghanistan would be deficient without considering the role of *hawaladars*.

#### 5.4.2. Hawala and the Afghan Drug Trade

As the world's largest opium-producing country, the proceeds from the drug trade form a major component of IFFs in Afghanistan. An in-depth study into the nexus between *hawala* and the drug trade in Afghanistan concluded that most drug-related export revenues are remitted to Afghanistan through the *hawala* system, in the form of either hard currency or commodities. The study found that the *hawala* system in Afghanistan is central to laundering of drug money. As long as Afghanistan depends on the *hawala* system—which is inevitable for the foreseeable future—the door for large-scale money laundering activities remains wide open (Thompson, 2007).

According to FATF, terrorists profit from and are engaged in opiate trafficking; over half of the Afghan Taliban senior leadership listed under United Nations Security Council Resolution (UNSCR) in 1988 were involved in drug trafficking<sup>47</sup>. Illicit use of money service providers is critical to the operation of opiate trafficking networks in Afghanistan, and these MSPs appear to be the leading value transfer instruments at the cultivation and manufacture stages of the international distribution of opiates, according to the FATF (2014).

### 5.5. Regulatory Framework, Supervision, and Enforcement

Recognizing the significant role MSPs can play in curbing IFFs linked to ML and TF, FATF requires close supervision and regulation of these important actors in the financial system. Indeed, MSPs are subject to Afghan AML/CFT laws. AML law applies to both financial institutions and designated non-financial businesses and professionals (DNFBPs), collectively referred to as “reporting entities.” Article 5(2)(iv) of the AML law states that “financial institutions” include any natural or legal person or entity who conducts as a business the transfer of money or its equivalent, including financial activity in both the formal or informal sector (FATF). Moreover, MSPs must comply with specific regulations promulgated by Da Afghanistan Bank (MSP regulations). Under the MSP regulations, money service provider means “a person or entity that engages in funds transfers and may also provide safekeeping and check cashing services” (regulation 2.1.3). The next sections will analyze the key regulatory provisions governing MSPs and discuss issues relating to enforcement and implementation of these measures.

47 The UN Al Qaida and Taliban Monitoring Team assesses that opiate-financing will imminently be the leading source of income for the Afghan Taliban and thus enable a major threat to the national security of Afghanistan and wider regional stability (FATF, 2014).

### 5.5.1. Licensing, Registration, and Permitted Activities

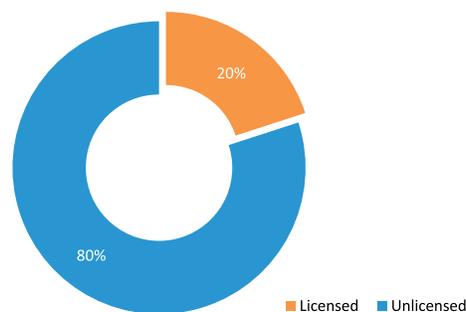
Under the MSP regulations, each *hawaladar* must hold a valid license issued by DAB. The central bank will grant a license<sup>48</sup> to the applicant for the establishment and operation of a money service provider business only if the applicant can meet the following conditions: “(a) demonstrate that the owners or proprietors of the business are fit and proper persons deserving of public trust; (b) establish at least one fixed address from which the business will be operated; (c) agree to apply the appropriate procedures for the prevention of money laundering and terrorist financing; and (d) agree to abide by the terms of the “Money Service Providers Licensing Agreement” (regulation 2.2.1).

For each issued license, the Financial Supervision Department’s Licensing Section of DAB records the following information in its registry of MSPs: “title and location of licensed legal entity; license number, taxpayer identification number, date of issue, and registration number of the license; the type(s) of services to be provided according to the license; location(s) where licensed provision of services may occur; agents, associates, and employees allowed to conduct business under the license; and information on re-registration, suspension, and termination of license” (regulation 2.3.1).

Upon approval by DAB and issuance of license, a *hawaladar* is permitted to engage in the following activities: “(a) money transmission; (b) safekeeping of funds to the extent necessary in order to facilitate a specific transaction; and (c) check cashing” (regulation 2.3.1).

In practice, most MSPs do not hold a license. Kabul is the largest financial center in the country, and almost all major Kabul-based MSPs are found at the Saraye Shah Zada (Shah Zada market). According to several *hawaladars* at the Shah Zada market, approximately 80 percent of MSPs operating in Kabul do not hold valid licenses. That figure will likely be higher in other parts of the country due to insecurity and even less supervision by relevant authorities.

Chart 4: MSPs Operating in Kabul



### 5.5.2. Preventing Money Laundering

MSP regulations explicitly refer to the obligations of *hawaladars* under the AML/CFT laws and regulations. Every licensee is obliged to take all necessary measures for the effective prevention of money laundering. Measures include “continuous training of staff so that they are able to recognize transactions that might be related to money laundering, instructions as to what action they should take in such circumstances, effective internal control and communication procedures, and submission of any required reports on suspicious transactions to FinTRACA” (regulation 2.3.7).

48 A non-refundable license application fee of Afs 15,000 must be paid to DAB upon submission of each license application (regulation 2.4.7).

Despite these regulatory provisions, MSPs largely ignore these requirements and may inadvertently assist in the commission of ML/TF. Many MSPs are not well-trained themselves to recognize transactions linked to ML/TF, let alone possess the ability to train others under their supervision. While DAB has attempted to train MSPs on AML/CFT issues, such trainings are infrequent, inadequate, and optional. Moreover, there are typically no internal controls, policies, or programs to prevent ML/TF, nor are there any internal audit arrangements or an “AML officer” to check compliance with AML/CFT rules. While some MSPs may have developed such internal controls and procedures, they are not implemented rigorously. There are also *hawaladars* who facilitate ML/TF with full knowledge of the nature of the transaction. In short, effective internal controls and communication procedures are rare, as are STR submissions to FinTRACA.

### 5.5.3. Customer Due Diligence, Record-Keeping, and Reporting

*Hawaladars* are subject to AML/CFT laws and regulations concerning customer due diligence (CDD), record-keeping, and reporting. These requirements were discussed in the earlier section of this report concerning Afghanistan’s compliance with FATF standards. In addition to those requirements, within 10 days of the end of each financial month, MSPs are required to submit a report on the number and aggregate volume of transactions to the Financial Supervision Department of DAB (FSD). The transmissions must be broken down according to the following parameters: inbound and outbound, foreign and domestic, and currency of denomination of amounts transmitted (MSP regulation 2.4.2).

The level of compliance of *hawaladars* with these measures is very low. While licensed and registered MSPs do submit monthly reports as required by the regulations, these reports tend not to be comprehensive and rarely disclose suspicious transactions. Indeed, according to SIGAR’s recent report, to date, no Afghan money-service business or *hawaladar* has ever submitted a suspicious-transaction report to the government, as required under Afghan law (2015). According to several *hawaladars*, out of nearly 300-400 MSPs operating at the Shah Zada Market—the center of the informal financial system in Afghanistan—only an approximate 5-10 fulfill the reporting obligations (and they do so very loosely).

Complying with CDD, record keeping, and reporting obligations means losing clients, and business, to competitors who would happily process a transaction without any questions. According to one *hawaladar* who wished to remain anonymous, “the unwritten law is to take any client and transmit the money without any unnecessary questions.” Having a reputation as a *hawaladar* who asks “unnecessary questions” is a “grave and unforgiveable business mistake.” As such, collaboration with DAB, FinTRACA, and other law enforcement authorities is minimal.

### 5.5.4. Supervision, Enforcement, and Penalties

The Financial Supervision Department of DAB (FSD) is tasked with the supervision of MSPs<sup>49</sup>. Under regulation from DAB, FSD will inspect licensees “on a regular basis, after having given reasonable notice in advance of the scope and duration of the inspection, at the licensee’s headquarters or any other location from which the licensee or its authorized agents provide money services.” DAB also has the authority “to send internal personnel to the provincial branches of DAB on an as-needed basis for the purpose of extending the range of this regulation.” Moreover, DAB “may undertake inspection of the licensee or any of its authorized agents without any prior notice, if DAB reasonably believes that the licensee or his authorized agents are contravening the provisions of this regulation” (MSP regulation 2.4.4).

Under the rules, MSPs “operating without a license will be referred to the Attorney General’s Office (AGO) for closure, confiscation of records and property, and prosecution” (MSP regulation 2.4.11). Noncompliance with the rules can also result in fines and late fees, as well as suspension and revocation of license (MSP regulation 2.4.5 and 2.4.10).

49 DAB FSD is responsible for ensuring the health of the banking sector by controlling the issuance of licenses for banks and other informal financial institutions, such as *hawalas* and foreign exchange dealers.

Despite these inspection powers and penalties, most MSPs operate without licenses. According to Kabul-based MSPs, instances of *hawaladars* being reported to the AGO are very rare<sup>50</sup>. Corruption is one factor in the lackadaisical and haphazard enforcement of the rules. Noncompliance (e.g. not holding a license) is not necessarily a *hawaladar's* worst nightmare, so long as there is adequate provision for “bakhshish”<sup>51</sup>.

A key reason for the weak implementation of the regulatory measures is lack of resources and expertise. A recent SIGAR report highlighted the weakness of the central bank in regulating the financial sector<sup>52</sup>. There has been no technical assistance provided to DAB by the U.S. since 2011<sup>53</sup>, when the Afghan government banned U.S. advisors from working with the central bank (SIGAR, 2014). Moreover, technical support from international organizations remains very limited. The World Bank is terminating one of its two programs with DAB because of unsatisfactory results that were caused, in part, by “a deteriorating security environment.” The IMF does not currently have any advisors assisting DAB. In short, the Afghan banking sector remains unstable and is at risk of experiencing another crisis similar to the near collapse of Kabul Bank if these weaknesses remain unchecked (SIGAR, 2014).

## 5.6. Reasons for Noncompliance

There are several factors explaining the high level of noncompliance with the rules governing MSPs. One major reason is that following the law is not in *hawaladars'* business interests. The customs and culture of Afghanistan mandate keeping transactions discreet and not asking too many questions.

Additionally, DAB, FinTRACA, and other relevant authorities do not have the necessary human and technical resources and expertise to effectively monitor and enforce regulatory measures. International organizations' support to the central bank has diminished significantly in recent years, partly due to the deteriorating security environment. The resource-constraint issue is especially acute in the remote and more insecure parts of the country, which fall largely outside of the reach of competent authorities<sup>54</sup>.

The culture of corruption is another impediment in the enforcement of the rules. Noncompliance is not necessarily a problem for MSPs provided that hush money is exchanged. Bribery ensures that violating the rules does not result in sanctions.

Another related reason is the general mistrust of authorities. *Hawaladars* are reluctant to report suspicious transactions for fear of being put under the spotlight, attracting unfair scrutiny and bogus allegations of complicity in the illicit transaction, and potentially being forced to pay bribes to settle the case. One *hawaladar* who wished to remain anonymous analogized the reporting of suspicious transactions to helping the victims of motor vehicle accidents: “as soon as you touch the injured person or report the incident, you are considered a suspect or accomplice.”

Noncompliance can also be motivated by tax evasion. Having a license requires the MSP to pay business taxes. This is a key reason why the vast majority of *hawaladars* operate without legal authorization. Moreover, the volume of transactions—and hence business income—will be a factor in the determination of one's tax obligations. As such, MSPs have an incentive to understate the number and volume of transactions they facilitate. Larger transactions, which tend to be illicit, are often unreported for this reason. In short, according to one *hawaladar* who wished to remain anonymous, “running a profitable business as a *hawaladar* through legal means is practically impossible” for the reasons discussed above.

50 *Shaheen Money Exchange Service Provider* was cited by the interviewees as one of the rare instances of *hawaladars* being prosecuted for ML.

51 Forgiveness in return for an illicit payment or other form of bribe.

52 While the SIGAR report focused mostly on the commercial banking sector, that finding is consistent with this report's examination of the *hawala* system.

53 In particular, the U.S. Agency for International Development (USAID), the Department of the Treasury, the Department of State, and the Department of Defense have not provided technical assistance to DAB since 2011.

54 As mentioned earlier, by way of example, FIU staff examined an MSP in Kandahar but the staff were beaten and threatened. Insurgents were actively operating in that area as well.

## 6. CONCLUSION AND RECOMMENDATIONS

The actual volume of IFFs and their different components are extremely hard to measure.

The Ministry of Finance reports that only about 35 percent of financial flows in Afghanistan stem from licit sources. This means that approximately 65 percent of the country's funds are illicitly earned, transferred, or utilized and includes IFFs linked to money laundering, tax evasion, corruption/bribery, and lost Customs revenues.

Afghanistan has made positive strides in its efforts to curb IFFs. The establishment of relevant agencies (e.g. FinTRACA) and regulatory measures (e.g. AML/CFT laws and MSP regulations) are important steps in stymieing the illegal flow of money within and out of the country. However, much work still remains, particularly with respect to the implementation and enforcement of the regulatory measures. As indicated by several institutions, enforcement is the key challenge in curbing IFFs in Afghanistan, particularly when it comes to high-level officials and individuals who are politically well-connected. On the basis of the research, interviews, and analysis of the data findings included in this report, the following recommendations can be made to the relevant authorities:

**Amending the relevant laws and regulations to increase compliance with international standards in combating IFFs.** All felonies should be made predicate offenses for money laundering. Currently, ML criminalization does not apply to the full range of FATF-designated offenses. Several activities listed in the international standard (e.g. participation in an organized criminal group, kidnapping, or illicit arms trafficking) remain outside the purview of the ML offense. In addition, unlike the FATF standard, there is no provision in the AML/CFT laws requiring the application of PEP measures to family members or close associates of politically exposed persons (PEPs). This is a significant regulatory oversight considering the prevalence of corruption and potential risk posed by PEPs in Afghanistan. Moreover, customer due diligence (CDD) requirements relating to wire transfers must be strengthened. Unlike the FATF standard, the current rules do not require information about the beneficiary or recipient of the wire transfer. The beneficiary's name is only required when the value of the wire transfer is less than Afs 1,000,000. Furthermore, the monetary threshold for triggering the verification of originator's information is substantially higher than what is contemplated in the FATF standard.

**Training the judiciary and law enforcement authorities on AML/CFT rules.** There is a lack of sufficient knowledge of AML/CFT laws and regulations by the courts, law enforcement, and other relevant authorities. Given the recent amendments and revisions to the AML/CFT laws and the introduction of relevant regulations, it is critical to ensure that the relevant institutions and agencies are adequately trained on the new laws and regulations designed to comply with international standards.

**Raising awareness and training governmental institutions, agencies, and relevant authorities on IFF issues and related measures.** There is an alarming absence of measures and a lacking sense of urgency in key governmental institutions involved in curbing IFFs. Many key ministries and institutions either fail to view IFFs as a significant challenge or remain unaware of the extent of the problem in the country. Some ministries and agencies do not follow specific rules, guidelines, or policies designed to prevent IFFs; for example, vetting or background checks are often not conducted to ensure non-involvement of prospective employees in previous IFF-related matters. In addition to the absence of whistleblower policies, there is a shortage of specialists and experts who can train and raise awareness on IFF issues. Qualified experts must provide regular workshops and trainings to relevant institutions and authorities on appropriate measures to help curb IFFs.

**Increasing supervision of MSPs and enforcement of regulatory measures.** MSPs are the preferred choice for criminals and terrorists to conduct illicit financial transactions. The level of noncompliance with AML/CFT rules and MSP regulations is very high. According to SIGAR, despite the widespread use of *hawala* in the Afghan financial system, no MSP or *hawaladar* has ever submitted a suspicious transaction report to FinTRACA, as required under Afghan law (2014). The penalization of MSPs for noncompliance is rare. Serious attempts to curb IFFs in Afghanistan must involve MSPs receiving very close attention. However, DAB FSD, FinTRACA, and other relevant authorities lack necessary resources and expertise to properly supervise MSPs and enforce

regulatory measures. Considering that most MSPs operate without legal authorization, relevant authorities must ensure strict compliance with licensing and registration requirements. *Hawaladars* also must be closely supervised and monitored to ensure compliance with CDD, record-keeping, and reporting obligations. MSPs in violation of the rules must be penalized and, where appropriate, referred to the AGO. The security and personal safety of officials responsible for enforcing and implementing the regulatory measures, particularly in the remote and insecure parts of the country, must be ensured as well.

**Strengthening monitoring systems for non-profit organizations and DNFBCs.** There is a high risk of non-profit organizations (NPOs) and DNFBCs being used to launder money or fund terror. There are no supervisory frameworks for NPOs and DNFBCs. Many DNFBCs operate without licenses or legal authorization. Relevant agencies and institutions lack the necessary resources to effectively monitor NPOs and DNFBCs. Supervisory frameworks must be established, and regulatory agencies must be supported in effective monitoring practices of these organizations.

**Enhancing transparency of beneficial ownership and control structure of legal persons and arrangements.** FIs and DNFBCs are required to take reasonable measures to understand the ownership and control structure of the customer. Reporting entities, particularly MSPs and DNFBCs, often do not bother with identifying and verifying beneficial owners. In addition, no measures are currently in place to ensure the fit and properness of beneficial owners and controllers of FIs, and no criminal background checks are conducted to prevent criminals from owning or controlling FIs. Moreover, the relevant authorities tasked with the registration of legal persons do not collect information on beneficial ownership in a systematic and adequate manner, nor do they update the general information on legal persons in the registry. Lack of resources and expertise is a contributing factor to these shortcomings. Requirements on recording and updating beneficial ownership information must be enforced stringently.

**Providing training and guidance to FIs and DNFBCs.** There is a serious dearth of regular and adequate training, education, and capacity building offered to FIs and DNFBCs on their obligations under the AML/CFT rules and other relevant measures. Many FIs, particularly MSPs and DNFBCs, are completely in the dark about their CDD, record-keeping, and reporting obligations. Moreover, there has been insufficient guidance provided to reporting entities about developing internal controls and programs to prevent ML/TF. DAB, FinTRACA, and other competent authorities must provide regular training and guidance (e.g. via publications or communications) to the reporting entities to curb IFFs. Attending such trainings must be mandatory and nonattendance must be penalized.

**Providing support and technical assistance to DAB by resuming collaboration with the international community.** The central bank's capacity to effectively regulate and oversee the banking sector is severely limited, largely due to lack of resources and expertise. For several years, the U.S. has not provided any technical assistance to the central bank, and the World Bank and IMF have also significantly scaled back their cooperation with DAB. Failure to address these issues heightens the risk of another banking crisis.

**Supporting FinTRACA and other relevant institutions.** Lack of resources and expertise is a major obstacle in curbing IFFs in Afghanistan. This problem is particularly pronounced in the insecure and more remote areas outside the purview of relevant authorities. Additional measures must be adopted to ensure FinTRACA can adequately perform the functions of an FIU. FinTRACA is not operationally independent, as it lacks human and technical resources and a significant portion of its budget, passed on by DAB, is dependent on dwindling foreign aid. Lack of IT facilities is another significant challenge preventing FinTRACA from proactively combatting IFFs. Financial support and provision of these technical resources are needed to bolster the FIU's capacity to effectively prevent IFFs.

**Strict enforcement of the declaration system and money laundering controls for cross-border transportation of currency and bearer negotiable instruments.** Currently, the declaration system for transportation of currency and bearer negotiable instruments into and out of the country is only implemented, somewhat deficiently, at the Hamid Karzai International Airport in Kabul. Approximately USD 4.5 billion in bulk cash left Afghanistan via this airport alone in 2011. Re-locating cash counter to higher-trafficked areas with better accessibility by Customs and FinTRACA officials is key, as is connecting the machines to the Internet or internal servers for better data collection and data sharing. VIPs also must be required to use cash-counting machines

even in spite of their elevated or protected status. Another vulnerability is the recent increase in the limit on the amount of currency persons travelling outside of Afghanistan are required to declare from USD 10,000 to USD 20,000. This change increases the risk of illicit bulk cash movement and further weakens controls for monitoring money movements at airports. Given the cash-based nature of Afghanistan's economy, strict enforcement of the declaration system and anti-money laundering measures along Afghanistan's crossings is critical to curbing IFFs.

**Increasing national coordination and cooperation among relevant ministries, agencies, and authorities to curb IFFs.** Despite attempts to enhance cooperation and coordination among relevant institutions and agencies, poor enforcement and implementation of regulatory measures indicate that effective inter-agency collaboration is lacking, particularly with respect to MSPs. A committee should be tasked with the goal of enhanced and meaningful cooperation among the competent authorities with a focus on operational matters. The roles of FinTRACA and other agencies must be clarified to eliminate redundancies and leverage synergies. A centralized system must be established to link all relevant governmental departments, institutions, and authorities and to facilitate collaboration on IFF matters. As part of such centralized system, a general database must be developed to compile and share information. There should also be a mechanism for supervision of various government agencies responsible for enforcing the regulatory measures. Cooperation among financial institutions must also be enhanced. Sharing information and best practices among FIs must be emphasized. Furthermore, despite signing MOUs with international counterparts, cross-border cooperation on IFF-related counter-measures is inadequate.

**Addressing tax evasion.** Tax-motivated IFFs present major challenges to Afghanistan. Poor government standards, weak enforcement mechanisms, unfamiliarity with tax obligations, and lack of resources and expertise are some of the factors contributing to the tax evasion issue. Effectively tackling tax evasion also necessitates addressing corruption, bribery, and political influence.

**Tackling corruption.** The pervasive culture of corruption is a major challenge in the enforcement of regulatory measures designed to curb IFFs. It is not uncommon for the relevant authorities charged with implementing the rules to ask for bribes in return for leniency. Moreover, despite the high risk of ML/TF in the country, there have not been many convictions in such cases. Various institutions and agencies have cited corruption and political influence as major obstacles in curbing IFFs. According to MEC, there is minimal transparency and accountability by the relevant institutions tasked with preventing IFFs, and MEC's recommendations are practically ignored.

**Commitment and political will to enforce regulatory measures.** According to several relevant stakeholders in the Afghan financial system, a substantial challenge in curbing IFFs is the absence of political support and backing for the enforcement of the AML/CFT laws. Orders from the upper echelons of the political establishment have lifted freezing orders on designated terrorist persons' accounts, allowing them to leave the country. The Kabul Bank case is one high-profile example of the lack of commitment and political will to respond emphatically to financial crimes. Various institutions and agencies have cited corruption and political influence as major obstacles in preventing IFFs.

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## GLOSSARY

**Beneficial owner:** Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement.

**Bulk currency counters:** Bulk currency counters are important anti-money laundering tools because they can capture currency serial numbers and other important data useful for detecting and investigating financial crimes.

**Confiscation:** The term confiscation, which includes forfeiture where applicable, means the permanent deprivation of funds or other assets by order of a competent authority or a court.

**Correspondent banking:** Correspondent banking means the provision of banking services by one bank to another bank.

**Customer due diligence (CDD):** Under Afghan law, all financial institutions and designated non-financial business and professions must comply with CDD requirements. CDD measures include identifying the customer and verifying the customer's identity, identifying the beneficial owner and verifying the beneficial owner's identity, understanding the ownership and control structure of the customer, and conducting ongoing due diligence on the business relationship and scrutiny of transactions.

**Da Afghanistan Bank (DAB):** DAB is Afghanistan's central bank. The central bank plays a key role in the Afghan economy by supporting the general economic policies of the government and strengthening sustainable economic growth. The primary objective of the Da Afghanistan Bank is to achieve and maintain domestic price stability

**Designated non-financial businesses and professions (DNFBPs):** DNFBPs qualify as "reporting entities" and are, hence, subject to obligations concerning customer due diligence and record keeping under Afghan law. DNFBPs include lawyers, other independent legal professionals, accountants, real estate agents, rahnamai mamelaat (property dealers), Trust and Company Service Providers, and natural or legal persons dealing in precious metals and stones (article 5(3)).

**Financial Action Task Force (FATF):** The FATF is an inter-governmental body established to set standards and promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system.

**Financial Intelligence Unit (FIU):** FIUs are national centers responsible for collecting information on suspicious or unusual financial activity from the financial industry and other entities or professions required to report transactions suspicious of being money laundering or terrorism financing. Afghanistan's FIU is the Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA).

**Foreign direct investment:** A foreign direct investment is a controlling ownership in a business enterprise in one country by an entity based in another country.

**Hawala:** An informal system of providing money services such as financial transfers. Ninety percent of financial transactions in Afghanistan are conducted through *hawala* rather than the formal banking system.

**High Office of Oversight and Anti-Corruption (HOOAC):** Established in accordance with the Afghan Constitution and the United Nations Convention Against Corruption (UNCAC), HOOAC is the highest office for the coordination and monitoring of the implementation of Afghanistan's anti-corruption strategy and for the implementation of administrative procedural reform in the country.

**Illicit financial flows (IFFs):** IFFs are illegal movements of money or capital from one country to another. This movement is classified as an illicit flow when the funds are illegally earned, transferred, and/or utilized.

**Independent Joint Anti-Corruption Monitoring and Evaluation Committee (MEC):** MEC independently monitors and evaluates national and international efforts to fight corruption in Afghanistan. It reports to the public, parliament, president, and international community.

**Large cash transaction:** Under Afghan law, a large cash transaction is a transaction with value equal or exceeding Afs 1,000,000 (approximately USD \$20,000). A large cash transaction also includes the completion of two or more such transactions by or on behalf of the same person during any two consecutive business days when the total value of the transactions is equal to or exceeds Afs 500,000.

**Money laundering (ML):** ML is the process of disguising the proceeds of crime and integrating it into the legitimate financial system. It consists of three stages: placement, layering, and integration.

**Money service provider (MSP):** Under Afghan law, money service provider means a person or entity that engages in funds transfers, and may also provide safekeeping and check cashing services. MSPs are also known as *hawaladars*.

**Politically exposed person (PEP):** A PEP refers to any natural person who is or was entrusted with a prominent public function in the Islamic Republic of Afghanistan or a foreign country, a person who is or has been entrusted with a prominent function in an international organization, or a key figure of political parties including family members and close associates.

**Predicate offense:** Predicate offenses are crimes underlying money laundering or terrorist finance activity. A predicate offense is an offense whose proceeds may become the subject of any of the money-laundering offenses established under the law.

**Reporting entities:** Reporting entities refer to financial institutions and designated non-financial businesses and professions (DNFBPs) that are subject to *Afghan Anti-Money Laundering Law*.

**Reverse money laundering:** Money laundering can involve the use of clean money—or money from an unknown source—to commit crimes in the future. In reverse money laundering, similar techniques can be used to conceal the ownership of the money and the purpose for which it will be used (e.g. financing of terrorism).

**Shell bank:** According to Afghanistan’s *Anti-Money Laundering law*, a shell bank is a bank that is incorporated or licensed in a country or jurisdiction in which it has no physical presence and that is not affiliated with a financial group subject to effective consolidated supervision.

**Special Inspector General for Afghanistan Reconstruction (SIGAR):** SIGAR is the U.S. government’s leading oversight authority on Afghanistan reconstruction.

**State party:** State parties are countries that have ratified a particular international convention.

**Suspicious transaction:** Under Afghan law, a suspicious transaction is a transaction where here any of the following circumstances exist: 1) there is no underlying legal or trade obligation, purpose, or economic justification; 2) the client is not properly identified; 3) the amount involved is not commensurate with the business or financial capacity of the client; 4) taking into account all known circumstances, it may be perceived that the client’s transaction is structured in order to avoid being the subject of reporting requirements under law and regulations; 5) there are circumstances relating to the transaction which are observed to deviate from the profile of the client and/or the client’s past transactions with the financial institution; 6) the transaction appears to be in any way related to an unlawful activity or offense that is about to be, is being, or has been committed; or 7) it is a transaction that is similar or analogous to any of the foregoing.

**Suspicious transaction report (STR):** An STR is a report that reporting entities are obligated to submit to FinTRACA in the case of any “suspicious transactions” along with any additional information that might confirm or invalidate the suspicion. Reporting entities are prohibited from disclosing to a customer or any other person the fact that an STR has been made or any information has been submitted to FinTRACA.

**Tax evasion:** Tax evasion is using illegal means to avoid paying taxes. Tax evasion is a major component of IFFs.

**Tax haven:** Tax havens are jurisdictions or geographical areas which have a system of financial secrecy in place, often levying taxes at a low rate or not at all. In these jurisdictions, financial institutions and actors are often allowed to accept money from basically anywhere without reporting it to the authorities in the country where it originates or from which it is controlled.

**Terrorist financing:** Terrorist financing involves the raising and processing of assets to supply terrorists with resources to pursue their activities.

**Trade-based money laundering (TBML):** TBML is the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimize their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity, or quality of imports or exports.

**Trade mispricing/misinvoicing:** Trade mispricing/misinvoicing is a method for moving money illicitly across borders, which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to Customs.

**Withholding tax:** Withholding tax includes income tax withheld from employees' wages and paid directly to the government by the employer.





INTEGRITY  
WATCH  
AFGHANISTAN

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