



SAFER CORRIDORS RAPID ASSESSMENT

Case study: Somalia and UK banking

SEPTEMBER 2013

This report was commissioned in August 2013, and does not reflect any developments since its completion in September 2013. The findings are the authors' and do not necessarily reflect the views of Her Majesty's Government.

RICHARD DEACON

UW84DC #7 (2001)

This sculpture is part of the Government Art Collection. The title derives from mobile phone text messaging and reads, 'you wait for the sea'. Deacon is fascinated by communication, especially by the ways that new technology influences our use of language. In its turning forms, we see an echo of the dynamic, complex, and interconnected global financial system as it enables cross-border money flows, and the difficulty of navigating a 'safer corridor'.

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ABOUT THE TEAM

The core team was made up of six people with combined expertise across the main areas covered in this report, and a further five researchers. The team leader was Dr Edwina Thompson, the director of Beechwood's non-corporate practice.

Dr Edwina Thompson

Edwina draws from a diverse career working with humanitarian organisations, governments, and the military in complex environments from South-Central Somalia, Sudan and Sri Lanka to Papua New Guinea, Pakistan, and Afghanistan. Through grassroots research, she became a leading expert on the *hawala* system and its particular historical and sociological dynamics in the Middle East and Horn of Africa. Edwina has been an independent expert for various agencies of the United Nations, including as the lead evaluator of UNDP Somalia's Financial Sector Development Programme (2002-2007) which aimed to strengthen the Somali remittance sector by increasing its compliance with international financial regulations, and to lay the groundwork for the entry of a formal commercial banking sector within Somalia.

Dr Keith Sentis

Keith has devoted his career to pioneering sophisticated techniques to understand complex decision-making and the marketing implications. He is a leading practitioner in the application of conjoint-based methodologies. Earlier experience includes being Managing Director of two leading market research organisations in Australia, and Research Director at the New York headquarters of an international agency with more than 100 offices around the world. Keith has lectured in the Psychology departments of Princeton University, New York University and the University of Michigan, and published widely on topics including perceptions of fairness and estimation of choice model parameters.

John Thompson

John set up Beechwood International in London in 1989 and co-founded the TEAMWIN mobilisation methodology to enhance collaboration between diverse subject matter experts and leaders from all levels. John is an accomplished strategic thinker and facilitator, with extensive experience in planning and implementing strategic initiatives and projects in both developed economies and fragile states. He was previously European MD for an international advertising agency, following the sale of his own Australian agency. He spent his early career in national and international marketing and general management roles with a British multinational in the chemicals sector, both in Australia and the UK.

Robin Plummer

Robin retired from the Serious Organised Crime Agency in 2013 where he was the Strategic Co-ordinator for Criminal Finance and Profits. Robin was the lead for Project QUAVER, a multi-agency response to the threats posed by money laundering through the Money Service Business (MSB) sector in the UK. He was also chair of the Strategic Alliance Partnership - Proceeds of Crime Group. The group included law enforcement representatives from the UK, US, Australia, Canada, and New Zealand, and focused on developing activity to tackle global money laundering risk. As part of this activity Robin established the Expert Laundering Evidence Programme within SOCA, which was designed to allow the knowledge garnered through global law enforcement investigations to be exploited within the criminal justice arena.

Michael Catalano

Michael has over 25 years of experience with the procurement and implementation of revenue-generating and transactional intelligence solutions for communication service providers in the US, Canada, Caribbean, and Latin American markets. Michael's thought leadership on the application of mobile money and mobile commerce for high growth emerging markets and social impact development has been recognised by GSMA, USAID, and the Bill & Melinda Gates Foundation. He has worked as an advisor to mobile network operators, financial institutions and their implementing partners on best practices and regulatory frameworks for electronic money services in fragile states such as Afghanistan, Haiti, and Zimbabwe.

Tom Keatinge

Tom is a banker with nearly 20 years' experience in a leading investment bank where he has dealt with financial institution and private sector clients such as sovereign wealth funds and Central Banks. He brings to the team a deep understanding of the international financial system as well as the compliance processes of the banking industry. Tom recently completed a sabbatical year studying for a Masters in the War Studies Department of King's College London where he wrote his dissertation on the role of the global counter terrorism finance effort in international security and influence on remittance payments by diaspora groups and charities.

Ahamed Al-Khalifa, Olivia Archibald, Philippa Brown, Georgina Grubb and Rosie Bate-Williams were the other main researchers on the report.

ACRONYMS AND ABBREVIATIONS

AML	Anti-Money Laundering	NGO	Non-Governmental Organisation
API	Authorised Payment Institution	OFAC	US Office of Foreign Assets Control
BBA	British Bankers' Association	PEP	Politically Exposed Person
BIS	Bank for International Settlements	PFM	Public Financial Management
CaLP	Cash Learning Partnership	PPP	Public-Private Partnerships
CBS	Central Bank of Somalia	PRI	Pakistan Remittance Initiative
CDD	Customer Due Diligence	PSRs	Payment Services Regulations
CH	Clearing House	SOCA	Serious Organised Crime Agency
CHIPS	Clearing House Interbank Payments System	SAMSA	Somali-American Money Services Association
CTF	Counter-Terrorism Finance	SFF	Special Financing Facility
DIFC	Dubai International Finance Centre	SFSA	Somali Financial Services Association (stood-down)
DFSA	Dubai Financial Services Authority	SOMSA	Somali Money Services Association
DfID	Her Majesty's Government Department for International Development	SOMTA	Somali Money Transfer Association (stood-down)
EDD	Enhanced Due Diligence	SPI	Small Payment Institution
F&P	Fit and Proper	SWIFT	Society for Worldwide Interbank Financial Telecommunications
FAO	Food and Agriculture Organisation (UN Body)	UKMTA	UK Money Transmitters Association
FATF	Financial Action Task Force		
FCA	Financial Conduct Authority (formerly the Financial Services Authority)		
FGS	Federal Government of Somalia	hawala	'transfer' (Arabic) denoting an informal banking system that facilitates domestic and international monetary transfers
FSNAU	Food Security and Nutrition Analysis Unit	xawilaad	Somali variation of <i>hawala</i> . Somalis in Britain refer to specialised Somali money transfer companies as 'Xawala' or 'Xawalas'. Therefore, while this is not strictly correct, this variation has been used throughout as the shorthand where relevant.
HMRC	Her Majesty's Revenues and Customs		
HMT	Her Majesty's Treasury		
IDP	Internationally Displaced Person		
IFAD	International Fund for Agricultural Development (UN Body)		
IVTS	Informal Value Transfer Systems		
KYC	Know Your Customer		
MM	Mobile Money		
MMT	Mobile Money Transfers		
MSB	Money Service Business		
MSF	Médecins sans Frontières		
MNO	Mobile Network Operator		
MTO	Money Transfer Operators		
NCA	Shadow National Crime Agency		

1. INTRODUCTION

1.1 RESEARCH AIMS

The aim of this rapid assessment is to reconcile two important policy goals in relation to international remittances and funds transfers: first, to support poverty alleviation and investment in fragile states by safeguarding cost-effective transfer mechanisms; and second, to minimise the risk that these mechanisms be used for criminal or terrorist purposes. A number of considerations have informed this focus:

- 1 Remittances are a major source of private capital for developing countries, amounting to an estimated USD401 billion globally in 2012, with UK outflows alone estimated at USD23.3 billion in 2011, according to the World Bank.
- 2 The common currency for remittances is the US dollar, and the US Patriot Act gives US regulators oversight of all dollar transfers by making it compulsory that they go through US Correspondents.
- 3 A large proportion of those remittances flow to poor people for daily subsistence and livelihood investment. Remittances also play an important role in relieving foreign exchange constraints and strengthening the balance of payments of recipient countries.
- 4 HMG is committed to achieving the G8/G20 target of reducing the global average cost of sending remittances from 10 per cent to 5 per cent over 5 years made by leaders at the 2009 L'Aquila Summit.
- 5 Money Transfer Operators (MTOs) in the UK and overseas, or Money Service Businesses (MSBs) more broadly, provide intermediation for remittances, and they require a bank account in order to deliver effective commercial services.¹
- 6 Most MSBs are intensive cash handling businesses and thus vulnerable to the risk of facilitating illicit finance flows to finance on-going criminality and hide or move profits. The UK National Crime Agency (NCA) estimates that up to GBP1.5 billion is laundered through UK MSBs annually to finance international crime and terrorism.²
- 7 Major banks are withdrawing bank accounts from MTOs because of the reputational and regulatory risk of being associated with illicit finance and fear of fines triggered by (particularly US) investigations, together with inadequate profitability, leading to a possible market restructure.
- 8 The question of what kind of challenge this presents to fragile states or situations where the banking sector and other alternative payment mechanisms are either not well-developed or restricted remains under-researched. Concerns have been raised about Somalia due to the potential negative impact on the humanitarian situation and development goals.

In light of this, the Safer Corridors project has been established, deriving from the NCA Project QUAVAR, and is a priority piece of work for the Strategic Alliance Group of Law Enforcement (including UK, US, Australia, Canada & New Zealand). The goal of this rapid assessment was to collect more evidence of the problem, including research on how the systems in question work, and develop policy solutions that will allow the flow of diaspora and other cross-border transfers to continue in a cost-effective and secure manner.

1 There is no legal requirement in UK regulation, however, for MTOs to have a bank account.

2 NCA Economic Crime Command/Project QUAVAR Team (2013) 'Criminal Finances: Criminal Exploitation of the Money Service Business Remittance Sector,' SOCA Assessment ODX-6504 (07/13)

The ultimate beneficiaries of this work will be people who rely on remittances or aid from the UK and whose lives may be adversely affected by UK market restructuring. The research recommends ways forward that involve a range of actors: MTOs, UK banks and other industry stakeholders including payment providers, regulators, law enforcement and supervisors as well as donors and multilateral institutions.

1.2 METHOD

There were over 1,000 people consulted for this rapid assessment, including aid practitioners based in Nairobi and Somalia, Dubai-based CEOs, Somali diaspora in the UK and US, and others within affected ethnic communities in the UK, such as Afghans, Bangladeshis and Syrians, to triangulate key findings. A number of key people in Government, banking and professional services offered to dedicate their time in a personal capacity to exploring and testing whether any proposed interventions would provide a sound basis for future development.

The assessment focused on understanding the current situation and exploring what an eventual 'private sector-led government endorsed' approach to a 'safer' system in high risk corridors could look like. The analysis was grounded in one country context – Somalia, where the priority is to identify technically feasible and marketable improvements to the established money transfer systems, and recently-introduced mobile banking options.

Our team engaged closely with different government departments, banks, MSBs, and the charitable sector, drawing on our combined expertise in banking, mobile money, data management and ID systems, migration and diaspora issues, and fragile states. Workshops (using Beechwood's methodology) conducted in parallel and an online survey involving over 900 from the Somali diaspora community were crucial in exploring potential marketability of technology-based solutions and improved compliance methods. Another online survey was designed to capture open-ended responses and some quantitative information from the aid community operating in Somalia. The survey was sent through various networks, such as the Cash Learning Partnership (CaLP) and the United Nations Humanitarian Country Team in Somalia. It elicited 16 responses from international non-government organisations (INGOs), several local partners, and one humanitarian donor.

Both open and classified sources have been used to inform the analysis, and have been cited where appropriate.

1.3 WHAT IS A 'SAFER CORRIDOR'?

There are three distinct types of corridors where this dilemma is most acute and requiring special measures: **crisis-affected**, **restricted**, and **post-conflict**. Each has unique characteristics (see Table 1); therefore the challenge is to identify enough common elements so that a replicable model can be developed to address the issue of facilitating legitimate finance, while isolating the criminal or terrorist funds.

In situations of crisis, restricted regulations or sanctions, and post-conflict recovery where the established banking system is compromised, remittances are mostly delivered to the intended recipients via an informal network, or in many cases (such as in the Middle East, South Asia and Horn of Africa) *hawala* or *hundi*. The origins of *hawala* go back thousands of years³, so these networks are deeply embedded in the local culture, trusted, reliable, fast and extremely cost-effective.

3 Thompson, Edwina (2008) 'Introduction to the Concept and Origins of Hawala,' *Journal of the History of International Law* 10: 83-118

TABLE 1: TYPOLOGY

	CRISIS-AFFECTED	RESTRICTED	POST-CONFLICT
Definition	Corridors impacted primarily by natural disasters and conflict (and in some cases financial crisis)	<ol style="list-style-type: none"> 1) A country has an established formal financial services sector but is subject to external sanctions 2) Severe legal and operational restrictions exist, preventing certain forms of financial service provider, and restricting exchange controls 	Formal financial systems are often absent, weak, or distrusted (due to bankruptcies or other factors) in countries or regions recovering from conflict. The timeframe for recovery is long, and often the situations are extremely complex. Parts of the country may still be subject to conflict that involves designated entities
Context and consequences	<p>An immediate crisis creates a surge in financial transactions (remittances and aid) to meet the humanitarian need, causing the existing system problems of capacity and a reversion to informal cash carrying or other informal means or situations.</p> <p>In a war situation, funds in support of parties to the conflict can be mixed in the same corridor with transfers that have a humanitarian purpose.</p> <p>The environment tends to be characterised by constant change as a country or society reacts to the crisis.</p>	<ol style="list-style-type: none"> 1) Global financial systems are reluctant to engage, or they have to navigate complex and diverse licencing frameworks which can often hold up payments 2) <i>Hawala-like</i> service providers are illegal but prevalent, with official channels either inaccessible or overly bureaucratic. Money flows are forced to find alternate routes, and often opt to clear through third parties, creating additional linkages within the corridor, and exposure to controllers who can intermingle legitimate funds with criminal money. 	<p>In these situations, regulations may have limited or counterproductive effects if efforts to develop financial infrastructure and supervisory capacity do not complement the systems that emerged during the conflict.</p> <p>In order to reverse the negative reputation of predecessors and build public confidence or legitimacy, Governments must manage pressing fiscal problems (e.g. payment of regular salaries to public servants) and deliver tangible development benefits (e.g. public works) quickly as a signal of future intent.</p>
Remittances	In recovering from crisis, countries rely heavily on remittances and targeted aid.	Remittances do not stop flowing; improvised channels can emerge and form a grey/shadow economy. These corridors can become another route for the illegal movement of funds.	In achieving stability and economic security, post-conflict countries rely heavily on remittances and targeted aid.
Examples	Haiti earthquake in 2010, where the banking system literally collapsed causing huge problems in providing cash in the country and the reconstruction of the banks.	<ol style="list-style-type: none"> 1) Syria, North Korea, Myanmar 2) India, Pakistan 	Afghanistan, Mali, Somalia

These transfers pass through three stages: at the **'First Mile'** agents deposit their takings in the bank account of a UK MTO company. This MTO instructs its bank to transfer tranches of money to the third party, which acts as a clearing house for these remittances, as well as for other funds sent or received by traders through the same network. This **'Clearance'** stage is followed by the **'Last Mile'** when the local agent in the destination country receives payments required to balance his books. The Clearing House is critical to this process as it utilises settlement mechanisms based on trade flows to reimburse the in-country agents.⁴

⁴ This process is explained in more detail in section 2.4 of this report.

While UK regulators can only influence operations within their jurisdiction, a bank's exposure to regulatory action is across an entire transaction. This is especially pertinent to the US, where the Patriot Act gives US regulators oversight of all dollar transfers by making it compulsory that they go through US correspondents.

Globally, banks are required to understand in detail who their customer is, and what risk they represent to the country of domicile in relation to ML. When banks transfer money overseas to their correspondent banks or subsidiaries, they draw comfort from the due diligence that they have done on the bank to ensure that they have adequate controls in place to prevent and detect ML or TF.

The increased scrutiny applied by banks to their customer base also extends to their correspondent banking relationships, particularly where the transfer of US dollars is concerned, thus bringing banks into the purview of US regulators. Historically, banks could rely on their correspondent partners to conduct appropriate due diligence on beneficiary payments. Correspondent banking partners typically maintain close relationships that facilitate due diligence of the procedures and operations of each other. However increased liability for transactions involving correspondent banking links (even if not directly the responsibility of the originating bank) has led banks to reconsider their willingness to make transfers that include correspondent links.

This concern increases as the risk profile of the partner bank on behalf of which transactions are being executed on a correspondent basis increases; for example, its predominant geography of operation or the destination to which payments are instructed. Correspondent banking plays an important role in the facilitation of international money transfers. MTOs very rarely transmit money directly to the ultimate beneficiary, particularly when the beneficiary is in a fragile or conflict-affected state such as Somalia. Rather, they use a third party 'clearance' mechanism (or correspondent), which is often opaque and set up in a jurisdiction that is only lightly regulated. Regulation of the Last Mile in many high risk corridors is also either non-existent or of limited impact, and the ability to identify customers is hampered through a lack of trusted government identification systems (e.g. birth certificate, driver's licence). As a result of the diligence and compliance weaknesses of a number of points in the transmission, and given the significant tightening of scrutiny under which banks operate, costs of providing banking services to certain classes of client have increased to levels that are no longer considered to be economic.

In light of the factors this section has identified in defining the problem, it is clear that there is no 'fail safe' solution to the problem at hand. However, a series of improvements and enhancements in a number of areas of the cross-border funds transfer chain should lead to a meaningful increase in compliance and security. It is for this reason that this assessment focuses on the need to establish 'safer corridors'.

Examples of Closed and Open Corridors

A safer corridor would be operated by the private sector for profit, perhaps with initial investment by Governments of both the 'send' and 'receive' countries. It would operate at the First Mile under UK supervision through a transparent framework that can be tested and audited by the UK regulators and key service providers. It can be considered as falling into one of two categories, with important distinctions within each:

- **A closed corridor** from First Mile to Last Mile with hard currency transfers passing in a way that the collection and distribution of funds can be audited at both ends
- **An open corridor** where the operator uses a clearance mechanism, but where the mechanism is audited and open to scrutiny from international regulators, for example with the regulator of the remitting MTO defining and auditing a strong framework from First to Last Mile

Closed corridor: Pakistan Remittance Initiative (PRI)

In response to a World Bank estimate revealing that globally 50 per cent of the officially recorded remittances move through informal channels, a State Bank of Pakistan (SBP) Task Force on Home Remittances conducted a comprehensive analysis of any 'bottlenecks' and 'weak links' in the existing formal channels.⁵ The outcome of this analysis was the formulation of a joint strategy between the SBP, Ministry of Overseas Pakistanis and the Pakistan Ministry of Finance to increase the flow of remittances through formal banking channels, and in the process increase the country's foreign reserves.

In this model, the agents at either end of the remittance are established financial institutions, promoting and extending access to financial services for the unbanked. In its current form, therefore, this model only works where there is a formal financial system in the receive country.

In terms of the PRI, there has reportedly been a dramatic increase in home-bound remittances from USD6.4 billion in FY 2007-2008 to USD13.2 billion by FY 2011-2012 and USD14 billion by FY 2012-2013.⁶ Recent figures suggest that remittances now account for around 5.5 per cent of GDP, and inject much needed additional aggregate demand into an economy that has been mired in stagflation during the last five years.⁷ At present, more than 50 per cent of the trade deficit is also covered by these non-debt creating inflows. An independent evaluation, however, has not yet been conducted to assess the PRI's contribution to the increase of remittances through formal channels.

From the perspective of sustainability, the subsidy has been kept at between 0.82-1 per cent of the volume, as compared with the 3.5 per cent cost of an IMF loan which has conditions attached. Therefore, when considering the huge inflow of remittances and the value this brings in terms of the increase in foreign reserves, it is perceived to be a viable long term initiative by the Pakistan Government.

There are clearly real-time lessons to be learnt, both for Pakistan and for other countries seeking to use a similar approach, but it is important to note for the present purpose that Pakistani authorities attribute success to PRI in terms of its ability to achieve a shift in migrant practices from using either unregulated channels or vehicles requiring a third party clearance process to making straight-line, direct bank-to-bank payments that ultimately benefits the country.

Open corridor (1): BICS HomeSend

A current example in Somalia: WorldRemit uses the BICS HomeSend Mobile Money Transfer (MMT) hub as an open corridor mechanism that is connected with a local closed loop payment services component at the Last Mile (Telesom's ZAAD Services). The Customer Due Diligence (CDD) provided by the payment service providers on both the send and receive sides is the key area of focus for international regulators and local financial intelligence units. See Diagram 1 overleaf.

This open corridor model relies on mobile phone technology. According to GSMA, in 2012 Somalia had 4 million mobile phone connections, and the SIM penetration was 41 per cent.⁸ Over 90 per cent of the country has mobile coverage, and some parts, like Somaliland, have 99 per cent coverage.

5 State Bank of Pakistan Task Force Report on Home Remittances, p.5; World Bank blog (2013) Pakistan Remittance Initiative (PRI), <http://blogs.worldbank.org/peoplemove/pakistan-remittance-initiative-pri>

6 Shabbir, Najm-us-Saqib (2013) 'Committed Financial Sectors', *Khaleej Times* Special Report (19 January), p.6

7 Amjad, Rashid; Irfan, M; Arif, G.M. (2013) 'How to Increase Formal Inflows of Remittances: An Analysis of the Remittance Market in Pakistan', International Growth Centre (May), p.43

8 GSMA (2012) *Market Intelligence Report*.

In order to send money internationally from an online payment account to mobile, the MTO in the sending country (i.e. UK) can take advantage of an interoperable MMT hub which operates with an appropriate AML/CTF compliance framework set up between the participating actors. This then connects into a domestic closed loop system.

Domestically, the closed loop system has allowed for successful aid cash transfers to poor people across Somalia for several years now. When asked to share her experiences of receiving aid through MM, a disabled lady from Mogadishu, replied: 'When you use the 'Xawala' system, you wait in a long queue. You have to carry cash and you might meet thieves. E-cash is safer. It is in your mobile phone and you can carry it everywhere. You can buy things with it much better'.⁹

Open corridor (2a): Compliance Assurance

A 2005 Review of the Somali Financial Services Association (SFSA) recommended that the industry research electronic platforms with built-in regulation compliance, and explore the possibility of all operators adopting a common platform that would help facilitate cross-border, cross-currency payments in a multilingual environment. The cited benefits were to standardise customer data requirements so that agents followed the same customer ID procedures, create permanent records of transaction details for secure audit trails of agent and operator actions, and ensure that relevant filters (such as OFAC screening) were in place across the sector.¹⁰ Such a system would have to accommodate various payment methods, including cash and card-based transactions. The industry did not follow the advice at that time.

Sophisticated MTOs serving the migrant community or start-up 'Fintech'¹¹ companies such as The Currency Cloud¹² are now harnessing technology to automate due diligence screening and drive down costs.¹³ Compliance in this situation is audited by an external entity or third party which tends either to be an independent payments company or a larger multi-channel wholesale MTO acting as an aggregator. KYC and CDD¹⁴ can increasingly be conducted on an automated basis. In many cases, the processes are audited and approved by banks¹⁵ such that transactions instructed by these organisations are rarely delayed by the transmitting bank. Whilst manual checking is sometimes necessary – for example interrogating 'false positives' flagged by PEP¹⁶ database analysis – automation of this process by a third party could significantly enhance the integrity of the due diligence undertaken by MTOs whilst at the same time reducing costs and system friction. This is particularly important when dealing with corridors perceived to be high risk as identity data can often be

9 Oxfam (2013) 'E-cash on the rise in Somalia', East Africa Blog <http://www.oxfamblogs.org/eastafrica> (8 January)

10 Ahmed, Ismail (2005) 'A Review of the Somali Financial Services Association' (August), pp.5 & 21-22

11 A term used to describe a rapidly growing range of financial service providers operating outside the mainstream financial sector, such as peer-to-peer lenders, online currency exchanges and crowd-funding sites.

12 <http://www.thecurrencycloud.com/>

13 Automation of this process can reduce costs from 8-10 per cent to as little as 0.25 per cent.

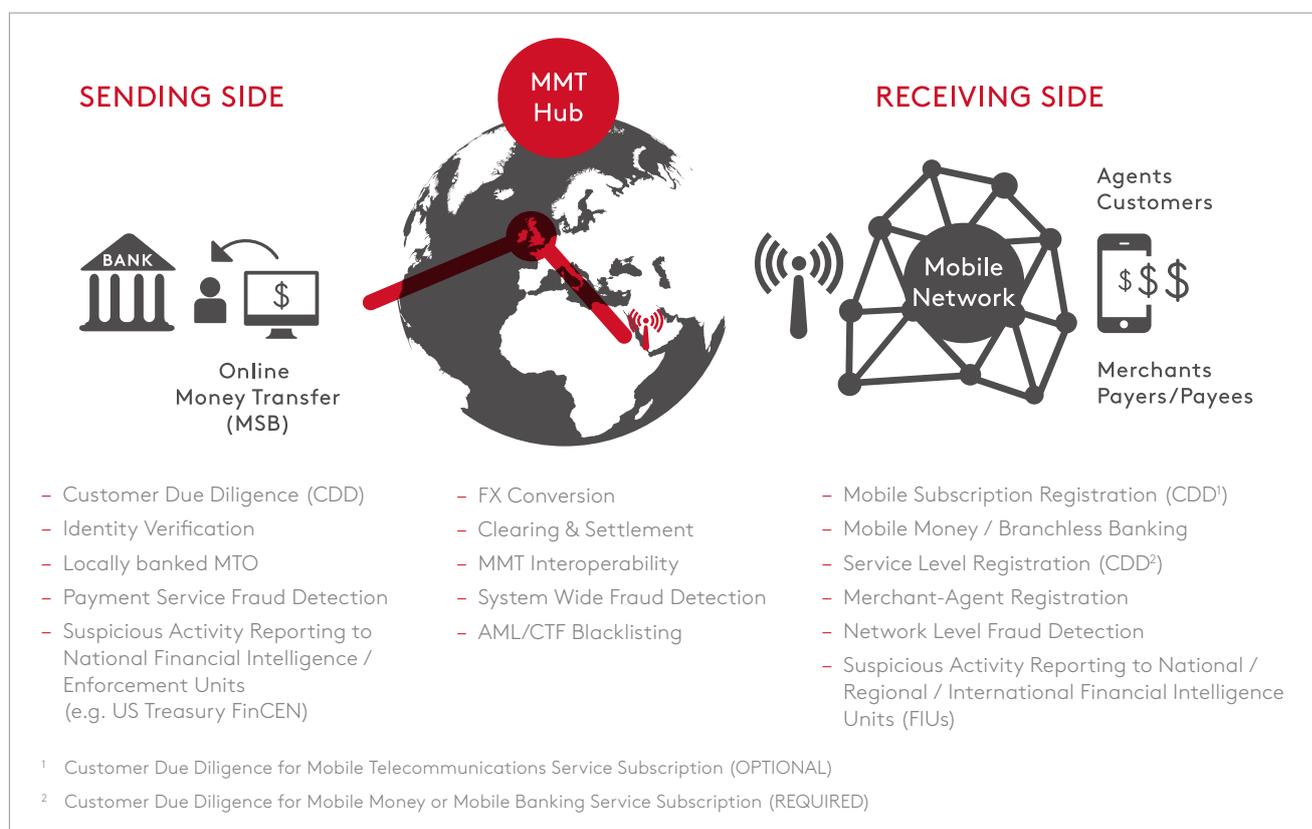
14 Know Your Customer (KYC) and Customer Due Diligence (CDD) are terms referring to the requirement for MTOs and other regulated entities to establish the credentials of customers such as account holders and remitters.

15 One interviewee from a medium-sized migrant remittance company informed us that his bank undertakes a quarterly compliance audit of his business.

16 Politically Exposed Persons – a class of accountholder that is deemed by the authorities to be of higher risk for banks.

incomplete or misleading (for example a large number of people with similar names or spelling variations) – scrutinising and then flagging such sender/receiver data with an identifier can ensure transmission to/from the specifically identified individual does not get caught in future, leading to ever-greater process efficiency.

DIAGRAM 1: GLOBAL MOBILE MONEY TRANSFER HUB



Open corridor (2b): Safer Corridor Portal

The international aid and law enforcement communities have for some time discussed the possibility of creating a 'Safer Corridor Portal', which is an extended version of 'Compliance Assurance'. This relies on the willingness of banks to continue to provide accounts and banking services to the MTO sector, however, there are stringent measures that are introduced to the transmission chain so that they are able to serve high-risk corridors.

In such a system, a third party entity (the 'Safer Corridor Portal') could take responsibility for auditing procedures at MTOs to ensure appropriate compliance is maintained, auditing the identity of the sender and receiver of funds, monitoring remittance amounts for abnormal activity, as well as scrutinising any key intermediate correspondent channels such as Clearing Houses (CHs) in third party countries. Critically, this scrutiny would be undertaken on an on-going and real time basis to ensure that the standards that were required for an MTO to register with the authorities are maintained.¹⁷

¹⁷ Some of this analysis is undertaken by HMRC during intermittent site visits, but these visits are rare and manual, whereas technology can be used to conduct such monitoring on an on-going basis to ensure compliance.

Initial, high level thoughts on the construction of the Safer Corridor Portal envision it undertaking:

- 1 Housekeeping:** Aggregation and auditing of key MTO information such as ownership structure detailing beneficial owners/controllers,¹⁸ CVs of key individuals, business plans, audited accounts, required external compliance reports, details of professional advisors, confirming 'fit-and-proper' status of MTO agents, etc
- 2 Processes/processing:** Automatically screening and authenticating individual transactions for sender/receiver KYC completeness and abnormal transaction size or instruction and other red flags
- 3 Reviewing clearance:** Commissioning and maintaining audit/compliance reports on intermediate correspondent steps, for example Clearing Houses given that the structure of the groups to which the Clearing House businesses belong in third party countries makes it hard for outsiders to determine the precise nature of these groups' business.¹⁹ The Safer Corridor Portal should therefore conduct due diligence on these entities via a reputable international audit firm, enhancing the confidence of UK banks²⁰
- 4 Funds Transmission:** Instructing UK banks once checks are complete that onward transmission can be made

The Safer Corridor Portal itself will need to be subject to rigorous external compliance checks for the benefit of the banks holding funds that are transmitted onward at the instruction of the Safer Corridor Portal.²¹ The banks remain accountable, however, for their own ongoing monitoring of transactions passing through their systems. To the extent that the Safer Corridor Portal is a new entity (i.e. the role is not played by an aggregator MTO performing enhanced due diligence), it is envisioned that it may initially take the form of a public-private partnership (PPP) – the precise legal structure would need to be researched further if this concept is deemed to be an 'in principle' solution, and it is important that key constituent groups have a stake in its creation and operation (see Annex 1).

1.4 WHY IS THIS IMPORTANT?

1 Regulatory and reputational risk²²

The 'international financial system' can be likened to a large pot into which money obtained legitimately and illegitimately is pooled, and from which money is used for legitimate and illegitimate purposes. A key regulatory challenge is to distinguish between the legitimate and illegitimate flows so that **the threat of criminality and terrorism may be minimised while still allowing cost-effective, cross-border payments which support poverty alleviation and facilitate investment in fragile states and situations.**

18 Controllers are individuals who directly or indirectly hold 10 per cent or more of the capital or of the voting rights of an undertaking, or who can exercise significant influence over the management of the undertaking.

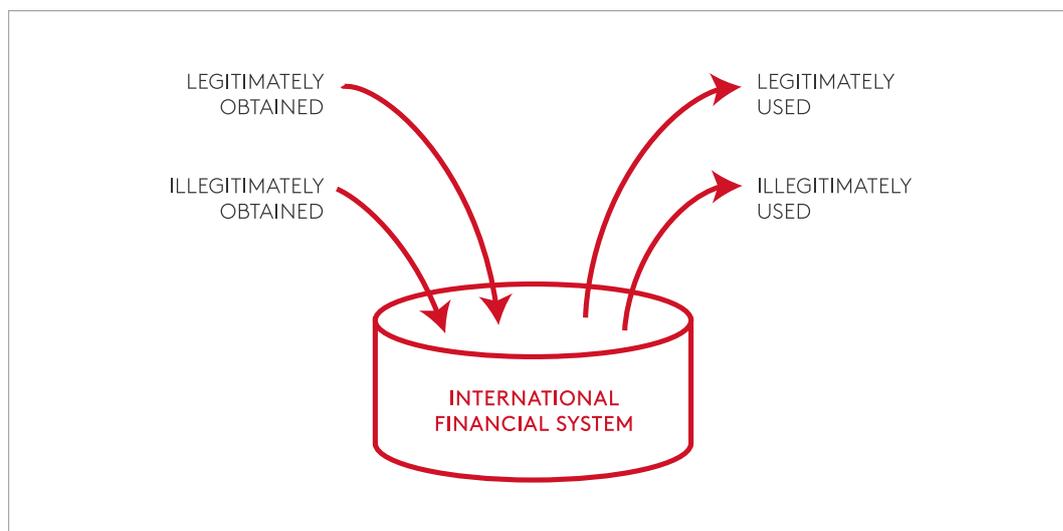
19 Refer to section 2.4.

20 Recommendation 13 of the revised Financial Action Task Force (FATF) Recommendations (February 2012) requires banks to undertake thorough due diligence on cross-border 'correspondent' banking relationships. Whilst not banks *per se*, the role played by Clearing Houses makes applying the standards of Recommendation 13 appropriate. See http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf, pp.16-17.

21 For example, one interviewee informed us that his bank undertakes a quarterly compliance audit on his business, operations, and procedures.

22 This section was informed by the contribution of Brian Stevenson, former CEO of Global Transaction Banking at Royal Bank of Scotland Group Plc (RBS), in a personal capacity.

DIAGRAM 2: THE INTERNATIONAL FINANCIAL SYSTEM



This year, the US authorities dismantled the operations of global currency exchange Liberty Reserve, which was responsible for laundering USD6 billion through 55 million transactions over seven years. The special-agent-in-charge for Immigration and Customs Enforcement Homeland Security Investigations declared this as ‘critical because transnational criminal organizations can succeed only so long as they can funnel their illicit proceeds freely and without detection’.²³ When put into the broader perspective of cross-border money flows, however, even the case of Liberty Reserve takes on a lesser significance.

According to the Clearing House Interbank Payments System (CHIPS), which is responsible for over 95 per cent of cross-border US Dollar-denominated transactions and nearly half of all US domestic wire transactions, in 2011 the average daily USD transfer was USD1.6 trillion at an average of over USD4 million per transaction. In September 2013, the Bank for International Settlements (BIS) reported that its average daily turnover on foreign exchange has reached USD5.3 trillion.²⁴ Such huge traffic certainly makes spotting the relatively small amounts that are believed to be transferred through the formal banking system by terrorists virtually impossible, despite the enhanced monitoring and reporting requirements put in place following 9/11.²⁵

MTOs are regulated directly to minimise the threat of criminal or terrorist use. All UK MTOs ultimately rely on international payments services offered by banks to relay funds, and as such are affected by regulation of the banking sector and how the banking sector responds. Historically banks regarded the international payments activity as low risk, stable and robust. However, there have been significant changes in the last five years, as cost and regulatory pressure have combined to significantly shift the risk:reward balance from the banks’ perspective.

23 Prosecutors found that ‘third party exchangers’ were used to avoid a ‘centralized paper trail’. Santora, Marc, William Rashbaum & Nicole Perlroth (2013) ‘Online Currency Exchange Accused of Laundering \$6 Billion,’ *New York Times* (28 May)

24 BIS (2013) ‘Foreign exchange turnover in April 2013: preliminary global results,’ *Triennial Central Bank Survey*, p.4

25 As the 9/11 Commission notes, the wire transfers associated with the 9/11 plot were ‘essentially invisible in the billions of dollars in wire transfers that take place every day throughout the world’. Roth, John, Douglas Greenburg & Serena Wille (2004) *Monograph on Terrorist Financing* (Washington, DC: National Commission on Terrorist Attacks Upon the United States), p.135

The established cross-border payments business has required considerable investment in technology to make it efficient, and it is generally a 'scale' business. It serves all types of customers from low value, low volume private consumers and charities through to high value high volume multinational corporations. The infrastructure investment needed to be competitive covers secure technology networks, branch networks (or correspondent banking networks), and human networks (for example, customer service). This means that large banks dominate and especially those that are volume players in USD.

Two developments have caused the senior management of banks to reconsider their positions in this field. The first, led by the US in the wake of 9/11, is the tightening of the regulatory and legal framework around Know Your Customer 'KYC', Anti Money Laundering 'AML' and Counter-Terrorist Finance 'CTF' and enforcement of those rules.²⁶ The second is the opportunity and the threat of the internet and mobile technology²⁷ opening up a whole new area of competition. At the practical level, this means that the small fee currently attached to payments may no longer be sufficient to maintain expensive 'legacy' infrastructure and to cover the potential downside risk of substantial fines that are imposed for breaching the AML/CTF regulations. This is true in all countries but is particularly an issue in relation to payments involving territories perceived to be of 'high risk'.

The net result is that the banks are rationalising their business models back to lower risk locations,²⁸ while the internet is creating opportunities for new web-based players free from legacy infrastructure and in many cases, at least at present, free from much of the regulatory burden borne by the banks. Therefore, banks and other service providers to MTOs are increasingly looking at the risks posed by the entire remittance chain from end to end. While this is encouraging from the perspective of law enforcement, it means that an MTO that meets regulatory requirements in the UK may still appear 'high risk' and struggle to find the services it needs to operate.

Risk also relates to reputation – a concern shared by all key stakeholder groups, including MTOs, banks, Government, regulators, aid agencies, and civil society. As Warren Buffet said in relation to his business, 'We can afford to lose money – even a lot of money. But we can't afford to lose reputation – even a shred of reputation.'²⁹

Following the financial crisis, banks around the world are striving to transform their operations and refocus their ideals in an attempt to win back customer trust and rebuild legitimacy. At the same time, MTOs operating in high-risk jurisdictions often have to counter unsubstantiated claims that appear on the internet alleging there

26 There are signs of a more robust approach taken by the regulator, the Financial Conduct Authority (FCA), and transatlantic pressure applied either directly by the US Treasury and its various arms or indirectly, primarily via the FATF. The UK banks' awareness of these risks in the MSB sector has also increased following closer engagement on the issue by Serious Organised Crime Agency (SOCA) (now the NCA).

27 Mobile money in its simplest form allows mobile telecom service subscribers ("customers") to convert cash to electronic value ("e-money"), which can then easily be transferred using a connected mobile phone to other customers, agents, or merchants also registered with a service provider. In most markets the cash-in and cash-out functions are performed by registered merchant-agents following the guidelines of an authorised agency or regulated correspondent "branchless banking" model. Today there are over 192 deployments of mobile money services globally with at least three functioning services currently operating via licensed mobile network operators (MNOs) in Somalia, one in Iran, and at least two now available in Afghanistan.

28 In Australia, the majority of banks have responded to global regulatory activity by commencing projects designed to exit identified MTOs. In a recent discussion reported by PwC, the heads of compliance for two of the four largest Australian banks recognised the impact that this may have on poorer countries in terms of family support, but indicated that there is a global regulatory risk that cannot be mitigated. High level analysis provided by PwC in Australia on behalf of World Vision during this research.

29 Ovide, Shira (2011) 'Warren Buffett on Ethics: 'We Can't Afford to Lose Reputation,' *Wall Street Journal* (31 March)

is a connection between their business and listed terrorist organisations. During this research, the compliance and sanctions team of a global US bank confirmed that 'whether true or not' this information 'posed problems for onboarding'.

Equally, ethnic minorities are acutely sensitive to reports that further a sense of marginalisation and negative misrepresentation; a point communities underscored in consultations undertaken in parallel with this report.³⁰

Governments also have to mitigate the reputational consequences of events. Donors are committed to supporting development in Somalia as evidenced by the London Somalia conference and the EU Brussels Summit in September – the former coincided, however, with Barclays' announcement that it was planning to terminate the majority of its MTO accounts, including the remaining four specialised Somali MTOs still holding accounts in the UK. Options for MTOs to source alternative banking facilities within the two-month notice period were limited, with those in corridors perceived to be of significant risk facing particular constraints.

For Somalia, remittances are a primary source of private capital, foreign exchange and driver of economic development, while providing a vital safety net for households. Therefore, although governments cannot control the commercial decisions of banks, an apparent risk to remittance flows within this context could undermine their perceived commitment, and that of the international community as a whole, to supporting development in Somalia.³¹

These issues highlight the clear need for open dialogue and cooperation between stakeholders to debunk misinformation and rebuild trust in the market; and yet it appears that large banks view the consequences of getting it wrong as so great that caution pervades decision-making, which results in a tendency to withdraw rather than find ways to engage. Fundamental fears are (a) fines triggered by regulatory (particularly US) investigations, (b) headlines about 'financing terrorists', and (c) loss of access to the US market/US dollar system. The outcome can be highly counterproductive, forcing money obtained or used both legitimately and illegitimately into underground or unregulated channels where it is even harder to trace criminality and terrorism.

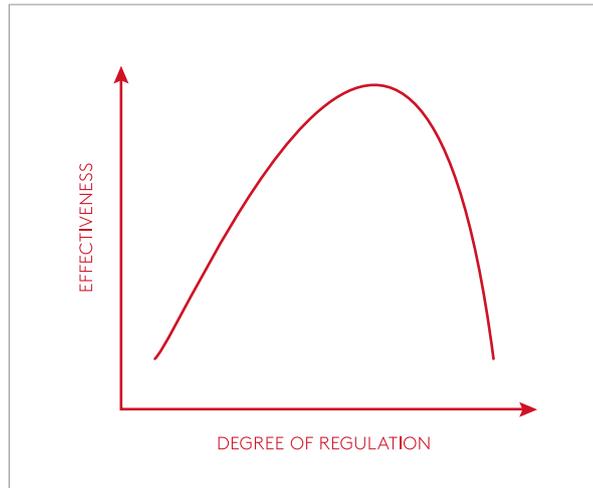
At the core of this dynamic is the non-linear relationship between the degree of regulation and its effectiveness in curbing illegitimate activities.³² The ideal solution minimises the cumulative risk of directly funding illegitimate activities and/or indirectly fostering them. Instead, however, it is likely that each of the parties, and indeed each decision maker within each party, has a different perspective on where the optimal balance lies – like everyone else, judgements made by decision makers are easily shaped by their past experiences and world views, which can blind them to others' perspectives and leave them without useful predictors of the future, especially in an uncertain and volatile environment.

30 During the research, various news reports also affirmed this view. For example, in response to information published about the situation of Britain's Somali population, one Somali news outlet commented that while it 'tells a very real story, it is important to ensure that no single article, set of statistics or even opinion ends up defining an entire community.' Various role models who have emerged in British-Somali culture, such as Mo Farah, were featured to remind people that the story is 'not all doom and gloom'. Sawlani, Samira (2013) 'British Somalis: It's not all Doom and Gloom,' *Mareeg*, accessed at <http://www.mareeg.com/fidsan.php?sid=30166&tirsan=4> (9 September 2013)

31 A woman in Somalia reported on UK television that 'We have heard the British are stopping our money. We depend on this little money that our relatives send us. We request the British, please do not stop this money coming.' Interview with Hawa Abdulle, in Osman, Jamal (2013) 'Somali families' banking lifeline under threat,' Channel 4 News (27 June)

32 For a recent analysis of this in the context of terrorism, see Dean, Aimen, Edwina Thompson & Tom Keatinge (2013) 'Draining the Ocean to Catch one Type of Fish: Evaluating the Effectiveness of the Global Counter-Terrorism Financing Regime,' *Perspectives on Terrorism* 7(4) (August): 62-78.

A crucial dilemma for governments, regulators and law enforcement agencies is how to tailor and balance their approach according to the need of different corridors, yet maintain consistency across the diverse international financial system. Because remittances have such huge economic and developmental benefits, there are high profile system failures, and the sector is so complex, there is a growing consensus that constructive dialogue between all parties is crucial to moving forward.



2 Financial sector development

Traditional methods of funds transfer – or specifically *hawala* in the Gulf/Middle East regions – have evolved over time to create a strong overlap with the formal banking system.³³ *Hawala-like* companies are increasingly embracing modern technology throughout their business; without direct access to banking, they may be forced to retreat into a more informal network, or opt to become more deliberately obscure and difficult to trace. They also play an important part in helping post-conflict and crisis-affected states participate in the global financial system, having been described as ‘social brokers’ and ‘mediators’ between the local infrastructure and an intricate web of banking and trade partnerships across the world.³⁴

In fragile states such as Afghanistan and Somalia, international trade and investment also rely heavily on the receipt of remittances as part of the *hawala-like* transaction chain. It is critical to consider the wider implications of an ‘unbanked’ MTO sector in such a situation.

3 Financial inclusion

There are currently an estimated 2.7 billion ‘unbanked’ or ‘financially excluded’ people in the world today. Earlier this year, CARE International UK’s chief executive, Geoffrey Dennis, claimed that ‘it cannot be right’ for these people to be ‘ignored by the current financial system for being too poor. ... These people are full of potential, and are desperate to work their way out of poverty and invest in the future of their families.’³⁵ Barclays’ chief executive has also underlined the importance of addressing this issue and recently called on Prime Minister David Cameron, in his role as co-chair of the *High-Level Panel of Eminent Persons on the Post-2015 Development Agenda*, to consider the importance of ‘financial inclusion’ in the replacement of the UN Millennium Development Goals (MDGs): ‘That financial inclusion stimulates economies and improves lives is undeniable; the question is how sustainable, savings-led financial inclusion can be scaled up to make a real difference’.³⁶

33 ‘Chapter 6: Globalisation and the Money Dealer,’ in Thompson, Edwina (2011) *Trust is the Coin of the Realm: Lessons from the Money Men of Afghanistan* (Oxford University Press), pp.189-213

34 *Ibid.* While the system has a purely commercial function in one sense, in another it plays a social role in the preservation and reproduction of relations between migrants and family or friends in the homeland. This was confirmed in workshops with Somalis in the UK; it seemed that they viewed the ‘Xawalas’ as distinct from the ‘commercial’ banks.

35 Thompson, Jennifer (2013) ‘“Financial inclusion” mooted as UN goal,’ *Financial Times* (21 January)

36 The Banking on Change Partnership (Barclays, CARE and Plan UK) claims that developing countries could receive a yearly savings boost of up to USD145 billion if the 2.7 billion who are unbanked participate in the formal economy.

Donors are increasingly focusing on encouraging greater financial inclusion of remittance recipients in countries where a large part of the population depends on money sent home from abroad. Remittances provide crucial support to development in some of the world's most fragile states and situations,³⁷ and they are often the first formal point of entry for people into the formal financial system, therefore it is imperative to identify appropriate models for high-risk corridors which ensure their continued flow, and assist in accelerating the trend towards financial inclusion.³⁸

South Asia, Latin America and the Caribbean are the least expensive regions to remit money to, with an average cost of 7.02 per cent and 7.28 per cent respectively.³⁹ The most expensive corridors are to Africa, where average costs stand at 12.4 per cent, and the average cost of sending remittances globally is 8.85 per cent.⁴⁰ The UK-Somalia corridor is conspicuous for its low average remittance costs, standing at just 5.14 per cent.⁴¹ This already reaches the G8/G20 '5x5' target of reducing the global average cost of sending remittances from 10 to 5 per cent over five years made by leaders at the 2009 L'Aquila Summit. The UK-Somalia corridor needs to be examined to understand how it has achieved such competitive pricing in a particularly costly region.

Most regulations in Africa permit only banks to pay remittances, and about 41 per cent of payments and 65 per cent of pay-out locations are serviced by banks in partnerships with Western Union and MoneyGram. These IFAD figures exclude Algeria, where payments at post offices are especially significant, and Somalia, where the country-wide 'Xawala' networks are integral to the remittance payments.

The Somali 'Xawala' networks also exceed many African countries in their ability to dispense payments to rural areas; the rural pay-out ratio in Somalia is 64 per cent, whilst the average for Africa as a whole is 39 per cent. In 2012, a review of 463 banks in 39 African countries revealed that 83 per cent of the population live in rural areas, yet are serviced by just 64 per cent of bank branches. Again, the Somali case is worthy of protecting not only for its low cost, but also for its impressive coverage.

4 International aid

International aid to Africa and other regions is witnessing a shift from material forms of assistance to 'cash transfers', which have proved more effective and appropriate in many conflict- and disaster-affected states. In its flexible form, cash increases choice and access to essential commodities, while also reinforcing dignity and accountability for the affected people when administered well.

37 In Somalia, remittances account for around 50 per cent of Somalia's Gross National Income (GNI) and support the livelihoods of 40 per cent of the population.

38 HMG has an interest in fostering a more competitive payments market that includes remittances. HM Treasury Press Release (2013), 'Government Plans to Open up Banking Sector Take a Step Forward' (March)

39 The World Bank (2013), 'Remittance Prices Worldwide', <http://remittanceprices.worldbank.org/en/corridor/United-Kingdom/Somalia>, p.1

40 *Ibid.*

41 For the first quarter 2013, see World Bank 'Remittances Prices Worldwide'. An HMG study conducted in 2008 also calculated that this could be lowered even further to 3-4 per cent. Chalmers, Caitlin & Mohamed Aden Hassan (2008) 'UK Somali Remittance Survey,' Department for International Development (May)

Kadija Mohammed, a beneficiary of 'e-cash' in Mogadishu prefers the new cash transfers; 'the money gives me choices, it gives me the power to buy and sell things... all you can do with the food is eat'.⁴² The 'invisibility' of cash transfers makes them more safe and reliable, as beneficiaries can collect the aid as they might remittances, or via their mobile phone.⁴³ The route from agency to beneficiary is also more direct, thus there is less risk of diversion.

Cash transfers require cheap and efficient methods of transfer to ensure the greatest return on the aid dollar. In humanitarian situations, *hawala-like* companies provide one of the fastest and most efficient vehicles for sending money. Nowhere is this more evident than in Somalia. During the famine of 2011, for example, which put 750,000 people at risk of starvation, and plunged millions more into a state of high malnutrition, UNICEF reported that 'the use of *xawalas* was extremely efficient' and that 'while aid was concentrated in certain areas... the presence of *xawalas* meant that some was re-distributed to the epicentre of the famine affected areas'.⁴⁴

British Somalis saved hundreds of thousands of lives by remitting money through Somali MTOs at this time, reaching family members before aid agencies could mobilise during the initial critical months. The unconditional cash transfer programme that followed in 2011-2012 moved USD110 million through the same channels, contributing to the food and non-food needs of 1.5 million beneficiaries.⁴⁵ Consequently, the effects of a humanitarian disaster were mitigated; markets benefited from the cash injection, and predictions that cash transfers would cause inflation never materialised.

Despite the immense potential for cash transfer programming to provide humanitarian relief at scale in times of crisis, there have been serious – and in some practitioners' minds 'deadly' – delays due to risk aversion in moving to this new form of assistance.⁴⁶ This is partly due to the assessment made by large aid agencies that they may face serious penalties for unwitting breaches of counter-terrorism legislation. Fear of the extra-territorial measures taken by regulators of large donor states and a desire to minimise their vulnerability to abuse has often led to paralysis.

Counter-terrorism and sanctions measures have been described by some humanitarian actors as having a 'chilling effect'⁴⁷ upon aid operations in affected states. Charities operating in regions with high incidence of instability and terrorist activity have suffered the most, with reports that they are refused banking services and other financial services as well as being subject to greater suspicion and due diligence. The Finance Director of a large faith-based charity suggested that, 'Muslim charities have been considered a risk by many banks and measures continue to be taken on a daily basis to hinder them from working effectively'.⁴⁸

42 Oxfam Horn, East and Central Africa Blog (2013) 'E-cash on the rise in Somalia' (8 January)

43 Cash Based Response Working Group (2011) 'Q&A: How to scale up Cash Programming in South-Central Somalia' (July), p.1

44 UNICEF (2013) 'Final Evaluation of the Unconditional Cash and Voucher Response to the 2011-12 Crisis in Southern and Central Somalia,' p.xiii

45 *Ibid.*, p.ii

46 Ali, Degan (2012) 'A deadly delay: risk aversion and cash in the 2011 Somalia famine', *Humanitarian Exchange Magazine* 54 (May)

47 Mackintosh, Kate & Patrick Duplat (2013) 'Study of the Impact of Donor Counter-Terrorism Measures on Principled Humanitarian Action,' OCHA/NRC, p.84

48 Charity statement (2012) 'Regulatory challenges facing charities and NGOs working in difficult environments,' House of Lords (7 November)

More broadly, the aid agencies argue that those working in dangerous parts of the world, with a high potential threat of terrorism, are automatically perceived as 'risk liability' which banks are reluctant to take on as they understand neither a) the way aid agencies work, nor (b) how the regulators will react in the event of theft, loss or fraud, even if governments are funding the programmes. There is no shared analysis of risk or risk appetite between institutions with very different missions.

In countries under some form of sanction, such as North Korea, Iran, Myanmar or Syria, aid organisations experience great difficulties in finding formal ways to remit funds to pay local partners. In the case of Syria, for example, OFAC Licence 11 allows payments to be made for humanitarian purposes, and yet the banking sector remains risk averse and unwilling to accept such licences at face value.⁴⁹ Aid agencies report that banks require extensive evidence to be satisfied that the payments are intended for humanitarian purposes, and even once this is supplied, there is no guarantee that an intermediary bank would not block the funds during transmission.⁵⁰ At the Last Mile, there is also the question of which local banks in such a situation remain operational and liquid.

While the FATF warns that Non-Profit Organisations are 'particularly vulnerable [to abuse by terrorists]', it also enjoins financial institutions to avoid disrupting or discouraging legitimate charitable activities (R8 Interpretive Note, 3b). Talks between the aid community and Governments within FATF have led to formal recognition that this spirit must be supported by concrete guidance as to how banks can strike the appropriate balance in their risk-based approach.⁵¹ Unless this guidance builds mutual trust and understanding, is fully understood, thus providing clarity and assurance to aid agencies and banks that they are operating within the law, humanitarian assistance will continue to be disrupted.

5 Law enforcement and stability

In Iraq (2005-2010) and Afghanistan (2008-2010), inter-agency Threat Finance Cells were created to create a better understanding of terrorist finance networks so that they could be attacked. All the major intelligence and law enforcement agencies within the US now maintain a specific counter-threat finance mission, defined as the identification and degradation of financial networks used by militant groups.

At a tactical level, it has been recognised that disruption of local financial networks has some initial desired effects, but also the potential to result in follow-on undesired effects. Arrests and seizures have predominantly led to the targeting of easily replaceable low-level clerks with limited overall knowledge of the network, and intelligence collection through exploitation of records and ledgers that are also of limited value because they tend to relate to the licit side of the business.

49 The British Bankers' Association (BBA) is working with Freshfields and the Disasters Emergency Committee (DEC) to produce a briefing on the risk management of Syrian humanitarian payments. This briefing will explain the legal and risk framework and sets out examples of how aid agencies can navigate the licencing process. Little traction, however, has been gained on a proposal to government that a safer payment corridor of 'acceptable routings, institutions and partners' could be agreed between the key stakeholders.

50 'Note on Meeting between DEC agencies and the Charities Commission: Syria Response' (9 May 2013)

51 A typology is currently being developed on best practices in combating the abuse of NPOs and protecting their legitimate activities.

The *hawala* networks have proven that they are extremely resilient, and hold significant potential to stabilise fragile states, meet the needs of people in crisis, and provide a valuable source of intelligence.

Much of the policy discussion has focused on the problem, rather than on developing solutions, and has been confined to individual country desks. Clearly, however, this is an issue that cuts across countries, foreign policy externalities, and specific financial corridors. The present situation provides an opportunity to further the conceptual work that NCA has been leading on the possibility of creating a 'safer corridor' for migrant remittances and other flows in fragile states or situations.

2. POST-CONFLICT CORRIDOR: SOMALIA

In order to ground the concept, HM Government has investigated how this may be practical for the special case of Somalia. As mentioned above, it is critical to understand fully each of the three steps of the cross-border funds transfer mechanism as transparency at each step is equally important to the on-going provision of remittance services from the UK, particularly in the case of systems with weak receiving country financial infrastructure, and which employ third-country Clearing Houses rather than straight-line transmission to the destination.

Kevin Watkins, Executive Director of the Overseas Development Institute, highlights in a letter to Barclays that their most recent evaluation of a major cash transfer programme introduced in response to the Horn of Africa famine underscores the fact that 'preconceived ideas about risk in Somalia may be overriding a more balanced assessment'.⁵² Only when some of those preconceived ideas and the facts are clarified will it be possible to sketch out a more enduring solution.

2.1 SIZE OF UK-SOMALI CORRIDOR

The key figure used to underline the importance of MTOs to Somalia is the total amount remitted by the international diaspora. Official sources range from USD0.5bn to USD2bn, which covers a huge range. But there are also other outstanding discrepancies, between figures supplied by the FCA, those imputed from the US, and those extrapolated from UK MTOs and a recent FAO-sponsored survey of recipient families in Somalia.

The FCA values the total of reported transactions through the UK-Somalia corridor during 2012 as USD39,764,006; whereby APIs and SPIs transacted USD9,152,908 and USD30,611,098 respectively.⁵³ These figures are obtained through the annual 'Capital Adequacy Return', in which APIs can choose one of three ways to calculate ongoing capital requirements: Methods A, B and C. Only APIs electing to use Method B have to report their total payment volume, so the FCA figures will not include any that opt not to use the other two methods, which is indeed the case. Therefore, the above reported transactions certainly understate reality and cannot be taken as a meaningful representation of the flows facilitated by registered MTOs in the UK-Somalia corridor.

The bank statements of Somali MTOs would be the most reliable source of information on flows from the UK, but these figures are withheld by the banks for reasons related to competition, regulation and client confidentiality. However, in December 2011, before closing its accounts with 15 Somali MTOs in the US, Sunrise Bank in Minnesota reported that it facilitated USD111 million on behalf of those companies.⁵⁴ As the UK flows to Somalia are known to be greater than those of the US (SOMSA members consulted in the UK confirmed this), the size of the UK-Somalia market at least exceeds that figure.

Registered companies which elected to provide details from their transaction databases for this study demonstrated that the regulated flow is likely to be in the order of USD380 million. This figure includes the contribution of aid agencies and corporate clients because it is reportedly difficult to disaggregate these from individual customer transactions in the current databases.

52 ODI Letter to Antony Jenkins (2 September 2013)

53 Actual figures reported in Euros: EUR30,925,499; EUR7,118,454; EUR23,807,045. Average annual exchange rate for 2012 used at 1.2858.

54 American Refugee Committee (2012) 'Supporting the Use of Remittances to Somalia for Humanitarian Purposes,' Proposal submitted to USAID-OFDA (30 March)

Working backwards by deduction from research conducted within Somalia, this figure becomes very much higher again.⁵⁵ In order to use any of the estimates to measure the degree of impact of the present banking situation on Somalia, they would however need to be compared with the:

- Actual proportion of the actual number of UK-based Somalis sending remittances
- Average amount sent per person per annum
- Aggregated figures extracted from all MTO transaction databases
- Aggregated settlements shown on known UK bank statements

If the exercise conducted for this study led to anywhere close to a realistic actual figure for UK-Somali money flows, there is an urgent need for more accurate reporting of this remittance data. NCA notes that feedback from the sector more broadly reveals that 'more legislation would be welcomed' to deal with this challenge, including requirements for MTOs to submit trading statements on a yearly or six-monthly basis.

2.2 REMITTANCE FLOWS

After a protracted period of civil war since 1988, Somalia's diaspora came to be known as the 'missing million', significant when compared with an estimated in-country population of some seven and a half million, and has further swelled as a result of the violence, famine and displacement of 2011, despite growing pressures from host states to return refugees.⁵⁶ Somalis are a far-flung population – already living across borders in the Horn of Africa, they also have a strong presence in Europe, North America, the Middle East, other parts of Africa and seem to be moving increasingly across the Indian Ocean to Asia.

Estimating the true scale of remittances is challenging, due to limited access for large-scale survey research, the caution of MTOs regarding the sharing of their commercial data, and differences in what different actors count as a remittance. A recent FNSAU/FAO study suggests that remittances amount to a minimum of USD1.2 billion per year, far exceeding typical levels of international aid of around USD800m per year, exports of USD500m, and Foreign Direct Investment of USD100m.⁵⁷

The FSNAU/FAO bears out the findings of earlier research,⁵⁸ concluding that the bulk of remittances cover basic household expenses – food, clothing, education, and medical care. Indeed, 'Roughly one third of respondents said that they would not be able to afford food, medicines and school fees if remittances were stopped'. Other contributions go towards family emergencies, weddings, community projects, investments, political projects and peace processes.

55 The research team used assumptions and calculations based on official population data and findings from the Food Security and Nutrition Analysis Unit's most recent study in Somaliland and Puntland. According to this research, 41 per cent of Somalis receive remittances from friends and relatives, of whom 26 per cent live in the UK and 20 per cent in the US. Food Security and Nutrition Analysis Unit (FSNAU) Somalia (2013) 'Family Ties: Remittances and Livelihoods Support in Puntland and Somaliland' (5 June)

56 Sheikh, Hassan & Sally Healy (2009) 'Somalia's Missing Million: The Somali Diaspora and its Role in Development,' UNDP Somalia Report

57 For precise figures, see FSNAU (2013) 'Family Ties: Remittances and Livelihoods Support in Somaliland and Puntland' (Nairobi: FSNAU).

58 See FSNAU 2013 above. Other research includes Lindley, Anna (2010) *The Early Morning Phone Call: Somali Refugees' Remittances* (Oxford: Berghahn Books), Horst, Cindy (2006) *Transnational Nomads: How Somalis Cope with life in Kenya's Dadaab Camps* (Oxford: Berghahn Books), Hammond et al. (2011) 'Cash and Compassion,' UNDP Somalia Report, and Hoehne, Markus (2010) 'Diasporic engagement in the educational sector in post-conflict Somaliland: A contribution to peacebuilding,' University of Jyväskylä *Diaspeace Working Paper 5: 1798-1689*.

A policy paper released by the association which preceded the current Somali Money Services Association (SOMSA) revealed that remittances are a primary source of income for two thirds of the urban population, and they fund 80 per cent of start-up capital for all businesses.⁵⁹

The diaspora population in the UK is one of the largest and longest-established, dating back to the colonial recruitment of merchant seamen from the British Somaliland Protectorate. The 2011 England and Wales Census identified 101,370 people born in Somalia, and 'the community' – which might be thought of those identifying as ethnically Somali or as a part of a Somali diaspora – is likely to be larger due to the second generation, the length of the conflict, and the cross-border nature of the Somali population in the Horn of Africa.⁶⁰

While many Somali UK citizens can comfortably afford, given the economic disparities, to send substantial amounts by local standards in Somalia, often people make considerable personal sacrifices to send money home because of the great needs of their relatives – their support is vital to livelihoods and survival in Somalia.⁶¹ The issue of remittances, and of the recent threat to MTOs is a major topic of debate on radio, internet and media popular with Somali British citizens.

Our online surveys revealed that of the regions receiving the most money, Banaadir (where Mogadishu, the capital city, is situated) was ranked first, followed by Woqooyi Galbeed (where Hargeisa, the second largest city, is situated). These two cities account for almost 70 per cent of all remittances sent by these people on a regular basis. A large proportion of recipients of remittances from the UK live in areas at two extreme ends of the security spectrum – Woqooyi Galbeed is likened to an enclave of peace and security, while Mogadishu and surrounding areas are well-known as being Al-Shabaab's primary target due to the large number of government and military targets situated there.⁶²

Our online survey with aid agencies revealed that they are also most concentrated in the above two urban centres. This is in line with UNICEF's 2013 report which found that almost half of the recipients of cash and voucher programmes are located in Mogadishu.⁶³ This is partly due to the expansion of al-Shabaab's ban on aid operations in the areas they control, restricting access to many people in need,⁶⁴ and their displacement to Mogadishu (where aid agencies are able to operate more easily) in search of aid.

Therefore, the highest concentration of aid operations, remittance flows and al-Shabaab activity coexist in the same area (see map overleaf), raising concerns of governments and banks about potential benefits for al-Shabaab.

59 Somali Money Transfer Association (SOMTA) 'Policy Paper: The Somali Money Remittance Business'

60 *The Economist* (2013) 'Britain's Somalis: The Road is Long' (August)

61 Lindley (2010) above. 19 per cent of the Somali-born population in the UK are unemployed, the highest rate of all foreign born communities. *The Economist* (2013), 'Britain's Somalis: The Road is Long' (August).

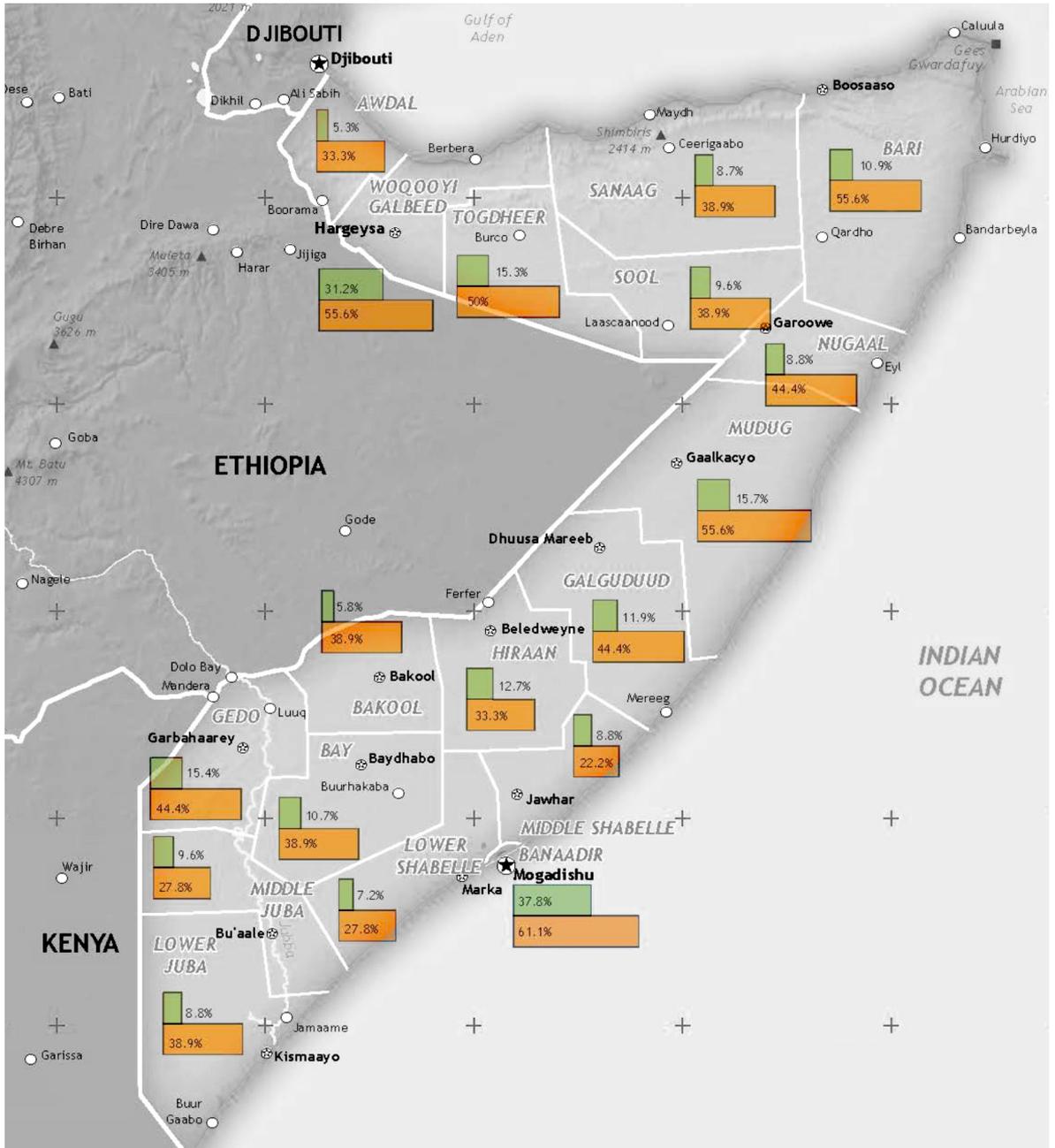
62 In the period January-June 2012, 57 per cent of al-Shabaab attacks were in Banaadir, of which 78 per cent were in Mogadishu. JTR 451 12 RESTRICTED (14 Sep 12). See Annex 2 for a much more detailed review of the security situation in Somalia.

63 Mogadishu received 48 per cent of the total cash grants and vouchers in southern Somalia in 2011-12, of which 80 per cent was targeted at IDPs. UNICEF (2013) 'Final Evaluation of the Unconditional Cash and Voucher Response to the 2011-12 Crisis in Southern and Central Somalia,' p.38

64 Report of the Monitoring Group on Somalia and Eritrea pursuant to Security Council resolution 2060 (2012): Somalia (S/2013/413), p.9

SOMALIA

SURVEY: CONCENTRATION OF AID AND UK REMITTANCES



LEGEND

- AID OPERATIONS
- UK REMITTANCES

In February 2008, USAID enhanced the due diligence requirements on its local Somali partners, demanding that 'all reasonable steps' are taken to minimise diversion of funds to al-Shabaab. After the UN declared the famine in southern Somalia in July 2011, the US Treasury issued an exemption authorising USAID to provide 'urgently needed humanitarian assistance in Somalia' regardless of the potential profit for al-Shabaab, and that 'good faith efforts to deliver food to people in need will not risk prosecution'.⁶⁵

In spite of this exemption clause, a recent report published by the aid sector reveals that US aid to Somalia diminished 88 per cent between 2008 and 2010 due to fears of legal liability, and in 2010 at least three American NGOs ceased to work in southern Somalia as a direct result of this lack of available funding.⁶⁶ US NGOs were reportedly 'ambivalent' about the waiver because its technicalities meant that it did not apply to all non-US charities and their donors.⁶⁷

This provides a well-documented case of where the need for a 'humanitarian waiver' was recognised, but its potential impact was nullified by a lack of clarity and awareness.

65 Mackintosh & Duplat, 'Study of the Impact of Donor Counter-Terrorism Measures on Principled Humanitarian Action,' p.85

66 *Ibid.*, p.83

67 *Ibid.*, p.85

2.3 REMITTANCE CHANNELS

By the end of the 1980s, the formal banking sector in Somalia was already crippled by corruption and mismanagement, with a significant informal sector relaying much of people's international transfers.⁶⁸ Efforts to re-establish the banking system since the collapse of the state in 1991 have been stymied by the lack of a secure political framework and rule of law, and controversies over the issuing of banking licences by the various government entities which have been established.

In the context of mushrooming demand for money transfer services from refugees, migrants, traders and aid agencies, a thriving specialised indigenous MTO industry has emerged in the 1990s, connecting Somalia to other parts of the world.⁶⁹ Known as 'Xawala' by Somalis, these MTOs provide the primary channel for funds transfers between the different parts of the far-flung diaspora, communities in Somalia, and regional refugee camps and urban enclaves. In recent years, large operators have extended their customer base to serve other migrant communities as well. The MTOs provide funds transfer services for aid agencies seeking to pay in-country staff members and contractors, and facilitate the disbursement of cash transfers to aid beneficiaries.⁷⁰ The companies also serve the needs of Somalia's strong business community. Within the Somali territories, some companies provide deposit services for private individuals, businesses and aid agencies.⁷¹

The service provided is competitively priced when compared with other corridors: Somali MTOs are unique in that they all charge roughly the same commission of 5 per cent, for sending amounts up to approximately USD1000. The vast majority of household Somali remittances fall into this category. For amounts greater than USD1000, fees drop to either 3 or 4 per cent depending on the company. Beyond this, some high-volume or regular clients are able to negotiate discounted fees with specific companies. This compares very favourably with Western Union and MoneyGram's fee of around 7 per cent for sending the same amount to neighbouring countries such as Ethiopia. This is partly as a consequence of the Somali market being relatively well served.

Collectively, the MTOs cover nearly all towns and villages within Somalia. This is despite the fact that a large proportion of the population live in rural areas and there is poor infrastructure for travel and coordination in the country. While most Somali MTOs began as clan-aligned entities, over time they have grown and become more diversified to cover numerous clans and regions. Some larger companies, such as Dahabshiil and Kaah Express, serve nearly all regions and clans. Importantly, however, some of the smaller companies serve the most vulnerable and insecure parts of the country, such as Tawakal or Bakaal in parts of Puntland and South-Central Somalia. Thanks to this comprehensive coverage of the MTO sector across Somalia, any hidden costs in the Last Mile (due to travel) are minimised.

Money is transferred in USD because of the unreliability of local Somali currencies: 'When our country collapsed,' said one CEO of a Somali MTO based in Dubai, 'the first thing we trusted was the US dollar'.⁷² Today, the Central Bank of Somalia (CBS)

68 United Nations Development Programme – Program of Governance in the Arab Region, 'Financial Transparency Report: Somalia', <http://www.pogar.org/countries/theme.asp?th=12&cid=17#sub3>. Also Powell, Benjamin, Ryan Ford & Alex Nowrasteh (2006) 'Somalia After State Collapse: Chaos or Improvement?' Independent Institute Working Paper 64.

69 See Lindley, Anna (2010) 'Between Suspicion and Celebration: The Somali Money Transfers Business' *Development Viewpoint* 45 (London: SOAS) <http://www.soas.ac.uk/cdpr/publications/dv/file56260.pdf>

70 The vast majority of the 16 international and local NGOs we surveyed used MTOs to transfer funds as part of their operations in Somalia.

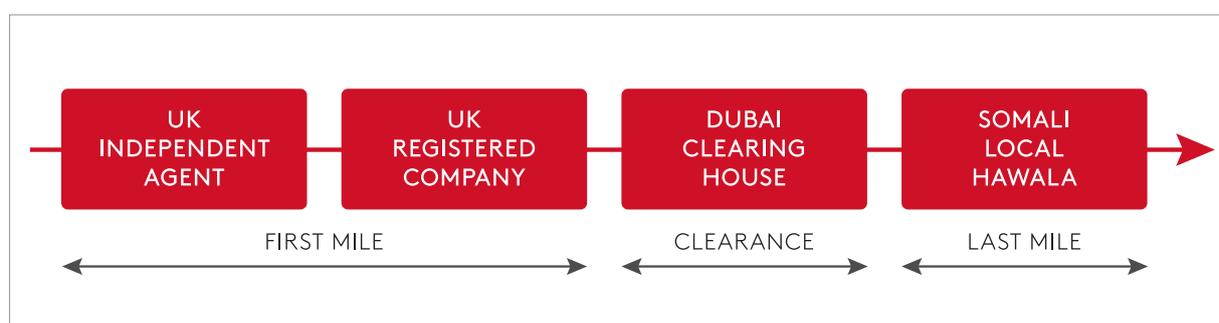
71 More than half the NGOs we surveyed used MTOs as deposit-taking institutions in Somalia.

72 Interview, 3 September 2013.

does not hold reserves in the Somali Shilling, it cannot influence the value of the Shilling because the bank does not control the bills in circulation, and there are no commercial banks for it to regulate. The CBS therefore has few basic tools to encourage growth. The currency recently appreciated 25 per cent against the US dollar because of an injection of dollars and euros into the market on behalf of aid workers and investors who want to convert the money to shillings. The 1,000 shilling notes were last officially printed in the 1990s, and batches of counterfeit cash produced by conflict entrepreneurs have undermined faith in the currency. Meanwhile, there have been major concerns about irregular activities for private gain and patronage in the CBS, and reports that it has struggled to function free of interference, thus not satisfying international banks that it can operate as a credible institution: the road to a functioning and well-regulated banking sector is likely to be a long one.

2.4 ISSUES AT CLEARANCE, FIRST AND LAST MILES

Before examining the different issues at the Clearance, First and Last Miles of the Somali remittance flows, it is important to review the basic mechanism by which remittances from the UK-based diaspora find their way to Somalia. Typically the process comprises four distinct entities, connected across a network through common ownership and/or contractual arrangements.



A common mistake in the current dialogue is to view it through the lens of a UK-based entity, rather than from the perspective of the principals who tend to operate out of third party countries, such as the UAE in the case of Somalia. Notably, all those in the chain use a common umbrella brand name prescribed and owned by those principals. They determine how the remittances are collected in the sending countries, and provide the network of local agents through which to disburse the remittances in Somalia, as well as facilitate imports and exports. Their businesses are usually family or individually controlled, albeit with an Emirati majority shareholder.⁷³ UAE is the place of choice because it is the gateway to trade, and so the pivotal point where remittance flows intersect with money involved in import/export business.⁷⁴

73 Companies established outside a Free Trade Zone (FTZ) need to have majority ownership of a UAE citizen. In the case of 'Money Changers', the UAE Central Bank interprets this as meaning that the 'national shareholding should be not less than 60 per cent of the total paid-up capital'. UAE Central Bank website: http://www.centralbank.ae/en/index.php?option=com_content&view=article&id=136&Itemid=103

74 Dubai also has a permissive regulatory environment that encourages both financial and trade-related business. As one humble observer in Afghanistan noted, 'Dubai is at the centre of it all,' in Thompson, *Trust is the Coin of the Realm*, p.200

The following describes an example of the two separate but interdependent movements of cash associated with the remittance process across one of these networks:

Individual remittance transfer and information flow

- A remitter in Manchester hands over GBP100 to a local agent who represents a Somali MTO and might also run other enterprises (e.g. internet cafe, travel agency, retail shop).
- This agent directly or indirectly instructs an agent in Mogadishu to make the payment in USD, and the recipient is notified by text message to collect the money.
- This creates a debt between the agents in Manchester and Mogadishu.

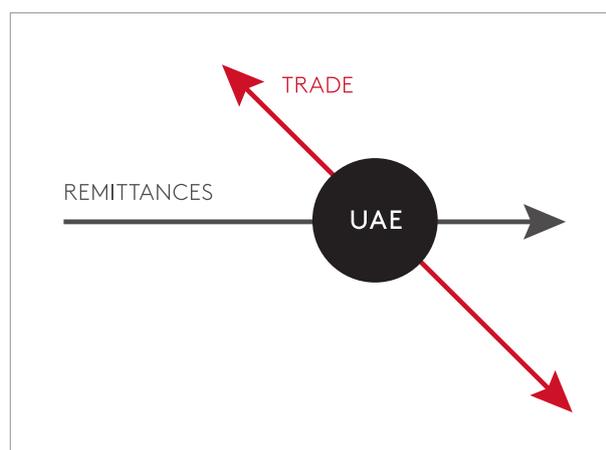
Aggregate clearance and settlement

- The Manchester agent aggregates remittances received until a certain threshold (e.g. GBP3,000) and then deposits this cash into a UK bank account held by the UK-registered company.
- This company instructs the UK bank to convert and transfer funds in USD to the Clearing House (CH).
- The CH acts as a hub where remittance and trade-related flows from across a complex network intersect. For example, a Somali importer might require credit to purchase Chinese-made goods held by a Dubai wholesaler. He will settle this debt with the CH on the sale of these goods in Somalia, by handing the cash proceeds to the Mogadishu agent.
- This trade-related cash provides the means for the Mogadishu agent to make remittance pay outs.

Banks and regulators identify various vulnerabilities within these flows of finance and trade settlement. The following analysis takes each of the main concerns in turn.

Clearance

Clearly the current system will only work through a central hub that maintains equilibrium across the network, and herein lies the primary problem. Control issues implicit in this model are familiar to the managements of larger global businesses like banks and professional services firms that also operate under one brand, but comprise a mix of fully and partly owned subsidiaries through to franchise-like, agency and other commercial arrangements. Ultimately they rely on shared values, objectives and mutual trust to function as an effective network.



The entity that serves as a CH is sometimes referred to as the 'headquarters' due to its centralised function, while the main correspondent entity in a country such as the US or UK may be called the 'super-agent company' because of its responsibility to acquire a licence, have the necessary start-up capital, and corporate structure to

comply with the host regulation. Beneath the 'super-agent' can be found the many customer-facing agents across the UK (concentrated in London).⁷⁵

Due to its significance, an understanding of the CH landscape and its regulation and operation is critical in determining how the current remittance process can be enhanced and secured.

CHs registered as 'Money Changers' or 'Exchange Houses' with the UAE Central Bank are all located *outside* Dubai's International Financial Centre (DIFC) because firms authorised to operate in the DIFC by its regulator (the DFSA) are prohibited from conducting retail business. Regulation outside the DIFC has, in the view of many experts, historically fallen short of international standards.⁷⁶ It should be noted that in 2012, it was announced that an overhaul and updating of the UAE regulatory system, along lines found in Australia, was being undertaken and the results are still forthcoming.

A detailed review of the AML/CTF environment in the UAE is not within the scope of this report, however in order to inform the conclusions, we have drawn on previous research undertaken by the team and some desktop analysis including the FATF's *Mutual Evaluation Report* on the UAE, based on research undertaken in March 2007, and the 9/11 Commission. These reports raised a number of concerns, highlighting that a combination of geography (as the nexus for trade in an unstable region) and non- or only partial-compliance with 29 of the FATF's 40+9 Recommendations led to fundamental vulnerabilities.⁷⁷

A range of measures have been enacted since the publication of these reports and, in particular, standards in DIFC have been enhanced. However, in March 2013, the US State Department noted that ML vulnerabilities remain as there are still a large number of CHs and trading companies, including of Somali origin, that are unregistered.⁷⁸ The July 2013 Article IV Consultation produced by the IMF noted that 'In the context of mounting international efforts against money laundering and tax crimes, the [UAE] authorities are encouraged to continue improving their understanding of the origin of financial inflows and of the beneficial owners of deposits and loans in the UAE ... and to continue their efforts in bolstering the soundness of the financial sector which could benefit from measures designed to improve compliance with the standard, including those related to customer due diligence, cross-border cash couriers, and *hawaladars*.'⁷⁹

Improved transparency at the clearance stage of a remittance through third party countries is important to reduce risk. This could include, for example, the provision of annual audit reports of CHs that submit to enhanced levels of transparency by a

75 Thompson, Edwina (2007) 'Independent Evaluation of UNDP Somalia Financial Sector Development Project 2002-2007,' commissioned by EU and UNDP (September)

76 For example, in 2007 lawyers from Clifford Chance noted that '[t]he financial regulations promulgated by the Central Bank [and other UAE regulators outside the DIFC] are in many cases less detailed than the equivalent regulations promulgated by the DFSA'. Henderson, Andrew & Antony Hainsworth (2007) 'Financial Regulation in the UAE,' *International Financial Law Review* (April). This view was supported by those interviewed during the research who cited, among other things, an absence of work similar to assignments in the UK involving Section 166 of the Financial Services and Markets Act 2000. This gives the FSA the right to require a regulated firm to source a report (sometimes known as a 'Skilled Persons' Review') on its operations; for example, risk management or compliance procedures in order to confirm that important procedures are being adhered to.

77 FATF (2008) *Mutual Evaluation Report: Anti-Money Laundering and Combating Financing of Terrorism – United Arab Emirates* (9 April); 9/11 Commission, *Monograph on Terrorist Financing*

78 US Department of State (2013) 'International Narcotics Control Strategy Report,' *Money Laundering and Financial Crimes* Vol.II, p.204

79 IMF (2013) 'United Arab Emirates: 2013 Article IV Consultation,' *IMF Country Report* No.13/239 (July), p.19

carefully selected team from a reputable international audit firm.⁸⁰ This would follow the spirit of the 'Compliance Assurance' model outlined in section 1.3.

UK regulators can only directly influence operations within their jurisdiction – in other words, the First Mile. This leads to the question of what can be improved in the UK and how to address the issues involved in the Last Mile – Somalia itself. Each will now be taken in turn.

First Mile

Due to the nature of the corridor they serve, Somali MTOs are expected to display an enhanced level of due diligence (EDD) in relation to ID systems, database management, and checks on agents in the Last Mile. Most of the businesses in this sector appear to be relatively small organisations handling disproportionately large amounts of cash. They are dynamic and agile traders with very different cultures to that of bureaucratic Western institutions like banks, governments and regulators.

A specific concern of HMRC is also the lack of clarity in the 'beneficial ownership' of these businesses – this is where, specifically in relation to the payment received, there is an obligation to pass on an item of income. In other words, 'where a person does not have the full right to directly benefit from income because of an obligation to pass it on to another person'.⁸¹ The lack of transparency impacts the validity of the Fit & Proper (F&P) tests conducted by HMRC and FCA. The problem has been explained as partly a cultural consideration – that it is not well understood why the regulator is interested in the (in some cases many) shareholders in the business who reside offshore. The reason why this is important in the case of Somalia is because the main controllers of the business operate from Somalia itself or third party countries. Therefore, in order to understand the business properly, the regulator would need to learn more about these individuals.

Last Mile

Security and the regulatory environment create two of the biggest obstacles for fast financial sector development in Somalia. The physical and soft threats posed by al-Shabaab's footprint in Somalia, coupled with the inaccessibility to much of the country due to security concerns, elevates the current significance and urgency of remittances, and the connection between the diaspora and Somalis at home. The security situation and its variation across the three main regions of the country warrants a slightly extended analysis, so please refer to Annex 2.

Despite the constraints on the ground in Somalia, aid agencies identify 'Xawalas' as a very 'safe, secure and reliable' vehicle for transferring funds.⁸² A recent UNICEF report praised the efficiency of the 'Xawalas' during the period of famine, but notes that so long as they retain their informal and unregulated nature they 'are not immune from the complexity, politicisation and violent character of the Somali environment and will inevitably be caught up in malpractices from time to time'.⁸³

80 Some Dubai-based CHs claim to already produce such reports although none said that they have provided these to their UK bank relationships.

81 HMRC 'INTM504030 - Double taxation treaties: Beneficial ownership: What beneficial ownership means,' accessed at < <http://www.hmrc.gov.uk/manuals/intmanual/intm504030.htm>> (September)

82 Cash Based Response Working Group (2011) 'Q&A: How to scale up Cash Programming in South-Central Somalia,' p. 1

83 UNICEF Final Evaluation (2013), p.71

A case study concerning one NGO's local partners concluded that whilst its remittance provider had followed 'poor operational practices', it was the local partner NGO that had been 'primarily responsible for corruption and diversion'.⁸⁴ The remittance provider admitted that they did not always follow payment protocols and that their sub-contracting of sub-agents at local levels was 'inappropriate'.⁸⁵ The case points to weaknesses in risk management and procedural incompetence, rather than deliberate diversion and fraud, and there are signs that this experience is replicated in other companies at the Last Mile.

The Federal Government of Somalia (FGS) also focuses acute issues in terms of regulation and public financial management (PFM). Somali President Hassan Sheikh has made it clear that his Government sees improved public financial integrity as a vital aspect of national renewal. In a statement in January this year, he laid out the full extent of the challenges involved as the FGS begins to rebuild its public institutions from the ground up:

'Our state institutions have been destroyed by war and neglect. Our payments systems are entirely ad hoc. Our Central Bank has no electronic capacity, and can only handle hard cash. There is no longer any functioning public procurement process. There is no recent tradition of sharing information on financial management with the general public. Most of our civil servants lack training, clear job descriptions and relevant experience -- indeed, they lack the offices, chairs, computers and transport facilities that all of you [donors] consider essential to your work. We are committed to building up all these systems – but it will take time, and there will be setbacks and mistakes. What has been destroyed in a generation cannot be rebuilt overnight. In return for our commitment to transparency, we ask you for your patience, your flexibility and your realism. Creating a new PFM system is an intensely political process, at a time when the nation is still very fragile. Compromises will be needed. Perfection will not be achieved. But we will, I can promise you, do a much better job than anyone who has come before us in recent memory'.⁸⁶

Citing the New Deal's⁸⁷ insistence on responsible financial management, he stated that 'sound public financial management is the heartbeat of a credible state,' describing good PFM as a process 'in which the key element is trust... National stability and prosperity depend on creating an effective, honest and transparent public financial management system – and that is what we are committed to do'. The President noted that the PFM Self-Assessment then underway with World Bank and DfID support should provide 'a simple, clear diagnosis of our current deficiencies – and a realistic Action Plan covering the next two years'.

84 UNICEF Final Evaluation (2013), p. 69

85 *Ibid.*

86 H.E. President Hassan Sheikh Mohamud (23 January) cited in Federal Republic of Somalia (2013) 'Public Financial Management (PFM) Self-Assessment Report and Proposed PFM Strengthening Initiative 2013-2016' (April), p.30

87 The New Deal includes revenue management as one of its five peace- and state-building goals. The five are: (i) Legitimate Politics (foster inclusive political settlements and conflict resolution); (ii) Security (establish and strengthen people's security); (iii) Justice (address injustices and increase people's access to justice); (iv) Economic Foundations (generate employment and improve livelihoods); (v) Revenues & Services (manage revenue and build capacity for accountable and fair service delivery). See *A New Deal for Engagement in Fragile States*, 4th High-Level Forum on Aid Effectiveness at Busan, November 2011.

Clearly any reforms in the Somali MTO sector should aim to enhance or complement those efforts being made with Somalia to revitalise the formal economy. The Norwegian Government is soon to launch the Special Financing Facility (SFF), which is intended to play a transitional role in helping the CBS to transfer salary payments to public servants in Mogadishu. A critical first step has been the reportedly successful national ID system rolled out to the Civil Service Commission.

SUMMARY OF KEY ISSUES

Clearance

- A combination of weaknesses in regulatory oversight in third party countries and the opacity of the business practices and complex ownership structures of CHs⁸⁸ have led to reticence of UK-based banks in transferring funds to these entities when instructed to do so by their MTO clients in the UK
- Until new technology such as mobile money dis-intermediates CHs, or until a banking system and infrastructure develops in Somalia such that straight-line, direct bank-to-bank payments can be made,⁸⁹ CHs will play an important role in the mechanism that allows remittance monies to reach their intended recipients in Somalia
- As part of an end-to-end compliance and diligence upgrade, steps should be taken to 'demystify' the CHs in order to enhance the confidence that UK banks have in this critical element of the remittance mechanism.

First Mile

- There is scope for enhanced CDD with the requests for customer IDs
- Beneficial ownership must be clarified to reassure the regulator that the appropriate F&P tests have been completed for all relevant parties in the business
- Cultural considerations are important in the transition to a more 'compliant' system

88 One interviewee from the CH community noted that many Dubai-based CHs do not take Western compliance concerns seriously and lack knowledge and professionalism. A report from a Somali CEO contradicted this through his explanation of the much more onerous reporting requirements of the UAE Central Bank in comparison to UK regulators.

89 Note: a number of UK-based MTOs have applied for banking licences in Somalia but the lack of *inter alia* a regulatory framework and laws to cover deposit taking and lending means that these applications have not advanced.

SUMMARY OF KEY ISSUES

Last Mile

- Compliance is weak in some of the 'Xawala' companies, but in the documented cases this is due more to apparent laxity than deliberate malpractice
- Supervisory capacity is low to non-existent in the CBS
- The three different regions of Somalia present different challenges
- There is scope for transitional arrangements that will go some way to satisfying external regulators that an appropriate AML/CTF framework is monitoring inbound transactions
- It will be important to learn from the effective ID programme within the Civil Service Commission, and whether this can be extended to citizens more broadly
- Creative approaches are required, therefore appropriate technical assistance should be provided from less traditional sources

3. IMPACT OF BARCLAYS' DECISION: SOMALIA

Following the withdrawal of other banks from the MSB market in the UK, including HSBC in late 2012, Barclays became the largest supplier of banking facilities – this precipitated an internal review of its risk exposure, which found that there would need to be a 'strategic tightening' of risk controls on MSB business.

As with any fast-moving commercial situation, it is virtually impossible to predict exactly what the impact of the banks' evolving decision-making will be on the various MTOs in operation today, and in turn the specific corridors that they serve. Therefore, it is instructive to explore certain banking scenarios based on both evidence and anecdotal information gleaned from industry experts and customers.

Other research has been conducted into the drivers of banks' actions, the impact on structure and pricing across the whole UK remittance market, and options for regulators. Our focus is on ethnic corridors where people face potential exclusion from the formal financial system, and there is a perceived risk of funds being moved for legitimate purposes (e.g. migrant remittances) mixing with funds being moved for illegitimate purposes (e.g. criminality and terrorism). The UK-Somali corridor has been identified as a priority corridor, therefore much of this analysis aims to support a strategy for that geography/case. Barclays provided bank accounts for the five APIs serving that market, where remittances make up the bulk of transfers.

Our analysis of potential impact on this particular corridor considers the **technical** and **market** aspects for both the First Mile and Last Mile. The market view is important given that any required technical changes may influence the experience of the customer, or rely on them to change behaviour.

3.1 FIRST MILE

Technical view

Somalia is a typical example of a country that is emerging from protracted conflict that created a vacuum for formal financial systems. Consequently MTOs are the only form of financial service provider in Somalia (with the exception of two banks which are registered in Djibouti, and operating within the country – Dahabshil Bank and Salaam African Bank). They are used by almost all international organisations and companies operating there, and without them no regulated funds will flow.

In the UK-Somali corridor, an estimated 17 companies currently serve the market. At the time of writing, five retained API status, and are the only companies currently banked 'directly' in the UK that transfer funds to Somalia.⁹⁰ A further 12 companies are registered as SPIs,⁹¹ and of those, one was also banked directly until May 2013.

⁹⁰ Western Union, whose banking arrangements do not appear to be threatened, has one office in Hargeisa, but does not have enough coverage at the present time to say that they serve the wider Somali market - in our aid survey, one international aid agency reported that in early 2013 they 'tested using Western Union transfer services from the US to Somalia; all three attempts failed and the funds transferred (USD10 test) are still missing'. There are indications that Western Union's position in the market could, however, change quickly.

⁹¹ Amaana Express; Amal UK Express Ltd; Amoud Express; Bakaal Worldwide Limited; Hodan Global Limited; Iftin Express; Juba Express; Kaah Express; Ladan Express; Oloompic Money Transfer; Medina Money Transfer; Towfiq Express. The FCA did not have a record of several companies listed on the SOMSA website (www.somsa.co.uk) – however, these were found on the HM Customs register.

At the time of writing, WorldRemit is the only company that did not receive a termination notice from Barclays, so pending no further extensions granted by the bank, it will be the only company serving the UK-Somali corridor to retain 'direct banking' services from October in the UK. WorldRemit only operates an online/mobile money model (refer Diagram 1), and currently restricts its coverage to Somaliland.⁹²

The remaining SPIs have been operating without direct access to bank accounts for some time. Instead they have either relied on '**indirect banking**' – using the banking facilities of another business as a customer, or '**banking by proxy**' – becoming an agent of another banked MTO. In either scenario the SPI uses these routes to deposit cash into the banking system via bank branches based across the UK and then facilitate onward payment. When acting as a customer, they will provide the instructions for onward transmission of funds; when acting as an agent, they will often be tied to the Clearance and Last Mile facilities exploited by that banked MTO.

As a result of these developments, several larger wholesale MTOs are now believed to be handling more payments than the principal UK banks, through 'indirect' banking relationships; in much the same way, certain domestic or foreign banks in the UK utilise the cross-border payments infrastructure of larger international banks.⁹³

One underlying assumption is that the service providers that have their account closed will leave the market. This clearly does not apply to the majority of existing SPIs serving the UK-Somali corridor because they have long been operating without direct access to bank accounts, utilising a variety of mechanisms to access banking services indirectly.

Therefore the specific questions in this case are: in light of the tightening in banks' MTO policy and the need for the remaining four SPIs to adapt and potentially adopt the same model, how sustainable is this type of arrangement? Does this market restructure create an increased risk profile for this sector? What are the other alternatives? To what extent do banks scrutinise the business of wholesale MSBs to identify when they are acting as principal and when they are acting as agent? Would an increase in agent business jeopardise the provision of banking services to these wholesale/aggregator MSBs?

Sustainability

In order to answer the question of sustainability, it is important to understand who provides banking services to relevant wholesale MSBs and what those banks' position will be once they realise the extent of the relationship between their customers and MTOs serving the UK-Somali corridor, or become aware of the new relationships that they are forming. While some of the wholesale MSBs interviewed for this study are currently offering facilities to MTOs without bank accounts, they expressed concern about the possible secondary effects if their bank gains more oversight of those relationships.

⁹² This is a business decision based on compliance considerations.

⁹³ Not all banks are able to transmit funds from the UK directly. Typically only those with international operations will have this capability (either globally active UK banks or UK-based subsidiaries of international banks). Domestically-focused UK banks will have to enter into an arrangement with one of these internationally active banks to use their transmission capability (a so-called "correspondent banking relationship").

Risk profile

In terms of the risk profile, it is widely recognised that the worst case scenario is that a lack of access to banking encourages legitimate payments to move underground, making it even more difficult for regulators and law enforcement agents to distinguish between 'clean' funds and those intended for criminal or terrorist causes. This is a risk that has been recognised by the IMF as early as 2003 following the *First International Conference on Hawala*, hosted by the UAE Central Bank, when reflecting on the design of regulatory and supervisory systems.⁹⁴

The belief of members of the UK Money Transmitters Association (UKMTA) and agents of various affected ethnic corridors is that if MTOs cannot access banking either directly or through an alternative relationship with another MTO, they will trade illegally.⁹⁵

Evidence from law enforcement investigations indicates that criminal groups, due to increasing vigilance from the regulators, are finding it harder to register as MSBs but can still easily obtain banking facilities, especially access to the all-important international currency accounts, under the guise of other business activity. In one particular example a UK-based individual involved in an international money laundering crime group was unable to set up an MSB as he failed HMRC's F&P test, due to him having a previous conviction for fraud. The evidence suggests that this individual then arranged with friends, business associates and members of his extended family to set up a series of trading companies. The bank accounts of these trading companies were then used to receive large amounts of criminally derived cash, deploying the 'quick cash drop' banking method. The trading companies then transferred the value of the cash they received to countries overseas.

A pattern of activity was therefore established whereby a trading company would be set up, its bank account would receive large volumes of cash, the value of this cash would then be sent by bank transfer to wholesale MSBs with instructions to complete payments to companies overseas; after a short period of time, the trading company would close down and another would be set up to take its place, with the same activity repeated. This pattern has been repeated in excess of 15 times with the amount laundered exceeding GBP20 million.

Historically this type of behaviour has been limited to those individuals or groups who are actively seeking to launder criminal proceeds, either in isolation or as part of a global network engaged in criminally exploiting informal value transfer. NCA assessments, however, identify that this type of activity is becoming more prevalent as banking facilities are withdrawn from MTOs.⁹⁶

Much credence has been given to the stature of APIs within the market⁹⁷ and the options of either establishing principal/agent relationships between APIs and SPLs⁹⁸

94 IMF (2005) 'Regulatory Frameworks for Hawala and Other Remittance Systems,' p.3

95 While this study focused predominantly on the Somali sector, interviews were also conducted with other ethnic corridors such as UK-Bangladesh. Those Bangladeshi agents reported that their clients were primarily recurring customers from families they knew well, and that their remittances made a significant contribution to the clients' families in Bangladesh; on this basis, they conjectured that if the regulated channel for transferring this money was removed, the people would use illegal ways to move the funds.

96 This type of activity was predicted in SOCA's threat assessment ODX-6504, paras. 97 & 98.

97 The EU Payment Services Directive has an exemption for SPLs, which allows small companies to compete with the likes of Western Union (albeit as minnows), and operate on a lower standard of diligence and regulatory compliance. The European Payments lobbying group has argued for some time for the elimination of SPLs; one of the main arguments is based on a judgement of risk and assumed level of exposure to criminality on behalf of 'less regulated' smaller companies.

98 This includes entering into an agent relationship with another company in the UK which is banked by a foreign entity. This alternative does not solve the need for a network of locations for cash to be deposited, as the majority of foreign entities do not have this reach.

or for the limited number of APIs to buy out the business of smaller SPIs in their entirety. Whilst recognising that this could lead to a potential reduction in access to remittance services and unknown consequences in terms of cost, it has been argued that it will strengthen the sector and as a consequence improve compliance across the market.

As such, a managed closure of accounts within certain parts of the Somali sector is seen as a generally positive move in terms of crime reduction and consumer protection. Such arguments are based on the premise that it is preferential to keep MTO banking visible, thereby preventing unbanked financial transactions through the use of Informal Value Transfer Systems (IVTS), and that the 'tougher' requirements in order to gain API status better serve the requirements for customer protection.

This position does not take into account the recent introduction of revised requirements for SPIs under the Payment Service Regulations (PSRs), and it is also not one necessarily endorsed by the remittance sector or supported by experience from law enforcement and regulatory activity.

Prudential Risk

It has been suggested that SPI status leads to weaker regulatory compliance, especially if the company is only banked indirectly. The rules for SPIs do not require firms to take steps to safeguard customer funds (except if they choose to do so voluntarily), therefore there is a risk that they do not segregate and thus safeguard funds correctly. The only fine, however, against a Payment Institution is in the UK-Somalia corridor with a larger API – the FCA imposed a public sanction on the Somali MTO Qaran Express Money Transfer Limited for breaches of the Payment Services Regulations (PSRs).

At times during 2009 to 2011, the company mixed customer funds with its own monies in the same bank account and failed to record accurately how much of the money in that account were customer funds. It also failed to properly reconcile the customer funds held in its bank account, and risked (in the event of its insolvency) the loss of customer funds due to not setting up the bank account correctly.⁹⁹

Money Laundering/Terrorist Financing

Current reporting on criminal investigation activity¹⁰⁰ would appear to indicate that MTOs operating as APIs present more of a money laundering risk, in terms of volume, than SPIs. In these case examples it has been the size and level of transactional activity of the MTO, coupled with poor or fraudulent record keeping, that have allowed it easily to hide the placement of criminal cash without alerting the banks or regulators.

This appears to correlate with the experience of a number of the SPIs or smaller APIs within the Somali corridor who deal in far lower levels of cash placement and maintain a good level of transparency and accuracy within their records - due to their transaction volumes, they have been at reduced risk of exposure to the facilitation of flows on behalf of organised criminals.¹⁰¹

99 Financial Conduct Authority (2013) 'FCA publicly censures Horn Express Ltd (formerly known as Qaran Express Money Transfer Limited) for breaches of the Payment Services Regulations' (Published 30 April)

100 SOCA Assessment ODX-6504

101 Of course this deduction is reliant on the accuracy of the entries actually made by an SPI or API. If criminal transactions are kept 'off record', then this judgement would be flawed. Whilst some criminal MTOs will create false records, however, the usual practice is for them not to bother – it is the volume of transactions within the larger MTOs that makes the placement of criminal funds within the banking system less obvious.

Regarding terrorist finance, the only documented evidence in the US-Somali corridor shows that those funds are not corralled in the illegitimate part of the market – the customers deliberately spread their transactions across the main companies.¹⁰² In reported UK prosecutions, all known funds transfers in support of terrorism in Somalia have been made through the same company, and one other company which has since been closed down – the funds tend to be spread across different agents within the same company.¹⁰³ The size of the companies used indicates a similar vulnerability of larger APIs to abuse by terrorists as that by criminal money launderers.

One ‘unknown’ at the moment is what will eventuate from the recent criminalisation of *khat*¹⁰⁴ within the UK.¹⁰⁵ Dialogue with British-Somalis reveals that ‘Xawala’ companies have historically facilitated payments in support of *khat* importation into the UK. It is widely held that the UK’s decision is unlikely to act as a deterrent and will actually add to the commodity’s value.¹⁰⁶ As such there will be a continued requirement for those involved in the importation of this commodity to facilitate payments for the harvesting, transport and eventual distribution amongst the Somali community.

Again, if we return to trends in law enforcement, historically the link between MSBs and criminal groups has been limited to certain ethnic corridors depending on the type of illegal commodity, the relevant smuggling routes, and the requirements to release funds in certain areas of the globe. To date the Somali remittance corridor has rarely featured in law enforcement investigations involving criminal money laundering.

The cultural acceptance of *khat* use amongst minority groups from the Horn of Africa will provide a challenge to UK authorities, not only in terms of behavioural change for those who engage in its use, but also those who have played vital roles in its, up until now, legal supply to the UK. The ability to be able to identify the appropriate financial entities is therefore vital in facilitating dialogue between the regulators, law enforcement, and the sector to ensure that such changes in legislation do not expose individual businesses to abuse.

From both a law enforcement and regulatory perspective there are evident and significant dangers in withdrawing banking services from large parts of the UK remittance market such as the whole Somali sector. The strategy from the regulators and HMG, through guidance and formal regulation, has been to make remittance activity transparent and drive illegal activity out of the sector. Rather than preventing the use of opaque banking solutions, there is a risk that such behaviour will increase as businesses seek to provide legitimate remittance services within the affected ethnic

102 Two US-Somali women were charged for knowingly conspiring to provide support to a designated Foreign Terrorist Organisation by assisting in the collection and forwarding of funds from unwitting US-Somali citizens to al-Shabaab. They sent over 10 tranches of USD250-1195 from September 2008 to July 2009. United States District Court of Minnesota, Indictment CR 10-187 PJS/FLN.

103 In January 2012 Shabaaz Hussain pleaded guilty to seven counts of terrorist fundraising contrary to s15(3)(a) and (b) Terrorism Act 2000. In July 2012, brothers Mohammed Shabir Ali and Mohammed Shafik Ali pleaded guilty to a joint offence of sending, over a period of time, and with the help of Hussain, GBP3,000 to their elder brother Mohammed Shamim.

104 There has been pressure to criminalise the drug ever since two of *khat*’s compounds – cathine and cathinone – were added to the UN’s Convention of Psychotropic Substances in 1988. In January 2013, the Advisory Council on the Misuse of Drugs (ACMD) concluded that there was ‘insufficient evidence’ that *khat* caused health concerns. The British Home Secretary rejected this advice and announced it would control it under the Misuse of Drugs Act 1971 as a Class C drug. ACMD (2013) ‘*Khat*: A Review of its Potential Harms to the Individual and Communities in the UK’ (23 January); Home Office (2013) ‘Written Statement to Parliament: Written Ministerial Statement Outlines The Government’s Decision To Ban *Khat*’ (3 July).

105 Until July 2013 the UK was the largest importer of *khat* after Somalia, and generated over GBP3 million in VAT annually. Anderson, David & Neil Carrier (2011) ‘*Khat*: Social Harms and Legislation: A Literature Review,’ UK Home Office Occasional Paper 95 (July)

106 Trade is still lively in the US, which has more draconian punishments for its import.

corridors. Such behaviour only reinforces the poor perception/risk associated to the sector and the potential difficulties for law enforcement to differentiate between individuals surreptitiously accessing banking facilities for nefarious purposes versus those engaging in such activity in an effort to continue legitimate remittance activity.

Market restructure

It is unclear what level of market restructuring will occur in the Somali MTO sector. Some have predicted that it will be resized, move underground, and be exploited if firms were to lose their banking: 'Lots of small informal operators would fill the gap left by Dahabshiil and the regulated firms whose transaction records can be inspected. We have seen this before – when al-Barakaat's money transfer business was closed down in the USA after 9/11.'¹⁰⁷ Market fragmentation did not, however, actually eventuate in the wake of al-Barakaat's closure because agents simply changed their allegiance to the next biggest operator, allowing it to assume the dominant position in the market. In the case of the closure of Qaran Express, Kaah Express similarly acquired many of its agents to become a significant competitor.

Contrary to some perceptions being promulgated in the media, MTOs operating in the UK-Somali corridor are likely to remain active despite Barclays' decision, and remittances will still reach migrants' families in the short to medium term. In fact, if only the larger operators retain bank accounts, a market already dominated by one business with 40 and 60 per cent of the market (depending on location) will be controlled by the few. This would put upward pressure on the relatively low commission rates of around 5 per cent.¹⁰⁸

In the event that Somali MTO accounts are closed, there is a possibility that some companies will revert to less secure (even if legal) methods, such as cash couriers, which will be more vulnerable to potential abuse.

Market view

Any required technical changes may either influence the experience of customers, or rely on them to change behaviour. Therefore it is critical to gauge their perceptions of the issue, and level of propensity to adapt if necessary.

Reactions

In our online survey, people responded quite consistently to the question about the extent to which 'decisions made by British and US banks' would affect the diaspora's ability to send money home. Just over 80 per cent of the sample answered 'Significantly', almost 15 per cent reported 'Moderately', and less than 4 per cent answered 'Not at all'. Participants in our workshops strongly reflected their alarm and stress at the prospect of their remittances to families in need being disrupted, and their responses appeared to be based on the assumption that the termination of MTO accounts would stop money flowing through what they term 'Xawala'¹⁰⁹ companies in the UK.

107 Paice, Edward (2013) 'Somalia, remittances and unintended consequences: in conversation with Abdirashid Duale' (29 July)

108 According to IFAD, the African remittance market has monopolistic tendencies due to its regulatory environment, which has a negative effect on pricing due to market capture, and thus financial exclusion. IFAD (2013) 'Africa,' accessed at <<http://www.ifad.org/remittances/maps/africa.htm>>

109 The official Somali translation of *hawala* is *xawilaad*. Somalis in Britain refer to specialised Somali MTOs as 'Xawala' or 'Xawalas'. Therefore, while this is not strictly correct, this variation has been used throughout.

From consultations and media reporting, it is therefore clear that there is significant misinformation about the potential outcomes that will occur in the Somali corridor because of recent changes in the market. These need to be corrected in order to prevent alarm in the Somali community, and in the worst case scenario, a 'run' on deposits held by MTOs.

The community strongly defends 'Xawalas' because of speed, cost, convenience, confidence, credit, and feeling of a direct connection with families and friends overseas – they are a deeply embedded and trusted part of Somali culture based on a long history of 'Xawalas' serving the income-generating diaspora in Gulf state countries. They are also a strong source of pride due to their continued service provision despite decades of conflict in Somalia – 'This is a Somali system, run by Somalis for Somalis. Please do not let a Bank destroy it!' was the response of one person in the workshops, and a sentiment expressed by many.¹¹⁰ It is therefore a very distinct challenge if the community were forced to use other non-bank service providers for international money transfers originating from the UK diaspora.

A number of people who participated in the diaspora discussions were quick to point out that 'Women use the services on a daily basis to support their families and friends back in Somalia and I think with their added voice, a big change can be made'; 'Majority of *hawala* senders are females and the majority of those we receive it are females ... it is a way women [can] empower women'; 'Why don't we involve the women in the community in the Xawala board of directors? I think Somali women will have a lot to contribute' (workshop participants). There was certainly a strong sense that women present an untapped potential in the search for solutions to problems facing the 'Xawala' businesses.

Preference

When discussing possible solutions, there was overwhelming support again for the 'Xawala' companies and their role in any future developments: 'The solution is there; we just need to implement and enforce the regulation and compliance; therefore we should stick to Xawaalabs but improve their system and make sure they meet the regulator's conditions' (workshop participant). Increasing the professionalism of the companies featured heavily, and where possible, the participants concurred that there would be widespread willingness to help the companies improve compliance (e.g. by providing ID for every transaction, or re-registering with companies to ensure that their full details – name and date of birth – were captured accurately). On the question of ID, there was an important qualification about the use of biometric data – behind this was a sense of perceived discrimination and a strong suspicion of what might be motivating the authorities.

The Somali diaspora has been accustomed to having many different options available for sending money home. When a well-accepted and trusted model with unique cultural ties and associated 'affinity branding' is threatened with sudden market extinction, the risk of customers knowingly or unknowingly selecting or using an alternative provider operating extra-legally is increased. Trust of new models may decrease within marginalised sender segments. The goal with any intervention approach should be to promote and incentivise transparent activity during any transitional period.

110 Another workshop participant summed it up this way: 'The trust element in the *xawala* is one of the few best characteristics of the Somali people so please let's not disrupt that'.

Mobile money

The diaspora survey revealed an extremely low level of exposure to mobile money among British-Somalis despite the widespread use in parts of Somalia. This was confirmed during the community consultations. In the workshops, experts from the telecommunications sector explained the Somali-led customisation of mobile money for domestic local market acceptance and the remarkable growth phenomena of Telesom's ZAAD Services in Somaliland. The groups were asked for their views on why so many people have adopted this technology so quickly in Somalia, and what they thought it would take for an online or cashless system to be adopted by the UK diaspora.

One of the factors leading to greater adoption of ZAAD mobile money in Somaliland was their commitment to salary and merchant payments in an attempt to minimise one of the major operational challenges that many other contemporary mobile money service providers typically face with supporting cash-in and cash-out transactions. Paying for goods and services through merchant and vendor acceptance program, including the electric utility and a major university, is a key differentiator and success factor for Telesom compared to their peers operating mobile money services in other markets. The ZAAD mobile money services in Somaliland are offered free of charge to Telesom's mobile subscriber customers.¹¹¹

People were most concerned about data protection, the safeguarding of funds, and ability of those in Somalia to receive the money in this format. In the UK, they perceive a move to transferring to mobile transfers as creating too much of an electronic footprint that could be exploited by authorities, and also criminals wishing to steal the money. Despite the large-scale loss of deposits from three collapsed companies (Al-Barakaat, Dalsan, and Qaran) and the 'Soma-leaks' scandal where a snapshot of one company's entire customer database was posted online, a large proportion of those consulted in the UK perceive 'Xawala' companies to be much safer and more trustworthy than more 'modern' alternatives.

Many of the concerns were ill-founded from a technical perspective, and it may simply be a matter of time until they begin to use it (which was the case 10 years ago before text messaging revolutionised the information flow in Somali remittances). One major concern, however, had a sound technical basis – as several workshop participants explained, short term credit is currently extended to regular or known 'Xawala' customers: 'Mobile money is definitely easier and quicker but you cannot send money immediately to Somalia in the case of a family emergency like you can with the xawalas if you don't have enough money. The xawalas trust us and we trust them so they are willing to loan us money when we need it. Mobile money cannot do this.' Therefore a phone call (live voice communication) from a regular customer to 'Xawala' agent is sufficient in many cases to complete a remittance, without face-to-face customer due diligence: 'I doubt that mobile phone would be beneficial to us because mobiles will not give us a loan,' said one workshop participant.

Diaspora acceptance of an online or mobile money transfer service which neither involves cash, nor the credit facility currently provided by the 'Xawala' companies, appears to be low and will therefore be a limiting factor towards full adoption in the short term.

111 Pénicaud, Claire & Fionán McGrath (2010) 'Innovative Inclusion: How Telesom ZAAD Brought Mobile Money to Somaliland,' GSMA Mobile Money for the Unbanked

Sending practices

People have speculated about changes in sending practices if the Somali MTOs were forced to close in the UK and elsewhere – one view is that ‘a great many people would simply stop sending money altogether. That is a certainty. For some, it has to be said, remittances are an unpopular obligation. They can be quite a burden. Any excuse to stop sending money would be seized upon by these people.’¹¹² During the research there were certainly several mentions of the current situation presenting an opportunity to shift from a state of dependency and to focus on the long-term change that would help develop the banking system inside Somalia and the region. But overall, while this study confirmed the often substantial sacrifices made by those who send money home to meet the needs and expectations of those within Somalia,¹¹³ it revealed no evidence to support the view that people would stop sending remittances.

3.2 LAST MILE

Technical view

Economic growth and financial sector development

In countries such as Somalia, the traditional money transfer operators provide the only functioning financial services in the country. Therefore to criminalise them or to make it impossible to interact with the international financial system would lead to even greater financial exclusion. The reality is that these businesses will continue to operate, whether banked or unbanked; their potential role in the rebuilding of Somalia, however, remains unexploited if they are ignored for their apparent informality and lax compliance. As the impressive rural pay-out ratio demonstrates, Somali money transfer networks create a vital connection for isolated communities in the absence of a formal banking system, and should be viewed as integral to supporting the economic growth and financial sector development that international donors, including the UK, are committed to supporting.

International aid

All of the aid agencies that completed the survey (see Annex 3) use Somali MTOs with UK branches to operate in Somalia.¹¹⁴ Of these aid agencies, the majority use Somali money transfer companies as deposit-taking institutions (definition). Six aid agencies are, in combination, depositing up to USD2.4 million in money transfer companies at any one time. Indeed, one agency alone has USD0.8-1 million in an MTO at any one time. Therefore, donor money being managed by aid agencies would be at risk should the withdrawal of banking services precipitate the collapse of any of these MTOs.

Mobile money

At the time of writing, the two providers of mobile value transfer services in South-Central Somalia have limited their offering to ‘Restricted E-Vouchers’ in Mogadishu (transactions limited at USD100). These basic electronic value distribution services have been utilised by NGOs operating in southern areas, albeit in a limited way. They do not currently have the capability to facilitate international mobile transfers, and they have

112 Paice, Edward (2013) ‘Somalia, remittances and unintended consequences: in conversation with Abdirashid Duale’ (29 July)

113 Dr Anna Lindley reports from her research among British-Somalis living in London that ‘relatives in Africa think that people *dibadaha* – ‘outside’, or in the west – are rich, seeing incoming remittances (often substantial amounts by local standards) as proof.’ Lindley, Anna (2007) ‘The early morning phonecall: Remittances from a refugee diaspora perspective,’ *Centre on Migration, Policy and Society Working Paper 47* (University of Oxford), p.17

114 This is with the exception of the European Commission (ECHO), which does not directly use Somali money transfer companies, however it funds a number of NGOs and UN agencies that do use the companies to deliver cash to beneficiaries, and also to transfer money to staff and suppliers.

decided not to launch a more comprehensive mobile money service offering at this time due to a previous ban by al-Shabaab.

Serious prudential risk issues due to the lack of internal and external controls need to be addressed before full mobile money services are launched in South-Central Somalia. For example, a mobile wallet service in that part of the country currently advertises one of the customer benefits as being able to save money *safely* in their account, and yet discussions revealed that prudential oversight of the customers' deposited funds in the network remains weak at the present time.

The prudential risk increases with conversions of local fiat currency to US dollar-denominated electronic value without internal and external foreign exchange controls in place. Mobile money industry best practices require external deposits to a trust account to maintain a 1:1 balance, corresponding to the aggregate value of all the customer accounts. This should ideally be performed on a daily basis and is in addition to any capital reserve amounts that may be appropriate to address risk of network failure or service provider collapse.

Market view

Confidence in MTOs

In recent years misinformation and rumour have led to 'runs on the bank' and the subsequent collapse of the associated money transfer companies. In the present situation, there is a risk that the publicising of the removal of banking services and the closure of accounts could lead to a loss of confidence in the MTO brands affected. In many cases, these MTO brands act as deposit-taking entities – a run on these entities would be as catastrophic as any classic 'bank run' as they will be unable to meet all the withdrawal demands made of them with the consequential humanitarian fallout. Some anecdotes collected from the 'better off' segments¹¹⁵ of the population within Somalia indicate a high level of nervousness about the potential impact on their savings. The community consultations in London, however, indicate no such loss of confidence – rather a further lack of trust in 'Western' systems.

Mobile money

If it was explained that the adoption of mobile money could assist the existing 'Xawala' companies to remain banked. There is a distinct possibility that the family and friends who use mobile money to send and receive funds domestically will be able to influence those who remit funds to them internationally to migrate to an online or mobile system. This could be the opportunity on the other side of the risk-averse trends affecting the banking system in the UK.

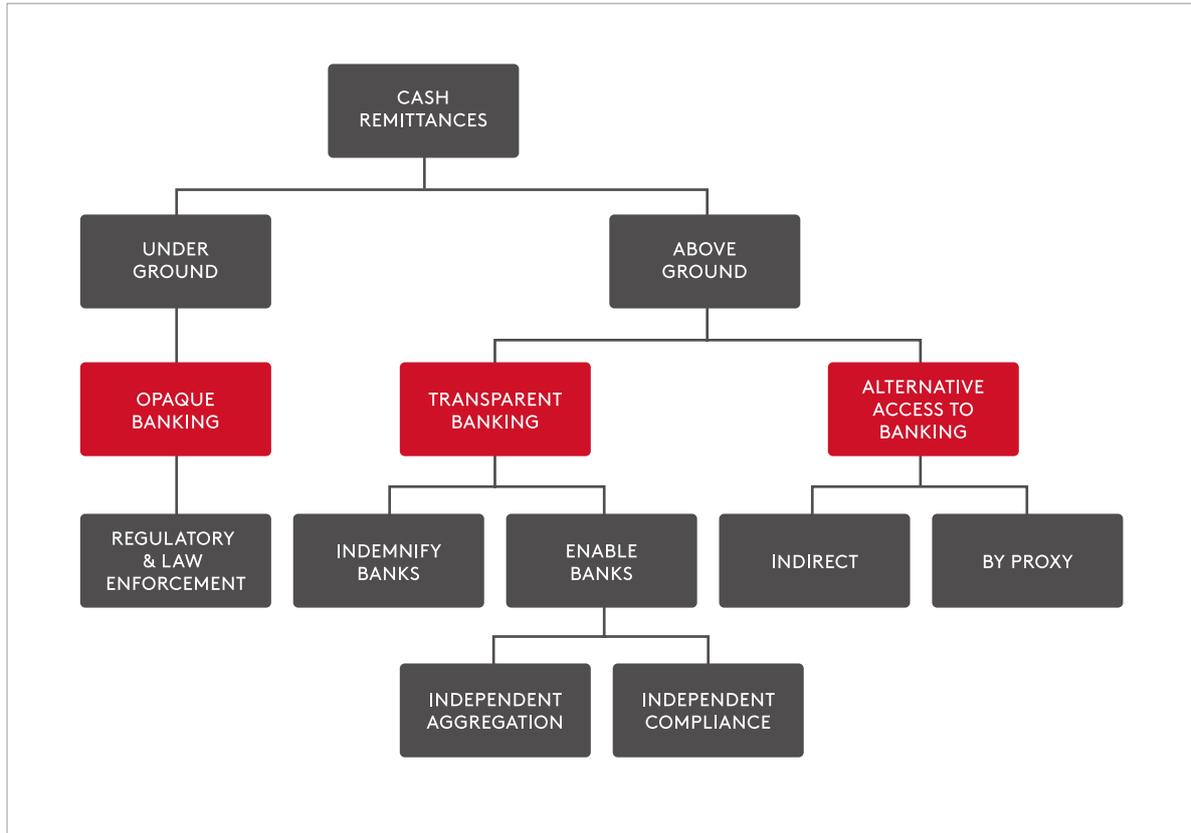
Radicalisation

If aid transfers are unable to reach Somalia, al-Shabaab would be able to mobilise its propaganda machine to portray the consequent cessation of operations as a victory for their 'ban' on international relief agencies (see Annex 2). Indeed the longer term impact of INGOs scaling down their operations, or withdrawing completely, could be the recruitment of vulnerable Somalis to al-Shabaab, given the correlation between poverty, instability and radicalisation.

115 FSNAU describes the different wealth groups as 'Poor,' 'Middle' and 'Better-off' in their assessment of food security.

3.3 ASSESSMENT

As the market restructures and risk aversion among banks makes the securing of banking facilities more unlikely in the short-term, there seem to be two distinct pathways ahead for the affected Somali MTOs: to continue either through alternative access to banking that is still ‘above ground’, or ‘underground’ channels that lead to ‘opaque’ banking.



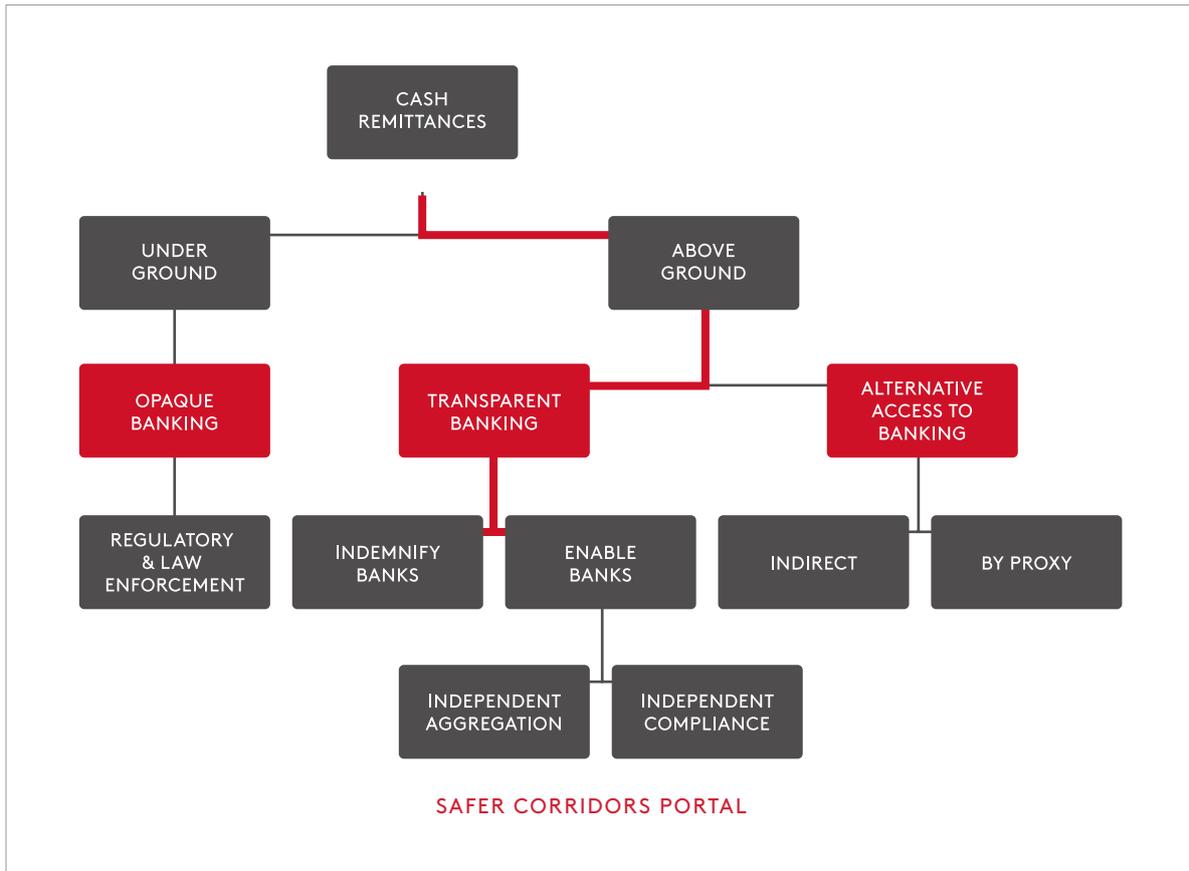
Some SPLs already have alternative banking arrangements that are ‘indirect’ or ‘by proxy’ (explained above), as do the APIs. This is most likely to continue in the immediate term; however it is unclear how sustainable the arrangements are due to expected future pressure on wholesale MSBs and the resultant ‘chilling effect’ the current situation will have on their willingness to continue to provide this aggregation service. The worst case scenario is for companies to feel forced into more ‘opaque’ banking arrangements, where the only response can be regulatory and law enforcement.

As for collapse, this is only a significant risk if public confidence is lost in the main players. Therefore, it is absolutely critical to treat this area sensitively.

The timeframe is important in any of these scenarios – for an MTO to meet some of the preferred requirements of the banks (e.g. cashless, capitalised), they need strong marketing plans to migrate people to a new system, which the community consultations indicate will still take time. This could be compressed, however, with strong leadership from companies and innovative approaches, such as more deliberately engaging women.

4. CONCLUSIONS

Without a clear, broadly accepted solution, it is inevitable that evidence-based reporting on risk will continue to make the banks risk averse, leaving some corridors under-served, unbanked and with remittance flows driven underground. The ideal situation, as indicated in the graphic below, is that 'transparent banking' continues; however the clear message delivered by the banks during this study is that on-going provision of banking services will need to be supported by a certain level of 'indemnity' or 'enablement' through a tighter compliance model.



The only way forward is for the decision-makers of existing parties to collaborate, admit the severity of the problem, and constructively set about seeking mutually workable solutions. This will be immensely difficult, and the outcome will depend on the will of leaders from each side, and whether others with different perspectives and fresh insights are encouraged to contribute. As any form of indemnity is unlikely, the most creative but ambitious alternative will be the Safer Corridors Portal.

Meanwhile, there are immediate possibilities for improving the current systems, and scaling mobile money. Conclusions for each will be taken in turn, followed by three high-level recommendations.

4.1 SAFER CORRIDORS PILOT

The goal of a 'safer corridor' is to provide a secure route for funds that have been obtained legitimately and are for legitimate use, and preclude the flow of illegitimate funds across the three stages of Clearance, First and Last Miles. With the support of Government, regulators, supervisors, and international partners, the private sector could design a controlled UK-Somalia pilot to clarify what audit mechanisms are required to make this effective. HMT and FCA could play an advisory role on any legislative or regulatory queries, while DfID could play a key role, in cooperation with partners, in capacity building at the Last Mile in Somalia (see below). In its role within the Strategic Alliance Group of Law Enforcement, NCA can involve other partners in the pilot, especially Australia where the banks are reviewing their arrangements with money transfer operators, and the US.

The pilot should feature a component on mobile money using the MMT platform or hub outlined in this report. Such a hub is designed to be interoperable with mobile network operator infrastructures and utilises telecom best practices for clearing and settlement between the wholesale and retail carriers. Individual transactions are auditable at the hub, giving the process entire transparency.

At the Last Mile, integration and implementation challenges are still present with lack of national ID systems and proper CDD processes. DfID is well-positioned to build on current efforts of the FGS and other donors that will help improve on these processes, and create enduring financial sector regulation and infrastructure. Identified options include:

- An interim regulatory and enforcement vehicle to strengthen AML/CTF safeguards in Somalia
- Digital technologies to develop formal identification and audit systems
- Support for a multi-donor programme to build the capacity of the CBS to regulate cross-border remittances
- Scaled branchless banking solutions to accelerate mobile payment systems.

Underpinning the technical approach is the need for improved interaction between financial service providers in high risk corridors and those administering the AML/CTF regime – communication via generic letter is not helpful and gives the impression that banks or regulators simply 'don't care'. A different kind of dialogue will increase the mutual understanding of the operational realities that the former face, along with the proposed benefits of participating in a regulated system, so that more appropriate and effective regulatory regimes can be developed. Past research and findings from this study indicate that dialogue is often overly formal, confrontational, and characterised by inflexibility and an unwillingness or inability to consider alternative points of view.¹¹⁶

A more open dialogue must therefore occur between these communities so that the companies attempting to improve their standards have the opportunity to share their concerns, and understand the perspective of regulators and banks. The dialogue should be oriented towards finding solutions, rather than restating the problem.

116 A Somali CEO interviewed in Minnesota commented that the talks between US Treasury and the MTOs about the banking issue 'seemed to be one-way conversations – neither listening to the other'. Interview, 20 June 2013. Thompson uses Mlada Bukovansky's 'politics of mutual incomprehension' to explain the parallel lack of progress made towards reconciling the different interests of local markets and international institutions in Afghanistan. *Trust is the Coin of the Realm*, p.279

There has been much investment to date in creating an open environment for Somali MTOs to engage with the international system;¹¹⁷ it is therefore critical to learn from those experiences, in particular the importance of ensuring the right groups are involved – such as banks and regulators – rather than being led by the development community.

Any dialogue involving the banks presupposes that there is an innate willingness within the UK banking sector to provide MTOs with accounts and financial services. It remains to be seen whether this is the case, as two major concerns will fundamentally impact their decision, namely commercial reality, perceived reputational hazards, and the position and guidance of the regulators in both the UK and the US. No amount of ‘public spirit’ will overcome the fear of being sanctioned by the FCA/US authorities and/or losing access to the US market.

Given the present lack of appetite of the private-sector banks to provide banking services to any but the largest MTOs, a more radical approach must be taken through collaboration of the main stakeholders so that, in the words of one person interviewed, ‘We [can] create a more flexible approach to risk tolerance for payments where there is a wider public good.’ For the immediate term, this may include consideration of alternatives that exclude the involvement of private-sector banks. However, it will be important to hold in tension the short and longer term goals in view of the huge market potential for financial services represented by the world’s 2.7 billion ‘unbanked’ people.

The dialogue between regulators from both sending and receiving countries, banks, international aid agencies and local NGOs on issues at the Last Mile must also be improved in order to enhance mutual awareness of constraints and possibilities: we could learn from the Danish model used after the Ministry of Foreign Affairs considered the cessation of its aid in September 2009, but instead through collaboration developed a set of operational principles that would mitigate the potential mixing of aid with funds obtained illegitimately.¹¹⁸

In summary, therefore, there are three key ‘enablers’ for effective engagement in such an initiative: a different kind of dialogue, leadership from the Government, and a long-term horizon that takes into account the poorest in our society.

4.2 IMPROVING THE CURRENT SYSTEMS

In relation to improving the systems used by Somali MTOs in the UK, members of SOMSA have committed to introduce ‘above standard’ CDD, including ‘implementation of zero threshold policy’ where ID will be requested for all transactions regardless of size, and review all agents in the UK by 31 December 2013. They have also pledged to ‘coordinate third party auditing’ and training.¹¹⁹ The Somali MTO community is small, with less than 300 agents operating in the UK, and a very active diaspora willing to support it. Therefore targets for these very welcome improvements to CDD could be more

117 For example, between 2002-2007 the UNDP organised a similar initiative which aimed to strengthen the Somali remittance sector by increasing its compliance with international financial regulations, and to lay the groundwork for the entry of a formal commercial banking sector within Somalia; little progress, however, was achieved. The lead author of this report conducted the Independent Evaluation of the UNDP Somalia Financial Sector Development Project (September 2007). As can be seen from the findings of a conference held during the programme, many of the same issues that are being raised now were highlighted as priorities for improving regulation at the time - <http://mirror.undp.org/somalia/Remittance/Final%20Conference%20Report.pdf>

118 Mackintosh & Duplat, ‘Study of the Impact of Donor Counter-Terrorism Measures on Principled Humanitarian Action,’ p.83

119 SOMSA, 10 September 2013, pp.3-4. The need to improve compliance has long been discussed by the Somali MTO community in previous associations. Action is the true test of commitment, and a small number of the companies have taken compliance seriously over the years which has disadvantaged them in relation to those who opt to avoid necessary changes.

ambitious, and the programme should be monitored and documented carefully to encourage transparency between members.

Again, rapid lessons must be captured from previous attempts to assist in the self-regulation of the Somali remittance sector. All of the associations that the companies have formed to date are a genuine achievement due to the intricacies around clan, geography, and competition between many of the industry leaders; however, there are some serious challenges yet to overcome. SOMSA members must strike the right balance between competition and cooperation in order to be effective.¹²⁰

The assessment highlights one common mistake in the current dialogue, which is to view the remittance process through the lens of a UK-based entity, rather than from the perspective of the principals who tend to operate out of third party countries - including the UAE. The CH-based model by which remittances are transferred into high-risk and fragile jurisdictions such as Somalia will continue to be pivotal in remittance flows. Therefore important steps should be considered to increase their transparency and enhanced due diligence.

From the perspective of the banks, the study has confirmed the concerns of others who have dedicated more time to the issue that there is an unintended 'ethnic penalty' incurred by people whose names are either similar or the same as those on designated terrorist lists,¹²¹ or whose payment is directed to a high-risk destination.¹²² These consumers are often delayed or even denied the ability to transact on this basis through the formal banking system. Reports from wholesale MSBs and those involved in the business of Compliance Assurance (see section 1.3) indicate that banks have low tolerance for individually correcting these 'false positives', even when they are able to provide evidence to demonstrate that the customer is not the individual who appears on the sanctions lists.

MTOs that feel their customers have been 'unreasonably excluded' by the banks have the option of seeking redress from the bank directly, and once those avenues are exhausted, they are able to appeal through the Financial Ombudsman Service. The companies interviewed for this study, however, refrained from taking action for fear of jeopardising their own banking. The FCA advises that if this is happening at a particular bank multiple times, it might be indicative that their systems and controls are not functioning effectively. As a follow-on to this rapid assessment, further evidence should be gathered to evaluate whether there is a trend requiring attention from the regulator.

4.3 SCALING MOBILE MONEY

Despite the weak infrastructure in post-conflict states like Somalia, it is important to plan now for the long term, and identify short-term wins that can be used in the transition to the establishment of a banking system and infrastructure that allow straight-line, direct bank-to-bank payments to be made.¹²³ New technology such as

120 This was the observation of one of the members of SAMSAs during an official meeting in Minnesota earlier this year attended by one of the authors.

121 The US Treasury Office of Foreign Assets Control (OFAC) lists suspected terrorists, drug traffickers, and other 'specially designated nationals', and runs over 250 pages long and includes more than 6,000 names. See Sinnar, Shirin (2007) 'The OFAC List: How a Treasury Department Terrorist Watchlist Ensnarers Everyday Consumers,' Lawyers' Committee for Civil Rights (March).

122 For example, a third party auditing company referred to two payments that were blocked by the bank the day before the interview - one on behalf of a British-Afghan sending money to family in Afghanistan, and another on behalf of a holidaymaker attempting to pay a travel agent with 'Myanmar' in the company's name, despite being based in Thailand.

123 Note: bank-to-bank payments are possible in some regions of the Horn of Africa, facilitated by banks in Djibouti with rep offices in Somaliland (Hargeisa). Note also that a number of UK-based MTOs have applied for banking licences in Somalia but the lack of *inter alia* a regulatory framework and laws to cover deposit taking and lending means that these applications have not advanced.

mobile money can be used to dis-intermediate traditional CHs, therefore plans to scale its use should be explored as a matter of priority to begin the diffusion process.

A 'safer corridors' project must take into account the most insecure areas of the receive country, which, in the case of Somalia, hold the highest concentration of remittances and aid. Earlier this year, an information technology specialist predicted that 'Somalia will recover and develop regardless of such problems as violence, infighting and damage resulting from terrorism, which has destroyed the country's infrastructure ... The expansion of 3G service by Hormuud [Telecom in South-Central], which now has a customer base of 5 million users, shows Somalia's ability to quickly adapt and adopt new technologies'.¹²⁴ This positive outlook should encourage innovation in the southern part of the country, which has received less attention from the perspective of economic development due to the prolonged conflict.

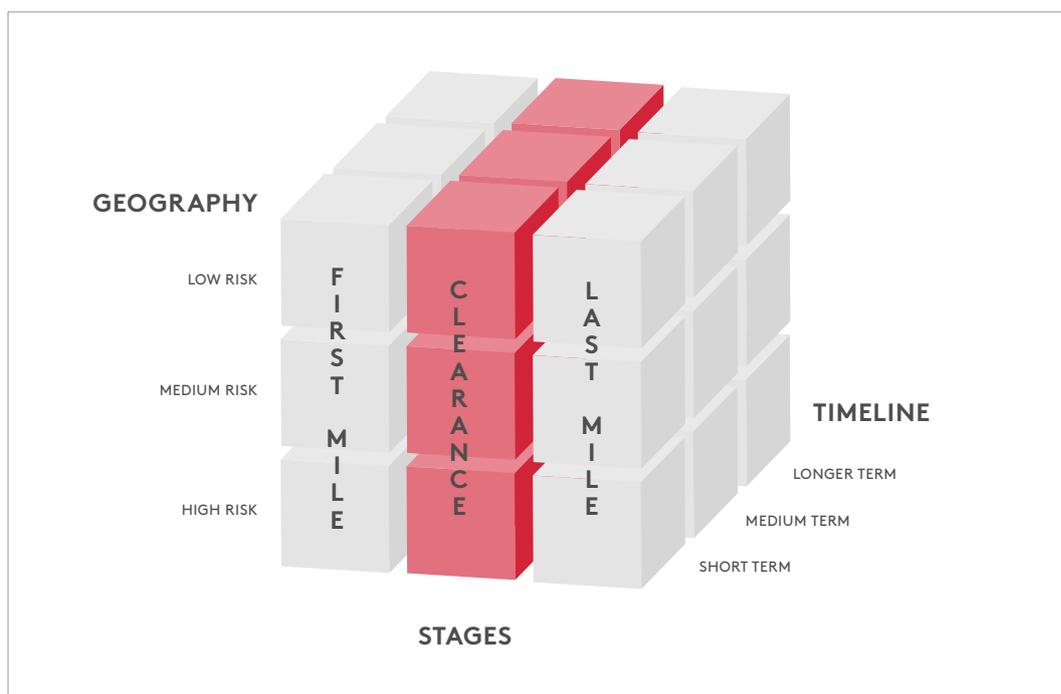
4.4 HIGH-LEVEL RECOMMENDATIONS

There are three high-level recommendations for HMG that call for leadership, proactivity, and long-term thinking.

- 1 **An Action Group on Cross-Border Remittances (or Money Flows – to incorporate trade and aid flows), a tripartite body representing the private sector, regulators, and Government, should be stood up immediately to facilitate the necessary co-operative and action-oriented dialogue that will find solutions to the present dilemma.**
 - Rapid lessons must be captured from previous attempts to engage and assist in the self-regulation of the Somali remittance sector.
 - Immediate steps should be taken to help identify and scale what is working well in the UK-Somalia corridor.
 - The Action Group should be limited to a 12-month timeframe, which incorporates a deeper assessment of the PRI model and a 6-month pilot of the Safer Corridors Portal for remittances to Somalia, and be able to demonstrate results against a clear and agreed milestone map.
 - The Action Group should be led by a strong independent chair who is responsible for initiating dialogue and strategic partnerships with the US Government, EU, and relevant G20 Finance Ministers. Strong coordination should take place with the Strategic Alliance Group of Law Enforcement.
 - The UKMTA and aid agencies should have observer status.
- 2 **Alternatives to the current situation are considered for affected corridors such as Afghanistan, Pakistan and Somalia in the event that private-sector banks do not change their position and continue either to terminate banking services for MTOs or to pressure wholesale MSBs that are providing alternative access to banking.**
- 3 **Assistance is provided to the FGS and private sector in developing direct, straight-line payment mechanisms for remittances via banking systems or advancements in mobile money, recognising that this is a long-term challenge.**

¹²⁴ Interview with Farhan Ahmed Abdullahi in Hussein, Adnan (2013) 'Mobile customers gain access to 3G technology in Mogadishu,' *Sahabi Online* (7 January)

5. A MODEL FOR FUTURE ACTION PLANNING



When plotting a road map ahead for this multifaceted challenge, it can be deconstructed across three dimensions: the stage of the remittance flow being addressed, the level of risk associated with the local geographic areas directly involved, and whether the intended action or decision is primarily impacting the short, medium or long term.

This graphic provides a simple check to ensure that there are no critical gaps and that the actions are aligned. It is equally applicable to crisis-affected, restricted and post-conflict countries, and if used as a template will over time build a readily accessible repository of useful information that will inform subsequent endeavours in similar situations elsewhere.

Each decision or action could also be categorised in relation to the sector most affected (regulator, banks, MTOs, diaspora, Government, etc) and the 'degree of intervention' required; for example:

- 1 **None** — leave private sector to adapt
- 2 **Low** — accelerate what works e.g. MM
- 3 **Somewhat** — increase compliance e.g. list, audit
- 4 **High** — assume leadership e.g. PPP concept

In the case of Somalia, the geography can be divided into Somaliland (Low Risk); Puntland (Medium Risk); and South-Central Somalia (High Risk).¹²⁵ This 'safer corridors' model could be used to illustrate how the various stakeholders can play their part in working towards a resolution to this dilemma. Only when a dialogue becomes grounded does it begin to reap the tangible benefits that all parties are seeking at the present time.

¹²⁵ The specificities of each of these regions are laid out in DfID Somalia's *Country Operational Plan 2011-2015* (updated June 2012), p.16

ANNEX 1: PUBLIC-PRIVATE PARTNERSHIP?

DEFINITION

There is no broad international consensus on what constitutes a public-private partnership (PPP). Broadly, PPP refers to arrangements, typically medium to long term, between the public and private sectors whereby some of the services that fall under the responsibilities of the public sector are provided by the private sector, with clear agreement on shared objectives for delivery of public infrastructure and/or public services.

PPPs can take a wide range of forms varying in the degree of involvement of the private entity in traditionally public infrastructure.

PPPs combine the skills and resources of both the public and private sectors in new ways through sharing of risks and responsibilities.

An increasing number of countries are enshrining a definition of public-private partnerships in their laws, each tailoring the definition to their institutional and legal particularities.

Source: World Bank 2013ⁱ

The aim of a PPP is to deliver improved services and better value for money primarily through appropriate risk transfer, encouraging innovation, greater asset utilisation and an integrated whole-of-life management, underpinned by private financing.

Source: Australian Government 2008ⁱⁱ

The differences in this initiative include that (a) the PPP model is applied to an area outside infrastructure; (b) the risk transfer is from the private sector to the public sector; (c) the private sector will not serve the 'high-risk' corridors unless there is an arrangement whereby the public sector 'endorses' the initiative in such a partnership model.

We recommend that ongoing work in defining the Safer Corridor model should take into account the lessons captured in a recent CAFOD Discussion Paper on asking the right questions regarding PPPs which have a development outcome.ⁱⁱⁱ The following includes relevant extracts from this paper.

Development-oriented PPPs

While PPPs are one potentially beneficial tool for channelling UK aid to deliver sustainable solutions for the poorest and most marginalised in developing and transition countries, equally there are many challenges to these initiatives realising positive development impacts.

Moreover, research has shown that 'the majority of finance in existing PPPs goes to well-performing sectors such as telecoms, where commercial returns are likely to be high'.^{iv} Other research analysing the destination of the development finance channelled to the private sector by the European Investment Bank and the private sector arm of the World Bank found that big business, wealthier countries and tax havens benefitted most, with:

- just 25% of recipient companies domiciled in low-income countries
- 50% of funds channelled to companies based in OECD countries and tax havens
- 40% of recipient companies being 'big companies listed in some of the world's largest stock exchanges'.^v

There are inherent tensions between the pressures on a private sector actor to make a profit from a PPP contract and the use of aid to deliver for the poorest and most marginalised in markets and/or geographical zones where the private sector have chosen not to invest. This is a particularly pertinent issue given DfID's increased profile in fragile states and the urgency of needing effective incentives for the private sector to invest in innovative solutions (e.g. low carbon) where commercial returns might take some years to materialise.

The specifics of how these issues are addressed within the terms and conditions of each PPP will be crucial to its success, which cannot be taken for granted.

Recommendations for a PPP contract

CAFOD^{vi} recommends the following:

- clearly defined, specific objectives that the PPP is designed to achieve
- disclosure of the full details of how the contract is structured to deliver these objectives, including who will bear which risks (i.e. risk allocation)
- robust indicators of success identified and agreed amongst all parties
- an inclusive design and implementation process
- robust and independent monitoring and evaluation processes
- an adequate redress mechanism in place, in case all does not happen as planned.

i World Bank (2013) <http://ppp.worldbank.org/public-private-partnership/overview/>

ii Australian Government (2008) *National PPP Guidelines: Policy Framework* (December)

iii Commentary provided in Wallace, Beck (2013) 'Public-Private Partnerships (PPPs) in International Development: Are We Asking the Right Questions?' CAFOD Discussion Paper (April).

iv Byiers, Bruce & Anna Rosengren (2012) 'Common or Conflicting Interests? Reflections on the Private Sector (for) Development Agenda,' European Centre for Development Policy Management (ECDPM) Discussion Paper No. 131, p.7

v Kwakkenbos, Jeroen (2012) 'Private profit for public good? Can investing in private companies deliver for the poor?' Eurodad http://eurodad.org/wp-content/uploads/2012/05/Private_profit_report_eng-VF5.pdf, p.5

vi Wallace, 'Public-Private Partnerships (PPPs) in International Development: Are We Asking the Right Questions?' p.18

ANNEX 2: SECURITY SITUATION IN SOMALIA

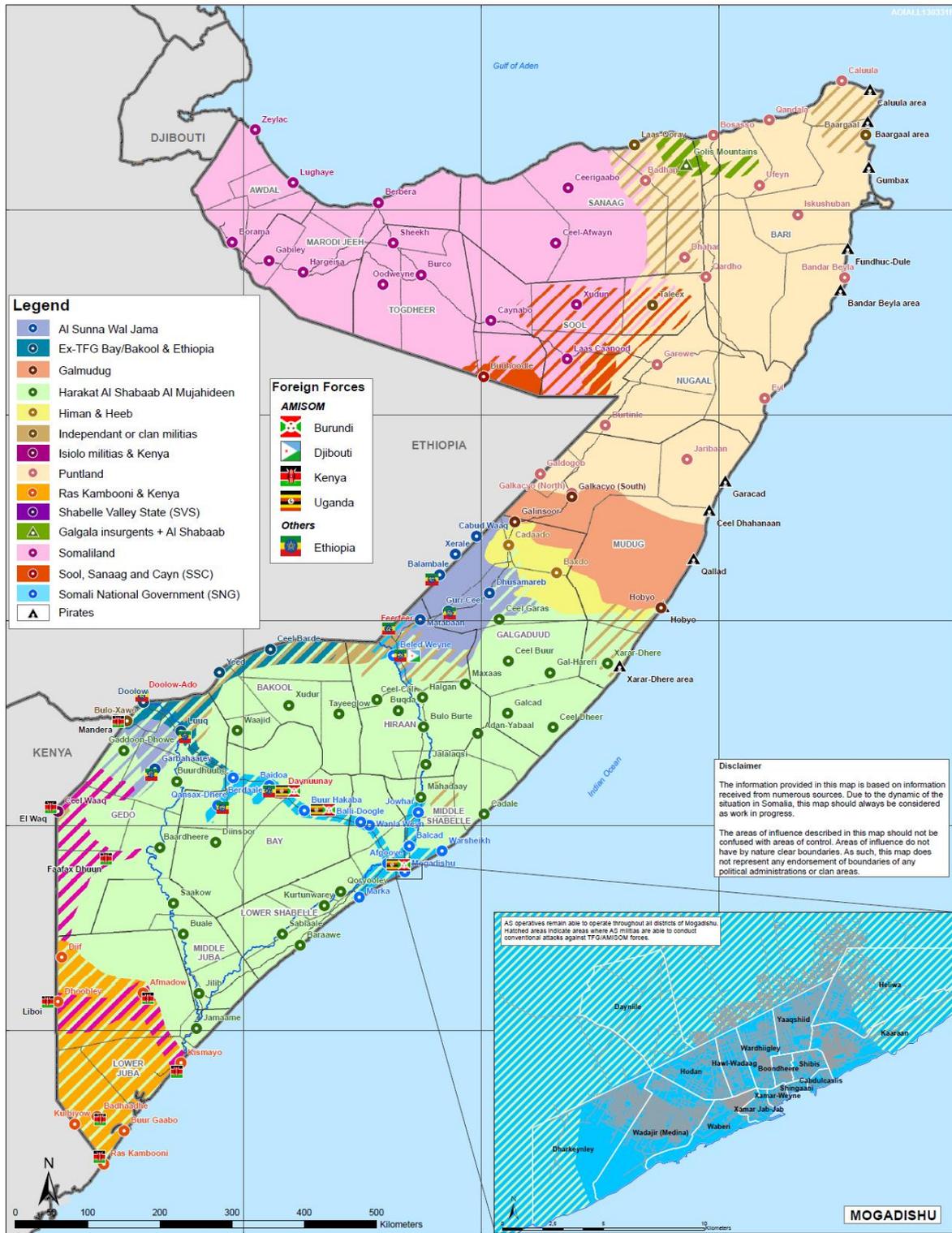
According to the most recent UN Security Council Monitoring Group report, the Somali Islamist militia group al-Shabaab 'remains the principal threat to peace and security in Somalia'.ⁱ The listed terrorist organisation reached its greatest territorial extent in January 2011, but has since suffered losses particularly in major urban centres, such as the Kismayo port which it controlled between 2006 and 2012.ⁱⁱ Since 2006, Ethiopian and Kenyan forces have combined with the Somali National Army and AMISOM to make inroads into al-Shabaab-controlled areas along the Somali-Kenyan-Ethiopian border and in the Lower Juba region. The withdrawal of al-Shabaab from Mogadishu in August 2011 has allowed progress to be made towards reconnecting Mogadishu, which had been isolated till now, with the key inland city Baidoa.

As can be seen in the above Areas of Influence Map produced in March 2013 (which has been confirmed by classified Government sources), al-Shabaab remains, however, in control of the Middle Juba, Lower Shabelle, Middle Shabelle (excluding Mogadishu), and Hiraa regions. They also continue to hold the majority of the Gedo and Galgaduud regions. Their shift in strategy from conventional warfare to guerrilla tactics has allowed them to preserve their strength and maintain an operationally-ready, 5000-strong military force.ⁱⁱⁱ Since 2007 this has diminished from 16,000 and Captain Robert Kamara (spokesperson for the United People's Democratic Front) commented; 'the situation now is different, and al-Shabaab cannot do the things they once did'.^{iv} Yet they are still causing civilian fatalities with the use of improvised explosive devices (IEDs), particularly in Mogadishu, and have allegedly strengthened their 'secret service', 'Amniyat'. The UN Monitoring Group reported they had 'clear indications that the Amniyat were responsible for most of the person- and vehicle-borne suicide attacks'.^v Their threat lies in their clandestine nature, their ability to gather intelligence and to conduct special operations, and their targeted attacks on the government and AMISOM.^{vi}

Their renewed attempts to destabilise Mogadishu and their increased targeting of foreign aid agencies and their employees have contributed to the withdrawal of Médecins sans Frontières (MSF) from Somalia.^{vii} MSF's departure demonstrates the degree of obstruction to international aid, and the extent to which al-Shabaab are still able to exert their influence despite the shrinking of their controlled areas and core fighting force.^{viii} MSF claim that 'acceptance of violence against health workers has permeated Somali society and this acceptance is now shared by many armed groups and many levels of civilian government, from clan elders to district commissioners to the Federal Somali Government'.^{ix} The withdrawal of MSF not only leaves needy people without access to medical care but could set a worrying precedent if other NGOs also feel the safety of their personnel is being irrevocably compromised.

Due to the expansion of al-Shabaab's ban on aid operations in the areas they control, restricting access to many people in need,^x many displaced people travel to seek aid in Mogadishu, where aid agencies are able to operate more easily. Mogadishu received 48 per cent of the total cash grants and vouchers in southern Somalia in 2011-12, of which 80 per cent was targeted at IDPs.^{xi} This is a major concern as IDP camps are controlled by 'gatekeepers' who have a monopoly over the delivery, distribution and management of aid. They are able to divert funds away from beneficiaries by collecting 'rent', 'taxes', (often using force or intimidation) and charging for 'protection' by the local militia which they control. Humanitarian assistance has reportedly proved a lucrative source of income for powerful landowners, particularly those from majority clans who can manipulate those from the minority clans.^{xii}

Areas of Influence Map (31 March 2013), National Safety Program



Al-Shabaab’s influence extends beyond the physical threat to a ‘soft’ influence evidenced by their media output; they have multiple channels through which to disseminate information and propaganda. Their Twitter account features multiple, daily updates, whilst their previous account enjoyed a substantial following of 21,000 before it was closed by Twitter on 25 January 2013.^{xiii} The Al-Kataib media foundation (or Al-Kataib news channel) represents the second major strand of

their international media campaign, producing audio recordings and video footages.^{xiv} Within Somalia itself, al-Shabaab has two radio stations, Al-Andalus and Alfurqaan, and six news websites: Amiimuur, Somaliminimo, Somalimemo, the Shahada News Agency and two corresponding with the radio stations.^{xv} Since al-Shabaab prohibits other news reporters from their own areas, these stations and websites have a monopoly over what information is available to large sections of the Somali populace. Moreover, they clearly maintain support in government-controlled areas too: in a poll conducted in Mogadishu in December 2012 by the African Union/Information Support Team (AU/IST), 56 per cent of respondents said they listen to radio Al-Andalus 'daily' or 'several times a week'.^{xvi}

The physical and soft threats posted by al-Shabaab's footprint in Somalia, coupled with the inaccessibility to much of the country due to security concerns, elevates the current significance and urgency of remittances, and the connection of a non-radicalised diaspora with Somalis at home.

ⁱ UN Security Council S/2013/413 (2012) 'Report of the Monitoring Group on Somalia and Eritrea pursuant to Security Council resolution 2060: Somalia,' p.11. Al-Shabaab's hostility towards international aid agencies has also been cited as 'the single greatest obstacle to the provision of humanitarian assistance' in Somalia. Zimmerman, K.L., 'Al-Shabaab and the Challenges of Providing Humanitarian Assistance in Somalia,' *American Enterprise Institute for Public Policy Research* (8 September 2011), p.1

ⁱⁱ Previous control of the southern port of Kismayo in Somalia allowed al-Shabaab to raise tax revenue estimated at \$1 million per month, which was paid not just by local traders but also NGOs, including the UN World Food Programme, seeking to supply their relief efforts. Wise, Rob (2011) 'Al-Shabaab', *Centre for Strategic and International Studies*, p.6

ⁱⁱⁱ UN Monitoring Group Report (2012), p.7

^{iv} Williams, S. (2013) 'Somalia: AMISOM seeks to 'mop up' latent Al Shabaab terror threat' (20 August)

^v UN Monitoring Group Report (2012), p.57

^{vi} *Ibid.*, pp.57-9

^{vii} Williams, 'Somalia: AMISOM seeks to 'mop up' latent Al Shabaab terror threat'

^{viii} Lloyd-George, W. (2013) 'Somali officials back terrorists against aid', *Inter Press Agency News Service* (16 August)

^{ix} President of MSF International, Dr. Unni Karunkara (2013) 'Why MSF Left Somalia' (20 August)

^x UN Monitoring Group Report (2012), p.9

^{xi} UNICEF (2013) 'Final Evaluation of the Unconditional Cash and Voucher Response to the 2011-12 Crisis in Southern and Central Somalia,' p.38

^{xii} The Somalia Cash Consortium (2013) 'Gatekeepers in Mogadishu' (31 January), p.32

^{xiii} BBC News (2013) 'Al-Shabab opens new Twitter account' (4 February)

^{xiv} UN Monitoring Group Report (2012), p.79

^{xv} *Ibid.*, p.82

^{xvi} *Ibid.*

ANNEX 3: AID SURVEY

HUMANITARIAN AND OPERATIONAL IMPACT OF RECENT DECISIONS AFFECTING SOMALI MONEY TRANSFER COMPANIES

Summary

Money flows: Aid and UK Remittance footprint

Reliance on Somali remittance companies

Alternative methods for money transfer

Looking ahead: Potential role for aid agencies

SUMMARY

An online survey designed to capture open-ended responses and some quantitative information was sent through various aid networks, such as the Cash Learning Partnership (CaLP), which has 800 members, and the United Nations Humanitarian Country Team in Somalia. It elicited 16 responses from international non-government organisations (INGOs), several local partners, and one humanitarian donor.

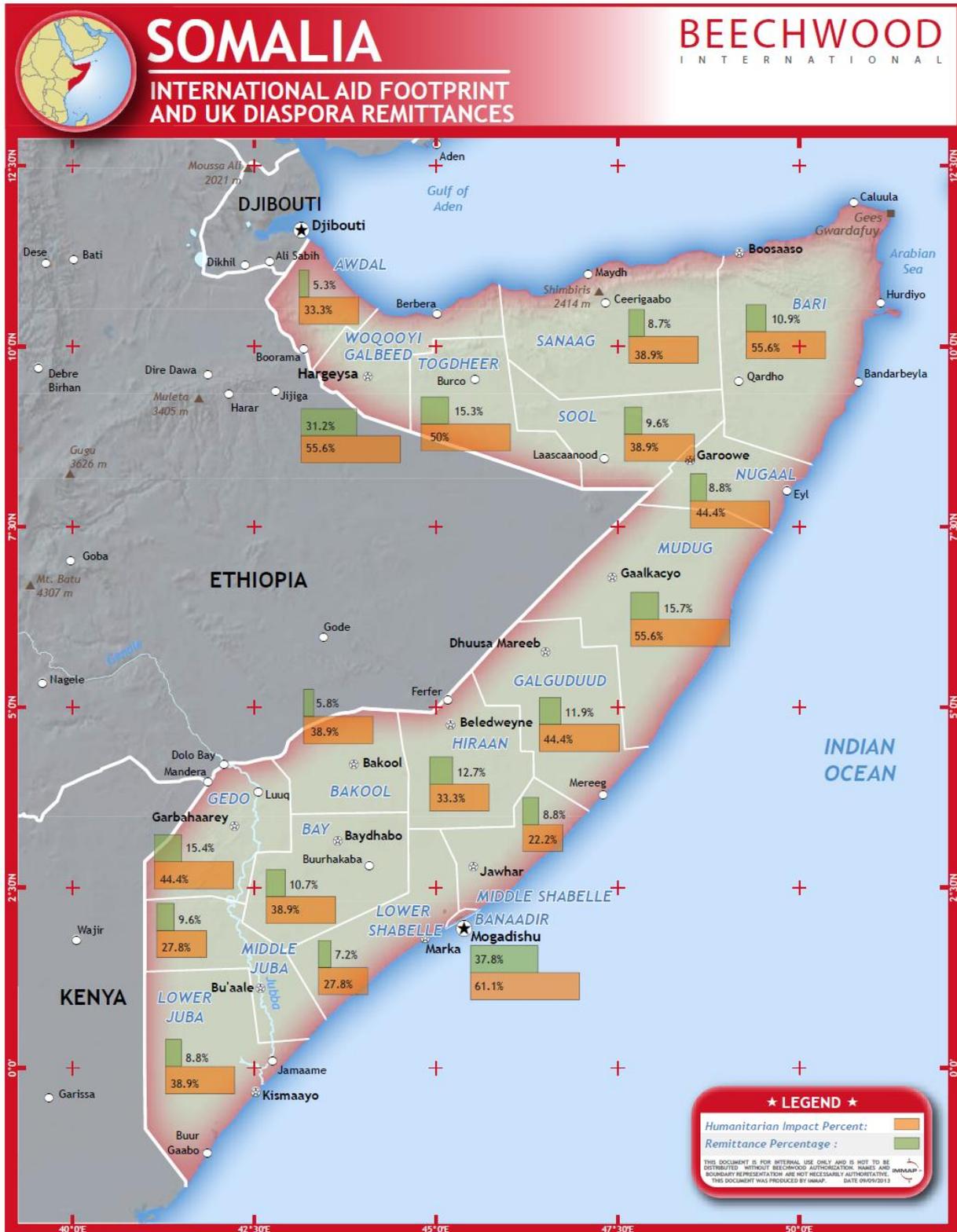
The majority of aid agencies use Somali money transfer companies to move money into and within the country, and also treat them as temporary deposit-taking institutions. This level of operational reliance has certain implications for those agencies if the companies were threatened.

One of the key findings when compared with the responses from the diaspora is the similarity of their footprint – aid agencies are concentrated in the same two primary destinations of remittances flowing into Somalia from the UK: Mogadishu/Banaadir and Hargeisa/Woqooyi Galbeed, the two largest urban centres in the country (see map overleaf). This is in line with UNICEF's 2013 report which found that almost half of the recipients of cash and voucher programmes are located in Mogadishu.ⁱ

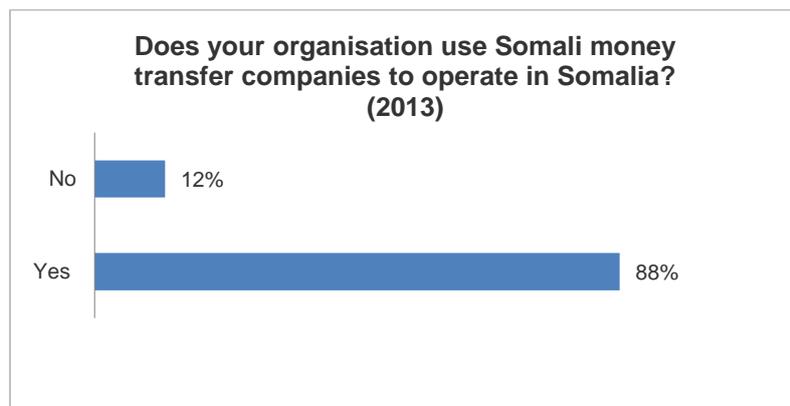
Al-Shabaab has attacked Mogadishu and surrounding areas more than any other region due to the large number of government and military targets situated there. In the period January-June 2012, 57 per cent of al-Shabaab attacks were in Banaadir, of which 78 per cent were in Mogadishu.ⁱⁱ

Therefore, the highest concentration of aid operations, remittance flows and al-Shabaab activity coexist in the same area. This has both positive and negative implications for planning interventions in the country that will help clarify the compliance concerns at the Last Mile.

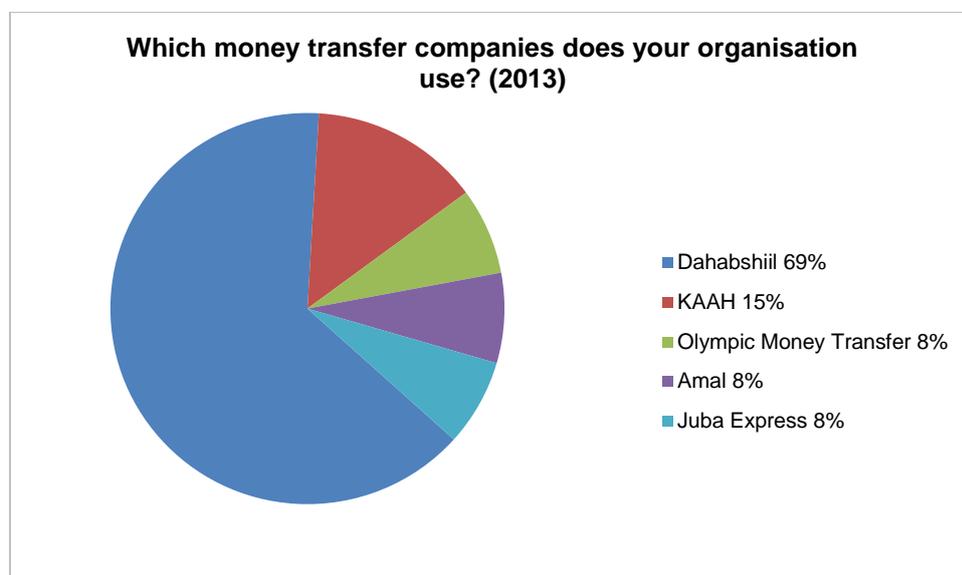
MONEY FLOWS: AID AND UK REMITTANCE FOOTPRINT



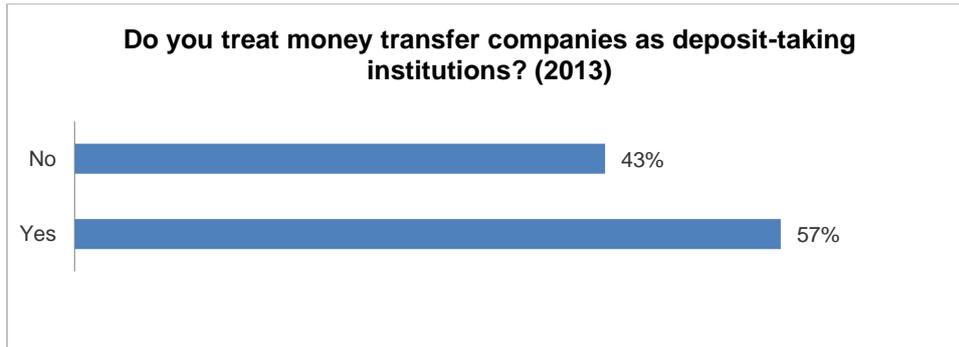
RELIANCE ON SOMALI REMITTANCE COMPANIES



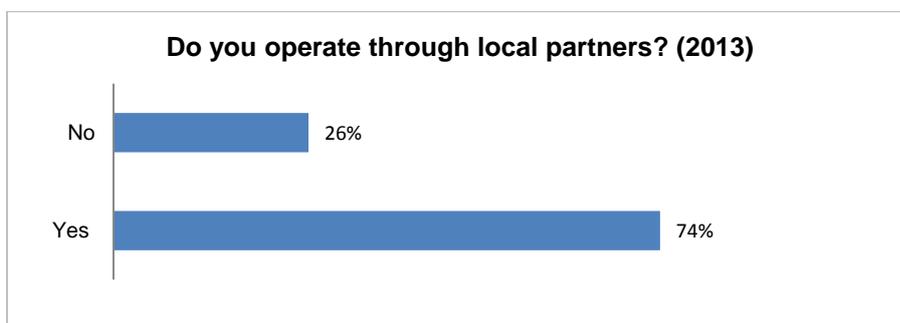
All international NGOs, bar one, who used MSBs transferred money using Dahabshiil. The following graph represents data only for INGOs.



The survey revealed that both international and local NGOs use Somali money transfer companies as deposit-taking institutions (NB: the UN did not respond to the survey; we suspect they are some of the most significant depositors). Six aid agencies are, in combination, depositing up to **USD2.4 million** in money transfer companies at any one time, whilst the average amount deposited is **USD333,000**. One INGO deposits between USD880,000-\$1 million in the account of a Somali money transfer company at any one time. Thus in the present times of uncertainty, the aid agencies appear extremely susceptible to significant losses of donor aid money.



It was important to ask the aid agencies whether they operate through local partners because the logistics of moving money is often left to people running field offices; in the case of Somalia, this is on the whole national staff.



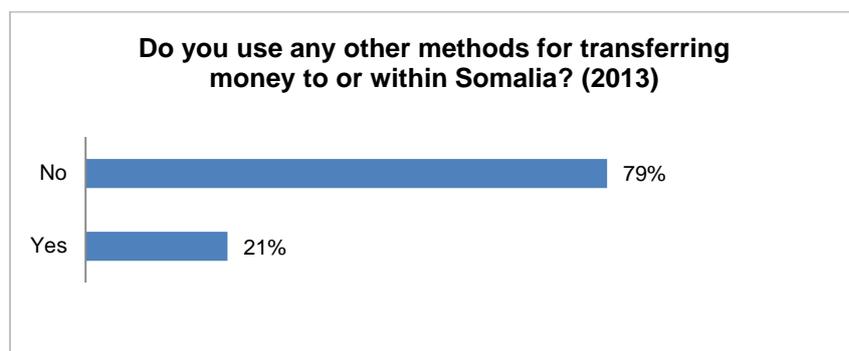
One quarter of the INGOs use Dahabshiil to transfer funds to local partners, using either cash, cheque or wire transfer. Meanwhile, another quarter use money transfer companies or banks based in neighbouring countries, such as Kenya and Djibouti, from which to transfer the funds into Somalia. In some cases, the money will go via banks in other European countries before it reaches Africa.

The major theme which emerged was that INGOs could not see any other viable way of getting money into Somalia or to pay for the operations of local partners; in other words, they are virtually entirely reliant on Somali money transfer companies.

One INGO commented that while they do not anticipate any major **short term** impact on their programmes as they currently send money via Nairobi to Somalia, they were extremely concerned about the impact on recipients of remittances:

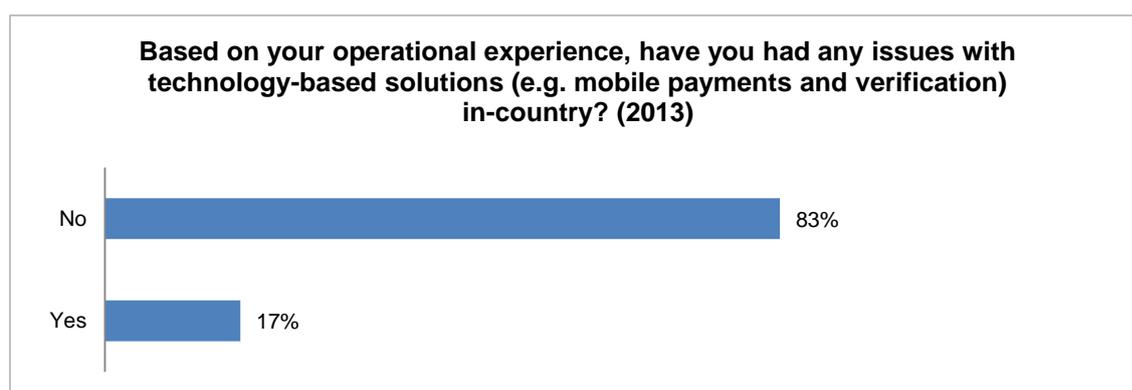
'The recent FSNAU study showed 40% of families in Somaliland and Puntland receive some form of remittance, and that they are integral to their survival. Our experience on the ground tells us that individuals, families and communities are dependent across the whole of Somalia on remittances from abroad. The UK is one of the main sources of this money and the closure will without doubt impact on recipients who rely on the money for basic costs such as food, water, education and healthcare, and to cope with new crises. In form of remittance, and that they are integral to their survival. In addition if the aim of the UK Government is to increase stability in Somalia, forcing remittances underground seems to run counter to this objective.'

ALTERNATIVE METHODS FOR MONEY TRANSFER



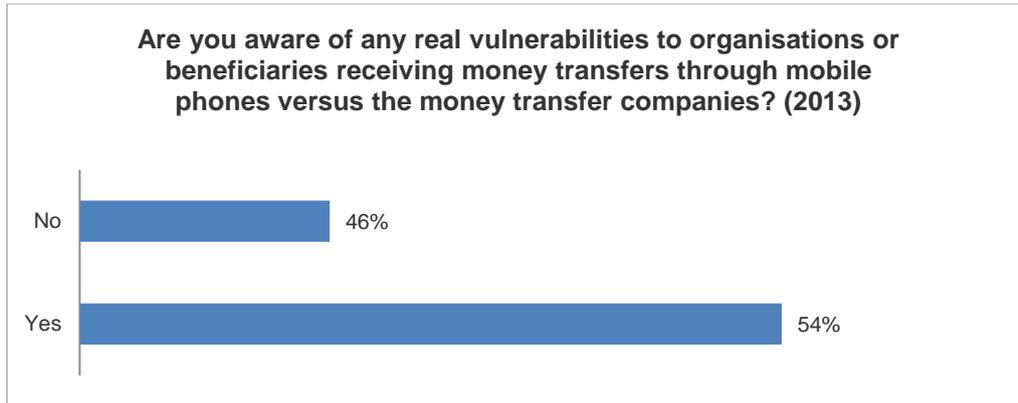
One INGO used a bank which carried out a successful pilot in Mogadishu whereby beneficiaries had to register for assistance with biometric data.

Two others have considered or are considering mobile money transfers; one has tried to implement a mobile money programme with private, local businesses but the pilot was never realised as the companies could not reach the conditions required. Another has plans for piloting cash programming in the near future.



There was very little operational experience of technology-based solutions. One had initiated attempts at a trial but could not get the mobile company to pre-finance the project.

One INGO however did identify technology-based solutions as reducing vulnerability, delivering cash more quickly and reducing the risk of diversion and taxation as there is confidentiality for the beneficiary. It must be noted, however, that this was not based on their own operational experience.

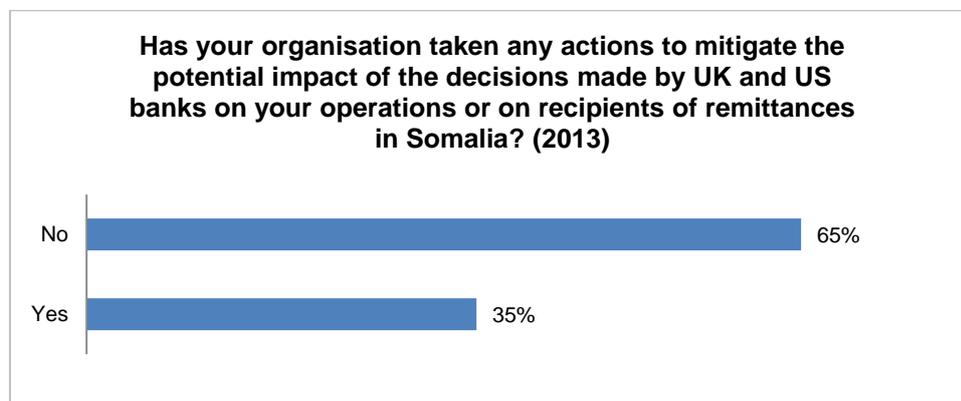


The INGOs' primary concern was the limit to the amount of money that can be transferred through mobile phones. One INGO uses Somali money transfer companies as a means to pay operational costs such as salaries to field employees, thus the cap on mobile money transaction would be problematic in this instance. Their other concerns included the lack of mobile network coverage in Somalia and the potential for taxation on mobile transfers. One local NGO suggested that lack of education and awareness would be an obstacle to overcome if mobile money was introduced to new areas.

The two INGOs that spoke of experience with mobile money gave positive feedback: 'we see mobile money transfer as reducing vulnerability and aid diversion', reported one agency. 'Some of our partners are transferring cash to beneficiaries through Somali mobile phone companies. The small sample of beneficiaries I have spoken to have been satisfied. Partners have not reported any problems and have negotiated reduced transfer fees.'

LOOKING AHEAD: POTENTIAL ROLE OF AID AGENCIES

Respondents were asked to share what actions they have taken to mitigate the potential impact of the present situation, and to share what they see as their role going forward.



Do you see a role for your organisation, or the aid sector as a whole, in providing support to the development and delivery of a solution to the current situation?

Type of organisation	Comments
International NGO	Encourage commercial banking services to be opened in Somalia
International NGO	<p>We are happy to support in any way possible, however the solution really lies with the UK government, banks and MTOs. We are working actively on this issue and remain very concerned about it because of the impact on vulnerable people across Somalia. We have experience of use of biometrics and mobile money transfer in our programme work (covered above). This has been mainly based around ensuring aid reaches the intended beneficiary but the lessons from this may be useful – see our blog about the issue; we are able to share evaluation documents on request:</p> <p>We also have a series of recommendations:</p> <p><u>British Banks:</u></p> <ul style="list-style-type: none"> - Barclays should extend the deadline for closing remaining MTO accounts by 12 months to allow a comprehensive solution to be established that works for banks, government, MTOs and the Somali people. Remittance transfers must not be driven underground even in the short term. Regulators should encourage and support such a move. - Banks should review how they manage risk in this sector and develop specialised services for MTOs engaged in remittance transfers: Banks should acknowledge their social responsibility, the fragility of the remittance sector, and the critical role that MTOs play. They should review MTOs’ applications on a case-by-case basis and identify with them key risks and mitigations both on the transferring and the receiving end; measures should be proportionate both to the regulatory risk and to the potential impact. Banks should invest in managing this risk working closely with MTOs and call for the Government to clarify, and if necessary to revise, regulations to

allow these vital transfers to continue.

- Banks, beyond Barclays, should come forward to ensure that this service continues.

UK Government:

- The Government should acknowledge the social, economic and political significance of remittance transfers, and work with the financial services sector to ensure that remittances continue to flow to Somalia in the short as well as the long-term: The UK Government should lead a review of the remittance sector whilst ensuring that there is no interruption in money flows reaching vulnerable people.
- The FCO, DfID and HM Treasury as the relevant Government Departments should coordinate initiatives within Government, and facilitate dialogue between regulatory bodies, Banks and MTOs to identify potential risks and collaborate on best practices: Banks and the regulators should be transparent about which regulations cause problems and promote flexible, workable and shared solutions.
- The Government should engage key international regulators to ensure other countries' regulation does not adversely impact regulated remittance flows: Since US legislation particularly is a major element in the risk analysis of UK based banks, the UK government should use its influence to promote a robust and transparent system that has the buy in of key international stakeholders.
- The Government should support Somalia to establish a robust banking sector and regulate its payment systems through technical assistance and capacity-building and as part of a broader financial inclusion strategy.
- HM Treasury and HMRC should work with Banks and MTOs to identify and support capacity building needs in the UK that would build the banks confidence in MTOs. This might include mechanisms to integrate MTOs into an automated clearinghouse which would aggregate transactions originating from all MTOs and agents, thereby helping regulators and MTOs identify remitters attempting to avoid scrutiny by sending funds through multiple MTOs.
- Explore the possibility of reinforcing and extending mobile money transfers with banks and MTOs as appropriate. At least three Somali mobile network providers have developed money transfer platforms and Somalis are already using mobile technology for payments. Efforts to develop this throughout the country should be encouraged following a strong risk assessment.

Somali MTOs should:

- Improve collaboration within the money transfer industry, investing in improved standards and strengthened self-regulation. This should include strengthening agreed ways of working across the industry, specific investment in systems to identify and report suspicious activities, investment in the training and monitoring of agents, improving reporting and documentation, and strengthened oversight of offices.
- Invest in further developing money transfer technology for Somalia,

including reaching out to the Somali diaspora in the UK to promote e-transfers, investing in community education programmes to promote this, and investing further in mobile money.

Somali authorities should:

Rapidly pass the legislation to strengthen the Somali banking system and facilitate regulation of international transfers. In addition to rapidly establishing a much needed formal banking system, Somali regulation to prevent money laundering would demonstrate the Federal Government's willingness to listen to the concerns of international partners, as well as build the confidence of banks.

International NGO

We believe that CARE's experience in bringing savings and credit to poor, remote communities may provide insights for the development of solutions to provide access to remittances for similar communities in Somalia and elsewhere. Our experience includes developing mobile phone based savings and credit systems, including in Tanzania and Rwanda. CARE International is a leading NGO in facilitating the financial inclusion of poor people. CARE's Village Savings and Loan Association (VSLA) model has proven to be one of the world's most effective, allowing members to save flexibly, access loans to invest in small businesses, and build a social fund to strengthen their ability to cope financially with unexpected events such as an illness in the family. Today, CARE's VSLAs reach over three million people in 26 African countries, including a small number of groups in Somaliland. There are also around three million more people participating in savings groups supported by other development organisations globally. As groups mature, many seek the security of a bank account to hold their growing savings, or wish for larger loans than the group can provide. To respond to these needs, CARE established partnerships with a range of companies to explore models for connecting savings groups with formal financial services. In Uganda and Kenya, it partnered with Barclays to offer groups low-cost savings accounts with no minimum deposit. In Kenya through a partnership with Orange and Equity Bank, CARE has brought banking products to groups. In this work we have navigated issues around "know your customer" and similar regulatory requirements. We have documented some of our learning on linkage to formal banking systems. What we have learned from our program work with VSLA's in Somalia this is that the 'banking culture' is significantly absent. An effective, government regulated (Islamic) banking system is necessary, and should be an ultimate goal – though realistically this is a 10-20 year investment, but one which is necessary.

International NGO	Yes. Short-term, we are actively involved in advocacy with other INGOs to raise awareness of alternative money transfer options such as a clearinghouse for transfers. We have a vetting policy whereby we vet recipients of transfers to ensure they are individuals who are not engaging in terrorist activities. Long-term, this is an issue of for the SFG in passing banking regulations and developing a banking system.
Specialist Regional NGO	Raising awareness among the Somali Community if new ways to deliver money to Somalia are identified; working with local community in Somalia in teaching how to use mobile phones to transfer money
International NGO	X
Local NGO	Yes
International NGO	Save the Children would be interested in this, but I do not have a specific example at this time.
Local NGO	Yes
Local NGO	Identification and training of local traders as cash transfer agents if the <i>hawalas</i> are not in position. How the money will reach the traders is open for discussion!
International NGO	We have not been involved in researching this area of concern while other NGOs have. As a result we do not see a direct role for our organisation in finding a solution - apart from discussing with Dahabshiil alternative means of channelling money through them.
International NGO	Yes, I think that there is significant learning from the cash programme (through <i>Hawalas</i>) and the current increase in mobile phone transfers that can help the aid sector develop rigorous risk management processes that can be shared to reduce risk across the board.
Specialist Regional NGO	X
Donor	First and foremost, advocating with Barclays Bank to agree to a transition period allowing other solutions to be put in place, including helping money transfer companies to meet expected standards. Second, identifying alternatives to Barclays, so that individuals and organisations can continue working with those money transfer companies that demonstrate willingness to put in place the right controls. UK banks could provide pro bono expertise and support to manage this as part of their commitments to corporate social responsibility. At the Somali level, training and expertise could be provided through the World Bank or other development partners. Development of transfers through mobile phone companies cannot replace the money transfer companies given the wide network of agents that is needed in remote locations, but can be complementary.
Local NGO	X
International NGO	CAFOD has ended emergency projects in Somalia.

ⁱ UNICEF (2013) 'Final Evaluation of the Unconditional Cash and Voucher Response to the 2011-12 Crisis in Somalia,' Humanitarian Outcomes Report

ⁱⁱ JTR 451 12 RESTRICTED (14 Sep 12)