THE INFLUENCE OF MONEY REMITTANCE REGULATIONS ON THE GROWTH OF FINANCIAL SECTOR ON THE KENYAN ECONOMY

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ABSTRACT

The biggest source of foreign exchange for poor countries has been the remittances because the above-mentioned short calculations show that the remittances from the rich countries have emerged as an important source of foreign exchange for poor countries. Remittances were double the amount of foreign aid and ten times higher than the net private capital transfers in 2001 knowing that the net private capital transfers are the product after deducting all financial flows, such as interest payments and profit repatriation. The objective of this study was to find out the influence of money remittance regulations on the growth of financial sector on the Kenyan economy. The study used both primary and secondary data. Primary data was collected using semi-structured questionnaire having mostly close-ended questions and a few open-ended questions. The close-ended questions enabled the researcher to collect quantitative data for statistical analysis. Secondary data will be collected using relevant information from the financial records, CBK publications, newspaper among others. The findings of the survey confirm that countries have taken different approaches to the regulation of *hawala* and other similar service providers, with a slight majority of countries treating hawalas and other similar service providers as illegal. Reporting (STR), Record keeping, Training, Compliance Officers, and Internal Controls Requirements. In particular, all these countries require compliance with CDD requirements. All except one country require STR reporting. All except two countries require training of staff on AML/CFT regulations and record keeping for a minimum of five years. The study concludes that As *hawala* and other similar service providers are treated the same as any other remittance companies for the purpose of AML/CFT obligations, sanctions applicable to *hawala* and other similar service providers for failure to implement AML/CFT requirements are general provisions that apply to all MVTS whether they are called remittance companies, money service providers, or payment institutions. The questionnaire did not specifically ask whether sanctions are the same for all the financial institutions including MVTS or not, but some countries impose the same range and scale of sanctions for all the financial institutions while others have different scale and range of sanctions depending on types of financial institutions (for example, there are differences between banks and MVTS). The study recommends that it is important that all types of money service businesses including regulated *hawala* and other similar service providers report promptly to the financial intelligence unit (FIU) or any relevant authority if they suspect or have reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing or related to unlicensed money remittance business. The information collected by FIU through STRs can be used by law enforcement agencies (or by supervisors) to conduct further investigations which can help identify illegal *hawala* and other similar service providers. STRs can be very useful technique to track down flow of money especially when banks and other financial institutions are used as a medium of settlement.

Keywords: *Money Remittance, Regulations, Financial Sector and Growth*

INTRODUCTION

The biggest source of foreign exchange for poor countries has been the remittances. Remittances from the rich countries have emerged as an important source of foreign exchange for poor countries. Remittances were double the amount of foreign aid and ten times higher than the net private capital transfers in 2001 knowing that the net private capital transfers are the product after deducting all financial flows, such as interest payments and profit repatriation. Lower and/or lowest middle-income countries are the main beneficiaries of remittances, especially those with a gross national income per capita between $736 and $2,935 receive nearly half of all remittances world. According to Nofie (2011), innovations in the financial sector is the arrival of a new or better product and/or a process that lowers the cost of producing existing financial services. Akamavi (2005) also notes that innovation in the financial services sector has led to recent fundamental changes including; deregulation, increasing competition, higher cost of developing new products and the rapid pace of technological innovation, more demanding customers and consolidation of corporations.

Currency exchange and unregistered money transmissions dominate STR filings: 57% of filings referenced suspicious currency exchange, while 30% referenced unregistered Money service businesses (MSB) activity (with unregistered currency exchange being the leading cause). 48% of the suspicious currency exchange activity referenced Venezuela, Argentina, Brazil, and Mexico. While 89% of STRs before the advisory referenced Latin America, only 41% of post-Advisory STRs did. Post-advisory transactions involving exchange houses in the UAE, Jordan, and Kuwait, Yemen, and Iran were common. For the subject location, over 49% (1 019 subjects) were associated with foreign addresses, almost 40% of them in Venezuela. Over 90% of New York filings reporting possible unregistered money services business activity involved convenience/grocery stores and the Middle East.

Because of the government laws and regulations govern the formal remittance industry, the money transfer dealers have opened currency exchanges as front offices to conduct legal money transactions; behind the scenes, however, a lot of money transfers take place using the community-based systems. Some hawalas even perform the function of deposit taking hence maintaining accounts for their regular customers. Thus currency exchanges then operate as central points for other small *hawala* agencies.

They communicate by radio (in the remote parts of North Eastern Kenya and Somalia), fax, mobile phones, e-mail, and the Internet. Most of the *hawala* agencies have different branches in different parts of the world and, in the case of money transfer; the person in charge of the agency on the other end is authorized to pay the recipient. The sending agency calls the receiving agency and provides the recipient’s transaction number and telephone number and the amount being transferred. The receiving agent calls the recipient and tells him or her where to collect the money. The recipient must produce identification; however, a third party may receive money on behalf of the recipient if there is a witness. The sender pays the fee, which depends on the amount of money sent. For every US$100 (KSh 9,000) sent, the sender must pay US$1.75 (KSh 157.5) as commission. These businesses are usually located near large migrant populations. Remittances are paid in cash, in total confidence, and there is no complex documentation. The agency owner keeps a simple ledger, and customer service is adequate. Liquidity to the money transfer agencies is not a problem because they always have money with them.

Hawalas are widely popular popular in the Middle East and parts of Asia, had been gaining popularity in Kenya, particularly as a cash remittance system for residents of Eastleigh Estate in Nairobi who mostly receive money from friends and relatives mainly in Somalia and further across the globe. Its informal nature was, however a concern because it could be used for money laundering and financing terrorism, resulting in the Central Bank Of Kenya issuing new guidelines in the year 2013 that outlawed it (Aker, Jenny and Isaac Mbiti. (2010).

According to reports available at the Central bank of Kenya (CBK, 2014), In a *hawala* transaction, the sender of the money gives the cash to the remitting agent who notifies a corresponding counterpart in the country or location of the recipient, giving them instructions to release an equivalent sum of money to the intended recipient. The transaction cannot be traced back as *hawala* operators do not keep any records. The firms must verify the identity of the person sending or receiving the money and to log the transaction in an information system. Further, the operators are to furnish the CBK with details of any person who transacts more than Sh880,000 ($10,000) in a day and a weekly report of all its transactions. Three of the licensees are Amal, UAE and Continental, who previously used to operate as forex bureaus, but have increased their capital and invested in information technology so as to enter the new business (CBK, 2014).

Banks and other participants in the economy have become used to ever increasing regulation, but constantly complain about the burden they face in fulfilling the requirements (Aker, Jenny C. (2010). According to the “Banana Skin Report” in 2005, “the remorseless rise in regulation has become the greatest risk facing the banking sector”. Regulators have taken up these concerns and consider the balance between costs and benefits of existing and upcoming regulatory requirements today. This is, however, not true for all regulatory aspects. One notable exception is the area of money laundering and terrorism financing. Various provisions have been enacted which engage the financial services industry in the fight against the use of the financial sector by criminals. In contrast to other regulatory areas such as capital adequacy or risk management, benefits and costs of Anti Money Laundering ventures are not considered. The Anti-Money Laundering pipeline is full of upcoming provisions, especially as the relevance of organized crime; drug trafficking and other illegitimate ventures did not decrease in spite of the massive measures taken during the last two decades.

STATEMENT OF THE PROBLEM

The licensing of the money remittances allows the CBK to capture more information on money sent in and out of the country in compliance with the anti-money laundering practices. The formulation of the regulations was informed by the need to subject money remittance providers for enhanced Anti-Money Laundering and Financing of Terrorism standards (CBK, 2014). Financial sector experts said the rules are targeted at *Hawala*, a system of money remittance that involves transfer of cash without any records of the parties involved in the transactions. *Hawala*, which is widely popular in the Middle East and parts of Asia, has been gaining popularity in Kenya, particularly as a money remittance system for residents of Eastleigh Estate in Nairobi who mostly receive money from friends and relatives mainly in Somalia and further across the globe. Hawalas are also used to transfer money to Somalia by all UN agencies and International organizations that operate from Kenya due to insecurity and political instability in Somalia.

Its informal nature has, however, raised fears that it could be used for money laundering and financing of terrorist activities. A central bank source was quoted saying “We are trying to tighten regulation around outflow and inflows in the country. Services like the *Hawala* which are totally unlicensed and not formalized are the ones we are seeking to control so that we have information on who is transacting and how much Financial Reporting Centre, (2014) . The new rules were published by the Central Bank of Kenya through a gazette notice on 19th April 2013. Kenya has committed to tighten money laundering regulations to avoid being put on a global blacklist of countries whose financial systems have loopholes for manipulation by criminals and terrorists intent on cleaning dirty cash Financial Reporting Centre, (2014).

Kenya risked being blacklisted by the international community owing to its lax anti-money laundering laws, which made it a fertile ground for criminals, especially Somali pirates, to launder their cash. The new rules do not, however, apply to operators of other CBK licensees such as banks, Post Bank and deposit taking microfinance institutions and forex bureaus — which are already subject to tight regulations that require maintenance of records for customers remitting significant amounts of cash. “They are targeting institutions that they do not have control over,” said a source who did not want to be mentioned owing to his close links with the CBK. In a *Hawala* transaction the sender of the money gives the cash to the remitting agent who notifies a corresponding counterpart in the country or location of the recipient, giving them instructions to release an equivalent sum of money to the intended recipient. The transaction cannot be traced back as *Hawala* operators do not keep any records. It is against this background that this study seeks to find out the effect of money remittance companies on the growth of financial sector in the Kenyan economy

OBJECTIVE OF THE STUDY

The objective of this study was to find out the influence of money remittance regulations on the growth of financial sector on the Kenyan economy.

LITERATURE REVIEW

Several factors determine the choice between a licensing regime and a registration regime—which in themselves have different impact on the ease/control of market access and the resources required for regulatory/supervisory oversight. This choice is also likely to have a bearing on the incentives for businesses between staying informal or entering the regulated economy. Registration regimes require fewer conditions to be fulfilled at the time of entry thus making it easier to enter the market. Licensing regimes are most often more involved processes with more demanding conditions. They also usually require front-end screening of the applicants by the authorities. As a result, registration processes are expected to be faster and less resource consuming, while more supervisory capacities are expected to be necessary for licensing regimes. All things being equal, the less stringent up-stream conditions under registration regimes are expected to call for more on-going supervision and surveillance—particularly if the market is composed of a large number of smaller players.

Another important factor is how the registration/licensing regimes comparatively affect the incentives for expanding remittances through regulated channels. Survey results do not point to any clear cut benefit from one system compared to the other. It is however expected that the lower the barriers at entry and application fees, the easier it would be for market participants (notably the smaller ones) to enter the regulated market. Both registration and licensing regimes create a framework for supervisors to exercise control over who can act as a principal service provider or an agent and to ensure compliance with AML/CFT obligations. Licensing requirements are expected to be more comprehensive and rigorous; they are also more expensive, which increases compliance costs for both the authorities and the service providers – irrespective of ML/TF risks.

A large portion of Africa's money transfer infrastructure operates beyond state regulations, and has been caught up in debates about the role of the informal economy in development. Diagnosed by neo-liberal policy makers in the 1980s as the result of market distortions, the informal economy was by the late 1980s hailed as exemplary barefoot capitalism and popular resistance to the failures of the state, and then from the 1990s increasingly associated with corruption, criminality, conflict, and extremism.

In particular, there has been great interest in how extra-state economic activities, often with a significant global reach, become part of the endogenous dynamics that protract conflict in parts of Africa. At first, as the trade-based method of remitting funds was slow and easily disrupted by the violence, hand-carrying money or delivering cash via qaad flight operators became commonplace. But these rather risky methods were soon superseded by a more ingenious and reliable mechanism. Xawilaad was the Somali rendering of the Arabic word *hawala*, meaning 'transfer of debt', referring to a system of value transfer that has facilitated long-distance trade in the eastern Mediterranean, the Red Sea, Mesopotamia, and Iran since the early medieval period of Islam and is still popular in the Middle East, Asia, and their trading and migrant diasporas.10 In its simplest version, the customer gives money to an agent who contacts a second agent with the instruction to pay the recipient. The value or debt is transferred rather than actual money. The debt is settled at a later point, via reverse transactions, trade transactions, multilateral transfers or consolidation of debts involving other agents. *Hawala* agents are independent actors transacting with a loose network of contacts. This soon took off in the midst of the Somali civil war, as high frequency radios, which formerly only the military and police were authorized to use, fell into the hands of private individuals, and imported radios also flooded in. Radio operators (taar) would relay payment instructions to operators elsewhere in the region, usually clans people or trusted business associates.

Agarwal and Agarwal (2006, 2004) estimate from forecasts, from regression analyses and taken from economic intelligence units, that global money laundering amounts to more than 2.0 to 2.5 trillion US$ annually or about 5-6% of World GDP in 2006 (44,444 trillion US$ in 2006) to be contrasted against an observed figure of US$ 500 billion to one trillion in 2004 (Agarwal and Agarwal (2004)) within the banking sector only. Recent IMF estimates on money laundering by the drug traffickers who "introduce" the proceeds gained through the role of drugs into the legitimate financial market amount to between 2-5% of world's GDP, about 600 billion annually. The IDB (2004) reaches the conclusion that for Latin America a rough estimate appears to be somewhere between 2.5 and 6.3 % of annual GDP of Latin American countries. A great deal of the money derives from drug-dealing, with total revenue of 338 Billion USD in 200.

One of the most well known economists doing macro estimates of the size and development of money laundering is John Walker (2007, 2004 and 1999). His model of global money laundering is based on standard economic theory, in which he tries to develop an international input-output-model. The Walker model relies on estimates of the extent of various different types of crimes in single countries around the world, estimates of the proceeds resulting from these crimes and the probability of those proceeds being laundered. Walker determines the laundering pathways by an "attractiveness index", which is based on a range of factors that express the opportunities and risks presented by the financial sectors/institutions in each country. He claims that his approach to quantify money laundering is arguably superior to those based on analysis of financial transactions, since there is no potential for the double counting inherent in the layering and placement stages of money laundering processes.

a) **An ancient and static system:** Even pure traditional *hawala* is actually an ever evolving one. Country experiences suggest that entities within licit network adapt their structure and methods to ensure remittance corridors are serviced efficiently. Each end of a remittance reflects the rules, regulations and context that they operate in. In many countries, an operation described as *hawala* looks and acts the same as a MSB in another country.

b) **Remittance system only, it also offers other financial services:** In its heartland, "pure traditional *hawala*" are not pure remittance systems. Apart from sending remittances, they also usually offer other financial services such as currency exchange, and in some jurisdictions, short term lending, trade guarantees, and safe keeping of funds. In some countries, they may operate as pawn shops, travel agencies and mobile phone shops.

c) **Paperless system:** Many *hawala* investigations have revealed that *hawaladars* and similar service providers actually keep detailed records. They maintain manual accounts, ledgers, computerized records or a combination of these. The businesses of some *hawaladars* are based on small margins of profit, and recording and tracking deposits, payments and transfers is important to their good reputation and efficiency; alternatively HOSSPs that service the criminal market need to keep detailed records in order to keep track of transactions completed through complex settlement methods such as third party payments and trade transactions.

To gauge the impact of the legalisation of *hawala* and other similar service providers, the surveyed countries were asked whether legalizing *hawala* and other similar service providers has helped in formalizing the remittance market successfully in their country. 80%11 of the surveyed countries where *hawala* and other similar service providers are legal answered positively to this question, confirming that licensing or registration requirements have led to an expansion of the regulated remittance market. However, this seems contradicted by the numbers of registered/licensed *hawala* and other similar service providers provided in the questionnaire responses by the countries where *hawala* is legalised. The number of domestic principal licensed/registered *hawala* and other similar service providers in seven12 countries reporting numbers ranged from four to 26. In one country, the number of businesses registering as unregulated value transfer services (informal value transfer services or IVTS), a broader category than HOSSPs, was over 1 000. This country uses the term IVTS to refer to any system, mechanism, or network of people that receives money for the purposes of making the funds or an equivalent value payable to a third party in another geographic location, whether or not in the same form.

In general, the numbers of regulated HOSSPs are still very few—making it very likely that unregulated *hawala* and other similar service providers are in effect continuing their business in these countries. In most of the countries where *hawala* and other similar service providers have been legalised, they operate as licensed Money Service Operators (MSOs).

RESEARCH METHODOLOGY

Research Design

The study used descriptive research design, to establish the effect of public financial management reforms in the management of public funds in Kenya. The method is chosen since it is more precise and accurate since it involves description of events in a carefully planned way (Babbie, 2004). This research design also portrays the characteristics of a population fully (Chandran, 2004). The research design was both quantitative and qualitative with the aim of determining the relationship between the aspects of PFMR (independent variables) and effectiveness of management of public funds (dependent variables).

Data Collection Procedures

The study used both primary and secondary data. Primary data was collected using semi-structured questionnaire having mostly close-ended questions and a few open-ended questions. The close-ended questions enabled the researcher to collect quantitative data for statistical analysis. Secondary data will be collected using relevant information from the financial records, CBK publications, newspaper among others. Both electronic mail and hand delivery will used to deliver the questionnaire and follow up the respective respondents via telephone or e-mail.

RESEARCH FINDINGS

The findings of the survey confirm that countries have taken different approaches to the regulation of *hawala* and other similar service providers, with a slight majority of countries treating hawalas and other similar service providers as illegal.

Among the 33 surveyed countries, 18 countries treat *hawala* and other similar service providers as illegal while 15 countries consider them legal if registered or licensed. Interestingly, most developed countries allow licensing or registration of HOSSPs, while developing countries do not.

Most countries have some form of sanctions available for unlicensed/unregistered money transmitters, but few surveyed countries appear to have used them. Surveyed countries indicate having both criminal and administrative sanctions available if HOSSPs keep operating as money transmitters without a license or registration after initial warnings. Most of the surveyed countries consider unauthorized operations as a criminal violation and apply sanctions such as imprisonment and criminal fines. As shown in Figure 3.8, in respectively 77% and 73% of the 22 countries that provided data, imprisonment and criminal fine can be imposed for unauthorized money transmission operations. In only 59% of the countries administrative sanctions are available.

Within the developed countries respondents, only six out of 17 countries define hawalas and other similar service providers as “illegal” and the remaining eleven have legalised *hawala* and other similar activity if service providers are either registered or licensed. On the other hand, 12 out of developing countries respondents define *hawala* and other similar activity as “illegal” and only 4 countries allow them to operate legally if licensed or registered. One of the reasons put forward by developing countries to consider *hawala* and other similar service providers as “illegal” is their capacity constraints.

Under a registration regime, the service provider has to identify its business to the authorities and provide certain information (as may be requested by the authorities). Authorities usually attach few or no conditions to the ability of the service provider to provide its services under the registration regime, making the market entry easier. Although there are varying practices of registration requirements, registration regime tend not to require AML/CFT compliance systems prior to registration unlike licensing system, and the initial application fee for registration is also lower than that for obtaining a license. A licensing regime provides more front-end screening by authorities and requirements to meet certain criteria. Regulatory authority grants the licensee the permission to engage in certain activities subject to specified terms and conditions. Such terms and conditions may define purpose, time-period, territory, compliance requirements, and operational instructions among others.

Where legal, money service businesses and *hawala* and other similar service providers are usually treated the same way and subject to the same regulations as far as AML/CFT obligations are concerned. Out of 15 countries where *hawala* and other similar service providers are legal, 14 countries provided data on AML/CFT obligations of regulated *hawala* and other similar service providers in their countries. Survey results as shown in Figure 3.2 indicates that 75-100% of these countries impose Customer Due Diligence (CDD), Identify (ID) verification, Suspicious Transaction.

Reporting (STR), Record keeping, Training, Compliance Officers, and Internal Controls Requirements. In particular, all these countries require compliance with CDD requirements. All except one country require STR reporting. All except two countries require training of staff on AML/CFT regulations and record keeping for a minimum of five years.

In developing countries, the Central Bank is most of the time the supervisory authority for HOSSPs, while there is more diversity in the case of developed countries. Except for one country, the same agency is responsible both for regulation and supervision of the legal *hawala* and other similar service providers. Though the sample size is small, there are essentially four different institutional arrangements for the regulation and supervision of legal HOSSPs:

1. Central Bank
2. Financial Supervisory Authority (FSA)
3. Financial Intelligence Unit (FIU)
4. Others like Excise and Customs department, Department of Internal Affairs

Having the central Bank as the regulator and supervisor is the most common model in developing countries, as the Central Bank is the default supervisor for the whole financial market in addition to being one of the most established state agencies in these countries.

The most common regulator and supervisor in developed countries is the Financial Supervisory Authority. In the case of Germany, Norway and Sweden, this authority is the sole regulator and supervisor for the legal HOSSPs. In the UK, the FCA (Financial Conduct Authority) regulates and supervises in cooperation with another authority, "H M Revenue and Customs".

In several countries, the FIU has been designated as the AML/CFT regulator and supervisor of legal *hawala* and other similar service providers – for instance Canada and United States. In the U.S., the FIU has delegated examination of HOSSPs to their tax authority. In Australia, all the AML/CFT supervision including those of *hawala* and other similar service providers is undertaken by the Australian Transaction Reports and Analysis Centre (AUSTRAC), Australian FIU.

CONCLUSIONS

As *hawala* and other similar service providers are treated the same as any other remittance companies for the purpose of AML/CFT obligations, sanctions applicable to *hawala* and other similar service providers for failure to implement AML/CFT requirements are general provisions that apply to all MVTS whether they are called remittance companies, money service providers, or payment institutions. The questionnaire did not specifically ask whether sanctions are the same for all the financial institutions including MVTS or not, but some countries impose the same range and scale of sanctions for all the financial institutions while others have different scale and range of sanctions depending on types of financial institutions (for example, there are differences between banks and MVTS).

Though sanctions are applicable for failure to implement AML/CFT requirements in most of the countries, survey data pointed out that actual enforcement cases where sanctions were imposed against *hawala* and other similar service providers have been very few in most of the countries in the last five years.

RECOMMENDATIONS

It is important that all types of money service businesses including regulated *hawala* and other similar service providers report promptly to the financial intelligence unit (FIU) or any relevant authority if they suspect or have reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing or related to unlicensed money remittance business. The information collected by FIU through STRs can be used by law enforcement agencies (or by supervisors) to conduct further investigations which can help identify illegal *hawala* and other similar service providers. STRs can be very useful technique to track down flow of money especially when banks and other financial institutions are used as a medium of settlement.

To improve STR reporting by regulated *hawala* and other similar service providers as well as by banks and other financial institutions on illegal *hawala* and other similar service providers, the regulatory authorities, in collaboration with the FIU, may issue specific guidelines. Such red flag indicators can be developed also in collaboration with MVTS players which can help detect suspicious transactions.

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