



# UNDERGROUND BANKING AS INSTRUMENT FOR THE LEGALIZATION OF „DIRTY MONEY“

Katarina Kovač\* 

<sup>1</sup> PhD candidate,  
Singidunum University,  
Belgrade, Republic of Serbia

## Abstract:

This paper aims to study the way underground banking works and how it eases money laundering. Money laundering is the process of masking the original source of assets and making it usable without the risk of facing legal matters. This is preceded by criminal activity. Since it allows anonymity, lower costs and speed of transactions, underground banking makes it highly effortless to disguise sources. It actually represents informal values transfer system (IVTS), with the most well-known being Hawala, Hundi and others. Using this system is possible to make a transaction without leaving any trace, which attracts criminals. However, it was originally designed for different activities that have nothing to do with crime. With set regulations, informal banking still has significant use for illicit financial transactions. Secondary sources are used for this research.

## Keywords:

Underground Banking, IVTS (Informal Value Transfer System), Money Laundering, Hawala, Hundi.

## 1. INTRODUCTION

This study researches the way money laundering works and describes how underground banking helps the perpetrators execute this criminal offense. Money laundering and terrorism financing are closely connected, which is why the United Nations (UN) classifies them together. Money laundering is a complex criminal process directed at masking an illegal assets source, so that there would be zero consequences in enjoying the fruits of it. There are many different definitions, but the main idea is that the primary motive is financial gain as big as possible, regardless of its origin. It is part of grey economy because for it to happen there must be predicate crime, which means that money laundering can take place only after the crime has been executed. In this way, the illusion is created so that the actors can freely use the illegally gained money. With the help of unconventional banking channels, money laundering has been greatly simplified. Underground banking that operates outside of government regulation is considered to be susceptible to abuse. While it has a huge impact on facilitating illicit transactions, it should be noted that it is not the only or primary way of money laundering or financing terrorist operations. The main difference between the formal and informal banking sector is in regulation; while the formal is fully regulated, the informal has no regulation, anonymity is fully guaranteed, and there is no bureaucracy. These features make the informal system highly desirable for criminals. In addition to criminals, this system is also used by migrants, as well as those with limited literacy - which was the main idea of this system, in addition to making travel easier by reducing the possibility of robbery.

Correspondence:  
Katarina Kovač

e-mail:  
katarina.kovac.24@singimail.rs





The advantages as well as the disadvantages will be shown throughout this paper. This study is mostly based on secondary sources, such as literature drawn from social sciences and documented case studies. The second part analyses the method and procedure of money laundering. The third part describes underground banking and reviews the most popular systems such as Hawala and Hundi as well how these systems are used to commit financial crime. Fourth part provides solutions for combating money laundering through underground banking.

## 2. LITERATURE REVIEW

Underground banking is a term that describes informal banking arrangements that operate in parallel, but independently of the formal banking sector, which makes it attractive for illegal activities (McCusker, 2005). It is often associated with money laundering, terrorist activities, and other heinous acts (Daudi, 2004). Although it facilitates crimes, including money laundering, underground banking is not the only way of transferring money to finance illegal activities, but it can also be done through legal means (Passas, 2003). Although some countries, such as France, Spain and Colombia, make it illegal to do so, in most countries it does not violate the law; transactions do not have to be made between two countries, but also can be done within a country alone, and they do not have to take place exclusively between organizations or institutions, but can be made also between individuals or families (Passas, 2005).

The most important difference between formal and informal banking is that informal banking is not as regulated and operates outside of the government's control, making it amenable to money laundering and illegal in many countries (Varese, 2015). Due to international recommendations and regulations that make it difficult for governments to provide incentives, there is a misconception that the formal banking system is not interested in developing initiatives that would allow for cheaper and faster money transfers, especially since the threshold for entry into a regulated market is very high; which is why many turn to informal ways of transferring money (Borgers, 2009.). After the terrorist attack on September 11, 2001, banking sector regulations became stricter, while terrorists increasingly turned to informal methods of transferring money (Kholmatova, 2024).

It is mainly used by illegal immigrants, who are afraid of being caught by immigration authorities, as well as legal migrants who are insufficiently educated or illiterate - because these transactions do not use the classic identification as in the formal system, take place at high speed (from a few minutes, to several hours) and fees are lower (Đorđević, 2008). Although used in the illegal trade in goods, weapons, drugs or body parts, as well as in corruption, covert operations, terrorism, money laundering and other illegal activities, some other ways of money laundering are preferred, because they cannot transfer huge sums of money, but certainly because criminals understand that they do not have to integrate their dirty money into the legal system by laundering money; which leads to different opinions about the matter itself (Passas, 1999.).

## 3. EXPLANATION OF THE CONCEPT OF MONEY LAUNDERING

There are many definitions of money laundering. The UN Convention Against Transnational Organized Crime describing it as “the conversion or transfer of property, knowing that such property is derived from any offense(s), for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in such offense(s) to evade the legal consequences of his actions” (United Nations, 1988). Although the path of money, stained by criminal act is often tangled and complex, it does not change the fact of its origin, and attempt to cover it up represents money laundering (FATF, 2012). It portrays complex techniques for illicit assets origin cover-up through many different financial institutions, transactions and mediators, with goal to reward everyone that participated in the process itself (Schott, 2006). In short, it's basic motive is financial gain in an illegal manner and its enjoyment without facing the legal matters.

The way in which actors get rich is not as important as the unhindered use of the financial benefits they have achieved. Đorđević gives a very clear explanation of why perpetrators of criminal offenses have the need to lease property acquired in this way, but also discusses how they provide a mask so that they can continue to use the property in a legal manner (Đorđević, 2023). The most important thing for the perpetrators of this act is to gain as much security as possible in the appearance of the legality of the acquired property. Money laundering cannot exist without committing a crime and falls into the gray area of crime. Crimes like this can affect the financial sector and economy of countries making them less stable, weakening rule of law, governance, regulation, foreign investments and international capital flows, which spreads over countries border, as weak and noneffective control attracts criminals (International Monetary Fund, 2023).



The easiest way to explain the money laundering process is that large sums of money should be divided into smaller ones, which do not raise suspicion. After that, they are paid into several different accounts in several different banks under different names. Thereafter, money gets to become part of lawful companies and assets, attaining tracking back to original source almost impossible. To make this process easier, places of investment with little or no control are targeted, which is why underground banking is an excellent choice for money transactions.

#### 4. THE WAY DIRTY MONEY IS LAUNDERED THROUGH UNDERGROUND BANKING

With the help of underground banking, money can be transferred to any part of the world without physically moving the money. This method of transferring money has been used for centuries and was not originally used by criminals to launder money. In fact, it was used as a protection against robbery when traveling; and later by legal and illegal immigrants, so that they could send the money they earned to their families. As modern banking becomes more regulated, criminals are increasingly turning to alternative options, and as underground banking is one of the most efficient ways to transfer money, it is becoming increasingly popular among those who want to transfer value illegally. This is the most popular alternative because it is cheaper, faster, does not have a lot of documentation, the easiest to transfer money and exists on most continents.

Like it was said before, as formal banking becomes more efficient, theorists and criminals are increasingly turning to this kind of banking, so as not to leave traces behind. Given the nature of underground banking, such bankers are difficult to trace. Although they have a system by which they work and keep statistics of the transactions they perform in order to know which transactions they have made, this kind of work is not systematized and is very difficult to discover. Working in deep secrecy with clients who want their transactions to be unknown makes it easier for them to be invisible to the authorities.

Underground banking does not include ordinary banking operations such as credit or deposit, which is why the term “Informal Value Transfer System” (IVTS) is more suitable for this type of informal transactions. Although this is the case, it can be said that both are used equally. We know different systems like Hawala, Hundi and many more. Through these unique systems, it will be explained in detail how underground banking works.

##### 4.1. DEEP DIVE INTO HAWALA

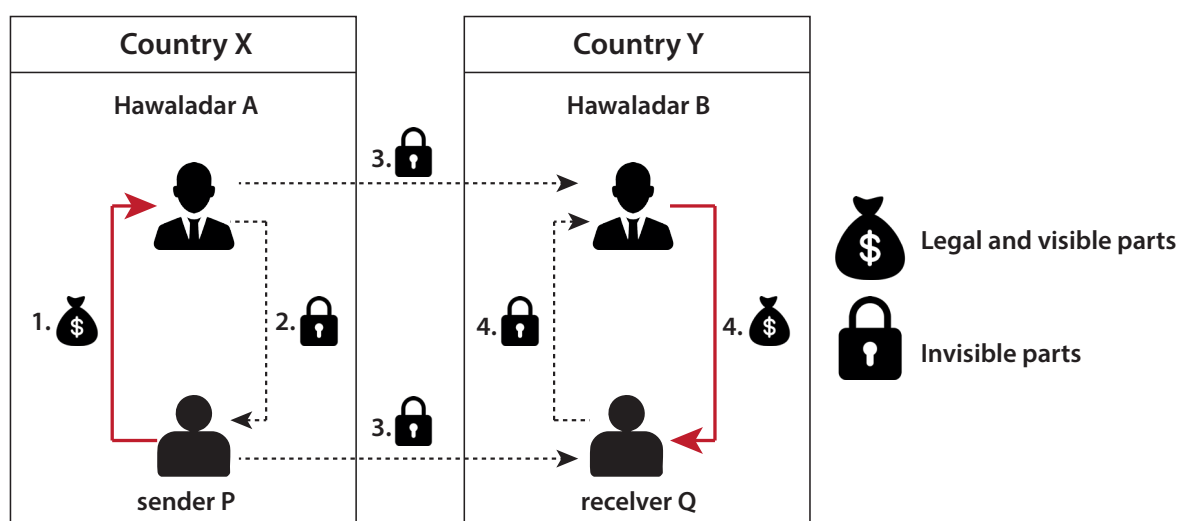
Many people nowadays associate Hawala strictly with crime, money laundering and terrorism, but originally it was actually designed for other reasons. This money transfer system has a long history and goes back centuries. Its origins are from India, but it is very much associated with the Islamic world (Iraq, Iran, Afghanistan, Pakistan, etc.). Initially, Hawala was used to transfer money from people and merchants who traveled a long way so that they would not be robbed during their journey. Systems have also been used and continue to be used by legal and illegal immigrants for sending money to their families. It is only after the September 11, 2001, terrorist attacks that the Hawala system has come to be regarded as the mechanism that enables criminals and terrorists in transferring and financing their operations. Its mode of operation has also brought Hawala into the spotlight among the public bodies in anti-crime and anti-terrorist duties.

Hawala is based on trust, and if that trust didn't exist, then the system would collapse. Its ability to move forward, even though the contemporary political, economic, and technological environment, is attributed to its resilience and adaptability through the historical revolution (Kanellopoulos, 2024). There is no formal method of identification and there is no bureaucracy. It would be considered an insult to require formal identification. Next to the fact that bureaucracy is practically non-existent, the transfer of money is carried out at a lower cost, and there is greater trust in this system than in the formal banking sector. As no formal identification is required, it is easier to disguise the origin of the money.

The functioning of the system consists of the principle of balance compensation. As shown in Figure 1, the sender from country X transfers money to the recipient from country Y, which he does by going to the dealer in his country and leaving the money to him. The dealer from country X then contacts the dealer from country Y and leaves him a password that is used to withdraw money. After that comes the recipient, who needs to know that password to withdraw money. Once he provides the password, he collects the money from the dealer in his country. When the transactions are completed, equalization begins between the dealers, which happened face to face after a certain period to balance the accounts. This shows that the money has not actually changed its physical location.



Figure 1. Example of Hawala transaction



Source: Alenova, Utaliyeva, & Li, 2024

The dealers who work in this system are called Hawaladars. Hawaladars often cannot even know the origin of the money, whether it is from illegal or legal sources. If they don't know its origin, they can easily engage in money laundering without even knowing it. Therefore, three types of Hawala are distinguished – pure traditional (the Hawaladar strictly takes money for the transfer from those for which he is sure that the money is of legal origin), hybrid traditional (it is not always legal, thus the Hawaladar can accidentally participate in illegal activities because he cannot always know the origin of the money) and criminal (the Hawaladar chooses to exclusively participate in illegal money transfers) (Dobayev *et al*, 2020.). Although it is not possible to know for sure, it is estimated that between 100 billion and 300 billion US dollars annually are transferred in this way today (Moin, 2024).

#### 4.2. EXPLORING THE INFORMAL FINANCIAL SYSTEM OF BANGLADESH - HUNDI

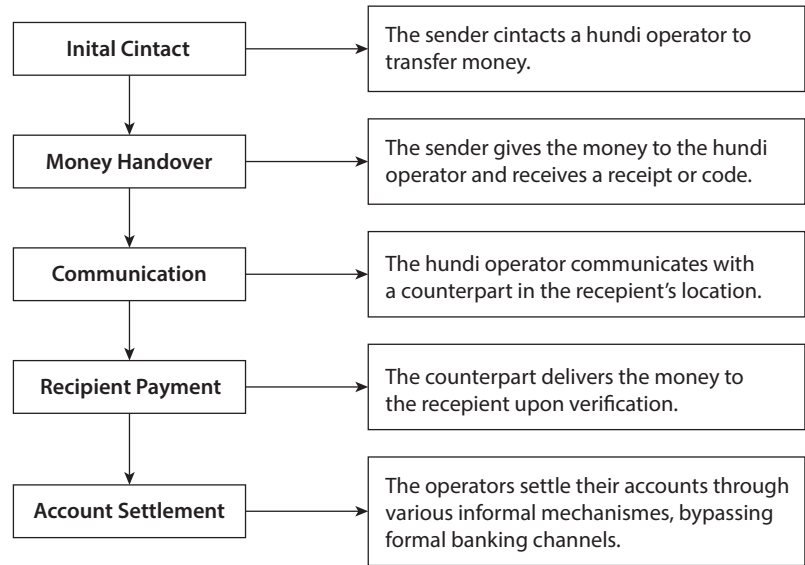
The Hundi, which has a similar function as the Hawala, is also native to the Indian subcontinent. It's just that its spread trajectory is slightly different. Hundi has spread from Bengal (located on India's border with Bangladesh) to India, but also to Bangladesh and Pakistan. Although illegal in Bangladesh, it has a purpose - which tells us that a lot of people in Bangladesh actually use this service (especially from rural areas) because they either don't trust the banking system or don't have access to it. Hundi operators offer more favorable exchange rates for money transfers, compared to banks and financial institutions, which makes this system more attractive for migrants, who want to maximize the value of their remittances, especially for the economy of countries where remittances are crucial for its stability (Rana & Islam, 2024).

A sender who wants to transfer money to the recipient goes to a Hundi broker to complete the transaction. He gives money to that broker and receives a code or receipt from him. After that, he communicates with another broker located in the place where the recipient of the money is. That other broker provides the money on the same day or a couple of days later. The receiver should provide the code or receipt, depending on what he received from the sender. When all this is done, the brokers settle the accounts. This process can be seen in figure 2.

Due to its nature in which the changes taking place are not documented, this system is often susceptible to abuse in criminal activities. It poses a serious risk to the stability of the economy, as it allows criminals to launder money easily. This phenomenon can be explained in the following way – since the system is not controlled and transparent, criminal activities can very easily take place without unnecessary attention, and thus it is very easy to evade taxes or transfer money without any trace – this environment is ideal for strengthening and spreading financial crime. Financial stability is disrupted and compromised, because such activities reduce tax revenues, cause a decline in living standards, increase inflation, reduce investments, and threaten confidence in the banking system. It has consequences for the country's international reputation. Based on the above, it can be concluded that the Hundi system has a negative impact on the country's economy and the security of citizens.



**Figure 2.** The full process of Hundi



Source: Dash, Shibli, & Saha 2024

## 5. LEVERAGING UNDERGROUND BANKING TO REDUCE MONEY LAUNDERING

Underground banking plays a major role in the international financial sector. This is the case especially in countries where individuals do not trust or do not have access to the international system, while the basis of the informal system is actually trust. IVTS is used for legitimate purposes, although it is unregulated, which leads to misuse by criminals. The process itself has no supervision, it works outside the traditional banking structure and leaves no evidence. This can be a problem because tracing such transactions is hard. The way of transferring money is based on trust and the transactions are made verbally or through personal connections.

In order to reduce criminal activity, since it can never be completely exterminated, different actions need to be taken. What is important is to be able to separate those who launder money from the ones using this system for legitimate purposes, such as to send money to their families. One of the best ways to combat money laundering that occurs through IVTS is to understand how the system works. More efficient methods should be developed to identify all suspicious financial transactions, to make it easier to detect loopholes in the system. In order for this to succeed, cooperation between the formal and informal sectors is necessary, which would improve the monitoring of transactions.

Considering the complexity of the topic, it should be essential to educate all individuals in both sectors. Raising awareness about the risks that money laundering carries and how important transparency is, should be passed on to the participants. In this way, caution is increased and those who would use the system for illegal purposes are discouraged. This must be approached with caution, so that privacy is not violated and that legitimate users continue to use this kind of system. With all this, it is very important that the regulatory framework is agile enough to constantly evolve, which should include the development of technology, with the use of digital money transfer platforms. With the development of technology, the sophistication of both legitimate users and those who have the purpose of abusing the system and deceiving other users is increasing. Cooperation at the international level is necessary in order to preserve the integrity of data, maintain balance with regulation and reduce risk.

## 6. CONCLUSION

Deeply rooted in the history and tradition of the Eastern world, underground banking, that is, the informal value transfer system (IVTS), plays a role in the daily life of those who use that system for various legitimate purposes. In addition to such users, there are also those who are ready to use this banking for their own purposes with criminal origin. Due to its nature where regulation, the influence of regulatory institutions, and traces of transactions are non-existent, IVTS represents an excellent environment for criminal activities. Beside Hawala and Hundi, informal banking includes many additional systems that are more or less known. It has a major impact on the international financial system, given that large sums of money are actually transferred through IVTS. That sum cannot be fully known to the public,





because it is impossible to track something that leaves no trace and whose very point is to hide evidence. Migrants, in order to send money to their families, use this system, because it is cheaper, faster, but they also put more trust in it than in the formal financial sector. In addition to being used in this way, the system is prone to abuse for the purpose of money laundering, terrorism financing, and other criminal activities. Abuses occur because anonymity and lack of transaction traces make it difficult for regulatory institutions to investigate and detect illegal activities. Because IVTS is based on trust, and verbal agreement between the participants is sufficient, bankers do not have to be institutions, but also individuals who are closely related. That is why it is very important to educate the participants about money laundering, the balance between transparency and integrity of the system, as well as international cooperation. The fight against money laundering and the use of underground banking for criminal purposes is very demanding and therefore the cooperation of the formal and informal sectors is essential. In this way, the tracking of transactions is improved. In order to create a more effective method for identifying suspicious financial transactions, a better understanding of how money laundering and underground banking work is needed. Respecting privacy is one of the main challenges in regulating this system, especially when it comes to users who need legitimate services. With the development of technology, all users are becoming more sophisticated, and so are abuses and frauds. Therefore, regulatory bodies need to be agile and open to change and development. In short, although underground banking was created with the aim of facilitating the functioning of individuals, it is exposed to abuse. By understanding the functioning of the system, educating participants, international cooperation and openness to development, it is possible to reduce criminal activities, although complete elimination is not possible.

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