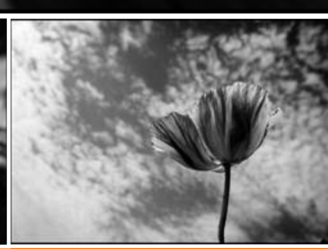
UNITED NATIONS
Office on Drugs and Crime

RAINBOW STRATEGY

Financial Flows linked to the Illicit Production and Trafficking of Afghan Opiates



November 2008 – Work in Progress

This document is part of the UNODC's Rainbow Strategy which aims to reduce the supply, trafficking and consumption of opiates in Afghanistan and neighbouring countries. Each of its seven operational plans addresses jointly agreed targets in the region; supplements existing interventions from national governments and other Paris Pact partners; and allows for constructive engagement with prime regional actors.

This document has not been formally edited. The boundaries, names and designations used in the maps do not imply official endorsement or acceptance by the United Nations.

RAINBOW STRATEGY

The Orange Paper is a work-in-progress produced in November 2008 and is made up of two parts.

The first part is the Executive Summary of a background paper produced in October 2008 by a Paris Pact working group of experts on financial flows linked to Afghan opiates production and trafficking with the assistance of two United Nations consultants. The background paper is primarily based on publicly available information and was produced thanks to contributions from the EAG, the Egmont Group, Interpol, IMF, WB, and UNODC. The views expressed in the background paper are those of the authors and should not be attributed to any of the organizations and bodies mentioned above, their Executive Boards, or management. The working group was set up by the United Nations Office on Drugs and Crime (UNODC) in April 2008 and made up of experts from the Eurasian Group on combating money-laundering and financing of terrorism (EAG), the Egmont Group, the Financial Action Task Force (FATF), the International Monetary Fund (IMF), Interpol, UNODC and the World Bank (WB). The background paper should not be seen as having any official endorsement from any of the parties mentioned above.

The second part of this paper lists the recommendations of participants to the Expert Round Table on Financial Flows linked to Afghan opiates production and trafficking held in Vienna on 6-7 November 2008.

Illicit Financial Flows in the context of Afghanistan's Opium Economy

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Part I: Executive Summary of the background paper on the financial flows linked to Afghan opiates production and trafficking

Introduction

The background paper on the financial flows linked to Afghan opiates production and trafficking is part of the UNODC's Rainbow Strategy which aims at reducing the supply, trafficking and consumption of opiates in Afghanistan and neighbouring countries. It has been produced in October 2008 by the Paris Pact Working Group of experts with the assistance of two United Nations consultants. This working group was set up by the United Nations Office on Drugs and Crime (UNODC) in April 2008 and is made up of staff from the Eurasian Group on combating money-laundering and financing of terrorism (EAG), the Financial Action Task Force (FATF), the International Monetary Fund (IMF), Interpol, UNODC and the World Bank (WB).

This background paper attempts to summarize the current status of knowledge about the financial flows related to the opiates economy in Afghanistan, including financial flows through neighbouring and some other affected countries. The paper has been drafted on the basis of existing information drawn from a variety of published analytical studies and assessment reports.

The paper does not present any new research or analysis on the subject nor does it represent the outcome of on-site research. Rather, the purpose of the paper is to (1) summarize what is presently known about the drug industry in Afghanistan, (2) describe the financial flows within, in and out of Afghanistan and related vulnerabilities, (3) outline the anti-money laundering framework in place in Afghanistan, neighbouring countries and other affected countries, and (4) articulate some initial recommendations for consideration by policy makers.

The background paper is still a work-in-progress. It has been recently updated based on the outcomes of the Paris Pact Expert Round Table on financial flows to and from Afghanistan linked to opiates production and trafficking held in Vienna on 6-7 November 2008.

1. Drug industry in Afghanistan

Afghanistan has an important geopolitical location, sharing borders with Pakistan, Iran, China and Central Asia. Linking Central Asia with South Asia, it provides China and the Far East with a direct trade route to the Middle East and Europe. It is also by far the world's largest producer of opiates, which include opium, morphine, and heroin processed from opium. The complex ethnic composition of the region, the lack of basic security in many areas of the country, the extreme levels of underdevelopment and thriving illicit opiates industry have turned Afghanistan into one of the most challenging development and rehabilitation cases that the international community has faced in recent times. Despite the efforts by the Government and the international community to end terrorist and extremist activity, security has steadily deteriorated since 2006. Terrorism, instability, corruption and weak capacity in governance interact with the financial flows linked to opiates, and contribute to the Government's incapacity at establishing effective control over the country.

Based on information from key informants and seizures in neighbouring countries over 2003-2007, the UNODC estimates that :

- About 60% of the opium produced in Afghanistan is transformed into heroin and morphine locally.
- Heroin and morphine are then trafficked mostly via Pakistan and Iran and, to a lesser extent, Central Asia (mainly Tajikistan and Turkmenistan) to markets in Europe, the Middle East, Africa, southern and south-eastern Asia and, to a lower degree, to North America and the Oceania region.
- The rest (some 40%) of the opium produced in Afghanistan is exported, mainly to Iran (mostly for domestic production of heroin and morphine) and, to a lesser extent, to other neighbouring countries (Central Asia and Pakistan).
- Direct exports of opiates to China (by land and air) and India (by air) also have been reported but do not appear to constitute a significant share of total production.

Afghan traffickers are estimated to have earned US$ 1.4 billion gross from opium exports in 2008. In addition, they are estimated to have earned US$ 2.1 billion gross from heroin and morphine exports. The total gross income from exporting opiates to neighbouring countries was estimated at US$ 3.44 billion in 2008. Deducting the estimated cost of the opium purchased from farmers (US$ 0.73 billion) results in estimated gross profits for Afghan traffickers of US$ 2.7 billion in 2008[1].

About 79% of the total profit is estimated to have accrued to traffickers, while Afghan farmers earned about 21% of the total. In order to arrive at net profits, additional cost factors would have to be considered, including the cost of bribes; taxes to warlords and insurgency groups; labour costs to convert opium into morphine and heroin, for smuggling the opiates across the border, etc; transport costs, including the cost of protecting shipments; and the cost of laboratory equipment and precursor chemicals, which reportedly increased substantially in 2008.

The estimated gross income accruing to traffickers (US$ 2.7 billion) is equivalent to 26% of Afghanistan's licit economy (US$ 10.2 billion) or around 20% of the total Afghan economy including the illicit opium sector[2] . The estimated income of traffickers and farmers from the opium sector, taken together (US$ 3.4 billion), is equivalent to around 34% of Afghanistan's licit GDP.

Financial flows linked to opiates can circulate into the formal financial sector and/or alternative remittance systems, be held in cash without being transacted through the formal or informal financial system, or be invested in the non-financial sector (legal and illegal business) in the region and elsewhere.

2. Financial flows within, in and out Afghanistan

Only a segment of the population has access to formal banking services. It is estimated that about 90% of Afghanistan's financial flows pass through the *hawala*, the "non-bank

[1] UNODC/Government of Afghanistan, Afghanistan Opium Survey 2008
[2] This estimate does not take into account double counting. Some of the income generated by the opiate industry may have already found its way through into the licit GDP calculations.

informal" financial sector and only 10% flow through "formal" financial channels. Despite the rapid growth of the banking sector assets, financial intermediation remains relatively low. Indicators of financial depth, including bank credit to the private sector and deposits as a percent of GDP, remain well below those of neighbouring countries.

The bulk of activities of the formal banking sector remain in foreign currencies. As of September 2007, 77% of all deposits and loans were denominated in U.S. dollars. Moreover, foreign currencies and Afghanis are used interchangeably for domestic transactions. There are thought to be large amounts of money in foreign currencies such as U.S. dollars and Pakistani rupees outside of the formal financial sector. The prevalence of foreign currency in circulation could mean that not much currency exchange takes place through traditional banks or currency changers.

2.1 Vulnerabilities in the formal financial sector

The lack of a core set of basic commercial laws, including mortgage, secured transactions, and commercial arbitration laws, prevents banks from providing credit to small and medium-sized businesses. As a result, the formal banking sector in Afghanistan coexists with a large and vibrant "non-bank informal" financial sector, which has played an important role in both internal and external trade finance.

In a fragile context, where the economy has existed in a legal vacuum over a prolonged period, it is exceedingly difficult to segregate legitimate from opiates-related financial flows.

2.2 Alternative Remittance System [ARS]

<u>Context of use</u>

''Alternative Remittance System'', ''underground banking'' and ''informal fund transfer systems'' are generic terms to describe any banking arrangement which run parallel to any formal financial systems. In Afghanistan, the large bulk of financial transactions, both licit and illicit, flow through a common alternative remittance system known as *hawala*. Its role has been enhanced during the three decades of conflict, and especially under the Taliban regime, when the *hawala* markets fully replaced the formal banking system. The *hawala* system used to be the only facility for the transfer of money into and out of the country, hence becoming host to a complex interplay of actors, and very likely to be misused for illicit purposes.

Hawala, operating through *hawala* dealers or *Hawaladars*, offers a diverse range of services: money exchange, transfer of funds domestically and internationally, trade finance, microfinance, and limited deposit taking. Hawaladars' capital base depends both on licit and illicit trade in goods and opium. At the same time, even the aid sector relies on *hawala* networks for transfers.

Reliability, low cost, convenience, accessibility, speed and anonymity continue to be the main factors which contribute to the attractiveness of *hawala*, and other ARS in Afghanistan.

Risks and vulnerabilities in the informal financial sector

Due to this system's distinct features from the transparent formal banking system, and the fact that it was not regulated previously, *hawala* was and still is highly exposed to misuse. According to available information, it clearly appears that the *hawala* system does facilitate the transfer of drug-related funds , within, in and out of the country . The largest shares of laundered funds through the *hawala* system are located in the border regions. In 2005, it was estimated that Helmand could account for roughly US$ 800 million of Afghanistan's drug-related *hawala* business and that Herat was the second largest contributor, with between US$ 300-500 million of drug money laundered annually. At that time, the qualitative accounts of medium-large *Hawaladars* indicated that about 60 per cent of the financial flows were drug-related and that 80-90 per cent of the Hawaladars in Kandahar and Helmand were involved in money transfers related to narcotics. Hawaladars report that the largest turnovers occur during the two phases of opium cultivation and harvesting.

The areas that raise particular concern around the *hawala* system include: a lack of consistency across *hawaladars* accounting and book-keeping systems, which complicates the financial investigation process; the delivery of funds in consolidated tranches, which often masks the point of origin; and the client relationships, which are based on trust and repeated interaction, rather than complying with internationally recognized Know Your Customer (KYC) guidelines.

The regulatory regimes and exchange control mechanisms found in neighbouring countries, such as the United Arab Emirates [UAE] and Pakistan, provide a platform that help to fully integrate the Afghan *hawala* system into the global economy. For example, Dubai's 'Free Zones Authorities' make the city one of the most attractive transit points for Afghan imports.

2.3 Non-financial sector

The real estate market is vulnerable to money-laundering activity in many economies. In countries like Afghanistan, the financial transaction related to real estate purchases often will occur overseas, outside the scrutiny of the national government, and the only local manifestation of the sale is a transfer of real property (without a concomitant visible exchange of cash or other value). Property market speculation also lends itself to laundering of criminal proceeds including drug related and corruption money (for example hidden commissions), which are invested without attracting too much attention. The rental market can provide a stable, regular and discreet return as well as safe 'housing' for such proceeds of crime.

Import/export. It is assumed that a large share of opiates-related funds are either channelled through traditional alternative remittance systems or through trade based money-laundering. Trade by means of fake invoicing or by falsely invoiced exports and imports can go in both directions, in and out of Afghanistan.

2.4 Customs and border trade

Porous borders are also a problem for Afghanistan and its neighbouring countries. Afghanistan's largest border is with Pakistan (2,450 km), followed by Tajikistan (1,206 km); Iran (936 km); Turkmenistan (744 km); Uzbekistan (137 km) and China (76 km).Most of the opium-producing areas in Afghanistan are located along the Iranian and the Pakistani borders.

Some parts of the border are not under the control of the government, particularly in areas along the southern border with Pakistan (Helmand, Nimroz and Kandahar provinces). For example, drug dealers and others can transport their criminal proceeds in cash across porous borders for deposit in the banking systems of other countries. In addition, even in areas where the government exercises some degree of control, the detection of trafficking of drugs, precursors chemicals or cash is hindered by corruption and by the lack of training and detection equipment.

Smuggling of cash. Traffickers are believed to avoid the main transportation routes to take advantage of the numerous uncontrolled borders. Surveys in other countries in the region showed that border control authorities very often consider cash transactions to be a private matter and not a public concern. There are few opportunities, if any, to share financial information with foreign law-enforcement authorities. There is limited counter-narcotics cooperation and exchange of information between and among Afghanistan, Iran and Pakistan. No effective reporting requirements exist for cash imports and exports in most of the countries of the region.

3. AML/CFT framework in place in Afghanistan and neighbouring countries

Afghanistan and its neighbouring countries have established or are in process of building and strengthening their AML legal and institutional frameworks. These frameworks relate mostly to the formal financial sector but also provide for the regulation and detection of suspicious transactions by, non-financial businesses and professions.

Afghanistan has had comprehensive AML and proceeds of crime legislation since 2004 which includes all crimes as predicate crimes for money-laundering. The law applies to natural persons and corporate entities. A Financial Intelligence Unit [FinTRACA] was created pursuant to the AML legislation in 2006.

The same year, the licensing of money service providers [MSP] was introduced by regulation pursuant to which MSPs are required to report suspicious transactions to the FinTRACA. However, no money-laundering case has been prosecuted since the enactment of the law.

The background paper also provides an overview of the AML regime in place in Pakistan, Iran, EAG countries, China and the UAE, where significant financial flows related to Afghanistan take place. Where available, the background paper refers to the findings from mutual evaluation reports or other assessment reports conducted by the relevant Financial Action Task Force Style Regional Bodies [FSRBs] and the International Financial Institutions.

4. Summary of the background paper's recommendations

4.1 Increase knowledge about financial flows within, in and out of Afghanistan

- Develop methods to estimate the extent of money-laundering

- Improve information on the formal and informal financial sectors and the proceeds of crime, including on:
  - The nexus between the licit economy and the illicit economy;
  - Sectors inherently vulnerable to money-laundering;
  - The relationship between currencies in circulation and money-laundering;
  - The motivations of key drug traffickers for wealth acquisition and the pattern of reinvestment of such wealth – including within the Afghanistan's licit and illicit economy and overseas.

- Study new possible trends:
  - Role of transport might change due to development initiatives;
  - Role of the new information and communication technologies in laundering schemes.

In Afghanistan, increasing knowledge about financial flows could be improved by conducting a comprehensive assessment of Afghanistan's ML and TF risks. Such an assessment would evaluate all of the crime threats facing the country, as well as the vulnerabilities in and around the country that tend to facilitate money-laundering activity.

4.2. Address the identified ML and TF risks in Afghanistan and in relevant countries of the region

- **Formal financial sector (general AML/CFT related recommendations)**

➢ Afghanistan

- Increase awareness of money-laundering and AML measures;
- Implement the recommendations of the first AML/CFT mutual evaluation of Afghanistan by the Asia Pacific Group on Money-laundering, scheduled for 2009, once adopted.

➢ Pakistan:

- Implement the recommended actions from the TA assessment of Pakistan (APG, April 2008);
- Implement the recommendations of the AML/CFT evaluation of Pakistan by the World Bank and the Asia Pacific Group on Money-laundering, scheduled for early 2009, once adopted.

➢ Eurasian Group countries (EAG):

- Enact laws on combating money-laundering in all member-states of the EAG;
- Increase awareness of money-laundering and AML measures;
- Develop information exchange between the national FIU and law enforcement bodies ;
- Establish a set of indicators to point out the potential links of financial transactions with the laundering of money from illegal drug trafficking in order to identify suspicious transactions;
- Give attention to specific money-laundering techniques typical of the EAG region.

➢ China:

- Address the vulnerabilities identified by the FATF in the Mutual Evaluation Report (MER) adopted in June 2007 by the FATF and in December 2007 by the EAG.

- The UAE:
  - Implement the recommended actions from the Fund assessment that was adopted as a MER in April 2008 by MENAFATF and in June 2008 by FATF.

- **Alternative remittances systems**

- Afghanistan
  - Create more robust monitoring mechanisms to track progress in the current regulatory and supervisory framework;
  - Consider an incentive scheme for money dealers which demonstrates the benefits of progressing towards regulatory compliance in the industry;
  - Consult hawala dealers more closely regarding potential ML and TF risks in the sector;
  - Address related weaknesses that may exist in the formal financial sector.

- Pakistan
  - Take action to identify and enforce the regulations prohibiting nonregistered Hawaladars.

- China
  - Implement the FATF MER' s recommendations concerning alternative remittances (SR. VI)

- The UAE
  - Implement the Fund assessment's recommendations concerning alternative remittances (SR. VI)

- **Non-financial sector**

Enhance monitoring of the following sectors that present particular ML and TF risks:

- Trade and transit trade, in particular regarding the Export Processing Zones (EPZs) established in Pakistan and in the UAE, and black market for smuggled goods in Uzbekistan;
- Real estate market, in particular in Afghanistan and in the UAE in order to have a central database to show registered property owners;
- Charitable foundations;
- Casinos in the EAG countries;
- Gold and diamonds in Uzbekistan and the UAE.

- **Customs and border trade**

  - Increase cooperation between and among Afghanistan and its neighbouring countries, in particular between Afghanistan, Pakistan and Iran, as well as countries in Central Asia and the Gulf.
  - Increase the control of the currently porous borders, including in order to detect the physical transportation of currency and bearer negotiable instruments. The UAE and China should implement their MER's recommendations concerning cash couriers (SR. IX).
  - Improve estimates of unrecorded border trade, and increase capacity in tracking suspicious cross-border transactions.

Part II: Recommendations of the participants to the Paris Pact Expert Round Table on the financial flows linked to Afghan opiates production and trafficking, Vienna 6-7 November 2008

1. To increase knowledge

1.1 Increase knowledge on the risks of money-laundering associated with financial flows linked to Afghan opiates/ in and out of Afghanistan, in particular on:

- How cash is laundered in the Afghan [and World] economy;
- How money laundering impacts financial institutions/the financial sector;
- How money laundering impacts the non-financial sector;
- Which trade, goods and mechanisms facilitate trade based laundering;
- Where is money-laundering occurring physically? Through which corridors does the money flow? what happens to the money that can not be accounted for in the money-laundering detection process?
- What is the relationship between different currencies and where do they appear in the money-laundering process?

Through:

- Conducting in-country surveys and interviews;
- Conducting a national money-laundering risk assessment on Afghanistan mechanisms to move funds; [some experts highlighted the fact that this point require further review by their national experts should look at]
- Compiling and analyzing case studies, looking at which are the sectors and financial centres involved, the amounts and currencies.

Lead : Paris Pact Partners and all relevant countries

Support: IMF, UNODC, Interpol, Europol, EAG, World Bank and bilateral donors.

1.2. Target the flow of money and the underlying costs of the opium industry at each step of the opiates chain, from the source to the consumer including transit countries and the flow of money or property back to the traffickers.

Through:

- Compiling and analyzing existing case studies;
- Conducting strategic analysis on each step of the opiates chain;
- Conducting in-country surveys and interviews at each part of the chain;
- In order to estimate the extent of drug-related money flows, Paris Pact members should be encouraged to collect and provide information on individual drug seizures and strategic intelligence information, drug prices, purities, prevalence estimates and per capita consumption estimates.

Lead : Afghanistan and neighbouring countries, as well as other Paris Pact partners

Support: Interpol, Europol, Egmont Group and UNODC. Possibilities should be explored for the engagement of centres such as the Central Asia Regional Information and Coordination Centre (CARICC), Gulf Centre for Criminal Intelligence (GCCI), as well as other relevant partners.

2. To address potential vulnerabilities

2.1. Apply the Anti-Money Laundering framework to all Paris Pact Members and concerned countries: Continue the process towards building and strengthening effective anti-money laundering frameworks.

Through:

- Country strategy and technical assistance.

Lead: Paris Pact Partners
Support: International organizations and bilateral donors

2.2. Implement AML frameworks in all Paris Pact Members and concerned countries

Through:

- Determining effectiveness : FATF/FSRB/mutual evaluation/FSAP process/in-country assessments, bilateral assessment sharing of information (where possible);
- Conducting and sharing technical assistance needs assessments;
- Enhancing capacity and awareness, by making use of existing regional training centres.
- Implementing the provisions regarding the physical cross-border transportation of currency and bearer negotiable instruments.

Lead: Paris Pact Partners
Support: International organizations (IMF) and bilateral donors

3. To increase national and international cooperation

3.1. Enhance cooperation at the national level

Through:

- Establishing special committees and task forces
- Establishing public-private partnerships

3.2. Facilitate information-sharing and cooperation at regional and international levels: administrative (tax and customs) , intelligence (FIUs and national security agencies), investigation (law enforcement), judicial (MLA requests and asset forfeiture units).

Through:

- Exploring ad hoc joint investigative teams/placement of liaison attachés;
- Making optimal use of existing mechanisms such as the Egmont group, Interpol (including Interpol Response Teams to facilitate coordination), FATF-Style Regional Bodies, World Customs Organization.
- Establishing permanent regional and sub-regional working groups to facilitate information-sharing.
- Conducting trainings on cash flow related to heroin trafficking in anti-corruption academy.

Lead: Paris Pact Partners and relevant international organizations
Support: International organizations and bilateral donors