



## Money Laundering in India: Concepts, Effects and Legislation

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**Abstract:** Money laundering has become a buzzword internationally. It is an area of concern for developing as well as developed countries. Money laundering is concerned with conversion of money earned from illegal sources into legitimate source. IMF as well as world bank estimates that around 2- 4% of the world GDP stems from illicit sources. 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. These figures can tell us about the volume of illicit activities and the importance to curb money laundering for the overall growth of a nation. The present study is intended to cover the concept of money laundering, process, techniques and anti-money laundering act in India.

**Keywords:** Money laundering, HAWALA, The prevention of money laundering Act, 2002

**Introduction:** Money laundering is the process of concealing the source of money obtained by illicit means. It is the process of creating the appearance that large amounts of money obtained from serious crimes, such as drug trafficking or terrorist activity, originated from a legitimate source. Money laundering allows crime to pay by permitting criminals to hide and legitimize proceeds derived from illegal activities. According to one recent estimate, worldwide money laundering activity amounts to roughly \$1 trillion a year. These illicit funds allow criminals to finance a range of additional criminal activities. Moreover, money laundering encourages corruption, distorts economic decision-making, aggravates social ills, and threatens the integrity of financial institutions. According to the United States Treasury Department: Money laundering is the process of making illegally-gained proceeds (i.e. "dirty money") appear legal (i.e. "clean"). Typically, it involves three steps: placement, layering and integration. First, the illegitimate funds are furtively introduced into the legitimate financial system. Then, the money is moved around to create confusion, sometimes by wiring or transferring through numerous accounts. Finally, it is integrated into the financial system through additional transactions until the "dirty money" appears "clean." Simply stated, the process of money laundering basically implies cleansing of money earned through illegal activities like extortion, drug trafficking and gun running etc. The tainted money is projected as clean money through intricate processes of placement, layering and laundering. In Black's Law of Lexicon the term 'laundering' is referred to as being used to describe investment or other transfer of money flowing from racketeering, drug transactions and other illegal sources into legitimate channels so that its original source cannot be traced. Money launderers are to be found in all walks of life, many acting entirely innocently however, anyone who helps a criminal to launder the proceeds of his crime is, in most jurisdictions, also a money launderer. This means bankers, lawyers, accountants, car dealers and others are money launderers if they allow their businesses to be used by someone else to launder the proceeds of a crime. Persons possessing assets out of the proceeds of crime are also money launderers. So an accountant who recommends a tax evasion scheme is himself a money launderer.

**History of Money Laundering:** Money laundering is interwoven with the history of trade and banking as



it hides money and assets from the state from confiscation and taxation. Origin of money is unknown but it has been going on for several thousand years. In “Lords of the Rim” Sterling Seagrave explains how, in China, merchants some 4000 years before Christ would hide their wealth from rulers who would simply take it off them and banish them. In addition to hiding it, they would move it and invest it in businesses in remote provinces or even outside China. With the passage of time there emerged the offshore industry and tax havens culminating in money laundering and investment abroad and deposits in secret bank accounts. Money laundering has been used to move money resulting from crime, to hide and move it out of the reach of governments – including oppressive regimes and despotic leaders. Many minorities like the Jews have taken steps to preserve wealth from rulers, both un-elected and elected, who have targeted them simply because of their beliefs or colour. The term “money laundering” is often said to have originated at the time of the infamous American gangsterism that arose originally out of prohibition – the banning of alcoholic drinks. Several mechanisms were used to disguise the origins of the large amounts of money generated by the import and sale of alcohol and other “rackets” such as gambling, some of which were illegal. The term “Money Laundering” is said to have originated from Mafia ownership of Laundromats in the United States. Gangsters were earning huge sums in cash from extortion, prostitution, gambling and bootlegging. They needed to show a legitimate source for these monies. One of the ways in which they were able to do this was by purchasing outwardly legitimate businesses and to mix their illicit earnings with the legitimate earnings they received from these businesses. These gangsters chose Laundromats because they were cash businesses and this was an undoubted advantage to people like Al Capone who purchased them.

**Process of Money Laundering:** To understand money laundering as it is practiced today on a global basis, one has to appreciate money as a commodity. Professional money launderers differ little in this respect from corporate money managers. A corporate money manager enters the money markets of various countries where the corporation will need national currencies during the next year and buys/sells currencies in a constant effort to improve the manager’s average position at the time of payment. Similarly, money launderers use a bidding system to buy/sell drug proceeds, especially US dollars. Just as a sound investment portfolio will contain stocks, bonds and other monetary instruments, the money brokers vary their holdings. The operational principles of money laundering are a three-stage process which require, first, moving the funds away from any direct association with crime; second, disguising the trail to foil pursuit; and, third, making the money available to criminals once again while keeping its source secret. The deeper the “dirty money” goes into the international banking system, the more difficult it is to identify its original source. Financial criminals use legal tricks such as “walking accounts”, where banking officials have standing instructions to move accounts to another jurisdiction at the first hint of an inquiry by law enforcement officials. There are also common factors regarding the wide range of methods used by money launderers when they attempt to launder their criminal proceeds.

There are three stages of money laundering. These three stages in money laundering are:

**Placement Stage:** The first stage is the physical disposal of cash. The launderer introduces his illegal profits into the financial system. This placement is accomplished by depositing the cash in domestic banks or in other types of formal or informal financial institutions. This is done by breaking up large amounts of cash into less conspicuous smaller sums that are then deposited directly into a bank account, or by purchasing a series of monetary instruments (cheques, money orders, etc.). The cash is usually siphoned off across borders for deposit in foreign financial institutions, or used to buy high-value goods, such as artwork,



airplanes, and precious metals and stones, that can then be resold for payment by cheque or bank transfer.

**Layering Stage:** The second stage in money laundering is known as layering. "Layering" refers to the separation of illicit proceeds from their source by creating complex layers of financial transactions. Layering conceals the audit trail and provides anonymity. The launderer engages in a series of conversions or movements of the funds to distance them from their source. The funds might be channeled through the purchase and sale of investment instruments such as bonds, stocks, and traveler's cheques or the launderer might simply wire the funds through a series of accounts at various banks across the globe, particularly to those jurisdictions that do not cooperate in anti-money laundering investigations.

**The Integration Stage:** "Integration" refers to the reinjection of the laundered proceeds back into the economy in such a way that they re-enter the financial system as normal business funds. The funds re-enter the legitimate economy.

The layering and integration stages of money laundering are using more sophisticated money laundering techniques. Cash is now being held in bulk or placed into the financial system through exchange houses and other non-bank financial institutions. Not only is it moved through wire transfers but also through innumerable varieties of licit and illicit financial instruments, including letters of credit, bonds and other securities, and prime bank notes and guarantees, without a parallel increase in the capability of the far-flung elements of the world's financial system to verify the beneficiaries or authenticity of such instruments.

Techniques and Trends Drug trafficking and other criminal organizations have developed a series of highly specialized techniques and methods designed to remove the taint from the money and to place it out of the reach of law enforcement. The conducive conditions are:

1. Multiple entry points in the global financial system.
2. Rapid transmission of funds making the task of investigators difficult.
3. Lack of proper monitoring of movement of huge funds through banks and other financial transactions.
4. Temptation of bribery and corruption in the illicit financial world.
5. Existence of parallel/informal economies outside the control of government.

Currency smugglers use a variety of techniques to take money out of the country. However, four main avenues have been identified as being most favored by the smugglers, viz. air, sea, land and mail.

**Role of technology:** Technology has created a virtual free zone of financial activity by permitting the proliferation of financial centres outside the regulatory sphere. By aiding the fluidity of capital, technology contributes to a global market for both legitimate and illegitimate capital. It is now possible to move slush funds at the speed of light on roads where there are no policemen to call halt, custom or immigration authorities to detect and seize. Money laundering is no more a physical effort as in the past. Funds can be laundered without physically transporting them completely hidden to the attention of tax and enforcing agencies. Electronic cash, digital cash, digital currency and cyber currency are synonymous for an electronic medium of exchange.

Cyberlaundering by means of anonymous digital cash is the latest technique in money laundering. Digital cash is also known as electronic cash and is an electronic substitute for cash. It involves a number of series having an intrinsic value in some form of cash. Assets are transferred through digital communications with the help of identified representation of bills. All the players in the game have one trait in common: lack of anonymity – which is the feature of E-cash. Initially money laundering involved a physical effort to conceal the illegal source and application of income. The physical world of money laundering gave way to



electronic transfers to avoid detection, also known as wire transfers. Wire transfers are more reliable and provide a fast and risk free conduit for moving money between countries. It is not possible to keep record of transactions which makes the task of investigators difficult and thus increasing the possibility of successful laundering. An online payment product called “ecash” which is contributed by an Amsterdam-based company Digicash. It is designed for secure payments from any personal computer to any other workstation, over e-mail or internet. It uses public key digital blind signature technique and makes it impossible to link the payment to the payer. Perfect anonymity is maintained. But users can prove without doubt whether they made or did not make a payment without revealing anything more. This provides anonymity to the money launderers.

**Hawala:** Another way to move money is an underground system known as hawala. “For many people in remote areas of the world, the hawala system is faster, cheaper and more reliable than Citibank,” Wechsler said. Organized through a series of informal chits and promises, such a system can move huge amounts of cash. None of it crosses borders, and except for personal notes there’s no record of the transactions. Banks have three functions – warehousing savings, lending money, and settling obligations between customers. Advisory services are, in essence, developments or broking of one of these three. Parallel bankers strip out the basics and perform only one or more of those three functions. Underground Banking is sometimes called ‘parallel’ banking. These systems tend to mirror more conventional bank practices, but are highly efficient and use wholly unauthorized methods of transferring money around the world.

Hawala operates on trust and connections (“trust” is one of several meanings associated with the word “hawala”). Customers trust hawala “bankers” or “operators” (known as hawaladars) who use their connections to facilitate money movement worldwide. Hawala transfers take place with little, if any, paper trail; and, when records are kept, they are usually kept in code. Hawala is an ancient system; it was the primary money transfer mechanism used in South Asia prior to the introduction of Western banking. Today, hawala continues to be used for many legitimate transfers for cultural and financial reasons; and it also often operates in conjunction with Western banking operations. Some illicit money does not enter the formal banking system but is instead transmitted through underground or alternative banking systems such as the “hawala” in India and Pakistan. These “parallel banking systems are based on family or gang alliances.” They work without a paper trail. As Malhotra notes, a “Hawala banker issues neither a written receipt for the sum received nor an order for payment of rupees in India. What he does make is a firm verbal commitment to the seller of dollars to make an equivalent rupee payment, at the agreed rate of exchange, through his agent in India; he then sends a coded message to his partner containing the designated recipient’s name and the time, date, and address for the payment”. For such services the dealer can charge up to 15 per cent of the sum exchanged. In spite of the significant commission charges, the hawala system handles large amounts of money. Hawala is an ‘alternative remittance system’ predating traditional’ or ‘western’ banking used primarily in India and Pakistan. It can be exploited and abused for a wide range of illegal purposes. ‘Black Hawala’ is to refer to illegal transactions involving hawala. Certain aspects of hawala are contributing to significant problems in India, such as corruption and smuggling. In Pakistan, hawala is a component of corruption and drug trafficking. Elsewhere in the world, hawala has been found to be a component of many financial crimes, such as money laundering and tax evasion.

#### **Other techniques to circumvent anti-money Laundering legislation**

**Smurfing:** Smurfing consists of breaking down a large volume of cash in amounts less than the threshold



of the particular country's reporting requirements, thereby avoiding the requirement to justify the transaction. Smurfing is labour-intensive, expensive and time consuming, but it is still used by money launderers because it enables the disbursement of large amounts of bulk cash.

**The Use of Front and Shell:** Companies Restaurants, hotels, casinos, bars, nightclubs, dry cleaners, retail outlets, video rental companies, vending machine companies, parking lots of construction companies are cash intensive concerns. Money launderers use these as front companies where illegal profits can be commingled with revenues derived from legitimate undertakings. Front companies are of medium-to-large-scale money laundering operations and are used in both the placement and layering stages of the laundering process. Shell Corporations are businesses which have no commercial purpose. They are incorporated (normally in offshore centres which ensure anonymity) to conceal the true ownership of accounts and assets owned by the criminal organisation.

**Accounting Techniques:** Invoice manipulation – over-invoicing of imports and under-invoicing of exports – is an important money laundering technique used by front companies. Merchandise is purchased from abroad at an artificially high price. The difference between the invoice price and the actual price is deposited in a special offshore account.

**Private investment techniques:** The criminals' objective is to repatriate the funds parked in offshore shell companies. Repatriation is done by a "loan back" method. The criminal with a foreign account decides to make an investment which he secures with a down payment of legitimate funds. He arranges the balance payment by taking two loans – one legitimate and second, from foreign bank holding his illicit funds. He repays the loan and the interest as if both were legitimate. The income from the initial investment is fully documented and legitimate. He also repays the loan of his initial illicit funds, they are again available to him for "borrowing" and the cycle can be repeated.

**Acquisition of sick companies:** The launderer acquires total or partial management control of ailing business. He draws the benefit of the cover of a "clean front" company. When the money market is tight, the money launderer acts as a moneylender at higher rates of interest. In addition to the increase in currency smuggling the emergence of new payment technologies has presented new challenges. For many years the banking and financial services industry has been developing new methods of cash payments. One of these methods is generally referred to as "Cyber payments". A significant feature of the new cyber payments is that they include a new form of currency. Cyber payments also comprise other payment components, which emulate current payment systems. For example, already in use are cyber-cheques, cyber-credit and cyber debit. However, the problem for government and law enforcement agencies is that there is no way to track the card's transactions because, unlike Visa and MasterCard, there is no registration of the transaction. The inability to trace such funds presents an opportunity for the movement of illicit funds.

**Corruption and Money Laundering:** Money laundering and corruption are interrelated. The linkage is clear – those who take bribes must find safe havens where they can place their ill-gotten wealth. The bribe givers may themselves be willing to be conduit to place these funds in some far off banks. The banks come handy all over the globe in money laundering. International action is needed because bribes enable criminals to escape conviction for crimes that cause global damage: money laundering, environmental pollution, drug running, terrorism, etc. The state power and authority is misused by Heads of States, Ministers and top officials for private and pecuniary gain. The skill and magnitude of operations is so vast that it amounts to "corruption eruption". High-profile corruption scandals have rocked countries around the world. The





breaking down of order in Russia, the financial crisis in Asia, the scandals in Italy, Venezuela and Brazil were the result of mega-scale corruption. Grand corruption affects the quality of projects adversely. The bribe-givers often recover their money by compromising the quality of the projects at the cost of serious risks to the people. The acceptors of bribes will have no moral authority to demand quality from their paymasters. It has also been noticed that projects are approved not because the country needs them but because they provide the easiest opportunities to receive bribes. As a consequence uneconomic and inappropriate projects are selected.

**Money Laundering and Terrorism:** Terrorism Funding: According to the Monitoring Committee of the Security Council which observes the implementation of the UNSC Resolution Number 1373, terrorists' assets and funds worth \$ 112 million have been seized/frozen in the aftermath of September 11, 2001. It is estimated that the AlQaeda and its allies in the International Islamic Front (IIF) has about \$ 300 million at their disposal. Funds continue to flow and the organization is engaged in the acts of terror in different parts of the world. Similarly, funds continue to flow from Pakistan's ISI to the operatives of Harkat-ul-Mujahideen (HUM), the Harkat-ul-Jihad-al-Islamic (HUJI), the Lashkar-e-Toiba (LET) and the Jaish-e-Mohammad (JEM) to carry out terrorist acts against India. Transaction history of money laundering for funding terrorism is of little predictive use as the accounts are opened for very short duration. Transaction analysis is retrospective and therefore will give little information about the purpose of a transaction. This impedes efforts to provision early warning that an account is likely to be used for funding the activities of terrorists. Moreover the amount involved is small which does not fall within the ambit of cash transaction reporting nor suspicious transaction reporting system. Even the enforcing agencies will not be geared into action as they would hardly have any time before terrorist act to respond to a withdrawal of money for terrorist purposes. Terrorists transfer millions of dollars into untraceable accounts. They also finance and smuggle commodities like diamond and gold to avoid seizure abroad. Diamonds can be smuggled across borders without detection.

**Effects of money laundering:** Mr. Stanley Morris, Chairman of the OECD's Financial Action Task Force (FATF) Working Group on Statistics and Methods, stated that "the need to estimate the size of money laundering and quantify its constituent parts has been a concern of the FATF since its initial report".

He concluded however "there is not at present any economic deus ex machina that will allow the accurate measurement of money laundering worldwide, or even within most large nations. The basis for such estimations simply does not exist." What is defined as a crime in one country may not necessarily be a crime in another. The most profitable crimes in some countries may not be profitable in others. Criminals in some countries might choose to launder their profits, while those in other countries might simply spend them. To this extent, Morris's conclusion that there is no single model that explains money laundering may be correct.

**Anti-money laundering in India:** In view of the increased concerns regarding money laundering activities and to prevent AMCs from being misused for such activities, Reserve bank of India has formulated suitable policies and procedures in this regard. To enable AMCs to put in place the policy framework and systems for prevention of money laundering while undertaking money changing transactions, the Reserve Bank has brought out detailed Anti-Money Laundering (AML) guidelines. The purpose of prescribing Anti-Money Laundering Guidelines is to prevent the system of Authorized Money Changers (AMCs) engaged in the purchase and / or sale of foreign currency notes/Travelers cheques from being used for money laundering.



**Anti-money laundering legislation in India:** To achieve the objective to curb money laundering, the Prevention of Money-laundering Bill, 1998 was introduced in the Parliament. The Bill was referred to the Standing Committee on Finance, which presented its report on 4th March, 1999 to the Lok Sabha. The Prevention of Money-Laundering Bill having been passed by both the Houses of Parliament received the assent of the President on 17th January, 2003. It came on the Statute Book as THE PREVENTION OF MONEY-LAUNDERING ACT, 2002.

**The Prevention of Money Laundering Act, 2002 (PMLA):** The Prevention of Money Laundering Act, 2002 (PMLA) enacted to prevent money laundering and provide for confiscation of property derived from, or involved in, money laundering Enacted on 17Th Jan, 2003 Brought into force from 1st July, 2005 which is administered by:

- 1).Financial Intelligence Unit for verification of identity of clients, maintenance of records and reporting.
- 2).Enforcement Directorate for investigation of and prosecution for money-laundering offences.

**Rules detailing the legal obligations of reporting entities:** Prevention of Money Laundering (Maintenance of Records of the Nature and Value of Transactions, the Procedure and Manner of Maintaining and Time for Furnishing Information and Verification and Maintenance of Records of the Identity of the Clients of the Banking Companies, Financial Institutions and Intermediaries) Rules, 2005 Legal Obligation under PMLA.

**Conclusion:** Money Laundering is a serious threat to financial system of all countries and it leads to destruction of the country's sovereignty and character. The combating of money laundering has assumed an urgent impetus at both national and international levels as a result of the scale that money laundering has begun to assume, especially with respect to the financing of terrorist acts. The negative economic effects of money laundering on economic development are difficult to quantify, just as the extent of money laundering itself is difficult to estimate. Nonetheless, it is clear from available evidence that allowing money laundering activity to proceed unchallenged is not an optimal economic-development policy because it damages the financial institutions that are critical to economic growth, reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, and can distort the economy's international trade and capital flows to the detriment of long-term economic development. The efforts being made to combat money laundering are beginning to bear fruits in that it is now taking center stage in all jurisdictions. Black money and Money laundering are hot topic that a government needs to focus on. In India BJP led by Shri Narendra Modi won the 2014 Lok Sabha elections on the poll promise of curbing black money and bring it back to India and AAP led by Mr. Arvind Kejriwal won Delhi elections by the promise to curb corruption and bring Jan Lokpal in Delhi. We have to understand that it is problem not only for the government of the country but for the people at large. Public awareness is necessary as masses do not understand the problem itself. Our education system should be able to inculcate the ideologies that our future generation does not get involved in this process. There needs to be a vigilant mechanism and our judiciary needs to punish these criminals early to send out a message that money laundering is not tolerable to this democratic society.

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