

# THE CONVERGENCE OF TELECOM AND FINANCIAL SERVICES AND ITS EFFECTS ON AML/CFT WIRE REMITTANCE OPERATIONS

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Fast-moving technology that is bringing about the convergence of telecom and financial services is challenging the cash-based premise of current anti-money laundering (AML) efforts. The cellular phone value transfer system is one of these convergence areas. In the Philippines this transfer system is currently very well controlled and deemed greatly beneficial to consumers as it greatly facilitates remittance flows from migrant workers, reduces cost to the poor, and is convenient to use. Careful thought however should be given to the effects of this fast growing phenomenon on AML operations and legal regimes.

In this presentation we will review a typical cash-based remittance money laundering operation; examine how it was brought to successful fruition and how the use of small payments technology may provide beneficial and possibly not so beneficial outcomes for the future.

## I. MONEY LAUNDERING THE OLD-FASHIONED WAY

### A. The Simple Drug-Trade Model

The simple drug-trade business model calls for drug-producing organizations in the home country to focus on product development and packaging, to develop ways to nullify or limit regulatory and security efforts, and to develop a culture of corruption, including systems of drug transportation. In the target country they need to focus on market penetration in the target country through development of sales networks, and revenue collection mechanisms which may include both direct and outsourced collections — via brokering, profit repatriation and investment.

### B. Cash Is Heavy but Still King

Drugs and terror financing at the street level generally involve cash collections and, in the USA, most street drug sales generate cash in small denominations of under \$100. Booming drug sales mean booming volumes of cash. Each kilo of cocaine sold generates 3 kilos of cash in street collections of \$10s and \$20s. Five million dollars in \$100 bills is a stack 20 feet high.

The quantity and velocity of drug money is high risk to the criminal organizations. It invites competitors and law enforcement to target the collection and consolidation points—known as “stash houses”. Bulk cash movements are risky and even though heavily used, the organizations are always looking to find a safer way to move the cash around.

### C. How to Launder a Million the Old Fashioned Pot Smuggler’s Way

The most basic of these schemes, as outlined in the attached diagram (compliments of the Rolling Stone magazine and author Robert Sabbag), is the use of bulk cash movements where the cash is flown out of the collection country, moved via cargo or mail to an off-the-shelf company in a haven country. The off-the-shelf company is only a shell, with merely a bank account opened under a corporate name. Money is “borrowed” from the corporation in the haven country and wired to a subsidiary company of the drug organization to open a front business that is cash-based (for example a retail store) to cover the illegal funds being supplied by the offshore account. The money is reported to tax authorities as revenues to keep the authorities happy and the resulting net funds are successfully “cleaned”.

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#### **D. How to Launder A Million Dollars—the Government-Destabilizing Colombian Drug Lord Way— Compliments of Rolling Stone Magazine<sup>1</sup>**

Mr. A is a Colombian drug lord. A million dollars he has made from cocaine sales sits in New York in need of deodorizing. Mr. B is a legitimate Colombian businessman who wants to buy a million dollars worth of American computers but his government wants 21 cents on every American dollar he buys with pesos. As a solution they both contact a money broker who takes care of their needs for a nominal fee, following these steps: 1) the million dollars is smurfed (transferred in tiny amounts) or hauled overland to an account in a Mexican bank; 2) the broker writes a check for \$1 million at a New York correspondent bank and gives it to XYZ computers; 3) XYZ computers ships Mr. B his machines from its Panamanian free-trade zone warehouse; 4) Mr. B gives the broker a million dollars worth of pesos; and 5) the pesos become squeaky-clean pocket change for Mr. A. This results in a \$6 to \$8 billion annual loss in revenues to the Colombian government.

#### **E. The New York City Situation**

In the year 1995, over \$900 million flowed through 23 licensed money remitters to Colombia based on payment order data. Census figures show there are only 25,521 Colombian households with incomes of approximately \$27,000 or \$689,067,000 in total. Even given a significant allowance for undercounting, \$900 million is a suspiciously large amount of remittances. A street survey by the “El Dorado<sup>2</sup>” Task Force indicated that an average remittance was valued at \$250-\$300 per transaction. The El Dorado study focused on wire transfers and not other forms of remittances like checks, money orders or cash in the mail. US Treasury estimated, based on the flow patterns, that about \$400 million was being laundered. Operation Wire Drill had as its mission the behaviour modification of the wire remittance industry in New York City (NYC).

#### **F. Things Get Out of Hand**

Things got out of hand and the El Dorado Money Laundering Task Force and Department of Justice requested the US Treasury Department to issue a Geographical Targeting Order (GTO) to examine NYC remittance flows to Colombia. The GTO is used to impose stricter reporting and record keeping requirements on specified financial service providers in a certain geographical area for a limited time. At first, 12 remittance license holders were involved but then it was expanded to 23 covering approximately 3,200 store fronts. The Order required a special remittance form to be filled out and ID presented for transactions in excess of \$750 going to Colombia.

The EL Dorado Task Force coordinated with DIAN, an investigative agency under the Colombia Treasury Department, and with local law enforcement in New York as the Order took effect. Disruption in the laundered funds chain in NYC caused the drug organizations to turn to other methods, primarily bulk cash movements. Undercover operations, highway, and outbound port seizures saw dramatic increases in activity. There was an increase of \$63 million in cash seizures at ports of Miami, Boston, and NYC over the seizures made during the previous year.

#### **G. Aftermath**

The aftermath of the Geographical Targeting Order and Operation Wire Drill was a drop in remittance costs in NYC from 7% to 3.5%. Drug money was forced out of the marketplace causing wire remitters, who relied on the drug trade, to drop their fees for legitimate customers. There was also an increase in bulk cash seizures in USA and Colombia. Remittance cells were hit in NYC with more than 100 arrests and resulting convictions and approximately \$13 million seized. Anti-Money Laundering requirements for Money Services Businesses were enhanced in USA and Colombia. Crackdowns on unlicensed remitters in Colombia and USA took effect. Creative use of a trade-based targeting system used to identify trade anomalies proved effective in tracking the displacement for payment orders and remittances. Money laundering patterns in NYC then shifted to commodities, bank drafts, and other transfer methods.

#### **H. The Indispensable Money Broker**

Money brokers are very active and important actors in the drug trade. They serve as intermediaries

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<sup>1</sup> Sabbag, Robert. Rolling Stone Magazine, August 21, 1997 pages 82 and 86.

<sup>2</sup> The El Dorado Money Laundering Task Force was a multi-agency law enforcement entity operating as an integral part of the New York New Jersey High Intensity Drug Trafficking Area Task Force.

between drug, cash, and domestic importers. They operate fairly openly where importers shop for US Dollars. Why? A surplus of cash from the drug trade reduces the exchange rate on the black market, plus no taxes and tariffs are paid. Buyers could save as much as 21% on a foreign exchange transaction. Brokers' commissions are based on the location and type of financial instrument used to transfer value, and a wire transfer is the lowest risk - highest value instrument.

### **I. Smurfs - the Money Launderer's Army**

Smurfs are workers in the money launderer's army. Smurfs fan out and spread small denomination drug deposits at remittance centres, open multiple bank accounts, and purchase money orders and traveller's checks at the direction of money brokers. Detection systems spurred on by government oversight and penalties have slowed this option down in recent years.

### **J. Wire Remittance Payment Orders—the Crown Jewel**

Criminals constantly look for ways to infiltrate or establish wire remittance outlets to convert cash into the prized wire transfer orders. The payment order is the primary accounting document and serves two purposes: as an invoice to account for cash received and as a receipt for the customer. Because Payment Orders are required under law to have specific information (including: names of sender and recipient, telephone numbers, transferred amount and the fees charged) generating false payment orders became a cottage industry for money laundering in NYC. Phone books were used to create fictitious senders and recipients, other customers' information was used, and various combinations of individuals' information were used to cover the placement of drug cash.

### **K. Remittance Industry Vulnerabilities**

#### **1. Franchisees/License Holders**

Franchisees and license holders need to be vigilant for instructions to transfer funds that are inconsistent with the other details of the payment order. If franchisees or license holders choose to be "wilfully blind" to criminal activity, they can be prosecuted. Some franchisees were in fact operated by criminals.

#### **2. Store-Front Outlets**

Store-front outlets that are used as remittance centres are usually working for multiple license holders making it hard to detect money laundering patterns. There are usually many locations giving smurfs easy access. Large cash deposits, night depository drops, and armoured cars make it easy to cover money laundering activities. The storefronts are authorized to validate identity documents making it easy to assist the smurfs. They create the payment order—easy to launder or structure transactions for smurfs. They are usually connected to paying agents in foreign countries making it easier to use codes or other methods to launder. They also are usually involved in marketing other products making it easy to cover lack of real remittances.

### **L. The Tools Used By Law Enforcement**

The tools used by law enforcement to track down these types of operations include the Bank Secrecy Act which required the reporting of cash and provided the capability to bring into effect the Geographical Targeting Order, the Money Laundering Act of 1986 and the "sting provisions" of the Act, which were the legal provisions for a certified undercover operation with on-hand cash and operational flexibility.

Most importantly, the criminal and civil forfeiture laws were enacted and an Asset Forfeiture Fund created which permitted law enforcers to share and use a portion of the forfeited criminal funds for operational purposes. This was one of the key elements that held the various law enforcement agencies together under the El Dorado Money Laundering Task Force.

The purpose of the undercover operation was to place the government between the street cash and the money broker/launder in an attempt to understand the process, identify the conspirators and build criminal and civil investigations against the criminals for money laundering or other crimes. Operation Wire Drill was one such investigation that focused on modifying the behaviour of the wire remittance industry in NYC.

### **M. Lessons Learned From the NYC/GTO and Operation Wire Drill**

Lack of effective AML supervision can cost money-service businesses money and destabilize the

economy of the target country. Taking criminal funds out of the transfer system will help to drive down remittance costs to the legitimate customer as we have seen above. The use of new technology to address old problems still brings us back to the basic question—who is the sender and receiver? Consider the use of an AML monitor for noncompliant firms. Some firms were cleaned up using this method. Use non-law enforcement data to help identify the size of the problem. And team agency members from various disciplines to pursue launderers. Focus on systemic money laundering issues, try to modify bad behaviour and continue until the job is done.

#### **N. The Wire Drill Group**

The Wire Drill group continued on spinning off significant cases from the remitter activity. One was the use of gold items such as screws and belt buckles, to laundering based on undercover operations, and the trade-based money targeting systems. In one case, developed as a GTO investigation, seven years led to the arrest of four Colombian North Valley cartel kingpins smuggling one million pounds of cocaine into the United States, laundering \$10 billion dollars using bribery, murder, and wiretaps on rival drug traffickers. One group member, previously arrested for GTO-related money laundering investigations, also committed more than 34 homicides at the same time he was laundering cartel money through three remittance store fronts he owned in NYC.

#### ***Secretary Rubin's Question***

More visionary than the Wire Drill team, in July 1996 then US Secretary Rubin asked, "What do you and your team think about the electronic wallet idea? Will it affect your operations?"

The Wire Drill team responded, "Well, Mr. Secretary, until the day comes that a drug dealer and the buyer can find a safe and easy way to exchange dollars for drugs it won't affect our anti-money laundering operations. It will be still cash-centred".

## **II. MONEY-LAUNDERING INNOVATIONS**

### **A. The Electronic Wallet (1996-2002)**

Secretary Rubin was referring to the electronic wallet of Europe, which did not catch on for a number of reasons. The inconvenient technology made the devices cumbersome to use. After the Atlanta Olympics, the electronic wallet designers went back to the drawing board to work out problems but some technical glitches remained and more importantly, people's preference was for cash. To make matters worse, banks viewed the new technology effort as competitive pressure that would cost the bank clients and they were not happy to lose business. A lot was said about the authentication protocols, a possible digital "know-your-customer". In sum, these efforts were ahead of their time, the technology infrastructure to support them was not ready, and user acceptance was low.

### **B. The Convergence of Financial Services and Telecommunications**

#### ***Secretary Rubin's question resonates in 2004***

In November 2004, Secretary Rubin's question resonated during a presentation at the Asian Development Bank (ADB) in Manila, Philippines, where representatives of Globe Telecom, a cellular phone operator, explained their G-Cash product, and its myriad applications, to an interested audience. What was discussed was peer-to-peer cash transfer in an easy, safe, convenient manner, among other things. Would this be the system that would replace cash in drug sales or other criminal activity, would it cause a paradigm shift in law enforcement operations? Or would it provide a sea change for the good guys and deny the cover of legitimate remittance to the drug trade and terror financing, helping to close this avenue of abuse? Which of these alternative futures will prevail is not yet clear, but the story in the Philippines is a good one and bodes well for the future. The question is whether or not continued progress in technology and market forces will eventually overtake that well-designed system as well. Let's see.

### **C. The Wireless Situation in the Philippines November 2004**

In November 2004 there were three wireless providers in the Philippines. Sun Telecom was very small and still emerging - it had not developed a value transfer programme at that time. The Philippine Long Distance Telephone (PLDT), the largest telecommunications company in the Philippines was the parent company of Smart Telecoms who started Smart Padala, a bank-based remittance system in conjunction with local bank Banco de Oro.

Globe Telecom rounds the field out as the second largest wireless provider, and the only one at that time with peer-to-peer (P2P) value transfer. Globe is a good solid firm and was awarded a prize from an international technology panel in France for the G-cash technology. In November 2004, Globe's G-Cash had 20,000 subscribers and by March 2005, it grew to 320,000 subscribers. By January 2006, the total registered users had grown to 1.2 million.

#### **D. Philippine Cellular Phone Facts**

The Philippine wireless market is somewhat unique. It has the largest population of Short Message Service (SMS) users in the world and has a very mature market for SMS services, as the "texting" capital of the world. Ninety five percent (95%) of the market is prepaid rather than post-paid. This is for a lot of reasons—lack of credit, convenience for operator and user, extensive infrastructure to support prepaid cards. Thirty five percent (35%) of the population has a cell phone; while 95% of the remaining has access to a cell phone through friends or family members. Even geographically inaccessible locations normally have cell phone coverage.

#### **E. Why it Works**

The Philippine wireless value transfer system works well for a number of reasons: there is a convergence of technologies and services at low cost that is easily understood by the market, and uses the most accessible device in the Philippines - the cell phone.

Overseas remittances from the Middle East, other parts of Asia, USA, and to a lesser degree Europe, account for an estimated value inflow of \$7 to \$8 billion a year. Most experts consider it most likely to be 25% more. The figures are vague and amorphous due to statistical collection methods and the variety of transfer methods. One thing certain is that, as in the NYC scenario, remittances are normally in small amounts, usually \$200-\$300. Remittance volume spikes on holidays, as expected.

From a remittance standpoint, the Philippine system also responds to first and last mile issues. The "first mile" is that time a person has to take to get the remittance or value into the system in one location and the "last mile" represents the efforts needed to deliver the value/money to the recipient. Near-universal cellular site coverage in the Philippines eliminates the last mile.

Other features like the SMS direct transfers and the salutations that can accompany the value transfer, line notations of an event like "Happy Birthday", "Happy Anniversary" or "Study harder or I won't send any more money", make the system more appealing. In the end, the system reduces or eliminates the first and last mile in most cases. The value transfers of very small permitted amounts puts the system in the realm of most people and does not give rise to money laundering concerns. The system is also inexpensive for small businesses since they need no special equipment other than a cell phone.

#### **F. Who Benefits**

It benefits many sectors, mainly those with no bank accounts, since there is no need to maintain an account balance even with Smart. Also, the poor on limited incomes and those remotely located now can conduct limited financial transactions. The overseas foreign workers remittances, from where a major percentage of the country's incoming cash flow is generated, are a major support for the Philippine economy. The Government also benefits - from more accurate remittance flows, better view of transfers and overseas connectivity; petty corruption in government is eliminated when citizens can pay for its services directly. Businesses are happy about fast settlement of accounts. As mentioned earlier, there are no requirements for major systems purchases at points of sale (POS). Money launderers do not have a significant entree at current Philippine standards – CFT? That could and will change within the next year as the technology evolves.



## G. How Does It Work?

Figure 1: G-Cash Phone-to-Phone Remittance



Sender enters amount and PIN,  
then sends to mobile number of  
recipient.

Sender and recipient receive an SMS  
advisory message, with a corresponding  
trace number.

Source: Gartner Research (February 2005)

Figure 2: G-Cash Purchase at a Registered Outlet



Merchant keys in sell  
command, amount, PIN and  
mobile number of recipient.

Subscriber receives SMS,  
requesting confirmation,  
and replies with yes, PIN  
and reference number to  
confirm.

Merchant and subscriber  
receive SMS  
confirmation of the  
deduction; merchant  
releases product.

Source: Gartner Research (February 2005)

## H. How is the G-Cash Regulated?

G-Cash is regulated by Bangko Sentral ng Pilipinas (BSP) and the Anti-Money Laundering Council

(AMLC) of the Philippines as a money services business. The AMLC set strict limits agreed to by Globe - a maximum per transaction value of PhP10, 000 (\$182), a maximum per day of PhP40, 000 (\$750) and a maximum per month of PhP100, 000 (\$1,825). In addition, G-Cash remains a closed system - you must be a Globe subscriber and register with Globe to receive value - thereby fulfilling the AML "Know Your Customer" requirements. Customers can load cash into G-Cash in the form of prepaid cards, Globe e-Load website, bank accounts or Globe sales stores. They can withdraw cash by filling out a withdrawal form at the point of sale (POS), at G-Cash ATM's (wireless, card-less), Globe outlets and participating banks. All withdrawals require a form to be completed. The system worked out by Globe and the BSP/AMLC is a good model: it has controls on cash in and cash out, it is a closed system and the amounts transferred are reasonable and small.

### **I. Smart Telecom**

G-Cash is not alone in the market. Its big brother is Smart Communications, a subsidiary of the Philippine Long Distance Telephone Company (PLDT), a long established firm, and the dominant fixed-line telephone operator in the Philippines. Smart is the leading wireless provider in the Philippines with 12.5 million subscribers, of which 98% are prepaid users. Together Globe and Smart control 98% of all the GSM phones which account for 92% of the market. Like Globe, Smart is an innovative and dynamic company. It offered the world's first electronic cash card linked to mobile phones back in 2000. In this effort it has teamed with Banco de Oro, a large commercial bank. In August 2004, it offered the first text-based remittance system - Smart Padala - which focused on overseas Philippine workers and tied to a large number of retail and service locations.

### **J. How is Smart Money/Padala Regulated?**

Smart differs widely from Globe from a Philippine regulatory perspective. The BSP regulates Smart as a bank (as opposed to regulating Globe as a money-service business) due to the existing partnership with Banco de Oro. It is viewed as a bank-centric model because all value transfer subscribers need to have accounts/access cards and have customer due diligence preformed by Banco de Oro or other banking partners. Because of its banking status the limits are higher; 10 transactions per day with a PhP100, 000 a day limit (\$1785).

### **K. Philippine Regulatory Regime in Sum**

There are two models in the Philippines: Globe, as a telecommunications company is viewed as Money Service Business (MSB)<sup>3</sup> - telecom centric. Smart, since it is tied to Banco de Oro, is viewed as bank-centric. Each firm is compliant with BSP AML requirements relative to ID for subscriber and beneficiary as well as valid ID required for both parties to obtain services of cash in cash out. Globe and Smart both use pattern recognition systems, which is a necessary and complementary part of both anti-fraud and AML to monitor account/subscriber activity. Both are required to report any suspicious activity to the AMLC. Both are also subject to AML compliance examinations by regulators. At this time everything looks good from a regulatory perspective but what does it all mean going forward?

## **III. CONCLUSION**

### **A. What Does it Mean for Law Enforcement?**

Is this a paradigm shift from cash to digital money? The easy peer-to-peer funds transfer makes Secretary Rubin's far-sighted question more relevant today than in 1996 when it was first posed. Wireless transfers through international roaming opens up new possibilities for abuse by money launderers if the systems are opened up and value transfer limits are increased. These developments will create a need for increased international cooperation and data sharing of data analysis on suspect accounts. Thought will also have to be given to KYC requirements in this digital age; perhaps a digital KYC needs to be explored on an international level. SIMs can be easily compromised, retrieved from stolen phones, and with the advent of third generation (3G) phone technology, can carry more than one phone number, possibly acting as a "digital smurf".

Anti-money laundering law enforcement operations will need to be more visionary. They need to plan to move beyond traditional pick-up and surveillance operations to other more pro-active strategies - these will

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<sup>3</sup> MSBs are those firms that fall outside of the traditional banking system but provide regulated financial services.

require a high level of technical skills. To support these initiatives, mobile commerce (M-commerce)/M-AML legislation relative to search, arrest and seizure may need to be enacted. There will need to be more emphasis on "cyber-AML" capacity-building and tools. If open system between providers is allowed, then AML controls will need to be rethought.

#### **B. Other Things to Think About**

As I mentioned, SIMs can be easily compromised, duplicated, retrieved from stolen phones, and - with the advent of 3G, cellular phones can carry more than one phone number, possibly acting as "digital smurfs" or "bots". Street operations groups will need to think about the phones as much as (or instead of) the cash. The key question is: Where does the value lie and who controls the transactions? The answer to this is not easily obtained through mere observation.

Current forfeiture, also laws, may not fit the coming environment, which will affect asset-sharing arrangements. Undercover operations of the future need to consider and plan for these eventualities.

Are you ready for the end of cash? In a cashless crime world, who investigates? How do they do it? How do you prepare?

#### **C. Can This Wireless Train Be Slowed Down? – Not Likely**

The likelihood that the G-Cash wireless value transfer model will remain an exclusively Philippine model or meet with only limited success - like the electronic wallet of the late 1990's - is not likely. It is a well thought-out award winning programme that helps the overseas workers get money home efficiently. It is also being used for direct payment for government and business services, charities, microfinance, and others. A cell phone now means access to a wide variety of financial services with more to come with the advent of the 3G (third generation cell phone). G-Cash, started in 11/2004 started with only 20,000 subscribers, has taken the Philippines by storm and by 01/2006 had in excess of 1.2 million subscribers.

There is also significant international interest in M-Commerce within Asia. Globe partners include Bridge Mobile Alliance - Airtel (India), CSL (Hong Kong), Globe Telecom (Philippines), Maxis (Malaysia), Optus (Australia), SingTel (Singapore) Taiwan Mobile (Taiwan) and Telkomsel (Indonesia). Together, the operators have almost 70 million mobile subscribers. We can expect more major regional efforts soon.

Smart is not standing still either; they are currently rolling out 3G phones. According to Smart, 3G is shorthand for the next generation of mobile communications networks running on the WCDMA (Wireless Code Division Multiple Access) platform. This technology allows for faster data transmission speeds from 114 kbps up to 2 Mbps, making possible high-speed data communications and mobile multimedia services such as video conferencing, audio streaming and mobile internet. All those changes will support mobile banking of which Smart is the Philippine leader.

Some other efforts include Japan's NTT-DoCoMo recently launched i-mode FeliCa (TM) Mobile wallet which is also a closed system but with Radio Frequency Identification Device (RFID) swipe capability. Korea's SK Telecom MONETA has m-financial services via internet and the MONETA card. Sun Java programmes and Microsoft's new m-commerce applications for cell phones will speed up m-commerce applications. If the system operates on a peer-to-peer transfer basis, then the drug money laundering model described above could be easily adapted using the wireless transfer systems.

#### **D. Where Does That Leave Us?**

Back in Manila. What do these changes mean to law enforcement and AML/CFT specifically? The AMLC asked ADB to do a study on possible international cell phone value transfer standards for submission to the Asian Pacific Group on Money Laundering (APG). A first draft of the report was submitted and is undergoing finalization. The report will not be a definitive work but a seminal work in M-Commerce/AML. The purpose is to open the dialogue to prepare us for the fast moving wireless digital world effects on AML. Let's hope it does its job

I would like to thank the Philippine Government, in particular the BSP and the AMLC for permitting ADB to examine their process. I wish you all luck and good fortune pursuing the money launderers in your countries.