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# Illicit Trading in Nepal: Fueling South Asian Terrorism

*PRIO South Asia Briefing Paper #3*

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## Illicit Trading in Nepal: Fueling South Asian Terrorism

### PRIO South Asia Briefing Paper #3

#### Executive Summary and Recommendations

A tight-knit network of informal traders is exploiting a vacuum of law enforcement in southern Nepal to generate significant operating capital for the Pakistani militant group Lashkar-e-Taiba (LeT). The traders employ the same money laundering techniques as others in Nepal did a decade before, as the legal loopholes, lack of infrastructure, and widespread corruption that created these opportunities were not addressed. Nepal and India continue to focus on individual criminals in their attempts to shut down the networks, rather than reforming the structural conditions allowing the networks to operate. As a result, the traders operate in an environment conducive for the creation of vast sums of informal wealth with few barriers to operation and at little risk.

#### Short-Term Suggestions

- 1) **Arrest the criminals without destroying the *hawala* system.** Large scale raids are counterproductive, as most overseas workers require *hawala* to support their families. Reform can be achieved by integrating legitimate *hawaldars* into the formal banking sector, provided they comply with transparency and recordkeeping guidelines designed to decrease the likelihood that they are unknowingly laundering money.
- 2) **Improve Indo-Nepal bilateral relations through border security.** India and Nepal should jointly consider how border security policy can be more than a zero-sum game. Mutual cooperation on border security strategy benefits both bilateral relations and internal stability. Frameworks whereby either country could propose a joint operation on an ad hoc basis, keeping authority clearly under control of the host country, can build trust without encroaching upon sovereignty. Further, the link between corruption and national security needs to be recognized and problematized.
- 3) **International actors** can contribute to Nepal's security at border points by providing logistical support, providing equipment and securing directed funding to modernize and bolster existing checkpoints. The United Nations should maximize Nepal's request for increased border security assistance. Countries hosting direct flights to/from Kathmandu should increase scrutiny of incoming passengers for illicit materials.

#### Long-Term Suggestions

- 1) **Roll back the growing culture of corruption.** Nepal's culture of corruption is pervasive at the individual, local, regional, and national levels. Practical measures can reduce demand, but punitive approaches may backfire in a society where the judicial system is itself corrupt. Nepal has steadily deteriorated in both real and comparative terms regarding corruption indicators, but leadership-by-example can be a powerful attitudinal tool for change, and need not involve massive bureaucratic undertakings.
- 2) **Comprehensive banking sector reform** would include a trident of reforms to prevent graft, institutionalize checks and balances for day-to-day operations, and increase the availability of services in areas currently underrepresented. However, opening more bank branches catering to microcredit needs can be counterproductive. Indian efforts to push more money flows through the formal sector could also be adopted by other countries.
- 3) **Create and enforce anti-corruption and pro-transparency laws.** The challenge of prosecuting transgressors is immense, as suspects are put into the hands of a poorly-paid, corrupt judicial system that lacks legal precedent and impartiality for its most difficult cases. Solutions must also incorporate Nepal's youth population as stakeholders, emphasizing rule of law over militancy, informal trade and corruption.
- 4) **International donors** should continue to tie funding to the implementation of banking, money laundering and counter-terrorism measures that raise Nepal's laws and oversight to international standards. Although conditionalities are unpleasant, they have a proven track record in Nepal of forcing needed legislation on the agenda in Kathmandu.

## Introduction

A tight-knit network of informal (or black market) traders is exploiting a vacuum of governance and law enforcement in southern Nepal and the Indo-Nepal border area to generate operating capital for Lashkar-e-Taiba (LeT), a militant group in Pakistan. The traders employ many of the same funds generation and laundering techniques as others in Nepal did a decade before, as the legal loopholes, lack of infrastructure, and widespread corruption that created these opportunities were not addressed. In attempts to shut down the network, Nepal and India continue to focus on individual criminals, rather than reforming the structural conditions that allow the networks to operate. As a result, the traders operate in an environment conducive for the creation of vast sums of informal wealth with few barriers to operation and at little risk.

## Background and Present-Day Situation

The Terai region of Nepal encompasses the southern belt of the country and the entirety of Nepal's southern border with India.<sup>1</sup> The Terai houses roughly half of Nepal's 26 million inhabitants, but there is little police or government infrastructure, and those few officials who are posted are often extremely corrupt. As a result, the Indo-Nepal border is one of the most illegally trafficked borders in the world due to its openness (Indians and Nepalis are not required to show identification), length (approx. 1800 km), generalized condition of lawlessness, and strategic location as an overland trade route crossroads between West Asia, China, India and Southeast Asia. Illustrating the power of criminal organizations in the area, locals now call the criminal-police nexus that controls border districts the 'Jungle Raj' (Law of the Jungle).<sup>2</sup>

The geopolitical environment of the Terai is favorable to facilitating criminal smuggling activities and hosting safe havens; conditions that have attracted the interest and followers of LeT. Originally focused on fighting Indian forces in the separatist struggle in Kashmir, LeT has expanded its mandate and is believed to be responsible for several attacks in Indian cities over the last ten years, including the November 2008 attacks in Mumbai. LeT was officially banned in Pakistan in 2002, but Pakistan's Inter-Services Intelligence (ISI) bureau is alleged to maintain a working relationship with the group. The degree of cooperation between ISI and LeT is hotly debated, but regardless of the strength of links to the upper echelons of power in Pakistan, LeT remains a serious militant group in South Asia, responsible for several large-scale terrorist attacks.

Indian intelligence agencies have been suspicious of LeT involvement in Nepal since at least 1990.<sup>3</sup> In 1999, rumors of LeT activity in the Terai came to a head when Indian Airlines Flight IC 814 from Kathmandu to Delhi was hijacked and diverted to Kandahar, Afghanistan. This was followed by a 78 page secret report by India's Research and Analysis Wing (RAW) entitled "The Nepal Gameplan," leaked in 2000 by the news magazine India Today. The "Gameplan" pinned the hijacking on the ISI and LeT, accused of jointly coordinating 26 criminal organizations operating in the Terai with 66 ISI-funded, LeT-run *madrassas* along the Indo-Nepal border.<sup>4</sup> The report claimed that ISI

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<sup>1</sup> For more information on the growing lawlessness in the Terai, see Miklian, Jason, 2008. *Nepal's Terai: Constructing an Ethnic Conflict*. PRIO South Asia Briefing Paper #1.

<sup>2</sup> Author interviews, November 2008.

<sup>3</sup> Ahmed, Farzand, 19 June 2000. "Wake-Up Call." India Today.

<sup>4</sup> "The Nepal Gameplan," India Today, 12 June 2000. The report has since been removed from India Today's website. Although "Gameplan" makes a number of strong claims, most have since been independently verified by scholars who have examined them, and no primary assertions were debunked. See Saikia, Jaideep, 2000. "The ISI Reaches East: The Anatomy of a Conspiracy." South Asia Terrorism Portal. <http://www.satp.org/satporgtp/publication/faultlines/volume6/Fault6-JSaikia-F.htm>. Accessed 10 January 2009; and Sudhindra Sharma, 2004, "Muslim Population in the Terai: Security Perspectives," in *India-Nepal Relations: The Challenge Ahead*, Observer Research Foundation, New Delhi.

agents were using locations in Nepal as safe havens to prepare for attacks in India, that the ISI earmarked over \$185,000 for LeT Nepal operations in 1999, and that LeT-affiliated traders in Nepal were sending up to \$4 million USD per year back to Pakistan from gold and currency operations to replenish LeT coffers.<sup>5</sup>

The official response from Kathmandu was swift and angry. Then-Prime Minister G.P. Koirala called the report “a despicable attempt at casting aspersions on the friendly relationship between Nepal and India.”<sup>6</sup> However, several Nepali officials privately confirmed the accuracy of the report, lamenting the dual indignity of being exposed on the matter by a foreign intelligence agency, and of being unable to control militants within their own borders, admitting that “in Nepal, their arms are longer than the law.”<sup>7</sup> Adding credibility, several Nepali politicians, smugglers, and officials at the Pakistani Embassy in Kathmandu were later arrested on various charges related to the report. These convictions and subsequent deportations stemmed the tide of illegal trading for a period of years, but the structural environment that facilitated these activities remained unchanged. Inaction and inattentiveness from Kathmandu gave the networks an opportunity to rebuild, and they now operate in a similar or greater capacity than before.

When Nepal’s ten-year civil war ended in 2006, the military drawdown did not dovetail with the reestablishment of a competent local-level police force in the Terai. As a result, the Terai is severely destabilized, as violent regional political parties compete with youth wings of national political parties over control of the population in a territory virtually unpatrolled by either the Nepal police or Army in a post-war vacuum of power.<sup>8</sup> Echoing the descriptions of the Terai from the ‘Gameplan’ report, there are again many promises from Kathmandu to tighten security by adding more checkpoints on the border and police across the region, but funding allocations, personnel, and motivation remain wanting.<sup>9</sup> Further, the limited funding to modernize Indo-Nepal checkpoints that was allocated remains unused due to bureaucratic tie-ups.<sup>10</sup>

Recognizing the opportunities provided by this situation, several different criminal organizations are again exploiting these systemic weaknesses to their benefit. The most comprehensive, far-reaching, and strategically important network is composed of approximately two dozen high-level traders of Pakistani and Kashmiri origin who have been expanding and consolidating their operations since the fallout of the 2000 crackdown subsided.<sup>11</sup> Most of the traders have close kinship relations with each other, the convicted from the 2000 cull, and other known LeT members.<sup>12</sup> The traders mostly operate out of cities along the Nepal side of the Indo-Nepal border, taking advantage of the larger population bases (and potential customers) that they provide, as well as the proximity to India should the need to escape arise. They have divided up Terai spheres of influence in a mafia-style agreement, allocating specific districts to individuals so as to

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<sup>5</sup> “Gameplan,” *op. cit.* Also see Baweja, Harinder, June 12, 2000. “The Kathmandu Nexus.” *India Today*. The report highlighted connections with LeT-affiliated terrorist Dawood Ibrahim, believed to be responsible for 1993 Mumbai bombings and possible logistics coordinator for the 2008 Mumbai attacks.

<sup>6</sup> Ahmed, Farzand, 19 June 2000. “Wake-Up Call.” *India Today*.

<sup>7</sup> *Ibid.*

<sup>8</sup> For more information on the rise of Madhesh parties, see Miklian, *op. cit.* The national party youth wings are from the Congress Party, Communist Party of Nepal-Maoist, and Communist Party of Nepal-UML.

<sup>9</sup> Ananda, Anil, 5 January 2009. “India Tightens Security along Borders.” *Indo-Asian News Service*.

<sup>10</sup> Paul, Bappaditya, 10 January 2009. “Turning a Blind Eye to the Other Side.” *Statesman*. Available at: <http://www.thestatesman.net/page.news.php?clid=6&theme=&usrsess=1&id=239625>. Access. 11 Jan. 2009.

<sup>11</sup> Their nationalities are disputed, as several claim to be Nepali. As the traders have close access to forgery networks, and the fact that Pakistan Embassy employees in Kathmandu were deported in 2000 for providing fake passports, these claims are circumspect. However, most lower-level operatives are Nepali.

<sup>12</sup> Author interviews, Senior Police Officers, Kathmandu and Biratnagar, and local-level trader informant, Biratnagar, November and December 2008.



minimize internal turf squabbles.<sup>13</sup> In exchange, the traders are expected to financially support the overseas networks that secure their positions and facilitate access to international markets.<sup>14</sup>

However, while several of the traders admit their role in LeT, they also have some degree of autonomy. For this reason, it is difficult to ascertain if they are criminal entrepreneurs first and LeT agents second or vice versa, but several mutual advantages to their close cooperation exist. First, partnership with LeT ensures traders the access to gold markets in the Mideast that are essential for money laundering. Second, traders gain logistical support and inside information on police activities as LeT uses their territory to recruit, train, and hide operatives outside Pakistan's borders. Third, familial relationships increase the level of trust and transaction security on both sides. Fourth, and perhaps not least, is the allure for traders of contributing to the greater cause of a rising Pakistan and global jihadi movement through a weakening of India in Kashmir and major cities.

After LeT was implicated in the November 2008 Mumbai attacks, attention turned to their Terai operations. Based upon the confession of the sole surviving attacker, India demanded that Nepal take swift action against several of the traders. Aslam Ansari (Pakistan) and Nasim Ansari (Nepal) were arrested in the border town of Birgunj in December 2008 by police behind pressure from India and Interpol for their suspected roles in funding LeT.<sup>15</sup> Aslam Ansari's networks in particular had been previously identified by Indian police in 2005 to be funding both Hizbul Mujahadeen and LeT, but the cases in India were dropped against him at the time, as he was thought dead.<sup>16</sup> India is pushing to extradite Aslam Ansari for his relation to the Mumbai attacks, and both Aslam and Nasim are held on charges of counterfeiting currency, smuggling, and running hawala banking operations.

Others in the network remain at large, and some utilize self-preservation tactics to make arrest more problematic. For example, Hamid Ansari is another top-level trader, but local police have not attempted to arrest him because of his high political connections and the large bribes that he pays to police, customs, and regional militants.<sup>17</sup> Ansari also plays up communal tensions to protect himself, using two attacks on Mosques in the area by Hindu fundamentalists to both galvanize support behind his organizations and mask a turf war against Hindu traders in the area as Hindu-Muslim communal violence.<sup>18</sup> Officials see through this veneer, but do not stop Ansari's employees who smuggle goods through border checkpoints, for fear that doing so will incite a religious war.<sup>19</sup>

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<sup>13</sup> Ibid.

<sup>14</sup> Author interviews, Senior Police Officers, Kathmandu and Biratnagar, November-December 2008.

<sup>15</sup> On Aslam Ansari and Nasim Ansari, see "Terror-Funding Pak Kingpin in Nepal Police Net," Times of India, 21 December 2008, and "Nepal Nabs Fake Money Kingpin," Telegraph India, 21 December 2008. Nasim was a specialist in fake documentation, Aslam was a currency specialist.

<sup>16</sup> See: Rahul Tripathi. "Did Counterfeit Currency King Finance 26/11?" Times of India, 23 December 2008. Accessed 10 January, 2009. Available at: [http://timesofindia.indiatimes.com/Delhi/Did\\_counterfeit\\_currency\\_king\\_finance\\_2611/articleshow/3877539.cms](http://timesofindia.indiatimes.com/Delhi/Did_counterfeit_currency_king_finance_2611/articleshow/3877539.cms).

<sup>17</sup> Name changed for security purposes. A local police chief claimed "we know where he is, we are investigating," Author interview, November 2008. Ansari is close to former Prime Minister GP Koirala, and has switched political affiliations several times in attempts to insulate himself from prosecution. He currently self-identifies as a member of the Madhesi Jahnadikar Forum (MJF), a regional political party. Author interview, Ansari, November 2008.

<sup>18</sup> Author interview, Ansari, November 2008. His main competition is a gang of smugglers led by one Bagwan Yadav. Two others include the 'Liberation Army' led by Sankar Singh and the Faizan Gang. Ansari claims he is "holding back" his more aggressive followers, who "are ready to cut off heads" for him if he desires. Gang information supplied by anonymous gang informant, author interview, November 2008.

<sup>19</sup> Author interview, senior Nepal border official, November 2008. However, this concern could also be a convenient excuse for inaction by border officials 'on the take'.

Intelligence estimates place the annual budget of LeT to be less than \$10 million USD per year.<sup>20</sup> While Pakistan has banned LeT-affiliated charities that siphoned up to \$500,000 per year to the group following international pressure after the 2008 Mumbai attacks,<sup>21</sup> the trader networks in Nepal are still potentially raising ten times that amount. LeT funding is assumed to be coming from Saudi Arabia and/or the ISI.<sup>22</sup> But with at least \$4 million USD in funding coming from Terai traders, either half of LeT's budget is coming from Nepal, the Nepal networks are the true source of the funds that are funding LeT through the Saudi Arabia informal currency networks, or LeT's budget is significantly larger than currently assumed.<sup>23</sup>

### Funds Generation

There are three overlapping ways in which the traders illegally generate funds in the Terai: the *hawala* system, fraudulent letters of credit and the distribution of counterfeit Indian currency.

#### *Hawala*

The *hawala* banking network is a source of funds for the traders as well as a conduit of transfer to contacts in both Pakistan and the Middle East.<sup>24</sup> In a typical transaction, a client approaches a *hawaladar* (*hawala* operator or broker) to request the transfer of money to a recipient in a different location. The *hawaladar* will give the details to his counterpart and payment will be made within hours to the requested party, many times in person. No physical money changes hands between *hawaladars*, who operate on something approaching the world's biggest honor system. *Hawaladar* profits come from commissions of 0.25-1.25% on legitimate transactions, but if the transaction involves known criminal proceeds or transactions by the client, the charged commission may increase to 15-20 percent.<sup>25</sup> Nepali *hawaldars* operate at black market exchange rates, increasing margins when there are large discrepancies on official and unofficial rates. When more value is transferred from or to a given country or operator, the accounts are balanced through transfers via conventional bank routes, postal money orders, the smuggling of currency or other commodities, or through invoice manipulation.<sup>26</sup>

Other advantages of *hawala* (including speed, convenience, lack of tracing, discretion) make it attractive for both legitimate and informal transfers. Although it is often claimed that *hawala* networks only operate outside the formal banking system, *hawala* operators often do have conventional bank accounts in which they deposit their clients' money and

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<sup>20</sup>From analysis by South Asian Terrorism Portal, available at:

[http://www.satp.org/satporgtp/countries/india/states/jandk/terrorist\\_outfits/lashkar\\_e\\_toiba.htm](http://www.satp.org/satporgtp/countries/india/states/jandk/terrorist_outfits/lashkar_e_toiba.htm). The figure was corroborated by two senior scholars at the Institute for Defence Studies and Analyses, New Delhi, although hard data cannot be stated with 100% certainty. Author email interviews, 20 January 2008.

<sup>21</sup> The largest was Jamaat-ud-Dawa, rumored to be the 'political wing' of LeT. Up to 195 JuD members have been detained or placed under house arrest following the Pakistan government's crackdown.

<sup>22</sup> For the US perspective, see Kronstadt, Alan, December 19, 2008. "Terrorist Attacks in Mumbai, India and Implications for US Interests." United States Congressional Research Service, report number R40087.

<sup>23</sup> The \$4 million figure is based upon the amount of funding that the network previously generated for LeT when the operation was of similar scope in 1999. However, as the amount and scope of operations have increased substantially, this figure is likely on the conservative side.

<sup>24</sup> Researching *Hawala* banking in Nepal is challenging due to lack of structure, scant bookkeeping, lack of physical monetary transfers, and questionable reliability of official sources. On *hawala*'s relationship to terrorist finance, see Benedetta Berti, "The Economics of Counterterrorism: Devising a Normative Regulatory Framework for the Hawala System," *MIT International Review*, Spring 2008. On the abuse of Hawala systems and its predecessors, see Sharma, Divya, 2006. "Historical Traces of Hundi, Sociocultural Understanding, and Criminal Abuses of Hawala." *International Criminal Justice Review* 16 (2):99-121.

<sup>25</sup> Passas, Nikos, 1999. *Informal Value Transfer Systems and Criminal Organizations; A Study into So-Called Underground Banking Networks*. Available at SSRN: <http://ssrn.com/abstract=1327756>.

<sup>26</sup> Passas, op. cit.

balance accounts with their counterparts in other parts of the globe.<sup>27</sup> Bank of America in New York is reputed to be a popular bank account location for many *hawaladars* in Nepal. Several banks in the United States purged their accounts of suspected *hawala* dealers after 9/11, but the meshing of formal and informal trade in these accounts has made it much more difficult to authorities crack down further. The lack of formal exchange services also makes it easier for *hawala* traders to mask laundering, as illicit transactions become a lower percentage of the overall transaction pot.

The majority of *hawaladars* in Nepal are not criminal actors, as the *hawala* system has also expanded due to consumer demand. For most citizens of Nepal, international transfers are more accessible, more secure, and cheaper through *hawala* than banks.<sup>28</sup> Banking services outside of Kathmandu are poor at best, and often nonexistent. Most rural villages do not have a bank, and lack of identification can make opening a traditional bank account problematic. In addition, there has been an explosion of Nepalis working overseas, driving demand at the local level. Remittances have tripled in the last 10 years, and are expected to triple again in the next 10 as Nepali women increasingly leave for domestic positions in East Asia, supplementing the men who go to the Middle East for construction projects.<sup>29</sup> Up to 5% of the country is working abroad, and official remittances totaled almost one billion USD in 2004, a figure that doubled in 2008.<sup>30</sup> The World Bank estimates that informal flows are likely to at least match official figures, meaning that another one billion USD comes each year to Nepal through unofficial channels.<sup>31</sup>

*Hawaladars* in Nepal are recruited almost exclusively from a small pool of extended families or close associates of current *hawaladars*, ensuring a tight control over access to the organization.<sup>32</sup> Traders who provide both *hawala* and Western Union services to their customers have observed that formal remittance rates are down slightly over the past two years despite a tremendous outflow of Nepali workers overseas; however, *hawala* has increased substantially.<sup>33</sup> This is due to the better accessibility of *hawala* in the country of employment and the lower fees on *hawala* trades. Further, many migrant workers establish relationships with the *hawala* traders to whom they send money back, both for security purposes (such as giving family members a single contact for transactions) as well as favorable exchange rates on US dollars (5-15% above the official rate) that the traders give returning overseas workers in order to drive Nepal's informal sector.<sup>34</sup>

### *Letters of Credit*

<sup>27</sup> UN Special Session on the World Drug Problem, 8-10 June 1998.

<sup>28</sup> See Maryam Razavy, 2005. "Hawala: An Underground Haven for Terrorists or Social Phenomenon?" *Crime, Law, and Social Change* 44(3): 277-299. Razavy's case studies of Afghanistan and Somalia are more extreme than the Nepal case, but structural banking conditions are similar.

<sup>29</sup> European Union, 2007. Nepal: Country Strategy Paper 2007-2013. P. 17-18. Available at: [http://ec.europa.eu/external\\_relations/nepal/docs/07\\_13\\_en.pdf](http://ec.europa.eu/external_relations/nepal/docs/07_13_en.pdf)

<sup>30</sup> IRIN News Network. NEPAL: Remittances - making a real impact. <http://www.irinnews.org/report.aspx?reportid=28609>, for 2008 figures, see <http://www.thehimalayantimes.com/fullstory.asp?filename=aFanata0va3qzpcalVa4ua.axamal&folder=aHa oamW&Name=Home&dtSiteDate=20080315>

<sup>31</sup> Ratha, Dilip, Sanket Mohapatra, KM Vijayalakshmi, and Zhimei Xu, 2007. *Remittance Trends 2007*, World Bank. Available at: <http://siteresources.worldbank.org/EXTDECPROSPPECTS/Resources/476882-1157133580628/BriefingNote3.pdf>. Accessed 19 January 2009.

<sup>32</sup> Author interview, senior customs official and *hawala* tracker, Morang. This is also due to the high fees and oftentimes unfavorable exchange rates that Western Union charges.

<sup>33</sup> Author interviews, Biratnagar foreign exchange traders, December 2008.

<sup>34</sup> Ibid.



A letter of credit is a document issued by a financial institution on behalf of an importer that promises payment to an exporter in exchange for goods.<sup>35</sup> In Nepal, to get a letter of credit a company will typically secure a contract with a foreign supplier to import a certain amount of goods (textiles, electronics, etc.). The bank will then give the importer a loan to cover the purchase, and expect to be repaid once the goods are imported and sold. However, the system has been abused on several occasions. The most brazen Nepal LC fraud took place in 1996, when two businessmen aligned with corrupt bank officials and customs officials established dummy companies that received LCs of over US \$36 million from the Nepal Rastriya Bank.<sup>36</sup> Another was a multi-billion Rs. scam of the Rastriya Banijya Bank, with the culprits never arrested because of political connections. The only legal action taken was the suspension of two bank managers for giving out 10 million Rs. loans without requiring collateral. In both cases, the money vanished.

The scandals illustrate the transnational nature of money flows in Nepal, the ease of corruptive practices and corrupt officials, and the utter lack of checks and balances in Nepali banking systems. One of the primary accused during the Nepal Rastriya Bank case, Anand Agrawal, claims that his operation was so profitable and well-known during its height that he had to turn down many police, government officials and bankers who also wanted to take part in the scam.<sup>37</sup> Agrawal also stressed the international nature of the network, claiming that gold traders in Dubai and Bangkok worked hand-in-hand with LeT and other Pakistani-based networks, using local recruits as cover for overseas capital extraction.<sup>38</sup> After the scandals, there was an effort to pass laws to prohibit this activity in the future, but Agrawal himself notes that it would “not be difficult” to establish a similar network again given the degree of top-level corruption and government disarray.<sup>39</sup>

The Terai networks often use the LC and *hawala* systems in tandem. As Passas notes:

“To illustrate this, let us assume that more money has been transferred out of Nepal than came into the country, causing an imbalance of USD 80,000 between the *hawaladars* concerned. In such eventuality, the *hawaladar* based in the West (or an associate) purchases USD 150,000 worth of goods, such as computer equipment, and sends them through ordinary channels to Nepal with an official invoice for only USD 70,000. The Nepalese operator can then sell the merchandise and make a legitimate profit, retrieving at the same time the USD 80,000 owed to him from overseas. The same method is employed when the funds must move in the opposite direction, Instead of under-invoicing by \$80,000, the overseas operator will over-invoice by that amount.... Further, when *hawala* transfers are combined with gold deals and smuggling operations, the main profit is made from the sale of smuggled commodities rather than from the money transfer service.”<sup>40</sup>

These mis-invoicing techniques and abuse of the LC and *hawala* systems have been utilized for well over a decade with almost no interference from the authorities, as senior police, customs, and industry officials all attest.<sup>41</sup>

<sup>35</sup> The Wikipedia entry for “Letter of Credit” provides a fine overview, available at: [http://en.wikipedia.org/wiki/Letter\\_of\\_credit](http://en.wikipedia.org/wiki/Letter_of_credit). Accessed 18 January, 2008.

<sup>36</sup> The executives were Anand Agrawal and Prakash Tibadewala, both of Indian origin. To give perspective on the truly staggering scale of this crime, over 92 companies were thought to be involved, and the monetary figure represented almost 1% of Nepal’s GDP at the time, equivalent to a theft today in Norway of over 20 billion Kr. Nothing was ever imported, resulting in a total loss for the government-owned bank.

<sup>37</sup> Author interview, Agrawal, November 2008. Agrawal was released on Rs. 50 million bail in 2003, and while the case against him is still technically pending, it is unlikely that he will go to trial.

<sup>38</sup> Agrawal, op. cit.

<sup>39</sup> Agrawal, op. cit.

<sup>40</sup> Passas, op. cit.

<sup>41</sup> Kathamndu Crime and Investigation Branch, senior customs officials, and the head of the Chamber of Industry (Morang) all confirm that this system continues to operate. Author interviews, December 2008.

### *Fake Currency*

A comparatively simpler process is the production and distribution of counterfeit currency. Trader networks in the Terai deal in fake Rs. 500 and Rs. 1000 Indian notes, trading them at a 2-1 rate on the underground market. For example, when Ansari and Ansari were arrested in December 2008, they were carrying Rs. 12 million in fake currency. Sophisticated printing presses are used, and in many cases the better forgeries will use the same paper that India imports for printing authentic notes.<sup>42</sup> According to Indian officials, the amount of fake currency flowing from Nepal has quadrupled in the last five years alone, and is of a much higher quality than fakes made in India.<sup>43</sup>

There are two ways in which the fake currency is exported to India. The preferred method for those who exchange in gold and dollars is through *hawaladars* who trade hard currency in high-volume areas, and can even be seen operating at Tribhuvan International Airport.<sup>44</sup> The flights in and out of Kathmandu to Karachi, Bangkok, Dhaka, and Doha in particular are high-volume flights for illegal smuggling.<sup>45</sup> However, it is unclear where the majority of the currency itself is manufactured. Indian sources contend that it is manufactured in Pakistan, shipped to Nepal, and given to LeT-affiliated traders to exchange for goods (see below) or enter into their Hawala networks. Indian intelligence sources claim that the ISI generates \$500 million USD per year from the fake currency trade, but the Reserve Bank of India disputes these figures, and other intelligence agents themselves dispute claims of ISI masterminds behind the operation and the direction of fake currency flows.<sup>46</sup> Regardless, no official sources in either Nepal or India dispute the huge influx in fake currency over the past 1-2 years, nor its role in funding terror organizations on both sides of the border.

Together, these three processes create hundreds of millions of Rupees that need to be converted, a process that cannot be conducted through official channels. This creates a strong demand for goods on the informal (or black) market.

### **Exchange and Extraction<sup>47</sup>**

Once created, illicit funds are exchanged within Nepal for liquid imported goods that hold concentrated value or are otherwise difficult to trace, including weapons,<sup>48</sup> gold, US dollars, mobile phone parts and SIM cards,<sup>49</sup> electronics (Chinese-made), cement and fertilizer,<sup>50</sup> grain, drugs, fuel, textiles and consumer durables, and even low-grade

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<sup>42</sup> Based upon assessments of B.S. Jayant, Inspector General (Economic Offence Wing), Patna, Bihar. See: Dipak Mishra, "Fake Currency Menace on the Rise," Times of India, 22 December 2008.

<sup>43</sup> Ibid.

<sup>44</sup> Author observation, December 2008. Unfortunately, the traders refused repeated interview requests.

<sup>45</sup> Author interviews, airport customs officials, December 2008. As of January 2009, there are 4 direct flights to Karachi weekly, and 10 weekly to Dhaka.

<sup>46</sup> <http://www.rediff.com/money/2008/dec/19mumterror-how-fake-currency-funds-terror.htm?zcc=1>

<sup>47</sup> The intent of these processes overlap substantially with what the United Nations and others term as the 'layering' and 'integration' stages of money laundering in the drug trade.

<sup>48</sup> The demand for weapons has tapered off since the end of formal hostilities during Nepal's 1996-2006 civil war, and prices for authentic AK-47s remain high (\$2,000). However, the gun flow networks remain open, and could supply any number of the Terai's Madhesi separatist groups should they choose to escalate their conflict. Author interviews, local gun merchant, Biratnagar, November 2008.

<sup>49</sup> Mobiles and SIM cards are in high demand in the Terai because phone restrictions were put in place after the connection of phone networks in the Terai to the 2003 Mumbai blasts (also suspected in the 2008 attacks), and because of high demand for untraceable SIM cards by criminals, Madhesi separatists, Maoist cadres, and others who fear surveillance. SIM cards are often trafficked through Bihar. See Sanjeev Kumar Verma, "Sale of SIM: Police to Get Tough with Norms," Times of India, 18 December 2008.

<sup>50</sup> Fertilizer is a contentious product due to its dual use properties as a farming tool and potential explosive. India has restricted the import/export of fertilizer, requiring many farmers in the Terai to buy their fertilizer on the black market despite government subsidies. For an argument for even tighter restrictions, see

uranium.<sup>51</sup> Upon first glance, informal trading between India and Nepal would be thought to be low, as both are signatories to the South Asian Preferential Trading Agreement (SAPTA), and the Indo-Nepal Treaty of Trade bestows mutual Most Favored Nation status, with only minor exceptions.<sup>52</sup> However, even commonplace items can be smuggled profitably in a state without strong controls if they are state-subsidized by either India or Nepal, delivered more efficiently informally than by state mechanisms, or are ‘knockoffs’ of otherwise more expensive branded goods.<sup>53</sup>

Well-established informal trade networks not only route Indian goods to Nepal (primarily food and generic consumer goods), but also bring Chinese and Southeast Asian products to India through Nepal (mostly electronics).<sup>54</sup> Smuggling networks also use *hawala* transactions as clearing systems for gold, silver and illicit drugs transactions, linking Nepalese, Indian, Pakistani, Danish, German, Dutch and Polish traffickers.<sup>55</sup> Informal traders on both sides of the border contend that these transit corridors can be manipulated at almost no risk of interference from either police or politicians, as shipments are rarely if ever seized.<sup>56</sup> However, regular bribes to enforcement agencies are almost universal, as traders have recognized that it is easier (and safer) to bribe officers and operate in broad daylight than to sneak shipments across the border at unregulated points.<sup>57</sup> Further, since the Indo-Nepal free trade agreement was signed, bribery has increased as involvement by higher level officials in the process has required both legitimate and illegitimate traders to make more and larger payouts to obtain necessary import/export licenses.<sup>58</sup>

The entrenched system of bribery on both sides of the Indo-Nepal border is institutionalized, has developed specific rules and mechanisms defining accepted roles for traders and enforcement officials to follow, and is profitable for all involved. Unfortunately, this is not a problem confined to the border, as Nepal is one of the most corrupt countries in the world.<sup>59</sup> Airport customs jobs are among the most coveted police

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“Closing the Terror Gap.” Available at: [http://indiatoday.digitaltoday.in/index.php?option=com\\_content&task=view&id=24603&sectionid=4&issueid=87&Itemid=1](http://indiatoday.digitaltoday.in/index.php?option=com_content&task=view&id=24603&sectionid=4&issueid=87&Itemid=1). India Today. Accessed 11 January 2009.

<sup>51</sup> Human trafficking (particularly women and girls sold to Mumbai brothels) and the timber, tiger, and antiques trades are also common on the Indo-Nepal border and represent serious concerns, but as the traders dealing in these arenas generally use different networks, they are omitted. On uranium, see: Indo-Asian News Service, 2008. “Uranium seized along Indo-Nepal border, six arrested.” February 18.

<sup>52</sup> For more information, see Pohit, Sanjib, and Nisha Taneja, 2000. “India’s Informal Trade with Bangladesh and Nepal: A Qualitative Assessment.” Indian Council for Research on International Economic Relations, Working Paper 58, and Government of India, 2002. Indo-Nepal Treaty of Trade. Available at: <http://commerce.nic.in/trade/nepal.pdf>. This treaty was renewed in 2007 for another 5 years.

<sup>53</sup> Pohit, Sanjib, and Nisha Taneja, 2000. “India’s Informal Trade with Bangladesh and Nepal: A Qualitative Assessment.” Indian Council for Research on International Economic Relations, Working Paper 58. The study interviewed 77 informal traders on the Indo-Nepal border, but did not ask questions regarding dealing in contraband, recognizing that most traders deal in both, to get candid answers.

<sup>54</sup> Pohit. op. cit., p. 54-59.

<sup>55</sup> Pappas, op. cit., and Author interview, Criminal Branch and Investigation, Kathmandu, December 2008.

<sup>56</sup> Pohit op. cit., p. 60-65. 94% of informal traders had under 5% of shipments seized, and 66% had never had a shipment seized. A common way to skirt customs duties and other applicable laws is to legally import an item, and then reuse the customs documentation *ad infinitum*, as the paperwork is examined by border police, but never collected, stamped, or otherwise verified. Author interview, gang informant, Nov. 2008.

<sup>57</sup> Pohit, op. cit., p 66. The amount was usually under 6% of the items’ value, and rarely more than 10%.

<sup>58</sup> Pohit, op. cit., 66-67. Although the Pohit report is almost 10 years old, November 2008 author interviews with traders and border officials confirm that this picture parallels the present-day situation.

<sup>59</sup> Nepal ranks 121<sup>st</sup> on Transparency International’s 2008 Corruption Perceptions Index, a global assessment of corruption (available at [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)). Unfortunately, Nepal was not included on TI’s Global Corruption Barometer ([http://www.transparency.org/policy\\_research/surveys\\_indices/gcb/2007](http://www.transparency.org/policy_research/surveys_indices/gcb/2007)), which is a more direct assessment of public opinion, and an index where Nepal would likely score lower based upon the increase in bribery at local levels during the transition from war to democratic rule, as well as the general perception within Nepal that bribery is more common at the local level and in rural areas than in urban centers.

positions in Kathmandu. The lack of security and entrenched, systematic bribery mean that most Airport Customs officials become millionaires within months after starting the job.<sup>60</sup> Even the high-profile arrests of Aslam and Nasim Ansari were marred by corruption. Although the main accused were arrested under severe pressure from India, cases against the other primary people of their network were scuttled by the police due to pressure from the smugglers themselves and political pressure from Kathmandu.<sup>61</sup>

India-Nepal checkpoints are severely understaffed and make only anemic attempts to stop smugglers. The rolls on both sides are littered with crooked officers, and attempts to remove them are often met with punitive action against the whistleblowers. One Nepal border checkpoint commander was explicitly told when he got the position that if he tried to remove anyone from their jobs for any reason, he would be fired.<sup>62</sup> Many officers pay heavy bribes to senior staff and politicians in Kathmandu to get hired, who then require kickbacks each month if they are to keep their jobs.<sup>63</sup> Even incremental efforts to modernize the checkpoints are met with stiff resistance for fear that this lucrative scam will be either closed or exposed. As the checkpoint commander remarks:

“We know exactly how the gold and drugs are coming into this country. People swallow it and walk across the border. But without a holding area or any equipment, we are powerless to stop them. (...) We have been asking our superiors in Kathmandu for months for an x-ray machine to arrest the smugglers, but our requests are denied every time.”<sup>64</sup>

More brazen smugglers who are physically fit simply walk across the border with contraband in full view, and then outrun police if they are spotted. Requests for a vehicle to catch these criminals have also been denied.<sup>65</sup> Smugglers also recruit the disabled as mules, knowing that they will not be checked as they pass.<sup>66</sup> As a result, at one major border checkpoint not one person was apprehended for or charged with smuggling during the entire August-November 2008 period.<sup>67</sup> Those not ‘on the take’ are frustrated by the ignorance of new recruits sent by Kathmandu, the lack of enforcement prioritization at the center, and the politicization of law enforcement in Nepal after the 2008 elections.<sup>68</sup>

Checkpoints on the Indian side are driven by different fears that encourage denial of the problem, either out of ignorance or fear that publicity of any criminality will mean the loss of a job. One customs inspector claimed that he had not seen a single case of smuggling since he took over the checkpoint the year before.<sup>69</sup> Technological assets are barely better than in Nepal, as Indian officers also complain of a lack of modern resources to catch smugglers.<sup>70</sup> Indian officials have also bemoaned the ineffectiveness and corruption of India’s Border Security Force (BSF), as well as funding cuts of almost

<sup>60</sup> Author interview, Airport Central Customs Officer, Kathmandu, December. ‘Millionaire’ is expressed here in Rupee terms, equating to about \$15,000 USD.

<sup>61</sup> “Fake Currency Kingpins in Police Net.” Himalayan News Service, 20 December 2008. Of the estimated 84 people that the police wanted to charge, only the three specifically requested by India were arrested. <http://www.thehimalayantimes.com/fullstory.asp?filename=aNPata0sgqzpla5a9a3ra.axamal&folder=aNPataiaoaanaaal&Name=National&sImageFileName=&dtSiteDate=20081221>. Accessed 15 January, 2009.

<sup>62</sup> Author interview, senior Nepal border official, November 2008. Author visited 3 border crossing areas., and findings paralleled a CNN-IBN TV expose on the Indo-Nepal border in October 2008. Summary available at: <http://ibnlive.in.com/news/fake-indian-currency-network-exposed-in-nepal/76564-3.html>

<sup>63</sup> Author interview, senior Nepal border official, November 2008.

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Pawan Kumar Shah, 12 January, 2009. “Physically Disabled Helping Smugglers Across India-Nepal Border.” Gorakhpur / Asian News Service.

<sup>67</sup> Author interview, senior Nepal border official, November 2008.

<sup>68</sup> Author interview, Bisho Gautam, Sub-Inspector, Rupadhia, November 2008.

<sup>69</sup> Author interview, Head Customs Officer, Bahraich, November 2008.

<sup>70</sup> Das, Pushpita, 2008. The Need For a Regulated Indo-Nepal Border, IDSA Report.



50% for border security at the state level.<sup>71</sup> Uttar Pradesh Chief Minister Mayawati even went so far as to claim that the BSF had “no positive impact” on security, withdrawing the BSF’s power of search and seizure after repeated complaints by border residents of abuse of power and sexual harassment, as other senior officials assert that rampant corruption in the BSF leads it to do more harm than good wherever it is stationed.<sup>72</sup>

### **Geopolitical Considerations and Infrastructure Limitations**

Potential solutions need to be multi-pronged, cross-institutional, and regional in focus if informal trading networks are to be eliminated. Unfortunately, solutions cannot be implemented in a political vacuum. Nepal is often played an unwitting pawn in ‘Great Game’-style regional politics between India and Pakistan, as intelligence agencies from both countries engage in what a recent workshop called an “undeclared intelligence war”...that civilian governments seem incapable and/or unwilling to rein in.”<sup>73</sup> Indian Prime Minister Manmohan Singh continues to see Nepal as a corridor for terrorists, accusing several others from the Terai networks who were not arrested of having a hand in the November 2008 attacks.<sup>74</sup> In a repeat of 2000, Kathmandu again denies these charges vehemently, perhaps wishful thinking for fear that proof will again expose the lack of control and intelligence that Nepal has over activities within its own borders.

The Indo-Nepal border is a highly sensitive issue, and ideas for border security forwarded by India are viewed in Nepal through a skeptical lens that assumes hidden motives to erode Nepal’s sovereignty.<sup>75</sup> Cross-border cooperation over the past 15 years has incorporated Joint Working Groups, Boundary Committees, and other high level collaborations that for the most part have failed to achieve even moderate change due to mutual mistrust. Current wrangling focuses on anger in Nepal over alleged incursions by the BSF into Nepal territory without permission, and paranoia from the Indian side about alleged ‘linkages’ between the Communist Party of Nepal-Maoist and the Communist Party of India-Maoist.<sup>76</sup> Areas such as Susta (Nawalparasi district) have become flashpoints, where territory disputes between Nepal farmers and the BSF have displaced hundreds.<sup>77</sup> The Susta dispute has even spawned a violent splinter group from the ruling Communist Party of Nepal-Maoist, called the Revolutionary Left Wing.<sup>78</sup> However, the dispute is also popular political fodder for Nepali politicians looking to demonize ‘big brother’ tactics by India in the name of nationalism to gain votes.<sup>79</sup>

The debate highlights the uncomfortable fact that the Indian government, while expressing publicly the unalienable right of Nepal’s sovereignty, privately sees itself as South Asian hegemon. This philosophy aggravates Indo-Nepal tensions when Indian

<sup>71</sup> Press Trust of India, 6 January 2009. “No Consultation Before Setting up NIA: UP.”

<sup>72</sup> Ahmed, Farzand, 7 January 2009. “Centre Should have Consulted States Before Formulating NIA: Mayawati.” *India Today*. Available at: [http://indiatoday.digitaltoday.in/index.php?option=com\\_content&task=view&id=24603&sectionid=4&issueid=87&Itemid=1](http://indiatoday.digitaltoday.in/index.php?option=com_content&task=view&id=24603&sectionid=4&issueid=87&Itemid=1). Accessed 14 January, 2009.

<sup>73</sup> International Peace Institute and Center on Global Counterterrorism Cooperation, 13 November 2008. “Implementing the UN Global Counter-Terrorism Strategy in South Asia.” Workshop, IPI, New York.

<sup>74</sup> “Pakistan Using Terrorism as State Policy: PM.” Press Trust of India, 6 January 2009.

<sup>75</sup> See “India Cashing in from Nepal Political Fluidity,” 31 December 2008, *The Weekly Telegraph*, Kathmandu, and the works of Indo-Nepal border expert Buddhi Narayan Shrestha (many excerpts available at his blog <http://bordernepal.wordpress.com>, accessed 14 January 2009).

<sup>76</sup> Others include Antu (Ilam district) and Kalapani (Darchula district). On the border issue see Srijana, January 6 2009, “India is Taking Nepal Lands.” Available at: <http://bordernepal.wordpress.com/2009/01/06>. Regarding Naxal/Maoist links, three years of research in India and Nepal by the author has uncovered no proof that Nepali and Indian Maoists cooperate beyond ideological support, despite claims to the contrary.

<sup>77</sup> “Indian Terror Continues in Nepal’s Susta.” *Telegraph Nepal*, January 9, 2009.

<sup>78</sup> “Maoists’ Break-away Group Demands Scrapping of Indo-Pact.” *Zee News*, 1 January 2009.

<sup>79</sup> For an interesting account, see “India, While Seeking UN Security Council Status, Takes Nepali Land,” 16 October 2005, *Daily News*, by then-Princess Shrestha.



officials make public statements on perceived collusion between Nepal and Pakistan, claiming that some Nepali politicians are little more than ISI operatives. These complaints would carry greater weight if India didn't also attempt to shape Nepali politics. Most notably, several national and Terai-based political parties in Nepal are alleged to rely on Government of India funding for day-to-day operations.<sup>80</sup> However, India's loyalties are notoriously fickle, and once parties fall out of favor they are often approached by LeT members, who offer funding in exchange for safe shelters for militants, turf rights on informal trade and other related criminal activities.<sup>81</sup>

Despite calls from both Indo-Nepal experts and politicians in Nepal that border security reform is desperately needed, the Nepali government has pledged only to add more base camps of troops to combat 'criminal activities' and 'rampant smuggling',<sup>82</sup> measures destined to be inefficient when most goods are trafficked through the main checkpoints already. A cynic may even see the additional troops as little more than cash machines for top-level officials. However, the border is too long to undertake the vast expense of comprehensive monitoring in addition to the hardships for thousands of individuals who cross the border daily for jobs, migrate for seasonal employment or to visit family.<sup>83</sup> Interestingly, both the Maoists and government were responsive to border security issues during the war as they attempted to curry favor with locals, efforts now forgotten as cross border criminality remains the primary threat to community security in border areas.<sup>84</sup>

The Government of Nepal has been inefficient at curbing the legal and de facto openings that the informal traders use to operate. The Asia/Pacific Group on Money Laundering (APG) assessment of Nepal's efforts to halt money laundering reads like an invitation for informal traders to operate, stressing Nepal's utter lack of legislation to curb terrorism financing, no prevention or detection measures for such crimes, nonexistent oversight of the banking sector, and even "no current provisions that specifically criminalize money laundering."<sup>85</sup> Further, there are no laws requiring banks to maintain customer information, pay attention to specific transactions, develop internal security measures, or prohibit bank from dealing with shell companies or shell banks.<sup>86</sup> The lack of legal precedent helps to illustrate why so few are convicted in Nepal of serious financial offences—the laws don't exist to break. The interim parliament did pass two bills in 2008 ostensibly designed to bring Nepal in to compliance with international standards on money laundering and anticorruption, but no criminals have yet been tried with them.<sup>87</sup>

Nepal's record is equally anemic on counter-terrorism cooperation. Resolution 1373 of the United Nations Security Council requested UN member states to take a variety of measures in order to enhance the ability of all states to collectively combat transnational

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<sup>80</sup> Author interviews, several Terai scholars, November-December 2008.

<sup>81</sup> Author interview, senior Terai scholar, November 2008.

<sup>82</sup> See Speech of Dr. Baburam Bhattarai, 11 May 2008, Nepal Samacharpatra Daily. Bhattarai even went to far as to blame the open border for all of Nepal's development problems, Das, op. cit., and Xinhua News Service, 11 January 2009. "Nepal Sets Up More Border Security Camps in S Districts." Available at: [http://news.xinhuanet.com/english/2009-01/11/content\\_10639083.htm](http://news.xinhuanet.com/english/2009-01/11/content_10639083.htm). Accessed 12 January.

<sup>83</sup> For more, see International Crisis Group, 9 July 2007. "Nepal's Troubled Terai Region." p. 23-4.

<sup>84</sup> Bharadwaj, Narad N., et. Al, 2007. "Nepal at a Crossroads: The Nexus Between Human Security and Renewed Conflict in Rural Nepal." Page 29, 44. In one example, the Maoists allowed government security forces to combat a growing cross border sex trade after requests from communities

<sup>85</sup> Asia/Pacific Group on Money Laundering, 2005. *Nepal Mutual Evaluation: Executive Summary*. p. 1-6. Available at: <http://www.apgml.org/documents/docs/8/Nepal%20MER%20Executive%20Summary.pdf>. Accessed 19 January, 2009. A follow-up report will be published in 2011.

<sup>86</sup> Ibid., p. 6.

<sup>87</sup> Nepal passed the Money Laundering Prohibition Bill on January 14, 2008 per a mandate from the Asian Development Bank to pass the bill in order to continue to receive funding. Asian Development Bank, 2008. "Report to the FATF Plenary." Available at: <http://www.adb.org/Documents/Others/OGC-Toolkits/Anti-Money-Laundering/documents/FATF-Report-February-2008.pdf>. Accessed 20 January 2009.

terrorism.<sup>88</sup> Nepal's most recent report to the Counter-Terrorism Committee is a laundry list of prior suggestions that were not implemented, including regulation of *hawala* traders, banking reform, and international cooperation on breaking transnational terrorist networks.<sup>89</sup> A 2006 addendum requested the UN to provide equipment, logistics, and training to border forces, police, and the Department of Immigration to improve compliance, but as of December 2007, these requests have as of yet gone unfulfilled.<sup>90</sup>

A lack of momentum in shutting down the LC, Hawala, or currency operations despite the high-profile arrests in 2000 illustrates that the problem is as much structural as a function of criminal individuals. For each ringleader that is brought to justice, others have taken their place. As long as the smuggling networks remain profitable and corrupt police and border officials desire a supplementary source of income, new laws banning these criminal activities will remain ineffective. Further, supply of would-be criminals is effectively endless, so other solutions need to be examined. In this regard, India and Nepal would be wise to heed the words of an independent task force for the US Council on Foreign Relations, speaking on terrorist financing after the 9/11 attacks:

“In the short term, “following the money” can go a long way toward disrupting terrorist cells and networks and thereby can help prevent future terrorist attacks. But real and sustainable success will be achieved only over the very long term, as key countries make fundamental changes to their legal and regulatory environments.”<sup>91</sup>

### Recommendations:

The complexity and entrenched nature of these funding networks requires a several-pronged approach for resolution. Nepal can take short-term measures to shut down the trading networks without distressing the greater community, and long-term structural enhancements can reduce the likelihood that the networks will rebuild. Incremental steps can be taken now and in the near future by actors on all sides to diminish the ability of criminal networks to generate illicit funds.

### Short-Term

The first step of any serious resolution in **Nepal** is to arrest the remainder of Terai traders that continue to operate with impunity. However, conducting large scale raids on the *madrasas* and *hawala* system may be counterproductive, as honest *hawala* traders and families without alternative means of banking will also be punished in such a ground-clearing operation. The backbone of Nepal's economy is remittances, and most overseas workers support extended families with the incomes. And although there is a contentious debate on the foreign funded *madrasas* pitting parallel non-governmental educational systems against the benefits of free schooling in a country that cannot afford to provide universal education, the head of one *madrasa* admitted that the only attention paid to him by Kathmandu is from the tax authorities, looking for bribes for revenues extracted from the Hawala trade.<sup>92</sup> However, reform of the *Hawala* system can still be achieved without wholesale uprooting of vulnerable societies. For example, legitimate *hawaldars* can be integrated into the formal banking sector as a stop-gap solution, provided they comply with APG guidelines designed to decrease the likelihood that they are unknowingly

<sup>88</sup> Res. 1373: <http://daccessdds.un.org/doc/UNDOC/GEN/N01/557/43/PDF/N0155743.pdf?OpenElement>.

<sup>89</sup> United Nations Security Council report S/2005/442.

<sup>90</sup> United Nations Security Council report S/2005/442 Add. 1. Lack of assistance verified by December 2007 report on technical assistance to Nepal, available at: <http://www.un.org/sc/ctc/matrix/reports/NEP.pdf>.

<sup>91</sup> Council on Foreign Relations, 2002. *Terrorist Financing*. Available at: <http://www.cfr.org/publication.html?id=5080>. Accessed 22 January, 2009.

<sup>92</sup> Sharma, op. cit. Nepal has a particular aversion to non-government affiliated education given the large number of schools started by the Maoists, accused of using the schools to indoctrinate youth recruits. Also author interview, Sunsari district *madrasa* head, November 2008.

laundering money. These guidelines, including measures to increase transparency, improved recordkeeping, and funds tracing techniques, would be only a small inconvenience for legitimate traders that would not affect their income.<sup>93</sup>

**India and Nepal** should jointly consider how border security policy can be more than a zero-sum game. Traders on both sides of the border as well as police and local border officials are all profiting, at the expense of state and human security. Both countries have dealt with the frustrations of tracking militants to the border, only to see them escape due to a lack of coordination, will and/or ability by their counterparts to continue. However, closing the border in the name of protectionism and security would only needlessly hassle the thousands who cross the border daily, while doing little to stop the illegal trafficking that already takes place at the main border crossings through bribed officials. The challenge to restore accountability to these essential civil servants is made more difficult by the continued political flux in Kathmandu, but at the very least whistleblowers and those who do wish to uphold the duties of their position should have a forum to do so without fear of retaliation. Further, the link between corruption and national security needs to be recognized and problematized. Transparency International is one of a number of organizations examining this relationship, recognizing that corruption can be both a facilitator and cause of security risks.<sup>94</sup>

Mutual cooperation on Indo-Nepal border security strategy benefits both bilateral relations and internal stability. Unfortunately, **Nepal** first needs to swallow a hard pill and admit to India that it has lost control of the Terai, and make use of Indian intelligence in order to improve its own assessment of the situation. This admission, however, must be buttressed with a good faith effort by **India** to respect Nepal's sovereignty. India's record of 'cooperation' with its smaller neighbors over the past two decades on anti-terrorism operations is littered with heavy-handedness and animosity, as evidenced in both Bangladesh and Sri Lanka. India should resist the temptation to go it alone on border operations, and instead extend suggestions for best practices to Nepal that engage border security forces on both sides, as well as punishing those who take and encourage bribery. Forums have previously proposed frameworks whereby either country could propose a joint operation on an ad hoc basis, sharing sensitive information with the other but keeping authority clearly under control of the host country. The host country can reciprocate with an offer of non-binding joint operations, similar to the arrangement now being slowly rolled out between India and Bangladesh. Furthering discussions along these roads could be beneficial as both a trust-building exercise and security operation.

**International actors and the United Nations** can help Nepal improve its security at border points and the airport by sharing best practices, funding better equipment (and ensuring that it is used) and discouraging graft through financial incentives.<sup>95</sup> Further, international border security experts (leaning heavily on Interpol's expertise and working relationship with Nepal police) can provide logistical support, suggest equipment and help to secure directed funding to modernize and bolster existing checkpoints while minimizing the risk of corruption. The United Nations should also maximize the opportunity given it when Nepal requested additional funds for border security in 2007. Those countries who have airlines operating direct flights to/from Kathmandu (including Thailand, Bangladesh, Pakistan, Qatar, and the United Arab Emirates), should also increase scrutiny of incoming passengers from Kathmandu for illicit materials.

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<sup>93</sup> See Barti, op. cit., APG, op. cit.

<sup>94</sup> Transparency International, 2008. "Corruption and (In)security. Working Paper #4. Available at: <http://www.transparency.org/content/download/37783/596628>. Accessed 20 January, 2009.

<sup>95</sup> This assessment is given with the caveat that development aid itself is often a significant cause of corruption, especially if the aid is distributed in a top-down manner.

### Medium- to Long-Term

**Nepal** can create robust structural barriers to informal trade over the long-term by focusing on two sectors: reducing the culture of corruption, and comprehensive banking reform. However, this must be buttressed with implementing the laws pertaining to both.

Nepal's culture of corruption is pervasive at the individual, local, regional, and national levels. Of course, this is a problem that is as obvious to identify as it is difficult to correct, but there are openings for change. Practical measures can reduce the demand side, including better pay for more and better trained border officials, local police, and security forces. Punitive approaches, such as prosecution of officials caught taking bribes, are also welcomed but difficult in a society where the judicial system itself is corrupt. 2008 World Bank figures on corruption, governance, and accountability show that Nepal has steadily deteriorated in both real and comparative terms regarding control of corruption, accountability of public figures, rule of law, government effectiveness, and regulatory quality-ranking near or below the lower quartile of countries in each indicator.<sup>96</sup> This is contrasted with Liberia's improvement in almost every major category in the same index over the same period, despite the shared past of a recent civil war. Liberian President Ellen Johnson-Sirleaf prioritized reduced corruption and increased accountability through robust transparency measures both for herself and all of her political appointees; this and other decisions have contributed to a dramatic turnaround in corruption.<sup>97</sup> Leadership-by-example can be a powerful attitudinal tool for change, and need not involve massive bureaucratic undertakings.

Targeted overhaul of the banking sector would ideally include a trident of reforms to prevent graft at the top, institutionalize checks and balances for day-to-day operations, and increase the availability of services in areas currently underrepresented. The growth of *hawala* banking in Nepal is as much a symptom of Nepal's weak infrastructure as a cause of its graft. However, the simple solution of opening more bank branches that cater to microcredit needs, while positive in theory, could actually be counterproductive if done rashly. Even widely-acclaimed Grameen Bank was unable to create a successful program in Nepal due to corruption and pressure from high-ranking officials to get kickbacks from the local level in exchange for the right to operate. In this regard, the Reserve Bank of India's effort to bring more money flows from India to Nepal into the formal sector through low-cost wires is commendable,<sup>98</sup> and could be adopted by other countries that have a high number of transactions to and from Nepal.

The inherent challenge of prosecuting transgressors, however, is immense. As the LC scandals of the 1990s illustrated, even if suspects are arrested, they are then put into the hands of a poorly-paid judicial system that is often even more corrupt than the police. Prosecutors are often forced to seek convictions without robust legal precedents or frameworks, tremendous pressure from political actors, and personal danger, handicapping them before a trial even begins. In the long term, overhaul of both the judiciary and police establishments is the preferred solution to root out corruption and avarice, but any solution must incorporate large swaths of Nepal's youth population as stakeholders, emphasizing rule of law and legitimate employment over militant groups, informal trade, and corruption in order to take root in Nepali society.<sup>99</sup>

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<sup>96</sup> Based upon a large-n study of 212 countries by the World Bank, incorporating over three dozen broad indices. Full report for the 2008 Worldwide Governance Indicators Project available at:

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1148386](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148386), dataset available at:

<http://info.worldbank.org/governance/wgi/pdf/wgidataset.xls>, Accessed 23 January, 2009.

<sup>97</sup> Ibid.

<sup>98</sup> "RBI Launches Indo-Nepal Remittance Scheme." Business Standard, India. January 7, 2009.

<sup>99</sup> Thanks to Andreas Føllesdal for this point.

**International donors** should follow the example of the Asian Development Bank and tie funding to the creation of laws in order to bring Nepal in line with international banking, money laundering and counter-terrorism measures. Although the thought of 'conditionalities' are unpleasant for recipient countries in general, and will be heavily scrutinized during a time of global banking upheaval, they do have a proven track record in Nepal of forcing needed legislation on to the agenda of parliamentarians in Kathmandu. Development aid is an essential component of Nepal's economy, and with the current Maoist leadership in need of a huge influx of funds to fulfill the myriad of development promises made during elections, an opportunity for influence exists.





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