lawanddevelopment.org
exploring the links between law and economic development

Soft Law, Hard Compliance

Somalia's Informal Funds Transfer Systems in the International Legal Order

Volker Hüls

Global interactions increasingly rely on law to govern them. Today, numerous rules dominate the interactions between states and non-state parties. International courts and dispute settlement mechanisms are in place to ensure compliance with commonly agreed norms.

International Law, however, is complex and often lacks universal acceptance. Worse, its influence is disproportionally strong on the poorest countries and countries in crisis. It is in situations of poverty and conflict where international law has the most impact - for better or worse. International legal structures can provide security, stability and access to economic support, but they can just as easily prevent timely and adequate assistance. Development and humanitarian actors must increasingly be aware of their potential as well as their pitfalls.

Good Governance is easily prescribed, but must become a mindset of all involved to make the system work. Less and least developed countries are often governed by constitutions that are complex and inaccessible for their citizens. Without acceptance by their subjects, they weaken and cease to safeguard the nation state against failure. Development assistance must provide more than just models and institutions to move these countries forward.

Papers in the lawanddevelopment.org series aim to contribute to the understanding of the importance of these linkages and strive to support a better concept of how law can aid development. All papers are original works and are solely published on lawanddevelopment.org

---

For queries write to:

The Editor
lawanddevelopment.org
P.O.Box 1106
Nairobi 00502
Kenya

info@lawanddevelopment.org

www.lawanddevelopment.org

ABSTRACT

This paper illustrates the process of international law making from soft sources. By studying the interaction of the norms of the Financial Action Task Force with Somalia's informal funds transfer systems it demonstrates how soft law is made and compliance with it ensured. While examining these processes it identifies the strengths and the weaknesses of the use of non-binding norms in the international order. The argument that emerges is that soft law, while having the virtue of flexibility in its making, suffers from variance and ambiguity in its hardening. It therefore certainly has a very hard impact on the Somali remittance sector, an impact that may threaten a vital lifeline for the country. Arguably, it is the step into municipal law where the process is flawed, essentially leading to two levels of compliance, soft and hard. While it seems that although the regulators in many countries have developed an understanding for the particular situation of Somalia, the commercial sector has not or cannot afford to understand, adding another level of compliance. This may currently be a necessary consequence of using of soft law, but not an inevitable one. If compliance was assured on a truly international level, the variability of hardening through municipal legislations could be avoided.

TABLE OF CONTENTS

Acknowledgments

Many events and people have awakened and motivated my interest in Somalia. In five years of project work in the country I have met countless Somalis who are engaged in rebuilding their nation, and many Somalia enthusiasts in the international community. While I am grateful to all of them for helping me understand a unique people in a beautiful country, I would like to particularly thank those who have directly contributed to this dissertation.

Randolph Kent, the former UN Resident Coordinator for Somalia, came up with the idea of looking more closely at the problems the Somali remittance systems currently face. His enthusiasm for the cause of the Diaspora has been an invaluable motivation, and in many discussions he offered a plethora of thoughts and suggestions.

Paul Simkin of the European Commission's Somalia Operations in Nairobi kindly provided me with a collection of project documents to support my section about the assistance to the remittance sector.

Gina El-Khoury, the programme officer in the UNDP Somalia programme providing assistance to the sector, gave me further information and the opportunity to discuss my ideas with a 'real lawyer' deeply involved in these topics.

At the School of Oriental and African Studies I would like to thank my supervisor, Balasingham Skanthakumar, who not only at length and with enthusiasm encouraged and challenged my thinking, but also initiated me to the concept of soft law in his teaching.

John Hatchard helped me discover the Financial Action Task Force as the ideal link between soft law and Somalia's remittance sector.

Liesl Karen Inglis, the Environmental and Liaison Officer for the Horn of Africa Relief and Development Organization, very kindly edited and proofread the final document while in Bossaso, Somalia

I INTRODUCTION

This paper is about how international law can evolve from soft sources and how it affects its subjects in the process. While soft law fills gaps and consequently enhances the stability of the international legal system, it can have a harder impact than treaty law. This dilemma appears to be caused by the need to ensure compliance of otherwise non-binding norms. Compliance, it seems, is often too hastily enforced in the drive towards improved order and in the process universality is lost.

The question of compliance with norms is at the heart of the international legal system. Arguably, only rules that are followed have sustained standing in the global community. Codified international law, derived from its traditional sources as defined by the Statute of the International Court of Justice, encourages such commitment through legally binding treaties between parties and judicial organs to punish deviation. However, not only do these treaties leave gaps where compromise could not be found, but they also must often reflect the lowest common denominator between the signatories.

Soft Law[1] has increasingly become a remedy for both shortcomings of treaty law. Although often said to be a term redundant in itself, the phrase appropriately describes the numerous non-binding norms that today regulate international processes where no treaty exists. The very softness of these instruments has certain advantages. Parties to such agreements apparently accept more commitment than in a legally binding treaty – simply because they can easily be abolished or renegotiated without any negative consequences. The definition process is consequently faster and less controversial than treaty negotiations.

These rules however, are not law as such, and must be hardened to make them effective. In practice this takes place through various compliance mechanisms and by incorporation into municipal law. Soft Law can therefore be seen as a transitional process rather than a permanent structure, which at its outcome will have created codified law.

International Financial Law in particular has very successfully embraced Soft Law as a way to address urgent issues swiftly and flexibly without the need to immediately conclude treaties. Factors promoting compliance such as peer-pressure, market incentives, and oversight bodies are firmly in place in this environment, supporting the use of non-binding instruments. A paradigm of soft law with high compliance is the output of the Financial Action Task Force (FATF), an interest group created by the G7 to combat illegal use of the international financial system. Through several mechanisms these non-binding norms are substantially hardened, making them applicable not only to members but also to entities and territories depending on these members.

[1] This paper will use the terms 'Soft Law' and 'Non-binding Norms' as synonyms, describing as soft an agreement that does not contain legally binding wording and where the adoption process does not incur a legal obligation for the signatory.

The FATF process displays the advantages and disadvantages of soft law particularly in its effect on the informal funds transfer systems in Somalia. The country makes a perfect example for the impact of soft law - it has been without a government since 1991[2] and can therefore neither enter a treaty obligation nor can be subjected to international mechanisms to enforce existing obligations. In this case hard law instruments, through their traditional means, fail to have the intended impact. As a trade and service based economy, however, Somalia engages with other jurisdictions and is consequently exposed to their norms.

The absence of a conventional banking sector in particular has strengthened informal funds transfer companies in Somalia[3], which rely on interactions with the global financial system to operate. Previously unaffected by FATF rules these businesses, due to their informality, have attracted attention in the recent intensified focus on fighting terrorism and terrorist financing. New FATF guidelines now deal with terrorist financing and informal banking. Somali companies, with no government to advocate their cause, find it hard to comply with these new regulations.

The hard impact of FATF soft norms on the Somali remittance systems is an especially suitable model to demonstrate the advantages and the disadvantages of soft international law for several reasons. Firstly, the creation process and the formulation of FATF norms are typical of non-binding norms. Secondly, the flexibility inherent in these soft norms is utilised to adapt the norms to a changing environment, a clear advantage of soft law. Thirdly, the typical shortcomings of soft law are all prominently displayed in the FATF system, in particular the consequences of translation into municipal law. This hardening process arguably has the strongest effect on remittance companies by creating a variety of versions of the original rules. Finally, Somalia as a country without a government is particularly exposed to the translation of FATF norms into the national laws of its members; its businesses lack the backing of a state structure. Arguably, the FATF process is a paradigm of international law making, and in its interaction with Somalia it exposes the virtues and shortcomings of non-binding international norms.

---

[2] The last peace process, started in 2002, appears to be leading to the creation of a truly national government for Somalia. The interaction of Somali informal funds transfer systems with FATF norms, however, precedes these developments and arguably has created problems for these businesses and the country as a whole that require solutions notwithstanding the potential role of a future government.
[3] This paper will use the expression "Informal Funds Transfer Systems", as adopted by the IMF / World Bank (El Qorchi, Maimbo et al. 2003) in a general context and "Remittance Sector" or "Remittance companies / businesses" in the specific case of Somalia to reflect the generally beneficial use of these systems in this country. Another term commonly used in the literature is "Informal Value Transfer Systems" (Passas 1999; Ballard 2003), the FATF uses a combination of these terms, "(Informal) Money or Value Transfer Services" or "Alternative Remittance Systems" (www.fatf-gafi.org). The traditional Islamic term "Hawala" is used in all writings as an alternative expression for such systems.

The paper develops this line of reasoning in four main steps: After setting the stage with a brief overview of the interaction of FATF rules with the informal funds transfer systems in Somalia, it examines the current thinking on Soft Law and its role in the international legal system. It proposes that compliance with soft norms occurs at two distinct levels of hardness and presents FATF rules as a paradigm of soft law displaying this feature. The FATF norm-making process is then analysed in light of soft law theory. Introducing the world of informal funds transfer systems, and revisiting the case of Somalia, the paper exposes the theory and the mechanism to this particular environment and provides an analysis of how the virtues and shortcomings of non-binding norms apply in practice. In concluding the argument the paper proposes how to improve the process of soft law making and hardening for it to become an overall more beneficial tool in the international legal order.

II *PROLOGUE:* SOMALIA AND THE FATF - INTERACTIONS IN THE INTERNATIONAL LEGAL ORDER

Somalia has been a country without a government since 1991[4]. This makes it the longest and currently the only case of a collapsed state in the world[5]. Under international law Somalia is therefore unique in many respects. It cannot participate in international fora[6] and consequently has neither a national voice nor treaty-making capacity. Holding Somalia as a state responsible for existing treaty obligations is equally impossible. International law, however, still impacts on Somalia in various ways. The air traffic in the country is under supervision of the International Civil Aviation Organization[7] and telecommunications operators have linked the country to the global communication network under the provisions of the relevant treaties. While these examples reflect custom more than obligations of a functioning state[8], other sectors of the Somali economy are further exposed to international law – if only of the soft variety.

Traditionally Somali people are very adept traders, and the situation in the country has appropriately been described as "Economy without State"[9]. Arguably, economic interests, while they partially fuel the ongoing fighting in some areas, have stabilized and pacified large parts of the country where trade and small businesses thrive and constitute a vital basis for the development and stability of the region. This development takes place predominantly on a local level, with private individuals investing in small and medium-sized enterprises such as shops and trade services, but also telephone and Internet companies.

In the absence of a conventional banking sector[10] such remarkable development was largely made possible by informal funds transfer systems remitting between other countries and Somalia. Although often said to be 'underground' schemes[11], they in reality function like formal banks[12], with many operating openly from offices in these countries.

[4] A brief history of contemporary Somalia can be found in Annex II (page 38)
[5] (Rotberg 2004)
[6] For example the seats in the General Assembly and on the Boards of the World Bank and the International Monetary Fund are currently vacant (www.un.org/ga, www.worldbank.org and www.imf.org as of August 2004)
[7] ICAO, a specialized agency of the United Nations, tasked with developing safe and efficient international air transport (www.icao.int)
[8] Arguably, these are traditional areas where international law is said to be truly universal and complied with (Shaw 2003)
[9] (Little 2003)
[10] The restrictive state banking system under Siad Barre (see section VI for more details) encouraged private businesses to fill the gaps. Later, in the absence of government, they provided banking services without central control
[11] (Lambert 2002)
[12] (El Qorchi, Maimbo et al. 2003)

Such informal funds transfer businesses, dependent on having subsidiaries in Western countries, have come under scrutiny in most jurisdictions. The main concern is that they can potentially be used more easily for illegitimate purposes than formal banks, due to less formalised record keeping and a certain degree of customer anonymity. This unease of the financial establishment with the informal funds transfer sector has increased after reports that some of these companies were allegedly used to transfer operational funds to terrorist cells[13]. Somalia, being without central control, is seen to be a potential harbourer of terrorist groups; its money transfer operations are therefore a particular target of the international regulators like the FATF[14].
The recent focus of the FATF on these businesses has created uncertainty and risk of closure for many. Although the swift closing of the US operations of one of the major remittance companies in 2002 was later reversed, national legislations in Western countries are increasing the pressure on offices of remittance companies in their jurisdiction[15].

This has raised concern in the international aid community, which works towards stabilising and developing Somalia in order to return it to the community of states. It has been recognised by development actors in Somalia that the remittances from abroad are vital for the survival of Somalis and their economy[16]. Efforts therefore are made to support the legal use of the alternative money transfer businesses while making them compliant with FATF rules. Three major conferences, involving these companies, donors and government representatives in 2003 have attempted to reconcile the traditional, long-standing informal practices with the increasingly strict requirements of Western states. This effort has achieved that the newly formed 'Somali Financial Services Association' is about to publish an 'Anti-Money Laundering Compliance Guide' to assist its members to comply with key requirements of FATF norms[17]. In addition, the United Nations Development Programme (UNDP) is assisting the businesses with expertise to improve compliance and lobbies governments and financial institutions to increase their acceptance[18].

Arguably, such interventions, while targeting the shortcomings of soft law as epitomised by FATF rules, also benefit from this softness. It is only because there are specific 'Best Practices' for dealing with informal remittance systems and their abuse that it is possible for the affected companies to adapt. At the same time, however, the sector suffers from their flaws, in particular the loss of homogeneity during inclusion into municipal law in Western countries. Both facets of this interaction will be discussed in detail in this paper, as they very aptly demonstrate the advantages and disadvantages of using soft law to create and maintain international order.

---

[13] (Zagaris 2002) at page 140
[14] (De Goede 2003)
[15] (Report and Conclusions, 2003)
[16] ("Feasibility Study on Financial Services in Somalia" 2003)
[17] Press release on www.so.undp.org (UNDP Somalia)
[18] ("**Financial Sector Development Project**" 2004)

III THE VIRTUES AND THE SHORTCOMINGS OF SOFT LAW

A UBIQUITOUS TOOL

Soft Law has a unique position in jurisprudence. It is not law as such, as it neither has a binding character nor enjoys enforcement through the traditional judicial system. Its role as a (quasi-) legal instrument has consequently been controversial[19]. While some claim that it does not do anything that hard, codified law cannot do equally well[20], others confer more relevance to non-binding norms[21].

In the international arena soft law has surely achieved standing. Many international legal instruments either comprised of soft law or evolved from it, for example Human Rights treaties. The whole GATT/WTO system originates from non-binding trade agreements between states, and the international financial system relies heavily on 'Best Practice' documents governing the operations of its players[22].
International Finance seems to be a particularly conducive environment for the creation and maintenance of soft law norms, which can be attributed to several causes. Firstly, financial law is strongly influenced by economic considerations. While legal certainty is always desired, economists caution against rigidity of rules to maintain flexible and adaptable markets[23]. Secondly, the international financial sector has been less regulated than other areas of international economic law such as trade[24], and after the global financial crises of the 1990s the need for more homogeneity became imminent[25].

Thirdly, and most importantly for the feasibility of soft instruments, bankers and economists have the advantage of operating in an environment that exerts its own pressures on the participants, making enforcement of non-binding norms possible even in the absence of a dedicated conflict resolution system. Market incentives and peer pressure amongst states and financial institutions ensure strong compliance with non-binding norms, and oversight bodies monitoring the various soft norms evolved from voluntary associations within the industry[26]. While the central institution in the banking sector is the Financial Stability Forum (FSF), the Financial Action Task Force, FATF, specifically focuses on the illegal uses of financial channels.

---

[19] (Klabbers 1996) and generally (Shelton 2000a)
[20] (Hillgenberg 1999)
[21] (Shelton 2000a)
[22] (Giovanoli 2002)
[23] (Giovanoli 2000) at page 51f
[24] While trade relations are governed by the GATT/WTO treaties the global flow of money mostly relies on bi- and plurilateral agreements in its regulation.
[25] (Giovanoli 2002) at page 7
[26] (Giovanoli 2000)

THE VARIETY OF SOFT LAW

Notwithstanding such abundance, soft law has difficulties in finding its exact role in the international legal order. Its main difficulty seems to be that there exists a multitude of norms in its realm that are "of various degrees of cogency, persuasiveness and consensus"[27]. Adding to this complexity is the fact that many treaties, although legally binding in their entirety, contain soft parts, which use the typical hortatory language of non-binding norms[28]. Conversely, some soft law instruments may have a more specific normative content than such soft parts of treaties[29]. It is therefore difficult to give a general definition of international soft law norms. They share, however, a number of common characteristics. They influence the behaviour of the parties, they raise patterns of state behaviour from a national to an international level, and they establish new standards and guiding principles that give a certain legal structure to negotiations, settlement and general international relations[30]. A basic commonality is the exclusion from the hard international legal system: The Vienna Convention on the Law of Treaties, in its Article 26, defines a treaty as "binding upon the parties to it", a requirement soft law instruments cannot meet; they are never binding agreements between parties.

Non-binding norms are consequently often classified in their relationship to hard law. They can provide guidance and detail on the interpretation and application of existing hard law and can be emergent hard law (as is often the case in the Human Rights field) or they can provide evidence of existence of hard obligations (as in the use of General Assembly Resolutions as proof of state practice and *opinio juris*)[31].

THE VIRTUES OF SOFT LAW

What then are the virtues of soft law? It has been said "States undertake legal obligations only when they expect to be able to comply with them"[32]. This certainly reflects *realpolitik* in international relations, where usually at least reciprocity is required to get states to agree on certain common behaviour. Soft law instruments in this respect have an unparalleled advantage – they require no legal commitment whatsoever and can be ignored at will when policy goals shift. While this is a somewhat negative perspective, there is strong argument in favour of the advantage of such flexibility. Soft Law instruments seem to attract more support in their formulation; the very fact that the norms are non-binding leads to more commitment by parties throughout their negotiation[33]. The results are often very detailed texts[34], which in many cases contain provisions not less specific than treaties[35].

[27] (Baxter 1980) at page 549
[28] (Shelton 2000b) at page 10
[29] ibid.
[30] (Chinkin 2000)
[31] (Chinkin 2000) at page 30
[32] (Gruchalla-Wesierski 1985) at page 40
[33] (Giovanoli 2000) at page 43
[34] Soft law often comes in the form of 'guidelines', 'best practices' and 'codes of conduct', much more technical documents that regulate specific issues. Their level of detail is therefore necessarily high.
[35] (Giovanoli 2000) at page 43

Treaties, on the other hand, must ultimately be ratified and therefore parties to their negotiation tend towards the lowest common denominator in their negotiations.
This makes soft law the ideal tool to facilitate commitment while leaving a back door for non-compliance; it is an intermediate, a stage between the absence of regulation and codified law. It has accordingly been defined as a transitional tool that can provide an experimental response to new challenges, which is easier to correct or even abandon if the reaction turns out to be inappropriate[36].
While these benefits clearly make soft law attractive to use, usage of soft norms must be supported by mechanisms that ensure compliance, giving them clout.

COMMITMENT AND COMPLIANCE[37]

While binding treaties exist in a defined legal environment, which allows for judicial recourse or arbitration in case of their violation, such mechanisms are not accessible for disputes over soft law. Neither the Vienna Convention on the Law of Treaties nor the Statute of the International Court of Justice, the traditional forum for disputes over treaties, accommodate non-binding norms as primary sources[38]. Arguably, there must be other means to ensure submission to soft rules. A number of factors have been identified that facilitate commitment to and compliance with non-binding norms. While generally their links to established hard law, their 'fitting in' with existing norms and general practice of states and institutions give soft norms logic and reason, the transparency of the norm and the creation process certainly improves allegiance[39]. Of particular importance are the utilitarian interests of the targets of the norm, the legitimacy and inclusiveness of the creation process, moral, ethical and social aspects and, prominently, the capability of the objects of the norm to conform to it[40]. Clearly, compared to treaties, soft law instruments can meet these criteria better. The absence of a strict legal obligation allows for the inclusion of non-state actors such as private and community entities and more flexibility.
These are still very lenient factors for compliance. It has been said by critics of the soft law concept that, in accordance with its non-legal status, it could only have recourse to soft remedies[41]. This has, however, been disputed[42].

While disputes over these norms cannot be taken to the traditional courts of international justice, other enforcement mechanisms are in place that ensure compliance and punish non-compliance. They are most apparent in international economic law, where policy issues like the concept of "Good Governance" are well enforced in developing countries through IMF and donor conditionalities. Protection of the environment, another classical field of soft law instruments[43], is a factor in World Bank funding decisions. Economic sanctions, at bi- and multilateral levels, are further factors for compliance.

---

[36] (O'Connell 2000) at page 109f
[37] Title of a recent book examining the role of nonbinding norms in international law (Shelton 2000a)
[38] The ICJ, however, often refers to General Assembly or UN Security Council resolutions in its opinions
[39] (Charney 2000) at page 177f
[40] ibid.
[41] (Klabbers 1996)
[42] (Charney 2000) at page116
[43] (Shelton 2000a) pages 121ff

Similar remedies are usually sought for non-compliance with hard international law; normally an aggrieved party to a treaty only in exceptional circumstances resorts to law-based remedies[44] – of which there are not many available at an international level[45]. Treaties, just like soft law agreements, need the commitment and compliance of states; "…when that willingness to cooperate diminishes, it is unlikely that attempts will be made to enforce them either in court or through reprisals"[46]. It seems that at this level soft international law is not at a particular disadvantage to hard treaty law.

This multitude of mechanisms could be seen as characterising a lower level of compliance, the voluntary and semi-voluntary commitment to norms that do not enjoy a direct enforcement process. The rules are complied with to avoid disadvantages, but can still be ignored without legal consequences. A significantly higher level of compliance is reached when soft law norms enter municipal jurisdictions. By incorporating non-binding rules into national law, states harden these rules into positive law, law that enjoys full enforcement by the established judicial organs of the state. This is a crucial step between soft law and hard law, which takes the norms out of the sphere of (semi-) voluntary commitment and removes the option of opting out of compliance.

[44] (Charney 2000) at page 116
[45] For disputes between states recourse is only possible to the International Court of Justice (ICJ), which is, however, based on consent to its rulings. On trade matters the WTO dispute resolution body is the forum of arbitration. Disputes between States and private entities, unless Human Rights are concerned, can only be pursued on a national level.
[46] (Hillgenberg 1999) at page 502

Compliance with soft law instruments could therefore be seen as happening at two distinct stages, in themselves soft or hard. At the first stage, states and non-state actors commit to a common norm, to directly or indirectly protect their interests. These actors then project their commitment outwards, onto non-participants in the making of the norm. While this exerts a certain pressure, the mechanisms still are within the scope of commitment and induced (soft) compliance. Opting out, re-negotiation, and choosing alternatives are still possible at this level. When soft international norms become municipal law, however, these options cease to be available. Interacting with the legislation of a sovereign state exposes external actors to a full legal system with enforcement mechanisms, where absolute rules apply. Negotiations and alternatives are no longer available, and opting out means not to deal with the respective country at all. To emphasize this crucial difference in the use of soft norms, a two-step model of compliance with non-binding norms is proposed, which differentiates between soft and hard compliance, as summarised in Table I.

Degree of Compliance	Actors	Behaviour	Mechanisms
Soft ***Commitment to the norm and protection of interests drive compliance***	**Parties** to the Norm	**Commitment** *Voluntarily through direct or indirect incentives*	Direct Benefit Peer Pressure Market Incentives Net Benefit
	Non-Parties to the Norm	**Soft Compliance** *Voluntarily through direct or indirect incentives, or to avoid economic and political disadvantages*	Direct Benefit Group Pressure Market Incentives Market Pressures Avoidance of harm
Hard ***Enforcement mechanisms ensure compliance***	**Non-Parties** to the Norm	**Hard Compliance** *Municipal laws based on the norms enforce compliance, the only alternative is to avoid interaction with the system*	National Law-Enforcement Mechanisms

Table I Soft and Hard Compliance

In reality, therefore, soft law seems not to suffer from significantly less or softer enforcement than hard law. Moreover, the step from soft to hard compliance mechanisms considerably reduces the benefits of soft law, as it frustrates its intrinsic flexibility. This is a significant flaw of soft law that shapes the hard impact of FATF norms on Somalia's informal funds transfer sector.

THE SHORTCOMINGS OF SOFT LAW

While the main virtues of soft law seem to be its flexibility, which is even more accentuated by the variety of mechanisms to ensure compliance, it has serious shortcomings. In particular in international financial law, soft instruments are designed and applied by groups that do not represent all stakeholders. An obvious example is the FATF, which with 33 members is far away from the virtually universal membership of the Bretton Woods Institutions; the same is true for other sectoral standard setting bodies like the Basel Committee on Banking and the Financial Stability Forum. There is therefore a geographical legitimacy issue[47], as the standards, through the economic influence of the parties to their creation, will affect non-participants. It has been said that such limited legislative process needs to be more inclusive to ensure the ownership and the commitment of all affected states and groups[48].

Legitimacy of these non-binding norms also has a procedural dimension. The process of norm making is often performed by experts and bypasses the normal legislative process of the participating countries. This leads to valid criticism about "…technocratic bodies establishing rules in a relatively closed environment, outside democratic control and accountability…"[49]. Not surprisingly has there been a certain impetus to establish a global oversight body for all existing soft norms in finance[50].

The essential flaw of soft law, however, lies in the step to hard compliance, its incorporation into national legislations. While non-binding norms are usually homogenous rules that are easily defined and adapted according to needs, their adoption into municipal law of state parties frustrates this virtue. It is evident that the variety of national jurisdictions cannot easily be overridden by international norms – a traditional hindrance also of treaty making that leads to 'lowest common denominator' results. While the European Union certainly has achieved outstanding homogenisation of national laws, it is still the exception globally[51]. International financial standards, which are soft law, therefore must adapt to existing municipal law in the adopting country. The result is a variety of versions of the original standards, implemented to different degrees. It is here that soft law looses its main virtue of flexibility, and it apparently also looses its virtue of universality.

This leads to the question whether soft law can truly create the homogenous global order that was envisaged following the financial crises in the 1990s. "Does the implementation at the domestic level of each jurisdiction…ensure a sufficient degree of consistency and internationally harmonized implementation, providing for the level playing-field that is essential for competition in a global market?" [52] is an obvious question and the answer is at best ambiguous.

[47] (Giovanoli 2000) at page 43
[48] (Morais 2002) at page 794
[49] (Giovanoli 2000) at page 43
[50] (Giovanoli 2000) at page 58f
[51] (Morais 2002) at page 783
[52] (Giovanoli 2000) at page 44

It seems hardening through national legislation is not the most suitable way to 'legalise' soft law. It leaves behind its original universality and acquires a weakness not unlike the inherent 'lowest common denominator' problem of hard treaty law. The adoption of non-binding norms by truly international bodies like the Bretton Woods Institutions seems a more promising way towards universality[53]. Even this has a long way to go. The Fund and the Bank, however, have recognised their potential role and are addressing some of the need for homogenous global rules. In international financial law both have undertaken to help harmonise the existing norms[54].

This takes the argument back to the interaction between Somalia and the soft norms of the FATF. While the softness of the instruments have allowed guidelines specifically focussed on alternative remittance systems, the enforcement of these norms takes place through the national jurisdictions of FATF members (other international sanctions or economic pressures are mostly inefficient against a country without government). This highlights the shortcomings discussed before. Somalia – like most other developing countries – did not participate in the process creating the original norm, but its nationals and businesses must submit to the various individual versions of these instruments. And while other countries may be able to achieve a more lenient approach on an intergovernmental level, this option at present is not available for Somalia. The interaction of the FATF norms with the country therefore displays the problem of compliance at two levels of hardness remarkably well.

[53] (Giovanoli 2000) at page 58
[54] (Aninat, Hardy et al. 2002)

This exposes its negative impact further, as the effect is significantly exacerbated by the role of private entities like banks: While they must, and can, comply, they amplify the compliance regime through a strict pursuit of business interests. This, as will be shown in more detail in the discussion of the effect of FATF rules, hardens the impact of the norms even further. Table II amends the original model of soft and hard compliance accordingly. Arguably, this makes the FATF process and its interaction with Somalia a suitable model for soft law, a paradigm of international law making from soft sources.

DEGREE OF COMPLIANCE		ACTORS	BEHAVIOUR	MECHANISMS
	SOFT *Commitment to the norm and protection of interests drive compliance*	**Parties** to the Norm	**Commitment** *Voluntarily through direct or indirect incentives*	Direct Benefit Peer Pressure Market Incentives Net Benefit
		Non-Parties to the Norm	**Soft Compliance** *Voluntarily through direct or indirect incentives, or to avoid economic and political disadvantages*	Direct Benefit Group Pressure Market Incentives Market Pressures Avoidance of harm
	HARD *Enforcement mechanisms ensure compliance*	**Primary Non-Parties** to the Norm *Banks and private monetary institutions in countries who are party to the norm*	**Primary Hard Compliance** *Municipal laws based on the norms enforce compliance, the only alternative is to avoid interaction with the system*	National law-enforcement mechanisms
		Secondary Non-Parties to the Norm *Businesses dealing with primary non-parties*	**Secondary Hard Compliance** *Primary Non-Parties must adhere to rules under municipal law and project them onto their business partners. As a result, interaction may become unviable for secondary non-parties.*	National law-enforcement mechanisms and direct market pressure

Table II Soft and Hard Compliance: Primary and Secondary Hard Compliance

IV A PARADIGM FOR INTERNATIONAL LAW MAKING

THE SOFT BEGINNINGS OF THE FATF: AGREEMENT AND COMMITMENT

The FATF is a creation of the G7 and the European Union, founded to address the need for a unified approach to international money laundering. At its inception in 1989 money laundering was a concern all developed countries shared, and the membership of the FATF quickly grew to today's membership of 33, built on strong consensus with a common goal in mind.

Its decisions are reached through discussions between high-level experts of the member governments[55]. In this it mirrors the modus operandi of other international financial bodies that are sources of soft law in the sector[56]. Decisions must be reached in consensus.

The first output of the body, the "Forty Recommendations"[57], reflects this aim and commitment. These recommendations represent typical soft law in every respect. There is no ratification procedure, only voluntary adoption. The wording is non-binding, hortatory; "Countries should…." is usually the form used. Furthermore, the instrument fulfils the basic criteria of influencing and internationalising state behaviour while by establishing new standards it gives legal structure to negotiations.[58] The FATF itself clearly defines its limited scope as a norm setting and monitoring body.

The choice of a non-binding accord has further merits. As discussed before[59], flexibility and the ability to react to a rapidly changing market environment certainly guided the choice of instrument for the FATF[60]. Furthermore, it seems rather unlikely that the supervision mechanisms of the FATF – explained in more detail in the following paragraphs – would have been agreed to in a legally binding context[61].

This supports the earlier argument that states prefer less commitment but may accept more detail and stringency as long as there is an option to abandon the norm if it turns out to be impractical.

The specific targeting by the FATF of not only states but also financial institutions provides a third reason for the choice of non-binding legal norms. "It is difficult to imagine gaining the cooperation of private financiers with a binding international agreement that forces change in the way they conduct much legitimate business and alters, for many, their fundamental relationship with their clients." [62] This exemplifies the opt-out character of soft compliance[63].

---

[55] This highlights the procedural legitimacy problem of many soft law instruments (see page 15)
[56] (Giovanoli 2002) at page 18ff
[57] These are the original anti-money laundering rules of the FATF, which, in a revised form, are still at the heart of the FATF set of norms (*The Forty Recommendations*, Financial Action Task Force 2003)
[58] A common characteristic of soft law (see page 13). Adherence to the "Forty Recommendations" was a condition in the recent accession of new member states to the European Union.
[59] See page 11f
[60] (Simmons 2000) at page 262
[61] ibid.
[62] (Simmons 2000) at page 262
[63] See Table I (page 14)

Other instruments have been added since the 'Forty Recommendations' were established. The 'Special Recommendations on Terrorist Financing' in October 2001[64] and the 'International Best Practices for combating the Abuse of alternative Remittance Systems'' in June 2003[65] are of direct relevance to the interaction with Somalia; both are worded like the "Forty Recommendations" and adopted in a similar process[66].
There has been critique of these additions to the original recommendations. They were said to simply "…restate rather than innovate the most relevant measures expressed previously in the framework of terrorism" and that the framework of measures "…does not constitute an original mode of prescription" [67]. They reflect, however, the advantages of soft instruments in that they were easily put in place as needed and specifically target issues of concern.
The commitment of FATF members to these norms originates from the perceived threat the abuse of the international financial structure poses for these countries, typical of soft law. The FATF norms fit in with existing rules and standards, such as the individual national anti-money laundering legislations[68].

While such commitment was vital for the creation of the norms, continuing compliance and the inclusion of non-members is needed to give them sustainability. The FATF structure and additional provisions for monitoring of members and influence on non-members therefore add clout to the rules.

THE HARD WORKINGS OF THE FATF: POWER AND COERCION

Building on member's commitment, the compliance with FATF norms is encouraged on several levels. Members undergo an annual self-assessment exercise, the results of which are made available to all other members. In addition, a mutual evaluation process takes place regularly, where expert teams from member states examine the compliance in each country. Both processes are, like the whole FATF structure, typical of soft law regimes in international finance. Peer pressure is the main driving force, and, to a certain extent, market incentives[69], as compliance with FATF guidelines arguably makes a country more attractive for legitimate foreign direct investment. The common economic interest of FATF members (virtually the same as that of the OECD[70]) strengthens these mechanisms.

[64] (*Special Recommendations on Terrorist Financing*, Financial Action Task Force 2001)
[65] (*Combating the Abuse of Alternative Remittance Systems: International Best Practises*, Financial Action Task Force 2003)
[66] www.fatf-gafi.org
[67] (Sorel 2003) at page 372
[68] See also *Commitment and Compliance* (page 16ff)
[69] (Giovanoli 2002) at page 18ff
[70] Only five OECD members out of thirty are not members of the FATF (Czech Republic, Hungary, Korea, Poland and the Slovak Republic). However, with the exception of Korea, these countries have become member states of the European Union in 2004 and are under the accession treaty obliged to full FATF compliance (www.oecd.org and www.fatf-gafi.org)

Non-members are encouraged to comply through their interaction with members, for example in trade and finance, but also through other international bodies that have adopted the FATF guidelines. The International Monetary Fund (IMF) refers to the norms in its loan agreements, and countries drawing from the Fund may have to include FATF compliance in their letters of intent[71]. The World Bank similarly uses FATF compliance as an indicator of good governance[72].

While these mechanisms, still at the level of soft compliance, ensure commitment of non-members to a certain extent, they have been criticised for violating the spirit of international cooperation. The naming of "Non-Cooperative Countries and Territories" by the FATF[73] and the implied threat of economic sanctions has been said to suggest "…a policy redolent of extraterritorial bullying"[74].
As much as this may be the case, arguably the adoption of the norms into municipal law of member states has an even stronger and potentially more adverse effect on non-members, especially those who are not dependent on IMF or World Bank funding or, as in the case of Somalia, do not have access to it. "The clout of FATF recommendations stems from their reproduction by the appropriate state authorities…for the benefit of private and public bodies."[75] Economic pressure can be avoided and relations can be re-negotiated. Municipal law offers neither option[76]. This marks the step from soft to hard compliance[77].

HARDENING FATF RULES: THE MAKING OF LAW

All but one of the members[78] of the FATF have incorporated the full recommendations into municipal law, although to different degrees. While this surely contributes immensely to their hardening - any non-member interacting with these jurisdictions will have to comply with the rules over the duration of this exchange - it also diversifies the initially uniform recommendations.

The aim of adaptability to different jurisdictions exposes the FATF norms to this fundamental shortcoming of soft law; it is intended that each state can apply the rules differently and only a minimum common standard should be maintained. The introduction to the "Forty Recommendations" gives adaptability to national legislation as one of the reasons why a soft instrument was chosen: "*The FATF recognises that countries have diverse legal and financial systems and so all cannot take identical measures to achieve the common objective, especially over matters of detail. The Recommendations therefore set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks*."

---

[71] For example Letter of Intent Pakistan of 11th October 2003 (www.imf.org)
[72] www.worldbank.org
[73] A current list is available at www.fatf-gafi.org
[74] (Doyle 2002) at page 281
[75] (Bantekas 2003) at page 327
[76] See also Table I (page 14)
[77] See Table I (page 14)
[78] Turkey has not passed all necessary legislation (as per the latest annual FATF reports): www.fatf-gafi.org; see also (Simmons 2000)

Examples are statements from annual FATF reports concerning the United Kingdom and Denmark. While the former fulfils and even exceeds FATF recommendation, "*...the United Kingdom anti-money laundering system is an impressive and comprehensive one…which meets the FATF Forty Recommendations and indeed in many areas goes beyond them*", the Danish legislation still falls short of the norm: "*Overall...the Danish anti-money laundering system meets the FATF Forty Recommendations, and…appears to be reasonably effective in implementing them…but…there are some refinements and improvements which would enhance its deterrent and enforcement capability.*"[79]
While this certainly facilitates the commitment of members, 'nationalisation' of FATF norms puts universality and homogeneity at risk, an issue of significance for the FATF impact on Somalia. It creates an uncertainty and ambiguity the original soft instrument did not have, which will be discussed in more detail in Part VI.

Informal funds transfer systems are particularly exposed to the various municipal laws based on FATF norms. Their unconventional character lets them more easily be abused for criminal purposes than formal banks. Undoubtedly, the targeting of these businesses by the FATF therefore has certain merit. However, it seems that the balance between recognising the benefits to the society they serve and the prevention of potential abuse has not yet been found. This balance is crucial, especially so in Somalia where a fragile but thriving economy survives and grows because of these companies. A short discourse into the workings of these systems and their role is therefore essential to better understand the consequences of FATF norms and the virtues and shortcomings of soft law that are apparent in this particular context.

[79] Both quotes from excerpts of annual reports on www.fatf-gafi.org/legislation_en.html

V *DISCOURSE*: TRADITIONAL FUNDS TRANSFER SYSTEMS IN THE MODERN FINANCIAL WORLD

TRUST AND BANKING

Trust has always been at the heart of financial transactions.[80] The whole monetary system, with its use of tokens instead of items of corresponding worth to the transaction, is based on trust in the value of currencies, bonds and account balances. Transactions are conducted between parties over long distances with only indirect means of assuring the identity or the integrity of the partner in the deal. Such implicit trust in peers, institutions and governments is one of the major achievements of modern international finance[81] – but is still regularly and often abused for criminal purposes, like fraud, money laundering or the financing of criminal and terrorist activities[82]. It is widely assumed that modern control mechanisms, like the codes of conduct adopted by most financial institutions in regards to customer identification and documentation of transactions, is sufficient to prevent most abuses of the system. However, the very interest of conducting business runs counter to such measures. Influential customers do not appreciate intrusive control mechanisms, and most banks are attempting to walk a fine line between control and customer privacy. Although even traditionally secretive European banks have submitted to certain checks, there is still a compromise between these and their business interests, and trust continues to be at the heart of banking operations, regulations notwithstanding[83]. The only difference is that modern banking has moved away from trust in individuals to trust in institutions.

HAWALA OR THE MYTH OF 'UNDERGROUND BANKING'

Not only do informal funds transfer systems work in a surprisingly similar way, they are "…connected to the institutions and practices of Western banking in a myriad of ways".[84] The allegation of 'underground banking' is therefore clearly a myth. In such systems trust is as much the basis of the operation as in "formal" banks, and the transfers work in a very parallel fashion. Numerous informal funds value transfer systems are known globally, most of which originate from the days of early trading, when the value of goods and services had to be transferred over long distances but gold or other payment tokens were too risky to transport physically.
These informal funds transfer systems have received increasing attention in recent years. Initially an object of law enforcement studies[85], they have also been examined in their cultural[86] dimension.

[80] (De Goede 2003) at page 515
[81] (Valdez and Wood 2003)
[82] As evidenced by the efforts against these abuses, like the creation of the FATF
[83] (Valdez and Wood 2003)
[84] (De Goede 2003) at page 516
[85] (Passas 1999; Lambert 2002)
[86] (Ballard 2003)

The Bretton Woods Institutions recently recognised their role in economic development and have embarked on a more understanding and cautious approach towards regulating them[87]. This is reflected in the relevant FATF norms[88]: "*In certain jurisdictions, informal [funds transfer services] provide a legitimate and efficient service. Their services are particularly relevant where access to the formal financial sector is difficult or prohibitively expensive… Government oversight should be flexible, effective, and proportional to the risk of abuse*."
Clearly, while potentially open to abuse for criminal purposes, these informal funds transfer systems have been acknowledged as an economic factor that needs integration rather than termination. This however depends on the individual situation. Pakistan, seemingly concerned with the interference of informal funds transfer systems with the banking sector, has completely prohibited such operations[89].

While the FATF concedes to such interest, "*It is acknowledged that in some jurisdictions informal [funds transfer services] have been banned. Special Recommendation VI does not seek legitimisation of informal [funds transfer services] services in those jurisdictions*." It cautions against the consequences: *Mechanisms that minimise the compliance burden… without being so burdensome that it in effect causes [funds transfer services] to go "underground" making them even harder to detect should be given due consideration…"*[90]
Generally there seems to be a trend towards supporting the beneficial uses while preventing illegal usage of these systems. However, a balance has yet to be struck between the hard impact of the existing rules and the need to preserve these services, as exemplified by the threat FATF norms present to the Somali remittance sector.

MECHANISMS OF INFORMAL FUNDS TRANSFER SYSTEMS

The systems examined here are based on the traditional *Hawala*, the version of informal value transfer predominantly used in the Middle East, South Asia, and Islamic communities in Africa and elsewhere throughout the world. The principle of *Hawala* is simple (a schematic overview is provided in Annex I). An example will illustrate the basic procedure[91]:
A Somali man, who works in London, wants to send money to his family in Mogadishu. He visits his local *Hawaladar*, and gives the operator £300 in cash and the details and whereabouts of the family member receiving the money. The *Hawaladar* sends an email to his business partner in Mogadishu, often a relative, with the details of the recipient and the amount to be paid out, minus his commission of £9 (3 %). The *Hawaladar* in Mogadishu sends a message to the recipient, the recipient comes to the office of the *Hawala* and receives the £291 in cash, either in US$ or in Somali Shillings at the daily rate. The transaction usually takes place on the same or the next day, depending on the distance between the receiving *Hawaladar* and the recipient.

---

[87] A current IMF study analyses the economic benefits of such systems (El Qorchi, Maimbo et al. 2003; Maimbo 2003)
[88] (*Combating the Abuse of Alternative Remittance Systems: International Best Practises*, Financial Action Task Force 2003): Principles
[89] ("Pakistan cripples the Money Movers" 2002)
[90] (*Combating the Abuse of Alternative Remittance Systems: International Best Practises*, Financial Action Task Force 2003): Principles
[91] The example is based on an IMF / World Bank Study (El Qorchi, Maimbo et al. 2003) and adapted to the Somali context based on personal observations

While the actual – if virtual - transfer of funds, as in the example illustrated above, is straightforward and fast, the system is more complex as it requires settlement like any other banking transaction. *Hawala* systems use different forms of settlement. In the Somali context those that are most commonly used are trade and capital flight. Settlement by trade is highly attractive for a country without formal links to international banking, which makes it difficult for Somali businesses to pay for imports from Western countries. To overcome this, the *Hawaladar* in London pays the £291 he has received into an account he maintains with a London bank for his partner in Mogadishu. The Mogadishu businessman, amongst other activities, imports goods from the United Kingdom. His partner in London orders them and pays the supplier from the account he keeps on his behalf. This closes the circle, as the *Hawaladar* in Mogadishu can use the cash he receives for selling the goods to pay recipients of remittances, he therefore does not have to be concerned about keeping cash in his offices, and through these payouts he credits his account in London so he can order new stocks.
Settlement by capital flight is similar in effect; only the *Hawaladar* in Somalia does not run a business with imports from Europe. However, he wants to keep his profits safe to later send his children to university in Europe or to keep reserves to invest in his business in the future. By crediting his account through *Hawala* transactions, this again allows him to virtually move his income out of the country without having to worry about keeping or transporting large amounts of cash. More complex settlement structures may include more than one *Hawaladar*, but achieve essentially the same.
Such transactions neither have an underground nor an illegal character of any kind. To the contrary, they closely resemble "formal" banking; with the only exception that the interface between customer and funds transfer service is less formal and often based on friendship or family links. Settlement procedures resemble those of formal banks, with the only difference that there are fewer central settlement institutions that can facilitate them.

However, the *Hawala* are used in preference over formal banks by their clientele for a number of reasons. Most prominent is the ease of use and the speed with which transactions are conducted. In addition, while formal banks usually require the sender to hold an account with them before allowing international transfers, cash can be used in informal funds transfer businesses. Banks usually only operate in larger towns, restricting access for rural populations.

Furthermore, many senders of remittances receive social security benefits in European countries and can either not open a bank account or may prefer not to be on record with what amounts to in effect, the transferring of their host country's tax payer's money abroad.[92] While this to a certain extent has supported the success of 'formal' cash transfer companies like Western Union or Money Gram, they suffer from geographical limitations. Informal businesses operate through a network of friends and relatives and can therefore send funds to virtually the smallest village without much delay, for the commercial international companies this is not viable and they operate offices only in larger centres, not unlike formal banks.

---

[92] Personal communication of the author with Somali people using informal funds transfer systems and with senior staff of remittance companies

Other facets are cultural. In many Islamic countries women may not be allowed to enter the offices of formal banks or commercial businesses, but can perfectly well interact with a family-based informal business in their neighbourhood that is accepted and is aware of the cultural and social codes in dealing with the recipients. Also, senders of money often do not know the exact whereabouts of the recipient, but name and family relations, a means of identification common in Somali society[93]. Formal systems cannot deal with such issues. These advantages of using informal systems are "…precisely the attributes that modern globalising investment banking aspires to"[94] but, arguably, has not achieved.

What, then, are the concerns of the international community about these informal systems? Their very informality seems to be the central point for criticism. An established provision of all anti-money laundering regimes is the principle of "Know Your Customer". It is widely understood that while banks trust each other, this trust must end at the interface to the customer, as there is no incentive for them to adhere to the bank's rules. Generally therefore customers of Western banks must prove their identity under the respective laws of the country, producing official identity documents. This seems to be lacking in informal banking – or at least it does not fulfil the Western idea of identity confirmation. Certainly, in a country like Somalia, where neither government nor a national identity system exists, proof of identity seems impossible.

However, in this specific case of a clan-based society such concern is mostly unfounded. Somali people can usually establish within minutes the origin of any of their nationals by asking for clan, sub-clan and family relations. Such lineage information is used to establish the identity of recipients of funds, and appears to be highly accurate.
In contrast to this system of family ties the West relies on documents, which with all current security provisions can still be faked and used to conceal identities. In addition, the fact that businesses are often used as fronts for illegal financial transactions the accuracy of the 'Know Your Customer' principle in the developed world is as easily questionable as in the informal banking sector. Nevertheless, the formal banking sector believes that its regulation regime is sufficiently strong to prevent most forms of abuse, while the informal sector is seen as weak and easily accessible for criminal activities. The principle of 'Know your Customer' and the arguably better documentation of transactions in the formal sector are therefore the main tenets at the heart of FATF rules and related norms[95]. These two principles and a strict requirement for reporting suspicious requirements are commonly the main components of applied FATF rules in western countries[96].

[93] See note 92
[94] (De Goede 2003) at page 517
[95] As for example the output of the "Basel Committee on Banking Supervision" (www.bis.org/bcbs) and the "Egmont Group" (www.egmontgroup.org)
[96] (Report and Conclusions, 2003) and (Campbell-Tiech 2004)

VI SOMALIA AND THE IMPACT OF FATF RULES

INTRODUCING THE "ECONOMY WITHOUT STATE"[97]

A visit to present day Somalia will surprise the uninitiated; too ingrained is the expectation of how an African state without a government should look like. Instead of utter chaos, poverty and even starvation the visitor encounters in many areas a booming urban economy and an impressive rural livestock and agriculture sector. Although this has to be differentiated, as in areas of conflict – which are still common and widespread in the South of the country – the situation is not at all stable and prosperous, it does give the picture of an unusually resilient economy. City market traders sell imported goods for every need imaginable, all larger towns have mobile phone networks and Internet facilities; and trade and transport businesses, including international airlines, offer their services. Compared to the neighbouring countries Kenya and Ethiopia international phone calls cost in Somalia are less than half. Livestock is exported through port facilities that can accommodate most modern cargo ships, and imports through these ports contribute significantly to the supply of the wider region. The largest Somali airline serves the Gulf region and Europe, while foreign Airlines have started to connect their international routes to Somalia through regional partners. This facilitates the import trade, which mostly operates through Dubai, the trade and financial hub of the Gulf. This remarkable economy, based almost exclusively on individual private businesses has contributed immensely to the stability it depends on for its prosperity

The Somali economy has been without state control since 1991[98], and businesses have taken over the provision of services that originally were the domain of the state. Numerous water supply systems in Somalia are managed by consortia of local businessmen, and appear to function more efficiently and transparently than the old state services. Similarly, the supply of electricity is mostly in private hands. The international development actors have recognised the benefits of these initiatives and actively support such enterprises.
There is a reason for the unusual persistence of private initiative in the country, which lies in the restrictive economic regime of the Siad Barre era. From the mid 1970's, an informal market had developed that provided goods and services not available through the state-controlled enterprises[99]. This market benefited from the substantial amounts of remittances from Somali workers abroad, who were coveted workers in the oil-based economies of the Gulf and in other countries.
A large part of the national income therefore arose not from domestic enterprises, but from the funds these expatriate workers sent home[100]. This "remittance economy"[101] is a unique feature of Somalia and sustained the population throughout the turmoil of two civil wars and through the current state of functioning without a central government.

---

[97] While the expression is taken from the title of a recent book about the Somali economy (Little 2003), the main part of this section is based on personal observations by the author made during numerous visits to Somalia and neighbouring countries between 1998 and 2003, unless otherwise referenced.
[98] With the exception of north western Somalia, where the self-declared independent Republic of Somaliland has a functioning government. However, even here private business is mostly permitted to operate freely, as its value for the economy has been recognised.
[99] (Mubarak 1997)
[100] (Jamal 1988) at page 203
[101] (Jamal 1988)

REMITTANCES AS LIFELINE

It is estimated that family support remittances alone contribute 22.5 % (US$ 360 million annually) of the total household income in Somalia, considerably more than international aid[102]. They undoubtedly provide a vital lifeline for a large proportion of the Somali population[103].

The remittance system in Somalia began as the officially endorsed *franco valuta* scheme, which allowed expatriate workers in the Gulf States to ship high-value consumer goods back to relatives in the country[104]. This scheme supported traders, who facilitated the shipment of goods, and created a mutually beneficial network between them, the migrant workers and their families[105]. These traders increasingly also facilitated funds transfers to the families and subsequently created a whole remittance sector that took over a considerable percentage of the foreign exchange transactions. This sector gave private traders access to foreign currency and significantly increased import and consumption of goods. Today these remittance companies provide much more than just funds transfer services for the Diaspora. They facilitate business investment of Somali businesses abroad and make large-scale investments in the country, such as mobile phone networks possible[106]. A further role in the provision of health services is being discussed.

The fact that the remittance companies in Somalia established themselves as an alternative to a state-controlled banking system has given them unique standing. At the outbreak of the civil war they were in control of all international and national financial transactions, and up to date remain the only functional banking service of any kind in the country[107]. This has been recognised by the international development partners operating in Somalia; while they understand the vitality of the sector for development and provide support, they at the same time depend on it to move their programme funds to Somalia without having to rely on the risky transport of cash[108].
Many of these companies have now become truly global enterprises. The largest businesses operate not only offices in the capitals of their main constituencies, but run web pages and conduct some of their business over the Internet. They also often supply integrated services such as telephone and Internet access, in line with their reliance on telecommunication as a means for a swift and efficient service.
The increasing exposure to regulations has driven the companies to improve the coordination of their activities better; and in 2003 the "Somali Financial Services Association" (SFSA) was launched to harmonise and strengthen the sector.

---

[102] International assistance to Somalia in 2003 totalled US$ 271 million (Somalia Aid Coordination Body Donor Report 2003) and ("**Financial Sector Development Project**" 2004)
[103] This is particularly relevant – and very current – in regions where due to a combination of complex factors sections of Somali society, in particular pastoral society, are losing their livelihoods and are becoming increasingly dependent on support from remittances to survive.
[104] (Mubarak 1997)
[105] ibid.
[106] (Omer 2002)
[107] ibid.
[108] Observation by the author; the transfer of programme funds to Somalia is an accepted part of their implementation and donors permit budget positions for the cost of these transfers

THE IMPACT OF FATF RULES: REVISITING THE SHORTCOMINGS OF SOFT LAW

The impact of FATF norms on the Somali remittance industry is predominantly through the national legislation of FATF members. In the United States, the United Kingdom, Norway, Sweden, Denmark, The Netherlands and Germany, countries that have the largest Somali Diaspora populations, FATF rules have been incorporated very differently into municipal law. While the strictest national legislations in Norway and The Netherlands practically ban informal funds transfer businesses, the US, Sweden, Denmark and the UK maintain a high degree of flexibility in dealing with these companies.[109] Not surprisingly, the former countries have been commended[110] by the FATF for the high degree of their compliance with the recommendations. The initially universal norms of the FATF have become highly diversified in the process of hardening, a major shortcoming of soft law creating several levels of compliance[111]. The Somali companies have to adjust to the different requirements in the individual country, which requires additional effort and is often not financially viable[112].

While the national regulators show a variety of responses to informal funds transfer companies in their jurisdiction, lobbying by development actors has achieved a certain understanding of their specific situation[113]. Commercial banks in Western countries, however, seem less and less willing to deal with these businesses. Being subject to FATF norms themselves through their national regulators, they believe that they are taking unnecessary commercial risks by having informal funds transfer companies as customers.[114] From the perspective of a large commercial bank the avoidance of unnecessary risks makes sense, as formal banks are exposed to the full requirements of the FATF norms, while informal funds transfer businesses, at least in most countries, have been met with a certain flexibility by the national enforcing bodies.

This exposes the informal businesses to a second level of hard compliance and is an even more serious threat to their existence[115]. They absolutely require access to formal banks to hold and move their funds for settlement purposes. This informal-formal interface is at risk and currently threatens the survival of the remittance sector more than the actual legislation. While regulators in most European countries now understand the capacity limits of informal funds transfer businesses to quickly become compliant, commercial banks do not[116] and, granted, are not required to do so.

---

[109] In the US this is correct on a Federal level, at the State level there is as wide a variation as between European Countries (<u>Report and Conclusions</u>, 2003)
[110] FATF Annual Report 2002-2003 at www.fatf-gafi.org/FATDocs_en.html
[111] See Table I (page 14) and Table II (page 17)
[112] In The Netherlands a large Somali remittance company decided to employ Dutch nationals with an accounting background to achieve compliance with the very strict version of FATF rules (personal communication of the author with representatives of remittance companies). This arguably stretches the financial resources of most other informal funds transfer businesses, effectively forcing them to close.
[113] (<u>Report and Conclusions</u>, 2003)
[114] ibid.
[115] see Table II (page 17)
[116] See note 113

The role of formal banks also points to another shortcoming of soft law, the problem of geographical legitimacy. Commercial banks, while directly affected by the norms, have not been voting participants of the creation process of the FATF rules. Although they have as much a role to play in enforcing the norms as the state members, they have been degraded to being a third party upon whom the rules are enforced.

In this respect they are not much different from non-member states, which are pushed to implement FATF regulations by economic pressure. They, however, are usually well established in their respective countries and have the capacity to implement these norms. Part of this implementation may be distancing themselves from potential hazardous clients that have not reached full compliance. Such a projection of enforced norms makes them an additional factor in the hard impact of FATF regulations[117].

ADDRESSING THE SHORTCOMINGS OF SOFT LAW

Recognizing the essential role remittance transfers have in the survival of Somalia, all major development actors in the country are committed to assist the sector to remain operational by achieving sufficient compliance with FATF norms and their national variations. The activities are led by the United Nations Development Programme (UNDP), which gives technical assistance to the sector[118].
Efforts are directed at achieving compliance on the Somali side of the operations. While in the different legislations the operations of the companies have to fulfil different requirements, generally the basic compliance with FATF rules in Somalia itself is generally still lacking. This seems to be a concern of all regulators, and is certainly the biggest challenge as it is unlikely that there will be an official regulatory body for the industry in the near future[119].
The programme's objective is therefore to establish equal standards for all Somali remittance companies, with the ultimate goal to lay the ground for evolution into a formal banking sector[120]. A first step has been the formation of the 'Somali Financial Services Association' and its production of an 'Anti-Money Laundering Compliance Guide' [121].

[117] As illustrated in Table II (page 17)
[118] ("**Financial Sector Development Project**" 2004)
[119] It can be assumed that even if the currently forming government establishes itself nationwide, the rebuilding of essential administrative functionality will take time. Banking regulation may only be effectively established at a later stage.
[120] This, according to representatives of Somali remittance companies is also the interest of the sector in general (personal communication of the author with senior staff of remittance companies)
[121] Press release on www.so.undp.org (UNDP Somalia)

Another strong component of UNDP's activity continues to be lobbying regulators and, recently, commercial banks to maximise the flexibility remaining in national legislation and banking standards resulting from FATF recommendations[122]. These activities target the main flaw of the hardening of FATF norms, the entry into municipal law and the consequences for primary and secondary compliance. This is summarised in Table III.

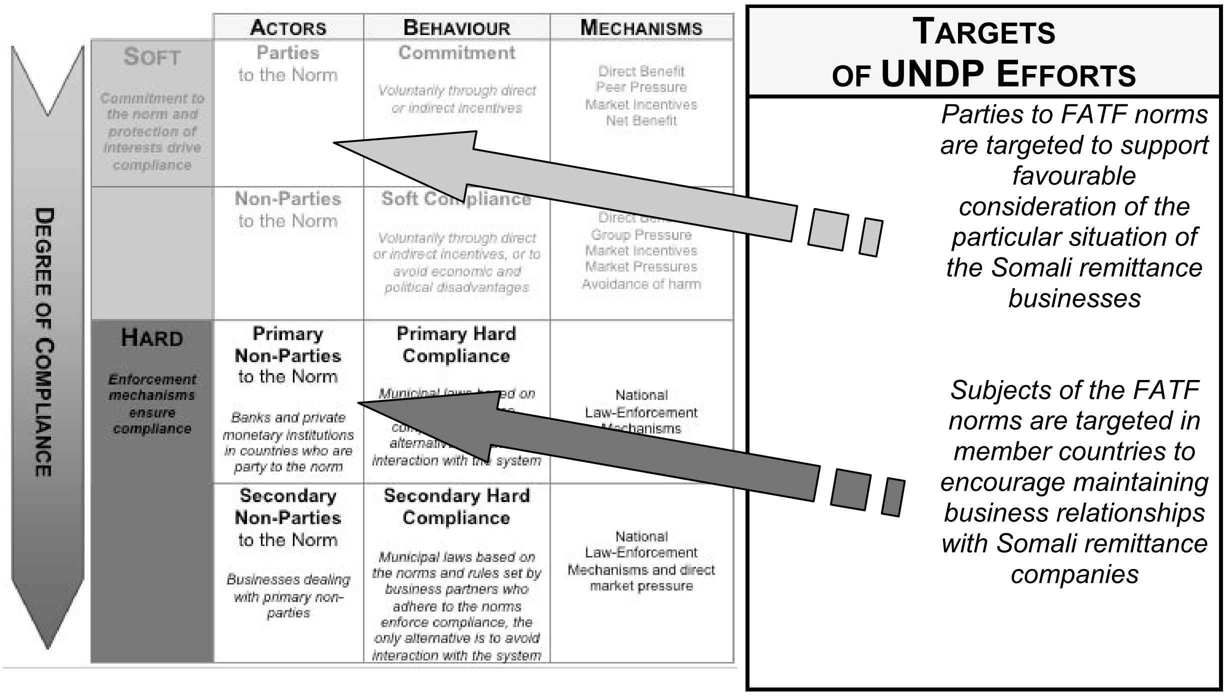


Table III Addressing the Shortcomings of Soft Law

Overall, to a certain extent, these activities will address the two major defaults of the softness of FATF instruments. By raising the awareness of the regulators in different countries the variance of municipal incorporation of FATF norms is cushioned; and by the creation of an all-inclusive association and lobbying, the geographical legitimacy problem is addressed and the pressure for secondary hard compliance reduced.

[122] ("**Financial Sector Development Project**" 2004) and personal communication of the author with project and donor staff

The outcome at this point is unpredictable; arguably these combined efforts have bought time for the Somali remittance sector to adjust to the FATF norms and their national varieties. However, adjust they must or they risk being banned from operating in these countries. It is clear that no FATF member, and certainly no commercial bank, intends to risk non-compliance to accommodate the special case of Somalia[123].

The return of a central government, provided the current peace process succeeds, will not necessarily change the situation in the near future. A central regulatory body will simply have to evolve out of the work already done by the association, and a formal banking sector will only evolve gradually in the country, whether a central bank and other oversight bodies exist or not. It could be suggested that, in the current situation in Somalia (not having a government) the initiative of the affected companies may prove to be easier than if it were in a stricter environment of central oversight, where other considerations come into focus[124] and may sideline the importance of the remittance sector.

---

[123] (Report and Conclusions, 2003)
[124] (Faundez, Footer et al. 2000), chapters 16 and 17

VII *CONCLUSION:* SOFT LAW, HARD COMPLIANCE

This paper has illustrated the process of international law making from soft sources. By studying the interaction of FATF norms with the Somali informal funds transfer systems it has demonstrated how soft law is made and compliance with it ensured. The argument that emerges is that soft law, while having the virtue of flexibility in its making, suffers from variance and ambiguity in its hardening. It therefore has had and is having a very hard impact on the Somali remittance sector, an impact that may threaten a vital lifeline for the country. Arguably, it is the step into municipal law where the process is flawed, essentially leading to two levels of compliance, soft and hard. While it seems that although the regulators in many countries have developed an understanding for the particular situation of Somalia, the commercial sector has not or cannot afford to understand, adding another level of hardness to the compliance spectrum. It is submitted that this hard impact, while it may currently be a necessary consequence of the use of soft law, is not inevitable. If compliance were assured on a truly international level the variability of incorporation into municipal legislations could be avoided.

While the case of the Somali remittance sector fittingly highlights this shortcoming of the current usage of many soft law instruments, it also demonstrates their intrinsic advantage of flexibility. Overall, the use of soft law at the international level therefore certainly has merits, and the virtues of these non-binding norms have surely contributed to the quality of the global legal order.

How then can soft law be used more appropriately to avoid its flaws and strengthen its benefits? Again, the case examined here is illustrative. The absence of a government, and the need to comply with FATF regulations not only abroad but also in Somalia has led to the creation of a sector association of all remittance companies. This, in the absence of a central bank, will be the regulatory body of the industry, and is likely to remain in a central position even under an emerging administration. If it could actively engage in the further evolution of rules for informal funds transfer systems, it would contribute to a more appropriate and understanding set of norms for combating the abuse of the global financial system. Such participation would overcome the geographical legitimacy problem discussed earlier, and make use of the potential of soft law to accommodate non-state actors in its formation.

Caution must be applied, however, to ensure that by making the process all-inclusive the virtues of flexibility and, above all, timeliness are not contravened. One needs not be reminded of tedious treaty negotiations that suffer from as many different interests as there are participants, often ending with a lowest common denominator outcome. It has been argued in this paper that this may, however, be due rather to the objective of the negotiations (a binding treaty) rather than the process. The observation that parties to soft law instruments are more ready to compromise their interests as long as they are not legally bound by the result, points to a different attitude towards non-binding norms. It is not unlikely therefore that inclusion of all stakeholders will still lead to the expected results much more swiftly and decisively than in a treaty negotiation.

Such an all-inclusive instrument should then consequently be administered by an international body of similar legitimacy. In economic law the IMF is the obvious candidate, and such a role for the Fund has been discussed, as well as the creation of a new international oversight body for financial standards. Outside of economic law there is no current world body that could claim almost universal membership while having the operational capacity of the Fund. While the lack of universal oversight may prevent soft law from playing a more prominent and, arguably, more beneficial role than it does today, a development in that direction would certainly benefit international law making. It can be envisaged that soft instruments, being created in a legitimate and inclusive process, could be tested and adapted over a certain period, in the process creating state practice, custom and even *opinio juris*. At a certain point these instruments may be firmly ingrained in the international order or will have been disbanded, re-designed or succeeded by new ones to adapt to a changing world. If only at this stage a treaty were derived from these instruments, it would certainly enjoy unprecedented standing in the global community.

This elegantly bypasses the need to use incorporation into municipal law as an early step of ensuring compliance. If a global body were to set the norm, the norm would be adhered to uniformly, as is evidenced by the behaviour of members of global institutions. Municipal law would mirror, but not change these rules. The soft character of the initial norm would overcome the problem of suitability for the variety of jurisdictions it covers – soft law as an experimental and testing stage. And when the norms, through trial and testing, reach the point where their full capacity and benefit is proven and they enter treaty law, states could uniformly ratify these treaties. The threat of the creation of a variety of versions of a basic norm would have been eliminated.

While this may be utopian thought at the present time, certainly the FATF could achieve some of its scope. By including non-members in their review and monitoring process they have taken the first step towards inclusiveness. If they achieved the participation of all affected countries (i.e. more or less all countries in the world) they could certainly use the flexibility of their soft instruments to create unprecedented commitment to fighting the abuse of the international financial system. Somalia, which due to the lack of government has suffered disproportionately from the enforcement of FATF rules, could under such an inclusive process participate either through the newly emerging regulatory body of the remittance industry in the country or, if the peace process succeeds, as a new state through their government – or both.

Somalia, in a way, is a 'pilot study' for how the international community could deal with 'unorthodox' systems in its realm. If the Somali remittance sector can adapt and at the same time the FATF can work more towards inclusiveness, a case will have been made for the move to universal governance of soft law. In the current world of uncertainty regarding cultural and religious divides a decisive push for all-inclusiveness and the creation of truly universal norms is more important than ever.

VIII REFERENCES

(Web-links, and treaty texts available on the Internet are referenced fully in the footnotes)

1. Aninat, E., D. Hardy, et al. (2002). "Combating Money Laundering and the Financing of Terrorism." Finance and Development **39**(3).

2. Ballard, R. (2003). "A Background Report on the Operation of Informal Value Transfer Systems (Hawala)." Centre for Applied South Asian Studies, University of Manchester.

3. Bantekas, I. (2003). "The International Law of Terrorist Financing." American Journal of International Law **97**: 315.

4. Baxter, R. R. (1980). "International Law in her Infinite Variety." International and Comparative Law Quarterly **29**: 549.

5. Campbell-Tiech, A. (2004). Money laundering and hawala - London in focus. The Middle East in London. **May 2004:** 19.

6. Charney, J. L. (2000). Compliance with International Soft Law. Commitment and Compliance: The Role of Non-Binding Norms in the International System. D. Shelton. Oxford, Oxford University Press.

7. Chinkin, C. (2000). Normative Development in the International Legal System. Commitment and Compliance: The Role of Non-Binding Norms in the International System. D. Shelton. Oxford, Oxford University Press.

8. Financial Action Task Force *Combating the Abuse of Alternative Remittance Systems: International Best Practises* (20th June 2003)

9. De Goede, M. (2003). "Hawala Discourses and the War on Terrorist Finance." environment and planning d **21**(5): 513.

10. Doyle, T. (2002). "Cleaning up Anti-Money Laundering Strategies: Current FATF Tactics needlessly violate International Law." Houston Journal of International Law **24**: 279.

11. El Qorchi, M., S. M. Maimbo, et al. (2003). Informal Funds Transfer Systems - An Analysis of the Informal Hawala System. Washington D.C., International Monetary Fund.

12. Faundez, J., M. E. Footer, et al., Eds. (2000). Governance, Development and Globalization. Law in its Social Setting. London, Blackstone Press.

13. "Feasibility Study on Financial Services in Somalia" *Report by **KPMG,*** Nairobi, September 2003

14. UNDP Somalia: "**Financial Sector Development Project**", Project funded by European Commission, Nairobi 2004

15. Financial Action Task Force *The Forty Recommendations* (20th June 2003)

16. Giovanoli, M. (2000). A new Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting. International Monetary Law - Issues for the New Millenium. M. Giovanoli. Oxford, Oxford University Press.

17. Giovanoli, M. (2002). Reflections on international financial standards as "soft law". London, The London Institute of International Banking, Finance and Development Law.

18. Gruchalla-Wesierski (1985). "A Framework for Understanding "Soft Law"." McGill Law Journal **30**: 37.

19. Hillgenberg, H. (1999). "A fresh look at Soft Law." European Journal of International Law **10**(3): 499.

20. Jamal, V. (1988). "Somalia: Understanding an Unconventional Economy." Development and Change **19**: 203-265.

21. Klabbers, J. (1996). "The Redundancy of Soft Law." Nordic Journal of International Law **65**: 167.

22. Lambert, L. (2002). "Asian Underground Banking Scheme." Journal of Contemporary Criminal Justice **18**(4): 358.

23. Lewis, I. M. (2002). A Modern History of the Somali. Cambridge, Hargeisa, James Currey / Btec Books.

24. Little, P. D. (2003). Somalia: Economy without State. Oxford, James Currey.

25. Maimbo, S. M. (2003). The Money Exchange Dealers of Kabul - A Study of the Hawala System in Afghanistan. Washington, World Bank.

26. Morais, H. V. (2002). "The Quest for International Standards: Global Governance vs. Sovereignty." Kansas Law Review **50**: 779.

27. Mubarak, J. A. (1997). "The "Hidden Hand" Behind the Resilience of the Stateless Economy of Somalia." World Development **25**(12): 2027-2041.

28. O'Connell, M. E. (2000). The Role of Soft Law in a Global Order. Commitment and Compliance: The Role of Non-Binding Norms in the International System. D. Shelton. Oxford, Oxford University Press.

29. Omer, A."Supporting Systems and Procedures for the effective Regulation and Monitoring of Somali Remittance Companies (Hawala)" *Report by **UNDP Somalia,*** Nairobi, 2002

30. "Pakistan cripples the Money Movers" **Business Week Online**, 1 February 2002:

31. Passas, N. (1999). "Informal Value Transfer Systems and Criminal Organizations; a study into so-called underground banking networks." Research and Documentation Centre of the Ministry of Justice of the Netherlands.

32. Report and Conclusions (2003). International Conference on Migrant Remittances, London, DFID / World Bank.

33. Rotberg, R. I., Ed. (2004). When States Fail. Princeton NJ, Princeton University Press.

34. Shaw, M. N. (2003). International Law. Cambridge, Cambridge University Press.

35. Shelton, D., Ed. (2000a). Commitment and Compliance: The Role of Non-Binding Norms in the International System. Oxford, Oxford University Press.

36. Shelton, D. (2000b). Law, Non-Law and the Problem of 'Soft Law'. Commitment and Compliance: The Role of Non-Binding Norms in the International System. D. Shelton. Oxford, Oxford University Press.

37. Simmons, B. (2000). International Efforts against Money Laundering. Commitment and Compliance: The Role of Non-Binding Norms in the International System. D. Shelton. Oxford, Oxford University Press.

38. Sorel, J.-M. (2003). "Some Questions about the Definition of Terrorism and the Fight against its Financing." European Journal of International Law **14**(2): 365-378.

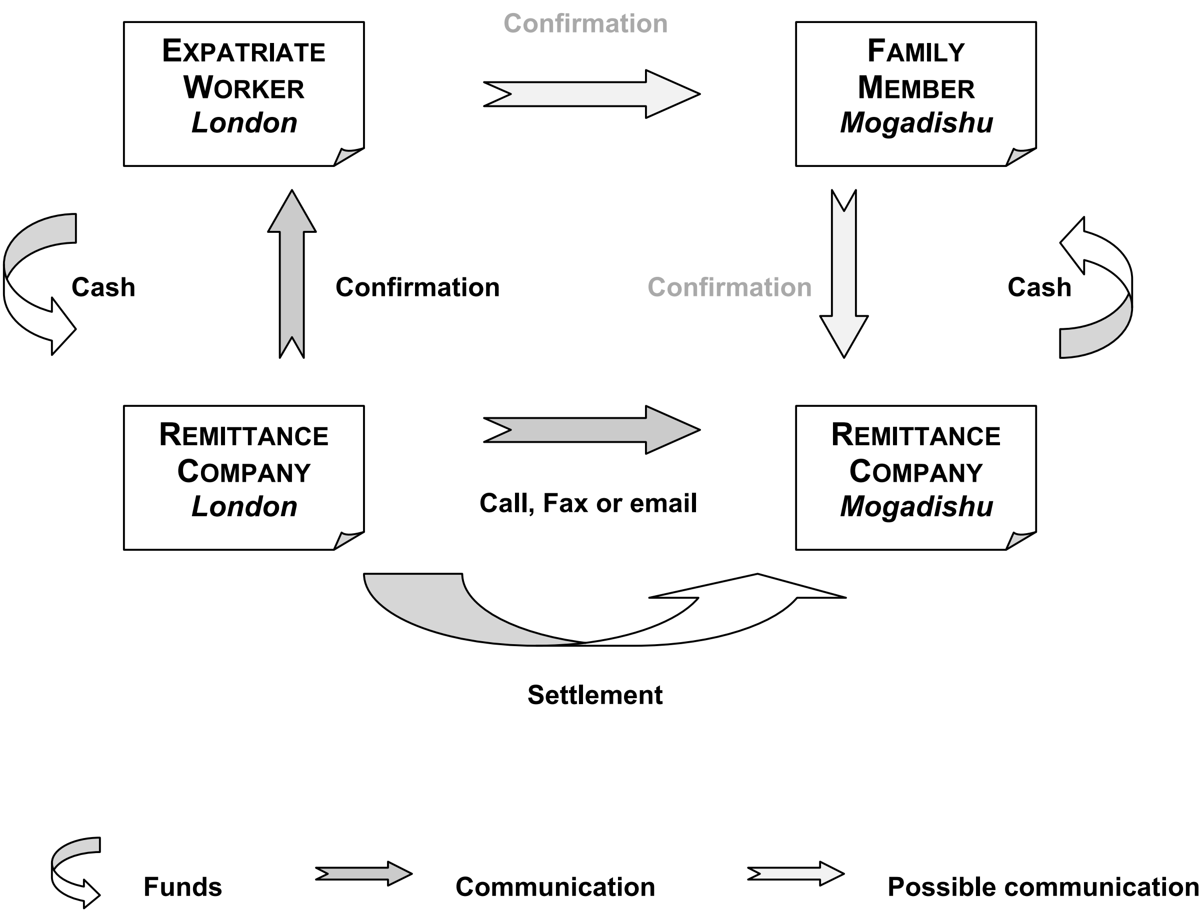
39. Financial Action Task Force *Special Recommendations on Terrorist Financing* (31st October 2001)

40. Valdez, S. and J. Wood (2003). An Introduction to Global Financial Markets. Basingstoke, Palgrave Macmillan.

41. Zagaris, B. (2002). "The merging of the Counter-Terrorism and Anti-Money Laundering Regimes." Law & Policy in International Business **34**: 45.

XI ANNEXES

ANNEX I – INFORMAL FUNDS TRANSFER SYSTEMS[125]



A SIMPLIFIED SCHEME OF THE REMITTANCE CYCLE In the case of Somalia the transfer may take place without a remittance code passed on from the company to the sender and then to the recipient to allow identification of the recipient, and substituted by clan information provided by the sender. Settlement can be direct as the illustration suggests (through trade or capital movement) or through other remittance companies in a network or central clearing houses. A central clearing-house for remittance companies exists in the United Arab Emirates ("Feasibility Study on Financial Services in Somalia" 2003).

[125] Adapted to the Somali case from a recent World Bank / IMF study of these systems (El Qorchi, Maimbo et al. 2003)

ANNEX II – MODERN HISTORY OF SOMALIA[126]

DATE / YEAR	**KEY EVENTS**
26 June 1960	*Independence of British Somaliland*
1 July 1960	*Independence of Italian Somaliland and formation of the Somali Republic together with Somaliland*
21 October 1969	*Military coup, totalitarian regime of Siad Barre begins*
1988 to 1991	*Rebel opposition group SNM increases attacks against government which retaliates, mostly in the former British Somaliland*
January 1991	*Overthrow of the Barre government in a popular uprising of several clans,*
18 May 1991	*Declaration of former British Somaliland as independent Republic, start of successful internal peace process*
1991 to 1992	*Increasing clan warfare cuts off food supplies to the population, famine*
December 1992	*US-led UN military intervention (UNOSOM) commences to secure food transports into and in the country*
March 1994	*Complete withdrawal of US troops from UNOSOM*
March 1995	*Withdrawal of remaining UN troops, international assistance restricted to humanitarian aid*
1994 to 1998	*Several attempts at peace processes, separation of the North Eastern region (Puntland) as semi-independent state of a future federal republic*
2000	*Djibouti-sponsored peace process forms a Transitional Government, which in the following years fails to gain control over the country*
May 2002	*Beginning of new peace process in Kenya*
22 August 2004	*Swearing in of members of the new National Parliament commences*

[126] Summarised from (Lewis 2002) and recent reporting on the current peace process at www.reliefweb.int