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Black Money in the Real Estate Sector

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ABSTRACT

Money laundering is the process of making dirty money look clean. It erodes financial institutions and weakens the financial sectors role in economic growth. It has the habit of facilitating corruption, crime and other illegal activities at the expense of countries development and can increase the risk of macroeconomic instability. The negative economic effects of money laundering on economic development are difficult to quantify. Real estate has been the preferred choice of criminals for masking illegally gained funds and manipulations, also when unaccounted funds (black money) are funneled into real estate by individuals and institutions, then it becomes impossible for an ordinary individual to buy a piece of land.

Keywords: Money Laundering, Black Money, Terrorist Financing, Real Estate, Property.

INTRODUCTION

Real Estate industry is probably the oldest industry in the world and it is proved to be the only business which has never lost its glamour since the ancient times. Until 19th century the concept of real estate has not undergone much change but in last two decades it has undergone major changes which have made this industry vulnerable towards Money Laundering that benefits anti social elements. Various reports produced by the Financial Action Task Force (FATF) and International Monetary Fund (IMF) over the last few years have made reference to the fact that the real-estate sector may be one of the vehicles used by criminal organizations to launder their illicitly obtained money. Due to the international nature of the real-estate market, it is extremely difficult to identify real estate transactions associated with money laundering, terrorist financing and tax fraud. Several countries are taking extreme measures to combat money laundering and terrorist financing as it is a serious threat to their economy and reputation.

Money Laundering

The International Monetary Fund estimated that the aggregate size of money laundering is between 2% and 5% of the world's Gross Domestic Product (GDP) ranged between USD 590 billion and USD 1.5 trillion. One of the effective ways to understand how the real estate sector is abused for money laundering is to examine with a simple example. A money launderer would like to buy a property with 25% legal funds paid through bank account and 75% illegal funds paid to seller in the form of cash. After a stipulated period of time the launderer sells the property with the same amount or some amount of profit. During the time of selling money launderer would request the buyer to pay the property value through bank account, cheque or demand draft so that all his money gets legitimate appearance. Criminals generate substantial profits and invest the funds without drawing the attention of legal persons. Criminals do this by disguising the sources, changing the form, or moving the money to a place where it is less likely to attract attention. In real estate transactions both legitimate and illegitimate funds may be funneled which leads to blending of funds.

Black Money

Individuals and institutions globally are engaged in evading taxes and generating surpluses which do not get accounted for in the formal economy. These funds are generated from activities which may be legal or illegal by nature. However the mere fact that taxes have not been paid on such incomes, as per the rules of the land, converts such funds to form a part of the Parallel economy or Black Money generation. The fund generated is normally held as currency notes and/or assets through investments in gold, jewellery, precious stones, art and artifacts, real estates and others (Agarwal, 1991). This menace is observed in both developed and developing regions of the world. Most studies done to understand the cause and concerns to un-earth black money component have shown that these have led to creation of strong parallel economies due to high level of corruption and week hold of regulatory mechanism in developing regions of the world.

If we take a quick look at the case of Marc Rich, one of the world's leading commodity traders was indicted by a Federal grand jury on charges that he and his partner (Pincus Green) had evaded the US Treasury of US$ 48 million in income taxes. US Prosecutors in 1983 said it was the biggest tax-fraud indictment in American history (Berg, 1983). Marc Rich had bid for a pardon from President Clinton, which was accompanied by letters of support from dozens of politicians, financiers and officials of charitable organizations, a virtual Who's Who of Israeli society and Jewish philanthropy; prosecutors and former prosecutors renew attack on pardon of Rich and his former Partner, Pincus Green, who for 18 years evaded prosecution on charges of tax evasion, racketeering and violating sanctions against trading with Iran (MeGeehan and Cowan, 2001). Despite this act, President Bill Clinton's last-minute pardon of Marc Rich (Newlin, 2001) became very controversial however, clearly showed the failure in observing regulatory prudence in the economy along with the economic loss to the nation and the citizens. Within Europe, the EU institutions are troubled with the way Italy manages its financials. The said economy is known for the mafia to run and manage the economic affairs of the country. This is a classical case where the parallel economy is actually the normal economy itself.

Rise in Real Estate Demand

In the last two decades, the demand for real estate, particularly residential properties, has seen a dramatic rise. Property prices, which once remained stable for longer periods, are now changing rapidly—sometimes on a weekly or even daily basis-especially in prime commercial and residential areas. Despite the government’s attempt to control prices by slightly increasing the guideline values to help poor and middle-class people afford land, sellers and property agents continue to raise prices beyond these suggested limits. Often, these price hikes are based on speculative reasons that have little or no direct connection to the actual property, such as expected future developments or market trends.

This situation is largely driven by rapid urbanization and a growing working population. As more people move to cities in search of better job opportunities and living standards, the pressure on housing increases. Additionally, individuals’ aspirations have evolved significantly. Home ownership has become a symbol of financial stability and success, leading to a surge in demand for houses and apartments. Many people now aim not just for a basic home, but for well-facilitated residences with modern amenities. These factors combined have caused a sharp increase in the demand for residential properties, pushing prices higher and making the real estate market a key target for investment, including through illegitimate means.

Banking Sector: Medium, Regulator and Cause

Banks have been widely used for money laundering. The flow of funds via the banking system has been fueled due to secrecy and non-transparency norms observed by large part of the banking systems globally. Banks have a central role to play in curbing the menace, however have fallen to be instruments in the money laundering process. The money 1aundering activities have been subject of eight prior investigations in US. According to the US Permanent Subcommittee's Report (2001), there are five major factors which create money laundering vulnerabilities: the role of private bankers, private banks as client advocates13, powerful customers14, and a corporate culture of secrecy15, a corporate culture of lax controls16 and the competitive nature of the industry17. In a recent case reported by an online newspaper moneylaundering.com on the November 10th, 2006 “the American Express Co. has said this week that it may face an enforcement action by the U.S. Justice Department related to “concerns” about the anti-money laundering procedures at its Miami-based private banking operation. The giant financial and travel services company said in a quarterly regulatory filing on Thursday that federal investigators are seeking more information about certain client accounts at American Express Bank International, which also has an office in New York”. Another interesting case reported by the Washington Post on May 21st, 1997 outlined that the US Justice Department had began to investigate allegations that top officials in former president Carlos Salinas de Gortari's administration used the state food distribution agency Compania Nacional de Subsistencias Populares (CONASUPO) for criminal activities, including laundering drug profits through US bank accounts and contracts.

It is clearly visible in these two cases as to how vulnerable are the Banks and how they turn to becoming the medium and cause for money laundering. Cases before enforcement agencies have shown that some of the more common laundering methods used are: the Black Market Peso Exchange, cash smuggling (couriers or bulk cash shipments), Black dollar, gold purchases, structured deposits to or withdrawals from bank accounts, purchase of monetary instruments (cashier's checks, money order, traveler's checks, etc.), wire transfers, purchase of derivative products (as seen in September 11 attack) and forms of underground banking, particularly the Hawala system. Recent IMF estimates on money laundering by the drug traffickers to introduce the proceeds gained through the sale or distribution of controlled substances into the legitimate financial market amounts to between 2 to 5 percent of the world's GDP, about US$ 600 billion annually (US-DEA, 2005). In our opinion this is a very conservative estimate and far lower than the actual money laundered (i.e. 2-3 times of the DEA projections – US$ 1.5 trillion) within the drug trafficking business. Money laundering allows the true source of the funds gained through the sale and distribution of drugs to be concealed and converts the funds into assets that appear to have a legitimate legal source. The need to launder conspicuously large amounts of small-denomination bills renders the traffickers vulnerable to law enforcement interdiction. Tracking and intercepting this illegal flow of drug money is an important tool used to identify and dismantle international drug trafficking organizations.

Capital Flight and Kick Backs

Capital Flight and kick backs are a major problem facing global economies, including India, as these have severe economic, political and social impact. Capital flight may also reflect money laundering activities resulting from criminal activities such as drugs and arms smuggling and white collar crimes. There are many techniques used to expedite capital flight and a significant amount of research has resulted in detailed explanations of capital flight techniques and in estimates of its magnitude (Walter, 1985; Cuddington, 1986; Varman-Schneider, 1991; Zdanowicx, Welch and Pak,1995 & 1996; Agarwal and Agarwal, 2004). One technique that can be used to move significant amounts of capital out of a country is the over-invoicing of imports and the under-invoicing of exports. The focus of joint research between IIF and FIU which was projected through the works of Zdanowicx, Welch and Pak in 1995 and 1996 is on the development of a global price matrix that allows one to analyze every India-United States import and export transaction and determine estimates of the magnitude of capital flight from India to the United States during 1993 due to abnormal pricing. The findings estimated that the capital flight from India to US was about US$ 4.4 billion (in 1993), US$ 5.8 billion (in 1994) and US$ 5.6 billion (in 1995) (Zdanowicx, Welch and Pak,1995 & 1996).

Black Dollar Exchange Scam

The so-called "Black Dollar" scam entails defacing the US$ to transfer currency using Hawala. In this the currency is coated with black substance, which can be removed by use of special chemical. The blackened US$ bank notes are shown to the victim, and the special chemical is ordinary cleaning fluid which reacts with the black mixture of Vaseline and iodine. This is majorly used when there are large number of civilian transporter's involved, who are seeking quick money for holding or transferring the packets of black dollar from one to the other. To prevent one from using the currency during transfer, the intermediaries are told that exposure to air will cause the black substance to ruin the money. After the advance payment has been received, the chemicals are not delivered to the victim, who is left with suitcases full of worthless black paper instead of the US$ notes. The Black Currency Scam is believed to be based on a centuries old traditional West African con called the "Red Mercury" scam. In a recent news in the Deccan Herald on July 21st, 2005 on a Black-dollar' gang busted in Goa reported that Five Nigerians and a Liberian were behind bards and the gang had larger operations in other Indian cities. It was also reported that the Bangalore and Mumbai police have detained similar gangs operating in those cities. Goa police has also alerted the Interpol branch of the CBI and has written to the Nigerian Embassy.

Uprooting Money Laundering

Investigators have been toddled with the puzzle of un-earthing and uprooting socio- economic criminal offenses. With the difficulty posed by criminal organization towards erasing of the links between crime and money, their ownership and the final destination delivering shelter to such acts is like finding the right leaf of the right plant in a thick forest in a new neighborhood. With over 30 years of extensive work on by government agencies and institutions, the given complexity for the enforcement and investigating agencies is not impossible. These institutions are well networked and have a fairly good idea of the housing assets of such socio-economic criminal transactions. It is mostly found that consumption of luxurious assets in large or multiple small quantities like precious stones, art and artifacts, real estates, movie financing, casinos, flesh trade, NBFCs and banking institutions are where the dirty money are mingled and housed. It is more a question of political will in tune with an active society, media agencies and clean regulatory framework.

It is also vital that governments in power and regulators frame economic policies which are not detrimental to market movements and trades. In India, as mentioned earlier, we have found that Economic Policy framework for taxation and trade restriction have lead to the emergence and growth of dirty money and money laundering activities. These can be taken care off, if economic policy framework is well debated and tested for their ill effects in democratic environments, before implementation. To have effective supervision, the following components need to be well addressed in any given regulatory framework for effective reduction of leakages (a) Purpose of Regulation (b) Accountability (c) Market Abuse (d) Due Process (e) Manner of Regulation (f) Cost of regulation (Lal, 2003). International banking continues to grow, developing worldwide connections among banks, as well as the increasing sophistication of banking methods. The constant challenge is to ensure that every bank can account for its customers. Every government has laws which ensure the prosecution of financial crimes, and that every society sets moral and ethical standards for the conduct of commerce. Many important financial centers have now adopted legislation to curb drug related money laundering, and the number of governments which have ratified the 1988 UN Convention continued to increase. But the race between criminals seeking new ventures, and oversight bodies seeking more widespread compliance, still goes to the crooks.

Money Laundering is the biggest Fear for Finance Industry. The entire industry in the world or any separate country must understand that financial crime needs to be understood, analyzed and fought proactively. Banking Industry needs to be one step ahead of money launderers in order to control the menace of money laundering and financial crimes. Concern regarding financial crime is growing to unprecedented levels amongst UK financial institutions (Logic CMG Report, 2003).

One of the best control techniques for the banks to control money laundering is to know your customer (FSA Report, 2003). The consultation paper, published in August 2003, describes the FSA's money laundering directions on two important anti-money laundering controls: One, Issues relating to obtaining and using customer information for anti-money laundering purposes, and secondly on Anti-money laundering monitoring, assessing customers use firms' products and services and how possible money laundering activities can be identified from this. Eleven world money centre banks agreed in October 2000, to a set of anti-money laundering guidelines - for private banking activities. These guidelines state at the outset that “bank policy will be to prevent the use of its worldwide operations for criminal purposes.”

With organized crime in control of banks and able to launder huge sums of money not only for themselves but also for other criminal organizations it is a call for concern. Already in Russia it is said that criminal groups control over 400 banks and 47 exchanges. This is worrying bank chairmen in Russia as between July 1994 to 1995, there were thirty assassination attempts against top bank officials, sixteen of who were killed. These killings along with earlier ones were important indicators of the efforts by criminal organizations to infiltrate the Russian banking system. Infiltration of the banking system offers significant advantages for criminal organizations, not least the opportunity it gives to facilitate money laundering for both Russian and foreign criminal organizations. Russian officials have worked with FATF and us government agencies to put into place more effective regulations and proceedings to combat money laundering, in accordance with international standards.

In February 1988, the OECD's Financial Action Task Force- for money laundering in its Annual Report highlighted the problem in Mexico and stated “One of the most favored technique continues to be out bound currency smuggling, along with electronic transfers, Mexican bank drafts and the parallel peso exchange market. Corruption remains the chief impediments to Mexican's anti-laundering efforts.” Under the auspices of UNO, there is an international campaign to crack down on an essential component of the problem of money laundering. Now countries have enacted laws to prevent money laundering and allow closer scrutiny of suspect bank accounts of criminals. SWIFT is the principal international service for wire transfer message trafficking that can initiate funds transfers. In Russia and some East European states, banks can be readily purchased for very little money - though few of them have electronic banking access to SWIFT. SWIFT is a co-operative society located in Belgium having 2600 institutions in 65 countries providing services to security bankers & dealers; clearing institutions; and security exchanges.

CONCLUSION

The global world and economies are faced with challenges to counter money laundering and terrorist deeds. Safer estimates indicate that about 2 - 2.5 trillion dollars are laundered every year. Though it is the responsibility of every citizen of the global world to fight against such socially-ill and un-humane acts, however the duty primarily rests on the shoulders of investigating agencies, the judiciary and the enforcement bodies to play a pro-active role in clearing the menace. In recent years in India, we have seen the emergence of the judiciary playing a pro-active role quite independent of the government in place. This is a positive sign. We need to see similar acts of “functioning without fear” to be practiced by the investigating agencies and the enforcement bodies as well.

Till the fear of loosing jobs for adhering to bring justice to floor would be there within the system, one will not see the sunlight minimizing financial and criminal ills in the society. We are reminded of a quote of our professor – Prof. Kanti Sawrup often says “The Law rides the Poor and the Rich ride the Law”, which is reflection of the functionality of societal setups in general, irrespective of their maturity or being a developed/developing economy. We also believe that people in general are God Fearing, honest and want to lead a simple peaceful honorable life. It is the acts of governance which in most cases has turned them to lead life otherwise.

In the last 40 years, there has been a dire need for emergence of “Economic Intelligence Units” and “Economic Investigating Agencies”. Though these have been formulated as divisions within the existing Intelligence and Investigating agencies, but are neither independent nor have the expertise to handle economic frauds. In India these are handled by the IPS officers using IPC or CrPC, who have been primarily trained to deal with criminal scenarios as against economic.

We do not wish to counter or undermine the competence of the officers currently engaged in re-solving some the economic offences, however the need to first obtain the money lost due to economic offenses as against tracing the group/gang involved is vital, and not addressed so far. It is also vital that a specific degree of freedom is granted to these agencies making them to function independently (autonomously) without the interference and control of government like the Election Commission of India. We do have a series of regulatory bodies and enforcement agencies in place in India, however they are also subjected to low degree of independence and seepage of corruption which has resulted in their low level of performance leading to a strong mafia for money laundering and terrorist activities. Most of these authorities want more teeth. Grant them bigger teethes but ensure that these teeth are not used to extort money from the honest. A consequence of the current state is already felt in large number of innocent families losing their support life systems due to terrorist activities and poor governance systems.

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