INSTITUTE FOR DEFENCE STUDIES & ANALYSES
रक्षा अध्ययन एवं विश्लेषण संस्थान

IDSA
Policy Brief

Demonetisation and Beyond: Addressing the Finance of Terrorism

Vivek Chadha

November 21, 2016

Summary

Demonetisation is an important step in the fight against the finance of terrorism. However, it should neither be the first nor the last, if the interlinked threats of corruption, crime and the finance of terrorism have to be controlled.

The impact of the demonetisation policy as related to curbing the finance of terrorism announced on November 08, 2016, is gradually emerging from the shadow of its surprise announcement. It is becoming abundantly clear that this is unlikely to remain a one off decision taken in isolation and will in all probability be accompanied by additional measures against the financing of terrorism and corruption. Even as the rollout takes place, it provides an opportunity to assess its potential fallout in the mid and long term, as also possible future options available to the government to further build upon the ongoing initiative.

Nature of Threat

Prior to attempting this analysis, it is important to outline the nature of threat faced by India as part of the ongoing fight against the finance of terrorism and its linkage with other internal challenges. It is also relevant to determine its implications, as this becomes the basis of future policy options.

The finance of terrorism in India follows a hybrid model, which includes terror funding from within and beyond the country's borders. An assessment of past cases that have come to light suggests that terrorists have employed a variety of formal and informal channels to fund their activities. Amongst formal channels, money has been moved through the banking channels, as was witnessed prior to the 1993 Mumbai bomb blasts.[1] It can also involve the use of money transfer service scheme (MTSS), as has been resorted to repeatedly by the Indian Mujahideen (IM) to finance their operations in India.[2] Benefactors in Pakistan transferred money to innocuous middlemen not previously suspected of terrorist linkages in India. This money was later withdrawn and handed over to IM cadres to fund their activities. There have also been attempts to exploit the barter trade between India and Pakistan through over or undervaluing the invoice, thereby creating a surplus value, which was then diverted for funding terrorism.[3]

As part of the informal channel, large amounts of money are also received in the form of counterfeit currency or fake Indian currency notes (FICN) that are smuggled into India.[4] This is done through a variety of routes, including movement of parcels by air, land and sea. The transfers have at times been routed through third countries in West, South or Southeast Asia in order to avoid close scrutiny of shipments. These have also been smuggled across the borders through existing

---

1 "1993 Mumbai blasts: four Memons convicted", The Times of India, http://articles.timesofindia.indiatimes.com/2006-09-12/india/27822418_1_hanifa-essa-rubina-memon, September 12, 2006, (Accessed March 20, 2012).

2 See "Supplementary Chargesheet 1", *NIA*, Case RC-06/2012/NIA-DLI, http://www.nia.gov.in/NIA-Cases/DLI/2012/RC-6-2012-DLI(SCS-1).pdf, accessed on August 31, 2015, para 17.125(f).

3 "Trade money across LoC being used to finance LeT in J&K: Police", *The Times of India*, March 21, 2010, http://articles.timesofindia.indiatimes.com/2010-03-21/india/28123912_1_salamabad-pok-hawala-money, (Accessed March 09), 2013.

4 For case study of FICN smuggling into India see Vivek Chadha, *Lifeblood of Terrorism: Countering Terrorism Finance*, Bloomsbury, New Delhi, 2015, p. 70.

criminal networks to facilitate their redistribution into the economy. However, the most commonly exploited method of transferring terror funds, remains movement by cash. Money is transferred in the form of cash across borders through couriers, and thereafter converted into Indian currency to support terror funding. Cash also forms the last mile instrument of choice, for financing both organisational activities and terrorist operations. This includes money spent for buying weapons, paying cadres, or organising terror strikes. This is especially the case with groups which collect their funds directly in the form of extortion, kidnapping or so called taxation etc. The resultant funds generated are stored as cash or gold.[5] There have also been cases of money being invested in real estate deals or investments in businesses both inside and beyond Indian borders, to cater for long term needs.[6]

The last, and possibly the most commonly used method of transferring value remains hawala in the Indian context, especially by Pakistan and Pakistan based terror groups which have been fuelling, funding and coordinating terrorism in Jammu and Kashmir (J&K) as well as through the IM. This does not involve the physical movement of cash across borders, but through the employment of *hawaladars* or *hawala* agents to collect and disburse money across different countries and continents.

Impact of Demonetisation

An assessment of these threats provides a clear picture of various options employed by terrorists and countries like Pakistan to fund terrorism in India. In order to draw a co-relation between demonetisation and its impact on each of the formal and informal channel of terror funding, it is important to examine the role played by 500 and 1000 rupee denominations at various stages of the finance of terrorism cycle. The same is indicated at Table 1 below.

5 Karn Kowshik, Gold biscuits found on Andhra Naxals sets police thinking", The *Indian Express*, September 07, 2006, http://www.indianexpress.com/news/goldbiscuits- found-on-andhra-naxals-sets-police-thinking/12858 (accessed on March 27, 2013) and "Maoist gold dump recovered", July 14, 2010, *The Hindu*, http://www.hindu.com/2010/07/14/stories/2010071464141300.htm (accessed March 27, 2013).

6 "Rs 1.14 crore "terror fund" for investment seized by NIA", *The Indian Express*, November 5, 2013, http://www.indianexpress.com/news/rs-1.14-crore-terror-fund-for-investment-seized-by-nia/1190993/, (Accessed on December 14, 2013).

Table 1: Impact of Demonetisation on Channels of Money Transfer

Means of Transfer	**Stage at which Cash Involved**	**Likely Impact of Demonetisation**	**Terror Groups Most Affected**	**Implications**
Formal Money Transfer Channels				
Banking Channels	Deposit or Withdrawal	Limited as formal channel usage will remain linked to the currency in use	Limited impact on all groups.	Squeeze of cash flow could witness increase in exploitation of formal channels by NGOs. Amongst these, J&K most susceptible.
MTSS	Deposit or Withdrawal	Limited as formal channel usage will remain linked to currency in use	IM, J&K based terror groups	Squeeze of cash flow could witness increase in exploitation of formal channels by NGOs. Its usage could increase further in case of IM and J&K based groups.
Trade	Creation of surplus by over or under valuation	Limited given low volume of trade with Pakistan	J&K based terror groups	Squeeze of cash flow could witness increase in exploitation of trade with other countries through proxies
Informal Money Transfer Channels				
FICN	Introductio n into India	• Printing press in Pakistan redundant till ability to counterfeit new notes created • Existing FICN in India redundant	J&K and Pakistan based terror groups	Severe impact on existing FICN in India and in transit. Likely to remain effective in medium term until Pakistan recreates ability to counterfeit new currency notes and circulate it in India
Cash	All stages	Substantial, based on financial reserves in cash held	All terror groups, especially NE India based groups and CPI(Maoist)	The groups which have most of their financial reserves in the form of cash likely to be affected the most. Subsidiary money parking options like property could also be affected adversely affected due to limited liquidity

Means of Transfer	Stage at which Cash Involved	Likely Impact of Demonetisation	Terror Groups Most Affected	Implications
Hawala	Introduction abroad and entry into India	Moderate impact on the liquidity of hawala agents	J&K based terror groups and IM	The immediate efficacy of *hawaladars* affected given a liquidity crunch that will come into play. In some cases their long term viability could also take a hit due to dwindling of cash reserves

As the table suggests, the financial hit likely to be taken by a terrorist group is closely linked with its cash reserves, the ability to retain liquidity in a business where terror groups choose to invest and the ease of reconverting these assets into liquid money. Groups in Northeast India and the CPI (Maoist) operating in the Naxal affected areas of the country are likely to be hit the most, as a large proportion of their financial reserves are more likely to have been held as cash. Further, investments in property will become relatively difficult to liquidate in order to recreate funds for organisational support mechanisms.

In contrast, Pakistan and J&K based terror groups while impacted, will be able to recuperate faster, as they are financed by the Pakistani state, rich donors in West Asia, voluntary collections in Pakistan, FICN or drug money. None of these can be impacted in the long term and to the extent that terror organisations are unable to sustain themselves. However, the impact will certainly be felt in the immediate and midterm future, wherein, the cash available for sustaining activities like civil disobedience in Kashmir Valley, will be sucked out of the terror economy.

Suggested Policy Options to Sustain Impact on the Finance of Terrorism

Demonetisation is an important measure and possibly one which can potentially create the necessary conditions for combating the finance of terrorism. However, as the table above indicates, demonetisation is not a complete and all-encompassing end in itself. It is part of a process which must be taken forward through additional allied and subsidiary policies.

The objective of demonetisation is linked with removing unaccounted wealth (black money), criminal proceeds (which is different from black money), as well as FICN and Indian currency hoarded and distributed by terrorist groups. There are different estimates of the percentage of cash within the overall share of each of these three categories. However, irrespective of the percentage of cash, it is certain that removing a major portion of cash alone will not resolve any of these challenges. There is a need to take interlinked steps and it is only the sum of these individual initiatives that can impact the larger fight against the financing of terrorism. While there can be a large number of measures in this regard, this policy brief focusses on five that deserve special attention from the central government's perspective.

- Two of the most vulnerable sectors that have traditionally been exploited for parking crime proceeds and black money is the property, and gems and jewellery market.[7] These sectors have also been used for the temporary investment of terror funds. Unless transactions are made transparent and reflect real market value, black money and terror funds will continue to find their way into these businesses.
- FICN can potentially be reintroduced into India after a break by Pakistan. In order to sustain action, the following are suggested:
- Enhance detection measures at public sector banks which have lagged behind some of the private banks over the years.
- Establish a forensic cell which monitors each case of counterfeit currency to better understand the technology being applied to counterfeit notes. This must contribute to future measures to enhance security against counterfeiting.
- The involvement of Pakistan established through a Special Court judgement in 2014 should be built upon to enhance international diplomatic pressure.[8]
- Demonetisation provides an opportunity to encourage a shift to a digital economy. This is an essential requirement to not only reduce corruption but also create an electronic trail for transactions. This will help bring transparency into the financial transactions of individuals and organisations thereby constraining corruption, criminal proceeds, money laundering and the finance of terrorism, which are all linked given the common channels employed for transferring funds. While demonetisation is likely to encourage it, incentives by the government for payment of bills can further encourage people to take up plastic and e-money options. This is also likely to be enhanced by the forces of market economy which are already offering money back options.
- A large percentage of funds have been routed through NGOs in West Asia, especially in case of Kashmir. Each institution receiving funds must:
- Register itself and seek clearance for receiving funds from foreign sources.
- The controlling group of the NGO or establishment receiving money should be clearly established.

---

7 "Designated Non Financial Businesses and Professions (DNFBPs) in relation to AML/CFT", *MENAFATF*, 10 November 2008, http://www.menafatf.org/images/UploadFiles/DNFBPs_in_relation_to_AMLCFT.pdf, (Accessed May 03, 2013), pp 3-4.

8 Special Court judgement of January 30, 2014, in the Gr. Mumbai Sessions Case No. 674 of 2009(NIA).

- A government panel of charted accountants should audit the accounts of these NGOs.
- The finance of terrorism is yet to become a priority area for intelligence and enforcement agencies. While funding of terrorism by Pakistan in J&K may be an almost thirty year old phenomenon, groups in Northeast India have continued to extort the local population blatantly for almost seven decades. This has been facilitated by the inability of the state to clamp down on these groups and enforce its writ. Some of these regions have also witnessed a collusion between power brokers and militant groups, which has been complicit in the creation and utilisation of terror funds. The impact of demonetisation must therefore be seen in the context of corruption, crime, money laundering and the financing of terror being closely linked as a symbiotic contagion that collectively affects the security of the country. This is most relevant in some of the Northeastern regions.

Demonetisation is an important step in the fight against the finance of terrorism. However, it should neither be the first nor the last, if the interlinked threats of corruption, crime and the finance of terrorism have to be controlled. These must also not be addressed simply within departmental and ministerial silos. Instead, an all-ofgovernment approach is imperative if each of these challenges is to be met.

About the Authors

Vivek Chadha is a Research Fellow at the Institute for Defence Studies & Analyses, New Delhi.

The Institute for Defence Studies and Analyses (IDSA) is a non-partisan, autonomous body dedicated to objective research and policy relevant studies on all aspects of defence and security. Its mission is to promote national and international security through the generation and dissemination of knowledge on defence and security-related issues.

Institute for Defence Studies and Analyses
1, Development Enclave, Rao Tula Ram Marg
New Delhi 110 010 India
T +91-11-2671 7983 F +91-11-2615 4191
contact.idsa@nic.in www.idsa.in
Twitter @IDSAIndia
www.facebook.com/InstituteforDefenceStudiesAnalyses