Reframing the Hundi Challenge: A Behavioral Analysis of Informal Value Transfer Systems, Institutional Incentives, and Policy Responses in Nepal.

Policy Brief

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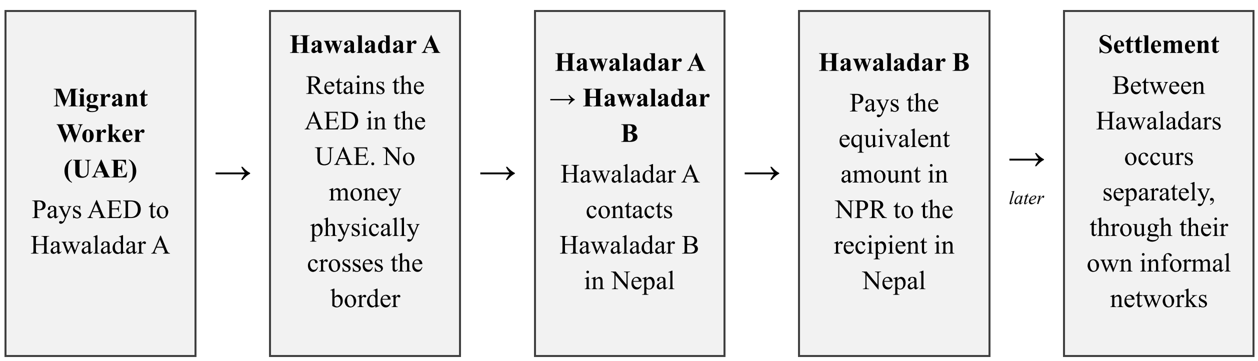
Executive Summary

Nepal's sustained reliance on Informal Value Transfer Systems (IVTS), notably Hundi/Hawala systems, presents an important and increasingly urgent policy challenge amid intensified Financial Action Task Force (FATF) scrutiny and Nepal's more extensive financial inclusion objectives. Existing discussions around Hundi often frame it as an illegal financial activity that requires strengthening enforcement. This policy brief proposes an alternative framework to examine Hundi as a behavioral economics response to a mix of structural, behavioral, and institutional incentives offered by formal and informal remittance channels. With evidence derived from literature and Key Informant Interviews (KIIs), the brief identifies fundamental friction points influencing consumers' remittance channel choices and develops two policy recommendations aimed at addressing information failure and improving access to formal remittance channels. The aim is not to supersede existing AML/CFT efforts, but rather to reinforce them through a behavioral framework highlighting underlying drivers of Hundi.

To contextualize the presented recommendations, it is essential to clarify the scope and limitations of this policy brief. Although the brief acknowledges the institutional constraints as supporting the persistence of Hundi, policies addressing these factors would mandate broader inter-agency coordination between various government agencies and exceed the immediate scope of social, behavioral, and financial sector policies as well as the abilities of the intended audience of this brief. Fundamentally, the primary focus for the policy recommendations is on addressing the behavioral motivations and structural friction points influencing individual remittance and financing choices rather than institutional loopholes. Additionally, due to the largely undocumented nature of Hundi, this policy brief faces the issue of limited availability of quantitative data on IVTS, necessitating a qualitative methodology based on literature review and KIIs rather than a quantitative, empirical analysis of Hundi/Hawala systems in Nepal.

What is Hundi?

Hundi/Hawala is a form of Informal Value Transfer System (IVTS) that facilitates money transfer through professional intermediaries known as Hawaladars, who receive, settle, and coordinate the transfer of funds through informal trust-based systems of Hundi/Hawala and operate outside the formal regulatory framework. For this policy brief, the analysis excludes informal transfers made through friends, family, and other personal connections. By making this distinction, the policy brief aims to reframe Hundi/Hawala as an alternative to formal remittance channels for ordinary migrants and households and examine its persistence through the economic concept of the substitution effect rather than solely as an illegal financial activity. It is important to note that the core subject of the analysis is not actors engaged in Anti-Money Laundering (AML), Combating the Financing of Terrorism (CFT), and other illicit crimes. However, some policy recommendations may strengthen related efforts. The figure below outlines an example of the mechanism of the Hundi/Hawala system.



Why Hundi is illegal and Why it Matters for Nepal

As the figure illustrates, the foreign currency never enters the receiving country; that is, the transaction bypasses regulated financial institutions and reporting mechanisms. This is problematic because the receiving nation fails to record remittance inflows in its national accounts and Balance of Payments (BoP), which can be troublesome for heavily remittance-dependent nations like Nepal. Additionally, the entire system has minimal documentation and customer identification mandates, meaning that the identities of the sender and the receiver are not subjected to regulatory Know-Your-Customer (KYC) procedures. This is a feature heavily misused by actors in illegal activities such as drug cartels, illegal wealth hoarding, human and organ trafficking, terrorist funding, Trade-Based Money Laundering (TBML), and cryptocurrency and cyber frauds. Following the 9/11 investigations linking terrorist networks to Hundi, efforts intensified to combat illegitimate IVTS to reduce AML/CFT risks across jurisdictions, including the U.S. Patriot Act of 2001 and Nepal's Penal Code Act of 2017.

The Hundi challenge remains substantial in Nepal's remittance-dependent economy, with remittances accounting for approximately 26.5% of Nepal's GDP in 2022. Although the documented reliance on informal channels has declined over time, Hundi remains a central concern. According to the *Study of Remittances in Nepal* done by the *Centre for the Study of Labor and Mobility (CESLAM),* remittance through Hundi declined from 30% in 2011 to approximately 7% in 2023, which is broadly consistent with the estimates of around 2-3% from the *National Living Standards Survey (NLSS)*. In raw figures, based on *Nepal Rastra Bank's*[1] official remittance inflow statistics, Nepal saw an inflow of roughly NPR 1.4 trillion in 2023/2024; a 7% Hundi share would still represent around NPR 100 billion in 2023 coming through Hundi/Hawala systems. It is important to note that because Hundi/Hawala works primarily out of formal regulatory monitoring and its true scale is largely undocumented and difficult to observe, all official estimates are widely regarded as conservative. At the time of writing, industry experts continue to suggest that remittance inflow through channels like Hundi may still account for as much as 20-30% of aggregate remittances. With *Nepal Rastra Bank's* reported formal remittance inflow for 10 months ending mid-May 2026 of roughly NPR 1.91 trillion (USD 13.26 billion)[2], an estimate range of 20-30% would be around NPR 382-572 billion (USD 2.65-3.98 billion) in raw figures coming through Hundi/Hawala channels.

Despite the documented progress, *Nepal's 2020 National Risk Assessment* recognizes Hundi as a prevalent and high-risk IVTS, as highlighted in both the *APG Mutual Evaluation Report (2023)* and the *Financial Intelligence Unit (FIU) Nepal Newsletter 2024,* which published updates on the International Cooperation Review Group (ICRG) observation process. Moreover, Nepal was placed on the Financial Action Task Force (FATF) grey list in early 2025, with Hundi cited as a key cause, as noted in its 2025 Public Statements and Assessments. Nepal is to face a critical FATF assessment in September 2026 and runs the risk of being blacklisted, which makes reducing Hundi no longer a remittance policy goal, but a broader, rather urgent regulatory priority to avoid significant economic and financial repercussions.

Understanding the Persistence of Hundi

This policy brief proposes that Hundi/Hawala persists not merely due to weak enforcement but prominently because of the relative utility and attractiveness of the Hundi/Hawala channels. Drawing from theories of behavioral economics, Hundi can be better understood through the lens of the substitution effect, where it is viewed as a competing substitute to formal remittance channels whose continued use is underpinned by a mix of structural, behavioral, and institutional incentives. Reducing confidence in Hundi would therefore

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[1] Nepal Rastra Bank. (2024). *Current Macroeconomic and Financial Situation (Based on Annual Data of FY 2023/24).* Kathmandu: Nepal Rastra Bank.

[2] Nepal Rastra Bank, *Current Macroeconomic and Financial Situation of Nepal: Based on Ten Months' Data (Ending Mid-May) of Fiscal Year 2025/26* (Kathmandu: Nepal Rastra Bank, 2026).

require increasing the relative utility as well as attractiveness of and confidence in the formal remittance channel rather than through brute force, which is the underlying perspective grounding the policy recommendations presented in this brief.

Behavioral and Economic Mechanisms Underlying Hundi Persistence:

- ***Substitution Effect and Relative Utility:*** The Substitution Effect is defined as the tendency of consumers to replace one good or service with another when the perceived relative utility, convenience, or value of the money spent increases for the other good or service. In the case of Hundi, the substitution effect often plays out such that when formal services involve delays, repetitive and lengthy documentation, and procedural complexities, consumers substitute formal channels for more convenient, simpler transaction systems offered by Hundi/Hawal channels to maximize their relative utility. Industry experts have noted in KIIs that the simplicity of the process not only makes the relative utility greater for Hundi than formal channels, but also often overrides the perceived risks of Hundi, leading to its continued use.
- ***Nudge Theory and Fear of Formal Banking:*** Nudge Theory is a behavioral economics and psychology concept suggesting that subtle alterations in the decision-making environment and incentives can systematically influence human behavior without restricting freedom of choice. Key Informant Interviews reveal that many first-time migrants and rural households tend to fear the financial banking system due to repetitive and tiresome documentation processes for which they might not have adequate documents and/or might face harsh consequences if a minor mistake is made. This psychological fear acts as a nudge towards Hundi as an easier default option, which has been noted often in related literature.
- ***Social Norms and Observational Learning:*** Observational Learning Theory, developed by psychologist Albert Bandura, states that individuals tend to learn behaviors, attitudes, and values through observation and imitation, meaning that they are likely to continue behaviors they repeatedly observe within their family, peers, communities, and social networks. Vast and repeated use of Hundi by relatives, parents, employers, and peers increasingly normalizes its use in society to the point that several reports, including the *IOM's 2019 Study on Remittance Regulatory Frameworks and Accessibility of Regular Remittance Channels of the Colombo Process Member States,* note that many people aren't even aware of the illegitimacy and risks of Hundi/Hawala channels due to normalization. The normalization of observed use of Hundi further reinforces social trust in Hawaladars and reduces the recognized need to shift to formal remittance channels.

Together, these mechanisms indicate that policies aiming to reduce reliance on Hundi should alter the relative utility derived from formal and informal remittance channels in favor of formal channels by reducing information failure, structural friction, and increasing proactive use of behavioral nudging. Additionally, the fundamental categorical drivers identified in the literature are distilled below.

Behavioral & Social Incentives	Structural Frictions	Institutional Constraints
Limited financial literacy and awareness of the legal, financial, and AML/CFT risks associated with Hundi.	Complex onboarding and documentation requirements (e.g., bank account opening and KYC) create barriers, particularly for first-time migrants and rural populations.	Fragmented regulatory coordination across agencies responsible for migration, financial regulation, and AML/CFT enforcement.
Established trust networks and social referrals make Hundi a familiar and socially accepted remittance channel.	Limited accessibility of formal financial services, particularly in rural areas and among financially excluded populations.	Regulatory barriers limiting product innovation that could make formal remittance channels more attractive and competitive.
Weak positive incentives to use formal channels, resulting in little motivation for users to switch despite the legal risks.	Transaction delays and procedural complexity reduce the utility of formal remittance channels compared to Hundi.	Limited monitoring and visibility of informal cross-border transactions, making enforcement and risk assessment difficult.
Convenience and speed outweigh perceived risks, particularly for urgent or small-value transfers.		

Policy Recommendations

1. Address Information Failure through Financial Literacy and Behavioral Nudging

Objective: Address information failure and limited financial literacy regarding the difference between formal and informal remittance channels, while improving knowledge on the legal, financial, and security risks associated with the use of Hundi, particularly amongst migrants and underserved rural households and communities, to promote informed decision-making through correction of information failure and grow confidence in formal financial services.

Rationale and Literature: Information asymmetry and limited awareness remain a significant psychological barrier to formal remittance adoption. Multiple IOM reports such as the *Study on Remittance Regulatory Frameworks and Accessibility of Regular Remittance Channels of the Colombo Process Member States (IOM, 2019)* repeatedly recognize financial information failure as an actionable essential to reducing the reliance on informal remittance channels and enabling informed decision-making. Similarly, IOM's 2017 study titled *Maximizing the Development Impact of Migration in Nepal: Comprehensive Market Study* underscores extremely low levels of financial literacy within migrant household populations, citing Nepal's ranking of 136th out of 144 countries in the *Standard & Poor's Global Financial Literacy Survey*, indicating that merely 18% of the respondents correctly answered three out of four basic financial literacy questions. This makes the role of comprehensive yet pivotal financial literacy campaigns a growing necessity amongst rural and migrant populations. Informing migrants and rural households on the basics of financial decision-making, the existing and often underrealized benefits of formal sector usage in the form of incentives can help behaviorally nudge them to formal remittance channels. Information campaigns are also highlighted in KIIs as a doable policy reform that could reduce the perceived fear around the complexity of documentation of formal remittance channels and improve national financial inclusion objectives.

Recommended Actions:

- Mandate pre-departure financial literacy orientation for all outbound first-time migrant workers, detailing the various risks of Hundi, formal remittance alternatives, along with a completion certification that is required documentation to present during departure.
- Conduct targeted information campaigns to make people aware of the illegality and informal nature of Hundi, focusing on how the anonymity and untraceable nature of Hundi may finance illicit crimes such as money laundering and terrorist financing, risks the general users may unintentionally be associated with.
- Develop community-based education sessions addressing basic-level financial decision-making frameworks and the fear around the complications of formal remittance channel usage, covering topics of documentation, support available, account opening process, and accessibility to formal remittance services.
- Promote long-term benefits of using formal remittance channels, such as income proof, easier loans, education and property acquisitions, stronger customer protection, and positive impact on Nepal's economic development and national security.

2. Reduce Structural Frictions through Centralized National Identity (NID) Integration

Objective: Reduce procedural barriers to access to formal financial services by centralizing the National Identity (NID) systems across national and commercial financial institutions, facilitating easier, faster, and more convenient account opening for migrants and underserved rural households, while simultaneously co-benefiting the advancement of Nepal's financial inclusion objectives.

Rationale and Literature: Complicated banking procedures and lengthy documentation are consistently identified as the primary structural friction points to formal remittance use, especially amongst first-time migrants and underserved rural households. The *Report on Inclusive Innovation Strategies in Migrant Remittances and Financial Services: Nepal Country Assessment (UN-CDF & IOM, 2022)* repeatedly emphasizes that *"there is an unclear distribution of remittance-related responsibilities between the central bank and central government, particularly where incentives for formal remittances are concerned"* and that *"another key inhibitor to remittance usage inclusivity in Nepal is the country's fragmented and inconsistent nature of financial literacy education."* These remarks highlight the complexity of financial accessibility as a major concern affecting the adoption of formal remittance channels. Likewise, KIIs persistently identify fragmented identity verification systems and repetitive documentation as one of the most preventable but chronic barriers that incentivize the use of Hundi. Experts foreground that even well-educated and financially literate urban consumers find the formal channels' documentation procedures unnecessarily repetitive and burdensome, implying that the challenge is even more profound for first-time migrants and underserved rural households.

Recommended Actions:

- Mandate NID registration for all outbound migrants prior to departure for employment.
- Allow NID-based integration across regulated financial institutions and NID centralization for efficient, secure, and traceable customer data transfer between the central bank and various financial institutions.
- Enable regulated financial institutions to access the centralized NID records, with customer consent, to securely verify customer identity, enabling customers to open accounts at various banks without needing to report the same documents at a physical branch.
- Expand mobile biometric registration through agent banking, allowing the under-resourced rural households to complete NID verification and identity authentication to access formal financial services and remittance channels.

Conclusion

Hundi/Hawal cannot be reduced through enforcement since it is as much a problem incentivized by behavioral and social factors as it is by institutional constraints and illicit intent. Therefore, treating Hundi as solely an illegal financial activity is likely not going to help reduce its prevalence. Rather, this policy brief proposes a behavioral economics-informed framework to approach the Hundi challenge in Nepal, responding to structural frictions, behavioral incentives, and information failure. Accordingly, policies addressing fundamental constraints and aiming to improve financial literacy, improve accessibility, and nudge people away from Hundi may complement the government's existing AML/CFT efforts while advancing Nepal's financial inclusion and macroeconomic targets, especially during the ongoing FATF scrutiny.

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