THE ROLE OF FINANCIAL INSTITUTIONS IN COMBATING MONEY LAUNDERING IN PAKISTAN

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Abstract

Financial institutions in Pakistan play a strategic role in combating money laundering as they are the first line of defense in the financial landscape. They want to prevent these operations with the help of strict measures of legalization, progressive technologies for monitoring transactions, and cooperation with law enforcement agencies. This paper aims to understand what roles and measures the financial institutions in Pakistan need to undertake and the changes that need to be made. It also considers the general legal and supervisory systems in operation within the area of study by exploring the difficulties that financial organizations encounter in administering of the Anti-money laundering measures. The study also elaborated on the measures drawn out from Pakistan's precedence which the other nations going through the same experience can implement while enhancing the facets of the financial institutions to contain the illicit exercises. The paper then provides an overview of the money laundering process, and an explanation of the various phases in the money laundering process of placement, layering, and integration, and how the financial institutions can identify and counter the money laundering process. Furthermore, there is an analysis of relations between money laundering, terrorism financing, and other related forms of financial crimes to pay attention to the notion that the fight against such crimes requires more consistent and integrated efforts of the financial industry, supervisors, and the police.

Keywords: Money laundering, Financial institutions, Anti-money laundering (AML), Customer due diligence (CDD), State Bank of Pakistan (SBP), Financial Action Task Force (FATF)

Introduction:

The list of countries that continue to experience the problem of money laundering includes Pakistan. Besides, heinous financial offenses including drug and human trafficking, and white-collar crimes like corruption and financing of terrorism are core concerns for Pakistan. Pakistan is defenseless and sensitive to money laundering; its neighbors India, Iran, and China are critical players in the drug market. Also, their location is in a strategic position on the transit belt of narcotics.

Moreover, according to the Transparency International Corruption Perceptions Index, Pakistan scored 31 out of 100 in 2023, indicating a high level of perceived corruption. The World Governance Indicators report further indicates that Pakistan scores 21 out of 100 in controlling corruption, highlighting significant weaknesses in this area. The prevalence of corruption exacerbates the threats of smuggling, fraud schemes, and kidnapping. Therefore, factors such as corruption and geographic challenges demonstrate that Pakistan needs to implement more efficient policies against financial crimes.

The measures against terrorism financing and money laundering have remained critical and highly discussed issues on the agendas of both government and international organizations, as well as within global financial systems. This is because terrorist organizations and criminal networks often exploit financial systems to fund their activities, thereby destabilizing and undermining the security and well-being of societies.

After the occurrence of the September 11 2001 tragedy, the global society has significantly stepped up the processes aimed at prevention of financing terrorism. The Financial Action Task Force (FATF) as an international organization has contributed precisely towards the formation and formulation of International standards and Recommendations for the Anti-money laundering as well as combating the financing of terrorism measures. Thus, Pakistan has consistently been on the 'wrong side' concerning terrorism financing and money laundering because of its geographic position, historical conflicts, and the availability of numerous criminogenic terrorist and criminal groups. It has earlier been included in the so-called grey list of the FATF, which indicates that it still experiences vulnerabilities in its AML/CFT system and needs further improvement of this system.

This conflict has primarily affected stakeholders within the Pakistani financial sector, including banks, money service businesses (MSBs), and other financial entities. The rules and regulations governing these financial organizations, particularly those involved in the provision of funds, are controlled and supervised solely by the State Bank of Pakistan and other legal authorities. However, when it comes to assessing the success or failure of these measures in identifying and counteracting illicit financial flows (IFFs), the decisions have been a subject of controversy and extensive research both domestically and internationally.

This study aims to identify how Pakistan's financial institutions are addressing the issues of terrorism financing and money laundering. It will examine the current state of regulations, the strategies that have been adopted, and the future challenges that hinder the improvement of this sector's role in combating these domestic and global threats.

Research Objectives

The primary objectives of this research are:

1. To evaluate measures forwarded by the financial institutions in Pakistan combating terrorism financing and money laundering.

2. To evaluate the effectiveness of the measures implemented by the state and other vertices of regulation in the sphere of AML/CFT of financial institutions.

3. To assimilate the new knowledge about the issues and ideas connecting to the improvement of the perspective of the financial sector in combating such nefarious transactions regarding Pakistan.

Research Questions

1. In what ways have the financial institutions in Pakistan altered their strategies, rules, and measures in identifying and filing reports of any transactions, particularly those connected with terrorism financing and money laundering?

2. What are the compliance measures for the AML/CFT standards, and how is the supervisory process carried out in the financial sector in Pakistan?

3. What are the major difficulties faced by financial institutions in Pakistan in implementing AML/CFT control measures, and what strategies are applied to mitigate these difficulties?

Methodology

In this research, only secondary qualitative data will be collected and analyzed therefore it is established that this work will be conducted using a qualitative research approach. The study will start with a literature review of peer-reviewed journals, government documents, policy papers, and industry journals that contain information on the involvement of the financial institutions and Pakistan in anti-terrorism and anti-money laundering exercises. For this reason, this review will serve as a background of the state of knowledge and the available literature in the field.

Literature Review

Money laundering involves the transformation of "dirty money," which is ill-gotten wealth, into "clean money," which appears to be legitimately acquired. This process occurs in three key stages. The first stage, known as placement, entails funneling illicit funds into the legitimate economy. The purpose of this step is to separate the cash from its illegal origins. Common practices during this stage include smurfing or structuring, where large amounts of cash are deposited into bank accounts in small increments to avoid detection. Additionally, money launderers may purchase high-value items such as cars and jewelry, or use cash-intensive businesses like restaurants, casinos, and building contractors to mix illicit cash with legitimate revenue streams (Unger & Busuioc, 2007).

The second step is called layering, which intends to hide the sources of the money through a sequence of activities. It can include money moving from one account to another from one institution to another or from one country to the other, converting cash into different forms such as shares, bonds, and so on, and moving money through the purchase and sale of goods and services, and use of offshore companies or trusts among others. Because of this, it is almost impossible to monitor the previous history of the money that is involved in the unlawful activity (Business Crime Solutions Inc., 2017).

The last process, integration, tries to bring the 'purified' cash back into the 'lawful' stream of the economy, making it look as though such money has a legal source. At this stage, methods include buying properties, companies, or other legal activities, spending for own and business needs, and opening overseas bank accounts and trust accounts to secure the money. The integration stage is very important because it incorporates the proceeds of crime into the legal economy thus giving it a clean façade (Bussler, 2023).

Money laundering is combated in the financial sector through various techniques collectively referred to as Anti-Money Laundering (AML) measures, which are applied by governments and financial institutions. The first measure is Customer Due Diligence (CDD), through which a client's identity must be verified, and the risks associated with the transaction must be assessed. Another measure is the submission of Suspicious Activity Reports (SARs), where banks and other financial institutions are required to report any suspicious activities related to transactions to the government. Additionally, Know Your Customer (KYC) policies are adopted to ensure financial institutions understand their clients' businesses and can analyze various transactions for suspicious activities. Legal compliance is also fundamental and involves adhering to laws and regulations designed to identify money laundering activities (State Bank of Pakistan, 2018).

Overall, some essential factors have been illustrated where money laundering is a serious criminal offense and a legal concern and its prevention and detection are highly dependent on competent international collaboration. These approaches are vital in addressing money laundering from an international perspective since they involve teamwork.

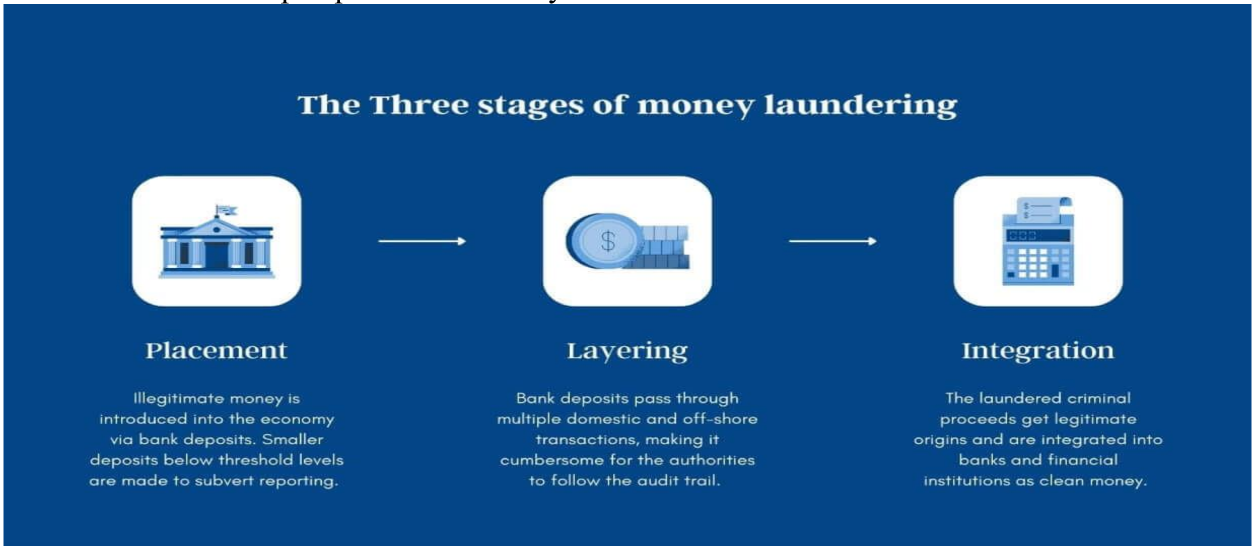


Figure 1 The three stages of Money Laundering

Role of Financial Institutions:

In the fight against terrorism financing and money laundering, the following key financial institutions have played a crucial role in assisting Pakistan:

1. Financial Action Task Force (FATF): Financial Action Task Force (FATF):

• FATF is the independent inter-governmental policy-making anti-money laundering & combating the financing of terrorism body.

• Pakistan has also continuously cooperated with the FATF in the process of improvising the country's non-compliance issues on AML/CFT.

• Pakistan has made several legislative and regulatory changes through the FATF's recommendations and surveillance in this regard.

• Example: The growing interest in FATF as well as the measures taken by Pakistan have enhanced the role and capacity of the Financial Monitoring Unit (FMU) and are in compliance with the commitments of the same regarding appropriate Know Your Customer (KYC) and Customer Due Diligence (CDD) standards in the country's financial sector.

2. International Monetary Fund (IMF):

The International Monetary Fund (IMF) has been actively engaged in offering technical expertise and other related policies to Pakistan to enhance its Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) system.

Among its lending instruments, the IMF has made the enhancement of the country's AML/CFT compliance standards one of the prerequisites for monetary assistance.

For example, Pakistan has established the national risk assessment process with the help of the IMF's engagement and has further improved the operational independence of the Financial Monitoring Unit (FMU) and its coordination with other Law Enforcement Agencies (LEAs).

3. World Bank:

• The World Bank has also supported the rehabilitation of the Pakistani AML/CFT system and its correlation with international standards.

• The World Bank has offered support in the form of technical aid and capacity development in different areas to the regulators and a large number of institutions including banking houses and police agencies.

• Example: The World Bank has assisted Pakistan in conducting risk assessments for Pakistan, formulating a national AML/CFT plan, and enhancing the legal framework concerning non-profit organizations to tackle the menace of terrorism financing.

4. Asia-Pacific Group on Money Laundering (APG):

• It is laden with the responsibility of enhancing the implementation of the FATF Recommendations in the Asia-Pacific region.

• Pakistan is a member of APG, and it has been engaged in mutual evaluations as well as follow-up processes.

• Example: Through APG's assessments and recommendations the latter managed to encourage Pakistan to further develop its legal and institutional environment which requires the creation of specific AML/CFT courts as well as the improvement of related Financial monitoring units (FMUs) analytical capacities.

These international financial institutions have been very instrumental in supporting Pakistan in its fight against terrorism financing and money laundering thus helping Pakistan achieve its goal of improving its financial sector while at the same time maintaining its policies with an accepted international framework.

Attempts and improvements in the regulation of money laundering in South Asian countries seem to present considerable compliance and implementation difficulties. In Pakistan, the legal acts Anti-Money Laundering Act, 2010, and other related amendments have strengthened the regulatory environment. It was removed from the Financial Action Task Force's grey list in October 2022 as some advancements were made in eradicating the strategic shortcomings. Nonetheless, different challenges such as informal funds transfer methods like Hawala Hundi, poor borders with Afghanistan leading to contraband business, and corruption in governmental organs persist and hamper the expansion of anti-money laundering efforts (Financial Action Task Force, 2022; International Monetary Fund, 2023). India has already well-established anti-money laundering and counter-terrorist financing measures, mainly operating under the Prevention of Money Laundering Act, of 2002, as well as significantly raised due diligence with the help of additional monitoring based on artificial intelligence and other innovative solutions. However, the practical challenges present in the implementation include limited resources, lack of personnel training, and cultural restrictions (Viritha, 2015). The Money Laundering Prevention Act formulated in 2012 further strengthened the anti-money laundering process, where the Bangladesh Financial Intelligence Unit stands as the central figure. However, social informal methods of money transfer, lack of infrastructure, and a focus on rural areas slow the progress down (Ahmed, 2017). Sri Lanka has also advanced with the Financial Transactions Reporting Act and intensified its cooperation with international organizations. Nevertheless, corruption and lack of regulation remain the key issues that hinder the anti-money laundering processes (World Bank, 2023).

Some of the advancements of the nations within this category from 2019 to 2023 entail the incorporation of other technologies such as artificial intelligence and machine learning in the monitoring of transactions and risk evaluation as well as enhanced cooperation with international organizations and bodies such as the Financial Action Task Force and the Asia-Pacific Group on Money Laundering. Such efforts increased the effectiveness of combating money laundering actions and their prevention. However, due to political instabilities and economic vulnerabilities in the respective nations, sometimes attention and efforts toward anti-money laundering measures have been compromised, resulting in the efficiency of such measures (International Monetary Fund, 2023). The process to fight money laundering via technology, one of them entails the collection and analysis of individual information. Banks bear a legal obligation to maintain the confidentiality of their customer's data and adhere to the rules of the Data Protection Act. The primary source of Pakistan's bank secrecy law is the Banking Companies Ordinance of 1962. It was formulated with the understanding that banks and other financial institutions did not interfere with clients' private information. The law requires banks to be private on their customers' financial transactions and strictly bars every such information from being divulged without the permission of the customer though there are exceptions under certain circumstances. Although laws protecting bank secrecy are meant to safeguard the clients, they have several disadvantages (Mushtaque et al., 2014). Also, the Electronic Crimes Act, of 2016 is one of the core laws which provides regulation of the privacy of the individuals in cyberspace. This law regards personal data protection and contains measures for the protection of data concerning financial transactions and their performance, as well as criminalizes personal data's unauthorized access, alteration, and interception. The Act also provides penalties for breach of the provisions of the Act, including fines and imprisonment. Instead, quite recently, certain extensive regulations (as referred to by their proper name, the General Data Protection Regulation) pertaining to the acquisition, storage, and utilization of individuals' private data came into effect across the European Union in May 2018, replacing the weaker European Union's Data Protection Directive, promulgated in 1995. Let there be no misunderstanding, this new law applies to any sector, to any EU institution, and to any business that processes personal data belonging to EU citizens. Data ownership, openness, and explainability as well as the trustworthiness of the algorithms that were trained or built using such data are often highlighted by data-driven regulations. Data-driven automated systems, such as AML systems, must adapt the following during implementation in order to be compliant with the General Data Protection Regulation (GDPR): Some of the considered subjects are (1) legal dealing with the data and information ownership; (2) interpretations of the data and techniques; and (3) moral compliance (Goddard, 2017). The researcher notices the difference between the GDPR that was adopted in the EU and the shortage of an analogous omnibus regulation in Pakistan at present. Nevertheless, there are now a number of staking proposals aimed at the establishment of such legislation. The Personal Data Protection Law was duly passed by the government of Pakistan in the year 2020 to regulate how people, companies, and the government handle personal data. The law defines the requirements that the companies who process personal data must follow and it provides certain rights for the individuals like the rights to access, correct, and erase their personal data. The duties that accompany the necessity of processing personal data in the organizations are specified by the Act. This bill, if enacted, will give the legal guidelines to safeguard individuals' identification and data in Pakistan and offer a closer view of the GDPR. Hence, the statement can be said to be accurate because Pakistan requires a law similar to the GDPR that can safeguard the privacy of the citizen and their personal data, and the authorities of the country are working towards that end.

Money Laundering Risks in Pakistan:

Money laundering, however, is a very delicate and risky, especially for any economic, financial, and security systems of most countries in the world. Money laundering is therefore a threat to the social integrity of Pakistan as is a threat to many other countries of the world for it provides a basis for the commission of other crimes, particularly terrorism, and is an enemy to the economy and reputation of the country. Some of the risks are mentioned below, These are normally linked to money laundering in Pakistan:

1. Economic Risks

Distortion of Markets: As one of the financial crimes, money laundering affects the financial markets and therefore shifts the economic stats thereby locking out the policy makers from making the right choices.

Loss of Revenue: This is so because out of ill-gotten resources, the revenue loses these monies as they do not form part of the exercising of taxation by the government.

Resource Allocation: This can lead to embezzlement of capital because, for the money laundering exercise, money is channeled into a business that seems unprofitable to the economy.

2. Financial Sector Risks

Reputation Damage: Money laundering in financial institutions is very common because it only leads to the detachment of the business image of the concerned financial institution implication of which will lead to detachment of clients and other business partners.

Regulatory Penalties: Any mean involvement in money laundering by banks and financial institutions attracts very severe penalties and sanctions.

Operational Risks: Therefore, while some of the layouts of money laundering bring out the whole scenario, they in fact enhance the operation threats in the financial institution.

3. National Security Risks

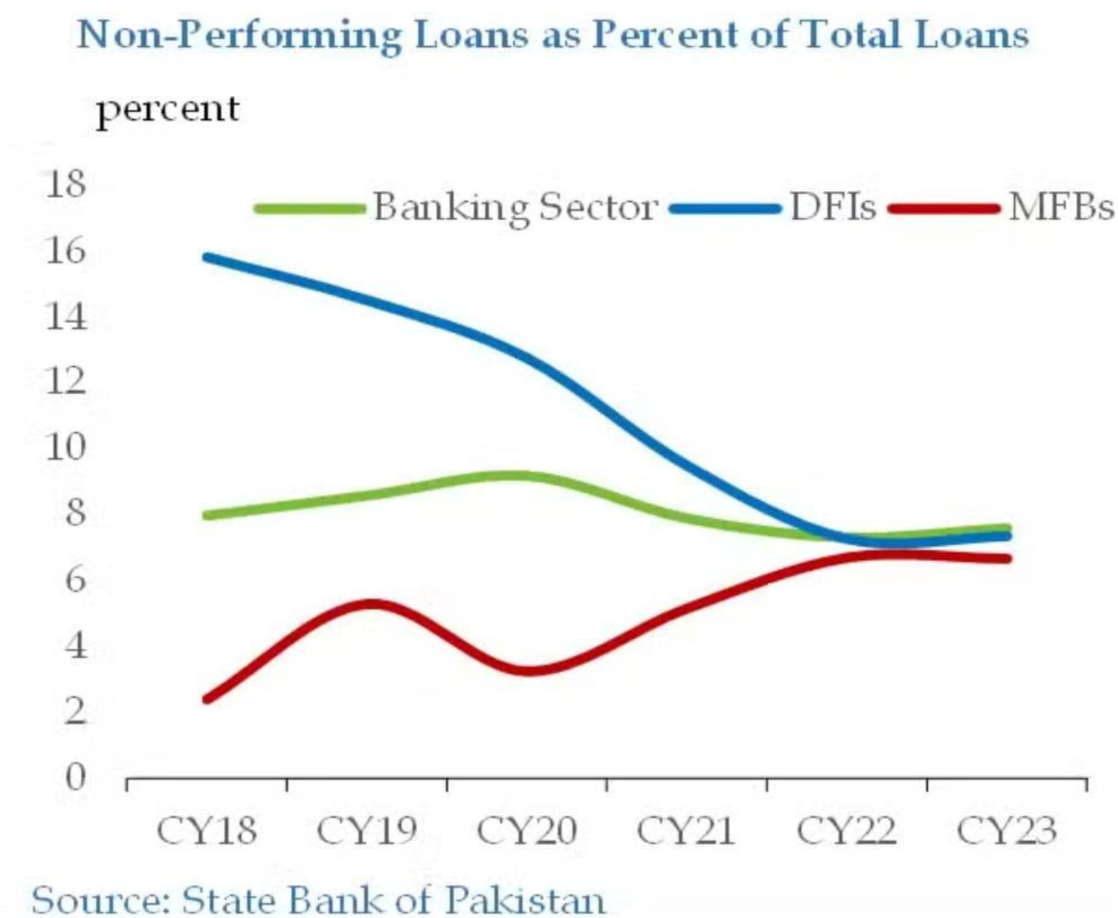
Terrorism Financing: Terrorists' situations regarding their operations are financed and are produced through money laundering which is a threat to internal as well as international security.

Corruption: And that may unfortunately lead to higher conduct of corruption by individuals in governmental and other organizations at the expense of the normally practiced rule of law and governance frameworks.

The financial system of Pakistan:

Currently, Pakistan's financial structure is subjected to several challenges while at the same time experiencing reforms and enhancements till 2023. Key points include:

1. Banking Sector: The Pakistan financial sector consists of commercial banks, development finance institutions DFIs, micro financing banks MFBs, Non-bank financial companies NBFCs, insurance companies and others. Some of the measures are undertaking periodic assessments, monitoring for systematic risks, and having formally set up a contingency planning and resolution framework of the financial state of Pakistan which is through the State Bank of Pakistan SBP (State Bank of Pakistan 2024).



Digital transactions continued their strong growth momentum, and Raast transactions gained further traction in the calendar year 2023. The State Bank of Pakistan (SBP) launched the Person to Merchant (P2M) service in Raast to facilitate digital payment acceptance for merchants and businesses.

1. IMF Stand-By Arrangement (SBA): Pakistan completed six reviews including a staff-level agreement with the IMF in November 2023 for the first review of its economic program under the SBA. On this baseline, the stabilization plan, which includes fiscal consolidation, reform of the energy sector, a market-determined exchange rate, and governance reforms is part of the agreement. In this regard, approval means that Pakistan will have access to about $700 million taking the total disbursals under the program to almost $1.9 billion.

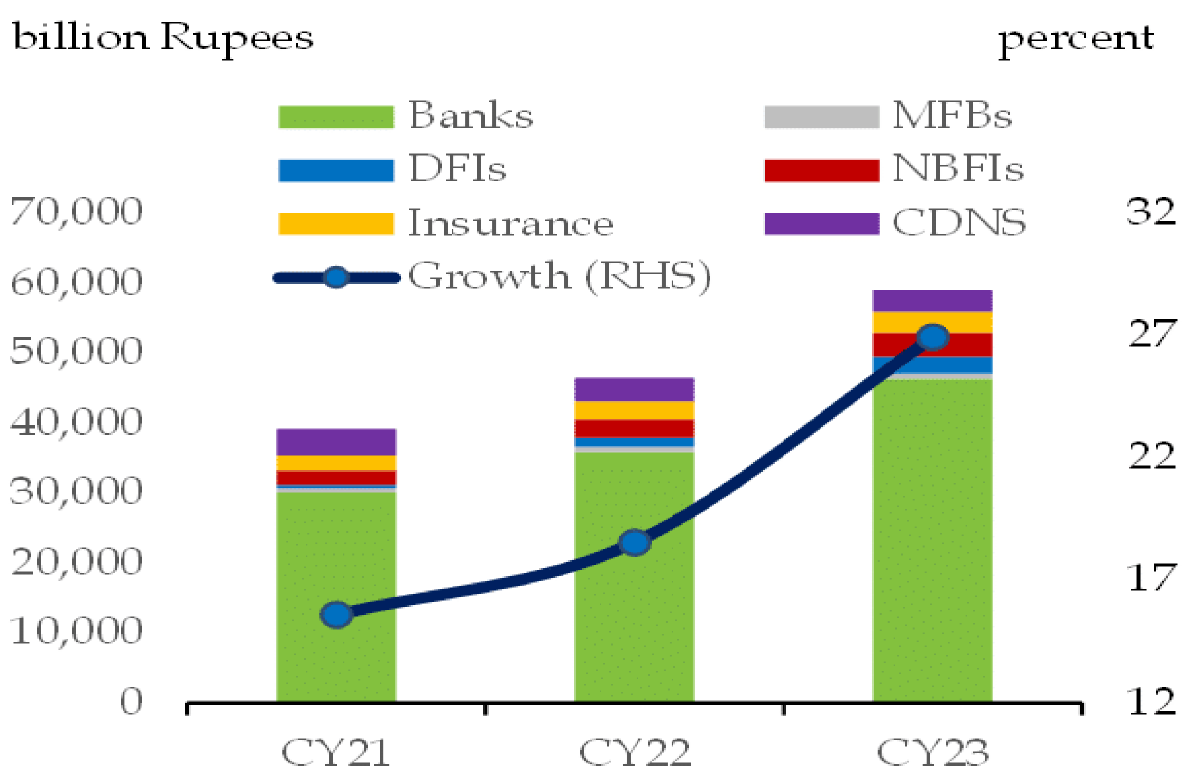
2. Economic Challenges: Pakistan still has major economic problems; the foreign exchange reserves are still low, down from $11. A regulated amount of $1 billion ended FY22 up to $5.4

billion by March 2023 to study the factors affecting the correlation between the two variables and to identify potential strategies. The country also experiences threats posed by high inflation, and large fiscal deficit (The World Bank, 2024; State Bank of Pakistan, 2024).

3. Impact of Remittances: Overseas Pakistanis send a large amount of money as remittances which are very helpful for the economy. Absolutized, in FY23 remittances were $27 billion as against $31, Three billion the previous year, thereby causing fluctuations in the levels of economic stability. Due to this decline, the balance of payments has further been hindered and pressure on foreign exchange reserves is more (State Bank of Pakistan).

4. Financial Stability and Reforms: The stabilization of the external balance is managed by monitoring and regulating the operating financial institutions together with other organs of the state, collaborating with members of various authorities, and implementing directions meant to strengthen the banking framework. This consists of deregulation of the economy to make it more appealing to investors, boost employment, and enhance social security nets Supported by a 20-year high growth in deposits, the assets base of the banking sector grew by 29.5 percent in CY2023 (State Bank of Pakistan, 2024).

Composition of Financial Sector Assets



Source: State Bank of Pakistan and SECP

The sources of terrorism financing and money laundering in Pakistan are still active despite the efforts of the respective authorities to eliminate them for the sake of the economy and security. However, there are questions as to the sufficiency of the current AML/CFT measures and corporations' capacity to meet such demands by the government and the financial sector. Consequently, the purpose of this exploration is to understand the role of the financial sector in fighting these adverse actions now and find out the areas of potential enhancement. This study will benefit the knowledge of the current research as it will help to enrich the information about the activities of financial institutions in combating terrorism financing and money laundering taking place in Pakistan. The results of this study will help to understand the problems that the financial industry encounters, the role of the regulation that at present supports and develops the financial institutions, and what strategies can be implemented in order to reinforce the financial institutions' support of this crucial national and global process. The findings of Pakistan's case study will be helpful for other countries struggling with such problems in this sphere.

Findings:

1. Banks and money service businesses in Pakistan are directly responsible for being the first level of prevention against money laundering. They use various measures to prevent money laundering operations, including the ones that result in heavy practicalities in meeting customer due diligence (CDD) requirements use progressive methods of monitoring the identified transactions due to their preferred status for law enforcement cooperation, the company cooperates with various law enforcement agencies.
2. It is still a subject of debate and research as to how efficiently the AML/CFT measures of the financial sector and the regulatory authorities have been in the context of Pakistan. Since 2018 Pakistan has been put on the grey list, which means that the country's AML/CFT framework has some weaknesses that should be strengthened.
3. The framework of the legal regulation and supervision of AML/CFT compliance in the Pakistani financial area is coordinated and regulated by the State Bank of Pakistan and other competent authorities.
4. There are critical challenges that the research establishes that impose the major difficulties experienced by financial institutions in implementing adequate AML/CFT controls that have to be met.
5. The paper seeks to identify success stories and hindsight from Pakistan's experience so that other countries confronting the seemingly unending menace of terror financing and money laundering can benefit from it.
6. In essence, the study aimed to offer recommendations on the required changes/ modifications in the existing role and strategies of the Financial sector of Pakistan for addressing IFLs more effectively.

Conclusion

This study has pointed out the significant part of the financial organizations of Pakistan in dealing with the terrors of money laundering as well as terrorism financing. The research discovery shows that financial institutions have adopted several methods in improving the standardized AML/CFT measures for instance increasing customer's due diligence process, improving the transaction monitoring ability, and improving their relations with law enforcement agencies.

However, the research also discovered some factors that the financial institutions have encountered in the implementation of AML/CFT control measures. Others are those concerning the regulatory challenges, technological constraints, and poor compliance capacity within the staff in charge of compliance. Furthermore, there are unyielding geographical factors in Pakistan which include corruption terrorism, and other criminal organizations that advance the menace of money laundering.

To reinforce the field of financial institutions, the study suggests the constant improvement of the AML/CFT regimes and their proper implementation by the State Bank of Pakistan and other overseer authorities. It also proposes the use of sophisticated approaches to data analysis and artificial intelligence by financial institutions to improve the processes of transaction monitoring and identification of suspicious activities. Another preventive measure is the strong compliance staff training programs to enable them to detect and report suspicious transactions.

A higher level of cooperation and integration of the financial sectors with the police and the authorities to dismantle the channels for money laundering is also important. Finally, the study stresses that since money laundering is associated closely with corruption and the influence of organized crime and other socioeconomic and political factors it is imperative to come up with a more holistic way of combating this menace in Pakistan.

Thus, through the above measures, the financial institutions in Pakistan can contribute better in addressing the menace of money laundering and financing of terrorism nationally as well as internationally. This would aid in preventing manipulation of the financial system and forbidding risks that are not beneficial to the security of the country.

Recommendations:

The key recommendations for improving the role of the Pakistani financial sector in combating illicit financial flows:

1. **Strengthen the regulatory and supervisory framework for AML/CFT compliance :**
   - By building up the capability and strengths of the State Bank of Pakistan and other related regulatory bodies in the supervision and enforcement of the AML/CFT standards in the financial sector of the country.
   - Regularly revising and updating the AML/CFT legal and regulatory framework is the fourth recommendation to address constantly changing and innovative methods of money laundering and financing terrorism.
2. **Enhance the AML/CFT measures implemented by financial institutions:**
   - By requiring deeper standard customer identification and verification checks, and deeper examinations where necessary, especially where the clients are high-risk types.
   - By enhancing the manner of using technology in transaction monitoring as well as reporting in identifying different suspicious cases.

- By Increasing the interaction and communication between and among financial institutions, regulators, and the police.

3. **Address the challenges faced by the financial sector in AML/CFT compliance:**
    - By ensuring appropriate training and capacity development, especially of the compliance officers and the staff of the financial institutions.
    - The following are friendly policies: Simplify and lower the compliances and expenses for MSBs and other small financial institutions.
    - It is necessary to apply the AML/CFT measures in a manner that is proportionate and risk-sensitive so as to prevent over-compliance and resulting adverse outcomes.
4. **Promote a collaborative and comprehensive approach:**
    - Policies promoting the enhancement of cooperation and the exchange of information between the financial industry and other related entities of the government and with international organizations such as the FATF.
    - Thus, the best strategy should be an integrated one that ties AML endeavors to the warfare against Terrorism Financing, Corruption, and other related Financial Crimes.
    - Engage with existing knowledge of IFFs and experience from other countries dealing with similar issues with regard to their fight against such flows.
5. **Enhance transparency and accountability:**
    - The incorporation of strong measures in the registration, especially in the beneficial ownership registration will help to reduce cases of misuse of legal entities for the purpose of money laundering.
    - Enhance the measures related to asset forfeiture and confiscation in the fight against criminals and their illegal incomes.
    - Enhance public and private sector participation and encourage raising awareness on AML/CFT initiatives.

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