MONEY LAUNDERING IN PAKISTAN

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ABSTRACT

Money laundering is defined as the activity through which the criminals converted the true source and ownership of such illegitimate money into legitimate money. Through which money can lose its original identity forever. Interpol definition adopted by UNO General assembly 1995 states "Any act or attempted act to conceal or disguise the identity of illegally obtained proceeds so that they appear to have originated from legitimated sources"

Illegitimate sources may include the illegal arms sales, smuggling and other crimes such as drug trafficking and prostitution can produce the huge quantity of earnings. Frauds, insider trading, bribery and other frauds in terms of offering the fake scheme they can also generate the huge profits. When such type of activities generates the profit the persons or people involve must find the different ways to organize / control these funds by breaking these funds into many small pieces and then invested in some legitimate source to conceal its original identity.

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INTRODUCTION

History of Money laundering indicates that it's not belonging to any country but it is the global problem which faces by all the countries collectively. Financial institution is a preferential means of money laundering for the launderer to convert their black moneys generated from the illegitimate sources like *(illegal arms sales, smuggling and other crimes such as drug trafficking and prostitution can produce the huge quantity of earnings. Frauds, insider trading, bribery and other frauds in terms of offering the fake scheme they can also generate the huge profits).*

Money laundering activities best describe from its three main stages i.e. ***(Placement, layering & integration)*** through which launderer diverted their black money generated from the illegitimate sources into the financial systems. Main methods of money laundering mainly includes ***Underground / Alternative banking, Shell companies, Investment in Business Projects*** **and** many others, which helps the money launderer to generate the sums. When this illegally gotten money enters into the system it will create the great consequences for the economy, society as whole.

On continuous basis the world financial sector facing the problem in the shape of money laundering activities, world's financial sector needs that somebody regulate these activities. To secure the financial sector of the world and to reduced such money laundering activities the anti money laundering world governing body. The FATF came into being in the year 1989 through G-7 summit, after the completion of initial successful phase of five years, the ministry and its members extended its duration for further 8 years till 2012. FATF has the power to regulate the financial sector of any country and penalize them if found anything fishy in the financial system of any country.

The major responsibility of the financial action task force (FATF) is to first implement some policies relating to the money laundering and implement its policies both at national level as well as international, at the end of the successes full 1st phase FATF formulate its 40 comprehensive recommendations pertaining to anti money laundering.

After the incidence of terrorist act in the year 9/11, G-7 directed FATF to introduce some regulations against terrorist act or terrorist financing as well, FATF implemented further its nine (9) recommendations pertaining to the terrorist financing.

FATF send his recommendations to many countries for the formulation of policies at domestic level, because of the weak implementations of the FATF guidelines as well as weak domestic rules against the money laundering, recently FATF issued the list of countries they are riskier and continuously violated the rules, which includes mainly eight countries i.e. ***Angola, Ecuador, Ethiopia, Iran, Pakistan, North Korea, Turkmenistan & Sao Tome and principe.***

Pakistan economy from the day of its independence till today experiencing from financial crimes related to ***terrorism*** (the main problem faced by the Pakistani people and economy, now a day's major concerned of the world), ***narcotics trafficking*** (this activity mainly be done from the tribal areas because of the weak control of government over these areas), counterfeit ***goods and frauds***, Pakistan is also the major drug-trafficking country (mainly this activity done from the Afghanistan areas and use the land Pakistan for further dealing due to less effective control of government in tribal areas and northern areas).

Pakistan has implemented many of the domestic rules (i.e. Narcotics Money laundering Law, Criminalizes Terrorist Financing, KYC (Know Your Customer) Regulation, Large Currency Transaction Reporting, Suspicion Transaction Reporting, Bank Record Retention, Cross Border Currency transaction requirements) the main reason is to tighten its policies against money laundering and terrorist financing and also to strengthen its financial sector, to some extent Pakistani government and regulatory authorities succeeded in his mission but it's an ongoing process to achieve the final outcome and remove the name from the black listed countries.

Currently the major concern of the FATF is the free trade zones operating worldwide because it is the one of the best place for the money launderer to convert its black money generated from the illegitimate sources into white money through this channel, because in free trade zones government as well as financial sector regulatory body is less efficient and very relax policies just to motivate the exporter to export more and helping the country to improve its balance of trade deficits.

During the project many of the areas were identified which greatly impacted the business of the Pakistani banking sector and also suggest some recommendations which are still not in force to control the money laundering and terrorist financing details of which is provided in the research paper.

Government and all regulatory authorities monitoring either financial sector or non financial sector should adopt or evaluate its performance through various indicators to improve the ranking of Pakistan as well as keep monitoring the different sectors of the economy to avoid any money laundering and terrorist financing activities through Pakistani channels.

Money laundering:

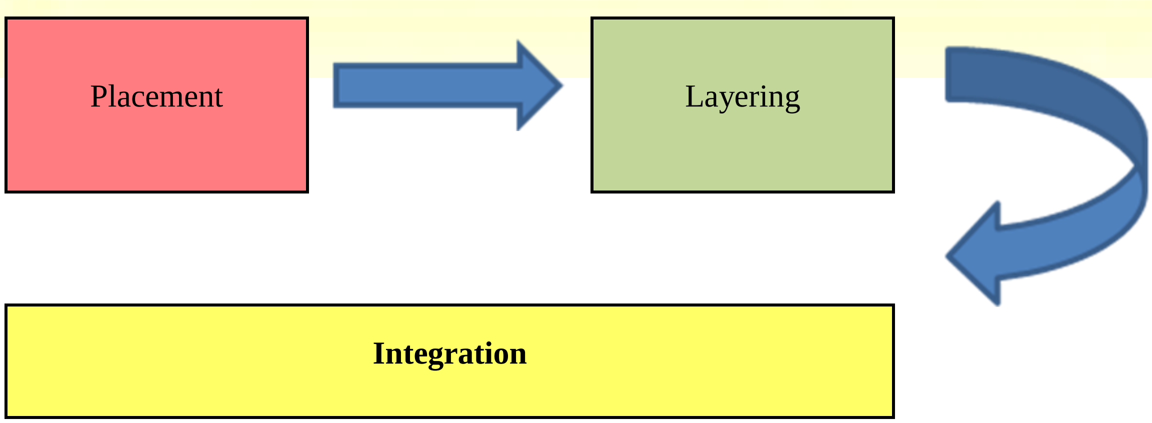
Money launderer used these channels to control his money generated from illegitimate sources.

- To deposit these moneys into the financial sectors
- To be invested in some development work project
- To be invested in some government securities
- All other forms of legitimated sources

Sources of Money laundering:

- Smuggling of goods and people
- Drug trafficking
- Embezzlement
- Bribery
- Fraud
- Tax Evasion (Most common in Pakistan)
- Under / Over invoicing
- **Stages of Money Laundering:**

Money laundering can easily be understand through its three main stages i.e. placement, layering and integration, description of which are here as under.



1. **Placement**: in this stage the illegitimate money generated from some illegal source i.e. drug trafficking, illegal activities, human trafficking etc, the money launderer then break this illegal funds into small cash and then enter into the financial intermediaries, trade economy or Physical smuggling by means of depositing money in the bank through opening fake accounts, investment in term certificates, money order, checks or other monetary instruments. The main purpose is to conceal the original identity of the money from where it is being generated.

2. **Layering**: The 2nd stage comes after the placement stage; when money launderer succeeded in placing the illegitimate money into the financial sector then money launderer create the layer after layer over these funds by means of moving this money from one channel to another through transferring from one account to another or one financial intermediary to another. The subject funds are also channelized to purchase and sale of government securities or for the payments of goods and services.

3. **Integrating:** The third stage after successfully completion of the 2nd stage, money launderer used these funds to re-enter into the economy in any legitimate source either to invest in public development projects, luxury assets, or any business ventures. It may also involve in the following activities.

- Lend the proceeds back to the launderer as a loan
- Repay the proceeds back to the launderer as payments for goods supplied or services rendered.
- Place funds as collection with bankers in different countries and then obtaining loans.
- Over / under invoices foreign trade transactions

Methods of Money Laundering:

Money laundering can also described through its various methods, some of which are here as under.

Underground / Alternative banking: In third world countries or under developed countries underground / alternative delivery channel is very strong mainly in Asian countries namely china, ***Pakistan, India and Srilanka***, these channels provide the vast variety to the customers from withdrawing to sending money from one channel or country to another without any formal documentation, peoples trust on these systems. This system may include **"*hawala*"** system in Pakistan & India and **"*fie chen*"** system in china.

Shell companies: These are the fake companies only be used for the purpose of money laundering, the main purpose of these shell companies to take funds in exchange of goods but in actual whole transaction were carried out on the basis of fake invoices and balance sheets.

Investment in Business Projects: Sometimes money launderer invested its black money in some legitimate large businesses like brokerage firms, casinos, stock exchanges where the daily cash turnover is high or they might be invested in small business like opening the chain of servicing stations, Petrol Pumps, commercial shops and hotels etc, they actually provide the efficient services to their customers but the main motive is to convert black money into white in quickest time. Money launderer mixed its black money in the money generated from legitimated business.

Money laundering Consequences:

The negative and long lasting impact of money laundering can easily be understand or it can be determined through one of the most common and important ways which are here as under.

Societal Impact: The one of the most important area which greatly and deeply impacted from money laundering which is non other then the society where all the people living, money laundering destroy the norms and culture of the society the further impact may elaborated as follows.

- The initial impact of money laundering on every society which promotes the crime rates, the major reason behind is due to the large amount of money supply is circulating in the economy which generated from illegitimate sources, which motivated the low class to improve himself by means of crime.
- Promotes White collar crimes and corruption in the organization. This further creates the imbalance in the society.
- Badly affected the moral value of the society, every person in the society is willing to earn more to take lead on the others without concerning whether the funds or wealth coming from the legitimate sources or not.
- Creates evils in the society & Promotes dirty politics
- Money launderer establish any legitimate business from the money that previously generated from illegitimate sources, to get the higher return from the legitimate business the

launderer reduces the prices with higher quality and this expense is to be financed through the funds coming from illegitimate source which increase the u fair competition in the society.

Economic Impact : The other area which is also impacted from the money laundering, which further impacted the other areas which is directly or indirectly linked with the economy or from the growth and development of the economy, some of which are here as under.

- Parallel economy which is one of the most common economies in the Asian markets like casinos, brokerage firms, parallel remittance systems (hawala, hundi, fie chen) one of the most reliable systems in Pakistan, India and china, parallel economies greatly affected economy as whole in the shape of reducing the earning from foreign exchange through banking sector.
- Money laundering will help to increase the un-employment level in the economy because due to high level of corruption in the economy will reduces the growth cycle of the economy which will ultimately affected the new development project, when the new projects are not starting on time then it will create less opportunities for new employments.
- Tax evasion, illegitimate business, bad integrity, affects public policy making badly.
- The impact of money laundering will affects foreign and domestic investments.

a) Organizational Impact:

The third and last activity which affected by the money laundering which is organizational structure and its image, some of key understandings are here as under.

- It hurts the corporate & brand image of the organization, it will also hurt the goodwill of people at key levels of organizations.
- It's created encumbrance in creating new institutional relationship as well as affects the banking business.

Anti Money laundering Definition:

Anti money laundering is a broader term which mainly uses in the developed or non developed financial institution or any legal entity, which mainly represent the internal control that require from any organization to regulate and follow the international standards and if found then report any money laundering activities.

- **UAE: Money laundering Laws 2002**

"Transfer, conversion or deposit of proceeds by concealment or disguise of their true nature knowing that such proceeds are derived from an identifiable criminal activity"

- **USA: Money Laundering Control Act 1986**

"Involvement in any transaction or series of transactions that assist a criminal in keeping, concealing or disposing of the proceeds derived from illegal activities"

- **Anti Money laundering Ordinance 2007 (SBP)**

"A person should be accountable of offence of money laundering if the person

a) Acquires, converts, possesses or transfer of property, knowing or having reason to believe that such property is proceeds of crime or

b) Renders assistance to another person for the acquisition, conversion, possession or transfer of , or for concealing or disguising the true nature, origin, location, disposition, movement or ownership of property knowing or having reason to believe that such property is proceeds of crime"

(Source: SBP anti money laundering ordinance 2007 www.sbp.org.pk)

Money Laundering & Role of FATF:

The Financial Action Task Force (FATF) is inter-governmental organization whose principal agenda is to formulate and implement the anti money laundering and terrorist financing laws, both at national and international levels. So, we called the FATF as policy making organization, which works to gather the information and monitor the different countries laws and its implementation, and penalize them if not followed. The other functions included to evaluate the countries performance relating to anti money laundering measures as well as the implementation of new laws if introduced by the FATF organization.

FATF does not have defined constitution or the unlimited existence. The task force performance review conducted after every five years. The FATF came into being in the year 1989 after completion of first / initial successful five years, the ministry and its members extended its duration for further 8 years till 2012.

The FATF has the power to work with the local or national task force agency of any country, if they found some fishy or non implementation of anti money laundering laws in such countries. Currently FATF is working with many countries to develop their own countries internal as well as external policies relating to money laundering and terrorist financing.

The main focus of FATF, now a days is on free trade zones of every country which established for the purpose of offering the free trade environment with minimum regulations, as per the record of FATF the free trade zones in the span of one year has sharply increased to approximately 3000 in 135 countries around the globe.

Free trade zones provide the incentives to the companies for the purpose to route the maximum business through this ventures, incentives by means of tax rebates, exemption of duties and well defined procedures and not very stringent policies, however these exemption is also very much attractive for the illegitimate business as well as money launderer used these places for smooth running of their operations.

Formation & Purpose of FATF:

FATF came into existence in the year 1989 in Paris during the G-7 summit; the purpose of the formation is due to the increasing risk of money laundering faced by the world's financial sector and especially the banking sector. The G-7 head of state or Government and the president of European commission and eight other countries govern FATF.

The main responsibility of the financial action task force (FATF) is to first formulate some policies relating to the money laundering and implement its policies both at national level as well as international, the main reason is just to strengthen the financial sector around the globe, at the end of the successes full 1st year FATF formulate its 40 comprehensive recommendations pertaining to anti money laundering.

After the incident of 9/11 in America, FATF also includes the nine special standards against terrorist financing in his mission statement and formulate the nine special recommendations pertaining to the terrorist financing in the month of October 2001.

In the year 2003-2004 due to more violation of money laundering FATF further elaborated the previous eight recommendations and then comprehensively define in Nine (9) recommendations in addition to the previous 40 recommendation of money laundering, which accumulated to 40+9 recommendations on both anti money laundering and terrorist financing. At the time of formation its total member was 16 but now till 2007 it expands to 31.

Risky Countries & Violation of AML Rule:

In many countries around the globe does not have stringent policies regarding the anti money laundering or terrorist financing which will ultimately help the illegitimate business to work in the country premises and hurt the financial performance of the country as well as banking and other financial intermediaries and also the risk for other countries where the trade transaction occurs.

Within the period from 2000 to 2006, FATF conducted the exercise about these non cooperative countries where the anti money laundering laws are very week or not prevail yet. During this whole process FATF obtain the data around 23 countries where these sorts of problems mainly prevails, but due to constant efforts made by FATF all the countries in negative list will no longer be in the same list due to effective implementation of FATF recommendations in the said countries.

Those countries were these anti money laundering laws or terrorist financing laws not prevails or weaken as compare to other countries its big risk for the global economy as well country's own economy too.

Financial Action Task force conducted its exercises as an ongoing process, which was conducted in 2005-2006. Since 2007, FATF and its apparent international review committee closely analyze the highly risk countries and recommend to take the initiative immediately. In the year 2008 FATF issued a series of warning to different countries for none complied of anti money laundering and terrorist financing laws, the tries mainly included ***Iran, Uzbekistan, Pakistan, Turkmenistan & Sao Tome and Principe*** in his watch list countries**.**

The members of FATF allowed this independent body to monitor tightly the transactions dealings in the high risk countries (i.e. Iran, Pakistan, & Uzbekistan) due to less stringent anti money laundering policies in these countries and no proper frame work to monitor the suspicious transactions and reporting.

In the year 2009 FATF advised to the financial institutions of the FATF member's countries to take additional counter measures against these higher risky countries while dealing with them and become more cautious the reason behind this advised is just to save the financial institution from this business globally.

FATF take additional measures because they observe the growth in money laundering transactions and terrorist financing around the globe and indirectly / directly they effected the international financial institutions.

FATF look into this matter seriously and adopted few more recommendations for the non cooperative countries to take measures against the money laundering and advise these countries to implement the country anti money laundering law. FATF revised its review policy especially for the non cooperative countries and tighten the rules and monitor all the transactions closely.

In the year 2010 FATF, an inter-governmental body after giving warnings to the risky countries to introduce the anti money laundering measures but they fail to implement the same. Finally in the month of February 2010 the FATF black listed the eight countries which named, ***Angola, Ecuador, Ethiopia, Iran, Pakistan, North Korea, Turkmenistan & Sao Tome and Principe.***

FATF 40 Recommendations of AML:

At the time of formation of FATF, introduces its special 40 recommendations (detail attached in annexure "A") to control the money laundering activities around the globe and to strengthen the financial sector of the world economy. Subject recommendations also very much help full to monitor the performance of non-cooperative countries and highly risky countries in respect of implementations and evaluation of anti money laundering laws.

FATF call upon all the member countries to strict implementations of the anti money laundering rules and take steps for necessary compliance of their financial systems to avoid any money laundering and terrorist financing problem.

FATF recommendations are an ongoing process and to improve these recommendations on continuity basis and also invite all the members as well as non-members countries to give feedback on these recommendations were they need to change the thing necessary.

The original 40 (forty) recommendations was introduced in the year 1990 the main reason behind these recommendations is to put the financial institution around the globe under one umbrella of regulation pertaining to anti money laws and terrorist financing.

The initial forty (40) recommendations introduced by Financial Action Task Force (FATF) are here as under.

FATF 40 recommendations divided into four main portions.

- Legal Systems (Possibility of illegal offence of Money laundering)
- Measures to be taken by the non bank financial sector as well as financial sector of the individual country and its implementations according to the world desire.
- Other measures taken by different institutions against money laundering and terrorist financing.
- International Cooperation.

RESEARCH METHODOLOGY

Following are the research methodologies considered during the research work.

- Analyze the impact of money laundering and terrorist financing on Pakistani banking sector.
- Actions against money laundering and terrorist financing suggested for State bank of Pakistan to take & ensure implementation.
- Actions suggested to government to take and ensure implementation through its departments.
- Miscellaneous ways to protect our financial sector & specially banking sector from Reputational Risk, Market risk, Country risk, Currency Risk etc.
- Initial due diligence at the of account opening (especially fake trust accounts, madarsas accounts, real estate sector, foreign currency accounts & individual accounts), proper filling of Know Your Customer form (KYC), effective monitoring of CTR & STR reporting to SBP & FMU for taking further action by laws & enforcement agencies.
- Ongoing due diligence for Trade related activities, Alternative remittance system (Hawala / Hundi), fraudulent invoicing.
- Audited Financials of the various commercial banks, State bank annual / quarterly reports, Economic Watch, news articles, published reports and self design questionnaire is used as tool to conduct the research.

Objective: "The risk of money laundering and terrorist financing faced by Pakistan banking sector and its impact on their businesses"

Hypothesis:"Effective Implementation of international acceptable anti money laundering measures throughout country and failure of which will affect the growth of banking sector in Pakistan"

Money laundering and Pakistan Economy:

Pakistan the one of the fastest growing economy in the Asia after (China & India) with the average growth rate of 7% in the last 4-5 years, but due to the economic turmoil in the world's economy from the mid of 2008, which also affected the Pakistani economy. Currently Pakistan economy's GDP growth rate is 2.2% and expected to grow at the rate of 4.2%.

As far as money laundering is concerned Pakistan is recently added in the list of "8" eight black listed countries in the month of February 2010, due to the delay of implementing the laws against the money laundering and terrorist financing at national level. After giving the time and reminder call from FATF (Financial action task force) Pakistan still not managed to implement the same on time which allows the worlds governing body to black list the Pakistan but afterwards Pakistan implemented the national laws and regulations against the money laundering and terrorist financing through senate.

Pakistan economy from the day of independence till today experiencing from financial crimes related to **terrorism** (the main problem faced by the Pakistani people and economy, now a day major concerned of the world), **narcotics trafficking** (this activity mainly be done from the tribal areas because of the weak control of government over these areas), **counterfeit goods and frauds,** Pakistan is also the major **drug-trafficking** country (mainly this activity done from the Afghanistan areas and use the land Pakistan for further dealing due to less effective control of government in tribal areas and northern areas).

Pakistan is also facing the trade related crime activities for which the Pakistan economy losses the biggest amount of foreign exchange earnings or the earning in the shape of import duty and the evasion of taxes which is the biggest source of government funding and to use these funds in many development projects which ultimately directly or indirectly helping the economy to move towards the growing phase, these trade related mainly includes (**Under / over invoicing**, **smuggled goods** from Afghanistan, china and Iran) then these goods shipped to the tribal areas and Baluchistan, some goods also traded through Pak-Afghan trade agreement but sold illegally.

In addition to all of the above Madarssas (Islamic schools) in Pakistan, not all but mainly schools used for the purpose of terrorist activities and for terrorist funding. They got the funds from the different charities and use in the terrorist crime, they used the underground economic channels by means of Hawala / hundi for payment or receiving purposes, they are not using the legal sources (i.e. banking channels) just because of the transaction monitoring and remittances, other cash transactions ***(which is restricted by the SBP to report such cash transactions which is over and above PKR 2.5 Million)*** and records keeping, to avoid such things and recording of transactions they mainly used the underground economy and deal in physical cash transactions only.

After the incidence of 9/11 FATF (Financial action task force) also propose the nine special recommendations pertaining to the terrorist financing, to resolve the problem and tighten or special monitoring of those countries they have weak policies or the crime rate is very high due to the less control of governmental policies and laws & regulations implementations and proper monitoring against the same and on the other hand where the laws in the financial systems quite weak or the transactions mainly conducted on cash basis, no transaction record is in the safe custody of laws regulatory authority or financial institutions.

Another problem for developing economies like Pakistan is because of money laundering external sector of such economies are effected which is the main source of foreign exchange. Capital flows will obviously affect the economy. Due to such flows the policies of regulators may be collapse including small tax based economy.

Pakistan currently has 4 free trade zones (i.e. Karachi, Risalpur, Sialkot and Saindak) but the government has finalized total 10 export processing zones (free trade zones) but only above mentioned four are operational. FATF also shown deep concerned over the presence of free trade zones around the globe because the government policies is less stringent as compare to other areas because of providing the extra benefit to promote more trade and exports. These free trade zones are ideal places for the money launderer to perform its activities (invoice manipulation is commonly reported) due to relax policies of the government and less control of regulatory authorities over these zones.

AML / Terrorist Financing Rules set by Pakistan:

Pakistani law enforcement agencies have introduced or implemented various laws for anti money laundering as well as terrorist financing details of which are here as under.

Narcotics Money laundering Law: The major source of earning for the money launderer is from the narcotics, the huge sums from this activity to be control by the launderer into the financial sector to convert its original source to white money. Pakistani law enforcement agencies has implement two major laws to control this crime and full fill the conditions imposed by the world governing authority FATF against AML and terrorist financing.

- General Offence of money as defined in Section 3 of the AML act (AMLA 2009)
- Criminalization of narcotics money laundering in section 12 of the control of Narcotics substances act (CNSA OF 1997)

Criminalizes Terrorist Financing: If any citizen of Pakistan or foreigners commits any crime in shape of fund raising, uses the public or private property or other sources should be used or may be used in some future time for the purpose of terrorism in Pakistan or any other world country that person or foreigners should be treated under sections 11H-K of ATA (Anti Terrorism Act 1997).

KYC (Know Your Customer) Regulation: This regulation is mainly being complied and major requirement for all the financial institutions, as one of the main rules of FATF 40 recommendations against anti money laundering**.**

The main purpose of this recommendation is to take the reasonable precautionary measures to determine the true identity of the depositor / customer, the source of income / earning, purpose of opening account.

The financial institution should adopt the specific procedure to verify the true identity of the customer / depositor before opening any account, source of earning and monitoring of the account transactions on the regular basis. If the financial institution found any suspicion should report to FMU.

Large Currency Transaction Reporting: CTR (currency transaction reporting) are one of the part of the AMLA (anti money laundering act) in this regard State Bank of Pakistan issued the instructions vide their circular number 39 of 2009 to instruct all the financial institutions to mandatory reporting to SBP of currency transaction in cash over and above Rs.2.5 Million (approximately us$ 30,000).

The main purpose of this regulation is to restrict the money supply and to ensure the anti money laundering law pertaining to the physical cash transfer from one place to another or cross border physical cash transfer or to use the physical cash in any terrorist activity.

Suspicion Transaction Reporting: As per the AML act, all the financial institutions required to submit the suspicious transaction report (STR) to Financial Monitoring unit (FMU) and Financial Intelligence unit (FIU) directly working under the federal government.

Through this regulation all the banks / financial institutions should ensure to report these sorts of transactions within 7 days from the date of occurrence: involves the funds which does not have any justification or any true source of earning or derived from the gambling, illegal property or any activity which is against the laws should be identified and reported. If any banks / financial institution fail to comply with this regulation the FMU / FIU have the rights to cancel the license of the particular bank or to impose heavy penalty on them.

Bank Record Retention: As per the directives of FATF recommendations, SBP directed the banks through its regulations i.e. M-3 pertaining to the records of the banks. All the banks are liable to retain the records of the bank for the period of 5 years from the date of closure of relationship with the customer but in some cases where the suspicious transactions were reported or the case is pending at court or any other form of case filed.

Cross Border Currency transaction Requirements: Pakistan government has restricted the transportation of Pakistani rupee. People who live in Pakistan or abroad cannot carry more than Rs.3000/ guilty of which punished in the form of heavy fine. For the foreign currency transaction if any person wants to carry more than $10,000 or the equivalent other currency first takes permission from the SBP in writing.

Money Laundering & Terrorist financing & its Impact on Pakistani banking sector: Money laundering is not only the threat for Pakistani economy or financial sectors it's a global challenge for all the economies and the financial institutions; it's greatly impacted the business of the banks around the globe in the shape of Foreign exchange earnings, trade volume, business, deposits, core business. If the banking business got disturb with these kinds of activities it will directly or indirectly affected the other sectors of the economy and finally it will affected the economy as a whole.

During our study that "is money laundering affected the banking business of Pakistan or not?" we have focused on the following channels step by step and analyzed the situation, the channels to be discussed are as follows.

- Alternative banking system and Banks FX income
- Trade related Money laundering
- Diversification from Core banking business
- Fake Services Provided by Accountants
- Banks fraud and Robberies
- Reputational risk
- Country risk

Alternative banking system & Banks FX Income: In the Asia market namely china, Pakistan, India and Srilanka, the alternative banking system mainly it is the alternative remittance system which is used very commonly , these channels provide the vast variety to the customers from withdrawing to sending money from one channel or country to another without any formal documentation, peoples trust on these systems. This system may include ***"hawala"*** system in Pakistan & India and ***"fie Chen"*** system in china.

Alternative remittance system "Hawala / Hundi" most popular and most reliable in Pakistan because of the beliefs and trust of the peoples, now a day's it's not very much active in big cities but covering the major chunk of the rural areas because the people of the rural areas are hesitant to use the banking system and not interested to enter into the documented economy because the main reason includes they are illiterate not to know how to use the banking channel or other way not to share the personal income source.

If we are talking about that alternative banking system is affected the banking FX income (by means of remittances) than we have to look what things do attract the people towards the Hawala / hundi.

- It's cheaper than banking system (low fess than banking system)
- People trust on oldest system

- Available at the doorstep
- No paper work is required
- Identity of customer and funds are hidden
- Funds can be transfer on those areas where banking services not available

Alternative banking system being used by the different criminals or the money launderer?

- No requirement of Know Your Customer
- No record maintenance
- Not to show the source of earning and purpose of remittance
- Regulatory authorities cannot traced any transaction

Foreign exchange earnings from the remittances system is the cheap source for any bank to earn the income only by transferring funds and getting benefitted by means of currency exchange earning as well as the commission / service charges of the banks.

Pakistani banking sector is greatly affected by means of foreign exchange earnings from the last year i.e. 2008 to 2009 the main reason for this sharp decline mainly due to

i) People use the alternative banking system due to un-precedent condition of Pakistan as well as less reliability on the banking channels.

ii) Lack of trust over current government policies.

iii) People live abroad invested in other forms like gold.

But if we are looking the deposit size of the banks mainly from the rural areas which increases enormously, which means remittances is coming to the country but not through legal source.

Below mentioned table and chart clearly portrays the FX income of the different banks in the last two years, which clearly indicated that banks has loose the major chunk of its income from this source the main reasons are.

a) Strict KYC policy implementation

b) SBP stringent policies over Money Laundering

c) Banks strict transaction monitoring

d) Countries down grading

Trade related Money laundering: Trade related activities mainly includes the Import and Export business services provided by the bank on behalf of its customers both in local and foreign, trade related activities also includes the bills discounting and other discounting for the certain specific period as defined by the SBP.

Banks will open the Letter of credit or to provide the export related services to its customer, banks deals in documents not in goods, if the documents is as per the defined formats banks will conduct the transactions. Money launderer choose mainly use the discounting of bills activity to transfer the funds internationally by opening the fake companies abroad, discounting the fake documents on behalf of these fake companies through the banking channels with proper documentations.

The one of the most common example of money laundering in the banking industry is negotiations / purchase of fake documents of those companies they does not exist.

Through the international trade system the huge amount of money can be transfer with fake company formation and fake documentation with 0% chances of being kept. The main channels for which the trade based money laundering occurs in Pakistani banking channels are here as under.

- Over / Under invoicing
- False Invoices does not tallied with the goods
- Fake company / parallel company invoicing

Over and Under Invoicing: The one of the oldest method and one of the most common method which is being used in the Pakistani banking channels now a days, fraudulently transferring of money by means misrepresentation of the value of goods and services with the understanding among the importer and exporter, when the prices mentioned on the invoices is over the market prices the importer will send the additional money to the importer or vice versa, the whole transaction is being conducted through legitimate source i.e. banking channel and there is 0% chances to get trapped, because both the importer and exporter are involved in this fraudulent transaction many times exporter will discounted these bills from the banking channels and secured its payments by involving the banking channel in this transaction.

False Invoices does not tallied with the goods: Another most common way to manipulate the transaction is to wrong invoicing. Goods send by one company is only worth to Rs.1.0 Million but the invoices send by another company worth Rs.2.0 Million, this will create the discrepancy between the shipment and the invoices, which will benefited by both the importer and exporter by means of tax benefits and to deposited the rest of the funds in the banking channels till the further instruction of the counter party, the money launderer convert his black money into white with this sort of false trading.

Fake company / parallel company invoicing : Many companies in Pakistan are working only on documents with no physical existence, due to lake of control over the non9-financial sector and laws and legal authorities the help those launderer for the making of fake companies with proper documentations. The biggest example of this sort of money laundering in Pakistan is the Punjab bank scandal through which bank financed the illegal companies in the huge amount with verifying and negligence.

Diversification from Core banking business : The main purpose of banking around the globe is to receive the deposits from the customer and then lend the money on high spread to earn profit and pay interest to the depositors. In Pakistani banking industry all the banks have diversify from its core banking business to other businesses like investment in TFC's, Bonds, Government Securities or other banks securities and bank assurance etc.

Banks normally diversify from its core business i.e. landing towards the investment or bank assurance or any other products?

The main reason for the banks to diversify from its core banking business i.e. accepting of deposit for the purpose of lending, but now a days banking is no more only the name of lending, because in today's competitive banking environment every banking company offers the most attractive rates to get more deposits but in current scenario banking business is badly affected by means of many other factors but here we are discussing the few.

- Compliance of KYC
- Strict Transaction Monitoring
- CTR (Cash Transaction Report)
- Suspicious Transaction Reporting

The total assets of the Pakistani banking sector are PKR 6,435 billion which shows a slight downturn as total assets on Dec. 2009 was PKR 6,529 billion. It is because the challenging economic and business environment which continues to effect the growth and asset quality of the banking system.

The deposit side of the overall banking industry showing the increasing trend from the last four quarter except the last quarter which shows the marginal decline of 0.27%, due to the competitive environment in the banking industry, due to which banks offered the very attractive rates to the customer to retain the deposits. Reportedly, banks are now relying mainly on their top depositors / older customers to retain them even on the higher cost of deposits, banking business now a days is fragmented towards the corporate customers the reason behind the banks not taking exposures on the small customers due to the involvement threat in money laundering and terrorist financing.

On the other side, The advances the core earning side of the every bank showing the massive decline of 2.40% due to low banking spread on the deposits and increasing amount of NPL's (Non Performing Loans) which is 14.41% of the total advances.

Pakistani banks now diversified from the core banking products (i.e. advances) towards the investment side due to less chances of default and expected returns are high, banks holds their deposit at higher cost due to avoidance of the individual depositors / companies mainly low cost because of higher chances of money laundering involvement and also the higher cost of admin to verify the whereabouts of the individual customer / companies and to verify their source of earnings.

Banking industry mainly invested their funds in Treasury bills or any other securities from the last few quarters, the massive increase was observed in the last two years which is 40.04% of the total investment (i.e. from Rs.1,276 Billion to Rs.1,787 Billion) in the year (from 2007 to 2009) respectively.

Know Your Customer (KYC) Policy: SBP directed to each and every bank to ensure the customer physical / documents verification and source of earning before starts any relationship with them. After the implementation of the same banks administrative cost increases by means of using the NADRA system (to verify the customer identification) charges mainly deducted from the customers, to verify the customer address through courier and all other tools to verify the customer existence banks has to designated the number of staff to perform the operations for this specific purpose. Bank has to pay the cost in terms of time and also affected the customer services. Staff member of the banks also reluctant to open the account of individual customers / companies not very well established due to money laundering / terrorist financing risk, which will impacted on the banking business in the shape of low cost banking deposits / lending and also the customer services provided to the customers.

CTR & STR Reporting: As per the SBP directives each and every bank should prepare and report the CTR (Currency Transaction report) in which the cash transaction over and above PKR 2.5 M to be reported. Under STR (Suspicious transaction reporting) banks required to furnish the subject suspicious transactions directly to FMU (Financial monitoring unit) working under federal government, banks are liable to report such transactions to FMU with seven days time. These reports will impacted the banking business not directly, the staff of the banks are more cautious to report such transactions to head office for onward reporting due to this reason they are not focusing on the customer services.

Fake Services Provided by Accountants : The accountants or the financial service provider firms will also help the money launderer to enter in to the financial systems by means of converting their black money into the white money. The accountant will provide the fake documents to the money launderer (i.e. balance sheet, income statement etc) on the basis of these documents the money launderer will open the account to justified its source of earning, then deposited this money earned from the illegitimate source or taking the loan from the financial institution to establish any legal firm and then mixed up his black money with white money earned from the legitimate source.

These fake service providers will also help the money launderer's to establish the companies only on the papers with no physical existence, the main purpose of these fake companies is to transfer / receiving the funds from abroad or opening the accounts for deposit purpose.

Banks fraud and Robberies: Banks continuous frauds and robberies will affected the image of the bank as well impacted the banking business and deposits. After the polices implementations from State bank of Pakistan and strict compliance of these policies relating to the money laundering and terrorist financing, the source from where the terrorist and money launderer gets the funds being monitored closely. The only one way for them to get involve the employees of the banks or the bank robberies to finance their terrorist activities.

In the recent past many of the banks looted especially the biggest robbery of the Pakistan banking history of Allied bank Limited (I.I Chundrigar road Karachi branch) by the guards itself with other members and transfer their moneys to the tribal areas, other major banking robberies includes HBL, UBL and SCB its includes the lockers robbery in various banks, the main purpose to financed the terrorist financing activity which is being stopped due to the banks measures and SBP policies.

On the other hands money launderer or terrorist financing dealer may also use the banking channels for fishy dealings likewise done in bank of Punjab which greatly hurts the bank image as well as bank business, small summary on the banks fishy dealing are here as under.

Bank of Punjab suspicious dealing: The bank of Punjab scam was firstly reported in "The News" article written by **"Ansar Abbasi"** the world fame journalist "article enclosed in annexure "B".

The bank of Punjab fraud is one of the unique frauds of the banking history which mainly involves billion of rupees**.** The state bank of Pakistan showing its great concerned over the banking **"systems and controls"** which is quite weak while inspecting the bank, the internal audit also pointed out at various time where banks deviate from its policies.

Bank financed to those fake companies they only exist on the papers, in many or few specific cases the fake identity card were used to open the account or financing purpose which is against the "know your customer" rule, properties used for financing was overvalued, this whole scenario comes under the money laundering regime.

The GM audit of the bank pointed out not to enter in any further deal with this group or its allied concern (i.e. Harris steel), during the audit of inland LC's and Foreign bills for discounting (the major source of money laundering, transferring of funds without the existence of the companies) the same is the case with the bank of Punjab. The bills discounted at bank of Punjab under other banks LC's without concerning the FIRMU (financial institutional risk management units) to verify about the LC's are genuine or not.

As per the Abbasi report several proprietorship account were opened on the basis of fictitious National identity card, the limits allowed to them included both funded and non funded, this is the huge negligence on the part of the bank or deviated from the policies of SBP against the KYC and anti money laundering. The total fraud as reported by the Abbasi is approximately Rs.13 Billion, these sources as "rip-off" the common people's money and also hurt the bank image in the shape of loosening the deposit share as well as people trust.

Reputational risk: Reputational risk is a sort of risk which not only includes the monetary losses but also the market repute of any bank, if the customers trust on any bank weaken which is not only the customer trust, it's the weakening of society trust and bank has to pay the cost in terms of deposit.

In the recent years the Pakistani banking industry is very competitive because of the large number of banks enter into the industry, the main reason behind is due to the higher growth in this sector and huge profits, which will attract the new entrants, when the new entrants enter into the market they offer very attractive rates just because they don't have the market repute or the only tool to capture the market is the higher rates on deposits as compare to the others.. While entering into the market or to give the best service to the customers many banks may involve in some activities which they doesn't allow in the normal course of business like opening of accounts and allow the customer for transaction without KYC formality or the true verification of the customer by means of source of income or physical house verification.

The banks doing these sort of practices, money launderer used these banks to perform the activity afterwards the banks suffer with the passage of time both in terms of the public image, penalty imposition from the state governing authorities or the also pay the cost in the form of loosening the deposit share ultimately declining the banks profitability. On the other hand share price of the company also decline which hurts the image of the company in the eyes of the investors they reluctant to invest in the particular company share.

Country Risk: Pakistan currently added in the list of black listed countries issued by the world governing body FATF (Financial action task force) due to non implementation of the domestic rules against the money laundering and terrorist financing after reminders.

Investing opportunities in the high risk countries like Pakistan is lower as compare to the other non riskier countries, due to the same facts the business environment of the country greatly affected due to non availability of foreign direct investment or indirect investment which will create the lesser opportunities for the business in the country, due to the higher risk in the country the whole chain affected, due to less opportunity in the business market which will impacted the banking business as well as the profitability of the banking sector, due to the same problem banks may face the liquidity problem.

Before the month of February 2010, local banks LC's not need to confirmed from the end of the foreign buyers, most probably one in hundredth of opened LC's needs foreign buyer confirmation, but after the black the name of Pakistan added in the list of black listed country now from the nine out of hundred LC's needs confirmation by the foreign buyers and local banks confirmed their LC's from its correspondent bank in the same country or any reputable bank whose ranking is acceptable worldwide.

The higher the risk of any country relating to money laundering transactions or the terrorist financing from its financial sector, the chances of trade (by means of accepting the LC's or any other transactions) with the world's financial institution become lesser and lesser, which will impacted the banking business because the customer is willing to perform the business with any foreign banks to save the time and cost both at a time.

RECOMMENDATIONS

On the basis of our previous discussion relating to the Pakistani banking and financial sector including the non bank financial sector and development financial institutes, few of recommendations are here as under relating to the anti money laundering and terrorist financing. Also some recommendations for the government to made his effort to remove the name of Pakistan from the black listed countries which is being included by world governing body FATF (Financial action task force) in the month of February 2010 due to non compliance.

- Monitoring of Free Trade Zones
- Developing one account opening form for customer to stock broker
- Centralized reporting system from all Banks
- One regulatory authority for all Banks, Non Banks & DFI's
- Monitoring of auditors, lawyers & legal advisors
- Mandatory anti money laundering training for banks employees including international training and seminars.
- Decision making should be decentralized instead of one man show in financial institutions.
- Employees and officers of the financial institution should be legally protected.

Monitoring of Free Trade Zones: Currently in Pakistan four free trade zones are in operations (i.e. Karachi, Risalpur, Sialkot and Saindak), the main purpose of these free trade zones is to promote more exports with tax benefits and less stringent policies of the government over these export zones.

All the bank's branches are working in these zones and they allowed huge amount of financing to the customers operating and also accepting the deposits but the SBP prudential regulations in these free trade zones are still not implemented and no proper guidelines being provided to the banking channels who are working in these trade zones, banks are showing their assets or liabilities from these zones in offshore banking.

Money launderer used these sorts of places for the purpose of whitening their money previously generated from the illegitimate sources due to weak policies and no special transaction monitoring from the state bank of Pakistan and banks itself.

Banks and especially state bank should regulate the free trade zones to strengthen the policies and strict monitoring and implementations of the policies against money laundering and terrorist financing, these sorts of early measures will help the government and regulatory authorities to remove the name of Pakistan from the black listed countries list or to take precautionary measures for the banking sector from any future losses.

Developing one account opening form: Currently the brokerage houses and stock exchanges all over the country were monitored by the SECP (security and exchange commission of Pakistan) and the two local governing bodies i.e. (SECP and SBP) are in touch and they keep exchanging their views and regulations pertaining to the money laundering and terrorist financing.

A comprehensive one account opening from is required for all brokers of stock exchanges, modarba companies, exchange companies, customer's who opened an account for deposit purpose at any bank and all other non bank financial corporations.

The main idea behind the one comprehensive account form is to better focused on the KYC "Know Your Customer" and also better monitoring from the side of the two regulatory authorities, because it is easy to understand the one format with comprehensive details which save the time and also its easy to gather the information in one format for all. If the same customer is open the account at any bank for the purpose of depositing the money and the same is pursuing for opening the account at CDC (Central depository company) the two organization is being monitored by the two different regulatory authorities it is easier or better for the both to verify the credential of the same customer at both end due to the same unique account opening form, which will help to minimize the chances of money laundering and properly reported to the higher authorities if any found guilty with this crime.

Centralized reporting system from all Financial Institutions: Currently all banks are liable to report their exposures both funded and non funded as well as the reporting to those customers they defaulted in payment of any facility amount granted to them by the banks, it will help the other institutions to asses the financial history of the company before granting them further.

The main theme for this recommendation is to gather all the information from all the financial institutions including (Modarba Companies, Insurance companies, NBFI's, banks, DFI's) at one place to monitor the each and every activity of the person or any company for better monitoring of the financial transactions and gathering of record at one place.

If the transactions or all the financial activities being monitored at one place it is difficult to the person or the company to get involved in any money laundering activity or any terrorist financing activity, it will also help the regulatory authority to closed monitor the suspicious transactions found if any.

One regulatory authority for all Banks, Non Banks & DFI's: Currently State Bank of Pakistan is monitoring the banks and DFI's and SECP monitors the non banking financial sectors including the stock exchanges. The regulations in both the areas were different from each other and less closely monitored.

All the financial institution or the non bank financial sector should be regulated under one umbrella so the one regulation is applied to the all and effective monitoring for all the sectors, it is also helpful for the regulators to gather the information pertaining to the money laundering and terrorist financing if conducted by any person or company.

Monitoring of accountants & legal advisors: There should be a regulatory authority in order to regulate the lawyers, consultants & accountants (individual / firm) who can impose penalties as well as ban of services, it is in general practice that lawyers suggest different ways of money laundering to their clients like fake property documents, fake property dealings, tax evasion etc. On the other hand accountants also take part to strengthen the money laundering by means of making the fake financials (balance sheets. Profit loss account, cash flow accounts & change of equity) for the purpose of using the same to avail the credit facilities from the different financial intermediaries to convert their black money generated through illegitimate sources into the white money. If these services is monitored it will help to reduce the chances of money laundering / terrorist financing in the financial sector.

Mandatory anti money laundering training from banks: Training is a tool which enhanced the capabilities of the individual to monitor & highlight the main stream issues like money laundering & terrorist financing. State Bank of Pakistan and SECP should regulate and penalize the financial institutions as well as Non Bank Financial institutions incase of non compliance, in addition to this SBP & SECP should also take initiatives to arrange the international trainings and seminars for the designated compliance head / officers for better understanding of the rules and regulations implemented and monitored globally.

Decision making should be decentralized instead of one man show in financial institutions.

In Pakistan another problem faced by financial institutions is some of the banks are not completely decentralized in decision making. Powers given to different committees for decision making is like a window dressing and committees are not functioning as per requirement and influence by the owner of the bank.

On the other hand departments like compliance, audit and internal control are functional just for fulfilling the requirement of SBP and fully dominant by centralized decision making.

Such committees and departments are not working in true letter and spirit. The aim of such institutions is just is to earn profits by either way.

Regulatory authorities should focus on this issue and should take necessary steps in order to avoid such practices and encourage the completely management based institution with the power to take decisions and should follow the policies and regulation instead of one man show institution.

Employees should be legally protected: Regulatory bodies like SBP or SECP should frame a law approved by relevant authorities protecting employees and officers of FI's and NBFI's. This step will encourage the employees to report, highlight and stop the unlawful transactions without any hurdle which should automatically reduces the risk of money laundering and terrorist financing.

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