



Royal United Services Institute  
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# Security Through Financial Integrity

Mending Pakistan's Leaky Sieve

Tom Keatinge and Anton Moiseienko



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RUSI Occasional Paper, May 2019



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# Executive Summary

## Corruption and Financial Integrity

Corruption in developing countries is a major challenge for development and stability. Illicit cross-border outflows of corruption proceeds are particularly damaging, as they drain the country of finances with little chance of them ever being recovered. Pakistan is among the states that face this challenge. The current government of Pakistan has claimed its commitment to reducing corruption in the country on many occasions. In addition to repatriating stolen assets, the effective prevention of corruption-related illicit outflows is key to delivering on that commitment.

Alongside trade, Pakistan's financial system is a key conduit for moving value in and out of the country. It is therefore the first line of defence against the exfiltration of corruption proceeds from Pakistan. This relates to both the formal financial system, including banks and licensed exchange companies, and the informal value-transfer systems, better known as *hawala* or *hundi*. Although prohibited by law, *hawala* and *hundi* remain widespread in Pakistan. To ensure the resilience of Pakistan's financial system against abuse by corrupt actors, it is essential to drive up financial crime compliance standards in regulated businesses and take enforcement action against *hawaladars* operating illegally.

## Challenges Facing Pakistan's Financial System

There are several challenges in relation to the capacity of banks, exchange control companies and other financial institutions to prevent, detect and report suspicious activities that may be related to corruption.

### **Tax Avoidance and Shadow Economy**

The first of these challenges is the extent of tax evasion in Pakistan. Much of the country's economy operates under the radar of the tax authorities and is therefore cash-based and undocumented. For a financial institution that seeks to ascertain the legitimacy of its client's business, this poses practical challenges. In law, regulated businesses are theoretically expected to report suspicious activities related to a range of crimes including tax evasion in the amount equivalent to approximately £55,000. In practice, this poses challenges given the number of businesses that would have to be reported and investigated in a country where only approximately 1.5 million people out of 200 million file tax returns, as required by law. Once a financial institution deals with an individual or business that cannot adequately account for the source of their money, the capacity to identify where the money comes from – that is, initially legitimate but untaxed business or criminal activity – is limited.



Tackling this challenge will require several changes to current approaches in both the public and private sectors. The regulators of Pakistan's financial sector, the State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP), should clarify their expectations in relation to the reporting of tax evasion. These clarifications should reinforce the need to comply with reporting obligations while ensuring that financial institutions' resources are not disproportionately directed towards addressing tax offences at the expense of other predicate offences (offences that give rise to criminal proceeds).

### **Challenges in the Banking Sector**

In relation to other predicate offences, including those that are seen as particularly serious – such as corruption – financial institutions should share best practices in relation to identifying higher-risk customers – for instance, customers operating in industries known to be particularly susceptible to criminal infiltration – and establishing the source of their funds and wealth. As two RUSI workshops held in Karachi suggest, this conversation is still in its infancy, with most of the banks' compliance efforts to date being directed at establishing automated transaction-monitoring processes. The SBP's supervision style should also be adjusted to pay greater attention to banks' understanding and mitigation of risks. The current focus of the SBP's enforcement effort has been the implementation of decision-making processes in relation to the reporting of suspicious transactions, as well as automated transaction-monitoring systems.

### **Challenges in the Exchange Companies Sector**

Outside the banking sector, the activities of exchange companies appear to pose money-laundering risks. Like banks, they can move funds in and out of Pakistan. But unlike banks, the ownership of exchange companies is opaque and potential links to politically exposed persons, who pose higher corruption risks, are impossible for an outside observer to ascertain. Very little is known about compliance practices in the sector and there is evidence that at least some Pakistani banks are wary of doing business with exchange companies due to money-laundering risks. These are exacerbated by the historical ties of exchange companies with *hawala/hundi* businesses, which are known for moving money surreptitiously. More visible SBP supervision of exchange companies is essential, as are enforcement efforts by the Federal Investigation Agency against unlicensed *hawala/hundi* operators.

### **Challenges in Other Parts of the Financial Sector**

Businesses regulated by the SECP are only beginning to come to terms with anti-money-laundering requirements after the SECP promulgated a new set of regulations in 2018. Some of these businesses question either the need for such regulation altogether or their practical ability to follow it. Outreach and enforcement efforts by the SECP, including the publication of case studies that show how regulated businesses can be abused for money-laundering purposes, can both demonstrate the rationale behind the regulations and alert the sector to the possibility of enforcement.

## International Aspects

### Private Sector Role

It is not only Pakistani institutions or individuals that are involved in transferring corruption proceeds out of Pakistan. The role played by overseas banks in their interactions with Pakistani financial institutions cannot be ignored. Non-Pakistani correspondent banks enable Pakistani banks to make transfers to a wider range of banks all over the world than would otherwise be possible. With correspondent banks, including those in London that were interviewed for this research, being aware of money-laundering challenges that Pakistan faces, they seek to ensure that their Pakistani respondent banks have appropriate anti-money-laundering controls. However, this outside pressure has its limits and does not negate the need for changes discussed above.

### Inter-Government Engagement

International engagement on financial crime issues at the government-to-government level is also ongoing. To date, however, this conversation has largely been at cross-purposes. The 'grey-listing' of Pakistan by the Financial Action Task Force (FATF) in June 2018 has been perceived as political and therefore unfair in Pakistan. The focus of the FATF on counterterrorist financing in Pakistan is seen as a foreign preoccupation that unjustly obscures the issue of greatest relevance to Pakistan itself, namely the proceeds of corruption siphoned off outside the country. It is possible that this perception could be mitigated if issues related to financial crime were discussed in concert and covered both terrorist financing and money laundering, including the questions of exfiltration of corruption proceeds from Pakistan that its government is concerned about.

A similar mismatch in Pakistani and international illicit finance-related priorities is evident in the UK–Pakistani relationship, with the UK seen in Pakistan as a prolific enabler of corruption in the country. In contrast, although the UK government has been active in supporting Pakistan's criminal justice development, the predominant focus of UK law enforcement efforts in connection with Pakistan has been drug trafficking. Combining the UK perspective on Pakistan as a destination country for the proceeds from drug trafficking and from other organised crime activities, and Pakistan's view of the UK as a magnet for corruption proceeds, is vital to promoting a productive dialogue and cooperation.



# Introduction

**T**HE MISAPPROPRIATION AND illicit transfer of billions of dollars to financial centres and offshore jurisdictions as a result of grand corruption and other forms of financially motivated illicit activity deprives states of the funds they could spend on security, healthcare and education, all while contributing to a climate of impunity. As the UN Economic and Social Council's Special Rapporteur Christy Mbonu wrote in 2005, '[t]he devastating effect of capital flight brought about by corruption can never be overstressed'.<sup>1</sup> In the worst-case scenario, grand corruption can be among the factors contributing to civil strife or conflict, as shown by the Arab Spring experience.<sup>2</sup> It is therefore arguable that disrupting cross-border flows of the proceeds of corruption should be a top priority area for interventions aimed at strengthening the integrity and stability of domestic institutions in developing countries.

The issue is particularly salient in view of the difficulties that beset attempts to recover stolen assets once they have been siphoned abroad. Despite occasional success stories, such as the repatriation of \$2.3 billion to Nigeria after the collapse of Sani Abacha's military regime,<sup>3</sup> international asset recovery remains a time-consuming and complex endeavour with generally modest outcomes. The Stolen Asset Recovery Initiative, a joint initiative run by the World Bank and the UN Office on Drugs and Crime, estimates that each year between \$20 billion and \$40 billion is diverted through corruption worldwide, but only a fraction of this amount is ultimately seized and returned to the jurisdictions of origin.<sup>4</sup> Moreover, there are difficult legal and policy questions in relation to asset repatriation.<sup>5</sup> In short, there is compelling evidence that large-

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1. Economic and Social Council (ECOSOC), Commission on Human Rights, Sub-Commission on the Promotion and Protection of Human Rights, 'Economic, Social and Cultural Rights: Corruption and its Impacts on the Full Enjoyment of Human Rights, in Particular, Economic, Social and Cultural Rights: Progress Report Submitted by the Special Rapporteur, Christy Mbonu', 22 June 2005, E/CN.4/Sub.2/2005/18, p. 39.
  2. On the nexus between corruption and the prevalence of violence, particularly terrorism, see Sarah Chayes, *Thieves of State: Why Corruption Threatens Global Security* (New York, NY: WW Norton & Company, 2015); Louise Shelley, *Dirty Entanglements: Corruption, Crime, and Terrorism* (New York, NY: Cambridge University Press, 2014) pp. 69–73; Robert I Rotberg (ed.), *Corruption, Global Security and World Order* (Washington, DC: Brookings Institution Press, 2009).
  3. Tim Daniel and James Maton, 'Is the UNCAC an Effective Deterrent to Grand Corruption?', in Jeremy Horder and Peter Alldridge (eds), *Modern Bribery Law: Comparative Perspectives* (New York, NY: Cambridge University Press, 2013) p. 299.
  4. Larissa Gray et al., *Few and Far: The Hard Facts on Stolen Asset Recovery* (Washington, DC: World Bank, 2014) p. 2.
  5. See Anton Moiseienko, 'The Ownership of Confiscated Proceeds of Corruption Under the UN Convention Against Corruption', *International & Comparative Law Quarterly* (Vol. 67, No. 3, July 2018), pp. 669–94.

scale diversion of public funds through corruption deprives developing countries of much-needed resources and diminishes trust in state institutions, thereby undermining their stability and the rule of law.<sup>6</sup>

Against this background, it is essential to make full use of all available opportunities to prevent illicit funds from leaving the country. Among the first lines of defence are the standards adopted by the affected country's financial institutions, and the regulatory framework within which they operate. Complacency or complicity of banks,<sup>7</sup> their capture by political elites or lax supervision all have the potential to facilitate the transfer of illicit funds, which is all too often irreversible. Consequently, holistic anti-corruption strategies in developing countries should be informed by an understanding of the vulnerabilities that exist in their financial sectors and of how these can be addressed. This is not to say that developing countries alone are vulnerable to corruption, or to absolve developed states of their responsibility to combat foreign bribery. The approach that this paper adopts is to focus on measures that a developing country – such as, in this case, Pakistan – can usefully take at its end of the problem.

Moreover, the interaction of the victim country's financial system with key offshore jurisdictions and international banking centres should be analysed to develop insights into how illicit financial flows are routed and facilitated. While much of the attention of policymakers and researchers has been focused on the role of offshore centres in receiving and recycling stolen funds, far less attention is paid to the 'first mile' of this financial pathway. As these authors have argued previously:

[F]or practical reasons, 'Western' activists and academics can exert greater impact on public opinion and policy in their own countries, although even that cannot be taken for granted. So, it is perfectly sensible for them to concentrate their efforts on the wrongdoing that is closer to home. Ideally, however,

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6. See, for example, World Bank, 'Combatting Corruption', last updated 4 October 2018, <<http://www.worldbank.org/en/topic/governance/brief/anti-corruption>>, accessed 26 April 2019; UN General Assembly, 'Battle Against Corruption Vital to 2030 Agenda, General Assembly President Tells High-Level Commemoration of Anti-Corruption Treaty's Adoption', 23 May 2018, <<https://www.un.org/press/en/2018/ga12017.doc.htm>>, accessed 26 April 2019; Johann Graf Lambsdorff, 'Causes and Consequences of Corruption: What Do We Know From a Cross-Section of Countries?' in Susan Rose-Ackermann (ed.), *International Handbook on the Economics of Corruption* (Cheltenham and Northampton, MA: Edward Elgar, 2006) pp. 22–38; Michael Johnston, *Syndromes of Corruption: Wealth, Power, and Democracy* (Cambridge: Cambridge University Press, 2005), pp. 23–31.
  7. A 2016 UK study contains a helpful summary of various 'categorisations of knowingness and complicity in the literature' in the context of professionals' involvement in money laundering. See Katie Benson, 'The Facilitation of Money Laundering by Legal and Financial Professionals: Roles, Relationships and Response', PhD Thesis, University of Manchester, 2006, p. 54, <<https://www.escholar.manchester.ac.uk/item/?pid=uk-ac-man-scw:301608>>, accessed 26 April 2019.

they should be complemented by analysis of opportunities for remedial intervention available within 'source' countries of corruption.<sup>8</sup>

## Pakistan as a Case Study

In light of this review, this paper presents findings of a research project that examined how anti-money-laundering (AML) compliance in Pakistan's financial sector can be improved, with a view to making it more difficult to transfer the proceeds of grand corruption outside Pakistan. Pakistan was chosen as a case study for two reasons:

- **Policy focus on corruption in Pakistan.** Successive Pakistani governments have recognised fighting corruption as a priority. This is demonstrated, for instance, by the establishment of the National Accountability Bureau (NAB) in 1999. Most recently, while this research project was underway, Prime Minister Imran Khan ascended to power largely on an anti-corruption platform and reaffirmed his focus on anti-corruption in subsequent public appearances.<sup>9</sup>
- **Financial links with and significance for the UK.** Given RUSI's location and expertise in the UK, and London's role as a major global financial centre, Pakistan's significance for the UK was a relevant factor. The UK National Strategic Assessment of Serious and Organised Crime states that '[t]he UK remains a prime destination for foreign corrupt Politically Exposed Persons (PEPs) to invest in. Russia, Nigeria and Pakistan are the most commonly seen source countries for PEPs investing in the UK'.<sup>10</sup> Pakistan is also a recipient of UK development support, which speaks to the UK's interest in Pakistan's development and prosperity.<sup>11</sup>

Although the effect of AML measures is notoriously difficult to measure empirically,<sup>12</sup> it is sensible to assume that improving the integrity of Pakistan's financial sector can contribute to the following interlinked objectives:

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8. Tom Keatinge and Anton Moiseienko, 'Fighting Corruption Through Strengthening Financial Integrity: Reflections on Pakistan's Experience', *Public Administration Review*, 22 October 2018, <<https://www.publicadministrationreview.com/2018/10/22/647/>>, accessed 16 April 2019.
  9. Aamir Shah, 'Khan's 100-Day Speech: "Pakistan Has No Future Until the Menace of Corruption is Tackled"', *Arab News*, 29 November 2018.
  10. National Crime Agency, 'National Strategic Assessment of Serious and Organised Crime 2018', May 2018, p. 44.
  11. Department for International Development, 'Where We Work', 11 August 2017, <<https://www.gov.uk/guidance/where-we-work>> accessed 26 April 2019.
  12. Michael Levi, Peter Reuter and Terence Halliday, 'Can the AML System be Evaluated Without Better Data?', *Crime, Law and Social Change* (Vol. 69, No. 2, March 2018) pp. 307–28.

- Making corruption less profitable.<sup>13</sup>
- Reducing the scale of capital flight from Pakistan.
- Bolstering trust in domestic institutions, including those in the private sector.

Furthermore, reducing opportunities for transferring the proceeds of corruption abroad is in line with the anti-corruption agenda promoted by the current Pakistani government led by Prime Minister Khan.<sup>14</sup> In particular, according to Khan, substantial funds were corruptly misappropriated from Pakistan by government officials prior to his election and transferred abroad, with approximately £3.75 billion allegedly tracked down by the Pakistani government as of November 2018.<sup>15</sup> As a result, the government of Pakistan formed an asset recovery unit in autumn 2018 and appointed a special assistant to the prime minister on accountability.<sup>16</sup>

Since asset-recovery processes tend to be complex, expensive and time consuming,<sup>17</sup> preventing corruption and capital flight from reoccurring in the future is essential to the success of Pakistan's anti-corruption agenda. This research aims to identify measures that will contribute to that end.

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13. This is in line with one of the characteristics of an effective anti-money-laundering system as understood by the Financial Action Task Force (FATF). According to the FATF, in such a system 'the prospect of detection, conviction, and punishment dissuades potential criminals from carrying out proceeds generating crimes and money laundering'. See FATF, 'Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems', updated February 2018, p. 111. Empirical measurement of the effect that anti-money-laundering measures have on the profitability of domestic crimes is very difficult, if at all possible. See Michael Levi and Peter Reuter, 'Money Laundering', in Michael Tonry (ed.), *Crime and Justice: A Review of Research*, Vol. 34 (Chicago, IL: Chicago University Press, 2006) p. 320. Policymakers therefore must rely on the common-sense assumption that the less criminal benefit one can successfully retain, the less criminal benefit one has – an assumption that is only wrong if retaining a lesser proportion of one's criminal proceeds prompts one to earn more criminal proceeds to begin with.
  14. For instance, two weeks after his election, Imran Khan stated in an official meeting that 'curbing corruption and retrieving wealth of the country, amassed through illegal means and laundered abroad, were among the biggest challenge for the Government'. See Prime Minister's Office, Islamic Republic of Pakistan, 'Prime Minister Imran Khan Today Chaired a Briefing on Ministry of Interior and its Attached Department', 27 August 2018, <[http://www.pmo.gov.pk/press\\_release\\_details.php?pr\\_id=2405](http://www.pmo.gov.pk/press_release_details.php?pr_id=2405)> accessed 26 April 2019.
  15. See for example, *Press Trust of India*, 'Ex-Rulers Transferred Wealth Abroad, Says Imran Khan About Nawaz Sharif', 17 November 2018.
  16. *Dawn*, 'Asset Recovery Unit to Begin Probing Thousands of Foreign Properties Held by Pakistanis', 5 October 2018.
  17. See, for example, Kevin M Stephenson et al., *Barriers to Asset Recovery: An Analysis of the Key Barriers and Recommendations for Action* (Washington, DC: World Bank, 2011). As an example, a former prime minister of Ukraine was convicted of money laundering in the US in 2004. Civil litigation in relation to his allegedly ill-gotten gains was still ongoing as of June 2018. See US vs.

## Methodology

This project ran throughout 2018 and involved the following steps:

- A literature review assessed relevant Pakistani legislation, guidance and other publications issued by Pakistani state authorities, publications by international organisations and foreign (non-Pakistani) governments, annual reports published by Pakistani banks, academic publications on Pakistan's financial sector and/or corruption in Pakistan, and press reports. Since relevant pieces of Pakistani legislation are published in English on official governmental websites, no translation efforts were necessary to undertake this research.
- Semi-structured interviews were conducted to corroborate or contradict information obtained via the literature review, fill in the gaps and solicit interviewees' views on improvements that could be made within their area of expertise. The choice of semi-structured interviewees ensured that conversations both addressed the issues central to this research and were sufficiently flexible to draw on the interviewees' specific area of expertise as opposed to, for example, a uniform survey distributed to all interviewees. In total, the research team conducted 29 semi-structured interviews during a week-long field trip to Karachi and Islamabad in November 2018 and through in-person/phone interviews from London. Interviewees included representatives from UK and Pakistan academia, UK- and Pakistan-based banks, Pakistani state authorities, current and former UK law enforcement officers and a Pakistani law enforcement officer. Interviewees were identified on the basis of their professional activities or expertise, publication record or recommendations by other interviewees. In all cases, interviews took place on a non-attributable basis to facilitate candid conversations. Statements made off the record were not included in the paper. All interviews were conducted in English.
- Three expert workshops were also held: one in London with experts on Pakistan's economy, anti-corruption and international development; and two in Karachi with regulated entities to discuss AML compliance challenges facing Pakistan's private sector, to identify possible approaches to tackling those challenges. The preliminary workshop in London was held to validate the overall objective of the research, refine questions asked and identify key institutions or individuals for engagement at later stages. As discussed above, London was selected due to both RUSI's location and London's role as an international financial centre of relevance to understanding the flow of funds from Pakistan. The two workshops in Karachi were organised in partnership with a Pakistan-based consultancy firm to discuss key financial crime risks, including those related to the proceeds of corruption as faced by businesses regulated by the State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP), as well as their approaches to mitigating those risks. The workshops provided an opportunity to engage with a number of Pakistan-based businesses at the same time and obtain sectoral views that would not be available through a limited number of one-to-one interviews.

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Lazarenko, 'Case No 00-cr-0284-01 CRB (ND Cal 4 February 2010) Amended Judgment'; *UNIAN*, 'Kyiv Post: Feds and Lazarenko Near Settlement in Asset Forfeiture Case', 16 August 2018.



Whenever possible, statements made by interviewees were verified against publicly available information to ensure, for instance, that the interviewees' understanding of relevant legislation was supported by other sources. Some statements, such as the accounts of interviewees' (or their organisations') experiences or views, do not lend themselves to independent verification, nor should they necessarily be understood as representative of the experience of the relevant sector. Nevertheless, a reflection of these statements by well-informed interviewees contributes to a better understanding of the issues involved. References in footnotes to the number of interviewees making a specific point, the relevant interviewee's area of expertise, and their consistency or inconsistency with publicly available information cited in this paper will enable the reader to judge the reliability and accuracy of a given statement.

## Structure

Chapter I discusses Pakistan's legislative, regulatory and enforcement framework that affects the financial sector's ability to move funds in and out of Pakistan. These include AML, currency control, and taxation rules, which are considered in turn.<sup>18</sup> Chapter II examines the composition of Pakistan's financial sector and the state of its AML compliance. Chapter III discusses the international context within which Pakistan's AML system is developing. The paper concludes by offering recommendations to the range of stakeholders concerned with the integrity of Pakistan's financial system.

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18. Relevant rules were identified on the basis of literature review and interviews, including one with researchers specialising in Pakistani law.

# I. Legislation, Regulation and Enforcement

**S**INCE THIS PAPER focuses on the role of Pakistan's financial institutions in detecting and preventing the transfer of corruption proceeds, this chapter reviews the legislation and regulation that sets out the responsibilities of those institutions in that respect. This includes rules on AML, currency control and taxation.

## Anti-Money Laundering

Until 2010, Pakistan's anti-money-laundering and counterterrorist-financing (AML/CTF) framework rested on the Anti-Money Laundering Ordinance 2007 issued by then-President Pervez Musharraf on the basis of presidential emergency powers. The validity of presidential ordinances, including the AML Ordinance 2007, was affirmed by Pakistan's Supreme Court.<sup>19</sup>

The Anti-Money Laundering Act 2010 replaced the AML Ordinance 2007. Among other things, the Act provides for the offence of money laundering, imposes AML obligations on financial institutions and designated non-financial businesses and professions,<sup>20</sup> and defines the functions of the Federal Monitoring Unit (FMU), which is Pakistan's financial intelligence unit.<sup>21</sup>

On top of the AML Act 2010, the SBP<sup>22</sup> and SECP<sup>23</sup> publish regulations for businesses covered by AML obligations and supervise their compliance with those obligations.

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19. World Bank and the Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', 9 July 2009, p. 37.

20. Including real-estate agents, jewellers, dealers in precious metals and precious stones, lawyers, notaries and other legal professionals, accountants, and trust and company service providers.

21. The FMU is housed within the State Bank of Pakistan but is operationally independent.

22. The SBP is authorised to issue 'such directives, instructions and regulations in whatsoever form as may be necessary' under Section 17H of the State Bank of Pakistan Act 1956. This section also provides for enforcement powers. According to the World Bank and the Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', p. 143, the SBP's power to regulate and supervise banks specifically is provided for in the Banking Companies Ordinance 1962.

23. The SECP's regulatory powers stem from the SECP Act 1997 and legislation applicable to specific sectors. See World Bank and Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', pp. 43–44.

The SBP has published the following regulations and guidelines:

- AML/CTF Regulations for Banks & Development Finance Institutions (DFIs),<sup>24</sup> last updated in October 2018.<sup>25</sup>
- A chapter on AML obligations of exchange companies in the Exchange Companies Manual, last updated in December 2017.<sup>26</sup>
- AML/CFT Guidelines on Risk Based Approach for Banks & DFIs, last updated in March 2015.<sup>27</sup>

The SECP adopted the Securities and Exchange Commission of Pakistan (Anti-Money Laundering and Countering Financing of Terrorism) Regulations 2018 in June 2018. Until then, the SECP had prescribed reporting thresholds for regulated entities but had issued no other AML regulations.<sup>28</sup> It therefore made itself vulnerable to charges such as that made by the World Bank and Asia/Pacific Group on Money Laundering (APG) in 2009,<sup>29</sup> namely that the SECP did not require enhanced due diligence on PEPs.<sup>30</sup>

In addition to its functions as an AML supervisor, the SECP is responsible for registering companies, including non-profit organisations, and withdrawing their registrations.<sup>31</sup> The SECP also has investigatory and prosecutorial powers set out in Sections 256–267 of the Companies Act 2017.<sup>32</sup>

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24. DFIs ‘provide long-term financial and technical assistance to economic sectors of the country’, see World Bank and Asia/Pacific Group, ‘Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)’, p. 20.
  25. State Bank of Pakistan, ‘Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Regulations for Banks & DFIs’, last updated 18 October 2018, <<http://www.sbp.org.pk/bprd/2018/CL16-B.pdf>>, accessed 26 April 2019.
  26. State Bank of Pakistan, ‘Exchange Companies Manual: 2017’, last updated 31 December 2017, Chapter 6, <<http://www.sbp.org.pk/epd/ec/2017/EC-Manual.pdf>>, accessed 26 April 2019.
  27. State Bank of Pakistan, ‘AML/CFT Guidelines on Risk Based Approach for Banks & DFIs’, last updated 31 March 2015, <[http://www.sbp.org.pk/l\\_frame/AML-CFT-Guidelines-RiskBasedApproach.pdf](http://www.sbp.org.pk/l_frame/AML-CFT-Guidelines-RiskBasedApproach.pdf)>, accessed 26 April 2019.
  28. *Express Tribune*, ‘SECP Sets up Cell to Fight Money Laundering’, 31 March 2017.
  29. The APG is one of the regional bodies that assess their members’ compliance with international AML/CTF standards promulgated by the FATF.
  30. World Bank and Asia/Pacific Group, ‘Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)’, p. 5.
  31. ‘Companies Act 2017 (Pakistan)’, Sections 42 and 43, <[www.na.gov.pk/uploads/documents/1487136261\\_767.pdf](http://www.na.gov.pk/uploads/documents/1487136261_767.pdf)>, accessed 26 April 2019.
  32. Substantially analogous provisions were contained in the Companies Ordinance 1984, which were applied before the Act entered into force in May 2017.

## Currency Control

Other statutes relevant to the control of incoming and outgoing financial flows include the Foreign Exchange Regulation Act 1947 and Protection of Economic Reforms Act 1992 (1992 Act).<sup>33</sup> The former in effect makes it illegal to run a money remittance business, including *hawala/hundi*,<sup>34</sup> without registering with the SBP as an exchange company. In contrast to the restrictive approach taken in the Foreign Exchange Regulation Act 1947, the Protection of Economic Reforms Act 1992 stated, until it was revised on 1 July 2018:

All citizens of Pakistan resident in Pakistan or outside Pakistan and all other person shall be entitled and free to bring, hold, sell, transfer and take out foreign exchange within or out of Pakistan in any form and shall not be required to make a foreign currency declaration at any stage nor shall anyone be questioned in regard to the same.<sup>35</sup>

The 1992 Act had therefore, in theory, contributed to deregulating the movement of funds in Pakistan.<sup>36</sup> In practice, the situation was more complex because of the various regulatory obligations faced by financial institutions (banks and exchange companies) that can transfer money in and out of Pakistan on behalf of their customers, as a result of AML obligations imposed on them. Consequently, even though a Pakistani citizen was free to transfer foreign exchange in and out of Pakistan in any form, there were in practice few avenues for doing so. In particular, banks would only make transfers outside Pakistan if they had supporting documents, such as receipts, to show the rationale for the transaction,<sup>37</sup> whereas exchange companies (see below) could only transfer up to an equivalent of \$50,000 without special permission from the SBP.<sup>38</sup>

The apparent contradiction between the Protection of Economic Reforms Act 1992 and Pakistan's other legislative and regulatory instruments was resolved with the amendments introduced by the Finance Act 2018, which entered into force on 1 July 2018. The Finance Act 2018 removed from the 1992 Act the wording that overrode the provisions of the Foreign Exchange Regulation

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33. 'Foreign Exchange Regulation Act 1947 (Pakistan)'; 'Protection of Economic Reforms Act 1992 (Pakistan)'.

34. *Hawala*, also known as *hundi*, involves "money transfer without money movement." That is, a broker on one side of the transaction accepts money from a client who wishes to send funds to someone else. The first broker then communicates with the second broker at the desired destination, who distributes the funds to the intended recipient (less small commissions at both ends). See John Cassara, *Trade-Based Money Laundering: The Next Frontier in International Money Laundering Enforcement* (Hoboken, NJ: Wiley, 2016), p. 51.

35. For the text of the, now outdated, Protection of Economic Reforms Act 1992, see Embassy of Islamic Republic of Pakistan: Oslo, Norway, 'Protection of Foreign Investment in Pakistan', <<https://www.pakistanembassy.no/protection-of-foreign-investment-in-pakistan/>>, accessed 7 May 2019.

36. Authors' interview with a senior accountant, Karachi, November 2018.

37. Authors' interview with Pakistani businessman A active in finance, London, September 2018.

38. State Bank of Pakistan, 'Exchange Companies Manual: 2017', Regulation 9; authors' interview with a Pakistani banker and former government official, Karachi, November 2018.

Act 1947. It also inserted in the 1992 Act certain limits on the free movement of foreign currency in and out of Pakistan. In particular, the rule on free movement of foreign currency does not apply to 'cash exceeding US\$ 10,000 or equivalent subject to such annual ceiling as may be prescribed by the State Bank of Pakistan'.<sup>39</sup> These amendments eliminated the uncertainty that previously existed in relation to the legal basis for restrictions on the flow of foreign currency in and out of Pakistan.

The Finance Act 2018 also introduced changes concerning the use of foreign-currency bank accounts in Pakistan. From July 2018, cash can only be deposited in a foreign-currency bank account of a Pakistani citizen residing in Pakistan if he or she is a tax filer.<sup>40</sup> Previously, the option was open to both tax filers and non-filers. The distinction between filers and non-filers is key to Pakistan's taxation system and is explained below.

## Taxation

'Tax filer' refers to 'a taxpayer whose name appears in the active taxpayers' list issued by the [Federal] Board [of Revenue] ... or is holder of a taxpayer's card'.<sup>41</sup> In principle, all Pakistani residents fulfilling certain conditions – for instance, having an annual income of over PKR400,000<sup>42</sup> – need to register as tax filers and submit an annual tax return.<sup>43</sup> In practice, many Pakistanis subject to these obligations do not comply with them. As of late 2018, only 1.4 million Pakistanis (less than 1% of the population) were tax filers,<sup>44</sup> which partly accounts for the narrow tax base in Pakistan.

To increase the number of tax filers, the Pakistani government has introduced incentives to becoming a filer – or, rather, disincentives for those who remain non-filers. These include higher taxes on certain types of income, such as dividends.<sup>45</sup> Self-evidently, such measures only work in relation to taxes that can be levied by means of withholding tax collected from the person making the payment to a non-filer (a non-filer would not comply with any requirement to identify and report their tax liability – otherwise they would not be a non-filer to begin with).

By providing that only tax filers can deposit cash in their foreign-currency bank accounts, the Finance Act 2018 aims to ensure that such deposits can only be done by those who report their

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39. 'Protection of Economic Reforms Act 1992 (Pakistan)', as amended by the Finance Act 2018, Section 4(2)(g).

40. *Ibid.*, Section 5(4).

41. 'Income Tax Ordinance 2001 (Pakistan)', Section 2(23A).

42. Deloitte, 'International Tax: Pakistan Highlights 2018', <<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-pakistanhighlights-2018.pdf>>, accessed 26 April 2019.

43. 'Income Tax Ordinance 2001 (Pakistan)', Section 114.

44. Kamran Yousaf, 'The Price of Being a Tax Filer', *Express Tribune*, 26 November 2018.

45. KPMG, 'Pakistan Tax Profile', last updated July 2016, <<https://home.kpmg/content/dam/kpmg/xx/pdf/2016/09/country-tax-profile-pakistan.pdf>>, accessed 26 April 2019.

income and therefore pay tax. However, this does not guarantee that the tax filer will in fact report the income in question.

### Tax Offences and Money Laundering

In May 2016, Pakistan designated offences under the Income Tax Ordinance 2001 as predicate offences for AML purposes provided the amount in question is over PKR10 million (£55,000).<sup>46</sup> Critically this provision means that financial institutions have the responsibility to report suspicious transactions related to the laundering of the proceeds of tax evasion. In response to this legislative change and noting ‘the increasing inflow of fresh STRs [suspicious transaction reports],’<sup>47</sup> the Federal Board of Revenue (FBR) established a dedicated AML unit.<sup>48</sup> The FBR document making the case in favour of establishing that unit notes that ‘[m]ajor risk areas for money laundering in Pakistan include real estate dealers, trade-based money laundering, and financial sector’.<sup>49</sup> Given Pakistan’s cash-based economy and widespread tax avoidance, the obligation to report untaxed funds captures a potentially large proportion of financial institutions’ customers and creates uncertainty as to whom they should or should not report. In view of this, one of the interviewees – a representative of a Pakistani bank – argued in favour of removing tax crimes from the category of predicate offences – the argument being that financial crime prevention efforts should focus on ‘real’ crime, such as large-scale corruption.<sup>50</sup> However, that would be incompatible with the Financial Action Task Force (FATF) Recommendations, which set out globally accepted AML standards.<sup>51</sup>

### Tax Exemptions

The government has used tax incentives to encourage the investment (or repatriation) in Pakistan of assets held overseas by Pakistanis. The best-known of these is Section 111(4) of the Income Tax Ordinance 2001, under which any income or expenditures whose source a person cannot explain are subject to income tax, except ‘any amount of foreign exchange remitted from outside Pakistan through the normal banking channels that is encashed into rupees by

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46. Government of Pakistan, Finance Division, ‘Notification SRO 425(I)/2016’, 14 May 2016.

47. Federal Board of Revenue (FBR), ‘Concept Paper for Chairman FBR Regarding Establishment of Dedicated Unit for Anti-Money Laundering at I&I-IR’, undated, p. 2, <<http://download1.fbr.gov.pk/Docs/2017425134113476ESTABLISHMENTOFDEDICATEDUNITFORANTIMONEYLAUNDERINGATI-I-IR.pdf>>, accessed 26 April 2019.

48. International Monetary Fund, ‘IMF Country Report No. 17/212: Pakistan’, July 2017, <<https://www.imf.org/en/Publications/CR/Issues/2017/07/13/Pakistan-2017-Article-IV-Consultation-Press-Release-Staff-Report-Informational-Annex-and-45078>>, accessed 26 April 2019.

49. *Ibid.*

50. Authors’ interview with a senior accountant, Karachi, November 2018.

51. See designated categories of offences in the FATF’s glossary at <<https://www.fatf-gafi.org/glossary/>>, accessed 26 April 2019.

a scheduled bank'.<sup>52</sup> The Finance Act 2018 capped the amount of funds that benefit from this exemption to PKR10 million (£55,000) per calendar year.<sup>53</sup> In addition, the government has occasionally announced tax amnesty schemes that enable the declaration of previously undeclared wealth at an attractive tax rate.<sup>54</sup>

There is a tendency to mistake tax exemptions for exemptions from all rules, including AML, not only among the general public but also among some of the consultants advising Pakistani financial institutions.<sup>55</sup> This is incorrect. In 2014, the FMU issued a clarification in connection with a then-announced tax amnesty scheme that it provided 'no exemption, in whole or in part, from AML/CFT legal or regulatory measures'.<sup>56</sup>

## Enforcement

At present, neither the SBP nor the SECP publish comprehensive statistics of their enforcement actions. This is despite the widespread perception among interviewees that enforcement activity, particularly that of the SBP, has intensified considerably in the aftermath of the enforcement action taken by the US regulator against HBL Pakistan, a commercial bank, in August 2017.<sup>57</sup> Although the SBP is praised as a technically competent and demanding supervisor, two areas of its activity appear in need of refinement:

- **Supervision and enforcement style.** The SBP's supervision style is reportedly prescriptive and places emphasis on compliance with a range of technical requirements, many of them related to systems for automatic transaction monitoring.<sup>58</sup> This approach can result in penalising banks for implementing practices solely on the basis that they are not mandated by the SBP regardless of how effective they are in preventing financial crime. It is important to bear in mind that similar criticism could be levelled against

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52. Government of Pakistan Federal Board of Revenue, 'Income Tax Ordinance, 2001', amended up to 11 March 2019, <<http://download1.fbr.gov.pk/Docs/2019430124658611IncometaxOrdinanceAmen dedupto11-03-2019.pdf>>, accessed 7 May 2019.

53. 'Finance Act 2018 (Pakistan)', Section 8(25)(b).

54. For instance, see the amnesty scheme launched in April 2018 by the departing Pakistan Muslim League government, *Dawn*, 'PM Announces Simplified Income Tax Package, Amnesty Scheme for Foreign Assets', 5 April 2018.

55. Authors' interview with a senior accountant, Karachi, November 2018.

56. Financial Monitoring Unit (FMU), 'Guidelines for Financial Institutions on Investment Incentive Scheme', 31 October 2014, <<http://www.fmu.gov.pk/docs/Guidelines%20for%20Financial%20Institutions%20on%20Investment%20Incentive%20Scheme.pdf>>, accessed 16 April 2019.

57. Authors' telephone interview with a bank based in Karachi, February 2018; authors' follow-up interview with the same bank, November 2018; authors' interview with Pakistani businessman A active in finance, London, February 2018; authors' telephone interview with a former UK banker with experience of the Pakistani banking sector, February 2019.

58. Authors' telephone interviews with a former UK banker and current UK banker, both with experience of the Pakistani banking sector, February 2019.

AML supervisors in some developed countries. Furthermore, its apparent rationale is the SBP's effort to ensure, in the wake of the fine imposed by the US regulator on HBL (see below), that it does not suffer the embarrassment of a large Pakistani bank being fined again by a foreign regulator.<sup>59</sup> However, more enforcement does not necessarily translate into more effective prevention of money laundering. Instead, enforcement should be used as a tool by the SBP to instil a responsible and proactive approach to money-laundering prevention.

- **Communication.** Since neither enforcement statistics nor summaries of specific enforcement cases are published, the SBP is missing an opportunity to educate its supervised population about what bad practice looks like and what the consequences are. Although information about enforcement appears available to key banks in Pakistan via their engagement with the SBP,<sup>60</sup> this can produce asymmetries in the information available to various banks and no rationale is apparent for this disparity.

Even less is known about the SECP's approach to enforcement. Although the SECP publishes in its annual report information on the number of inspections and enforcement actions it undertakes, it is silent on the amounts of fines levied, if any.<sup>61</sup> Some information available to the research team indicated that the amounts of fines were very low, although at least several dozen warning letters are issued by the SECP every year. The relatively limited enforcement is unsurprising given that the SECP's AML regulations were only adopted in September 2018, which may presage a reinvigorated approach to AML enforcement. As with the SBP, greater transparency about the level of the SECP's sanctions, and the circumstances in which they were imposed, can act as a powerful stimulus for improving AML compliance across the sector.

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59. Authors' telephone interview with a UK banker with experience of Pakistani banking sector, February 2019.

60. Authors' interview with a bank, Karachi, November 2018.

61. Securities and Exchange Commission of Pakistan (SECP), 'Annual Report', 2018, pp. 47–51.





## II. Pakistan's Financial Sector

**T**HIS CHAPTER REVIEWS opportunities for laundering the proceeds of crime, including corruption, that exist in various parts of Pakistan's financial sector: the banking sector; exchange companies and *hawala/hundi*; stock trading; the non-banking financial sector; and prize bonds. The chapter also discusses how and by whom existing money-laundering risks can be mitigated in those sectors.

### Banking Sector

Pakistan's banking sector consists of 28 banks.<sup>62</sup> These include seven foreign banks, of which only Standard Chartered maintains a significant retail presence in Pakistan.<sup>63</sup> Information on the ownership of Pakistani banks is available in their annual reports. Typical shareholders include institutional investors from Pakistan and Gulf countries, and a range of individuals. Several banks are majority-owned by Pakistani state institutions.<sup>64</sup> One of the mid-sized banks, Askari Bank, is run by the Fauji Foundation Consortium, which is a military-controlled charitable trust.<sup>65</sup> As Ayesha Siddiqi points out in her book-length study of military corruption in Pakistan, there have been allegations in the media that some Pakistani military officials have been engaged in drug trafficking, but '[i]t is not known whether those involved in such activities used institutional sources [sic] for moving black funds to and from Pakistan'.<sup>66</sup>

Of the few evident links between banks and politicians, the most notable is Mian Muhammad Mansha's stake in the MCB Bank. Mansha is one of Pakistan's wealthiest individuals and a reported close personal friend of former Prime Minister Nawaz Sharif,<sup>67</sup> although that of itself

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62. KPMG Taseer Hadi & Co, 'Banking Results 2017: Commercial Banks Operating in Pakistan', 14 May 2018, <<https://home.kpmg/pk/en/home/insights/2018/05/banking-results-2017.html>>, accessed 26 April 2019.

63. Export.Gov, 'Pakistan Country Commercial Guide', undated, <<https://www.export.gov/article?id=Pakistan-US-Banks>>, accessed 26 April 2019. Although Barclays is on the list in this guide, the sale of its Pakistan business to HBL was announced in 2015, see *Express Tribune*, 'HBL Acquires Barclays Bank', 18 June 2015.

64. These include, in order of size: National Bank of Pakistan, Bank of Punjab, Bank of Khyber and Sindh Bank Limited.

65. Fauji Foundation, 'Fauji Foundation Overview', <<http://www.fauji.org.pk/fauji/about-us/aboutus-overview>>, accessed 26 April 2019.

66. Ayesha Siddiqi, *Military Inc.: Inside Pakistan's Military Economy*, 2<sup>nd</sup> Edition (London: Pluto Press, 2017), pp. 182–83.

67. Authors' interview with academic F, London, February 2018; authors' interview with journalist A, London, February 2018; authors' interview with academic G, London, February 2018.

does not necessarily mean that Sharif felt any need to exploit this connection with MCB.<sup>68</sup> Mansha himself has denied his ‘friendship’ with Sharif.<sup>69</sup>

### Compliance Practices

According to a number of interviewees, the US enforcement action against HBL served as a wake-up call for Pakistan’s government, specifically the SBP in its capacity as the AML supervisor for banks.<sup>70</sup> As part of efforts to improve compliance within the sector, the SBP launched a Compliance Forum in November 2017 that brought together banks, exchange companies and other financial institutions.<sup>71</sup>

At present, Pakistani banks appear to be well aware of their AML obligations, such as conducting customer due diligence (CDD) and making STRs, and largely agree with the need for AML regulation in their sector.<sup>72</sup> However, the regulatory environment in Pakistan means that the focus of banks’ compliance efforts gravitate towards processes, such as the use of automated transaction-monitoring systems, rather than developing a better understanding of the specific money-laundering risks they face. At present, banks therefore mostly rely on their own analysis to identify higher-risk geographies, industries, customers and activities. For instance, one bank has suggested that construction, pharmaceuticals and extractive industries pose higher risks of being abused to launder the proceeds of corruption.<sup>73</sup> Establishing the source of funds and wealth of PEPs is another enduring challenge.<sup>74</sup> Mitigating these risks – those of dealing with higher-risk industries and higher-risk customers, especially PEPs – is an area where greater sharing of experience would be useful.

So far, the SBP’s prescriptive supervision style has succeeded in bringing AML to the attention of banks but has not necessarily encouraged banks to develop a solid understanding of red flags and risk factors related to proceeds of crime, including corruption, in the specific sectors they deal with. This could be done by facilitating the sharing of experiences among banks, including via the provision of feedback or typologies by the FMU. Unless accompanied by these efforts, the current approach risks fostering a ‘tick-box’ compliance culture, characterised by an excessive focus on processes.

Another objective that greater outreach by the FMU could achieve is reassuring banks of the usefulness of STR reporting by providing comprehensive statistics on the numbers of STRs

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68. Authors’ interview with a journalist, London, February 2018.

69. Hindol Sengupta, ‘The Man Behind Pakistan’s Biggest Conglomerate’, *Fortune India*, 5 May 2011.

70. Authors’ interview with Pakistani businessman A active in finance, London, September 2018; authors’ interview with a bank, Karachi, November 2018.

71. *Frontier Post*, ‘SBP’s Organizes Compliance Forum Session for Bank Officials’, 14 November 2017.

72. Intervention from a representative of a Pakistani bank at the RUSI workshop, Karachi, 13 November 2018.

73. *Ibid.*

74. Authors’ telephone interview with a bank in Pakistan, June 2018.

received and disseminated to relevant law enforcement agencies. The use of STRs in specific investigations is occasionally reported in the media or mentioned in court judgments, but no official statistics on the utility of STRs are published.<sup>75</sup> It is difficult to provide any meaningful analysis of gaps in banks' compliance practices beyond the observations made above. To some extent, the submission of STRs can be seen as a proxy for AML compliance, albeit an imperfect one. While anomalously low rates of STR submissions suggest insufficient attention to AML compliance, high rates of STR submissions do not in and of themselves evidence strong compliance practices.

Publicly available data related to STR filings is incomplete. In 2009, Pakistan's mutual evaluation by the APG was critical that only 170 STRs had been submitted in 2008 and only 350 in the period between January and April 2009, all of them from the banking sector.<sup>76</sup> According to a 2014 report published by the US Department of State, the FMU received 560 STRs and 204,417 currency transaction reports in 2011; presumably more up-to-date data was unavailable at the time.<sup>77</sup> In January 2015, the FMU's director-general was quoted as saying that 5,774 STRs had been received over the five previous years, suggesting some increase in the yearly number of STRs generated after 2011.<sup>78</sup> To put this in an international perspective, the financial intelligence unit in Bulgaria received approximately 11,000 STRs between 2006 and 2014, although Bulgaria has one of the lowest STR reporting rates in the EU.<sup>79</sup> Bulgarian financial institutions held approximately \$57 billion in assets as of 2016, making its banking sector considerably smaller than Pakistan's, at approximately \$132 billion.<sup>80</sup> While there is no 'right' number of STRs, assuming that the above figures are correct and the STR filing levels in Pakistan have not changed substantially since 2014/2015, these statistics suggest that the SBP should consider whether Pakistani banks' money-laundering detection efforts are proportionate to the risks they face.

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75. See, for example, Supreme Court of Pakistan, Human Rights Case No 39216-G of 2018 (Judgment of 5 September 2018); *Dawn*, 'SBP Blocks \$65 Million "Suspicious" Transaction', 23 February 2015; Mashhud Aslam, 'Suspicious Transactions: Financial Monitoring Unit Forwards Several Cases to FBR', *Customnews.pk*, 1 January 2019.
  76. World Bank and Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', p. 134.
  77. US Department of State, 'International Narcotics Control Strategy Report: Volume II, Money Laundering and Financial Crimes', March 2014, p. 169. A contemporaneous report by PwC noted there was no publicly available information on the STR numbers, see PwC, 'Know Your Customer: Quick Reference Guide', January 2016, p. 109, <<https://www.pwc.co.uk/assets/pdf/kyc-qrg-final-interactive.pdf>>, accessed 26 April 2019.
  78. Khurram Husain, 'Analysis: Tracking Terror Money: Mission Impossible?', *Dawn*, 25 January 2015.
  79. Europol Financial Intelligence Group, *From Suspicion to Action: Converting Financial Intelligence into Greater Operational Impact* (Luxembourg: Publications Office of the European Union, 2017) p. 10.
  80. For Bulgaria, see IMF and World Bank, 'Financial Sector Assessment: Bulgaria', May 2017, p. 32, <<https://openknowledge.worldbank.org/bitstream/handle/10986/27555/Bulgaria-FSAP-Update-2017-FSA-06092017.pdf?sequence=1&isAllowed=y>>, accessed 26 April 2019; for Pakistan, see SBP, 'Financial Statement Analysis of Financial Sector 2013–2017', 2017, p. vii, <<https://www.sbp.org.pk/departments/stats/FSA-2013-17.pdf>>, accessed 26 April 2019.

A practical challenge faced by Pakistani banks is the lack of well-qualified compliance experts, which is compounded by a 'brain drain' of Pakistanis who prefer to continue their careers abroad.<sup>81</sup> The issue affects financial institutions and state authorities, and it is not customary for private sector experts to move into a civil service career in the manner that is commonplace in the UK or some other countries.<sup>82</sup>

### Money-Laundering Risks

Pakistan's largest banks by volume of assets are HBL Pakistan,<sup>83</sup> National Bank of Pakistan (NBP) and United Bank Limited (UBL). All three have faced regulatory scrutiny in the US due to AML/CTF deficiencies, thereby disclosing what appears to be a pattern of poor compliance in Pakistan's largest banks.

- **HBL Pakistan (August 2017).** Enforcement action against HBL resulted in the revocation of its licence to operate in New York state. As a consequence, HBL lost the ability to directly clear transactions in US dollars. The enforcement action culminated in a settlement agreement (consent order) with the New York Department of Financial Services (NYDFS) that obliged HBL to pay a civil monetary penalty of \$225 million and surrender its licence to operate in New York. While some of the allegations in the consent order pertained to CTF and sanctions compliance, it also stated that HBL had not adequately reported suspicious activity, including that by PEPs.<sup>84</sup> The consent order indicated that HBL was in breach of the terms of a previous consent order from 2015 and a written agreement from 2006 related to its AML/CTF failings.
- **NBP (March 2016).** In March 2016, NBP entered into an agreement with the NYDFS and the Federal Reserve Bank of New York whereby it undertook to enhance its AML compliance, in particular by retaining a third-party independent reviewer of its AML policies. Analogously to HBL, NBP was directed to develop a revised CDD policy.<sup>85</sup> Unlike HBL, NBP was not fined, nor was its licence to operate in New York revoked. However, NBP's alleged non-compliance is troubling since it is 75% owned by the SBP.<sup>86</sup> AML/CTF failings in a bank owned by the SBP may reflect unfavourably on the SBP's own approach to AML/CTF.

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81. Authors' telephone interviews with a former UK banker and current UK banker, both with experience of the Pakistani banking sector, February 2019.

82. Authors' interview with a UK banker with experience of the Pakistani banking sector, February 2019.

83. HBL (formerly Habib Bank Limited) is not to be confused with Bank Al Habib or Habib Metropolitan Bank Limited. All three banks were founded by members of the Habib family. However, HBL was nationalised in 1974 and is now majority-owned by the Aga Khan Fund for Economic Development.

84. New York State Department of Financial Services, 'In the Matter of Habib Bank Limited and Habib Bank Limited, New York Branch: Consent Order Under New York Banking Law §§ 39, 44 and 605', 24 August 2017, p. 2.

85. *Ibid.*, p. 4, §5.

86. National Bank of Pakistan, 'Annual Report 2016', p. 347, <<https://www.nbp.com.pk/FinancialStatements/AnReport2016.aspx>>, accessed 26 April 2019.

- **UBL (October 2013).** In October 2013, UBL entered into an agreement with US regulators and undertook a programme to enhance its AML compliance, ‘particularly with regard to international remittance services’. More specifically, UBL committed to retaining an ‘independent consultant acceptable to the Reserve Bank to conduct a comprehensive review of the Branch’s compliance with the BSA [Bank Secrecy Act]/AML requirements with regard to the Branch’s international remittance services’.<sup>87</sup>

In addition to these US enforcement actions, several Pakistani banks were reported to feature in domestic Pakistani investigations of corruption and/or money laundering:

- **NBP.** Press reports referred to the role of NBP’s president Saeed Ahmed in the corruption trial of Ishaq Dar, a former finance minister of Pakistan. According to Pakistani media, ‘[Dar] is accused of possessing assets beyond his declared sources of income in the reference filed against him by NAB on the directions of the Supreme Court in the Panama Papers case judgment’.<sup>88</sup> The same report notes that ‘the [NAB] is yet to determine the role of ... Ahmed and others over their involvement in “aiding and abetting” the minister in making a 91-fold increase in his assets’. Similarly, there were allegations of Ahmed’s involvement in ‘transferring large sums of money abroad through opening fictitious foreign currency accounts’ for then-Prime Minister Sharif.<sup>89</sup> In August 2018, NBP took the decision to suspend Saeed Ahmed.<sup>90</sup>
- **Summit Bank.** In July 2018, Summit Bank’s Vice-Chairman Hussain Lawai was arrested for allegedly helping Sharif open nominee bank accounts (known as *benami* accounts in Pakistan) to launder funds.<sup>91</sup> Lawai was accused of facilitating the opening of 29 benami accounts in Summit Bank, Sindh Bank and UBL,<sup>92</sup> allegedly helping to launder PKR35 billion (£20 million).<sup>93</sup> Prior to becoming Summit Bank’s vice-chairman, Lawai had served as its president between 2008 and 2016, and before that was president and CEO of MCB Bank Limited in between 1991 and 1997.<sup>94</sup> He was at the time of his arrest the chairman of Pakistan Stock Exchange, but the alleged crimes did not relate to his functions in that capacity.

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87. New York State Department of Financial Services, ‘In the Matter of Habib Bank Limited and Habib Bank Limited, New York Branch: Consent Order Under New York Banking Law §§ 39, 44 and 605’, pp. 2–3.

88. Azam Khan, ‘Bank Officials Record Statements in Ishaq Dar Corruption Case’, *GeoTV*, 23 October 2017.

89. Farid Sabri, ‘Javed Kiyani, Saeed Ahmed Helped Sharifs in Laundering Money’, *Pakistan Today*, 11 July 2017.

90. Shahbaz Rana, ‘Govt Suspends NBP President Saeed Ahmad’, *Express Tribune*, 29 August 2018.

91. *Express Tribune*, ‘Lawai Removed as PSX Chairman’, 10 July 2018.

92. *Ibid.*

93. *Express Tribune*, ‘Money Laundering Case: Court Sends Lawai, Taha Raza to Jail on Judicial Remand’, 15 July 2018.

94. Summit Bank, ‘Board of Directors’, <<http://summitbank.com.pk/index.php/about-us/board-of-directors/>>, accessed 26 April 2019.

- **MCB Bank.** In autumn 2015, the NAB reopened an investigation into possible corruption in relation to the privatisation of the MCB by Mian Muhammad Mansha, in 1991.<sup>95</sup> In 2017, the Lahore High Court ordered a discontinuation of the investigations. The NAB announced its intention to appeal the decision in the Supreme Court.<sup>96</sup> While the allegations are not related to AML compliance per se, they show that Pakistan's banking sector has not been entirely immune to controversies over allegedly irregular privatisations.
- **Bank of Punjab.** According to the US Department of State's 2010 Human Rights Report, 'the NAB assisted in extraditing former Punjab Bank president Hamesh Khan. He was accused in a nine-billion-rupee (\$105 million-dollar) scam ... His case was pending at year's end'.<sup>97</sup> The Lahore High Court denied bail to Khan and his co-accused in May 2011,<sup>98</sup> but the Supreme Court reportedly granted bail and adjourned the case in April 2015.<sup>99</sup>

In addition to these incidents, there are a number of historical allegations of Pakistani banks intentionally extending non-performing loans so as to benefit insiders or their accomplices. For instance, Faysal Bank was alleged to have extended a \$20-million loan to a company owned by the family of Nawaz Sharif, but the SBP's inquiry concluded that neither Sharif nor his family owned the company in question.<sup>100</sup> According to the US Department of State's 2003 Human Rights Report, the creation of the NAB was largely a response to systemic bank fraud perpetrated by wealthy Pakistanis.<sup>101</sup>

## Exchange Companies and *Hawala/Hundi*

Before 2002, only banks were authorised to make money transfers in Pakistan. This changed with the establishment of two types of exchange companies:

- Those that can carry out remittances ('category A exchange companies').
- Those acting only as money changers in Pakistan ('category B exchange companies').<sup>102</sup>

As of 2017, there were 27 category A exchange companies and 25 category B exchange companies.<sup>103</sup> Exchange companies must obtain the SBP's prior consent to outward remittances

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95. *Express Tribune*, 'Revival of Probe into MCB's Privatisation Irks Mansha', 8 October 2015.

96. Hasnaat Malik, 'MCB Privatisation Case: NAB Wants SC to Overrule LHC's Verdict', *Express Tribune*, 12 March 2017.

97. US Department of State, '2010 Country Reports on Human Rights Practices: Pakistan', 8 April 2011.

98. *Express Tribune*, 'Bank of Punjab Scam: Hamesh Khan, Sheikh Afzal Denied Bail', 24 May 2011.

99. *92 News*, 'BOP Ex-Chief Hamesh Khan Granted Bail in Fraud Case', 14 April 2015.

100. *Dawn*, 'PTI Leader for Probe into \$20m Loan for Sharifs-Owned Company in '90s', 13 April 2016.

101. US Department of State, 'Human Rights Report', 2003, p. 2004.

102. World Bank and Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', p. 167.

103. State Bank of Pakistan, 'Exchange Companies Manual: 2017', pp. 81–82.



of \$50,000 or its equivalent.<sup>104</sup> Operating an unlicensed money-service business, such as *hawala* or *hundi*, is an offence under the Foreign Exchange Regulation Act 1947, as amended in 2002. The Act authorises the Federal Investigation Agency (FIA) to enforce this prohibition.

Notwithstanding the legislative prohibition, the US Department of State's 2017 International Narcotics Control Strategy Report notes that unlicensed *hawala/hundi* operators remain prevalent 'because of poor ongoing supervision efforts and a lack of penalties levied against illegally operating businesses'.<sup>105</sup> The size of the sector is unknown, but the view that unlicensed *hawala* businesses are widespread was reinforced during interviews.<sup>106</sup>

There are diverging views among the interviewees on why *hawala/hundi* retains its attractiveness notwithstanding the government's efforts, including the establishment of the Pakistani Remittance Initiative in 2009, which aims to facilitate the use of banks for remittances.<sup>107</sup> While some suggest that *hawala/hundi* offers a better exchange rate than banks or exchange companies,<sup>108</sup> others see its appeal in familiarity among workers employed overseas.<sup>109</sup>

It was a common view among the interviewees that law enforcement efforts will fail to eradicate *hawala/hundi* in the foreseeable future given how ingrained it is in Pakistani society. At the same time, one interviewee suggested that Dubai banks had begun rejecting large cash deposits of unexplained provenance, which had caused trouble to *hawaladars* who need to smuggle cash to Dubai to balance the books on both ends of the *hawala/hundi* corridor.<sup>110</sup>

### Beneficial Ownership of Exchange Companies

The ownership and management of exchange companies is highly opaque, which carries an increased risk of affiliations with PEPs or criminal elements. Unlike in relation to banks, for 13 out of the 26 exchange companies in Pakistan, neither the directors nor owners could be identified in open-source research. For most of the remaining 13 companies, only basic information is available, such as the names of top managers, without any further context. The names of directors and shareholders are made available to both the SBP and SECP as part of the registration process,<sup>111</sup> but the rules do not require an exchange company to report beneficial owners of its shareholders (in case a shareholder is a corporate entity). An exchange company's

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104. *Ibid.*, Section 9(iii)(i).

105. US Department of State, 'International Narcotics Control Strategy Report: Volume II, Money Laundering and Financial Crimes', 2017, p. 138.

106. Authors' interview with businessman B, Karachi, November 2018; authors' interview with a Pakistani banker and former government official, Karachi, November 2018.

107. Global Forum on Migration and Development, 'Pakistan Remittance Initiative', 6 October 2016, <<https://www.gfmd.org/pfp/ppd/2676>>, accessed 26 April 2019.

108. Authors' interview with Pakistani businessman A active in finance, London, September 2018.

109. Authors' interview with a Pakistani banker and former government official, Karachi, November 2018.

110. Authors' interview with businessman B, Karachi, November 2018.

111. State Bank of Pakistan, 'Exchange Companies Manual: 2017', Chapter 2 and Annexure 2.



licence needs renewal after three years initially, and every five years thereafter; the SBP can also inspect it at any time.<sup>112</sup>

In August 2018, the SECP issued a circular requiring all Pakistan-incorporated companies to identify their ultimate beneficial owners.<sup>113</sup> Companies that do not comply are liable to a fine of up to PKR100 million (£550,000) and up to PKR500,000 (£2,700) for every day in default.<sup>114</sup> That means that the information on beneficial owners of exchange companies, and any other companies incorporated in Pakistan, must be at the SECP's disposal even if not publicly disclosed.

### Money-Laundering Risks

Since exchange companies can remit funds outside Pakistan, their misuse poses a money-laundering risk. Their capacity to transfer large amounts of money should not be underestimated.<sup>115</sup>

This is confirmed by the case of Khanani and Kalia International, the first category A company registered in Pakistan. Until designated as a financial institution of primary money-laundering concern by the US Treasury in 2015, it had allegedly been transferring billions of dollars in criminal proceeds annually, including to 'the United Arab Emirates (UAE), United States, United Kingdom, Canada, Australia, and other countries'.<sup>116</sup>

Notwithstanding this cautionary example, there is little visibility of the SBP's supervision of the sector. In 2017, the SBP issued an exchange companies manual, of which one chapter deals with AML obligations applicable to exchange companies of both categories. That said, the SBP does not publish enforcement statistics; nor is there any publicly available information on outreach to and engagement with the sector. In view of the risk profile of exchange companies, this represents a weak point in Pakistan's AML/CTF framework.

### Compliance Practices

Given the opacity of the sector, close to nothing is known about current compliance practices of exchange companies. Other parts of the regulated sector appear to tacitly acknowledge elevated money-laundering risks associated with such companies. For instance, one bank

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112. *Ibid.*, Articles 3 and 4 of Chapter 2 and Article 15 of Chapter 3.

113. KPMG, 'Circular 16 of 2018 – Maintenance of Register of Ultimate Beneficial Ownership Information by the Companies', 14 September 2018, <<https://home.kpmg/content/dam/kpmg/pk/pdf/2018/10/Flyer%20-Circular%2016.pdf>>, accessed 3 May 2019.

114. 'Companies Act 2017', Section 510(2).

115. Authors' Skype interview with an expert on *hawala*, February 2018.

116. US Department of the Treasury, 'Treasury Sanctions the Khanani Money Laundering Organization', 12 November 2015, <<https://www.treasury.gov/press-center/press-releases/Pages/jl0265.aspx>>, accessed 26 April 2019.

has confirmed that it eschews any dealings with exchange companies.<sup>117</sup> However, exchange companies inevitably require bank accounts in Pakistani banks; so do many, if not all, *hawala/hundi* operators. The SBP can therefore adopt a two-prong strategy for ensuring adequate AML compliance standards in the private sector. First, it should ensure that its supervision of exchange companies reflects the sector's evidently high-risk profile. Second, it should promote awareness among banks of red flags and risk indicators related to possibly illegitimate activities of registered exchange companies and activities of unlicensed *hawala/hundi* operators.

## Stock Trading

As of 2017, there were reportedly 390 registered stock brokers in Pakistan, of which 140 were based in Karachi.<sup>118</sup> According to one interviewee, the number has now sunk to 240–250 active traders as a result of consolidation that happened in the market.<sup>119</sup> However, the website of the Pakistan Stock Exchange (PSX) lists 521 holders of the Trading Right Entitlement Certificate (TREC), which may be due to the fact that not all registered persons are in fact active brokers.<sup>120</sup>

Stock trading in Pakistan is done at PSX, which requires authorised stockbrokers to comply with the Anti-Money Laundering Act 2010 and 'any rules and regulations made thereunder'.<sup>121</sup> Verifying compliance with these requirements is one of the mandatory tasks of an audit required by the PSX Rule Book.<sup>122</sup>

## Money-Laundering Risks

For a long time, there have been reports of money laundering on the Pakistani stock market.<sup>123</sup> The sector may be attractive for money-laundering purposes due to the opportunities it provides for investing in liquid assets. Furthermore, as with bank accounts, in the absence of adequate AML/CTF controls a person may be able to invest funds and hold securities on behalf of another person, included a PEP. In addition to these risks, there is potential for fraud by rogue securities brokers. For instance, in 2017 the SECP investigated a Lahore-based brokerage, MR Securities, for alleged fraud.<sup>124</sup>

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117. Authors' interview with a bank, Karachi, November 2018.

118. *The News*, 'Stock Brokers Approach FBR, SECP on Seizure of Bank Accounts', 19 August 2017.

119. Authors' interview with a stock market expert, Karachi, November 2018.

120. Pakistan Stock Exchange Limited, 'Find a Brokerage Firm', <<https://www.psx.com.pk/psx/resources-and-tools/TREC-Holders>>, accessed 26 April 2019.

121. Pakistan Stock Exchange Limited, 'Rule Book of Pakistan Stock Exchange Limited (PSX)', Rule 4.20.4, updated 12 April 2019, <[https://www.psx.com.pk/psx/themes/psx/uploads/PSX-Rulebook-\(new-as-of-April-12,2019\)\\_1.pdf](https://www.psx.com.pk/psx/themes/psx/uploads/PSX-Rulebook-(new-as-of-April-12,2019)_1.pdf)>, accessed 26 April 2019.

122. *Ibid.*, Clause 12.5 of Schedule A.

123. Katharine Houreld, 'Insight: Pakistan's Booming Market no Black And White Matter', *Reuters*, 12 April 2013.

124. *GeoTV*, 'SECP Reports Defaulting Broker to International Securities Regulators', 3 March 2017; *ProPakistani*, 'SECP and PSX Start Inquiry into MR Securities' Fraud with Investors', 10 February 2017.

The true extent of money laundering in the sector is controversial; for instance, one interviewee argued that the growth of the Pakistani stock market reflects the increasing prosperity of the country's middle class that looks for investment opportunities.<sup>125</sup> However, the SECP reportedly conducted a review of securities brokers' AML/CTF compliance in summer 2018. The reason for this is several instances of non-compliance identified by the SECP on the basis of analysing the monthly transaction data reported by securities brokers. The outcome of the review is not known at present.

### The Role of PSX

With the amount or incidence of money laundering on the Pakistani stock market unknown, vigorous supervision and enforcement are key. At the moment, both PSX and the SECP fulfil supervisory functions. However, enforcement powers differ. While the SECP can launch criminal prosecutions for AML breaches, PSX can only levy civil fines.<sup>126</sup> In addition to its enforcement functions, PSX also acts to raise awareness of the SECP's AML requirements among stock brokers.<sup>127</sup>

According to one interviewee, intensified supervision would ideally lead to further consolidation and professionalisation of the market, with 'mum-and-dad shops' dropping out of business.<sup>128</sup> In their view, this would be a positive development given that such small businesses have limited ability to adhere to robust financial crime compliance policies.<sup>129</sup> However, a businessman operating in Pakistan argued that there was a risk of compliance processes becoming so restrictive that this may stifle legitimate business activity; in that interviewee's view, current know-your-customer processes required to open a stock account are unnecessarily laborious.<sup>130</sup>

While PSX could drive further changes both by amending admission rules and by intensifying enforcement, its genuine ability to do so may be constrained by how its governance arrangements operate in practice.<sup>131</sup> PSX's Regulatory Affairs Department is accountable to the Regulatory Affairs Committee, which is composed of four independent experts ('non-TREC directors')<sup>132</sup> appointed with the SECP's agreement.<sup>133</sup> Notwithstanding these arrangements safeguarding the

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125. Authors' interview with academic C, London, February 2018.

126. Author's interview with a stock market expert, Karachi, November 2018.

127. Anjum Shahnawaz, 'PSX Asks Brokers to File Suspicious Transaction Report to FMU', *PKRevenue.com*, 16 January 2019.

128. Author's interview with a stock market expert, Karachi, November 2018.

129. *Ibid.*

130. Author's interview with Pakistani businessman A active in finance, London, September 2018.

131. Authors' interview with a stock market expert, Karachi, November 2018.

132. TREC is a certificate that must be held to trade on PSX. Non-TREC directors are therefore not traders themselves.

133. PSX, 'Regulatory Affairs Committee: Terms of Reference', <<https://www.psx.com.pk/psx/exchange/profile/board-committees>>, accessed 26 April 2019.

independence of the Regulatory Affairs Department, it has been suggested that in practice the department may feel deferential to PSX members.<sup>134</sup>

## Non-Banking Financial Sector

Other businesses forming part of Pakistan's non-banking financial sector include, among others, insurance companies, *modarabas*, leasing companies, investment banks and mutual funds.<sup>135</sup> This represents a sizeable and diverse regulated population.

### Adoption of SECP's 2018 Regulations

The SECP is reported to have determined reporting thresholds for regulated entities, including non-financial businesses, but for a long time it had issued no other AML regulations.<sup>136</sup> It was therefore vulnerable to charges such as those made in the FATF's 2009 Mutual Evaluation Report, namely that the SECP did not require enhanced due diligence on PEPs.<sup>137</sup> In June 2018, the SECP officially adopted the Securities and Exchange Commission of Pakistan (Anti-Money Laundering and Countering Financing of Terrorism) Regulations 2018.

Remarkably, the SECP's AML/CTF regulations provide in relation to CDD that the '[r]egulated person shall apply CDD measures when establishing business relationship with a customer and when there is doubt about the veracity or adequacy of previously obtained customer identification data'.<sup>138</sup>

It would appear that 'and' should be 'or'; it remains to be seen whether this drafting defect will in fact result in an unduly restrictive approach to the circumstances when CDD must be undertaken. Also, while most of the provisions in the regulations use the word 'shall', some of those use the word 'should', with no obvious reason apparent for this divergence.<sup>139</sup>

Importantly, in relation to enhanced due diligence, the SECP's regulations provide that regulated persons 'shall implement appropriate internal risk management systems, policies, procedures

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134. Author's interview with a stock market expert, Karachi, November 2018.

135. For a full list except insurance companies, see SECP, 'Annual Report', pp. 86–87.

136. *Express Tribune*, 'SECP Sets Up Cell to Fight Money Laundering', 31 March 2017.

137. World Bank and Asia/Pacific Group, 'Mutual Evaluation Report: Anti-Money Laundering and Combating the Financing of Terrorism (Pakistan)', p. 5.

138. Securities and Exchange Commission of Pakistan, 'Securities and Exchange Commission of Pakistan (Anti-Money Laundering and Countering Financing of Terrorism) Regulations, 2018', Regulation 6(2).

139. *Ibid.*, Regulation 6(5): 'Regulated person should verify the identity of the customer and beneficial owner before or during the course of establishing a business relationship or may complete verification after the establishment of the business relationship, provided that- [several conditions are met]'. Regulation 6(7): 'For all persons, regulated person should determine whether the person is acting on behalf of a customer'.

and controls to determine if any customer presents high risk of ML/TF [money laundering or terrorist financing]’.<sup>140</sup> Such circumstances ‘include but are not limited to the following:

- customers/policy holders belonging to countries which are non-compliance with anti-money laundering regulations according to FATF;
- such body corporate, partnerships, associations and legal arrangements including non-governmental organizations or not-for-profit organizations which receive donations; and
- legal persons or arrangements with complex ownership structures’.<sup>141</sup>

These provisions speak to the vital importance for regulated entities of obtaining beneficial ownership information on their customers – as discussed later, many consider this a particularly challenging requirement.

### Impact of SECP’s 2018 Regulations

These being early days, the impact of the SECP’s newly published 2018 regulations remains to be seen, but there are grounds for concern that businesses across the sector may not be entirely attuned to the importance and relevance of AML compliance.<sup>142</sup> A reported lack of meaningful outreach on the SECP’s part to clarify the objectives of the new regulations may have also compounded confusion. Additional engagement from the SECP, as accompanied by the issuance of sectoral guidance, could remedy this perception and help businesses understand their money-laundering risks. Throughout the past several years, the SECP has taken steps in this direction, with its website referring to several workshops and other outreach events in Islamabad, Karachi and Lahore.<sup>143</sup>

A practical challenge highlighted by non-banking financial institutions – and, to a lesser extent, banks – in the context of CDD is the difficulty of accessing and verifying customers’ beneficial ownership information. In the non-banking sector, some participants questioned the commercial practicality of severing business relationships with customers who refused to provide such information. These statements highlight the importance of emphasising

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140. *Ibid.*, Regulation 9(1).

141. *Ibid.*, Regulation 9(2).

142. Interventions from a representative of a leasing company and other representatives on non-banking financial institutions, RUSI workshop in Karachi, November 2018.

143. SECP, ‘SECP Holds an Awareness Sessions [sic] on AML/CFT Obligations’, 21 December (year not stated), <<https://www.secp.gov.pk/media-center/press-releases/secp-holds-an-awareness-sessions-on-aml-cft-obligations/>>, accessed 3 May 2019; SECP, ‘SECP Holds Awareness Sessions in Lahore, Peshawar on AML/CFT Obligations’, 19 September (year not stated), <<https://www.secp.gov.pk/media-center/press-releases/secp-holds-awareness-sessions-in-lahore-peshawar-on-aml-cft-obligations/>>, accessed 3 May 2019; SECP, ‘SECP Holds Two-Day Awareness Session on AML/CFT’, 3 October (year not stated), <<https://www.secp.gov.pk/media-center/press-releases/secp-holds-two-day-awareness-session-on-aml-cft/>>, accessed 3 May 2019.

that transacting with customers in the absence of CDD is impermissible and will result in the non-compliant business facing enforcement. Furthermore, the identification of beneficial ownership should be facilitated by the fact that all Pakistan-incorporated companies are now obliged to disclose their beneficial owners to the SECP, as discussed above.

Finally, in the absence of a widespread compliance culture, some businesses are concerned about possible competitive disadvantages in case they adhere to AML requirements, in particular in relation to requesting documents necessary for CDD, while their competitors do not. Visible supervision and enforcement will therefore be required to convince market participants that they benefit from a level playing field and compliance will not put them at a business disadvantage.

## Prize Bonds

Prize bonds are government-issued bonds that generate no fixed return but give an opportunity to win monetary prizes in a regular draw. Prize bonds are bearer bonds that are freely transferable. As a result, a person seeking to launder criminal proceeds may wish to purchase a winning bond. In turn, the holder of a winning bond may be prepared to sell it because he or she would be liable to tax on the amount of the prize.<sup>144</sup> In effect, the purchaser of the bond pays to the seller a portion of the tax due as a fee for purchasing the bond.

The misuse of prize bonds for money laundering is well known. However, attempts to abolish them in the 1990s proved unsuccessful given the government's reliance on the interest-free borrowings enabled by prize bonds.<sup>145</sup> Indeed, James Richards recounts the following story:

[I]n 1992, the State Bank of Pakistan ran an ad in *The Wall Street Journal*, advertising its new issue of government bearer bonds, announcing 'No Questions Asked About Source of Funds! No Identity To Be Disclosed!' Originally to be marketed in the U.S., Pakistan withdrew its bond offer from American markets after 5 days due to severe pressure from the international banking community.<sup>146</sup>

The most recent attempt to tackle the abuse of prize bonds was the introduction in 2017 of a premium prize bond, which is registered in the name of a given investor, pays bi-annual interest of 1.965% and attracts a slightly higher maximum prize than an ordinary prize bond of the same denomination.<sup>147</sup>

Notwithstanding the economic advantages associated with premium prize bonds, ordinary prize bonds continue to be the more popular option. In the view of one interviewee, the statistics on

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144. Income from prize bonds is subject to income tax under Section 39(1)(h) of the Income Tax Ordinance 2001.

145. Authors' interview with a Pakistani banker and former government official, Karachi, November 2018.

146. James R Richards, *Transnational Criminal Organizations, Cybercrime, and Money Laundering* (Boca Raton, FL: CRC Press, 1999), p. 286.

147. National Savings, 'Premium Prize Bond', <<http://savings.gov.pk/premium-prize-bond/>>, accessed 26 April 2019.

the purchases of premium and ordinary prize bonds suggest that the latter are valued precisely because of the money-laundering opportunities they offer, their estimate being that 70% of prize bond use is criminal.<sup>148</sup>

Despite these challenges, the introduction of premium prize bonds may enable the phasing-out of bearer bonds without causing a sudden economic shock that would jeopardise the success of the whole enterprise. In September 2018, the FBR announced its intention to follow up on the recommendations of the Tax Reform Commission that had advised to abolish high-denomination bearer prize bonds.<sup>149</sup>

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148. Authors' interview with a Pakistani banker and former government official, Karachi, November 2018.

149. Mubarak Zeb Khan, 'A Fresh Start for Federal Board of Revenue', *Dawn*, 3 September 2018.

# III. International Aspects

## FATF Grey-Listing

In February 2018, the FATF reached a political agreement to place Pakistan on its list of jurisdictions with strategic AML/CFT deficiencies that are subject to ongoing monitoring (the so-called 'grey list'). In consultation with the government of Pakistan, the FATF's International Co-operation Review Group has developed an action plan that Pakistan should follow to avoid becoming subject to the FATF's call for countermeasures (the so-called 'blacklist'). The FATF officially announced Pakistan's placement on the grey list on 29 June 2018.<sup>150</sup> As a result, since July 2018, in line with the European Commission's Directive 2015/849 (also known as the Fourth Anti-Money Laundering Directive), Pakistan has also been included on the EU's list of high-risk third countries that pose a significant threat to the EU's financial system.<sup>151</sup>

Pakistani interviewees widely view the FATF's decision as politically motivated and at the same time damaging to Pakistan's reputation.<sup>152</sup> Despite the perceived injustice of the grey-listing, in practical terms they unanimously acknowledge the need to engage with the FATF process. When the research team suggested that improving Pakistan's financial crime defences dovetails with Pakistan's anti-corruption agenda, several interviewees agreed but argued that the FATF's focus on CTF in Pakistan obscured the issue that was of greatest relevance, namely the proceeds of corruption siphoned outside the country.<sup>153</sup> This mismatch in Pakistani and international illicit finance-related priorities is also evident in the UK–Pakistani relationship, as discussed below, and should be taken into account in future engagement.

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150. FATF, 'Outcomes, FATF-MENAFATF Joint Plenary, 27–29 June 2018', 29 June 2018, <<https://www.fatf-gafi.org/publications/fatfgeneral/documents/outcomes-plenary-june-2018.html>>, accessed 26 April 2019.

151. Commission Delegated Regulation (EU) 2018/1467 of 27 July 2018 amending Delegated Regulation (EU) 2016/1675 supplementing Directive (EU) 2015/849 of the European Parliament and of the Council, as regards adding Pakistan to the table in point I of the Annex.

152. Authors' interview with a bank, Karachi, November 2018; intervention from a representative of a Pakistani bank at the RUSI workshop, Karachi, 13 November 2018; authors' interview with a group of academics specialising in politics and economics, Islamabad, November 2018.

153. Authors' interview with a bank, Karachi, November 2018; interview with a group of academics specialising in politics and economics, Islamabad, November 2018.



## Role of the UK

The UK is universally seen as an enabler of corruption in Pakistan.<sup>154</sup> In part, this is a consequence of high-profile cases such as that of Nawaz Sharif and Asif Ali Zardari, both of whom owned UK-based real estate. More broadly, there is a palpable feeling that the UK is a favoured destination for dirty funds from Pakistan, and that UK law enforcement would be able to reverse the situation if there were sufficient political will to do so. In particular, there is widespread awareness of recent legislative developments, most prominently the introduction of Unexplained Wealth Orders, although there appears to be less understanding of their limitations.

Related to the indignation directed at the UK was the belief expressed by some interviewees that improving financial integrity in destinations of illicit financial flows, such as the UK, was of considerably greater importance than doing so in source countries, such as Pakistan.<sup>155</sup> While one interviewee evoked the metaphor of a leaky sieve (Pakistan) and a bucket where the water flows (UK), in their view the only reason why Pakistan is a leaky sieve in the first place is the availability of attractive destinations for dirty funds. Regardless of the logic behind this approach, it is important for Pakistan's government to accept its responsibility, and acknowledge the opportunity that it has, to improve financial integrity within Pakistan and therefore, at long last, stop the sieve from leaking.

While the UK government has provided a raft of measures to support Pakistani criminal justice capabilities, including technical assistance programmes, the involvement of UK law enforcement agencies in Pakistan has been largely focused on combating drug trafficking, and therefore Pakistan is seen predominantly not as a source country of criminal proceeds (that is, of corruption) but as a destination country for the proceeds of drug trafficking and of other organised criminal activities.<sup>156</sup> Although the focus of UK law enforcement agencies has shifted towards looking at corruption in addition to drug trafficking,<sup>157</sup> to some extent the UK and Pakistan talk at cross-purposes insofar as each is fixated on the threat it cares about most. This situation mirrors some of Pakistanis' concerns that the FATF is oblivious to the issues of greatest relevance to Pakistan (corruption and capital flight) while focusing on the 'Western' concerns about terrorist financing.

An open recognition of each other's interests and priorities can provide an impetus for more effective cooperation both on corruption, which is of primary concern to Pakistan, and on organised criminal activities that the UK is anxious to address. The appointment by the National Crime Agency (NCA) of an envoy in charge of cooperation with Pakistan provides auspicious

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154. Authors' interview with a bank, Karachi, November 2018; intervention from a representative of a Pakistani bank at the RUSI workshop, Karachi, 13 November 2018; authors' interview with a group of academics specialising in politics and economics, Islamabad, November 2018.

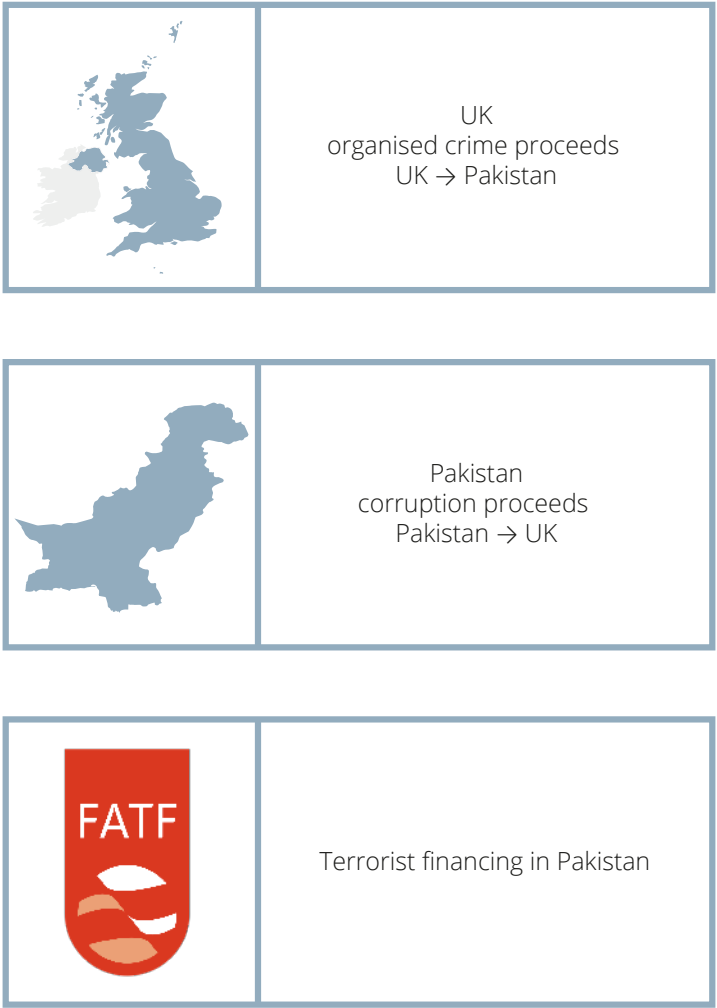
155. Authors' interview with a group of academics specialising in politics and economics, Islamabad, November 2018.

156. Authors' interview with UK law enforcement officer A, Karachi, November 2018.

157. Authors' interview with UK law enforcement officer B, Islamabad, November 2018.

context for a continued dialogue in line with the UK’s ongoing support for criminal justice improvements in Pakistan, although risks raising expectations.<sup>158</sup>

**Figure 1:** Mismatch in Illicit-Finance-Related Priorities



Source: Authors’ research.

At the non-governmental level, UK banks, including UK-based subsidiaries of international banks headquartered elsewhere, provide correspondent banking services to some Pakistani banks. Pakistani banks often list their correspondent relationships on their websites.<sup>159</sup> When

158. Foreign and Commonwealth Office, ‘British Home Secretary Visits Pakistan, Announces New Anti-Corruption Partnership’, 18 September 2018, <<https://www.gov.uk/government/news/british-home-secretary-visits-pakistan-announces-new-anti-corruption-partnership>>, accessed 26 April 2019.

159. For instance, see NBP, ‘Financial Institutions and Cash Management Division’, <<https://www.nbp.com.pk/CORRESB/CorrespondentBanks.aspx>>, accessed 26 April 2019.

deciding whether to provide these services to Pakistani banks, UK banks consider several factors, including:

- The Pakistani respondent bank's financial crime controls.
- The effectiveness of the SBP's supervision and enforcement.
- The overall country context, including the levels of corruption, tax evasion and drug trafficking.
- The UK bank's risk appetite and perceived importance of the Pakistani market.<sup>160</sup>

The last three factors are key to the initial decision to establish a correspondent banking relationship; once the relationship is in place, the correspondent bank acquires a progressively better understanding of the respondent bank's financial crime controls and can decide whether to continue the relationship.<sup>161</sup>

Pakistan has long been perceived as a difficult country for business. As one interviewee observed, the prevalence of a shadow economy and corruption impedes the ability of Pakistani banks to understand the source of their customers' funds and wealth even if reasonably robust compliance practices are in place.<sup>162</sup> As a result, perhaps contrary to what might have been expected, events such as the HBL fine in the US or the FATF grey-listing did not bring about a significant change of attitude among UK banks to dealing with Pakistani banks.<sup>163</sup> This is because those UK banks had adjusted to this already difficult environment; this is not to say that their commitment is unconditional or cannot be shattered by the next big scandal. However, their presence is both a positive signal for Pakistan and a welcome additional layer of incentives for Pakistani banks to maintain adequate financial crime controls, in addition to the SBP-mandated requirements.

## Role of Dubai

Dubai is frequently referred to as a potent magnet for Pakistani money. This is explained through a combination of factors, especially Dubai's developed financial system, geographic proximity to Pakistan and well-developed transport connections. In particular, it has been reported that a number of Pakistani officials have purchased real estate in Dubai.<sup>164</sup> *Hawala/hundi* and cash couriers are the principal means of sending money to Dubai, often as a transit point en route to a different destination. The 2018 Canadian terrorist-financing risk assessment speaks of the same typologies of moving funds from Pakistan to Dubai, namely *hawala/hundi*, cash couriers

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160. Authors' interview with a UK banker with experience of Pakistan, London, February 2019.

161. *Ibid.*

162. *Ibid.*

163. Authors' telephone interviews with a former UK banker and current UK banker, both with experience of the Pakistani banking sector, February 2019.

164. *Dawn*, 'NAB Begins Probe into Assets Held by Pakistanis in Dubai', 4 August 2018.

and trade-based money laundering (TBML) (although it is written in the context of terrorist financing, the same methods can be used to transfer the proceeds of corruption).<sup>165</sup>

While Pakistani customs service is taking action to interdict shipments of smuggled goods and cash to Dubai, it is only now that the government is beginning to integrate various law enforcement and other government databases, which is a precondition for effective border control. For instance, at the moment a customs officer working at the FBR will not have access to the tax database, which is also maintained by the FBR, and will therefore not be able to verify whether a person detained at the border with a sizeable amount of cash has made tax declarations that are consistent with that amount.<sup>166</sup> Furthermore, one official with expert knowledge of the subject told the research team that cash couriers make multiple flights per day between Pakistani cities and Dubai to make cash deliveries, yet law enforcement has limited capacity to analyse flight manifests to identify such ‘cash commuters’.<sup>167</sup>

In the context of goods smuggling and TBML, the use of UAE-based free-trade zones (FTZs) creates challenges in view of the difficulty of obtaining cooperation and information.<sup>168</sup> Little information is available on the use of UAE-based FTZs to launder specifically the proceeds of corruption. However, typical money-laundering vulnerabilities of FTZs in the UAE, of which there are 45,<sup>169</sup> are relatively well known. Broadly speaking, they can be divided into two major categories:

- **Exemption of FTZ-based businesses from AML requirements.** A 2019 report by the US Department of State notes: ‘Companies located in the FTZs are considered offshore or foreign entities for legal purposes ... [T]he operation of financial entities in FTZs not identified, regulated, or supervised for financial activity presents a gap in regulatory oversight’.<sup>170</sup>
- **Relaxed customs controls.** These are intended to facilitate swift legitimate trade. However, they also enable smuggling and TBML.<sup>171</sup> For instance, a trader could import goods from Pakistan for an artificially low price to be resold in the UAE, which results in the flow of untaxed value from Pakistan.

With the FATF mutual evaluation of the UAE scheduled for summer 2019, with possible plenary discussion lined up for February 2020 (and hence international attention drawn to the UAE’s

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165. Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), *Terrorist Financing Assessment 2018* (Ottawa: FINTRAC, 2018), pp. 7–8.

166. Authors’ interview with a senior state official with knowledge of Pakistan’s customs system, Islamabad, November 2018.

167. *Ibid.*

168. *Ibid.*

169. US Department of State, ‘International Narcotics Control Strategy Report: Volume II’, March 2019, p. 188.

170. *Ibid.*

171. Cassara, *Trade-Based Money Laundering*, p. 166.

AML regime), the timing is right for Pakistan's government to continue the AML discussions it has already initiated with the UAE,<sup>172</sup> now with a specific focus on the operation of FTZs and their role in facilitating corruption and other crime in Pakistan.

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172. *National UAE*, 'UAE Set to Partner With Pakistan in Fresh Clamp Down on Money Laundering', 31 October 2018.

# Summary and Conclusions

**T**HE ELECTION OF Prime Minister Imran Khan in 2018, and his apparent desire to address the illicit financial activity that has beset Pakistan for decades, offers an important opportunity for both those within and outside the country to drive up the integrity of Pakistan's financial system, which should be seized by the Pakistani leadership and supported by key international stakeholders such as the UK government.

Thus, to this end, and to conclude, the authors offer recommendations for the Pakistani government, the private sector and the UK government.

## Pakistani Government Action

Both the SBP and SECP should:

1. Clarify the interaction between tax and AML rules by:
  - a. Promoting the understanding among regulated entities that tax exemptions do not provide exemptions from AML rules.
  - b. Providing guidance on the detection and reporting of tax-related money laundering, in particular the circumstances in which suspicious transactions related to tax offences must be reported to the FMU. The guidance should balance the need to address tax offences with the need to ensure that financial institutions' resources are not disproportionately directed towards that end at the expense of other types of money laundering.
2. Publish, on a regular basis, comprehensive enforcement statistics and summaries of specific enforcement cases.

The SBP should:

1. In relation to the banking sector:
  - a. Utilise its consultative forum to a greater extent to enable information-sharing between banks on money-laundering risks they face in business sectors they deal with.
  - b. Promote awareness among banks of red flags and risk indicators related to possibly illegitimate activities of registered exchange companies and activities of unlicensed *hawala/hundi* operators. In doing so, the SBP should seek to avoid de-risking by compliant banks of legitimate exchange companies.
2. In relation to exchange companies:
  - a. Take the information on beneficial ownership of exchange companies into account for supervision purposes: for instance, exchange companies with ownership links to PEPs may need to be prioritised for inspection.

- b. Ensure that its supervisory and enforcement efforts in relation to exchange companies reflect the sector's elevated risk profile.

The SECP should:

1. In relation to all sectors it supervises, continue its outreach efforts, with a particular focus on explaining:
  - a. Money-laundering risks faced by various sectors (and hence the rationale for the application of AML regulations to their activities).
  - b. The importance of obtaining customers' beneficial ownership information.
  - c. The consequences of beneficial ownership information not being provided or raising suspicions as to its veracity.
2. In relation to exchange companies, ensure that exchange companies identify their beneficial owners as required under Circular No 16 of 2018 and notify the SECP of any changes.
3. In relation to stock brokers, publish the outcomes of its review of stock brokers' AML/CTF compliance.

The FMU should disseminate typologies and/or anonymised case studies to banks and other reporting entities on a regular basis.

National Savings should phase out bearer prize bonds in favour of registered premium bonds.

The Pakistani special assistant to the prime minister on accountability should publish a report twice a year to evidence progress on both asset recovery and measures taken to strengthen the integrity of the Pakistani financial system.

The FIA should vigorously enforce the prohibition on unlawful *hawala/hundi* to prevent the displacement effect of improved AML compliance in the formal financial sector.

The FBR should have access to and use taxation and flight passenger data to monitor cash courier activity and increase interdictions of cash at the border, in particular on air routes to the UAE.

The Pakistani government should seek a coalition of international support for pressing greater responsibility and accountability from the government of the UAE for facilitating illicit financial flows from Pakistan, in particular in view of the FATF's upcoming evaluation of the UAE in 2019.

## Pakistani Private Sector Action

Pakistani banks should seek to develop an understanding of red flags and risk factors related to proceeds of crime, including corruption, in business sectors they deal with. A better understanding of risk must complement current process-focused compliance approaches.

Pakistani private sector actors should proactively engage with their relevant supervisor (SBP or SECP) to promote the need for greater dialogue, partnership and collaboration; private sector actors should be willing to engage positively with any information-sharing and collaboration initiatives proposed by their supervisors.

## UK Government Action

The UK government should emphasise that the UK and Pakistan share a common interest in tackling illicit financial flows. In the case of the UK, these are predominantly the proceeds of drug trafficking and other organised criminal activities flowing from the UK to Pakistan. In the case of Pakistan, these are predominantly the proceeds of corruption flowing from Pakistan to the UK. This shared interest should form the basis for reinvigorated cooperation.

The NCA should consider posting one or more liaison officers with one or more of Pakistan's law enforcement agencies specifically to improve their understanding of the requirements the UK has to mutual legal assistance requests. The NCA should also ensure that at least one resident liaison officer has a background in illicit finance and an understanding of international financial flows.

The UK's envoy to Pakistan on justice and accountability should produce a progress statement twice a year to ensure the UK government's continued commitment to assisting the Pakistani government is publicly evidenced.





# About the Authors

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