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NAVIGATING CURRENCY EXCHANGE: THE INTERPLAY OF MONEY LAUNDERING AND TERRORISM FINANCING

HAJRA HASHMI

IPRI Islamabad Policy Research Institute
Research | Innovation | Dialogue | Policy

ECONOMIC POLICY & BUSINESS DEVELOPMENT

Chair, International Law

Executive Summary

Money laundering and terrorism financing are intricately connected to one another. Money laundering refers to the processing and movement of money or assets of illegal origin stemming from criminal activity. Terrorism financing is the raising, moving and using of funds to support terrorist activities. Both these activities exploit the same gaps within the financial structures of a country or countries to suit their agendas. Money laundering is often a cover for terrorism financing. Therefore, strict legal regulations are imperative to prevent the exploitation of financial systems for either of these illegal activities.

A major part of preventing such schemes is keeping check on currency exchange in the country, setting stringent rules for the transfer of large amounts of funds and ensuring there are proper procedures involved for setting up and managing bank accounts. To this end, the international organisation Financial Action Task Force (FATF) was set up. Its mandate set out that it must ensure that countries integrate anti money laundering, counter terrorism financing and proliferation financing[1] in their financial systems. Pakistan is not a member of the FATF, but it is a member of Asia Pacific Group (APG), the largest FATF-style regional organisation. Pakistan has its own National Financial Action Task Force Secretariat that coordinates inter-agency cooperation in order to combat money laundering and terrorism financing. However, there are still gaps that are left despite the implementation of meticulous measures. In October 2022, the FBR uncovered Rs 69.5 billion in money laundering through 6,232 import invoices. This illustrates that there is a need for better enforcement of relevant laws.

Policy Recommendations

- The NFATF Secretariat needs to prioritise working on FATF recommendations that Pakistan is only partially compliant with, namely recommendations number 15 and 38.
- Hawala/hundi networks in Pakistan need to be completely dismantled. Stricter legislation and penalisation must be implemented to achieve this.
- Cryptocurrency needs to be officially regulated by the state in order to not allow any gaps for illegal financial activities via digital finance systems.

[1] The act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials in contravention of national laws or international obligations.

Money laundering and terrorism financing in Pakistan

Since its inception in 1947, Pakistan has faced problems of money laundering in the country. The Indian subcontinent generally has relied on informal systems of money transfer for centuries and these trickled into Pakistan after its partition from India. Networks based on trust, honour and community had been established a long time ago; these continued to be used despite a shift towards modern day banking and stricter laws related to financial systems being implemented. This became the basis for ease of money laundering, tax evasion, corruption, etc. In a newly created country where allocation of resources, especially for the administration of such a large country, were scarce, this was an issue that quickly gained momentum. Despite efforts to prevent money laundering, underground networks continued operating, culminating in an eventual peak after which many more stringent measures were introduced.

An example of a very high profile case related to money laundering is that of Khanani and Kalia. In 2008, before a raid resulted in the arrests of the management team, Khanani & Kali International (KKI) was one of the biggest foreing exchange (forex) companies in the world. Roughly 40% of all money exchange transfers happening in Pakistan were processed by the company. The company was investigated as over 40 billion US dollars passed through the company. Due to this, Pakistan's State Bank and Federal Investigation Agency (FIA) revoked the company's license. In November 2008, it was discovered that KKI had setup a parallel money transfer system out of the country relying on the system of underground 'banking' networks that exist in the country which clearly exposed the large scale money laundering that the company was involved in. After this was uncovered, the State Bank of Pakistan issued a warning to all exchange companies that their licenses would be cancelled if they failed to bring in remittances.

Similar to money laundering, terrorism is an issue that has plagued Pakistan for a long time. In the late 1970's, extremist religious ideologies started gaining traction in the country for various reasons. Iran's Islamic Revolution and the Soviet invasion of Afghanistan both had profound effects on the mindsets of the people of Pakistan. The idea that jihad, a war against the enemies of Islam, was a duty upon all Muslims took a hold of much of the country. This led to religious schools/madrassas teaching a highly intolerant version of Islam that imbued the minds of the youth with the ideology that they had to fight against all evils of society by using violence to instill terror in people. All these factors led to a wave of terrorism gripping the nation. This brought with it a large rise in terrorism financing through money laundering. Terrorist organisations did not employ only illegal means to generate funds for their activities; they also used legitimate means such as charity foundations, business investments and trades for producing finances. Foreign funding was also a large source of money for such groups, smuggled into the country by illegal means. More recently, sources such as 'protection money' which are charged by terrorist groups from convoys travelling in dangerous areas, and illegal activities such as smuggling or drug dealing have become the main sources of terrorism financing in Pakistan.

Hawala/hundi system

As mentioned above, there exist in Pakistan networks of underground banking that make it easy to transer funds without leaving any digital traces. This is called the hawala or hundi method. Funds are transferred through hawala without any actual physical movement of money. The entire premise is based on a system of trust and debts in the name of the guarantor.

To simplify things, one of the ways in which it works is: if one person wants to send money outside or into the country, they approach a 'hawaladar' or hawala dealer. They tell the hawaladar the amount they want to send which he notes down in a register of debts and credits. Then, the hawaladar contacts someone from their network in the country where the money needs to be transferred to the final person. Their contact gives the amount to the intended person and then the hawaladar owes him the sum of money transferred which can be settled in land, property or other valuables.

Due to the informal nature of this method, it is easy to exploit the system. It was reported that at its peak, the hawala system was processing 90% of the exchange business in Pakistan, as reported by exchange companies.[2] People involved in money laundering as well as terrorism financing can transfer multiple small sums in this manner so that ultimately the money trail cannot be traced back to them.

International Financial Action Task Force (FATF)

[2] 'Publication: Pakistan's Parallel Foreign Exchange Market' (23 October 2023) <https://www.freiheit.org/pakistan/pakistans-parallel-foreign-exchange-market> accessed 7 November 2024.

The Financial Action Task Force (FATF) was set up in 1989. Its mandate set out that it must ensure that countries integrate anti money laundering, counter terrorism financing and proliferation financing in their financial systems. The FATF has 40 written recommendations on how countries should set up their laws, regulations, and enforcement instruments to effectively fight financial crime.[3]

Three times every year, FATF publishes a list of countries that are very compliant, somewhat compliant and non-compliant with these recommendations. These are referred to informally as the white list, grey list and black list. The FATF urges all member countries and jurisdictions to implement enhanced due diligence for all identified black list countries. In the most severe cases, it calls on countries to adopt counter-measures to safeguard the international financial system from the risks of money laundering, terrorist financing, and proliferation financing originating from these countries. When placed on the grey list, it indicates that the country has pledged to promptly address the identified strategic deficiencies within set timelines and will be subject to closer oversight.

Despite not being a member of FATF, Pakistan is still evaluated by the FATF regulations by the Asia Pacific Group (APG), the largest FATF-style regional organisation, which it is a member of. This membership makes Pakistan indirectly accountable to FATF, as it is bound by the APG to follow FATF guidelines. In 2018, Pakistan was put on the grey list, meaning that it needed increased surveillance to see whether it was furthering compliance with the regulations to prevent money laundering, terrorism funding and other financial crimes. By 2022, it had performed much better and was taken off the grey list. It was noted that there were significant improvements in the country's anti money laundering and counter terrorism financing frameworks.

National Financial Action Task Force Secretariat (NFATF)

Pakistan has set up a National FATF Secretariat in order to better coordinate all efforts within the country to counter money laundering and terrorism financing.[4] It promotes inter agency cooperation in order to achieve its goals as effectively as possible. Many ministries and departments who work together for an effective and sustainable system of countering financial

[3] 'FATF Recommendations' <https://www.fatf-gafi.org/en/topics/fatf-recommendations.html> accessed 22 October 2024.
[4] 'FATF - About_FATF' <https://fatf.gov.pk/AboutUs/About_FATF> accessed 22 October 2024.

crimes in Pakistan, such as Ministry of Foreign Affairs, Ministry of Interior, Ministry of Finance and Ministry of Law and Justice. Law enforcement also plays a major role; agencies such as the National Accountability Bureau (NAB), Federal Investigations Agency (FIA), customs, and others are highly involved in the process.

The NFATF Secretariat was set up to comply with international FATF regulations. Its crackdown on financial crimes, especially terrorism financing, led to the removal of Pakistan from the grey list. It currently continues to operate as the major organ in charge of synchronizing all efforts to continue improving the frameworks and enforcement of prevention of financial crimes in the country.

Legislative frameworks to prevent money laundering and terrorism financing

Legislation for the regulation of foreign transactions have existed since the creation of Pakistan. Over the years, more specified legislation has been created to address various aspects of fund transfers and foreign exchange. Anti money laundering and counter terrorism financing legislative acts are part of these later legal instruments.

Foreign Exchange Regulation Act, 1947 (FERA)

The first Act created to address foreign exchange was actually created before the partition of Pakistan and India in 1947. It is still in use today, with certain amendments. The Act dictates the conditions for dealers of foreign currencies to be authorised as legitimate in the eyes of the state. The State Bank of Pakistan is the body in charge of making these authorisations. Notably, authorisation can be revoked by the State Bank if it at any time deems a dealer as non compliant with the laws pertaining to foreign exchange in the country; in other words, if any dealers are found to be channeling funds for any other purpose or in any other way than compatible with the laws of the country, their license to trade can be revoked immediately.

Anti Money Laundering Act, 2010

Money laundering is criminalized in Pakistan under FERA but it is expanded upon in the Anti Money Laundering Act of 2010.[5] The Act serves as a crucial legal framework designed to combat money laundering and enhance the overall integrity of the country's financial system. At its core, the Act provides a comprehensive definition of money laundering, focusing on the processes involved in concealing the proceeds of illegal activities. To effectively implement its provisions, the Act established the Financial Monitoring Unit (FMU), tasked with overseeing anti-money laundering efforts, collecting and analyzing financial intelligence, and facilitating communication among various stakeholders.

One of the key elements of the Act is the imposition of stringent reporting requirements on financial institutions and designated non-financial businesses. These entities are obligated to report any suspicious transactions to the FMU and maintain detailed records to assist in investigations. The Act empowers law enforcement and regulatory authorities to conduct thorough investigations, prosecute offenders, and impose significant penalties for non-compliance or involvement in money laundering activities.

Moreover, the Act emphasises the importance of international cooperation, aligning Pakistan's legal framework with global standards to combat money laundering effectively. This includes collaboration with international organisations and adherence to guidelines set by FATF. The Act also mandates financial institutions to develop and implement comprehensive anti-money laundering policies, including risk assessments, internal controls, and ongoing employee training programs to ensure that staff are equipped to recognize and report suspicious activities.

Through these measures, the Anti-Money Laundering Act of 2010 not only aims to deter money laundering practices but also seeks to enhance the transparency and accountability of Pakistan's financial system, ultimately fostering a safer economic environment and strengthening the country's position in the global financial community.

ANTI TERRORISM ACT, 1997 (ATA)

Countering terrorism financing falls under the same laws as those concerning anti money laundering but there are separate rules pinpointed to address the former in the Anti

[5] Anti Money Laundering Act, 2010.

Terrorism Act of 1997.[6] This Act is aimed at preventing and countering terrorism within the country. Enacted in response to escalating violence and security threats, the Act provides a comprehensive legal framework to address acts of terrorism and their financing. It defines terrorism broadly, encompassing a range of violent acts intended to intimidate or coerce the public or government for political, ideological, or religious purposes.

One of the key features of the Act is the establishment of special courts for the swift trial of terrorism-related offenses. These courts are designed to expedite legal proceedings and ensure that cases are handled efficiently, reflecting the urgent need to address security challenges. The Act also empowers law enforcement agencies to conduct arrests and investigations with broader authority, including provisions for preventive detention to disrupt potential terrorist activities before they occur.

The ATA mandates the registration and monitoring of organisations and individuals involved in terrorist activities, including the requirement for financial institutions to report suspicious transactions that may be linked to terrorism financing. Additionally, it includes provisions for the forfeiture of assets used in or derived from terrorist acts, which aims to disrupt the financial networks that support terrorism. This is of note especially in the context of this paper as it addresses counter terrorism financing within Pakistan and its foreign exchange policies.

Furthermore, the Act reiterates the importance of international cooperation in combating terrorism, allowing for collaboration with foreign governments and organisations to enhance security measures and share intelligence. It underscores the need for a comprehensive approach to counter-terrorism that includes not only legal measures but also community engagement and preventive strategies. This adds to the emphasis on compliance with FATF regulations as it promotes cooperation with the international community as a whole to combat terrorism and terrorism financing.

Recent State Bank initiatives

The Exchange Policy Department (EPD) is a key division of the State Bank of Pakistan responsible for overseeing the country's foreign exchange regime. The department is actively

[6] Anti Terrorism Act, 1997.

involved in formulating and implementing policies to ensure that Pakistan's foreign exchange framework aligns with the objectives set by the Federal Government and the State Bank of Pakistan.

Last year, in 2023, the State Bank initiated a severe crackdown against illegal currency dealers in the country. There were multiple reasons for this; the exchange rate was getting more and more unstable due to illegal dealers buying dollars at a higher price than the market rate. There was also suspicion of increased terrorism funding as dollars were being smuggled across the border into Afghanistan and Iran. To address these developments right away, the EPD implemented a series of stricter rules for currency dealers.

These rules included major and minor changes. One of the structural reforms ordered was that various types of exchange companies already functioning, as well as their franchises, would have to be consolidated into one category of exchange company with a single mandate. This meant that the head office of the consolidated exchange company would be in charge of the activities of all its subsidiary branches also. Furthermore, banks engaging in exchange operations were directed to set up separate entities for such transactions. Implementation of these new rules led to much better internal controls and more rigorous control of the foreign exchange flow of the country, as only one category of foreign exchange dealers now needs to be monitored.[7]

Other rules, such as companies not being allowed to sell more than 1000 US dollars at a time to a client and more stringent requirements for ID of the clients, also contributed to the control of the exchange rate in the country. However – more importantly for the purposes of this brief – all these rules also led to the decline of the 'grey market' in Pakistan, meaning the illegal buying and selling of the dollar. Therefore, the flow between bordering countries came to a halt, with buyers only going to state-authorised branches rather than to networks of hawaladars or other underground banking systems.

This has brought much of the already decreased illegal financial activities within the country to a standstill. Money laundering and terrorism financing have both been virtually put to a stop. Laundering is no longer possible at as large a scale as the grey market allows because buyers are only going to authorised sellers of currency. Hawala networks cannot be relied upon because buyers at authorised branches are only allowed to purchase a certain amount of

[7] Shahid Iqbal, 'Crackdown Restores Confidence in Rupee' (*DAWN.COM*, 05:16:11+05:00) <https://www.dawn.com/news/1776858> accessed 23 October 2024.

currency and they have to provide extensive identification in order to be able to buy it. In turn, this has led to no currency being passed over the border, so terrorism financing is also virtually impossible.

Existing gaps that need to be addressed

Despite a large improvement in the anti money laundering and counter terrorism financing situation of the country, there are still some issues that are prevalent. These need to be addressed in order to continue to better compliance with FATF regulations.

Even though hawala networks were largely dissolved, or at least not functional, they have recently resurfaced. The 2023 crackdown did improve matters but there are still some gaps that left that must be addressed which have led to certain incidents of laundering and terrorism financing this year. In June 2024, two facilitators of the banned Tehreek-e-Taliban Pakistan, a terrorist organisation, were arrested in Karachi.[8] A significant sum of money intended for the funding of terrorist activities was recovered from them. This in itself is worrying enough, but evidence has brought to light the fact that foreign funding for terrorist activities is still being sent into the country. In December 2023, a commander of the Baloch National Army (BNA) separatist group, who had turned himself in to the Pakistani government, alleged that India had been secretly backing terrorist activities in Balochistan and funding separatist forces in the region.[9]

The aforementioned incidents suggest that terrorism funding, and therefore, money laundering within the country and also at its borders have not been completely eradicated. These standalone incidents could very well culminate in another surge of terror attacks, the revival of the grey market for currency and so forth. Therefore, they need to be nipped in the bud before they become a much bigger threat.

Recommendations for Pakistan on how to address these gaps

[8] 'Two TTP Facilitators Nabbed in Karachi with Arms and Terror Funds' (30 June 2024) <https://www.pakistantoday.com.pk/2024/06/30/two-ttp-facilitators-nabbed-in-karachi-with-arms-and-terror-funds/> accessed 23 October 2024.

[9] Global Times, 'GT Investigates: Evidences, Sources Prove India "supports Terrorism" in Pakistan's Balochistan - Global Times' <https://www.globaltimes.cn/page/202401/1305842.shtml> accessed 23 October 2024.3

Addressing the two FATF recommendations that Pakistan is not fully compliant with

In its FATF evaluation report of 2022, Pakistan was categorised as fully or largely compliant with 38 out of the 40 recommendation points published by FATF.[10] However, there are still two that it is only partially compliant with still. Working on improving these areas will lead to a further improvement in addressing issues of money laundering and terrorism financing.

Point 15 of the FATF recommendations refers to new technologies developed and put into use for the purpose of countering financial crimes. Pakistan is partially in compliance with the standards required by this point.

Point 38 concerns the freezing and confiscation of assets in matters of mutual legal assistance as soon as illegal activity is detected. In this case Pakistan is also partially compliant, mainly because there are circumstances in which authorities cannot act without notifying the subject of the asset freeze, leading to significant time lost in which assets and funds can be relocated. This deficiency needs to be addressed in order to become fully compliant with this recommendation also.

Further dismantlement of hawala/hundi networks

Hawala networks are illegal under FERA 1947 in Pakistan. Despite this, they are prevalent and operate across the country, albeit in a much smaller quantity than a few decades ago. However, they need to be dismantled completely for the effective eradication of money laundering and terrorism funding via these networks.

Cryptocurrency regulation

The rise of cryptocurrencies internationally has led to a rise in investments in digital currencies within Pakistan also. Since there are no specific regulations regarding cryptocurrency in the country, there is a whole new are of financial systems that is open to be used; and also to be misused. Specific legislation concerning the regulation of digital currency

[10] 'Pakistan's Progress in Strengthening Measures to Tackle Money Laundering and Terrorist Financing' <https://www.fatf-gafi.org/en/publications/Mutualevaluations/Fur-pakistan-2022.html> accessed 23 October 2024.

needs to be passed in order to prevent money laundering or terrorism financing via this method of fund transfers.

Recommendations:

Regarding the improvement of compliance with FATF recommendations, there are steps that need to be taken to specifically address both the points in which Pakistan is still lacking. For Point 15, further work needs to be done to digitize setups as much and as quickly as possible. This will streamline the process of regulating currency in a way where there will be little scope for any secondary streams of money to remain undetected. For Point 38, Pakistan can work on strengthening the rules of ordering an asset freeze without notifying the subject, in cases of money laundering or terrorism funding, where it is clear that the notification would lead to further violations of the law by the individual being targeted.

For the dismantlement of hawala/hundi networks, there are many measures that can be taken, such as:

- Stricter legislation and penalties for hawaladars and buyers
- Increased grassroots monitoring by national FATF
- International cooperation, especially by bordering countries to keep strict checks on their end
- Training and awareness of law enforcement.

Finally, for the regulation of cryptocurrency, there is a method of regulation that is used worldwide for new products, services or business models which have not been addressed under existing laws and regulations is the 'regulatory sandbox approach'.[11] This approach enables live, time-limited testing of cryptocurrencies under regulatory supervision in a controlled setting, helping to evaluate their viability for full-scale launch. Interested participants can apply to be part of a cohort that will go through the entire lifecycle of the regulatory sandbox, testing their innovation within a defined timeframe. Continuous monitoring at each stage, along with an assessment of the final outcomes, will help shape a conducive regulatory environment for further development.

[11] Dr Aneel Salman and Syed Murtaza Abbas, 'Crypto Currency – Regulatory Challenges and Opportunities'.

Action Matrix				
Options for International Community				
Option	**Pathways to Solution**	**Implementation of Solution**	**Actors Responsible**	**Implementation Timelines**
Bettering compliance with FATF recommendations number 15 and 38	Better digital systems of monitoring financial networks in the country need to be installed. Procedural steps in the freezing of assets for crimes of money laundering or terrorism financing need to be streamlined.	The NFATF Secretariat should allocate funds, or delegate the allocation of funds to all the agencies working under it, for the upgrading of equipment. A committee of lawmakers within the NFATF network should be called to analyse and improve relevant legislative procedures.	• National Financial Action Task Force Secretariat • FBR • FIA • State Bank of Pakistan	12-24 months for evaluation, investigation and implementation.
Dismantlement of hawala/hundi networks	Stricter legislation and penalisation must be implemented.	The NFATF network and lawmakers should pass stricter legislation that contains higher penalties for participation in or the use of hawala networks. Law enforcement must be trained to detect hawaladars and their networks and apprehend them.	• National Financial Action Task Force Secretariat • FBR • FIA • State Bank of Pakistan • National Assembly • Provincial and Federal police departments.	1-3 Months to draft and pass the legislation. 3-6 Months for training and deployment of law enforcement.
Regulation of Cryptocurrency	Cryptocurrency needs to be officially regulated by the state in order to not allow any gaps for illegal financial	Specific legislation concerning the regulation of digital currency needs to be passed.	• National Financial Action Task Force Secretariat • FBR • FIA	1-3 Months to draft and pass the legislation.

	activities via digital finance systems.		• State Bank of Pakistan • National Assembly	