

# **Trade-Based Money Laundering- Impact & Corrective Measures**

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## **Abstract**

There are three ways to move money for concealing the origins of the proceeds of crime and integrate it with the formal economy; the use of the financial system, bulk cash smuggling and the use of international trade to launder and move the values across borders. In contrast to the other two methods, the scope for abuse of the international trading system is very high but it has attracted little attention. The international trading system has many vulnerabilities that can be exploited by criminals; the enormous and growing volume of trade, involvement of different jurisdictions with their own laws, diversity of finance & trade arrangements, limited resources of Customs authorities whose main focus is not to combat the ML but to collect duties, and pressure from WTO and WCO to eliminate barriers for free flow of trade.

This Paper sheds light on the factors that make Pakistan more prone to TBML. This includes the trading practices of its important trading partners. UAE and Hong Kong are transshipment hubs; transshipment makes the origin and ownership of the consignments blurred. Imports from China have been documented to be heavily under-invoiced. Afghanistan has been surviving for decades with a nominal central government with no control over most of the country. Then, some customs clearance practices make Pakistan more vulnerable to TBML.

This Paper highlights the enactment of the Antimoney Laundering Act 2010 as an important milestone; this Act defines money laundering and grants sufficient powers to various agencies to investigate predicate offences. The Financial Monitoring Unit is supposed to play the role of the central nervous system for coordination and information sharing. The Directorate of Intelligence & Investigation of Customs is the notified agency to investigate various forms of money laundering including TBML. It has recently detected a few cases of TBML.

This Paper concludes that with growing trade volume and peculiar trade, finance and customs practices, TBML remains a serious and compelling threat to Pakistan that can have grave economic, social and political consequences. Pakistan has established a legal and institutional framework that has the capacity to curb and control TBML.

In the last part, this paper suggests measures that can increase the capacity and effectiveness of the Pakistani authorities to address the threat of TBML; these include deeper coordination and data sharing among LEAs/institutions, international cooperation, awareness campaigns, training for staff to better identify

TBML techniques and changes in Customs laws and procedures.

**Introduction:**

Money Laundering simply means cleaning the dirty money (G. o. Pakistan, Guidelines on Investigations of ML for LEAs 2020) ; the money that has its origin in the crime needs laundering to hide the linkage with the illegal means. There are many methods for money laundering like the use of financial intuitions and bulk cash smuggling but the most sophisticated one is the trade-based money laundering; it uses the complex system of trade involving transshipments, import and export of goods/services. The involvement of multiple jurisdictions and territories makes the customer due diligence an uphill task. Money laundering is the third-largest global industry after oil and currency according to the International Money Laundering Information Bureau (IMLIB) (Daniel n.d.) .

Money laundering is defined as “disguising financial assets so that they can be used without detection of the illegal activity that produced them” (Treasury n.d.) . While trade-based money laundering is defined as (FATF, Trade based Money Laundering 2006) ”the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimize their illicit origin” “or finance their activities” (FATF, Best Practices Paper on Trade Based Money Laundering 2008) . In order to use the proceeds of crime and corruption, the criminals and the criminal organizations must cover the origin of the ill-gotten money and try to make the dirty money blend into the formal economy. Traditionally this has been done by using the financial system and moving the money physically (bulk cash smuggling). This involves a three-step approach (CHEN n.d.) :

- Placement: ill gotten money is placed in the financial system; this can be done by depositing the money into a bank account or buying some monetary instruments
- Layering: a series of transactions are done so that the funds move away from the source and thereby the origin of the funds are hidden
- Integration: the money now can be withdrawn from the account for integration into the formal economy by investing it into real estate or other businesses

As per UNODC (UN, unodc.org n.d.) estimates, 2.7% of global GDP (\$1.6 trillion) consists of the laundered money. The colossal dimensions of this problem show that transnational cooperation is required to combat this menace. As a result of strong action by FATF and Pakistan, the use of financial institutions to launder money has been reduced drastically. The criminals are now opting for more sophisticated methods to launder their profits from the crime. So, they are

increasingly using the international trade to conceal the origins of the proceeds of crime and to move the value across international borders. Thus, the trade-based money laundering is a new front on which countries as well as international institutions like FATF are turning their focus to.

### **Statement of the Problem**

International trade is being increasingly used by criminals and organized criminal groups to transfer the value across international borders and launder proceeds of crime with serious and far-reaching consequences for the nation states. Pakistan's increasing trade volume and peculiar trade patterns and practices make it prone to trade-based money laundering. Strengthening of Pakistan's anti-money laundering legal framework and enhancing monitoring and coordination among the financial institutions and law enforcement agencies can help in effectively curbing this crime.

### **Significance and Scope**

International trade is swelling with every passing day as almost all countries are becoming part of the global value chain where raw material is produced in a country, processed in another and the finished good is produced in yet another country. World bodies like World Trade Organization and World Customs Organization are making endeavors to ensure that the goods and services are traded across borders with minimal barriers and without delays. This provides the opportunity for the criminals to use the trade vulnerabilities to launder their ill-gotten money. In this context, this study would examine the FATF's guidelines on the issue, techniques used in TBML, Pakistan's vulnerability to this type of money laundering, effects of money laundering and the legislative and institutional framework available for combating the TBML. As TBML relies on trade to hide its relationship to crime, so the study has been restricted to the use of international trade of goods only for money laundering.

### **Review of Literature**

While conducting secondary research for the paper, extensive use of the Financial Action Task Force (FATF) website was made where the text of various reports and standards are available. The most significant and influential report on the subject of the trade-based money laundering (TBML) is the FATF's report of June 2006 (FATF, Trade based Money Laundering 2006) which is considered a groundbreaking document on the topic. This report points out that trade-based money laundering is one of three main methods of money laundering and explains the techniques that are used for TBML. FATF's subsequent report titled Best Practices Paper on Trade Based Money Laundering 2008 (FATF, Best Practices Paper on Trade Based Money Laundering 2008) broadened the scope of the definition of the TBML and suggested various ways to counter it like the capacity building of the staff, risk-based scrutiny of the shipments and international

cooperation. A report from FATF subsidiary group called Wolfsberg issued two reports in collaboration with the International Chamber of Commerce (ICC) in 2017 (W. G. Commerce 2017) and 2019 (W. G. Commerce 2019) titled Trade Finance Principles which highlighted the role of financial institutions in financing trade as well as the measures that these institutions can take to counter TBML. The latest report that FATF has issued on TBML is “TBML-Trends and Developments 2020 (Group 2020) ” ; this report captures feedback from the public and private sectors to provide significance and extent of TBML and highlights tools, methods and capabilities to detect and disrupt TBML. Asia Pacific Group (APG)’s reports on TBML typology 2012 ((APG) 2012) recommended that anti-TBML strategies must not hinder the free flow of the genuine trade rather bilateral and multilateral cooperation and exchange of data should be relied upon.

The report titled, Transshipment and TBML (Acharya 2011) suggests that transshipment substantially increases the chances of TBML; this aspect of the trade is very relevant to Pakistan that has a substantial volume of trade with free ports like UAE and Hong Kong which are the hub of transshipment globally.

Reports and documents of Pakistan’s various financial institutions like the Finance Division, Federal Board of Revenue and State Bank of Pakistan were studied to understand the current legal framework and measures taken by the Government to curb the TBML. The website of the Financial Monitoring Unit of Pakistan (FMU n.d.) provides quick access to all Acts and Rules framed at the Federal as well as Provincial level to deal with money laundering.

### **Methodology**

This research is a qualitative analysis based on primary sources comprising of relevant laws, rules, notifications and other official records of the financial and law enforcement institutions of the Government of Pakistan and secondary sources available in the form of various reports, data of FATF and other international agencies. Moreover, discussions with officials of the FBR and law enforcement agencies have also been relied upon in this study.

### **Global Dimension**

Before the pandemic, the world trade registered a growth of 10% in 2018 as compared to the previous year, the global trade amounted to \$ 38.7 trillion (UN, 2018 International Trade Statistics Yearbook-Volume 1 2018) . This astronomical growth has been made possible by the World Trade Organization which continuously presses for reduction/elimination of tariff & non-tariff barriers to trade (WTO n.d.) through its various agreements. Moreover, World Customs Organization is promoting international trade through the harmonization of policies and system of classification. The result of all these measures is that goods and

services are being traded across borders with convenience and predictability. The clearance time of the customs and border agencies is being reduced to minutes from days and hours. To meet the demands of ever-increasing international trade, bigger cargo ships are employed; for example, the capacity of the biggest cargo ships like P. Moller–Maersk – 4.1m Twenty Feet Equivalent Unit (TEU), Mediterranean Shipping Company – 3.8m TEU and COSCO Shipping Lines – 3.1m TEU (Technology n.d.) . These ships can only anchor at the deep seaports ensuring that more cargo in Asia is transshipped through regional hubs; this phenomenon makes the ascertainment of origin of the shipments difficult. The major downside of this humungous amount of international trade is that it makes trade-based money laundering easier. The situation becomes more complex due to the following:

- There are a very limited number of customs officers in most of the administrations including Pakistan who are more focused on finding out contrabands and narcotics in the shipments rather than looking for the signs of money laundering
- Terrorist and criminal organizations do not necessarily use funds from the illicit trade of contrabands; for example, ISIS earned around \$ 1million/day from the sale of oil (cgrs 2015)
- FATF through its 40+9 recommendations hit the money laundering through financial institutions (FATF, Transshipment and trade-based money laundering 2011) and cash smuggling hard, these recommendations were also endorsed by the UN and International Monetary Fund. So, the narcotic smugglers, corrupt etc tend to use trade-based money laundering which has the advantage of moving huge amounts of value through it in fewer transactions

### **Factors Making Pakistan Vulnerable to TBML**

Pakistan's international trade volume was \$ 93 bn in 2018-19 (Division 2021) ; Pakistan's trade and finance patterns have specific peculiarities that make it especially prone to trade-based money laundering:

#### **China**

China is the biggest trade partner of Pakistan. 33% of Pakistan's imports originate from China valuing Rs 2328 bn (Division 2021) , the misdeclaration in quantity and value on the Chinese imports is quite widespread and it is estimated that Pakistan misses on revenue on the underreported imports of around \$ 4-6 bn (Zafar 2019) . The misdeclaration in value or quantity is one of the major ways to launder money under the garb of trade. In 2019-20, a customs fraud involving an amount of Rs 7 bn was committed by an importer with the collusion of a freight forwarder based in Hong Kong, a free port of China (Khan 2021) .

Pakistan has been taking up the issue with the Chinese authorities to develop electronic data interchange to arrest the rampant misdeclaration by using the File Transfer Protocol (FTP) (Akhter 2015) . However, the Chinese authorities were less than enthusiastic on sharing data through this means; they proposed to share data through Messaging Queuing and Encryption (Akhter 2015) for EDI for real-time data sharing. Thus, despite the sharing of the data, the instances of misdeclaration still persist. The major reliance of Pakistan on China as a source of imports has made Pakistan more prone to trade-based money laundering.

### **United Arab Emirates (UAE)**

The second-biggest trading partner of Pakistan is UAE. 11.6% imports valuing Rs 812.7 bn (Division 2021) originate from UAE. It is also the destination of the 5% of Pakistan's exports that value Rs 178.9 bn (Division 2021) . It is important to note that most of the consumer durables, food items, medicines, equipment etc being imported into Pakistan from UAE are not actually made there. UAE with its Jabel Ali and Fujairah ports (Project 2017) , the biggest free ports in the world, has emerged as the transshipment hub in the region where the shipments from across the globe are brought for warehousing and processing of various kinds before shipment to the final destination. The processing includes repackaging, bulk breaking, consolidation, relabeling etc. These transshipment hubs and free trading zones pose a serious threat of money laundering and other trade related criminal activities as they are areas that are ruled through loose regulations and policies that favor and encourage the free flow of trade (Acharya 2011) . The less rigorous implementation of the rules leads to the transgression of trade and finance regulations like making cash payments and impairing of the data. The consolidation/deconsolidation of the cargo and relabeling/repackaging of the shipments make the determination of the origin of the cargo an arduous task. Thus, tracking of the shipment from origin to the destination becomes onerous and complicated; this makes the important details, like the name of the real owner of the company involved in the trade and origin of the funds used in the transaction, more blurred. Moreover, Pakistanis have made a huge investment there (Shafaat 2015) and got various companies registered in UAE; trade of these firms with a related entity in Pakistan raises a red flag for TBML as per SBP directions.

### **Afghanistan**

It is the third biggest export destination of Pakistani goods which are valued to be Rs 134.3 (Division 2021) bn annually. Pakistan also provides a transit trade facility for Afghanistan which is a landlocked country and does not have direct access to the sea. As per one estimate, only 35% of local money transfers are legal, opium economy in the country is worth \$1.5 bn or 7 % of the country's GDP (Kelvington 2019) . These are not the only problem with the Afghani economy which is replete

with many other ills like corruption as Afghanistan was ranked as the 11th most corrupt country in the world in 2015 (Kelvington 2019) ; this country has other economic financial woes like tax evasion, kidnapping for ransom, human trafficking, arms trafficking and most importantly hawala system (Government n.d.) . Not all transactions of hawala system are bad but the absence of centralized monitoring makes the hawala transactions suspect. To make the matters worse, the Afghan government's jurisdiction does not cover the whole of Afghanistan where different armed groups and warlords exercise control over different pockets of territories. Thus, the trade with Afghanistan poses the biggest challenge to check sources of funds. The data of the Government that does not hold control over its territory is by no means reliable. Afghanistan is also the biggest source of smuggling of goods to Pakistan. The trade worth billions of dollars with Afghanistan increases Pakistan's proclivity to trade based money laundering. Though Pakistan has established EDI with Afghanistan but the integrity of the Afghan data remains doubtful and unauthentic.

### **Custom Clearance System**

Pakistan has made great strides in rolling out an indigenously designed and paperless automated customs clearance system. (FBR, customs n.d.) . This system is called WeBOC and is operational since 2012 in the country; it connects various stakeholders including importers and exporters, banks, Customs Clearing Agents, Ports and Shipping Lines seamlessly with each other. The System is currently operating on all Sea Ports, Airports and almost all land Customs stations. It currently covers more than 97% of exports and more than 96% of imports in the country (Ali 2021) . The System itself processes GDs through its Risk Management System and clears the goods through one of the channels which are labeled as Green, Yellow and Red. In the case of Green Channel, without any human involvement, the goods are released after payment of duties and taxes based on the risk profile of the importer and type of goods. In the case of Yellow, consignment is referred to the Appraising Staff through System for scrutiny of the documents filed by the trader. However, in the case of high-risk consignments or traders under the Red channel, goods are referred for a physical examination before clearance (Ali 2021) . Despite this development and advancement in the clearance system, there are certain procedures and practices in the customs clearance system of the country which can be exploited by the unscrupulous elements for trade-based money laundering, these include the following:

- Border customs stations like Sost, Torkhum, Ghulam Khan, Angoor Adda etc have very recently been linked to WeBOC system (Ali 2021) . Previously, misdeclarations were rampant at these stations. As a result of the linking with WeBOC system, now there is a greater element of transparency but still the staff is not as trained as at bigger customs stations;

moreover, as they are far off stations, so there is a lack of supervision over the field staff. Importantly, these border customs stations mostly lack basic equipment for a transparent custom clearance like weigh bridges and container scanners. So, these are more prone to be used for trade-based money laundering.

- Importers do not tender original invoices, packing lists etc as this practice does not carry any prohibitive penalty (Khan 2021) . Thus, the unscrupulous elements may take chances to get the mis-declared quantities/items cleared.
- As per Customs Rules, the consignee of the shipment destined for Pakistan must place a copy of the invoice in the shipment (Khan 2021) . The violation of the instructions carried a penalty of just Rs 5000. Importers preferred to pay the penalty instead of directing their shipper to place the invoice in the shipment. In this way, an important tool to eliminate misdeclaration was rendered toothless.
- In case of used/old items, the importers avoid making any declaration and make an application under section 79 (1) of the Customs Act 1969, requesting that the goods be examined first; thereby they shift their responsibility to Customs staff and open the doors for misdeclaration with the collusion of the staff (Khan 2021)
- A very small fraction of Pakistan's imports are actually made under contracts/agreements involving banking finances (M. Ali 2021) . In the absence of bank finances, the ascertainment of the bonafide of the sources of funds become next to impossible
- The concessionary regimes designed to encourage industrialization, development of less developed sectors etc are misused by importers (Haider 2019)
- Import/export of free of cost goods are a red flag for TBML but customs staff is just concerned about the safeguarding of revenue only
- The misdeclaration in import/export is a redeemable offence as the goods are released on redemption fine under SRO 499(I)/2009 (FBR, SROs n.d.)
- In Exports, the over invoicing is seen benignly as if it is bringing more foreign exchange to the country and it passes without raising any alarm. Moreover, exports are mostly dealt by the examiners only whose concern is to examine the consignment to ensure that no contrabands are smuggled. No appraising staff is available in the export section to check the valuation aspect of the exports.

## **Techniques**

The trade-based money laundering can be affected through misdeclaring the value, quality, or quantity of the imported or exported goods or services. Abuse of the financial system can also be involved in this type of money laundering by employing fraudulent financial transactions. Following are the basic techniques used for the trade-based money laundering:

### **Over/Under Valuation**

The oldest and most commonly used method for fraudulent transfer of value is the over or under-invoicing of the goods/services. In order to transfer additional value to the importer or exporter, the value of the goods/services is misrepresented (Daniel n.d.) . If an exporter intends to transfer value to the importer, he shall invoice the value lower than the market price; thereby the importer shall receive extra value when he sells the goods in the open market. On the other hand, if the exporter intends to receive the extra value, he shall over invoice the importer by charging the goods more than the market/fair price. For example, Company X exports 1 million shirts having a market value of \$4/piece to Company Y at the rate of \$2/piece Thus the importer will receive an extra \$ 2 million on sale of the shirts in the local market. Company Y deposits the extra money earned into the bank account whose ultimate beneficiary could be Company X. It is important to note the following points in this scenario:

- A. Collusion between Importer and exporter: such transaction would not make any business sense unless there is fraudulent collusion between the importer and exporter. Company X would otherwise suffer a loss of \$2 million.
  - B. There could be a parent company that would be controlling both Companies X & Y. A parent company can theoretically set up an affiliate in a territorial jurisdiction that has loose tax laws and lower tax rates. The parent company uses under-invoicing to transfer the value to a jurisdiction where the parent company could avoid taxes without being detected.
  - C. The over/under invoicing can have serious tax implications. An exporter that over invoices his exports can claim fraudulent Sales Tax refunds and rebates on his unfairly and illegally overvalued goods. Alternately, an importer is inclined to under-invoice his imports so that he can evade the import duties that he had to pay to the tax authorities. However, both cases are the vivid depiction of trade-based money laundering.
1. It has been found out that the under-invoicing of export is the most commonly used method of trade-based money laundering (FATF, Trade

based Money Laundering 2006) . As the Customs authorities are generally more focused on detecting contrabands in imports/exports, so the chance that the misdeclaration in the exports goes unnoticed is quite high. The lack of willingness to share data among various customs authorities is another major element that abets criminals in money laundering.

### **Multiple Invoicing of Goods/Services**

Another commonly used technique to launder the money is to issue multiple invoices for the same import/export transaction (FATF, Trade-based Money Laundering 2006) . In this way, a money launderer justifies the multiple payments on the basis of a single transaction. The complexity is further enhanced by involving various financial institutions in making these additional payments. If any agency detects the multiple payments, it can be justified legally on the ground of charging late fees, change in terms of payments, amendment to instructions of the previous payment. It is sophisticated as compared to under or over-invoicing as no misdeclaration or misrepresentation of the value of the goods/services is involved in this technique.

### **Over/Under Shipment**

In this technique of money laundering, the declaration of the quantity of the shipment is misdeclared or misrepresented (Daniel n.d.) . The money launderer may underdeclare or overdeclare the quantity being imported or exported. In extreme circumstances, the exporter of the goods may ship nothing at all; rather he attempts to get the documents processed from customs in collusion with the importer. This type of shipment is called Phantom Shipment. Unknowingly or unwittingly, the banking institutions also get involved in such transactions by providing the financing of such shipments.

For example, a company X receives payment of \$2 million for the shipment of 1 million pieces of shirts at the rate of \$ 2/piece from an importer company Y. However, the exporter, company X, ships 1.5 million pieces to the importer who sells the goods in the domestic market and earns an extra \$ 1 million which is deposited in the bank account whose ultimate beneficial is the owner of the company X.

### **Obfuscation**

In this type of money laundering, the quality of the goods is changed so that the exporter receives the value for superior quality goods but the exported goods are actually of lower quality. Thus, the documents like invoice, L/C etc are for the premium quality but the shipment is of secondary or “lot” quality of the goods. Thereby a discrepancy is created between what is on the customs documents and what has been shipped. This false description becomes harder to detect when used for the trade in services like consultancy, financial advice etc. As the market value

or fair price of such services vary a great deal.

For example, an exporter Company A receives payment of \$1 million for shipment of secondary quality steel at the rate of \$ 500/ton from importer Company B. But exporter ships the same quantity of prime quality steel of \$ 1000/ton to the importer. Thus, Company B receives an extra value of \$ 1million.This extra money can be disbursed as per the instructions of the exporter.

In a mega scandal (Dawn 2004) , a Pakistani company got a shell company registered in Dubai. It started exporting “tents” to Dubai but shipments not only weighed much less than the declared but also contained cheap dusters instead of tents and transferred an extra amount of Rs 1.25 bn across international borders.

### **Surrogate Shopping Networks**

It involves the individuals or shoppers making purchases of goods on behalf of wealthy or criminal groups to circumvent the customs controls and antimoney laundering scrutiny (Group 2020) . The shoppers may or may not be fully aware of the fact that they are acting on behalf of the organized criminal organizations.

### **Infiltration of Legitimate Supply Chain**

In this method, professional money launderers buy a stake in the legitimate business that may or may not be struggling financially to integrate their illegal funds into the financial system (Group 2020) . The aim of the launderers is not to change the business practices but to gradually increase their investment so that they can launder their funds steadily. This type of laundering is very challenging to detect.

### **Black Market Peso Scheme**

The main driver for this technique is the currency restrictions that limit the local businesses to access foreign currency for purchases (FATF, Trade based Money Laundering 2006) . So businesses take the help of the drug cartels or the money launderers to exchange local currency for dollars. Such type of technique was used by the Columbian drug cartels in the past; this type of payment is also being used by the Afghan importers to make their payments to Pakistani exporters.

### **Effects Of Trade Based Money Laundering**

The effects and impacts of all forms money laundering are similar, extensive and far reaching. It can have global as well as local consequences:

#### **Economic Effects**

Some of the economic ramifications of ML and TBML are explained as under:

#### **Foreign Investment and Growth**

Countries that have a high volume of money supply are considered risky places for

investors. The financial institutions are not stable in the countries where drug money and black money is in abundance. This shall scare the rational investors away from the country. The countries which have strong institutional mechanisms for combating black money are attractive to the investors as it boosts the confidence of the foreign investors (Sanctions scanner n.d.) . Without foreign direct investment, the economic growth of the country would stagnate.

### **Economic Distortion and Instability**

The money launderers invest in businesses which may essentially be neither beneficial to the country nor profitable to them. They invest assets in low quality schemes and projects to conceal the origin of funds. (Sanctions scanner n.d.). The hotel and construction industry are generally attractive avenues for investment for such funds. However, such funds can be parked for the short term only; on withdrawal of these funds, the projects are shelved and the economic sectors collapse causing economic uncertainty and instability in the country.

### **Revenue Loss**

As a result of the economic distortions and the economic slowdown that is accompanied with money laundering, the government's ability to revenue collection is damaged (Nevis May 2001) . In order to make up for the loss of revenue, the governments resort to increasing the tax rates which harms the honest taxpayers.

### **Weakening of Private Sector**

The money launderers use shell and front companies to mix up the proceeds of crime with legitimate funds. The illegitimate funds are basically used to subsidize the front company products; this subsidy allows the front company to sell at rates lower than the market rates as well as the cost of production. Thus, such front companies distort the market where smaller businesses with reliance on legitimate funds only find it hard to compete with them and may go out of business. In this way, money laundering has extremely negative microeconomic effects for the private sector (Nevis May 2001) .

### **Erosion of Integrity of Financial Markets**

Many bank failures have been associated with money laundering; the reason being that the bank that holds the funds of the crime find it difficult to manage their operations as large sums of funds may evaporate without a notice due to non-market factors like law enforcement operations (Nevis May 2001) . Markets have to face liquidity problems.

### **Loss of Economic Authority & Sovereignty**

As per UNODC's estimates, 2.7% of global GDP is comprised of money

laundering; for some countries, the magnitude of money laundering is so huge that it eclipses the actual economy of the country; as per the World Bank Report of 2010, some countries like Panama, Tanzania, Nigeria had black economy as big as more than 50 % of formal national economies (Montenegro 2010) . When illicit proceeds dwarf the actual budgets, then the government loses control of economic policies. With the large magnitude of the laundered money, the interest rates and currencies are affected as the laundered funds are invested in the sectors where they can be hidden instead of profit considerations (Nevis May 2001) .

### **Social Effects**

Some of the important social impacts created by the money laundering in a society are highlighted as under:

#### **Spread of Crime**

Without crime, there would be no proceeds of crime for money laundering. The organized criminal organizations feel rewarded when they successfully launder money so they escalate their criminal endeavors causing law and order problems in the society.

#### **The Socio-Cultural Disintegration**

It's a phenomenon in which a high unemployment rate and cultural animosity combine to create a strain on the community compelling them to adopt illegal means to alleviate the economic hardships (Haydock 2020) . Such a social environment is used by the organized crime groups to recruit the labor for their illegitimate enterprises by exploiting the hardships of the people. The victim of the crime feels alienated from society as they are not provided justice and protection by the state and society (Haydock 2020) .

#### **Corruption**

Successful laundering of money by the criminals persuades legitimate businesses and public sector managers to join hands with the criminals to share the booty. It has been documented that the countries with a high level of corruption have weak institutions making them also prone to higher levels of money laundering (FATF, Laundering the proceeds of corruption 2011) . The Politically Exposed Persons (PEP) who hold positions of authority not only indulge in corruption but indulge in money laundering too so that they can avoid public attention to their living beyond means. These corrupt PEPs by virtue of their authority, not only acquire state assets but also avoid scrutiny for money laundering as the institutions avoid implementing AML provisions against such individuals (FATF, Laundering the proceeds of corruption 2011) .

#### **Political Effects**

Democracy means the participation of people to develop a structure of governance that can deliver socioeconomic development and national unity to its citizens. This involves the creation of formal and informal structures of the collective and deliberative decision making. The dirty money through money laundering gets integrated into financial institutions granting control of the economic sectors to the criminals who bribe their way to political power. (FATF, fatf-gafi.org n.d.) The profitability of the crime is enhanced through money laundering which has negative consequences for the good governance. The magnitude of the power that becomes available to the criminals is akin to a virtual takeover of the government (Novis Vol. 6, No. 2, May 2001) . Mr Jan Van Djik, a former Director of UNODC, has established that political corruption is the natural outcome of the organized crime as it buys political influence to create space for their criminal practices; bribes to police, judiciary and politicians etc ultimately end up in infiltration of the political structure by the criminals (eease 2008) . Another outcome of the control of the political structure by the launderers and criminals, as per UN Interregional Crime & Research Institute (UNIRCI), is the diversion of government funds from education, health and development needs of the poor to the sectors which are beneficial to the elites. The cost of public services is escalated worsening the poverty, social instability, loss of public confidence in government, violence and political instability (Okunlola 2014) . All these factors combine to hinder the growth of democracy in the developing countries.

The developed nations are also finding out that the money laundering is becoming a threat to the democracy and internal stability of their countries. The electoral laws in western democracies allow the political parties to accept donations but do not require the disclosure of the source of the funds. It has been established that the funds from opaque sources and laundered money are being used to sponsor the political parties and influence the elections and referendums (Solan 2018) . In the absence of the disclosure of the beneficial ownership, USA has become a haven for money laundering where around \$ 300 bn are laundered annually; a substantial part of this money is used to influence the political parties and election results (Luce 2019) . The permeation of dirty money in American politics can be assessed from the fact that more than 80% of apartments in the Trump Tower are held by shell companies and the lobbyists are so powerful that they easily gun down any demand for reforms in the electoral and donation laws (Luce 2019) . The studies have found out the following three specific instances where suspected laundered money was used to influence the electoral results in the Western democracies (Solan 2018) :

- The far-right political party in Germany, Alternate for Germany (AFD), was financed during 2016-18 by a murky German company that received funds amounting to euro 20-30 million from a Swiss Association, these funds were used to launch media campaign during elections that helped this

party increase its seats in the Assembly

- Aaron Bank made the largest ever political contribution to the “Leave Campaign” during Brexit 2016 Referendum but failed to satisfactorily disclose the origin of the funds
- Under US law, the contributor of less than \$ 200 to the presidential candidate needs not to be identified. President Trump raised two third of his campaign funds through these types of donations baffling the watchdogs to ascertain the origin of these funds

Thus, dark money and political laundering can subvert the democracies in the developed as well as the poor countries.

### **Terrorism Financing**

The United Nations General Assembly in 1994 defined terrorism as (UNODC 2017) “Criminal acts intended or calculated to provoke a state of terror in the general public, or a group of persons or particular persons for political purposes are in any circumstances unjustifiable whatever the considerations of a political, ideological, racial, ethnic, religious or any other nature that may be involved to justify them.” The funds for terrorism may come from legitimate sources like legitimate businesses, fundings from religious and cultural organizations. However, a major portion of the funds of terrorist organizations is generated through illegal activities like kidnapping, smuggling, drug trafficking. It has been estimated that \$ 2.5 bn worth of otherwise legal goods like electronic goods, mobile phones etc are smuggled to Pakistan from Afghanistan annually (UNODC 2017) .

Terrorism and money laundering are intertwined with each other; if money laundering of the proceeds of crime is stopped, it reduces the money supply to terrorists. It may not be possible to apprehend all terrorists but it is possible to stop terrorism by halting money laundering. (Kagan 2021) . Terrorism financing also uses trade-based procedures to launder money. As per FATF, the Trade Based Terror Financing is defined as concealing the movement of value from legitimate or illegitimate sources by employing trade transactions to finance terror (Group 2020).

### **Combatting Trade-Based Money Laundering**

To combat money laundering including TBML, Pakistan has established a legal and institutional framework which is examined and explained in this Section.

### **Anti-Money Laundering Act (AMLA), 2010**

Pakistan took up its fight against money laundering solemnly with the enactment of an Act. The AMLA 2010 was enacted on 26th March 2010 (G. o. Pakistan n.d.) to combat money laundering and terrorist financing. Money Laundering is defined

vide section 3 of the AML Act as "A person shall be guilty of an offence of money laundering if the person: a) Acquires, converts, possesses, uses or transfers property, knowing or having reason to believe that such property is proceeds of crime; b) Conceals or disguises the true nature, origin, location, disposition, movement or ownership of property, knowing or having reason to believe that such property is proceeds of crime; c) Holds or possesses on behalf of any other person any property knowing or having reason to believe that such property is proceeds of crime; or d) Participates in, associates, conspires to commit, aids, abets, facilitates, or counsels the commission of the acts specified in clauses (a), (b) and (c)".

Predicate offences notified in relation to the Customs Act, 1969 include Sections 2 (s), 15, 16, 32, 32(A) and 139 read with Section 156(1), (8), (9), (14), (14A), (70), (89) and (90) of the Customs Act, 1969 (FBR, Customs n.d.) . Sections 192, 192 A, 194 & 199 of Income Tax Ordinance 2001 dealing with the submission of false statement and concealment of income to evade Income Tax of more than Rs 10 million are also predicate offence under the Schedule to the AML Act 2010. Similarly, entries 11 and 13 of Section 33 of the Sales Tax Act 1990 and section 19(3) of the Federal Excise Act 2005 are also part of the Schedule of the Act. The AML Act designates and specifies the jurisdictions and responsibilities of various LEAs to investigate the predicate offences. The Act also provides powers of arrest, search and seizure as well as gives mechanism of freezing, seizing and forfeiture of properties acquired through the proceeds of crime. Thus, there are sufficient powers for the LEAs to counter various types of ML including TBML.

Some regulators have been authorized to act as regulatory authorities under the AML Act, these include the following (G. o. Pakistan, fmu.gov.pk n.d.) :

- I. State Bank of Pakistan for entities licensed under any law administered by the Bank;
- II. Security and Exchange Commission of Pakistan for any entity licensed under any law administered by SECP;
- III. Federal Board of Revenue for jewelers, dealers in precious metals and precious stones, real estate agents;

#### **Institutions Established under AML Act 2010**

Following institutions have been established under the AML Act 2010:

##### **National Executive Committee (FMU n.d.)**

National Executive Committee is established under section 3 of the Act. Minister of Finance or Adviser to PM on Finance heads the committee and includes four other ministers and the Governor SBP as its members. It makes recommendations on the policy formulation, amendments in the Rules, monitors the implementation

of the national policy on combating the money laundering.

### **National General Committee (FMU n.d.)**

It is the subordinate committee to the National Executive Committee and is headed by the Secretary Finance division. It helps in the development of the national strategy to fight the money laundering. It seeks reports from the investigation and regulatory bodies under the Act and issues necessary instructions and guidance to them.

### **Financial Monitoring Unit (FMU)**

FMU was established in 2007 under Section 6 of the AML Act 2010 (G. o. Pakistan, fmu.gov.pk n.d.) . It is the focal agency that receives and analyses the financial information about the suspect proceeds of the crime and then disseminates this information to the concerned investigation and regulatory agencies. It also receives regular reports about suspicious currency transactions from designated reporting entities. It plays the role of the central nervous system for the detection and investigation of financial crimes. This unit is also responsible for ensuring the compliance of the country to the recommendations of the FATF on anti-money laundering and terrorism financing. FMU has established a dedicated data center with the collaboration of UNODC to launch the goAML (U. Pakistan n.d.) , a dedicated software that collects and analyses the information about the suspected financial transactions in an efficient manner and helps in the exchange of information among stakeholders including banks and LEAs.

### **Role of Banks & Financial Institutions**

In order to combat TBML, the State Bank of Pakistan has circulated common red flags for the banks (S. B. Pakistan, sbp.org.pk/EPD 2019) , some of the red flags are as under:

- Significant variation of the value of the goods on invoice, Electronic Import Form (EIF), payment voucher and fair market value
- Trade transactions with the related party
- Open account
- Variation of the description of goods on Goods Declaration or Transport Note and EIF or relevant contract documents
- Variation in the description of goods on invoice and bill of lading (B/L)
- Receipt of documents such as L/C through unauthorized/unverified channels

- The shipment does not match with the importer or exporter's regular business
- The size of the shipment is inconsistent with the importer or exporter's routine business
- The shipment has been transshipped through various jurisdictions unnecessarily
- The country of origin in case of the import consignments has been designated as a high-risk country for money laundering
- High risk methods of payment like advance payment to a new supplier of goods from a high-risk country
- Payments from third parties that have apparently no connection to the transaction
- Consecutive trade discounts to the same importer by the exporter
- An exporter receives the advance payment but makes no shipment against it
- Repeated amendments or frequent extension in the L/C
- Use of frontline or shell companies to hide the true identity of the parties involved

Trade Finance is an important aspect of the TBML and is defined as the provision of finance by the financial institutions to facilitate the movement of goods and services between any two points (W. G. Commerce 2019) . As the trade finance is a high-risk area so SBP has rightly issued the standards and controls in the shape of red flags for the guidance of all financial intuitions in the country. 80% of global trade is carried out through Open Account (W. G. Commerce 2019) which implies that the buyer and seller enter into a contract agreeing on the terms and conditions and the banks clear the payment on delivery of the goods and services. As the full range of the transaction is not visible to the banks so the financial institutions restrict their checks to the routine screening. In order to overcome this hindrance, it is important that all stakeholders including banks, law enforcement agencies, FMU and Customs authorities cooperate and communicate with each other in ensuring that money laundering is not facilitated through financial institutions.

#### **Role of Private Sector (Freight Forwarders & Customs Brokers)**

Freight forwarders help importers and exporters in the movement of goods while ensuring compliance with the complex customs and shipping procedures. They have access to the various vital documents relating to the shipment that might

contain information about money laundering too (Group 2020) . Commercial invoice holds information about the parties involved in the transaction, value and description of the goods and certification about the authenticity of the invoice. Another important document that is available to the freight forwarder is the bill of lading that contains information about the basic terms of the contract and the date of the loading of the goods. The customs broker is another critical private sector stakeholder who has to arrange the customs clearance of the goods. As he has to submit the correct declaration of the goods so he holds all necessary documents relating to the goods including the contracts, licenses, value and tariff heading. Like most other administrations, Pakistan does not place any obligation on these stakeholders to extend assistance in curbing TBML.

### **Role of FBR**

Pakistan's AML law has obligations for Designated Non-Financial Businesses and Professions (DNFBP) which include lawyers, accountants, notaries, precious gemstone dealers, real estate agents and builders when conducting the transaction of an amount of over Rs 2 million in cash (FBR, fbr.gov.pk n.d.) . As each DNFBP must understand the risk of money laundering and terror financing so it must ensure due diligence for each of its customers. As AML Act 2010, puts the responsibility on FBR to monitor the compliance of the DNFBPs so a Directorate General has been established to ensure AML compliance of this sector. Regulation of businesses of Real Estate and Jewelers would be a challenging task for FBR. Notwithstanding the recent regulatory regime, these sectors are high risk areas regarding ML. In both of these sectors, the transaction is mostly cash based, hence an important and challenging task for the investigators would be to identify the actual value, source of the investment and actual beneficiaries.

### **Customs**

Information of global supply chain, trends of import/exports, access to the vital information and documents relating to the goods and physical custody of the consignments place the Customs in a uniquely advantageous position to unearth any crime taking place under the garb of the international trade (Group 2020) . However, burgeoning trade volume with an ancillary increase in trade data and pressure for reducing dwell time present the major challenges for Customs in identifying trade-based crimes. The situation is further complicated by the fact that consignments involved in TBML present a very small fraction of the legitimate international trade coupled with the focus on the collection of duties and taxes diverts the attention and resources of customs away from the fight against the TBML. The customs authorities have wide experience of encountering various methods of misdeclaration of value, description, tariff heading and origin of the shipments. So they have a key role in all strategies of combating TBML.

FATF has recommended (FATF, FATF Guidance National ML & TF Risk Assessment 2013) that countries should identify, assess, and understand the ML and TF risks for the country and should take action and apply resources by ensuring that the risks are mitigated effectively. Based on that assessment, countries should apply a risk-based approach (RBA) to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified. In compliance, Pakistan carried out its National Risk Assessment (NRA) (FMU, fmu.com 2019) in 2019 identifying seven threats as high risk which included Smuggling, Cash smuggling and TBML as Tax Fraud (under section 32 & 32 A of Customs Act 1969). This amplifies FATF apprehensions that TBML poses a significant threat for money laundering and terror financing to the most jurisdictions though they may lack the awareness of the extent of the problem (ETMG 2020) .

The Customs Act confers adequate powers to the officer of Customs regarding search, examination, detention and seizure and confiscation of smuggled currency and other contraband goods through various provisions of law, particularly the ones contained in sections 17,156 [(1) (8) & (89)], 139, 158, 162,163,164,168 and 179 of the Act.

Proceedings in cases involving the seizure of unlawfully carried/undeclared currency, as well as those involving illegal transfer of money through unlawful trading practices of TBML, are carried out under the AML Act without prejudice to, the penal action (that is, confiscation of the valuables and initiation of prosecution against the individuals/companies involved) taken under the Customs Act (Zaman 2021) . Such proceedings start with the filing of a complaint in the court of Special Judge Customs under section 21 of the AMLA for obtaining permission to initiate AML investigation against the accused. For initiation of terrorist financing enquiries, the cases are transmitted to the Financial Management Unit (FMU) for onward referral to the relevant Law Enforcement Agencies (LEAs).

Pakistan Customs has improved its Customs Business Procedures (Zaman 2021) for en-route monitoring and cross border verification of the transit trade which was a major source of TBML in the past. Pakistan Customs implemented tracking of Transit Consignment System, which has diminished the phenomenon of en-route pilferage of transit consignments. During the last three (03) years not even a single case of misuse of transit facility has been reported. The transit cargo is safely received in Afghanistan; however, a portion of it is smuggled back into Pakistan. The DG of Intelligence and Investigation, the notified LEA to investigate the crimes of ML, has signed an MOU with other LEAs under the auspices of the National Counter Terrorism Authority for information sharing of predicate offences (G. o. Pakistan, Guidelines on Investigations of ML for LEAs 2020) . Though Pakistan

has established a comprehensive legal and institutional framework to counter ML but its success against TBML has been very limited so far. The Directorate General has so far filed FIRs in 9 cases for alleged TBML which may not correspond to the volume of problem but still significant (Ali 2021) . It is pertinent to mention that the Directorate of Valuation (Shah 2021) conducted an academic exercise to check the quantum of under invoicing on exports to Central and Eastern Europe; it was found out that around \$ 1 million were laundered on exports of manmade staple fiber, articles of apparel etc to Europe only. However, no formal investigations were initiated for TBML as the DG Valuation was not the notified agency. Filing of 9 cases for TBML is just a beginning which can be construed that a proclamation of war against TBML has been made in this country.

### **Conclusion**

Given the ever increasing and dynamic complexion of the transnational trade with an immense diversity of tradable goods and services coupled with the involvement of a variety of persons, jurisdictions, territories and speed of the trade, TBML remains a serious and compelling risk. The global trade registered a growth of almost 10% in 2018 before the outbreak of COVID and amounted to \$ 38.2 trillion as per the UN yearbook. Pakistan's trade volume is also increasing which reached \$ 93 billion in 2018-19 before the pandemic. Apart from the huge volume, the trade and finance trends and practices of Pakistan make it especially vulnerable to TBML. If TBML is not checked, it can have economic, social and political implications that countries like Pakistan ill afford. Being cognizant of the pernicious effects of money laundering, Pakistan has enacted AML Act 2010 which grants sufficient powers to tax authorities, LEAs and especially Customs to investigate the predicate offences leading to TBML; some cases have recently been filed too. Pakistan has also created various institutions under the Anti-money Laundering Act like National Executive Committee, FMU, DG of DNFBP to curb this menace. However, lack of awareness among officials and poor domestic coordination among Customs, financial institutions and other law enforcement agencies is hampering the fight against TBML. As international trade involves multiple jurisdictions, so the importance of international cooperation and data sharing can also be not overlooked.

### **Recommendations**

TBML, as already explained, is not easy to detect (FIU 2021); the funds from the illicit sources are converted into commercial products like food items, electronics, gemstones etc; then these items are made part of global commerce making the functions of LEAs extremely difficult. To overcome the challenges and combat TBML effectively in Pakistan, following recommendations are made:

#### **Domestic Coordination**

An effective legal structure has been put into place in Pakistan where various

financial, tax and commercial crimes have been made predicate offence under the AML Act. SBP has issued a circular for the banks to identify red flags for TBML. Agencies in Customs and IRS have been notified to investigate the predicate offences. However, TBML cannot be encountered successfully unless there is greater, deeper and frequent cooperation and communication between all the domestic law enforcement agencies and various stakeholders. SBP would remain unsuccessful without the cooperation of Customs and Customs would fail to investigate and prosecute the criminals if financial intuitions do not extend a helping hand. Each agency holds a large amount of data on its servers but they avoid sharing this with other departments. Cross sharing and referencing of databases can go a long way in curbing the menace of TBML. A National Targeting Center has been proposed to be established by FBR (Ali 2021) for information and data sharing with other LEAs. This center should be established at the earliest. Domestic cooperation is the fundamental pillar of any successful strategy against TBML in Pakistan.

### **International Cooperation**

TBML is a transnational crime wherein the shell company registered in one jurisdiction is used to transfer funds and goods to the other. But administrations are generally reluctant to share information with their international counterparts for privacy and local laws. Pakistan's important trading partners like China, UAE, Afghanistan and other free ports are identified with greater risks of under/over invoicing and misdeclaration of the description of goods. There are reported cases where related or shell companies registered in these countries have been used for financial crimes in Pakistan and elsewhere. Electronic transfer of information and data sharing could help in the detection and prosecution of criminals. Though not very satisfactory but EDI has been established with China. Pakistan seeks to deepen this cooperation by converting EDI to a single window in the future. Data sharing agreements with other trading partners can immensely improve Pakistan's ability to curb TBML. Pakistan may also weigh the options of entering into a memorandum of understanding with international data exchange platforms like Egmont Group Secure Network of FIU etc

### **Changes in Customs Procedures**

Following changes in the Customs clearance laws and procedures are suggested to discourage the criminals to attempt money laundering under the cover of trade:

- Risk-Based Approach (RBA) should be implemented so that legitimate trade is not hindered or harassed
- Misdeclaration in weight, value, description, or tariff heading of goods etc is cleared on imposition of redemption fine under SRO 499(I)/2009 which

is akin to shot in the arm for the criminals to attempt the crime with minimal consequences. It is recommended that the misdeclaration of any sort may be removed from the ambit of the SRO and the offending goods may be confiscated outrightly

- GDs claiming duty/tax exemptions should not be cleared under the Green channel, such GDs should be properly scrutinized to see the validity of the exemptions claimed
- Assessing Officers should be posted in the export sections to check over/under-invoicing in the export consignments, a favorite tool of TBML
- Weighbridges as well scanners on all customs stations especially border customs stations must be installed to curb the misdeclaration in the shipments.
- Hefty fines and penalties or outright confiscations of consignments not containing the original invoice in the shipment must be imposed.
- In case of import of lots or used items, the importer must himself inspect the shipment and file GD; the customs examination should be carried out to it
- Customs risk profile must also take into account the mode of payment of the consignments as cash payment, third party payment, segmental payment and alternate remittance modes are associated with TBML ((APG) 2012)

### **Awareness Campaigns**

The use of trade for money laundering was initially highlighted by FATF reports of 2006 and 2008 (Unit 2020) . Though many publications by the authorities, law enforcement agencies and academia have shed more light on the various aspects of the complex phenomenon of TBML but still authorities and officials in Pakistan have just a basic understanding of this crime and remain unaware of the more advanced aspects of TBML. Another challenge is that various authorities see just a piece of the puzzle in the form of the predicate offence and they restrict themselves to the investigation of the predicate offence only. Customs officials focus on the detection of misdeclaration or prevention of smuggling of the contrabands, tax authorities restrict themselves to tax fraud while FMU and banks look for the financial aspect of the transaction. Thus no one investigates the predicate offence with reference to the money laundering aspect. It is therefore imperative that awareness programs and campaigns are designed for the sensitization of the officials of Customs, Financial Institutions, law enforcement agencies, prosecutors and judges dealing with TBML.

### **Establishment of Directorates of TBML**

To counter the bulk cash smuggling, a Directorate of Cross Border Currency Movement (CBCM) was established in Islamabad by FBR under the Customs wing. (FBR, fbr.gov.pk n.d.) This Directorate has immensely enhanced the efficacy of the Customs administration in making record seizures of the smuggled currency. As TBML is a complex phenomenon that requires special skills, coordination with domestic authorities and cooperation of foreign governments and customs administrations, it is therefore proposed that two directorates one each for North and South regions may be established to control TBML.

### **Trade with Afghanistan**

Trade with Afghanistan has been a grey area that may be exploited by smugglers, tax evaders and money launderers. This is mainly because of the weak regulatory mechanism on the other side of the border and at times manipulation/connivance on the Pakistani side. It is recommended that all such trade should be dealt carefully by the Customs by treating it as Red Channel cargo. Moreover, financial institutions should also review their policy of flexibility on requirements of transfer of foreign exchange from Afghanistan through banking channels on exports.

### **Public Private Partnership**

Many private sector stakeholders like customs brokers, shipping agents etc have treasure trove information about the potential TBML; under the current laws, they are not obliged to take any action in this regard. It is proposed that an outreach program may be designed to create awareness among the private sector stakeholders and establish a confident relationship with the law enforcement agencies for information sharing.

### **Capacity Building**

Many officials of the AML law enforcement agencies fail to distinguish TBML from other methods. Trade, customs clearance and trade finance data are collected for purposes other than TBML and officials fail to cross-reference the data for AML. Anti-TBML strategy can only be successful if the customs, FMU and bank authorities are sufficiently trained to enable the frontline officials to detect and prevent TBML. The case studies and typology papers may be prepared for such training programs. Officials may also be trained and educated about the law and procedures of Pakistan's major partners like China, UAE, Hong Kong, Afghanistan etc.

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