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Shadow Banking and Legal Risks in Pakistan: Regulating the Unregulated

Dr. Abida Abdul Khaliq
Associate Dean Superior College of Law
Chairperson International School of Law and Business, Lahore, Pakistan
abidaak786@gmail.com
Mehreen Gilani
(Corresponding Author)
PhD Scholar
Department of Commerce
Bahauddin Zakariya University Multan, Pakistan
mehreen.gilani09@hotmail.com
Syed Mohammad Tahir Gohar
Advocate High Court
LLM, Gillani law College
Bahauddin Zakariya University Multan, Pakistan
syedmohammadtahir5@gmail.com

Abstract

The development of the shadow banking systems has posed a new regulatory challenge to financial and legal systems being observed throughout the whole world. This has made the construction of a parallel banking system in Pakistan, with its number of informal financial institutions, listed as wins, and operating beyond the reach of control of the State Bank of Pakistan (SBP) and traditional financial oversight. Although these individuals address access to credit gaps particularly within the underserved populations, they are accompanied by lifelong aspects of consumer protection, financial stability and systemic risk.

This paper is a critical analysis of the extent and character of shadow banking in Pakistan, the key participants, framework and the legal loopholes which enable the booms. It examines the danger that unregulated lending presents both legally and economically in regard to predatory interest rates, inability by the consumer to seek recourse, and susceptibility to fraud and money laundering. The paper uses the comparative regulatory models of other jurisdictions like India, the European Union, and China who have tried to control shadow banking in the strict regulatory model. In addition, the paper will assess how the current Pakistani financial regulations; including the State Bank of Pakistan Act, the SECP regulations, and anti-money laundering laws can be effective in limiting the practices of a shadow bank.

It claims that the disjointed legal and institutional framework in Pakistan is hardly suited to cope with the initiative in legal framework and speedy development in this field. The paper ends by making the policy recommendations which argue in favor of a unified legal definition of shadow

banking, increased registration and disclosure obligations and the implementation of a risk-based regime of regulation.
The study highlights the fact that although shadow banking can boost financial inclusion, its unchecked growth without any strong legal regulations would destroy financial stability of Pakistan in the long-term, and consumer confidence in the financial system.

Introduction

The term shadow banking is an issue getting more support in the international financial and legal community during the last several years. Initially the term was coined by Paul McCulley in 2007 to refer to non-bank financial intermediaries that resemble traditional banks in their functions but operate beyond the bounds of regulated banking systems, the term has since come to be used much more broadly to refer to a wide variety of entities and activities that add to credit creation in the economy without incurring the same degree of supervision as banks.[1] These are micro finance organizations, online lenders, cooperatives and informal networks of credit, most of which have permeated the emerging economies such as Pakistan.

Development of shadow banking in Pakistan is a double-edged sword because, on the one hand, it provides more people and small businesses (not able to work with formal banks) with an opportunity to access financial services, and on the other hand raises remarkable legal and regulatory issues. These un- or less-regulated financial operations carry system risk to national economy, expose an economy to the risk of fraud and open the issue of consumer protection, transparency and legal responsibility.[2] The difference between commercial banks and other institutions that are subject to supervision by the State Bank of Pakistan (SBP) under the Banking Companies Ordinance 1962 and other legal acts is that the shadow banking industry is not always in the light of the law, and it takes advantage of the existing gaps in the regulatory system and enjoys the decentralized control of various authorities, such as the Securities and Exchange Commission of Pakistan (SECP) and cooperative registrars at the Provinces.[3]

The aim of this paper is to discuss the legal framework within which the shadow banking in Pakistan operates, measure its exposures and evaluate the consequences of financial regulation, consumer rights, and integrity of institutions. The comparative experiences in India, European Union, and China can provide the best practices of controlling the risks of shadow banking systems. It eventually states that Pakistan needs to follow a streamlined, risk-based regulation approach to the expansion of this sector that does not throttle innovations or inclusion.

Understanding Shadow Banking: A Global and Local Perspective

Shadow banking as a concept more generally applies to credit intermediation done by other institutions and instruments that are not part of the normal banking system.[4] Such are hedge funds, money market mutual funds, peer-to-peer (P2P) lenders, micro Finance institutions,

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[1] "Sr458," n.d.

[2] Ahmed Khalid et al., "Shadow Banks in Pakistan: The Risky Underbelly of Finance," *Journal of Business and Management Research* 3, no. 1 (March 12, 2024): 393–98.

[3] "The Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules) (Updated till Sept 27, 2022) – SECP," accessed July 10, 2025, https://www.secp.gov.pk/document/the-non-banking-finance-companies-establishment-and-regulation-rules-2003-updated-till-sept-27-2022/.

[4] "When Billions Meet Trillions: Impact Investing and Shadow Banking in Pakistan: Review of International Political Economy: Vol 26, No 3," accessed July 10, 2025, https://www.tandfonline.com/doi/abs/10.1080/09692290.2019.1608842.

fintech platforms, and other non-bank financial intermediaries that render services almost like those of traditional banks but rendered without such level of prudential control, as the banks.[5] Although the term might have negative implications owing to its links with the 2007-2008 global financial crisis, shadow banking is also important in terms of accessibility to credit and financial innovation.

The Financial Stability Board (FSB) at a global level has defined shadow banking to be the intermediation of credit to organizations and activities carried outside the normal banking system.[6] Recent estimates by the FSB reveal that in certain jurisdictions, the shadow banking industry (more technically, non-bank financial intermediation, or NBFI) comprises more than 50 per cent of the total financial assets in some jurisdictions.[7] Assessment As jurisdictions like China and the European Union have been experiencing great growth in this industry, regulation attention has been paid to systemic risk, protection of investor and integrity of the market.

Shadow banking has been developed in Pakistan as an alternative to the formal system of banking as there are disparities in the accessibility of formal banking especially in the rural and low-income urban centers. In the case of strict requirements, aversion to risk by traditional banks has led to the spread of informal lending circles, rotating credit associations (popularly referred to as committees), unregistered microfinance operators, cooperative societies, and online lending apps.[8] Lack of legal body to supervise these entities has enabled them to act with little or no control, which leads to the question of high interest rates, unsound loan recovery approaches, misuse of information, and fraud.

The State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) have attempted to extend some regulatory reach to microfinance and fintech sectors, but much of the shadow banking activity remains under the radar.[9] Unlike in developed economies where shadow banking largely involves sophisticated financial instruments, in Pakistan, it tends to manifest in more informal, community-based or tech-driven lending arrangements, thereby creating a distinct set of regulatory challenges that require localized legal solutions.

Legal and Regulatory Framework in Pakistan

The regulation of financial institutions in Pakistan is primarily bifurcated between the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP). While traditional banks and licensed microfinance institutions (MFIs) fall under the purview of the SBP, the SECP regulates non-banking financial companies (NBFCs), insurance companies, and capital markets. However, this institutional division leaves a significant regulatory vacuum for shadow banking entities that do not fit neatly into either category.[10]

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[5] Rustom M. Irani et al., "The Rise of Shadow Banking: Evidence from Capital Regulation," *The Review of Financial Studies* 34, no. 5 (2021): 2181–2235.

[6] "Regulation of Shadow Banks and Its Implication for Financial Stability in Emerging Economies | SpringerLink," accessed July 10, 2025, https://link.springer.com/chapter/10.1007/978-3-031-86224-3_9.

[7] "Global Monitoring Report on Non-Bank Financial Intermediation 2023 - Financial Stability Board," accessed July 10, 2025, https://www.fsb.org/2023/12/global-monitoring-report-on-non-bank-financial-intermediation-2023/.

[8] "Factors Influencing Informal Credit Access and Utilization among Smallholder Farmers: Insights from Mountainous Regions of Pakistan," accessed July 10, 2025, https://www.mdpi.com/2077-0472/14/10/1764.

[9] "Circular 8 of 2024 – Guidelines for NBFCs, Engaged in Digital Lending – SECP," accessed July 10, 2025, https://www.secp.gov.pk/document/circular-8-of-2024-guidelines-for-nbfcs-engaged-in-digital-lending-2/.

[10] "Financial Sector Assessment Program (FSAP)," accessed July 10, 2025, https://www.imf.org/en/Publications/fssa.

The Banking Companies Ordinance 1962, the SBP Act 1956, and related prudential regulations form the core of Pakistan's formal banking legal structure. These instruments establish licensing requirements, capital adequacy standards, risk management practices, and consumer protection norms for conventional banks. Microfinance banks (MFBs), introduced as part of the Microfinance Ordinance 2001, are also regulated by the SBP. However, this legal architecture does not extend to informal or semi-formal lenders, cooperative credit societies, or digital-only lending apps operating without licenses.[11]

The SECP, under the Companies Act 2017 and NBFC Regulations, oversees a range of financial service providers, including leasing companies, investment advisory firms, and mutual funds. In recent years, the SECP has tried to bring some structure to digital financial services by introducing regulatory sandboxes and publishing Digital Lending Guidelines (2023) to curb exploitative practices by mobile lending apps. Yet, many platforms continue to operate outside the regulatory perimeter by exploiting definitional loopholes or using overseas corporate shells.[12]

Cooperative societies, often implicated in fraudulent lending and savings schemes, are governed by provincial laws such as the Punjab Cooperative Societies Act, 1925. These laws are outdated, inconsistently enforced, and often administered by under-resourced registrars.[13] As a result, thousands of informal cooperatives operate without meaningful oversight, posing significant risks to consumers and the financial system.

In addition, anti-money laundering (AML) laws, including the Anti-Money Laundering Act 2010, create another control level on money conditions. But this is mostly enforced on structures that are registered officially. Unregulated lenders, hawala networks as well as informal digital payment platforms are parts of the financial flows that remain off the AML radar thus channeling illicit financial flows and tax evasion.[14]

Essentially, the legal and regulatory approach of Pakistan to shadow banking is half-baked, reactive in character and incapable of going with the dynamically changing fashion of the industry. There is no single definition, inefficiency of the coordination among regulators, and the failure of technological monitoring that contribute to the aggravation of the problem. A unified national system that controls the shadow banks in a logical manner to safeguard financial consumers as well as maintain integrity and avoid systemic risks is desperately needed.

Risks and Consequences of Shadow Banking

Although shadow banking in Pakistan has led to the provision of financial inclusion services-which has been quite significant especially to the poor and small firms, it has very grave legal, economic and systemic risks. All these are risks that are largely brought about by the lack of

[11] "(PDF) Micro Financing in Pakistan: A Historical Study Micro Financing in Pakistan: A Historical Study," accessed July 10, 2025, https://www.researchgate.net/publication/387541304_Micro_Financing_in_Pakistan_A_Historical_Study_Micro_Financing_in_Pakistan_A_Historical_Study.

[12] "Circular No. 03 of 2023 – Requirements for NBFC Relating to Digital Lending – SECP," accessed July 10, 2025, https://www.secp.gov.pk/document/circular-no-03-of-2023-requirements-for-nbfc-relating-to-digital-lending/.

[13] "Legal Framework | Cooperatives," accessed July 10, 2025, https://cooperatives.punjab.gov.pk/legal_framework.

[14] "Follow-up Report to Pakistan's Assessment of Anti-Money Laundering and Counter-Terrorist Financing Measures," accessed July 10, 2025, https://www.fatf-gafi.org/en/publications/Mutualevaluations/Fur-pakistan-2021.html.

regulation, system of consumer protection and uncontrolled growth of credit made possible by the use of shadowy channels.[15]

Consumer Exploitation and Lack of Legal Recourse

The misuse of the consumer is one of the most important issues. Unrestricted lenders usually charge very high-interest rates, fees, and aggressive collection wrangles. As an example, many lending apps entice mobile users with quick loans and little documentation, only to get them into debt traps, hijacking financial data and other sensitive information, and enslaving borrowers with confusing terms, similar to the recent story of the lending app Lend Earnings.[16] These entities are not licensed and monitored, thus they tend to avoid required norms of disclosures, dispute resolutions or data protection. There is no legal redress whatsoever (or, at least, very little), victims of such practices may resort to, since such entities are not subject to traditional consumer protection acts or banking laws.

Systemic Financial Risk

Regulators cannot rely on the shadow banking system to make appropriate decisions about credit exposure, default rates or risk accumulation because of lack of transparency characteristic of the shadow banking system. Without capital adequacy requirements or prudential norms, the institutions may increase the systemic risk by using excessive leverage, taking unbalanced maturity structures, or by use of risky off-balance-sheet lending.[17] In a time of financial turmoil, insolvency of one or several of the key shadow lenders may have domino effects to the financial system particularly in an economy as the developing country of Pakistan, whose financial health has been weak.

Fraud and Financial Crime

Shadow banking is also unregulated and thus creates a good breeding ground of frauds, Ponzi schemes and other illegal financial activities. Fraudulent cooperative societies or unlicensed investment companies that claim abnormally high returns have in many occasions led to big losses on behalf of unsuspecting persons.[18] Moreover, loans that are handled in an informal setting and cash-based activities exist mostly outside of the oversights of anti-money laundering (AML) and counter-terrorism financing (CTF) processes, establishing law enforcement blind spots that can be abused to further illicit activities.

Regulatory Arbitrage

One of the most dangerous effects of the shadow banking system is the aspect of regulatory arbitrage, where regulated businesses figure out ways in which their operations may be structured so as to escape regulation by taking advantage of the overlapping or ambiguous jurisdictions. As an example, a fintech lender can receive an exemption on SBP licensing by posing as a technology company as opposed to a financial institution in order to evade the scrutiny of

[15] "Follow-up Report to Pakistan's Assessment of Anti-Money Laundering and Counter-Terrorist Financing Measures."

[16] Jonathan Fu and Mrinal Mishra, "Combatting Fraudulent and Predatory Fintech Apps with Machine Learning," *IPA Policy Brief*, 2022.

[17] Asunción Alonso et al., "Basel Core Principles for Effective Banking Supervision: An Update after a Decade of Experience," *Financial Stability Review* 46 (2024).

[18] Samia Maqbool Niazi, "Investment Policies in Pakistan: A Critical Analysis of Investor Protection under Securities and Exchange Commission of Pakistan," *Journal of Law & Social Studies (JLSS)* 5, no. 3 (n.d.): 564–73.

banking regulations.[19] Not only does it deprive the regulator of credibility but also introduces unfair competition to the licensed financial institutions, whose standards of compliance present an extra requirement.

Erosion of Public Trust

The more of the consumers become victims of fraud or manipulation on the part of shadow banks, the less may be people trusting financial institutions as a whole. Such a loss of trust may not only discourage financial engagement, particularly among tentative populations already at large, but also it may impede more ambitious programs of financial inclusion and literacy.[20] Shadow banking activity without any controls can lead to two parallel systems of payment, one formal, controlled and the other informal, murderous, with nothing in common in their principles and implications in the behavior of users.

Comparative Legal Approaches: India, European Union, and China

Some of these jurisdictions have implemented more serviceable legal and regulatory measures in controlling, monitoring and integrating the non-bank credit intermediation into the overall financial system in dealing with the challenges posed by shadow banking. Pakistan has the shadow banking less regulated, and a comparative analysis of the same in India, European Union (EU) and in China can help to define the situation in Pakistan.

India: Gradual Formalization and Sector-Specific Regulation

The Indian perspective on shadow banking approaches it in terms of Non-Banking Financial Companies (NBFCs) regulation given by the Reserve Bank of India (RBI) through the RBI Act, 1934. RBI has followed the four-tier scale-based regulation of the NBFCs and the regulation is proportional depending on size, risk, and interconnectedness.[21] NBFCs have to comply with capital requirement, inspection, disclosure standards and limit on lending exposure.

Moreover, India has brought on certain targeted measures against apprehension of digital lending. RBI guided the Digital Lending under the Guidelines (2022) by limiting loan disbursals to regulated entities, blocking unauthorized access to phone information of users and making the application of lending- initially to be registered with the central bank.[22] Such measures have drastically reduced predatory lending activities and enabled the catering of the legitimate fintech companies to prevail in the open legal framework.

European Union: Prudential Oversight and Risk-Based Supervision

The policy of EU towards shadow banking fits the larger context of the Capital Requirement Directive (CRD) and the Alternative Investment Fund Managers Directive (AIFMD). The motive behind such regulations is to govern the systemic risks same are caused by non-bank financial

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[19] Afrasiab Ahmed Rana, Fiza Zulfiqar, and Salman Masud, "The Legal and Regulatory Framework for Cryptocurrency and Fintech in Pakistan: Challenges and Policy Recommendations," *UCP Journal of Law & Legal Education* 2, no. 1 (2023): 01–27.

[20] Bashir Ahmed et al., "Cryptocurrency and Traditional Financial Systems: Exploring the Impact of Cryptocurrencies on Traditional Banking Systems, Financial Regulations, and Monetary Policies," *International Journal of Business and Management Sciences* 6, no. 1 (2025): 587–609.

[21] Maxwell Sutton, "The Indian Banking System," *1. Which Firms Drive Business Investment? New Evidence on the Firm-Size 1 Distribution 2. 12 Why Are Investment Hurdle Rates So Sticky? 3. 21 Do RBA School Talks Improve Student Outcomes? 4. 33 The Central Bank's First Economist*, 2021, 65.

[22] Alka Vaidya, "Digital Lending in India," *INDIA BANKING AND FINANCE REPORT 2024*, n.d., 163.

intermediaries, in the form of capital, liquidity and reporting requirements.[23] The European Systemic Risk Board (ESRB) and European Banking Authority (EBA) are the key actors in the macro prudential regulation including developing threats to shadow banking institutions.

EU has also pursued legal action to address regulatory arbitrage, especially by setting up the operations of investment vehicles and money market funds to take place under bank-like prudential standards.[24] The framework based on the passporting and centralized licensing regimes of EU, will lead to uniformity of standards applicable across member states and to more effective enforcement of shadow banking activities in cross border transactions.

China: Aggressive Crackdown and Tight Control

The case example of China depicts more interventionist practice. The shadow banking extended its operation to include wealth management products, trust companies as well as peer-to-peer (P2P) systems, and it used to be one of the largest in the world. The Chinese regulators initiated a systemic crackdown of frauds that started as early as in 2017, after a series of high-profile cases and growing debt bubbles.

The People Bank of China (PBOC) and the China Banking and Insurance regulatory commission (CBIRC) put limits on off-balance-sheet lending system, prohibited risky financial instruments, and closed thousands of unlicensed online lending websites.[25] New regulations limited P2P platform to gathering deposits of the public and all business activities needed to be disclosed. Though this has minimized risk, critics say that it could have had the effects of reducing innovation and growth of credit in the private sector.[26]

Lessons for Pakistan

- These comparative examples stress some regulatory measures that Pakistan can adopt:
- The risk-tiered NBFC model in India provides an expanding model of regulating various financial players.
- The EU cross border coordination, disclosure standards, may enhance transparency and investor confidence.
- The decisiveness of the decision by China bears witness to the effectiveness of regulatory capability and willingness in reducing systemic risk.

Pakistan's current patchwork of legal instruments is insufficient to tackle the complex and evolving nature of shadow banking. A hybrid approach that balances innovation with accountability, access with security, and flexibility with enforcement is essential.

Gaps in Pakistani Law and Regulatory Oversight

Despite some regulatory developments, Pakistan's legal framework remains fundamentally inadequate to address the complexities and risks associated with shadow banking. The system is marked by fragmentation, outdated laws, weak enforcement capacity, and a lack of institutional coordination, creating significant gaps that allow shadow banking entities to thrive outside the law.

[23] Farina Casselmann, "Financial Services Regulation in the Wake of the Crisis: The Capital Requirements Directive IV and the Capital Requirements Regulation" (Working Paper, 2013).

[24] Eddy Wymeersch, "Shadow Banking and Systemic Risk," 2017.

[25] Ding Chen et al., "Too Much Technology and Too Little Regulation? The Spectacular Demise of P2P Lending in China," *Accounting, Economics, and Law: A Convivium*, no. 0 (2021).

[26] Bo Jiang, "The Real Effect of Shadow Banking Regulation: Evidence from China," *Emerging Markets Review* 59, no. C (2024), https://ideas.repec.org//a/eee/ememar/v59y2024ics1566014123000924.html.

Absence of a Unified Legal Definition

One of the most basic but critical gaps is the lack of a legal definition of "shadow banking" in Pakistan's financial legislation. While international organizations such as the Financial Stability Board (FSB) provide standardized terminology, no Pakistani law or regulatory guideline expressly recognizes or defines shadow banking entities.[27] This omission has profound implications: regulators cannot impose sector-wide rules or monitor activities without clearly knowing who falls within the regulatory net.

Jurisdictional Overlap and Fragmentation

Regulatory oversight of financial services in Pakistan is split between the State Bank of Pakistan (SBP), the Securities and Exchange Commission of Pakistan (SECP), and various provincial cooperative departments, none of which coordinate systematically. This lack of inter-agency cooperation leads to regulatory arbitrage and institutional loopholes that allow unregistered or hybrid financial entities to evade detection.[28] In many cases, entities choose to register under the least regulated framework—or not register at all.

Inadequate Oversight of Digital Financial Services

The rapid emergence of fintech lenders and mobile-based loan apps has far outpaced regulatory adaptation. While the SECP's 2023 Digital Lending Guidelines are a positive step, enforcement remains weak, and many foreign or shell-operated apps continue to exploit users.[29] These platforms often fail to disclose terms transparently, misuse personal data, and lack redress mechanisms. Moreover, current data protection laws are insufficient to protect users from algorithmic manipulation or exploitative data harvesting.

Neglected Cooperative Societies Sector

Thousands of **cooperative credit societies** operate across Pakistan, particularly in rural areas. These societies are governed by provincial cooperative laws that are decades old, poorly enforced, and riddled with ambiguity.[30] In many instances, fraudulent cooperatives have collected deposits from the public and disappeared, with little to no legal consequences. The lack of licensing, capital adequacy, auditing requirements, or consumer safeguards leaves investors dangerously exposed.

Weak Consumer Protection Framework

Pakistan lacks a dedicated financial consumer protection law. While the SBP and SECP have some grievance redress mechanisms, these are institution-specific and ineffective against unregistered or cross-sectoral entities.[31] Victims of shadow banking abuses have no clear legal path to compensation, and the civil court system is often too slow and expensive for small-scale financial disputes. As a result, regulatory inaction has allowed rogue lenders to operate with near impunity.

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[27] "Global Monitoring Report on Non-Bank Financial Intermediation 2023 - Financial Stability Board," accessed July 10, 2025, https://www.fsb.org/2023/12/global-monitoring-report-on-non-bank-financial-intermediation-2023/.

[28] "Pakistan and the IMF," accessed July 10, 2025, https://www.imf.org/en/Countries/PAK.

[29] "Circular 8 of 2024 – Guidelines for NBFCs, Engaged in Digital Lending – SECP," accessed July 10, 2025, https://www.secp.gov.pk/document/circular-8-of-2024-guidelines-for-nbfcs-engaged-in-digital-lending-2/.

[30] Ayat Ullah et al., "Factors Influencing Informal Credit Access and Utilization among Smallholder Farmers: Insights from Mountainous Regions of Pakistan," *Agriculture* 14, no. 10 (2024): 1764.

[31] "State Bank of Pakistan," accessed July 10, 2025, https://www.sbp.org.pk/whatnew/whatsnew.asp.

In sum, the regulatory infrastructure in Pakistan is reactive rather than preventive, allowing shadow banking to expand unchecked. Unless these structural gaps are addressed through legal reforms, inter-agency coordination, and stronger enforcement, Pakistan risks facing a full-blown financial crisis rooted in unregulated credit markets.

Recommendations for Legal Reform

Given the systemic, legal, and consumer risks posed by shadow banking in Pakistan, it is imperative to adopt a multi-pronged reform strategy. Effective regulation must strike a careful balance between enabling financial inclusion and ensuring legal accountability. Drawing on comparative models and local realities, the following recommendations are proposed:

Enact a Comprehensive Shadow Banking Regulation Law

Pakistan urgently needs a dedicated legislative framework that explicitly defines and regulates shadow banking activities. Such a law should:

- Clearly define the scope of "shadow banking" in line with Financial Stability Board (FSB) standards.[32]
- Establish licensing and registration requirements for all non-bank credit providers.
- Impose capital adequacy, transparency, and reporting obligations similar to those applicable to formal financial institutions.
- Create a mechanism for cross-agency oversight to prevent regulatory arbitrage.

This framework should be embedded within Pakistan's financial sector strategy and harmonized across the SBP, SECP, and provincial cooperative registrars to avoid jurisdictional confusion.

Strengthen Regulatory Coordination and Enforcement

A central regulatory coordination body—possibly modeled after India's Financial Stability and Development Council—should be established to ensure collaboration between the SBP, SECP, FIA, and tax authorities.[33] Regular information-sharing protocols, unified audit mechanisms, and joint enforcement actions would allow for better surveillance and crisis prevention.

In addition, regulators must invest in technology-enabled supervision (RegTech) to monitor high-volume digital lending platforms and detect illicit activity in real time.

Regulate Digital Lending and Fintech Entities

Although the Digital Lending Guidelines (2023) provided by SECP are a step in the right direction, it needs to:

- Formalized, making them rules that are to be adhered to with consequences of non-adherence.
- Extended to cover cross border lending apps, detecting through IP based mechanisms and international app stores partnered.
- With ward a detailed data security regulation to avoid abusing the data of borrowers and safeguard the privacy of customers.

The startups in Fintech ought to be incited to enroll in a regulatory sandbox framework whose innovation is tolerated on a risk-tested level.

[32] Kehinde Damilola Ilesanmi, "Regulation of Shadow Banks and Its Implication for Financial Stability in Emerging Economies," in *Shadow Banking and Financial Risk in Emerging and Developing Markets: The Growth and Development of Non-Bank Financial Intermediation* (Springer, 2025), 233–52.

[33] SANJAY MALHOTRA, "RBI's Financial Stability Report.," *Finance India* 38, no. 4 (2024).

Reform Cooperative Societies Law

The provincial laws covering the cooperative societies, most of which date to 1925 need a serious overhaul.[34] New legislation should:

- Create some form of compulsory licensing and regular audits to financial cooperatives.
- Ban taking of deposits without a regulatory license.
- Develop criminal punishments against embezzlement and financial fraud.
- strategically put cooperative credit societies under the supervision of SECP or SBP, with proper boundaries of jurisdiction.

Establish a Financial Consumer Protection Authority

Pakistan needs to form a free standing Financial Consumer Protection Authority (FCPA), whose mandate should be:

- Probe complaints against all the financial entities including the unregistered entities.
- Carry out financial literacy campaigns aimed at recognizing and circumventing trap in shadow banking.
- Keep a black list of non-licensed lenders, available publicly and incorporated in telecom/app channels.[35]

The power to mediate disputes, to grant compensation and penalize the offender should also be given to this authority and relieve civil courts of excessive pressure.

Normalizing such reforms is one way Pakistan can bridge the gap between a fragmented, reactive and dysfunctional regulatory system and achieving a coherent and future-proof legal system. It is not that, but to integrate shadow banking into the formal financial architecture so that the benefits can be maximized and the risks intermediate.

Conclusion

Shadow banking in the Pakistani market is a paradox. On the one hand, it seizes the most important niche in the financial system and provides credit to people and companies outside the official banking systems. Conversely, its unregulated qualities (which in many cases are non-transparent) put the economy at risk of systemic risks, exploitation of consumers, and vulnerability in financial terms. As the shadow banking sector becomes increasingly complex, especially using digital platforms and non-traditional intermediaries, the regulatory and legal framework of Pakistan has not been able to evolve even at the same pace as shadow banking has evolved.

This paper has also shown that multi-jurisdiction, obsolete regulation and poor enforcement powers are the features defining the legal vacuum in which shadow banking industry operates in Pakistan. The regulatory arbitrage and abuse have taken place because of a lack of a comprehensive legal definition as well as coordination between the SBP, SECP and the provincial governments. This has opened gaps to actors in the shadow banking industry who can get away easily through coercive mobile lending applications to fraudulent cooperative societies and hurt the collective confidence of the people in financial systems and consumer safety.

Indian and EU comparative experiences as well as the experience of China demonstrate how a risk-based, tiered and coordinated regime may enable regulation of the shadow banking without

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[34] "The Cooperative Societies Act, 1925," accessed July 10, 2025, http://punjablaws.gov.pk/laws/32.html.

[35] Carolina Guerini, Donato Masciandaro, and Alessia Papini, "Literacy and Financial Education: Private Providers, Public Certification and Political Preferences," *Italian Economic Journal*, 2024, 1–52.

inhibiting innovation. The example of scale-based regulation of NBFCs in India, strong prudential regulation in EU, and China with its stringent presence in the regulatory control of digital lending are good lessons to take from in Pakistan. Nevertheless, these lessons will have to be translated according to the socio-economic, institutional, and legal facts of the Pakistani financial environment.

In order to avert the emergence of shadow banking as a systemic threat, Pakistan needs to make bold legislative and institutional initiatives. It is important to strike a delicate balance between financial inclusion and adherence to law by means of developing an extensive Shadow Banking Regulation Law, reformation of archaic cooperative legislature, stimulating a central financial consumer protection agency, and overhauling digital lending regulations. Moreover, a cross-sector regulatory coordinating body should be developed, in order to seal the jurisdictional gap and establish a logical approach to the national financial strategy.

Increased availability of credit is not the only variable auguring well with the future of the financial system of Pakistan but also its accessibility as being safe, fair, and having legal protection. The complete elimination of shadow banking is impossible (not to mention that it should not be, as integration is what is needed), but must instead be allowed to form part of the formal financial system evidence-based regulation, and diligent enforcement, coupled with the process of policymaking is needed. Pakistan can then make good use of financial innovation, provided that there is protection of economic stability and the rule of law.

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Ahmed, Bashir, Ayesha Abrar, Mohsin Ullah, Muhammad Nouman Dawood, and Maria Waheed. “Cryptocurrency and Traditional Financial Systems: Exploring the Impact of Cryptocurrencies on Traditional Banking Systems, Financial Regulations, and Monetary Policies.” *International Journal of Business and Management Sciences* 6, no. 1 (2025): 587–609.

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