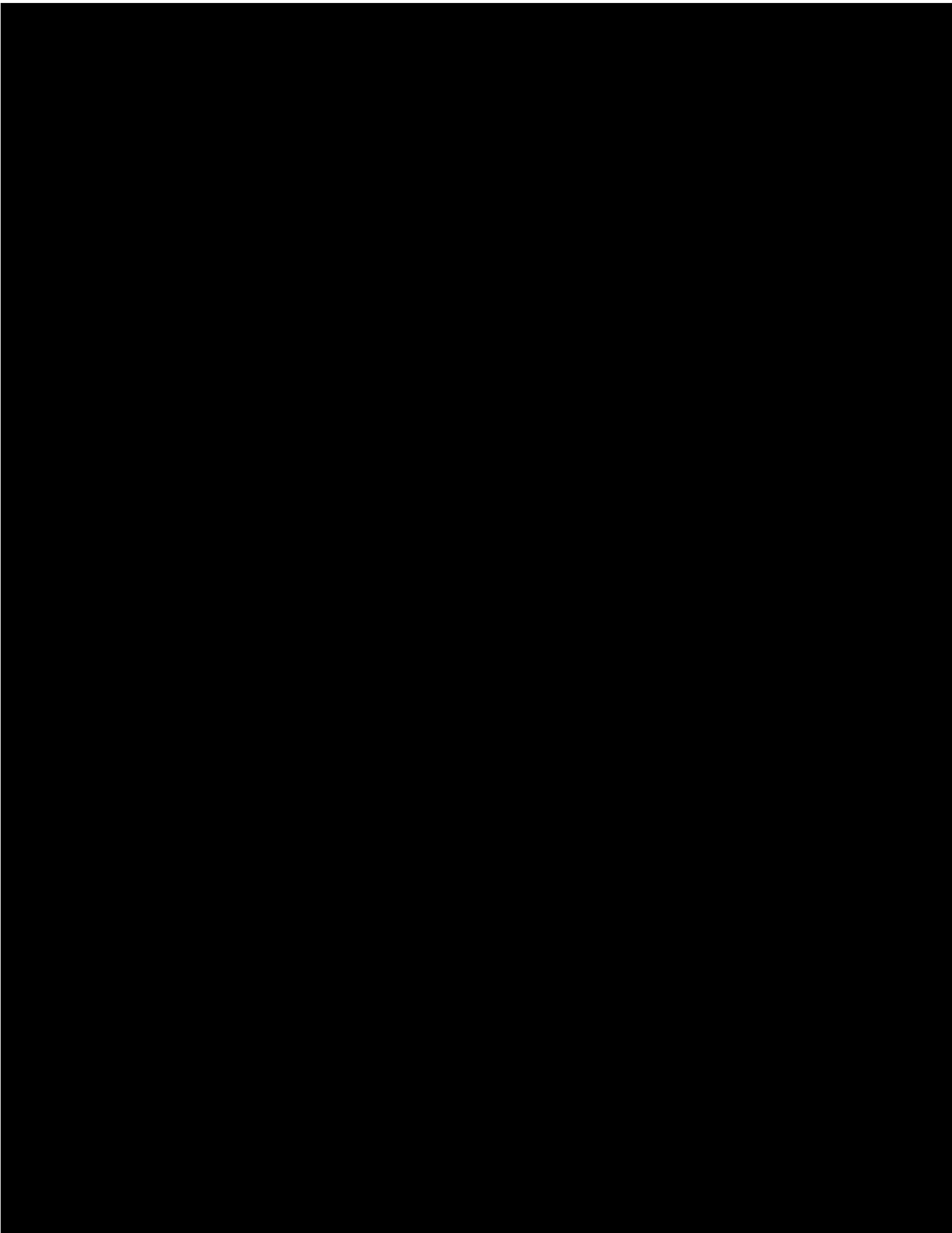

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Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)

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ABSTRACT

The money laundering (ML) and terrorist financing (TF) risks associated with conventional finance are generally well identified and understood by the relevant national authorities. There is, however, no common understanding of ML/TF risks associated with Islamic finance. Some are likely to be the same as in conventional finance, but there may also be different risks. This is notably due to: (i) the complexity of some Islamic finance products; and (ii) the nature of the relationship between the institutions and their clients. The limited capacity and experience in the supervision of Islamic finance, especially in jurisdictions that face higher ML/TF risk factors represents an additional vulnerability. The Financial Action Task Force (FATF) standards are implemented without any form of tailoring to the specificities of Islamic finance. The FATF, the Islamic finance standard-setters, and the national regulators should seek a greater understanding of the specific ML/TF risks that may arise in Islamic finance and develop an appropriate response.

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I. INTRODUCTION

1. **Following a peak in interest post 9/11, relatively little critical attention has been devoted so far to the study of money laundering and terrorist financing (ML/TF) risks in Islamic finance.** ML, TF and the related predicate crimes[1] create financial flows that may threaten a country's financial stability and macroeconomic performance. These include risks to the soundness and stability of financial institutions, including Islamic finance institutions, and of financial systems, increased volatility of international capital flows, and a dampening effect on foreign direct investment. The ML/TF problem is global; money launderers and terrorist financiers exploit loopholes and differences in national AML/CFT systems and move their funds to or through jurisdictions with weak or ineffective legal and institutional frameworks.[2] Similar to conventional finance, Islamic finance, which has been growing at a fast pace for some time, is not immune to ML and TF risks.

2. **This note examines the potential ML/TF risks specific to Islamic finance and the potential applicability and adequacy of the international standard to it.** More specifically, the note explores the differences between Islamic and conventional finance and the potential implications of these differences for the design of AML/CFT regimes. The note: (i) reviews the key characteristics of Islamic financial institutions and products; (ii) discusses what ML/TF is and how the FATF[3] standards address it; (iii) examines whether there are ML/TF risks specific to Islamic finance; (iv) considers the applicability of the FATF standards to Islamic finance and the potential implementation challenges; and (v) concludes with policy recommendations.

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[1] Predicate crimes are the underlying crimes that give rise to money laundering. Traditionally, the most important of these crimes was considered to be narcotics trafficking. As the 1990s progressed, however, the increasing recognition of the significance of the proceeds generated by non-drug-related crimes led to the designation of such crimes as predicates to money laundering. The FATF standards designate the following categories of offenses as predicate offenses to money laundering: participation in an organized criminal group and racketeering; terrorism, including terrorist financing; trafficking in human beings and migrant smuggling; sexual exploitation, including sexual exploitation of children; illicit trafficking in narcotic drugs and psychotropic substances; illicit arms trafficking; illicit trafficking in stolen and other goods; corruption and bribery; fraud; counterfeiting currency; counterfeiting and piracy of products; environmental crime; murder, grievous bodily injury; kidnapping, illegal restraint and hostage-taking; robbery or theft; smuggling; (including in relation to customs and excise duties and taxes); tax crimes (related to direct taxes and indirect taxes); extortion; forgery; piracy; and insider trading and market manipulation.

[2] http://www.imf.org/external/np/leg/amlcft/eng/aml1.htm

[3] The Financial Action Task Force (FATF) is an inter-governmental body whose objectives are to set standards and promote effective implementation of legal, regulatory and operational measures for combating ML, TF, and other related threats to the integrity of the international financial system. The FATF is a policy-making body that works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas. It has developed a series of Recommendations that are recognized as the international standards for combating of ML, TF and proliferation of weapons of mass destruction. They form the basis for a coordinated response to these threats to the integrity of the financial system and help ensure a level playing field. www.fatf-gafi.org

3. **The main principle of Islamic finance, i.e., finance that is consistent with the principles of Shari'ah, is its adherence to "Riba" (usury)[4]-free financial transactions.** Other principles are: risk sharing, prohibition of excessive uncertainty and short sales, and the recognition that money does not have an inherent value in itself. Furthermore, Shari'ah prohibits investing in businesses that provide goods or services considered forbidden (Haram), such as tobacco and other drugs, alcohol, pork products, gambling, speculation, pornography, and armaments and destructive weapons. Based on these principles, Islamic financial products are designed to facilitate financing according to Islamic norms.[5]

4. **Islamic finance is a fast growing global phenomenon.** Institutions offering Islamic financial services are present in more than 70 jurisdictions around the world. As of October 2014, there were nearly 400 Islamic banking institutions[6] worldwide with assets estimated to have reached more than US$1.4 trillion.[7] The assets of Islamic financial institutions are currently concentrated in the Middle East (i.e., mostly in Iran and member countries of the Gulf Cooperation Council[8]) and in Southeast Asia (mainly in Malaysia) and constitute a small but growing sector of the overall financial industry. While sukuk and other Shari'ah–compliant financial assets continue to grow, Islamic banks dominate the Islamic financial industry. Banking assets currently account for about 80 percent of total assets of the industry.[9] Except in Iran and Sudan, Islamic banks operate side by side with conventional banks, fostering competition in the banking industry.

5. **There is no evidence that the ML/TF risks in Islamic finance are any different from those posed by conventional finance.** Rather, the choice of conventional or Islamic financial institutions to launder the proceeds of crimes or finance terrorism would appear to be dictated by

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[4] This does not mean that there is no capital cost but rather that the focus is on the cost of the underlying asset or project.

[5] The main products include: *Murabahah* (deferred payment sale transaction), *Mudarabah* (profit-sharing and loss-bearing financing), *Musharakah* (profit-and-loss sharing partnership), *Ijarah* (sale of the right to use an asset for a period of time), *Salam* (forward financing against future delivery), *Istisna* (contract in which a commodity can be transacted before it comes into existence). Sukuk financing (Islamic alternative to conventional bonds, which grants the investor a share of an asset, along with the commensurate cash flows and risk) constitutes partial ownership in assets financed according to one or mix of these modalities. Islamic financial institutions have developed other hybrid financial contracts based on these traditional instruments.

[6] http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,contentMDK:23492074~pagePK:64168182~piPK:64168060~theSitePK:8816097,00.html. Nearly 70 percent are "standalone" Islamic banks, while the remaining 30 percent are conventional banks offering Islamic banking services through "windows".

[7] Islamic Financial Services Board Stability Report, 2015.

[8] The Cooperation Council for the Arab States of the Gulf, known as the Gulf Cooperation Council (GCC), is a regional intergovernmental political and economic union consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[9] Islamic Financial Services Board Stability Report, 2015: http://www.ifsb.org/docs/2015-05-20_IFSB%20Islamic%20Financial%20Services%20Industry%20Stability%20Report%202015_final.pdf

convenience and opportunity rather than by inherent differences between them. However, very little work has been done by the international community to develop an understanding of the specific ML/TF risks that may be posed by Islamic finance or to determine whether modifications need to be made to FATF standards to address them. The harmonization and soundness of Islamic finance practices are promoted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), respectively.[10] These organizations have not yet developed comprehensive standards or best practices related to AML/CFT[11] in the Islamic finance context. Moving forward, it will therefore be important for stakeholders within the international community to devote greater attention to these issues. This would include the Islamic finance standard-setters and the FATF, the AML/CFT standard setter.

II. WHAT IS ML/TF AND HOW DO THE FATF STANDARDS ADDRESS IT?

6. **Financial institutions (both conventional and Islamic), are vulnerable to abuse by money launderers and terrorist financiers**. Criminal activities, such as drug trafficking, smuggling, human trafficking, and corruption among others, tend to generate large amounts of proceeds. *Money laundering* is the process by which the illicit sources of assets obtained or generated by a criminal activity are concealed to obscure the link between the funds and the original criminal activity. *Terrorist financing* involves the solicitation, collection or provision of funds with the intention that they may be used to support terrorist acts or terrorist individuals or organizations. Funds used for the purposes of financing terrorism may stem from legal and/or illicit sources. In order to mitigate the risk of misuse by money launderers or terrorist financiers, it is essential that financial institutions adopt and implement adequate controls and procedures that enable them to know the person(s) with whom they are dealing. Adequate customer due diligence (CDD) on new and existing customers is a key part of such controls.

7. **The FATF and other key stakeholders[12] place CDD and other so-called preventive measures at the heart of an effective AML/CFT framework.** Effective CDD requires: (i) the identification of a customer and/or beneficial owner;[13] (ii) the verification of the identity of the

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[10] The AAOIFI is an Islamic international autonomous non-for-profit body that issues accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and the industry www.aaoifi.com. The IFSB is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues and organizes roundtables, seminars and conferences for regulators and industry stakeholders www.ifsb.com.

[11] The IFSB has published in April 2015 its Standard-17 (Core Principles for Islamic Finance Regulation - CPIFR) which addresses under CPIFR 33 the abuse of financial services for criminal activities, including ML/TF. In this respect, the CPIFR 33 retains the provisions of Basel Core Principle (BCP)[11] 29 unchanged.

[12] In particular, the Basel Committee on Banking Supervision (Basel Committee).

[13] *Beneficial owner* refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement.'

customer or beneficial owner; as well as (iii) an understanding and, if appropriate, the collection of information on the purpose and intended nature of the business relationship and the source of the funds; and (iv) the ongoing monitoring of the business relationship. These requirements are designed to ensure that financial institutions know the persons on whose behalf they are holding funds or conducting transactions, and to identify any potential suspicious activity. Where appropriate, financial institutions are required to report suspicious transactions to the competent authorities. Financial institutions' AML/CFT programs consist of internal policies, procedures and controls, including appropriate compliance management arrangements, and adequate screening procedures for hiring employees.

8. **While the FATF standards increasingly focus on the effectiveness of AML/CFT frameworks, the level of compliance with the standards is still relatively low.** The FATF, the FATF Style Regional Bodies (FSRBs), the IMF, and the World Bank conduct peer reviews and assessments of countries on an ongoing basis to assess the level of implementation of the FATF Recommendations. The last round of assessments revealed important weaknesses in countries' AML/CFT regimes, mainly in the areas of CFT measures, ML/TF prosecutions and convictions, implementation of preventive measures, and international cooperation.[14] In 2012, the FATF standards were revised to set a higher benchmark, focused on risk-based implementation and effectiveness. Accordingly, a new round of assessment of countries' compliance started in 2014 based on more demanding standards and assessment methodology. It has proven challenging for countries, so far, to demonstrate the effectiveness of their ML/TF risk mitigating measures.[15]

III. ARE THERE ML/TF RISKS SPECIFIC TO ISLAMIC FINANCE?

9. **Money launderers and terrorist financiers typically use any available means to minimize the likelihood of detection of their funds, their confiscation or other legal consequences.** This will be the case whether or not the financial system in which they are operating includes Islamic financial institutions. At the same time, it needs to be determined whether there are any specific features of Islamic finance that give rise to risks of money laundering or terrorist financing that are different from those presented by conventional finance. As discussed further below, there is, at present, no evidence that this is the case. Rather, the choice of conventional or Islamic finance institutions to launder the proceeds of crimes or finance terrorism would appear to be largely dictated by convenience and opportunity rather than by the nature of the financial institution or the transactions in which it engages.

10. **Any examination of the ML/TF risks posed by Islamic finance needs to take into account three important considerations:**

[14] Overall compliance by countries with the standards is still low. Of the 142 countries assessed using the methodology from 2004 to April 2011, full compliance with any principle was rare, occurring in only 12.9 percent of the cases. Eleven countries achieved the second highest score, largely compliant, only 26 percent of the time. IMF working paper, Compliance with the AML/CFT international standard: Lessons from a cross-country analysis, Concepcion Verdugo Yepes, July 2011.

[15] Previous rounds of assessments focused on technical compliance and to a limited extent on the implementation of national legal and institutional frameworks.

- **There has been very little study of the potential ML/TF risks arising from Islamic finance.** While the ML/TF risks of conventional financial sector activities have been the subject of numerous studies and publications on methods, trends, and typologies[16] prepared by FATF and FSRBs and their members,[17] there are no corresponding studies in the field of Islamic finance. No ML/TF typologies or indicators related to Islamic finance have been published by AML/CFT agencies or FSRBs, and there is no common understanding of the typologies and techniques used for ML/TF in Islamic finance. Identifying the main typologies would facilitate raising the private sector's attention to the techniques most commonly used by criminals in Islamic finance and would enable relevant governmental agencies to identify the areas of greater ML/TF risks and take appropriate mitigating measures.

- **International standards for the design of AML/CFT regimes make no special provision for Islamic finance.** Rather, the recommendations of the FATF standards apply equally to conventional and Islamic financial systems. Most countries with an Islamic finance presence have put in place AML/CFT regimes that are based on the FATF standards. They have not, however, conducted an assessment of the ML/TF risks posed by the specific features of Islamic finance, nor have they incorporated any lessons learned from these assessments into their regimes. For conventional and Islamic financial institutions alike, legislators and regulators have imposed the same requirements to identify and verify the identity of clients, conduct due diligence to verify the source of funds, and report suspicious transactions.[18]

- **The AML/CFT regimes of some countries with a strong Islamic finance presence are relatively weak.** While most of these countries have adopted legislation and regulations generally in line with the FATF Recommendations, compliance with the standards is still low. Problems with poor compliance in the relevant countries, particularly in the Middle East and North Africa, have been compounded by political threats and vulnerabilities that are independent of the specific features of Islamic finance.

11. **At the same time, there is a need for further study of Islamic finance and the potential ML/TF risks it may pose.** In particular, some specific features of Islamic finance could present vulnerabilities that require a different approach in the design of AML/CFT regimes. Areas that merit further study include: (i) the specific nature of the relationship between a financial institution and its customers; (ii) the modus operandi of Islamic financial institutions and the complexity of certain transactions; and (iii) the management of the high volume of Zakat[19] by Islamic financial institutions. It should also be noted that the limited capacity of AML/CFT supervisors combined with a weak

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[16] http://www.fatf-gafi.org/topics/methodsandtrends/

[17] Furthermore, relevant national authorities (i.e., FIUs) regularly publish reports containing ML/TF trends and methods to improve the quality of suspicious report and raise the awareness of the reporting entities

[18] Some countries (i.e., Malaysia, Oman) included some provisions related to AML/CFT preventive measures into their Islamic Banking laws based on the same standards.

[19] Zakat is intended to be a poverty reduction, income redistribution, and stabilization scheme. It is levied on those individuals whose wealth is beyond a certain exempted allowance. The wealth used for zakat purposes is broadly defined and includes cash, precious metals (such as gold and silver), animal stock (such as camels, sheep, and cows), and agricultural produce (like wheat, barley, dates, and grapes).

understanding of the specific features of Islamic finance in jurisdictions generally identified as facing higher ML/TF risks[20] represents a vulnerability that could be exploited by criminals and terrorist financiers. While there is no conclusive evidence to date to suggest that features associated with Islamic finance represent different or indeed greater actual ML/TF risks, additional work on typologies and a better understanding of these features is called for.

- ***Nature of the customer relationship -*** In Islamic finance, the specific nature of the relationship between the financial institution and its *customers* could diminish the level of transparency of the related transactions and create vulnerabilities that increase the related ML/TF risk. In principle, an Islamic financial institution has a "partner" relationship with its clients (rather than an "institution to customer" relationship) that might be seen as susceptible of introducing an additional vulnerability. First, the partnership dimension may distort the institution/client relationship from an AML/CFT perspective, and render more difficult the adequate fulfillment of obligations such as ongoing customer due diligence or suspicious transaction reporting. As a result, the effectiveness of some preventive measures' requirements such as the reporting of clients' suspicious transactions could be compromised, due to the potential conflict of interest. Second, in the event the client is a money launderer or a terrorist financier, the institution as its partner, could be considered jointly liable for ML/TF. For example, if a mudarabah investment is found to have involved illicit activities or the funding of terrorism, both partners (and not only the client) could be considered to have perpetrated the offense and be criminally liable.

- ***The complexity of Islamic finance products as a factor increasing exposure to risk–*** Money launderers and terrorist financiers often use complex products and transactions to conceal the source of the funds or their intended use. Islamic finance products are designed with an asset based feature to provide for economic intermediation, as opposed to financial intermediation for conventional finance products. This feature introduces a layer of complexity, which may render it more vulnerable to abuse by criminals. For instance, tawarruq[21] or murabaha-style commodity and asset trading are financing models in which transfers of commodities take place to back the transfer of funds, thus providing the model its Islamic legitimacy. Since tawarruq can provide quick access to funds, which can be factored against the purchase of an asset and repaid relatively quickly, it has the potential of being misused in frequent or large recycling of criminal proceeds. Further, for the purpose of creating a mechanism to deal with the underlying assets to back the operations of financial intermediation, Special Purpose Vehicles (SPV) are commonly established in offshore financial centers in connection with

[20] Countries with a higher likelihood for the generation of terrorist-related financing, or subject to TF-related sanctions, embargoes, or similar measures (issued, for example, by the United Nations), or countries identified by authoritative sources as having significant levels of corruption or other criminal activities (i.e., fraud, drug trafficking), and therefore susceptible of generating high level of proceeds of crimes that could be laundered in the financial sector (conventional and Islamic), or countries having a low level of compliance with the FATF standards.

[21] Under commodity murabahah, a customer in need of liquidity or financing arranges for an Islamic bank to buy metals for that amount on his behalf. The bank then sells the metals to the customer at a mark-up that is payable over a period of time (overnight, one month, 12 months, etc.). In turn, the client immediately sells the metals on the spot market and obtains the needed liquidity.

Islamic finance transactions, introducing in the process an additional element of complexity. Indeed, even outside of Islamic finance, SPVs are often associated with a relative lack of transparency regarding the origin and destination of the underlying assets and the opacity of their valuation.

- ***Management of high volume of Zakat and Sadaqat by Islamic finance institutions* -** Zakat and Sadaqat funds are collected on behalf of and from customers, often in large volumes, and are managed and disbursed by Islamic financial institutions. The institutions have often the discretion to designate as beneficiaries natural and legal persons, including non-profit organizations (NPOs). Such high volume of activities in the absence of sound ML/TF risk management processes can increase the exposure of banks to serious risks, especially reputational, operational, compliance and concentration risks.

IV. Are the current FATF standards applicable and adequate for Islamic finance?

12. **The FATF standards were developed mainly with the conventional financial sector in mind.** Further work is needed to determine whether they need to be modified to address the specific features of Islamic finance.

13. **Two specific features of the FATF standards would not appear to fully take into account the specific features of Islamic finance: the concept of a "customer" and the definition of a "financial institution."**

- **Definition of a "customer"** - A key element of an effective AML/CFT framework is the identification of the "customer." The concept of "customer" is not defined in the standards and its meaning is not entirely clear. In particular, it is not clear whether it applies to the types of partner-based relationship (rather than an "institution to customer" relationship) that are a key feature of Islamic finance. To the extent that such parties are not considered to be "customers," they would fall outside of the provisions of the standards requiring countries to have in place robust regimes for customer identification and due diligence. While it may be argued on the basis of the rationale for customer identification requirements that such parties should be considered to be "customers" for the purposes of the standards, it would be useful to make this explicit. It should also be clarified that the FATF standards CDD measures apply to the other party in the contractual relationship, including the partner in the type of "partnerships" used in Islamic finance.

- **Similarly, the definition of a "financial institution" included in the glossary of the FATF Recommendations does not encompass comprehensively the reality of Islamic financial institutions -** Financial institutions are defined as natural or legal persons conducting one or more financial activities (e.g., deposits, lending) listed in the glossary, which do not seem to incorporate the variety of existing Islamic finance's products and services. Moreover, the glossary defines a financial institution as acting for or on behalf of a customer, whereas Islamic financial institutions engage for or on behalf of partners.

V. Conclusion and Policy Recommendations

14. **There would appear to be no fundamental differences between ML/TF risks in Islamic and conventional finances.** FATF, FSRBs and their member countries are imposing the standards and best practices similarly on conventional and Islamic finance institutions. It is clear, however, that the issue of Islamic finance ML/TF risks requires further study.

15. **At this stage, three recommendations can be formulated:**

- *The standard setter*[22] *and regulators* should develop a better understanding of the ML/TF risks in Islamic finance, including through an enhanced dialogue with supervisors, Islamic finance institutions, and practitioners. A better understanding of the nature and scale of ML/TF risks would require a more in-depth analysis of the intrinsic characteristics of instruments and arrangements used in Islamic finance. This would require an analysis of ML/TF methods, trends, and typologies in Islamic finance and of the related risks arising from the nature of the contractual relationship between the institutions, their customers, and the providers of assets. Building on the findings of this work, customized mitigating measures to maintain the integrity of Islamic finance and safeguard the industry against ML/TF may be developed, if necessary.

- *Islamic financial institutions* should build additional experience in assessing the ML/TF risks they are facing, and in effectively implementing preventive measures tailored to the characteristics of their products and services. The lack of supervisory experience and capacity that prevails in certain countries with a strong Islamic finance presence should be addressed. As discussed in this paper, the areas that merit further attention include: (i) the specific nature of the relationship between a financial institution and its customers; (ii) the modus operandi of Islamic financial institutions and the complexity of certain transactions; and (iii) the management of the high volume of Zakat by Islamic finance institutions.

- *Assessors and competent AML/CFT authorities,* including in the context of the ongoing round of assessment of the effectiveness of AML/CFT regimes, should seek to understand whether the current recommendations set out in the FATF standards require further adaptation to mitigate any ML/TF risks that might be specific to Islamic finance.

[22] FATF, in coordination with AAOIFI, the IFSB and the relevant FSRBs.

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