



صندوق النقد العربي
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ISLAMIC FINANCIAL SERVICES BOARD

JOINT IFSB–AMF WORKING PAPER ON MONEY LAUNDERING AND FINANCING OF TERRORISM (ML/FT) RISKS IN ISLAMIC BANKING



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MONEY LAUNDERING AND FINANCING OF TERRORISM (ML/FT) RISKS IN ISLAMIC BANKING

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Note: This Joint Working Paper should not be reported as representing the views of the Islamic Financial Services Board (IFSB) and the Arab Monetary Fund (AMF). The views expressed are those of the authors and do not necessarily reflect those of the IFSB and AMF.

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ABBREVIATIONS

| | |
|----------|-------------------------------------------------------------------------|
| AAOIFI | Accounting and Auditing Organization for Islamic Financial Institutions |
| AML/CFT | Anti-money laundering and countering the financing of terrorism |
| ARS | Alternative remittance system |
| CDD | Customer due diligence |
| CIBAFI | General Council for Islamic Banks and Financial Institutions |
| ECDD | Enhanced customer due diligence |
| FATF | Financial Action Task Force |
| Fintech | Financial technology |
| IFSI | Islamic financial services industry |
| IIFS | Institutions offering Islamic financial services |
| KYC | Know your customer |
| MENAFATF | Middle East North Africa Financial Action Task Force |
| ML/FT | Money laundering and financing of terrorism |
| NGO | Non-governmental organisation |
| NPO | Non-profit organisation |
| PEP | Politically exposed persons |
| RBA | Risk-based approach |
| RSA | Regulatory and supervisory authority |
| SPE | Special purpose enterprise |
| SPV | Special purpose vehicle |
| STR | Suspicious transaction reporting |

GLOSSARY

| | |
|-----------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Islamic window | That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharī'ah-compliant – that is, with separate funds. It could also provide <i>takāful</i> or <i>retakāful</i> services. |
| <i>Muḍārabah</i> | A partnership contract between the capital provider (<i>rabb al-māl</i>) and an entrepreneur (<i>muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms. |
| <i>Murābahah</i> | A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin. |
| <i>Mushārahah</i> | A contract between the institution offering Islamic financial services and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of real estate or a movable asset, on either a temporary or a permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>mushārahah</i> agreement, while losses are shared in proportion to each partner's share of capital. |
| <i>Ṣadaqah</i> | <i>Ṣadaqah</i> has been defined as an act of giving something to somebody without seeking a substitute in return and with the intention of pleasing Allah. |
| Sharī'ah | The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (<i>ijmā'</i>), analogy (<i>qiyās</i>) and other approved sources of the Sharī'ah. |
| Sharī'ah board | An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharī'ah compliance and governance system. |
| Sharī'ah non-compliance risk | An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī'ah in its products and services. |
| <i>Ṣukūk</i> | Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant. |
| <i>Tawarruq</i> or commodity <i>murābahah</i> | A <i>murābahah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābahah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts. |
| <i>Zakāh</i> | An obligatory financial contribution disbursed to specified recipients that is prescribed by the Sharī'ah for those who possess wealth exceeding a minimum amount that is maintained in their possession for one lunar year. |

ABSTRACT

This joint working paper examines money laundering and financing of terrorism (ML/FT) methods, trends and typologies as specifically related to Islamic banking, and attempts to address whether there is any evidence that ML/FT risks in Islamic banking are indeed different from those that arise in conventional banking. The paper also analyses ML/FT risks emanating from the intrinsic characteristics of instruments and arrangements used in Islamic banking, or from the nature of the contractual relationship between Islamic banks and their customers. While reviewing existing literature, the paper also reviews the current status of anti-money laundering and countering the financing of terrorism (AML/CFT) legal and regulatory frameworks (e.g. laws, regulations, guidelines) in countries where Islamic banks operate to assess whether there is a need for further customisation of the AML/CFT requirements to the specific characteristics of Islamic banking. Finally, the paper attempts to address the measures used to prevent ML/FT risks arising in Islamic banking.

The paper discusses survey responses received from banking regulatory and supervisory authorities (RSAs). Overall, the paper does not find any significant difference in the ML/FT risks between conventional and Islamic banking. Moreover, the concerns often raised regarding the potential for Islamic social finance platforms such as *zakāh*, *waqf*, *ṣadaqah*, etc., to be used to mobilise, store and disburse funds for ML/FT is unfounded based on the survey responses.

Most respondent RSAs view that there is no merit in introducing specific regulations or preventive measures to address the ML/FT risks in Islamic banking. Since risk levels are largely similar in both conventional and Islamic banking, Islamic banks should adhere to their own country regulations and the Financial Action Task Force standards to combat ML/FT.

1. INTRODUCTION

1.1 Background

Money laundering and financing of terrorism (ML/FT) can adversely affect macroeconomic performance and, therefore, may pose significant risks to the soundness and stability of a country's financial system. This, in turn, threatens its reputation and investment climate. At the same time, while globalisation of the financial services industry and advancement of financial technology (fintech)¹ solutions and applications enhance financial inclusion, those developments are challenging to national regulatory and supervisory authorities (RSAs). For Islamic banks, technological innovation should not provide a premise that would compromise the principles of Shariah. As such, the proliferation of innovative financial products and processes due to fintech should not make Islamic banks susceptible to ML/FT activities in such a way that money launderers might use the sophisticated methods employed by financial institutions to launder illicit funds.² Such ML/FT risks make anti-money laundering and combatting the financing of terrorism (AML/CFT) a priority for international, governmental, regulatory and supervisory agencies, as well as for research institutions.

Though the terms “money laundering” and “financing of terrorism” are often conjoined, there is a clear difference in their risk processes. In the view of the Financial Action Task Force (FATF)³, money laundering is the process of disguising the illegal origin of criminal proceeds, whereas financing of terrorism is the financing of terrorist acts, and of terrorists and terrorist organisations. According to Article 6 of the UN Convention Against Transnational Organized Crime, money laundering is:

The conversion or transfer of property, knowing that such property is the proceeds of crime, for the purpose of concealing or disguising the illicit origin of the property or of helping any person who is involved in the commission of the predicate offence to evade the legal consequences of his or her action; or the concealment or disguise of the true nature, source, location, disposition, movement or ownership of or rights with respect to property, knowing that such property is the proceeds of crime.

¹ Though not given specific coverage in this paper, the value of fintech to AML/CFT is duly acknowledged, especially for enhancing digital identity as a crucial factor in the customer due diligence process to reduce fraudulent practices and improve regulatory compliance. When this working paper was commenced, the regulatory focus on reviewing the policy implications of the various fintech approaches for AML/CFT practices across countries was still ongoing.

² It is worth mentioning that FATF recommendations are recognised as the pertinent international standards for the AML/CFT Financial Action Task Force (2012–2018). *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. Paris: FATF, p. 123.

³ The Financial Action Task Force is the leading organisation that formulates global standards for AML/CFT. The FATF is mandated to develop and ensure effective implementation of legal, regulatory and operational measures to combat money laundering and terrorist financing across the diversified jurisdictions of its 38 member countries.

According to Article 2 of the the UN Convention for the Suppression of the Financing of Terrorism, financing of terrorism is defined as follows:

Any person commits an offence within the meaning of this Convention if that person by any means, directly or indirectly, unlawfully and wilfully, provides or collects funds with the intention that they should be used or in the knowledge that they are to be used, in full or in part, in order to carry out: (a) An act which constitutes an offence within the scope of and as defined in one of the treaties listed in the annex; or (b) Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.

Without prejudice to the pervasive effect of ML/FT on the global financial services industry, the banking sector is arguably the most susceptible and most affected.⁴ Money launderers use a range of banking products and services in the banking sector's interconnected system with the financial sector, both within and across jurisdictions, to transfer their illegal money.

In general, the ML/FT act is usually driven by opportunity and convenience, rather than by the nature of the financial institution or transaction. From that point, it can be argued that ML/TF is not exclusive to any specific banking system, whether conventional or Islamic. Most AML/CFT efforts in this regard, however, focus on the conventional banking system, in stark contrast to consideration of the specificities of the Islamic financial services vis-à-vis ML/FT.⁵ Notwithstanding, AML/CFT matters are also of interest to regulators, standard setters and governments of countries with a significant presence of Islamic banking.⁶

ML and FT are at variance with the essential principles of Sharī'ah, which are based on removing hardship, protecting the public interest and ensuring justice. For instance, ML can harm a society via the injection of unjust earnings from illegitimate activities and by the amplification of societal corruption upon which the perpetuation of such activities depends. Furthermore, the principle of distributive justice may be infringed upon, due to the fact that illicit economic gains from ML/FT activities may negatively disrupt the just distribution of income, allocation of assets and resources, and determination of commodity prices that are fundamental to promoting societal civility and mutual economic prosperity. To this extent, the

⁴ J. Said, E. K. Ghani, N. Omar and S. N. S. Yusuf (2013). Money Laundering Prevention Measures among Commercial Banks in Malaysia. *International Journal of Business and Social Science*, 4(5), 227–35.

⁵ N. Kyriakos-Saad, M. Vasquez, C. E. Khoury and A. E. Murr (2016). *Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)* (IMF Working Paper No. WP/16/42). Washington, D.C.: IMF.

⁶ Mutual Evaluation Reports (MUR) and Follow-Up Reports (FUR) on a few countries published by the FATF also include Islamic banking in their coverage.

Sharī'ah foundational premise upon which Islamic banking is based, and which to a large extent may have influenced the patronage intents of customers, abhors the commingling of illicit funds with legitimate funds.

The global Islamic financial services industry (IFSI) is now worth USD 2.19 trillion.⁷ The Islamic banking segment, which accounts for about 72% of the value of the total global IFSI, is present in over 60 countries of which at least 12 are of systemic significance.⁸ While there is no evidence to prove that Islamic banks pose different ML/FT risks than conventional banks, the potential for institutions offering Islamic financial services (IIFS) in general, and Islamic banks in particular, to be used as a transmission channel for ML/FT may require empirical evidence to disprove.⁹ The IFSB's *IFSI Stability Report 2016*, in addition to providing a detailed exposition of the structure of Islamic banking and its inherent AML/CFT features due to Sharī'ah provisions, nonetheless noted the lack of empirical data to validate such theoretical statements.

A number of concerns have been raised as to the susceptibility of IIFS to ML/FT.¹⁰ There were concerns based on the fact that extant international AML/CFT standards make no special provision for likely ML/FT risks emanating from the product structure and the nature of the customer relationship in Islamic finance. The 40 recommendations of the FATF address issues related to AML/CFT¹¹ from a purely conventional standpoint. It is worth mentioning that these FATF recommendations are recognised as the pertinent international standard for AML/CFT.

Further concerns were raised about whether the nature of the contractual relationship between an Islamic bank and its customer could hamper the fulfilment of AML/CFT obligations – in particular, customer due diligence and the process for reporting clients' suspicious transactions. For instance, it is likely that, in providing Sharī'ah-compliant financing, an Islamic bank based on Sharī'ah principles may have to disburse funds to parties other than its customer who is the immediate beneficiary and on whom due diligence may have been conducted. Failure to include such a third party in the due diligence process may inadvertently create an opportunity for illicit use of such funds by a fraudulent third party.¹²

⁷ Islamic Financial Services Board (2019). *Islamic Financial Services Industry Stability Report 2019*. Kuala Lumpur: IFSB.

⁸ International Monetary Fund (2017). *Ensuring Financial Stability in Countries with Islamic Banking. Country Case Studies*. IMF Country Report No. 17/145.

⁹ International Monetary Fund (2017). *Ensuring Financial Stability in Countries with Islamic Banking. Country Case Studies*. IMF Country Report No. 17/145.

¹⁰ N. Kyriakos-Saad, M. Vasquez, C. E. Khoury and A. E. Murr (2016). *Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)* (IMF Working Paper No. WP/16/42). Washington, D.C.: IMF.

¹¹ Islamic Financial Services Board (2016). *IFSI Stability Report 2016*. Kuala Lumpur: IFSB.

¹² See: Money laundering concerns in Islamic financial transactions. *IFN News*, 18 July 2012, 9(28).

Moreover, the fact that Islamic finance products are based on assets that need to be related to real economic activities or values renders the financial transaction more sophisticated, which could facilitate the hiding of ML/FT activities. This is also coupled with the special purpose vehicle (SPV) as a pass-through mechanism that is usually established in an offshore financial centre and which may imply more ambiguity and lack of transparency regarding the assets and their origins, including in an Islamic banking context.

Additionally, there were concerns about the huge volume of money collected and disbursed through the various highly unregulated Islamic social finance platforms such as *zakāh*, *waqf*, etc.,¹³ which may expose Islamic banks to operational, reputational and compliance risks.¹⁴ Without any concrete empirical evidence to the contrary, there has been at best what may be described as speculation about the vulnerability of Islamic financial institutions to ML/FT risks, due mainly to weak AML/CFT regulations and control in jurisdictions with a significant presence of Islamic banking and allied financial services.¹⁵

This working paper derives from these concerns. It takes cognisance of the fact that non-conclusive evidence may also heighten the hidden vulnerability of the IFSI to ML/FT risks. This may also lead to inefficient channelling of regulatory resources in order to provide an additional AML/CFT regime for Islamic banking when the existing FATF regimes may be sufficient. For instance, the AML/CFT regulatory laxity presupposition in jurisdictions where Islamic banking is practised is attenuated by the fact that conjectural evidence seems to suggest the contrary. Based on the latest FATF list of high-risk and other monitored jurisdictions as at October 2019, only one of the 12 jurisdictions recognised as having a systemically important¹⁶ Islamic banking sector is on the “public statement” list.¹⁷

This working paper notes that, in most jurisdictions with a significant presence of Islamic finance, commendable efforts have been made to enhance the legal, regulatory and supervisory aspects of combatting money laundering and financing terrorism. This is either by ratifying laws, issuing regulations and guidelines, or setting up financial intelligence units or money laundering units in the monetary authorities. Moreover, RSAs adopt similar monitoring processes for both conventional and Islamic banks.

¹³ Islamic Research and Training Institute (2014). *Islamic Social Finance Report 2014*. Jeddah: IRTI (Member of Islamic Development Bank), p. 10.

¹⁴ In a publication published by the Christian Concern Legal Centre, a study by Brisard (2002) was cited wherein it was claimed that Al-Qaeda received between USD 300 million and USD 500 million in charities via a *zakah* system aided by Islamic banking institutions: J-C. Brisard (2002). *Terrorism Financing: Roots and Trends of Saudi Terrorism Financing* (report prepared for the President of the Security Council, United Nations), p. 3, cited in: *What's Wrong with Islamic Finance?* UK: Christian Concern Legal Centre. www.christianconcern.com.

¹⁵ A. N. Maruf (2018). Compatibility of Islamic Finance and Anti-Money Laundering Laws: A Myth or Reality? *International Islamic University Malaysia (IIUM) Law Journal*. 26(1), p. 58.

¹⁶ Systemic importance is based on 15% market share as per the IFSB's *IFSI Stability Report 2019*.

¹⁷ A public statement is a call on a jurisdiction of the FATF to implement the requisite measures needed for AML/CFT.

Essentially, there may not seem to be a strong basis for introducing specific regulations for AML/CFT based on the nature of the operation (i.e. whether they are conventional banks, Islamic banks or Islamic windows of conventional banks), as no main difference is observed in the exposure to ML/FT risks across the banking nature divide. Thus, the FATF standards provide the framework for AML/CFT regulations and serve as a benchmark for managing AML/CFT risks across the board in the jurisdictions sampled in this paper.

The IMF, in its report,¹⁸ accentuated the need for a continuous and concerted collaboration among the standard setters, RSAs and practitioners of Islamic finance – in particular, on AML/CFT issues. A similar view was shared by the IFSB in its *IFSI Stability Report 2016* wherein a survey-based study was suggested of IFSB member jurisdictions in relation to the unique elements of IIFS's operations and developments aimed at improving their legal and supervisory infrastructure from an AML/CFT perspective. As such, based on empirics, an understanding of the peculiar AML/CFT risks in Islamic banking, as well as an assessment of the adequacy or otherwise of extant AML/CFT regimes, are imperatives.

1.2 Objective and Structure of the Paper

The main objective of this joint working paper is to elicit the views of the regulatory and supervisory authorities in those jurisdictions where Islamic banking is practised on whether there are AML/CFT risks peculiar to the contractual relationship and complex product structure in Islamic banking operations. Specifically, this research paper aims to explore the diverse risks of ML/FT activities in the banking system, and to identify if it varies between conventional and Islamic banking.

The presumed likely susceptibility of Islamic banks to ML/FT abuse through the activities of various Islamic social finance platforms such as *zakāh*, *waqf* and *ṣadaqah* is also investigated. This is in addition to investigating whether specific legislation or regulatory and supervisory frameworks are needed for the Islamic banking sector in addition to the existing provisions of the FATF standards.

The working paper is divided into five sections. Immediately following this introductory section is a brief description of the methodology used in the research. This is followed by analyses of the results obtained from the survey responses on understanding, regulating and preventing ML/FT risks in various jurisdictions. The last section presents the conclusion and recommendations.

¹⁸ International Monetary Fund (2017). *Ensuring Financial Stability in Countries with Islamic Banking, Country Case Studies*. IMF Country Report No. 17/145, p. 28.

1.3 Methodology

The working paper is based on a survey that was designed to frame the three main sections of the research paper, so that empirical evidence can support the paper's findings. The respondents to the questionnaire represent a diversified pool of RSAs, including central banks, monetary authorities, capital markets authorities, and/or regulators that govern more than one financial sector. These RSAs are located in different geographical areas around the globe, such as Africa, the Middle East and North Africa, Asia, South-East Asia, and Europe. A list of the RSAs that participated in the survey is provided as an appendix to this paper. In all, 24 RSAs provided responses to the survey, which comprised both closed-ended¹⁹ and open-ended questions.

A number of questions were posed to the RSAs relating to their understanding of ML/FT risks, the approaches they take in implementing customer due diligence, their understanding of the peculiarities of non-profit organisations (NPOs) and SPVs as possible transmission channels, the reporting of suspicious transactions (STR), etc. Analysis of the responses obtained is thus based on a regulatory and supervisory view of how money laundering and financing of terrorism are understood, regulated and prevented in the respondents' jurisdictions.

The remaining sections of this paper present a descriptive analysis of the responses to the survey questionnaire. The paper aims to identify from the survey results what (if any) ML/FT risk differences exist between the Islamic and conventional banking sectors, and whether Islamic banks have a particular need for laws or regulations to address ML/FT risks.

¹⁹ The closed-ended questions make the following assumptions: "Low" means non-compliance or non-applicability of the related AML/CFT regulations in the respective jurisdiction; "Medium" implies low compliance; "Substantial" implies significant compliance; and "High" implies full compliance.

2. UNDERSTANDING MONEY LAUNDERING / FINANCING OF TERRORISM RISKS IN ISLAMIC BANKING

This section discusses the operational framework and nature of ML/FT risks in Islamic banking, highlighting how it differs from conventional banking in terms of banking contracts and transactions. Customer relationships on a wide range of Islamic banking products and services are clarified in the discussion, which attempts to identify the potential areas of ML/FT risks in Islamic banking. This section also highlights the ML/FT risks in Islamic banking of raising or moving funds. Finally, it examines mechanisms in the collection and distribution of *zakāh* and *ṣadaqah* (charity), and investigates the potential risks associated with the banking system in dealing with such transactions.

2.1 Understanding ML/FT Risks

Theoretically, the importance of purity of the sources of money has been addressed in many provisions in the Al-Quran²⁰ and Sunnah (sayings of the Prophet Muhammad, Peach Be Upon Him), which conceptually abhor money laundering. To highlight the importance of the purity of sources of income, Islam prohibits the earning of any kind of illegal money even if it can be distributed to charity.²¹ Therefore, there is a clear need to distinguish between *halal* (lawful) and *ḥarām* (unlawful) earnings and property ownership.²²

While RSAs in many jurisdictions where Islamic banking is prominent have either adopted or adapted the FATF recommendations to varying degrees,²³ it is important to investigate to what extent those RSAs consider the performance of ML/FT risk management in their jurisdictions in terms of understanding the ML/FT risks posed regardless of the nature of the financial institution.

In the survey, the RSAs were asked about their supervisory experience in their jurisdiction in relation to the performance of a number of the FATF's preventive measures. Specifically, the RSAs were asked about managing and preventing ML/FT risks in terms of understanding the intricacies involved. The distribution of responses, as shown in Table 2.1, indicates a similar level of understanding among the RSAs regarding the risks involved in both ML and FT.

²⁰ "O you who believe! Squander not your wealth among yourselves in vanity, except it be a trade by mutual consent, and kill not one another. Allah is ever merciful to you. Whoever does that through aggression and injustice, we shall cast him into the fire. And that is ever easy for Allah" (Pickthall, 2005, verses 29–30).

²¹ Prophet Mohammad (Peach Be Upon Him) said, "*Ṣadaqah that comes from theft is not acceptable*" (Sahih Muslim 1/204).

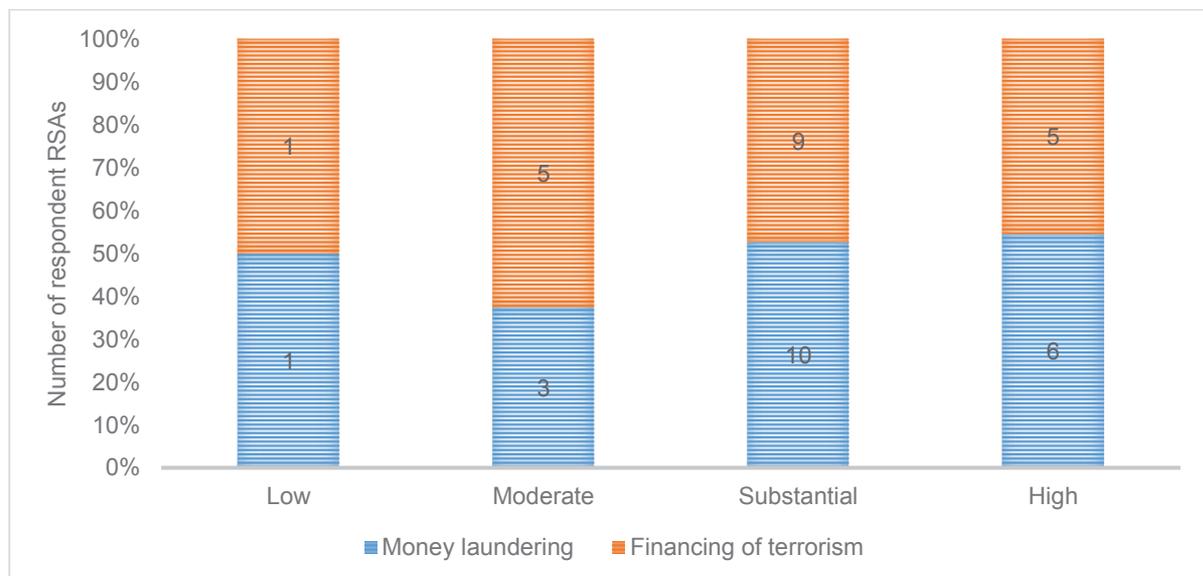
²² Prophet (Peach Be Upon Him) said, "*Al-ḥalāl is explicit or clear, and Al-ḥarām is clear...*" (Al-Boukhary 1/28 and Muslim 3/1, 219).

²³ Some IFSB member jurisdictions have actually adapted and incorporated into their Islamic banking law some provisions from the FATF standards for preventing ML/FT.

Most of the RSAs (80%) consider that, based on their regulatory experience, Islamic banks in their jurisdiction have at least a substantial understanding of the ML/FT risks. Mild differences observed relate to the fact that there may be a slightly higher understanding of the ML risk over the FT risk among Islamic banks (Figure 2.1). Specifically, while 10 (50%) RSAs indicate a substantial understanding of ML risks among Islamic banks in their jurisdictions, nine (45%) RSAs also indicate a similar level of understanding of FT risk. Six (35%) RSAs indicate that Islamic banks in their jurisdictions have a high understanding of the ML risks, compared to five (25%) for FT.

There is thus a view that the responses from the participating RSAs indicating that there is at least a substantial understanding by Islamic banks of the risks posed by ML/FT imply either or both of two things. First is the attenuation of the speculation about the high susceptibility of Islamic banking to ML/FT even if, as claimed in some studies, there is low compliance with AML/CFT regimes, especially in jurisdictions where Islamic banking is prominent. Second, the prevalence of ML/FT in such jurisdictions is more a matter of convenience and opportunities likely influenced by other attributes than the prominence or burgeoning presence of Islamic banking practices.²⁴

Figure 2.1 Understanding ML and FT Risks for Islamic Banking



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

²⁴ In fact, the example of Malaysia, Brunei and the UK as jurisdictions where Islamic banking is practised is often cited as a basis. A. N. Maruf (2018). Compatibility of Islamic Finance and Anti-Money Laundering Laws: A Myth or Reality? *International Islamic University Malaysia (IIUM) Law Journal*, 26(1), p. 73.

2.2 Managing the ML/FT Risks of Customer Relationships in Islamic Banking

The operational framework of bank financing based on Shari'ah-compliant sales, lease or equity-based instruments creates a unique relationship between an Islamic bank and its customers, which is different in many aspects from how contracts are executed in conventional banking. In sales-based financing contracts, for example, in case of *murābahah*, or *istiṣnā'*, an Islamic bank must ensure that it purchases the asset from a third party such as a supplier, developer or manufacturer before it is sold to a customer. That is, Islamic banks must have legal and constructive possession of the asset before selling it to the customer. If any Islamic bank violates this operational process in executing the contract, it would be an incidence of Shari'ah non-compliance risk. The IFSB's working paper No. 5 (WP-05)²⁵ provides detailed examples of Shari'ah non-compliance risks by type of contract and suggests that Islamic banks should be aware of the implications of those risks and them for the bank's solvency. Applying the process of addressing Shari'ah non-compliance risk would, in fact, strengthen transparency in business activities between an Islamic bank and its customers, and help to lower the incidence of ML/FT risks.

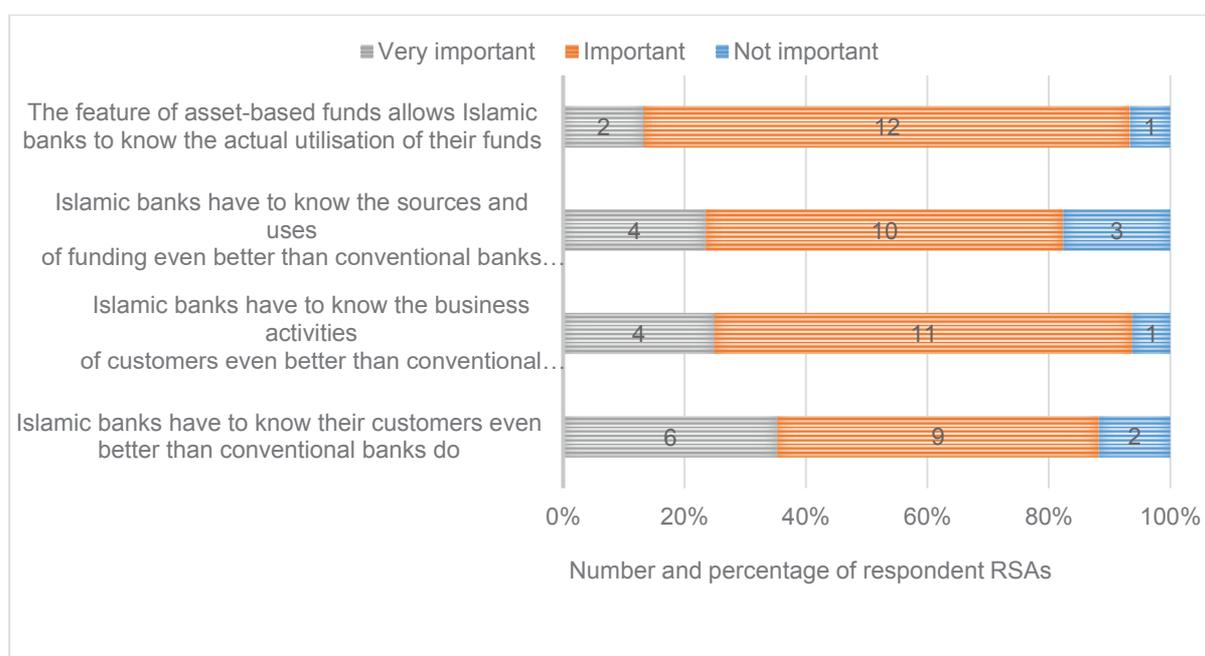
Therefore, a prudent operational framework with regards to Shari'ah compliance provides Islamic banks with more opportunities to know their customers. Islamic banks should develop and enforce clear customer acceptance and identification procedures for clients and those acting on the behalf of clients. Islamic banks need to conduct adequate customer due diligence (CDD) based on customers' risk profiles, which includes standard risk indicators such as personal background, country of origin, possession of a public or high-profile position, linked accounts, and type and nature of business activity.²⁶ The need to "know your customer" (KYC) should not be limited only to Islamic banks' customers, but should include the end-to-end parties involved in the Islamic contract. Banks should also conduct CDD and screening of suppliers/developers/manufacturers and consider the nature of the Islamic banking contract (e.g. *murābahah* or *istiṣnā'*).

The survey response is also consistent with the theoretical framework of Islamic banking in executing the contract and mentions that it is "very important", or at least "important", that Islamic banks should know their customers, as indicated by 15 (88%) out of 17 RSAs, and their business activities, as indicated by 15 (94%) out of 16 RSAs (Figure 2.2).

²⁵ E. Oz, Z. R. Khokher, M. M. Ali and R. Rosman (2016). *Shari'ah Non-Compliance Risk in the Banking Sector: Impact on Capital Adequacy Framework of Islamic Banks* (IFSB Working Paper Series WP-05/03/2016). Kuala Lumpur: IFSB.

²⁶ Basel Committee on Banking Supervision (2001). *Customer Due Diligence for Banks* (Consultative document). Basel: BCBS.

Figure 2.2 Importance of Characteristics in Managing ML/FT Risks of Islamic Banks



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

The survey results indicate that Islamic banks have a greater requirement than conventional banks to know the sources and uses of their customers’ funds, with 14 (82%) out of 17 RSAs indicating that this is “very important” or “important”. In principle, Islamic banks cannot pay or receive interest on received or used funds, respectively. Since Islamic banks always have to oversee the theoretical and operational mechanisms for the receipt and distribution of payments, with a view to avoiding engaging in any transaction with customers involving interest, such monitoring in effect enhances the scope for identifying ML/FT risks in Islamic banking transactions. This monitoring is consistent with the results found in Figure 2.2. The respondent RSAs’ comments on managing ML/FT risks in Islamic banking are summarised below:

- (i) Banks, whether they are conventional or Islamic, have to establish an effective and efficient internal control system and compliance framework in order to detect ML/FT risks. The control procedures may vary based on the structure, size and global linkages of the bank.²⁷

²⁷ In some jurisdictions, better controls are observed in larger banks/subsidiaries of global banks, given their larger resources and greater capacity to put in place the necessary AML/CFT measures, compared to the smaller banks which include stand-alone Islamic banks. This makes them more vulnerable to ML/TF risks, given the assertion that criminals are likely to abuse financial institutions with weaker controls.

Operational Structure of an Islamic Bank and ML/FT Risks

Islamic banks receive funds divided mainly into two categories: (i) non-remunerative funding, and (ii) remunerative funding. Non-remunerative funding from customers is based on *qard* or *wadī'ah* contracts, for example, and banks use those funds in their business operations at their own risk. Remunerative funding basically includes equity-based or profit-sharing investment contracts such as *muḍārabah* (a “partnership between work and capital”, where the capital provider is a sleeping partner while the managing partner provides the work) or *mushārah* (similar to a conventional partnership), among others.

In the case of a profit-sharing investment account, the investment account holder, as the customer, has the right to monitor their investments and associated risks, and this allows Islamic banks to know the actual utilisation of funds. Principle 2.1 of IFSB Standard No. 3: *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services [Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds]* sets out that “IIFS shall acknowledge IAHS’ right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.”

Moreover, an Islamic bank has a number of incentives to follow Sharī'ah rules appropriately. First, it would face reputational damage and lack of customer confidence if it does not comply with Sharī'ah rules. Second, Sharī'ah non-compliance may impact on its profitability, as any Sharī'ah non-compliant income must be deducted and should be transferred to charitable activities.

A prudent Sharī'ah governance framework that requires ex-ante and ex-post review of any contract executed between an Islamic bank and its customers will not only enhance Sharī'ah compliance but also increase the disclosure requirement. Principle 3.1 of IFSB-3 also explains that Islamic banks should have in place an appropriate mechanism for monitoring Sharī'ah compliance in all aspects of their products, operations and activities. Islamic banks must follow these control measures from a Sharī'ah point of view, which ultimately lowers the ML/FT risks in the Islamic banking sector.

- (ii) Islamic banks can seek more information on customers, their assets, and transactions made between Islamic banks and customers, subject to the nature of the underlying contract of products offered by Islamic banks.
- (iii) Since Islamic banks are not permitted to invest in *ḥarām* (prohibited) businesses, they have to ensure that their funding sources are not associated with any kind of Sharī'ah non-compliant activity.

2.3 Managing the ML/FT Risks of Products and Services

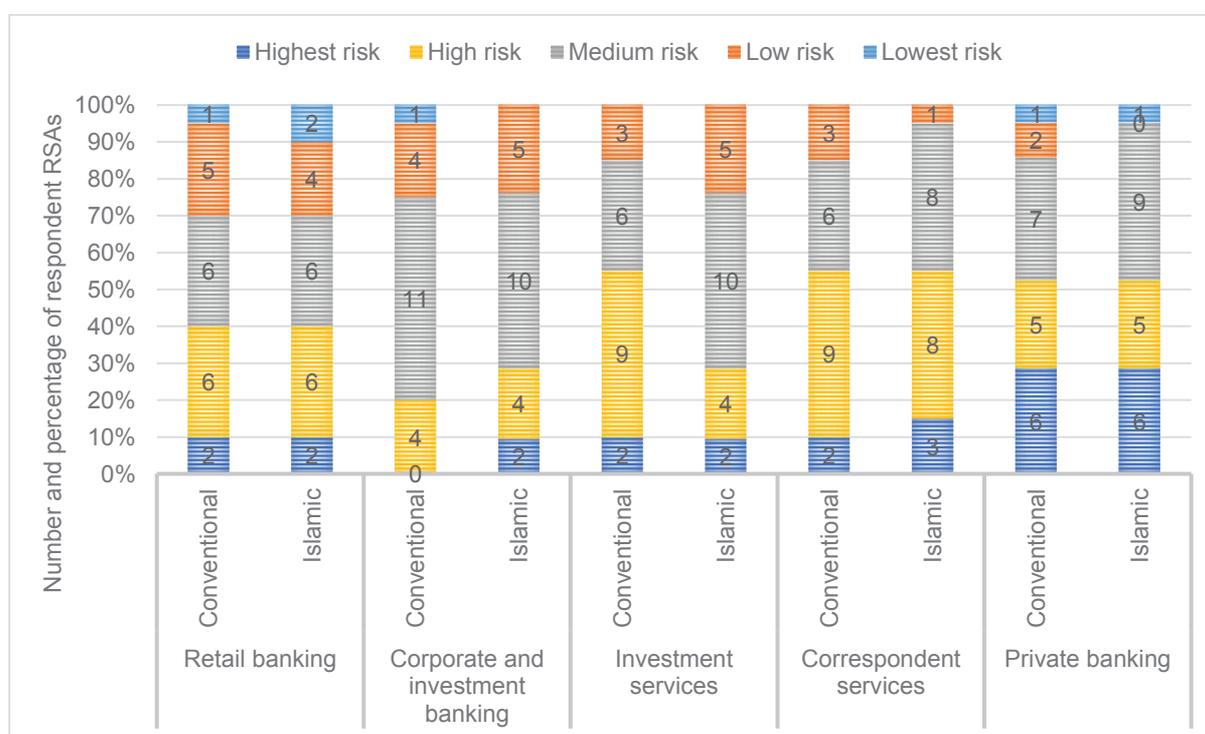
This section attempts to identify the potential ML/FT risks of a wide range of products and services, and discusses how to assess and mitigate those risks appropriately. The survey conducted broadly covers the following types of products and services: retail banking; corporate and investment banking; investment services; correspondent services; and private banking. The survey respondents were asked about the level of risks of the above-mentioned products and services for both conventional and Islamic banks in their respective jurisdictions.

2.3.1 Retail Banking

“Retail banking” refers to products and services offered by banks directly to personal and business customers, such as current accounts, loans (financing for Islamic banks) and savings products. Potential ML/FT risks in retail banking may come from the provision of services to cash-intensive businesses, or those with a high volume of transactions, high-value transactions or a diversity of services.

From a conceptual point of view, there is no difference between conventional and Islamic banking in terms of retail banking and retail customers. However, there is a very significant difference in terms of services and products, which are primarily based on unique structures/contracts in the Islamic banking system. The survey results find that only two RSAs (10% of respondents) view retail banking activities as having “highest risks” regardless of whether they are conventional or Islamic banking. In addition, the results show that the RSAs do not find any difference in the level of risks between conventional and Islamic banking (Figure 2.3).

Figure 2.3 Comparison between Conventional and Islamic Banking on the Level of ML/FT Risks by Type of Product (Note the difference in investment services)



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

2.3.2 Corporate and Investment Banking and Services

“Corporate and investment banking” refers to finance and banking products and investment services provided by banks to corporate customers, body corporates, corporations, governments and institutions. The issuance and trading of shares and securities fall within the scope of corporate and investment banking and services. The ML/FT risks associated with these types of products and services arise from the layering and integration stages of securities. The ML risks associated with corporate finance may be related to the transfer of assets between parties in exchange for cash and other assets. They can also come from the global nature of the securities markets.

As compared to the conventional bond market, the markets for *şukūk*²⁸ and for Sharī'ah-compliant securities in the Islamic banking sector are very small. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)²⁹ defines *şukūk* as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of a particular project or special investment activities. Though the *şukūk*³⁰ and Islamic securities markets are gaining acceptance internationally, regulators must be careful to monitor their ML/FT risks in regard to gathering detailed information about the originator of the *şukūk*, location of origin, issuer, location of issuance, and *şukūk* holders, among others. However, it is important to understand the underlying structure of *şukūk* with a view to investigating the possible sources of ML/FT risks. In Islamic finance, asset-backed structures of *şukūk* involve ownership rights in the underlying assets.³¹ On the other hand, in conventional asset-backed structures, the asset backing takes the form of collateral rights, not ownership rights. For asset-backed *şukūk*, it is necessary that key securitisation elements are

²⁸ “*Şukūk*” refers to a Sharī'ah-compliant financing instrument that differs from conventional bonds in terms of its structure.

²⁹ AAOIFI Sharī'ah Standard No. 17: *Investment Şukūk*, 2015, p. 468.

³⁰ As per the IFSB's *IFSI Stability Report 2018*, the outstanding volume of *sukūk* was USD 399.9 billion at the end of 2017.

³¹ According to the Sharī'ah Board of the Islamic Development Bank (IDB), *sukūk* assets must be undividedly owned by the *sukūk* holders either directly or through their agent (SPE). This ownership should be valid from both the legal and Sharī'ah perspectives, in the sense that the *sukūk* holders (whether as individuals or through their agent – that is, an SPE) have the ownership of the underlying assets. The ownership of the underlying assets should be transferred to the *sukūk* holders and registered in their names with the legal authorities. These *sukūk* may be known, rather incongruously, in the market as “asset-backed”. However, in jurisdictions where there is a prohibition on transferring legal title to such assets, only the beneficial ownership is permitted to be transferred to the *sukūk* holders based on the following conditions: (a) The definition of beneficial ownership must be stated clearly in the *sukūk* document. “Beneficial ownership of *sukūk* assets” refers to valid ownership with all the rights and obligations, but excluding the right of registration in the legal authorities. (b) There must be a statement by the transferor (by way of the trust certificate) confirming that the valid ownership has indeed been transferred to the *sukūk* holders along with the associated rights and obligations. The SPE does not have any right to utilise these assets without prior permission from the *sukūk* holders to the fact that the assets have been registered under the SPE's name as a fiduciary only. (c) The trust certificate, as mentioned above, can be enforced by the official authorities that prohibit the legal transfer of the underlying assets to the *sukūk* holders. In the case of breach of, or not being able to take into consideration, any of these conditions, the *sukūk* is not permitted to be issued legitimately from a Sharī'ah perspective on the basis of such assets. (Source: IFSB Standard No. 15: *Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*, Kuala Lumpur: 2013, pp. 106–107, footnote 115.)

in place to ensure that *şukūk* holders have legal title and a realisable security over the assets. The IFSB provides detailed guiding principles³² of disclosure requirements regarding information about the originator, location of origin, issuer, location of issuance, and *şukūk* holders, among others, which will help to avoid any ML and FT concerns expressed about the *şukūk* structures,.

The survey responses in Figure 2.3 show that, in terms of corporate and investment banking and investment services, there is, in fact, no significant difference in associated ML risks between conventional and Islamic banking.

2.3.3 Correspondent Services

“Correspondent services” refers to banking services provided by one bank (the “correspondent bank”) to another bank (the “respondent bank”). Respondent banks may be provided with a wide range of services, including cash management (e.g. interest-bearing accounts in a variety of currencies), international wire transfers, cheque clearing, payable-through accounts, and foreign exchange services.

Correspondent services have been identified by 11 out of 19 RSAs as being at least of a “high risk” for both conventional and Islamic banks, indicating the need to take enhanced measures to manage and mitigate the ML/FT risks that may crystallise from such services (Figure 2.3). The FATF guidance³³ explains that a wide range of correspondent banking services do not carry the same level of ML/FT risks. The guidance focuses in particular on cross-border correspondent banking relationships involving the execution of third-party payments, due to their potentially higher risk. Limited information regarding the structure of activity in the execution of third-party payments in cross-border banking transactions may create greater exposure to ML/FT risks.

Overall, a correspondent Islamic banking institution should take a holistic view of the above indicators and other available information, determine the levels of inherent ML/FT risks, and apply appropriate control measures for effective management of those risks. However, it is noteworthy that Islamic banking is recently facing a decline in correspondent banking relationships. The General Council for Islamic Banks and Financial Institutions (CIBAFI) mentions in its recent survey reports³⁴ that the closing of correspondent banking relationships

³² IFSB Standard No. 19: *Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (Sukūk and Islamic Collective Investment Schemes)*, Kuala Lumpur: 2017.

³³ Financial Action Task Force (2016). *FATF Guidance – Correspondent Banking Services*, Paris: FATF, paragraph 13b.

³⁴ General Council for Islamic Banks and Financial Institutions (2018). *Global Islamic Bankers’ Survey 2018 – Evaluating Future Impacts: Strategic Thinking, Branding and Financial Technologies*. Bahrain: CIBAFI, p. 46.

is the fifth-biggest risk faced by Islamic banks. In this respect, the FATF recommends using a risk-based approach to avoid the unintended consequences of de-risking.

In the correspondent banking relationship, the level of CDD measures employed by the respondent institution depends on its ML/FT risk profile. In this respect, the role of RSAs is critical. IFSB Standard No. 17³⁵ provides guidelines for RSAs to ensure that, in addition to normal due diligence, Islamic banks have specific policies and processes regarding correspondent banking. The Standard proposes policies and processes such as:

- (a) gathering sufficient information about their respondent IIFS to fully understand the nature of their business and customer base, and how they are supervised; and
- (b) not establishing or continuing correspondent relationships with those that do not have adequate controls against criminal activities, or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.

2.3.4 Private Banking and Services

“Private banking and services” refers to customers who are given prioritised or privileged treatment. The survey responses show the same level of ML/FT risks for both conventional and Islamic banking in terms of “highest” or “higher” risks as identified by 11 (55%) out of 20 respondents (Figure 2.3). In fact, Islamic banking is no different from conventional banking in terms of its requirements in regard to private customers for reducing ML/FT risks. These customers should be assessed as presenting a higher risk of money laundering if they are identified as being politically exposed persons (PEPs), or are in higher risk categories of sanction lists and jurisdictions, or if their nature, business or location indicates a higher risk. Moreover, in the case of transacting with non-face-to-face private customers, additional CDD measures are required, such as certification of documents. The RSAs will need to decide whether private customers should require additional identify information, and/or whether to verify additional aspects of identification.

In all, Islamic banks only need to ensure that their customers’ use of business structures and investments has a genuine and legitimate purpose from the perspective of both national laws and Sharī’ah principles.

³⁵ IFSB-17: *Core Principles on Islamic Finance Regulation (Banking Segment) (CPIFR)*, 2005, p. 64.

2.4 Managing ML/FT Risks in Dealing with *Awqāf*

The AAOIFI³⁶ defines *waqf* as making a property invulnerable to any disposition that leads to transfer of ownership and donating the usufruct of that property to beneficiaries. The AAOIFI also categorises *waqf* into several permissible types, the most important of which are charitable *waqf* (*al-waqf al-Khayri*), family *waqf* (*al-waqf al-Ahli*), joint *waqf* (*al-waqf al-Mushtarak*) and self-dedicated *waqf* (*al-waqf 'Ala al-Nafs*). The key elements of *waqf* include the form of donation, the *waqif* (the donor) and the donated property.

Waqf funds are usually established by a non-profit organisation in a country. *Waqf* activities could fall within the FATF's definition of an NPO³⁷ – that is, a legal person or arrangement or organisation that primarily engages in raising or disbursing funds for purposes such as charitable, religious, cultural, educational, social or fraternal purposes, or for carrying out other types of “good works”. The definition is based on the activities and characteristics of an organisation which is considered to be at risk of abusing funds for ML/FT purposes, rather than on the simple fact that it is operating on a non-profit basis. The FATF recommendations explain that specific CDD measures as required by the banks are needed for the legal persons or legal arrangements, in order to understand the nature of the customer's business and its ownership and control structures.³⁸

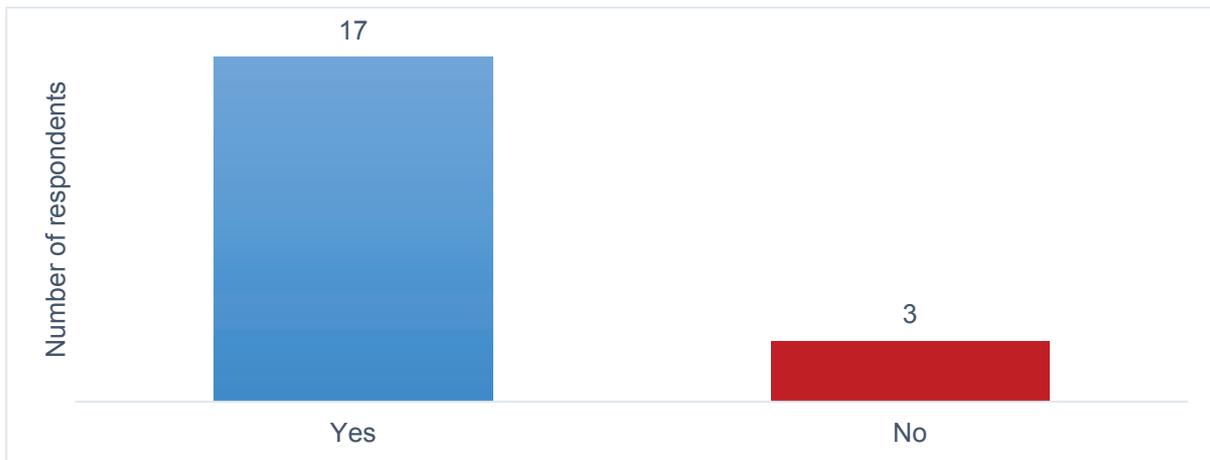
An NPO dealing with *waqf* funds in a country is allowed to open accounts at banking institutions. This type of account is known as a trust account in many jurisdictions. Out of 20 respondent RSAs, 17 indicate that Islamic banks are permitted to open accounts for *awqāf* in their countries (Figure 2.4).

³⁶ Accounting and Auditing Organization for Islamic Financial Institutions (2015). *AAOIFI Shari'ah Standard No. 33: Waqf*, pp. 814–15.

³⁷ Financial Action Task Force (2012–2018). *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. Paris: FATF, p. 52.

³⁸ Financial Action Task Force (2012–2018). *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. Paris: FATF, recommendations 10, 24 and 35.

Figure 2.4 Islamic Banks Allowed to Open Accounts for *Awqāf*



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

In response to the question about whether there is any specific type of ML/FT risks in dealing with *awqāf* accounts, six of 12 RSAs find there are no specific ML/FT risks (Figure 2.5). The respondents' common understanding is that dealing with *awqāf* accounts is similar to dealing with other types of accounts and services, as they are exposed to the same levels of ML/FT risks. Without imposing any restrictions specific to the opening of accounts for *awqāf*, the regulatory provisions applicable to account opening for legal persons and arrangements for *waqf* funds are sufficient, as relevant.

Figure 2.5 Specific ML/FT Risks in Dealing with *Awqāf*



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Another four RSAs categorise the opening of *awqāf* accounts as specific to ML/FT risks (Figure 2.4). The respondent RSAs mention several reasons for categorising *awqāf* as being of a higher risk of ML/FT. A review assessment conducted by one RSA of NPOs in its jurisdiction finds that religious NPOs have a higher risk of abusing *waqf* fund for FT purposes. Similarly, there is a risk of illegitimate diversion of *waqf* funds and property for FT purposes that are not consistent with the intent of the *waqf*. In this respect, another RSA points out that the higher risks in *awqāf* accounts could be due to banks' failure to know the beneficiaries of such accounts. It is also likely that in some jurisdictions the CDD regulations on trust and legal arrangements may not be totally applicable to *awqāf* due to their nature and operation.

Therefore, one respondent RSA recommends enhanced customer due diligence (ECDD) requirements for *awqāf* accounts, as they consider that such accounts are highly vulnerable and may be used for ML/FT-related activities. These accounts are known as trust accounts in many jurisdictions, and trustees should not be prevented by law or enforceable means from providing the competent authorities with any information relating to the trust as recommended by the FATF.³⁹ In this respect, banks should initially only allow those NPOs that have been approved by a competent authority to open *awqāf* accounts. The International Working Group on *Waqf* Core Principles⁴⁰ provides several criteria for protecting *waqf* services from ML/FT risks.

In line with these core principles, there is a need for a *waqf* Act that establishes the duties, responsibilities and powers of the *waqf* supervisor in relation to supervision of internal controls and regulations regarding criminal activities such as terrorism, money laundering and corruption. However, if there is no active supervision or monitoring for the requirements of NPOs, significant knowledge gaps may remain regarding the composition of the entire NPO sector, relating to both registered and unregistered NPOs. Therefore, RSAs dealing with NPOs under *waqf* will also need to determine that those NPOs have appropriate policies and processes for imposing Islamic ethics and professional standards and for preventing criminal activities. Moreover, coordination among the financial sector authorities, including domestic and foreign supervisory authorities, is critical in combatting ML/FT risks. In this respect, the *waqf* supervisor would need to report any suspicious activities and incidents to the financial intelligence unit or relevant authorities in order to maintain the transparency, accountability and credibility of the *waqf* institutions.

³⁹ Financial Action Task Force (2013–2018). *Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems*, updated November 2018 (additional revisions adopted during the October 2018 Plenary). Paris: FATF, p. 70 (recommendation 25.4).

⁴⁰ International Working Group on *Waqf* Core Principles (2018). *Core Principles for Effective Waqf Operation and Supervision, A Joint Initiative of Bank Indonesia, Indonesian Waqf Board (BWI) and Islamic Research and Training Institute – Islamic Development Bank*, pp. 51–52.

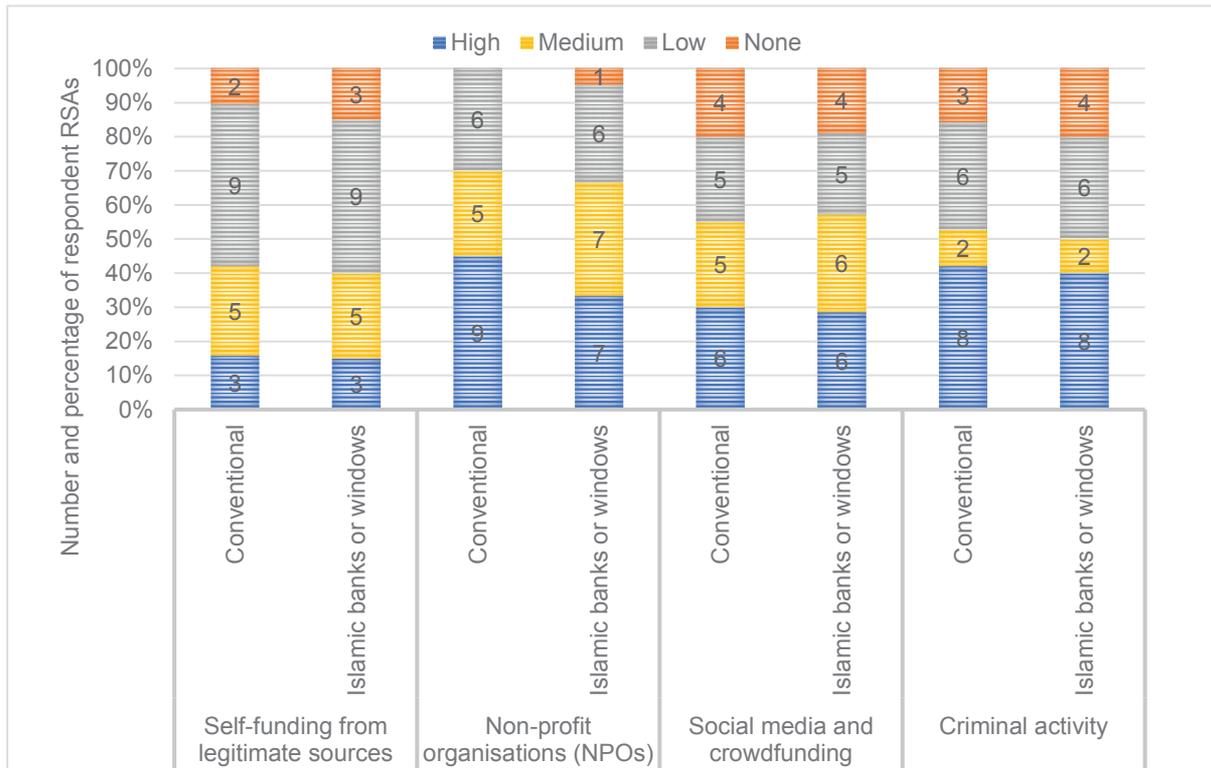
Therefore, in conclusion, if the customer is a legal entity for managing the *waqf* fund, Islamic banks are required to obtain and record specific information and to verify the customer's legal existence and structure, including information about the sources and beneficiaries of the funds.

2.5 Managing the ML/FT Risks of Raising or Moving Funds

Funds can move to the banking system in a number of ways that are exposed to ML/FT risks. Potential areas include self-funding from legitimate sources, NPOs, social media and crowdfunding, and criminal activities. Terrorist organisations can receive funds from legitimate sources, including charities and businesses.

Figure 2.6 shows that "high risk" level is mentioned by the same numbers of RSAs in the case of raising funds through self-funding from legitimate sources, social media and crowdfunding, and criminal activity. There are slight increases in "higher risk" for conventional banking compared to Islamic banking (16% in conventional banking versus 15% in Islamic banking for using self-funding from legitimate sources, 30% versus 29% for social media and crowdfunding, and 42% versus 40% for criminal activity). Terrorist individuals or organisations use legitimate, social and criminal methods to finance their organisational and operational activities. Conventional banking is also found to have a "high" risk of being used by NPOs to raise funds for FT activities. A total of nine RSAs (45%) out of 20 respondents find that conventional banking has a "high" risk, compared to seven RSAs (33%) out of the respondents that indicate Islamic banking has a "high" risk in this regard.

Figure 2.6 Likelihood Levels of Methods Used to Raise Funds for FT

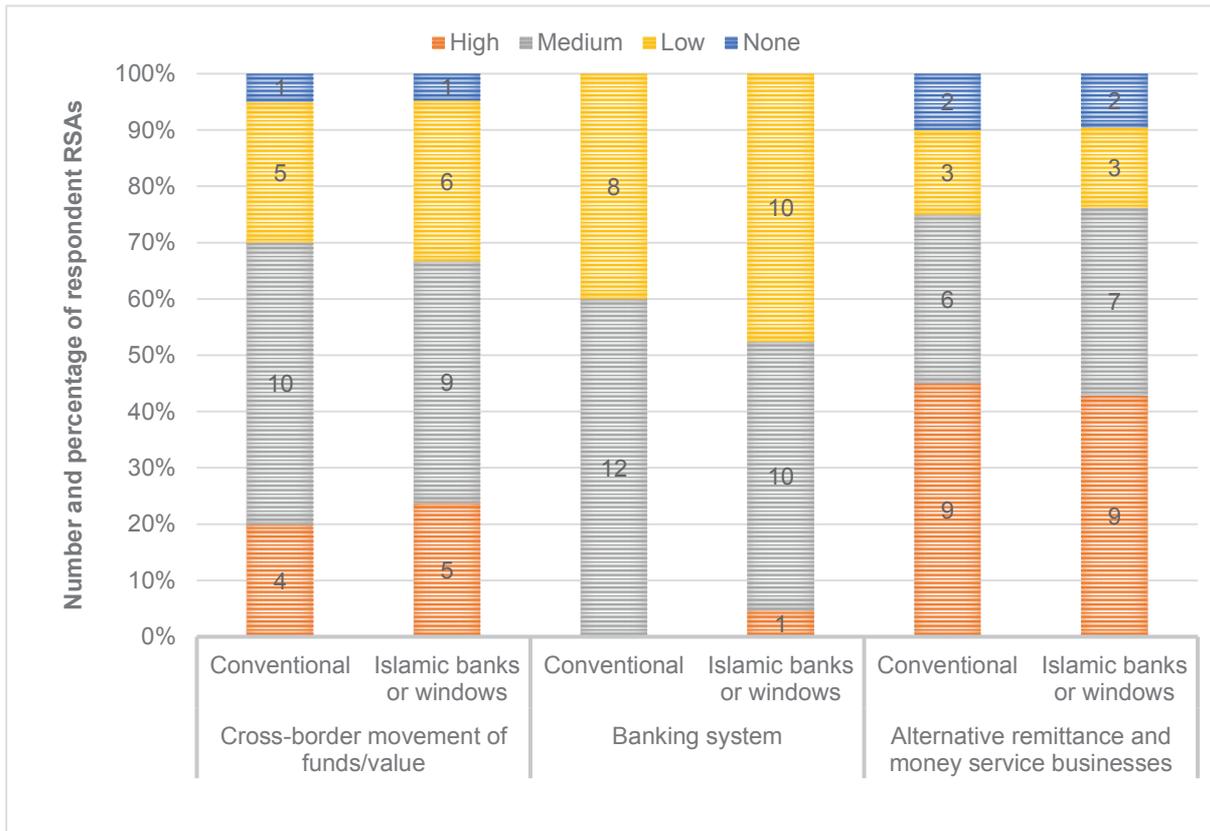


Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Cross-border movement of funds for FT purposes

The survey results do not differ significantly between conventional and Islamic banking on the utilisation of funds for FT activities, as indicated by Figure 2.7. A total of five RSAs indicate that Islamic banking has “high” risk, as compared to four RSAs for conventional banking, in terms of funds cross-border movement for FT purposes.

Figure 2.7 Likelihood Levels of Methods Used to Utilise Funds for FT



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

More than 40% of the respondent RSAs indicate that the risk of using an alternative remittance system (ARS) for cross-border movement of funds for FT purposes is “high”, while no notable difference is observed between conventional and Islamic finance (Figure 2.7).

Banking system

The likelihood levels of “high” or “medium” risk for utilising funds for FT purposes remain almost the same for both conventional banking (11 out of 19) and Islamic banking (12 out of 21) within a jurisdiction’s banking system.

Alternative remittance system

“Alternative remittance system” refers to the informal remittance system, informal value transfer system, parallel banking, underground banking or informal funds transfer, among

other systems.^{41,42} The ARS has been used to disguise the movement of terrorist funds in countries where the electronic banking system used for movement of cash across borders remains embryonic or is little used by the populace. Therefore, the ARS in many countries has the additional attraction for terrorists of having weaker and/or less opaque record-keeping systems, and of being subject to less stringent regulatory oversight. Identifying areas where more regulatory oversight is needed is therefore important for both conventional and Islamic banking.

The above discussion indicates that terrorist individuals or organisations can use any bank account, whether it is conventional or Islamic, for FT activities. The survey results also do not mention any significant difference between conventional and Islamic banking in terms of raising or movement of funds to finance terrorism activities. Terrorists will take advantage of weak monitoring of bank accounts. Financial intelligence bodies should always be active in monitoring STR of unusual transactions with individual banks. An effective AML/CFT system, in general, is important for addressing terrorist financing. The FATF has some recommendations that are unique to terrorist financing which are also applicable to the Islamic banking sector. These are recommendation 5 (terrorist financing offence), recommendation 6 (targeted financial sanctions related to terrorism and terrorist financing) and recommendation 8 (non-profit organisations) set out in Section C of the FATF recommendations.⁴³

2.6 Avoiding ML/FT Risks through De-risking

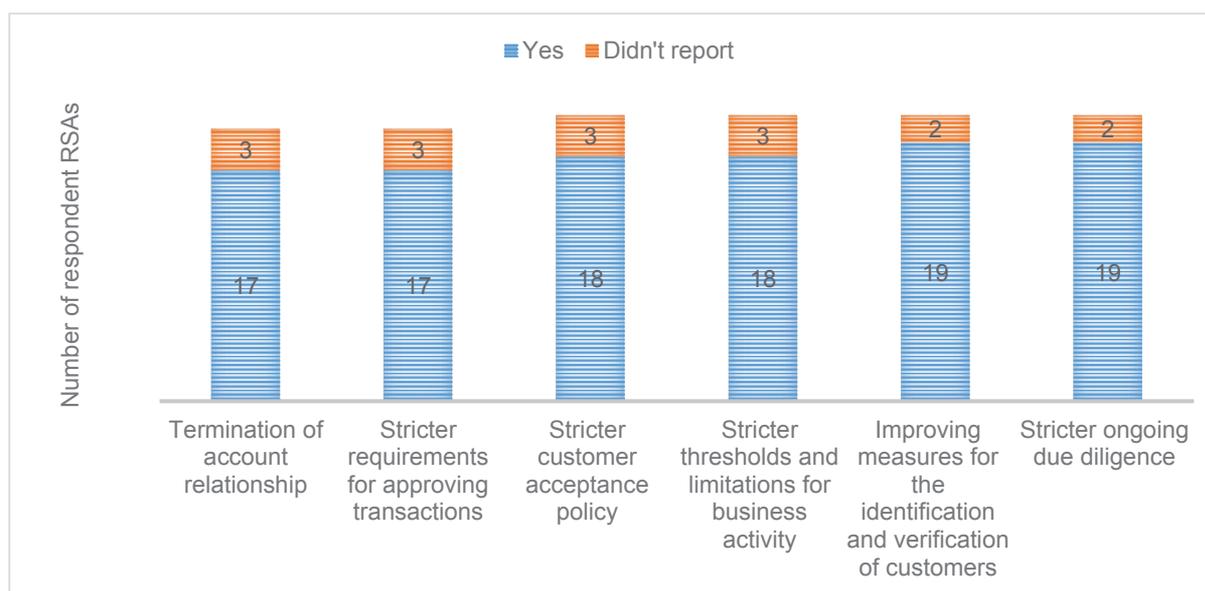
The FATF defines de-risking as the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients in order to avoid, rather than manage, risk in line with the FATF's risk-based approach. The RSAs were asked how, in their view and based on their regulatory experience, an Islamic bank or window in their jurisdiction can effectively manage ML/FT risks associated with certain categories of customers or money transmitters, or charities. Figure 2.8 shows that most of the survey respondents (19 RSAs) indicate that those risks can be managed by: (i) improved measures for identifying and verifying customers (including KYC/CDD); and (ii) stricter ongoing due diligence (keeping records up-to-date and monitoring of transactions). Other measures mentioned by 18 RSAs include stricter customer acceptance policies, and stricter thresholds and limitations for business activity.

⁴¹ A. A. Shah (2007). The International Regulation of Informal Value Transfer Systems. *Utrecht Law Review*, 3(2), 193–218.

⁴² R. McCusker (2005). *Underground Banking: Legitimate Remittance Network or Money Laundering System?* Trends & Issues in Crime and Criminal Justice No. 300. Canberra: Australian Institute of Criminology.

⁴³ Financial Action Task Force (2012–2018). *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. Paris: FATF, p. 11.

Figure 2.8 De-risking: Managing ML/FT Risks



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

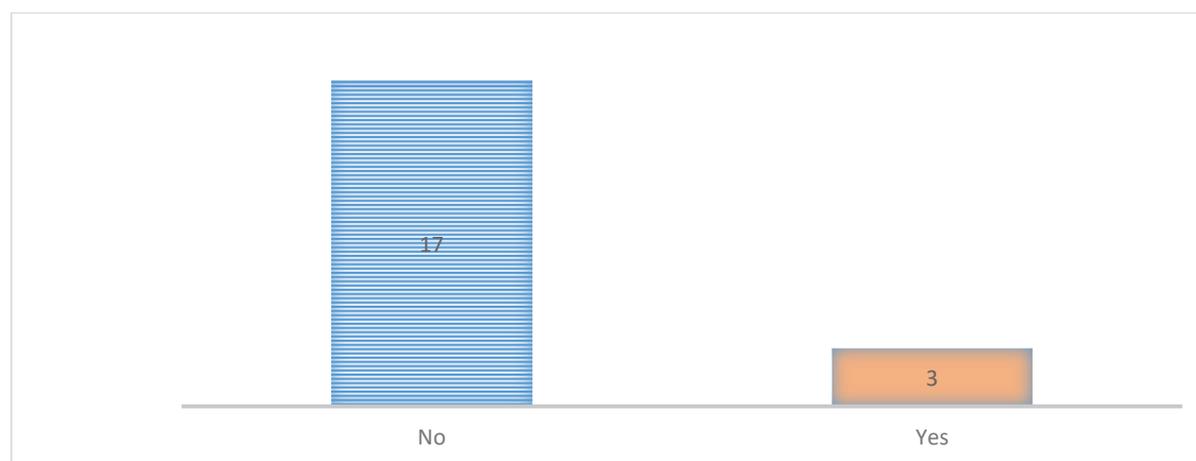
De-risking is a complex solution by which banks can simplify the business model, as well as reduce ML risks, by taking measures to eliminate some products or clients, or both. However, a potential impact of de-risking is that it can create concerns about instability in the financial sector. It is argued that de-risking measures taken by banks have the potential to divert legitimate business towards risky, less regulated and/or unregulated alternatives such as *hawāla* (an informal system for transferring money without money movement) and shadow banking (credit intermediation involving entities and activities outside of the regular banking system). Therefore, in line with the FATF standards, rather than following the de-risking approach, the Islamic banking sector should focus on implementing a risk-based approach (RBA). The FATF defines RBA in relation to AML/CFT as implying that a competent authority in a jurisdiction is expected to identify, assess and understand the ML/FT risks to which they are exposed and to take AML/CFT measures commensurate with those risks in order to mitigate them effectively.

2.7 Collection and Distribution of *Zakāh* and *Ṣadaqah* (Charity)

Zakāh refers to a certain share⁴⁴ of assets and wealth to be distributed among the deserving categories of individuals or institutions entitled to receive it on an annual basis. Therefore, business companies and institutions are also subject to pay *zakāh* out of their earnings.

Islamic banks in some jurisdictions are involved in both the collection of *zakāh* and *ṣadaqah* on behalf of government agencies and the payment of *zakāh* and *ṣadaqah* as part of their obligations under *Sharī'ah*. In respect of bank activities relating to *zakāh* collection and distribution, it is essential for an Islamic bank to ensure that it is dealing with donors and recipients who are well known to them and are compliant with applicable AML/CFT regulations. The survey finds that out of 20 respondents, 17 RSAs consider that there are no ML/FT risks related to the collection and distribution of *zakāh* and *ṣadaqah* by Islamic banks (Figure 2.9).

Figure 2.9 ML/FT Risks Related to the Collection and Distribution of *Zakāh* and *Ṣadaqah* (Charity) by Islamic Banks

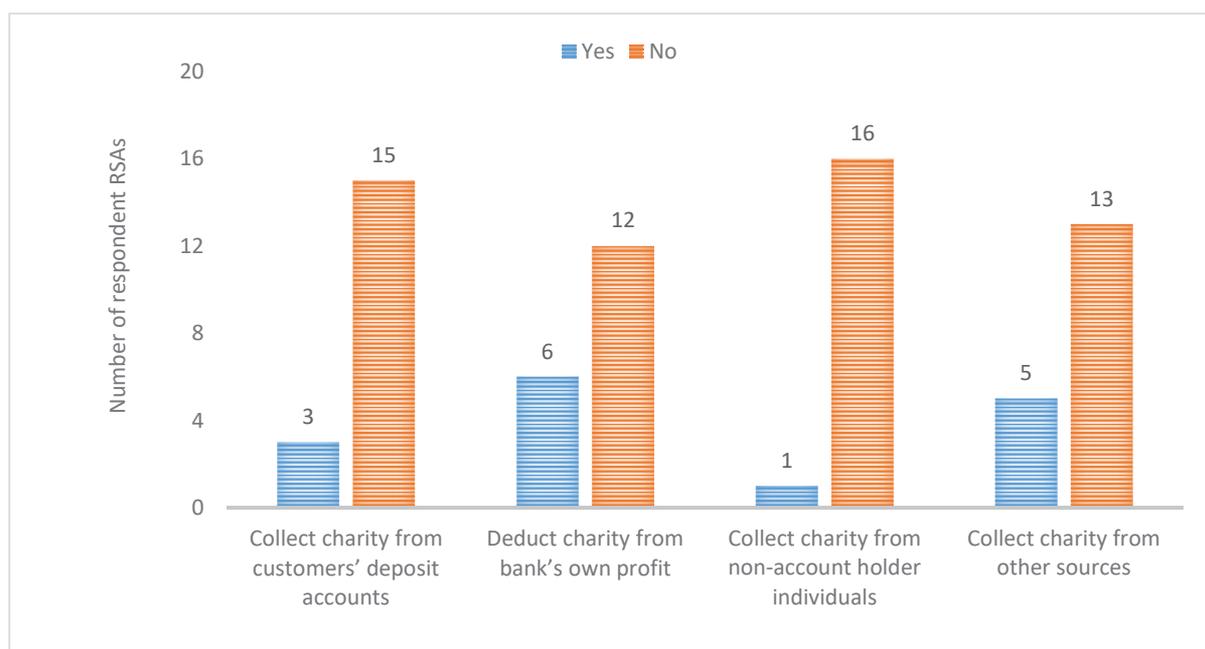


Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

When asked about the roles of Islamic banks for charity collection in their respective jurisdictions, most of the respondent RSAs indicated that Islamic banks do not play any role in the collection of charity. Islamic banks collect charity from customers' deposit takers in three jurisdictions and from non-account holder individuals only in one country. A total of six RSAs mention that their Islamic banks deduct charity from the bank's own profit (Figure 2.10).

⁴⁴ The rate of *zakāh* applicable to gold, silver, currencies and articles of trade is 2.5% whereas the rate applicable to agricultural produce is one tenth (10%) for the produce of non-irrigated lands, half of the tenth (5%) for the produce of irrigated lands, and three quarters of the tenth (7.5%) for the produce of partially irrigated lands. (Source: Accounting and Auditing Organization for Islamic Financial Institutions (2015). *AAOIFI Sharī'ah Standard No. 35: Zakāh*, p. 874.)

Figure 2.10 Charity Collection by Islamic Banks

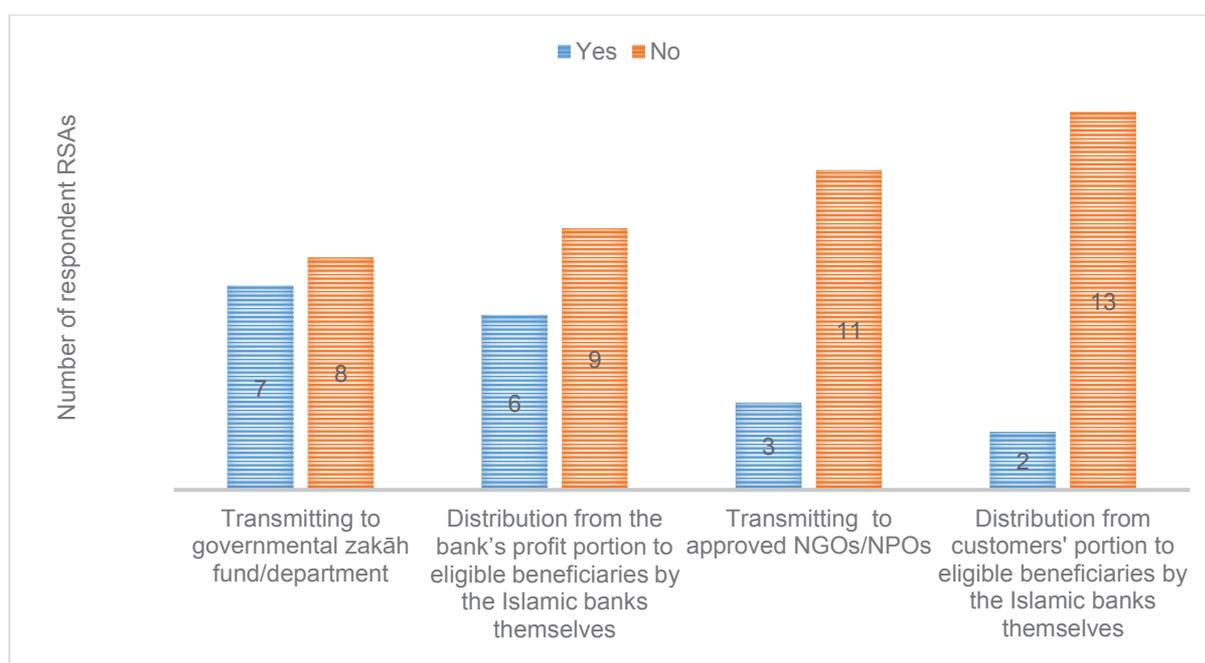


Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Banking transactions related to *zakāh* and *ṣadaqah* would need to be covered under the KYC/CDD rules and regulations. Such regulations, when compliant with FATF standards, would require that the parties making payments to, or receiving payments from, the Islamic bank are identified as clients and are subject to applicable KYC/CDD processes. In the event that there is a higher risk scenario, enhanced due diligence should be applied.

On the other hand, the Islamic banks that collect *zakāh* and deduct the charity from their own profit have an obligation to distribute that received amount. If the government manages the distribution of *zakāh*, Islamic banks transmit the collected charity to government agencies, as indicated by the RSAs from seven jurisdictions (Figure 2.11).

Figure 2.11 Charity Distribution by Islamic Banks



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Only two RSAs mention that their Islamic banks transmit collected charity to approved non-governmental organisations (NGOs) or NPOs, other than government agencies. The role of Islamic banks in transmitting *zakāh* collections to NPOs may expose them to FT risks owing to their association with the NPOs, especially where the NPOs are not regulated.⁴⁵ Therefore, as prescribed by the FATF, countries should review the adequacy of their laws and regulations for NPOs so that they can identify whether the NPOs are vulnerable to terrorist financing risks.

A total of six out of 15 respondent RSAs indicate that the Islamic banks in their jurisdiction, of their own accord, distribute the charity generated from the bank's own profit to eligible beneficiaries. Similarly, Islamic banks themselves distribute the charity collected from the customers' portion to eligible beneficiaries in two jurisdictions.

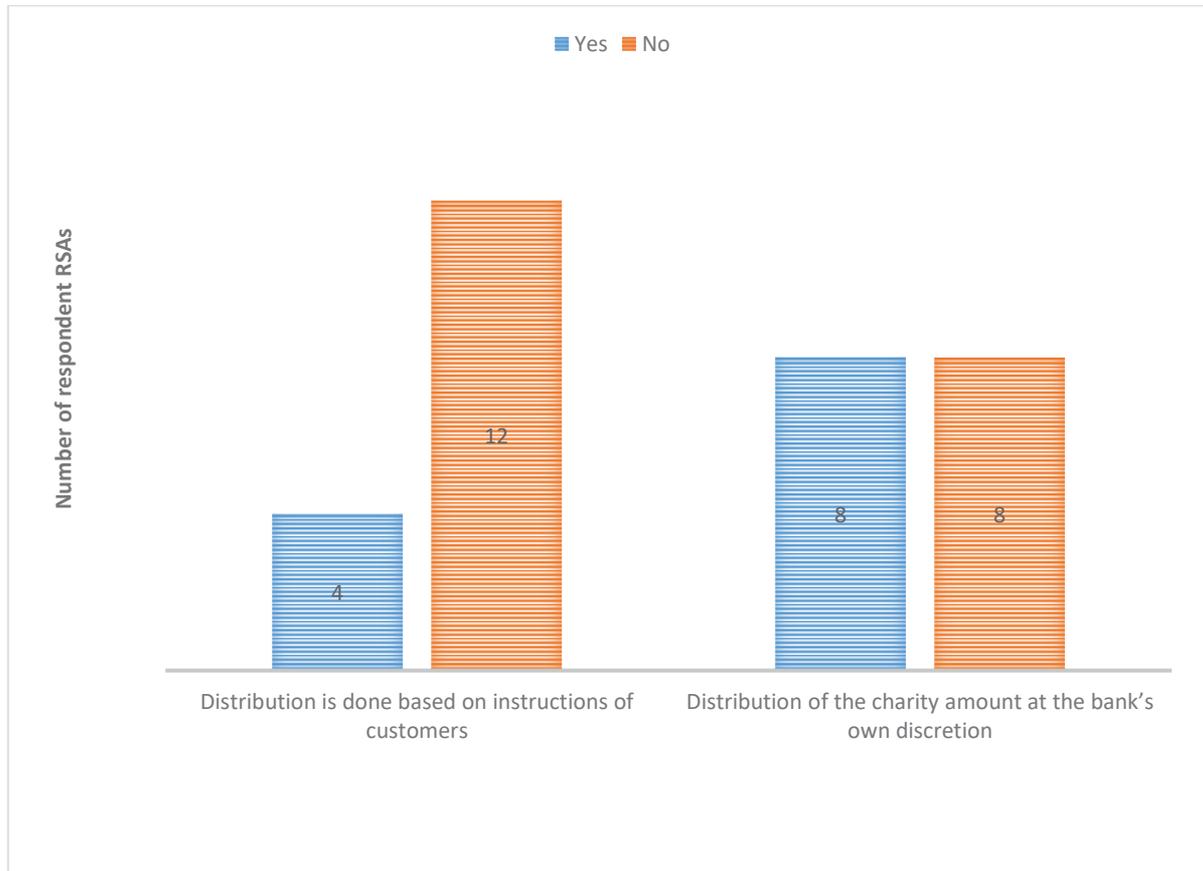
The question now is: What should be the basis for distributing this charity amount to different categories of eligible beneficiaries, including institutions? Four out of 16 RSAs mention that Islamic banks distribute the charity based on the instructions of customers (Figure 2.12). This highlights the need for enhanced CDD when dealing with such customers and those transactions.⁴⁶ A total of eight RSAs (50%) out of 16 respondents indicate that Islamic banks

⁴⁵ The payment of *zakāh* on their own behalf, as well as collections from their customers, to charities which are mostly regulated NPOs does not increase the potential exposure of such transactions to FT risks.

⁴⁶ Although the intent of distributing charity is in itself admirable, doing so on a magnitude that would require engaging the services of an Islamic bank may indicate that enhanced CDD is warranted so that additional information may be gained and provide a fuller understanding of the source of the wealth.

distribute the charity amount at the bank's own discretion. It is pertinent that Islamic banks should have sufficient information about beneficiaries, including NPOs, before distributing such funds.

Figure 2.12 Basis of Charity Distribution by Islamic Banks



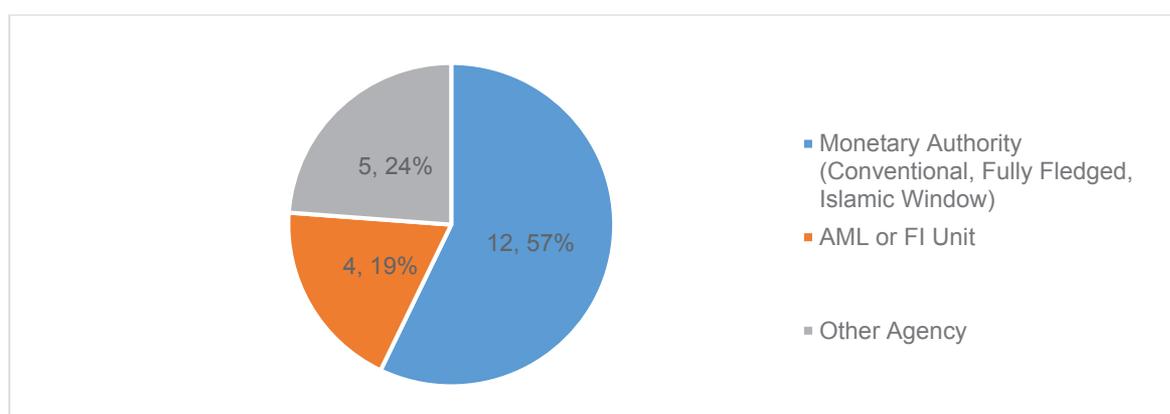
Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

3. REGULATION AND SUPERVISION OF ANTI-MONEY LAUNDERING AND COMBATTING THE FINANCING OF TERRORISM IN ISLAMIC BANKING

This section sheds light on the regulatory and supervisory frameworks that govern both Islamic and conventional banks, and on whether pertinent regulations have been adopted to enhance a robust AML/CFT regulatory framework. Through the designed questionnaire, this section of the paper attempts to determine if particular laws or regulations for Islamic banks need to be formulated regarding ML/FT, and whether Islamic banks encounter specific challenges in applying the AML/CFT regulations.

Three main groups of countries are identified with regards to the authorities that are responsible for AML/CFT regulation and supervision. Twelve respondent RSAs (57%), reported that the responsible authority for AML/CFT regulation and supervision is the monetary authority for conventional banks, fully fledged Islamic banks, and Islamic windows of commercial banks. In addition, in some jurisdictions, the AML/CFT committee and a Financial Intelligence Unit are integrated into the supervision activities of the monetary authority; while in others, the AML and Financial Intelligence units are incorporated into the regulatory and supervisory aspects side by side with the central bank. Meanwhile, five RSAs have another supervisory entity, rather than the monetary authority, that is responsible for the regulation and supervision of all types of banks (i.e. conventional, Islamic fully fledged, and Islamic windows of conventional banks, if any) (Figure 3.1).

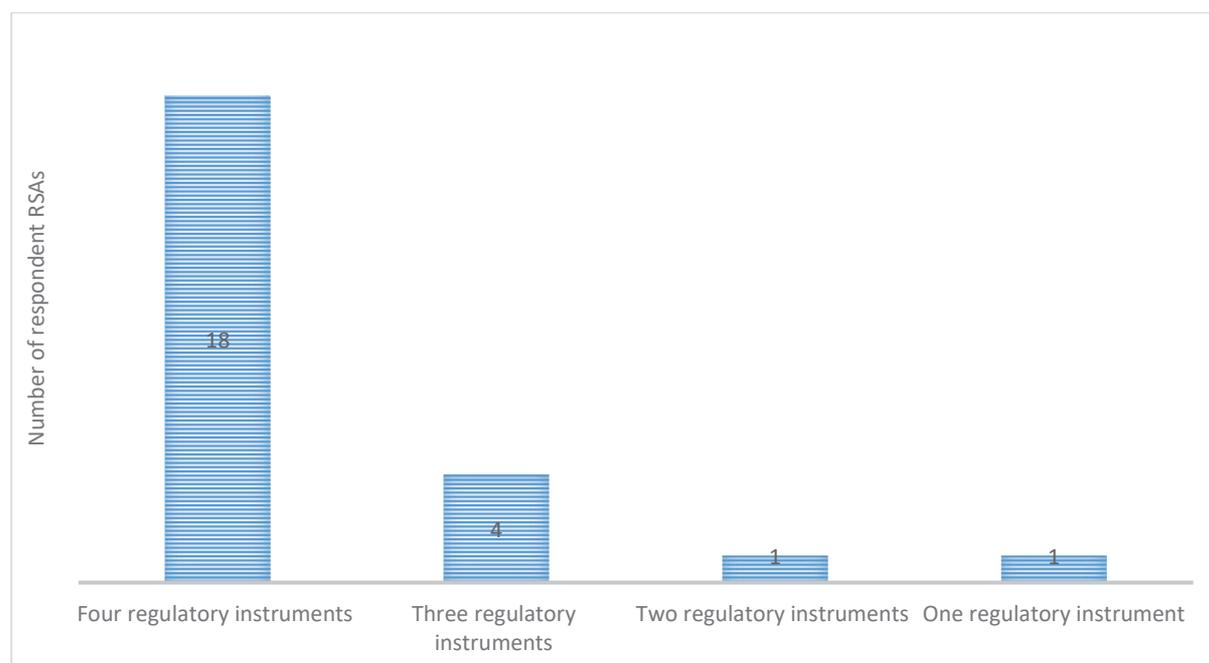
Figure 3.1 Responsible Authority for AML/CFT Regulation and Supervision



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

A majority of the respondent countries noted that a set of regulations has been adopted to enhance a robust AML/CFT legal and regulatory framework. The applied set of legislation that addresses the AML/CFT framework involves a diversified pool of laws, conventions, decrees, manual guidelines, as well as instructions. The questionnaire pointed out the different regulatory instruments such as laws, regulations, supervisory guidelines, and supervisory circulars or statements. The survey responses in Figure 3.2 show that eighteen respondent RSAs indicated that they apply the four regulatory instruments – namely, laws, regulations, supervisory guidelines and supervisory circulars/statements. Four other RSAs use three regulatory instruments, excluding the supervisory circulars/statements, to regulate and supervise the ML/FT activities in their banking system. One monetary authority deploys two regulatory tools to govern the ML/FT activities in its jurisdiction, mainly laws and regulations. Another authority depends only on the two existing laws in that jurisdiction relating to AML/CFT, being a law on countering the financing of terrorism and another on anti-money laundering and the proceeds of crime.

Figure 3.2 Instruments Included in the AML/CFT Requirements for Banks



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

The survey asked whether specific laws or regulations have been formulated for Islamic banks, whether the regulatory authorities are facing particular challenges while conducting AML/CFT supervision of Islamic banks, and whether Islamic banks have encountered challenges in applying AML/CFT regulations. A total of 23 (96%) respondents out of 24 RSAs noted that there are no specific laws or regulations,

including provisions that are dedicated to governing Islamic banks. This includes, for example, different terminologies used to designate products and/or services, or customers, specific due diligence regarding certain Islamic products, etc. Moreover, 22 respondents (83%) among the 24 RSAs affirmed that RSAs do not encounter any particular challenges in implementing the laws and regulations pertaining to ML/FT activities, taking into consideration that the same requirements apply to both conventional and Islamic banking in individual countries.

There is no evidence of specific laws or regulations that are formulated for Islamic banks. Also, none of the regulatory authorities indicate that they face any specific challenges while conducting AML/CFT supervision of Islamic banks, and no Islamic banks indicate that they encounter challenges in applying AML/CFT regulations.

Regarding the approach that RSAs follow in monitoring banks, most of the responses showed that similar monitoring processes are in place for both conventional and Islamic banks. Regardless of whether the approach adopted is risk-based, on-site or off-site, or a combination of them, 23 (96%) respondents indicated that the same rules apply for Islamic and conventional banks alike. Meanwhile, four of the respondent RSAs noted that they are following a risk-based approach while supervising AML/CFT compliance, where key risks, including ML/FT risks, are monitored on a continuous basis as part of the ongoing supervisory activities conducted each year. Therefore, in some cases, ML/FT risks and AML/CFT measures are assessed in conjunction with the assessment of banks' significant activities, as guided by the supervisory framework.

In other cases, where necessary, the monitoring based on significant activities is complemented by thematic AML/CFT reviews (based on environmental scanning and supervisory planning). Branch reviews are determined based on a risk-based approach (e.g. “hot spot” areas). Off-site monitoring of selected financial crimes or risks, such as illegal financial schemes and mule account activities, is also done on a periodic basis (e.g. monthly, quarterly, etc.).

As defined by the FATF, the “risk-based” approach to AML/CFT means that countries, authorities and financial institutions are expected to identify, assess and understand the ML/FT risks to which they are exposed and to take preventive AML/CFT measures that are appropriate to mitigate those risks effectively.⁴⁷ A risk-based assessment is a dynamic process

⁴⁷ Financial Action Task Force (2014). *Guidance for a Risk-Based Approach – the Banking Sector*, October.

involving regular reviews, and these reviews should be used to establish the appropriate processes to match the levels of risk.⁴⁸

The “risk-based” AML approach differs from the “regulation-based” approach in that it requires banks to proactively identify and seek out various “outlets” and changes of “black money” in order to find ways to control money laundering. The “regulation-based” approach only requires reactive enforcement of regulatory requirements and standards.⁴⁹

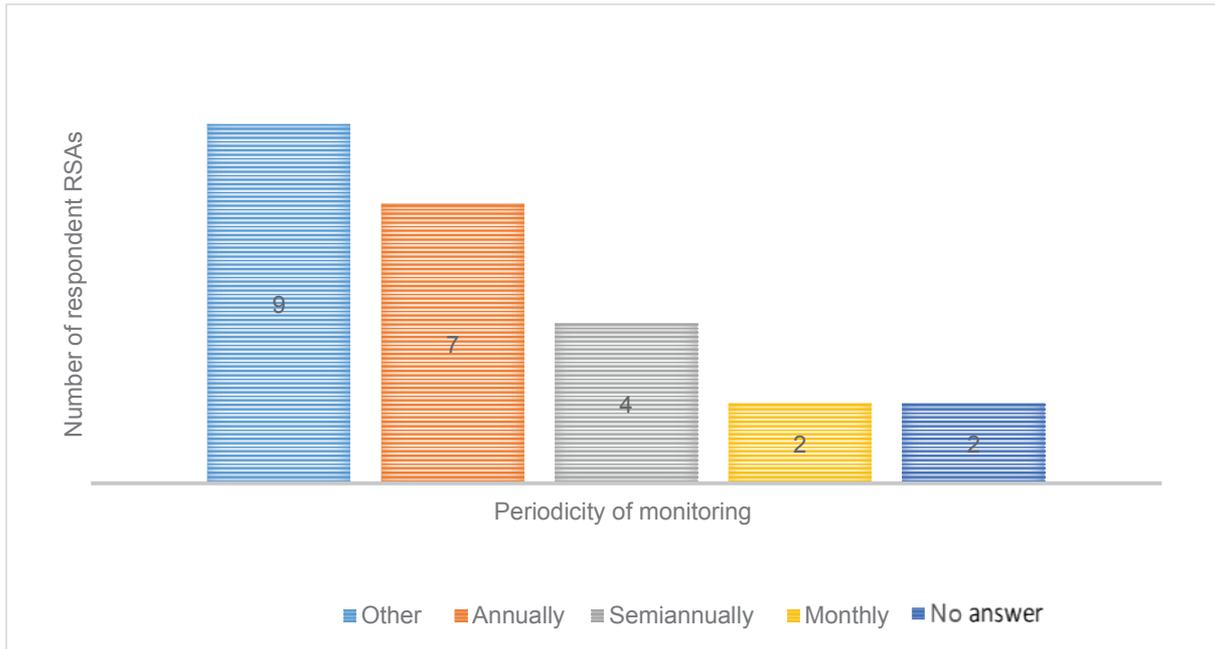
The periodicity of monitoring money laundering and financing of terrorism risks for Islamic banks varies across the respondent countries. A total of nine RSAs (38%) indicated that their frequency of monitoring ML/FT risks differs from that specified in the questionnaire. This is mainly because the frequency of on-site examinations depends on the bank’s size and previously determined risk level. In other cases, on-site and off-site supervision are based on an annual plan. In addition, one of the respondent RSAs reported that regular on-site examinations are performed at least once every two years, or within such other period as the central bank may determine according to the Banking Act. This is in addition to the ad hoc monitoring of ML/FT risks conducted through special on-site examinations.

Another group of seven RSAs (29%) maintain regular monitoring of ML/FT risks on an annual basis, while four respondent RSAs (17%) conduct monitoring on a semi-annual basis. Two respondent RSAs (8%) maintain monthly monitoring of ML/FT risks for Islamic banks, while two other organisations did not report on the periodicity of their monitoring of ML/FT risks (Figure 3.3).

⁴⁸ Dubai Financial Services Authority (2013). *The DFSA Rulebook: Anti-Money Laundering, Counter-Terrorist Financing and Sanctions Module (AML)*. Dubai: DFSA, June.

⁴⁹ Z. Fan (2017). The “Risk-based” Principle of AML Management. *ACAMS Today*, 19 September.

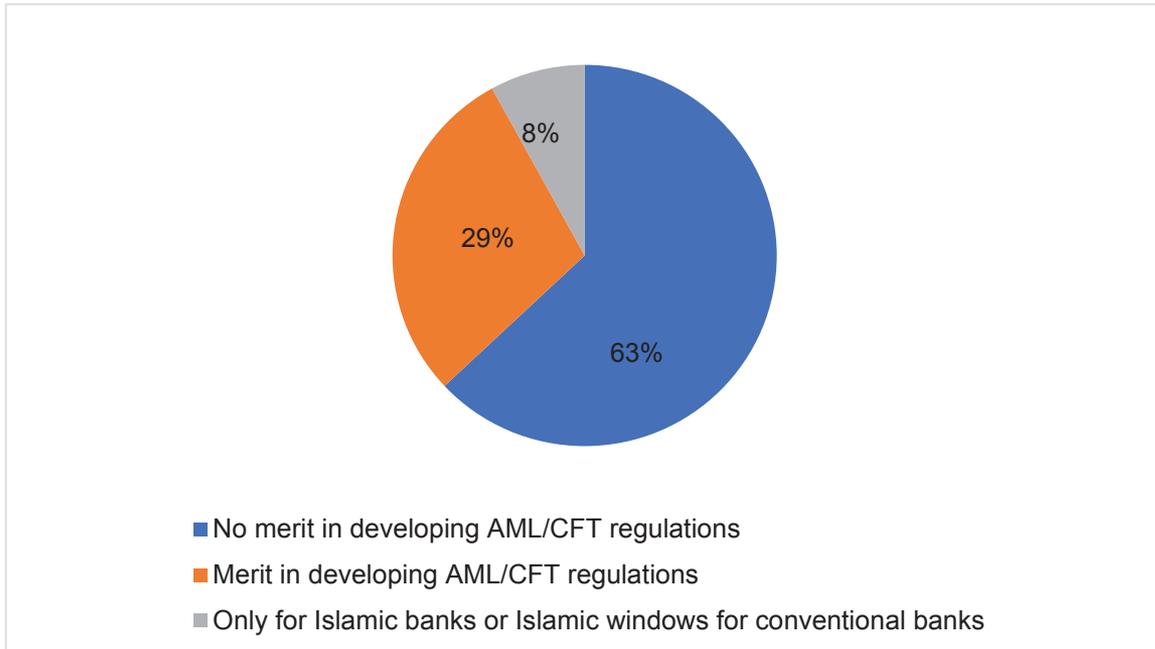
Figure 3.3 Periodicity of Monitoring of ML/FT Risks for Islamic Banks



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

The majority of RSAs’ responses pointed out that there is no merit in introducing specific regulations for AML/CFT segregated by industry type. Figure 3.4 shows that among the 24 responses, two main groups emerged regarding the merit of developing AML/CFT regulations that are specific to industry type in order to mitigate ML/FT risks more effectively. A total of 15 RSAs (63%) highlighted that there is no need for particular regulations by type of banking activities (i.e. conventional, Islamic, and Islamic windows of conventional banks), while seven RSAs (29%) responded otherwise. However, two (8%) of the respondent RSAs reported that there is merit in formulating particular sets of regulations for Islamic banks and for Islamic windows of conventional banks.

Figure 3.4 Merit in Developing AML/CFT Regulations Based on Industry Type



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

All but three of the respondent RSAs reported that neither Islamic banks nor conventional banks have been subject to sanctions. Most of the responses, specifically 21 RSAs, showed negative evidence of being subject to sanctions/listing by foreign governments, lawsuits, or pressures by correspondent banks in relation to the management of ML/FT risk associated with Islamic financial products. However, two financial institutions in two of the respondent countries indicated they have been subject to sanctions due to their relationship with one of the sanctioned countries. In addition, another respondent RSA noted that one correspondent bank has been subject to termination after failing to satisfactorily justify a few suspicious transactions. The deficiency that led to this measure is the pressure from a shareholder, which resulted in the bank breaching its internal controls despite having adequate AML/CFT control measures.

4. PREVENTIVE MEASURES

The FATF as the international standard-setting body for AML/CFT provides 40 recommendations relating to AML/CFT of which Part D (Recommendations 9–23) focuses on preventive measures. Drawing from this set of recommendations, this section of the working paper elicits responses from various RSAs on the preventive measures prevalent in their jurisdictions.

A number of questions were posed to the RSAs relating to their understanding of ML/CF risks, approaches to implementing customer due diligence, understanding of the peculiarities of NPOs and SPVs as possible transmission channels, the reporting of suspicious transactions, etc. Analysis of the responses obtained is thus based on a regulatory and supervisory view of how ML/CF can be prevented.

4.1 Managing AML/CFT Risks

4.1.1 Customer Due Diligence

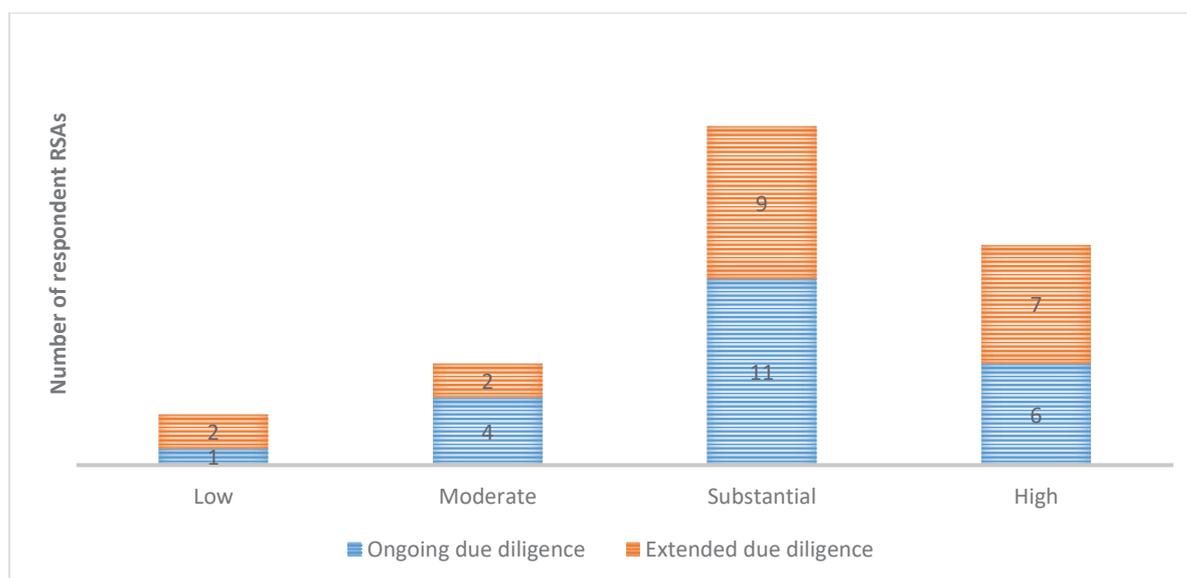
Recommendation 10 of the FATF provides the requisite guidance and essential elements for conducting CDD. Furthermore, the interpretive note to Recommendation 10 states that in instances where the ML/FT risks are considered to be higher, enhanced customer due diligence may be necessary.⁵⁰ This is particularly relevant for customers that, based on a bank's acceptance policy, would maintain a large account balance,⁵¹ engage in frequent overseas electronic transfers, reside in a high-risk jurisdiction or are on the list of politically exposed persons.⁵² It may also be pertinent that an Islamic bank mitigates against sanction risks that may crystallise in the event that it fails to conduct the detailed name or transaction screening which would have indicated a potentially blacklisted customer for offences that would be regarded as ML/FT-related.

⁵⁰ There is also what is known as consolidated customer due diligence (CCDD), which allows for consolidating and streamlining customer acceptance policy and ongoing monitoring of customers across organisational, national, regional and international divides.

⁵¹ For instance, licensed money changers, clubs, societies and charities, shell banks and companies, etc.

⁵² A "politically exposed person" is defined in the FATF Recommendations document (2018), p. 120, as an individual, domestic or foreign, who has been entrusted with prominent public functions in a foreign country, such as a head of state, senior politician, senior government official, judicial or military official, senior executive of a state-owned corporation or an important political party official. The definition also covers the families and close associates of those listed. See Financial Action Task Force (2012–2018), *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. Paris: FATF, www.fatf-gafi.org/recommendations.html.

Figure 4.1 Ongoing and Extended Due Diligence



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

The respondent RSAs were asked about the performance of risk management of Islamic banking in their jurisdiction in relation to both ongoing and enhanced CDD. As indicated in Figure 4.1, most jurisdictions consider the performance of both the CDD and ECDD to be at least substantial. Specifically, 11 (55%) RSAs indicate that the performance of the ongoing due diligence is substantial, thus reflecting significant compliance with the prevailing AML/CFT guidelines used in their local jurisdiction. Six (30%) RSAs also consider their performance in this regard to be very high as an indication of full compliance with extant related AML/CFT standards and guidelines. In specific instances where the need arises to conduct ECDD, most of the RSAs surveyed consider the performance in their various jurisdictions to be at least substantial. While nine (45%) RSAs indicate substantial performance, an equal number also consider the performance of ECDD in their jurisdiction to be very high.

It is quite interesting to observe such substantial performance on both the CDD and ECDD in the jurisdictions covered. This would help forestall possible ML/FT risks that the Islamic banks have been speculated to be exposed to, especially arising from the peculiar nature of the relationship they share with their customers, who consider the banks as partners.

Interestingly, beyond such speculation, the modus operandi and the fundamental tenets that underlie the structure of most Islamic banking products, especially those based on profit- and loss-sharing contracts such as *mudharabah* and *musharakah*, strengthen rather than weaken CDD as an ML/FT preventive measure. The participatory nature of Islamic banking would make it more compliant with CDD policy, due to the relative emphasis on the integrity and

personality of the client (partner to the bank with whom any profit and losses are shared) as well as inherent prohibition of proceeds from crime and of investing funds in ML/FT-related ventures such as drug and weapons trafficking even if the source is legal.

4.1.2 Managing Risks of Complex Transactions and Private Banking in the Islamic Banking System

In an attempt to cover their tracks, the perpetrators of ML/FT engage in complex transactions and procedures that make it difficult to link the source of their funds to the activities they engage in. It is important, therefore, that RSAs continuously assess the inherent ML/FT risks arising from the complex financial businesses that banks in their jurisdiction engage in. For instance, it is possible that institutions engage in brokered deposits, private banking, trade financing, etc.

Driven by competitive pressure and high fee earnings, banks also offer private and confidential banking products and services to their high-net-worth customers. Private banking requires close supervisory monitoring given that the fee earnings by the bank and compensation to relationship managers are tied to the value of assets under management, which often results in a lack of transparency. Another notable susceptible process often used for private banking is concentration accounts.⁵³ ML risk may be heightened as the audit trail may be lost if information on customer identification is separated from the respective financial transactions.

⁵³ Concentration accounts are used as an internal process to quicken the processing and settlement of many transactions at the same time and usually on the same day.

Figure 4.2 Managing Risks of Complex Transactions and Private Banking Business



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Based on the response elicited from the respondent RSAs to the question relating to the performance of risk management on complex transactions and private banking business, Figure 4.2 indicates that better compliance is recorded for the latter relative to the former. Similar to the response distribution for previous questions, 15 RSAs (75%) view the risk management performance relating to ML/FT risks arising from private banking to be at least substantial, thus indicating significant compliance with relevant ML/FT standards and guidelines.

In terms of complex transactions, on the aggregate, more than half (12 RSAs, or 60% of the respondents) of the RSAs also consider requisite risk management performance to be at least substantial, indicating significant compliance with related jurisdictional AML/CFT standards and guidelines. Nonetheless, more than one third (eight RSAs, or 33%) of the respondent RSAs consider their performance of managing ML/FT risks relating to complex transactions to be moderate. This is perhaps notable given the concern that Islamic banking products, being asset-based by nature and by extension focused on economic intermediation, present additional complexity in structuring compared to conventional banking products which are based on financial intermediation.⁵⁴ An example is made of a commodity *murabahah* transaction and how it can be misused to recycle proceeds from crime. While this remains a theoretical conjecture, mitigation against its practical possibility placed against the distribution

⁵⁴ N. Kyriakos-Saad, M. Vasquez, C. E. Khoury and A. E. Murr. (2016). *Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)* (IMF Working Paper No. WP/16/42). Washington, D.C.: IMF, p. 9.

of responses obtained regarding risk management of complex transactions should elicit supervisory interest.

4.1.3 Preventing ML/FT Risks Arising from Non-Profit Organisations and Special Purpose Vehicles

Non-Profit Organisations

Islam is theologically communitarian and provides numerous platforms through which distributive justice can be enhanced in a society. In fact, added to its third pillar, *zakāh*,⁵⁵ Islam provides for other social finance mechanisms such as *waqf*, *ṣadaqah*, etc. Non-profit organisations play a major role in ensuring the potential of these Islamic social finance mechanisms to provide humanitarian aid, especially in disaster-prone and war-ravaged regions. The FATF notes that, notwithstanding their usefulness in providing humanitarian aid, NPOs are highly prone to misuse. This is mainly due to the fact that the funding cycle of most NPOs is not transparent, and they generally lack governance relating to accountability due to the cash-intensive nature of their funding and spending.

There are concerns raised regarding the huge volume of activities conducted by NPOs in general, and by Islamic NPOs in particular. The number of NPOs in countries with a significant Muslim population and the presence of Islamic banking ranges from close to 500 in Brunei Darussalam to as many as 337,000 in Indonesia, while the combined assets of NPOs in Malaysia alone is estimated at USD 3.5 billion.⁵⁶ In some countries with Islamic finance significance, NPOs are subjected to regulatory oversight, especially as it relates to their raising, storing and transferring of funds.⁵⁷ However, there are concerns that donations through some NPOs are not being used for charitable purposes and that there is scope for raising or moving funds for criminal activity.

In addition to strong oversight of governmental and regulatory bodies in jurisdictions with Islamic finance such as Indonesia, as per the FATF's *Mutual Evaluation Report* (MER) for the country in 2018, the key risks in this regard could be effectively mitigated by improving

⁵⁵ *Zakah* is essentially a compulsory annual levy on the wealth of an adult and sane Muslim individual who might possess wealth beyond a prescribed minimum. For wealth to become liable for *zakah*, it must remain in the ownership of the individual for one Hijri calendar year (*Hawl*) and must exceed a minimum threshold (*Nisab*) (*IRTI Islamic Social Finance Report*, 2015, p. 36).

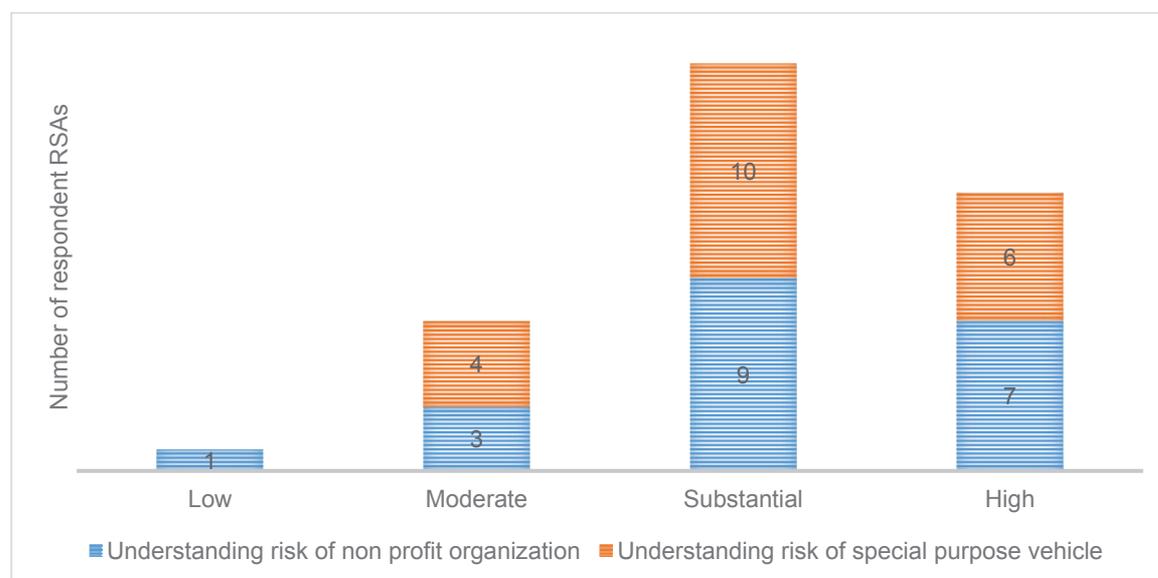
⁵⁶ NPOS Reporting Austrac (2017). *Non-Profit Organisations & Terrorism Financing | Regional Risk Assessment 2017*. https://www.austrac.gov.au/sites/default/files/2019-06/regional-NPO-risk-assessment-WEB-READY_ss.pdf.

⁵⁷ For instance, in Saudi Arabia new laws have been put in place to ensure that the genuine intention to provide humanitarian aid abroad via charitable donations from the Kingdom is not abused. As such, all such charitable contributions to be made abroad will have to seek approval of the Foreign Ministry subject to meeting some stringent conditions for reporting and accounts operation.

awareness to ensure that donations are made to legitimate NPOs via a centralised control on *zakat* aimed at ensuring targeted compliance with effective ML/FT preventive measure for the NPOs as is done in Malaysia. While Pakistan has commenced taking steps to ensure effective oversight of NPOs via their stringent registering and licensing, and the monitoring or revoking of such licences in the event of abuse, Bangladesh has requested NPOs that receive foreign donations to provide audited accounts, among other documents, for monitoring purposes.

In this paper, the RSAs were asked about the activities of NPOs in their jurisdictions and their performance in terms of managing the ML/FT risks that the prevalence of these NPOs portends. As indicated in Figure 4.3, most of the RSAs (16 RSAs, or 70% of the respondents), based on their supervisory experience, consider their understanding of the peculiar risks that ML/FT portends for Islamic banks in their respective jurisdictions to be at least substantial. Specifically, while nine RSAs (45%) consider the understanding of Islamic banks in their jurisdiction to be substantial, seven (35%) indicate a high level of understanding of the peculiarities of the ML/FT risks that may derive from the high volume of Islamic banking activities of the NPOs in their respective jurisdictions.

Figure 4.3 Understanding the Risks of NPOs and SPVs



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

Special Purpose Vehicles

Furthermore, there may be an increasing possibility of using various special purpose vehicles such as corporations, trusts, endowments, etc. as transmission channels for illicit funds, especially because the identity of the beneficial owners, as well as the intended purpose of

such funds, can be easily concealed. The FATF also notes the use of shell and shelf companies for the purpose of hiding the true identity of those behind the establishment of firms by appointing nominees to the front as true owners on behalf of suspected or alleged perpetrators of ML/FT. Although not necessarily peculiar, Islamic financial transactions also have the potential to be used to establish offshore financial centres through SPVs. The added complexity of Islamic financial transactions in terms of the opacity of the valuation, underlying assets, origination and destination of funds fits the preferred concealed transaction disposition of the ML/FT perpetrators.

Figure 4.4 also indicates that the use of special purpose vehicles, although a valid concern given the possibility of their being used to commingle or hide illicit funds, is nonetheless well understood by the RSAs that responded to the survey. Specifically, 10 RSAs (50%) consider their understanding of the peculiar risks posed by the activities of ML/FT perpetrators through SPVs to be at least substantial, while seven RSAs (35%) also indicated a high level of understanding in this regard.

4.1.4 Reporting Suspicious Transactions

What may constitute a suspicious transaction is a very subjective judgment. In fact, banks sort through a plethora of financial transactions every day and, as such, may have to rely on a risk-based approach informed by their foreknowledge of customers when determining if a transaction is suspicious. Therefore, following substantial compliance with the CDD and ECDD policies, it is expected that a bank will have a fair idea of the range of financial activities its clients can engage in. An established pattern of financial transactions by a customer, including amount size, frequency, product type, the source of funds, and geographical coverage if international wiring of funds is involved, would be known to the bank. As such, any unusual or suspicious transactions would require the bank to file a suspicious transaction report.

It can be argued that the relationship an Islamic bank has with a client with which it has entered into a profit- and loss-sharing contract may infringe on both the CDD process and STR.⁵⁸ For instance, the conflict of interest that may arise from joint liability of an Islamic bank and its client in the event of proven involvement of the latter in an ML/FT may prevent the former from filing an STR. Beyond the financial loss that may result, an Islamic bank may also consider its exposure to reputational risks. However, the FATF's *Mutual Evaluation Reports*⁵⁹ for Malaysia

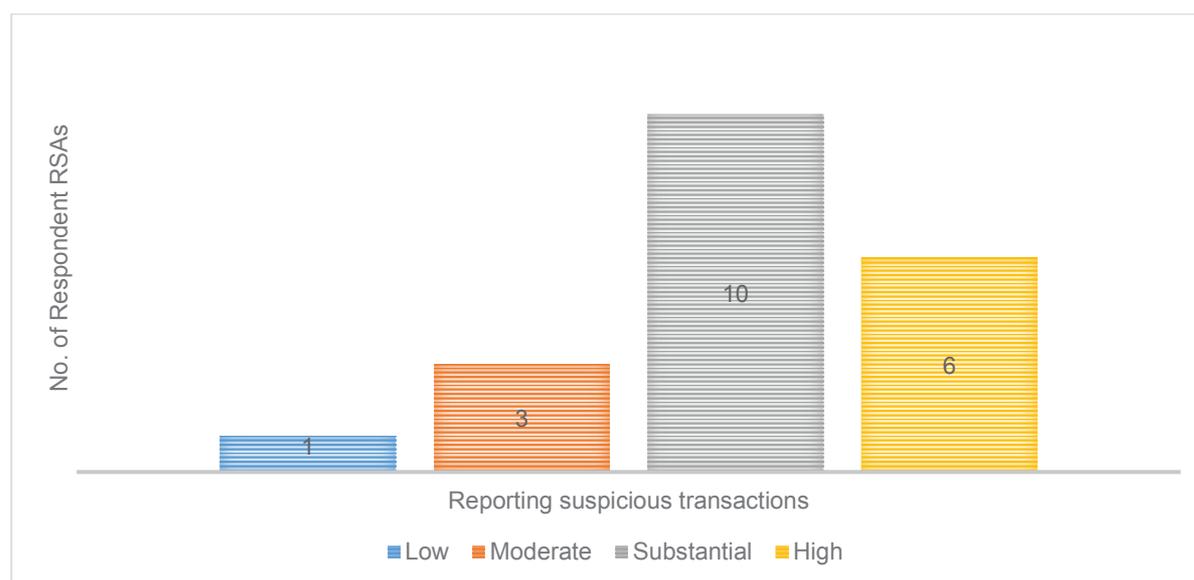
⁵⁸ N. Kyriakos-Saad, M. Vasquez, C. E. Khoury and A. E. Murr (2016). *Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)* (IMF Working Paper No. WP/16/42). Washington, D.C.: IMF, p. 9.

⁵⁹ Financial Action Task Force and Asia / Pacific Group (2015). *Anti-Money Laundering and Counter-Terrorist Financing Measures – Malaysia* (Fourth Round Mutual Evaluation Report). Paris and Sydney: FATF and APG, www.fatf-gafi.org/publications/mutualevaluations/documents/mer-malaysia-2015.html.

in 2015, Bangladesh in 2016, Indonesia in 2018, and Pakistan in 2019 indicate that, like their conventional counterparts, Islamic banks also file STRs in these jurisdictions.⁶⁰ In fact, in the case of Bangladesh, given that it is a cash-based economy, Islamic banks also filed about 670,000 cash transactions.

As indicated in Figure 4.4, while only three (15%) RSAs indicate the low performance of suspicious transaction reporting among Islamic banks in their jurisdictions, 10 RSAs (50%) consider that, based on their regulatory experience, the performance of STR in their jurisdictions is substantial. Specifically, six RSAs (30%) are of the view that the performance of STR as an ML/FT preventive measure is very high in their jurisdiction, indicating full compliance of Islamic banks with related provisions in the jurisdictional AML/CFT standards and guidelines.

Figure 4.4 Reporting Suspicious Transactions



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

4.2 Identifying ML/FT Beneficial Owners in Islamic Banking

It is expected that having a robust CDD would enhance the identification of customers, as well as of natural or legal persons acting on their behalf and beneficial owners.⁶¹ As provided in the FATF standards, the onus is on banks to ensure that the identity of beneficial owner(s), if any, is established. The bank may request written documentation from the customer about

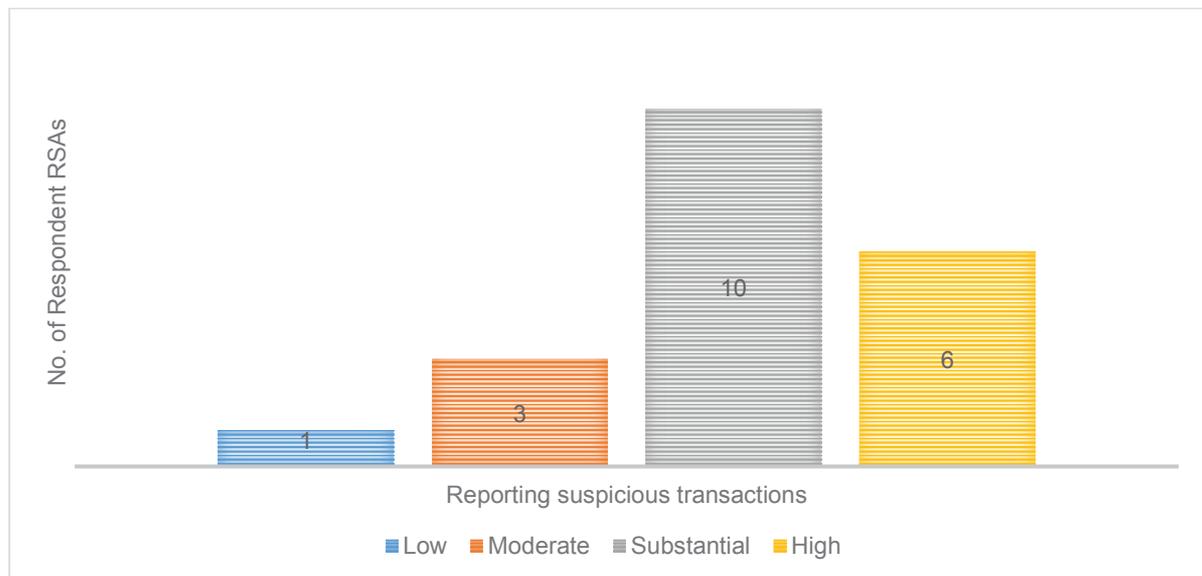
⁶⁰ For instance, in Bangladesh the Islamic banks had filed up to 426 STRs by 2015, while Islamic banks in Pakistan had filed up to 172 STRs as at 2018.

⁶¹ As stated in the FATF standards (2018), p. 111, “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.”

beneficial owners, or the information may be gained via other independent sources. If a bank consistently fails to report information on beneficial ownership, it may be considered to have very poor compliance with the CDD obligations.⁶²

The process of identifying beneficial ownership can be very difficult and complex. As such, RSAs in various jurisdictions have issued special guidelines to address pertinent related issues. For instance, where the beneficial ownership belongs to a “legal person” – that is, a firm – it is expected that a bank would take extra measures to understand the ownership and control structure of the corporate customer.

Figure 4.5 Identifying Beneficial Owners



Source: Joint IFSB–AMF Survey on the Money Laundering and Financing of Terrorism Risks in Islamic Banking, 2019.

The respondent RSAs were asked about their supervisory experience relating to how financial institutions in their jurisdiction conduct identification of beneficial owners. As indicated in Figure 4.5, most of the RSAs that participated in the survey consider the performance of financial institutions in their jurisdiction to be at least substantial for Islamic banking. Out of the 20 RSAs that responded to this question, 50% considered performance to be largely in compliance with the FATF and other guidelines prevalent in their jurisdiction relating to identifying beneficial owners in the financial transactions or business relationships in which the bank is engaged. Specifically, six RSAs (30%) consider compliance with procedures for identifying beneficial owners to be very high.

⁶² P. Chatain, J. Mcdowell, C. Mousset, P. A. Schott and E. V. D. D. Willebois (2009). *Preventing Money Laundering and Terrorist Financing: A Practical Guide for Bank Supervisors*. Washington, D.C.: The World Bank, p. 149.

Given that Islamic banking transactions are based on a partnership relationship with clients, and that more cognition is given to integrity and economic intermediation, the CDD and customer acceptance policies of Islamic banks should ideally be satisfactory. However, there are also arguments that such a partnership relationship may be an issue given that the FATF standards provide only for due diligence on customers. It would be interesting, therefore, to find out how Islamic banks treat their partners in a contractual relationship vis-à-vis conduct of due diligence as a preventive measure for ML/FT.

The RSAs that participated in the survey were asked how Islamic banks and windows in their jurisdictions generally identify the beneficial owner(s) and if the approach used differs from that adopted by conventional banks. The responses obtained indicate a general view that there is no notable difference between Islamic banks and conventional banks in their practice of identifying beneficial owners. It would seem there is no significant peculiar beneficial ownership identity issue relating to ML/FT prevention that warrants a different treatment for Islamic banking. It is likely, therefore, that while the word “partner” is not catered for by the FATF standards, an Islamic bank would follow all the CDD provisions in the standards to obtain all the needed information from its partners for the purpose of identifying beneficial owners. In fact, the risk-sharing financial contracts used in Islamic finance, as well as their asset-based nature, offer added disclosure of the partners’ source and use of funds, thus compatible with the existing FATF standards.

In responses to the open-ended questions, some RSAs indicated that banks in their jurisdictions, regardless of the nature of their operation, seem as much as possible to follow due process relating to identifying beneficial owners. Such practices include the use of a publicly available system that contains updated information on the beneficial ownership of legal entities, government card reader information, and use of authenticated documents to identify and verify beneficial owners.

The ability to identify natural persons as required by regulation varies across banks, depending on the robustness of their systems and processes and the availability of the requisite resources. For instance, where it is difficult to identify beneficial owners based on a 25% controlling interest in a particular jurisdiction as per the AML/CFT guidelines, the banks (regardless of whether they are Islamic or conventional) are required to identify through other means the natural person exercising control. Where there is no natural person identified, the identity of the senior management must be identified and verified.

4.3 Does Being Partners Preclude Islamic Banks from Filing a Suspicious Transactions Report?

The likely reputational risk and financial loss to an Islamic bank following the prosecution of a business partner based on an STR filed by that same Islamic bank may prevent it from proceeding. This postulation informed the following question posed to the RSAs that participated in the survey: Is an Islamic bank (independent of any considerations about the possible freezing of assets) less likely to report a suspicious transaction involving a customer with whom it has entered a partnership, as compared to a suspicious transaction involving a customer with whom it does not have a partnership?

The responses obtained from the RSAs to the open-ended questions seem unanimous that an Islamic bank would not hold back on such an STR even if it is at variance with its corporate economic and reputational interest. This is very much expected as per the ethical precept upon which Islamic banking is based.⁶³ The fundamental principles of Sharī'ah upon which the edifice of Islamic finance in its entire ramification is built emphasise protection of the public interest, removal of hardship and the promoting of justice. Against this backdrop, any other response would have been a surprise.

Providing further elaboration, the approach taken to suspicious transaction reporting in Islamic banking operations is essentially similar to that taken by conventional banks regardless of the Islamic contracts used. In general, as expected, suspicious transactions are identified based on a bank's defined scenarios/red flags after satisfying its internal investigation. In addition, viewed against the rarity of reportage of ML/FT issues relating to Islamic finance even in developed jurisdictions,⁶⁴ the lower-risk nature of Islamic financial services and the inherent customer due diligence in the structure of Islamic financial contracts, it is considered less likely (but certainly not impossible) that an STR would become necessary. However, where it is necessary, as indicated by one RSA, many banks do submit STRs. However, no reluctance has been observed on the part of any banks, Islamic or conventional, to make STRs a preventive measure for ML/FT risks.

⁶³ The Prophet Muhammad (peace be upon him) said: "If you have four characteristics, whatever worldly advantage passes you by does not matter to you: keeping a trust, speaking the truth, a good character, and (moderation in eating)." Al-Tirmidhi, Hadith 1370. The Prophet also said: "God, show mercy to Umar, (for) he speaks the truth even if it is bitter." Al-Tirmidhi, Hadith 1613.

⁶⁴ A. N. Maruf (2018). Compatibility of Islamic Finance and Anti-Money Laundering Laws: A Myth or Reality? *International Islamic University Malaysia (IIUM) Law Journal*, 26(1), p. 73.

4.4 Effect of an STR on Islamic Banking Assets

As a rider to the question about the likelihood of an Islamic bank conducting suspicious transaction reporting when it is involved as a partner in the underlying transaction, the RSAs were also asked whether the bank's assets would be affected due to its partnership with the client if, as a result of an STR, the client's funds are frozen or ultimately confiscated.

Generally, the responses obtained indicate that such a situation has not been experienced by the RSAs that responded. Nonetheless, respondents expressed the view that the scenario that is likely to play out in this regard depends on the nature of the partnership contract between the Islamic bank and its customers.

For instance, for a restricted profit-sharing investment account (RPSIA), the Islamic bank would be acting on the specific mandate of the fund providers to place the fund in a specific Shari'ah-compliant investment. The confiscation of such a fund due to the RPSIA holder's conviction of involvement in ML/FT should be borne by the RPSIA holder except in the case where an Islamic bank, while actualising the mandate of the RPSIA holders, is found guilty of negligence in its CDD or ECDD, or of failing to adhere to other AML/CFT standards.

Another case is that of unrestricted profit-sharing investment account holders (UPSIAH), where investment account funds are pooled together and at times commingled with other non-investment funds. Given that the UPSIA funds are raised under *mudarabah*, which is a profit-sharing joint scheme, confiscation or freezing of the funds will invariably affect the bank's assets to the extent of the client's investment as the deployment of the confiscated/frozen funds will be compromised.

4.5 Comparison of STRs Submitted by Islamic Banks and Conventional Banks

The final question in this segment elicited responses from the RSAs regarding the frequency and number of STRs by the Islamic banks compared with the conventional banks in their jurisdictions. The responses obtained indicate that such a comparison is not possible in some jurisdictions due to, among other reasons, the relatively small size of the Islamic banking sector, which makes such STR frequency and number very insignificant. Similarly, some RSAs indicate that another agency within their jurisdiction is saddled with such responsibility and, as such, they could not provide the requisite response.

For the RSAs that provided a response to the question, in general, it seems that the conventional commercial banks have submitted more STRs compared to Islamic banks. It is instructive to note that such STRs are mainly for offences other than ML/FT. Also, the number of STRs reported by the banking sector generally has been on the increase in most

jurisdictions, with the larger banks more likely to submit more STRs as compared to their relatively smaller peers. This implies that structural factors such as size, network and customer base have implications for increased risks, and these are reflected in the number of STRs reported.

In terms of quality of STRs, no notable or significant difference is reported between conventional commercial banks and Islamic banks. A plausible reason could be the fact that most banking groups use the same compliance team for both conventional commercial and Islamic businesses. However, one jurisdiction noted that continuous improvement is being recorded on the quality of STRs by the Islamic banks in its jurisdiction due to continuous guidance by the financial monitoring unit of its RSA.

5. CONCLUSION AND POLICY RECOMMENDATIONS

This working paper attempts to seek a better understanding of ML/FT risks in Islamic banking, including the extent to which these risks are addressed by the current standards. In addition to reviewing the theoretical aspects of the ability of Islamic finance to combat ML/FT risks, the paper also analyses survey responses in order to understand: (i) ML/FT methods, trends and typologies related to Islamic banks; (ii) ML/FT risk-sensitive information emanating from the intrinsic characteristics of instruments and arrangements used in Islamic banking, or the nature of the contractual relationship between the Islamic bank, its customers, and the providers of assets; and (iii) the current status of AML/CFT legal and regulatory frameworks (e.g. laws, regulations, guidelines) in target countries to assess whether there is a need for further customisation of the AML/CFT requirements to the specific characteristics of Islamic banking. The paper also highlights the preventive measures needed to be taken to address the ML/FT risks in Islamic finance.

Notwithstanding the pervasiveness of the perpetration of ML/FT regardless of the nature of the financial system in place, there is speculation, albeit contestable, about the susceptibility of institutions offering Islamic financial services (IIFS), especially Islamic banks, to the consequential risks. This speculation is hinged on the argument of a weak ML/FT regulatory regime in most countries with a significant Islamic banking presence and the peculiarity of the products and partnership relationship an Islamic bank ideally should have with its clients, among other reasons.

The main findings and policy recommendations are pointed out below:

- **The findings from this research, based on the opinions of the RSAs that participated in the survey, are indeed not only contrary to the speculation about the susceptibility of IIFS to ML/FT risks, but also indicate that Islamic banks have very satisfactory practices in place to prevent ML/FT.** In terms of understanding the peculiarity of the ML/FT risks, responses to the survey indicated that most RSAs consider the IIFS in their jurisdictions as having at least substantial performance in managing ML/FT risks. This performance is nonetheless different from that of their conventional counterparts in terms of the contractual relationship with customers, understanding and managing the complexity of Islamic banking products, and deploying preventive measures. **Overall, there appears to be no need at present for Islamic banks to adhere to particular ML/FT regulations in conducting their activities, as compliance with the various FATF standards seems sufficient for the purpose.**

- **No notable difference is observed in the ML/FT risks between conventional and Islamic finance.** However, the discussion highlights that if Islamic banking follows the theoretical framework of Sharī'ah in contracts and transactions, the system itself can contribute to combatting ML/FT risks. Moreover, the discussion finds that Islamic banks also have incentives to follow Sharī'ah rules for the sake of maintaining their reputation and customer confidence. **The discussion also recommends the need for ongoing due diligence regarding the contractual nature of the relationship between an Islamic bank and its customers.**
- **Correspondent services have been identified as “highest risk” or “high risk” for both Islamic banks and conventional banks, indicating that there is a need to amend the applicable AML/CFT regulations on correspondent banking services given the nature of the partnership contract between Islamic banks and their customers.** Since Islamic banking involves a partnership contract with customers, the respective Islamic bank would need to ensure that the customer's use of business structures and investments has a genuine and legitimate purpose from the perspective of both national laws and Sharī'ah principles. **It is recommended that, in line with the FATF's guidance and the BCBS's guidelines, Islamic banking institutions need to take into consideration the risk-based approach in the context of providing corresponding banking services.**
- **The survey responses show the same level of ML/FT risks for both conventional and Islamic banking in terms of private banking and services. Therefore, it is recommended that Islamic banks only need to ensure that the customer's use of business structures and investments has a genuine and legitimate purpose from the perspective of both national laws and Sharī'ah principles.**
- **In terms of *awqāf* accounts, the survey results indicate the need to conduct enhanced due diligence for opening such accounts, which may include approval of the NPO by the respective competent authority, thorough customer profiling, and ongoing monitoring and transaction scrutiny.** Additionally, Islamic banks should develop a profile of anticipated account activity, and ensure that such transfers are in accordance with the spending plans of the charity.
- **The survey results also do not find any conclusive difference in ML/FT risks between conventional and Islamic banking in terms of raising and moving of funds for FT purposes.** Since the risk levels of conventional and Islamic banks in this respect are very similar, Islamic banks should adhere to country regulations and FATF standards to combat against ML/FT. **Moreover, it is suggested to conduct enhanced due diligence and to intensify ongoing monitoring processes of customer accounts with identified alternative remittance system transfers or**

movements of funds in Islamic banks or in conventional banks that have Islamic facilities or windows.

- The paper also suggests that Islamic banks should focus on implementing a risk-based approach, rather than following the de-risking approach. In order to lessen ML/FT risks, it is important to assess the customer profile and involve senior management in issuing approvals prior to accepting the customer and disbursing funds.
- The paper finds that the role of Islamic banks in transmitting *zakāh* collections to non-profit organisations may expose them to FT risks owing to their association with NPOs, when the NPOs are not regulated. Therefore, a careful and thorough review of the adequacy of AML/CFT rules and regulations for NPOs, especially in identifying their ML/FT risks and vulnerabilities, is needed. **In addition, Islamic banks should have sufficient information not only on the NPOs, but also on the beneficiaries, before distributing charity funds under *zakāh*, especially if the NPOs can distribute them by their own discretion.**
- **The conduct of the IIFS in various jurisdictions in terms of CDD and ECDD as per the views of their respective RSAs is also very satisfactory.** The substantial performance recorded based on responses to survey questionnaire offers an indication of relative attention paid to these crucial preventive measures needed to understand what falls within the range of reasonable and usual banking activity of customers and what activities portend suspicious transactions. This practice, when complemented with the inherent focus of Islamic banking on the integrity of the client and the prohibition of proceeds from illicit acts, no doubt enhances the identification of the beneficial owners, but also attenuates the speculation about the Islamic banks being relatively more prone to ML/FT risks.
- **Notwithstanding their prominence in Muslim-dominated countries and jurisdictions with a significant Islamic banking presence, the satisfactory responses from the RSAs indicate satisfactory regulatory oversight of the NPOs.** As such, the concerns often raised regarding the potential of Islamic social finance platforms such as *zakāh*, *waqf*, *sadaqa*, etc. to be used for mobilising, storing and disbursing funds for ML/FT is also unfounded. Similar satisfactory responses are obtained regarding the unlikelihood of Islamic banks having a relatively higher susceptibility to ML/FT risks arising from their operation of private banking or engagements with special purpose vehicles.
- **In terms of regulatory development, the majority of respondent RSAs mention that they have a robust AML/CFT legal and regulatory framework. However, no specific laws or regulations were formulated for Islamic banking to address the**

particular challenges in ML/FT risks. Regarding the approach that RSAs maintain in monitoring both Islamic and conventional banks, the majority of respondent RSAs mention that there is no merit in introducing specific regulations for AML/CFT segregated by industry type.

In addition to the FATF standards, various jurisdictions have also enacted laws and provided regulatory guidelines to help prevent the occurrence of money laundering and financing of terrorism, to detect when it has occurred, and to prosecute the perpetrators. The fact that ML/FT risks still constitute a major threat to the global financial system warrants the strengthening of preventive measures against those risks. It is incontrovertible that the danger such risks portend for the financial stability and economic prosperity of a nation is enormous.

Finally, the practice of suspicious transaction reporting is also considered very satisfactory, regardless of whether the banks are Islamic or conventional. Furthermore, the survey results establish that, in terms of compliance with the fundamental principles of Sharī'ah, which is the foundation upon which Islamic banking is built, suspicious transaction reporting would not be impeded even if an Islamic bank inadvertently partnered with a perpetrator of ML/FT, thereby impairing its assets or increasing its economic or reputational risk. Interestingly, there seems to be no notable difference across jurisdictions as far as suspicious transaction reporting is concerned, even though most RSAs indicate that conventional banks in their jurisdiction have reported more suspicious transactions than the Islamic banks.

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APPENDIX: LIST OF RESPONDENT REGULATORY AND SUPERVISORY AUTHORITIES

- 1 Autoriti Monetari Brunei Darussalam
- 2 Bangladesh Bank
- 3 Bank Al-Maghrib
- 4 Bank Negara Malaysia
- 5 Bank of Mauritius
- 6 Banking Regulation and Supervision Authority, Turkey
- 7 Central Bank of Bahrain
- 8 Central Bank of Egypt
- 9 Central Bank of Iraq
- 10 Central Bank of Jordan
- 11 Central Bank of Kuwait
- 12 Central Bank of Oman
- 13 Central Bank of the United Arab Emirates
- 14 Central Bank of Tunisia
- 15 Central Bank of Yemen
- 16 Da Afghanistan Bank
- 17 Dubai Financial Services Authority
- 18 Financial Services Authority (OJK), Indonesia
- 19 Labuan Financial Services Authority
- 20 National Bank of the Kyrgyz Republic
- 21 Palestine Monetary Authority
- 22 Qatar Financial Centre Regulatory Authority
- 23 Saudi Arabian Monetary Authority
- 24 State Bank of Pakistan

Note: In alphabetical order by name of the regulatory and supervisory authority.

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