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"Islamic Banking and Anti-Money Laundering Compliance in the UAE"

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Introduction

Undoubtedly law has played a pivotal role in the 'upkeep' of the modern State as a structure for offering rights and duties, offering enforcement mechanism or even by offering a focal point for behaviours to coalesce. However, with development or economic development becoming a crucial goal of all modern States, there has been interest to better explain the role law plays to facilitate this process. In this vein law is seen to play an important, if not a critical role in achieving economic development.

The financial sector (here banking) materializes growth as it assures the functioning of an efficient and evolutionary payment system – a reliable and sound financial exchange system is seen as necessary for growth. First it mobilizes savings and makes it available to use for investments. Second the sector promotes growth when it is able to direct financial resources towards the sectors that demands such resources the most and thereby facilitates the formation of physical capital, leading to economic growth. So, despite opposing views a well-regulated financial sector along with external finance or 'finance generally' is vital for economic development.

A State (government) can facilitate development more effectively in the early stages of economic development when the private sector is underdeveloped. So, in relation to the Islamic Financial Institutions (IFIs') in the United Arab Emirates (UAE) the State should continue for two reasons; first because the State could direct and assess the growth of the sector – taking remedial action. Second, the Sharia Boards may not be focussed on issues of Money Laundering (ML) and terrorist financing risks. However, when conflicting supervisory roles in the development of policies exist, the law may not be that effective. In this sense, IFI regulations in the UAE are subject to such two supervisory bodies – Higher Sharia Authority and the Central Bank. Additionally, successful implementation requires reinforcement of the necessary socioeconomic conditions, including competent personnel, technical expertise, financial resources, and cultural and political acceptance of their regulatory objectives.

Understanding the above said becomes significant in the case of the Islamic economy, when its size (global) is considered. It is estimated to be more than $ 2.2 trillion and is expected to grow at over 7% annually until 2022. These projected figures are based on the expected growth of the Muslim population globally and of which much of the growth is due to happen in Asia. The UAE maintains second place in the Global Islamic Economy Indicator (GIEI) rankings for 2018 and occupies third in the Islamic Finance sector. The Islamic economy contributes 8.3 per cent of Dubai's GDP, but the UAE as a whole is in a strong position to act as a core trade hub.

Overall the UAE has gained economically from a strong banking system. With the penetration of Islamic banking in the UAE Islamic finance loans overtook conventional loans and has seen a growth of 7 per cent for 2018 while conventional finance stood at 4.5 per cent. Islamic banking assets account for about 80 percent of total assets of the Islamic finance industry, albeit representing less than 1 percent of global banking assets. Family owned companies with no government support have started successfully accessing the bond market and for this to continue investors need assurance that risks are minimised with strong practices in favour of governance. Thus, if the UAE /Dubai has to become a centre for Islamic Finance, it is important to understand the standards practised by IFIs' and to know whether they conform to them. Since there is limited understanding about such standards this research is planned to bridge this gap.

Regulating Islamic Finance in the UAE

For Islamic finance is subject to two types of regulation or Sharia contract-based regulatory policy consists of two parts. First Sharia requirements incorporate the Sharia rulings relating to a particular contract and second operational requirements incorporate sound banking practices, expectations for good governance, robust documentations, fair market practices and effective risk management. Failure to observe the essential conditions of a specific Sharia contract could render the financial transactions invalid, having adverse effects on the institutional safety and soundness. This can cause issues especially disputes arising from the Islamic financial contracts subsisting in or interacting with non-Islamic legal systems.

Islamic banks follow a method of risk sharing with ownership and promotes asset-based lending activities, all of these limit excessive leverage and fosters financial stability. However, in terms of ownership, this structure also could be a reason for extra caution in regulating IFIs', as the interest/s of the institution is closely aligned with that of the customer. Similarly with risk, Sharia prohibits investments that are too risky or uncertain. So theoretically Islamic banks should have better financials than conventional banks. These direct links between the financial and the trade sectors could limit technical speculations and potential bubbles and makes us think that once the products are created, IFI's require less regulatory oversight. Perhaps this is true to a certain extent in terms of the product itself, but this is no guarantee against compliance with other regulations.

In the UAE, the regulation of Islamic finance is treated separately as an economic (and not a cultural) issue. Notably, unlike the rest of UAE, Dubai has preferred a light touch or minimalist approach, where the regulatory authorities expect the Islamic banks to have Sharia compliance systems in place with minimal intervention from their side. But, it was not until 2016 that the UAE Cabinet approved a new Sharia Authority, designed to set standards for Islamic finance products. The Higher Sharia Authority was formalised as per Federal Law No. 14 of 2018, with a mandate to determine the applicable Sharia rules and principles (it adopted the AAOIFI, standards) and supervise and oversee the internal Sharia supervisory committees of all IFIs'. However as per Article 5 of UAE Federal Law No.6, 1985 it is the Central Bank that regulates Islamic banks (financial free zones excluded). This mean that IFIs' would have to comply with regulations Anti-Money Laundering (AML) of the Central Bank.

Islamic Banking Products and Potential for Money Laundering

Generally, the legal systems differentiate the religious activities from those which are not, but Shariah jurisprudence makes no such distinction and stretches into social or political aspects as well. So, it does prohibit activities that would be considered as commercial under non-Islamic legal systems. Also, certain activities are considered as Haram, for example, manufacturing or providing goods or services linked to tobacco, drugs, alcohol, speculation, pornography, armaments etc.

Before looking into the products of IFIs', it is useful to know some of its fundamental principles (finance that follows the principles of Sharia). First, the contract should be 'equitable', which could be interpreted as *riba, gharar* or *zakat*. Here 'Riba' means usury/ predetermined payments and unrelated to productive work. The intent here is two, first to protect the weaker contracting party to in the transaction and second to stop the increase of wealth accruing from a non-productive activity. Gharar prohibits excessive uncertainty arising from ambiguity in contracts or the elusiveness of payoff. To avoid Sharia compliant products being void, parties selling such products are required to share information about them to the customer (avoid information asymmetry).

Second is participation; wherein Islamic finance interprets that interest is prohibited as this accrues due to passage of time and not from productive work. To counter this drawback, IFIs' rewards capital with a return by sharing in the increase in wealth arising from risk taking. Thus under (Islamic Finance (IF) money does not have any inherent value.

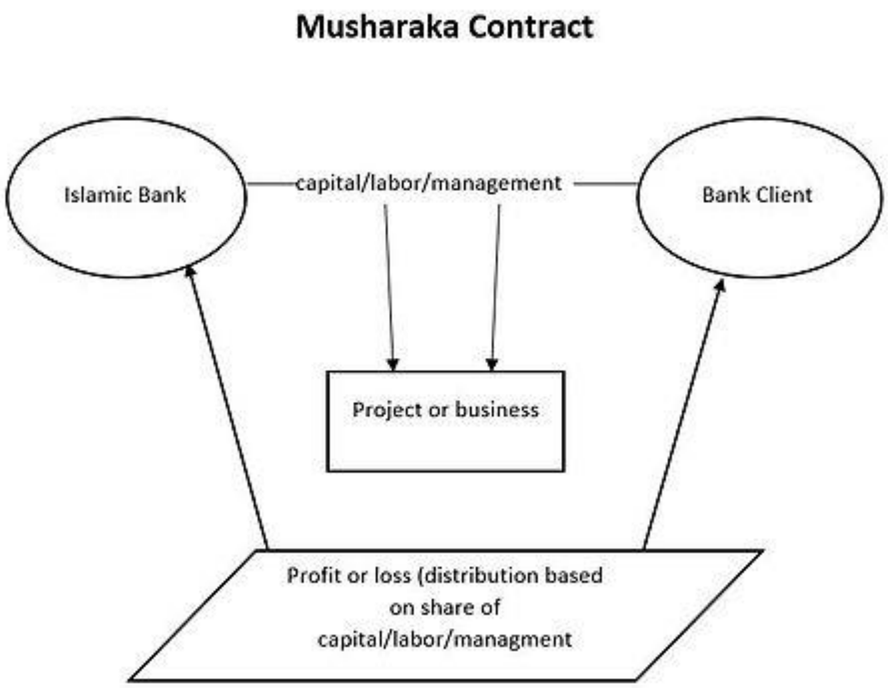
Third is 'ownership'; whereby one could not sell what one does not own (short-selling) nor can one person be dispossessed of a property except on the basis of right or ownership should be vested in a person before transacting. Islamic finance is therefore called asset-based financing. It also requires preservation and respect for property rights, as well as upholding contractual obligations by underscoring the sanctity of contracts. Although it is said that a comparison of conventional finance to IF is more about form rather than substance, the latter also offers opportunities for laundering.

Sharia compliant products are generally referred to as 'modes of financing' and some of this financing is done by sharing the profits and losses, others without sharing of the profits and losses and some others for a fee. Although these are closely related to the method of organising Islamic Finance, but give rise to money laundering concerns.

With ML, trading asset and commodity at profits or losses (perhaps multiple times) is a typical technique employed to obscure the source of funds (predicate crime) or their destination (in terrorist financing).With IF, the transfer of ownership is effected upon entering into a valid sale and purchase contract even though there is no legal registration of the ownership, provided that the sale and purchase is supported by evidence of transaction. This 'asset (or commodity)-based' feature of Sharia-compliant financing may pose risks. So, the informality involved in ownership of assets used in IF resembles 'layering' in money laundering and would yet represent pure legal financial dealings. First, we look at the some of the straight-forward contracts and then we look at the more complex structure of sukuk's.

Looking at the different IF contracts (products); for example, In a **mudarabah contract** the possibility of laundering cannot be ruled out. Whenever funds are deposited banks are vulnerable to instances of ML, similar to conventional banks. Especially in the case of mudarabah, since the banks stands to take a cut in the profits and not the burden of the losses. Except that since the person who deposits money into a bank to be invested into projects, they would be asked to explain the source of funds. Thus the possibility of detection is straight forward, whereby ordinary due diligence procedures would suffice.

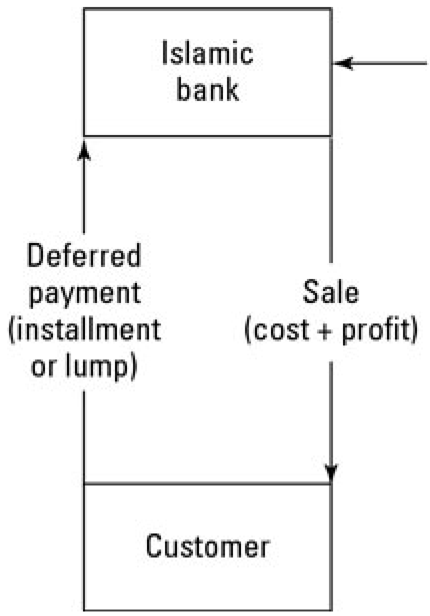
Now going on to a **musharakah contract** (as shown below), here the bank is a partner in the deal and shares both in the profits and losses of the investment.



In this case perhaps it is fair to think that there is lesser likelihood of the banks trying to partner with a person who they would suspect of trying to launder money. However, for instance take the case of a popular IF product – the *Musharakah mutanaqisah* or 'diminishing *musharakah*' developed by contemporary scholars and not in fiqh. It has gained popularity in Islamic banks and financial institutions and used for various purposes especially for home financing and car financing. This product combines three *Shariah* contracts, namely *musharakah*, *ijarah* and sale. Here, the customer and financial institution enters into a joint ownership of property or vehicle and subsequently the latter leases its shares to the former who starts purchasing the shares of the financial institution in small units until he becomes the sole owner of the property.

Here it is quite straight forward, the person who wants to launder money could jointly buy an expensive house or car and it could be paid back quickly. However the real deal could lie in the fact that the property could be bought over-priced and later sold at a loss. In the end the person gets the money clean.

In the case of **Murabaha** it is opined that it is not convenient for criminals looking to launder ill-gotten gains for various reasons – neither would they receive cash or an amount of money that can be transferred to another account, nor would they be granted a loan against cash collateral because tangible assets have to be purchased from a third party .



However it is easy to see opportunities for layering in this structure; unlike the comment above, various permutations are possible. The customer could insist that he wanted to buy the product from a particular seller whose selling price could be higher and thereby transferring the excess value, or the customer could simply take the product and sell it at a higher price to another buyer who could be passing on a bribe through the mark up price.

Finally in the case of **Sukuk's**, they use a special purpose vehicle (SPV) to which the asset is sold and then leased back to the seller or originator. The SPV then issues bonds based on the asset and the proceeds go to the originator who gets paid for the asset. The asset is then leased back (ijara) for which periodic rental payments are made to the SPV and this is then disbursed to the investors for the periodic payments. At maturity the asset is sold back to the originator who will buy it back. The same transaction could be structured in another way as well. In this structure the asset could be held by a wakala who/which would then transfer the same to an SPV, after which the SPV transfers the sukuk amount who then invests this in other portfolio investments which could be an ijara and murabaha.

As could be seen from the above, this structure could be used to launder money and could exit as clean money at the end of the deal. Questions about the identity can be raised at various levels – a) who are the investors, are they companies or natural persons? b) The underlying assets is transferred and the sukuk is issued – the SPV is incorporated in places which are officially tax havens (grey list). In fact the UAE is also one among the black listed jurisdictions by EU (2019). However, even more revealing is that a jurisdiction like 'cayman islands' which is used by many sukuk issuers to form the SPV, is in fact a jurisdiction that 'failed' to include information relating to lawyers and 'excluded activities' in its National Risk Assessment. What this shows is that there is a real threat of this mechanism being exploited by persons who wish to launder proceeds.

Also, sukuk's they vary according to the techniques used to structure them. In fact multiple Sharia contracts could be used to structure a sukuk. So factors like the character of the underlying assets, taxation (VAT arising from selling of underlying assets), regulatory considerations, the targeted investor base and the views of the Sharia scholars who approve the sukuk issuance all affect its structure. The most commonly used sukuk structures are the ijara, murabaha and mudaraba-wakala. Since the new regulations in the UAE require that sukuk issuers buy back the sukuk at their face value and prohibits mandatory interest-free loans or liquidity facilities that are typically used to make up for any shortfalls in income from the underlying sukuk assets the use of musharaka and the mudaraba sukuk structures have declined. So it is more complex to do a sukuk than a conventional bond and it is more difficult to see the structure, the underlying assets and time consuming to discuss with Islamic scholars and lawyers. Thus standardisation of documentation would help open investment opportunities.

Thus, in order to prevent the placement of ill-gotten gains into their institutions, Islamic banks should have the same firewalls as those of conventional banks. They need to adopt and implement adequate controls and procedures that enable them to know the person(s) with whom they are dealing. Adequate customer due diligence (CDD) on new and existing customers is a key part of such controls. In the CPIFR document except for Principle 33, nowhere is the word money laundering used. CPIFR 33 says, 'The supervisory authority determines that IIFS have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent IIFS from being used, intentionally or unintentionally, for criminal activities'. It also gives a list of reference documents, namely - FATF Recommendations, February 2012; BCBS's Consolidated KYC risk management, October 2004; BCBS's Shell banks and booking offices, January 2003; and BCBS's Customer due diligence for banks, October 2001. But the footnote to CPIFR 33 says that in some jurisdictions the responsibility for compliance could be with the FIU of the jurisdiction rather than Banking Supervisor (Central Bank).

Problem/Issue

As we are aware there is literature expressing doubts whether the Islamic Banks follow a different set of AML standards or even on the desirability for such standards. Also as discussed above there is real potential for Islamic banking products to be used for laundering. However due to the highly sensitive nature of the documents and not being an insider, accessing such information was difficult. Hence it was decided to gather this information through a survey from personnel working in the Islamic Banks.

As mentioned earlier, the purpose of this research is to understand whether the Islamic Banks within UAE have AML policies geared specifically towards Islamic products. FATF and the UAE regulator for IFIs' have not come out with any particular AML recommendations for Islamic products. So the aim here is limited to understanding whether the Islamic Banks in the UAE do have AML rules based on the specialized products they sell.

Methodology

Issues Accessing Data

Since this research is to elicit information about the practices related to AML within the Islamic Banks in the UAE a structured interview was designed. The respondents included 7 personnel within the AML compliance department from 4 Islamic Banks in the UAE. Although the data was collected in Dubai, since most of the Islamic banks operating in Dubai are pan UAE, the results would be applicable to banks operating in UAE generally.

The method used to get data was through questionnaire (structured) and a snowball sample. Such a sample had to be used due to issues faced to access these populations – especially people were unwilling to talk. As the initial approaches made to contacts did not bear fruit in getting face-to-face interviews, questionnaires were prepared and sent to selected interviewees. The personal contacts in the banking sector helped to get access to the interviewees working in the compliance sector of these banks. The researcher was from the same background as the personal contact and this process works because of an assumption that a connection exists between the initial sample and the others in the same social population and this facilitates referrals to be made within their circle of relationships. In relation to the questionnaire, it is set up to study the association between particular variables and is done to explore a particular hypothesis.

Unlike as with sample surveys (quantitative), a qualitative type of survey does not attempt to establish frequencies, means or other parameters but to determine the diversity of some topic of interest within a given population and thereby establish the meaningful variation (relevant dimensions and values) within that population. So, in a survey while studying a population, the individual persons are not selected due to their membership of the population, but because of their experience with the topic of study. Therefore, the study only focusses on characteristics of individual members involved, e.g. alcohol consumption, political affiliation etc. Also, here the individuals need to be considered only as a tertiary collectivity or a set of loose entities for data collection as we are not investigating their social interaction here but merely their accounts and evaluations of social interaction.

In the pre-structured surveys (deductive) the diversity to be studied is defined beforehand and guided by a structured protocol for questioning or observation and a descriptive analysis is undertaken to empirically establish the predefined characteristics in the population under study.

To understand the practice a set of questions had to be prepared and supplied to personnel. The first aspect to be understood is the personal knowledge about the scope of Islamic products being used to launder money. If the bank has done a risk analysis of their Islamic products, then this would be conveyed to the staff and hence they would be able to clearly specify the approach taken while selling Islamic products. Second, the personal knowledge of the personnel about AML regulations and practices generally. If it could be established how the staff working in the AML compliance gained knowledge on AML (to understand the depth of the knowledge), the importance of AML practices in curbing ML (belief in the objectives) etc., then they should be in a position to clarify whether the present AML rules or procedures are sufficient.

Since these two aspects would corroborate each other, from these it would be possible to make deductions about the effectiveness of the AML practices within Islamic banks. From these we would be able to deduce whether the Banks have a robust AML policy geared towards ML threats posed by Islamic products.

Thus the predictive value of these questionnaires are utilized here to predict whether the Islamic banks operating in the UAE follow specific rules to limit ML which may be specific to such products. Here the independent variables are the knowledge of the AML compliance staff about AML compliance issues and the knowledge they have about the Islamic banking products with reference to the likelihood of them being used for money laundering. The dependent variable here would be the rules and processes specifically tailored for Islamic banking products.

The questions were piloted to understand the possibility for misinterpretation and thus to improve the clarity of the questions. This was done with some bank staff itself – other than those whose responses have been taken as evidence about the banks AML practices/policies. To limit superficial answers, the number of questions have been limited. Certainly, then there is the issue of the person answering the questions thinking - what is the benefit for them to answer these questions? Here it is assumed that approaching the person through contacts could help limit such effects from arising.

In analysing the data, as with explorative surveys, well-performed interviews or observations may produce valuable sophisticated knowledge by concurrent validity checking (probing, replicating, triangulating). Also, the data is to be coded into two themes – first, the knowledge about the Islamic products and the specific practices within their institution and second, the general knowledge of the participant about regulating ML. This coding (prefigured) would ensure that the trainings reflected the ground reality (experiences) and this would be reflected in the knowledge of the staff.

Results

Vulnerability of Islamic Banking Products

All the respondents agreed that Islamic banking products are vulnerable to money laundering when adequate controls are not in place. However, the respondents do not see much difference between the risks posed by the Islamic and conventional banking products – as they felt methods of laundering are the same. Thus, the opinion has been expressed that the AML rules applicable for conventional banking products would be sufficient for Islamic banking products as well. All of them agreed that cash deposits pose the single largest threat of money laundering. In terms of the risk assessment of the products, it is clear that the risk assessment is done from different perspectives (sectoral, country, business relationship and bank etc.), but the relationship that exists between an Islamic Bank with its clients was not mentioned. Therefore, product risk assessments followed the risk-based approach.

Knowledge of the AML Compliance Staff

All of the respondents said that they gained knowledge about AML compliance partially through in-house training and also gaining relevant certifications. In relation to training none of them said that they were trained on money laundering typologies related to Islamic banking products. In fact, three respondents said that the typologies in relation to Islamic banking and conventional banking were not different. Also, the trainings regularly 'reminded the staff of the AML red flags.

In terms of adherence to AML regulations, all concur that adherence to AML regulations is important for the survival of the business – to avoid reputational damage, fines and prison sentences. While talking of the standards, it has been opined that, as long as the AML staff understood the working of Islamic products that could help mitigate all ML risks'. Finally, regarding the role of Sharia Boards, three respondents said that the Sharia experts were knowledgeable about AML regulations and their typologies. However, a respondent who had worked closely with internal Sharia experts refuted this assertion and said that many Sharia experts 'never had to at AML aspects and had limited knowledge of such regulations'.

Limitations

Subtle variations that the banks have made to AML compliance in relation to Islamic banking products or the variances in practice between them to perceived or felt laundering threats may not be captured by the survey. The findings here based on a survey may not be conclusive to claim that IFIs' in UAE need to change their AML practices as secondary data (Suspicious Activity Reports, their analysis) were not accessed. However, the standard documentation (Customer Due Diligence) of one of the banks was accessed and there was nothing that specifically alluded to the risks posed by Islamic products. Also, one has to be aware that there could be a bias from the side of the respondents. To limit this bias the purpose of each question was explained in the survey and the patterns in the answers were reanalyzed in this light. Finally, not the entire portfolio of Islamic banking products was analysed – notably Zakat.

Conclusions

It is clear that most or all of those who responded had moved into Islamic banks from conventional banks, this is quite understandable considering that Islamic banks have been relatively new on the scene. As the results show none of the respondents clearly defined or identified the threats money laundering posed to the various Islamic banking products. However, akumar@ud.ac.ae all of them were unanimous in saying that all banking product (whether Islamic or conventional) would be vulnerable to laundering if not monitored, and money deposits offered the biggest avenue for laundering in Islamic banks.

When it came to fighting money laundering - all the respondents identified the long-term survival of the firm as the reason for adhering AML regulations. From this it is reasonable to conclude that the respondents understood the real implications of non-compliance to AML standards for the business and hence their compliance may not be linked to fear of reprisals. The fact that none of the respondents said that training based on typologies related to Islamic bank products were required or practised could point to a lack of understanding of the specific threats posed by money laundering. Especially with the Sukuk market attracting a lot of global attention, there was no mention of potential laundering threats.

Although the respondents did say that Islamic banks do a thorough risk assessment of the products, the absence of typologies for training staff shows there is either inadequate attention to the laundering issue or an unwillingness to disclose. From the above discussion it can be seen that there is a mismatch between the potential threats to Islamic banking products from money launderers and the knowledge exhibited by the respondents. There could be various reasons for this gap and this calls for closer attention from the UAE Banking

Supervisor. This certainly poses a challenge to the growth of IFIs' in the UAE and overall growth of the economy.