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Can the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Compliance Examination Manual (2014) be used as a benchmark to audit the AML controls in Islamic financial institutions in Malaysia?

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EXECUTIVE SUMMARY

The rapid growth of Islamic finance is remarkable. According to the International Monetary Authority, its assets grew from $200 billion in 2003 to over $1.4 trillion in 2014 while the Sukuk issuance reached $66.4 billion in 2015.

Policies, procedures and processes in Islamic financial institutions (IFIs) are greatly influenced by and developed in accordance with the *Shariah* Law. Hence, their operations may be exposed to certain risks that Conventional financial institutions (CFI) may not.

Rapid growth of the Islamic finance industry may necessitate an examination of whether some of the precepts and principles as contained in the Federal Financial Institutions Examination Council's (FFIEC) Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Compliance Examination Manual (2014) could be applied to AML audit in IFIs in Malaysia.

The risk assessment process uncovers and identifies four risks that are peculiar to IFIs. They are namely the *Shariah* noncompliance risk, rate of return risk, displaced commercial risk and equity investment risk. These four risks have been discussed in conjunction with the contracts of partnerships under the high risk arising from the *Mudarabah* and *Musharakah* schemes wherein the IFIs take an equity stake.

Most IFIs would have put in place their policies, procedures and systems pertaining to risk profiling and screening systems, transaction monitoring systems, case management systems, and those that have been readily provided by the Malaysian Central Bank for the filing of suspicious transaction reports through financial intelligence systems and the reporting of frauds in the Fraud Information Database System (FIDS).

It is found that IFIs treat and regard their customers as their "partners." For instance, a fixed deposit is treated more as an investment and on reaching the maturity date, the depositor (partner or shareholder) is entitled to a dividend payment. This ambiguous terminology—whether customers are partners or vice-versa—shall need to be clearly defined as they may give rise to unpleasant implications of money laundering and terrorist financing.

It is advisable that the Islamic banking and finance fraternity seek early advice of the Financial Action Task Force (FATF) to help elucidate and define the term "partner" in the light of the fast growing Islamic finance. The question whether a partner can be considered a customer has to be clarified.

Zakat contribution or tithing is an important religious obligation that all Muslims should observe since it is one of the five pillars of Islam. Regulators shall have clear cut policies in force to ensure that IFIs have established internal processes and procedures to determine and identify who are the ultimate beneficiaries of the *Zakat*. "Know your ultimate beneficiary (KYUB)" internal controls or mechanisms shall need to be strictly administered so as to stem

out any possibility of terrorist financing within the IFI. A case in point and reference is the Holy Land Foundation in the U.S.

In my considered view, with some modifications and redefinition of terms, the FFIEC BSA/AML Compliance Examination Manual examination procedures can be used as a guide for AML audit in the IFI.

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GLOSSARY[1]

Term	Description
Hiwala	Debt is transferred from one debtor to another. After the debt is transferred to the second debtor, the first debtor is free from her obligation. This contract is used by Islamic financial institutions to remit money between people.
Ijārah (Lease, lease purchase)	A party leases a particular product for a specific sum and a specific time period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.
Istisna' (Deferred payment, deferred delivery)	A manufacturer (contractor) agrees to produce (build) and to deliver a certain good (or premise) at a given price on a given date in the future. The price does not have to be paid in advance (in contrast to *Salam*). It may be paid in instalments or part may be paid in advance with the balance to be paid later on, based on the preferences of the parties.
Kafala	A third party accepts an existing obligation and becomes responsible for fulfilling someone's liability. In conventional finance, this situation is called *surety* or *guaranty*.
Mudarabah (Trustee finance contract)	An investment which represents the ownership of units of equal value in the equity of the *Mudarabah*. The provider of capital supplies the funds needed to finance a project while the entrepreneur offers labour and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by capital's owner. The liability of the entrepreneur is limited only to his time and effort.
Murabahah (Mark–up financing)	A widely-used sale transaction between customers and banks. The buyer approaches the bank to acquire goods. In turn, the bank purchases them from a third party (a supplier) and then resells them to the borrower at an agreed mark-up for immediate or deferred payment. The seller informs the buyer of the cost of acquiring the specified product and the profit margin is negotiated between them. The total cost is usually paid in instalments.
Musharakah (Equity participation)	An investment that represents ownership of partnership equity. The bank enters into an equity partnership agreement (joint venture) with one or more partners to jointly finance an investment project. Profits

[1] Kyriakos-Saad, N., C. El Khoury, M. Vasquez, and A. El Murr. 2015. "Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism." IMF Working Paper (forthcoming), International Monetary Fund, Washington, DC, pgs 33-34, online document can be viewed at https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf

Term	Description
	are distributed according to predetermined ratios, and losses are shared strictly in relation to the respective capital contributions.
Rahn	A property is pledged against an obligation. A customer can offer collateral or a pledge via a *rahn* contract in order to secure a financial liability.
Salam (Prepayment, deferred delivery)	The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date.
Tawarruq	A multi-step transaction heavily used for interbank financing and liquidity management, often based on commodities traded on the London Metal Exchange (LME). The AAOIFI (2006, 525) defines *Tawarruq* as 'the process of purchasing a commodity for a deferred price determined through *Musawama* (bargaining) or *Murabahah* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash. *Tawarruq* is most disliked by *Shariah* scholars when the borrower sells the commodity back to the original seller. These practices have yet to gain AAOIFI's *Shariah* Board consensus.
Wadi'ah (Demand deposits)	Deposits held at the bank as a trustee for safekeeping purposes. They are guaranteed in capital value, and earn no return.
Wakalah (Agency)	One party (either the bank or client) acts as an agent to the other party to undertake transactions on his behalf. For example, the bank invests funds on behalf of a client or the bank appoints the client as an agent to buy the needed merchandise in a *Murabahah* transaction.
Zakat (Tithes)	The amount that is payable by a Muslim on his net income, salary or net worth as part of their religious obligations to benefit the underprivileged. *Zakat* contribution is also one of the five pillars of Islam.

ACRONYMS

Unless otherwise so defined, the abbreviations shall purport to include singularity.

AML	Anti-Money Laundering
BNM	Bank Negara Malaysia/Central Bank of Malaysia
BSA/AML	Bank Secrecy Act/Anti- Money Laundering
CAR	Capital Adequacy Ratio
CDD	Customer Due Diligence
CFI	Conventional Financial Institutions
CFT	Counter Terrorism Financing
CPI	Corruption Perception Index
CTR	Cash Threshold Report
CV	Curriculum Vitae
EALIS	External Assets and Liabilities Information System
EDD	Enhanced Due Diligence
EIR	Equity Investment Risk
FAST	Fully Automated System for Tendering
FATF	Financial Action Task Force
FFIEC	Federal Financial Institutions Examination Council
FICPS	The Financial Institutions Corporate Profile System
FIDS	The Fraud Information Database System
FINS	Financial Intelligence System
HR	Human Resource
IAH	Investment Account Holder
IFI	Islamic Financial Institutions
IMF	International Monetary Authority

IPSH	Islamic Profit Rate Swap
IRR	Investment Risk Reserve

ACRONYMS (CONT'D)

ISRA	International *Shariah* Research Academy for Islamic Finance
ITEPS	International Transactions and External Position System
ITIS	International Transactions Information System
ML/TF	Money Laundering / Terrorist Financing
OFAC	Office of Foreign Assets Control
PER	Profit Equalisation Reserve
ROR	Rate of Return Risk
SAC	*Shariah* Advisory Council
SAR	Suspicious Activity Report
STR	Suspicious Transaction Report
SPV	Special Purpose Vehicles

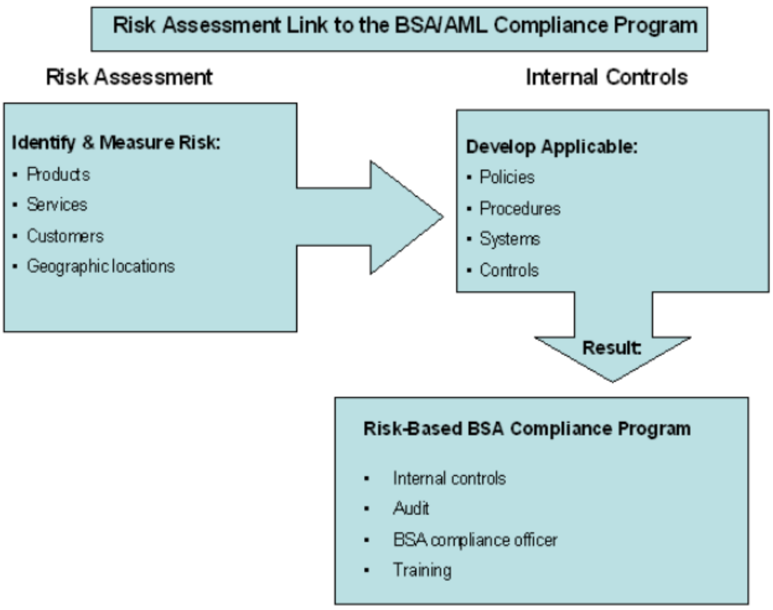
INTRODUCTION

The rapid growth of Islamic finance is indeed admirable; if not, remarkable. According to the IMF, Islamic finance assets have grown from about $200 billion in 2003 to over $1.4 trillion in 2014[2] and the Sukuk issuance reached $66.4 billion in 2015.[3]

The growth has lured conventional financial institutions to start their Islamic financial arms. Thus far, banks like Malayan Banking Berhad, RHB Banking Berhad, CIMB Banking Berhad, Citibank, HSBC, Goldman Sachs, BNP-Paribas and UBS have already started to provide their *Shariah* banking services.

This paper seeks to examine whether some of the precepts and principles as highlighted in the FFIEC BSA/AML Compliance Examination Manual (2014)[2] can be applied to auditing the AML controls in IFIs in Malaysia.

A sound and effective compliance program must be made in accord with the BSA/AML.[4] Its development should be based on the risks identified in the risk assessment process as shown in the diagram below.[5]



Source: FFIEC BSA_AML_Man_2014_v2, Appendix I, pp I-1

2 Islamic Financial Services Board Stability Report, 2015
3 http://www.thestar.com.my/business/business-news/2016/03/08/sukuk-market-to-remain-resilient/
4 Source: http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2
5 Source: http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2, Appendix I, pp I-1

In order to assess and identify the gaps, we have to understand the fundamental differences between IFIs and CFIs.

Fundamental Differences between IFIs and CFIs

There are some fundamental differences between IFIs and CFIs. The main difference is that IFIs are based on *Shariah* laws. The word *Shariah* is derived from the root word "*shin ra'ayn,"* which literally means "the road to the watering place, the path to be followed."[6] Technically, the word *Shariah* was defined by *al-Qurtubi* as the canon law of Islam which includes all the different commandments of Allah to mankind.[7] It is now used to refer to the legal system governing the code of behavior.

IFIs base their processes and transactions on the following broad principles:

- The absence of interest – based (*riba or usury*) transactions[8]
- Avoidance of speculations (*gharar*)[9]
- Avoidance of oppression (*zulm*)[10]
- Introduction of Islamic tax (*Zakat*)[11]
- Discouragement of the production of goods and services which contradict the Islamic value (*Haram*)[12]

The fundamental differences between IFIs and CFIs are tabulated as follows:[13]

IFI	**CFI**
IFIs have an oversight *Shariah* board that consists of scholars who are qualified to give opinions on Islamic business contracts	There is no such board
Functions and operations are based on	Functions and operations are based on

[6] Surah Al-Ma'idah 5:48, Tafsir Ar-Rahman, Interpretation of the meaning of the Quran, Department of Islamic Development Malaysia
[7] Al-Qurtubi, Al-Jami' li Ahkam Qur'an, vol 16, p. 10, Zaydan, Al-Madkhal liDirasat al-Shari'ah al-Islamiyyah, pg. 38
[8] Surah Al-Baqarah 2:275 and Surah Ali 'Imran: 3:130, Tafsir Ar-Rahman, Interpretation of the meaning of the Quran, Department of Islamic Development Malaysia; and Khan, H (2009). Islamic Finance: Is It an Answer to Global Crisis?. The U21 Global Newsletter, 1st Quarter
[9] Abdullah Alwi Haji Hasan, Sales and Contracts in Early Islamic Commercial Law, Islamic Research Institute, Islamabad, 1994, p. 41;
[10] Surah Luqman 31:13 and Surah Al-Fatir 35:32, Tafsir Ar-Rahman, Interpretation of the meaning of the Quran, Department of Islamic Development Malaysia
[11] Salehi, M (2014). "A Study On The Influences Of Islamic Values On Iranian Accounting Practice And Development", Journal of Islamic Economics, Banking and Finance 10 (2): 154–182. Zakat is a religious tax that every Muslim has to pay."
[12] Al-Qardawi, Yusuf (1999). The Lawful and the Prohibited in Islam. American Trust Publications. p. 26; Islam Annemarie Schimmel – 1992, p. 83; Khan, H (2009). Islamic Finance: Is It an Answer to Global Crisis?. The U21 Global Newsletter, 1st Quarter
[13] Differences Between Islamic Bank and Conventional, Ustaz Hj Zaharuddin Hj Abd Rahman, 2007, article can also be viewed at http://www.zaharuddin.net/senarai-lengkap-artikel/38/297-differences-between-islamic-banks-a-conventional.html

IFI	**CFI**
Shariah principles	man-made principles (largely capitalism theory)
Promotes risk-sharing between provider of capital (investor) and user of funds (entrepreneurs)	Investor is assured of pre-determined rate of interest returns
Aims at maximizing profit, but subject to *Shariah* restrictions	Aims at maximizing profit without any restrictions illustrated by derivatives trading
Partners, investors and traders, buyer or seller relationship	Creditor-debtor relationship
Encourage asset-based financing and based on commodity trading	Based on money trading. Money is a medium of exchange and not a commodity, its sale and purchase is prohibited in Islam
No right of profit if there is no risk involved. The profit and loss sharing depositor may lose money in case of loss	It is almost risk free banking and the depositor has no risk of losing its money because interest is guaranteed
In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a *Zakat* Collection Centre and they also pay out their *Zakat*	Does not deal with *Zakat*
Participating in a partnership business is the fundamental function of Islamic banks.[11] Understanding the venture is therefore essential. There is an embedded know your customer	Lending money and getting it back with compounding interest[11] is the fundamental function of conventional banks. Money is a commodity and the motivation
IFIs have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the ICI's discretion	CFIs can charge additional money (penalty and compounded interest) in the case of defaulters
IFIs give due importance to the public interest. Its ultimate aim is to ensure growth with equity	In most cases, it results in the CFIs' own interest becoming prominent. It makes no effort to ensure growth with equity.
Since it shares profit and loss, IFIs pay greater attention to developing project appraisal and evaluations and give greater emphasis on the viability of the projects	Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations. CFIs give greater emphasis on credit-worthiness of the clients
IFIs can only guarantee deposits for deposit accounts, which is based on the principle of *al-wadiah*, thus the depositors are guaranteed repayment of their funds; however, if the account is based on the	CFIs have to guarantee all its deposits.

IFI	CFI
mudharabah concept, clients have to share in a loss position	

Table 1: Summary of Differences between IFI and CFI
Source: Differences Between Islamic Bank and Conventional, Zaharuddin Hj Abd Rahman, 2007[11]

A point to note is that the relationships created in IFIs are that of partners, investors/traders and buyer-sellers, whereas in CFIs it is a debtor/creditor relationship. A question to be answered is whether the relationships that IFIs create fall within the ambit of what constitutes a customer.

Bearing in mind the fundamental differences between IFIs and CFIs, we shall now proceed to examine and identify their respective risks.

RISK ASSESSMENT

IDENTIFICATION OF RISKS

The common risk profile of an IFI and that of a CFI is summarized in the table below.

IFI	CFI	Definition of the Risks
Strategic Risk	Strategic Risk	The potential losses arising from uncertainties and untapped opportunities embedded in the strategic intent and how well these strategies are executed.[14]
Legal Risk	Legal Risk	The potential loss from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations.[15]
Reputation Risk	Reputation Risk	The potential loss resulting from damages to a firm's reputation, in lost revenue; increased operating, capital or regulatory costs; or destruction of shareholder value, consequent to an adverse or potentially criminal event even if the company is not found guilty.[16]
Transparency Risk	Transparency Risk	The potential loss for not being transparent and disclosing to the public of a bank's financial condition to depositors and other interested parties, allowing the stakeholders to assess the condition of the bank. It relates to transparency of the bank and its activities.
Regulatory Compliance Risk	Regulatory Compliance Risk	The potential exposure to legal penalties, financial forfeiture and material loss an organization faces when it fails to act in accordance with industry laws

[14] Sharpening strategic risk management, Armoghan Mohammed and Richard Sykes, PricewaterHouse Coopers, 2012, pg. 14
[15] Domain Name Protection: A Risk-Analytic Framework, Alex Tajirian, 2005, pg. 1-2
[16] http://ithandbook.ffiec.gov/it-booklets/wholesale-payment-systems/wholesale-payment-systems-risk-management/reputation-risk.aspx

IFI	CFI	Definition of the Risks
		and regulations, internal policies or prescribed best practices.[17]
Fiduciary Risk	Fiduciary Risk	The potential loss that funds: (i) are not used for the intended purposes; (ii) are not properly recorded and accounted for; and (iii) do not achieve the value-for-money objectives of the programs they finance.[18]
Credit Risk	Credit Risk	The potential that a counterparty fails to meet its obligations in accordance with agreed terms and conditions of a credit-related contract.[13]
Market Risk	Market Risk	The potential impact of adverse price movements such as benchmark rates, foreign exchange rates, equity prices on the economic value of an asset.[19]
Liquidity Risk	Liquidity Risk	The potential loss arising from the bank's inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.[17]
Operational Risk	Operational Risk	The potential loss resulting from inadequate or failed internal processes, people and system or external events.[13]

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The risk profile of the differences between an IFI and that of a CFI is summarized in the table below.

IFI	CFI	Definition of the Risks
***Shariah* NonCompliance Risk**	No Exposure	Risk arises from the failure to comply with the *Shariah* principles and rules.[18]
Rate of Return Risk	No Exposure	The potential impact on the returns caused by unexpected change in the rate of returns.[20]
Displaced Commercial Risk	No Exposure	The risk that the bank may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The bank foregoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.[18]
Equity Investment Risk	No Exposure	The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider

[17] http://searchcompliance.techtarget.com/definition/compliance-risk
[18] Current issues and future challenges in health SWAPs: Fiduciary Risk Assessment & Financial Management – Issues Note By Jean-Luc Bernasconi and Fabrizio Tediosi, pg. 4
[19] Risk Management In Islamic Banks, Asian Institute of Finance, 2013, Pg. 2, Table 1
[20] Prof. Dr. Mohamad Akram Laldin -International Shari'ah Research Academy ("ISRA") for Islamic Finance-Risk-Management-in-Islamic-Finance-Shariah-NonCompliance-Risk-Latest-AAOIFI-1, Pg. 11, Pg. 13

IFI	CFI	Definition of the Risks
		of finance shares in the business risk. This risk is relevant under *Mudharabah* and *Musharakah* contracts.[18]

Table 3: Risk Profiles of IFI and CFI – Unique Risks of IFI

IFIs have four additional risks (highlighted in bold) when compared to CFIs. Therefore, an understanding of the nature of the four risks is important to ensure that policies, procedures and internal controls are properly developed to mitigate and reduce the risks accordingly.

***Shariah* Non-Compliance Risk**

The main fundamental difference between IFIs and CFIs is that IFIs are based on Islamic principles. According to Dr. Akram of ISRA,[18] *Shariah* compliance is paramount and the reasons are as follows:

- It is the basis for having a banking system that meets the religious requirements of the Muslim community;
- It is the main factor that distinguishes Islamic banking from conventional banking;
- It ensures acceptance, validity and enforceability of contracts from the *Shariah* point of view; and
- It fulfills the objectives of Islamic finance (i.e., to achieve justice and fairness in the distribution of resources).

Noncompliance to *Shariah* may give rise to serious and severe financial and nonfinancial implications or impacts.

The financial impacts may include the following:

- Invalidation of contracts (‘*aqad*) – This will happen when contracts are entered with customers who are non-*Shariah* compliant;
- *Non-halal* income being received – This can arise from businesses that are involved in gambling, alcohol, pork and alike; and
- Capital Adequacy Ratio impact – The IFI will not be able to meet the CAR set by the local regulator.

The non-financial impacts may include the following:

- The transactions and practices are against the commands of *Allah*;
- There will be impediment from *Allah*’s blessing or *barakah*;[21]
- It contravenes Islamic Financial regulations in that country in question, and in Malaysia, Islamic banking licensing requirements Section 10(2)[22] and 10(4)[23] of the Islamic Financial Services Act 2013 will be violated; and

[21] “Allah deprives (the accumulation of wealth through) usury of al blessings, whereas He blesses (the wealth that is spent out of it for giving out) charity and alms-tax with growth. And Allah does not love anyone who is stubbornly ingrate and persists in sinful ways” (Surah Al-Baqarah, 2: 276, Tafsir Ar-Rahman, Interpretation of the meaning of the Quran, Department of Islamic Development Malaysia).

- It jeopardises the IFI's reputation as an Islamic bank.

Managing the Risk

The foregoing risks are managed by the oversight *Shariah* board whose primary function is to ensure that all policies, procedures and transactions are *Shariah* compliant.

For consistency and compliance, the local regulator should setup a *Shariah* Advisory Council where IFIs can seek advice on *Shariah* matters relating to its banking business.

There is a list of criteria that has been introduced by the local regulator to ensure that the validity of the persons in the committee are "fit and proper" prior to being a member of the oversight *Shariah* board. The basic criteria to be met are as follows:

- Probity, personal integrity and reputation
- Competency and capability
- Financial integrity

The most subjective criterion is that of probity, personal integrity and reputation. Proper guidelines should be in place to ensure that those who are appointed in the oversight *Shariah* board meet this criterion.

According to the Australian Government, Department of Finance, "Probity is the evidence of ethical behaviour, and can be defined as complete and confirmed integrity, uprightness and honesty in a particular process."[24]

From the experience of the author, some of the areas to look into when assessing and auditing probity, personal integrity and reputation include the following:

- Whether the person is subject to any potential criminal proceedings or investigations between the current time of review and the previous review
- Whether the person is willing to work and cooperate with regulators in any potential queries or investigations in relation to the financial institution or financial matters
- Whether the person has contravened any financial institution or organization in policies and procedures, professional bodies' ethical codes, local laws and regulatory requirements
- Whether the person has been declined entry, suspended or has had any application rejected/denied from any professional bodies for ethical and integrity reasons

[22] 10(2): "Upon making an assessment under subsection (1) and where the Bank is satisfied that such applicant may be granted a licence, the Bank shall make a recommendation to the Minister to grant a licence under subsection (4) with or without conditions". Malaysian Islamic Financial Services Act 2013

[23] 10(4): "Where the Bank makes a recommendation pursuant to subsection (2), the Minister may grant a licence to the applicant to carry on Islamic banking business, takaful business, international Islamic banking business or international takaful business, with or without conditions." Malaysian Islamic Financial Services Act 2013

[24] http://www.finance.gov.au/procurement/procurement-policy-and-guidance/buying/accountability-and-transparency/ethics-and-probity/principles.html

- Whether the person has a conflict of interest that has not been disclosed which is subject to investigation and queries from the stakeholders
- Whether the person's behavior in transactions, contracts and alike, dealings with auditors, customers, suppliers and regulators are dishonest and deceitful
- Whether the person has been subject to any domestic enquiry which led to his/her dismissal
- Whether the persons' CV has been thoroughly vetted and checked to ensure that the reasons for leaving the company or organization stated in their CV is genuine.

The above list is not exhaustive. The most important factor to consider and look for is integrity and honesty of the incumbent. Background of the candidate may be sourced from the HR Department.

The incumbent for appointment to the *Shariah* Advisory Board must be fit and proper having due regards to his religious upbringing, any previous performance records and assessment feedback from the compliance department.

Rate of Return Risk

Rate of Return (ROR) risk refers "to the potential impact on an IFI's net income margin or market value of equity arising from changes in the market rate of returns," according to Jeroen P.M.M[25] in his presentation on Risk Management in Islamic Banking at Bank Islam of Malaysia. ROR risk will cause a gap/mismatch risk. According to Professor Debajyoti, et.al (2013),[26] the gap/mismatch risk is the risk that arises from holding assets and liabilities and off balance sheet items with different principal amounts, maturity dates and re-pricing dates thereby creating exposure to unexpected changes in the level of market interest rates.

With the gap/mismatch risk identified, understanding of how ROR risk is applicable to the IFI is important. Jeroen P.M.M.[23] states that ROR risks are normally associated with the management of assets and liabilities and the rates are usually fixed rate long-term assets funded by variable rate short-term liabilities. The gap in IFIs is usually larger than that of a CFI. The rates are affected by the movement in benchmark rates that "may result in fund providers having expectations of a higher rate of return. This movement may result in displaced commercial risk where, due to market pressure, an IFI needs to pay a return that exceeds the rate that has been earned on its assets. If the Islamic bank does not yield to market pressure, it may lose its fund providers, which could subsequently lead to liquidity risk," according to Jeroen P.M.M.

Usually, there are not many liquid hedging instruments to hedge the gap for an IFI. The IFI's hands are tied as they have no way to sell the asset through a credit derivative transaction that is not *Shariah* compliant.

[25] Risk Management in Islamic Banking lecture at Bank Islam of Malaysia, Jeroen, P.M.M. Thijs; presentation can be viewed at http://www.bankislam.com.my/en/Documents/shariah/RiskMgmtinIslamicBkg.pdf
[26] BASEL I to BASEL II to BASEL III: A Risk Management Journey Of Indian Banks, Prof. Debajyoti Ghosh Roy, Dr.Bindya Kohl, Prof. Swati Khatkale, pg. 2, AIMA Journal of Management & Research, May 2013, Volume 7, Issue 2/4, ISSN 0974 – 497

As IFIs have a responsibility to manage their IAHs' expectation and their liabilities to current accountholders, this risk which is a strategic risk forms part of IFIs' balance sheet risk management.

Managing the Risk

There are a few ways to manage ROR risk[24] and they are as follows:

- Duration matching
- Securitization in form of *Sukuk* certificates
- Islamic profit rate swap

It is to be noted that equity type structures might significantly affect, if not complicate, an accurate assessment of the gap mismatch.

Duration Matching

Duration matching is when the duration of the assets are matched with the duration of the liabilities.[27] This is where the IFI "allocates positions taken into time bands, with remaining maturities or repricing dates, whichever is earlier. Fixed and floating rate assets will be classified according to their receivable dates because the return on these receivables represents the fund providers' direct and beneficial ownership of the assets."[28]

Actual cash flows may indicate a gap for a given time band, affecting the rate of return for that period. Depending on the complexity and the nature of the IFI's business operations, IFIs may employ techniques ranging from simple gaps to advance simulation or dynamic approaches to assess future cash flow variability and net income.[29]

Securitization in Form of *Sukuk* Certificates

Securitization is the "pooling of different types of contractual debt or other non-debt assets which generate receivables, and selling their cash flows to third-party investors in forms of securities or bonds."[30] Investors are then repaid from the principal and interest cash flows collected. *Sukuk* is generally a *Shariah* compliant bond.

In IFIs, securitization in the form of *Sukuk* certificates can help overcome the variable rate of short-term liabilities through this form of securitization.

Islamic Profit Rate Swap

An Islamic profit rate swap is an "agreement to exchange profit rates between a fixed rate party and a floating rate party (or vice versa) implemented through the execution of a series of underlying contracts to trade certain assets"[31] under the *Shariah* principles of *Bai'* and *Bai' Bithaman Ajil*.

[27] https://en.wikipedia.org/wiki/Immunization_(finance)#Duration_matching
[28] http://www.alhudacibe.com/AlhudaMagazine/Issue-033/article02.php
[29] Stulz, René M. (2003). Risk Management & Derivatives (1st ed.). Mason, Ohio: Thomson South-Western. ISBN0-538-86101-0.
[30] https://en.wikipedia.org/wiki/Securitization
[31] Article_6_Developments_of_Islamic_Swaps_in_Malaysia, Azmi & Associates, 2008

Each party's payment obligation is computed using a different pricing methodology or formula. In an Islamic profit rate swap, the notional principal is never exchanged as it is netted off. Swap typically refers to the difference in the price over and above the notional principal in which one party pays a fixed rate and another pays a floating rate.

With IPRS, IFIs are able to manage exposure to interest rate movement as IFIs still compete with CFIs for market space and IFIs are able to restructure existing short-term liabilities or debt profiles without raising new finance, or altering the structure of the balance sheet. With IPRS, IFIs are also able to match the funding rates with return rates from investment and thus achieve lower costs of funding.[30]

Displaced Commercial Risk

Displaced commercial risk is the risk where the IFI is under pressure to pay its investment depositors a rate of return which is higher than what should be payable based on the actual performance of the fund[32] or IFI. Based on the Malaysian Central Bank's Guidelines on Capital Adequacy Ratio, the definition of Displaced Commercial Risk "refers to the risk arising from assets managed on behalf of IAHs, which is effectively transferred to the Islamic banking institutions' own capital where the Islamic banking institution forgoes part or all of its portion of profits...[33]" This is to ensure that the investment accountholders get competitive returns comparable with CFIs.

Managing the Risk

A good policy and framework will always be suggested to the IFIs to manage this risk. This policy and framework will kick in when market rates of returns of CFIs are higher than that of those given to IFI's customers. IFIs will have to evaluate the nature and extent of their customers' expectations and assess the amount of the gap between CFIs and the rates given by the IFIs.

There are a few recommended ways to mitigate and manage this risk and they are as follows:

- Profit Equalization Reserve[34] – This is the "amount appropriated by the institution offering Islamic financial services out of the *mudharabah* income, before allocating the *mudarib's* share. This appropriation is necessary in order to maintain a certain level of return on investment for IAH (depositors) and to increase owner's equity."[35] The amount allocated should be pre-defined and applied in accordance with the contractual conditions accepted by IFI's customers and after a formal review and approval by the IFI's board of directors.
- Investment Risk Reserve[33] – This is the "reserve formed of appropriations from investment profits attributable to unrestricted IAH, that is, after profits are allocated between the bank as *Mudarib* (and so, in effect, the shareholders) and the unrestricted IAH."[34]

[32] Determinants of Displaced Commercial Risk in Islamic Banking Institutions: Malaysia Evidence, Noraziah Che Arshad, Roza Hazli Zakaria, Ahmad Azam Sulaiman @ Mohamad, Tubagus Thresna Irijanto, pg. 3.
[33] http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/06_psia.pdf, pg. 3
[34] Van, Hennie G. & Iqbal, Z. 2008. Banking and the Risk Environment. In Archer, S and Karim, R. A. A (eds), Islamic Finance: Regulatory Challenge, Singapore: John Wiley and Sons, Singapore
[35] Do Malaysian Islamic Banks Manage Earnings Through Profit Equalisation Reserve?, Raudha Md. Ramli, S.Shahida & Abdul Ghafar Ismail, pg. 1 and pg. 5

- Adjust the profit sharing ratio[36] – This is where both contracting parties have to come together to agree on the profit sharing ratio, if an adjustment is to be made.

The IFI will need to develop and maintain an informed judgement on the appropriateness of the balances of the PER and IRR—not too much and not too little. The team has to take into consideration that these reserves act as a buffer to provide mitigation of displaced commercial risk. Ultimately, an efficient management of both assets and liabilities is crucial.

Equity Investment Risk

Equity investment risk relates to risks that are inherent in the holding of equity instruments for investment purposes—typically the *Mudarabah* and *Musharakah* contracts. For example, the capital invested through *Mudarabah* and *Musharakah* may be used to purchase shares in a publicly-traded company or privately-held equity, or may be used to invest in a specific project, portfolio or through a pooled investment vehicle.[37]

The distinct difference between *Mudarabah* and *Musharakah* financing is in the terms of the IFI's involvement in the investments during the contract period. In *Mudarabah*, the IFI invests their money as silent partners and the management is the exclusive responsibility of their partners or customers, namely *Mudarib*. On the other hand, in *Musharakah* financing, the IFI and their customers or *Musharakah* partners invest their funds together, and the IFI may either remain as a silent partner or may participate in the management. Ultimately, both instruments are profit-sharing financing and do not necessarily constitute a fixed return and is exposed to impairment, in the event of losses.

The nature of *Mudarabah* and *Musharakah* financing exposes the IFI to a confluence of risks arising from the risks associated with *Mudarib* or *Musharakah* partners, business activity and operations.

It is paramount for the IFI to have policies and procedures in place to assess the risks that these forms of financing expose the IFI.

Managing the Risk

In assessing the risk profiles of the potential partners (*Mudarib* or *Musharakah* partner), due diligence is required to fulfil the IFI's fiduciary responsibilities and duties as an investor on a profit-sharing and loss-bearing basis (*Mudarabah*) or a profit and loss sharing basis (*Musharakah*). Past records of the management team, soundness of the business plans and human resources involved in the *Mudarabah* or *Musharakah* activity are important for risk profiling. Legal and regulatory environments may affect equity investment performance. Apart therefrom, tariffs, quotas, taxation or subsidies or sudden policy changes should also be considered as they affect the quality and viability of an investment.

To ensure that these risks are mitigated, it is recommended that IFIs should:

[36] Archer, S., R.A.A. Karim and V. Sundararajan. 2010. Supervisory, regulatory, and capital adequacy implications of profit-sharing investment accounts in Islamic finance. Journal of Islamic Accounting and Business Research 1(1): 10-31
[37] Central Bank of Bahrain Volume 2 – Islamic Banks, Part A, Business Standards, Risk Management, 3.1.1-3.1.3

- Define and set the objectives of and the criteria for investments using profit sharing instruments;
- Have and review the policies, procedures and organization chart especially the management structure to evaluate and manage the risks involved in the acquisition of, holding and exiting from such profit sharing investments. IFIs should also have the proper infrastructure and human resource capacity to continuously monitor the performance and operations of the entity in which IFIs invest as partners. *Shariah* compliance evaluation should be conducted as this is the main difference between IFI and CFI.
- Identify and monitor the changes in risk at various stages of the investment lifecycles.
- Analyze and determine the factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.
- Use *Shariah* compliant risk mitigating techniques which reduce the impact of possible capital impairment of an investment.
- Ensure that the valuation methodologies are appropriate and consistent as they can potentially impact the method on profit calculations and allocations. These valuation methodologies and methods on profit calculations and allocations must be mutually agreed between both the IFI and their partners.
- Define and establish the exit strategies, including extension and redemption conditions for equity investments, subject to the approval of the oversight *Shariah* board.

PRODUCTS AND SERVICES

All IFI products and services are based on *Shariah* compliant contracts. For such contracts to be *Shariah* compliant, the following four elements must be satisfied:

- There must be an offeror and an acceptor; they must be legally competent to enter into the contract.
- There must be an offer (*'ijab*) and acceptance (*qabul*). Offer as defined by the Oxford dictionary means "present or proffer (something) for (someone) to accept or reject as desired.[38]" As such there must be in existence something tangible to be presented to a person. The word *qabul* (acceptance) is used to represent a statement uttered indicating assent to the *'ijab* (offer).
- The subject matter (*mahal al-'aqd*). The *mahal al-'aqd* must be *mal*. *Mal* is defined as something which can be secured for use at the time of need like property or wealth.
- Legal capacity (*ahliyyah*). This is one of the elements for the purpose of acquiring legal rights and mutual benefits and to facilitate the imposition of the obligations on the parties to the contract.

Based on the four elements, some of the most commonly used contracts in IFIs are as follows:

[38] http://www.oxforddictionaries.com/definition/english/offer

- Contracts of partnership – Allows two or more parties to develop wealth by sharing both risk and return. Some examples are as follows:
    - *Mudarabah*
    - *Musharakah*
- Contracts of exchange – Sales contracts that allow for the transfer of a commodity for another commodity, the transfer of commodity for money, or the transfer of money for money. Some examples are as follows:
    - *Murabahah*
    - *Salam*
    - *Istisna'*
- Contracts of safety and security – Often used by IFIs to help individuals and businesses keep their funds safe. Some examples are as follows:
    - *Wadiah*
    - *Hiwala*
    - *Kafala*
    - *Rahn*

Kyriakos-Saad et al (2015) mentioned that while the risks associated with conventional finance are generally well-identified and understood by the relevant national authorities, there may be ML/TF risks that are specific to Islamic finance, including those specifically related to:

(i) The complexity of some Islamic finance products;
(ii) The nature of the relationship between the institutions and their clients; and
(iii) The limited experience in the supervision of Islamic finance, especially in jurisdictions that face multiple risk factors.[39]

From the types of *Shariah* contracts listed above (not exhaustive), the high-risk products are those contracts of partnership where IFIs do take equity in the entity (as described above in the Equity Investment Risk section).

Customers

IFIs operate in regulated industries where they have to report to their central banks. As such, prospective customers and existing customers would have to go through or have gone through the form filling to initiate a contract with the IFI.

Most IFIs follow the CDD requirements at the following stages:

- Customer onboarding;
- Continuous monitoring; and/or
- If there is a veracity of change on the customer's profile

[39] Kyriakos-Saad, N., C. El Khoury, M. Vasquez, and A. El Murr. 2015. "Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism." IMF Working Paper (forthcoming), International Monetary Fund, Washington, DC, pg 23

Therefore, IFIs have to know their customers, their business activities and sources and uses of funding. Moreover, the risk and reward-sharing models like *Mudarabah* and *Musharakah* oblige IFIs to leave no stone unturned in order for them to make the highest possible profit out of each investment. EDD will be applicable for higher risk customers.

<u>Who is IFI's customer?</u>

Here it is assumed that a customer will be defined to include a partner and partners as well. The question is "Are IFI partners customers?"

The Oxford dictionary defines a *customer* as "A person who buys goods or services from a shop or business"[40] and a *partner* as "A person who takes part in an undertaking with another or others, especially in a business or firm with shared risks and profits."[41]

In other words, customers are those who buy goods or services from a business organization, which includes a financial institution. A partner on the other hand, would go into business and share the risks and profits of the IFI. It is to be noted that in the case of *Mudarabah* and *Musharakah*, the IFI operates as shareholder of the legal entity. The FATF 40 Recommendations do not specifically define what a customer is.

However, in their paper *Customer Due Diligence for Banks (October 2001)*, the Basel Committee on Banking Supervision defines a *customer* as:

- "The person or entity that maintains an account with the bank or those on whose behalf an account is maintained (i.e., beneficial owners);
- The beneficiaries of transactions conducted by professional intermediaries; and
- Any person or entity connected with a financial transaction who can pose a significant reputational or other risk to the bank."

Can we, by basing on the third definition of customer, imply in any way that it embraces a partner? No, it does not. The definition is not clear. Customers of CFIs receive interest when their fixed deposits mature and they can be charged interest when they default in payment. For IFIs, they pay their "customers" dividends and not interests. The latter situation suggests that IFIs treat their clients or customers as partners.

Therefore, the Islamic and conventional banking and finance fraternity should address this ambiguity to the international body such as FATF to help resolve this terminological glitch.

<u>Locations</u>

IFI customer profiles vary from country to country. IFIs that use the U.S. dollar to transact have to comply with the OFAC sanctions lists, or if euro dollar is used, IFIs too will have to comply with the EU sanctions lists, and such other sanctions list. Besides, IFIs have to abide by the UN sanctions which have been imposed by the UN Security Council.

[40] http://www.oxforddictionaries.com/definition/english/customer
[41] http://www.oxforddictionaries.com/definition/english/partner

Most IFIs have their own assessment of high-risk jurisdictions and some of them base their assessment on Transparency International CPI, FATF's high-risk and non-cooperative jurisdictions and alike, for example.

Review of Examination Procedures for Products and Services

***Mudarabah* and *Musharakah**

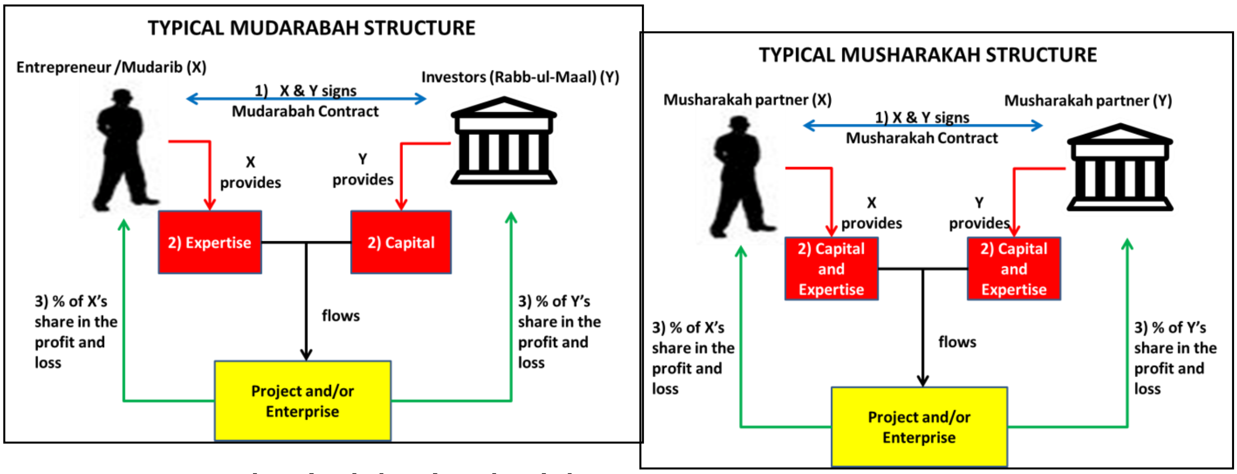


Diagram 1: Typical Mudarabah and Musharakah structures

The CDD Examination Procedures Section of the BSA/AML Compliance Examination Manual Transaction Testing section[42] would come in handy to audit the *Mudarabah* and *Musharakah* customers as these two products embed a higher degree of money laundering risk to the IFI. The level of details required to audit each customer should include the following areas:

1. Nature of business based on the company's Memorandum of Association and Articles of Association – An in-depth review of the customers' business is required to confirm that the customer complies with their nature of business.
2. Customers and vendors – Who are the IFI's customers dealing with and the areas of concern will be the country of origin, the individuals holding management positions, individuals and/or entities as shareholders, their nature of business and the assets that they possess as risk of these individuals or entities may be on the sanctions list.
3. If the customer has a bank account with the IFI (which should be the case and ideally should not have any other bank account or facilities with other financial institutions), auditing through the transactions can give an account as to whether their customers and vendors have violated any international sanctions regulations.
4. Ultimate beneficial ownership of customers and vendors– Disclosure of these can help the IFI screen and assess each customer and vendor more accurately, which can directly affect the risk scoring of the customer.

[42] http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2, pg. 59

5. In the case of *Musharakah* customers, the qualification and experience of the IFI's representative in their customer's board is paramount. The criteria to be met inter-alia include:
   - Probity, personal integrity and reputation
   - Competency and capability
   - Financial integrity

   As the IFI representative, it is crucial that he exercises his integrity to ensure that all of the transactions do not contravene the local and/or international laws.

   From experience, the areas of competency and capability can be assessed from the persons' educational qualifications, training, skills, work experience (have they met the Gledwell's[43] 10,000-hour rule) in the relevant industry, their commitment to effectively fulfil their role and responsibility, as stated in their job descriptions.

   Assessment of financial integrity can be made from the financial disclosures required to be given by the representative to the IFI in the areas of their personal financial affairs. The areas that can be seen is whether the person has made financial decisions properly and prudently; and whether the person has fulfilled the person's financial obligations whether in Malaysia or elsewhere and when they fall due.

INTERNAL CONTROLS

Policies and Procedures; Systems and Controls

A good understanding of the different products, policies and procedures of an IFI, can greatly help in the development of sound and effective systems and controls to mitigate the risk of money laundering.

IFIs are responsible for developing their products and services and ensuring that they are *Shariah* compliant. Their "customers" do not participate in the product or service development of IFIs. They just procure the products or services or schemes according to the terms and conditions of the IFI.

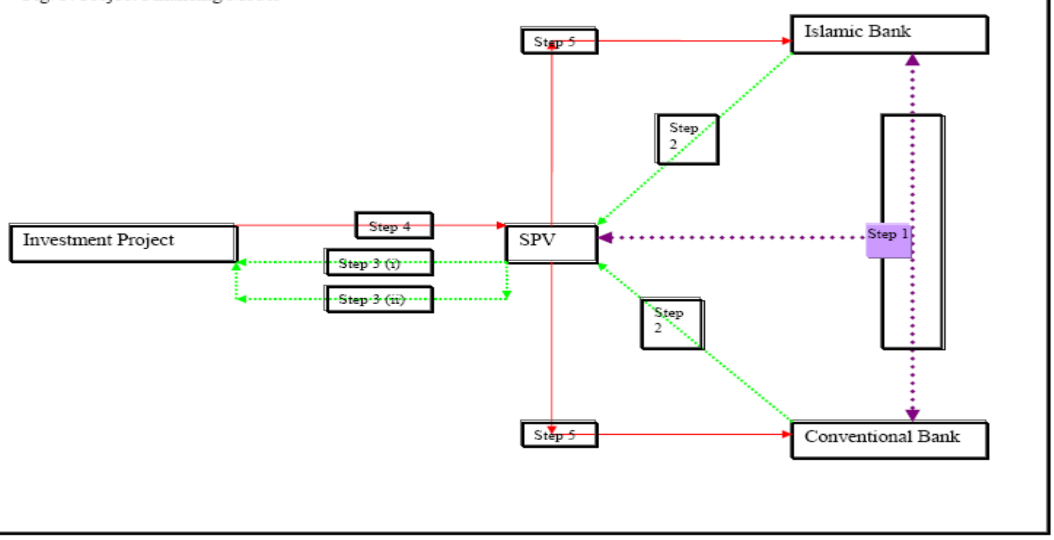
It should be emphasized that most money laundering and terrorist financing methods are legal in essence. It is when they are used for illegal purposes, that they becomes criminal in nature. Most IFI schemes engineered may resemble those used by money launderers. The difference is that the former use them for legitimate purposes. For example, Dr. Badr states that "commodities and assets used in Islamic finance as levels of separation, resembling 'layering' methods of criminal financiers, represent purely legal financial dealings."[44]

[43] Malcom Gladwell, Outliers The Story of Success, 2008
[44] Dr. Badr N. El Banna, 2011, Islamic Finance, Money Laundering and Terrorism Financing, ACAMS Today June to August 2011 Issue, Article can also be viewed at http://www.acamstoday.org/islamic-finance-money-laundering-and-terrorist-financing/

Another example is the issuance of *Sukuk* (a conventional bond) for project financing where IFIs together with their underwriters, use SPV in a complicated legal structure (which may well resemble the layering mechanism) to offer to their partners/customers a final *Shariah* compliant product. Some of these SPVs are shell companies incorporated in offshore centers or tax havens.

Below is an example of a typical structure of a project financing model using *Sukuk:*[45]

Fig. 3: Project Financing Model



Step 1: Either the conventional or Islamic bank finds an investment opportunity that needs equity as well as bond financing. The two banks negotiate with each other to establish an SPV.

Step 2: The two banks invest their funds in the SPV. The conventional bank has a bond-type investment in the SPV and the Islamic bank becomes the major shareholder of the SPV.

Step 3: The SPV invests funds in the project in two different modes of financing—equity and bond. The equity part of the project is financed by the Islamic bank while the bond part is financed by the conventional bank.

Step 4: Profit of the project comes to the SPV. This profit includes two kind of income: bond income and equity income.

Step 5: The SPV pays the fixed income to the conventional bank and the remaining profit is given to the Islamic Bank.

[45] Lee, KH, Ullah, S (2007). Integration of Islamic and Conventional Finance. Int. Rev. Bus. Res., 3(5): 241 - 265

The above structure may resemble a complicated structure using shell companies at offshore centers and tax havens do resemble red flags or high-risk indicators for money laundering. But these vehicles are necessary in most Islamic finance operations.

Therefore, policies and procedures in relation to CDD are important to ensure that these structures that are employed by IFIs do not appear to be a complex web used by money launderers and terrorist financiers. Most CDD policies and procedures will encompass the following:

- Identification and verification of documents produced by individual, entity or legal entity structures;
- Know your customer, which comprises:
    - Knowledge of source of funds;
    - Knowledge of source of wealth;
    - Ultimate beneficial ownership;
    - The type of business or principle activity(s);
    - Purpose of why the relationship is being formed or purpose of the account; and
    - Site visits (if required).
- If the customer risk scoring is high, then EDD will be required
- Ongoing monitoring and review of CDD

A good understanding of the fundamental types of *Shariah* contracts and the types of products derived from the *Shariah* contracts is mandatory for good policies, procedures, systems and controls to be drawn up and ultimately approved by the board of directors.

Generally, the typical policies and procedures and guidelines (not exhaustive) based on the type of risk of IFIs will have the following:

Type of risk	**Policy**	**Guidelines**
Credit Risk	**<u>Credit Risk Policy</u>** The policy addresses the broad credit management framework that covers the objective, strategy, structure and credit processes in order to establish the best practices in the management of credit risk that are in line with the regulatory requirements.	1. Pricing Matrix Guidelines 2. Acceptance Letter Offer Guideline 3. Negative List Guideline 4. Collaterals Guideline 5. Valuation Guideline 6. Discretionary Power Guideline 7. Sovereign Risk Guideline 8. Consumer Grading Guideline 9. Sectoral Guideline 10. Business Relationship Etiquette Guideline 11. Watch-list Guideline 12. Financing Process Guideline 13. Credit Recovery Guideline

Type of risk	**Policy**	**Guidelines**
		14. Guidelines on Risk Adjusted Pricing for Corporate and Commercial
Market Risk	**<u>Market Risk Policy</u>** Describes the Risk Policy and Analytics, Asset and Liability Management (ALM) and Middle Office functions of the Market Risk Department **<u>Trading Book Policy</u>** Addresses market risk factors, which include, but is not limited to, profit rate or rate of return, foreign exchange, equity and commodity risks inherent in the bank's trading and banking books	1. Market Risk Limits Guideline 2. Hedging Guideline 3. Mark-to-Market Guideline 4. Rate Reasonability Check Guideline 5. Value-at-Risk (VaR) Guideline 6. Asset and Liability Management Guideline
Operational Risk	**<u>Operational Risk Policy</u>** The policy provides the effective and efficient operational risk management throughout the bank through its strategies in terms of organization structure, process, risk tolerance, risk measurement and analytic model management information system	1. Operational Risk Management Guideline 2. Management Awareness and Self-Assessment (MASA) Reporting Guideline 3. Fraud Handling and Reporting Guideline 4. Takaful/Insurance Guideline 5. Key Risk Indicators (KRIs) Guideline 6. Outsourcing Guideline 7. Operational Risk Management Process for Information Security Management System 8. Customer Complaint Guideline
Shariah Compliance Risk	**<u>*Shariah* Compliance Risk Management Policy</u>** The policy provides the *Shariah* requirements applicable throughout the bank in its activities, products and services in compliance with the *Shariah* principles, and the Islamic Banking Act or Law	1. *Wadiah* Contract Guideline. 2. *Ijarah* and *Ijarah Muntahiah Bit Tamlik* Guideline 3. *Murabahah* and *Murabahah* to the Purchase Orderer (MPO) Contract Guideline 4. *Mudharabah* (financing) Contract Guideline

Type of risk	**Policy**	**Guidelines**
	and the countries' Central Bank's rules and regulations on Islamic Banking.	5. *Musharakah* (financing) Contract Guideline 6. Handling and Reporting of *Shariah* Non Compliances Guideline 7. *Mudharabah* (Deposit) Contract Guideline 8. *Musharakah Mutanaqisah* Contract Guideline 9. *Musharakah* (Investment) Contract Guideline 10. *Kafalah* Contract Guideline 11. *Wakalah* Contract Guideline 12. *Tawarruq* Contract Guideline 13. *Zakat* Contribution Guideline
AML/CTF Risk	**AML/CTF Policy** The policy provides the AML and CFT requirements applicable throughout the bank in its activities, products and services in compliance with the Islamic Banking Act or Law and the countries' Central Bank's rules and the AML/CTF legislation.	1. Group AML Policies and Procedures 2. AML Guidelines for different lines of business 3. Suspicious Activity Report or Suspicious Transaction Report Guidelines 4. AML Investigation Guidelines 5. Quality Assurance for AML Pre-Investigations 6. Internal Unusual Activity Escalation Guidelines 7. Money Laundering Red Flags for front office and back office

Table 4: List of policies, procedures and guidelines

***Zakat* Contributions**

Muslims are required to contribute Zakat as part of their religious obligations as it is one of the five pillars of Islam. In Malaysia, IFI's have to reflect *Zakat* contribution in the income statements or disclose their non-contribution pursuant to Central Bank of Malaysia's Guidelines on Financial Reporting for Islamic Banking Institutions (GP8-i) issued on 12 December 2012.

Zaharuddin (2007) states that today IFI is a *Zakat* Collection Center and they also pay out *Zakat* to the relevant religious authorities that manages *Zakat*. In Malaysia, the relevant state religious collection centers collect and manage the *Zakat* either directly or by payments made through the IFI.

It is important that IFIs know who the ultimate beneficiary of the *Zakat* is. IFIs can state that the *Zakat* is for the poor and needy, but do they know who the recipient of the *Zakat* is? Therefore, CDD should apply to the *Zakat* Collection Centers and it should not stop there. IFIs must know exactly how much is given, who receives the *Zakat* and what has been given to the intermediary and/or ultimate beneficiary. The reason for this level of scrutiny is to ensure that no *Zakat* is channelled to terrorist-controlled non-profit organisations or terrorist-controlled *Zakat* committees or intermediaries. This is in of reference to the Holy Land Foundation for Relief and Development case,[46] a non-profit organisation in the guise of a humanitarian relief organization whose founders were found guilty in 2009 of funnelling $12.4 million to Hamas (a terrorist organization), where *Zakat* was one of their source of funds.

Systems and Applications Available for IFIs

The systems and applications available for IFIs may vary from country to country. For Malaysia, the Malaysian Central Bank's *Guidelines on International Islamic Bank (BNM/RH/GL 002-9) Appendix II*[47] states that the systems and applications available for IFIs are as follows:

For regulatory and supervisory purposes:

1) International Transactions and External Position System

ITEPS is a database comprising detailed information on the payments and receipts between residents and non-residents effected through the banking system, as well as the stock of external assets and liabilities of the banking sector and the nonbanking corporate sector. The methodology and compilation of all external sector data is guided by standards set by the IMF. Two ITEPS submodules are:

(i) International Transactions Information System

ITIS is the balance of the payment module of the ITEPS. The system records inflows and outflows of funds between resident and non-residents that are effected through the domestic banking system, inter-company accounts maintained by residents with non-residents and overseas account maintained by residents with financial institutions abroad; and

(ii) External Assets and Liabilities Information System

EALIS is a system used to facilitate report on external assets and liabilities position of the banking and nonbanking sector.

2) Financial Intelligence System

[46] https://www.fbi.gov/dallas/press-releases/2009/dl052709.htm
[47] Guidelines on International Islamic Bank BNM/RH/GL 002-9, Central Bank of Malaysia, Appendix II, pgs. 18-19

FINS is a reporting system developed to cater for submission of STRs and CTRs from reporting institutions. FINS is currently accessed by financial and nonfinancial institutions nationwide.

3) The Financial Institutions Corporate Profile System

FICPS is a database on the profile of all banking institutions. The information available in this database comprises institution profile, shareholding structure, profile of chief executive officer or director, distribution network, employees' information (such as senior management, expatriate, etc.), auditors' information, assessment of rating agency, investments in subsidiaries or associate companies, and *Shariah* advisers' information.

4) The Fraud Information Database System

FIDS is a repository of all fraud and attempted fraud cases reported by the financial institutions, and fraud detected and investigated by BNM. The data are submitted by the financial institutions via the web application called eFIDS. The system facilitates the tracking of actions taken by the financial institutions and BNM on fraud detected.

For other purpose:

Fully Automated System for Tendering

FAST is an automated system for tendering, bids submission and processing of tender for scriptless securities in the Malaysian debt securities market. The system is developed to enhance transparency of information and efficiency of tendering process. All government securities and corporate debts are tendered through FAST.

The IFI should take into consideration systems that are not provided by the Central Bank of Malaysia, such as the following:

- **Risk Profiling and Scoring System**
  This is where the IFI will have their own risk profiling and scoring system that is based on their parameters and the necessary information that has to be obtained in order to do a good risk profile and score. The main elements that feed into the risk profiling and scoring system that IFIs should be looking at are as follows:
  - Customer type
  - Type of business
  - Legal arrangements or legal entities
  - Products and services
  - Geographical location

- **Screening and Transaction Monitoring System**

The screening system relates to the screening of all customers and potential customers against a set of watch list and sanctions list to ensure that there is no true positive detected. The transaction monitoring system is the system that triggers alerts based on certain rules and algorithms that have been set in the system. This is to help the bank's money laundering reporting officer decide if a STR (or SAR as known in other countries), need to be filed with the competent authority of the country.

- **Case Management System**
  The case management system relates to a system that records all triggers of unusual patterns from the transaction monitoring system, the cases escalated from the front office and other lines of business. This system will also be used by the AML team to conduct investigations and record their findings prior to it being escalated to the money laundering reporting officer.

The assessment of risks depends very much on the kinds of system(s) that the IFI has adopted and installed. Most central banks do not impose the type of information technology system that IFIs should use. The decision is left to the discretion of the board of directors of the IFI.

In Malaysia, during the early stage of Islamic finance, it was the CFI that started and offered Islamic banking services to their existing clients. They leveraged on their existing business infrastructure such as the information technology and applied them to both the conventional and Islamic banking operations. As a result, reports and statements generated for their Islamic banking customers contained terminologies which were incongruent with the operations of Islamic banking such as interest accrued and interest income. It is hoped that this anomaly has been rectified by now.

CONCLUSION

We have examined and shown how IFI could develop policies, procedures, and control systems, from a set of Islamic principles and certain theological precepts.

Vulnerability of *Shariah* compliant products and services to money laundering and terrorist financing depends on how stringent and robust prevailing CDD policies, systems and controls of the IFI are being administered and monitored.

Equity sharing products like *Mudarabah* or *Musharakah* carry a higher degree of money laundering risks since IFIs take equity positions in the business. Products like *Sukuk,* or Islamic bond, may face higher risks. Its processes typically look like layering and structuring.

As pointed out, CFIs and IFIs have their inherent administrative and operational differences and both provide products and services that carry a varying degree or level of money laundering risks. Despite the differences, when it comes to audit, it may be found that policies and procedures of financial institutions do not differ very much.

It is important that a more inclusive definition of “customer “ be made for IFIs for the purposes of accounting and mitigating any money laundering risk to which they may be exposed.

Zakat contribution is unique to IFIs because it is a religious obligation for Muslims to do so since it forms one of the five pillars of Islam. As a step forward, it is important that IFIs have install or put in place the “know your ultimate beneficiary” mechanism to track and determine the ultimate beneficiaries of the *Zakat*.

It is the considered view of the author that the FFIEC BSA/AML Compliance Examination Manual (2014) can be used as a benchmark and guide for auditing the policies and procedures, internal controls and systems of IFIs in respect of AML/CTF.

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