

Islamic Finance & UK money laundering considerations

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Islamic Finance

Money laundering considerations

Islamic finance enables financing structures to be implemented in conformity with Shari’ah principles.

This paper looks at the considerations when performing UK anti-money laundering checks in relation to Islamic financing.

UK money laundering compliance in Islamic finance

Introduction

In the UK, as in other jurisdictions, Islamic finance transactions are not regulated differently from non-Islamic transactions for anti-money laundering (“AML”) purposes. Existing UK legislation and regulations apply to Islamic finance as they would with any other finance structure or product.

Perhaps surprisingly, international standards and guidance relating to financial crime is silent on the topic of Islamic financings (for example, FATF and JMSLG).

This is striking given the fundamentally different nature of Shari’ah products and the different ways those products might be abused by criminals to launder money through the financial system.



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Key principles

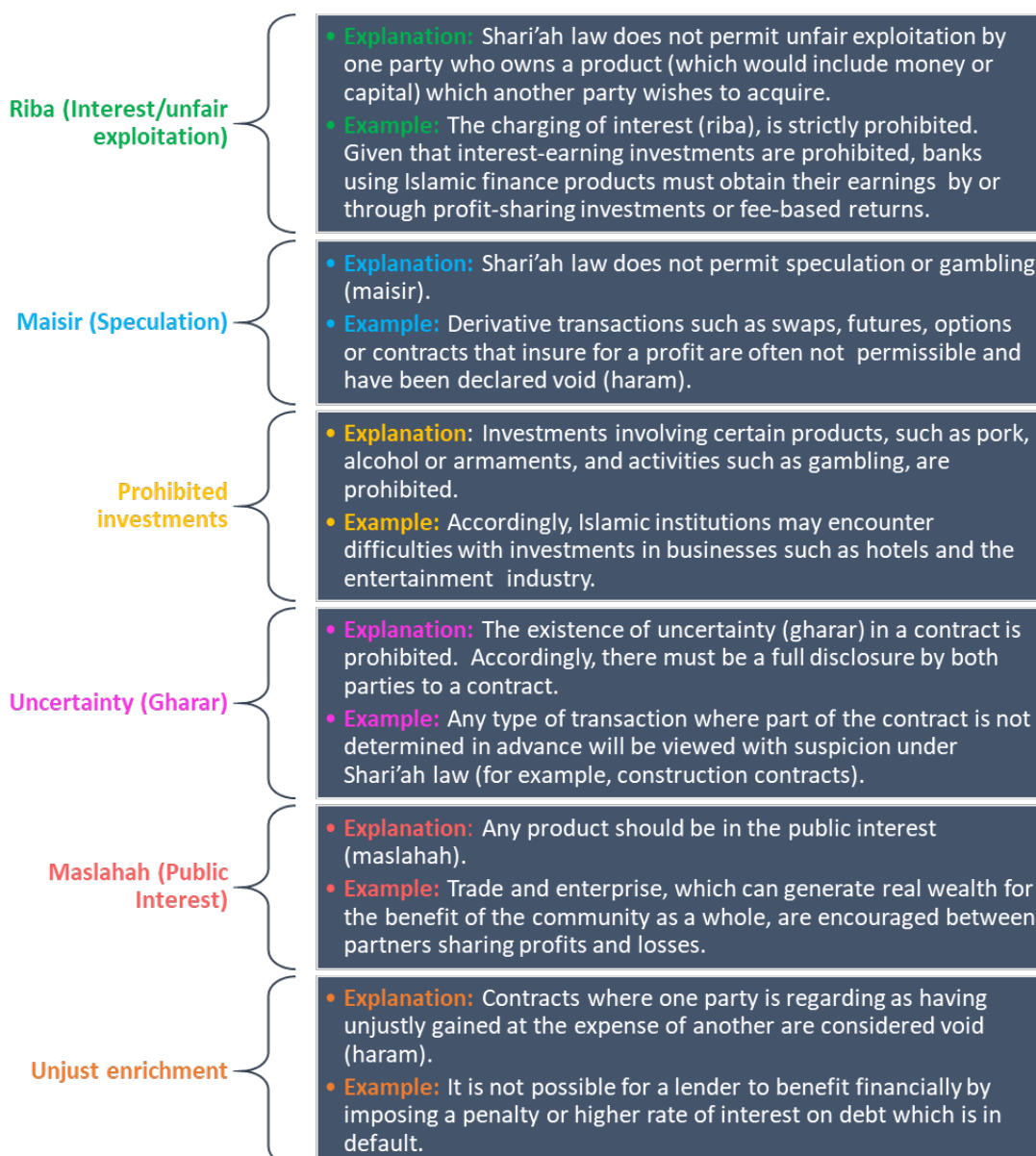
Why are Shari'ah products different from an AML perspective?

Shari'ah finance principles forbid, amongst other things, the charging of interest, speculation and unjust enrichment. This rules out any kind of interest-paying instrument and focuses most Shari'ah transactions instead on models more akin to sale and repurchase, or profit-sharing arrangements where one party invests capital and the other party invests its expertise in managing the investment. One key aim of AML KYC (know your client) investigations is to identify the UBO (ultimate beneficial owner) of the client or the customer who takes the economic benefit.

Because many Shari'ah-compliant structures distribute the profit through purchase and sale structures, on an arm's length basis, the Shari'ah investor with 'skin in the game' is, by conventional AML standards, remote from the structure and not a UBO. A non-Shari'ah finance-based AML analysis might overlook such a person all together.

Shari'ah principles

This diagram highlights the key Shari'ah principles:



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Key products

Shari'ah products

The diagram below identifies common Shari'ah products and structures used in Islamic financing.



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What is money laundering?

Money laundering is the process by which the proceeds of criminal conduct are dealt with in a way to disguise their criminal origins. The money laundering process can be viewed in three main stages. The first stage is placement, which is where illegal gains are placed into the financial system. The second stage is layering, which is the process of making the source of illegal money as difficult to detect as possible by using complex structures to disguise the source of funds. The third stage is the integration of the illegal proceeds back into the economy as legitimate funds through legitimate transactions.

Whilst Shari'ah products may be used at any stage of the money laundering process, this paper focusses specifically on how Islamic financiers can identify money laundering at the customer due diligence stage of the transaction (i.e. at the placement stage).

Overview of customer due diligence measures

Under regulation 28 of the UK Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017/692 (as amended), a "relevant person" is required to perform KYC checks comprising CDD (customer due diligence) where (amongst other things) it establishes a business relationship with a customer, which: (a) arises out of the business of the relevant person, and (b) that relationship is expected, at the time when contact is established, to have an element of duration.

Customer due diligence requires the relevant person to establish and verify the identity of a customer (including its UBO) and assess the purpose and intended nature of the business relationship.



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Anti-money laundering guidance for Islamic finance transactions

It is somewhat surprising that, unlike the legislative focus on AML compliance for conventional finance, and new developments like Cryptocurrency, Islamic finance has attracted no formal regulatory attention from a money laundering perspective.

For example the fifth EU Money Laundering Directive ((EU) 2018/843) extended the scope of AML rules to include those exchanging crypto for fiat currencies because of continuing concerns about anonymity and the fact the rules were struggling to keep up with the evolution of the crypto world. Yet there has never been any equivalent provision for Islamic finance techniques.

Much of the literature published on this topic tends to conclude that there is no evidence that money laundering risks in Islamic finance are different from those in conventional finance; whilst this may be correct, it does not ex-

plain how non-Islamic finance AML regulatory tools should be applied to common features in Islamic finance structures.

These features are discussed below.

Partnership relationship

In Islamic financing transactions, banks tend to enter in a “partnership” with their customers — musyarakah (joint-venture) and mudharabah (profit sharing). This is in contrast to the traditional lender/customer relationship which falls more neatly within the UK money laundering regulations which refer to “customers”. The partnership relationship (rather than the bank/customer relationship) may cause some uncertainty as to whether “partners” are customers under the UK money laundering regime. Whilst there is no definition of “customer” under UK regulations, many consider that this term should be given a broad meaning. Accordingly, a participant in an Islamic financing transaction—should, in our view, constitute a customer in this context.



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Customer due diligence

Such institutions would therefore be required to perform customer due diligence on those partners and due diligence on the underlying transaction. The following paragraphs identify particular structures which may present a higher risk of money laundering.

Structuring

Shari'ah structures often have the following features:

- **Identity of investors:** Often one investor will act on behalf of a number of investors (through musharaka) which may not be visible to the financier. Customer due diligence should identify any material contributors of capital who would be akin to ultimate beneficial owners in a non-Islamic structure.
- **Asset-based features:** Shari'ah structures are often designed with an asset-based feature to function as the conduit for the funds (e.g. a sale and onward sale with deferred repayment in a tawarruq). This offers a degree of complexity (layering) which can make these structures susceptible to money laundering .
- **Use of SPVs:** Shari'ah products (like non-Shari'ah products) often use Special Purpose Vehicles. SPVs are shell companies often located in offshore centres or tax-havens. However, the ownership of such vehicles can be unclear. Financiers should ensure that due diligence is applied to those SPVs to identify their ultimate beneficial owners even though they may purport to be 'orphaned'.
- **Series of transactions:** Many Shari'ah structures involve a series of transactions and multiple layers of structures (for example, tawarruq) whereby funds are transferred to several parties. The accessibility of such funds makes this structure vulnerable to misuse.

- **Zakat sources:** Zakat is a form of alms giving treated in Islam as a religious obligation or tax. Islamic finance often includes zakat payments. Given such payments come from many sources, it might be difficult to ascertain where such funds have originated which will be relevant to a financier's customer due diligence.
- **Use of Zakat:** It is also important to be satisfied that the recipient of Zakat payments does not pose AML or terrorist financing concerns.

Identification of key participants

As noted above, a number of structures used in Islamic financing can be used to provide anonymity as to the both the source of funds, beneficial ownership of funds and purpose of funds (see Structuring above). The onus will be on the financier to ensure that it has a workable KYC process to ensure that any lack of transparency is accounted for.

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Money laundering risks

Summary

An understanding of Islamic finance structures is essential to any compliance personnel seeking to perform KYC. UK AML rules were designed with non-Shari'ah structures and business relationships in mind. An entity performing KYC on an Islamic structure needs to think creatively and purposively when applying the UK rules to such a structure. A list of relevant considerations in this regard may include (but will not be limited to) the following:

1. Who are the investors and ultimate beneficial owners in the structure? Is there an element of musharaka? Is it clear what is the percentage of contribution from each investor?
2. Is the identified investor acting on behalf of somebody else?
3. Is the ultimate beneficial ownership of SPVs known?
4. What is the source of funds and can such sources be verified?
5. Does the structure of a transaction comply with Shari'ah principles? Or, does the structure of a transaction go beyond what is required under Shari'ah principles? Can this divergence be assessed?
6. Is the structure transparent at every layer of the transaction?
7. What risk do any charitable organisations in the structure pose from a money laundering perspective?
8. What are the risks posed by the jurisdictions involved? For example, the jurisdiction of (i) the recipient of funds, (ii) the sender of funds and (iii) any intermediate parties in the structure?
9. On the basis of the above, what risk does this transaction carry and what ongoing measures required to manage the risk (if the transaction proceeds)?



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