

Islamic Financial Institutions Financing the Terrorism? Regulators Role in Evidencing it a Fallacy

INTRODUCTION

Globally, there has been a remarkable growth of Islamic finance industry over the last four decades since 1980. The total global market capitalisation of the Islamic financial services industry that stood at a meagre US \$10 billion in 1980 has almost surpassed the three-trillion dollars mark. The assets of global Islamic banking sub-sector amounted to \$1.99 trillion out of the total Islamic finance assets of \$2.88 trillion in 2019.

According to the Islamic Finance Development Report (2020) compiled jointly by the Thomson Reuters' 'Refinitiv' and 'ICD' of IDB Jeddah, global Islamic finance assets are expected to reach \$3.69 trillion by 2024. The Report indicated the top five countries driving Islamic finance including Malaysia, Indonesia, Bahrain, UAE and Saudi Arabia, and highlighted the recent trend in Islamic finance growth driving ahead to social finance in line with the globally increasing focus for realizing the SDGs. The CEO of ICD, IDB resonated in the Report that Islamic finance could play a major role in alleviating the social and economic consequences of the Covid-19 pandemic.

Although the industry has successfully attracted many customers beyond the Muslim world, the Islamic finance industry faces some unique challenges. One main challenge is the perception that Islamic finance is seen as part of a wider agenda by political Islamists, which could threaten and undermine the state itself (Rashidah & Tirmizi, 2014). Such perception could be highly risky not only for Islamic finance industry, but also for the financial system of the countries where Islamic banking and finance has taken a sizeable place in their overall financial system.

Schneider (2010) indicated various sources of terrorism financing out of which we are concerned here with the illegal sources that could benefit the terrorist and that the Islamic Financial Institutions (IFIs) must avoid, one way or the other. The critics of Islamic finance express concerns about possible ties between Islamic finance and the terrorist financing and the use of Islamic finance to fund Islamic extremist groups. Such critic was particularly serious in the years following 9/11 and pertained to all financial flows based on *Zakāh* and other religious philanthropic remittances across borders (Rashidah & Tirmizi, 2014).

Following the 9/11 tragedy, there were several legislations and standards that mandated the financial institutions to adopt measures to Counter the Financing of Terrorism (CFT) and money laundering that could indirectly finance the terrorists. The Financial Action Task Force (FATF) on money laundering, an intergovernmental standard-setting organization, was established during the G-7 Summit in 1989 to put in place a legal and regulatory framework for Anti-Money Laundering (AML) and terrorist financing. The responsibility was later added (following 9/11) to include monitoring terrorism financing of member countries. As its monitoring function, the FATF conducts for different countries a five-yearly Mutual Evaluation assessment, which is based on country's compliance of the –40 + 9 Recommendations standard ¹.

The Perception Issue

Rashidah and Tirmizi (2014) conducted a perception study analysis of selected 120 articles published before and after 9/11. They divided the articles into three categories, those published during pre-9/11; five years after 9/11 and post 2007 global financial crisis (GFC). The negative effect of 9/11 in terms of perception towards Islamic finance and of being linked to terrorism finance was quite visible in articles of the first category. After the crises, however, "the tones of many business and research papers related to Islamic Finance have somewhat changed positively".

Rashidah and Tirmizi (2014) indicated that:

- 1) The negative perceptions on the IF industry were most visible during the first five years of the 9/11 attacks – e.g. "Islamist group such as the al-Qaida uses the Islamic banking sector for terrorism financing";
- 2) It was after 9/11 that the consistent oil-money supply from the Gulf region made Islamic finance attractive even to non-Muslim countries";
- 3) The public perceptions improved tremendously after 2005, particularly amidst the economic crisis in 2007 and 2010 that badly affected the Western countries, while Islamic finance gained its momentum with double-digit growth rates.

Strengths of Islamic Finance Explored

The GFC almost changed the perception about Islamic finance. The 'Washington Post', in an article captioned, "Islamic Banking: Steady in Shaky Times", by Ambah (2008) indicated this change while emphasizing the strengths of Islamic finance:

"Principles based on religious law insulate industry from the worst of financial crisis. As big Western financial institutions have teetered one after the other in the crisis of recent weeks, another financial sector is gaining new confidence: Islamic Banking. Proponents of the ancient practice, which looks into Sharī'ah law for

¹The FATF for its monitoring function comprises six regions that are Asia / Pacific Group on Money Laundering (APG); Caribbean Financial Action Task Force (CFATF); Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL); Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) and South America Financial Action Task Force (GAFISUD).

guidance, and bans interest and trading in debts, have been promoting Islamic finance as a cure for the global financial meltdown".

It was specifically highlighted that;

"Islamic finance does not allow the creation of debt through the direct lending and borrowing of money or other financial assets. The debts can only be created through the sale or lease of real assets through financing schemes such as murābahah, ijārah, and ṣukūk. The assets which are leased or sold must be real (building, property, or any other physical infrastructure), and the transactions must be genuine (approved by government regulators, as well as religious experts comprising the Sharī'ah board) with the full intention of giving and taking charge, and the associated debt (risk) cannot be sold or transferred to someone else. Such characteristics of Islamic finance are somewhat different from the conventional banking that promotes derivatives and future market transactions".

Ambah (2008) quoted an Islamic finance expert saying, *"We are more conservative and sober in our investments. That used to be considered a handicap. Now it's considered the height of wisdom"* and concluded, *"The current financial collapse is an opportunity. The ugly side of Wall Street is exposed; it's always been there but covered by a layer of glamour that is now stripped away"*.

Gheeraert (2008) expressed, likewise, *"After controlling for standard determinants and potential endogeneity, using religion as an instrument, we find strong and significant empirical evidence of a positive role of Islamic banking on countries' financial sector development, as measured by private credit over GDP"*.

Jobst (2009) explored the unique features of the ṣukūk market leading to the resilience of Islamic finance to the adverse effects of conflicts of interest apparent in the US subprime mortgage crisis and the subsequent fallout in global financial markets. As such, many publications added new frontier of knowledge and contributed in shifting the public perceptions on the Islamic Finance industry from negative to positive (also see: Ali & Syed, 2010).

Jabbar (2020) in a study published in the Journal of Money Laundering Control found no evidence to support the contention that the IFIs facilitate money laundering. He added that the IFIs were no more susceptible to money laundering than conventional financial institutions could be.

But, still there have been some serious voices linking Islamic finance with money laundering and terrorists financing. Islamic finance industry could be facing with a major challenge to create better awareness in the world at large of the ethical and well-regulated business of Islamic finance, besides facing the continuous challenge of misconceptions and negative opinions by linking it with terrorism financing. As such, the second most crucial infrastructural body of Islamic finance, after AAOIFI, the IFSB issued in December 2019 a working paper (WP-12) on *Money Laundering and Financing of Terrorism Risks in Islamic Banking*, prepared jointly with the Arab Monetary Fund. The WP discussed main features of Islamic banking and attempted to address whether there was any evidence that ML/FT risks in Islamic

banking could be different from those that might be in conventional banking. The IFSB particularly remarked:

"Islamic financial services industry may be highly prone to the issues of ML/TF risks which might emanate from the intrinsic characteristics of instruments and arrangements used in Islamic banking, or from the nature of the contractual relationship between Islamic banks and their customers."

The IFSB might be referring to any Islamic finance instruments that could be used by the customers for money laundering (ML) or terrorists financing (TF) by getting cash / liquidity. Organized *tawarruq* being used extensively by Islamic banks in almost all parts of the world could be one such product. Its use and the assets / goods involved for underlying sale / purchase are increasing to include such items like meat, gram, pulses, cotton, sugar or even instruments like *ṣukūk*, mutual funds units, etc. Earlier, it was mainly a vehicle for liquidity management or for financing the corporate sector. But lately, it is increasingly being used for consumers financing.

Other such products / instruments could be based on sale / discounting of debts / debt instruments as are prevalent in various jurisdictions. In all these cases, while the Sharī'ah advisors / reviewers / auditors need to ensure that the exchange contracts involving real assets practically take place for Sharī'ah compliance at least in letter, the regulators are required to put in place any reliable controls requiring that underlying trade and business activities take place strictly as per Islamic exchange law. It will also enhance credibility of Islamic finance as a value-based system.

The IFSB WP-12 particularly highlighted that if Islamic banking institutions follow the theoretical framework of Sharī'ah in contracts and transactions, the system itself would contribute to combatting ML/FT risks. *"Islamic banks need to ensure that the use of business structures and investments by the customers has a genuine and legitimate purpose from the perspective of both national laws and Sharī'ah principles"*, the WP added.

The WP, however, indicated vulnerability of the IFIs, especially Islamic banks, to the consequential risks emerging from any weak ML/FT regulatory regime in the countries with a significant Islamic banking presence and the peculiarity of the products. In respect of charity related accounts, it suggested that the IBIs should develop a profile of anticipated account activity and ensure that such transfers are in accordance with the spending plans of the charity.

Based on a survey with on ML/FT from the Regulatory and Supervisory Authorities (RSAs), the IFSB's WP did not find any significant difference in the ML/FT risks between conventional and Islamic banking. *"Since risk levels are largely similar in both conventional and Islamic banking, Islamic banks should adhere to their own country regulations and the Financial Action Task Force standards to combat ML/FT"*, the WP concluded.

The Perception that the IFIs could finance the terrorists must be done away with and Islamic finance regulators need to play their role by ensuring that each and every transaction or business by any IFIs is practically linked to the real sector exchange deals. It could be of both the real assets, or investment instruments representing their ownership. As per built-in

feature of Islamic finance, there is a clear disconnection between the IFIs and terrorists financing. By dint of unique features, Islamic finance is potentially in tune with Anti-Money Laundering or Anti-Terrorism Financing laws (Nasir, 2018).

Hence, the regulators need to move ahead to remove unquestionably the perception of IFIs financing terrorism. Rashidah and Tirmizi (2014) conclude that the "Government should implement a comprehensive strategy to be adopted by regulators, enforcers and Islamic financial institutions to mitigate those negative perceptions implicating terrorism with Islam".

To conclude, we reiterate that Islamic finance regulators all around the world, particularly in the OIC members countries with considerable presence of Islamic finance, may take it an opportunity to penetrate the global finance market by focusing on financing the real sector activities. The UNDP and many global finance institutions are already emphasizing moving to social finance and financial and social inclusion to realise the SDGs-2030. The rules and regulations for Islamic banking and finance sector must not allow the creation of debt and liquidity through lending and borrowing of money or other financial assets (Ambah, 2008) in the garb of *tawarruq* or other debt creating modes. It would not only remove the negative perception about Islamic finance of possibility of financing the terrorists, but also enhance credibility of the emerging banking and finance discipline leading to its faster growth.

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