

The Underground Banking Systems and their Impact on Control of Money Laundering: With Special Reference to Islamic Banking

Fath El Rahman Abdalla El Sheikh

INTRODUCTION

The concept of Islamic banking is gaining momentum nowadays. It has been reported that the establishment of Islamic banks and financial institutions has come as a result of the new challenges posed by the wave of globalisation which has swept all fields of life worldwide. There are now more than 200 Islamic financial institutions managing huge funds exceeding US\$200bn spreading all over the world, mostly concentrated in the member countries of the Organization of the Islamic Conference, particularly Kuwait, Malaysia, United Arab Emirates, the Sudan, Pakistan and Bahrain. The Islamic banks and financial institutions are growing at an annual rate of 10–15 per cent and they are expected very soon to be able to manage half of the deposits of the Islamic world.

Despite this rapid growth and expansion of Islamic banking, there are many hurdles and dangers which could be fatal to their operations. In this paper only one danger will be examined — money laundering, which has been characterised as the most serious danger threatening not only the economies of all countries but also their tranquillity and political stability. The main concern here is to show how much Islamic law contributed to controlling money laundering. No doubt the Islamic underground banking system according to Islamic law should be investigated thoroughly so as to reflect an insightful view of the practice, which might be different from the theory, and this emanates from the dilemma of the Islamic system, which permits many different interpretations of its tenets and rules.

THE IMPACT OF ISLAMIC BANKING LAW

Duty to disclose

To control money laundering under any system there should be accountability and transparency. This thesis contradicts the concept of bank secrecy, which is primarily considered a serious impediment to the control of money laundering.

Islam, like all modern systems, does not entrench absolutism. In Islam for every right there is normally a corresponding duty, which should be carried out as stipulated.¹ Thus, the right of bank secrecy and confidentiality is not always absolute.² This principle finds support in the verses of the Holy Quran,³ the teachings of the Prophet Mohammed (p.b.u.h.)⁴ and his followers (Hadith),⁵ and the writings of Islamic jurists (fiqh).⁶ Despite the supported principle, there are some exceptions to the right of bank secrecy. In certain instances, secrecy cannot be upheld and consequently disclosure becomes mandatory. Such instances are, for example:

- (a) When public interest dictates that law and order should be maintained.⁷ This may happen when a serious crime has been committed or is about to be committed.⁸ Here, the preservation of the public good overrides the protection of the right of privacy and secrecy. In such cases there is a duty on the bank to disclose the required information if it is ordered to do so by the competent authorities in the particular case.⁹ However, disclosure of the relevant information should be made in accordance with due process of law.¹⁰ Situations where disclosure becomes mandatory in criminal cases are numerous, especially in economic crimes such as fraud, drug trafficking, and money laundering.¹¹

Under the traditional Islamic system, the concept of 'Hisba',¹² certain economic rights of the individual may be interfered with or restricted for the benefit of the general public. These interferences or restrictions may extend to several economic activities conducted by individuals or legal entities.¹³ It is interesting to note that the concept of Hisba has developed throughout Islamic history to apply to controlling market prices and combating monopolies. To the surprise of many Islamic scholars and jurists the concept has been unwarrantly applied to cases where no interest or right is affected. For all intents and purposes it is a misinterpretation of

Islamic concepts and principles — an exercise which really distorts the good image of Islam, which is flexible enough to accommodate diversification, tolerance, and modern modalities in economic activities. Islam aims at respecting the dignity of mankind and fundamental human rights in a healthy and productive society.

- (b) When an individual's right has been denied or encroached upon, the right of privacy and secrecy related to bank accounts would not be upheld.¹⁴ In such cases the bank would be under a duty to disclose the information to the appropriate authority whether in compliance with a judicial order or a legislative provision.¹⁵ Clear-cut examples in this respect are succession cases and matrimonial causes.¹⁶
- (c) Disclosure of bank information could be made to non-official applicants in response and implementation of contractual provision.¹⁷ This is done when the client authorises the bank in advance to provide information to certain applicants.¹⁸ The authorisation should be executed in compliance with the contractual provisions, as under Sharia 'the contract is the law of the parties'.¹⁹
- (d) In many situations financial disclosure is mandatory.²⁰ When there is a duty to make financial disclosure in accordance with due process of law a disclosure occurs. This normally happens in cases when there is a duty on the banks to report certain transactions to the regulatory agencies such as the central banks or similar government agencies such as stock exchanges or other agencies for supervising certain economic activities.²¹ The role of such agencies could not be denied or alienated in a modern state and such concepts could not be condemned as repugnant to Islam (Sharia).²² It is alleged by some scholars that Islamic banks and institutions are over-regulated, because they are subject to complex three-tiered layers of regulation comprised of the commercial code, Sharia governance and the regulation of the central banks in the jurisdiction in which the Islamic banks and institutions operate.²³ Under the Sharia, Islamic banks and institutions are forbidden from engaging in or financing many transactions which led to gharar (speculation), interest and other activities (riba) such as gambling, prostitution, harbouring of prohibited goods and services, drug trafficking and corrupt practices.

They are required to carry on business in a lawful way, not involving any illicit profits derived from illegal activities. As these illegal activities are the major sources of dirty money, to be laundered by many techniques most of which are accomplished by underground operations that may be beyond the reach of the competent authorities, it could be asserted that Islamic law is contributing to a great extent in the control of money laundering by combating its sources.

As Islamic banks and institutions are required to abide by the laws and regulations of the countries in which they carry on business, they fall under the supervision of national regulators who are responsive to international initiatives to combat money laundering by issuing domestic legislation and directives for achieving this purpose. In this respect reference must be made to the 40 Recommendations of the FATF on money laundering which are now widely applied by the international community. The practical result has been remarkable in producing many national laws and the conclusion of regional agreements among countries²⁴ for combating money laundering, a process which is condoned by Islamic law, which aims at combating the evils threatening all societies.

THE PRACTICE OF ISLAMIC BANKS

Despite their short existence, Islamic banks have developed solid Islamic banking modalities of their own,²⁵ such as Morabaha (trade financing), Musharaka (partnership), Modarba (profit-sharing), Ijara (leasing), Istisna (manufacturing) and Takaful (insurance). However, they have encountered certain challenges in view of the integration of the world economy, which requires more flexibility in order to accommodate the many new investment instruments and products.

In all their investment and banking modalities, Islamic banks adhere ardently to the concept of banking secrecy and confidentiality. This concept is reflected in their dealings with customers and each other.²⁶ In the appropriate contract of each deal, it is normally expressly stated that the parties should treat all communications under the contract as confidential, and under no circumstances shall relevant information be divulged to third parties except by court order or in compliance with operative law.²⁷

Non-observance of such a contractual provision amounts to breach of contract, giving the aggrieved party the right to take the appropriate legal action to vindicate its claim.²⁸

Unlike other religions, Islam is not confined to just some moral teachings, rituals or modes of worship. It rather contains guidance for every sphere of life including socio-economic fields. The obedience from servants of Allah is required not only in worship, but it is at the price of other apparent benefits, because these apparent benefits may go against the collective interest of society.²⁹

However, despite the Islamic commands given by the divine revelations, which should be followed in letter and spirit and cannot be violated or ignored on the basis of rational arguments or inner desires, there have been several violations in the practices of Islamic banks, other financial institutions and individuals who claim to carry out business in accordance with Sharia principles. Such practices happen despite the tight scrutiny of the Sharia Board, both at the stage of vetting the transactions conducted by Islamic banks before execution and thereafter during implementation to ascertain their compliance with the Sharia rules and investment modalities. Thus, it was reported that an unknown Sudanese landed in the Sudan with US\$6m in cash to exchange them for Sudanese pounds on condition that he should not be asked to disclose the source of (by Sudanese standards) such a huge amount of money.

During the late years of Numeiry's regime it was reported that some Islamic banks were involved in harbouring consumer goods, including Dura (sorghum) which is the staple food of the majority of the Sudanese people. The result of this practice led to devastating starvation for many poor people who could not feed themselves, for they could not afford to buy their staple food, which was sold at astronomical prices prompted by the illegal practice of harbouring the same. Not only this, but these banks had engaged in massive illegal trading of foreign currencies in the spot marketing (black market), thus violating the Foreign Exchange Regulations. This has led to scarcity of foreign exchange and the devaluation of the Sudanese currency. It was not surprising that the accused Islamic banks were subject to extensive investigations by the transitional government which came to power after the Numeiry regime was overthrown by a popular uprising in 1985. Despite the heavy penalties imposed on these banks, the situation has been

made worse since the National Islamic Front Government (NIF) overthrew by coup d'état in 1989 the democratically elected government that succeeded the transitional government. The NIF government has imposed a distorted Islamic code on all aspects of life, which unfortunately has provided a shelter for Islamic banks to perpetrate their corrupt practices and be used as conduits for funneling funds to Islamic fundamentalist organisations that took refuge in the Sudan by the collusion of the NIF in the early years of its regime. It is worth mentioning that the Islamic fundamentalist organisations under the guidance of Osama Bin Laden, who was in the Sudan till 1996, had committed deadly attacks on Americans in many parts of the world, which claimed the lives of thousands of innocent people, as witnessed by the terrorist attacks on New York and Washington on 11th September, 2001. However, the situation has improved to some extent in view of the new wider policies and revisions which allow more transparency and accountability from all banks operating in the Sudan to Bank of Sudan (the Central Bank), which has issued as of late tough regulations to straighten out the conduct of business in the banking sector. Such an attempt, however, still falls short of the comprehensive reform which presupposes radical political reform securing long-lasting peace and a democratic regime based on a multiparty system with full respect for human rights and general freedoms and the supremacy of the rule of law.

Perhaps the most striking example of the violation of the ethics and rules of Islamic banking was the scandal that severely hit Dubai Islamic Bank, which lost more than US\$500m embezzled by certain high executive officers of the bank who had been responsible for the real estate portfolio. They took the money and invested it in South Asian markets for their own accounts, but unfortunately suffered huge losses as the result of the crash of the financial markets in that region.

The other clear example of exploitation of Islam to mobilising the financial resources of innocent people who believe in the Islamic faith in order to improve the standards of people by investing these resources in accordance with the Sharia, was the case of BCCI, in which some Islamic institutions and investors were encouraged to deposit substantial funds with the bank in response to the assurance that such funds would be invested in accordance with the Sharia. But they lost more than US\$800m in that

unsuccessful venture. It was discovered later that the deposited funds were not invested in accordance with the Sharia as alleged, but rather in financing the drugs trade and many other illegal activities, the proceeds of which were laundered by the bank in several jurisdictions — thus registering the biggest operation of money laundering in the last century.³⁰

CONCLUSION

Despite the theoretical tight regulation and control of banking activities under Islamic law which calls for clean, transparent and ethical dealing which is known to be positive for combating money laundering, there are many loopholes in the Islamic system, which presuppose the innocence and require cogent evidence to prove otherwise, that might allow underground operations of money laundering to be conducted. Such operations should not be left unchecked in view of the strenuous efforts being exerted at all levels to uproot the damaging phenomenon of money laundering, which is condemned by all legal systems. Islamic law is not an exception. However, international cooperation is required to combat underground banking operations, which are the major sources for conducting money laundering activities across international boundaries.

REFERENCES

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- (2) *Ibid.*
- (3) *Ibid.*
- (4) See (1982) 'The Scientific and Practical Encyclopedia of Islamic Banks, pp. 33–47.
- (5) *Ibid.*
- (6) *Ibid.*
- (7) *Ibid.*
- (8) *Ibid.*
- (9) Union of Arab Banks (1989) 'Islamic Banks', Beirut, Lebanon, pp. 25–34.
- (10) *Ibid.*
- (11) Al-Salos, A. (1986) 'Modern Financial Dealings in Sharia' Kuwait, p. 85.
- (12) On the origin and development of the concept of 'Hisba' throughout the Islamic history, see Shulg, A-F. (1993) 'The Nation and the State' (in Arabic), Beirut, pp. 135–1193.
- (13) *Ibid.*
- (14) *Ibid.*
- (15) *Ibid.*
- (16) For example, when a husband of a divorced woman refuses to pay the living expenses of his children by claiming that he is insolvent. In such cases the court may order the bank of the husband to disclose the balance of the account of the husband to ascertain the allegation and vindicate the claim of the woman. *Ibid.*
- (17) Shulg above, ref. 22.
- (18) This is usually imposed by special legislation. At the moment, most banking laws of Arab countries contain such a provision to which any Islamic bank is subject.
- (19) Al-Zarga, M. (1965) 'Introduction to Sharia' Damascus, p. 45.
- (20) Under the central banks' laws and directives.
- (21) Islamic International Bank for Investment and Development (1984), Centre for Islamic Research, Consultances, and Training, (1984), pp. 1–3.
- (22) *Ibid.*
- (23) See the writer in vols 1, 2 and 3 of *Journal of International Banking Regulation*.
- (24) See Dr. Hamdi Abdel Azeem (1997) 'Money Laundering in Egypt and the World', ch. 5, also El Sheikh, F. (1999), 'Anti-Money Laundering Guide', Middle East, Institute of Advanced Legal Studies, London.
- (25) See generally, Sheikh Saleh Kamil (1959) 'Islamic Banks and Financial Derivatives', *Arab Bank J*, Vol 15, p. 43.
- (26) This is a standard clause which is adopted by all Islamic banks.
- (27) This is the current procedure available to all banks under municipal law; Islamic banks are not an exception.
- (28) See Taqi Usmani, M. (1998) 'An Introduction to Islamic Financing', pp. 16–17.
- (29) See El Sheikh, F. (1996) 'Bank Secrecy and Confidentiality Law in Practice — A Middle Eastern Perspective', *Dickson Journal of International Law*, Vol. 14, p. 577.
- (30) See generally El Sheikh, F. (1995) 'B.C.C.I., Rise and Fall' (in Arabic), Cairo.

Dr Fath El Rahman Abdalla El Sheikh, Legal Adviser, Kuwait Investment Authority, formerly Head of Department of International and Comparative Law, University of Khartoum, Sudan.