

The Impact Of Customer Due Diligence In The Islamic Banking Institutions In Malaysia: A Legal Perspective

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Abstract

The money laundering and terrorism financing are the financial crimes that caused global threat to the financial integrity and economic activities of the country. In combating these financial crimes, the international standards imposed by the Financial Action Task Force (“FATF”) requires that all financial institutions in all countries to undertake the Customer Due Diligence (“CDD”) as its preventive measurements in combating these financial crimes. In Malaysia, this CDD requirement is regulated under Section 16 of the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (Act 613) (“AMLATFPUAA”). This CDD requirements is applicable to all the ‘Reporting Institutions’ listed under the First Schedule of the AMLATFPUAA which includes the Islamic banking institutions in Malaysia. As such, the legal requirements provide that there is no exception for the Islamic banking institutions to follow this statutory requirement. Therefore, the objective of this paper is to highlight the standards in conducting CDD requirements on the Islamic banking institutions in Malaysia. This paper is significant by emphasising the Policy Document on conducting CDD under the ‘Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT)- Banking and Deposit-Taking Institutions (Sector 1)’ which is set out by the Central Bank of Malaysia (“BNM”). This paper employs library based research by analysing the primary and secondary legal sources on CDD standards and legal requirements. This paper suggests that the Islamic banking institutions in Malaysia are in compliance with the international standards on CDD as imposed by the FATF and the statutory obligations under the AMLATFPUAA. Therefore, continuous efforts by the Islamic banks in Malaysia are required in combating these financial crimes.

Keywords: AML/CFT, Financial Crimes, Customer Due Diligence, Islamic Banking

1. Introduction

Compliance with the customer due diligence (“CDD”) requirements are one of the vital aspect in the financial institutions which includes the banking and deposit taking sector. The term CDD has been used by the western commercial term to signify a regular investigation procedure for the customer identification with the purpose of assessing any potential risk that may be existing in their business relations (Ai, 2009: 407). Initially, the term ‘Know Your Customer’ (“KYC”) has been used by the Basel Committee of Banking Supervision (“BCBS”) to denote the identification of customer background prior to the relationship with the customer. Nevertheless, the term has been changed to the current term, CDD after an introduction of the FATF 40 Recommendations by FATF in 20th June 2003. According to Freeland (2002: 292), the CDD

standards imposed to reflect the wider and continuous duties of the banker in protecting their reputation from the money laundering and terrorism financing crimes. Also, Koker (2006: 28) states that the term CDD often used to refer to a process that is slightly broader than the so-called 'KYC' procedure which is aimed at gathering sufficient information about a customer to compile a profile of the customer. In this regard, as at to-date the term CDD has been officially used by many regulators and supervisors for the purpose of identification and verification of the identity of the customer.

Further, one of the purposes for an imposition of CDD requirements to all financial institutions is in order to combat financial crimes such as the risks of money laundering and terrorism financing. In this regard, the CDD requirements require that all the financial institutions to identify the information and verify the legal entity of their customer at the initial stage of the current opening (Coto, 2016: 164). This CDD requirements also dictate in the laws and regulations of the country in order to maintain high ethical business standards as well as to protect the institution from the abuse of the money laundering and terrorism financing crimes.

In addition, as stated earlier, although the origin of the CDD requirements is by western term, this requirements is also extended to the Islamic financial institutions. This is due to the reason that combating these financial crimes is also applicable to the Islamic banks that offers the Islamic banking products and services. Mugarura (2014:84) states that the Islamic banks should not offer their products or services or provide active assistance in transactions which is associated with the money laundering and terrorism financing activities. In addition, the recent study by the International Monetary Fund ("IMF") states that both conventional and Islamic financial institutions are vulnerable to these crimes and adequate CDD on new and existing customers is an essential part in combating these financial crimes into their institutions (Nadim Kyriakos-Saad, 2016: 6).

In Malaysia, the mandate to undertake the CDD requirements are applicable to all the 'Reporting Institutions' listed in the First Schedule under the AMLATFPUAA. One of the 'Reporting Institutions' listed under the AMLATFPUAA is the activities carried out by a licensed Islamic bank as defined or provided on the Islamic Financial Services Act 2013 (Act 759) ("IFSA") (Paragraph 2(a) in the First Schedule of the AMLATFPUAA). As such, the Islamic banks in Malaysia have duties to comply with the laws. The law requires that all the Reporting Institutions which include the banking and deposit taking institutions to comply with this CDD requirements. As such, the Islamic bank under IFSA is no exception to undertake this CDD requirement to their customers.

Hence, the focal points on this paper is to highlight the standards in conducting CDD requirements on the Islamic banks in Malaysia. This study is relevant as to emphasise on the legal requirements and the practice required to the Islamic banking institutions in Malaysia. As such, the authors presented this paper into three parts. The first part focuses on the international standards for CDD requirements imposed to the financial institutions in global scale. The second part is on the legal requirement and practice for the CDD requirements for Islamic banks in Malaysia. The discussion includes on the statutory requirements imposed under AMLATFPUAA and highlight the practice requirement imposed by the Central Bank of Malaysia to the Islamic banking institutions in Malaysia. The third part of this paper is on the discussion on the effects of non-compliance with the CDD requirements to the Islamic banks in Malaysia. Finally, this paper ends by providing conclusions on the CDD requirements to the Islamic banks in Malaysia.

2. An Overview of The International Standards for Customer Due Diligence

This section provides an overview on the international regulations and standards in combating money laundering and terrorism financing to the financial institutions. There are many international standards and regulations applicable for combating these financial crimes such as the United Nations Instruments and Conventions, The Wolfsberg Group, Egmont Group of Financial Intelligence Units and others. Nevertheless, this paper is limited only to the study on the CDD requirements in combating these organised crimes to the banking institutions. As such, this overview will be limited to the BCBS and the FATF only.

2.1 Basel Committee on Banking Supervision

The BCBS is an international supervision on banking matters where its supervisory issues are applicable worldwide (Basel Committee on Banking Supervision - Overview, n.d.). The BCBS is also one of the committees under the Banks for International Settlements (“BIS”) which has its authorities by providing background analysis and policy recommendations for the purpose of promoting monetary and financial stability (About Committees and Associations, n.d.). The BCBS sets the primary global standards for the regulations of banks in terms of its regulation, supervision and practices for the purpose of enhancing financial stability globally (The Basel Committee Mandate, 2017).

Thus, in relation for the CDD requirements on the banks, the BCBS has published several guidance for banks among others are provided and explained as follows: -

- (a) *Statement of Principles on ‘Prevention Of Criminal Use Of The Banking System For The Purpose Of Money-Laundering’ (“Statement of Principles”)*

This Statement of Principles was issued by the BCBS on December 1988. The United Nations Office on Drugs and Crimes (“UNODC”) states that this Statement of Principles is the first international legal instrument to embody the strategy in combating the money laundering in international level (UN Instruments and Other Relevant International Standards on Money-Laundering and Terrorist Financing, n.d.). Thus, this Statement of Principles is issued to ensure that the financial system is not used as a channel for criminal funds and take reasonable efforts to determine the true identity of all customer (Paragraph II of the Statement of Principles).

- (b) *Customers Due Diligence for Banks (“CDD for Banks”)*

In October 2001, the BCBS has published this CDD for Banks’ standards which is applicable for the supervisors and banks in the countries. This standard has emphasised for the safety and soundness operation of the KYC procedures to help the bank’s reputation and integrity from these financial crimes as well as to have an essential part of sound risk management to the banks (Customer Due Diligence for Banks, October 2001: Paragraph 8). The standards also provide that an inadequacy or absence of KYC standards can subject banks to several risks such as the reputational risk, operational as well as legal risk which is further extended to concentration risk for the supervisor (BNM for Malaysia) (Customer Due Diligence for Banks, October 2001: Paragraph 10).

- (c) *Consultative Paper Consolidated KYC Risk Management*

This Consultative Paper was issued on August 2003 and its final version was issued on October 2004. This Consultative Paper is a supplement to the previous document on CDD requirements. This Consultative Paper has examined the critical elements for effective management of KYC policies and procedures in banks' foreign branches and subsidiaries, namely customer acceptance policies, customer identification, ongoing monitoring of higher-risk accounts and risk management (Jeanneau, December, 2003: 100).

(d) *Guidelines on Sound Management of Risks Related to Money Laundering and Financing of Terrorism*

Further, on February 2016, the BCBS has published the 'Guidelines on Sound Management of Risks Related to Money Laundering and Financing of Terrorism' on the guideline of how banks should include the risks of money laundering and terrorism financing within their overall risk (Guidelines on Sound Management of Risks Related to Money Laundering and Financing of Terrorism, 2017: Paragraph 1). This Guideline is further revised and re-published in June 2017. In addition, this Guideline is issued for the purpose of to rationalise the publications on anti-money laundering and counter financing of terrorism ("AML/CFT") guidance which has merged and superseded on the standards of CDD for Banks on October 2001 and Consolidated KYC Risk Management on October 2004 respectively (Guidelines on Sound Management of Risks Related to Money Laundering and Financing of Terrorism, 2017: Paragraph 9).

2.2 Financial Action Task Force

The FATF is an inter-governmental body established in 1989. The FATF have put its mandate to provide standards in combating the money laundering and terrorism financing based on its legal, regulatory and operational measures in combating these financial crimes. As such, the United Nation Security Council's ("UNSC") resolution has provided that all the countries should oblige with the standards imposed by the FATF (UNSC: Resolution 1373 (2001)). In addition, the countries that do not comply with the standards imposed by the FATF have been listed as the 'Higher Risk and Non-Cooperative Countries' (HRNC"). As at March 2018, the countries that have been listed as the HRNC countries are Iran and Democratic People's Republic of Korea (DPRK) (High-Risk and Other Monitored Jurisdictions, n.d.).

Further, on October 2003, the FATF had issued the 'FATF 40 Recommendations' in combating the money laundering. Then, in October 2001, the FATF has further expanded its Recommendations by providing the 'FATF 40+9 Recommendations' on the international standards for combating the money laundering and terrorist financing. Thereafter, on February 2012, the FATF adopted the 'International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations' ("The FATF Recommendations") which is now have been universally recognised as the international standards for AML/CFT and has been endorsed over 180 countries including Malaysia.

In this regard, the FATF 40 Recommendations provide that the financial institutions should conduct CDD to their customers. This CDD requirements is provided under Recommendation 10 of the said FATF 40 Recommendations and has been put as one of the preventive measures under Part D of the FATF 40 Recommendations. This CDD requirements require that all the financial institutions to take the CDD measures to their customers as well as to prescribed in the

law of the countries (FATF 40 Recommendations: Recommendation 10). The FATF also provide flexibility to the country to determine how it imposed specific CDD obligations which may be conducted under the law or enforceable means (FATF 40 Recommendations: Recommendation 10). In addition, Malaysia is a member of the FATF since 2015 for its commendable compliance with the FATF Recommendations. Malaysia has determined the law as well as its enforceable measures to the ‘Reporting Institutions’ in conducting the CDD requirements. In this regard, next section will highlight on the CDD requirement imposed to the financial institutions particularly to the banking and deposit taking institutions in Malaysia.

3. The Statutory Obligation on The Customer Due Diligence to Islamic Banks in Malaysia

IFSA is the law governing for the Islamic banks in Malaysia. This law came into force on 30th June 2013 (Federal Government Gazette: PU(B) 277/2013). Prior to IFSA, the law governing for the Islamic banks in Malaysia was the Islamic Banking Act 1983 (Act 276). As to strengthen the laws governing for the Islamic banks in Malaysia, the IFSA was enacted force in order to have its better regulations as well as governance in respect to Islamic financial institutions in Malaysia.

Further, the BNM, as the administering regulation for the Islamic financial institutions in Malaysia, has the duty to combat these financial crimes into the Islamic banks. This is also in line with the statutory duties of the BNM as to promote monetary and financial stability in the financial institutions in Malaysia which includes the Islamic banking institutions (Section 5(1) of the Central Bank of Malaysia Act 2009 (Act 701)). As such, one of these statutory duties is exercised under the duty to combat these financial crimes into the Islamic banks in Malaysia. As stated earlier, Islamic banks have been listed as one of the ‘Reporting Institutions’ under AMLATFPUAA and have statutory obligation to comply with the Part IV of the AMLATFPUAA. One of the statutory obligations imposed under Part IV of the AMLATFPUAA is the CDD requirements under Section 16 of the Act. In this regard, this paper is limited to the discussion on the CDD requirements as imposed by the Islamic banks in Malaysia. The reason is because the authors perceived that the CDD requirements is one of the essential preventive measures in combating these financial crimes into our Islamic banks.

4. The Legal Measures for The Customer Due Diligence in Islamic Banking Institutions in Malaysia

The previous section states that the CDD is one of the legal requirements that needs to be complied with the Islamic banks in Malaysia. As such, the BNM as the Competent Authority in combating these financial crimes in Malaysia has issued the Policy Document on ‘Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT)-Banking and Deposit-Taking Institutions (Sector 1) (“Sector 1”) which laid down the scope for the obligations under AMLATFPUAA as well as to manage the money laundering and terrorism financing risks into the banking and deposit taking institutions in Malaysia (Sector 1, 2013: Paragraph 3.1). In this regard, the effective date for this Sector 1 came into effect on 15th September 2013 (Sector 1, 2013: Paragraph 6.1) and issued pursuant to the Section 57(1) and Paragraph 57(2) of the IFSA (Sector 1, 2013: Paragraph 4.1(c)). Also, this Sector 1 is applicable to the ‘Islamic banking business’ as defined under section 2 of the IFSA (Sector 1, 2013: Paragraph 5.1(a)(ii)). The interpretation of ‘Islamic banking business’ under Section 2 of the IFSA is as follows: -

“Islamic banking business” means the business of—

- (a) accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or
- (b) accepting money under an investment account; and
- (c) provision of finance; and
- (d) such other business as prescribed under section 3”

This Sector 1 is also applicable to the branches and subsidiaries as well as to all products and services offered by the Islamic banking business (Sector 1, 2013: Paragraph 5.1(b)(c)). Hence, section 4.1 to 4.5 of this article will highlights on the requirements for the CDD to the Islamic banks in Malaysia based on the legal requirement imposed under Section 16 of the AMLATFPUAA and Policy Document of Sector 1.

4.1 Requirement for the CDD

The Sector 1 states that the Islamic banking institutions under IFSA is required to conduct CDD on their customers as well as to the persons that conduct the transaction with the Islamic banks. In this regard, the Sector 1 provides that there are seven requirements for the Islamic banks to conduct CDD.

- Establish business relation with their customer.
- providing money changing and wholesale currency business for transactions involving an amount equivalent to RM3,000 and above.
- providing wire transfer services.
- when carrying out occasional transactions involving an amount equivalent to RM50,000 and above, including in situations where the transaction is carried out in a single transaction or several transactions in a day that appear to be linked.
- carrying out cash transactions involving an amount equivalent to RM50,000 and above.
- when the Islamic bank has any suspicion of money laundering and terrorism financing regardless of an amount.
- when the Islamic bank has any doubt about the veracity or adequacy of previously obtained information (Sector 1, 2013: Paragraph 13.1.1).

Further, the Sector 1 provides that there are four grounds for what is required when conducting the CDD. The first requirement is the Islamic banks is required to identify the customer and verify the customer’s identity using reliable, independent source documents, data or information (Sector 1, 2013: Paragraph 13.2.1(a)). Also, the identification is also including the beneficial owner. In this regard, Sector 1 requires to identify the beneficial owner and take reasonable measures to verify the identity of the beneficial owner (Sector 1, 2013: Paragraph 13.2.1(c)). This can be done by using the relevant information or data obtained from a reliable source. The fourth requirement is where the Islamic banks are required to understand the purpose and intended nature of the business relationship of their customers.

In addition, the Sector 1 also requires that the Islamic banking institutions to comply with the requirements in combating the financing of terrorism in the Islamic banking sectors (Sector 1, 2013: Paragraph 13.2.2). In this relation, the Islamic banking institutions are required to keep updated with the resolutions passed by the United Nations Security Council (UNSC) (Sector 1, 2013: Paragraph 31.2). In addition, the Sector 1 requires that the Islamic banking institutions to maintain a databases and particulars of listed persons in the UN Consolidated List and order issued under sections 66B and 66C of the AMLATFPUAA (Sector 1, 2013: Paragraph 31.4). Also, the Islamic banking institutions are required to conduct checks on the names of new customers as well as regular checks on the names of existing customers and potential customers (Sector 1, 2013: Paragraph 31.6). In this regard, the Sector 1 requires that when there is confirmation, the reporting institutions are required to freeze the customer's funds or block the transactions if it is an existing customer (Sector 1, 2013: Paragraph 31.6(a)). Then, the Islamic banking institutions are also required to reject the potential customer if the transaction has not commenced as well as to submit suspicious transactions report (Sector 1, 2013: Paragraph 31.6(b)(c)). Finally, the Islamic banking institutions are required to inform the relevant supervisory authorities pertaining to the confirmation obtained (Sector 1, 2013: Paragraph 31.6(d)).

Further, the Sector 1 provides for the requirements of the timing of verification during the CDD process. The Sector 1 requires that the verification of identity of the customer and beneficial owner is required to be done before or during the course of establishing business relationship or when conducting a transaction for an occasional customer (Sector 1, 2013: Paragraph 13.3.1). Nevertheless, in the case for the risks of the money laundering and terrorism financing is low, the Islamic banking institutions may complete verification after the establishment of the business relationship to allow some flexibilities for its customers and beneficial owner to furnish the relevant documents (Sector 1, 2013: Paragraph 13.3.2). In the event when there is delay verification for the identity of the customer or beneficial owner, the Sector 1 provides that the delay must be reasonably practicable (Sector 1, 2013: Paragraph 13.3.3). In this regard, the term 'reasonably practicable' refers to the practicable not be later than ten working days or any other period as may be specified by the Central Bank of Malaysia (Sector 1, 2013: Paragraph 13.3.4). Also, the delay of the verification is essential for the reason of no interruption the normal conduct of business of Islamic banking institutions (Sector 1, 2013: Paragraph 13.3.5). Also, the delay must be satisfying that the money laundering and terrorism financing risks are effectively managed and there is no suspicion of money laundering and terrorism financing risks (Sector 1, 2013: Paragraph 13.3.6).

4.2 Specific CDD Measures

The Sector 1 requires the Islamic banking institutions should conduct a specific CDD measures when dealing with these six persons which include an individual customer and beneficial owner; legal persons; legal arrangements; clubs, societies and charities; counter-party; and beneficiary account.

(a) Individual Customer and Beneficial Owner

The procedures under Sector 1 provide that when dealing with an individual customer and beneficial owner, the Islamic banking institutions is required to obtain at least these following information which includes a full name of person, National Registration Identity Card (NRIC) number or passport number or any reference number of any other official documents bearing the

photograph of the customer or beneficial owner (Sector 1, 2013: Paragraph 13.4.1(a)(b)). Also, the Sector 1 further requires that the Islamic banking institutions should obtain the residential and mailing address, date of birth, nationality, occupation type, name of employer or nature of self-employment, contact number as well as the purpose of transactions (Sector 1, 2013: Paragraph 13.4.1(c)(d)(e)(f)(g)(h)(i)). In this relation, the Sector 1 further requires that the Islamic banking institutions should verify the NRIC number or passport number as well as the reference number that submitted by an individual customer or beneficial owner during the CDD process (Sector 1, 2013: Paragraph 13.4.3). In this regard, the Islamic banking institutions should require that their customers provide an original document and make a copy of the said document. Nevertheless, an exception for verification requirement is exempted when the biometric identification method is used. Then, when the Islamic banking institutions have doubts about the identity of an individual customer or beneficial owner, the Islamic banking should require their customer to produce other supporting official identification documents bearing their photographs, issued by an official authority or an international organisation for the purpose of an ascertainment and verification of the identity (Sector 1, 2013: Paragraph 13.4.4).

(b) Legal Persons

Then, the Sector 1 also requires that specific CDD measures should be conducted when dealing with the legal persons. In this regard, legal persons refer to any entities other than natural persons which includes companies, bodies corporate, foundations, partnerships, associations and other similar entities. Also, when dealing with legal persons, Islamic banking institutions are required to understand the nature of the customer's business, its ownership and control structure (Sector 1, 2013: Paragraph 13.4.5). As such, Islamic banking institutions are required to identify and make verification of the name, legal form and proof of existence, directors' resolution and the senior management position; and the registered office and principal place of the business (Sector 1, 2013: Paragraph 13.4.6). The Sector 1 further requires that when there is any doubt as to the identity of persons, Islamic banking institutions are required to conduct a basic search or enquiry so that the person has not been in the process of being dissolved or liquidated or insolvency (Sector 1, 2013: Paragraph 13.4.8(a)). Islamic banks are also required to verify the authenticity of the information provided with the Companies Commission of Malaysia, Labuan Financial Services Authority or any relevant agencies (Sector 1, 2013: Paragraph 13.4.8(b)). Nevertheless, there is an exception for the conduct of specific CDD measures by the Islamic banking institutions. The exception for the specific CDD measures is for these nine (9) persons which are:

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- public listed companies or corporations listed in Bursa Malaysia;
- foreign listed companies which is listed in recognised exchanges and not listed in higher risk countries;
- foreign financial institutions that are not from higher risk countries;
- government-linked companies;
- state-owned corporations and companies in Malaysia;

- an authorised person, an operator of a designated payment system, a registered person, as the case may be, under the Financial Services Act 2013 and Islamic Financial Services Act 2013;
- persons licensed or registered under the Capital Markets and Services Act 2007;
- licensed entities under the Labuan Financial Services and Securities Act 2010 and Labuan Islamic Financial Services and Securities Act 2010; or
- prescribed institutions under the Development Financial Institutions Act 2002 (Sector 1, 2013: Paragraph 13.4.9).

In this regard, the Islamic banking institutions may also refer to the Directives in relation to Recognised Stock Exchanges (R/R6 of 2012) issued by Bursa Malaysia in determining foreign exchanges that are recognised (Sector 1, 2013: Paragraph 13.4.10).

(c) *Legal Arrangements*

Further, Islamic banking institutions are also required to conduct specific CDD measures to the legal arrangements. Sector 1 provides a definition and interpretation of ‘legal arrangements’ which refers to “express trusts or other similar legal measures”. In this regard, the Islamic banking institutions are required to understand the nature of the customer’s business, its ownership as well as its control structure (Sector 1, 2013: Paragraph 13.4.11). In conducting the specific CDD measures to the legal arrangements, the Islamic banking institutions are required to identify the customer and verify its identity for these following information which are their name, legal form and proof of existence or any reliable references for the purpose of identification; powers that regulate and bind the customers and persons on senior management position; and the address of the registered office and its principal place of business (Sector 1, 2013: Paragraph 13.4.12). For the identification and verification of the beneficial owner, the Islamic banking institutions are required to take reasonable measures to identify the settlor, the trustee, the protector, the beneficiary or class of beneficiaries and any other natural persons that have control over the trust (Sector 1, 2013: Paragraph 13.4.13(a)). This identification and verification is only applicable for the trusts. In addition, for other types of legal arrangements, the Sector 1 requires that the Islamic banking institutions to identify of persons in equivalent or similar positions (Sector 1, 2013: Paragraph 13.4.13(b)). For the verification of an identity of the beneficiaries, the Islamic banking institutions may also rely on a third party for its verification (Sector 1, 2013: Paragraph 13.4.14). In this relation, the Islamic banking institutions are required further to comply with the Guidelines provided under Paragraph 21 of the Sector 1 (Sector 1, 2013: Paragraph 13.4.15).

(d) *Clubs, Societies and Charities*

Further, for the specific CDD measures on the clubs, societies and charities, the Sector 1 provides that the Islamic banking institutions are obliged to require their customers to furnish the relevant identification and constituent documents to represent the clubs, society or charity as the case maybe (Sector 1, 2013: Paragraph 13.4.16). For the beneficial owners, the Islamic banking institutions are required to take reasonable measures for identification and verification (Sector 1, 2013: Paragraph 13.4.17).

(e) *Counter-Party*

Then, the Sector 1 also required for the specific CDD measures to be conducted for the counter-party. In this regard, the Islamic banking institutions should ensure that a counter-party is properly regulated and supervised (Sector 1, 2013: Paragraph 13.4.18). As such, Islamic banking institutions should ensure that the counter-party's CDD process is adequate and mechanism for identification and verification of counter-party is reliable (Sector 1, 2013: Paragraph 13.4.19).

(f) *Beneficiary Account*

Finally, the Sector 1 also requires that the specific CDD measures to be conducted for the beneficiary account. The procedure for the specific CDD measures requires to be performed on the beneficiary and the person acting on behalf of the beneficiary on an individual basis (Sector 1, 2013: Paragraph 13.4.20). In such a case where the identification of an individual basis cannot be performed, the Islamic banks are required to satisfy itself that the account is not maintained in the interest of other parties which have no relationship with the account. In addition, the Islamic banking institutions also may rely on third party when they are unable to conduct CDD on the clients of professionals, such as legal firms or accounts acting on behalf of their clients (Sector 1, 2013: Paragraph 13.4.22). Also, the Islamic banking institutions should then proceed with the guidelines under Paragraph 24 on Failure to Satisfactorily CDD in the case where the person acting on behalf of the beneficiary is unable or refuses to provide the information on the identity of the beneficiaries or written undertaking (Sector 1, 2013: Paragraph 13.4.24).

4.3 Enhanced CDD

An enhanced CDD is required when the money laundering and terrorism financing are assessed as higher risk. In this regard, this enhanced CDD is considered as higher level of due diligence in order to mitigate the higher risk when dealing with the customers. In this regard, the Sector 1 provides that there three factors for consideration for the 'higher risk' enhanced CDD measures which are customer risk factors; country or geography risk factors; and products, service, transaction or delivery channel risk factors. Further elaboration on these three factors are provided as below: -

(a) *Customer risk factors.*

The customer risk factors are further classified into the categories of when business relationship is conducted in unusual manner; non-resident customer; legal persons or arrangements that are personal asset-holding vehicles; companies that have nominee's shareholders or shares in bearer form; business that are cash-intensive; the ownership structure that appears unusual or excessively complex given the nature of the company's business; high net worth individuals; persons from locations known for their high rates of crimes; businesses or activities that is identified by the FATF as having higher risk of money laundering and terrorism financing; legal arrangements that are complex; and persons who match the red flag criteria.

(b) *Country or geography risk factors.*

In this category, the Sector 1 also provides the higher risk of the money laundering and terrorism financing crimes is also based on the country or geography risk factors. The country is considered in high risk when countries having inadequate AMLCFT systems. Also, the countries are subject to sanctions, embargos or similar measures as well as the countries that having significant level of corruptions and other criminal activities. Lastly,

the country is in high risk which has been identified as providing fund or support for the terrorism. In this regard, whenever the Islamic banks are dealing with the customers from these country or geography risk factors, the Islamic banks should refer to credible sources for instance the Mutual Evaluation Report, reports published.

(c) Products, service, transaction or delivery channel risk factors.

In this category, the Islamic banks should also take enhanced CDD measures when dealing with the products, service, transaction or delivery channel that have high risk factors. In this regard, the Sector 1 provides that these includes anonymous transaction; non face-to-face business relationships or transactions; payment received from multiple transactions as well as the payment from unknown or associated third parties.

In mitigating these higher risk to the Islamic banking institutions in Malaysia, the Sector 1 provides the section for the enhanced CDD to be conducted when the risks of money laundering and terrorism financing foreseen by the Islamic banks. In this regard, the Sector 1 requires that the Islamic banks should obtain the CDD information as specified in the specific CDD measures against the individual customer and beneficial owner, legal persons, legal arrangements, clubs, societies and charities, counter-party as well as beneficiary account (Sector 1, 2013: Paragraph 13.5.1(a)). Further, Islamic banks should also obtain additional information on the customer and beneficial owner for instance by getting information from public database (Sector 1, 2013: Paragraph 13.5.1 (b)). Also, for the politically exposed person (“PEPs”), the Islamic banks should inquire in the source of wealth or source of funds where the Guidelines require that both sources must be obtained (Sector 1, 2013: Paragraph 13.5.1(c)). Also, the Islamic banks are required to obtain an approval from the Senior Management before establishing such business relationship with the customers in higher risk.

In addition to the above requirements for the enhanced CDD measures against the higher risk customers, the Sector 1 also provides additional measures that need to be considered by the Islamic banks. In this regard, the Islamic banks should conduct enhanced CDD for obtaining additional information on the intended level and nature of the business relationship (Sector 1, 2013: Paragraph 13.5.2 (a)). Also, the Sector 1 requires that the Islamic banks to update identification data of customer as well as their beneficial owner (Sector 1, 2013: Paragraph 13.5.2(b)). The Islamic banks should also to inquire on the reasons for intended or performed transactions by the higher risks customers as well as to require the first payment to be carried out through an account in the customer’s name with a bank subject to similar CDD standards (Sector 1, 2013: Paragraph 13.5.2 (c)(d)).

4.4 On-Going Due Diligence

On-going due diligence is required when the Islamic banks have established the business relationship with its customers. These measures include by scrutinising transactions in order to ensure the transactions are consistent as well as to ensure that the documents, data or information collected is up to-date and relevant (Sector 1, 2013: Paragraph 13.6.1). In conducting on-going due diligence, the factors for consideration of an economic background and purpose of transactions that appear unusual, inconsistent, no apparent economic purpose as well as doubt on the legality of the transactions may also take into consideration by the Islamic banks when dealing with their customers (Sector 1, 2013: Paragraph 13.6.2). The frequency for the on-going due diligence is commensurate based on the level of money laundering and terrorism financing

risks involved as well as on the nature of its transactions (Sector 1, 2013: Paragraph 13.6.3). In this regard, the Sector 1 requires Islamic banks to increase the number and timing of controls applied when conducting an on-going due diligence on customers (Sector 1, 2013: Paragraph 13.6.4).

4.5 Existing Customer – Materiality and Risk

This measures are applicable to the existing customer based on the basis of materiality and risk involved (Sector 1, 2013: Paragraph 13.7.1). Also, in assessing the materiality and risk involved on the existing customer, Sector 1 provides that the Islamic banks may consider on these following circumstances which is based on the nature and circumstances surrounding the transactions; material change in the account of business or insufficient information on the customer or change in customer's information (Sector 1, 2013: Paragraph 13.7.3).

5. Effect of Non-Compliance With The Customer Due Diligence Requirements

The Islamic banks that do not comply with the laws and regulations not only exposed to the legal and financial risks, but also could tarnish their reputations. For instance, non-compliance with the Sector 1 can cause an enforcement actions to be taken which includes its directors, officers and employees for any non-compliance in Sector 1 (Sector 1, 2013: Paragraph 32). There are few law cases where the banks have been punished as a result of non-compliance with the CDD requirements. Although most of the legal cases involved with the conventional banks, the Islamic banks also vulnerable to these financial crimes. For instance, in the case of *R v Duy Duc Nguyen* [2006] VSCA 184, where a fraud was perpetrated which involved with the illicit transfer of funds. In this case, an “insider” person had obtained the personal details of account and did not ascertain identity of the true owner of the fund. In another case of *Southern Bank Berhad v. Yahya Talib* [2006] 4 ILR 2509, the claimant in this case has been dismissed due to the reason of non-compliance with the KYC policy by the BNM.

In addition, although as at to date there are no cases for the breach of the AML/CFT regulations involved with the Islamic banks, the Islamic banks also vulnerable to these financial crimes. Norhashimah (2012: 299) states that there should be no excuse for Malaysian failure on the AML/CFT legislations as the regulations on AML/CFT in Malaysia is almost nearly to twenty years of coming into force. In this regard, Malaysia also can learn from the Financial Conduct Authority (FCA) for taking an action against the financial institutions that not comply with the CDD requirements. The list of banks for non-compliance with the CDD requirements is elaborated among others are as follows: -

(a) Sonali Bank (UK) Limited (“SBUK”)

The FCA on 12th October 2016 has fined the SBUK for £3,250,600 and has imposed a restriction by preventing the SBUK to not accept deposits from new customers for 168 days. The FCA states that there are serious weaknesses in its AML/CFT control and failed to comply with the CDD operational obligations, the identification of PEPs and failure to make reports on suspicious activities (FCA, 2016)

(b) Deutsche Bank

The FCA on 31st January 2017 has fined the Deutsche Bank for £163,076,224 for failing to maintain adequate AML/CFT control framework between 1 January 2012 and 31 December 2015. The FCA states that the Deutsche Bank performed inadequate CDD on their customer (FCA, 2017).

(c) EFG Private Bank

The FCA on 24th April 2013 has fined the EFG Private Bank Ltd for the amount of £4.2 million for failing to take reasonable care to establish and maintain effective AML/CFT controls for high risk customers (FCA, 2013).

(d) Standard Bank PLC

The FCA on 23rd January 2014 has fined the Standard Bank PLC for the amount of £7,640,400 for failings relating to its AML/CFT policies and procedures over corporate customers connected to PEPs. The FCA states that the Standard Bank did not carry out adequate Enhanced CDD measures before establish their business relationships with corporate customers that had connections with PEPs. The FCA also states that there is no appropriate ongoing monitoring for existing business relationship with the existing customers (FCA, 2014)

6. Conclusions

In conclusion, Malaysia is committed to protect its financial institutions which includes the Islamic banks from the conduit of these financial crimes. As such, Islamic banks as a 'Reporting Institutions' under the AMLATFPUAA is statutorily required to comply with the AML/CFT laws and regulations. The importance of compliance with the CDD measures is one of the keystones in combating these organised crimes into the Islamic banks in Malaysia. Although as of to date there is no specifically law cases that involved with the non-compliance with the CDD measures into Islamic banks in Malaysia, Malaysia also should learn from other countries that imposed heavy fines for the reason of non-compliance with the CDD measures. Like the United Kingdom, Malaysia has been commended for its compliance with the FATF Recommendations, a continuous compliance by its 'Reporting Institutions' for instance the Islamic banks should be adhered to in combating these emerging financial crimes.

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