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Title:

Money laundering risks in Palestinian banks
With Comparison between Islamic and Interest-Based Products

Sami Ghaben

Ph.D. student at Istanbul Sabahattin Zaim University, Istanbul

The faculty of Islamic economics and finance

e-mail – samighabin@gmail.com

Abstract

The purpose of the study was to understand the anti-money laundering environment in Palestinian banks, as well as the distinctions in assessing money laundering risks between Islamic banking products and interest-based products. This paper is based on the Financial Action Task Force's (FATF) guidelines as well as Palestinian laws and regulations. According to the paper, the money laundering risks of Islamic items were lower in certain elements of the examination and equivalent in others.

Keywords: Islamic banks, Money Laundering, risks



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Introduction

Money laundering is regarded as one of the most serious cross-border crimes, and governments are working hard to prevent it because of the negative economic and social effects. Because of the variety of goods available, financial institutions are one of the most important entry points for money launderers. Islamic banks are among the financial institutions being worked on by governments to increase their efficacy in combating money laundering.

The world is witnessing a significant acceleration in technology and digitization, which has contributed to the development of financial services offered by financial institutions worldwide. To keep up with these changes, financial institutions have begun to offer new services using current technology that may not require the physical presence of clients or long-distance traffic with these institutions. (Ali, Ali, Surendran, and Thomas, 2017), this acceleration has been accompanied by a development in the financial crime world, which is exploiting this technology in their criminal operations around the world to commit financial crimes such as fraud or to transfer money from other crimes or to use for related crimes such as terrorist financing (FATF, 2020).

Following the spread of the Covid 19 pandemic at the end of 2019, then transfer to the virtual world via digital bills became more common, and this became used to carry out frauds as well via such services, whether it's fraud on the level of persons or institutions (FATF,2020). In the absence of digital software, financial institutions can alleviate these problems through advancements in their equipment and surveillance software (Calleja,2019).



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Money laundering is a crime. Subsequent crimes were committed in order for the money launderer to conceal the unlawful supply and present the money as originating from legitimate sources. Money laundering methods are often divided into three steps (placement, layering, integration). The crime of funding terrorism involves three steps (collecting, transmission, and usage) of legitimate or unlawful price ranges to finance or assist any terrorist actions. Money laundering and terrorist funding tactics are constantly evolving, and this speed is one of the most significant challenges for countries seeking to reduce these crooked practices (ACAMS,2018).

On the other hand, states and international organizations are working to find solutions to minimize the abuse of this advancement in crooked operations, primarily because those operations are cross-border and necessitate the advancement of the device to fight those crimes in the same manner and expand the capacity to lessen them. Cash laundering and terrorist funding are two of the most essential issues that governments are concerned about because of the economic, social, and political risks they pose to their countries.

Countries adopted the Financial Action Task Force "40 Recommendations" criteria as the first anti-money laundering and counter-terrorist financing criteria in their national legislation, and other international organizations such as FINCEN, EGMOND, and WOLFESBEG (ACAMS, 2018) enacted regulations, and all of these bodies encouraged financial institutions to have effective anti-money laundering and counter-terrorist financing programs in place.

Financial institutions are included in a study of anti-money laundering and terrorist financing because they serve as conduits for money launderers to deposit funds or carry out covert activities. To reduce these risks, financial institutions must have an effective AML/CFT what are these program. An anti-money laundering program is built on five major pillars:

1. Effective Internal Controls Implementation
2. Appointment of an AML Compliance Officer



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3. Appropriate Periodic Employee Training
4. Independent Program Testing
5. Customer Due Diligence (Berman,2019).

To develop these elements, financial institutions must design systems and processes depending on the size of the institution, and the complexity of operations, and in line with the risk-based approach, which allows it to be utilized to optimize resources for higher risks (FATF,2012).

Islamic banks provide goods and services that are distinct from regular banks in ways that are related to Shariah law. They also provide services equivalent to those provided by conventional banks. As a result, each product has a unique method of being offered and used by customers, which may provide criminals with several opportunities to utilize it.

Purpose of paper

The purpose of this paper is to investigate the money laundering risks associated with Islamic products, how money launderers can exploit them, and how Islamic banks work to mitigate these risks, as well as to answer the question "Are the money laundering risks associated with Islamic products greater or lesser than those associated with interest-based banking products?" This is in accordance with the standards established by international organizations (Anti-money laundering inherent hazards in banking products).



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1. Money laundering: overview

Money laundering is clearly defined as the recycling of illegal cash into legitimate sectors such as investment channels. To appear to be an investment and real legitimate money, disguising the illegal source of assets gained or created by criminal conduct in order to obscure the link between finances and the initial criminal action (Arab Monetary Fund, 2016.)

Money laundering necessitates the use of an underlying primary crime as a source of funds (such as corruption or illicit drug trafficking), fraud, market manipulation, or tax evasion, as well as the desire to conceal crime proceeds in order to support criminal activity. Drugs, slavery, prostitution, arms trade, and money earned via corruption are the most visible instances of illicit conduct. In truth, no one knows the exact magnitude of the money being laundered in a specific location, although there is universal agreement that it is large quantities estimated in billions. Money laundering is not a monopoly for industrial countries or wealthy societies, but rather it grows and expands in the environment of countries that facilitate Access to it through loopholes in the financial or institutional system (Abdulkarim, 2008).

In this section, the definition of money laundering and its stages will be reviewed, in addition to the methods of money laundering through banks.

The Financial Action Task Force (FATF) defines money laundering as " *the processing of these criminal proceeds to disguise their illegal origin. This process is of critical importance, as it enables the criminal to enjoy these profits without jeopardizing their source*" This procedure is crucial since it allows the criminal to enjoy the gains without risking their source" (FATF ,2012). This indicates that the crime of money laundering is a subsequent crime, in other words, that a first crime must occur among the crimes stated in country laws and that it results in proceeds of crime, and then the criminal wants to conceal the source of this money and present it as lawful money.



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The money laundering process is divided into three steps, which pervade financial processes in which financial institutions such as banks may be utilized, and are depicted as follows:

- **Placement:** The actual disposal of banknotes or other assets obtained via illicit activities by depositing money in a bank. The money launderer enters the unlawful gains into the financial system at this point. This is mostly done by Trading through official financial institutions, casinos, and other legitimate businesses, whether local or international. This is the first and easiest stage in detecting the offender using a well-constructed technique.
- **Layering:** Separation of illegal earnings from their source by many layers of financial transactions meant to disguise the source of the cash. This second step comprises repurposing criminal earnings and organizing a complex network of financial transactions to conceal the source and ownership of funds.
- **Integration:** The apparent legalization of illegal wealth through the reintroduction of money into the normal system. They appear to be ordinary or private transactions. To comprehend the notion of validity. For example, funds laundered through seemingly routine transactions should be used at this stage. A money launderer may opt to invest the proceeds in real estate, financial initiatives, or high-end items. It is regarded as challenging during the integrating stage. It is critical to distinguish between legal and illegal riches. This stage provides the money launderer with the opportunity to grow his riches through criminal gains. It is difficult to discover integration in general until there are major disparities between a business's or person's legal, commercial, or investment activities and the person's wealth, company revenue, or assets.



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Banks have historically been, and continue to be, important players in the three phases of money laundering. The following are some of the specific areas of interest and focus on money laundering through banks and other depository institutions:

- Remote Deposit
- Correspondent Banks
- Payment via accounts
- Accounts aggregation
- Private banking services.
- The use of private investment firms in private banking services
- Segmentation of transactions (structuring)

As a result, the banking industry must build a solid defensive line to compete with these crooks, and this must be done within the confines of law and ethics.

In general, this phenomenon occurs in varying degrees in many nations throughout the world. The International Monetary Fund estimates that between 2 and 5 percent of global GDP, or up to 8 percent of all world commerce, is laundered yearly, with a total value of \$800 billion (United Nations, 2020b). It is carried and performed outside of the statistical framework.

The activities are focused under the wing of the stated economy of the countries, and so these operations are concentrated through hidden ways and procedures. There are even entire organizations and worldwide businesses dedicated to the commission of money laundering, which can reach as high as 60% or 70%. (Ammar Youssef, 2020).

However, individuals or companies that launder money tend to look for countries or sectors that suffer from weak or ineffective anti-money laundering programs. For example, in countries that are open to other countries, especially those that have tourism and regions with financial centers,



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and many large offices and companies, this is what constitutes a greater opportunity for money laundering.

Money laundering has an impact on the financial sector, which is the primary generator of economic growth, while also encouraging crime and corruption, which slows economic growth, decreases taxes, and diminishes efficiency in the real economy.

Overall, the majority of global money laundering research focuses on two primary sectors: drug trafficking and terrorist organizations. As a result, money laundering fuels more drug trafficking, crime, and violence. This leads to the weakness and disintegration of the society in social, economic and political terms (Vandana Kumar, 2012).

2. Money laundering risks in Palestinian banks

Legislative and Policy Framework

Since the beginnings of the Palestinian Authority, the Palestinian legislative and institutional framework has been incorporated in combatting money laundering in the form of directives.

Until laws and tactics are enacted. Based on the Basel Accords as a guideline for combatting money laundering, the Monetary Authority established the Financial Follow-up Office in 2001, which then monitored incoming and outbound remittances of \$10,000 or more. The strategic goal of establishing this office or department is to preserve economic security and safeguard banks and sectors from any excessive risks that jeopardize the safety and stability of their financial circumstances, as well as the danger of risk. The aforementioned office has worked in collaboration with the competent Palestinian authorities to implement relevant laws, as well as to disseminate and increase public awareness of the crime of money laundering and methods to prevent and combat it in light of recent developments on the international stage in this regard.



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The PMA published Circular No. 67/2005 in 2005, establishing the position of compliance observer.

In all banks that operate as an autonomous function in regions of jurisdiction, the responsibilities of this post include ensuring the execution of laws, regulations, directions, and standards of behavior for combating money laundering.

At the end of 2007, the Palestinian Authority's President issued a decree to combat money laundering based on his constitutional powers under Article 43 of the Basic Law of 2003, and the results appear to This statute has served as a means of allocating monies in the case. Theft, smuggling, money laundering, kidnapping, confinement, or hostage-taking (Decision of Law No. 9, 2007).

Acts constituting a money laundering crime include: replacing or transferring monies received from a crime with the goal of hiding or disguising the unlawful origin, or assisting a person implicated in the crime, such as minimizing the legal repercussions of the crime. The source of monies while knowing they are illegal proceeds or owning, holding, or using funds while knowing they are criminal proceeds, as well as collaborating in, assisting, and abetting the commission of any wrongful conduct.

Palestinian financial institutions operate in exceptional political, social, and economic conditions as a result of the country's prevailing political situation, which is represented by the presence of three main areas located under different laws (the West Bank, the Gaza Strip, and the areas of Palestine completely under occupation authority), resulting in duplication of laws and conflict of interests between the authorities. Increases the likelihood of money launderers taking advantage of Palestinian banking institutions.

Whereas Palestinian law provides for 26 crimes that fall under the scope of money laundering crimes, the Palestinian Monetary Authority's instructions constitute the institutional legal



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framework within which banks operate, in addition to some additional requirements imposed by correspondent banks on banks operating in Palestine and dealing with them. (Law Decree No. 20, 2015).

The findings of the national evaluation of the remaining threats of money laundering and terrorist financing for the State of Palestine in 2017, as well as the process of revising it in 2020, produced the following outputs:

1- The degree of money laundering risk in the financial sectors subject to supervision:

Sector	National self-assessment 2019	Update self-assessment 2020
Banking	High	Moderate to high
Money Exchangers	High	Moderate to high
Securities	Moderate to high	Moderate to high
Specialized Lending Companies	Low	Low



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Insurance	Moderate to low	Moderate to low
Financial leasing	Moderate to low	Moderate to low

2- The degree of terrorist financing in the financial sectors subject to supervision:

Sector	National self-assessment 2019	Update self-assessment 2020
Banking	Moderate to high	Moderate
Exchangers	Moderate to high	Moderate
Securities	Moderate	Moderate
Specialized Lending Companies	Low	Low



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Insurance	Moderate to low	Moderate to low
Financial leasing	Moderate to low	Moderate to low

3- Weaknesses in banking products and services after applying controls on them:

Products / services	National self-assessment 2019	Update self-assessment 2020
Current account	Moderate to high	Moderate to high
bank checks	Moderate to high	Moderate to high
Money transfer	Moderate to high	Moderate
Letter of credit, letter of guarantee and Documentary Credits	Moderate to high	Moderate



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Retail Deposits (saving, wadeah)	Moderate to high	Moderate
Legal entities deposits (saving, wadeah)	Moderate	Moderate
Legal entities financing	Moderate to high	Moderate
Express Transfers	Moderate to high	Moderate
electronic services	Moderate to low	Moderate to low
personal loans	Moderate	Moderate to low
Mortgage Loans	Moderate to low	Moderate to low
Small and medium enterprise loans	Moderate to low	Moderate to low



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In light of the aforementioned flaws, the Palestinian Monetary Authority emphasized the importance of strengthening procedures and controls for dealing with financial goods and services that have medium and medium-high flaws, according to the National Risk Assessment update.

3. Anti-money laundering in Palestinian banks

Because money laundering operations are worldwide in nature, international treaties have tended to oblige financial institutions to take the appropriate safeguards to prevent the use of their banking instruments to perpetrate major money laundering offenses. From shady sources. Given the important role that these institutions play in facilitating the commitment of this permit in the process of employing and investing funds from criminal migrants within regular operations, international interest in controlling financial institutions is an essential focus in the overall addressing of the phenomenon of money laundering. As a result, the international community was required to develop and implement an integrated set of laws and procedures aimed at increasing the role of the financial and banking sector in addressing this globally criminalized issue. (Banaal and tarfus, 2019).

There is a group of official institutions in charge of combating money laundering in Palestine, known as the National Committee to Combat Money Laundering, which seeks to reduce the phenomenon of money laundering and protect Palestinian society and the national economy from the negative effects of this crime in a way that ensures consistency with national legislation and international conventions. The national committee to prevent money



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laundering serves as a connection between financial institutions and the Palestinian National Authority in the fight against money laundering.

The Financial Follow-up Unit is given specific directives about banks and exchange businesses. The data was given instructions by the unit. This is required when opening a bank account (Financial Follow-up Unit, 2016d), as the banking sector is the primary institutional framework for preventing money laundering. To the Basel Customer Due Diligence Document and the General Principles for Customer Due Diligence. The general guidance on creating accounts and identifying clients was released by the "Basel" Committee in February 2003, together with the Monetary Authority's instructions and notifications in this respect. The following are the primary characteristics of these frameworks:

- Verify the identity of the authorized person from the identification documents.
- Keep records securely and reliably and obtain additional documents.
- Duty to report suspicious cases and provide information to the designated compliance controller in each bank.
- Forming committees in the bank concerned with setting policies to prevent and combat money laundering.
- Monitor the unusual activity of customers.

In response to Decree-Law 2-2015, the Palestinian government published the Anti-Money Laundering and Terrorist Financing Law, which detailed all of the specified offenses, fines, and obligations. Aside from reporting suspicious instances.

With the national assessment process for the State of Palestine approaching this year, there are intensive efforts to develop the Palestinian banking sector, and one of the most prominent requirements is the process of assessing money laundering risks at the level of sectors in the country, and within a narrower framework at the level of each financial



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institution, and since there is a clear text in the instructions indicating the need for the fi
(customer risks, geographical areas risks, product risks, distribution channel risks).

The anti-money laundering program which program, give details consists of several basic
components:

1. Hiring a competent and independent anti-money laundering and terrorist financing officer who reports to the Board of Directors and performs the following duties: (Reporting to the Board of Directors, Report suspicious cases and monitoring financial transactions).
2. Work policies and procedures that include: Existence of a document outlining a client risk assessment based on a risk matrix, Product and distribution channel risk assessment, Risk assessment in terms of geography, there is a policy in place to tackle money laundering and terrorist financing. In the presence of a process handbook, Customers are continuously reviewed and monitored based on their level of risk. Existence of automated systems for assessing client risks and monitoring transactions depending on certain circumstances Procedures for maintaining records and simple access to them, as well as the presence of extra safeguards for greater risks.
3. Training, which includes the availability of skilled and trained personnel. Having an appropriate number of personnel in proportion to the bank's size, Existence of a training budget for department workers as well as all bank personnel Training materials containing instructions and innovations are being adapted.
4. Independent audit for auditing money laundering policies and processes, anti-money laundering initiatives, and risk-based auditing.

To reduce the dangers of money laundering, the foregoing components must function continually and efficiently.



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4. Products money laundering risks

In Palestine, Islamic banks offer a wide range of services and products that rely on Islamic finance and investing techniques. Islamic banks primarily employ the Murabaha contract to finance automobiles and commodities, although it has lately been used in credit cards in conjunction with the leasing of benefits and services formula. (Qard Hasan) is also used in installment cards. The lease-to-own contract is mostly utilized for real estate acquisition financing, whereas the Istisna contract is primarily employed in the contracting industry. The remaining tools (musharakah, musauama, mudarabah, or salam) are used in very few cases in the Palestinian market, owing to Islamic banks' policies of avoiding the risks associated with these tools. Banking tawarruq was also used in limited aspects, most notably the postponement of installments related to the facilities.

In terms of investment products, banks mostly employ Mudaraba contracts for term deposits, whereas Qard Al Hasan contracts are used for current and savings accounts. The products connected with Islamic tools differ from other products in that they represent actual financial operations related to genuine commercial activities, and Islamic banks are part of the commercial operations since the Islamic system is built on profit from real ownership. The difference between products based on Islamic contracts and products based on interest is that Islamic banks require these proprietary products as well as the existence of real buying and selling operations, as opposed to interest-based products, which are based on the sale of money and do not create any addition.

Thus, in terms of the parties to the transactions, Islamic banks ensure the presence of genuine operations, as opposed to interest-based banks, which make the true beneficiary of the money clear to the banks. Another feature of partnership-based Islamic banking services is that the bank



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is involved in investments, which clarifies problems with the parties with whom it engages. In terms of money laundering, transactions based on genuine ownership and actual bank engagement in the transactions make things clearer, which minimizes the risks of money laundering in these transactions in principle, as will be described in the remainder of this research study.

When we want to evaluate products in terms of money laundering risks, the following must be taken into consideration (PMA instructions) and (FATF recommendations):

- 1- nature of the product.
- 2- Target customer risks.
- 3- Risks of the distribution channels used.
- 4- Targeted Geographical Area Risks.

5. Interest based vs Islamic products money laundering risks

based on the instructions of the Palestinian Monetary Authority and based on international recommendations and methodology, these factors can be used to evaluate products.

- a. Third party involvement :FATF define third party as *“the laundering of proceeds by a person who was not involved in the commission of the predicate offence”*(FATF ,2012). So, in both types of products, a third party can be involved and payment may be received from unknown or un-associated third parties, and some products (e.g., real estate financing, insurance, credit card) will require a third party to be involved in the life cycle of an offering even if the customer does not use the offering to make or receive payment from a third party. However, the Islamic product can define the third party more than others because the bank makes a transaction to the third party.



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- b. Delivery Channel: *“The ways in which products and services are provided by a firm to its customer (also referred to as servicing methods and distribution channels “.* (ACAMS ,2018).

FATF guideline 10 identifies non-face-to-face delivery channels as being a high risk *“Business interactions or transactions that do not take place in person. According to the FATF ”* (FATF ,2012). Financial institutions should be required to apply CDD measures to existing customers based on materiality and risk, as well as to conduct appropriate due diligence on such existing relationships, taking into account whether and when CDD measures were previously implemented, as well as the adequacy of data obtained. Existing customers may not be onboard using non-face-to-face channels, but they do use them for transactions. According to the preceding statement, there is no differentiation between interest-based and Islamic products; both types may be used in any channel, therefore the risk of money laundering is the same.

Cross-Border Geographical Risk: This danger is associated with using the product worldwide; each jurisdiction requires a distinct CDD metric, therefore the risk of cross-border payments is considerable. Furthermore, the FATF has a country national evaluation that identifies nations that are high risk and must exercise increased due diligence in dealing with it. So, there are no different between interest based and Islamic products, the two type can deal cross border so the risk of money laundering in this aspect is equal.

- c. Transparency and Anonymity: According to FATF guideline 10, anonymous transactions enhance the risk of ML (in the product, service, transaction, or delivery channel). Furthermore, in accordance with FATF recommendations 24 and 25, it is critical for the bank to identify the transparency and beneficial ownership of legal persons.



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Because the bank makes a transaction to the third party, the Islamic product can specify the third party and true beneficiary more than others because it is clearer for the bank and reduces the risk of an unknown third party.

- d. Liquidity and the use of cash: According to the FATF, cash transactions enhance the danger of money laundering. Because of the limited time that the bank has to analyze the transaction, instant access to cash raises the ML risks. From another perspective, Cash advances and overpayments are common ways for money to be laundered. Advance payments refer to payments for future months, whereas overpayment refers to payments in excess of what is necessary. These are common circumstances for money laundering.

When we examine the concerns indicated, we see that Islamic goods deal with cash in a different way than products that rely on interest, because the cash is transferred to the provider in a true sale process, making money laundering activities more difficult. However, the two types of goods may be utilized in advance payments and the ability to pay them early, indicating that there is no difference in the dangers of money laundering in this regard. In this regard, and in a broader sense, Islamic goods have lower money laundering risks than other products in this regard, owing to the bank's participation in the commercial process and the lack of money trading like other banks.

- e. Speed of Settlement raises the inherent ML risk; same-day settlement raises the AML risk since it does not provide the bank time to analyze the transaction in the event of an alert. When we look at practical Islamic products, particularly financing products, it takes more time than other products since the procedure is lengthy. It will also go through shareah compliance before it is completed, so the danger of money laundering is lower than with interest-based products.



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- f. Offering Recognition and Approval: Nonstandard offerings (made to a specific client or segment) may have a greater ML risk, and non-regulated commodities have a higher ML risk since their underlying value is harder to assess. So, both type of products has same money laundering risks in this aspect.
- g. Transaction Processing by Hand: Transaction processing by hand raises the possibility of mistake and makes monitoring more complex. In this regard, both types of goods provide the same money laundering concerns.

Finally, the product evaluation process outlined above reveals various features that make Islamic products less risky than interest-based products. We believe that Islamic bank transactions are less risky in terms of dealing with cash since the cash is for the seller rather than the recipient of the product with the bank. The third party is obvious to the bank since there will be an official contract between the bank and the sale, and so the dangers of not knowing who the true beneficiary of the activities is reduced. The process of ownership and transfer of ownership, as well as the notion of bank custody for the service performed, make money more analytical.

Conclusion and recommendation:

In order to avoid the harmful implications of this cross-border crime, it has become critical for banks to follow anti-money laundering and terrorist financing laws as a prerequisite for international guidelines and local laws and instructions. Given the world's openness to international trade and international accords, banks play a vital role in this system.

Islamic banks make up a significant portion of the Palestinian financial market. The Palestinian legislation, the Palestinian Monetary Authority's instructions, and the



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Financial Follow-up Unit's directions serve as a foundation for banks' commitment to countering money laundering and terrorist funding. Islamic goods are a significant and increasing element of the Palestinian banking sector's product offering. In some ways, the dangers of money laundering with Islamic products are comparable to the hazards of money laundering with other products. On the other hand, the dangers of money laundering in other areas are seen as lower, as follows:

- The goods share some risks associated with funding sources, distribution methods, and customers.
- Because Islamic goods rely on the reality of genuine businesses, they limit the possibility of money laundering.

Why The bank's active engagement in investment and commercial transactions identifies the true benefactor, lowering the danger of money laundering.

The following suggestions are based on the findings of this paper:

- The need of using a risk-based strategy in bank customer acceptance and ongoing monitoring operations.
- Using Islamic items instead of non-Islamic ones to reduce the danger of money laundering.

And here remains a question that can be studied whether money laundering operations are contrary to Islamic law or not, according to the fact that it is a subsequent crime. Are the crimes stipulated by the laws of countries also contrary to Islamic law, for example (tax evasion)?



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