

Denying the Islamic State Access to Money-Exchange Houses

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Brief Analysis

Regional regulators must take steps, as the Iraqi Central Bank has done, to wall off their financial systems from unlicensed or loosely regulated money remitters vulnerable to exploitation by the Islamic State.

This week, the entity known as the Foreign Ministers of the Small Group of the Global Coalition to Counter ISIL/Da'esh met in Rome to assess the coalition's work and accelerate its efforts to degrade and ultimately defeat the Islamic State. In a statement, the ministers stressed that they "are determined to keep ISIL/Da'esh cut off from the international financial system [and] to disrupt its economic and financial infrastructure." Making good on this pledge requires tackling the group's access not only to banks but also to remittance providers such as exchange houses, which play an important role in the local economies and are more difficult to regulate. In December, the Central Bank of Iraq took action against nearly 150 Iraqi money-exchange companies -- most, but not all, in Islamic State-controlled areas -- showing how U.S. and regional regulators, along with other coalition partners, can join forces to isolate the group from the international financial system.

Background

Given the Islamic State's 2014 budget of roughly \$2 billion, U.S. Department of Treasury officials have called the group's ability to draw revenues from its own territory "unprecedented." The sources of funds include between

\$500 million and \$1 billion seized from bank vaults as the Islamic State gained territory (a onetime take), hundreds of millions a year from taxation and extortion, and tens of millions a month from oil sales, among other sources. While the Islamic State derives most of its income from the territory it controls, denying the Islamic State the ability to use bank branches and exchange houses in its territory to make and receive international transfers -- to access foreign currency, procure goods, and finance foreign fighters and potentially foreign affiliates -- is a critical part of isolating the group.

Military strikes have played an increasingly important role in degrading the Islamic State's ability to derive income from resources in the territory it controls. Furthermore, given that the Islamic State derives most of its income from natural resource extraction and extortion directed at commercial activity, territorial losses will have a direct impact on the organization's bottom line. Recently, airstrikes have also targeted Islamic State cash collection and distribution points, depriving the group of millions of dollars stored at these "cash depots," according to military estimates.

Previously, the Iraqi government and other regional regulators have taken steps to cut off bank branches in Islamic State territory from participating in the broader financial system. The United States and other countries, together with Iraqi authorities, headquarters of international banks, and others within the international financial community, have partnered to counter the Islamic State's backdoor banking through these bank branches, as well as those in Syria. International banks now look closely for indications of Islamic State financing and file suspicious activity reports that, U.S. authorities say, have provided "valuable insight into financial activity in areas where ISIL operates." The Central Bank of Iraq instructed financial institutions incorporated in Iraq to prevent wire transfers to and from banks located in areas under Islamic State control, and international banks with regional branches in Islamic State-controlled territories have relocated staff away from areas around the group's territories.

Another area of effort is limiting new funds entering Islamic State territory through countersmuggling initiatives and by ceasing to pay Iraqi government salaries, which had been taxed directly and indirectly by the Islamic State, in areas under the group's control. As pressure mounts on the Islamic State's backdoor banking, the group has become more reliant on money-exchange houses to send and receive funds.

Iraqi Exchange Houses and Dollar Auctions

A related important step in isolating the Islamic State was the December 16 notice, referenced earlier, banning 142 money-exchange houses from participating in Iraqi Central Bank currency auctions. Largely excluded from bank activities, exchange houses are one of the Islamic State's primary means of moving money. The Central Bank notice, which was published only in Arabic, listed exchange companies predominantly located in Islamic State-controlled territory. Five of the companies, however, are based in Kirkuk, just outside Islamic State territory and an active area for allowing dollar flows into the territory, according to Iraqi officials.

The dollar auctions serve as the lifeblood for the Iraqi financial sector, providing banks and exchange houses access to the hard currency needed to conduct foreign trade and meet the demand of the largely cash-based society for a reliable store of value. Since the Iraqi Central Bank was established in 2004, following the U.S. invasion of the country, the Federal Reserve Bank of New York has shipped dollars to Iraq, drawn from Iraq's dollar reserves held with the Federal Reserve.

Like other Iraqi businesses, banks, and traders, the Islamic State also needs access to hard currency. Cash looted from bank vaults, for example -- a substantial but nonrenewable source of funds for the group -- was likely largely denominated in Iraqi dinars, making it less useful for external trade. Similarly, Iraqi government salaries paid to residents of Islamic State-controlled territory until July 2014, when Baghdad cut them off, were also likely in dinars. Vulnerable exchange houses can be exploited by the Islamic State both to obtain cash on exchange and to send and

receive cross-border electronic transfers.

The move by the Iraqi Central Bank follows a November confirmation from a Federal Reserve spokeswoman to the *Wall Street Journal* that the bank had temporarily suspended currency shipment to Iraq in 2015 "in response to larger-than-usual currency requests and to the evolving security situation [in the country]." Iraqi dollar procurements had tripled between 2012 and 2014. The November *Wall Street Journal* report cites U.S. concerns, confirmed by Iraqi officials, that the Islamic State was using Iraqi exchange companies to gain access to dollars through the auctions.

The currency auctions have previously been a subject of controversy. In 2012, Iraqi Central Bank governor Sinan al-Shahibi was ousted after he acted to constrain Iranian access to the auctions, which many believed was fueling volatility in the dollar-dinar exchange rate. The spike in dollar demand in Iraq at that time corresponded to rapid depreciation of the Iranian rial as pressure built on the Iranian economy from international sanctions and former Iranian president Mahmoud Ahmadinejad's economic mismanagement. As part of the new information exchanges between U.S. and Iraqi officials following the Fed suspension in 2015, Iraq confirmed that at least three designated Iranian banks had obtained millions of dollars via the currency auctions before being cut off, according to the *Wall Street Journal*.

Balancing Security and Social Benefit

The risk of exchange houses being exploited by terrorist financiers is not new. The Islamic State is attempting to take advantage of the same informal or weakly regulated channels as Iran and other illicit financial actors have done before. In a recent report on emerging terrorist financing typologies, the intergovernmental Financial Action Task Force highlighted the vulnerability of exchange companies and other remitters to terrorist financing where they are not regulated. The exchange houses recently targeted by the Iraqi government are a prime example, since most are located in Islamic State-controlled areas outside the scope of Central Bank supervision. By denying such exchange houses access to dollar auctions, the Iraqi government effectively found a way to regulate these out-of-reach enterprises.

More broadly, it should be noted that in areas where banking services are largely inaccessible to segments of society, or unavailable altogether, exchange houses can provide a much-needed means of sending or receiving remittances, including humanitarian support, in conflict zones and their environs. But they also present vulnerability as a potential conduit for comingling illicit funds with licit remittances. Even in nonconflict areas with sizable populations lacking bank access, exchange houses act as a bridge between cash-based informal economies and the banks upon which they rely to effect international transfers. But this layer can also help obfuscate the underlying party to a transaction and hide bad actors from the global financial institutions they transit.

It is in the nature of money flows -- formal and informal -- that cracking down on illicit activity in one place will likely lead it to balloon in another. Regional regulators, therefore, must take decisive steps, as the Iraqi Central Bank has done, to wall off their financial systems from unlicensed or loosely regulated money remitters vulnerable to exploitation by illicit actors. To that end, the U.S. Federal Reserve, together with the Central Bank of Iraq, has put in place information exchanges and safeguards to protect banks and exchange houses alike from abuse and deny the Islamic State access to U.S. banknotes. This not only blocks the Islamic State from moving money, it also protects legitimate exchange houses from abuse, thereby keeping them open and available to the public.

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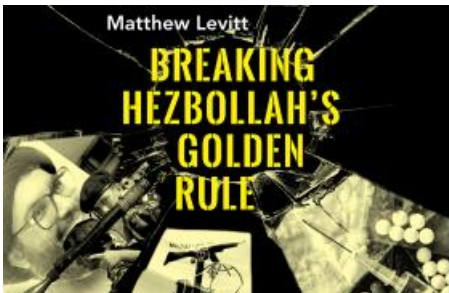
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