Chapter 1

Fundamental Concept of \textit{Sharī`ah} and \textit{Sharī`ah} Non-Compliance Risk

1.0. INTRODUCTION

\textit{Sharī`ah} non-compliance risk in Islamic finance and legal documentations is a very vital topic due to the risk involved, which might lead to serious financial implication rendering the financial contract invalid. This non-\textit{Sharī`ah} compliance status will trigger the legitimacy of the income generated by the Islamic financial institution. Hence, understanding the \textit{Sharī`ah} requirements in Islamic banking facilities and legal documentation is crucial. \textit{Sharī`ah} non-compliance risk consists of three important terms, namely: \textit{Sharī`ah}, risk, and compliance. A brief definition for each term is given below.

1.1. CONCEPT OF \textit{SHARĪ`AH}

The Arabic word \textit{Sharī`ah} refers in its literal meaning to the road to the watering place, the straight path to be followed,\(^{1}\) whereas the technical meaning refers to designating a rule of law, or a system of law, or the whole of the message of particular prophet.\(^{2}\) However, in the Islamic context \textit{Sharī`ah} refers to the laws and commandments and way of life prescribed by Allah to mankind.\(^{3}\) Another definition of \textit{Sharī`ah} is: “The sum total of Islamic teaching and system, which was revealed to prophet Muhammad (s.a.w) recorded in the \textit{Quran} as well as deductible from the Prophet’s divinely guided lifestyle called the \textit{sunnah}.”\(^{4}\) In other words, “\textit{Sharī`ah} refers to commands, prohibitions, guidance, and principles that God has addressed to mankind pertaining to their conduct in this world and salvation in the next.”\(^{5}\) It has also been defined as: “The body of those institutions that Allah has ordained in full or in essence to guide the individual in his relationship with God, his fellow
Muslim, his fellow men and the rest of the universe.”

Abdul Karim Zaidan defines *Shari`ah* by saying: “as the path of religion and the various aspects of laws (*al-ahkam*) which Allah provides for his servants, i.e. human.” In the context of the various definitions, *Shari`ah* basically is the knowledge of the laws relating to men’s acts and behavior, and the commands of Islam in particular matters and application. *Shari`ah* is the code of life that consists of ideology, faith, behavior, and obligation in the practical daily matters; since it is a divine law, it is a legislation based on the totality of Allah’s commands revealed to Prophet Muhammad.

*Fiqh* is another term that has been used with a legal connotation within the concept and scope of *Shari`ah*. *Fiqh* means understanding *al-fahm*, or the absolute understanding *Mutlaq al fahm*. In its technical sense, *fiqh* means “knowledge of the legal rules, pertaining to conduct that have been derived from their specific evidences.”

From the foregoing deliberation we conclude some points as follows:

1. The word *Shari`ah* has a very wide meaning as compared to *fiqh*.
2. *Shari`ah* consists of law, rules, regulations, commands, obligations, guidance, principles, ideology, faith, and behavior that govern the human being in every aspect of life.
3. *Shari`ah* includes all aspects of human life in this world.
4. *Shari`ah* is meant for two different worlds, happiness in this life and in the hereafter.
5. *Shari`ah* is the whole divine law and values as given by Allah, whereas *fiqh* is the law extracted by Muslim jurists from the sources of Islamic law.
6. *Fiqh* contains human involvement such as the involvement of jurists who perform a sort of *ijtihad* and interpretation.
7. The term *Islamic law* refers to *fiqh*, which can also be used to describe *Shari`ah*.

### 1.2. COMPLIANCE IN THE ISLAMIC FINANCIAL INSTITUTIONS: AN OVERVIEW

#### 1.2.1. Definition of Compliance

Compliance means to comply with all relevant laws, rules, regulations, and regulatory guidelines. Compliance refers to proper supervision and a competent system of internal controls within an organization to mitigate the risk and to preserve the Bank’s reputation as well as safeguarding of its assets and compliance with all relevant regulatory requirements.
1.2.2. Definition of Compliance Risk

Compliance risk can be defined as “The risk of legal or regulatory sanction, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities.”

1.2.3. Consequences of Non-Compliance

Failure to comply with all applicable laws, rules, regulations, and regulatory guidelines will constitute a breach. It may result not only in the imposition of disciplinary, civil, or criminal sanctions against the Islamic financial institution, but also in damaging one of Islamic financial institution’s (IFI’s) most important assets, its reputation. In addition, it may also result in the banking license being suspended/withheld by the regulator.

1.2.4. Objective of Compliance Operation Manual

Every Islamic financial institution has a compliance operation manual. This compliance operation manual describes the guiding principles for managing compliance at the business/support sectors within the IFI. The business/support sectors are responsible for ensuring that the activities of the department and its staff are conducted in accordance with all applicable laws, rules, regulations, Shari`ah rules and principles, and regulatory guidelines and the highest ethical standards.

1.2.5. General Objectives of Compliance Operation Manual

The compliance operation manual in the Islamic financial institution tries to achieve the following objectives:

1. Improve the quality and effectiveness of the compliance function.
2. Provide uniform practice guide on compliance, which would serve as a basis for guidance and measurement of performance of the compliance function by the compliance officer.
3. Facilitate the understanding and correct implementation of compliance function and procedures.
4. Ensure that compliance officers meet the minimum job expectation level imposed by the Bank.
5. Minimize the non-compliance to laws, rules, regulations, Shari`ah rules and principles, and regulatory guidelines that may result not only in the imposition of penalties, rendering the contract null and void, and staff disciplinary action, but also damage the IFI’s reputation.
Specific compliance responsibilities that compliance operation manual intends to convey is that compliance should be looked upon as an entire system of the following:

2. The prompt reporting of any compliance incidents (including Shari‘ah non-compliance).
3. Taking appropriate action if compliance incidents occur.

1.2.6. Process of the Compliance Operation Manual (COM)

The compliance operation manual normally applies to compliance officer and all staff of the IFI.

1.2.6.1. Scope of Coverage

The scope of compliance operation manual is one of the general compliance standards and requirements that govern the overall working and business within the IFI. It should neither be interpreted as an all-encompassing manual that has exhaustively and conclusively listed out all the laws, rules, and regulations that the IFI is subjected to, nor as a substitute to the regulations.

1.2.6.2. Areas of Compliance

The areas of compliance for business/support sector shall cover all regulatory (including Shari‘ah rules and principles) and statutory requirements.

1.2.6.3. Frequency of Review

Normally the compliance operation manual of the IFI needs to be reviewed on an annual basis and as and when the following circumstances occur:

- Change of work process/procedures/structures
- Computerization of work process
- Circulars issued by group compliance
- Regulatory requirements
- Others

1.2.6.4. Compliance Responsibilities

1.2.6.4.1. Compliance Officer

The responsibilities of a compliance officer are as follows:

1. To facilitate the business/support sector in complying with all applicable laws, rules, Shari‘ah rules and principles, regulations, and regulatory guidelines related to the business/support sector including monitoring the
changes in regulations affecting the respective business/support sector, and providing value-added feedback to relevant departments in the IFI.

2. To become the liaison officer and advice business/support sector on any compliance matters that they may face in the course of their work.

3. To ensure the establishment and proper/effective implementation of compliance program, which, amongst others, shall include submission of compliance reports, independent testing/checking, compliance education/training, and so on.

4. To proactively identify, measure, assess, and document the compliance risk related to the business/support sector. This shall include completing risk control self-assessment of the compliance functions and key risk indicators (KRI).

5. To conduct independent testing/checking/review in order to gauge the level of compliance with regulatory requirements (including Sharī‘ah rules and principles) at business/support sector as well as to mitigate/minimize the compliance/Sharī‘ah non-compliance risk.

6. To promptly inform the relevant head of the compliance of any compliance incidents/breaches/potential breaches upon discovery of the incidents. Thereafter, to monitor, manage, review, and follow up on any non-compliance issues reported and detected until resolved.

7. To participate in providing feedback, comments, recommendations and sign-off for any product/project/outsourcing/policy review sign-off.

8. To facilitate business/support sector in complying with FATF 40 Recommendations pertaining to anti-money laundering and counter financing of terrorism as well as Bank Negara Malaysia (BNM) UPW/GP1 and UPW/GP1(1) and other related regulatory requirements.

9. To promote a culture of compliance awareness at business/support sector by providing/arranging training/briefings, via regular/constant communications to all employees in the business/support sector.

10. To ensure proper record keeping on all the compliance activities/program conducted for future reference.

1.2.6.4.2. All Employees of the IFI   The responsibilities of the compliance officer as well as the rest of the staff of the IFI all play a role in creating the compliance atmosphere in the IFI; hence, compliance is every staff member’s responsibility.

1.2.7. Compliance Standards

The compliance standards are to be observed and guided by all staff in respect to the various compliance fundamentals as follows:

1. High standards of compliance ensure good reputation, which in turn will attract more business and a larger customer base.
2. Ensure that all applicable laws, rules, Shari'ah rules, principles, regulations, and internal policies and practices are strictly complied with.
3. These compliance standards of strict adherence to external requirements and the highest standards of ethical conduct must not, under any circumstances, be compromised in the name of commercialism or competition.
4. Identify and assess potential compliance issues (including Shari'ah non-compliance), guide and educate staff on compliance laws, rules, and standards, and perform a monitoring and reporting role.

Compliance staff shall also keep abreast of sound compliance practices and, in particular, take into account the recommendations of the BNM and Basel Committee on Banking Supervision as well as other international best practices such as Australian Standards AS3806 on compliance-related issues. Failure to put in place compliance personnel with the right abilities, skills, and resources may increase the risk in performing the business to the bank.

1.2.8. Independence and Accountability

Compliance function is independent from the business activities of the bank and is managed by the head of IFI compliance, who reports directly to the IFI board. The head of IFI compliance shall also submit a compliance report to the IFI board on the compliance-related activities/matters. Compliance staff shall not be placed in a position in which there is a possible conflict between their compliance responsibilities and any other responsibilities they may have.

1.2.9. Authority

The following is a list of the necessary authority needed for the compliance officer to fulfill his responsibilities:

- Unrestricted and unlimited access to all information and records.
- Authority to interview any employee regarding any conduct, business practice, ethical matter, or any other issue that is relevant to the discharging of compliance duties.
- Ability to retain any resources, at the bank’s expenses including outside experts it deem necessary in the performance of its duties.

1.2.10. Termination/Resignation/Hand-Over of the Compliance Officer’s Task

The compliance officer shall ensure proper hand-over of the compliance function to the person taking over the compliance function in the event of
transfer/termination/resignation/change of the compliance officer. The compliance officer shall hand over all documents and materials relating to work and ensure a smooth transition of duties and responsibilities.

1.3. CONCEPT OF RISK

Generally, risk is used as a synonym of hazard, danger, peril, jeopardy. However, as a noun the term *risk* is the possibility of loss or damage of money or property. If it is related to the stock exchange, for instance, it is the degree of possibility that an asset may increase or decrease in value. However, *risk* as a verb means to expose oneself or someone or something to danger, failure, or loss. There are a few definitions of risk that depend on the point of view of each particular discipline. Each particular area of knowledge will treat the term differently based on its background and area of specialization. In this regard, we may find various definitions according to the area of the knowledge as such economics, finance, or others. The definition will reflect the concept of that particular discipline.

In order to understand the wider scope of *risk*, a few definitions are provided below in order to give a comprehensive understanding of the term *risk* in various fields of knowledge:

- “Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.”
- “The chance of making a loss, this could be making a loss on an asset sale or the possibility of machine failure.”
- “The risk is amount one potentially stands to lose by a transaction.”
- “Risk can be defined as the volatility of unexpected outcomes, which can represent the value of assets, equity, or earning.”

From these definitions, there are different types of concepts provided under the purview of risk. It seems that the term *risk* has various classifications, the two major parts most related to the business and financial transactions are: the business risk and the financial risk. The business risks are those that the corporation assumes willingly to create a competitive advantage and add value for shareholders. Business risk includes the business decision companies make and the business environment in which they operate. On the other hand, the financial risk is related to possible losses owing to financial market activities.

As a conclusion, risk includes some important points:

- Risk is the concept of a potential negative impact to valuable thing.
- It may arise from some present process or future event.
It is often used synonymously with the probability of a known loss.

- The probable loss in the risk can be uncertain.
- Risk can be in business or finance or other classifications.
- It has a bad implication on the financial institutions.
- It can be managed in order to mitigate its impact, and avoid its implications.
- Risk is a part of the business portfolio.

1.4. THE CONCEPT OF SHARĪʻAH NON-COMPLIANCE RISK

1.4.1. Risk from an Islamic Perspective: The Islamic Financial Services Board/IFSB Point of View

According to the Islamic Financial Services Board (IFSB), there are six types of risks faced by the Islamic financial institution: credit risk, equity investment risk, market risk, liquidity risk, rate of return risk, and operational risk. The Sharīʻah non-compliance risk is discussed under the operational risk.

According to IFSB, there are two principles governing the operational risk:

**Principle 1:** Institutions offering Islamic Financial Services (IIFS) shall have in place adequate systems and controls, including Sharīʻah board/advisor, to ensure compliance with Sharīʻah rules and principles.

**Principle 2:** IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. When the Investment Account Holders (IAH) funds are commingled with IIFS’ own funds, IIFS shall ensure that the bases for asset, revenue, expense, and profit allocations are established, applied, and reported in a manner consistent with IIFS’ fiduciary responsibilities.17

The first principle is related to Sharīʻah risk, whereas the second principle is related to safeguarding the interest of the IAH funds.

- The Islamic bank is responsible for curbing any occurrence of operational risk; therefore, any losses resulting from this type of risk due to some inadequate or failed internal process will be borne by the Islamic financial institution. The possible cause of loss resulting from a Sharīʻah non-compliance event and the failure in its fiduciary is the responsibility of the bank as well.
- According to IFSB, Sharīʻah non-compliance risk is the risk that arises from IIFS’ failure to comply with the Sharīʻah rules and principles, as determined by the Sharīʻah board of the IIFS or the relevant body in
the jurisdiction in which the IIFS operate.\textsuperscript{18} \textit{Shar\textquotesingle ah} is highly appreciated in the Islamic bank operation, and failure to comply with \textit{Shar\textquotesingle ah} rules may expose the Islamic financial institution to high financial risk due to the invalidity of the transactions. IFSB highlighted the relevant issue very clearly by stating that: “\textit{Shar\textquotesingle ah} compliance is considered as falling within a higher priority category in relation to other identified risks. If IIFS do not comply with \textit{Shar\textquotesingle ah} rules and principles, their transactions must be cancelled and income generated from them shall be considered as illegitimate.”\textsuperscript{19}

Under principle 7.1 of \textit{Shar\textquotesingle ah} non-compliance risk, IFSB highlighted the following clauses:

- IIFS shall ensure that they comply at all times with the \textit{Shar\textquotesingle ah} rules and principles as determined by the relevant body in the jurisdiction in which they operate with respect to their products and activities. This means that \textit{Shar\textquotesingle ah} compliance considerations are taken into account whenever the IIFS accept deposits and investment funds, provides finance, and carries out investment services for its customers.

- IIFS shall ensure that its contract documentation complies with \textit{Shar\textquotesingle ah} rules and principles—with regard to formation, termination, and elements possibly affecting contract performance, such as fraud, misrepresentation, duress, or any other rights and obligations.

- IIFS shall undertake a \textit{Shar\textquotesingle ah} compliance review at least annually, performed either by a separate \textit{Shar\textquotesingle ah} control department or as part of the existing internal and external audit function by persons having the required knowledge and expertise for the purpose.

- The objective is to ensure
  a. The nature of the IIFS’ financing and equity investment.
  b. Its operations are executed in adherence to the applicable \textit{Shar\textquotesingle ah} rules and principles as per the fatwa, policies, and procedures approved by the IIFS’ \textit{Shar\textquotesingle ah} board.\textsuperscript{20}

- IIFS shall keep track of income not recognized arising out of \textit{Shar\textquotesingle ah} non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of \textit{Shar\textquotesingle ah} non-compliance, the IIFS may assess potential profits that cannot be recognized as eligible IIFS’ profits.

\subsection*{1.4.2. \textit{Shar\textquotesingle ah} Compliance and Area of Coverage}

\textit{Shar\textquotesingle ah} non-compliance risk has a wider scope in Islamic banking and finance. It is an end-to-end process that consists of these important parts: structure of
the facility/product/service, the terms and conditions of the facility/product/legal documentation, the execution of the legal documentations/product and implementation of the product or services in the market place, and the related IT system along with the related multimedia and broadcasting.

1.4.2.1. Structure of the Facility/Product/Service  The structure of the product/service or the facility should be Shari`ah-compliant, whereby it should be structured in such a way that complies with the underlying contract used such as `ijarah. This includes but is not limited to the flow and procedure of the product; the relationship between the parties in the facility; the source of the fund; the use of the fund; the profit generated; the nature of the relationship between the different contracts used in the facility; the nature of the combination of the contracts if applicable; how the product is built, structured, and designed; and how it works and functions.

The aforementioned aspects should satisfy the Shari`ah requirements, and when there is a potential Shari`ah non-compliance risk, a Shari`ah justification should be provided in order to demonstrate the position of the Islamic financial institution, along with giving guidance to the team of Shari`ah review and audit when they conduct their function to avoid misunderstanding and confusion. The people responsible for the Shari`ah compliance in this area are the Shari`ah board and the supporting division from Shari`ah management/Shari`ah advisory and legal Shari`ah review and Shari`ah audit.

1.4.2.2. The Terms and Conditions of the Facility/Product/Service  The terms and conditions (T&C) must be compliant with Shari`ah rules and principles, and the clauses in the T&C should reflect the underlying relevant contracts used in the facility (product or services). In addition, if the conventional documentations are used, the conventional T&C, which are not allowed by Shari`ah, should be removed and replaced by relevant terminologies to reflect the spirit of Shari`ah and Islamic finance in the form and substance. The T&C should be free from any clause that may contradict the very nature of the contract applied. The careful stipulation of the T&C will result in accurate legal documentation that comply with Shari`ah rules and principles. The people responsible for Shari`ah compliance in this area are the Shari`ah board and the supporting division from Shari`ah management/Shari`ah advisory, legal, Shari`ah review, and Shari`ah audit.

1.4.2.3. The Execution of the Legal Documentations/Product/Service  The other area of Shari`ah non-compliance risk that should be observed is the execution of the contracts along with the relevant legal documentation by looking at the sequence of the contracts according to the process and procedure required. The execution is looking at the way that the products and services have been
implemented at the operational level. The people responsible for *Shari‘ah* compliance in the execution and implementation are the relevant employees of the Islamic bank/the owner of the product. The people responsible to ensure that there is no discrepancy in the process of execution and implementation are the *Shari‘ah* review and *Shari‘ah* audit employees.

1.4.2.4. The Information Technology Infrastructure and System The information technology infrastructure and system has great importance in the daily banking operation of the Islamic bank. The IT system represents a risky area of *Shari‘ah* non-compliance risk. The Islamic financing facility, its execution, and its implementation are riding on the IT system. Hence, a proper consideration should be given to this area, which represents part of the *Shari‘ah* compliance process. The IT infrastructure and system should reflect the *Shari‘ah* requirements in the feature, information, sequence, and execution in such a way that helps the officers of the Islamic bank to *Shari‘ah* non-compliance if it has happened even by mistake. The system should be resilient enough to block any attempt to transact any non-*Shari‘ah*-compliance transaction. It should be understood that restructuring the IT infrastructure and system in a bank has a very huge cost; however, progressive improvement in the system and gradual enhancement of the IT system should be part of the concern of the management. Meanwhile, the gaps that exist should be addressed in a timely and careful manner, and discrepancies should be rectified manually to ensure proper transactions that fulfill *Shari‘ah* in its form and substance. The people responsible for *Shari‘ah* compliance in this area are the *Shari‘ah* board and the supporting division from *Shari‘ah* management/*Shari‘ah* advisory, and the IT team.

1.4.2.5. Marketing Collateral, Multimedia, and Broadcasting Marketing collateral and materials, multimedia, and broadcasting represent the image of the Islamic financial institution. These represent the means of communication between the Islamic bank and the public that build the reputation of the bank. The improper presentation of the Islamic financial bank will expose the bank to reputation risk. Therefore, a serious concern should be given to these tools to ensure that the IFI message is properly and clearly delivered without ambiguity or confusion.

The most important criteria that should be observed in the area of marketing collateral, multimedia, and broadcasting are as follows:

- Honesty and sincerity in advising the client when offering products, especially those related to some banking facilities or *takaful* products.
- Adequate disclosure on the information related to the product to the client, and no hidden cost.
Avoid deception and misrepresentation of the product.

Avoid convincing the client to buy the product or subscribe to it, if the marketing officer knows that the product is not within the interest of the client. Therefore, it should be fair advice, neutral presentation of the product by explaining the features and the facts without exaggeration that may mislead the client.

Balance between the key performance indicator (KPI), which is the self-interest of the marketing officer and his company and the interest of the client.

Marketing and pushing the product should be governed by the public interest of the market and customers, and not by the private interest of the company.

Consultancy and advice should be embedded in the process of marketing and selling as a kind of mutual help and co-operation.

Contentment is a valuable ethic that the seller should keep in mind when promoting its products in the market. Misunderstanding of this valuable ethic will lead to greed and self-interest without consideration of the interest of others, which may destroy the society.

Contentment brings barakah, the blessing from God, whereas greed brings evil and leads to corruption.

The profit maximization should be shifted to reasonable profit, because maximization does not give space to others who want to earn money and accumulate wealth. The concept of wealth and profit maximization will remove tolerance in the competition, and it will change the features of brotherhood and friendly competition to war and enmity, in which everyone wants to expel his competitor from the market. Maximization does not give space to sharing and cooperation. The thinking should change to bring the business community to a level of satisfaction on what they have in hand and avoid looking at the hand of others. Brotherhood is more important than wealth, living together with reasonable wealth is better than one person living alone with mountains of wealth while others serve him. The Prophet says: Who among you is safe in his house, healthy in body, he has a living for a day, he gathered him the whole world.

Avoid any improper description about the products that belong to other competitors. This is because the objective of selling and earning money does not justify the non-permissible means such as downgrading the value of other products to convince the client of subscribe to one’s own product. This is unethical.

Marketing collateral, multimedia, and broadcasting should be free from any Shari'ah non-compliance feature, contents, or image.
The people responsible for the *Sharāʾī*ah compliance in this area are the *Sharāʾī*ah board and the supporting division from *Sharāʾī*ah management/*Sharāʾī*ah advisory, and the marketing team.

### 1.5. REVIEW OF THE CONCEPT OF *SHARĀʾĪ*AH NON-COMPLIANCE RISK

According to IFSB’s definition, *Sharāʾī*ah non-compliance risk is the risk that arises from IIFS’ failure to comply with the *Sharāʾī*ah rules and principles determined by the *Sharāʾī*ah board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate. This definition puts the responsibility of *Sharāʾī*ah non-compliance risk solely on the IFI, which means the failure of the IFI to comply with the resolutions of the *Sharāʾī*ah board will lead to *Sharāʾī*ah non-compliance risk. This definition does not address the possible failure of the *Sharāʾī*ah board to provide a sound resolution in cases in which the *Sharāʾī*ah board changes its positions or amends its resolution because of the lack of information provided, or due to other reasons.

Therefore, the appropriate definition of *Sharāʾī*ah non-compliance risk should be as follows: “*Sharāʾī*ah non-compliance risk is the risk that arises from (1) IIFS’ failure to comply with the *Sharāʾī*ah rules and principles determined by the SAC (in case of Malaysia, the *Sharāʾī*ah Advisory Council is the high authority pertaining to Islamic finance matters, and their resolution are binding on the IFI) or, (2) IIFS’ failure to comply with the *Sharāʾī*ah rules and principles determined by the *Sharāʾī*ah board/committee or, (3) failure of the *Sharāʾī*ah board to achieve a sound resolution due to the lack of information provided to them or due to other reasons.” In all cases, rectification is required to put the practice back on track according to *Sharāʾī*ah status.

The preceding definition comprehensively addresses both types of risk and makes both parties responsible for *Sharāʾī*ah non-compliance risk. Both types of *Sharāʾī*ah non-compliance risk lead to the same results, so that, in some cases of non-*Sharāʾī*ah compliance, the profit will not be recognized and the income will be disposed of and channeled to a charitable fund account. (See Figure 1.1)

*Sharāʾī*ah non-compliance risk can arise either from the Islamic financial institution or from the *Sharāʾī*ah board. The concept of *Sharāʾī*ah non-compliance risk here is based on the argument that the issue of *Sharāʾī*ah non-compliance risk is about the failure to comply with the *Sharāʾī*ah rules and principles, regardless of the entity responsible for this failure, and regardless of the reasons behind this failure, be it a genuine reason or otherwise. Therefore, the concern is to identify the *Sharāʾī*ah non-compliance
risk and apply a proper process to resolve it. The new definition widens the scope of Shari‘ah non-compliance risk, respectively changing the shape of dealing with this type of risk; hence, additional risk-management tools will be addressed to cater to this type of risk. The attribution of the Shari‘ah non-compliance risk to the Shari‘ah board does not tarnish the board’s credibility and reputation. It will not be held liable because, from an Islamic jurisprudence perspective, the scholar who performs *ijtihad* in a proper manner, as prescribed in Islamic jurisprudence, will be rewarded in both cases, irrespective of whether his *ijtihad* is right or wrong. In fact, when the resolution is issued based on the information provided by the Islamic bank or third party, it is deemed sound. However, if additional facts and information emerge later, the resolution that has been issued will not be relevant anymore and it might be totally revised. The potential risk in this case is that the bank may start the execution of the product or services based on the early resolution of the Shari‘ah board. However, after the revision of the resolution based on the new information furnished, what has been executed and implemented by the IFI will be revised and rectified.

From a Shari‘ah review and Shari‘ah audit perspective there is no discrepancy in the process as far as their function is concern, because there is no Shari‘ah risk that should be addressed since the practice is in line with the resolution of the Shari‘ah committee (SC) of the IFI. But from the Shari‘ah board’s perspective, there is a discrepancy due to the additional facts disclosed, which requires a revision of the resolution that may have a
major impact on the existing transactions executed. Therefore, *Shari'ah* non-compliance is triggered, and measurement rectification should take place.

**1.6. FEATURES OF *SHARI'AH* NON-COMPLIANCE RISK**

*Shari'ah* non-compliance risk features and criteria can be summarized as follows:

- *Shari'ah* non-compliance risk is a major concern in the risk management framework.
- *Shari'ah* compliance is significantly considered the banking process, whether in the stage of fund mobilization in taking deposit or at the level of providing financing, services or investment (retail and/or corporate market).
- *Shari'ah* compliance is a consistent process which should be maintained at all times by the Islamic financial institutions.
- *Shari’ah* compliance is about ensuring that the financial transactions carried out by IFIs are in accordance with *Shari'ah* rules and principles. It means that financing, investment and the entire banking business operations are executed in strict adherence to the applicability of *Shari’ah* rules and principles.
- *Shari'ah* non-compliance risk is understood within the resolutions, policies and procedures approved by the IIFS’s *Shari'ah* board, meaning that if the IFI is executing some business operations that are against other resolutions issued by *Shari'ah* boards of other IFI, it does not trigger *Shari’ah* non-compliance risk.
- *Shari'ah* compliance risk should be observed in the legal documentation, which includes offer, acceptance, and other clauses of the contractual agreement that demonstrate the rights and obligations of the contracting parties.
- The ex-post *Shari'ah* non-compliance risk can be assessed or detected during the *Shari’ah* review process, either internally or externally.
- The profit arising from *Shari'ah* non-compliant transactions are considered illegitimate profit and should be disposed of by means that are acceptable from a *Shari'ah* perspective, such as channeling the funds to a charitable organization.

**1.7. *SHARI’AH* NON-COMPLIANCE RISK EVENTS**

For Islamic banking purposes, *Shari’ah* non-compliance risk may occur as a result of non-compliance with resolution/guidelines issued by the regulatory
bodies (BNM, SC), \textit{Shar'i}ah compliance framework issued by the bank and/or resolution and decisions made by the bank’s \textit{Shar'i}ah committee.

The following are examples of \textit{Shar'i}ah non-compliance risks events that may occur in a bank. The risk may be mapped to the scope of audit.

1.7.1. Audit of Financial Statement

- Income from an invalid transaction is not purified and channeled to charity.
- \textit{Tawidh} (compensation fee) amount was compounded.
- Zakat is not accurately calculated and not distributed to the proper recipients (\textit{asnaf}).
- Profit distribution calculation for \textit{mudarabah} fund is not calculated in accordance to \textit{Shar'i}ah where weightage was assigned for different types of deposits or deductions of ineligible expenses, for example, indirect expenses.

1.7.2. Compliance Audit on Organization Structure, People, Processes, and Information Technology

- Poor communication between the \textit{Shar'i}ah committee and management that leads to non-\textit{Shar'i}ah-compliance incidences.
- Failure to escalate \textit{Shar'i}ah non-compliance incidents to the \textit{Shar'i}ah committee.
- Fees/charges imposed to Islamic products and services not in accordance with \textit{Shar'i}ah principles.
- Uncertainty (\textit{gharar}) in price/rebate/compensation/fee disputes versus \textit{Shar'i}ah non-compliance status of advertisement, illustration/materials/forms/documentation used in offering products and services.
- Acceptance of deposit from \textit{Shar'i}ah non-compliance sources.
- Financing assets/goods that are non-compliant with \textit{Shar'i}ah requirements.
- Sequence of contract execution not in line with \textit{Shar'i}ah ruling/requirement.
- Non-existence of underlying asset during contract execution for Islamic product non-execution or renewal of \textit{aqad} (agreement) for Islamic contract.
- Improper usage of Islamic terminology and definition.
- Bundling of conventional products with Islamic products.
- Inability of system to cater for the \textit{Shar'i}ah features of the contract, for example, non-compounding of \textit{tawidh}, ceiling limit of selling price.
- System error resulting in specific \textit{aqad} not executed upon renewal or disbursement, for example, commodity \textit{murabahah}. 
1.7.3. Review of Adequacy of Shari‘ah Governance

- Non-compliance to requirements outlined in the BNM Shari‘ah governance framework.
- Non-identification or incomplete identification of Shari‘ah risk faced by the bank resulting in poor mitigation.
- Absence or irregular Shari‘ah review function to conduct compliance review of operations to ensure Shari‘ah compliance.
- Absence of Shari‘ah research functions to conduct in-depth Shari‘ah research before submission to the Shari‘ah committee.
- Absence of measures by the Shari‘ah secretariat to ensure that all Shari‘ah committee’s resolutions are properly documented and disseminated.
- Lack of management of the Shari‘ah committee’s interest and welfare, including remuneration that may result in difficulty in attracting Shari‘ah scholars as SC members.
- Absence of proper documentation to support the Shari‘ah committee’s resolution or decision that may hamper defence in any case of dispute.
- Absence of a comprehensive Shari‘ah policy manual to assist staff in ensuring Shari‘ah compliance.

1.7.4. Shari‘ah Governance Risk

- Non-identification or incomplete identification of Shari‘ah risk faced by the bank resulting in poor mitigation.
- Irregular Shari‘ah review function of operations to ensure Shari‘ah compliance.
- Absence of Shari‘ah research functions to conduct in-depth Shari‘ah research before submission to the Shari‘ah committee.
- Absence of control measures to ensure that all Shari‘ah committee’s resolutions are documented and disseminated.
- Lack of management of the Shari‘ah committee’s interest and welfare, including remuneration that may result in difficulty in attracting experienced Shari‘ah scholars as Shari‘ah committee members.
- Absence of proper documentation to support the Shari‘ah committee’s resolution or decision that may hamper defence in any dispute cases.
- Absence of a comprehensive Shari‘ah policy manual to assist staff in ensuring Shari‘ah compliance.
- Lack of checking to ensure the board’s annual attestation is accurately reported to BNM.
- Poor communication between the Shari‘ah committee and management that leads to non-Shari‘ah-compliance incidences.
Non-compliance to requirement in the BNM Sharī`ah governance framework (SGF).
- Failure by the management to identify and refer any Sharī`ah issues to the Sharī‘ah committee for decision, views, and decisions.
- Failure to disclose sufficient information in the annual report on the state of compliance of the bank’s operation in conformity with Sharī‘ah principles.

1.7.5. Sharī‘ah Product-Approval Risk

- Failure to ensure the Islamic finance product being subject to the correct product-approval process.
- New product-approval/guidelines/campaign/process not endorsed by the Sharī‘ah committee (SC).
- Product features non-compliance to Sharī‘ah principles.
- Failure to ensure that the contracts are in compliance with BNM’s Sharī‘ah parameter reference guidelines, that is, murabahah, ijarah, mudharabah, musharaka, and istisna.
- Lack of processes to ensure that a thorough research was conducted to review new products and business development prior to presentation the Sharī‘ah committee.
- Absence of records to show that a rigorous deliberation process was performed by the Sharī‘ah committee prior to their certification of new products and backed by the relevant fiqh literature, evidence, and reasoning.

1.7.6. Sharī‘ah Documentation Risk

- Incorrect legal documentation of financing facilities.
- Improper/Wrong usage of Islamic terminology and definition.
- Bundling of conventional products with Islamic products.
- Non-execution of aqad documentation.
- Blank or incorrect information and aqad documentation, for example, price, asset.
- Failure to ensure that specific clauses in the product documentation, for example, wadiah, mudharabah.
- Failure to provide control and reasonable assurance that two different contracts are concluded separately.

1.7.7. Sharī‘ah Operational Risk

- Incorrect sequencing of buy/sell transactions in BBA contents.
- Fees/charges imposed to Islamic products and services not in accordance with Sharī‘ah principles.
- Uncertainty (ghurar) in price/rebate/compensation/fee disputes.
- Shari’ah non-compliance status of advertisement, illustration/materials/forms/documentation used in offering products and services.
- Failure to escalate Shari’ah non-compliance incidents to Shari’ah committee.
- Acceptance of deposit from Shari’ah non-compliance sources.
- Financing assets/goods that are non-compliant with Shari’ah requirements.
- Disputes over performance or advisory activities (including Shari’ah advisory).
- Sequence of contract execution not in line with Shari’ah ruling/requirement.
- Failure to ensure the availability and existence of underlying assets during the execution or aqad contract for Islamic product.
- Non-execution of new aqad upon extension or renewal of facility, for example, MOD.
- Shari’ah underlying asset used for transaction of specific contract is non-Shari’ah compliant, for example, debt-based instrument used for debt-base sale.
- Non-execution of separate Aqad, for example, sale contract, after end of leasing in al-Ijarahthumma al-Bai (AITAB) products.
- Non-execution of supporting contract, for example, wakalah for commodity Murabahah.
- Failure to identify and comply with purification process of business income arising from Shari’ah non-compliance business transaction activities, that is, donated to charity.
- Failure to ensure that the contract transaction is in conformity with the basic tenets (elements and conditions) of the contract used in, for example, sell-based leasing.
- Failure to observe and implement rulings decisions and resolutions made by the Shari’ah committee.
- Failure to comply with BMN Shari’ah advisory councils (SAC) resolutions.
- Non-genuine sell and buy transaction by commodity vendors that may lead to invalid contracts for commodity murabahah products.
- Failure to ensure that any transaction involving payment of excesses by the bank is supported by an Islamic contract to avoid riba.

1.7.8. Shari’ah Reputational Risk

- Lack of knowledge of Shari’ah/Islamic banking products and competencies of staff.
- Lack of clarity/transparency in the Shari’ah product’s features, documentation, and marketing materials.
- Excessive charge/compensation or penalty.
- Corporate image with regards to perception by customers of staff dress code and other Islamic-related matters in the operations of Islamic banking outlets.
Non-Shari`ah-non-compliant marketing material that may result in poor perceptions of Islamic banking.

- Concept used for product not globally accepted.
- Non-restriction of Islamic credit-card facility to purchasing non-permissible goods, services, or at non-permissible merchants and establishments.

1.7.9. Sharī`ah Treasury Risk

- Shari`ah non-compliant instrument being used for treasury and hedging activities for the Islamic financial institutions.
- Investment staff did not monitor or divest from investment subsequently reclassified as non-compliant.
- Underlying asset used for issuance of the Islamic financial institution share certificate to branches for use during Bai` `inah execution was not monitored and replaced upon expiry or trade.

1.7.10. Sharī`ah IT Risk

- Inability of system to cater to the Shari`ah features of the contract, for example, non-compounding of tawith ceiling limit of selling price. System error resulting in specific aqad not executed upon renewal or disbursement, for example, commodity murabahah products.

1.7.11. Sharī`ah Credit Risk

- Lack of checking resulting in Islamic credit facility granted to non-eligible customers.
- Lack of checking resulting in granting of financing facility for the purpose of financing asset that is not permissible under Shari`ah.
- Lack of checking resulting in granting of financing facility for the purpose of financing asset intended for a purpose that is not permitted under Shari`ah.

1.7.12. Sharī`ah Investment Banking/Asset Management Risk

- Poor controls resulting in Shari`ah non-compliant securities allowed for trading using the Islamic stock broking facilities.
- Poor controls resulting in commingling of Shari`ah and conventional income.
- Lack of monitoring to ensure that the lease asset under Sukuk with ijarah contract is insured with Takaful instead of conversional insurance.
1.8. THE SHARI’AH BASIS FOR SHARI’AH COMPLIANCE

There are many provisions from Quran and sunnah that emphasize on adherence to Shari’ah compliance. These provisions are commands from the Lawgiver to ensure the status of Shari’ah compliance in human being activities including Islamic finance activities.

A. Quran

Allah Says:

“And now have We set thee (O Muhammad) on a clear road of (Our) commandment; so follow it, and follow not the whims of those who know not.” (Al Jathiya: 18)

Allah Says:

“But help ye one another unto righteousness and pious duty. Help not one another unto sin and transgression, but keep your duty to Allah. Lo! Allah is severe in punishment.” (Al Maeda: 2)

Allah Says:

“O ye who believe! Obey Allah, and obey the messenger and those of you who are in authority; and if ye have a dispute concerning any matter, refer it to Allah and the messenger if ye are (in truth) believers in Allah and the Last Day.” (AnNisa: 59)

Allah Says:

“But nay, by thy Lord, they will not believe (in truth) until they make thee judge of what is in dispute between them and find within themselves no dislike of that which thou decidest, and submit with full submission.” (AnNisa: 65)

Allah Says:

“Lo! We reveal unto thee the Scripture with the truth, that thou mayst judge between mankind by that which Allah showeth thee. And be not thou a pleader for the treacherous.” (AnNisa: 105)

Allah Says:

“And whoso opposeth the messenger after the guidance (of Allah) hath been manifested unto him, and followeth other than the
believer’s way. We appoint for him that unto which he himself hath turned, and expose him unto hell—a hapless journey’s end!” (AnNisa: 115)

Allah Says:

“And unto thee have We revealed the Scripture with the truth, confirming whatever Scripture was before it, and a watcherc over it. So judge between them by that which Allah hath revealed, and follow not their desires away from the truth which hath come unto thee. For each We have appointed a divine law and a traced-out way. Had Allah willed He could have made you one community. But that He may try you by that which He hath given you (He hath made you as ye are). So vie one with another in good works. Unto Allah ye will all return, and He will then inform you of that wherein ye differ.” (Al Maeda: 48)

Allah Says:

“And it becometh not a believing man or a believing woman, when Allah and His messenger have decided an affair (for them), that they should (after that) claim any say in their affair; and whoso is rebellious to Allah and His messenger, he verily goeth astray in error manifest.” (Al Ahzab: 36)

Allah Says:

“The saying of (all true) believers when they are called unto Allah and His messenger to judge between them is only that they say: We hear and we obey. And such are the successful.” (Al Noor: 51)

B. Sunnah

Narrated Abu Huraira: Allah’s Apostle said,

“Whoever obeys me, obeys Allah, and whoever disobeys me, disobeys Allah.” (Bukhari: Book 9: Volume 89: Hadith 251)

“A’isha reported Allah’s Messenger (may peace be upon him) as saying: He who innovates things in our affairs for which there is no valid (reason) (commits sin) and these are to be rejected.” (Muslim: Book 18: Hadith 4266)

These provisions have been conveyed on different occasions by the Lawgiver, depending on the occasion of each provision. However, the
provisions together convey the concept of compliance with the rules and commands of the Lawgiver that have been provided in *Sharīʿah*.

**NOTES**


4. Ibid.

5. Ibid., 12.


15. Ibid., 4.

16. Ibid.

17. IFSB, Islamic Financial Services Board (2005), Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services, 26.

18. Ibid., 26.

19. Ibid., 27.

20. Ibid.
