



Mechanism for Preventing Shariah Non-Compliance (SNC) Events in Islamic Financial Institutions

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ABSTRACT

Islamic financial institutions are fastest growing industry in all around the world. This occurred due to the need of Islamic banking and finance product among Muslim community as much as their concerns with Shariah non-compliance (SNC) event that may derive from banking and financial transaction. SNC event will raise the risk management of IFIs and have a negative influence on the IFIs' reputation among their present and future clients. Hence, this study is aimed to investigate the mechanism for preventing SNC events in Islamic financial institutions. This study employs a qualitative approach. This research achieves its objective through document analysis and interview with experts. Secondary data also gathered from sources such as journal papers and the websites of authorized authorities. General finding shows that, a sound Shariah governance and internal control mechanism are significant in overcome SNC events in Islamic financial institutions.

Keywords: Shariah non-compliance; Islamic Financial Institutions; Islamic Finance

INTRODUCTION

In recent time, Islamic financial institutions are growing all over the world. The rising number of Muslim populations in nationwide has become a catalyst for the growth of market in Islamic financial institution in which demanding for halal (permissible) product and services. According to the Islamic Financial Service Board (IFSB), the total assets of Islamic banks (IBs) around the world are estimated to reach USD 2.44 trillion in 2019, an increase from USD 2.19 trillion in 2018. (IFSB, 2020). Currently, the Islamic banking sector is growing at a rate of between

15% and 25% per year, and Islamic financial institutions are currently handling assets worth over USD 2.7 trillion internationally (IFSB, 2022). More than 1,500 Islamic financial institutions can be found in more than 80 countries. As reported by Asian Banker Research Group, the 100 largest Islamic banks worldwide have targeted an average asset growth rate of 13% (ICD-REFINITIV, 2021). Islamic financial institutions are an integral element of the contemporary global economy and are bound by the same economic regulations as conventional (non-Islamic) counterpart in the global financial system. In actuality, the function of Islamic finance plays an increasingly important role with each passing year.

Islamic financial institutions must be based on the Shariah rulings. The fundamental concepts that underpin Islamic financial institutions include the concept of mutual risk and profit sharing between parties, the guarantee of fairness for all parties involved, and the need that transactions be founded on an underlying commercial activity or asset. The key ideals of Islamic financial institutions, which encourage activities that foster entrepreneurship, trade, and commerce, as well as bring societal progress or benefit, provide support for these ideas. It is forbidden to participate in activities that involve interest (*riba*), gambling (*maysir*), and speculative trading (*gharar*). Islam has strictly prohibited Muslim to involve with the dealings that has *riba* and other prohibited element as mentioned in primary source in holy al-Quran and Hadith of prophet Muhammad:

“O you who believe! Fear God and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from God and His apostle, but if you turn back, you shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly. If the debtor is in difficulty, grant him time, till the time ease. But you remit it by way of charity, that is best for you if you only know” -(al-Baqarah:278).

Meanwhile in Hadith from prophet Muhammad S.A.W. also stated about the prohibition of *riba*:

From Jabir: The Prophet, may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike [in guilt]." (Riwayat Tirmidhi).

From both sources, it's clearly stated that the elements of interest and other prohibited elements are strictly impermissible in order to promote fairness and justice in commercial dealings.

Islamic financial institutions are often to expose to the Shariah non-compliance (SNC) events in the operational system. Conformity with Shariah is the most important aspect of managing a corporation since it is the fundamental tenet upon which businesses or Islamic financial institutions are founded. If businesses do not

follow the Shariah values and principles when it comes to managing their money, operating their enterprises, and carrying out their activities, they run the danger of falling out of compliance with them (Omar, 2019).

Therefore, the mechanism in preventing SNC events in Islamic financial institution is significant in order to promote a soundness and fairness financial services to the people especially to Muslim community. The main purpose of this article is to investigate a sound mechanism in preventing SNC events in Islamic financial institution operations. Due to the scarcity of literature on the analysis of Shariah non-compliance risk using modern operational risk frameworks, this study aims to address that gap by ensuring that operations in the Islamic banking and finance industry adhere to properly regulated Shariah compliance standards. The next section discusses the conceptual framework and mechanism for preventing SNC events.

LITERATURE REVIEW

Conceptual Framework

Literally, Shariah non-compliance event is referred to the practice or dealings that involved with interest (*riba*), uncertainty (*gharar*), gambling (*maysir*) and other prohibited element such as pork, liquor and pornography as stipulated by Muslim scholars. There are numerous SNC definitions. Al-Ghazali defines SNC event, also known as non-halal (prohibited) practice, as any property acquired through unlawful means, such as corruption, theft, *riba* (usury), hoarding, and gambling (Al-Bez, 2014). The other elements found to be forbidden in Shariah-compliant commercial dealings include *Ghubn* (inequality), *Ikra* (duress), *Ghala'* (error), *Taghrir* (deceit), and *Jahalah* (deception). In order to effectively implement Shariah risk management, Islamic banks need a comprehensive understanding of these factors (Hassan, 2016).

Shariah conformity has always been central to and continues to be the most important aspect of Islamic finance. The risk of Shariah non-compliance in Islamic finance is the potential for financial transactions, activities, and operations to violate Islamic law. Islamic finance is predicated on strict adherence to the Shariah law, which is considered essential. Any deviation from Shariah compliance will erode the credibility of Islamic finance and shake the confidence of investors and savers. To avoid muddying the waters between Islamic and conventional finance, Islamic finance must ensure that this distinct risk, i.e., non-Shariah compliant risk, is audited and properly handled (Syed, 2018). All IFIs operating in the banking and finance sector must adhere to Shariah standards in order to mitigate the negative effects of Shariah risks like usury (*riba*), gambling (*maysir*), and uncertainty (*gharar*). Any unethical business practises within the banking industry will not be tolerated under the current policy (Satkunasingam, 2006).

Shariah non-compliance risk is defined by Balz as the possibility that an Islamic financing transaction would be challenged on the grounds that it does not conform with Islamic law (Balz, 2008). Shariah-Risk is defined by other researchers as the risk of financial losses that an Islamic financial institution may incur as a result of non-compliance with Shariah precepts, as determined by the Shariah supervisory board or the competent authority in the relevant jurisdiction (Ginena & hamid, 2015). Shariah non-compliance risk may also lead to "legal risk," which is the failure to comply with contractual obligations, and "compliance risk," which is the risk of non-compliance with laws and regulations (Ginena, 2015).

The research conducted by Nabila Omar and Rusni Hassan (2019) demonstrates that SNC risk may stem from multiple sources, including the product's structure. Careful thought must be given to these factors, as any violation of Shariah law regarding the contract's provisions may result in Penalties. Since Islamic finance is distinct from its conventional counterparts, the documentation must not be in opposition with Shariah rules. The terms and conditions of the products and services provided by Islamic financing are more stringent. Even if the underlying contract complies with Shariah laws and principles, a Shariah non-compliant case may nonetheless arise if the product in question is executed improperly. Insufficient promotion or questionable and unsuitable marketing may provide a false image of the Islamic bank and the supplied product, so tarnishing the reputation of IFIs in the eyes of the general public. Nabila Omar and Rusni Hassan (2019) add that a weak system technology will make it more difficult to handle SNC risk efficiently.

Mechanism for Preventing Shariah Non-Compliance (SNC) Events

Shariah non-compliance event is a rising important risk and a tough issue that requires IFIs to prioritise its management and implement mitigating strategies. The mechanisms that commonly used by IFIs to prevent SNC events are:

1. A Soundness Shariah Governance Framework

Shariah governance is a framework by which Shariah non-compliance risk is assessed, and it can include both internal and external bodies. For instance, the Shariah board of the IIFS might be an internal mechanism for auditing Shariah-compliant products, or an external audit could serve as the point of reference. Important institutional structures include legal, regulatory, judicial, and legislative mechanisms to handle Shariah noncompliance risk (Ginena & hamid, 2015; Hamza, 2013). Shariah governance is important to guarantee that stakeholders have trust and confidence in the products delivered, and that they are informed of the Shariah-compliant nature of the transactions (Ginena, 2015).

One of the hazards mentioned in the Shariah governance structure is the interpretation of Shariah by Islamic scholars, either within the same Shariah board or across multiple Shariah boards. Lack of consistency among Shariah experts can result in Shariah non-compliance risk due to the possibility that a party may sue on

the grounds that the product is not compliant with Shariah law (Ginena, 2015). According to Hamza (2013), the soundness and dependability of Shariah governance will mostly depend on the autonomy of the Shariah Boards and the uniformity of their declarations and Sharia rulings within a state or region.

The Shariah governance principles of Islamic finance place a high value on strong corporate governance norms and structures, openness, information sharing, and adherence to those values. As a result, Choudhury and Hoque (2004) demonstrate an instructional Shariah governance framework for each organisation by exhibiting its comprehensive duties, functions, aims, and governing norms while taking Tawhid and shura epistemology into account (a joint board of Islamic scholars, Islamic bankers and lawyers). Islamic bank Shariah governance is diverse and distinct from regular corporate governance in that it provides a specialised governance structure under the umbrella of Shariah supervisory boards (Safieddine, 2009; Quttainah, 2013). The Shariah governance framework differs from traditional corporate governance in that it includes Shariah principles, a Shariah supervisory board, and Shariah officials. IFIs must establish a Shariah Department with some units to ensure Shariah compliance within their functions and activities.

Corporate governance regulates the compliance and practices of the institutions, making Shariah governance crucial and essential for IFIs. In addition, IFIs are required to observe Shariah values in all functions other than those governed by SG regulations. Thus, the absence of Shariah governance framework may lead to Shariah violations in IFIs, which may result in financial and non-financial losses. Furthermore, the lack of a comprehensive Shariah governance framework could diminish public confidence in the authenticity and legitimacy of the overall activities and results (Chapra, 2022). The most important concerns are the deterioration of the Islamic banks' institutional image and the erosion of their customers' faith (Zada, 2017).

Yet, Ginena and Hamid (2015) assert that Shariah governance is a comprehensive process of incorporating Shariah principles in the functions and transactions of IFIs. The SGF contains recommendations for a number of internal bodies, including the SSB, BOD, management, Shariah division executives, and Shariah auditors. Moreover, the IFSB defined Shariah governance in 2009 as a collection of global procedures through which IFIs ensure Shariah compliance from start to finish. In this instance, Hasan (2011) assumes that the ex-ante and ex post facto process of Shariah compliance enhances the credibility of IFIs. Thus, the legitimacy of IFIs in terms of their accountability and dependability can be bolstered through effective Shariah governance framework (Hidayah, 2014).

In Malaysia, the fundamental activities of the Shariah Governance Framework, such as Shariah risk management, Shariah review, and Shariah audit, must be done continuously to ensure the bank's successful management (Omar, 2019). Sections

28 (1) and (2) of IFSA 2013 are significant Shariah Required rules for Islamic banks and IFIs. It specifies that IFIs must guarantee that their objectives and their operations, business, and activities comply with Shariah law at all times. Compliance with any judgement and decision issued by the Shariah Advisory Council (SAC) about a particular objective, operation, business, or activity shall be considered Shariah compliance (Omar, 2019).

2. Internal Control

Internal control is a procedure intended to offer reasonable confidence on financial reporting, operational effectiveness and efficiency, and conformity with applicable laws and regulations (COSO, 2013). According to the internal control – integrated framework of the Committee of Sponsoring Organization (COSO), there are five primary components of internal control. First, control environment refers to the policies, processes, procedures, structures, and standards of internal control that are established by the board of directors (BOD) or the senior management of an organization and represent their perspectives on the significance of internal control practices. Second, risk assessment refers to the methods utilized to detect and evaluate an organization's SNC events in order to accomplish its goals. Furthermore, control process refers to activities based on policies and procedures that drive management directives to achieve organizational objectives. In addition, Information and communication refers to the means utilized to supply the information required to perform day-to-day internal control operations, including initiating, recording, processing, and reporting an organization's transactions. Monitoring refers to ongoing and/or distinct examinations conducted to measure the performance quality of a system over time (COSO, 2013).

The importance of internal control in any organization, particularly IFIs, cannot be overstated (Kamaruddin, 2018). This is due to the fact that effective internal controls aid in the management of all risks including SNC events, ensure that organizational operations are coordinated effectively, and contribute to sound managerial decision-making (Devi, 2007). Internal controls are considered an efficient method of risk mitigation. What this means is that there is a high danger that the organization will not be able to achieve its goals if it does not establish appropriate internal control methods. Internal control also plays a key function with regard to Shariah Islamic financial institutions 405 compliance management. In this instance, the internal control system and interaction between the Shariah committee and Shariah management team are utilized to guarantee that IFIs adhere to Shariah-compliant activities (Lewis, 2005).

Yet, prior research on the risk management practices of IFIs demonstrated that sufficient internal control as a component of risk management is still at a modest level (Ahmed, 2007). However, according to research by Rosman (2009), a high perception of risk in IFIs is a result of the absence of risk control through internal control, particularly with regard to operational risk. Internal control practices had

the lowest score on the corporate governance index for IFIs, which is 38%, (Darmadi, 2013). IFIs are recommended to establish a check-and-balance mechanism to identify any internal control system vulnerabilities and to update any outdated internal control procedures (Rahman, 2014). Thus, it is the obligation of the BOD and the Shariah committee of an IFI to ensure that internal control is adequately established and periodically reviewed, particularly for Shariah non-compliance issues. In order to do this, both the board and management of IFIs must be provided with the necessary expertise, not only in terms of internal control but also Shariah-compliance.

RESEARCH METHODOLOGY

For a study that analyses the range and diversity of any facet of social life, a qualitative approach is more acceptable and appropriate (Kumar, 2014). The qualitative technique is concerned with the subjective evaluation of ideas and attitudes and places greater emphasis on naturalistic settings. Due to the exploratory character of this research, a qualitative approach is judged more appropriate than a quantitative one for this work. This research achieves its aims through interview and document analysis. The purpose of the semi-structured interviews with respondents is to investigate the mechanism for Islamic Financial Institutions in preventing SNC events. Complementing the findings from the interviews are secondary data gathered from sources such as journal papers and the websites of authorized authorities. Table 1 below shows brief information of the interviewees:

Table 1: Respondents for the Current Research

No.	Respondent	Employment
1.	R1	Vice President (Risk Management), Development Financial Institution
2.	R2	Head of Shariah Review & Compliance, Development Financial Institution
3.	R3	Head of Shariah Review & Product Development, Commercial Bank
4.	R4	Shariah & Compliance Officer, Commercial Bank

ANALYSIS AND FINDINGS

The findings in this article will be based on the response by the respondents as mentioned in the above table. According to R1, mechanism for preventing SNC in Islamic financial institutions can be categorized as three namely Preventive Measure, Detective Measure and Corrective Measure.

“The preventive measure is through policy, framework and governance that existed inside the IFI as a pre-emptive measure to prevent SNC, secondly detective measure such as through check list that can be set up to measure the correctness of each

transaction and thirdly, corrective measure through Shariah review and Shariah audit process” (R1)

Based on response from the R1, it can be analysed that the SNC events in the Islamic financial institutions can be prevented through three measures as mentioned by the R1 and the process of identification and prevention are somewhat comprehensive for the IFIs. In reality, there is no room for SNC events if the process and measure are taken seriously by the IFIs.

R2 of the opinion that:

“The mechanism to prevent the SNC can be achieved through strong adherence and functions of the Shariah organs namely Shariah review, Shariah risk and Shariah audit...additionally through good business practices through proper check list of each process in the transaction” (R2)

It can be analysed as stated by the R2 that through adherence and comprehensive implementation of Shariah organs as mentioned in the Shariah Governance Framework monitored by BNM, the events of SNC are rare to be happened in IFIs. Nevertheless, human error and mistakes may lead to this event if not properly observed.

In addition, R3 mentioned:

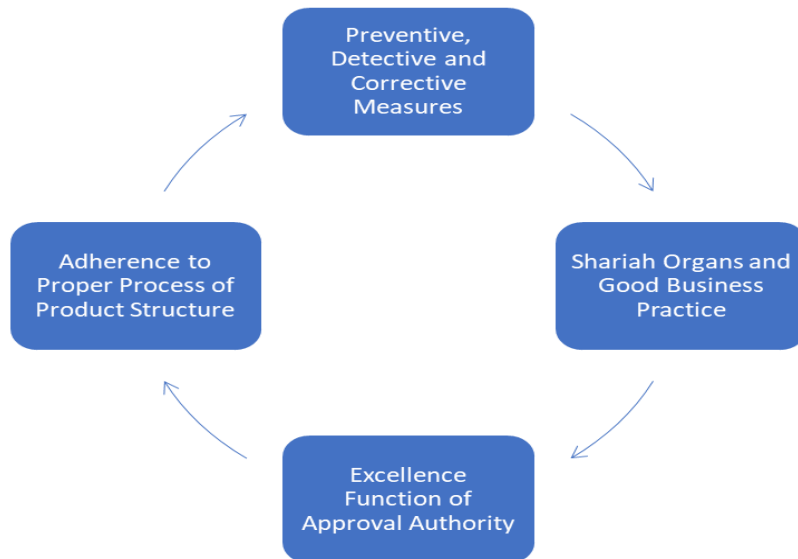
“SNC can be prevented through proper and excellence approval authority in the bank namely Shariah review team as well as Shariah Committee member of the bank, which it may avoid unnecessary mistakes with regards to Shariah if properly conducted” (R3)

R3 added a response that Shariah Review Team and Shariah Committee Member of the particular IFI able to prevent SNC events at the early stage. This response is coincided with R2 which highlighted the proper function of Shariah organs in the IFIs in order to avoid SNC events as early as possible.

According to R4:

“SNC event can be prevented if the IFI follow the exact process of new product structure as provided by the BNM before any product is launched in the market” (R4)

From the above explanation by the respondents, the Diagram 1 below shows the finding of this research, which is the Mechanism for preventing SNC event in IFI.

Diagram 1: Mechanism for Preventing SNC Event in Islamic Financial Institution

CONCLUSION

Since that IFIs are required to conduct their operations in conformity with Shariah principles, it is unquestionable that Shariah organs and audit should be implemented and utilized comprehensively. Based on the current research, the governance and internal control mechanism for Shariah-compliance lacks authorization and oversight, according to the results. This causes serious Shariah violations in the operations. SNC event will raise the risk management of IFIs and have a negative influence on the IFIs' reputation among their present and future clients. In this regard, it is vital to create a thorough, strong, and well-functioning internal control system for Shariah-compliance to guarantee that every SNC event is handled and controlled effectively. Hence, the whole staff of IFIs must establish and implement all protocols and procedures related to SNC events.

In order to prevent a recurrence of similar occurrences, proper checks and balances must be in place. Nevertheless, this research certainly has some limitations especially with regards to number of respondents that able to participate in this research due to their busy scheduled and commitments. In addition, due to the nature of IFIs which involves confidential and privacy of data and information, some data are not able to be discussed openly by the respondents.

Future research on SNC should be performed to fulfil the demands of the Muslim community in order to conduct economic transactions in a reasonable and equitable manner and to provide a solution to the SNC-related problem. Future researchers

must maintain their focus and keep their research regarding the current problem and solution of SNC in order to assist the ummah in avoiding Shariah non-compliance events in conducting commercial transactions for the purpose of a better improvement in economic sectors and as a reference for future generations.

ACKNOWLEDGEMENT

This research is benefited under Biduni Mizanniyah Research Grant, Universiti Sains Islam Malaysia (USIM) with the title: *Mekanisme Kawalan Bagi Insiden Ketidakpatuhan Shariah (Shariah Non-Compliance) Di Institusi Perbankan dan Kewangan Islam*. Research code: (PPPI/BM/FEM/USIM/13823).

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