

**THE 10th ISLAMIC BANKING, ACCOUNTING AND FINANCE
INTERNATIONAL CONFERENCE 2022
(iBAF 2022)**

**Potential Shariah Non-compliance Determinant Factors: A Guidance for Shariah
Control Function of Islamic Financial Institution in Malaysia**

Aizul Aiman Musa

Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia (USIM), Bandar Baru Nilai, 71800 Nilai,
Negeri Sembilan Malaysia
Tel: +60199049901 E-mail: aizulaiman@gmail.com

Zurina Shafii

Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia (USIM), Bandar Baru Nilai, 71800 Nilai,
Negeri Sembilan Malaysia
Tel: +606 798 6325 E-mail: zurina.shafii@usim.edu.my

Supiah Salleh

Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia (USIM), Bandar Baru Nilai, 71800 Nilai,
Negeri Sembilan Malaysia
Tel: +606 79886317 E-mail: chuyah@usim.edu.my

Abstract

Islamic banking is distinguished from conventional banking by its adherence to the principles of Shariah and it is perceived as a Shariah compliant financial intermediary which carry the image of Islam in providing the financial solution to the public especially for Muslim. Furthermore, as compared to its counterpart, Islamic banking is exposed to an additional risk that is peculiar to its operation which is Shariah non-compliance (SNC) risk. With that said, proper management of SNC risk is vital for Islamic banking since the impact of the risk could not just possibly affecting the financial but also the image its carry. One of the governance aspects in managing the SNC risk is the capability of its officer to identify, assess and report the SNC incident. In this regard, Bank Negara Malaysia (BNM) through its Operational Risk Integrated Online Network (ORION) policy document requires Potential SNC event and Actual SNC event to be reported to BNM. Referring to the latest ORION policy document issued in 2021, BNM has removed the requirement for a Potential SNC to be confirmed by a “qualified Shariah officer” and replaced with the “officer within Shariah control function” which could include officer with and without Shariah study background. Through this amendment, it raised question on the capability of the officer without Shariah study background to assess and subsequently confirm the incident as Potential SNC. This paper shall attempt to analyse the factor which contribute to Shariah non-compliance event in Islamic banking and develop a pragmatic parameter for the officer within Shariah control function as guidance for confirmation of Potential SNC event. This study adopted qualitative and case study approach focusing on one Islamic bank in Malaysia. The suggested parameter of Potential SNC event is based on the study of Shariah reasoning behind the decision of Shariah Committee for the Actual SNC events disclosed in the annual report of Islamic Financial Institution.

Keywords: Potential Shariah Non-Compliance Event; Shariah Non-Compliance Reporting; Shariah Control Function

1. Introduction

Shariah compliance is a vital aspect which all Islamic financial institutions (IFIs) shall observe. The term Shariah compliant refers to the adherence by IFIs to the religious laws of Islam, also known as Shariah. The Shariah is a religious code which governs the lives of Muslims in all aspects – including financial. Shariah compliance is a vital aspect which all IFIs shall observe in order to provide their customers with Islamic financial services in accordance with the Islamic requirements. The observance of Shariah compliance by IFIs is vital for the Islamic economy, since it ensures the upholding of religious values and principles, and also helps to increase the credibility of Islamic financial products in the eyes of consumers.

In this instance, the IFIs shall have in place an organizational structure and process in handling and managing Shariah non-compliance risk. Normally, the IFIs implement three (3) lines of defense concept; risk taking unit

being the first line, risk control unit being the second line and independent assurance unit being the third line. Overall, when we discuss about the management of Shariah non-compliance risk, it shall involve the analysis of the Bank's risk exposure to such risk, putting sufficient control in place as to proactively mitigate the risk and also to have the reporting system should the risk materialised.

The discussion in this paper shall be surrounding one aspect of such risk management which is the Shariah non-compliance event reporting mechanism of IFIs in Malaysia. As a background, Government of Malaysia has introduced Islamic Financial Services Act (IFSA) in 2013 which among other has outlined the importance of each IFIs to ensure that their aims, operations and business activities are all in compliance with the Shariah and also has provided the requirement for notification to Bank Negara Malaysia (BNM) and the IFIs internal Shariah Committee (SC) for non-compliance of Shariah (Malaysia, 2013). In relation to the reporting framework, BNM has first issued the Shariah non-compliance reporting guideline in 2013 which was then superseded with Operational Risk Integrated Online Network (ORION) policy document that outlined the Shariah non-compliance (SNC) event reporting requirement. In general, the policy document prescribed the process flow pertaining to SNC event and has classified the SNC event into Potential SNC event and Actual SNC event.

This paper shall only focus on the Potential SNC event of which it requires the confirmation to be made by the officer within Shariah control function. This study shall attempt to explore the determinant factor of Potential SNC confirmation using the qualitative case study approach and also by analysing the Shariah reasoning (*takyif fiqhi*) of the SNC event disclosure in the financial report of Bank Muamalat Malaysia Berhad (BMMB).

The significance of this study includes providing guidance and suggestion for the officer in the Shariah control function especially to those who does not have Shariah study background in confirming Potential SNC status of the reported or detected issues. The scope of the study is limited to the Islamic bank in Malaysia.

2. Literature Review

2.1 Potential SNC from Shariah and Regulatory Perspective

2.1.1 SNC from Shariah Perspective

Shariah in its literal meaning is a path to the source of water. By definition, Shariah can be defined as a divine revelation from Allah through its messenger to guide His creation on the path to live in this world. This would include all aspect in the human live such as belief, ethics, worship, the way human interacts with human, with nature or even animal. Above all, Shariah also comes with set of dos and don'ts which accompanied by the concept of reward and punishment by Allah. Anything that goes against the command of Allah or the rule sets out by Shariah is considered as Shariah non-compliance event and it is closely related to the concept of sin in Islam. Prophet Muhammad ﷺ explained the concept of good deed and sin in his hadith:

“Righteousness is in good character, and wrongdoing is that which wavers in your soul, and which you dislike people finding out about” (Hadith. Muslim. Kitab Al-bir wa al-Silah wa al-Adab. #2553)

The hadith explained the nature of good deed when we have a good morale and attitude while the nature of sin is when we did something which could disconcerting our mind of which we would like to conceal from everyone knowing it. In general, we can understand that the concept of SNC or sin in Islam would involve all its branches or principal namely; Fiqh Aqidah (act of believe), Fiqh Ibadah (act of worship), Fiqh Muamalat (law of transaction) and Fiqh Akhlak (morale) since all of these branches are established based on the command of Allah and His prophet.

In Islamic law of transaction, the general maxim outlined by Islamic scholar to be the foundation of ruling is *“the primary ruling for contracts and conditions in financial dealings is permissibility (unless proven otherwise)”*. This maxim indicates the general concept of contract between human being is allowable. With this, the Fiqh Muamalat discipline is made more dynamic, adaptive, accommodating, and flexible in its nature, allowing persons and institutions to play a greater role in their respective fields of expertise (Jalil et al., 2014). Although the general concept in contract and conditions is permissible, it is still bounded by certain Shariah requirements where failure to adhere could render the contract and conditions become Shariah non-compliance or have a potential to become SNC.

2.1.2 Actual Shariah non-compliance event

According to Islamic scholars, the effect of a contract in term of its validity could be categorized into two (2); *sahih* (valid) and *ghayr sahih* (invalid). *Sahih* contract refers to a contract that fulfill all its essential pillar (*Rukn*) and its related attributes (*Wasf*), also the contract is considered valid when the objective was met (Al-Razi, 1997; Al-Zarkashi, 1985). For instance, the sale contract is considered *Sahih* when its essential pillar such as offer and

acceptance was clearly executed, legal capacity of both contracting parties was sufficient and subject matter are Shariah compliant, and the objective of sale was met which is transfer of asset and ownership from buyer to seller, vice versa.

Whilst, the invalid contract being the opposite of valid contract is when its requirement was not met be it from the essential pillar or its related attributes. Although, majority of scholars do not differentiate the invalid contract – only *batil* – Hanafi school of taught has further classified the invalid contract into two; *batil* and *fasid* (Al-Razi, 1997; Al-Zuhaili, 2009). Al-Zuhaili (2009) explained the *batil* contract from Hanafi school of taught refers to defect in the essential pillar – offer and acceptance – or in the subject matter or lack of legal capacity while *fasid* contract refers to defect in its external conditions. Both would carry different consequences which the former would render the ownership become void and as for the latter, the ownership will only valid after the defect was removed and consent was obtained from the owner.

After all, in the context of Islamic law of transaction, non-fulfillment of the essential requirements of contract would render it become non-compliance to Shariah which requires rectification such as removal of the defect matter, purification of income and unwinding of contract. Dusuki et al. (2012) suggested that the Hanafi view is more practical in the current context as it provide more flexibility to the industry to apply the Islamic law as opposed to the view of majority of classical scholars.

Additionally, Islamic scholars classify the invalidity of the contract from the context of it caused into two (2); (1) invalid due to defect of its essence (*Haram li Dhatih*) and (2) invalid due to external reason (*Haram li Ghayrih*). The former refers to prohibition of itself such as prohibition of *riba*, prohibition of gambling which its original ruling is already prohibited. As for the latter, refers to ruling that was permissible in its original form but become prohibited due to the external factor such as sale during Juma'h prayer which the sale in itself is permissible but since it was done during Juma'h prayer it is prohibited or eating someone belonging unjustly which the act of eating in itself is permissible but since the way it derives is prohibited thus the eating is prohibited (Al-Salmi, 2005; Al-Taftazani, n.d.; Ibn 'Abidin, 1966). Al-Nawawi (n.d.), in his book *al-Majmu'*, gave another example of *Haram li Ghayrih* where he stated that a sale with undisclosed defect ('*Aib*) to the buyer while the seller knew about the defect is prohibited and he further explained:

وَحُرْمَتُهُمَا مُخْتَلِفَةٌ فَالتَّذْلِيلُ حَرَامٌ بِالْقَصْدِ فِي نَفْسِهِ وَالْبَيْعُ لَيْسَ حَرَامًا لِدَاثِهِ وَلَكِنْ حَرَامٌ لَغَيْرِهِ وَهُوَ كَمَا مَانَ الْعَيْبُ

(The prohibition (of sale & hiding the truth of the defect) is different. The falsehood is prohibited due to its essence and the sale is not prohibited by its essence but due to its attribute which is the act of undisclosed defect by the seller)

2.1.3 Potential Shariah non-compliance event

Apart from the above, there are circumstances in Shariah where the ruling is not clear which some Islamic scholar classified it as *shubhah*. The concept of *shubhah* was recorded in the hadith narrated by al-Nu'man bin Bashir:

“The lawful is clear and the unlawful is clear, and between the two of them are doubtful matters about which many people do not know. Thus, he who avoids these doubtful matters certainly clears himself in regard to his religion and his honor. He who falls into the doubtful matters falls into that which is unlawful like the shepherd who pastures around a sanctuary, all but grazing therein.” (Hadith. Muslim. Kitab al-Musaqah. #1599)

(Al-Nawawi, 1972), in his *al-Minhaj*, commentary book on Sahih Muslim, stated that the above hadith is one of the pivotal hadith which become the basis of most ruling in Shariah. Some Islamic scholar clustered this hadith to be one of three hadith that becoming the root of ruling in Shariah. This hadith shows there are also some circumstances in Shariah, albeit the clear ruling of *Halal* and *Haram*, human can also be in the state of *Shubhah* (doubtful). Referring to the classical Islamic jurisprudence, *Shubhah* is something that is uncertain on its permissibility or in the context of *Jinayat* (Islamic Law of Punishment), it refers to situation of ignorance or lack of evidence where the doubt still exists (Al-Jarjani, 1983; Al-Suyuti, 1983; Ibn Nujaim, 1999). There are two other terminologies which often used in discussing on this concept:

- i. *Al-Syak*: This refers to something which is uncertain between two things, it could be both doubtful matter stand on the same level of doubt or either one prevails. It also refers to situation where preferential was not made thus the matter left undecided (Al-Jarjani, 1983).
- ii. *Al-Dhzon*: This refers to something which is close to certain but could still have some room of doubt. Al-Jassas in his book *al-Fusul fi al-Usul* explained one of the types of *Ijtihad* would include the situation where

reasonable doubt is used in analogical reasoning (Qiyas) when the operative causes (Illah) is uncertain. Hence, *al-dhzon* is the highest level of probability or some would say the belief with reasonable doubt.

In Islamic law of transaction, *shubhah* could be in a situation where the contract resembles the prohibition such as Bai' al-Muhaqalah. This type of sale refers to a sale of unharvested grains with processed grain of its kind. This type of sale is prohibited due to the uncertain amount of subject matter and also it resembling to Riba (*Shubhah Riba*) which is invalid (Batil) from majority's view and voidable (Fasid) from Hanafis' (*Al-Mausu'ah al-Fiqhiyyah*, 1984).

In addition, the outcome of *shubhah* matter in general is two-sided; either it potentially turns into lawful activity or unlawful and in the context of transaction, the outcome could be valid or invalid. The same hadith suggest the concept of potential Shariah non-compliance event where the *shubhah* matter have more potential towards Shariah non-compliance event rather than Shariah compliance outcome. Hence, Shariah urges to avoid *shubhah* matter as to be safe. There is one Islamic legal maxim which states: "*Shubhah* does the work of the truth (in affirming the unlawful)²" (Al-Sarkhasi, 1993). This maxim suggests that *Shubhah* carries more burden towards unlawful from risk perspective hence it to be avoided or removed as to be innocuous.

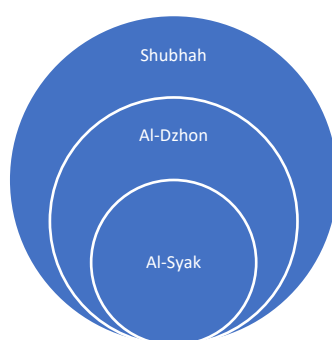


Figure 1: Component of Shubhah

2.1.4 SNC from Regulatory Perspective

Islamic Financial Services Act 2014 (IFSA) has outlined the importance of each Islamic Financial Institutions to ensure that their aims, operations and business activities are all in compliance with the Shariah (Malaysia, 2013). It is further supported by the BNM Shariah Governance Framework for Islamic Financial Institutions, which was revised in 2019 and called Shariah Governance Policy Document, which has stressed out the expectation to the board, Shariah committee and senior management in promoting a strong Shariah compliance risk culture within Islamic financial institutions (BNM, 2019).

Shariah compliance culture in Islamic banking institutions shall not only seen in the application of Shariah contracts used in the products offered, but Shariah compliance culture must also be seen in their aims, operations, business, affairs and activities of an Islamic banking institution. Failure to cultivate the Shariah compliance culture in all aspects outlined will expose the institutions to SNC risk. In this instance, Islamic Financial Services Board (IFSB) (2005) included SNC risk as part of the operational risk which defined as "The risk that arises from Institutions Islamic Financial Services (IIFS) failure to comply with the Shariah rules and principles determined by the Shariah Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate". Whilst, Section 28 (3) IFSA provides:

"Where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah or the advice of its Shariah committee or the advice or ruling of the Shariah Advisory Council, the institution shall—
(a) immediately notify the Bank and its Shariah committee of the fact;

² الشبهة تعمل عمل الحقيقة (في إيجاب الحرمة)

- (b) *immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and*
- (c) *within thirty days of becoming aware of such non-compliance or such further period as may be specified by the Bank, submit to the Bank a plan on the rectification of the non-compliance.”*

Based on the provision, it can be inferred that the SNC from regulatory perspective is when the business, affair or activity of IFIs is carried out in the manner contravene with; general Shariah requirement, resolution of its internal Shariah committee and ruling by the Shariah Advisory Council of BNM (SAC BNM).

In addition, BNM had introduced Operational Risk Integrated Online Network (ORION) policy document which the purpose is to require financial institution to report the exposure of operational risk to BNM which include Loss Event Data, Key Risk Indicators and Scenario Analysis (BNM, 2014). One of the reportable operational risk events that requires reporting into ORION is SNC event which shows that BNM as the regulator give a great concern on the Shariah risk exposed to IFI. In this regard, BNM has consistently, albeit the multiple revision of the policy document, classified SNC event into two (2) classifications; Potential SNC and Actual SNC. Potential SNC is defined as “any SNC event detected and confirmed by a qualified Shariah officer but pending decision by the SC” and Actual SNC is defined as “any SNC event that has been confirmed by the IFI’s shariah committee” (BNM, 2014, 2017, 2018a).

Interestingly, in the latest ORION policy document 2021, BNM had changed the definition of Potential SNC as “any SNC event detected and confirmed by an officer within the control function but pending decision by the SC” (BNM, 2021). In comparison to the ORION policy document version 2014, 2017 and 2018, BNM has removed the requirement for a Potential SNC to be confirmed by a qualified Shariah officer (QSO). BNM (2018b) , has defined qualified Shariah officer as an officer who holds at least a Bachelor’s Degree in Shariah, which includes study in Usul Fiqh (the origin of Islamic law) and Fiqh Muamalat (Islamic transaction / commercial). Whilst, the revised ORION has broadened the requirement to the officer within control function which is defined as an officer that meets the following criteria (BNM, 2021):

- (a) Performs one of the control functions under Shariah governance (i.e. Shariah risk management, Shariah review or Shariah audit);
- (b) Independent from the business lines and not involved in revenue generation activities; and
- (c) Possesses sound understanding of relevant Shariah requirements applicable to Islamic financial business.

2.1.5 Scope of Islamic Banking Business in Malaysia

Contrary to conventional banking, Islamic banking operates its business on the ground of Shariah principal without which it would have no different with conventional banking. Although, arguably, both types of banking are profit oriented organization and would have similar model of business which both are the intermediary in the society financial system but the way to achieve the goal is different (al Masry et al., 2015). As a financial intermediary, one might ask what is the scope of business which the bank can do? In this case, section 222 of IFSA provides the interpretation of Islamic financial intermediation activities which include:

- (a) the accepting of Islamic deposits or money under an investment account;
- (b) the giving of any advance, financing or other facility in whatever form or by whatever name called in accordance with Shariah;
- (c) Islamic leasing business;
- (d) Islamic factoring business;
- (e) the purchase of bills of exchange, certificates of Islamic deposit, Islamic securities or other negotiable instruments;
- (f) the acceptance of, or the giving of any guarantee in relation to, liability, obligation or duty of any person;
- (g) Islamic hire-purchase;
- (h) acquiring rights or interests in an Islamic hire-purchase, Islamic leasing or other similar transaction;
- (i) any activity that is incidental, ancillary or otherwise facilitates or is closely related to the activities referred to in paragraphs (a) to (h) above; and
- (j) such other business or activity as prescribed under section 3 (of IFSA).

In addition, section 15 of the IFSA has outlined that IFIs are restricted from carrying on any other business or activity in or outside Malaysia, unless the business or activity is:

- (a) its licensed business or is in connection with, or for the purpose of its licensed business;
- (b) specified by the Bank under section 14(1) of the FSA or section 15(1) of the IFSA; or

- (c) Islamic banking business, in the case of a licensed bank or licensed investment bank that has obtained an approval from the Bank under section 15(1) of the FSA.

Pursuant to item (b), BNM as the authoritative body that govern banking institution in Malaysia has specified the scope of business activity which can be carried out by banking institution in its guideline “Specification on Permitted Business or Activity for Licensed Person under Financial Services Act 2013 and Islamic Financial Services Act 2013”. Table 1 below summarized the specification of the guideline (BNM, 2015):

Table 1. Permitted and Prohibited Business Activity of licensed Islamic Bank.

Permitted Activity	Prohibited Activity
1. Activities which it is permitted under Schedule 4 of the Capital Market and Services Act 2007 (CMSA) under registered person (exclude underwriting of equities)	1. Engage in wholesale and retail trade including import and export trade except in connection with the realization of security given to or held by it for the purpose of carrying on its licensed business
2. Carry on money services business	2. Carry on underwriting of equities
3. Carry on custodial and clearing services for securities	3. Sell non-Shariah compliant products.
4. Carry on merchant acquiring services	
5. Sell takaful products on behalf of a licensed takaful operator	
6. Provide services for any related corporation, in or outside Malaysia, which carries on financial services	
7. Sell Shariah compliant financial products on behalf of a related licensed person or other related corporation in Malaysia which carries on financial services	
8. Provide estate planning and administration services	

Hence, subject to prior approval by BNM, the scope of business and activity which Islamic banks can do does not only limited to taking deposit and provide financing but it could include providing wealth management product such as takaful and estate planning, offer corporate advisory services for the related corporation, capital market product, merchant acquiring and selling third party product. The understanding on the scope of Islamic bank is paramount in crafting the factors to determine Potential SNC which relates to the Islamic bank business.

3. Methodology

The new ORION requirement on the confirmation of Potential SNC, as we can see, is extended to those who may not possess bachelor’s degree in Shariah but rather sufficient to have sound understanding of Shariah requirement. Some may argue on the capability of the officer without Shariah background to grasp the Shariah issue which it may create a difficulty for the officers to confirm whether an issue tantamount to Potential SNC event. This statement is supported by the research conducted by Omar & Hassan (2020) which highlighted one of the challenges faced by IFI in managing SNC event is the lack of knowledge of working level in detecting and analysing the Shariah issues. One of the recommendations highlighted is for BNM to come up with a criteria of SNC for the guidance of SC and QSO. Needless to say, if the suggestion to establish SNC criteria is for the guidance of SC and QSO – whom possessed Shariah degree – what more for those who does not have Shariah background. Here, the researcher agrees with the notion to have the parameter but the focus should be to guide the officer in the Shariah control function – especially for non-Shariah study background – in detecting and analysing the Shariah issues since their part in detecting Shariah issues is crucial for the event to be reported and further deliberated by SC.

The study employs qualitative approach using case study and content analysis methodology. This approach is more suitable to be used in order to achieve the objective and the information gathered is subjective in nature and the outcome could not be quantified in numerical form. This study shall take the disclosure of SNC event as stated in the Shariah Committees Report and Basel II Pillar 3 Disclosure in the financial report of BMMB as the case study and subsequently shall attempt to analyse the Shariah reasoning behind the decision of SC. Table 2 summarized the SNC event reported in the BMMB’s financial statement for the year 2019-2021.

Table 2. Summary of SNC event disclosed in BMMB Audited Financial Statement 2019-2021.

Year of Annual Report/Financial Statement	Report and Audited	SNC Event Disclosed
Directors' Financial Statements 31 March 2019	Report and Audited	1. SNC income from nostro account
Directors' Financial Statements 31 December 2019	Report and Audited	1. SNC income from five (5) number of events (The event was not disclosed in the report) 2. SNC income from nostro account
Directors' Financial Statements 31 December 2020	Report and Audited	1. One incident of zakat payment made to a different state zakat authority which was not as per the instruction on the Service Request Form (SRF) 2. Sponsorship granted to Shariah non-compliance event not as per the guideline approved by Shariah Committee of Bank Muamalat Malaysia Berhad
Directors' Financial Statements 31 December 2021	Report and Audited	1. Delay in allocating the gold in Muamalat Gold-i (Account) due to system error 2. Indication of repurchase term in the first aqad of Bai' 'inah 3. Two (2) events related to late payment charges due to system error 4. Two (2) events related to savings account used by customers for Shariah non-compliance purposes.

4. Discussion

From the disclosure, the SNC event occurred at the bank are not only related to the Shariah contract but also include other factors such as involvement with SNC entertainment, excessive charges and involvement of the Bank with SNC activities. Hence, the discussion here is beyond validity of Shariah contract such as valid or invalid contract but shall include *Haram* or *Halal* or *Shubhah* in the context of general Islamic transaction.

SNC event which occurred in 2019 is more straight forward where the Shariah reasoning of the SNC is *Riba* (interest) gained from the Nostro account. Nostro account is “an account that a bank holds in a foreign currency in another bank” according to Investopedia. All bank – including Islamic bank – which involve with foreign currency international trade or foreign exchange activity would have to open a Nostro account with its corresponding or agent bank at the correspond country in order to facilitate the trade or exchange settlement. Obviously, this Nostro account is a Shariah non-compliance account which operated based on conventional term (Syed Alwi et al., 2013). Similar to other type of deposit account, the correspond bank will give some return to the deposit placed, subject to terms and conditions such as minimum amount to be maintained (Thakur, n.d.). Needless to say, having placed the deposit with conventional bank, the return or interest gained from it is *Riba* in nature since the deposit will be used by the bank (which is a loan by depositor) and interest is promised upfront.

In 2020, the bank disclosed two (2) SNC events which are payment of Zakat not following the instruction and sponsorship for SNC event. For the former, SRF is the standard document where the customer of the Bank would like to make any changes or applied for certain services of the Bank. Referring to BMMB’s website, Ez- Zakat is a service provided by BMMB which it will calculate and make zakat deduction on behalf of its Muslim customer’s Current and Savings Account (CASA). Here, it is understood that Ez-Zakat applied Wakalah contract where BMMB is appointed by customer to be its calculation agent and payment agent. Based on the disclosure, it can be inferred that the Wakalah contract for Ez-Zakat is executed via SRF. The customer will specify their choice of Zakat institution and BMMB shall act on the instruction. The SNC in this case could be due to breach of certain condition which become the subject matter in Wakalah contract where the Bank acted contrary with the instruction by customer as the principal. As for the latter event in 2020, the SNC is not related to Shariah contract per se but it is related to the involvement of the Bank with SNC occasion where it breaches the internal guideline set up by SC. Here, we can see that SNC factor in the context of Islamic bank could be beyond the discussion of Shariah contract but rather would include the discussion on general commandments and prohibitions of Allah. In this instance, the act of giving sponsorship to SNC occasion is seemed to be contradicting with the command of Allah in His Quranic verse:

“Help each other in righteousness and piety, and do not help each other in sin and aggression” (Al-Maidah:2)

Move on to the latest financial statement 2021, the number of SNC event disclosed were increased. Some may argue that the increase of SNC event may indicate the weakness of internal control of the bank. Be that as it may, to some extent, the transparency in disclosing SNC event also shows that the risk management system of the bank is working finely which could boost the confidence and trust of customer, investor and the shareholder (Shafiai & Engku Ali, 2019). The idea is not just on the detection of SNC event but also the remedial action that has been taken to address the root cause of the issue as to prevent the same from recurring. In this case, the Shariah reasoning of SNC events occurred in 2021 are varies of which the first two (2) issues are related to Shariah contract where the first relates to *Riba Nasiyah* (delay in exchanging *ribawi* item) since – as per the terms and conditions - the underlying Shariah contract in Muamalat Gold-i is *Bai' Sarf* and the second relates to inter-condition terms

between first sale and second sale in *Bai' Inah*. Inter-condition term in *Bai' Inah* is prohibited according to the ruling by the SAC BNM (BNM, 2012). While the last two (2) events disclosed are not related to Shariah contract per se but it relates to excessive charges of late payment charge - in this case is *Ta'widh* (compensation) – which could give an adverse effect to customer and the bank is seem to have facilitated SNC activity, respectively for the two (2) issues. Table 3 below summarized the Shariah reasoning of all SNC events highlighted.

Table 3. Summary of Shariah reasoning of the SNC event disclosed in BMMB Audited Financial Statement 2019-2021.

Year of Annual Report/Financial Statement	SNC Event Disclosed	Shariah Reasoning
Directors' Report and Audited Financial Statements 31 March 2019	1. SNC income from nostro account	1. <i>Riba</i> (Interest from loan)
Directors' Report and Audited Financial Statements 31 December 2019	1. SNC income from five (5) number of events (The event was not disclosed in the report) 2. SNC income from nostro account	1. Could not be determine since the description of SNC event was not disclosed 2. <i>Riba</i> (Interest from loan)
Directors' Report and Audited Financial Statements 31 December 2020	1. One incident of zakat payment made to a different state zakat authority which was not as per the instruction on the Service Request Form (SRF) 2. Sponsorship granted to Shariah non-compliance event not as per the guideline approved by Shariah Committee of Bank Muamalat Malaysia Berhad	1. Contrary with the subject matter of <i>Wakalah</i> contract (<i>Haram Li Dzhatih</i>) 2. Seem to be associating with SNC activity (<i>Haram Li Ghayrih</i>)
Directors' Report and Audited Financial Statements 31 December 2021	1. Delay in allocating the gold in Muamalat Gold-i (Account) due to system error 2. Indication of repurchase term in the first aqad of <i>Bai' inah</i> 3. Two (2) events related to late payment charges due to system error 4. Two (2) events related to savings account used by customers for Shariah non-compliance purposes.	1. <i>Riba Nasiah</i> (Delay in exchanging ribawi item) 2. Invalid <i>bai' inah</i> contract due to inter-conditional (<i>Haram Li Dzhatih</i>) 3. Excessive charge of <i>Ta'widh</i> which render adverse impact to customer (<i>Haram Li Ghayrih</i>) 4. Seem to be facilitating the SNC activity (<i>Haram Li Ghayrih</i>)

Based on the Shariah reasoning as per Table 3, the determinant factors of SNC events in BMMB are quite a few and some of it is different in nature. The determinant factors of SNC events could be clustered according to its nature in order to develop the parameter of Potential SNC confirmation. The suggested parameter could be the guidance for the officer in Shariah control function in making decision, as far as ORION is concern. After all, the final decision would still rely on SC deliberation where some other factor could be taken into consideration – which is not the scope of this paper.

Illustration 1 depicts the parameter of Potential SNC confirmation which is based on the case study of the past SNC event. Officer in Shariah control function could assess the reported or detected SNC issues by using the parameter as a guidance in confirming status of Potential SNC. If the SNC issues hit either one of the parameter, the issues could be confirmed as Potential SNC event which it shall be reported to SC for further deliberation and confirmation.

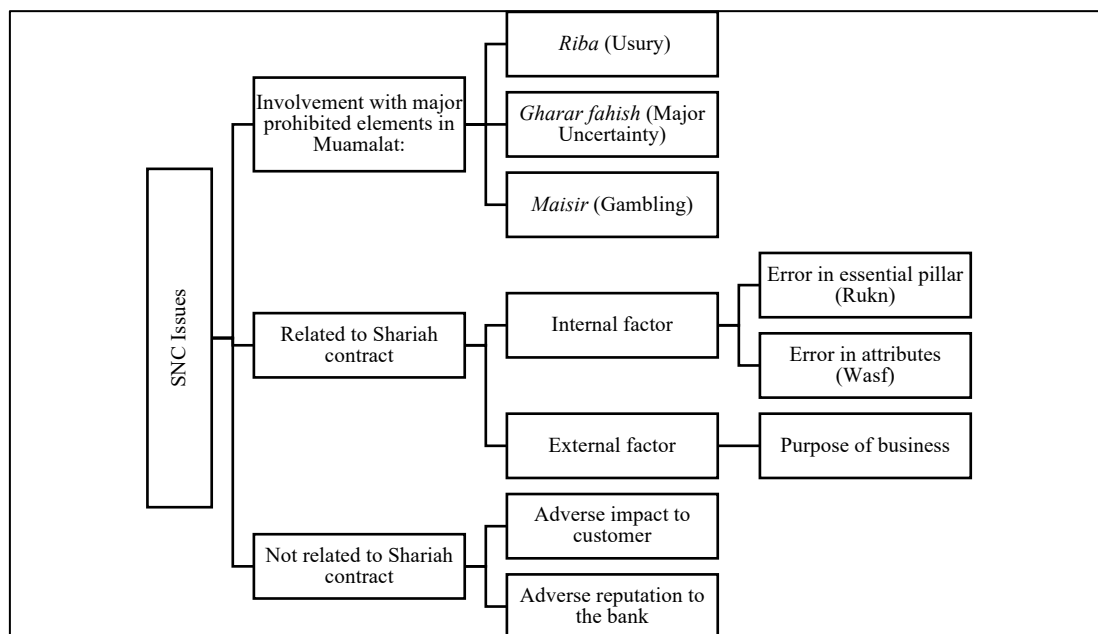


Illustration 1: Parameter of Potential SNC Confirmation

5. Conclusion

The scope of Shariah in Islamic banking operation does not only surround the discussion on Shariah contract but it also includes the value or morale on the name it carries. Officer in the Shariah control function of the bank must be able to articulate and relate the banking operation with Shariah requirement. It is important for the officer to have at least the basic knowledge in *Fiqh Muamalat* and *Usul Fiqh* – although it is not a requirement anymore - in order to assess the operational issues detected from Shariah perspective effectively. Of course, the final decision of whether the Shariah issue tantamount to SNC event relies on the decision of the SC but it started with the filtering process by the officer. Although the study is limited to one Islamic bank in Malaysia, but it is hoped that this paper could at least be the guidance for the industry and give an added value to the industry player.

References

- Al Masry, A., Debes, A., & el Baradie, M. 2015. Islamic & Commercial Banking Systems A Theoretical Comparison. *Asian Journal of Business Research*, 4(3). <https://doi.org/10.14707/ajbr.150005>
- Al-Jarjani. 1983. *Kitab Al-Ta'rifat* (First). Dar Kutub Ilmiah.
- Al-Mausu'ah al-Fiqhiyyah*. 1984. Wizarat al-Awqaf wa al-Shu'un al-Islamiyyah.
- Al-Nawawi. (n.d.). *Al-Majmu' Syarh Al-Muhazzab* (Vol. 12). Dar al-Fikr.
- Al-Nawawi. 1972. *Al-Minhaj bi Sharh Sahih Muslim* (Second, Vol. 11). Dar Ihya' al-Turath al-Arabi.
- Al-Razi. 1997. *al-Mahsool* (Third, Vol. 1). Muassasah al-Risalah.
- Al-Salmi, I. N. 2005. *Usul Fiqh - La Yasa'u al-Faqih Jahluhu* (First). Dar al-Tadmiriyyah.
- Al-Sarkhasi, M. A. 1993. *Al-Mabsut* (Not stated). Dar al-Makrifah.
- Al-Suyuti. 1983. *Al-Ashbah wa Al-Nadhzoir* (First). Dar Kutub Ilmiah.
- Al-Taftazani, S. A. M. (n.d.). *Syarah Talwih 'ala Tawdhih* (Vol. 2). Maktabah Sobih.
- Al-Zarkashi, B. A. M. ibn A. 1985. *Al-Manthur fi al-Qawaid al-Fiqhiyah* (Second, Vol. 2). al-Wizarah al-Awqaf.
- Al-Zuhaili, W. 2009. *Al-Muamalat al-Maliah al-Mu'asarah* (Seventh). Dar al-Fikr.
- BNM. 2012. *Circular on Implementation of Shariah Advisory Council of Bank Negara Malaysia's Resolution on Bai' 'Inah Effective Date*.
- BNM. 2014. *Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION)*. Bank Negara Malaysia.
- BNM. 2015. *Specification on Permitted Business or Activity for Licensed Person under Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA)*.
- BNM. 2017. *Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION)*. Bank Negara Malaysia.
- BNM. 2018a. *Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION)*. Bank Negara Malaysia.
- BNM. 2018b. *ORION Frequently Asked Questions (FAQ)*. Bank Negara Malaysia.
- BNM. 2019. *Shariah Governance Policy Document 2019*.
- BNM. 2021. *Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION)*. Bank Negara Malaysia.
- Dusuki, A. W., Ali, M. M., & Hussain, L. 2012. A Framework for Islamic Financial Institutions to Deal with Shari'ah Non-compliant Transactions. *ISRA Research Paper (NO. 42/2012)*.
- Ibn 'Abidin. 1966. *Rad Al-Muhtar 'ala al-Dur Al-Mukhtar* (Second, Vol. 2). Syirkah Maktabah wa Matba'ah Mustafa al-Babi al-Halbi.
- Ibn Nujaim. 1999. *Al-Ashbah wa Al-Nadhzoir* (First). Dar Kutub Ilmiah.
- Jalil, A., Ramli, A. M., & Shahwan, S. 2014. *The Four Introductory Theories of Fiqh Muamalat* (First). Wisdom Publication.
- Malaysia. 2013. *Islamic Financial Services Act 2013*.

- Omar, H., & Hassan, R. (2020). *Challenges Faced by Malaysian Islamic Banks in Treating Shariah Non-compliance Events*. 256–264. <https://doi.org/10.5220/0010145102560264>
- Shafiai, S., & Engku Ali, E. R. A. 2019. The Need for Credible Reporting of Shariah Non-compliance Event by Islamic Banks in Malaysia. In *Islamic Development Management* (pp. 249–261). Springer Singapore. https://doi.org/10.1007/978-981-13-7584-2_20
- Syed Alwi, S. F., Ibrahim, U., & Sawari, M. F. 2013. Issues on Islamic Banks' Nostro Account. *Terengganu International Finance and Economics Journal*, 3(2), 70–78.
- Thakur, M. (n.d.). *Nostro Account Meaning*. Retrieved June 22, 2022, from <https://www.wallstreetmojo.com/nostro-account/>