Sharī`ah Non-Compliance Risk Management and Legal Documentation in Islamic Finance

Ahcene Lahsasna

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AHCIENE LAHSASNA

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Foreword

First and foremost, I would like to seize this opportunity to extend my heartiest congratulations to Dr. Ahcene Lahsasna for writing this book. The timing of this publication is all the more relevant as Dr. Lahsasna encapsulates seismic past and present events, such as the 1997 Asian Financial Crisis and the 2008 global financial crisis.

We at Maybank Islamic are truly and deeply honored to be associated with this publication, which will prove to be instrumental in adding depth to the debate on Shari‘ah advisory in Islamic finance.

Maybank Islamic’s aspiration to become a global player in the industry is backed by the Shari‘ah Center of Excellence. The initiative aims to serve not only as a comprehensive and practical source of reference to the Islamic finance and banking industry but also to legal, regulatory, and academic institutions and contribute to the debate and development of the industry.

Islamic finance has made bold and progressive strides by endeavoring to reach beyond domestic and regional borders to become an increasingly important component of the global financial system. Consumers, sovereigns, and corporations at large are benefiting from the advantages of Shari‘ah-compliant banking solutions. It is therefore imperative, given the industry’s broad appeal and increasing popularity, that Islamic financial institutions adhere to Shari‘ah principles by virtue of a sound, consistent, and clear governance framework.

With the implementation of the Islamic Financial Services Act 2013 in May of that year in Malaysia, central governance has been consolidated into a single legislative framework. Such legal strength and certainty will surely allow Malaysia’s Islamic finance and banking sector to flourish in a responsible, ethical, and progressive manner while equipped with the tools to face the new complexities, uncertainties, and sophistication of the years to come.

—Muzaffar Hisham
Chief Executive Officer
Maybank Islamic
I would like to express my profound praise and thanks to Allah Almighty the Merciful; the Compassionate, Who enabled me to finish this book. I would like also to express my warmest greetings, appreciation, and thanks to Maybank Islamic for their kind support and co-collaboration in this research. A special thanks is extended to the chairman of the board of directors, Dato’ Seri Ismail Shahudin, for his wise direction and management, along with the other board of directors of Maybank Islamic. A special thanks to the CEO of Maybank Islamic, Mr. Muzaffar Hisham, for his strong support and commitment. A special thanks to the team of Maybank Islamic, who help me through their useful comments, advice, and support, especially Mr. Ramadhan Fitri Ellias, head of Shari‘ah Management; Mr. Mod Rusdi Che Yusof, head of Compliance and Review; Mohd Fikri Abd Ghapar, head of SME/BB; Ezry Fahmy Eddy Yusof, from Shari‘ah advisory; Rosmayati Ismail, head of Transaction Management; and others. I also would like to express my appreciation to the Association of Islamic Banking Institutions Malaysia for granting me the permission to publish its legal documents in this book. I hope that this book will be a significant contribution to the Islamic finance industry in the area of Shari‘ah compliance, Shari‘ah audit, Shari‘ah review, and legal documentation. I have to note here that the opinions expressed in this book represent the opinions of the author and not of Maybank Islamic.
About the Author

Associate Professor Dr. Ahcene Lahsasna (PhD, CIFP, ACIP, RFP, Sharīʿah RFP, Sharīʿah Advisor) is currently a lecturer at the International Centre for Education in Islamic Finance (INCEIF) Malaysia, known as the Global University of Islamic Finance. He is also the Graduate Studies academic advisor at the same university. He received his bachelor’s degrees in Islamic law and Islamic jurisprudence from Algeria, and his Master’s and PhD degrees in Islamic law and Islamic jurisprudence from IIUM (Malaysia). Dr. Lahsasna is equipped with industry qualifications as follows: Certificate Islamic Capital Market Sharīʿah Advisor (I Advisor), offered by the Securities Industry Development Corporation (SIDC), Securities Commission Malaysia; Certificate Islamic Capital Market (sukuk and structured products), offered by the SIDC, Securities Commission Malaysia; Chartered Islamic Finance Professional (CIFP), offered by INCEIF; Registered Financial Planner (RFP) and Sharīʿah RFP, offered by MFPC. Dr. Lahsasna is also a member of the ACIFP, Association of Islamic Finance Professionals, and National Council of Malaysian Financial Planning. Currently, Dr. Lahsasna is a registered Sharīʿah advisor at Bank Negara Malaysia and Securities Commission Malaysia; serves as Sharīʿah board member of Maybank Islamic, Etiqa Takaful in Malaysia, and RGA Re-Takaful based in Labuan; is on the Sharīʿah Advisory Council of MFPC; and is chairman of Takaful and Sharīʿah RFP at MFPC, Malaysia. Dr. Lahsasna has been appointed by the Finance Agency Accreditation as FAP (FAA Accreditation Panel).
Sharī'ah non-compliance risk is a unique aspect of Islamic finance that deserves specific focus. Research and studies should be dedicated to this topic in order to further expand its scope and depth, as it is still at its early stage and there is not much written about it. This book tries to lay down the first pillars and foundation in this emerging area of Islamic finance. Sharī'ah non-compliance risk means that the terms, conditions, and other related aspects agreed on in the contract do not effectively comply with the Sharī'ah rules and principles. In other words, the terms and conditions in the financial contract do not fulfill the Sharī'ah requirement, hence making the existing contract concluded invalid, or in need of rectification. It is very important to note that the risk management cycle and process should start from this point, because Sharī'ah non-compliance risk might be challenged at any point of the Islamic banking business activities, which may lead to legal conflicts, disputes, or litigations. Sharī'ah non-compliance risk may increase the risk portfolio of the Islamic Finance Industry (henceforth IFI), which may result in financial losses and reputational damages. In the context of this scenario, the present book tries to address this issue by discussing a few aspects related to the subject of Sharī'ah non-compliance risk management, which include but are not limited to the examination of legal documentations used in Islamic finance to make sure that they represent the Sharī'ah in its form, substance, and spirit. The Sharī'ah non-compliance risk and the methodology used within its process will identify the gaps between theory and practice.

1. PROBLEM STATEMENT

The main concern of this book is Sharī'ah non-compliance risk; it addresses the issues for the following questions:

- What are the types of Sharī'ah non-compliance risk in Islamic finance?
- What are the causes of Sharī'ah non-compliance risk in IFI?
- What are the tools and techniques used to identify the Sharī'ah non-compliance risk in Islamic finance?
What is the methodology and process used to address the Shari`ah non-compliance risk management in Islamic finance?

What are the types of issues in the legal documentation used by IFI in offering Islamic facilities?

What are the terms and conditions agreed on in the legal documentations that may trigger Shari`ah non-compliance risk?

2. OBJECTIVES OF THE RESEARCH

This book aims to achieve the following objectives:

- Introduce the framework of Shari`ah non-compliance risk management in Islamic finance.
- Identify the Shari`ah non-compliance risk in Islamic finance.
- Present the tools and techniques used to identify the Shari`ah non-compliance risk management in Islamic finance.
- Highlight the methodology used in Shari`ah non-compliance process.
- Elaborate on the Shari`ah rules and principles required in mitigating the Shari`ah non-compliance risk.
- Identify the Shari`ah non-compliance risk in legal documentation and operation.
- Eliminate Shari`ah non-compliance risk pertaining to legal documentations in Islamic banking facilities.
- Ensure Shari`ah compliance in legal documentation pertaining to Islamic financial contracts implemented by the Islamic banks.

3. METHODOLOGY

This research will use the following methodology:

- Induction methodology through collecting and checking the available legal documents and practices of the Islamic facilities offered by Islamic Financial Institution (IFI) in Malaysia.
- Analysis and comparative study methodology through the examination of the legal documents of selected financial transactions implemented by the Islamic banks.

4. THEORETICAL FRAMEWORK

This book tries to identify the area of Shari`ah non-compliance in Islamic finance, by introducing the Shari`ah non-compliance risk management
framework particularly in legal documents/contracts and practices of Islamic banks in various banking applications.

In order to achieve the objectives mentioned, the study has adopted the following approach.

4.1. Platform/Foundation of the Research

This platform is demonstrated in a discussion on the concept of *Sharī‘ah* non-compliance risk, followed by the nature of *Sharī‘ah* non-compliance risk in Islamic banking and finance, along with the Islamic tools and instruments to identify incongruence in *Sharī‘ah* non-compliance. In addition, there are some major elements of *Sharī‘ah* non-compliance risk in Islamic banking and finance that have been observed, such as *gharar* (uncertainty), *ghubn* (inequality), and others. There are also other factors that can cause *Sharī‘ah* non-compliance risk, such as human error, concept of risk, features of *Sharī‘ah* non-compliance risk, *Sharī‘ah* non-compliance risk events, and the *Sharī‘ah* basis for *Sharī‘ah* compliance.

4.2. Fundamental Blocks of the Research

The fundamental blocks represent the major pillars of the research; they form the *Sharī‘ah* fundamental requirements in contracts and the legal framework of the Islamic finance facility. These blocks are as follows:

4.2.1. *Sharī‘ah* Building Block/ *Sharī‘ah* Rules  *Sharī‘ah* rules are the first building block in this research; *Sharī‘ah* rules govern the fundamental Islamic principles and requirements in contracts and legal documentation in the Islamic finance facilities in the bank. The major elements of the contract are *sighah* of the contract (offer and acceptance), the contracting parties (seller and buyer), and the subject matter of a contract (goods and price). This *Sharī‘ah* building block enables the bank to structure the Islamic finance facility in a *Sharī‘ah*-compliant manner.

4.2.2. Legal Building Block/Legal Framework  The legal framework is the second building block, which is based on the incorporation of *Sharī‘ah* requirements into the legal documentations. It includes the functions of the legal documentations, determining the specific prohibitions that should be avoided in the terms and conditions of the legal documentation, and so forth. The purpose of incorporating *Sharī‘ah* requirements in legal documentation is to ensure *Sharī‘ah* compliance and monitor the *Sharī‘ah* non-compliance risk in the Islamic facilities. The critical areas in legal documentation are the terms and conditions (T&C) that affect the rights and liabilities of the
parties in the Islamic financial contract. In addition to that, the T&C govern the Islamic finance facility and represent a point of reference in case of dispute and litigation. The T&C include clauses such as right to recall, cross default, consolidation and set-off, prepayment clause, and others.

4.2.3. The Tools and Techniques Used for Shari`ah Non-Compliance Risk  The tools include accounting, financial statements, and cash flow. The techniques include observation, sampling, interviewing, and testing. The tools and techniques are both important to identify Shari`ah non-compliance risk.

4.2.4. The Process of Risk Management and Lines of Defence  This is related to the process and management of Shari`ah non-compliance risk, when the lines of defence have been used to screen Shari`ah non-compliance risk. The lines of defence, in order, are:

1. Product owner
2. Management of the IFI
3. Shari`ah risk management
4. Shari`ah management
5. Shari`ah committee/board
6. Board of directors
7. Shari`ah Advisory Council at the national level
8. Shari`ah review
9. Shari`ah audit
10. The public

These lines of defence play a crucial role in preserving the interest of Shari`ah in Islamic finance.

4.3. The Application of the Banking Facility  The Islamic finance application taken into consideration in this book represents various Islamic banking facilities in deposit and financing and other banking products and services.

5. THE TERMS USED IN THIS BOOK

- Shari`ah committee, Shari`ah supervisory board, and advisory board are used interchangeably. Shari`ah Advisory Council (SAC) refers to the Shari`ah Advisory Council of Bank Negara Malaysia.
- Shari`ah non-compliance risk and Shari`ah risk are used interchangeably.
- Shari`ah management, Shari`ah department, and Shari`ah advisory are used interchangeably.
CHAPTER 1

Fundamental Concept of Shari`ah and Shari`ah Non-Compliance Risk

1.0. INTRODUCTION

Shari`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-Shari`ah compliance status will trigger the legitimacy of the income generated by the Islamic financial institution. Hence, understanding the Shari`ah requirements in Islamic banking facilities and legal documentation is crucial. Shari`ah non-compliance risk consists of three important terms, namely: Shari`ah, risk, and compliance. A brief definition for each term is given below.

1.1. CONCEPT OF SHARI`AH

The Arabic word Shari`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 Shari`ah refers to the laws and commandments and way of life prescribed by Allah to mankind.³ Another definition of Shari`ah is: “The sum total of Islamic teaching and system, which was revealed to prophet Muhammad (s.a.w) recorded in the Quran as well as deducible from the Prophet’s divinely guided lifestyle called the sunnah.”⁴ In other words, “Shari`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 *Sharī‘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, *Sharī‘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. *Sharī‘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 *Sharī‘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:

- The word *Sharī‘ah* has a very wide meaning as compared to *fiqh*.
- *Sharī‘ah* consists of law, rules, regulations, commands, obligations, guidance, principles, ideology, faith, and behavior that govern the human being in every aspect of life.
- *Sharī‘ah* includes all aspects of human life in this world.
- *Sharī‘ah* is meant for two different worlds, happiness in this life and in the hereafter.
- *Sharī‘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.
- *Fiqh* contains human involvement such as the involvement of jurists who perform a sort of *ijtihād* and interpretation.
- The term *Islamic law* refers to *fiqh*, which can also be used to describe *Sharī‘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:

1. Compliance with laws, rules, regulations, Sharī'ah rules and principles, regulatory guidelines, and standards.
2. The prompt reporting of any compliance incidents (including Sharī'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 Sharī'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, Sharī'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 Shari‘ah rules and principles) at business/support sector as well as to mitigate/minimize the compliance/Shari‘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, \textit{Sharî`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 \textit{Sharî`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 SHARI‘AH 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 Sharī‘ah 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 Sharī‘ah board/advisor, to ensure compliance with Sharī‘ah 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.

The first principle is related to Sharī‘ah 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 Sharī‘ah non-compliance event and the failure in its fiduciary is the responsibility of the bank as well.
- According to IFSB, Sharī‘ah non-compliance risk is the risk that arises from IIFS’ failure to comply with the Sharī‘ah rules and principles, as determined by the Sharī‘ah board of the IIFS or the relevant body in
the jurisdiction in which the IIFS operate. Sharī`ah is highly appreciated in the Islamic bank operation, and failure to comply with Sharī`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: “Sharī`ah compliance is considered as falling within a higher priority category in relation to other identified risks. If IIFS do not comply with Sharī`ah rules and principles, their transactions must be cancelled and income generated from them shall be considered as illegitimate.”

Under principle 7.1 of Sharī`ah non-compliance risk, IFSB highlighted the following clauses:

- IIFS shall ensure that they comply at all times with the Sharī`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 Sharī`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 Sharī`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 Sharī`ah compliance review at least annually, performed either by a separate Sharī`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 Sharī`ah rules and principles as per the fatwa, policies, and procedures approved by the IIFS’ Sharī`ah board.
- IIFS shall keep track of income not recognized arising out of Sharī`ah non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of Sharī`ah non-compliance, the IIFS may assess potential profits that cannot be recognized as eligible IIFS’ profits.

1.4.2. Sharī`ah Compliance and Area of Coverage

Sharī`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