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SHARĪʿAH RISK MANAGEMENT PRACTICES IN MALAYSIAN *ISLĀMIC* BANKS

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ABSTRACT

Sharīʿah compliance in *Islāmic* banks is important to provide confidence and assurance to the public, as well as improve the credibility of *Islāmic* banking operations in the financial market. *Islāmic* banks can be potentially exposed to the *Sharīʿah* non-compliance risk if the operations and business activities do not adhere to *Sharīʿah* principles. In light of this, *Sharīʿah* risk management is very important in *Islāmic* banks. The Central Bank of Malaysia (Bank Negara Malaysia) requires *Islāmic* banks to incorporate *Sharīʿah* risk management practices as part of the necessary *Sharīʿah* functions in *Islāmic* banking institutions. This is part of the *Sharīʿah* Governance Policy Document, issued by Bank Negara Malaysia in 2019. The *Sharīʿah* risk management function is to systematically identify, measure, monitor and control *Sharīʿah* non-compliance risk and mitigate any potential non-compliance events. This is consistent with the other two *Sharīʿah* control functions, which involve *Sharīʿah* review and *Sharīʿah* audit. Within this setting, the present study is conducted to examine the existing *Sharīʿah* risk management practices in selected *Islāmic* banks in Malaysia as well as providing recommendations on the best *Sharīʿah* risk management practices. Institutional theory and contingency theory are used in this study. Interviews with several key officers from selected *Islāmic* banks were conducted to obtain their views on *Sharīʿah* risk management practices since they are involved directly in managing *Sharīʿah* non-compliance risks in their respective banks. Findings showed that existing *Sharīʿah* risk management practices in *Islāmic* banks are similar to those of conventional banking institutions in terms of risk identification, risk measurement, risk monitoring and controlling, and risk reporting. Nonetheless, for *Sharīʿah* risk management, the focus was on managing *Sharīʿah* non-compliance since *Sharīʿah* requirements need to be adhered to at all times. All of the interviewees from the selected banks agreed that the risk identification stage is the most crucial in *Sharīʿah* risk management. The implication of the study is to have a *Sharīʿah* risk management framework for *Islāmic* banks so that practices are consistently used. In addition, this can assist the *Sharīʿah* audit in conducting risk-based audit. Bank Negara Malaysia should also play a role by issuing guidelines on *Sharīʿah* risk management as a guidance for Islāmic banks in Malaysia.

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1. INTRODUCTION

The *Islāmic* Financial Services Board (2005) stated that *Sharīʿah* non-compliance risk arises from *Islāmic* banking institutions' inability to adhere to the *Sharīʿah* rules and principles established by an institution's own *Sharīʿah* Board or the relevant bodies in the jurisdiction where *Islāmic* banking institutions operate. *Sharīʿah* compliance is crucial to *Islāmic* banking institution practice, and such compliance necessity must be infused throughout the organization, its products, and activities. Since most fund providers use *Sharīʿah*-compliant banking services, their perceptions of *Islāmic* bank compliance with *Sharīʿah* rules and principles are critical for their sustainability. In this respect, *Sharīʿah* non-compliance risk is deemed the highest priority compared to other recognized risks. If *Islāmic* banks do not comply with *Sharīʿah* rules and principles, their transactions ought to be void, and any income made from them must be channelled to charitable organizations. Consequently, an efficient *Sharīʿah* risk management is crucial in managing *Sharīʿah* non-compliance risk and to improve institutional integrity and stakeholder confidence. The *Sharīʿah* risk management progression does follow the conventional risk management procedure by including risk identification, risk measurement, risk monitoring and controlling, and risk reporting in the operations, business affairs, and activities of the *Islāmic* Financial Institutions (*Sharīʿah* Governance Policy Document, 2019). However, the type of risks to be managed for *Sharīʿah* risk management is different which is the *Sharīʿah* non-compliance risk. Risk management, which is also relevant to *Islāmic* banks is for managing credit risk, market risk, liquidity risk and operational risk.

Since *Sharīʿah* risk management is one of the important *Sharīʿah* control functions in *Islāmic* banks to provide the support to the *Sharīʿah* committee in providing assurance on *Sharīʿah* compliance, *Islāmic* banks must ensure that oversight and management of the overall *Sharīʿah* non-compliance risk is structured such that the senior officers entrusted with control functions under *Sharīʿah* governance are able to exercise clear accountability over *Sharīʿah* non-compliance risk (Sharīʿah Governance Policy Document, 2019). This can instill and strengthen the *Sharīʿah* compliance culture to improve compliant behavior level.

This paper intends to examine the process affecting *Sharīʿah* risk management practices in selected *Islāmic* banking institutions in Malaysia and to offer recommendations on the most effective *Sharīʿah* risk management practices. This study is significant to the field of *Islāmic* banking in Malaysia and is related to the literature as it explores the *Sharīʿah* risk management practices in *Islāmic* banking institutions in Malaysia. As it is important for *Islāmic* banks to establish an effective *Sharīʿah* risk management in controlling the *Sharīʿah* non-compliance risk, the results of this study will add value to improving the integrity of *Islāmic* Financial Institutions (IFIs) in Malaysia and increase confidence of their stakeholders.

2. BACKGROUND OF THE STUDY

Islāmic banking institutions in Malaysia have begun to rise over the previous four decades from the formation of Tabung Haji, full-fledged *Islāmic* banks, *Islāmic* banking subsidiaries, Takaful institutions and *Islāmic* capital market. With the high growth of *Islāmic* banking institutions, in particular *Islāmic* banks, *Sharīʿah* compliance has become the most crucial matter observed by the stakeholders who participate in *Islāmic* banking business operations. The stakeholders who have invested in *Islāmic* banks are interested in ensuring that their investment has been ventured faithfully into a *Sharīʿah* compliant business (Grais and Pellegrini, 2006). Therefore, *Islāmic* banks need to operate in accordance with *Sharīʿah* principles to enhance stakeholder confidence. In 2010, Bank Negara Malaysia, as the regulator, has established the Shariah Governance Framework to provide a comprehensive guideline for *Islāmic* banking institutions to deliberate their activities and operations under *Sharīʿah* principles. This Shariah Governance Framework (2010) has superseded the Guidelines on the Governance of *Sharīʿah* Committee for the IFIs that regulates the governance of *Sharīʿah* committee of an *Islāmic* Financial Institution in 2004. The most recent guideline issued by Bank Negara Malaysia in 2019 is the Shariah Governance Policy

Document, effective in April 2020 to replace Shariah Governance Framework (2010).

The *Sharīʿah* risk management is still an important *Sharīʿah* function in the *Sharīiah* Governance Policy Document (2019) to ensure effective risk management of *Sharīʿah* non-compliance. *Sharīʿah* non-compliance risk refers to the risk of legal or regulatory sanctions, financial loss or non-financial consequences, inclusive of damages to reputations; *Islāmic* banking institutions may experience such circumstances from the inability to adhere to the rulings of the *Sharīʿah* Advisory Council (SAC) of Bank Negara Malaysia (BNM), which are standards on *Sharīʿah* matters issued by the BNM or decisions or advice of the *Sharīʿah* committee (Bank Negara Malaysia, 2019). The impact of *Sharīʿah* non-compliance risk includes non-financial impact, which are affecting the image of IFIs and not getting blessings from Allah as *Sharīʿah* Advisory Council's rulings are based on the sources of *Fiqh Muamalat*.

Several other definitions relate to the *Sharīʿah* non-compliance risk. Archer and Haron (2007) defined the risk of *Sharīʿah* non-compliance as "the risk of non-compliances resulting from a failure of an *Islāmic* bank's internal systems and personnel". Ginena (2014) asserted that *Sharīʿah* non-compliance risk is a type of operational risk which may include the risk of financial losses that an *Islāmic* banking institution may face in activities recognized by relevant authorities in the appropriate jurisdiction resultant of non-compliance with *Sharīʿah* principles. This is in line with the definition given by the Basel Committee on Banking Supervision (2011) on operational risk, which was defined as "the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events."

Bank Negara Malaysia places such a great importance in ensuring that the overall *Islāmic* financial system operates following *Sharīʿah* principles. The introduction of the *Islāmic* Financial Services Act 2013 that supersedes the *Islāmic* Banking Act 1983 imposed more strict regulations on *Islāmic* banks in Malaysia compared to before. Section 28(3) of the *Islāmic* Financial Services Act 2013. also regulates the actions to be taken when an *Islāmic* bank becomes aware that it is carrying on any of its business, affairs or activities in a manner not in compliance with *Sharīʿah* or the advice of its *Sharīʿah* committee or the advice or ruling of the *Sharīʿah* Advisory Council. The actions require the *Islāmic* bank to immediately notify Bank Negara Malaysia and its *Sharīʿah* committee of the *Sharīʿah* non-compliance event and immediately cease from carrying on such business, affair, or activity and from taking on any other similar business, affair, or activity. In addition, the *Islāmic* bank must submit a plan on rectifying the non-compliance to Bank Negara Malaysia within 30 days of becoming aware of such non-compliance. Failure to do this will result in the conviction, liability to imprisonment for a term not exceeding eight years or a fine not exceeding 25 million Malaysian ringgit, or both under Section 28(5) of the *Islāmic* Financial Services Act 2013. According to the Shariah Governance Policy Document (2010), an efficient and responsible board and management, an independent *Sharīʿah* committee that is both knowledgeable and accountable, assisted by active *Sharīʿah* review, *Sharīʿah* audit, and *Sharīʿah* risk management's functions, represents a sound and robust Shariah Governance Framework.

The Shariah Governance Policy Document (2019) requires the *Sharīʿah* risk management function to perform risk management processes so that *Islāmic* banks can mitigate any possible events that could lead to *Sharīʿah* non-compliance risk. In this case, the risk officer works to identify, measure, monitor, and control the *Sharīʿah* non-compliance risk as part of the integrated risk management framework in *Islāmic* banks. It is also crucial to highlight those *Islāmic* banks need a proper *Sharīʿah* risk management compared to their conventional counterparts because *Islāmic* banks are exposed to additional risks in their financial operations, which include *Sharīʿah* non-compliance risk and reputational risk (Van Greuning and Iqbal, 2008; Mohd Ariffin and Kassim, 2011). In the aspect of *Sharīʿah* risk management processes, Islāmic banks must develop a good risk management environment, such as an efficient risk measurement, mitigating and monitoring process together with an effective internal control (Khan and Ahmed, 2001).

Meanwhile, *Sharīʿah* compliance is not only related to *Islāmic* banking products. It also involves the structures, processes, people, and arrangements in *Islāmic* banks, which relate to the *Islāmic* financial operations. Failure to ensure *Sharīʿah* compliance in *Islāmic* banking activities and operations will lead to *Sharīʿah* non-compliance risk, which will jeopardize stakeholder confidence in *Islāmic* banking operations. The crucial need for governance and *Sharīʿah* risk management in preventing such losses can be observed from the disastrous losses experienced by the Ihlas Finance House in Turkey in 2001 (Ginena, 2014). In those cases, the *Islāmic* Financial Services Board developed the IFSB 1-Guiding Principles of Risk Management for Institutions (other than insurance institutions), which offer only *Islāmic* financial services that provide an inclusive guidance for risk management and reporting, including the *Sharīʿah* non-compliance risk as part of the operations in *Islāmic* banking institutions (*Islāmic* Financial Services Board, 2005). It is important to ensure a good governance system in *Islāmic* banking institutions is in place.

There is scarce literature on *Sharīʿah* risk management practices since they were only made mandatory in 2011 after the issuance of the Shariah Governance Framework in 2010 by Bank Negara Malaysia. Even in most *Islāmic* banks, the *Sharīʿah* risk management unit did not start too early. Since *Sharīʿah* non-compliance risk is part of operational risk, the tools used for *Sharīʿah* risk management is leveraging on the operational risk management tools. Hence, there are limited studies on *Sharīʿah* risk management practices in the literature.

Nevertheless, since *Sharīʿah* risk management is deemed as part of the banking operational risk, several studies on operational risk management have been examined. The complexity and fast expansion of the global banking sector in the past few decades have led to greater exposure to various kinds of risks, including operational risk. Since there is an increasing concern toward operational risk in *Islāmic* banking, several recent studies, for example by Abdullah and Shahimi (2011), Akkizidis and Khandelwal (2008), Archer and Haron (2007), and Izhar (2010) have highlighted this issue.

The banking sector is classified as a restricted industry as its operation involves a very high-risk exposure, which requires effective risk management. Arora and Agarwal (2009) explained that a bank is deemed a "risk machine" due to the risks taken, transformed, and embedded in products and services. Essentially, in terms of operational risk, *Islāmic* banks also encounter similar challenges as those faced by conventional banks as they also offer financial services in the various banking activities (Archer and Haron, 2007). This indicates that contemporary *Islāmic* banks face the same general exposure to operational risk as conventional banks. Furthermore, due to the specific contractual characteristics, the exposure to operational risk in *Islāmic* banks have the tendency to be critical (Van Greuning and Iqbal, 2008; Khan and Ahmed, 2001). Consequently, operational risk management in *Islāmic* banks necessitate a more detailed comprehension of operational risk sources from which losses could transpire (Izhar, 2010). The massive losses experienced by some financial institutions, such as Barings, Daiwa, and Merrill Lynch, were due to faulty operational risk management; hence, this is one of the crucial reasons for the analysis of operational risk to be considered highly significant at present (Hull, 2007).

Islāmic banking has grown rapidly since its advent four decades ago. It serves as an alternative to conventional banking. One of the unique characteristics that distinguishes *Islāmic* banks from their conventional counterparts is the compliance with *Islāmic* rules, i.e., *Sharīʿah* compliance (Abdelghani and Aziz, 2014). Although there have been studies on operational risk in Islāmic banks, no research is available on management of *Sharīʿah* non-compliance risk. Predominantly, *Islāmic* banking strictly forbids *riba'* (usury) or *gharar* (uncertainty) and demands all transactions to be *halal;* hence, added exposure to a new kind of risk has emerged. Additionally, Khan and Ahmed (2001) strongly agreed that, as a result of unique asset and liability structures in *Islāmic* banks, they face not only the same risks as conventional banks but also "new and unique" risks compared to conventional banking. The new and unique risks to *Islāmic* banks include equity risk, rate of return risk, displaced commercial risk and *Sharīʿah* non-compliance risk.

Notably, several studies have identified the perception of *Islāmic* banks on risk management. By using a field survey on 17 *Islāmic* banks from 10 different countries, Khan and Ahmed (2001) observed the banker perspective on numerous types of risks and issues linked to the risk management process in *Islāmic* banking institutions. The findings exhibited that bankers have rated the mark-up (interest rate) risk as the most significant risk, followed by operational risk, and liquidity risk. This outcome aligns with the study by Hassan (2009) on the most significant type of risks encountered by *Islāmic* banks in Brunei Darussalam. It was found that operational risk has been ranked among the top three of risk exposures to *Islāmic* banks in Brunei Darussalam. Meanwhile, Khan and Ahmed (2001) argued that *Islāmic* banks have comparatively higher operational risks, and these have a more extreme impact than credit risk and market risk.

Generally, there is some literature on the unique *Sharīʿah* non-compliance risk exposed by *Islāmic* banking institutions. Oz et al. (2016) attempted to examine the nature of *Sharīʿah* non-compliance risk and investigated its influence on the capital adequacy of *Islāmic* banks. The findings from 51 *Islāmic* banks in 11 countries showed that applying an extra capital charge to overcome *Sharīʿah* non-compliance risk in *Islāmic* banks would not achieve the purpose. The study further showed that the most applicable way for *Islāmic* banks to manage a high level of *Sharīʿah* non-compliance risk is to utilize available tools in the existing supervisory review process.

Since *Sharīʿah* non-compliance risk can also have a significant impact on *Islāmic* banks just like other risks, corporate governance needs to play its role in risk management regardless of risk exposure types. Kaen (2005) showed there is a positive connection between risk management and corporate governance. Both risk management and corporate governance should be integrated (McCrae and Balthazor, 2000). In addition, Van Greuning and Bratanovic (2009) identified the Board of Directors as the "ultimate risk managers" of a corporation when dealing with risk exposure impact. As *Islāmic* banks deal with much more risk exposure, specifically *Sharīʿah* non-compliance risk, Ginena (2014) proposed the importance of Board of Directors to provide risk management guidelines, to establish a robust risk management strategy, to foster a culture that stresses the importance of *Sharīʿah* compliance and to comment adequately on risk policies and control in annual reports.

Pertaining to the *Islāmic* bank risk management process, Rosman (2009) proposed that four important aspects in the process are: understanding risk and risk management, risk identification, risk analysis and assessment and risk monitoring, which are similar to the risk management process in conventional banks. The study anticipated a positive correlation between understanding risk and risk management, risk identification, risk analysis and assessment and risk reporting with risk management practices in conventional and *Islāmic* banks. The study, however, covered all types of risks in the banks (credit risk, market risk, liquidity risk, and operational risk), and did not only limit to the *Sharīʿah* non-compliance risk.

Embi and Shafii (2019) examined the risk management practices of *Islāmic* banks particularly in Malaysia. Specifically, the study aimed at investigating the level of the variables of understanding risk and risk management, risk identification, risk assessment and analysis, risk monitoring, credit risk analysis, and the risk management practices. Their findings showed that *Islāmic* banks are effective in their risk management practices. Risk monitoring was the most influential variable that affected the banks' risk management practices, followed by risk assessment and analysis, risk identification, credit risk analysis, and understanding risk and risk management.

Basiruddin and Ahmed (2019) investigated the relationship between corporate governance and *Sharīʿah* non-compliance risk and examined the roles of the *Sharīʿah* committee along with the Board of Directors in mitigating *Sharīʿah* non-compliance risk. The findings showed that banks with a smaller board size and higher proportion of independent board members were likely to have lower *Sharīʿah* non-compliance risk. The findings also indicated that the financial expertise and higher frequency of *Sharīʿah* committee meetings reduces the *Sharīʿah* non-compliance risk. The study, however, did not cover the *Sharīʿah* risk management process in *Islāmic* banks.

In Malaysia, one of the principles highlighted by Bank Negara Malaysia in the Shariah Governance Framework (2010) is that, in all *Islāmic* banks, there should be a robust *Sharīʿah* compliance function carried out through the review and audit functions and supported by risk management control process and internal research capacity. This is also similar to the principle mentioned in the Shariah Governance Policy Document (2019) in the exception of internal *Sharīʿah* research function which has now become the secretariat to the *Sharīʿah* committee. However, BNM did not specifically mention how all these functions should be operationalized in *Islāmic* banks. Therefore, the banks might translate the operation of all these *Sharīʿah*-related functions differently based on their level of understanding. In line with this, Khalid and Amjad (2012) concluded that in the case of *Islāmic* banks in Pakistan, a better understanding of risk and risk management, as well as risk monitoring and risk analysis could significantly contribute to *Islāmic* bank ability in undertaking better risk management. Based on the study by Hassan (2011) on 19 *Islāmic* banks and 24 conventional banks, the findings showed a positive relationship exists between risk management practices and understanding risk, risk identification, risk assessment, risk monitoring and risk analysis in both bank types. This implies that before moving into risk management activities, it is necessary for management to have a better understanding of risk first. An *Islāmic* financial institution shall ensure that its risk officers who perform the *Sharīʿah* risk management function have the requisite knowledge on *Sharīʿah* requirements applicable to *Islāmic* financial business (Shariah Governance Policy Document, 2019).

In ensuring effectiveness of an organization's risk management framework, the board and senior management must depend on adequate line of defense functions, including monitoring and assurance within the organization. The Institute of Internal Auditors (2013) recommended the "Three Lines of Defense" model to explain the link among these functions and to be used as a guideline in dividing responsibilities. The first line of defense includes the functions that own and manage risk belonging to the owner or business unit. The second line of defense involve functions that supervise or concentrate on risk management and compliance. The third line of defense offers independent assurance in the form of internal audit. The

Three Lines of Defense model is highly encouraged to be adopted by *Islāmic* banks. The first line of defense in the case of managing *Sharīʿah* non-compliance risk is the business unit (risk owner), the second line of defense will fall on the *Sharīʿah* risk management and *Sharīʿah* review, whereas the third line of defense is the *Sharīʿah* audit.

Hudin and Hamid (2014) suggested that institutional theory and contingency theory provide the theoretical base for implementing risk management practices in businesses. Institutional theory emphasizes that standard set of rules are mandatory to formulate an efficient risk management structure which can be achieved through institutionalization: "the process through which components of formal structure become widely accepted, as both appropriate and necessary, and serve to legitimate organizations" (Tolbert and Zucker, 1983). Therefore, for *Sharīʿah* risk management, the existence of the *Sharīʿah* risk management guidelines at individual *Islāmic* banks can enhance the *Sharīʿah* risk management practice. Accordingly, contingency theory suggest that implementation of risk management practices depends upon firm size, technology, and environment (Collier and Wood, 2011). Here, environment includes the policies from Bank Negara Malaysia, as stipulated in the *Sharīʿah* Governance Policy Document (2019) that provides key motivation for enacting *Sharīʿah* risk management practices.

From the risk identification aspect, Hassan (2009) discovered that *Islāmic* banks in Brunei Darussalam follow these important methods, namely inspection by *Sharīʿah* supervisors, executive and supervisory staff, audit and physical inspection, financial statement analysis and risk survey for risk identification. For measuring *Sharīʿah* non-compliance risk, Oz et al. (2016) found that the current method of measuring operational risk can be used to measure *Sharīʿah* non-compliance risk in *Islāmic* banks. Therefore, this indicates that there is no specific measurement introduced by the regulators on how to specifically measure *Sharīʿah* non-compliance risk.

Studies by Archer and Haron (2007) found that *Islāmic* banks expose a series of operational risks that are dissimilar from those exposed by conventional banks. They argued that the complexities of a number of their products, as well as the relative novelty of the contemporary financial services industry, in combination with an *Islāmic* bank's fiduciary roles of operating as a *Mudarib* (entrepreneur), signify those operational risks are highly substantial for *Islāmic* banks. As the *Sharīʿah* non-compliance risk is part of the operational risk of *Islāmic* banking institutions, this has provided evidence on the importance to manage the *Sharīʿah* non-compliance risk effectively. To ensure that risks are effectively identified and assessed, and that appropriate controls and responses are in place, effective risk management requires an effective reporting and review structure.

Bhatti (2020) discussed *Sharīʿah* non-compliance risk as a form of operational risk intending to ensure that operations in the *Islāmic* and banking finance industry comply with *Sharīʿah* procedures. The case of Beximco was studied using a comparative and normative method, as well as a legal analysis. The study suggested managing *Sharīʿah* non-compliance risk by augmenting the effectiveness of *Sharīʿah* governance systems with *Islāmic* banking and finance arbitration.

Most of the prior studies have examined the risk management practices in general, while studies undertaken for *Sharīʿah* risk management have been limited. Furthermore, the available literature has not provided such specific and detailed information as per need, and specifically, only a few studies have sought to analyze the risk identification, risk measurement, risk monitoring and controlling and risk reporting in *Islāmic* banks. Hence, this study contributes to filling this observed gap in the literature on *Sharīʿah* risk management practice and is expected to enhance academic studies based on the current issue and the literature.

3. RESEARCH METHODOLOGY

For this research, a qualitative research design was employed because it would allow the use of natural setting, data gathering from multiple sources, intense involvement of the researcher, and holistic account, among others (Creswell, 2014). A qualitative approach is designed to provide answers to what and how events unfold, to explore and research topics that require detailed answers (Creswell, 2013). The interview method was employed to gauge the perception of relevant officers in *Islāmic* banks toward the *Sharīʿah* risk management practices in selected *Islāmic* banks in Malaysia. Interviewing of selected interviewees is an important method used by qualitative researchers. Purposive sampling is widely used in qualitative research for identifying and selecting information-rich cases related to the phenomenon of interest. The aim is to collect in depth information from the right interviewees. Therefore, this study used purposive sampling technique based on key actors in *Islāmic* banks. The key actors are those having direct or indirect influence on the *Sharīʿah* risk management. The rationale of using the interview method is to find out what was on interviewees' minds, what they thought, and how they felt about a certain issue. Since interview is one method of obtaining primary data, face to face interviews were to be engaged (Creswell, 2014).

The study concentrated on four selected *Islāmic* banks in Malaysia. The interviews were conducted with the Head of *Sharīʿah* and Head of *Sharīʿah* risk management in the four selected *Islāmic* banks to understand their current *Sharīʿah* risk management practices. They have been involved directly in managing *Sharīʿah* non-compliance risks in *Islāmic* banks. Based on the Shariah Governance Policy Document (2019), the function of Head of Research is to provide day-to-day advice to relevant parties within IFIs on *Sharīʿah* matters based on the rulings of the SAC and decisions or advice of the *Sharīʿah* committee and for Head of *Sharīʿah* Risk Management is to systematically identify, measure, monitor and report *Sharīʿah* non-compliance risks in the operations, business, affairs and activities of IFIs, in this case *Islāmic* banks. Therefore, they are the best interviewees to be interviewed for this study.

In this study, written open-ended questions were prepared for the interviewees in a structured interview. The structured interview procedure protocol is important to be able to ask specific objective questions in an arranged order. Moreover, in line with the objective of the study, the open-ended questions were well structured and were asked to all interviewees to facilitate faster interviews that can be more easily analyzed and compared. This process encouraged the interviewees to respond to the questions as accurately as possible.

The focus of the interview is to gain in-depth understanding of the existing *Sharīʿah* risk management practice in Malaysian *Islāmic* banks. In order to develop the interview questions, the review of the existing *Sharīʿah* risk management guideline issued by Bank Negara Malaysia and also the previous literature related to *Sharīʿah* risk management practice in *Islāmic* banks are used. The length of the interview is approximately one hour for each interviewee. The data gathered from interview were transcribed and summarized according to categories, namely risk identification, risk measurement, risk monitoring and controlling, and risk reporting. In general, the data analysis intends to interpret text and image by way of data segmentation (Creswell, 2014). Creswell (2013) contended that data collection and data analysis must be done simultaneously in qualitative research. The information was then analyzed and interpreted following the objectives of the study.

4. FINDINGS

4.1 RISK IDENTIFICATION

Risk identification is mainly driven by the necessity to know the potential risks encountered by the organization from different processes and other potential sources. Benchmarks for identifying *Sharīʿah* non-compliance risk come from the rulings and decisions of the *Sharīʿah* Advisory Council of Bank Negara Malaysia, rulings and decisions of the *Sharīʿah* Committee of *Islāmic* banks and guidelines issued by Bank Negara Malaysia, for example *Sharīʿah* parameters. Consequently, the interview mainly sought to understand risk identification process for *Sharīʿah* non-compliance risk and to ascertain the stage at which the risk is triggered, with a focus on Business Units, *Sharīʿah* review, *Sharīʿah* audit, and regulatory inspections. The findings indicated similar risk identification practices in three of the four participating banks.

In general, all interviewees agreed that the most important process of *Sharīʿah* risk management is risk identification, as it relates to the process of understanding the nature and impact of the risk on the institution's current and future operations. The main purpose of the risk identification process is to identify the main causal factors contributing to incidents of non-compliance.

Risk Control Self-Assessment (RCSA) was found to be the common tool for risk identification, while the first stage for triggering *Sharīʿah* non-compliance risk differs among *Islāmic* banks. The RCSA is a useful self-assessment tool for identifying possible breaches of *Sharīʿah* parameters within the end-to-end process of each function. Accordingly, the interview findings showed that the responsibility to identify and assess *Sharīʿah* non-compliance risk is borne by the respective process (risk) owners. For instance, in Bank A, the interviewee noted that "the most critical part is the functional unit itself, which owns the *Sharīʿah* non-compliance risk and responsible to identify the risk." This further necessitated deployment of a Risk Controller at each functional unit and branch. Similar function was found in Bank C, with designations including Designated Compliance and Risk Officer (DCRO) and Risk Control Officer (RCO) for every business unit. The DCRO subordinates the RCO. Interestingly, "one of their Key Performance Indicators (KPIs) is self-identifying the breaches. The more they identify, the better their KPIs," the interviewee from Bank C disclosed. As for Bank D, the interviewee informed that, "the respective risk officer must identify and highlight the issue to the respective authority." Therefore, it can be noted that identifying the *Sharīʿah* non-compliance risk rests on the process owners and officers within functional units.

Consequent to RCSA practices, Business Units were found in three banks to be the first predominant triggering process for *Sharīʿah* non-compliance risk. In general, in both Banks A and C, the Business Unit is deemed as the first line of defense in identifying *Sharīʿah* non-compliance risk, while the *Sharīʿah* Review and *Sharīʿah* Audit are regarded the second and third line of defense, respectively, in improving identification of *Sharīʿah* non-compliance risk of the Business Units. For instance, the interviewee for Bank A emphasized that "when the second and third line of defense come, it is just to complete what has been done by the first line of defense (Business Units)." The interviewee further explained that in most cases, it is difficult for the *Sharīʿah* Review and *Sharīʿah* Audit to find any undetected *Sharīʿah* non-compliance risk due to the effectiveness of the Business Unit's risk identification process. Business Units include all units in *Islāmic* banks, for example finance, marketing, product, recovery and disbursement. Thus, there is minimal possibility that the other processes (lines of defense) will identify *Sharīʿah* non-compliance risk. In this regard, the interviewee from Bank D affirmed that "the chance is very minimal, though it is possible if the *Sharīʿah* non-compliance risk is not identified." Nevertheless, the interviewee from Bank C argued that the second and third lines of defense are important as there is a possibility that the "Business Units will overlook some of the risks".

In contrast, *Sharīʿah* review is the first process which triggers *Sharīʿah* non-compliance risk in Bank B. In this bank, "basically, we trigger the *Sharīʿah* non-compliance risk during our *Sharīʿah* review or *Sharīʿah* audit," noted the interviewee. The indication here is that the *Sharīʿah* Review involves regular review to identify the potential *Sharīʿah* non-compliance risk for safeguarding measures to be instituted. Consequently, the Business Units detect no risk of *Sharīʿah* non-compliance during or post implementation of contracts, products, and procedures. The interviewee testified that:

> "When the implementation starts, Business Units will not detect the risk anymore because they implement based on the Standard Operating Procedures (SOPs) approved by various committees. So normally, we detect the *Sharīʿah* non-compliance risk when we conduct the *Sharīʿah* Review."

The above indicates that the Business Units' process will not trigger the *Sharīʿah* non-compliance risk due to the implementation of approved SOPs. This is possible where the RCSA is either not placed or applied effectively. One of the key secondary findings is that, since the RCSA places responsibility to risk owners, the respective staff must have *Sharīʿah* knowledge to be able to identify the *Sharīʿah* non-compliance risk. In case of doubt, they require the support from dedicated *Sharīʿah* risk management functions in *Islāmic* banks.

For Bank D, in general, a *Sharīʿah* compliance governance requirement was incorporated in all of the bank's procedures and manuals. For triggering *Sharīʿah* non-compliance risk, the respective officers must highlight the issue to the respective authority. The respective authority must be notified immediately when the risk triggers. From this, based on the existing internal process and Bank Negara Malaysia's requirement, the responsibility is clear. All *Sharīʿah* non-compliance occurrences, upon discovery, are regarded as potential *Sharīʿah* non-compliance and must be discussed in the *Sharīʿah* Committee meeting. Essentially, *Islāmic* banks follow the guidelines issued by Bank Negara Malaysia. If there is any *Sharīʿah* non-compliance occurrence, the respective staff needs to bring the issue to the *Sharīʿah* committee. All the relevant functions must obtain the decision from the *Sharīʿah* committee, regardless of whether a potential *Sharīʿah* non-compliance event becomes an actual *Sharīʿah* non-compliance event.

To conclude, from the interview, all interviewees agreed that the *Sharīʿah* risk management is part of the operational risk management. Therefore, the methodology, including risk identification, measurement, monitoring, and others, is embedded in the operational risk framework. In risk identification, the course of identifying could occur at the first line of defense (risk owner), the second line of defense (*Sharīʿah* risk management and *Sharīʿah* review), and the third line of defense (*Sharīʿah* audit). The best-case scenario is when the *Sharīʿah* non-compliance risk is identified at the first line of defense, which will create an effective management of *Sharīʿah* non-compliance risk.

However, there is a possibility for the Business Units (risk owners) to overlook a *Sharīʿah* non-compliance risk event; yet the *Sharīʿah* review or *Sharīʿah* audit would be able to identify the issue. The chance that the *Sharīʿah* review, *Sharīʿah* audit, and Bank Negara Malaysia would come to identify similar issues as those of the business unit is very minimal. This could happen if they had performed the work at the same time and/or the issue was still not resolved. If the issue was resolved, the bank would normally make all the rectifications.

4.2 RISK MEASUREMENT

Risk measurement is the evaluation of the tendency that *Sharīʿah* non-compliance risk will have an impact on *Islāmic* banks. Therefore, the interview was conducted to identify the tools that *Islāmic* banks use to measure the *Sharīʿah* non-compliance risk. The findings affirmed that RCSA is the predominant tool for measuring the *Sharīʿah* non-compliance risk. This is not surprising as it appears to be the main risk management tool for *Islāmic* banks, as demonstrated in the earlier section. The findings further revealed that there is no detailed guideline for the specific measurement of *Sharīʿah* non-compliance risk. Consequently, the banks utilize risk management tools commonly used for conventional operational risk management in developing their guidelines. Only Bank D has not developed a guideline for the *Sharīʿah* non-compliance risk's RCSA. For instance, the interviewee of Bank A stated that "we have a detailed guideline. RCSA also has its own guideline and manual." Based on their respective guidelines, some *Islāmic* banks classify the *Sharīʿah* non-compliance risk as 'major,' 'moderate,' and 'low' while others use 'severe,' 'medium,' and 'tolerable.' For example, the *Sharīʿah* non-compliance risk will be classified as 'severe' if the event of non-compliance leads to contract invalidation or income derecognition. The middle risk category (medium) refers to a situation where the *aqad* requirements are not fulfilled. The tolerable risk applies to incidents which do not give rise to the effects of severe and medium risks. The banks' appetite primarily drives the risk ratings.

Uniformly, the impact of the *Sharīʿah* non-compliance risk is categorized as either financial or non-financial. In the case of the former, it is channelled to charitable organizations. For Bank B, there is also a combination of tasks between *Sharīʿah* department and Finance department. This is because the Finance department is responsible for the financial part. If the Sharīʿah non-compliance event leads to a financial impact, the income generated will be derecognized and channelled to charitable organizations or returned to the original owner. The *Sharīʿah* Committee must ensure that this action is done by the Finance department with the help of *Sharīʿah* department. In addition, this will be included in the *Sharīʿah* Committee Report of *Islāmic* banks.

In the absence of a guideline, all the banks, except Bank D, have called for a detailed guideline for measurement of *Sharīʿah* non-compliance risk. According to the interviewee of Bank D, *Sharīʿah* non-compliance risk is subjective. He said that "basically, this matter *Sharīʿah* non-compliance risk measurement is really subjective. As a result, we do not have a clear methodology." Nevertheless, the methodology for the *Sharīʿah* non-compliance risk rating exists. The interviewee explained that:

> "The bank does not have a clear methodology. However, similar to *Sharīʿah* review, the bank has its own risk rating. For *Sharīʿah* non-compliance risk, the methodology for risk rating is based on whether there is a breach of *Sharīʿah* requirement or not, as resolved by *Sharīʿah* committee and whether the contract is null and void."

The implication of the above quote is in contrast with Bank A, which has a detailed and well-defined methodology. In Bank A, the process is very structured with a clearly defined *Sharīʿah* non-compliance risk rating. Generally, the findings suggested that measuring the possibility and impact of the *Sharīʿah* non-compliance risk differs among banks, aggravated by the lack of a comprehensive regulatory guideline. However, if an *Islāmic* bank is able to have its own comprehensive guideline, in the absence of regulatory guideline to measure the impact of the *Sharīʿah* non-compliance risk and approved by its *Sharīʿah* committee, this can assist in measuring the *Sharīʿah* non-compliance risk in a more systematic manner.

4.3 RISK MONITORING AND CONTROLLING

The next stage in the risk management process deals with risk monitoring and controlling. Risk monitoring can be used to ensure that risk management practices are sound and effective. Proper and effective risk monitoring also helps *Islāmic* banks to discover mistakes at an early stage rather than suffering the bad consequences from dormant untraceable risks. The risk monitoring mechanism must monitor the variables and factors that can lead to *Sharīʿah* non-compliance risk. The monitoring process utilizes data collected from the previous audit or inspection.

Risk monitoring can be used to ensure *Islāmic* banks shall have in place effective structures to monitor, control and report *Sharīʿah* non-compliance risks in their activities. Based on the interview findings, one of the tools used in risk monitoring is Key Risk Indicators (KRIs). According to the BNM Operational Risk Integrated Online Network (ORION), KRIs refer to information that will provide insight into the operational risk exposure including *Sharīʿah* non-compliance risk and are used to monitor the main drivers of exposure associated with the key risks. KRIs can be utilized to measure the actual value of the cause and effect resulting from *Sharīʿah* non-compliance events. KRIs will predict potential *Sharīʿah* non-compliance events, allowing *Islāmic* banks to take reasonable preventive and corrective actions to avoid any losses resulting from such non-compliance events. KRIs are mostly quantitative indicators used to provide insight into operational risk exposures and controls.

The interview findings indicated that all interviewees agreed on the importance of KRIs in risk monitoring and controlling of *Sharīʿah* non-compliance risk. According to the interviewee from Bank A:

> "Chief Risk Officer is responsible to provide leadership to ensure that all risk is monitored and controlled. In order for Chief Risk Officer to discharge the responsibilities to highlight key risks, including *Sharīʿah* non-compliance risk, he needs to ensure functional area which own the risk to identify the risk, risk officers to monitor and control the risk using KRIs."

4.4 RISK REPORTING

Generally, in the case of *Sharīʿah* non-compliance risk, the reporting is required so that a comprehensive overview of risks can be obtained. Bank Negara Malaysia has specified the reporting requirements in its ORION. All *Islāmic* banking institutions must submit both potential and actual *Sharīʿah* non-compliance occurrences through the ORION. Nonetheless, the ORION describes a potential *Sharīʿah* non-compliance occurrence as any *Sharīʿah* non-compliance event distinguished and corroborated by only an officer within the control function; it defines the actual *Sharīʿah* non-compliance occurrence as any potential *Sharīʿah* non-compliance event that has been substantiated by *Islāmic* banks' *Sharīʿah* Committee.

A potential *Sharīʿah* non-compliance event must be reported in the ORION within one working day upon confirmation by an officer within the *Sharīʿah* control function. It must be tabled at the *Islāmic* bank's *Sharīʿah* Committee meeting within 14 working days for a decision. If the *Sharīʿah* Committee deduces it as an actual *Sharīʿah* non-compliance event, it must be reported within one working day. Subsequently, a rectification plan must be completed within 30 calendar days from the reporting date of the actual *Sharīʿah* non-compliance event. *Islāmic* bank's *Sharīʿah* Committee and Board of Directors must approve the plan before submission. Finally, *Islāmic* banks are required to monitor or follow up, to ensure that actual *Sharīʿah* non-compliance events are resolved with appropriate control mechanisms established to avoid recurrences. Such actions must be updated accordingly in the ORION.

In line with the regulatory requirements, this study aimed at ascertaining the extent that *Islāmic* banks follow the ORION policy document requirements. The interview findings indicated similar practices for all *Islāmic* banks under study. For instance, the interviewee from Bank B explained that the bank follows the time frame given by Bank Negara Malaysia. He said that:

> "There is a time frame. When we find the issue of *Sharīʿah* non-compliance events, we need to key-in in the ORION and submit to Bank Negara Malaysia. During that time, we only identify the potential *Sharīʿah* non-compliance risk. After confirmation by the *Sharīʿah* Committee, we need to resolve this issue within a certain period. We need to submit our report and rectification plan to the *Sharīʿah* Committee and the Board for endorsement. Lastly, we submit to Bank Negara Malaysia."

Based on the practice by Bank D, the interviewee described that they need to immediately notify the exact time of becoming aware of the risks, as required by their internal process and guided by Bank Negara Malaysia's ORION requirement. An officer within the *Sharīʿah* control function is responsible to confirm if there is any potential issue. Basically, the *Sharīʿah* Committee may delegate one respective officer for such duties. Actual confirmation of *Sharīʿah* non-compliance events is done by the *Sharīʿah* Committee.

5. CONCLUSION AND RECOMMENDATIONS

This study was expected to provide some empirical evidence on the *Sharīʿah* risk management practices in mitigating *Sharīʿah* non-compliance risk from the *Sharīʿah* review and *Sharīʿah* audit functions. Overall, the findings confirmed that all *Islāmic* banks in this study do have a good *Sharīʿah* risk management practice. *Islāmic* banks must certify that the *Sharīʿah* risk management procedures are efficient and effective, and that a similar risk management process is applied to the risk management of other non-specific risks, such as credit risk and market risk, which can be used as long as *Sharīʿah* principles are adhered to. The only exception to the above relates to the way *Islāmic* banks measure *Sharīʿah* non-compliance risk.

As a general suggestion, it is mainly essential to ensure the effectiveness of all three lines of defense, which are the Business Unit, the *Sharīʿah* review, the *Sharīʿah* risk management and *Sharīʿah* audit, so that the public is confident that *Islāmic* banking institutions' business operations and activities always conform to *Sharīʿah* principles. However, there is a need to have a comprehensive *Sharīʿah* risk management framework for respective *Islāmic* banks so that the practices are consistently used in the banks and can assist the *Sharīʿah* audit to conduct risk-based audit. This is in line with the institutional theory that *Sharīʿah* risk management that argued the existence of standard set of rules is mandatory to formulate an efficient risk management structure which can be achieved through the process widely accepted by *Islāmic* banks. The *Sharīʿah* non-compliance risk manual will be particularly useful as a reference by *Sharīʿah* review and *Sharīʿah* audit officers in performing their tasks. In addition, Bank Negara Malaysia should play a role by issuing guidelines on *Sharīʿah* risk management as a guidance by *Islāmic* banks in Malaysia, which is consistent with the contingency theory that confirmed the implementation of risk management practices depends upon environment, namely the guidelines issued by the regulator. The officers involved with the *Sharīʿah* risk management are accountable for overseeing the effectiveness of *Sharīʿah* risk management and the day-to-day management of the *Sharīʿah* non-compliance risk in *Islāmic* banking institutions. In addition, risk officers who perform the *Sharīʿah* risk management function must possess the requisite knowledge on *Sharīʿah* requirements applicable to *Islāmic* financial businesses (Shariah Governance Policy Document, 2019).

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