

SHARI'AH RISK MANAGEMENT FRAMEWORK FOR ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

In addition to systematic and unsystematic risks faced by traditional financial institutions, Islamic banks are widely exposed to Shari'ah risks with regards to the needs for ensuring Shari'ah compliance of its operational activities and financial products. In order to mitigate these additional risks, IFIs are urged to establish a comprehensive Shari'ah risks management tool that can help them to monitor their banking, financing and investment activities in conformity with Shari'ah principles and hence enhance their sustainability in the long run. Therefore, the objective of this paper is to contribute to discussion on the development of the Shari'ah risk management framework for IFIs. This paper refers to Islamic primary sources of knowledge, the Quran and hadith in scrutinizing the permissibility of risk management practices by IFIs. The processes that take place in Shari'ah risk management; (i) risk identification; (ii) risk measurement and; (iii) risk monitoring/controlling are then thoroughly discussed. This paper hopes to shed some light on the importance of having a comprehensive standard of procedures in performing Shari'ah risk management function.

Keywords: *Shari'ah risks, Islamic risk management, shari'ah compliance.*

1.0 Introduction

Having learnt from the recent global economic crisis that badly hit financial institutions around the globe in 2008 and 2009, many regulators, practitioners and researchers of banking industry have conceded that an effective risk management is indeed essential to sustaining business growth and profitability of the banks, be they conventional or Islamic. Moreover, it was found that effective risk management to be one of the significant factors influencing the performance of bank stocks¹. As a repercussion of the subprime bubble burst in 2007-2009 that led to the reprehensible collapses of financial giants including Lehman Brothers, a new rulebook, *Basel III*, was formulated to include several measures to reinforce resilience of the banking sector. With the formulation of effective control measures and revisiting bank and customer relationship, this newly amended rulebook aims to overcome risk management failures that previously were considered one of the main causes of the worldwide financial crisis². In addition, the fresh capital adequacy framework, which accentuates immensely on liquidity risk, credit risk and market risk under ordinary and stressed market conditions, has been made mandatory to require banks to maintain a minimum level of capital to cover up losses and to run operating activities as a going concern. In addition to systematic and unsystematic risks faced by traditional financial institutions, Islamic banks are widely exposed to *Shari'ah* risks with regards to the needs for ensuring *Shari'ah* compliance of its operational activities and financial products. In order to mitigate these additional risks, Islamic financial institutions (IFIs) are urged to establish a comprehensive *Shari'ah* risks management tool that can help them to monitor their banking, financing and investment activities in conformity with *Shari'ah* principles, and hence enhance their sustainability in the long run. Therefore, the objective of this research paper is to contribute to the discussion on the development

¹ R. Sensarma and M. Jayadev, "Are bank stocks sensitive to risk management?," *The Journal of Risk Finance* 10, 1 (2009): 7-22.

² G. Sabato, "Financial crisis: where did risk management fail?," (2009), Available at SSRN: <http://ssrn.com/abstract/41460762>.; J. Holland, "Banks, knowledge and crisis: a case of knowledge and learning failure," *Journal of Financial Regulation and Compliance* 18, 2 (2010):87-105.

of *Shari'ah* risk management framework for IFIs. In order to achieve its objective, this paper provide a thorough discussion on the processes that take place in *Shari'ah* risk management; (i) risk identification; (ii) risk measurement and; (iii) risk monitoring/controlling. We hope to shed some light on the importance of having a comprehensive standard of procedures in performing *Shari'ah* risk management function.

2.0 Definition of Risk Management Practice

Risk management is defined in *The Oxford Dictionary for Business and Management* as “a process that aims to help organizations to understand, evaluate, and take actions on all their risk”. Similarly, risk management can be defined as “the process by which managers satisfy the need to manage [a] Bank’s risk exposure by identifying key risk factors; obtaining consistent, understandable, operational risk measures; choosing which risk to reduce, and which to increase and by what means; and establishing procedures to monitor the resulting risk positions”³. In addition, the Basel Committee for Banking Supervision in 2001 defined risk management practice as a sequence of the following four processes:

1. The identification of events into one or more broad categories of market, credit, operational and other risks into specific sub-categories;
2. The measurement and assessment of risks using data and risk model;
3. The monitoring and reporting of the risk assessments on a timely basis; and
4. The control of these risks by senior management.

The definition of risk management was also provided in the Guiding Principles of Risk Management for Institutions issued by the Islamic Financial Service Board in December 2005, whereby risk management is defined as a process that consists of risk identification, measurement, mitigation, monitoring, reporting and control. This

³ Abdul Ghafar Ismail, *Money, Islamic Banks and the real Economy* (Singapore: Cengage Learning Asia Pte Ltd, 2010): 242.

definition was adopted and became the main area of interest of this research paper. An extensive discussion on these processes of risk management practice is provided in the latter section.

3.0 Islamic Perspective of Risk Management Practices

Given its vital roles in ensuring sustainability of the operations and market capitalizations of Islamic banks operations and market capitalization, enormous attention has been channelled to the development of risk management practices within their internal management and control system. Yet, to adopt such practice requires a valid explanation on its permissibility from the perspective of Islam. In this section, we provide a discussion on how Islam perceives the practice of managing risks among Islamic financial service providers by referring to the divine texts, the *Quran* and *hadith* of the Prophet.

It is evident that the concept of risk management was quite well-established in Islam. Based on verse 67 of *Surah Yusuf*, we read

O my children, do not enter the capital of Egypt by one gate but go into it by different gates. However, know it well that I cannot ward off you Allah's will for none other than He has nay authority whatsoever. In Him I have put my trust and all who want to rely upon anyone should put their trust in Him alone.⁴

This concept of risk management is also further supported by several *hadith of* Prophet Muhammad (peace be upon him) and a number of legal maxims derived from it as follows:

⁴ Sayyid Abul Ala Maududi, *Tafhim al-Quran – The Meaning of the Quran*, www.englishfsir.com.

Table 1: *Hadith* of Prophet and legal maxims on permissibility of risk management practices

Hadith	Legal Maxims
<i>“Prophet (s.a.w.) once asked a Bedouin who had left his camel untied, “Why do you not tie your camel?” The Bedouin answered: “I put my trust in God.” The Prophet (s.a.w.) then said, “Tie up your camel first then put your trust in God.”</i>	Harm must be eliminated
<i>“Whoever dies in protecting his property, he dies as a martyr”</i>	Harm must be eliminated as much as possible
<i>“In Islam, harm should neither be initiated nor reciprocated”</i>	Repelling harm takes priority over seeking benefit

In addition, the permissibility of risk management practice can also be discussed based on its relations to the objectives of *Shari'ah*. Majority of IFIs tend to utilize a risk management framework for the purpose of preserving wealth by ways of avoiding any potential risk that could possibly lead to financial loss to either depositors or shareholders⁵. This inarguably aligns with the important objectives of Islamic economics as prescribed by *shari'ah (maslahah)*. This, once again, can be referred to as a recommendation made on the act of recording debt transacted between contracting parties as narrated in verse 282 and 283 of *Surah al Baqarah*. The objective of recording debts is to minimize potential dispute and protect the interests amongst the contracting parties. Therefore, this act, as recommended in the Holy *Quran*, can be a manifestation for allowing the risk management practices in order to minimize credit risks, emanating from failures of settling debt.

⁵ A. Wajdi, “Principles and application of Risk management and hedging Instruments in Islamic Finance”, 2014, www.asyrafwajdi.com/v25/index.php/article

4.0 *Shari’ah* Risk Management Framework

In particular, *Principle 7.15* of the *Shari’ah* Governance Framework (SGF) 2010 defines *Shari’ah* risk management as “a function that consists of identifying, measuring, monitoring and controlling the *Shari’ah* non-compliance risks in order to mitigate the risks arising from non-compliance events”. The same principle also requires risk management to be systematic to enable the bank to have effective businesses and activities without being exposed to unacceptable risks. Therefore, apart from credit, market, liquidity and operational risk management, *Shari’ah* risk management and control function must also form one of the parts in IFI’s integrated risk management framework. Furthermore, *Principle 7.17* of the SGF 2010 adds that this technical and complex function indeed requires qualified or experienced risk management officers who have good *Shari’ah* knowledge to effectively perform such functions.

As referred to in *Principle 7.18* of the SGF 2010, *Shari’ah* non-compliance risk management function is determined by involving the following steps:

- i. Facilitating the process of identifying, measuring, controlling and monitoring *Shari’ah* non-compliance risks inherent in the IFI’s operation.
- ii. Formulating and recommending appropriate *Shari’ah* non-compliance risk management practices and guidelines; and
- iii. Developing and implementing processes for *Shari’ah* non-compliance risk awareness in the IFI.

5.0 *Shari’ah* Risk Management Process

As mentioned earlier, *Shari’ah* risk management involves three important steps:

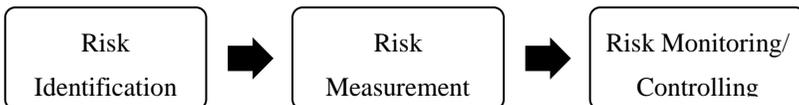


Figure 1: *Shari’ah* Risk Management Process

5.1 Risk Identification

Risk identification relates to a process of understanding the nature and impacts on current and future activities of the institution⁶. This process aims to enlighten the institution, as far as possible, about the nature of the key variables or factors that can lead to occurrence of unintended effects. Besides, the main purpose of risk identification process should be revolved around developing a robust understanding of the key factors that will pave ways for the next processes of risk management⁷. In this study, the identification process focuses on causal factors or variables that lead to non-compliance events. This is done based on a belief that a problem can only be solved if its origins and sources are known and are identifiable.

First, the risk management officer should be aware of internal and external factors that may lead to a *Shari'ah* non-compliance risk. *Shari'ah* non-compliance risk is determined as a subset of operational risk. Thus, it is vital to refer to the definition of operational risk in order to shed some light on this issue. According to the Basel Committee for Banking Supervision, the operational risk is the risk of financial loss or damage resulting from inadequate or failed internal processes, people and systems or from external events. This definition identifies the factors that can lead to operational risk and hence was adopted by this study as the guiding themes of the identification process. Therefore, it is noteworthy to mention that the above-mentioned elements, namely, people, system and process have been regarded as the main causal factors that contribute to the occurrence of non-compliance events as discussed in the next section⁸.

⁶ D. B. Hertz and H. Thomas, *Risk Analysis and its applications* (Chichester: Wiley, 1983).

⁷ Lubka Chankova, "Risk Identification- Basic stage in risk management," *Environmental Management & Health Journal* 13, 3 (2002): 290-297.

⁸ Hylmun Izhar and Zakaria Salah Ali Hassan, "Applying Core Principles of Risk Management in Islamic Banks' Operational Risk Analysis," *Afro Eurasian Studies* 2(1/2) (2013): 15-40; Hylmun Izhar, "Identifying Operational Risk Exposures in Islamic Banking," *Kyoto Bulletin of Islamic Area Studies* 3, 2 (2010): 17-53.

5.1.1 People

In this context, the word ‘people’ refers to groups of stakeholders who are involved in the operations of IFIs. Those include management officers, board of directors, *Shari’ah* advisors and staffs of IFIs. It is argued that accountability of ensuring compliance of Islamic banking products to *shari’ah* should not be confined merely to *shari’ah* advisor, but also to other divisions within IFIs. This factor has been given a significant attention in the SGF 2010, as reflected in the objective of SGF itself, which is to, *inter alia*, “provide a comprehensive guidance to the [B]oard, [they] *Shari’ah* Committee and [they] [M]anagement of the IFI in discharging its duties in matters relating to *Shari’ah*”. Based on this premise, it is submitted that any weaknesses or shortcomings arising from people, who are liable for the mismanagement of IFIs, may lead to events that can trigger a *Shari’ah* non-compliance risk. Next, we outline some of the possible events arising from people factor that could possibly lead to a *Shari’ah* non-compliance risk:

Table 2: Summary of events arising from people factor that lead to *Shari’ah* non-compliance risk

People factor	
<i>Fatwa risk</i>	<p>Lack of clarification and deliberation about the product will deprive the SC from having important information and facts that are crucial in the formation of <i>fatwa</i> for the given product and hence lead to misleading decision making.</p> <p>Failure to interpret <i>fatwa</i> given by the SC in the right context indeed can lead to adverse impacts on bank performance.</p> <p>The management of IFIs does not abide to the <i>fatwa</i> issued by the SC despite having a clear ruling on the matter and hence lead to <i>Shari’ah</i> non-compliance events.</p>

<i>Falsification of Information/ misrepresentation/ fraud and negligence</i>	Bank's staffs may falsify or amend the particulars of the products to prevent it from being declared void due to violation of <i>Shari'ah</i> principles.
<i>Guideline violations and unapproved products, transactions, or legal documentation</i>	Lack of communication and cooperation between SC and legal counsels may lead to <i>Shari'ah</i> non-compliance risk where the parties do not properly address some breaches contained in the instruments.
<i>Insufficient resources and inadequate training</i>	<p>This relates to the lack of qualified personnel to carry out the task in maintaining compliance with <i>Shari'ah</i> in all activities and operations of IFIs.</p> <p><i>Shari'ah</i> non-compliance risk may emerge when the staffs are not properly trained to conduct their job as specified in their job scope.</p> <p>Inadequacy of knowledge may cause the staffs to make mistakes in their task.</p>

5.1.2 Process

This element refers to the process involved in product development adopted in the operation of IFIs. The product development covers both the pre-product approval (i.e. process of product structuring and developing prior to introduction to the market) as well as to the post-product approval process (i.e. process after the product has been offered to the customers and transactions have been carried out). The process adopted in pre-product approval involves the issuance of *Shari'ah* decisions, product structuring or design processes backed by comprehensive *Shari'ah* research, vetting of contracts and agreements, as well as compliance checks, before the product is offered to the customers. On the other hand, the process involved in post-product approval includes *Shari'ah* audit and *Shari'ah* review

that are conducted to ensure compliance with *Shari'ah* in the implementation of every product offered to the customers. It must be noted that the whole process adopted throughout the life-cycle of any product must be given proper attention as any process in each stage may become potential avenues for *Shari'ah* non-compliance risk. *Shari'ah* non-compliance risk may occur during the product development process due to improper structuring of products, lack of internal research in understanding the appropriate *Shari'ah* concepts, and misrepresentation of the product at the issuance or marketing stage of the product. We highlight some of the events relating to process adopted in product development in Islamic banking that can lead to the occurrence of *Shari'ah* non-compliance risk:

Table 3: Summary of events arising from process factor that lead to *Shari'ah* non-compliance risk

Process factor	
<i>Unclear processes, policies, procedures, or responsibilities/lack of them</i>	<p>Lack of clear processes, policies and procedures may lead to variations of the practices within the IFI that will increase the possibility of <i>Shari'ah</i> violations.</p> <p>Leads to a situation where IFIs may mix the profit derived from unlawful activities with the rest of the lawful profit.</p> <p>Lack of clear process can be seen in distribution of profit derived from investment accounts that are operated based on profit sharing concepts. IFIs may end up managing such accounts on a fixed-interest basis, although it is declared that such accounts are administered according to a profit and loss basis.</p>

<i>Inadequate Shari'ah arrangements</i>	<i>internal governance</i>	<p>There are three main bodies in <i>Shari'ah</i> governance arrangement within an IFI, namely, Board of Directors, SC and management.</p> <p>The Board is ultimately accountable and responsible on the overall <i>Shari'ah</i> governance framework and <i>Shari'ah</i> compliance of the IFI.</p> <p>The SC shall be responsible and accountable for all its decisions, views and opinions related to <i>Shari'ah</i> matters.</p> <p>The management shall be responsible for observing and implementing <i>Shari'ah</i> rulings and decisions made by the SAC and the SC respectively.</p>
<i>Insufficient disclosure and transparency</i>		<p><i>Principle 2.9</i> of the SGF requires the SC to prepare full and proper disclosure on the state of compliance in an IFI's annual report to declare that the operation and business of IFI comply with <i>Shari'ah</i>.</p>

5.1.3 System

In this context, system factor refers to information technology system utilized in the operation of IFIs. The information technology infrastructure and system plays an importance role in the daily operation of IFIs. The registration, execution and implementation of products in IFIs are done using the IT system. Therefore, the IT system must be capable of reflecting the true nature of *Shari'ah* principles. In other words, the system must be capable of blocking any attempt to transact any impermissible contract. However, most IT systems used by IFIs are adopted from the ones that are utilized in conventional banks. They are deemed not suitable to be utilized in IFIs. Besides, restructuring the existing IT system to make it *Shari'ah*-compliant would involve huge cost. Thus, this section explains the events which originate from the failure of the IT system in complying with *Shari'ah* principles:

Table 4: Summary of events arising from the IT System factor that lead to *Shari’ah* non-compliance risk

System factor	
<i>Process and system accounting mismatches, inadequate product modules, poor reporting, and unapproved software</i>	IT system used by the IFIs must have a <i>Shari’ah</i> compliance status that is capable of ensuring strict adherence to <i>shari’ah</i> in all contracts entered into by the IFIs. Use of software and telecommunications systems that are not tailored to the needs of Islamic banks could also contribute to <i>Shari’ah</i> non-compliance risk, as it is not capable of blocking the impermissible transactions under Islamic Law.
<i>Inexperienced vendor, non-timely support, non-user friendly system, and system mistake</i>	Vendor of the IT modules may overlook some of the common features that must be inserted in the modules to ensure <i>Shari’ah</i> compliance in the system. Lack of knowledge and experience may lead the vendors to develop an IT system that is not friendly to <i>Shari’ah</i> rules and principles.

5.2 Risk Measurement

In the risk measurement process, the risk manager should be concerned with the extent of damage caused by the annulment and invalidation of the contract. The risk manager of IFIs must classify the risk according to the extent of damage that will be caused to the institution. This helps the IFI to give more attention on the severe risk as compared to the one that carries slight damage⁹.

⁹ Romzie Rosman, “Risk Management Practices and Risk Management Processes of Islamic Banks: A Proposed Framework,” *International Review of Business Research Papers* 5, 1 (2009): 250

Practically, the *Shari'ah* non-compliance risk can be classified into three categories, namely, severe, medium and tolerable. Normally, risk will be classified as 'severe' if the non-compliance event leads to invalidation of contracts or non-recognition of income. This risk that also causes the defects in the contracts cannot be rectified and cured. For instance, thus is true in a contract entered into by the IFI and the customer that involves non-halal income like financing gambling activities. Another example would be the illegitimate nature of a gambling activity that would cause the contract to be void and the income derived from that financing would not be recognized under Islamic transaction law.

Whereas, a medium level of risk can relate to a situation of conditions of the *aqad* that are not fulfilled. This event may cause the contract to be defective, yet non-fulfilment of the conditions can be rectifiable, and this may not necessarily invalidate the contract. In this regard, the *Hanafi* approach to dealing with defective contract can be applied to make necessary rectification for the impugned contract. One of the examples for this type of contract is a contract with invalid condition. According to *Hanafis'* view, the existence of the invalid condition in a contract does not render the contract void, but it causes the same to be irregular. Thus, this irregularity can be rectified by severing the invalid condition from the contract.

Lastly, tolerable risk relates to the events that do not lead to the consequences mentioned under the severe and medium risk. For example, indecent the mode of attire among the IFIs staffs may lead to a reputational risk since the staffs of Islamic Bank are expected to wear decent attire. Similarly, improper marketing through indecent posters made by IFI may also tarnish the reputation of the institution. The measurement of *Shari'ah* non-compliance risk, according to the status of a contract, can be summarized as follows:

Table 5: Measurement of *Shari'ah* non-compliance risk

<i>Level of Shari'ah non-compliance risk</i>	<i>Description</i>
Severe	Non-compliance events lead to invalidation of contract and non-recognition of income <i>Example:</i> financing gambling activities or investment in production of alcohol and liquor.
Medium	Contract with a defect in an accessory attribute (<i>wasf</i>) <i>Example:</i> existence of an invalid condition in a contract, problem with the delivery of the subject matter, insufficient information about the subject matter (<i>jahalalah</i>).
Tolerable	Events that do not lead to the consequences mentioned under high and medium type of risk <i>Example:</i> improper advertisement about product and indecent attire among the staffs.

5.3 Risk Monitoring

The last stage of 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. A proper risk monitoring also helps IFIs to discover mistakes at an early stage rather than suffer the bad consequences from the dormant untraceable risk¹⁰. Besides, a risk monitoring mechanism is used to monitor the variables and factors that can lead to a *Shari'ah* non-compliance risk.

The monitoring process utilizes data collected from the previous audit or inspection¹¹. One of the tools used in risk monitoring is the Key Risk Indicator (KRI). KRI is a mathematical formula that includes all parameters that describe the operational

¹⁰ Al-Tamimi, "Risk Management Practices: An Empirical Analysis of the UAE Commercial Banks," *Finance India* 16, 3 (2002): 1045-1057.

¹¹ Rosman, "Risk Management".

variation of specific operations within specific business lines¹². KRI can be used as a tool in measuring the actual value of the cause and effect arising from non-compliance events. KRI predicts possible occurrences of non-compliance events to enable the IFIs to take reasonable preventive and corrective measures to avoid any loss arising from such non-compliance events. For example, a *Shari'ah* non-compliance risk can be discovered from an employee's mistake and negligence. Hence, the risk monitoring mechanism would ensure that a similar risk will not happen again in the future by checking and analyzing the sources of the risk in order to avoid the events leading to the identified risk from such factors. The application of this tool depends heavily on the availability of information and data that refers to the KRIs. It is stated that KRIs consist of mostly quantitative measures intended to provide insight into operational risk exposures and control measures¹³. We provide some examples here of KRI to monitor potential sources of *Shari'ah* non-compliance risk:

Table 6: Application of KRI in monitoring process adopted from Akkizidis and Kumar (2008)

<i>Sources of Shari'ah Non-compliance risk</i>	<i>Events</i>	<i>Some Key Risk Indicators</i>
People	<ul style="list-style-type: none"> • <i>Fatwa</i> risk • Fraud and misrepresentation • Incompetent staff • Non-Performance of Obligation 	<ul style="list-style-type: none"> • Staff turnover rates • Staff training and experience level • Number of approvals that are not compliant to <i>Shari'ah</i> rules and principles

¹² L. Kalyvas and I. Akkizidis, *Integrating Market, Credit and Operational Risk: A complete guide for bankers and risk professionals* (London: Risk Books Incisive Financial Publishing Ltd, 2006).

¹³ J. Young, *Operational Risk Management: The practical application of a qualitative approach* (Pretoria: Van Schaik Publishers. Pretoria, 2006).

Process	<ul style="list-style-type: none"> • Unclear process and policies 	<ul style="list-style-type: none"> • Number of contracts that are inconsistent with IFI policies • Settlement failure rate • Number of default • Number of contracts that are not <i>Shari'ah</i> compliant
System	<ul style="list-style-type: none"> • IT is not <i>Shari'ah</i> compliant 	<ul style="list-style-type: none"> • Number of contracts that are not <i>Shari'ah</i> compliant. • System failure rate • Number of failed operation

Next, we explore the scope of the monitoring process as envisaged under the SGF. It is submitted that the role of the *Shari'ah* management risk department is confined to the area relating to the pre-product approval. However, the management of *Shari'ah* non-compliance risk requires collective efforts by all departments within the IFIs to ensure compliance with *Shari'ah* rules in all operations of the IFIs. This notion is enshrined under Principle 7 of the SGF which mentions that “the IFI must establish a robust and comprehensive *Shari'ah* compliance function comprising review and audit functions, supported by [a] risk management control process and internal research capacity”.

On the other hand, the controlling mechanism for post product approval is vested in the hand of a *Shari'ah* review department and a *Shari'ah* audit department. The *Shari'ah* review function refers to regular “check-up” made to assess the level of compliance to *Shari'ah* in the operation and business of IFIs. *Shari'ah* review function aims to ensure that the operation of IFIs does not conflict with *Shari'ah* compliance. *Shari'ah* review should cover end-to-end a product development process which starts from product structuring to product offering. *Appendix 7* of the SGF explains the end- to-end product development process as follows:

Table 7: End-to-end product development process as described in the SGF 2010

<i>Production stage</i>	<i>Description</i>
Pre-product approval	<ul style="list-style-type: none"> i. Pre-product approval process involves namely the issuance of <i>Shari'ah</i> decisions, product structuring or design processes backed by comprehensive <i>Shari'ah</i> research, vetting of contracts and agreements, as well as compliance checks, before the product is offered to the customers. ii. There shall be a formal and transparent procedure for issuance of <i>Shari'ah</i> decisions which are well documented and approved by the Board and <i>Shari'ah</i> Committee. iii. An IFI shall ensure that the pre-product approval process includes, among others, a review of the concept, structure, term sheet, documentations, policies and procedures, pamphlets, brochures and advertising materials. The documents shall be approved by the <i>Shari'ah</i> Committee of the IFI.
Post-product approval	<ul style="list-style-type: none"> i. Post-product approval process involves monitoring product implementation to ensure compliance with <i>Shari'ah</i> principles, identifying the area of potential <i>Shari'ah</i> non-compliance risk and proposing the relevant actions to the management. ii. An IFI must ensure that post-product approval in its <i>Shari'ah</i> governance framework also includes internal <i>Shari'ah</i> review and <i>Shari'ah</i> governance reporting. Without such follow-up, the IFI would not be able to monitor the consistency of its <i>Shari'ah</i> compliance and effectively manage any <i>Shari'ah</i> non-compliance risks that may arise over time.

Apart from that, the controlling and monitoring process is further enhanced by a *Shari'ah* audit that must be carried out by the

internal auditor of the IFI. *Principle 1.3* of the SGF 2010 mentions that *Shari'ah* audit is one of the main components in *Shari'ah* Governance Framework. *Shari'ah* audit refers to periodical assessment, with the purpose of providing independent assessment and valuation as to the level of compliance with *Shari'ah* in relation to businesses and operations of IFIs. The *Shari'ah* audit must be conducted at least once a year. The scope of *Shari'ah* audit covers a wide range of areas which includes audit on financial statement, compliance audit on organizational structure, people, process and information technology systems and review on the adequacy of the *Shari'ah* governance arrangement. This reflects the main spirit embedded in SGF since every key function must cooperate in ensuring compliance with *Shari'ah*. In addition, the SGF also mentions the appointment of external auditors to conduct independent *Shari'ah* audit on the IFIs. However, this requirement is not mandatory in nature, but it is left to the discretion of the IFI whether to hire external auditors or not. The following table summarizes the roles of the different organs in IFIs that are responsible in managing *Shari'ah* non-compliance risk:

Table 8: Summary of the role of different organs in IFIs in managing *Shari'ah* non-compliance risk

Organs	Roles
<i>Shari'ah</i> Research	<ul style="list-style-type: none"> - Conducts pre-product approval process, research, vetting of issues for submission, and undertake administrative and secretarial matters relating to the <i>Shari'ah</i> Committee. - Handles administrative and secretarial matters relating to the <i>Shari'ah</i> Committee. - Job scope revolves around pre-product approval (ex-ante).
<i>Shari'ah</i> Review	<ul style="list-style-type: none"> - Monitors <i>Shari'ah</i> compliance of products. - Supports the work of the <i>Shari'ah</i> committee and basic requirement of IFIs. - Job scope relates to a post-product approval or an ex-post assurance process.

<i>Shari'ah Audit</i>	<ul style="list-style-type: none">- Can be performed by internal auditor or external auditor.- Mandatory requirement under SGF only requires internal auditor.- Job scope relates to ex-post audit that report directly to the Board.
<i>Shari'ah Risk Management</i>	<ul style="list-style-type: none">- Facilitating the process of identifying, measuring, controlling and monitoring <i>Shari'ah</i> non-compliance risks.- Job scope relates to pre-product approval.

6.0 Conclusion

The objective of this paper is to contribute to the discussion on the development of the *Shari'ah* risk management framework for IFIs. Effective management of risks that could possibly lead to *Shari'ah* non-compliance of products is inarguably significant for IFIs to ensure they are able to retain customers' confidence on purity of their business operations and hence enhance their market capitalization in order to compete in the market which is highly dynamic in nature. Based on divine revelation, this study concludes that the risk management practice is deemed permissible and highly encouraged due to its protection of customer's wealth, with a provision that it does not involve any elements that contradict *Shari'ah* principles. This paper then presents a *Shari'ah* risk management framework, which comprises the following steps: (i) risk identification; (ii) risk measurement and (iii) risk monitoring/controlling. Abiding to this process of risk management is very important as it provide a comprehensive guidance for IFIs in detecting and eliminating risks from the entire aspect of operations in Islamic banking and finance, including human resources, business processes and procedures as well as technological advancements. This paper also provided a discussion on the roles of organs that are responsible for managing *Shari'ah* non-compliance risks such as *Shari'ah* Research, *Shari'ah* Audit and *Shari'ah* Review.