SHARIAH NON-COMPLIANCE RISK AND ITS EFFECTS ON ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

The objective of this paper is to provide the definition of shariah *non-compliance risk associated with Islamic financial institutions (IFIs). Having a precise definition of* shariah *non-compliance risks is highly necessary for the purpose of developing a comprehensive risk management framework for an Islamic financial system. This study is conducted through a literature review on Islamic* turath*, regulatory provisions and existing academic journals on Islamic risk management. This paper provides an in-depth discussion on the major elements that trigger* shariah *non-compliance risks and hence affects the validity of Islamic contracts such as* riba*,* gharar*,* taghrir*,* ghubn*, etc. These elements of risk were identified as that emerging from the entire process of developing an Islamic financial product, starting from the structuring stage until the execution of the product in the market and hence cause severe both financial and non-financial costs to IFIs. This research may have some implications to the Islamic finance industry in Malaysia, becoming a reference for Malaysian IFIs in structuring their own comprehensive risk management and internal control system and hence enhance the effectiveness of the* shariah *governance practice within the IFIs.*

Keywords: Islamic finance, Islamic risk management, *Shariah* compliance.

1.0 Introduction

Islamic finance industry has immensely grown comprising a diverse range of institutions, including commercial and investment banks, *takaful* operators and investment companies that offer various Islamic financial products in the global market. The world has witnessed the establishment of more than 600 Islamic financial institutions (IFIs) operating across around 75 countries. According to Ernst & Young's World Islamic Banking Competitiveness Report 2014/2015, the global Islamic banking industry had experienced a compounded annual growth rate of 17 per cent from 2009 to 2013 with total assets under management forecasted to exceed USD 1.8 trillion by 2019. This rapid development of IFIs helps to revolutionalize the Islamic financial system to become a competitive and comprehensive integral part of the mainstream global financial system not just in the countries with majority Muslim populations, but also in other parts of the world where Muslims are significant minority such as the United Kingdom and France. As a result, the increase in complexity of the operations of IFIs and Islamic contracts to cater the high demand on Islamic financial products remains inevitable. In fact, this causes IFIs to become more susceptible to many types of risks that may adversely affect their performance and sustainability in the long run. Therefore, developing a comprehensive risk management in the Islamic financial system deserves a significant attention in today's academic debates.

Despite this, it is argued that risk management in an Islamic financial system may not be significantly different from conventional banking[1], IFIs seem to be widely exposed to a unique set of risks in relation to the needs to operate in conformity with *shariah* principles such as prohibition of *riba*, excessive risks and gambling in addition to systematic and unsystematic risks faced by traditional financial service providers.[2] Indeed, Shariah compliance becomes the most

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[1] Thijs, J. P. P. M.,"Risk Management in Islamic Banking", accessed June 24, 2015, from http://www.bankislam.com.my/en/Documents/shariah/RiskMgmtin Islamic Bkg. pdf.

[2] A. Abdul Rahman, and A. A. Bukair, "The Influence of the *Shariah* Supervision Board on Corporate Social Responsibility Disclosure by Islamic Banks of Gulf Co Operation Council Countries". *Asian Journal of Business and Accounting*. (2013).

significant feature that differentiates IFIs with other subdivisions of the global financial system. Failure to comply with *shariah* may worsen public confidence on the purity of IFI operations and hence reduce their market capitalization. This study is undertaken based on the premise of the importance of having a precise definition of *shariah* non-compliance risks for the purposes of developing a comprehensive risk management framework in the Islamic financial system. Hence, the objective of this study is to provide a definition of risks associated with IFIs from a *shariah* perspective. This study has a literature review on Islamic *turath*, regulatory provisions and existing academic journals on Islamic risk management. This research may have some implications to the Islamic finance industry in Malaysia, becoming a reference for Malaysian IFIs in structuring their own comprehensive risk management and internal control system and hence enhancing the effectiveness of the *shariah* governance framework within the IFIs.

This paper is organized as follows: Section 2 defines risks from a contemporary branch of finance knowledge and from an Islamic perspective; Section 3 describes major elements that lead to *shariah* non-compliance; Section 4 suggests some events of *shariah* non-compliance that may exist in today's practice of Islamic banking and finance, Section 5 then discusses the possible effects of *shariah* non-compliance to the operations of IFIs; Section 6 presents our conclusion.

2.0 Defining Risks Faced by Islamic Financial Institutions

2.1 Definition of Risk

There is no single universal definition for the word *risk* that can be found in existing literature, suggesting that the meaning of the word should be determined according to the context in which the word is used. In other words, the meaning of risk perceived by a business organization may not necessarily be similar to that of a banking institution. In general, risk is defined as "an exposure to the possibility of a bad outcome" and "a state in which the number of possible future events exceeds the number of events that will actually occur, and in which some measure of probability can be attached to each possible outcome" respectively.[3] Whilst, in the context of banking, risk can be referred to as; (i) "exposure to uncertainty of outcome"[4]; (ii) "uncertainty potentially resulting in adverse variations of profitability and in losses"[5]; or (iii) uncertain future events that could influence the achievement of the financial institution's objectives, including strategic, operational, and financial and compliance objectives.[6]

Besides, Committee of Sponsoring Organization of the Treadway Commission (COSO) ERM Framework has defined risk in relation to business enterprise management as "the possibility that an event will occur and adversely affect the achievement of an objective."[7] This definition of risk was further elucidated by Sobel, who outlined fundamental elements of risk.[8] Firstly, the element relates to the need of a company to have clear and systematic business strategies and plans. Secondly, risk is perceived as the outcome of the occurrence of uncertain events and is not necessarily subject to specific events that have the effect of deviating the institution or company from its objectives. Thirdly, risk argued shall not be limited to only threats, but also cover opportunities as well.

2.2 Defining risks from the *Shariah* Perspective

The word *mukhatarah* commonly refers to risk, which is derived from the Arabic root word *khatar*. According to Al-Razi in his Arabic dictionary, *Mukhtar al-Sihah,* an abridgement of *Al-Sihah* by

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[3] D. Borge, *The Book of Risk*. (New York: John Wiley & Sons, 2001), 4; G. Bannock, E. Davis, M. Unceles, and P. Trott, *The New Penguin Dictionary of Business*. (London: Penguin Books Ltd., 2002), 323.

[4] E. Cade, *Managing Banking Risk*. (Cambridge: Gresham Books, 1997), 2.

[5] J. Basis, *Risk Management in Banking*, (United Kingdom: John Wiley & Sons, 2010), 25.

[6] I. Akkazidis and S. K. Khandelwal, *Financial Risk Management for Islamic Banking and Finance*. (Houndsmills: Palgrave Macmillan, 2007), 183.

[7] COSO, *Enterprise Risk Management: Integrated Framework-Executive Summary*. (New Jersey: The Committee of Sponsoring Organizations of The Treadway Commission, 2004), 16.

[8] P. J. Sobel, "Auditor's Risk Management in Islamic Banking," accessed June 24, 2015, http://www.bankislam.com.my/en/Documents/shariah/RiskMgmtinIslamicBkg.pdf.

Al-Jawhari defines *khatar* as "fear of destruction".[9] Besides, Ibn Faris, in his masterpiece, *Mu'jam Maqayees al-Lughah,* refers *khatar* as "impeding doom".[10] In the practice of Islamic commercial jurisprudence, the word *mukhtarah* is generally used to explain uncertainty that exists in business transactions. For instance, Imam Shafie in his *Kitab Al-Umm* clarified the meaning of *mukhtarah* in relation to a binding promise in a *murabahah* sale as follows:[11]

> If they go ahead [with the second sale] by binding themselves to the original agreement, the contract is void from two perspectives: first, the issue of selling before the seller has actually owned the subject matter of the sale; second, the sale is executed on the basis of mukhatarah (uncertainty), i.e., if you buy it for so much, I will give you a profit of so much on it.

Apart from the high level of uncertainty, the meaning of the word *mukhtarah* is extended to gambling (*maysir*) by Ibn Qayyim al-Jawziyyah in his book, *Zad al-Ma'ad fi Huda Ghair al-'Ibad,* where he relates '*mukhatarah*' to the issue of gambling as follows:[12]

> And risk can be in two forms…The second is in the form of gambling, which comprises consuming property unjustly.

From the above scholarly views on the definition of risk, we can conclude that risk that entails excessive uncertainty and elements of gambling is undoubtedly prohibited under Islamic law. However, it is noteworthy to mention that not all types of risk are prohibited under Islamic law. One notable exception has been made by ibn Taymiyyah in al-*Mustadrak 'ala Majmu' Fatawa Shaykh al-Islam*:

> There is no Shariah evidence to categorically prohibit all forms of risks. In fact, Allah and His Messenger have not prohibited all types of risks nor all activities of uncertain outcome, i.e., those which may incur profit or

9 Al-Razi, *Mukhtar al-Sihah* (Vol. 1), (Beirut: Dar an-Namuzajiah, 1999),173.
10 Ibn Faris, *Mu'jam Maqayees al-Lughah* (Vol. 2), (Dar al-Fikr, 1979), 199.
11 Imam Shafie, *Al-Umm*. (Beirut: Dar al-Ma'rifat, 1990), 39.
12 Ibn Qayyim al-Jawziyyah, *Zad al-Ma'ad fi Huda Ghair al-'Ibad* ,(1994), 723.