

# Shariah: Ethical & Self Regulatory

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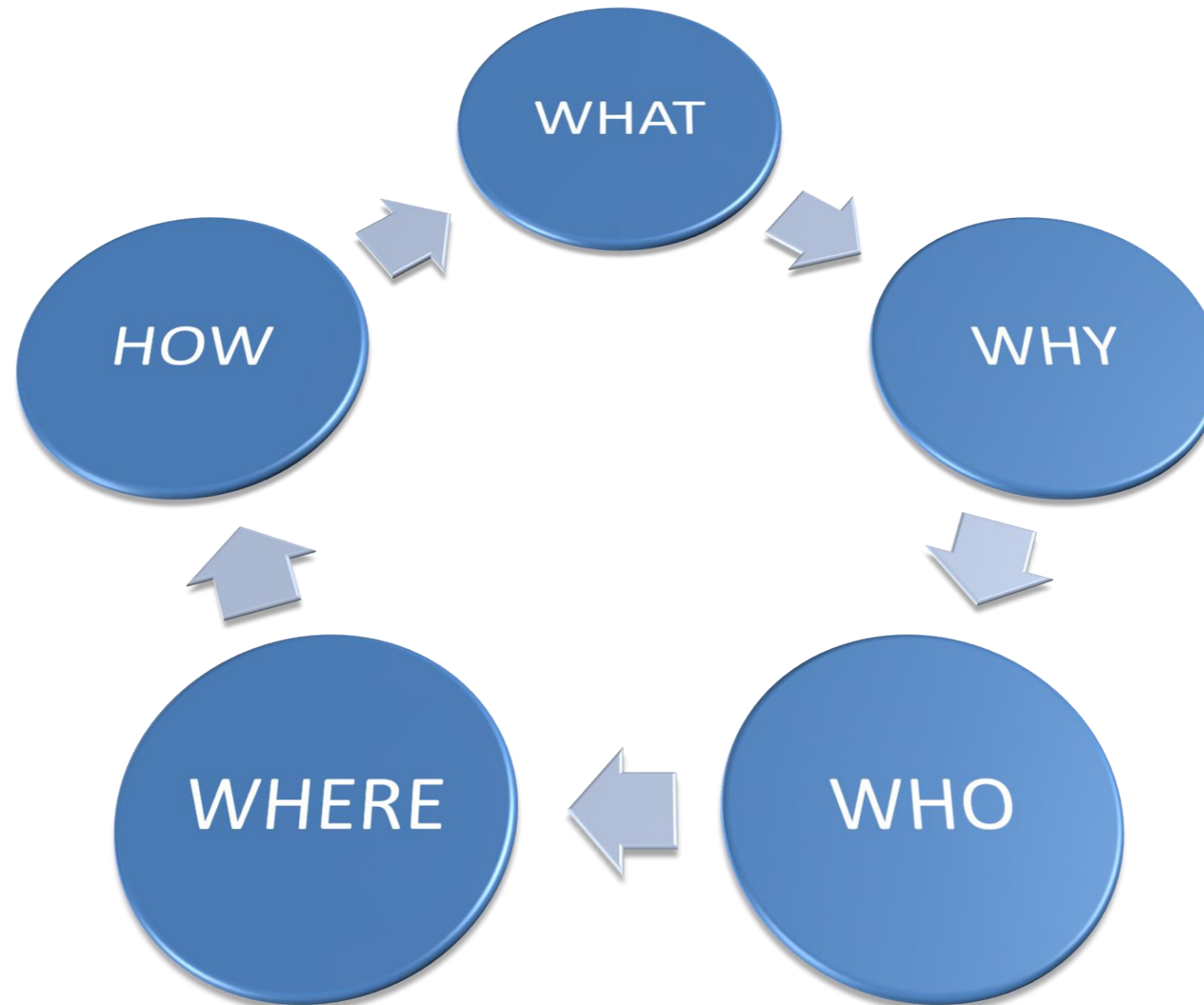
**ISRA**  
RESEARCH  
MANAGEMENT  
CENTRE

Chairman, Shariah Advisory Council, Bank Negara Malaysia  
Chairman, ACE, Noor Takaful

**NOOR**  
TAKAFUL



# Presentation Approach





# WHAT? (Shariah)



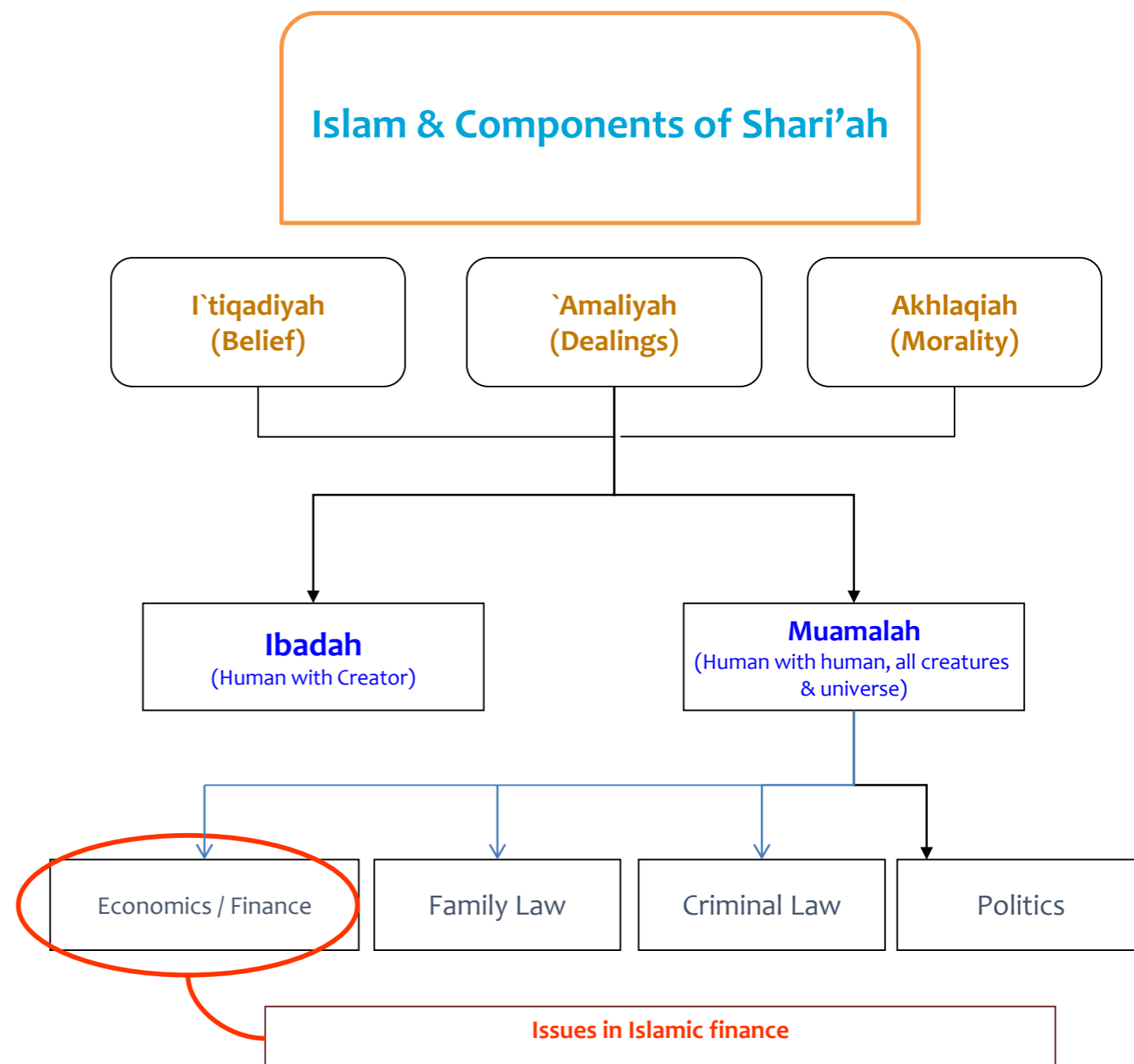
الْيَوْمَ أَكْمَلْتُ لَكُمْ دِينَكُمْ وَأَتَمَمْتُ عَلَيْكُمْ  
نِعْمَتِي وَرَضِيْتُ لَكُمُ الْإِسْلَامَ دِينًا ۗ

Today I have perfected your faith for you, completed My favour upon you, and chosen Islam as your way (Al-Qur'an, 5:3)

# Shari'ah and Finance

شريعة  
Shari'ah

- ❑ Shari'ah encompasses the following meaning:
  - ✓ Path to tread for guidance in this world
  - ✓ Commands, prohibitions, values prescribed by Allah for His slaves either through Al-Quran or As-Sunnah (the teachings of the Prophet Muhammad s.a.w.)
- ❑ Shari'ah is a set of norms, values and laws that go to make up the Islamic way of life .
- ❑ Shari'ah encompasses the whole dimensions of human life



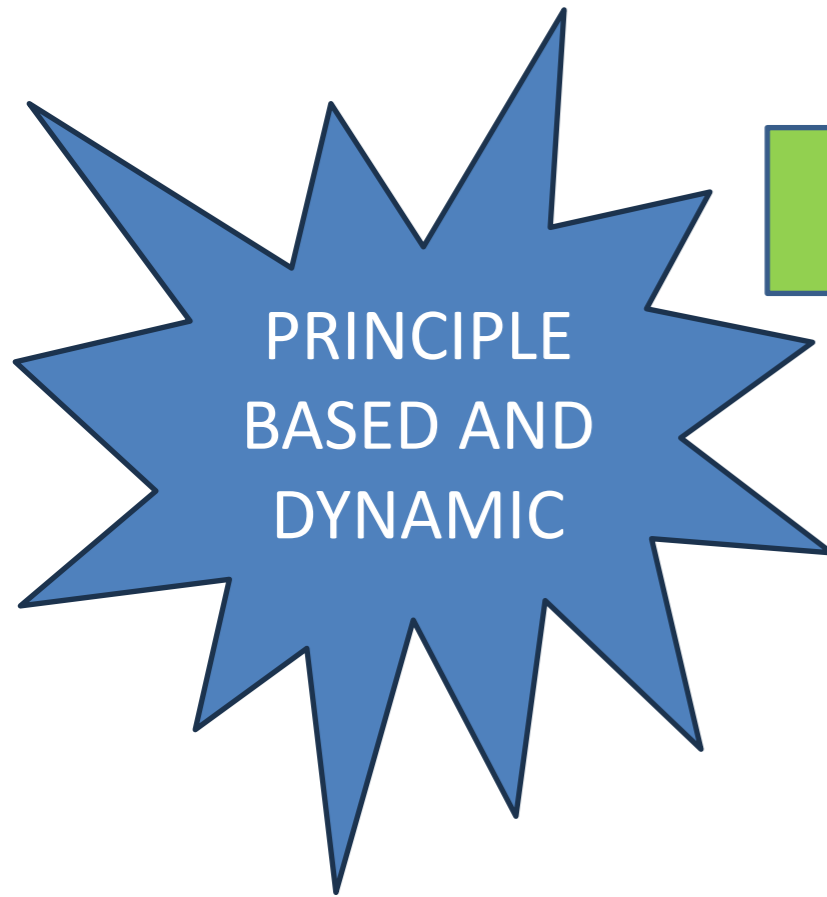
## Original rule in *muamalat* is permissibility

This principle is based, among others, on the following Qur'anic verses:

“It is He **who created for you all of that which is on the earth**. Then He directed Himself to the heaven, [His being above all creation], and made them seven heavens, and He is Knowing of all things” (Al-Qur'an, 2:29)

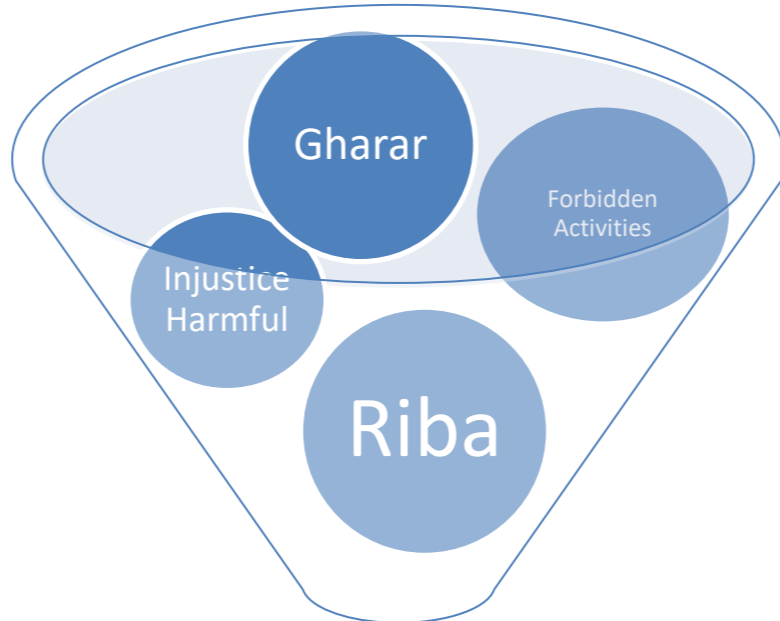
“And He has **subjected to you** whatever is in the heavens and whatever is on the earth - all from Him. Indeed in that are signs for a people who give thought.” (Al-Qur'an, 45:13)

# Overview of Shariah in Relation to *Muamalat* Matters



Original rule in *muamalat* is permissibility

Some Prohibitions



## PILLARS & CONDITIONS

Specific Rulings  
(Provide Certainty)

General Rulings  
(Provide Flexibility)

## SHARI'AH IS ETHICAL

The Prophet s.a.w. said:  
'I was sent to perfect the ethical conduct'

(Malik, Book 047, Section 08, Hadith Number 610).





# WHY?



وَلَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبُطْلِ

Do not consume one another's wealth unjustly (Quran, 2:168)

كل لحم نبتت من حرام فالنار أولى به (رواه ابن مسعود)

All flesh grown from prohibited (sources), then the hell fire has priority over it

Through, among others, review and audit exercise, there are some Shariah issues:  
After proper verification: **Shariah compliant (SC)** or **Shariah non-compliant (SNC)**.

يَا أَيُّهَا الَّذِينَ ءَامَنُوا ءَكُلُوا مِن طَيِّبَاتِ مَا رَزَقْنَاكُمْ  
وَاشْكُرُوا لِلّٰهِ إِن كُنتُمْ ءِِيَّاهُ تَعْبُدُونَ

O believers! Eat from the good things We have provided for you. And give thanks to Allah if you 'truly' worship Him 'alone'  
(Quran, 2:172)

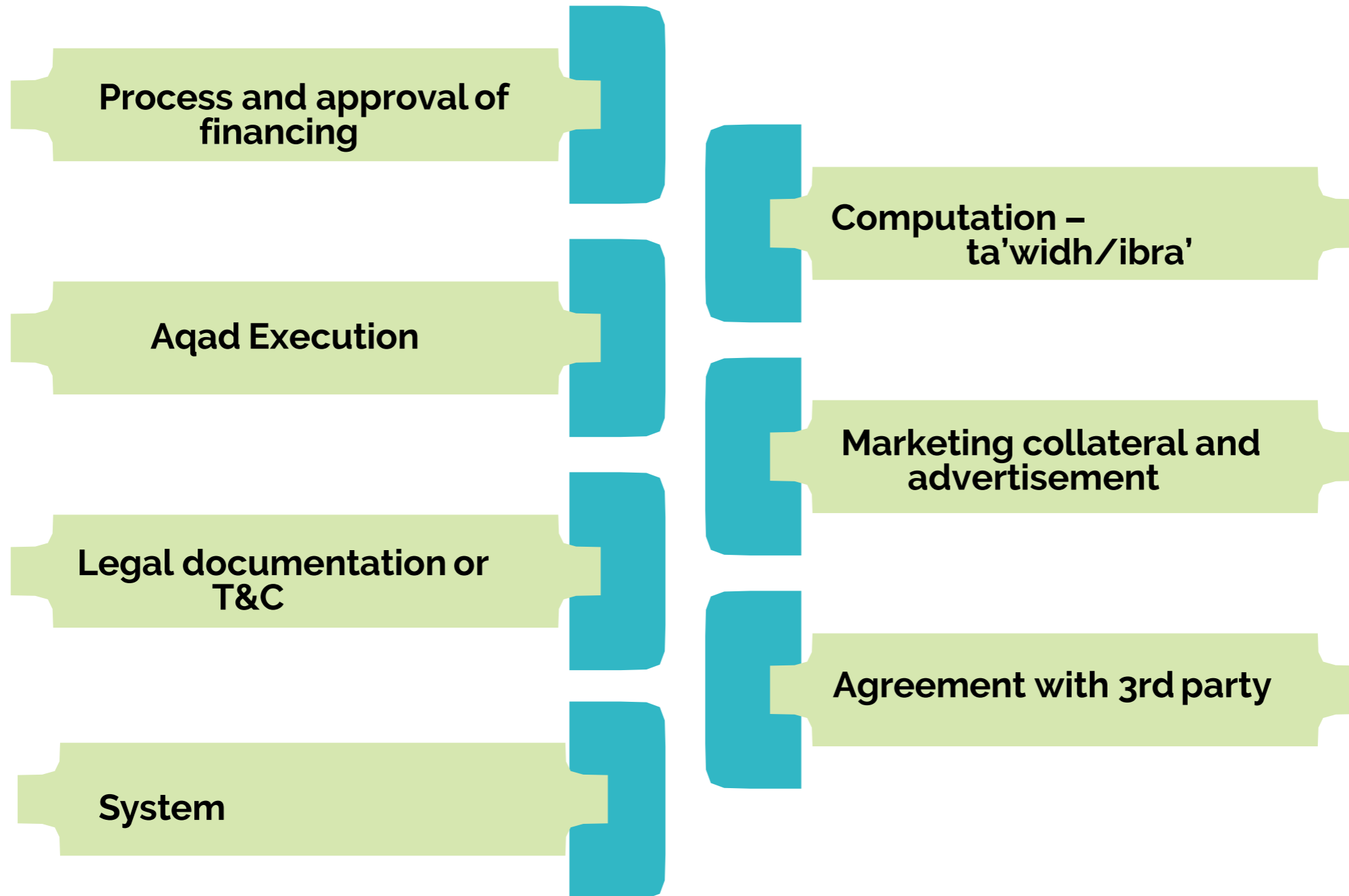




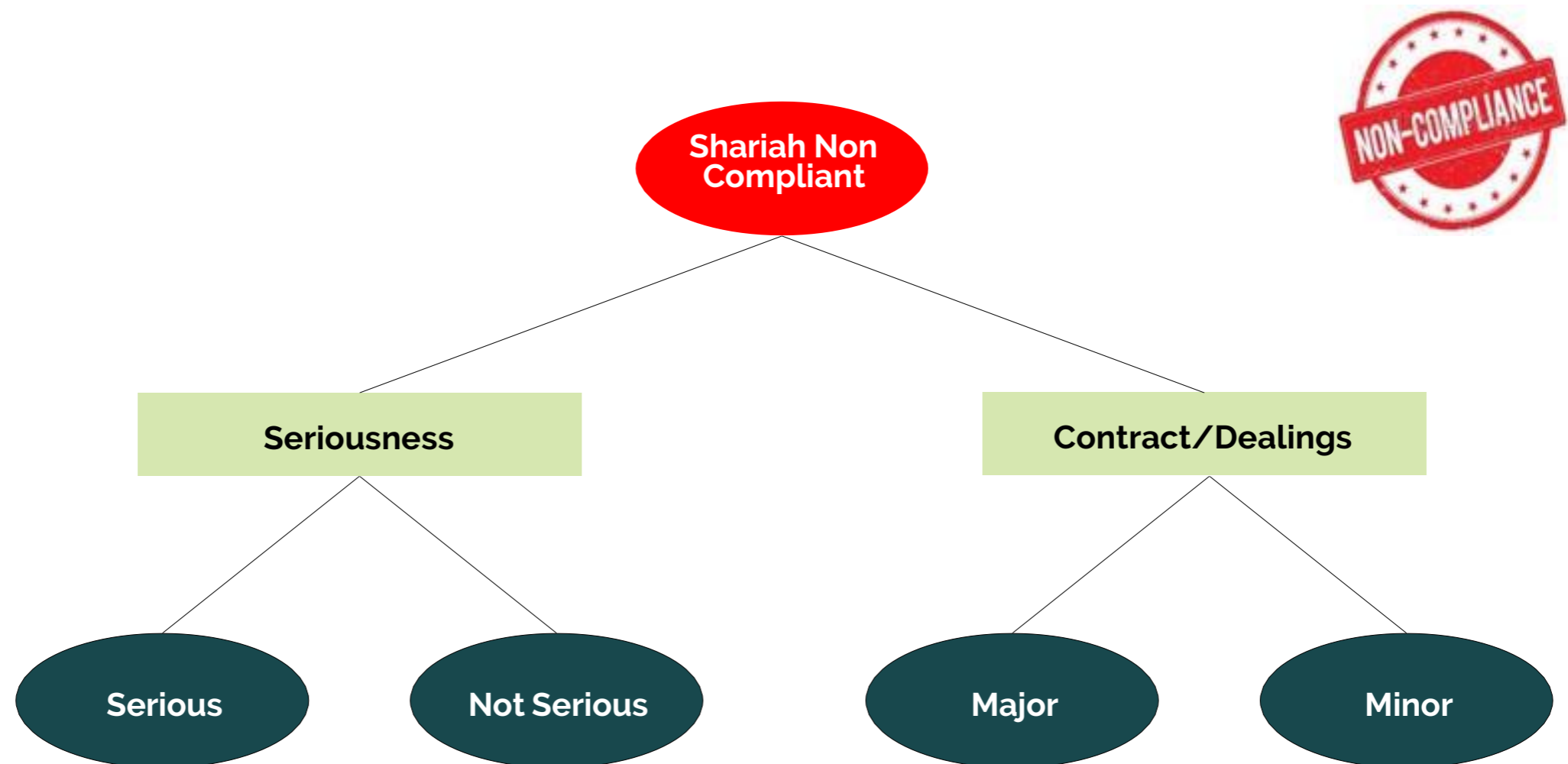
# WHERE?



## Identifying Areas of Shariah Non-Compliance Risk



## Shariah Non-compliant Risk – From Different Perspectives



# Shariah Non-compliant Risk – From Different Perspectives

**SNCR event is identified by examining the underlying contracts applied.**

The **Shariah compliance** status is assessed by making sure the **terms and conditions in an IFI's contracts adhere to the Shariah rules and principles** that govern those contracts.

The **contract is deemed valid and effective** provided that **all the essential elements of the contract are fully satisfied** (*Arkan Al-Aqd*).

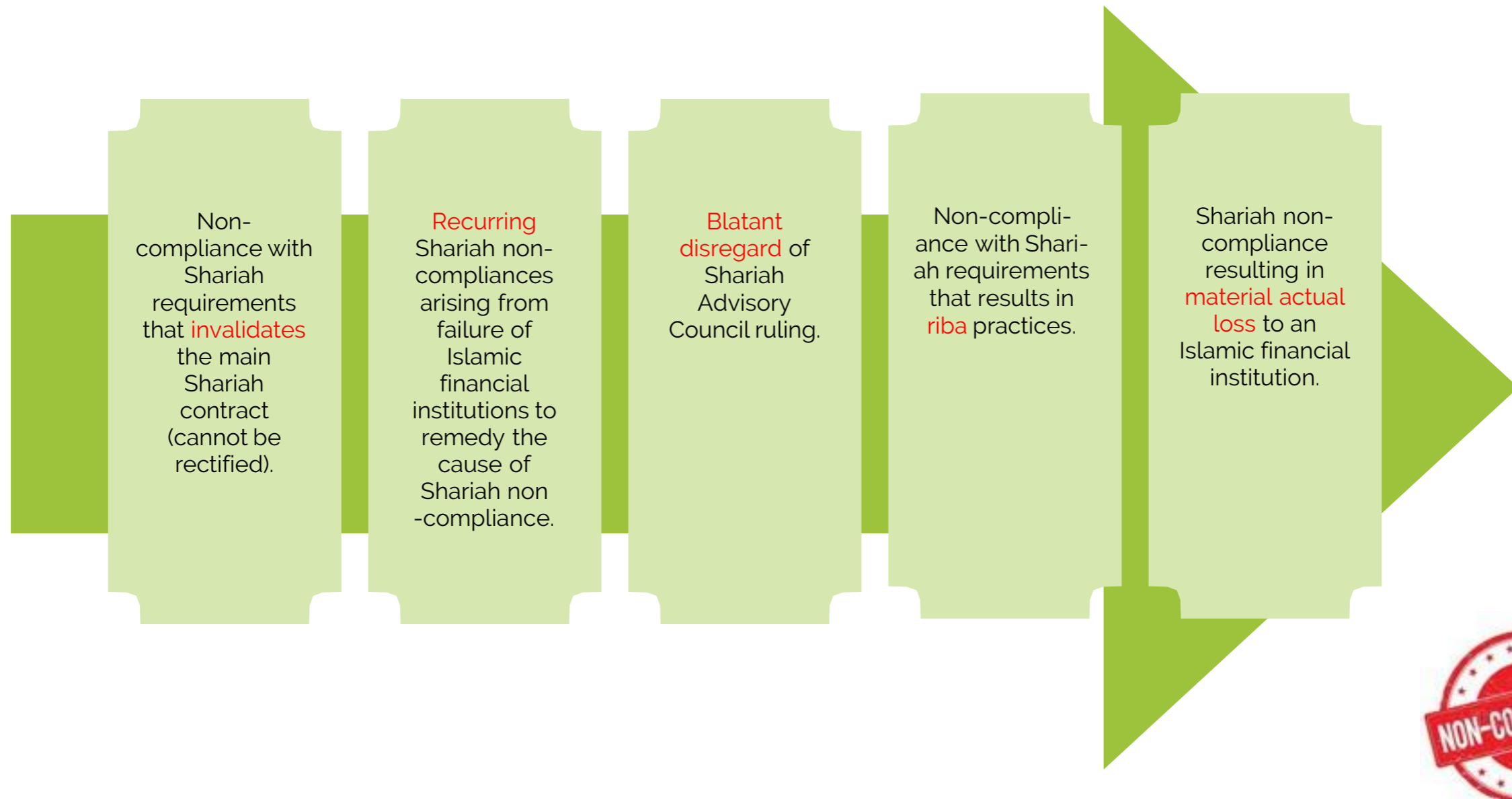
These include its **subject matter, contractual parties and sighah** (expression of intent). These are the three pillars of the contract which are of vital concern in determining its validity.

## Reasons

- ✓ **Lack of knowledge and competency in the area of Islamic finance** can be a major cause of SNCR.
- ✓ **Lack of proper training** to ensure adequate skills and competency of staff
- ✓ **Weakness in information technology and infrastructure** are other **important factors** that may trigger SNCR and hence affects the **validity of contracts**.

Therefore, **close monitoring and proper supervision are needed; a strong internal control system that ensures effective and efficient operation** are necessary not only for compliance with Shariah but with the applicable laws and regulations.

# Indicators of **Serious** Shariah Non-compliance Cases



# Parameters of Major Defects (SNC Triggering Factor)

Missing Pillar of the Main Contract

- z Non existence of one of the contracting parties
- z Selling "yet to be owned" asset in murabahah

Non fulfilment of the conditions related to the pillars of the contract

- z Ijab and qabul does not matched
- z One of the contracting parties does not have the legal capacity to enter into a contract

Major uncertainty

- z Selling asset which cannot be delivered



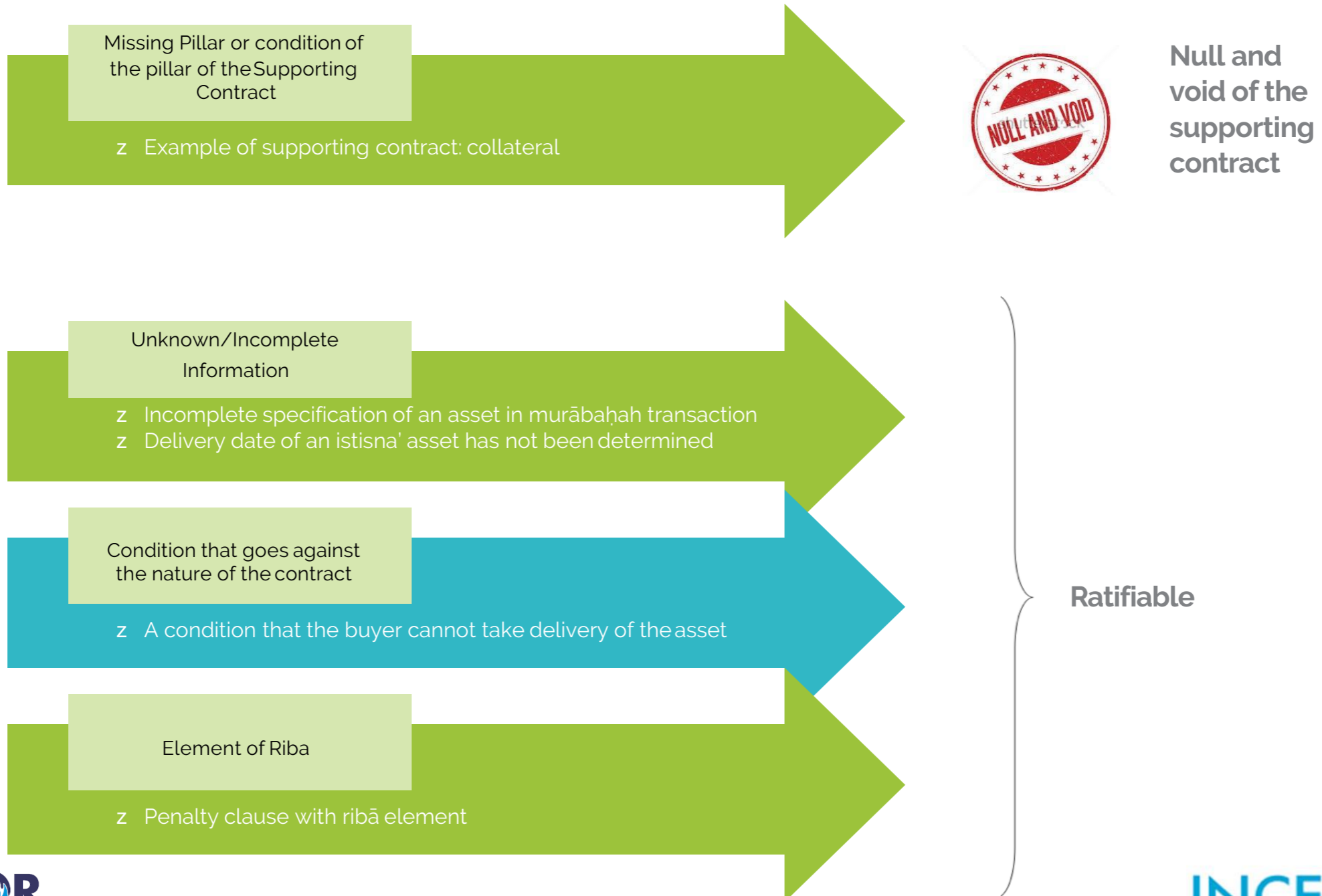


# Parameters of Major Defects

## Some examples

Situation	Shariah Standard	Consequence
A Bank sold an asset before taking ownership	<p><b>S</b> Murabahah            13.1 Asset to be traded in a murabahah contract shall meet the following conditions:            (a)the asset is recognised by the Shariah, valuable, identifiable and deliverable; and            (b)the asset is already in existence and owned by the seller.</p>	The contract is void
There was no offer and acceptance in a murābahah transaction between a bank and its client	<p><b>S</b> Murabahah            12.5 The murabahah contract shall be entered into through an offer and acceptance between the contracting Parties</p>	The contract is void
A bank has entered into a Mudarabah contract with a company that does not exist	<p><b>S</b> Mudarabah            12.2 Both the rabbul mal and the mudarib must be a natural person or a legal entity who shall have legal capacity to enter into the mudarabah contract including the capacity to perform agency (wakalah) contract either as a principal or as an Agent</p>	The contract is void

# Parameters of Minor Defects (Operational lapses)

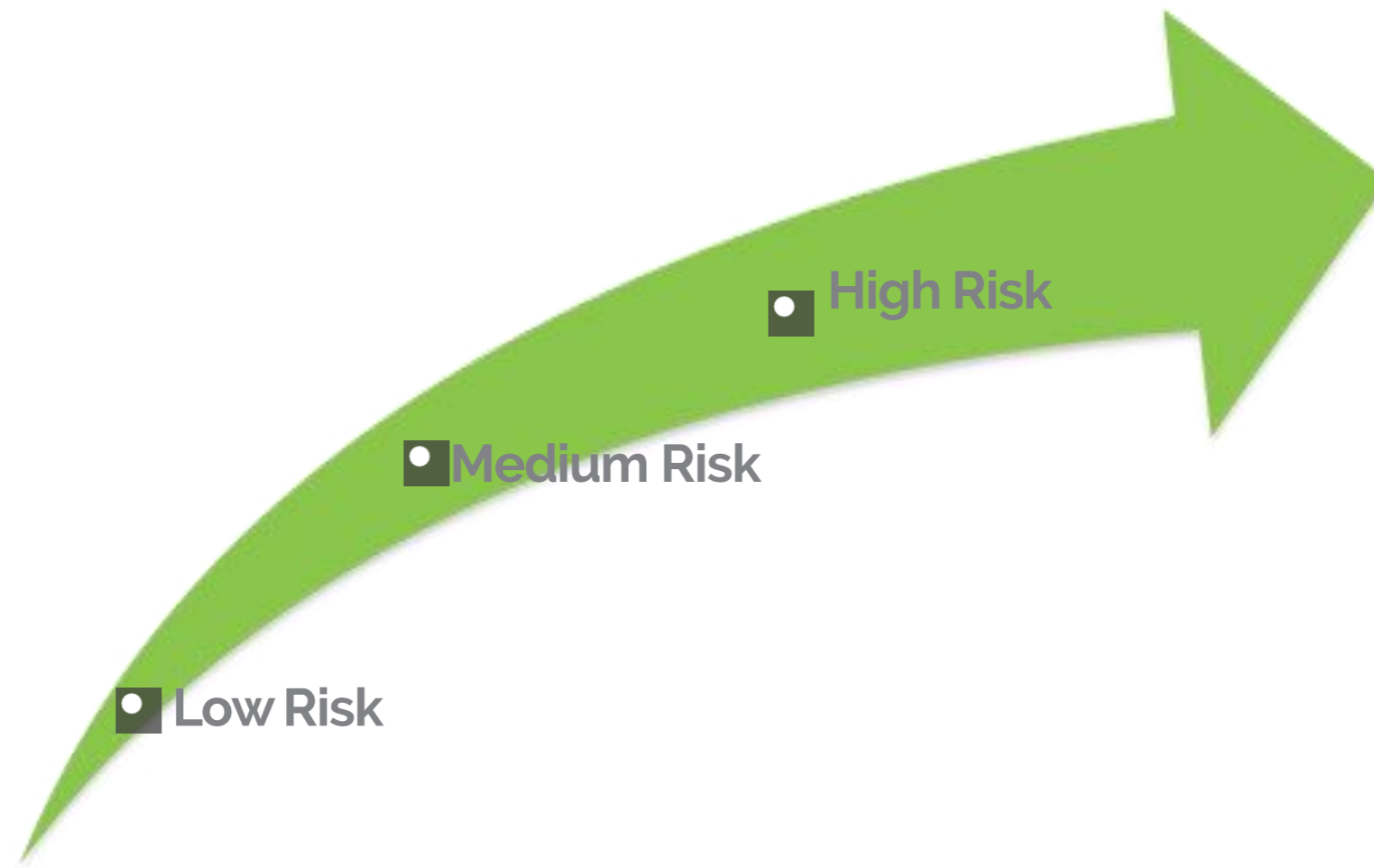


# Parameters of Minor Defects

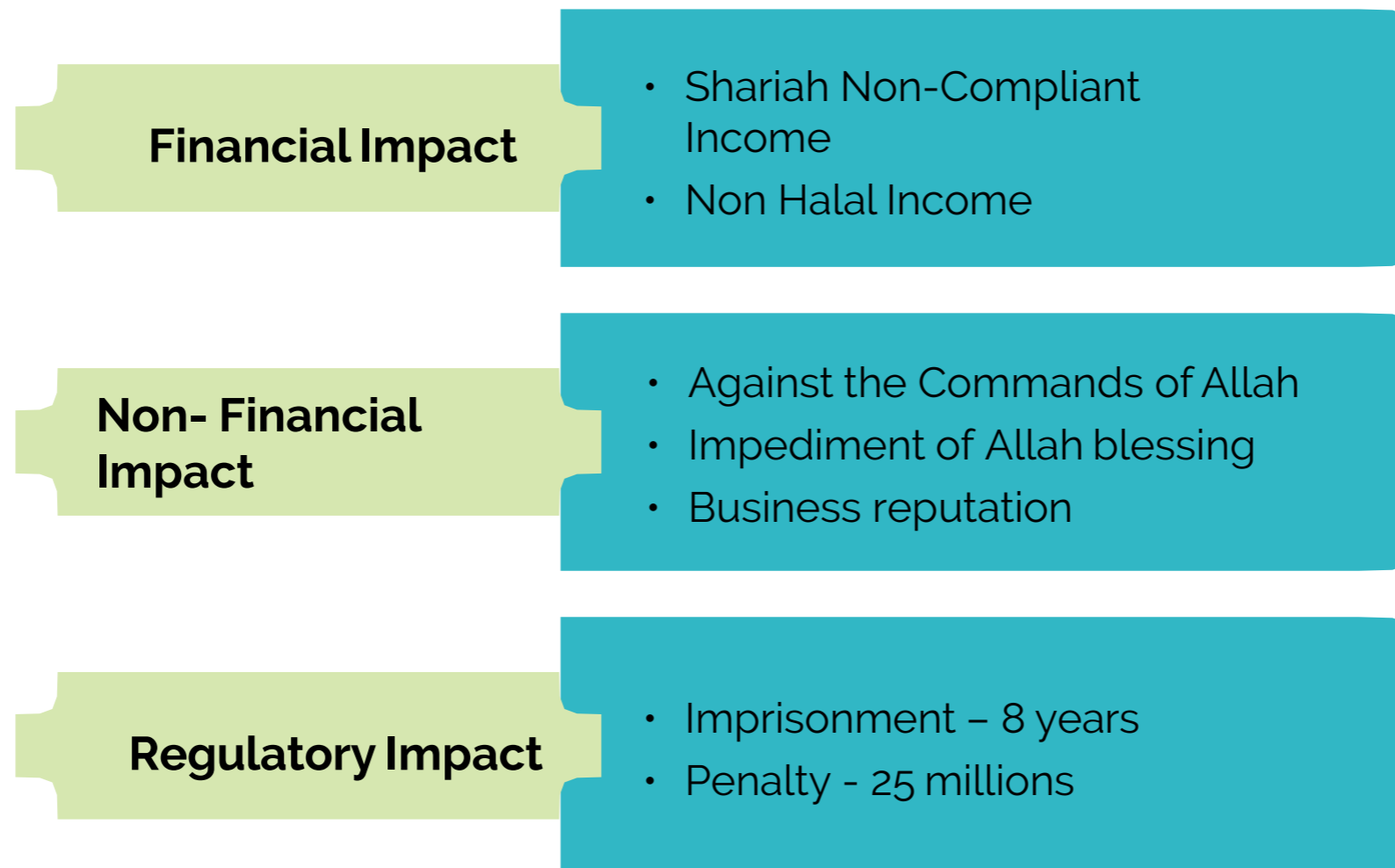
## Some examples

Situation	Shariah Standard	Consequence
Murabahah contract that does not allow the buyer to take delivery of the asset	<b>S</b> Tawarruq 15.5 The sale and purchase contract in the tawarruq shall not contain any terms and conditions that restrict the purchaser from taking delivery of the asset or create an obligation for the purchaser to sell the underlying asset.	The contract is ratifiable
The specification of the underlying asset in Tawarruq transaction is not complete	<b>S</b> Tawarruq 14.1 The price used for each sale and purchase contract in the tawarruq shall be determined and be mutually agreed by the contracting parties at the time of entering into each of the respective sale and purchase contract.	The contract is ratifiable
In murābahah transaction, a third party asset has been pledged to the bank without the consent of the third party owner	<b>S</b> Kafalah 14.4 In the case where the obligor (as pledgor) pledges collateral that is wholly or partially owned by a third party, the consent of the third party owner(s) must be obtained.	The kafalah contract is void. The murābahah transaction is valid

## Classification Of Shariah Non-compliant Risk



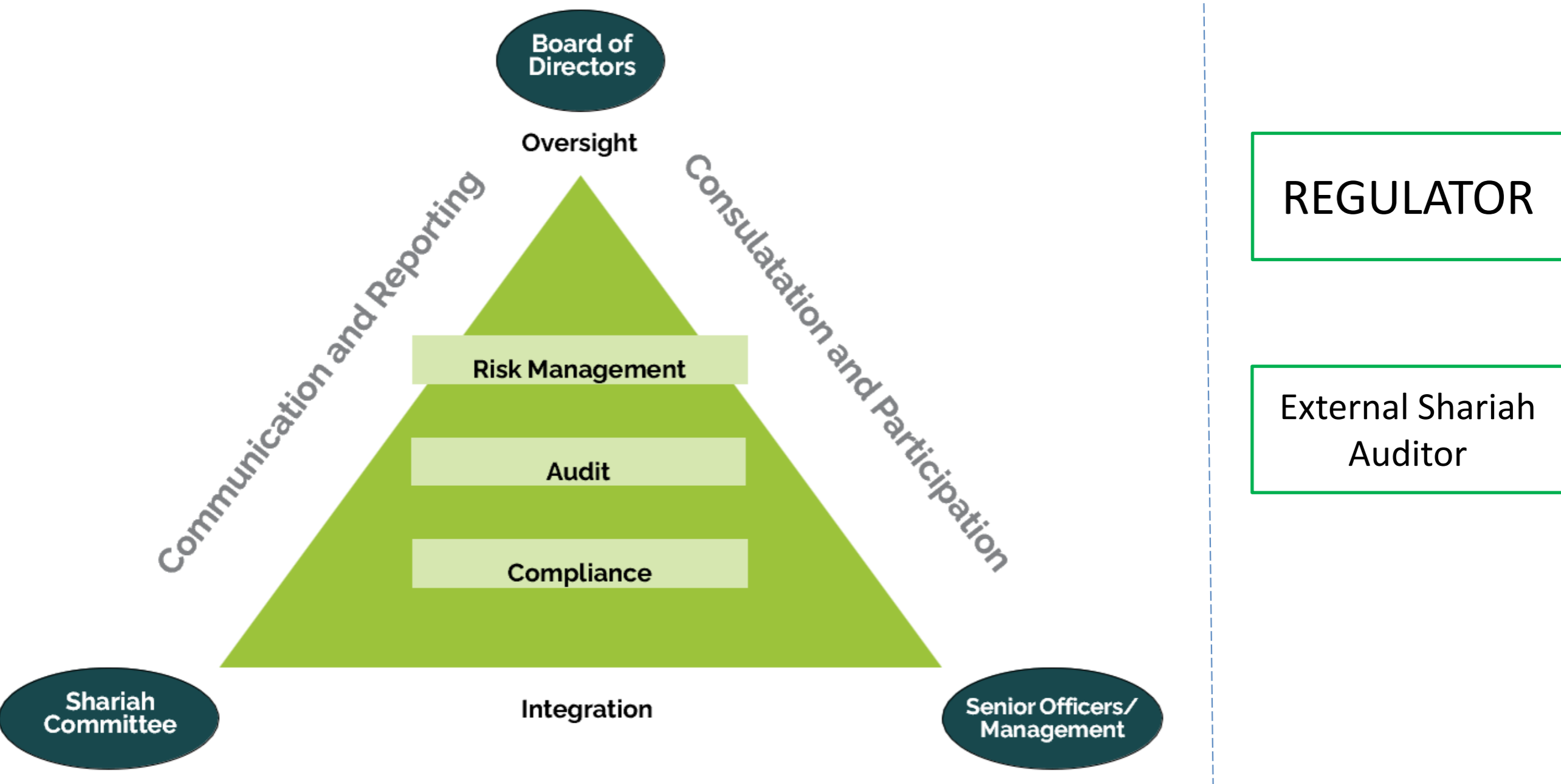
## Impact of Shari'ah Non-Compliance





# WHO?





*Islamic Financial Institutions to ensure end to end Shariah compliance*

# Collective Responsibility in Managing SNCR

1<sup>st</sup>

**Credit Officers, Branch Managers, Business and Support Heads, all staff**

- Sufficient knowledge
- Responsible for ongoing oversight of risk
- Day to Day affairs

2<sup>nd</sup>

**ORM Dept., Compliance, Shariah Compliance**

- Establish and maintain Operational Risk Management and Shariah compliance risk management framework

3<sup>rd</sup>

**Internal Audit including Shariah Audit**

- Independent Assurance to the Board and Senior Management that Risk Management processes and tools are implemented effectively

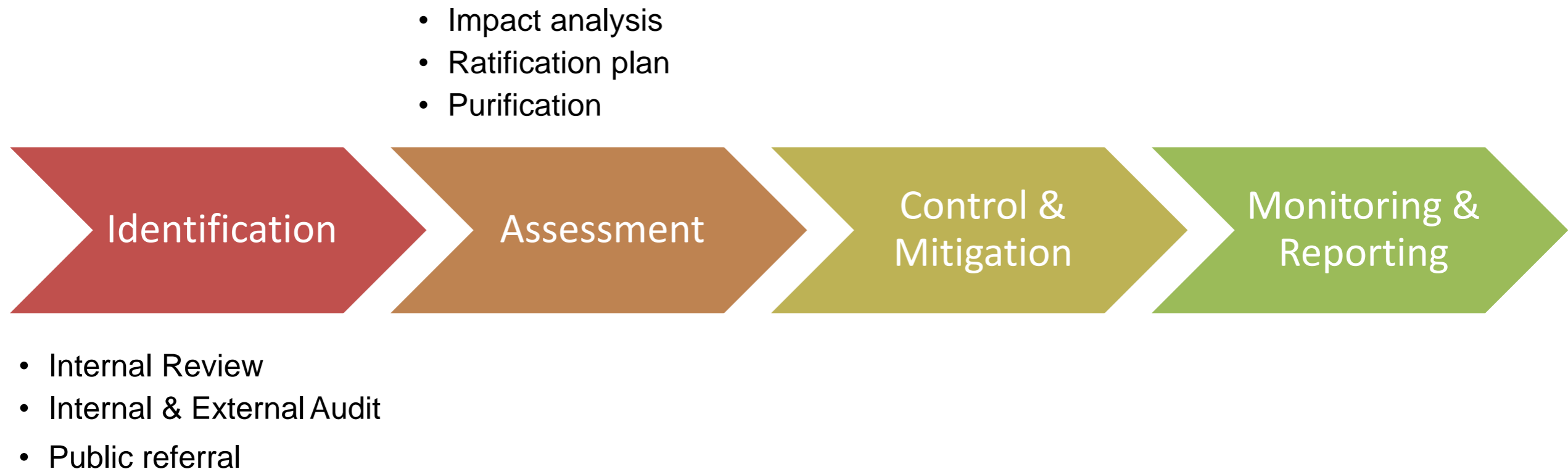




# HOW?



# Process of Shariah non-Compliant Risk Management



Non-Compliant found before the conclusion of agreement	Non-Compliant found during the financing facility	Non-Compliant after the completion of financing facility
Rectification done before the conclusion of the contract	Restitution	Non restitution
	Entering into new contract	Non-recognition of income (profit)
	Rectification of non-clear condition, etc	Only principal amount could be recovered
	Non-recognition of income	Any harm ( <i>darar</i> ) - if any - should be compensated

Where an institution becomes aware that it is carrying Shari'ah Non-Compliant Incidents, the institution shall:

Immediately notify the Bank and its Shariah Committee



Immediately cease from carrying on such business, affair or activity



Within X days, submit to the regulator a plan on the rectification of the non-compliance



# SOME CHALLENGES & RECOMMENDATIONS



# Issues and Challenges

## **Independence of the Shariah committee from management influence.**

- This is the ability of the Shariah committee to make objective decisions independently without any form of influence or coercion from the management.
  - A substantial amount of resources are spent by the management in developing processes and products with a focus on achieving their financial KPIs.
  - The function of Shariah committee may be viewed as perfunctory by the management.
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## **No direct communications between the Shariah committee and the board.**

- The Shariah committee communicates through the Shariah department or Shariah secretariat.
  - The board only relies on the report of the Shariah department for Shariah compliance assurance of the IFI.
  - The board may not understand how to implement a complete accountable Shariah oversight on the IFI and may need direct assistance from the Shariah committee.
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## **Consultation for deliberation.**

- The Shariah department are mostly consulted when they are needed to deliberate on a matter by other departments.
- The Shariah department may only detect non-compliance events during review or audit exercise.
- Other departments may want to communicate with the Shariah department on a regular basis to ensure that they can minimize Shariah and legal risks.

# Issues and Challenges

## **Complete reliance on Shariah department.**

- The Shariah department is known to be the main mechanism for running Shariah governance in the IFI.
- As most staffs are from Shariah background, IFI relies on the department to perform all Shariah related work.
- The department works on an “as and when” advisory basis; when a Shariah issue arises, the department are contacted.
- A Shariah department may consist of only a handful of Shariah qualified staffs with only a few years experience and it would be difficult to monitor the whole IFI.
- Conflict of interest issues: the Shariah department personnel are heavily involved in Shariah advisory, review, and even Shariah audit work.

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## **Training for Shariah advisors and the establishment of appropriate educational infrastructure.**

- Large IFIs may be fortunate to appoint experienced advisors but for small and medium-sized IFIs, they will appoint advisors who fulfill the minimum qualification criteria set out by the regulator.
- These advisors may not have the necessary knowledge, tools and skills about the industry or the experience of working with commercial organizations.
- Lack of necessary and relevant knowledge may cause the Shariah advisors to err when deliberating a matter.

# Recommendations

## Shari'ah



## Islamic Financial System

- Shariah is the backbone of Islamic finance industry which provides the foundations and direction.

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- A comprehensive **Shariah governance** aims to ensure a strict Shariah compliance in Islamic financial **services operations** and hence reducing Shariah non compliance risk.

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- A comprehensive framework of Shariah compliance and its implementation would realize our objective of **having a solid financial system based on Shariah.**

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# Recommendations

## A. Prudential control framework

- IFIS shall have in place a **comprehensive and sound framework** for developing and implementing **a prudent control environment** for the management of operational risks arising from their activities.
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## B. Shari'ah Compliance Mechanism

- IFIS shall have **adequate Shari'ah compliance mechanisms in place**:
    - a well-defined and adequately qualified and staffed organisational structure,
    - clear lines of authority and accountability;
    - policies and procedures pertaining to the approval of products and activities that require adherence to Shari'ah rules and principles.
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## C. Impact Review And Analysis

- Impact review and analysis of Shariah compliance in terms of frequency and prevalence of such compliance based on the internal Shariah control systems would **be facilitate the appropriate Shariah audit rating**.
- In terms of management and control this analysis provide **feedback to post audit or compliance review** as well as follow up with corrective actions prior to issuance of Shariah compliance review and audit reports.

**THANK YOU!**