

**SYSTEMATIC REVIEW: SHARIAH NON-COMPLIANCE (SNC) IN
ISLAMIC BANKING AND FINANCE**

Muhammad Ridhwan Ab. Aziz ⁱ & Noor Naemah Abdul Rahmanⁱⁱ

ⁱ (Corresponding author). Professor, Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia (USIM). ridhwan.aziz@usim.edu.my

ⁱⁱ Professor, Department of Fiqh and Usul, Academy of Islamic Studies, University of Malaya. naemah@um.edu.my

Abstract	<p><i>The requirement of the majority of Muslims to conduct and enjoy banking and financial services has contributed to the growth of the Islamic banking and finance sector, which has become an alternative to conventional banking and finance sector. However, non-compliance with Shariah law has become a hurdle for both banks and customers, which has resulted to financial losses for both parties. The management of Shariah non-compliance (SNC) events is significant for Islamic banks in order to provide the community with safe and transparent commercial transactions. As a result, the purpose of this study is to conduct research into the pertinent literatures that are related to Shariah non-compliance. A content analysis of the pertinent literature that is related to Shariah non-compliance events is included in the study approach that was used, which was a systematic review of the relevant literature. The findings as a whole showed that a better and sound Shariah governance framework is the key to mitigating Shariah non-compliance risk in Islamic financial institutions, which comprises of a collection of rules and guidelines.</i></p> <p>Keywords: Islamic, Banking, Finance, Shariah, Non-Compliance.</p>
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INTRODUCTION

Islamic banking and finance are one of the industries that has been growing up in the past few years. The development of Islamic banking and finance is significant to the Muslim in order to cater their needs and also become alternative to the existing conventional banking and finance that offer the prohibition of elements such as interest (*riba*) in their business operation. Islamic banking refers to a system of banking that abides by Islamic law, generally known as Shariah law. The fundamental principles that regulate Islamic banking are the mutual risk and profit sharing between parties, the assurance of fairness for everyone, and the fact that transactions are based on a commercial activity or asset.

These concepts are backed by the fundamental principles of Islamic banking, which encourage activities that foster entrepreneurship, trade, and commerce, as well as generate social progress or benefit. It is forbidden to engage in *riba* (interest), *maysir*, (gambling) and *gharar*, (speculative trade) as mentioned in Islam teachings. Allah SWT also mentioned that in the holy al-Quran:

﴿الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ۗ ذَٰلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا ۗ وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا ۗ فَمَنْ جَاءَهُ مَوْعِظَةٌ مِّن رَّبِّهِ فَانْتَهَىٰ فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّهِ ۗ وَمَنْ عَادَ فَأُولَٰئِكَ أَصْحَابُ النَّارِ ۗ هُمْ فِيهَا خَالِدُونَ﴾

Meaning: “Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, “Trade is [just] like interest.” But Allah has permitted trade and has forbidden interest. So, whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] – those are the companions of the Fire; they will abide eternally therein”. (al-Quran. al Baqarah : 275)

In addition, the Prophet S.A.W is supposed to have made a statement that can be interpreted as follows:

﴿رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ يَنْهَى عَنِ بَيْعِ الذَّهَبِ بِالذَّهَبِ وَالْفِضَّةِ بِالْفِضَّةِ وَالْبُرِّ بِالْبُرِّ وَالشَّعِيرِ بِالشَّعِيرِ وَالتَّمْرِ بِالتَّمْرِ وَالْمِلْحَ بِالْمِلْحِ إِلَّا سَوَاءً بِسَوَاءٍ عَيْنًا بَعِينًا فَمَنْ زَادَ أَوْ أَزَادَ فَقَدْ أَرَبَى﴾

Meaning: “(Allah’s Messenger SAW forbidding the sale of gold by gold, and silver by silver, and wheat by wheat, and barley by barley, and dates by dates, and salt by salt, except like for like and equal for equal. So he who made an addition or who accepted an addition (committed the sin of taking) interest)” (Hadith. Muslim. Bab al-Sarf wa Bay’ al-Zahab. 1587)

The fact that *riba*, or interest, in current world is expressly forbidden in both the Holy Quran and the deed of the Prophet Muhammad SAW is made abundantly clear by the discussion that has taken place up to this point. *Riba* can occur while taking out a loan, such as a vehicle loan, mortgage loan, term loan or overdraft, hire purchase loan, or personal loan. *Riba* can also occur in savings and fixed deposit accounts, as well as on credit cards. *Riba* is frequently and intricately entwined with conventional banking and financial practises, and it is deemed as Shariah non-compliance.

Islamic banking and finance have developed over the years into an increasingly important mechanism in many markets. Islamic banking and finance have progressed through exploring new opportunities for expansion in terms of both products and markets. There has been rapid expansion in the following financial sectors: Sukuk, Takaful, hedge funds, Mutual Funds, private equity and assets management, wealth management, real estate, corporate finance, liquidity management, treasury, derivatives, swaps, future and forward market, and the Islamic Stock Exchange (Mansoor Khan, 2008). In 2019, it is expected that the total assets of Islamic banks (IBs) in the world would reach USD 2.44 trillion, up from USD 2.19 trillion in 2018 (IFSB, 2020). There is now a 15–25% annual growth rate in the Islamic banking sector, and Islamic financial institutions manage approximately USD 2.7 trillion in assets worldwide (IFSB, 2022).

However, addressing Shariah non-compliance events is essential for Islamic financial institutions. Shariah compliance is the fundamental principle of Islamic finance, and it is the feature that is considered to be the most important for any Islamic financial institution. This study aims to provide a systematic literature related to Shariah non-compliance (SNC) in Islamic banking and finance sector to the future research in related field and to the IFIs in managing SNC risk exposure. Moreover, the present understanding of the effects that SNCs have on the Islamic banking and finance business is limited, but this study has the potential to enhance that information. This literature review helps in looking back and forth by creating a future research agenda in light of the fact that the field study is vast and continuing.

THEORETICAL BACKGROUND

The Concept of Shariah Compliance

The Shariah is a system of Islamic religious law that has been passed down through the generations. Specifically, Shariah is from Arabic term in which means “path to water” or “a path to be followed”. The term of Shariah also refers to the unchangeable divine law that God has established. This is in contrast to the term *fiqh*, which describes the various human intellectual interpretations of this law (Calder, 2019). Shariah is a foundation of Islamic

rulings that govern humankind in the worldly life and hereafter life. It is founded on the Quran and the Hadith, the two most important Islamic religious sources, and derives from Islamic religious precepts (M. Cherif Bassiouni, 2012).

Meanwhile, the philosophy of Islamic jurisprudence recognises four sources of Sharia: the Quran, *sunnah*, *qiyas* (analogical reasoning), and *ijma'* (juridical consensus) (Vikor, 2014; Calder, 2019). It is through the process of *ijtihad* that Sharia judgements are derived from scriptural sources, and the most significant legal schools in Islam include the Hanafi, Maliki, Shafie, and Hanbali schools. It lays out the rules by which the Muslim world is governed (or should control itself), and it establishes the foundation for humankind's connections with God, with other humans (Muslim and non-Muslim alike), and with the rest of creation.

In contrast, Shariah compliance often refers to adherence to and conformance with Shariah principles. In the context of Islamic financial transactions, this signifies that all financial transactions must adhere to Islamic law and the laws governing commercial transactions (*ahkam fiqh al mu'amalat*). These laws and rules, on the other hand, are derived and deduced from the primary sources of the Shariah (that are Divine in origin), i.e., the injunctions of the Quran and the directives and practises of the Prophet SAW, commonly referred to as the Sunnah; as well as the secondary sources of the Shariah that are based on human interpretation and reasoning, whether at the strongest level of *ijma'* (consensus) Thus, it is said that Shariah compliance stems from a Shariah foundation or Shariah framework of principles, injunctions, directions, norms, and prohibitions (Engku Ali, 2013). Moreover, Kunaifi et al. (2019) agree that Shariah-compliant means adhering to principles of Islamic law in commercial dealings (Shariah).

When it comes to banking and finance, all IFIs must follow Shariah norms to reduce the likelihood of Shariah risks like *riba* (usury), *maysir* (gambling), and *gharar* (uncertainty) in their commercial activities. Any unethical business practises within the banking industry are strictly prohibited (Satkunasingam, 2006). Apart from that, Md. Akhter is of the opinion that because this is a rule-based financial system, an individual must have a clear understanding of what the core rules are and how it is distinct from other financial systems.

According to the revealed writings and the practises of the Prophet Muhammad SAW, the three most significant principles are *riba*, *gharar*, and *maysir*, and all financial transactions must be free from these three factors; otherwise, the transactions would be null and void. According to further research, economic transactions that include components such as inequity (*ghubn*), coercion (*ikrah*), error (*ghala'*), deceit (*taghrir*), and deception (*jahalalah*) are likewise forbidden by Shariah law. For Islamic banks to effectively apply Shariah risk management, they must have a solid grasp of these issues (Hassan, 2016).

The Elements of Shariah Non-Compliance

According to Nabila Omar et al. (2019), there are several factors that can increase the likelihood of an SNC event. First and foremost, *riba* refers to the loan contract employed by conventional banking institutions today. They impose an interest rate with a predetermined increase on the amount of money a consumer borrows over a set time period. It is also prohibited to achieve an undue advantage in the exchange of goods on the spot. The hadith classifies the transaction of currency and commodities, including the six *ribawi* goods (gold, silver, barley, wheat, dates, and salt), as *riba*.

According to Aziz and Fatima (2012), the term Riba denotes an increase in capital attributable to a rise in wealth. It is often believed that the Quran forbade a particular form of *riba* that was widespread in Arabia at the time. In reality, however, the Quran forbade only the risk-free return of wealth and permitted the risk-free reward of human labour (known as "*al-bay'*"). The Islamic bank will be exposed to SNC risk if it fails to eradicate the element of interest and unjust benefit by either party from its products and services.

Moreover, a minor *gharar* in the contract and its implementation will not render the contract invalid. Furthermore, transactions involving an excessive amount of *gharar* may render the contract null and void since they may result in the development of a potential

SNC (Shafii & Salleh, 2010). Apart from that, *Maysir* is an Arabic word that literally means "gambling." In addition, the practise of gambling in any form is strictly forbidden in Islam. *Maysir* is an Arabic word that alludes to the simple and lucky acquisition of wealth, regardless of whether or not it violates the rights of others. *Maysir* is defined as gambling by Hameed (2009), and it can also refer to any sort of business activity in which monetary rewards are generated from only chance, speculation, or conjecture.

In addition, *Taghrir* constitutes fraud or deceit. In order to induce a buyer to enter into a contract, a vendor may, for instance, give a false fact about a product. This might result in SNC since it violates the Shariah's fundamental principles, which stipulate that any transaction must be based on the consent of both parties (Lahsasna, 2014). According to Lahsasna (2014) further, *Ghubn* in Islamic financial transactions refer to unequal product value in a cumulative contract resulting from the ignorance of both parties. When excessive *ghubn* is present in a contract, the deal may be invalidated since it is deemed a fraud by one party to encourage the other to engage into the contract.

IFSB (2016) also revealed that, another element of SNC is *Ikrah*. *Ikrah* is a threat made by one party to compel another party to sign a contract. The *Ikrah* or duress may render the contract invalid and result in SNC. In the other hand, *Ghalat* is an error that occurs in transaction contracts as a result of inaccurate forecast and assumption regarding the product or subject (Lahsasna, 2014). *Jahalah* or ambiguity on the topic may lead to conflict between the parties. Therefore, Islam obliged the seller to offer the customer with adequate knowledge and specifics regarding the subject. Excessive ignorance in any performed transaction invalidates the consent of the contracting parties and renders the agreement null and void (Hassan, 2016). In the other hand, *Ahliyyah* refers to a person's legal capacity to enter into a legitimate contract. The individual must be able to be held accountable and attain the age of criminal responsibility; otherwise, the contract is void (IFSB, 2016).

Another finding by Alam et al. (2021) mentioned that the quality of the Board of Directors (BODs), Shariah Supervisory Board (SSB), management, and Shariah executives have both positive and negative influences on the Shariah compliance quality, image, goodwill, and performance of Islamic banks. There is a correlation between the compositions, forms, and qualities of the Shariah Supervisory Board (SSB) and the Islamic banks' fatwas, Shariah decisions, compliance quality, and business performance. According to the findings of the study, Islamic banks' performance, Shariah compliance quality, image, and goodwill are all impacted by external factors such as prevalent banking pressure, the present political climate, the willingness of BOD and management, and social limits.

The Nature of Islamic Banking and Finance

According to Asyraf Wajdi (2008), the basic distinctions between Islamic banking and conventional banking stem not only from the manners in which they do business, but also from the beliefs that underlie Islamic banking's whole operation and attitude. Not only are these beliefs reflected in the minute details of Shariah (Islamic law), but also in its expansive function in society. This calls for the adoption of the form, spirit, and substance of the rules governing Islamic financial operations. In doing so, it exemplifies the purposes of Shariah to promote economic and social well-being. In other words, as Shariah-compliant institutions, Islamic banks are obligated to fulfil societal commitments that extend beyond the normal capitalist mindset that seeks to maximise profits alone.

The fundamental tenets of Islamic banking may be completely comprehended in the context of the Islamic economic system's overarching goals. Numerous prominent Islamic economists, such as Chapra (2000) and Ahmad, K. (2000), assert that Islamic banking is a subset of the overall Islamic economic system, which strives for a just, fair, and balanced society in accordance with the objectives of Shariah (also popularly known as *maqasid al-Shariah*). Consequently, the numerous restrictions (e.g., interest, gambling, excessive risks, etc.) are designed to level the playing field in order to preserve the interests and advantages

of all parties engaging in market transactions and to foster societal (Chapra, 2000; Ahmad, 2000; Siddiqui, 2001; Naqvi, 2003).

Moreover, being a system based on the ethical and moral framework of Islamic law, Islamic banking is similarly characterised by ethical values and social. Therefore, Islamic banking entails much more than not collecting interest and adhering to the legal formalities and regulations for selling Islamic financial products. It is a system that strives to contribute to the realisation of socio-economic goals and the establishment of a just society. Islamic banks strive to maintain a sustainable balance between income and spending in the course of conducting business so as to benefit the whole society (Ahmad, 2000; Mirakhor, 2000; Warde, 2000).

Shariah Compliance Risk in Islamic Banking and Finance

According to Muhd Amir (2019), the potential for SNCs to disrupt the business practises of Islamic banks stretches well beyond international borders. Shariah non-compliance is a high-priority risk in the administration of Islamic financial institutions for two principal reasons. Firstly, the vast majority of Islamic financial institution fund contributors recognise that Shariah-compliant services are crucial to the institution's long-term viability. Secondly, any ambiguities or inconsistencies in Shariah law will lead to the annulment of a transaction, resulting in a loss and an interruption in income. An agreement that would have resulted in a loss or rendered a possible source of income null and void (2019).

The Islamic Financial Services Board (IFSB) (2005) categorises the risk posed by SNCs as an instance of operational risk. In accordance with Principle 7.1 of the IFSB guiding principles, Islamic financial services (IFS) must implement sufficient mechanisms and controls, including a Shariah Board/Adviser, to ensure adherence to Shariah norms and principles (Islamic Financial Services Board, 2005). Shariah non-compliance risk is defined by Balz (2008) as the possibility that an Islamic financing transaction would be contested on the basis that it does not comply with Islamic law. Shariah non-compliance risk is included in operational considerations, and it is essential to address this risk in order to ensure that operations are conducted in accordance with the applicable Shariah rules and principles, as per the fatwa, policies, and procedures approved by the IIFS's Shariah Board. As a result of Shariah non-compliance, there is also the potential for 'legal risk,' which is the risk of failing to meet one's own contractual obligations, and 'compliance risk,' which is the risk of failing to meet one's legal obligations under applicable legislation and rules (Ginena K. A., 2015).

According to research by Kamal Abdel Karim and Hassan Yusuf (2010), there are multiple points throughout an IFI's operations and activities where Shariah noncompliance risk can arise. Each potential outcome is tied to the level of risk involved. A contract is inherently risky if it involves interest, gambling, or uncertainty. The second potential Shariah-violating factor is the product's composition and execution mechanism. Third, problems can arise if the structured product's procedure isn't carried out as the board recommends. This happens when the IFI's management introduces new procedures or eliminates old ones that weren't discussed with the Shariah board during the approval process. Last but not least, there is the issue of scholarly disagreements on how to apply Shariah principles.

Because of discrepancies in the interpretation of Shariah principles, procedures, and processes, the product may be ruled null and void by other scholars or regulatory authorities. The occurrence of an SNC event is typically determined on a case-by-case basis, and it is not exclusively focused on the financial transaction only; rather, it extends beyond documentation, language, and transaction. In addition to this, it could be the result of dysfunctional audit behaviour and an ineffective governance framework. For instance, failing to uphold Shariah governance or failing to acquire the consent of the Shariah Committee on a particular business may both lead to Shariah Non-Compliance, which is a legal sanction (Paino, 2010; Alam, 2013).

According to IFSB (2013) When compared to their conventional counterparts, Islamic Financial Institutions (IFIs) face the particular risk of Shariah non-compliance. International financial institutions (IFIs) have no choice but to follow Shariah law. If Islamic law (Shariah) is violated, the resulting contracts may be null and void. There will be far-reaching repercussions, including disappointment among participants, financial loss, and potential legal or regulatory action against the IFIs business. The occurrence and control of other risks are also likely to be affected. The risk of the IFIs sector not complying with Shariah law begins with the creation of new products. The items offered by IFIs are not only on par with their traditional counterparts but are also formulated in accordance with Shariah principles. Products from IFIs cannot be presented unless they are approved by the Shariah committee. This backing must come from the institution as well as the federal government. Before being released to the market, items developed by IFIs are subject to stricter regulations, including the submission of additional paperwork and permission from relevant authorities. (Islamic Financial Services Board, 2013)

According to Syed Ahmed (2018), the SNC risk is measured in a way that is distinct from conventional banking. When calculating operational-risk capital costs, traditional banks often look at gross income or a similar metric. However, SNC risk is calculated by subtracting any income that is not in line with Shariah law. There are, however, difficulties in Shariah non-compliance income (SNCI) measurement that must be overcome. A bank may simply refer to SNCI without providing any more context or facts. The attentiveness of the local Shariah authorities is essential to obtaining accurate SNCI data. Conventional banking, on the other hand, has established norms for institutional governance that may be utilised to make direct comparisons between different financial institutions. Furthermore, IBs with exceptionally high SNCI values are extremely uncommon. Using SNCI as an alternate to SNCR helps cut down on the number of observations needed.

RESEARCH METHODOLOGY

Existing research on Shariah non-compliance is limited, with only a few studies assessing relevant research papers and establishing a study agenda. As a result, the systematic review was chosen as a strategy to advance our understanding by examining theoretically and empirically based, presenting research findings derived from systematic, categorically organised literature reviews, and establishing connections between thematic areas of study of published studies (Watson, 2020). If employing this criterion would have precluded sanctioned research from being included, only articles from peer-reviewed journals were included for the investigation (Cooper, 2018).

Emerald, Elsevier, ScienceDirect, Scopus, Web of Science, and Wiley were the most popular databases for literature research. The researcher utilised an assortment of keywords that were mixed in various ways in accordance with our research aims. The AND and OR operators were applied for a more in-depth study. Our particular combination consists of "Shariah compliance" OR "Shariah non-compliance" OR "Islamic banking and finance" OR "Islamic finance." Each author provided a section to this study, and all sections were compared to their respective analysis' findings.

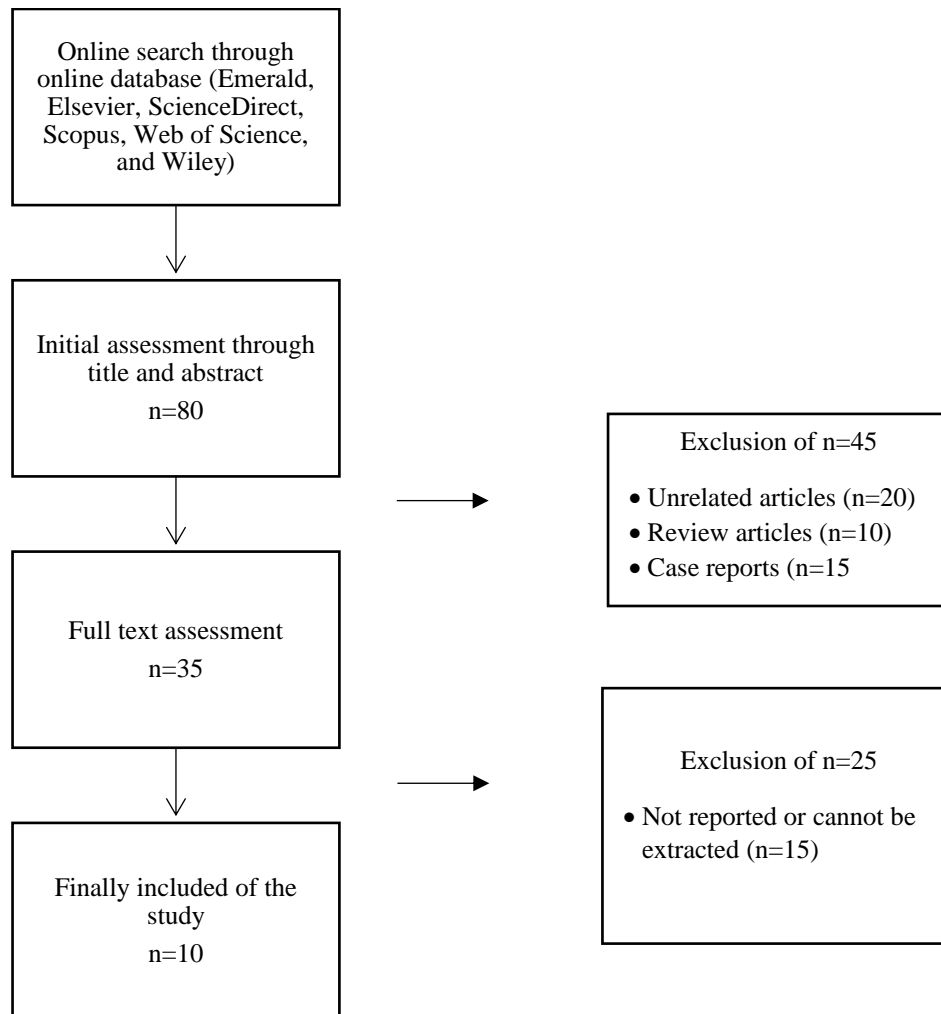


Figure. 1: CONSORT diagram for the screening and selection processes of included studies.

Following an initial investigation into various online databases, it was determined that there were 80 relevant findings (through title and abstract). Figure 1 depicts the procedure that was used to arrive at the final count of 10 relevant research. This final tally was achieved by utilising the method indicated in Figure 1 and determining the trustworthiness of the results in terms of their significance for the literature review.

ANALYSIS AND FINDINGS

From the analysis of 10 articles that has been going through, the researchers found that, many study had discussed that managing Shariah non-compliance risk exposure is significance to the IFIs in order to maintain the trust of the customers towards particular institutions. the researcher also found that on managing SNC risk through the analysis of data. Many study, stated that through a soundness of Shariah governance in IFIs also can assist in risk mitigation. Shariah governance is a framework by which Shariah non-compliance risk is assessed, and it can include both internal and external bodies. For instance, the Shariah board of the Islamic financial institutions might be an internal mechanism for auditing Shariah-compliant products, or an external audit could serve as the point of reference. Important institutional structures include legal, regulatory, judicial, and legislative mechanisms to handle Shariah non-compliance risk (Ginena K. A., 2015; Hamza, 2013).

Trust and confidence in the products offered and knowledge of the Shariah-compliant nature of transactions are both bolstered by the implementation of Shariah

governance. The interpretation of Shariah by Islamic scholars, either within the same Shariah board or across various Shariah boards, has been noted as a potential concern within the Shariah governance structure. Shariah non-compliance risk arises when there is inconsistency in the interpretations of Shariah experts, as in Beximco's case. This is because a third party could bring a legal action alleging that the product violates Shariah law (Ginena K. A., 2015; Hassan, 2016).

Moreover, the researchers also found that, the Shariah compliance audit framework is compulsory in order to mitigate SNC risk. The purpose of a Shariah compliance audit is to provide the Shariah Committee with sufficient evidence to form the opinion that the IFI's operations are carried out in accordance with the fatwas, rulings, and guidelines issued by the Shariah Supervisory Board of the Islamic financial Institutions, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), national accounting standards and practises, and relevant legislation and regulations applied by the IFI.

Shariah Compliance Audit Framework and Audit Programs for the products of IFIs will be capable of minimizing the Shariah non-compliance risk because it recognises the operational issues in the IFIs that complies to the Shariah and other sources of attestation or otherwise. Conformity to Shariah is essential for the operations of IFIs, and the standards for such conformity need to penetrate every aspect of the organisation, including both their products and their activities. The majority of the fund providers utilise Shariah-compliant operations as a matter of principle; hence, their perception regarding IFIs' conformity with Shariah regulations and principles is of utmost importance to the continued viability of IFIs (Johari, 2022; Johari et al., 2021; Zurina Shafii et al., 2010).

CONCLUSION

In conclusion, the Shariah non-compliance risk is classified as a high priority risk that Islamic financial institutions need to reduce in order to deliver services to consumers, particularly in countries where the majority of the population is Muslim. The performance of that Islamic financial institution, as well as their operations, had suffered as a direct result of the SNC risk exposure, as is obvious to everyone paying attention. Aside from that, this circumstance had an effect on the customers, which resulted in losses for the customers because the contract governing the transaction became invalid or null. As a result of the analysis, the general findings that can be drawn are that a soundness of Shariah governance framework may aid IFIs in limiting the SNC risk exposure. Specifically, it gave the guideline that IFIs needed to follow in order to manage the SNC risk.

As a precautionary measure against potential adverse outcomes, Islamic banks are required to manage the SNC risk. They are obligated to check that all of the arrangements, terms, and conditions do not go against the Shariah before the execution, with ongoing evaluation being done for the purpose of measuring. The goals, principles, and regulations of Shariah strongly influence the way in which IFIs conduct business. Building a culture of Shariah compliance throughout IFIs' operations is a huge undertaking. If Islamic banking and finance were fully compliant with Shariah principles, the public and financial markets would have more faith in the stability and legitimacy of these institutions.

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