



## The Study of Potential Shariah Non-Compliance Risks in Murabahah Along with their Risk Management

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**Abstract:** *The primary objective of this paper is to find out the Shari'ah Non-Compliance Risks (SNCRs) of Murabahah along with proposing its risk management system. As the activity of Shariah non-compliance is either due to negligence or failure to comply with the Shariah rules and regulations, as well as to some extent it causes breach to the law of the land. Hence, Identification, Monitoring, Control and Mitigation of SNCRs need to be undertaken sensitively, otherwise the spirit and objective of Islamic banks (IBIs) will be no more different than conventional banking system. Moreover, failure to controlling and mitigation of Shariah non-compliance risks may render the transaction into 'Null and Void' or 'Voidable', thus, the return/profit is considered impermissible. In addition, SNCR may expose the status of IBIs at high risk regarding their reputation, profitability and confidence of their stakeholders which may lead the Institution towards either downfall or even collapse. Keeping in view, the need of SNCR management, this paper is established to support the industry for development of their own SNCR management system so that the targeted outcomes of Islamic banking on the basis of Shari'ah principles i.e. Shariah compliance, permitted profits and sound reputation can easily be achieved.*

**Keywords:** Murabahah, SNCR, prohibited profit, voidable, null and void.

### Introduction

Shari'ah Compliance environment is the basic need and distinctive characteristic of any Islamic bank which discriminates the Islamic banks from their counterparts. Hence, in this modern era, no one can negate the active and effective role of Islamic banking system in economic development world widely particularly in Pakistan, It is growing day by day as presented by SBP - quarterly compendium: Banking Statistic, over viewing the total asset of Islamic Banking Institutions in Pakistan as of March 31, 2019 is 2,789,891 million (FSD, 2019), as compared to previous quarter database of 2,658,485 million (FSD, 2018). The reason behind its growing popularity is due to the flexibility of Islamic principles that were observed in global financial crises (Zahid & Basit, 2018). However, Islamic banking is not only the name of these two words (Islam+Bank) or few Arabic words that denotes just the Islamic terms but actually this is the system which bases on commands and injunctions described by Shariah principles according to Islamic spirit and ideology. These principles and values, rules and regulation are extracted from basic sources of Shariah: Quran and

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Sunnah as well as by secondary sources of Shariah: Ijma and Qiyas. These four foundations are known as “Sources of Shari’ah”. Therefore, the financial system which comprises of these above-mentioned sources is called Shari’ah compliant financial system. Consequently, IBI follows the Shari’ah principles and offers Shariah-compliant financing or banking products as compared to its counterpart (Aman, Sharif, & Arif, 2015). The need of Shari’ah Compliance with all products & services of Islamic Banking Institutions (IBIs) is concomitant. As well as, it is essential to be complied with Shariah in performing their roles & responsibilities and all-inclusive functions, activities and processes.

Furthermore, on behalf of sound and effective Shari’ah Compliance environment, the desired targets of IBIs such as permissible profits, Shariah compliance financial activities, promotion of Islamic banking system and accuracy and stability of Islamic financial system can be achieved. Otherwise, due to the facing of Shari’ah Non-Compliance Risks, the confidence of stakeholders and the reputation of the IBIs would be lost and finally the institution may collapse. Accordingly, this paper is an effort to highlight the most important Shari’ah Non-Compliance Risks (SNCRs) of key financing product – Murabahah and its risk management tools.

## Literature Review

During the research and before, various sources, materials and data particularly ‘Shari’ah non-compliance risk in the Banking Sector - Impact on capital adequacy framework of Islamic Banks’ (Oz, Ali, Khokher, & Rosman, 2016) have been studied. As well as, a detailed discussion was positioned on the matter of SNCR that how to treat with SNCR but once they started to explain SNCR, explained just few major SNCRs very slightly for some prominent products. However, it requires detailed discussion following the systematic way of identification, mitigation, monitoring, reporting and control of SNCRs in shape of framework or in the form of Shari’ah non-compliance risk management mechanism. However, there was a healthy discussion on the specific subject of capital adequacy requirement (Oz et al., 2016).

Another article; ‘Risk Management in Islamic Finance: An Analysis from Objectives of Shari’ah Perspective’ (Agha & Sabirzyanov, 2015) explains the risk in different styles following the Objectives of Shari’ah (Maqasid al-Shari’ah)<sup>1</sup>. There are three types of risk; (1) Essential risk, (2) Forbidden risk, (3) Tolerable risk, in other words this is the risk that can be managed. However, management and mitigation in this risk are desired otherwise it can be more dangerous and exceeds the bearable limits of the individual and institution. As Quran says: “And spend [freely] in God’s (Allah’s) cause, and let not your own hands throw you into destruction” (Al-Baqarah: 195) therefore, it should accurately be mitigated or minimized as this is the prerequisite of Shari’ah and considered one of the main factor of Maqasid al-Shari’ah. Liquidity risk, credit risk and market risk are the main

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<sup>1</sup>Maqasid al-Shariaḥ are basically five objectives of Shariah. They are known as mentioned by Chapra, Khan, and Al Shaikh-Ali (2008). Al-Ghazali defines Maqasid al-Shariaḥ as “promotion and protection of the well-being of the people, which lies in safeguarding their faith (din), their self (nafs), their intellect (‘aql), their lineage (nasl) and their wealth (mal)”. Almost the ruling of Shariah bases on to protect these five main objects for the welfare of human beings (Ali & Hasan, 2011).

examples of this category. Keeping in view the Shari'ah perspective, it is needed that these risks along with their all types to be managed and minimized by hedging or any suitable strategy. Moreover, SNCR also pertains to second category of risk, nonetheless complete list of SNCRs and their adequate points would not be discussed completely in the paper.

Dar, Azeem, and Masood (2013) focused on operational risk related to Islamic banking industry, being an exploratory study, first he explained classification of operation risk using model given by Izhar (2010) and then discussed a conceptual framework presented by Rosman (2009). They also tried to integrate the two models. In conclusion, they emphasized that in Islamic banking, exposure of operational risk is substantially different from conventional banking mainly due to additional Shari'ah compliance risk and fiduciary risk, however, no example of Shari'ah compliance/non-compliance risk was provided which should have been given due to major distinction between Islamic and conventional banking. Also, no suggestion, framework or technique was found regarding mitigation of risk but advice is given to Islamic banking sector that they should develop a framework for operational risk management. Ahmed (2011) discussed in his paper about risk management is vital for every organization and have greater importance for financial institutions in general due to nature of business. In particular, Islamic banking attracts additional risk of Shari'ah noncompliance and these additional unique nature risks should be identified and part of Risk assessment system of the bank.

Moreover, the complete chapter of risk management in very widespread books 'An introduction to Islamic Finance theory and practice' (Iqbal & Mirakhor, 2011) was established. All most important types of risks exposed to Islamic financial institutions were conversed along with the key factors and their details moreover the book emphasizes on the importance of Shari'ah compliance as this is the main difference among Islamic and conventional financial systems. Moreover, it explains that the relation of clients with the organization (Islamic Bank) is of trust basis in Shari'ah compliance regardless only profitability. Therefore, they focused and educated by their write-up to give high priority along with complete Shari'ah compliance with their all functions and duties (Iqbal & Mirakhor, 2011). Considering all these above mentioned characteristics, this intellectual literature also explains the requirement of SNCR mechanism (Iqbal & Mirakhor, 2011). As well as, keeping in mind, the instructions and guidelines devised by regulator on SNCR risk management, like; guiding principle on Compliance Risk (BPRD, 2017) particularly risk management strategies & guidelines for IBIs, (IBD, 2008) were considered. They also describe the meaning, status, instruction and strategies for groundwork of SNCR managing and controlling system without the example framework. Hence, this work proposes to develop such a material that encompasses all techniques that would define the SNCR of Murabahah product along with its risk management system. Thus, the paper firstly will identify the risk, then assess through screening stage, monitor, report, control and finally provide the corrective actions. Hopefully it will provide the structure that would fulfill the objective of standardization of risk management mechanism for all other remaining useful products of the industry as well.

## **Shariah Non- Compliance Risk**

Shari'ah non-compliance risk is the risk that rises from IBIs' failure to comply with the Shari'ah principles prearranged by State Bank of Pakistan and Shari'ah Advisor of the IBIs (IBD, 2008). Shari'ah non-compliance risk (SNCR) arises from the negligence or failure to comply with the Shari'ah principles as elucidated in product programs and respective documents which results the transaction into "Null and Void" (Batil), "Voidable" (Fasid) or Repugnant/Abominable (Makruh) as well as defined by IFSB and ISRA in their joint research paper (Oz et al., 2016).

Risks are uncertain upcoming events that can influence the accomplishment of desired aims and purposes of Financial Institution and, it also impairs the strategic, operational, and compliance objects. IFSB defines: "Risk is generally defined as "uncertainty about a future outcome". There are multiple definitions of risk that include what may constitute a risk and the range of possible risks. Some of the more widely discussed definitions of risk include the possibility of an undesirable event, the loss from an unexpected event, the probability that "things won't go right", and the effects of an adverse outcome" (Oz et al., 2016).

## **Importance of Shariah Compliance**

Shari'ah compliance is much-needed activity for IBIs' smoothly operations and such compliance necessities must prevail throughout the organization and their products and services. "As a Shari'ah-compliant banking service is a matter of principle. The perception regarding IBIs' compliance with Shari'ah principles is of great importance to strength and sustainability of IBIs. In this regard, Shari'ah compliance is considered as falling within a higher priority category in relation to other identified risks" (IBD, 2018).

## **Murabahah**

Murabahah is a particular type of sale where the seller unequivocally declares the price of the purchased goods, and sells it to another party by adding profit which is known to the buyer thereon. Thus, Murabahah is not a loan given on interest/usury; it is a sale for cash either on spot or on deferred price in which the buyer knows the profit of the seller as well. Usually in normal practice, Bai'e-Murabahah (Murabahah sale) involves purchase of the goods by an agent/client on behalf of the bank/financial institution and then sell it to prospective purchaser on cost-plus-profit basis. Under this arrangement, the bank discloses its cost and profit margin to the client. In other words, instead of advancing money to a client who wants borrowings for purchase of required asset or commodity, the bank purchases the goods from a third party and sell the very same goods to the customer at a mutually consented and declared cost-plus-profit price.

## Specified Terms and Condition of Murabahah

Basically, Murabahah is a sale contract, hence, all terms and conditions of a regular sale will be applied to Murabahah, but it has some specific conditions to be employed according to Shari'ah . [Ayub \(2007\)](#) described them in detail; below is the summary of that:

1. Goods to be traded should be real and permissible ([Shami, 1999/1420H](#)).
2. Any currency and monetary units that are subject to the rules of Bai-e-Surf cannot be sold through sale of Murabahah. (Standard, No. 8, clause 2/2/6).
3. Similarly, credit documents that denote debt payable by someone cannot be the subject matter of Murabahah sale (Standard, No. 8, clause 2/2/7 and its Shariah Basis).
4. The seller must state the real price and the other expenses incurred on the sale item and it must be just and true to his words ([Shami, 1999/1420H](#)).
5. The prospective seller in Murabahah is required to disclose all aspects relating to the commodity, any defects or additional benefits and the mode of payment to the supplier (Standard, No. 8, clause 4/4).
6. The margin of profit on the price so reached has to be mutually agreed upon between buyer and seller.
7. Price must be known as any unspecified price cannot become a base for Murabahah, as it contains the resemblance of uncertainty which renders the Murabahah sale into unlawful ([Marghinani, 1994/1415H](#)).
8. The purchaser in Murabahah has the right of option, even in the absence of this condition or its stipulation in the contract '([Ayub, 2007](#)).

As specific conditions are summarized for approximate comprehension of the mode of finance/ Murabahah product, furthermore it should be remembered that this mode also prevails in market by different names and variants, mean, on the basis of Murabahah, Credit Murabahah, Import Murabahah, Local Murabahah, Commodity Murabahah and other types of Murabahah are also useful to facilitate the clients. However, the main gist and essence is also of general Murabahah. This is why, we discuss herein below the process of general Murabahah that almost covers any other variant of Murabahah and educate more than others as well.

## General Process Flow of Contemporary Murabahah Sale

As a fact, the modern-day Murabahah is much different from that of classical practice, therefore, deliberate elaboration of the current method/flow of transaction is potently needed so that it could be understood in generic and easy way. On behalf of that, it will be easy to screen the stage of SNCRs and their respective issues. Therefore, followings are the usual steps of Murabahah Sale.

1. ABC Company executes a Murabahah Facility Agreement (MFA) with XYZ Bank for purchasing the goods.
2. XYZ Bank and ABC Company separately enter into an Agreement for Agency. The ABC Company as an agent of XYZ Bank purchases the described goods.
3. ABC Company proposes an Order Form to XYZ Bank for purchasing the desired goods.
4. Having received the Order Form, XYZ Bank issues instruction to ABC Company (as an agent of XYZ Bank) to obtain the goods in accordance with Agency Agreement according to ordered form.
5. Disbursement is made in ABC Company's escrow account, and consequently to the supplier's account through RTGD/PO/Cross Cheques for onward payments against purchases. Customer then provides copies of accounts of RTGD/PO/Cross Cheques as evidence for routing. In case of RTGS to supplier's account, customer submits formal RTGS request (clearly narrating amount, name and supplier's account no.) for transfer of funds to supplier(s)' account. The request should be in accordance with order form.
6. ABC Company on behalf of XYZ Bank as an agent makes sure the receipt of funds for onward payment to Supplier(s).
7. ABC Company presents the Declaration of taking physical/constructive possession of the exact goods along with an Undertaking for non-consumption/non-destruction of the subject goods. This information is documented on proper drafted Declaration format, duly supported by purchased acknowledgment. (It is suggested from Shariah risk point of view that Relationship Manager should perform official visit the customer and assure the non-consumption /non-destruction of the goods).
8. ABC Company provides copies of swift messages/Delivery Orders/Invoices (whichever is applicable containing complete details including description of the goods, quantity, price and name of suppliers etc.) for substantial proof of routing funds and as evidence of said purchases. It is hereby allowed to obtain Invoices/Delivery Orders in the name of the Customer.
9. Immediately after receiving Declaration from ABC Company/Customer, XYZ Bank offers to purchase (Offer of Murabahah Transaction) the goods to customer at agreed cost-plus profit on deferred Murabahah basis and customer accepts the offer to purchase (acceptance of transaction) of goods made by XYZ Bank accordingly. This concludes the Murabahah transaction.
10. Advance/Funding against Murabahah is converted into Murabahah Financing approximately within 15 days in parts, lump sum operative from the date of payment/disbursement of funds through executing first normal sale by XYZ Bank for the purchase of goods.

11. The Agreed Murabahah Price is payable by customer as per agreed schedule of the payment of Murabahah price in lump sum or installments. The customer adjusts the Murabahah from his own sources

## How to Deal with SNCR?

The elements of SNCR tend to make the transaction Null and Void (Batil) and sometimes voidable (Fasid). Both of them are fundamentally types of invalid sales (Bai'-e-Ghair Sahih). The Hanafi Fuqaha (Jurists) declare these classifications as invalid. Their status (rules and regulations) has been explained separately in this paper as well. Whereas other Jurists like Maliki, Shafi'i and Hanbali schools of thought did not categorize them as invalid sale as Hanafi Fuqaha have. In a nut shell, Fāsīd (voidable sale) is a contract which completes its fundamental principles but its attributes (Awsaf)<sup>2</sup> are impaired-but-rectifiable with some amendments as per the Shari'ah requirements, or sometimes cannot be rectified and needs to be re-executed with mutual consent at every cost. Whereas a Batil sale (null and void sale) carries faults in its original basis (Usul)<sup>3</sup> and there is no option to be corrected or rectified. It has no solution except for cancellation and re-execution of the contract with mutual consent (Ibn-e-Nujaim, 1999/1420Ha).

The above mentioned classifications and details of invalid sale are nowadays acceptable to the majority of contemporary Shari'ah scholars although they belong to different schools of thought.

Because the stand of Hanafi Jurists removes the obstacles of modern-day transactions in Islamic banks' products, it is preferable to do so because due to numerous transactions it is almost impossible to re-execute every contract which somehow falls into the category of invalid sales (Batil).

As well as, the above mentioned jurisdiction is the demand of modern-day international market as it surely removes the refutation among scholars regarding Shari'ah viability of Islamic financial system. Almighty Allah says in Holy Quran: He has selected you and has not kept any hardship upon you in religion (Hajj 22:78). More detail in this regard may also be evidenced in joint research paper of IFSB and ISRA (Oz et al., 2016). But proper detailed stance of Hanafi Jurists in this regard is still to be addressed.

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<sup>2</sup>Awsaf is the Arabic word, the plural of Wasf, it means attributes of anything therefore in Islamic financial laws, 'attributes' are known as conditions and perfections other than basic principles therefore with inadequate attributes or irrelevant conditions, the contract may exist/execute however in the absence of principle, transaction cannot exist, the result of first scenario is called 'Voidable' and the consequence of second scenario is called 'Null and Void'. Examples of Voidable sale: once the Shariah compliant subject matter/object of sale (like a car) is exchanged with permissible price/consideration meanwhile the seller conditioned that he will use that car after sale for one month, in this example basic principles are fulfilled but the condition of one month use of car impermissible and creates problem in the objectives of sale that is why this sale is Voidable until and unless this invalid condition is removed. Whereas (example of the Null and Void) sale of Pig with permissible price/consideration will be considered 'Null and Void' as the basic rule of sale that of being a permissible subject matter according to Shariah is missing in this example (Shami, 1999/1420H).

<sup>3</sup>Usul is plural of 'Asl that means basic principle.

## Shari'ah Non-Compliance Risk Mechanism for Murabahah in the Light of AAOIFI Shari'ah Standards

### SNCR of Absence of Basic Principles or Conditions of Mode of Finance

Islamic finance has various modes of financial transactions both for an individual and enterprise as well as through which they can fulfill desired financial requirements in accordance with the Shari'ah principles. Therefore, if a person or legal entity wants to invest in a business venture, Musharakah and Mudarabah are appropriate for them as well as if they want to sell/purchase or trade by any permissible means, they have number of choices to get involved in a business with a variety sale contracts and if they want to rent anything out, they have options of Ijarah with its both the classical types which are Ijarah-tul-A'ayan or Ijarah-tul-Ashkhas (operating Ijarah or service Ijarah) along with different existing types of Ijarah. Briefly, Islamic financial instruments along with fascinating ideology fulfill the requirements of every individual's financial needs as well as have vast scope to compete and modify the current, innovative and upcoming latest conventional instruments/tools according to Shari'ah. Therefore, there are some rudimentary requirements of Shari'ah that cannot be overlooked until and unless Shari'ah has granted permission for particularly desired exception as the deferment in delivery of subject matter in Salam and Istisna' contract is allowed by the Blessed Words (Bukhari, Hadith No. 2240) of the Holy Prophet (Allah's peace and blessings be upon him) otherwise, none of the following terms and conditions be ignored.

- Eligibility criteria of parties must comply as to they must be eligible, sane, competent and mature (Nizam, 1982-1403H).
- Normally in any Islamic financial transaction, it is compulsory that the subject matter (object of the sale) must exist before the execution of transaction (Ibn-e-Nujaim, 1999/1420Ha).
- Proper specification and determination of Price according to contract's requirements must be known by every contractor (Ibn-e-Nujaim, 1999/1420Hb).
- It is also compulsory that offer and acceptance must be complied with each other (Nizam, 1982-1403H).

The mentioned four components are the basis of any transaction and must be complied with Shari'ah principles, otherwise imperfection in their requirements usually invalidates the transaction, sometimes in the shape of 'Null and Void' (Batil) and sometimes in the shape of 'Voidable' (Fasid) or 'Repugnant (Makruh) (Shami, 1999/1420H). Voidable (Defective) transaction may be rectified with corrections whereas null and void transaction requires re-execution. Moreover, profit on voidable (if not rectified) and on void sale will be credited into charity account while the profit on abominable' (Makruh) sale is not favorite by Shari'ah though permissible for personal use. Actually, a layman can understand by these above few words mentioned above that the violation of Shariah principles can expose the Islamic Bank to many SNCRs.

### **Corrective Action in Case of Shariah Non-compliance**

SNCR, transaction cannot be executed, therefore, considered as Null and Void ([Nizam, 1982-1403H](#)). Profit will be credited into charity account.

### **Coherence with Process Flow**

Through Master Murabahah Facility Agreement (MMFA), this risk is also mitigated because all kinds of Murabahah goods are priory explained to be purchased by order form.

### **SNCR of Impermissible Subject Matter**

The subject matter is necessarily to be Halal (Permissible) according to Islamic laws in every transaction and in Murabahah transaction as well (Standard No. 08, clause 2/1/1). This SNCR is actually is the sub-kind of previous principle SNCR as written before, the violation in first SNCR triggers numerous SNCRS for Islamic financial institution.

### **Corrective Action in Case of Shariah Non-Compliance**

According to Shari'ah in this case, transaction cannot be executed and considered as Null and Void consequently (Standard No. 08, clause 2/1/1). Profit will be credited into charity account.

### **Coherence with Process Flow**

Through Master Murabahah Facility Agreement (MMFA), this risk is also mitigated because all kinds of Murabahah goods are priory explained to be purchased by order form.

### **SNCR due to Agent's Acceptance as Original Buyer in First Sale**

In modern-day Murabahah transaction, first transaction usually executes between the supplier and the bank. Therefore, on behalf of the bank, the potential customer (agent) accepts the supplier's offer on behalf of the owner (Islamic bank). Through this activity, first transaction is completed and the bank becomes the owner of the particular asset. However, there are two prospective SNCRs, (1) if the offer by the supplier is open i.e. not addressed to the actual owner (Islamic bank), meanwhile the agent accepts this offer on his own behalf rather than as an agent of his owner, or (2) an offer by the supplier is made/addressed truly to him (agent) personally. Then in these both cases, once the acceptance by the agent is done, transaction will be concluded among the agent and supplier, not among the supplier and owner (Islamic bank). Consequently, it will not be permissible for the Bank to execute the Murabahah transaction on the same item with the customer, who was actually agent of bank but due to non-compliance or negligence with sale process flow and Shariah instructions. Now he is already owner of the asset, at that moment, how he can purchase the same item through Murabahah transaction which is already in his ownership (Standard no. 08, clause 2/2/1 & clause No. 2/1/4).

Therefore, it is substantial for Islamic bank/Islamic financial institution that the first transaction must be concluded between supplier and bank not among supplier and customer (agent).

### **Corrective Action in Case of Shariah Non-Compliance**

In this case, Murabahah cannot be executed on this commodity. Second transaction (Murabahah transaction) will be considered as “Null and Void”. Additionally, despite the null and void transaction, if profit is realized, it will not be credited into Bank’s income due to idle and Shari’ah non-compliance activity (Standard no. 08, clause No. 2/1/4).

### **Summary**

It should be remembered that Murabahah can be executed without Wakalah contract but due to the practice of today’s Murabahah transaction, it seems that Wakalah contract is compulsory. Actually, Murabahah is the name of cost + profit sale therefore Wakalah is not the integral part of Murabahah sale. The perception of many practitioners is that without Wakalah, Murabahah cannot be executed which is an inappropriate awareness. Therefore, it is essential that in first stage of the contract, the nature and requirement of contract and its process flow should thoroughly be understood then following the proper steps, the transaction should be executed.

### **SNCR of Bai-e- ‘Iinah or by Element of Bai-e- ‘Iinah**

There should not be even a minor element of Bai-e-‘Iinahs as it is entirely banned in Shari’ah Standards as already was mentioned above in detail (Standard no. 8, clause: 2/2/3).

However, Hanafi Jurists explain that Bai’-e-‘Iinah is also classified into two types: (1) the first one is executed among the two parties which is banned among the Hanafi Shari’ah Scholars concurrently whereas (2) Bai’-e- ‘Iinah has a little Karahah once it is executed more than two parties (that is actually considered among other Fuqaha rather than Ahnaf as Tawarruq). This last one is permissible sale among the Ahnaf which is known as Tawarruq in other three major schools of thought. Although, this briefed detail is completely mentioned in very famous and authentic books of Ahnaf: Fath-ul-Qadiir and Raddul Muhtar ([Shami, 1999/1420H](#)). Therefore, two major conditions must be considered to avoid the transaction fall in ‘Iinah sale. First one the seller of first sale must not be a purchaser in second sale furthermore as per the law of land or regulatory requirement, the seller of the first sale will not structurally be a purchaser in any case whether in third usually last sale or onwards. While second condition is that the price of second sale with original seller (who is the seller in first sale and purchaser in second) must not be a less than first one when it occurs on spot, (Standard, No. 8, clause: 2/2/3 & 2/2/4).

### **Corrective Action in Case of Shariah Non-compliance**

Due to disliking of Bai-e-'Inah by AAOIFI Shari'ah Scholars, contract will remain "Null and Void". There is no way to make it rectified unless the element of 'Inah is eliminated. Profit will be credited into charity account. The Matter of Bai'-e-'Inah is considered as much controversial between today's Shari'ah Scholars, however, the true picture becomes much different once we study the classical books of Hanafi Jurists. Therefore, they have various opinions in this regard. First of all, they classify Bai-e-'Inah into two types; one of them Makrooh-e-Tahreemi and the second one is Makrooh-e-Tanzeehi. The later one is permissible according to Hanafi School of thought but the classification was not found as explained in Hanafi classical jurisprudence books.

### **SNCR of Subject Matter being not in Possession**

Subject Matter of Murabahah must be in possession of the owner either physically or constructively. Without either type of possession the transaction cannot be executed (Standard No. 8, clause No. 3/1/1).

### **Corrective Action in Case of Shariah Non-compliance**

Murabahah or in any absolute sale (Bai-e-Mutlaq) as well as absence of the possession from seller makes the contract Null and void. Profit will be credited into charity account. The above point requires more concentration in compliance as mentioned in introduction of the product. Because, it pertains the basic terms and conditions for the validity of an ordinary sales; therefore, non-compliance will invalidate the contract completely. The risks are highly considered and mitigated through the steps of 'Declaration' and 'Offer & Acceptance' in the process flow respectively.

### **Risk Management, Mitigation and Control**

As a first line of defense, it is the primary responsibility of Business line along with the Shariah compliance and product development (as well as other concerned department as per their business need) to find out the proper mode of finance before to involve in any transaction. Then, in this regard, if they feel any ambiguity or confusion, they should ask the clarification and search out the solution from Shariah Board (SB) and on an urgent basis from their Shariah Advisor. Therefore, having selected an identified mode of finance, the main responsibility once again pertains to product development department (PDD) along with the Shariah compliance department (SCD) to draft and design the process flow/modus operandi considering the need and demand of customer, furthermore, the problems faced by the customer should not be ignored as the steps of process flow vary from customer to customers. Perfect process flow in fact draws the line of action and responsibilities of every involved personnel, therefore the questions of the action of where and when have already been resolved through accustomed and approved process flow. At this stage, considering the SNCR mitigation tools, it is much obvious that truly designed process flow may almost save from all operations risks predominantly

from SNCR. After that the competent authorities like Shariah compliance review should strictly review the transactions following the guidelines and steps mentioned in process flow as well as Shariah audit and inspection team may perform their duties respectively. Moreover, process flow must be complied with proper approved producers, policies, regulators' instructions so that along with SNCR other risk would also be transferred for business benefits. After that, it is the responsibility of the Shariah Audit to report this type of disorder and non-compliance to the Senior Management and finally to the Board Audit Committee however in Islamic Bank Shariah Audit team present their observations to the Shariah Board for corrective actions. As well as, inspection team of regulator assigned this reporting task gradually and they report simultaneously to the Shariah Board and Central Bank of the country, therefore on behalf of their reports, corrective actions are taken by SB as well as the regulator direct the institution and make the polices for overall system. Consequently, on the basis of genuine and perfect steps of monitoring, reporting and control, corrective actions and rectifications are taken by Shariah Board (SB) so that unaffected findings and loopholes may be removed.

### **Safety Measure and Precautions**

Business team must comply the prescribed rules and regulation directed by SB and in case of ambiguity will seek with the clarification from Shari'ah Board through Shari'ah Compliance department as well as Product development must be aware of their SB instructions and follow their guidelines and instruction in developing the product as well as will find their approval on generic process flow and tweak the process flow according to customers' needs and market practice with the approval of Shari'ah board/Shari'ah Advisor. Moreover, the guidelines given by regulator should be complied with. In case of non-compliance of regulator's instructions, exemptions should be sought rather fall in breach of laws of the land.

As well as it is the responsibility of BOD and senior management to arrange continuous trainings, workshops and short courses for themselves as well as for capacity building and enhancement of knowledge and skills of their concerned departments.

### **Consequences & Impacts**

As explained in above few SNCRs and their consequences. Furthermore, we have discussed the treatment of profit generated through transactions facing SNCR whether this profit be considered as part of income or credited into charity account. Additionally, here in this section, we will elaborate a few more harmful impacts of SNCR which are faced by Institutions. Application of SNCR sometimes tends to increase in Operational Cost which bothers IBIs. In various cases, impairment in capital happens due to SNCR as well. This situation concerns the operations of IBIs. Because of the above-mentioned issues, loss of estimated profit has to be endured. Obviously, this causes trouble to the Islamic Banks. Shaking of stakeholders' confidence is a Problem which is in fact a product of previously depicted obstacles caused because of SNCRs.

## **Recommendations**

It is strongly recommended that there must be a proper list of SNCRs for every new product launched by IBIs along with its risk management/mitigation tools. Furthermore, it should be a regulator's demanded principal requirement from any IBI to devise complete risk mitigation mechanism for every newly-launched product and service. As the IBIs are obliged to fulfilling the many other regulatory requirements as needed by the regulator (i.e. SBP in Pakistan), like salient features of new products along with the approval of their Shari'ah Advisor/Shari'ah Board (IBD, 2008). It should be presented to IBD-SBP 30 days prior to launching a new product (IBD, 2013). Last but not the least, it is recommended that the causes of charity and charity's disposal along with its detailed deliberations should be documented and must be a part of SB's report in Annual reports/Financials, answering the subsequent queries as to what is the factor/SNCR behind this charity and how many times it happens and how they can be controlled and mitigated.

## **Conclusion**

Considering the significance of SNCRs, it is evident that functions of IBIs without following the Shari'ah compliance methodology are worthless as this is the rudimentary distinction between conventional and Islamic banking system which legitimize the profit for Islamic banks as Shari'ah compliant profit/proceed. Whereas, Shari'ah non-compliance risk in products and services might destroy the confidence of stakeholders and expose the bank to reputational risk as well. Ultimately, they might have to face major losses, like loss of stakeholders' equity, withdrawal of deposits by account holders, and ultimately the reluctance of clients in engaging into business of Islamic Banks as a whole. Finally, the entire institution might collapse due to negligence and inappropriate control in this regard. Subsequently, sound and effective Shari'ah non-compliance risk management system is the need of time and prerequisite of IBI's BoD and Senior management to ensure the overall vigorous Shari'ah compliance mechanism in their product, services and ultimately in all operations/activities. Furthermore, follow-up through inspection and oversight about IBIs' activities is the prime responsibility of the regulator.

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