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 Shari'ah non-compliance risk associated with Islamic financial institutions (IFIs). Having a proper definition of Shari'ah non-compliance risk 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 Shari'ah risk, regulatory provisions, and existing academic journals on Islamic risk management. This paper provides an in-depth discussion on the major elements that trigger Shari'ah non-compliance risk and hence affect the validity of Islamic contracts such as riba, gharar, tajarrud, ghubur, etc. These elements of risk were identified as 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 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 Shari'ah governance practice within the IFIs.

Author keywords

Islamic finance, Islamic risk management, Shari'ah compliance

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