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# The Determinants and Treatments of *Shariah* Non-Compliant Events in Malaysian Islamic Banks

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**Abstract**

This article delineates the concept of *Shari'āh* non-compliant events (SNEs) in Malaysian Islamic Banks, its determinants and treatments from the Islamic perspective based on Muslim scholars' discussion. This research is qualitative, and it utilises textual analysis technique in analysing the data. Its findings argue that SNEs occur in almost all Malaysian Islamic Banks due to factors like human errors and pressing needs. Furthermore, the research reveals that the treatment undertaken by the banks is rectification and re-execution but different from one Islamic bank to another. This article argues that the existing approach to SNEs could be improved, enriched and possibly standardised.

**Keywords**: Islamic Contracts, Determinants And Treatments, Shari'āh Non-Compliant Events, Unlawful Income

## Introduction

Section 28 (1) of the Islamic Financial Services Act (IFSA) 2013 states that all operations, businesses, affairs and activities of Islamic Banks and Financial Institutions must comply with *Shari'āh* (IFSA, 2013). Failure to comply with the *Shari'āh* (Islamic law) will result in the occurrence of SNEs. SNEs could be implied as any activities, operations, businesses, or affairs of IFIs that are against the principles prescribed by *Shari'āh*. It is undeniable that SNEs in Islamic banks might come from many factors. According to Bank Islam Malaysia Berhad, the *Shari'āh* non-compliant events could potentially arise in Islamic banks due to internal factors like human and system error, improper processes and external factors like dealings with foreign conventional banks (BIMB, 2012: 9). Islamic banking, which operates under the widely established conventional banking system, has to deal with conventional *ribā* -based activities

especially when there are transactions involving foreign currencies. In facilitating such transactions, Islamic banks have to open a nostro account in a foreign bank to keep their reserves of foreign currency which still earns a fixed interest (El-Gamal, 1999: 514). A Nostro account is an account at a foreign bank where a domestic bank keeps foreign currency reserves. A bank keeps a nostro account so that it does not have to make a currency conversion (which brings foreign exchange risk) should an account holder make a deposit or a withdrawal in that foreign currency (The Free Dictionary). Therefore, all products, documentation, banking activities and operations should be reviewed regarding their compliance with *Shari'āh*. This is because anything that opposes *Shari'āh* rules can lead to SNEs which may contribute to impermissible returns, earnings and profits, which is unlawful for the banks to keep and consume/use either for material or non-material purposes.

As Islamic banking's clients grow, their expectations from Islamic banks also grow. Other than the products and services offered, *Shari'āh* consistency in performance and operations is one of the expectations. In order to have such consistency, all key functions have particular roles in identifying the occurrence of SNEs and ensuring adherence to Islamic rules and regulations. Furthermore, *akhlāq*, religious responsibilities, and integrity are considered equally important to success.

This study contributes towards the discussion on the SNEs, where most previous discussions have been limited to its determinants, not so much on the treatments. With the emphasis on the Muslim Jurists' opinion on the classification of a contract either as *bātil* (void) or *fāsid* (defective) in determining the treatment, this study hopefully aims to suggest new direction and insight in the field. Therefore, this article explores the processes undertaken by Islamic banks in the case of SNEs, to investigate the determinants of SNEs in Islamic banks and propose their treatments. Following this introduction, this article will discuss the elements of SNEs in general including the category of contract based on the view of Muslim Jurists. The preceding part presents the discussion on its determinants and treatments.

**SNEs: An Overview of the Determinants**

From the interviews conducted on SNEs, the occurrence results from internal and external factors. Internal factors typically happen due to mistakes within the banks, for example, human and system errors, including defects in the documentation and *Shari'āh* non-compliant business operation. However, external factors are due to improper implementation of contracts when dealing with foreign banks, like nostro accounts the Islamic banks have in those foreign banks, which are primarily conventional. Usually, this situation cannot be avoided, and it is like a pressing need to facilitate a transaction, especially between two countries.

One of the internal factors mentioned above is defects in the documentation. Documentation is a process of preparing documents describing a contractual relationship between contracting parties involved in a transaction. It outlines the rights and responsibilities those parties must carry out (Azhar, 2010). The documents include product proposals, offer letters, agreements, legal documentation, product manuals, marketing advertisements, brochures and sales illustrations that Islamic banks use to describe and promote their products to the public (BNM, nd). Any issue relating to the documentation process found in the product's literature has the possibility to cause defects in the process. Issues like early disbursement of financing amount related to offer letter, terminologies and clauses used, description of products, terms and conditions stipulated in the documents

(Zulkifli, 2004; IBFIM, 2006). Letter of Offer here refers to a letter issued by the bank to offer the financing facility to the customer. It is one of the instruments used by the bank in its banking operations.

SNEs can also occur due to *Shari'āh's* non-compliant business operations. According to Islamic Banking Act 1983, an Islamic banking business is defined as a "banking business whose aims and operations do not involve any element which Islam does not approve" (*Islamic Banking Act 1983*, 1983). It is, therefore, necessary to ensure that the operations of Islamic banks are carried out properly according to *Shari'āh* principles so as not to involve any prohibited elements like *ribā* (interest), *gharar* (uncertainty), *ghabn* (inequality) in the product value in a cumulative contract, *ikrah* (duress) involved in undertaking contract between the contracting parties, *ghalaṭ* (mistake), *taghrir* (deception) and *jahālah* (ambiguity) in a subject matter (Omar & Hassan, 2019). With this end in view, a body called *SharÊÑah* Advisory Council (SAC) of BNM has been established under section 51 of the Central Bank of Malaysia Act 2009 to issue rulings on financial matters and advise banks on *Shari'āh* issues relating to Islamic banking operations (BNM, 2010).

Another essential aspect that causes SNEs is about the contract itself. This pertains to the pillars of the contract that support the product and, more particularly, relates to the status of the subject matter (*maḥal al-'aqd* or *mawdu' al-'aqd*) in terms of its permissibility, availability and deliverability (Al-Dhareer Siddiq, 1997; Ahmad Hidayat, 2000; Muhammad Tahir, 2007; Vejzagic, 2012). According to Ahmad Hidayat *gharar* will occur in the subject matter of a contract if one of these three elements does not exist, namely lack of knowledge (*jahala*) in its specification, character and quantum; inability to deliver and non-existent of the product. Other than fulfilling the conditions of the subject matter, a contract must fulfil the other two pillars, i.e. the conditions of the statement of contract (*ṣīghah*) and the contracting parties (*al-'āqidain*). These two aspects are of primary importance in any contract, without which the contract will be regarded as lacking perfection from the Islamic point of view (Ibn Quddāmah, 2004; Al-Kāsānī, 1986).

The subject matter refers to an asset for which the contract is concluded. 'Usmāni, in his discussion on rules governing the transactions as carried out by financial institutions, concludes that the ingredient of subject matter validity consists of ten requirements: the subject matter must exist, it must be in the ownership of the seller, and it must be in the physical or constructive possession of the seller during the time of the contract. According to 'Usmānī (2002), constructive possession refers to a situation where the seller does not physically possess the asset when the contract is to be delivered. However, the asset has come under his control, in which all the rights and responsibilities related to the asset are shouldered on the seller. Besides, the contract must be instant and absolute because it is not contingent on any future event. Furthermore, The subject must be valuable, useful, identifiable, deliverable and particular in price. Other than these requirements, he stresses that the sale must be unconditional in the sense that no conditions will be imposed for sale to occur.

Insertion of conditions against the nature or concept of the contract may also lead to SNEs. It means that different conditions not part of the contract are inserted in a product for the contracting parties' security, which can go against the rules and regulations of *Shari'āh* (Wajdi *et al*., 2012). An example of this is a capital guarantee that is inserted in a *muḍārabah* product, and the insertion could be considered *Shari'āh* non-compliant as it violates the nature of *muḍārabah* (AAOIFI, 2010). Another example is the insertion of late payment

charges. Most Muslim scholars agree that a charge on late payment (*gharāmah*) is impermissible because it resembles *ribā* (usury). Therefore, according to AAOIFI (2010), the imposition of a charge on reluctant customers to compensate for the loss of income or loss due to a change in the value of the debt currency is not applicable. However, AAOIFI (2010) states that it is applicable to solvent debtors and guarantors so as to ensure their commitment to pay with a condition that some of the charged amounts be given as charity under the supervision of the *Shari'āh* committee of the bank.

**1. Juristic Classification of Contracts**

According to the majority of Muslim Jurists (*jumhur*), contracts can be classified into two namely valid (*ṣaḥīḥ*) and void or invalid (*bāṭil*). They opined that not fulfilling or violating the contract's pillars and its conditions will cause a contract void or invalid (*bāṭil*), subsequently affecting the status and profits. For example, if the offer and acceptance are not in conformity, the subject matter is impermissible, undeliverable, unspecified and non-existent; it renders void or invalid (*bāṭil*). In terms of contracting parties, if one of the persons does not have *ahliyyah* (competent and capacity), which always being indicated through the person's sanity, maturity and puberty, the contract is void or invalid (*bāṭil*). The intention also plays a vital role in determining the validity of a contract. For example, a contract intending to harm others is considered void. Another element is that mutual consent among the contracting parties needs to be observed. In this case, moderate or excessive duress that occurred in the conclusion of contract will invalidate the contract.

However, *Ḥanafī* school of legal thought maintains that not fulfilling the pillars will cause a contract void or invalid (*bāṭil*) but not all conditions of the pillars if violated or not fulfilled renders invalidity. They classify contracts into three, those which are valid (*ṣaḥīḥ*), defective (*fāsid*) and void or invalid (*bāṭil*). A valid (*ṣaḥīḥ*) contract is a contract which fulfils all the pillars and conditions. A defective (*fāsid*) contract is a contract which does not fulfil one or more conditions while a void or invalid (*bāṭil*) contract is a contract that does not meet at least one of the pillars (Al-Kāsānī, 2005).

As for the legal consequences, both majority of Muslim Jurists (*jumhur*) and *Ḥanafī* opined that void or invalid (*bāṭil*) will affect the status of the contract and profit obtained. In this situation, the income or profit is unlawful and should be purified because no rectification is allowed. It requires re-execution with proper structure according to Shariah if the contracting parties want to remain the contract except those with impermissible subject matter. However for defective (*fāsid*) contract, which is according to *Ḥanafī,* any income or profit from this kind of contract is unlawful but not necessarily to be purified. This is because rectification of contract could be made to legalise the income. However, if no rectification is undertaken by the contracting parties the income is required for purification. As for the treatments, according to *Ḥanafī* Jurists, the rectification of the defective (*fāsid*) contract can be done through two ways. The first is by eliminating unlawful conditions and removing the inserted stipulation. The second is by modifying the contract to become a new contract which has the same structure with the *fāsid* contract (Wajdi *et al*, 2012). For the first, the *Sharī'ah* non-compliant event related to the condition and stipulation, could simply be removed. As for rectification by modification, the *fāsid* contract is changed to a contract recognised by *Sharī'ah* which brings different legal consequences from the *fāsid* one.

It is imperative to show the differences between the majority of Muslim jurists and *Ḥanafī* jurists on the classification of *bāṭil* and *fāsid* contracts. The classification become a

source of reference to Islamic banks in identifying and determining the status of a contract and income. However, the classification of contracts made by *Ḥanafi* jurists is more appropriate to be used in modern day transactions. According to Asyraf Wajdi, adopting the *Ḥanafi* jurists' classification is more relevant in comparison with that of majority Muslim jurists because of its flexibility (Wajdi *et al.,* 2012). Flexibility here means adaptability. The level of its adaptability to the current day transaction is higher when compared to the majority. For example, if the contract entered into by contracting parties does not fulfill the conditions of subject matter like the price is not mentioned clearly, the contract is *bāṭil* according to *jumhur* however it is *fāsid* according to *Ḥanafi*. According to *Ḥanafi* jurists whenever it is *fāsid*, there is still a room for rectification rather than re-execution. In addition, the transactions in Islamic banks do not really reflect invalid or *bāṭil* contracts, since there may be minor corruptions at certain times. If Islamic banks rely on the majority of Muslim jurists' classification, both minor and major defects related to the pillars as well as its attributes will render re-execution and the income will always be affected. This is complicated because re-execution should be done from the beginning which will also consume more time. The differences are summarized in table 2 below

Table 2
*Differences between Ḥanafi and Muslim jurists on the Category of contracts*

| Majority of Muslim Jurists | *×anafī* Jurists |
|---|---|
| Definition | |
| 1- They classify contracts into *ṣaḥīḥ* (valid) and ghayr *ṣaḥiḥ* (invalid).<br>2- *Ṣaḥīḥ* means all the pillars of the contract and its attributes are fulfilled.<br>3- *Ghayr ṣaḥiḥ* (invalid) is a contract in which the pillars and its attributes are not fulfilled.<br>4- The *ghayr ṣaḥiḥ* according to them consists of *baṭil* and *fāsid* which are interchangeably used. | 1- *Ḥanafī* jurists classify the contracts into *ṣaḥīḥ*, *fāsid* and *baṭil*. *Fāsid* and *baṭil* contracts are different contracts.<br>2- *Ṣaḥīḥ* carries the same meaning as what has been defined by the majority of Muslim jurists.<br>3- *Baṭil* contract refers to a contract which pillars and attributes are not fulfilled.<br>4- *Fāsid* contract is a contract which pillars are fulfilled but its attributes are not fulfilled. |
| Causes for *baṭil* and *Fāsid* | |
| 1- The offer and acceptance are not in conformity.<br>2- The subject matter is impermissible, undeliverable, specified and non-existent.<br>3- The contracting parties do not have *ahliyyah* (competent and capacity) which includes sanity, maturity and puberty.<br>4- Unfulfilling the pillars as well as its attributes renders the contract invalid. | According to them, a contract may become *baṭil* if:<br>1- The offer and acceptance are not made in conformity<br>2- The subject matter is impermissible, not existent and undeliverable<br>3- The contracting parties do not have *ahliyyah* and;<br>4- The excessive element of duress is observed. |

| | |
|---|---|
| 5- The intention for entering the contract is unlawful.<br>6- The mutual consent among the contracting parties is not observed due to excessive or moderate duress. | The contract is considered *fāsid* if the attributes of the pillars are not fulfilled as below:<br>1- In terms of subject matter, the deliverability causes harm to the seller;<br>2- The lack of knowledge as a result of unspecification on the time of delivery, price and the character will render the contract *fāsid* because of *gharar*. However if the *gharar* is excessive, the contract may render invalid;<br>3- External conditions attached to the contracts are unlawful or against the nature of the contract;<br>4- The element of duress is observed but still not nullifies the freedom of choice but it nullifies *ridā* (Dusuki, 2012: 12); and<br>5- According to *Ḥanafī,* element of *ribā* in a contract is also considered a *fāsid* contract (Dusuki, 20102: 18). |
| The legal consequences | |
| 1- The income is unlawful and should be purified<br>2- No rectification is allowed because it is void.<br>3- Re-execution is required if the contracting parties want to remain in the contract in *Sharī'ah* compliant. Here, the proper structure contract according to *Sharī'ah* is required.<br>4- However, if the subject matter is unlawful, re-execution cannot be made. | 1- The income is unlawful but not necessarily to be purified.<br>2- Rectification could be made to legalise the income.<br>3- If no rectification is undertaken the income required purification. |
| Examples of contracts | |
| 1- Selling of alcoholic beverages | 1- Selling an item without signing the agreement.<br>2- Selling with invalid conditions. |

*SNEs: MALAYSIAN ISLAMIC BANKS' EXPERIENCE*

It is found that generally, the occurrence of SNEs in Islamic banks in Malaysia is due to internal, mostly related to human error as well as external factors. The former is often related to improper implementation of the contracts while the external factor mostly is related to a pressing need through a *nostro* account. The internal and external factors have caused lapses

leading to SNEs which require a contract approach to identify its status and to determine their treatment via rectification or re-execution in order to avoid any unlawful income. The contract is essential to determine the *Sharī'ah* compliance even though SNEs might occur in various occasions and forms. Examples of SNEs are presented below based on some interviews conducted with seven Malaysian Islamic banks. The Islamic banks involved are: Maybank (personal communication with Maybank, 2019), Bank Islam Malaysia Berhad (personal communication with BIMB, 2019), Bank Muamalat Malaysia Berhad (personal communication with BMMB, 2020), Hong Leong Islamic (personal communication with Hong Leong Islamic, 2020), CIMB Islamic (personal communication with CIMB Islamic, 2020), MBSB Bank (personal communication with MBSB, 2020) and Saadiq Standard Charted (personal communication with Saadiq Standard Chartered, 2020).

It was found SNEs that occur in Islamic banks involve *baṭil* and *fāsid* contracts. The classification of *baṭil* and *fāsid* contract is based on *Ḥanafī madhhab*. According to the *madhhab*, *baṭil* contract occurs when there is a defect in the pillars of the contract while *fāsid* contract occurs when there is a defect in the attributes or the conditions of the pillars (Al-Kāsānī, 2005). Most SNEs in Malaysian Islamic Banks are *baṭil* because the subject matter is not wholly owned, prohibited initially or non-existent. On the other hand, for the *fāsid*, it mainly occurs due to external conditions which are against the nature of a contract, defects in the documentation and extra charge imposed on transactions which include early settlement, late payment over the actual cost and charge on an extension of time. Therefore, the contract is *fāsid* because the pillars are there but the conditions or attribution are defective.

Based on the interviews, most SNEs observed did not involve non-specific nominate contracts like bribery, *maysir* or gift for facilitating unlawful transactions, usurpation and stealing. However, specific nominate contracts like *murābahah*, *ijārah* and *tawarruq* require mutual consent between the contracting parties. Mutual consent is crucial since it determines the legal status of the income in the case of SNEs leading to financial implications. However, it is found that issues relating to mutual consent arise when Islamic banks impose charges without the knowledge of a customer, which can be considered as stealing others` property. Thus, proper knowledge of the SNEs will determine the suitable treatment and the legality of the income, whether it involves rectification or re-execution. The table below summarises the SNEs that have occurred in some Islamic banks in Malaysia.

Table 1
*SNEs in Islamic banks in Malaysia*

| SNEs in Islamic banks | Description of the SNEs | Category of the contracts |
|---|---|---|
| **1-Execution of murābahah li al-amri bi al-shirā' (sale and purchase order)** | The bank requires the customer to become the agent to purchase a car on behalf of the bank, but the reviewer does not find the wakālah agreement. The contract is concluded, but the agreement of *wakālah* is not in existence. | Specific nominate contract under the category of *fāsid* (defective) contract. The element to complete the transaction (*wakālah* agreement) does not exist. |

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| **2-Credit cards** | The banks receive commissions from unlawful companies selling assorted items and offering lawful and unlawful services through the payment made by the cardholders. The commission is the value of initially impermissible items, which is prohibited. | Specific nominate contract under the category of *baṭil. Baṭil* (void contract) due to the subject matter being prohibited items or services in its essence (*harām lizātihi*). |
| **3-Interest received from nostro account** | Most Islamic banks have to open nostro accounts with conventional banks outside the country, which do not have Islamic accounts to facilitate cross-border transactions; as such Islamic banks receive interest from conventional banks. | The contract is *baṭil* (void) since it is one of the forms of *ribā* transaction of which prohibition is mentioned in the *Qur'ān*. As such, the incomāe is non-*Íalāl*. |
| **4-Commitment fees imposed for unutilised lines in the case of club deal (syndication)** | The banks charge a commitment fee to avoid loss. | This is *fāsid* (defective) contract because it seems to cover the uncertain opportunity loss. The contract is inserted with the impermissible condition. The unjustified fee is similar to a conventional loan. |
| **5-*Gharāmah* (penalty) imposed on late payers.** | Islamic banks impose charges on delinquent defaulters as a deterrent against default and delays in an instalment payment. | Specific nominate contract under the category of *baṭil*. This is because the extra amount charged to the customer is unjustified, equivalent to *ribā.* |

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| **6-Charge imposed on the consumers as compensation for actual loss as a result of the delay in payment** | Islamic banks impose a 1% charge on late payers to cover the loss resulting from the late payment. Some Islamic banks disregard *Íalāl* income. Some Islamic banks charge customers more than the amount of actual loss incurred. | It is *bāṭil* contract because it involves *ribā*. |
| | An Islamic bank needs to correctly calculate the compensation for late payments in which the charge is compounding. | It is *bāṭil* as this involves *ribā.* |
| **7-*Murābaḥah*** | In this kind of transaction, the underlying asset in the *murābahah* is the item designed for public usage or *waqf*. | The contract is *bāṭil* because the seller does not own the subject matter; thus, the customer is not entitled to any right to sell. |
| | A customer named a fictitious commodity to facilitate *murābahah* transaction to obtain funds | The transaction is *bāṭil* because the subject matter for m*urābaḥah* is not in existence. |
| | A customer used unlawful shares as the underlying asset in this transaction. | This is *bāṭil* contract because the subject matter is unlawful according to Islam. |
| **8-BBA** | In a BBA transaction implemented by an Islamic bank, it was realised that the bank does not take ownership and hence does not assume the risk for the sold item before a sale transaction occurs. | This is *bāṭil* contract because it indicates the seller, which is the bank, does not own the sold item. As a consequence, something which the seller does not own is invalid to be sold to another party. |
| | Stipulation to repurchase imposed on the buyer. | The contract is *fāsid* because of the insertion of an invalid contract. If the contract involves financial implications, purification is obligatory. |

| | | |
|---|---|---|
| **9-*Ijārah*** | An Islamic bank concluded the *ijÉrah* contract with the customer without first owning the leased asset. | The contract is *bāṭil* because the subject matter's ownership is not clear. Therefore, the lessor should own the subject matter before the lease transaction. |
| **10-*Tawarruq* (commodity *murÉbaĺah*)** | Disbursement of money prior to the conclusion of contracts. | This is *bāṭil* contract because the money disbursed amounts to a loan since there is no underlying asset to facilitate cash. |
| | In implementing *tawarruq* transaction, the contracting parties do not sign the agreement. | The transaction is *fāsid* because the document is not correctly signed or is incomplete. This is in the case where no rectification is done. |
| **11-Execution of the option contract.** | An Islamic bank executed option based on wa'd and *tawarruq* transactions. However, after the *tawarruq* took place, it was found that the document was not signed, and the bank had already received the profit. This situation resembles the selling option to get a premium amount, which is prohibited. | The option is not allowed to have a counter value. In the Islamic option, it is not permissible to be an exchangeable item. However, *tawarruq* has yet to be executed without a signature on the contract. Therefore the contract is *fāsid.* |
| **12-Improper documentation in sales** | The documentation did not reflect the actual contract. The bank should purchase the property before selling it to the customer; however, the document showed no purchase before selling. | The contract is *fāsid.* The actual contract has occurred. Nevertheless, the documentation is wrongly prepared by the bank. |
| **13-Early settlement** | An Islamic bank charged on early settlement made by the customer. This is to cover the expected return incurred from the beginning of the contract until the maturity date. | This is *fāsid* contract because of the charges imposed. |

| | | |
|---|---|---|
| | An Islamic bank charged a certain amount on early settlement in Hire Purchase. However, the system charged an extra amount for each customer without them realising it. | The contract is *fāsid* because of the external charge. Therefore, the extra amount should be purified. |
| **14-Extension of time for settling of debt** | In order to extend the time for settling debt, the bank rolled over the contract of *murābahah* using the same asset, which is no longer in the bank's ownership. | The contract is *bāṭil* due to the non-existent subject matter. |
| **15-Charge on excessive use of services on CAL** | Usually the system will charge extra amount for the extra usage of services in CAL. The limit was found to be about RM 1 million, but the customer used the service over the RM 1 million limit. In this case, the system automatically charged the customers for the extra amount they had used. | The amount is not allowed to be recognised as income since the contract is *fāsid*. |
| **16-Financing for renovation purposes** | The renovation is identified as facilitating unlawful activities. In reviewing the application, it was observed that the renovation is related to non-*halāl* establishments like pubs, discos and casinos. | This contract is *bāṭil* because the financing purpose is unlawful, and the subject matter is also unlawful. |

**Identification of SNES By Malaysian Islamic Banks**

Generally, the identification is made to classify the SNEs either as merely potential or actual. A potential SNE is detected by the post-implementation checking function, namely *Sharīʿah* review and the *Sharīʿah* audit function. In some situations, the potential events could also be detected through the pre-implementation checking function, which involves the head of the *SharÊÑah* department, heads of business and support, *Sharīʿah* risk management control, *Sharīʿah* research function of the respective Islamic banks, the *Sharīʿah* officers in the department, business unit and product development unit, Branch managers and all staff. The identification of SNEs is not limited to the *Sharīʿah* officers but involves all staff from different divisions.

In the case of *Sharīʿah* reviewer`s function, a qualified *Sharīʿah* officer is required to make assessments regularly on the activities and operations of Islamic banks in order to ensure that their operations and activities are compliant with the *Sharīʿah* principles (BNM, 2010). The *Sharīʿah* auditor is a qualified *Sharīʿah* officer who has knowledge of *Sharīʿah* and has undergone training in auditing. His responsibility is to make periodic independent and objective assessments to improve the quality of *Sharīʿah* compliance relating to the operations and activities in Islamic banks. The assessment is undertaken mainly to ensure objectively that the *Sharīʿah* internal control has been effectively conducted (BNM, 2010). The SNEs are basically detected when there are *Sharīʿah* breaches or non-compliance with the *Sharīʿah* due to operations and activities of Islamic banks that are seemingly contravening the decision of the *Sharīʿah* committee or *Sharīʿah* rules and regulations.

Once the potential SNEs are identified, they will be tabled at the *Sharīʿah* committees of the respective banks for decision-making, whether or not the potential event will lead to the actual SNEs. If the actual events are associated with financial implications, the amount affected should be put in an account for purification as it is impermissible to be used. Meanwhile, the amount is permissible if the SNE is rectified and no financial implication occurs. However, if the actual SNEs are not rectified and persist, the income or the profit earned from the unrectified contract is impermissible.

**Treatment of Snes: Re-Execution and Rectification**

Re-execution occurs for *bāṭil* contracts, whereas rectification is meant for *fāsid* contracts. Some examples of SNEs occurred in Malaysian Islamic Banks that involved *bāṭil* and *fāsid* contracts together with their treatments are discussed below:

**Conditions for Batil contract and re-execution**

1- All contracts where the subject matter is impermissible and prohibited by *Sharīʿah* such as pork and tobacco cannot be re-executed. This is because it involves prohibited items. Examples of *bāṭil* contracts in this form in Islamic Banks include unlawful shares being used as the underlying asset in a transaction between an Islamic bank and its customer. Another example involves the renovation of building contracts for unlawful activities. This contract is *bāṭil* because the subject matter is related to unlawful things. Re-execution could not be made because the contract is *bāṭil*. The income should be purified.

2- The contracts where the subject matter's deliverability is uncertain because it belongs to someone other than the seller. This happens in banks that buy an item designed for *waqf* for a *murābahah* transaction, but the item cannot be sent to the customer because the subject matter is undelivered. The contract is *bāṭil* because the subject matter is not owned by the seller; thus he has no right to sell it. If the customer wants to continue with the contract, re-execution is required, but the subject matter should be one that can be delivered and owned by the seller.

3- Regarding the availability of a subject matter, a contract of *murābahah* is signed between the bank and a customer with a fictitious commodity merely to obtain funds. The transaction is *bāṭil* because the subject matter for *murābahah* is non-existent and is impossible to deliver. Re-execution is required if the customer wants to remain with

the contract. However, the *murābahah* transaction must be done correctly and in sequence.

**Conditions for Fasid contract and rectification**

1- For example, insertions of unlawful conditions happened when customers were charged for late payment over the rate of 1% and compounding. The *fāsid* contract is valid, provided that the charge stipulation is removed. Only the *ta'wid* charge of 1% stipulated on the customer who is late in payment is allowed by BNM to consider as its income.
2- Another example of unlawful stipulation is the *ijārah thumma al-bay'* (lease and purchase) contract. It is clear that the owner of the *ijārah* asset, the lessor, is responsible for paying the costs of maintenance of the asset and the *takāful* coverage. However, an Islamic bank transfers the responsibility to the lessee, which is prohibited. This is *fāsid* contract because the element of non-compelling duress is observed in the contract. The contract is valid if the element of duress is removed and the lessor shows his consent to remain in the contract. The contract is also valid if the Islamic bank appoints the lessor as an agent to pay on his behalf, and the amount will be deducted from the amount of sale at the end of the lease period.
3- Elements of moderate *gharar* are observed in the time of deliverability and specification of the assets and their price. The *fāsid* contracts with moderate *gharar* are illustrated below:
    i. Suppose an Islamic bank makes a condition in a sale contract that the price will be higher when the customer defers the payment and lower it when the customer pays in cash; the contract is *fāsid* because of *gharar* involving uncertain price. According to *Ḥanafī* jurists, if the price is contingent upon the time or the form in which it will be paid, the contract is *fasīd* (Ahmad Hidayat, 2000).
    ii. If the attributes of the subject matter are not specified, then the contract will fall into a *fasīd* contract. An example of this can be elucidated in the issue of *murābaḥah* transaction, whereby the commodity purchased is not specified by the customer in terms of its characteristics. However, such *murābaḥah* contract is rectifiable by providing the missing part. In the case of *istisnā'* contract, the purchaser requires specification on the commodity intended to be manufactured. Without the specification, the contract is *fāsid*; similarly, it is rectifiable by providing the specification.
    iii. In terms of *gharar* in its delivery time, an example is shown through *ijārah* contract. If an Islamic bank collects rental payment from the customer before the customer can benefit from a leased item, the contract is *fāsid*. This is because, in Islam, the payment of *ijārah* should be when the customer receives the item. Here, the delivery time is required after the contract so that the early payment required from the customer can be made along with the delivery of the item leased to avoid disputes. Consequently, delivery time is significant to be specified in *salām* contract and *istisnā'* without which both contracts are not effective ('Usmānī, 2002).

The discussion shows that *bāṭil* transactions with the unlawful subject matter can not be re-executed. The income should be purified, and the asset should be destroyed or

terminated. However*, bāṭil* transactions with unfulfilled pillars, like the subject matter, could be re-executed if the asset is still available and in good condition. The income is not required to undergo purification. For the *fāsid* contract due to the conditions of the pillars not being fulfilled, like lack of knowledge on the subject matter and the invalid condition imposed on the contracting parties, the contract could be rectified by removing the objectionable elements and turning the contracts into a new contract acceptable in Islam. If a *fāsid* contract can not be rectified using the two methods, the income is invalid and requires purification.

Table 3
*Rectification on SharÊÑah non-compliance events in Islamic banks*

| SNEs in Islamic banks | Description | Rectification that Islamic banks make |
|---|---|---|
| **1-Execution of *murābaḥah li al- amir bi al-shirā'* (sale and purchase order)** | The contract is concluded with the bank appointing the customer to become an agent to purchase the intended commodity, but the *wakālah* agreement is not found. | This contract is *fāsid* because pillars are fulfilled, but its attributes are not observed.<br>Rectification is undertaken by providing the missing *wakālah* agreement.<br>The income can be retained after rectification is made. |
| **2-Interest received from nostro account** | Islamic banks have to open nostro accounts with conventional banks outside the country and receive interest. | The contract is *fāsid* according to Ḥanafī Muslim Jurists.<br>This contract is rectifiable if the condition of paying interest is eliminated.<br>After elimination, if both contracting parties agree, the contract is valid. |
| **3-Commitment fees imposed for unutilised lines in a case of club deal (syndication)** | The banks charge a commitment fee to ensure customers utilise their line otherwise, losses occur to the banks. | This is *fāsid* contract because it is inserted with the impermissible *fāsid* condition, which is a kind of *ribā.*<br>The contract is rectifiable by eliminating the commitment fees. |
| **4-*Gharāmah* imposed on late payers** | Islamic banks impose a charge on delinquent defaulters as a deterrent against defaults and delays in an instalment payment. | The contract is *fāsid* according to Ḥanafī because of the alien condition inserted.<br>The contract is rectifiable by removing the *gharāmah condition.*<br>If not rectifiable, the *gharāmah* amount should be channelled to charity. |
| **5-*Ta'wiḍ* imposed on the consumers, which is compounding** | An Islamic bank has wrongly calculated the compensation. | The *ta'wiḍ* is allowed.<br>It is rectifiable by removing the irregular compounding calculation.<br>All compounding amounts should be calculated and |

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| | | returned to the customer because it is considered taking their money without consent. |
| **6-BBA based on *bay' 'īnah*** | Stipulation to repurchase imposed on the buyer. | The contract is *fāsid* because of the insertion of an invalid contract.<br>The contract is rectifiable by removing the irregular stipulation.<br>If the contract involves financial implications, the extra amount should be returned to the customer because an element of duress is imposed. |
| **7-*Tawarruq* (commodity *murābahah*)** | In implementing *tawarruq* transaction, the contracting parties do not sign the agreement. | The transaction is *fāsid* because the unsigned document is an irregular condition to complete the contract.<br>It is rectifiable by providing a new agreement. |
| **8-Improper documentation in the sale** | The documentation did not reflect the actual sale contract.<br>The Islamic bank purchased the property prior to selling. Unfortunately, the document showed no purchase made prior to selling. | The contract is *fāsid*. The actual contract has occurred. Nevertheless, the documentation is wrongly prepared by the bank.<br>The rectification could be done by providing the proper document reflecting the contract.<br>The profit can be retained because the contract follows the sale contract sequence. |
| **9-Early settlement charge imposed on the customer** | The early settlement imposed on the customer is to cover the actual cost incurred from the beginning of the contract until the maturity date. However, the system has charged more. | This is *fāsid* contract because it is considered *ribā* where extra amount is received without effort.<br>To have a valid contract, the irregular condition should be removed.<br>Since it involves financial implications, purification is |

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|---|---|---|
| | | necessary by returning the extra amount to the customer. |
| **10-Charge on excessive use of services on CAL** | Typically, the system will charge an extra amount for the extra use of services in CAL. However, it was found that the limit is about RM 1 million, but the customer used the service over the RM 1 million limit. In this case, the system automatically charged the customer for the extra amount. | The amount is not allowed to be recognised as income since the contract is *fāsid*.<br>It is rectifiable by removing the condition of charge.<br>The entire extra amount should be returned to the original owner. |

## Conclusion

This article has presented an approach to dealing with SNEs based on *Ḥanafī*`s approach to rectifying voidable contracts and re-executing invalid contracts. It started with a discussion on the overview of SNEs determinants in Islamic banks, followed by Muslim Jurists' views on the contract concept, including its categories. The discussion proceeds with the discussion on the *Ḥanafī*'s approach and the reason why the *Ḥanafī*'s 's model is employed in this study. Then, various SNEs occurring in Malaysian Islamic Banks are collected and presented to give a clear understanding of their invalidity or defects and their treatments. Overall this article may give some insights to the Islamic banks to improve *Sharīʿah* compliant practices in their operation, activities and transactions, particularly or at least assisting the banks in taking cognisance of the SNEs to avoid their recurrence. Having *Sharīʿah* compliance in every transaction, operation, and activity may increase confidence level among the stakeholders, which is essential for the growth and sustenance of Islamic Banking. In contrast, weak *Sharīʿah* compliance shown by the banks may reduce confidence, especially among the Muslim stakeholders hence diminishing their Islamic reputation. It is worth noting that Islamic banks are not genuinely Islamic until all the SNEs and the unlawful incomes are treated according to *Sharīʿah.*

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