

# Management of Shariah Non - Compliance Income (SNCI) in Islamic Financial Institution

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## ABSTRACT

The rapid growth of Islamic finance in Malaysia demonstrates strong demand for Shariah-compliant financial products, yet the risk of Shariah non-compliance income (SNCI) continue to challenge the credibility of Islamic financial institutions (IFIs). Such non-compliance, arising from contractual errors, operational weaknesses and governance limitations, threatens public confidence and raises questions about effective Shariah governance. This study examines the concept, sources, governance practices and disposal mechanisms of Shariah Non-Compliance Income (SNCI) in Malaysian Islamic financial institutions (IFIs). Using a qualitative document-based methodology, the research synthesises regulatory guidelines, academic literature and institutional practices to identify the challenges and variations in SNCI management. Findings show that IFIs adopt structured processes of detection, confirmation, reporting and rectification, with purification through charitable allocation being the most common disposal method. However, significant gaps remain including uneven Shariah expertise among staff, inconsistencies in interpretation and limitations in disclosure practices. The study highlights the need for enhanced capacity building, harmonised Shariah interpretation, and stronger governance to maintain the integrity and sustainability of Islamic finance.

**Keywords:** Shariah Non-Compliance Income (SNCI); Islamic Financial Institutions (IFIs); Shariah Governance; IFSA 2013; Risk Management.

## INTRODUCTION

The development and expansion of the Islamic finance and banking industry in Malaysia have shown remarkable progress over the past a few decades. This is evident as the industry's total assets have captured nearly 50 percent of the market share compared to the conventional financial and banking sector. Such growth has been driven by the strong demand for Islamic financial products and services among Malaysians, regardless of race or religion. The industry's ability to offer products comparable to conventional offerings has further encouraged customer loyalty. At the same time, adherence to Shariah-compliant principles ensures that clients remain free from the prohibited practice in Syariah law.

Despite this Shariah-compliant foundation, the risk of non-compliance may still occur due to failures in meeting regulatory standards or decisions issued by authorities, such as the internal Shariah Committees of Islamic financial institutions (IFIs) or the Bank Negara Malaysia (BNM). In line with these developments, BNM introduced the Operational Risk Reporting Requirement through the Operational Risk Integrated Online Network (ORION), which took effect on 22 September 2014. This policy requires IFIs to report all cases of Shariah non-compliance, whether actual or potential, in accordance with prescribed procedures.

In Islamic jurisprudence, wealth or income derived from prohibited elements cannot be retained, and must instead undergo a process of cleansing (tathir) through restitution or charitable disposal. However, differences in opinions among scholars, coupled with varying institutional capacities, have resulted in differing approaches across IFIs in Malaysia.

In Malaysia, authoritative bodies such as the State Islamic Religious Councils, Islamic Religious Departments, Shariah Advisory Councils, and Shariah Committees within IFIs adopt slightly different approaches to managing

and disposing of non-compliant income or assets. Nevertheless, these differences are relatively minor, allowing institutions to adopt the most suitable opinion. For IFIs regulated by BNM, every case of Shariah non-compliance whether actual or potential must first be reported to the Shariah Committee, which will then determine whether the case truly constitutes non-compliance.

This study aims to: (1) explain the concept and implications of SNCI; (2) identify sources and types of SNCI in IFIs; (3) analyse current management and disposal practices; and (4) compare variations in institutional approaches to highlight best practices and challenges.

## LITERATURE REVIEW

Shariah non-compliance event is referred to the practice or dealings that involved with interest (riba), uncertainty (gharar), gambling (maysir) and other prohibited element such as pork, liquor and pornography as stipulated by Muslim scholars. There are numerous SNC definitions. Al-Ghazali defines SNC event, also known as non-halal (prohibited) practice, as any property acquired through unlawful means, such as corruption, theft, riba (usury), hoarding, and gambling (Al-Bez, 2014). The other elements found to be forbidden in Shariah-compliant commercial dealings include Ghubn (inequality), Ikra (duress), Ghala' (error), Taghrir (deceit), and Jahalah (deception). In order to effectively implement Shariah risk management, Islamic banks need a comprehensive understanding of these factors (Hassan, 2016).

Shariah risk has always been central and continues to be the most important aspect of Islamic finance. Islamic finance is predicated on strict adherence to the Shariah law, which is considered essential. Any deviation from Shariah compliance will erode the credibility of Islamic finance and shake the confidence of investors and Muslim customer. To avoid muddying the waters between Islamic and conventional finance, Islamic finance must ensure that this distinct risk, non-Shariah compliant risk, is audited and properly handled (Syed, 2018). All IFIs operating in the banking and finance sector must adhere to Shariah standards in order to mitigate the negative effects of Shariah risks like usury (riba), gambling (maysir), and uncertainty (gharar). Any unethical business practises within the banking industry will not be tolerated under the current policy (Satkunasingam, 2006).

Every income that been classified as non-compliant with Shariah by the Shariah Committee of an Islamic financial institution must be reported and managed in accordance with the guidelines and policies issued by recognized authorities such as Bank Negara Malaysia (BNM), the State Islamic Religious Councils, or other accredited bodies. According to Sheikh Dr. Yusuf al-Qaradawi (2012), any unlawful income cannot be rightfully owned but instead should be channelled for public welfare. Such funds may be allocated to charitable causes, including the care of orphans, the development of Islamic missionary work, the construction of mosques and Islamic centres, the training of preachers, and the publication of religious works. Similarly, Zaharuddin Abdul Rahman (2010) emphasized that if the unlawful wealth originates from a known source and the rightful owner is identified, the disposal should be through returning the wealth to its owner, coupled with seeking forgiveness and repentance from Allah SWT.

Sheikh 'Atiyyah Saqar, former head of the Fatwa Committee at Al-Azhar, also highlighted that unlawful wealth must be disposed of as part of repentance. He outlined two methods, first, returning the wealth to its owner or their heirs if identifiable and second, if the owner is unknown, the wealth should be given to the needy, not as a means of earning reward but purely to cleansing the wealth. Imam al-Ghazali (2004), on the other hand, strictly prohibited the destruction of wealth, while Dr. Yusuf al-Qaradawi (2012) also prohibited leaving unlawful funds, such as riba, in conventional bank accounts. He argued that doing so would indirectly strengthen institutions that are fundamentally based on prohibited financial systems.

In this context, Asyraf, Mahbubi, and Lokmanulhakim (2012) explained that the rectification and cleansing process may vary depending on the source and circumstances of the Shariah non-compliance incident. Some types of income must be fully purified by channelling towards public welfare, while in other cases, the funds may need to be returned to their rightful owners. In certain situations, rectification can be achieved without requiring the total disposal of the non-compliant income, depending on the nature of the incident.

In Malaysia, the Islamic Financial Services Act (IFSA) 2013 was introduced as a comprehensive legal framework to ensure that Islamic financial institutions (IFIs) operate in full compliance with Shariah principles. The Act consolidates and repeals the Islamic Banking Act 1983 and the Takaful Act 1984, providing an end-to-end Shariah compliance structure for the industry. Specifically, IFSA 2013 aims to regulate and supervise Islamic financial institutions, payment systems, and related entities to ensure Shariah adherence in all activities, products, and services. Also oversee the Islamic money and foreign exchange markets and promote financial stability alongside strict Shariah compliance. Section 28(1) of IFSA 2013 required all operations, businesses, and activities of Islamic financial institutions must always comply with Shariah (Kunhibava, 2015). This indicates that Shariah compliance is not limited to certain stages but must be maintained through entire contractual process, from inception to completion.

### **Statutory Requirements on Shariah Non-Compliance Events**

The Shariah Governance Framework mandates continuous implementation of core functions such as Shariah risk management, Shariah review and Shariah audit to ensure compliance within IFIs. Under Section 28(1) and (2) of the Islamic Financial Services Act (IFSA) 2013, IFIs must ensure that their aims, operations, businesses and activities are always consistent with Shariah principles. Furthermore, compliance with the rulings of the Shariah Advisory Council (SAC) is deemed sufficient to establish Shariah compliance.

However, if there is any breach of Shariah principles, a violation of contractual terms, or failure to follow Bank Negara Malaysia (BNM) guidelines, the institution is considered exposed to Shariah non-compliance (SNC) risk. To handle this, under IFSA 2013, IFIs must immediately report any Shariah non-compliance event to their Shariah Committee and notify Bank Negara Malaysia. The institution is required to cease the non-compliant activity and submit a rectification plan within 30 days. Failure to comply may result in severe penalties, including heavy fines and imprisonment.

### **Shariah Governance Framework**

Shariah governance provides the structure through which SNC risk is assessed and managed. It includes both internal and external mechanisms such as Shariah boards, Shariah auditors, and regulatory frameworks. A strong governance system helps ensure that products and services are alight with Shariah-compliant, while also building confidence and trust among stakeholders (Ginena & Hamid, 2015). However, one challenge in Shariah governance is the lack of consistency in interpretation by scholars. Differences in rulings, either within the same Shariah board or across institutions, may create uncertainty and raise the risk of non-compliance (Ginena, 2015). Hamza (2013) argues that the effectiveness of governance largely depends on the independence of Shariah boards and the consistency of their decisions across a country or region.

Compared to conventional corporate governance, Shariah governance adds unique features such as Shariah supervisory boards and Shariah compliance departments. These bodies oversee Shariah risk management, Shariah review, and Shariah audit, which must be carried out continuously (Omar, 2019). In Malaysia, for example, the Islamic Financial Services Act (IFSA) 2013 requires IFIs to ensure that all operations are Shariah-compliant and in line with the rulings of the Shariah Advisory Council (SAC). Failure to do so could result in both financial and reputational losses (Chapra, 2022). In short, Shariah governance ensures that Shariah principles are embedded into every stage of decision-making, providing both accountability and legitimacy for IFIs (Hidayah, 2014).

### **Internal Control**

Internal control is another important tool for preventing Shariah non-compliance (SNC) in Islamic financial institutions (IFIs). It play a vital role in preventing operational and Shariah risks. Based on the COSO (2013) framework, effective internal control comprises control environment, risk assessment, control activities, communication and monitoring. Weak internal controls have been identified as a major contributor to SNC risks in IFIs (Darmadi, 2013; Rahman, 2014).

## METHODOLOGY

This study employs a qualitative research approach based on an extensive literature review. The primary method used is a comprehensive reading and analysis of existing academic articles, journal papers, regulatory guidelines, and institutional reports related to the management of non-Islamic income within Islamic financial institutions. By critically reviewing past research and documented practices, the study synthesises key insights, identifies prevailing frameworks and highlights scholarly perspectives on how Islamic banks manage, report and dispose of non-Shariah-compliant income. This method enables a deeper understanding of theoretical foundations, regulatory expectations and practical applications without conducting fieldwork, ensuring that the findings are grounded in established academic discourse and current industry practices.

The process began with the identification and selection of relevant sources through academic databases, library archives and regulatory publications, including materials from bodies such as Bank Negara Malaysia (BNM), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Islamic Financial Services Board (IFSB). Only sources that directly addressed SNCI or related themes in Islamic financial institutions were included to ensure the study's focus and relevance. Each selected work was then carefully reviewed to extract key arguments, findings and recommendations. Thematic content analysis was used to categorise findings into key themes: definition and concept, sources of SNCI, governance mechanisms and disposal practices.

## ANALYSIS AND FINDINGS

### Understanding Shariah Non-Compliance Income (SNCI)

The concept of SNCI is central to the operations of Islamic financial institutions because it highlights income that is tainted by elements prohibited under Shariah. This includes income that arises either directly from prohibited activities such as *riba* (interest) or indirectly from operational weaknesses that result in non-compliance (Omar & Hassan, 2019). The importance of addressing SNCI goes beyond financial considerations, as it relates to the ethical and religious obligations of the banks in upholding Islamic principles. The Islamic Financial Services Act (IFSA) 2013 reinforces this by requiring that all activities, operations, and business affairs of IFIs always remain Shariah-compliant (Johari, 2022).

The regulatory framework, particularly the BNM Shariah Governance Policy and the Operational Risk Reporting (ORR) system, further demonstrates the seriousness of SNCI management. By classifying Shariah non-compliance into Potential SNC and Actual SNC, the framework ensures that all doubtful or confirmed cases are monitored and reported (Musa, Salleh & Shafii, 2025). This dual classification reflects the principle of *ihtiyat* (precaution) in Islamic jurisprudence, where avoiding doubtful matters is encouraged to safeguard compliance.

### Types and Causes of SNCI

The findings reveal that SNCI originates from a wide range of sources, both contractual and non-contractual. On the contractual side, errors in documentation, misapplication of terms, or the structuring of products that inadvertently incorporate elements of *riba*, *gharar*, or *taghrir* may result in income being categorized as non-compliant (Omar & Hassan, 2019). For example, issues have been reported in contracts such as *Bai' Inah*, where certain terms may inadvertently suggest repurchasing arrangements, leading to concerns of resemblance to prohibited transactions (Musa et al., 2025).

Non-contractual causes are equally significant. These include operational failures such as system errors, delayed allocation of gold accounts, or *zakat* payments being routed incorrectly (Musa et al., 2025). Furthermore, financing without proper Shariah screening has led to banks unknowingly supporting businesses that are not permissible under Shariah, thereby creating SNCI (Johari, 2022). Another area of concern is sponsorship or corporate social responsibility (CSR) initiatives that may inadvertently fund non-compliant events or activities.

Underlying these incidents are governance weaknesses, particularly in knowledge and capacity. Several studies noted that the lack of qualified officers with strong Shariah backgrounds at the operational level hinders accurate

detection of potential non-compliance (Musa et al., 2025). This gap often results in delays or errors in escalating issues to the Shariah Committee (SC).

### Management and Disposal of SNCI

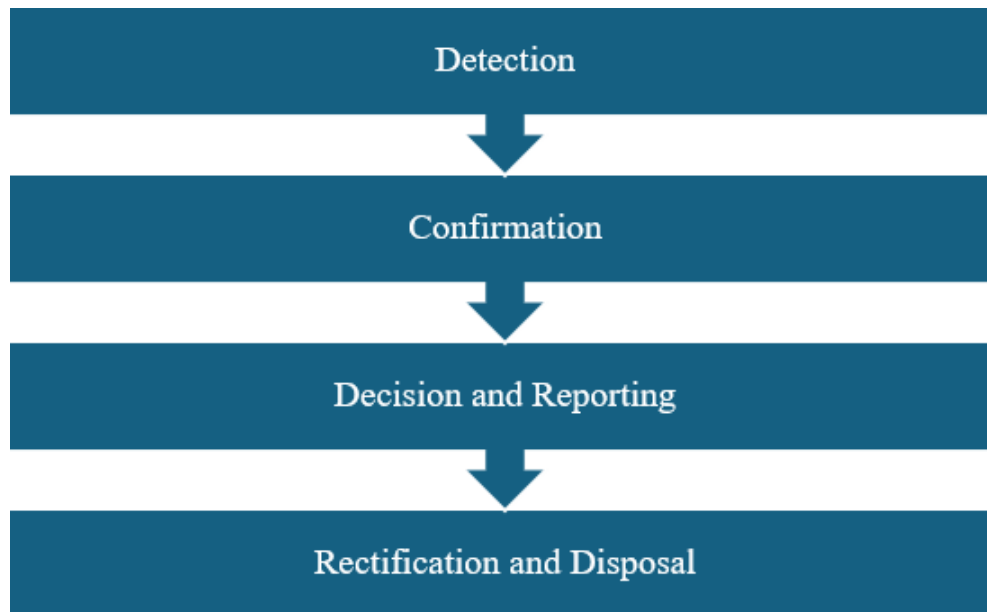


Diagram 1.0 A Systematic Process in The Managing of Shariah Non-Compliance Income

Based on digram 1.0 show that Malaysian Islamic banks generally follow a systematic process in the management of SNCI, reflecting both regulatory requirements and internal governance practices. The process consists of four key stages: detection, confirmation, decision and rectification/disposal (Omar & Hassan, 2019).

1. **Detection:** Potential SNC events may be identified by Shariah review teams, audit functions, operational risk units, or even external parties such as customers and whistle-blowers. Early detection is critical, as banks are required to suspend questionable transactions to prevent further exposure (Johari, 2022).
2. **Confirmation:** Once detected, issues are investigated and assessed by the Shariah control function. Under earlier regulations, confirmation required a Qualified Shariah Officer (QSO), but under the revised ORR, it may be undertaken by officers with sufficient Shariah knowledge even if they lack formal Shariah qualifications (Musa et al., 2025). This regulatory change, however, raises concerns about the consistency and quality of assessments.
3. **Decision and Reporting:** The SC deliberates and confirms whether the event constitutes actual SNC. Following confirmation, the bank must report the incident to BNM and submit a rectification plan within 30 days as mandated under IFSA 2013 (Johari, 2022).
4. **Rectification and Disposal:** The most common disposal method is purification, where the tainted income is channelled to charity to ensure that the bank does not benefit from impermissible earnings. Some banks also strengthen internal policies and procedures to prevent recurrence, such as refining Shariah screening tools or enhancing IT systems (Omar & Hassan, 2019).

The principle of prudence is evident throughout this process. Malaysian IFIs generally follow a systematic SNCI management process comprising detection, confirmation, decision and rectification. SNCI disposal is predominantly executed through purification by channelling tainted income to charitable accounts. However, disclosure practices remain inconsistent. While some banks provide detailed SNCI disclosures in their annual reports, others offer only general statements, raising transparency concerns (Johari et al., 2023; Rosman et al., 2017).



## Comparative Approaches and Best Practices

Although all Islamic banks in Malaysia operate under the same regulatory framework, implementation differs across institutions. Larger banks with dedicated Shariah departments often demonstrate greater capacity to manage SNCI effectively, employing specialized teams for Shariah review, risk management, audit, and research (Omar & Hassan, 2019). In contrast, smaller banks sometimes consolidate these functions under fewer officers, increasing the risk of oversight or delays.

Detection mechanisms also vary. Some banks rely heavily on manual audit and review processes, while others utilize computer-assisted audit techniques to conduct full-population testing of transactions, which improves accuracy and efficiency (Johari, 2022). Challenges are consistent across the industry. These include difficulty in defining parameters for potential SNC, limited Shariah expertise among operational staff, and inconsistencies in interpretation of Shariah rulings between institutions (Musa et al, 2025). Instances of attempts to conceal SNC issues, as highlighted by members of the Shariah Advisory Council (SAC), further underscore the need for robust governance and transparent reporting (Johari, 2022).

The comparative analysis between Malaysia and Bahrain demonstrates that both jurisdictions achieved relatively high disclosure indices (0.56–0.75), with Malaysia performing better in 2014 and 2015, and Bahrain leading in 2013 (Rosman et al., 2017). Bahraini banks demonstrated more consistent disclosure of SNCI classification, particularly in allocating such income to charitable accounts, whereas some Malaysian banks failed to disclose this information altogether. Best practices identified include the establishment of dedicated Shariah Supervisory Boards, internal guidelines that extend beyond regulatory requirements, and the use of multiple disclosure platforms such as Shariah Supervisory Board reports, Notes to the Financial Statements, and risk management disclosures (Johari et al., 2023; Rosman et al., 2017). These practices not only enhance transparency but also reinforce the stewardship role of Shariah governance mechanisms.

## CONCLUSION

The findings of this study affirm that effective management of Shariah Non-Compliance Income (SNCI) is essential to safeguarding the credibility and sustainability of Islamic finance. Malaysian Islamic financial institutions have established systematic processes of detection, confirmation, reporting and rectification to ensure compliance with Shariah principles. The practice of purifying non-compliant income by channelling it into charitable causes reflects both ethical responsibility and regulatory adherence. Nevertheless, the study reveals persistent challenges, including limited expertise among operational staff, inconsistencies in interpreting Shariah rulings, and uneven adoption of advanced audit technologies across institutions.

To strengthen Shariah governance, IFIs must enhance internal capacities by investing in the training of Shariah officers, adopting more sophisticated risk management tools and improving transparency in reporting practices. Greater harmonization of Shariah interpretations at the national and institutional levels would also reduce discrepancies and improve stakeholder confidence.

Future research should extend beyond literature-based studies to include empirical investigations through case studies or interviews with practitioners, regulators and Shariah scholars. Comparative studies between Malaysia and other jurisdictions with established Islamic finance sectors, such as the Gulf countries or Indonesia, could provide valuable insights into alternative governance models and disposal mechanisms. Additionally, exploring the role of technology such as artificial intelligence and blockchain in detecting and managing SNCI represents a promising avenue for innovation in Shariah-compliant financial practices.

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