



**SHARĪ'AH NON-COMPLIANT EVENTS IN ISLAMIC  
BANKS IN THE PRACTICE OF TAWARRUQ  
FINANCING IN MALAYSIA**

**BY**

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## ABSTRACT

Sharī'ah is the backbone of the Islamic banks (IBs) in which they operate. Failure to observe Sharī'ah compliance therefore triggers negative repercussions in IBs. Over the last two decades, a number of cases have been brought to court to challenge the legitimacy of Islamic banking products. In some cases, these challenges have resulted in financial loss for IBs. In view of this, Bank Negara Malaysia (BNM) has initiated commendable efforts to create a Sharī'ah non-compliant risk culture in IBs. However, ensuring Sharī'ah compliance is not a simple and straightforward matter. As IBs continue to witness a remarkable growth and product complexity, Sharī'ah non-compliance incidents and disputes are likely to emerge. This research investigates various forms of potential Sharī'ah non-compliant (SNC) events, and the Sharī'ah methodology adopted to deal with them, in IBs in the practice of *tawarruq* financing in Malaysia. The research also identifies the SNC event determinants and the various mechanisms for their mitigation. The research employs the Hanafi and the majority of the jurists (*jumhūr*) approaches in dealing with an invalid contract to examine the treatment of SNC events in *tawarruq* financing. A self-administered questionnaire was distributed to 16 respondents to explore SNC events in 16 Islamic commercial banks which related to the practice of *tawarruq* financing in Malaysia. The research also includes a series of structured interviews with practitioners, regulators, Sharī'ah advisors and researchers/academicians. Analytic Network Process (ANP) is adopted to prioritise the SNC event determinants as well as measures for their mitigation. The research found that some practices of *tawarruq* in Malaysia did not comply with the Sharī'ah, mainly due to improper sequencing of contracts and absence of commodity. The research suggested that the key SNC event determinants in *tawarruq* financing were lack of understanding and knowledge, inadequate control mechanism and reporting, ineffective functional structure, incompatibility of system to the execution of Islamic products, improper document execution and sequence, and inadequate internal policies and governing rules. Finally, the research proposes a Sharī'ah methodology and mitigation mechanism for IBs to deal with SNC events in the practice of *tawarruq* financing in Malaysia. The findings of the research are expected to serve as a reference source to industry players and regulators in formulating an appropriate policy and framework to enhance Sharī'ah governance and compliance practices in IBs in Malaysia.

## ملخص البحث

الشريعة هي عمود المصرفية الإسلامية وعلى ضوء مبادئها تشتغل، فعدم موافقتها لمتطلبات الشريعة يؤدي إلى تداعيات سلبية للمصرف. وفي العقود المنصرمين أحييت قضايا عديدة إلى المحاكم إعتراضاً على شرعية منتجات المصرفية الإسلامية. وقد أدت هذه المرافعات إلى خسارة مالية للمصرف. ولهذا ركز البنك المركزي الماليزي جهده في إنشاء ثقافة مخاطر عدم التوافق الشرعي في منتجات المصرفية الإسلامية. ومع توسع رقعة المصرفية الإسلامية توسعاً ملحوظاً، وازدياد تعقيد منتجاتها، أدى ذلك إلى بروز قضايا عدم الموافقة مع الشريعة والنزاع حولها. ولهذا، يهدف هذا البحث إلى دراسة مدى موافقة بعض صور التورق مع الشريعة الإسلامية في المصارف الإسلامية بماليزيا. وفي هذا الإطار حدد البحث عوامل عدم الموافقة مع الشريعة وآلية تقليلها. ومن الناحية المنهجية، فقد استخدم البحث منهج الحنفية وجمهور الفقهاء في تصحيح العقد الفاسد، كما تم أيضاً توزيع الاستبانة على ستة عشر مصرفاً إسلامياً وذلك للإطلاع على النماذج من المخالفة الشرعية في تطبيق التورق. واشتمل البحث أيضاً على إجراء المقابلات الشخصية مع العاملين والجهات الرقابية والإشرافية والهيئات الشرعية والباحثين والأكاديميين. واعتمد البحث على آلية تحديد الأولويات (Analytic Network Process "ANP") في تحديد أولويات عوامل عدم الموافقة مع الشريعة وتقليلها. ولقد توصل البحث إلى أنّ بعض عقود التورق المطبقة في ماليزيا لا تتوافق مع أحكام الشرعية الإسلامية لمخالفتها شروط ترتيب العقود وعدم وجود السلعة. وأظهر البحث أنّ قلة الفهم والمعرفة، واستخدام آلية الرقابة ورفع التقارير غير ملائمة، واستخدام هيكل وظيفي غير مجدٍ، وتعارض نظم المعلومات المستخدمة مع متطلبات المنتجات المصرفية الإسلامية، وتنفيذ العقود بشكل غير مناسب وغير مرتّب، وعدم ملائمة الأنظمة التشغيلية الداخلية غير ملائمة كلها عوامل رئيسة لتحديد عدم الموافقة مع الشريعة في التمويل المبني على عقد التورق. وأخيراً، اقترح البحث المنهج الشرعي وآلية تقليل عدم موافقة عقد التورق مع الشريعة في المصرفية الإسلامية. ويتوقع أن تفيد نتائج البحث العاملين والجهات الرقابية والإشرافية وتكون مرجعاً في تشكيل الإطار التنظيمي الفعال لتعزيز الحوكمة الشرعية والممارسات المتوافقة مع الشريعة في المصرفية الإسلامية بماليزيا.

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## DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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## LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
AHP	Analytic Hierarchy Process
ANP	Analytic Network Process
BBA	<i>Bay' Bithaman Ajil</i>
BIMB	Bank Islam Malaysia Berhad
BMIS	Bursa Malaysia Islamic Services
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BSAS	Bursa Suq Sila'
CM	Commodity <i>Murābahah</i>
CPO	Crude Palm Oil
DIB	Dubai Islamic Bank
DAB	Dallah Al-Barakah
DSN	Dewan Syariah Nasional
FAA	Finance Accreditation Agency
IBs	Islamic Banks
IFN	Islamic Finance News
IFSB	Islamic Financial Services Board
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Services Act
IIFA	International Islamic Fiqh Academy
IT	Information Technology
JFX	Jakarta Future Exchange
KFH	Kuwait Finance House
LME	London Metal Exchange
MIFC	Malaysia International Islamic Financial Services Centre
MUI	Majlis Ulama Indonesia
SC	Shari'ah Committee
MPO	Murabahah to Purchase Orderer
OIC	Organisation of Islamic Cooperation
PBUH	Peace Be Upon Him
PE	Plastic Resin
RBD	Refined, Bleached & Deodorised
SAC	Shariah Advisory Council
SGF	Shariah Governance Framework
SNC	Sharī'ah Non-Compliant
W	Weightage

## ARABIC TRANSLITERATION

ء	'/a	خ	kh	ش	sh	غ	gh	ن	N
ب	B	د	d	ص	s	ف	f	هـ	H
ت	T	ذ	dh	ض	ḍ	ق	q	و	W
ث	Th	ر	r	ط	ṭ	ك	k	ي	Y
ج	J	ز	z	ظ	ẓ	ل	l		
ح	ḥ	س	s	ع	ʿ	م	m		

### Short vowels

### Long Vowels

a	ā
i	ī
u	ū



# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF RESEARCH

Islam places a high priority on the subject of wealth the protection of which is among the ultimate objectives of Sharī'ah (*maqāṣid Sharī'ah*).<sup>1</sup> The legislation of contracts (*aqd*) in Islam is an important means (*wasā'il*) to secure the protection of wealth. Contracts play an essential role in Islam<sup>2</sup> to facilitate the exchange of ownership<sup>3</sup> and to smooth the circulation of wealth in society.<sup>4</sup> It serves as a basis of transaction and a mechanism for transfer of ownership from one party to another.

Islam requires that a contract is premised upon the notion of mutual consent (*tarādī*)<sup>5</sup> to realise fairness and justice between contracting parties,<sup>6</sup> representing the freedom of contract. Any element preventing the consent of parties such as usury (*ribā*), uncertainty (*gharar*), features of gambling and unfair treatment to the parties is prohibited in Islam.<sup>7</sup> Muslim jurists of various classical schools have laid down a set of contractual requirements and conditions to ensure mutual consent in place to make the contract valid so that all the legal effects that the Sharī'ah has assigned to become effective.

---

<sup>1</sup> Al-Shātibī, *Al-Muwāfaqāt*, 1<sup>st</sup> Edition (Cairo: Dar Ibn 'Affan, 1997), 3:236.

<sup>2</sup> Md. Abdul Jalil and Muhammad Khalilur Rahman, "Islamic Law of Contract is Getting Momentum", *International Journal of Business and Social Science*, vol. 1 no.2 (November 2010), 176.

<sup>3</sup> Muhammad Uthman Shubair, *Al-Madkhal ilā Fiqh al-Mu'āmalah al-Māliyah*, (Urdun: Dar Nafais, 2004), 124-143.

<sup>4</sup> Mohamad Akram Laldin and Hafas Furqani, "Developing Islamic Finance in the Framework of Maqāsid al-Sharī'ah Understanding the Ends (Maqāsid) and the Means (Wasā'il)," *International Journal of Islamic and Middle Eastern Finance and Management*, vol. 6 no. 4, (2013), 284.

<sup>5</sup> Qur'an, Al-Nisā', 29.

<sup>6</sup> Laldin and Furqani, 2013, 284.

<sup>7</sup> Al-Ṭabari, *Tafsir al-Ṭabari*, (Muassasah Al-Risalah, 2000), 8:217.

The overwhelming majority of jurists (*jumhūr*) classified the status of contract into two categories: valid (*ṣahīh*) and void (*ghayr ṣahīh*).<sup>8</sup> *Ṣahīh* is a contract which satisfies all essential elements (*arkān*)—such as the contracting parties, subject matter, and offer and acceptance—and all the underlying conditions (*shurūt*).<sup>9</sup> On the other hand, *ghayr ṣahīh* is a contract that violates essential elements of contract and their respective conditions.<sup>10</sup> From the Sharī’ah point of view, a void contract does not produce any legal consequence. Re-execution of contract has to be made if the parties intend to proceed with the contract.

The Hanafī school took a different position from the majority jurists. They classified the status of contract into three different categories: valid (*ṣahīh*), voidable (*fāsid*), and void (*bāṭil*). *Fāsid* is an in-between class of contract between *ṣahīh* and *bāṭil*.<sup>11</sup> The Hanafī’s stance is grounded upon the basis that defects in a contract originate either from a fundamental element (*aṣl*) or from an accessory attribute (*waṣf*). A defect in a fundamental element renders the contract void and that it cannot be rectified. However, a defect in an external attribute only results in voidable contract (*fāsid*)<sup>12</sup> but rectifiable.

As a business entity established within the ambit of Sharī’ah, Islamic banking products and services are structured based on various forms of Sharī’ah contracts.<sup>13</sup> The value proposition of Islamic banks (IBs) as promulgated by their advocates is manifested in the application of a diverse spectrum of Sharī’ah contracts in their

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<sup>8</sup> Wahbah al-Zuhaili, *Al-Fiqh al-Islāmi wa Adillatuh*, (Dimashq: Dār Fikr, 2004), 4:3086

<sup>9</sup> Al-Minyāwī, *Al-Mu’ṭaṣar min Sharḥ Mukhtashar al-Uṣūl min ‘Ilm al-Uṣūl*. (Egypt: Al-Maktabah al-Shāmilah, 2010), 34.

<sup>10</sup> Al-Shawkāni, *Al-Sayl al-Jarrār al-Mutadaffiq ‘alā Ḥadā’iq al-Azhār*. (Beirut: Dār Ibn Hazm, n.d), 539.

<sup>11</sup> Al-Bukhārī, A. *Kashf al-Asrār ‘an Usūl Fakhr al-Islām al-Bazdawī*. (Beirut: Dār al-Kutub al-‘ilmiyyah, 1418/1997), 37.

<sup>12</sup> Ibid, 38.

<sup>13</sup> Jalil and Rahman, 2010, 176.

business activities, i.e. deposit-taking and financing, which provides different risk and return profiles and draws its natures and objectives upon which IBs are established. Contract therefore plays an instrumental role in providing the criteria and parameters for determining the Shari'ah compliant status of every financial transaction entered into by IBs.<sup>14</sup> Failure to satisfy the Shari'ah requirements of contract will render the transactions null and void, and the income derived therefrom cannot be recognised as profit.<sup>15</sup>

Over the last two decades, a number of cases were brought to the court to challenge the legitimacy of underlying contracts of Islamic banking products. The judge's decision in some cases to annul the underlying contract used in a particular product threatens financial losses to the bank. As a case in point, in the *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors [2008] 5 MLJ 631*, the court declared that *bay' bi thaman ājil* (BBA) was invalid on the basis that the BBA facility was a *bona fide* sale transaction. Therefore, when the bank recalled the facility at a higher total price, the sale no longer represented a *bona fide* sale transaction but was merely a financing facility similar to a loan under conventional financing. As a consequence, it contravened the provisions of the Islamic Banking Act (IBA) and the Banking and Financial Institutions Act (BAFIA), which require Islamic banking businesses to be in compliance with the religion of Islam.<sup>16</sup> Nevertheless, the Court of Appeal in the case of *Bank Islam Malaysia bhd v Lim Kok Hoe & Anor and Other Appeals [2009] 6 CLJ 22* reversed the decision and the existing principle of law that had appeared in the *Taman Jaya* case, upholding the validity of the BBA as an enforceable contract.<sup>17</sup>

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<sup>14</sup> Muhammad Wahidul Islam, "Dissolution of Contract in Islamic Law," *Arab Law Quarterly*, Vol. 13, No. 4 (1998), 336.

<sup>15</sup> IFSB, *Guiding principles of risk management For institutions (other than insurance institutions) offering only islamic financial services*, (Kuala Lumpur: IFSB, December 2005), 26.

<sup>16</sup> *Arab Malaysian Finance Berhad v Taman Ihsan Jaya Sdn Berhad & Ors* (SuitNo: D4-22A-067-2003).

<sup>17</sup> *Bank Islam Malaysia bhd v Lim Kok Hoe & Anor and Other Appeals [2009] 6 CLJ 22*.

The validity of the BBA contract in financing facility was also challenged in the case of *Bank Islam Malaysia Bhd v Dato' Hj Nik Mahmud Daud*,<sup>18</sup> *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd*,<sup>19</sup> *Affin Bank Berhad v Zulkifli Abdullah*,<sup>20</sup> *CIMB Islamic Bank Bhd v LCL Corporation Bhd & Anor*,<sup>21</sup> and other cases.

As IBs continue to witness tremendous growth and move toward market maturity and increased product complexity, it is expected that more disputes and lawsuits are still likely to emerge.<sup>22</sup> Ensuring Shari'ah compliant aspects and strengthening robust Shari'ah governance are therefore paramount in maintaining the confidence level of Islamic banking stakeholders.<sup>23</sup> Inadequate attention to the whole process of Shari'ah compliance will inevitably trigger negative repercussions to the sustainability of Islamic banking industry.<sup>24</sup>

## 1.2 PROBLEM STATEMENT

On 1<sup>st</sup> January, 2011, Bank Negara Malaysia (BNM) introduced the Shari'ah Governance Framework (SGF) for the Islamic financial institutions (IFIs) operating under its purview (notably IBs and conventional banks offering Islamic financial services and *takāful* companies). The SGF aims to strengthen Shari'ah governance structures, processes and arrangements of the IFIs so as to ensure that Shari'ah-

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<sup>18</sup> *Bank Islam Malaysia Bhd v Dato' Hj Nik Mahmud Daud* [1998] 3 CLK 605.

<sup>19</sup> *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd* [2003] 1 CLJ 625.

<sup>20</sup> *Affin Bank Berhad v Zulkifli Abdullah* [2006] 1 CLJ 438.

<sup>21</sup> *CIMB Islamic Bank Bhd v LCL Corporation Bhd & Anor* [2011] 7 CLJ 594.

<sup>22</sup> Zulkifli Hasan & Mehmet Asutay, "An Analysis of the Courts' Decisions on Islamic Finance Disputes." vol. 3. issue 2 (2011). *ISRA International Journal of Islamic Finance*. 69.

<sup>23</sup> Zurina Shafi'i, et.al. "Post Implementation of Shari'ah Governance Framework: The Impact of Shari'ah Audit Function Toward the Role of Shari'ah Committee." 07-11 (2013) *Middle East Journal of Scientific Research* 13 (Research in Contemporary Islamic Finance and Wealth Management. 10.

<sup>24</sup> Asyraf Wajdi Dusuki, Mohammad Mahbubi Ali & Lokmanulhakim Hussain, "A Framework for Islamic Financial Institutions to Deal with Shari'ah Non-Compliant Transactions". *ISRA Research Paper No. 42/2012*. 02.

compliant aspects are in place in their operations and business activities.<sup>25</sup> The SGF requires IFIs to institute clear internal control and remedial rectification measures to address Sharī'ah non-compliant incidents in a holistic manner.<sup>26</sup>

The Islamic Financial Services Act (IFSA), which was enacted in 2013, further reinforced the policy orientation of having IFIs ensure that their aims, operations and business activities are all in compliance with the Sharī'ah.<sup>27</sup> Failure of an IFI to adhere to Sharī'ah-compliance requirements will subject it to criminal and civil penalties in the form of imprisonment of its executives and financial penalties. Section 28(8) of the IFSA clearly states:

“Any person who contravenes subsection (1) or (3) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.”<sup>28</sup>

To complement SGF 2011 and IFSA 2013 and to strengthen Sharī'ah compliance culture among IFIs, BNM has also embarked on the issuance of Sharī'ah standards featuring the most prevailing and applicable contracts and principles in Islamic banking and *takāful* industry in Malaysia. These include Sharī'ah standards on *murābahah*, *muḍārabah*, *mushārahah*, *ijārah*, *wadī'ah*, *istiṣnā'*, *wa'd*, *kaḳālah*, *hibah*, *tawarruq*, *bay' 'īnah*, *rahn* and *bay' ṣarf*.

However, ensuring Sharī'ah compliant aspects is not a simple and straightforward matter. In spite of commendable initiatives put forward by the

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<sup>25</sup>BNM, *Sharī'ah Governance Framework for Islamic Financial Institutions*, (Kuala Lumpur: Bank Negara Malaysia, 2011), 02.

<sup>26</sup> Ibid, 22.

<sup>27</sup> Government of Malaysia, *Law of Malaysia Act 759 Islamic Financial Services Act 2013*. Section 28 (1), 60.

<sup>28</sup>Section 28(1) of the IFSA states that all IFIs shall at all times ensure that their aims, business operations and activities are Sharī'ah compliant. Section 28(3) provides that when the IFIs are aware that their activities and operations are not compliant with Sharī'ah, they must immediately report to BNM, cease from carrying out the non-compliant activities and within 30 days of becoming aware of such non-compliance, submit a plan to rectify the non-compliance.

Malaysian regulator to ensure Shari'ah compliance in place, Shari'ah non-compliant events (known hereafter as SNC events) are, to a certain extent, unavoidable. Human error as well as poor governance, business processes and supporting systems; in addition to lack of awareness and understanding of Shari'ah matters are among factors which trigger SNC events in IBs.<sup>29</sup> Nonetheless, no specific Shari'ah guidelines and frameworks are made available so far on how to deal with SNC events. The treatment and rectification mechanism for SNC events in IBs rely heavily upon the direction of their Shari'ah committee (SC). Thus, an in-depth research has to be carried out to specifically and comprehensively tackle the SNC phenomena in IBs from various angles. A cursory review of the literature finds lack of research in this aspect due to the complexity of the subject and due to the fact that it is a relatively new area which calls for more academic researches.

The present research makes special reference to commodity *murabahah* (CM) financing via *tawarruq* arrangement (hereafter refers to *tawarruq* financing). A number of literatures reveal that *tawarruq* is exposed to a high degree of Shari'ah non-compliant risk due to its complexity nature. The report released by BNM in 2014 also discovered that *tawarruq* recorded a high frequency of SNC events in the practice of IBs.

### **1.3 OBJECTIVES OF RESEARCH**

Against the above background, the present research undertakes to explore the Shari'ah non-compliant phenomenon in IBs in the practice of *tawarruq* financing in Malaysia. Specifically, the study sets out to achieve the following research objectives:

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<sup>29</sup>Nasrun Mohamad@Ghazali, "*Tawarruq* in Malaysian Financing System: A Case Study on Commodity Murabahah Product at Maybank Islamic Berhad", (Master Thesis, Department of Shari'ah and Economics Academy of Islamic Studies University of Malaya Kuala Lumpur, 2013), 122.

1. To analyse the concept of Sharī'ah non-compliant transaction in Islamic law.
2. To examine various forms of SNC events in IBs in the practice of *tawarruq* financing in Malaysia and the Sharī'ah methodology to deal with each.
3. To assess the SNC event determinants in IBs in the practice of *tawarruq* financing in Malaysia.
4. To propose a Sharī'ah framework to deal with SNC events in *tawarruq* financing and the mechanism for their mitigation.

#### **1.4 RESEARCH QUESTIONS**

In view of the above objectives, the present research will address the following research questions:

1. What are the approaches prescribed by the Sharī'ah to dealing with Sharī'ah non-compliant transactions?
2. What are the common forms of SNC events in IBs in the practice of *tawarruq* financing in Malaysia and the Sharī'ah methodology to deal with them?
3. What are the determinant factors of SNC in IBs in the practice of *tawarruq* financing in Malaysia?
4. How SNC events be treated and mitigated?

#### **1.5 RESEARCH MOTIVATION**

The present research is motivated by the following facts and misconceptions:

1. IBs are guided by set of Sharī'ah values and principles. However, various SNC events are, to a certain extent, unavoidable for a number of reasons

and factors. Effective Sharī'ah non-compliant risk management is therefore important to maintain the confidence level of stakeholders and the sustainability of IBs.

2. BNM has recently issued Policy Document on *tawarruq* which is binding and enforceable upon IFIs under its purview. The policy document states that failure to comply with clause(s) in the standard may result in one or more enforcement actions.<sup>30</sup> However, BNM does not provide a methodology and mechanism to deal with Sharī'ah non-compliance activities resulting from IBs' failure to comply with the Sharī'ah requirements of *tawarruq* as detailed in the policy document.
3. There is some kind of misconception in the market today that should an Islamic bank fails to fulfil the requirements and conditions specified in the contract the transaction is eventually null and void and the income derived therefrom should be channelled to charity.<sup>31</sup>

## 1.6 SIGNIFICANCE AND CONTRIBUTION OF THE RESEARCH

A distinctive contribution of this research to the existing literature is its investigation of various forms of Sharī'ah non-compliant incidents in IBs in the practice of *tawarruq* financing in Malaysia and delineation of the Sharī'ah methodology to deal with them. No serious attempt has been put forward to study this subject so far. Past studies on the subject are scattered in various classical books of *fiqh*. Contemporary studies which have addressed this issue remain embryonic, mostly confined to the theoretical aspect.

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<sup>30</sup> For example, in the Sharī'ah Standard on Murabahah (BNM, 2013, 07) it is stated that: "S" denotes a standard, requirement or specification that must be complied with. Failure to comply may result in one or more enforcement.

<sup>31</sup> Asyraf Wajdi Dusuki, M. Mahbubi Ali and Lokmanulhakim Hussain, "A Framework for Islamic Financial Institution to Deal with Sharī'ah Non-Compliant Transaction", *ISRA Reserach Paper*, 42/2012, 02.