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Non-Shariah Compliance Risks (NCR) and the Danger of Potential Fraud in the Islamic Financial Institutions: A Conceptual Framework

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Abstract: This research paper is a conceptual study that aims to examine financial fraud and its relation to non-compliance to Shariah for the Islamic financial institution in Malaysia. The study is unique because it seeks to understand how deviations from Shariah guidelines could contribute to financial misconduct, examining the specific non-Shariah compliance risks that arise when the deviation of internal control fails to align with Islamic law. Utilizing quantitative methodology, this study adopts and adapts from an existing structured questionnaire survey to collect data. This study also employs Structural Equation Modelling (SEM) in its analysis of the data. The implication of this study for policymakers includes the development of an effective strategy for mitigating financial fraud and ensuring Shariah compliance, thus ensuring the integrity and reputation of the Islamic financial sectors. This will undoubtedly contribute to the stability of the economy.

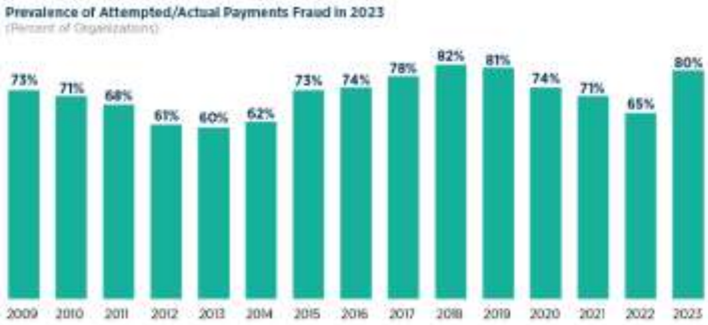
Keywords: *Non-Shariah compliance risk, financial fraud*

1. Introduction and Background of Study

As an ethical and Shariah-compliant alternative to traditional banking, the Islamic banking sector has grown into an essential part of the international monetary system. Financial institutions in Islamic finance are defined and validated by their adherence to Shariah principles, which is more than simply a legislative requirement. Non-compliance with Shariah principles in financial products, services, or activities is categorized as a Non-Shariah Compliance Risk (NCR). Shariah Non-Compliance Risk (SNCR) refers to the potential danger that arises from failing to adhere to the Shariah rules and principles set by the Shariah board of an Islamic Financial Institution (IFI) or the relevant authority in the IFI's operating jurisdiction, according to Islamic Financial Services Board (IFSB) (Ali & Hassan, 2019). This risk is significant due to the potential for monetary losses, damage to reputation, legal ramifications, and operational interruptions resulting from the deviation from Shariah. Since adhering to Shariah law is essential in Islamic finance, this risk is specific to that sector. Since Islamic money differs from mainstream finance in that it demands adherence to Islamic law in all dealings, this is crucial to Islamic finance. Financial products that are discovered to contain riba (interest), gharar (extreme uncertainty), or maysir (gambling) are deemed non-compliant and could result in financial losses and a betrayal of stakeholders' confidence. Therefore, Islamic financial organizations must remain true to themselves and their validity by following Shariah principles. Apart from that, keeping the confidence and integrity among stakeholders is crucial.

Despite the ethical guidelines and strict adherence to Shariah, Islamic financial institutions are not immune to financial fraud. This financial crime has been claimed to result in significant annual revenue losses for the organization. According to the 2024 ACFE Report on Occupational Fraud, organizations experience a loss of around 5% of their yearly income as a result of fraudulent activities. This translates to an average financial loss of $1.7 million per individual fraud case. The 2024 Association for Financial Professionals (AFP) Report on Payment Fraud and Control Survey reported that 80% of organizations payments fraud in 2023, as shown in Figure 1. Figure 1 also illustrates a sharp rise in the occurrence of attempted or actual payment fraud in the year 2023. The rapid evolution of fraud techniques has far exceeded some organizations' ability to adequately defend themselves against this fraud threat, resulting in a higher incidence of attempted fraud. The complexities of some transactions could also exacerbate these cases of attempted fraud.

Figure 1: Prevalence of Attempted/Actual Payment Fraud in 2023



Source: Association for Financial Professionals (AFP) Payment Fraud and Control Survey (2024)

The 2024 ACFE Report on Occupational Fraud revealed that 50% of fraud cases in 2023 were caused by a deficiency in internal controls, as illustrated in Figure 2, below. Internal control encompasses the systematic protocols and regulations established by an organization to guarantee the precision and dependability of financial and accounting data, foster responsibility, and deter fraudulent behavior. The purpose of these controls is to protect assets, guarantee the accuracy of financial reporting, and adhere to laws and regulations. Internal control systems typically consist of various essential components, such as the control environment, risk assessment, control activities, information and communication, and monitoring activities.

Figure 2: Sources of 50% of Occupational Fraud

Source: Association of Certified Fraud Examiners (ACFE) Report on Occupational Fraud (2024)

Previous studies on Shariah non-compliance risk mostly focused on its relation to governance (see: Basiruddin & Ahmed, 2020; Hassan, Othman, Omar, Napiah, Abdullah Arifin, Karim, 2017), documentation (Mohd Noor, 2024; Ali & Hassan, 2019; Rosly, Naim, & Lahsasna, 2017), audit or accounting (see: Shafii, Salleh, & Shahwan, 2010; Ahmad, Razali, & Said. n.d; Hanefah, Kamaruddin, Salleh, Shafii, & Zakaria, 2020) and sources of non-shariah compliance (Ilias, Nasrun and Muhamed, 2024; Hassan,2016). Despite the extensive research on Shariah non-compliance risk, there is a dearth of studies that examine the impact of non-Shariah compliance on the incidence of financial fraud in Islamic financial institutions. Consequently, this study aims to address the disparity by examining the risks associated with non-compliance with Shariah principles in the context of financial fraud. It aims to explore how deviations from Shariah guidelines contribute to financial fraud, examining the broader implications and specific risks that arise when financial activities fail to align with Islamic law. The deviations from Shariah guidelines include any failure to adhere to Shariah regarding products, services, operations and other aspects. Through this analysis, the study intends to offer a thorough understanding of the potential risks associated with non-compliance to Shariah principles which can exacerbate or contribute to fraudulent practices in the financial sector.

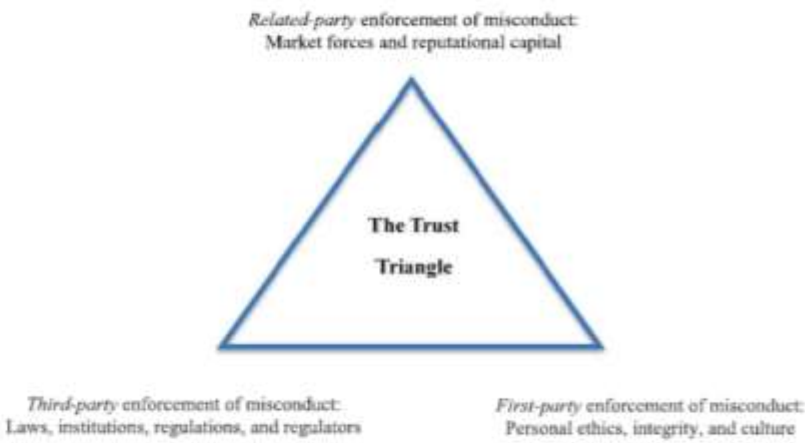
2. Literature Review

Financial fraud: Financial fraud can manifest in many different forms, including embezzlement, fraudulent documentation and cybercrime (Othman, Aris, Mardziyah, Zainan and Amin, 2015). The intricate operational framework of the Islamic financial institution, mudharabah, tawarruq and others, can unintentionally give rise to the chances for fraudulent activities, particularly when certain Shariah requirements are disregarded.

According to Othman et. al. (2015), staff fraud in the form of theft of funds, theft of resources, cybercrime and manipulation of documents as the leading forms of fraud in the Islamic Financial institution. The complexity of the Islamic bank products coupled with departure from the prescribed procedure and the need to comply with both Shariah and conventional financial rules may create a loophole in supervision, exacerbated by inept personnel which can be exploited by fraudulent individuals.

The Trust Triangle, as depicted in Figure 3, was developed by Dupont and Karpoff (2020). This framework identifies three pertinent components that are meant to explain the deterrent mechanism of opportunistic or fraudulent behavior, thereby fostering trust and facilitating economic transactions. The deterrent will only be implemented if these three "legs" of the triangle are present and functioning. The potential for financial fraud will arise in the event of its absence or dysfunction.

Figure 3: The Trust Triangle



Source: Dupont and Karpoff (2020)

Sources of Non-Shariah Compliance Risks: Non-Shariah Compliance Risk (NCR) emerges when Islamic financial institutions (IFIs) do not fully conform to Shariah principles in their operations, products, or services. This risk can manifest in various forms, each carrying distinct implications and challenges. These types of NCR include operational failures where processes do not align with Shariah guidelines, product non-compliance where financial products or services violate Islamic laws, and service-related issues where customer interactions or service delivery are inconsistent with Shariah requirements (Shah, Sukmana, and Fianto, 2020). Understanding and addressing these different types of NCR is crucial for ensuring that IFIs operate within the bounds of Islamic law and maintain their integrity and credibility. The discussions of these sources of non-Shariah compliance risks are as follows:

Operational Non-Compliance: Non-compliance with Shariah principles can arise from operational failures within Islamic financial institutions (IFIs). Operational non-compliance refers to risks stemming from deficiencies or breakdown in the organization's internal processes, systems, or personnel, which lead to deviations from Shariah guidelines. Research by Shah, Sukmana, and Fianto (2020) highlights that Shariah risk materializes when IFIs do not adhere to Shariah principles and guidelines in their daily operations and transactions. This risk can manifest through system inefficiencies, such as outdated or inadequate technology that fails to support Sharia-compliant activities, leading to potential non-compliance issues. Additionally, insufficient staff competency—resulting from inadequate training or a poor understanding of Shariah principles—can further exacerbate operational non-compliance, as discussed by Basiruddin and Ahmed (2019). For instance, an Islamic bank might inadvertently incorporate riba (interest) into a financing transaction due to a clerical error or a misunderstanding of the product's structure. According to Ali and Hassan (2019), such operational discrepancies can have severe implications, including significant financial losses and reputational damage.

Financial Non-Compliance: Participating in speculative transactions (may), earning or paying interest (riba), or investing in businesses that are involved in activities that are prohibited (haram) are all examples of behaviors that fall under the category of financial non-compliance for Muslims. According to Ali and Hassan (2019), this danger is most pronounced when revenue is obtained from sources that do not comply with Shariah requirements. For example, interest or investments in enterprises that do not adhere to Shariah guidelines also fall under this category. In addition, infractions of investment limitations can also potentially result in financial non-compliance. According to Basiruddin and Ahmed (2019), Islamic financial institutions (IFIs) are obligated to steer clear of investments that constitute immoral acts or involve an excessive amount of uncertainty (gharar). SNCR may be triggered by investments of this nature because they are in direct opposition to the precepts of Shariah. As an illustration, a Shariah-compliant Islamic bank would violate the law if it were to invest in conventional bonds. This is because the Shariah prohibits them from earning interest on these bonds.

Reputational Non-Compliance: Reputational non-compliance refers to situations where incidents of Shariah non-compliance become known to the public, resulting in a substantial loss of trust and confidence among important stakeholders, including consumers, investors, and regulatory agencies. Violations of Shariah principles can result in significant and enduring consequences for the institution's reputation and market position. Basiruddin and Ahmed (2019) argue that upholding Shariah compliance is crucial for preserving stakeholder trust, as stakeholders naturally anticipate Islamic financial institutions to strictly abide by Islamic principles. Publicized incidents of non-compliance might generate unfavorable perceptions, which may lead to a decline in business. For instance, if it is discovered that an Islamic bank is involved in non-compliant operations, such as speculative trading (gharar), the bank's reputation could be permanently damaged. Such public exposure has the potential to cause consumers to withdraw their deposits to distance themselves from unethical financial activities. This not only weakens the financial health of the institution but also does substantial harm to its reputation (Basiruddin & Ahmed, 2019). As a result, the institution may encounter both immediate and long-term difficulties in rebuilding the confidence of its stakeholders and reclaiming its place in the market.

Legal Non-Compliance: Legal non-compliance occurs when an institution fails to comply with the legal and regulatory frameworks that govern Shariah-compliant financial activity. This type of non-compliance can occur for several reasons, such as inadequacies within the legal system, disputes between conventional legal frameworks and Shariah law, or insufficient regulatory supervision. According to Mustapha, Kunhibava, and Muneeza (2020), in some places, the lack of a thorough legal system that properly includes Shariah principles leads to uncertainty in the law and increases the chances of not following the rules. Furthermore, the implementation of contracts that adhere to Shariah principles is frequently hindered by the judiciary's limited knowledge of Shariah affairs and the absence of dedicated legislation designed for Islamic finance. These legal problems provide substantial barriers to ensuring that Islamic financial transactions are carried out by Shariah law. In Nigeria, the absence of Shariah-based laws has created challenges in enforcing contracts for Islamic financial institutions. This has resulted in a higher risk of legal non-compliance and worsened Shariah Non-Compliance Risk (SNCR) (Mustapha, Kunhibava, & Muneeza, 2020).

3. Methodology

This study performs a comprehensive examination of pertinent literature, encompassing scholarly journal articles, with a specific focus on the ideas of financial fraud and the hazards linked to non-compliance with Shariah principles in Islamic Financial institutions. The study utilizes a quantitative research technique, collecting data through a questionnaire survey. The questionnaire has been derived from a prior investigation that examined the origins of non-Shariah compliance concerns and financial fraud inside the Islamic banking framework. This study specifically utilizes and adapts the questionnaires initially created by Kadoya, Khan, and

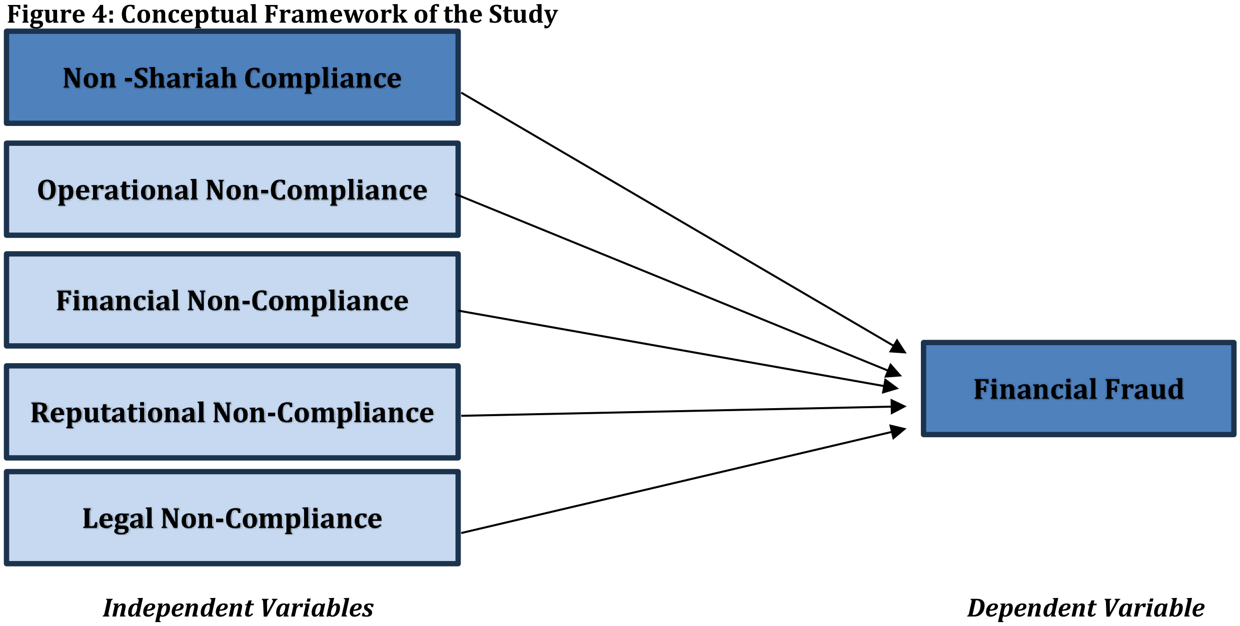
Yamane (2020), which focused on financial fraud as the variable being influenced. In addition, the study introduces a novel set of questions to evaluate the risk of non-Shariah compliance as an independent variable, along with certain demographic characteristics that are also treated as independent factors. This holistic approach seeks to offer a more profound understanding of the interaction between financial fraud and non-Shariah compliance concerns in Islamic Financial institutions.

This study intends to collect data from both prospective and current customers of Islamic financial institutions situated in the Klang Valley, an urban area in Malaysia that includes Kuala Lumpur, Putrajaya, and Selangor. The Malaysia Department of Statistics (DOS) reported that the population of the Klang Valley reached 9.21 million in 2023. Based on Krejcie and Morgan's (1970) sampling table, it is advised to have a sample size of 384 when dealing with a population of 1 million. Therefore, this study will utilize a sample size of 384 participants to accurately represent the entire population of Islamic bank clients in the Klang Valley. For this study, with a confidence level of 95% and a margin of error of 5%, a sample size of 384 is considered suitable, even when dealing with a bigger population, such as the 9.21 million individuals residing in the Klang Valley. This approach is by the widely recognized sample principles set forth by Krejcie and Morgan (1970).

To guarantee the sample's representativeness, respondents will be chosen using random sampling techniques. The survey will utilize a 5-point Likert scale, which spans from Strongly Agree to Strongly Disagree, to capture the views and impressions of the participants. The surveys will be sent to the chosen participants using diverse digital platforms, such as WhatsApp, Telegram, and other social media channels. The survey will be distributed over three months, ensuring ample time to reach a wide and varied range of respondents. This approach is specifically developed to guarantee that the data obtained is thorough and accurately represents the perspectives of the intended demographic.

The survey data analysis included confirmatory factor analysis, which consists of a measurement model and structural modeling. This study will employ Structural Equation Modeling (SEM), an influential statistical methodology that provides numerous benefits in analyzing the connections between independent and dependent variables. Zainuddin (2012) highlights that SEM is highly successful in evaluating the dependability and validity of variables, as well as managing the complexities associated with complicated models. Structural Equation Modeling (SEM) is particularly well-suited for assessing complicated models due to its ability to test the correlations among various variables. After conducting a comprehensive analysis of the existing literature, the pertinent factors have been chosen to establish the theoretical framework for this research, which is outlined as follows:

Figure 4: Conceptual Framework of the Study



4. Conclusion

In summary, financial fraud poses substantial hazards to the financial health of institutions and the overall integrity of financial systems. The necessity of rigorous legal framework enforcement and robust preventive measures is emphasized by the escalating number of financial fraud cases, as evidenced by a variety of studies. The Quran and Hadith explicitly condemn fraud in the Islamic context, emphasizing the importance of transparency, fairness, and justice in financial transactions. Fraudulent activities are subject to severe penalties under the Islamic legal system, which underscores the significance of upholding ethical standards and trust in financial transactions. Islamic financial institutions (IFIs) are acutely aware of non-Shariah compliance risks (NCR). These risks can result from operational, financial, reputational, and legal noncompliance, each of which presents obstacles that can undermine an institution's credibility and market position. These risks are further exacerbated by the absence of judicial expertise, regulatory supervision, and adequate legal frameworks in Shariah matters. The results will be instrumental in the development of more effective strategies to mitigate these risks, understanding the financial fraud and thus, guarantee the stability and integrity of Islamic financial institutions.

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