

The disclosure of shariah non-compliance (SNC) events by Islamic banks in Malaysia

Marina Mohamed^a, Norhazlina Ibrahim^{b*}

^{a,b}*Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia (USIM) Bandar Baru Nilai, 71800 Nilai, Negeri Sembilan*

ARTICLE INFO

Article history:

Received 15 January 2023

Accepted 25 March 2023

Published 1 May 2022

Keywords:

Accounting Disclosure

Transparency

Shariah non-compliance (SNC)

Islamic Banking and Finance.

DOI:

10.24191/jeeir.v11i2.22447

ABSTRACT

Ensuring *Shariah* compliance in their business activities, products and services is paramount for Islamic Financial Institutions (IFIs) to preserve public confidence. However, the occurrence of occasional *Shariah* non-compliance (SNC) incidents is unavoidable, and these are triggered for various reasons. Thus, IFIs must ensure appropriate communication and disclosure regarding the occurrence of SNC events; the purification of SNC income; and the adoption of control measures for financial information users. Despite the importance of SNC disclosure, few studies have analysed in detail the disclosure of SNC events. Thus, this study aimed to investigate SNC events disclosure in detail for all 16 Islamic banks in Malaysia from 2015 to 2020. While all the Islamic commercial banks in Malaysia were found to disclose and report SNC occurrences in their annual reports, complete compliance with BNM requirements had yet to be reached. Several banks were found to have made commendable efforts to make useful information available, such as root causes, linked Islamic contracts and the tracking of SNC income disposal. However, fewer banks disclosed information on the nature of SNC events, rectification activities and the control measures taken in response to these events. Continuous monitoring and strong enforcement by the regulator are required to ensure that SNC events disclosure can be streamlined across all banks. These findings add value to the information users by assuring them of the Islamic banks' accountability in terms of transparency, as well as their effectiveness in managing and mitigating SNC events.

1. Introduction

Islam imposes certain prohibitions that must be observed to ensure the *Shariah*-compliance of certain financial transactions and activities. These prohibitions include the abolition of interest (*riba*), the avoidance of uncertainty (*gharar*) and refraining from gambling or speculation (*maysir*) which contradicts the objectives and spirit of Islamic finance. The prohibition of *riba* in Islam is explicitly mentioned in several

verses of the Quran, including Surah Al-Baqarah (The Quran, 2:275-281), Surah Al-Nisa (The Quran, 4:161) and Surah Al Imran (The Quran, 3:130). The prohibition of *gharar* refers to the excessive ambiguity and uncertainty pertaining to the subject matter and price in exchange transactions, which may lead to fraudulent activities, disputes and injustice. Meanwhile, *maysir* is prohibited as it is associated with gambling, where gains or wealth are acquired by chance or speculation rather than genuine economic activities. Also prohibited are any transactions relating to the production and sale of non-halal goods or Shariah non-compliant (SNC) activities that affect the sanctity of Islam. These prohibitions are the cornerstone of Islamic finance and distinguish this system from the conventional one. They define the boundaries that should be observed to ensure contracts and transactions are valid from a Shariah perspective.

Malaysia's success in advancing Islamic finance can be attributed to its strong regulatory framework, government support, talent development, product innovation, market development, and international collaboration. These factors have helped Malaysia establish itself as a leading Islamic finance hub and attract both domestic and international players to its Islamic finance industry. For instance, Malaysia has established a comprehensive legal and regulatory framework to support Islamic finance. The country's central bank, Bank Negara Malaysia (BNM), has played a significant role in developing and implementing regulations and guidelines for Islamic financial institutions. These regulations provide a clear and robust framework for Islamic finance activities, ensuring transparency, compliance, and investor protection. Moreover, the Malaysian government has been proactive in promoting Islamic finance as part of its broader economic development strategy. It has created a favourable business environment and provided various incentives and support to attract Islamic financial institutions and investors to promote Malaysia as a global Islamic finance hub.

The journey of Islamic finance in Malaysia began with the establishment of Tabung Haji (Pilgrimage Fund) where for the first time, Malay Muslims are able to place their saving in a finance institution that is Shariah-compliant and benefit from the return of their saving. It is a change-catalyst to the Malay Muslims behaviour where they now have an avenue to participate in the nation's economic activities, instead of the traditional safe-keeping their saving at home. The increase of the awareness on Shariah-compliance finance leads to higher demand especially from the new generation of Muslims for Shariah-compliance financial instruments. The enactment of the Islamic Banking Act in 1983 saw the establishment of full-fledged Islamic bank namely Bank Islam Malaysia Berhad, as the first Islamic bank in Malaysia. This is followed by Bank Muamalat Malaysia Berhad in 1999 and the most recent one MBSB Bank Berhad in 2018. The introduction of the Islamic Banking Window Scheme in 1993 via amendments to the Banking and Financial Institutions Act 1989, enable all conventional banks to offer Islamic financial product and services.

Further, under the 10-year Financial Market Masterplan for the industry launched in 2001, the conventional banks participating in the Islamic Banking Window Scheme are encouraged to establish standalone Islamic banking subsidiaries (MIA, 2020). In 2004, licenses were also given to foreign Islamic banks to operate Islamic banking in Malaysia (Kunhibava, 2012; Puneri et al., 2020). At the present, there are a total of sixteen Islamic banks in Malaysia. Apart from Bank Islam, Bank Muamalat and MBSB Bank, the remaining thirteen Islamic banks composed of eight subsidiaries of local conventional banks, three subsidiaries of international conventional banks and two full-fledged International Islamic banks. The wide acceptance of these *Shariah*-compliance product proved the effectiveness and competitiveness of Islamic finance sector. Further, the issuance of licenses to foreign Islamic financial institutions has given the industry more dynamics with the highly innovative *Shariah*-compliance products and services (Ibrahim & Mohd Sopian, 2023). The establishment of Islamic Financial Service Act (IFSA) in 2013 is another significant milestone in the Islamic finance industry in Malaysia. IFSA 2013 repealed several of the earlier acts including Islamic Banking Act 1983. It further strengthens the regulatory framework for IFIs with the provisions of comprehensive specifications on the numerous Islamic financial contracts and its applications.

The issuance of the Act facilitates the market's growing need for Islamic financial products and services (MIA, 2020).

Ensuring Shariah compliance in business activities, products and services is paramount to gaining and maintaining public confidence (El Islamy, 2016). The growth and development of Islamic finance have primarily been due to the 'Islamic' brand and the values it carries and portrays. Customers' continued trust in this brand and these values gave the Islamic financial institutions the niche required to compete with conventional organisations (Radwan, 2017). As a result, failure to comply with Shariah may have adverse impacts on the financial and ethical credibility of Islamic banks, and this may cause society's trust in them to deteriorate further. These factors may impact a bank's long-term sustainability (Puneri et al., 2020). Thus, IFIs must ensure appropriate communication and disclosure regarding the status of their Shariah compliance, including the occurrence of SNC events; the purification of SNC income; and the adoption of control measures for the stakeholders and financial information users such as investors, depositors, shareholders, regulators and the general public (Amin et al., 2021). Reporting and disclosure will reflect the accountability of Islamic banks in terms of their transparency in their business and financial dealings (Rosman et al., 2017). SNC risk must be properly managed, which necessitates the establishment of Shariah auditing, Shariah reviews and Shariah risk management as the key organs in an organisation's Shariah governance structure to facilitate Shariah compliance and support the Shariah committee.

As emphasised in the Shariah Governance Framework (2011), a primary role of the Shariah committee is to oversee Shariah matters related to the IFI's business operations and activities. The Shariah committee is responsible for notifying the board and disclosing any concerns regarding SNC issues. Section 28(3) of IFSA 2013 also stipulates that Islamic Financial Institutions (IFIs) should immediately notify the Bank Negara Malaysia (BNM) and its Shariah Advisory Council (SAC) if any affairs or activities are identified that are not compliant with Shariah. The Shariah committee is expected to provide adequate disclosure of the state of the Shariah compliance of the Islamic banks. Hence, BNM has embedded the Shariah Committee Report (SCR) as a compulsory component for Islamic banks in their annual reports. The SCR must be made available as proof of the transparency of each Islamic bank and to confirm their state of Shariah compliance (Masruki et al., 2020).

El Islamy (2016) defined SNC as the failure of IFIs to comply with Shariah; it also involved going against the advice of the BNM SAC or the Shariah committee in respect of any business operations, affairs, activities and conduct. This aligns with Section 28(2) of IFSA 2013, which stipulates the requirement to report any business operation, affair or activity found not to comply with Shariah, the advice of the Shariah committee or an SAC ruling. In brief, non-conformance to Shariah would impact Islamic banks in several ways, such as invalidating contracts, derecognising income, as well as possibly writing down the value of their assets or causing financial losses due to legal or restitution costs (CPSA, 2020b). Hanefah et al. (2020) explained how any failure to manage SNC affects Islamic banks financially and non-financially. From the financial perspective, Islamic banks are potentially liable to punishments involving imprisonment for a term not exceeding eight (8) years or a fine not exceeding RM25 million, as imposed by Section 28(5) of IFSA 2018. Furthermore, SNC may affect the requirements of the capital adequacy ratio (CAR). From the non-financial perspective, SNC affects customer perceptions of and loyalty towards Islamic banks, as well as the banks' reputations.

Many studies on this subject have been preliminary and limited, having focused only on selected banks and short periods (Rosman et al., 2017; Puneri et al., 2020; Mat Nor & Md Sawari, 2020; Shafiai & Adawiah, 2019). The current study aimed to bridge this gap in the existing literature by empirically analysing the details of SNC events of sixteen Islamic banks over five years. Shariah compliance is the core and central element of Islamic banking. Failure to comply with the Shariah precepts will result in negative perceptions and adversely impact the confidence of the existing and potential investors in the IFI, thus putting their reputation at stake. Islamic banks must manage and mitigate the risk of Shariah non-

compliance effectively to protect their image, maintain their sustainability and retain customers' trust (Puneri et al., 2020). Additionally, ensuring the adequate audit, disclosure and management of Shariah non-compliant income are among the attributes that distinguish Islamic finance from conventional finance. Thus, the objective of this study was to examine the SNC disclosure details reported by all the Islamic banks in Malaysia from 2015 to 2020. The findings offer insights to the regulators and the public regarding Islamic banks' transparency levels in relation to SNC events disclosure. The results also provide an overview of the current SNC trends and the associated issues.

The remainder of this paper is organised as follows: Section 2 presents an overview of the literature pertaining to the significance of the Islamic banks' management of Shariah non-compliance events and activities, as well as the income realised from those SNC events. The research methodology, including the data collection strategy employed, is presented in Section 3. Section 4 contains the analytical section, which includes a detailed assessment of the composition of all SNC events for each bank. Finally, Section 5 presents the conclusion of the study.

2. Literature review

2.1 The evolution of SNC disclosure

Financial reporting is a way of providing the various stakeholders of an organisation with the financial information pertaining to its transactions and activities, as well as their financial and economic impacts. Amin et al. (2021) stated that the annual report is a channel used to communicate with shareholders and other stakeholders. Important disclosures are the occurrence of SNC events and how the bank deals with these events.

El Islamy (2016) classified SNC events into three (3) categories: i) mere irregularities, ii) fasid (voidable) and iii) batil (void). The first category represents SNC events that occur due to operational lapses or human error and which have no consequences for the contract. The use of inappropriate images or conventional terms like 'interest' in advertisements or promotional documents are among the SNC events classified into this first category. They pose no risk to the validity of any subsequent contracts. The second category, fasid SNC events, refers to those which may render a contract void. Examples of fasid SNC events are the presence of interest in a transaction or a contract term that guarantees a capital return to a capital provider (*rabbul mal*) in a *mudarabah* contract. In both cases, the removal of the conditions is necessary to prevent a transaction from becoming invalid or a contract from becoming void. Lastly, batil SNC events comprise those which invalidate the contract from its inception. A scenario in this category could be that the contract subject matter consists of items prohibited in Shariah, like pork or alcohol. This cannot be rectified as with a fasid SNC event; instead, the contracting parties must enter into a fresh agreement.

Failure to comply with Shariah requirements may cause an Islamic bank to suffer loss (Shafiai Adawiah, 2019). Any earnings or income realised from SNC events are deemed SNC income. The Islamic religion does not allow SNC income to be retained or consumed for the benefit of the individuals or institutions that earned it due to the unlawful elements associated with it. Both traditional and contemporary Muslim jurists are in consensus that any income containing unlawful elements must be purified. SNC income should be disposed of to prevent the income earner from committing sin. In general, it may be disposed of either by returning it to the real owner or channelling it towards public charitable purposes. It is imperative that Islamic banks diligently monitor the occurrence of SNC events and identify SNC income for purification

purposes. They would thus ensure their operations and earnings realised are fully Shariah-compliant (Al Haneef et al., 2017).

To ensure this compliance, BNM has issued several guidelines and policy documents to guide the Shariah committee on divulging adequate disclosure. In 2005, the Guidelines on Financial Reporting for Islamic Banking Institutions (GP8-i) were issued to provide the minimum disclosure requirements that must be adhered to by Islamic banks. The document was subsequently revised in 2012 before being repealed with the June 2013 release of a new policy document, Financial Reporting for Islamic Banking Institutions (FRIBI) (Rosman et al., 2017). FRIBI has also undergone several revisions, with the most recent being issued in September 2019. In 2010, the Shariah Governance Framework (SGF) 2010 provided the format and minimum content for a Shariah Committee Report. In 2019, the Shariah Governance Policy Document (SGPD) 2019 also touched on disclosure and superseded some related paragraphs in SGF 2010 and FRIBI 2018. Other guidelines highlighted by Shafiai and Adawiah (2019) and Abdul Ghani (2019) that contain provisions pertaining to SNC disclosure are the Capital Adequacy Framework for Islamic Banks (CAFIB) - Disclosure Requirements (Pillar 3) and the Guidelines on Late Payment Charges for Islamic Banking Institutions.

The 2005 GP8-i required the Shariah committee to provide a very simple disclosure, basically consisting of a general statement about their opinion on the conformity of the banks' operations with the Shariah principles. Later, BNM revised the Shariah Committee Report content through SGF 2010, which contained more comprehensive and detailed disclosure requirements. Apart from the introductory paragraph on the purpose of the Shariah committee and their responsibility to review the principles and contracts of the transactions for each financial year, the Shariah committee's opinion on the Shariah compliance of the Islamic banks comprised their attestation on four (4) aspects: i) contracts, transactions and dealings, ii) the appropriateness of the allocation of profit and loss in the investment accounts, iii) the disposal of earnings realised from sources prohibited by Shariah and iv) zakat computation (Mohd Hanefah et al., 2020). Further enhancements were evident in FRIBI 2013, which added aspects for the Shariah committee to attest: the identification of SNC events and the subsequent remedial actions. In addition, guidance was given on the extra information to be disclosed pertaining to SNC events and the associated SNC income.

Table 1 shows the evolution of the additional information requirements specifically pertaining to SNC events and income disclosure in the various documents.

Table 1. Additional disclosure requirements for SNC events and income

Documents	Evolution of disclosure requirements	Status
Guidelines on Financial Reporting for Islamic Banking Institution. [GP8-i]	Effective July 2005 Nil Effective Jan 2014 Para 8.6 - Additional disclosure information includes: (i) nature of Shariah non-compliant activities; (ii) amount of Shariah non-compliant income; (iii) number of non- Shariah compliant events occurring during the year; and (iv) rectification process and control measures to avoid recurrence of such Shariah non-compliant activities	Both repealed by the issuance of FRIBI

Documents	Evolution of disclosure requirements	Status
Financial Reporting for Islamic Banking Institutions (FRIBI)	<p>Effective June 2013</p> <p>Para 11.6(c) - Income derived from Shariah non-compliant activities may alternatively be disclosed under the Director's Report or Shariah Committee's Report. A licensed person shall disclose the additional information:</p> <p>(i) nature of Shariah non-compliant activities;</p> <p>(ii) amount of Shariah non-compliant income;</p> <p>(iii) number of non- Shariah compliant events occurring during the year; and</p> <p>(iv) rectification process and control measures to avoid recurrence of such Shariah non-compliant activities</p> <p>Para 11.21 - A licensed person shall disclose sources of donations / charity funds (e.g. gharamah amount, Shariah non-compliant income, shareholder's funds) and the uses of such funds (e.g. distribution to the poor, education)</p>	FRIBI revised around three times after the initial version, which were in 2015, 2016, 2018 and 2019, but no changes were made to the SNC disclosure requirements.
Capital Adequacy Framework for Islamic Banks (CAFIB) - Disclosure Requirements (Pillar 3)	<p>Effective Jan 2010</p> <p>Table 15: Shariah Governance Disclosures</p> <p>Qualitative disclosure</p> <p>Description of the Shariah governance structure, systems, processes and controls employed for the purpose of ensuring Shariah compliance</p> <p>Description of rectification process of non-Shariah compliant income occurring during the year</p> <p>Quantitative disclosure</p> <p>The amount of non-Shariah compliant income and the number of non-Shariah compliant events occurring during the year</p>	Still valid
Guidelines on Late Payment Charges for Islamic Banking Institutions	<p>Effective Jan 2012</p> <p>Para 8.2 - The receipt of gharamah that the IBIs have committed to distribute shall be recognised as 'Other liabilities' in the balance sheet. The utilisation of gharamah received for charitable purposes shall be disclosed in the notes to account for 'Sources and uses of donations/charities fund'.</p>	Still valid

Based on Table 1, six (6) common types of key information have been consistently placed in the guidelines or policy documents by BNM as additional disclosure requirements for the Islamic banks if SNC occurs. These types of information are as follows:

- i. Number of SNC events occurring during the year
- ii. Nature of SNC events
- iii. The amount of SNC income
- iv. The disposal of SNC income
- v. The rectification processes
- vi. The control measures taken

Other than these six types of information, SGPD 2019 recently added 'status' as a further element of disclosure.

2.2 Past studies on SNC

The majority of SNC studies have examined the disclosure of SNC events in Islamic banks. The comparative study by Rosman et al. (2017) examined banks in Malaysia and Bahrain based on a content analysis of their annual reports between 2013 to 2015. The authors concluded that a reasonably high overall SNC income disclosure index was obtained by both countries for these three years. Developing an SNC income disclosure index to measure the disclosure practices, the overall scores ranged between 0.56 and 0.75. Meanwhile, based on a study of sixteen (16) Islamic banks' annual reports between 2016 and 2017, Shafiai and Adawiah (2019) indicated that the disclosure of SNC events was low and required improvement.

Based on a comparative analysis of *Shariah* committee report disclosures collected from annual reports between 2012 and 2014 for three (3) banks from Malaysia, Pakistan and Bahrain, Puad et al. (2015) found that the sample from Pakistan disclosed more items compared to those from Malaysia and Bahrain for some aspects, including the steps taken to ensure *Shariah* compliance. Oz et al. (2016) revealed the issues and challenges pertaining to the IFIs' disclosure practices, based on a study of the nature of SNC risk and its implications for capital adequacy. Based on data from 51 Islamic banks from 11 countries over a five-year period (2010 to 2014), the authors highlighted that relevant data were reported negligibly or not at all due to inconsistent and unclear regulatory disclosure requirements.

Puneri et al. (2020) examined whether the category of an Islamic bank (full-fledged or subsidiary) influenced the disclosure practices in the *Shariah* Committee Report, as disclosed in the annual reports over a three-year period (2015 to 2017). Adopting a qualitative research method, a sample of four (4) Islamic banks (two in each category) was chosen. The study discovered that the category of an Islamic bank did not affect the disclosure practices. They also acknowledged that Bank Islam Malaysia Berhad had provided clear disclosure of their SNC income and should become the benchmark for other Islamic banks to emulate. Nonetheless, the levels of disclosure by the other Islamic banks in their sample were slightly lower. From another angle, the researchers acknowledged that commendable disclosure efforts were made by the subsidiaries in the sample, OCBC Al-Amin Bank Berhad and Public Islamic Bank Berhad. Nevertheless, an inconsistency was observed between the information in the *Shariah* Committee Report and that in the Notes to Financial Statements disclosed by Public Islamic Bank Berhad in relation to SNC income received for the 2017 financial year.

Mat Nor and Md Sawari (2020) identified that only nine (9) Islamic banks out of a total of sixteen (16) (i.e., slightly more than 50 per cent of all Islamic banks) complied with the disclosure requirements prescribed by BNM in their 2018 annual reports. The newly developed disclosure index covered two key types of SNC information, i.e., the number and nature of any SNC issues. The disclosure percentages of the 16 Islamic banks for these two types of information only ranged between 27 per cent and 44 per cent in the annual reports from 2013 to 2017. Nonetheless, a recent study by Amin et al. (2021) on the 2016 annual reports of 16 Islamic banks depicted their relatively high disclosure of SNC items. The method also involved the construction of a *Shariah* disclosure index, and the scoring results proved that the majority of the Islamic banks disclosed information on SNC activities, namely the nature and amount of SNC income, together with the rectification processes and control measures employed to prevent the recurrence of similar incidents. This contrasted with the conclusions of other studies that also examined annual reports for 2016.

The studies on this subject have been preliminary and limited, with reports tending to analyse all Islamic banks cumulatively rather than focusing in detail on particular banks. Moreover, some studies only focused on SNC income reporting or were confined to a specific year. By empirically analysing all the elements of

the SNC events for all sixteen Islamic commercial banks in Malaysia from 2015 to 2020, the current study aimed to bridge the gap in the existing literature.

3. Methodology

For this study, the method used was content analysis. Horuckova and Baudasse (2017), defined content analysis as “a research technique for the objective, systematic and quantitative description of the manifest content of communication”.

3.1 Locations of SNC information

In searching for information through content analysis, any SNC information disclosed by the Islamic banks in their annual reports was observed. This SNC data were searched for in two specific sections of each annual report, namely the Financial Statement and Pillar 3 Disclosure

3.2 Population

The data sample for this study covered the sixteen (16) Islamic banks in Malaysia, which represented the licensed Islamic Banking Institutions in Malaysia, as published on the BNM portal. The selected banks are listed in Table 2.

Table 2. List of licensed Islamic banking institutions in Malaysia

No	Name	Ownership	Full-Fledged / Subsidiary
1	Affin Islamic Bank Berhad (AFFIN)	Local	Subsidiary
2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad (RAJHI)	Foreign	Full-Fledged
3	Alliance Islamic Bank Berhad (ALLIANCE)	Local	Subsidiary
4	AmBank Islamic Berhad (AMBANK)	Local	Subsidiary
5	Bank Islam Malaysia Berhad (BIMB)	Local	Full-Fledged
6	Bank Muamalat Malaysia Berhad (MUAMALAT)	Local	Full-Fledged
7	CIMB Islamic Bank Berhad (CIMB)	Local	Subsidiary
8	Hong Leong Islamic Bank Berhad (HLEONG)	Local	Subsidiary
9	HSBC Amanah Malaysia Berhad (HSBC)	Foreign	Subsidiary
10	Kuwait Finance House (Malaysia) Berhad (KFH)	Foreign	Full-Fledged
11	Maybank Islamic Berhad (MAYBANK)	Local	Subsidiary
12	MBSB Bank Berhad (MBSB)	Local	Full-Fledged
13	OCBC Al-Amin Bank Berhad (OCBC)	Foreign	Subsidiary
14	Public Islamic Bank Berhad (PIBB)	Local	Subsidiary
15	RHB Islamic Bank Berhad (RHB)	Local	Subsidiary
16	Standard Chartered Saadiq Berhad (SAADIQ)	Foreign	Subsidiary

Taking into account the points mentioned above, the sources and scope of the data for this study were based on information collected from a specific period of six (6) years, from 2015 to 2020. The study used annual reports starting from 2015 as it was impossible to obtain annual reports from before 2015 for some of the Islamic banks.

4. Analysis and findings

4.1 Descriptive analysis of SNC events disclosure

For the purposes of this study, content analysis was performed on the information collected from the Islamic banks' annual reports covering the six-year period from 2015 to 2020. The annual reports referred to in this study were released at the bank entity level, except for AMBANK, whose annual reports were at the group level. This was due to an inability to obtain their annual reports at the bank level. The following section provides descriptive analyses of the SNC data from various angles and perspectives.

4.1.1 Location of SNC events in the annual reports

It was observed that all the banks disclosed information in one or more of four locations in their annual reports, namely:

- a. Shariah committee reports
- b. Notes to financial statements
- c. Pillar 3 disclosure
- d. Directors' reports

Referring to Table 3, the practice of most Islamic banks (10 out of 16, or 62.5 per cent) was to disclose SNC information in the *Shariah* Committee Report, Notes to Financial Statements or Pillar 3 Disclosure.

Table 3. Location of SNC information disclosed in annual reports

No	Islamic Banks	Directors' reports	Shariah committee report	Notes to financial statements	Pillar 3 disclosure
1	AFFIN		√	√	√
2	AL-RAJHI		√	√	√
3	ALLIANCE		√		√
4	AMBANK			√	√
5	BIMB		√	√	√
6	MUAMALAT		√		√
7	CIMB		√	√	√
8	HLEONG		√		
9	HSBC		√	√	√
10	KFH		√		√
11	MAYBANK		√	√	√
12	MBSB		√	√	
13	OCBC		√	√	√
14	PIBB		√	√	√

15	RHB		√	√	√
16	SAADIQ	√	√	√	√

The table above indicates that all sixteen (16) Islamic banks in Malaysia provided disclosure of SNC events. This contradicts the findings from a study by Mat Nor and Md Sawari (2020), who highlighted that only nine (9) out of the sixteen (16) Islamic banks provided reports on SNC. This contradiction may be due to their approach, which was confined to seeking SNC disclosure only in the *Shariah* Committee Reports.

4.1.2 Occurrence of SNC events and trends

From 2015 to 2020, a total of 159 SNC events were reported (refer to Table 4).

Table 4. Number of SNC events by year

Year	2015	2016	2017	2018	2019	2020	Total
SNC Events	42	33	26	15	19	24	159

Occurrences declined during the first four (4) years of the analysis period (2015 to 2018) but a gradual increase was evident in the last two (2) years. Nevertheless, the number of cases disclosed in both 2019 and 2020 was still below the number disclosed prior to 2018. The breakdown of all 159 SNC events disclosed by each Islamic bank is depicted in Table 5.

Table 5. Number of SNC events disclosed by Islamic Banks, 2015 to 2020

	AFFIN	RAJHI	ALLIANCE	AMBANK	BIMB	MUAMALAT	CIMB	HLEONG	HSBC	KFH	MAYBANK	OCBC	PIBB	RHB	SAADIQ
Total 2015 to 2020	5	5	12	17	27	3	10	5	2	1	22	15	11	3	21
Average for 6 years	1	1	2	3	5	1	2	1	0	0	4	3	6	1	4

The three (3) banks with the most occurrences of SNC events from 2015 to 2020 were BIMB, MAYBANK and SAADIQ; all three reported more than 20 SNC events. Meanwhile, seven (7) banks reported minimal numbers of SNC events (five incidents or fewer), including AFFIN, RAJHI and HLEONG. The remaining five (5) banks experienced between 10 and 20 SNC events. MBSB declared no SNC events at all throughout the six-year period.

Figure 1 depicts the trends of the SNC cases for fifteen (15) Islamic banks, excluding MBSB, from 2015 to 2020.

Note: ND denotes 'Not Disclosed'

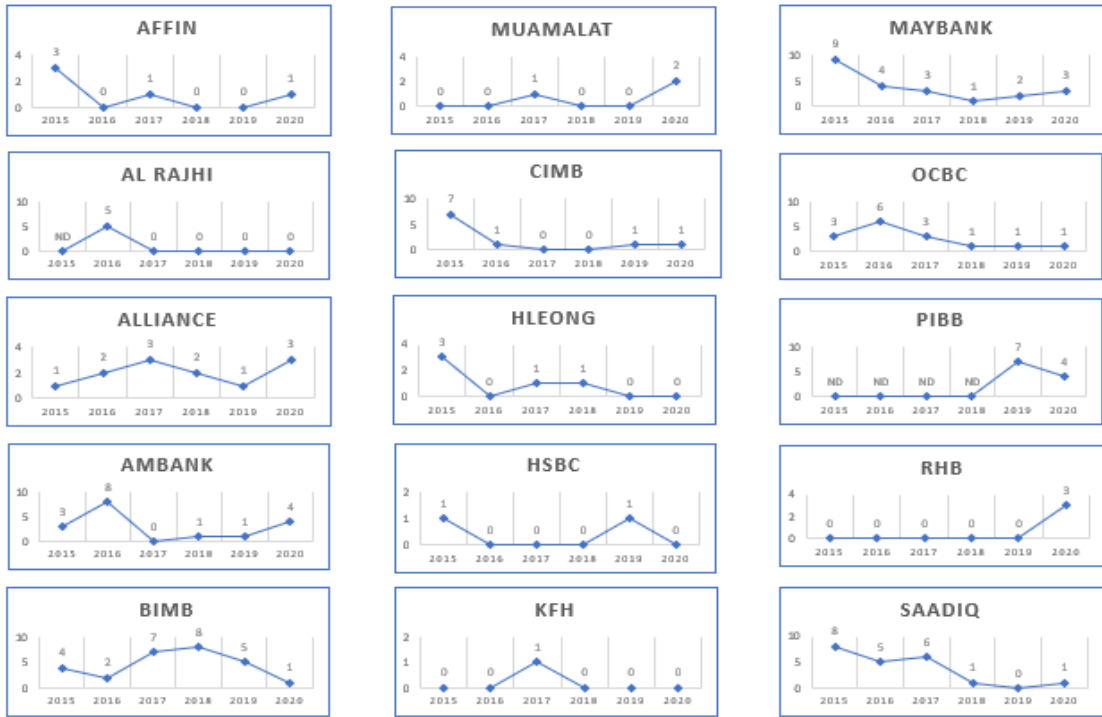


Figure 1. Trends of SNC event occurrences disclosed by Islamic banks in each Year

BIMB, which disclosed the most SNC incidents (a total of 27), showed a rising trend for the first four (4) years, from four SNC incidents in 2015 to eight in 2018 (with a slight drop in 2016). MAYBANK and SAADIQ, the other two (2) banks whose total incidents were above 20, both depicted a declining trend of SNC incidents, from totals of nine and eight incidents in 2015 to three and one in 2020, respectively. Apart from these three (3) banks, almost all the other banks showed reductions in the occurrences of SNC events, reporting zero incidents or one incident from 2018 onwards. The exceptions were the five (5) banks that experienced rising SNC incident numbers in 2019 and 2020.

4.1.3 Nature of SNC events

From the total of 159 SNC incidents, only 95 (59.7 per cent) involved descriptions of the nature of the incidents. This indicated a reasonably large percentage of non-disclosure by the Islamic banks and thus non-compliance with the disclosure requirements stipulated by BNM. Three (3) observations can be derived from the disclosure practices (Table 5):

- Seven (7) banks (46.7 per cent) consistently disclosed the nature of the SNC events since 2015: AFFIN, BIMB, HSBC, CIMB, KFH, MAYBANK and PIBB.
- Three (3) banks (20 per cent) showed improvements, moving from non-disclosure to disclosure of descriptions of SNC. These were ALLIANCE, AMBANK and MUAMALAT.

- c. The remaining five (5) Islamic banks (33.3 per cent) provided no description of SNC events and were therefore not adhering to the requirements stipulated by BNM.

Table 5. Categories of the nature of SNC events by year (2015 to 2020)

Nature of SNC	2015	2016	2017	2018	2019	2020	Total
Non-execution of transactions / trading prior to financing disbursement	5	1	2	3	6	2	19
Involvement in Shariah non-compliant activities	1	1	0	1	7	8	18
Non-existence of and / or insufficient underlying assets and absence of aqad execution	7	4	5	0	0	0	16
Absence of aqad execution	1	0	6	3	0	2	12
Incorrect computation or charges of fees, rate of return or profit	3	0	1	2	1	2	9
Involvement of conventional elements	5	1	0	0	1	0	7
Late payment charges	0	0	0	2	1	2	5
Non-existence of and/or insufficient underlying assets	1	0	0	1	0	1	3
Absence of rate of return	0	0	0	0	0	1	1
Disposal of Shariah non-compliant security	0	0	1	0	0	0	1
Fraudulent cases	0	0	0	0	1	0	1
Inappropriate advertising	1	0	0	0	0	0	1
Payment of zakat to wrong state authorities	0	0	0	0	0	1	1
Incorrect documentation	0	0	0	0	1	0	1
Grand Total	24	7	15	12	18	19	95

The various descriptions and explanations disclosed by the banks on the nature of the SNC events can be further summarised into fourteen (14) groups, based on the distinct characteristics of the events listed in Table 5. This indicates that 77.9 per cent (or 74 incidents out of a total of 95) of the SNC incidents occurred mainly due to:

- non-execution of trading / transactions prior to the disbursement of financing amounts to customers
- financing or other services related to *Shariah* non-compliant activities
- underlying assets not in existence or partially existent
- aqad* (contract) not executed for the transactions
- incorrect computation or charges.

All five (5) SNC categories were challenges to the Islamic banks since they continued and occurred consistently throughout the six (6) years from 2015 to 2020. Table 6 provides another perspective on the nature of the SNC events disclosed by the Islamic banks.

Table 6. Categories of the nature of SNC events disclosed by Islamic banks

Nature of SNC	AFFIN	ALLIANCE	AMBANK	BIMB	MUAMALAT	CIMB	HSBC	KFH	MAYBANK	OCBC	PIBB	TOTAL
(A)	3	3		7		1	1		1		3	19
(B)		1	1	5	1	1			3		6	18
(C)		2							14			16
(D)		2	1	8		1						12
(E)	1			3					3	1	1	9
(F)	1					5			1			7
(G)			3	2								5
(H)		1					1				1	3
(I)						1						1
(J)								1				1
(K)				1								1
(L)						1						1
(M)					1							1
(N)				1								1
TOTAL	5	9	5	27	2	10	2	1	22	1	11	95

Note: Refer to Table 5 for a detailed description of the nature of SNC, based on the correspondent's letter.

As the table above shows, areas of weakness or gaps can be deduced for several Islamic banks. Among the most prominent was MAYBANK, where out of 22 SNC incidents in total, 14 (63.6 per cent) resulted from either the non-existence of and/or insufficient underlying assets or the absence of *aqad* execution, which is fundamental in Islamic contracts and transactions. The SNC incidents at BIMB were mainly contributed by three (3) SNC categories: (i) *aqad* execution, (ii) managing the execution of trading prior to the disbursement of financing amounts and (iii) involvement in *Shariah* non-compliant activities. These three (3) categories comprised 74 per cent of their total SNC incidents.

4.1.4 Islamic contracts associated with SNC events

It was also observed that eight (8) banks that described SNC events were transparent on the corresponding Islamic contracts used for the SNC transactions. Nevertheless, this practice was minimal. Table 7 presents the various types of Islamic contracts underlying the SNC incidents.

Table 7. SNC events by the related contracts

Islamic Banks	Ar-Rahnu	Bay al Dayn	BBA	Tawarruq	Mudarabah	Qard	Sukuk	Wakalah	Wakalah bil Istithmar	Grand Total
AFFIN				3						3
ALLIANCE			1	2						3
BIMB	1			12	1				1	15
CIMB				1				1		2
KFH							1			1
MAYBANK				1						1
OCBC		1		1						2
PIBB			1			1				2
TOTAL	1	1	2	20	1	1	1	1	1	29

Only 29 SNC incidents reported this information, representing only 18.2 per cent of the 159 SNC events in total. This was unsurprising as reporting this information is not mandatory, according to the BNM guidelines and policy documents. Nevertheless, this information is important as it could indicate the types of contracts that pose a challenge to Islamic banks in terms of complying with the *Shariah* precepts. From the available information, the majority of the SNC events occurred in relation to *Tawarruq / Commodity Murabahah* (20 out of 29 SNC incidents). For the remaining Islamic contracts, few SNC incidents apparently occurred. This finding aligned with the study by Ali and Hassan (2020), who found that *Tawarruq* exposes Islamic banks to the risk of SNC as such operations involve a series of sales contracts that must be executed in a proper sequence.

4.1.5 Root causes of SNC events

Several Islamic banks revealed the causal factors that contributed to the occurrence of SNC events. Of the 159 SNC events in total, 70 (or 44 per cent) were presented with the various associated root causes. Figure 2 shows the percentages of the root causes of these 70 SNC incidents.

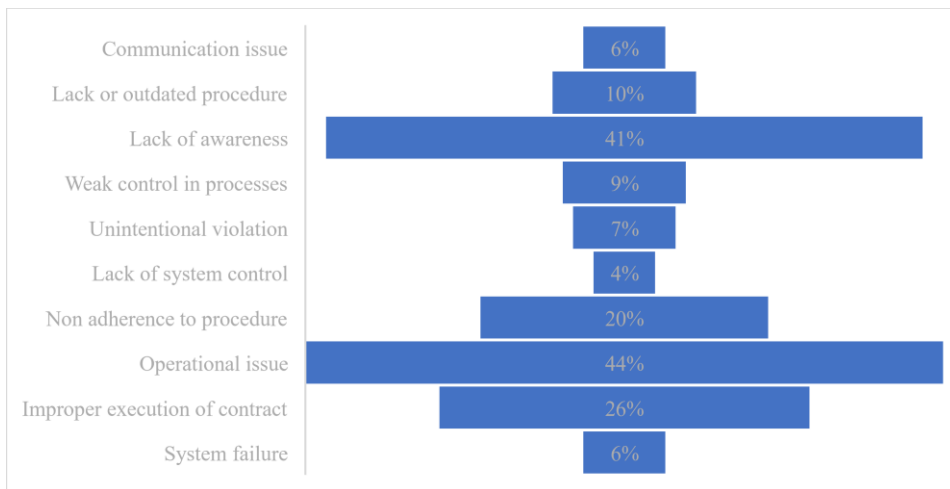


Figure 2: Analysis of root causes contributing to SNC events

As the above figure illustrates, the three (3) leading causal factors were (i) operational issues, (ii) a lack of awareness and understanding of the processes and products and (iii) the improper execution of contract/*aqad*.

The analysis of the root causes mentioned by the Islamic banks is presented in Table 8.

Table 8: Root causes of SNC events disclosed by Islamic banks

Root causes	ALLIANCE	AMBANK	BIMB	HLEONG	OCBC
Communication issue	√				
Lack or outdated procedure	√				√
Lack of awareness	√	√	√		
Weak control in processes	√				
Unintentional violation				√	
Lack of system control	√				

Non-adherence to procedure			√
Operational issue	√	√	
Improper execution of contract		√	√
System failure		√	

Of all Islamic banks, only five (5) divulged this information. Neither AMBANK nor HLEONG disclosed the nature of the SNC events, instead providing the root causes as part of their SNC disclosure. The table above demonstrates that four (4) root causes affected more than one (1) bank: (i) a lack of awareness and understanding of the processes and products, (ii) a lack of or outdated procedures, (iii) operational issues and (iv) the improper execution of contracts.

4.1.6 Rectification/Remedial actions for SNC events

The disclosure of rectification or remedial actions taken to address SNC events, as practised by the Islamic banks, can be grouped into three (3) practices: (i) a description of the types of remedial action taken, (ii) a general statement that the bank attempted rectification but without providing details of the actions and (iii) non-disclosure. The observations below outline the Islamic banks' disclosure practices:

- a. AFFIN, MAYBANK, PIBB and RHB were categorised into the first group, having disclosed the types of rectification action they had undertaken.
- b. BIMB and HSCB fell into the second group.
- c. Four (4) banks - AL-RAJHI, KFH, HLEONG and SAADIQ - fell into the last group, having not complied with the BNM disclosure requirements.

Four (4) Islamic banks - ALLIANCE, AMBANK, MUAMALAT and OCBC - gradually improved their disclosure from non-disclosure to providing general statements. ALLIANCE took a further step to enhance their transparency, moving from non-disclosure to detailed disclosure. CIMB, on the other hand, demonstrated the opposite behaviour, from providing detailed disclosure in 2015 to no disclosure in the most recent years, 2019 and 2020.

Further examination of the disclosed rectification actions revealed two patterns of disclosure. Several banks provided high-level rectification actions, which generically applied to all the SNC events detected in the same financial year. MAYBANK and PIBB appear to have provided the same default statements regarding their rectification actions for all the SNC events that occurred across the period. However, for 2020, both banks enhanced their disclosure practices by providing rectification details for individual SNC events. In contrast, AFFIN demonstrated good practice by consistently providing high-level and detailed rectification for individual SNC events for all the years. The types of remedial action performed by the Islamic banks to manage the SNC events, as per the disclosure in their annual reports, can be referred to in Appendix 1.

4.1.7 Control measures to mitigate the recurrence of SNC events

Similar to the Islamic banks' disclosure practices regarding rectification or remedial actions taken to address the SNC events, the disclosure of control measures can also be grouped into three (3) practices. The practices used to reveal this information are summarised below:

- a. AFFIN, AMBANK, HLEONG, MAYBANK and SAADIQ fell into the first group, having consistently provided the kind of control measures taken in their annual reports.
- b. AL-RAJHI and KFH again fell into the last group, having made no disclosure regarding the control measures; this also applied to HSBC and RHB.
- c. The Islamic banks of ALLIANCE, BIMB and OCBC modified their reporting of this information from non-disclosure to detailed descriptions, while MUAMALAT and PIBB moved from non-disclosure to general statements.

The majority of the banks stated the control measures undertaken during each financial year but not did itemize these according to the individual SNC events. Six (6) types of control measures were adopted by the majority of the banks to mitigate SNC incidents, as observed from their disclosure. These were (i) process and controls improvement, (ii) system enhancement, (iii) legal documentation reviews and refinement, (iv) procedures and guidelines development and improvement, (v) staff training and education and (vi) communication improvement. In addition, four Islamic banks undertook unique and distinct forms of preventive action. One of the efforts made by BIMB to prevent similar Shariah violations from recurring was to issue reminders and lessons-learned memos to the staff. Meanwhile, SAADIQ incorporated Islamic banking certification into the ways their staff handled Islamic banking transactions to enhance their employees' capabilities. CIMB emphasized inculcating the right culture of Shariah compliance to address SNC events. The efforts by these three banks indicated their emphasis on creating an environment or culture that promoted Shariah compliance, reinforced the right behaviors and developed the skills of the staff members. AMBANK, on the other hand, incorporated asset management improvement into their control measures.

4.1.8 Shariah non-compliant income

Income realised from transactions or activities that do not comply with the *Shariah* rules and principles is considered tainted; therefore, it cannot be reported in Islamic banks' earnings and must be purified. From 2015 to 2020, a total of RM19.2 million was declared by the Islamic banks as *Shariah* non-compliant income. The SNC income realisation trend over the six (6) years is depicted in Figure 3.

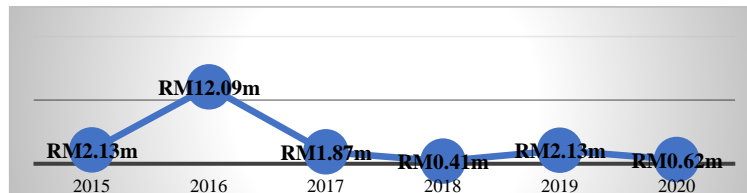


Figure 3: Trend of *shariah* non-compliant income (2015 – 2020)

The largest amount of SNC income was reported in 2016, with a total of approximately RM12.1 million. After 2017, the SNC income reported ranged between RM0.4 million and RM2.1 million. CIMB has to be commended as the bank reported no SNC income over the six (6) years. Three (3) Islamic banks reported negligible amounts of SNC income, namely MUAMALAT (RM859), OCBC (RM1,700) and KFH (RM3,000). Table 9 illustrates the SNC income trends for the remaining twelve (12) Islamic banks over the six-year period.

Table 9: Trends of SNC income reported by Islamic banks by year (2015 – 2020)

Year	Range of SNC income	AFFIN	AL-RAJHI	ALLIANCE	AMBANK	BIMB	HLEONG	HSBC	MAYBANK	MBSB	PIBB	RHB	SAADIQ
2015	<RM100K					■			■				
	RM100 to 500K	■	■	■	■		■	■		■	NA	NA	■
	RM500K to 1m												
	>RM1m												
2016	<RM100K					■	■	■	■				
	RM100 to 500K	NA	NA	■							NA	NA	■
	RM500K to 1m												
	>RM1m				■					■			
2017	<RM100K					■	■	■	■				■
	RM100 to 500K	NA	NA		NA						NA	NA	
	RM500K to 1m			■									
	>RM1m									■			
2018	<RM100K			■	■	■	■	■	■				■
	RM100 to 500K	NA	NA							■	NA	NA	
	RM500K to 1m												
	>RM1m												

2019	<RM100K				■	■	■	■	■	■			
	RM100 to 500K	NA	NA	NA								NA	NA
	RM500K to 1m												
	>RM1m										■		
2020	<RM100K			■	■	■	■	■	■	■	■		
	RM100 to 500K	NA	NA									■	NA
	RM500K to 1m												
	>RM1m												
Total (million RM)		0.4	0.2	1.1	9.9	0.2	0.6	0.3	0.2	3.7	1.9	0.4	0.5

Note: NA denotes 'Not Applicable', whereby the bank reported no SNC income during the year.

As Table 9 shows, four (4) banks reported relatively high overall SNC incomes, that is, above RM1 million. These were AMBANK (RM9.9 million), MBSB (RM3.7 million), PIBB (RM1.9 million) and ALLIANCE (RM1.1 million). In contrast, CIMB reported no SNC income at all, while AFFIN and AL-RAJHI only reported SNC income in 2015. Subsequently, no further SNC income occurred. BIMB and MAYBANK managed to maintain SNC income levels below RM100,000 throughout the period despite their numerous SNC event occurrences. The rest of the Islamic banks showed falls in their realisation of SNC income over the financial years, i.e., from within a range of RM100,000 to RM500,000 in 2015 to below RM100,000 from 2016 to 2020. SAADIQ improved even further, with no SNC income reported during the last two (2) years.

4.1.9 SNC amounts by SNC transactions

Very few banks attempted to itemise the amounts of SNC income, except for MAYBANK and SAADIQ. In the absence of detailed disclosure, only a minimal analysis could be undertaken to identify the kinds of SNC events with the greatest financial impacts on the banks.

Table 10 provides brief descriptions of the SNC transactions for the Islamic banks that declared SNC amounts of significant value. Based on Table 10, five occurrences of significant SNC amounts (i.e. over RM500,000) were detected. In addition, one SNC incident valued at a huge amount (amounting to RM26 million) was included, as detailed by PIBB in their annual report. The details disclosed by the Islamic banks regarding these occurrences are presented in the following table:

Table 10. Significant SNC transactions by Islamic banks and year

Year	Bank	SNC amount declared	Description of SNC incidents
2016	AMBANK	RM9,741,000	Contributed by eight SNC incidents due to operational issues
	MBSB	RM1,649,662	Late penalty charges (Gharamah)
2017	MBSB	RM1,079,831	Late penalty charges (Gharamah)
	ALLIANCE	RM729,164	Contributed by three SNC incidents: Three events pertaining to the absence of underlying Shariah contract and using SNC assets for Revolving Credit-I One event pertaining to the absence of underlying Shariah contract for several Alliance Term Deposit-i placement
2019	PIBB	RM1,901,000	Contributed by seven SNC incidents Three occurrences of improper execution of commodities trading for Term Deposit-i

2020	PIBB	RM26,064,000	<p>Three occurrences of breach of the Bank's Negative List for Islamic banking activities</p> <p>Recognition of conventional insurance commission as the Bank's income.</p> <p>The use of incomplete/under-construction properties as underlying assets for Bai' Bithaman Ajil ("BBA") House Financing-i ("HF-i") and Term Financing-i ("TF-i"). However, this amount was not declared as SNC income as the profits from these transactions were temporarily derecognised until the appropriate actions had been taken to rectify the SNC incidents.</p>
------	------	--------------	--

Little can be deduced from the information tabulated above as each bank was quite unique. PIBB attempted to be transparent on the 2020 SNC incidents despite these not being declared as part of their SNC income due to their praiseworthy immediate action of derecognising the profits from these transactions. Similarly, AFFIN disclosed an SNC event in 2020 involving *Tawarruq* financing, whereby a disbursement was made prior to *Tawarruq* trading and the reversal of the profit recognised from this incident totalled RM224,122.42. This form of transparency is good practice and should be emulated by other Islamic banks as it may increase their credibility and enhance their customers' trust.

4.1.10 SNC amount declared but No SNC events

Another aspect detected with regard to SNC income disclosure was that for some Islamic banks, tainted income was realised from SNC incidents that were not included in the incidents they disclosed. This could explain instances where SNC income was reported by a bank but no SNC events were disclosed, a scenario identified in eight (8) of the Islamic banks. Table 11 provides details of these additional incidents that contributed to SNC income.

Table 11: Disclosure of other incidents that contributed to SNC Income

No	Incidents contributing to SNC income but not reported as SNC events	AFFIN	ALLIA NCE	BIMB	HSBC	MBSB	MUAM ALAT
1	Commission from Shariah non-compliant merchants of card business	√		√			
2	Interest from NOSTRO accounts			√	√		√
3	Late penalty charges (gharamah)					√	
4	Commission earned from insurance policies		√				
5	Rental received from the bank's land used to facilitate Bai' inah-based transactions			√			
6	Commission from third-party product offering			√			

For AFFIN and ALLIANCE, this kind of disclosure seemed to be an isolated practice but was continually practised by the other Islamic banks. The same finding was highlighted by Rosman et al. (2017), whose analysis indicated that late penalty charges were not counted as part of SNC income. In contrast, some banks (like BIMB and AMBANK) did report late penalty charges as part of their SNC events. Such

reporting discrepancies require further guidance by the regulator so that practices can be streamlined across all banks.

4.1.11 Classification of SNC income for reporting

Seven (7) Islamic banks classified the income realised from SNC as charity funds, while three (3) were silent about their classification of SNC income: ALLIANCE, AMBANK and PIBB.

Others practised unique ways of classifying SNC income, as depicted in Table 12 and consistent with the findings of Rosman et al. (2017).

Table 12: Classification of SNC Income by Banks

No	Islamic banks	Classification of SNC income
1	AL-RAJHI	purification by shariah
2	RHB	other accruals and payables
3	HSBC	shariah penalty and impure income
4	KFH and SAADIQ	Separate account
5	MBSB	Gharamah

4.1.12 Purification of shariah non-compliant income

All the Islamic banks practised disclosing general statements on the purification of SNC income, which was to be distributed to charitable organisations or others approved by the *Shariah* committee. Table 13 lists the Islamic banks that made detailed disclosures of the beneficiaries of this income.

Table 13: Beneficiaries of banks' SNC income

No	Islamic banks	Beneficiaries of SNC income
1	AFFIN	Disabled children (2015, 2017, 2020) Association for less fortunate ex-government servants (2015, 2017, 2020) Module development of Islamic financial learning program (2015, 2017)
2	BIMB	Poor and needy (2015) Education (2015, 2018, 2019) School / Institutions (2015, 2016, 2017) Religious activities / Da'awah (2016, 2017) Public benefit (2020) Non-Profit organisations (2015, 2016, 2017)
3	HSBC	National kidney foundation (2015, 2012) National autism society (2015) Muslim Professional Forum (2016) Fastathon program (2015, 2016) 'Feed a family' program (2017) Pertiwi soup kitchen (2020)

		Individual staffs (2016)
4	HLEONG	Pertubuhan Tindakan Wanita Islam (2015)
5	MAYBANK / OCBC / RHB / SAADIQ	Non-Profit organisations (2015 to 2020)

Ten (10) Islamic banks presented their SNC income movement tracking via their Statements of Sources and Usages of Charity Funds, whereas ALLIANCE, AMBANK, KFH and MUAMALAT reported the movement in their Pillar 3 Disclosure, and HLEONG and PIBB disclosed it in the *Shariah* Committee Report (SCR) or the Pillar 3 Disclosure. This is another area of disclosure where practices can be streamlined. The use of these Statements meant the information disclosed was more structured, transparent and visible to interested parties.

The findings of Puneri et al. (2020) for PIBB were similar in that other instances were also detected, with information reported inconsistently by the Islamic banks across the financial years or in various locations in their annual reports. AFFIN, for example, reported different brought-forward balance and movement figures for 2018 in the Statements of Sources and Usages of Charity Funds in their 2018 and 2019 annual reports (refer to Figures 4a and 4b).

Statement of sources and usages of charity in annual report 2018

(b) Charity funds

	Economic Entity and The Bank	
	2018 RM'000	2017 RM'000
Sources and uses of charity funds		
At beginning of the financial year	63	90
Uses of charity funds		
- Contribution to medical aid	-	10
- Contribution to education	10	-
- Contribution to non profit organisation	-	13
- Contribution to program/event	30	4
	40	27
At end of the financial year	23	63

Figure 4a. Inconsistency of information reported in the statement of sources and usages of charity 2018 for AFFIN

Statement of sources and usages of charity in annual report 2019

	Economic Entity and The Bank	
	2019 RM'000	2018 RM'000
(b) Charity funds		
Sources and uses of charity funds		
At beginning of the financial year	67	113
Source of charity funds		
– AFFIN Barakah Charity Account-i	34	33
Uses of charity funds		
– Contribution to education	15	10
– Contribution to program/event	34	69
	49	79
At end of the financial year	52	67

Figure 4b. Inconsistency of information reported in the statement of sources and usages of charity for AFFIN (Continued)

A further information discrepancy was identified in the 2019 BIMB annual report, where the SNC income figures reported in the SCR and reflected in the Statement of Sources and Usages of Charity Fund did not tally (refer to Figure 5).

Excerpt from shariah committee report 2019		
<p>Within the financial year, the Bank has collected and purified Shariah non-compliant income amounting to RM89,339.69 and RM50,758.80 from the total amount was disposed to charitable causes upon our approval as further described in the Note 23 (Sources and Uses of Charity Fund) and the remaining amount of RM38,580.89 was refunded to the counterparties based on approved rectification plan.</p>		
Statement of sources and usages of charity fund 2019		
23. SOURCES AND USES OF CHARITY FUNDS		
Movement of sources and uses of charity funds are as follows:		
	Group and Bank	
	2019	2018
	RM'000	RM'000
Undistributed funds as at the beginning of the financial year	7	2
Shariah non-compliance income:		
<i>Funds collected/received during the year</i>	51	9
Uses of funds during the year:		
<i>Contribution to Education Fund</i>	(55)	(4)
Undistributed funds as at the end of the financial year	3	7

Figure 5: Discrepancy of SNC income 2019 reported by BIMB (Source: BIMB, 2019)

Another aspect to analyse pertaining to the Islamic banks' cleansing of tainted income was the duration taken to channel SNC income to any eligible beneficiaries. The purification behaviours of nine (9) banks regarding SNC income can be observed in Table 14.

Table 14. Duration of purifying SNC income

Islamic banks	Duration of SNC income purification
MAYBANK	Purification within the same year the SNC income declared
ALLIANCE, BIMB, HLEONG, HSBC, SAADIQ	Purification within two years (the year in which SNC income was declared and the subsequent year)
AFFIN, MBSB, OCBC	Purification took more than two years to channel the income to charitable organisations

Disclosure related to the cleansing of tainted income, like details of the beneficiaries or the time taken by a bank to perform a purification action, fell into the category of non-financial data. Although it has no financial impact, its availability may offer insights to the public and reassure them that SNC income purification was performed diligently by a particular Islamic bank. Taking more than two (2) years to purify SNC income would trigger questions regarding the oversight of a bank's *Shariah* committee on this matter.

5. Conclusion

In summary, all sixteen (16) Islamic commercial banks in Malaysia reported and disclosed SNC incident-related information in various sections of their annual reports. Nevertheless, the findings from this study revealed that not all the banks' disclosure practices fully complied with the requirements stipulated by BNM. The Islamic banks apparently faced challenges in revealing information on the nature of SNC events, as well as the rectification action and control measures taken to address SNC events. Several banks made praiseworthy efforts to disclose useful information, such as the root causes, the related Islamic contracts and the tracking of SNC income disposal. This information offers added value to its users by assuring them of the accountability of the Islamic banks in terms of transparency, as well as their effectiveness in managing and mitigating SNC events. This would eventually affect their credibility from their customers' perspectives.

This study also revealed discrepancies in the disclosure practices in terms of the formats used to disclose information, namely the movement of SNC income. While the majority (ten) of the Islamic banks reported this movement through the Statements of Sources and Usages of Charity Funds, the other six (6) only provided brief descriptions of the movement in their SCR or Pillar 3 Disclosure. Certain data inconsistency incidents were reported by the Islamic banks in different sections of their annual reports within the same year or across different financial years. These were detected for AFFIN and BIMB. Nevertheless, these were found to be isolated incidents. The findings reveal the levels of diligence and transparency of the Islamic banks in disclosing SNC information to their stakeholders. There is scope for further improvement and enhancement actions.

In addition to these points, the ownership and categories of the Islamic banks seemed not to influence their disclosure practices. The three banks with the highest overall average index - HSBC, BIMB and MAYBANK - were under different forms of ownership and fell into different categories, being a foreign subsidiary, a local full-fledged bank and a local subsidiary, respectively. No specific patterns or trends were observed to demonstrate that one category of Islamic banks behaved better than another regarding disclosure practices. The onus to do so is on the individual bank. The present study has attempted to provide finding on the disclosure practices of SNC by Islamic banks in Malaysia. Thus, it is recommended that appropriate action must be taken by the policy makers and regulators to improve the extent of transparency in *Shariah* compliance for all Islamic banking operations. Specifically, the study proposes that BNM establish a clear parameters in the SNC disclosure of IBs in Malaysia.

References

- Abdul Ghani, N. A. (2019). A Mixed Method Approach on Policy, Legal and Regulations of Non-Shariah Compliant Income in the Islamic Banking Industry: The Case Study of Malaysia (Issue March).
- AFFIN. (n.d.). Affin Islamic Bank Annual Report. www.affinislamic.com.my/Financial-Information
- AL-RAJHI. (n.d.). AL-Rajhi Annual Report. www.alrajhibank.com.my/financial_report_archive
- Al Haneef, S. S., Kamaruddin, Z., & Mahmud, M. W. (2017). Purification of Non-Halal Income in Malaysian Islamic Banks: An Overview. *Journal of Islam in Asia*, 14(2), 305–326. <http://journals.iium.edu.my/jiasia/index.php/Islam/article/view/616>
- Ali, M. M., & Hassan, R. (2020). Survey on Shari‘ah non-compliant events in Islamic banks in the practice of tawarruq financing in Malaysia. *ISRA International Journal of Islamic Finance*, 12(2), 151–169. <https://doi.org/10.1108/IJIF-07-2018-0075>
- AMBANK. (n.d.). Ambank Group Annual Report. www.ambankgroup.com/eng/InvestorRelations/AnnualReports
- Amin, N. A. M., Mohd Ariffin, N., & Abdul Hamid, F. (2021). Shariah Disclosure Practices in Malaysian Islamic Banks using the Shariah Disclosure Index. *International Journal of Islamic Economics and Finance (IJIEF)*, 4(SI), 63–86. <https://doi.org/10.18196/ijief.v4i0.9953>
- Bank, A. I. (n.d.). Alliance Islamic Bank Annual Report. www.alliancebank.com.my/investor-relations/annual-reports.aspx
- Bank, M. (n.d.). Bank Muamalat Annual Report. www.muamalat.com.my/financials/
- Bank Negara Malaysia. (2019). Financial reporting for Islamic banking Institutions.
- BIMB. (n.d.). BIMB Annual Report. www.bankislam.com/corporate-info/resources/annual-reports/
- BNM. (n.d.). Islamic Banking & Takaful. <https://www.bnm.gov.my/islamic-banking-takaful>
- BNM. (2010). The New Shariah Governance Framework. Financial Stability and Payment Systems Report 2009, 99–102.
- Shariah Governance Framework for Islamic Financial Institutions, (2011) (testimony of BNM).
- Chartered, S. (n.d.). Standard Chartered Saadiq Annual Report. www.sc.com/my/investor-relations/financial-results/
- CPSA. (2020b). Shariah Risk Management and Internal Controls. IBFIM.
- El Islamy, H. (2016). Revisiting the Cassification, Reporting and Treatment of Shari‘ah non-Compliant Events. *ISRA International Journal of Islamic Finance*, 8(2).
- Hanefah, M. M., Kamaruddin, M. I. H., Salleh, S., Shafii, Z., & Zakaria, N. (2020). Internal control, risk and Shari‘ah non-compliant income in Islamic financial institutions. *ISRA International Journal of Islamic Finance*, 12(3), 401–417. <https://doi.org/10.1108/IJIF-02-2019-0025>
- Horúcková, M., & Baudassé, T. (2017). Content analysis applied to social and environmental reporting. *Acta Academica Karviniensia*, 17(4), 32–45. <http://aak.actavia.cz/artkey/aak-201704->

0003_obsahova-analyza-aplikovana-na-socialni-a-environmentalni-vykazovani.php

Ibrahim, N. & Mohd Sopian, S. (2023), "Does Tawarruq still remain the top option for Islamic home financing (IHF) products in Malaysia?", *Qualitative Research in Financial Markets*, Vol. 15 No. 1, pp. 160-189. <https://doi.org/10.1108/QRFM-07-2021-0118>

Kunhibava, S. (2012). Islamic Banking in Malaysia. *International Journal of Legal Information*, 40(1–2), 191–201. <https://doi.org/10.1017/s0731126500006478>

Leong, H. (n.d.). Hong Leong Islamic Bank Annual Report. www.hlisb.com.my/en/personal-i/about-us/investor-relations/annual-and-quarterly-financial-reports

Masruki, R., Samsudin, S. N. B., & Dhar, B. K. (2020). Shariah Accountability Practices of Islamic Banks in Malaysia. *International Journal of Advanced Science and Technology*, 29(June), 1–11.

Mat Nor, N., & Md Sawari, M. F. (2020). The Practice of Reporting Shariah Non-Compliant Income in the Annual Financial Report of Islamic Commercial Banks in Malaysia. *Islamiyyat The International Journal of Islamic Studies*, 42(1), 93–102.

MBSB. (n.d.). MBSB Annual Report. mbsb.com.my/ar.html

MIA. (2020). *Accounting for Islamic Finance*. Malaysian Institute of Accountants.

Mohd Hanefah, M., Shafii, Z., Salleh, S., Zakaria, N., & Kamaruddin, M. I. H. (2020). *Governance & Shariah Audit*. USIM Press.

OCBC. (n.d.). OCBC Al-Amin Annual Report. www.ocbc.com.my/group/investors/financial-results-ocbc-al-amin.html

Oz, E., Khokher, Z. ur R., Ali, M. M., & Rosman, R. (2016). Shariah Non-Compliance Risk in The Banking Sector: Impact on Capital Adequacy Framework of Islamic Banks (Issue March). [http://www.ifsb.org/docs/WP-03-Consumer Protection\(final\).pdf](http://www.ifsb.org/docs/WP-03-Consumer Protection(final).pdf)

PIBB. (n.d.). *PIBB Annual Report*. www.publicislamicbank.com.my/About-Us/Financial-Information

Puad, N. A., R., N. J., Shukeri, S. N., & Rashid, N. J. (2015). Analysis of Shariah Audit/Review Report: Malaysia, Pakistan and Bahrain. *2nd International Conference on Management and Muamalah 2015*, 489–499.

Puneri, A., Chora, M., Ilhamiddin, N., & Benraheem, H. (2020). The Disclosure of Sharia Non-Compliance Income: Comparative Study between Full-fledged and Subsidiaries Malaysian Islamic Banks. *JESI (Jurnal Ekonomi Syariah Indonesia)*, 9(2), 104. [https://doi.org/10.21927/jesi.2019.9\(2\).104-117](https://doi.org/10.21927/jesi.2019.9(2).104-117)

Radwan, S. (2017). Islamic Banking: Why Transparency Matters? *Wahedinvest.Com*. journal.wahedinvest.com/islamic-banking-why-transparency-matters/

Rosman, R., Che Azmi, A., & Amin, S. N. (2017). Disclosure Of Shariah Non-Compliance Income by Islamic Banks in Malaysia and Bahrain. *International Journal of Business and Society*, 18(1), 45–58.

Shafiai, S., & Adawiah, E. R. (2019). Islamic Development Management. In *Islamic Development Management* (Issue July). <https://doi.org/10.1007/978-981-13-7584-2>