

REVISITING THE CLASSIFICATION, REPORTING AND TREATMENT OF SHARĪ'AH NON-COMPLIANT EVENTS

*Hurriyah El Islamy**

Abstract

For Islamic financial institutions, ensuring that their activities, products and services are in compliance with the Sharī'ah (Islamic law) is paramount for many reasons. Among the most important is that it is a means of attaining and maintaining public confidence. With the introduction of Islamic Financial Services Act (IFSA) 2013 and new policies in Malaysia, the industry's awareness of such requirement has also increased. Stakeholders are concerned and keen to ensure that the full lifecycle of Islamic financial products and services are compliant with the Sharī'ah. Sharī'ah non-compliance (SNC) is seen as a serious risk that has to be properly managed. Bank Negara Malaysia (BNM) has introduced policies dealing with the way to report and treat SNC events in financial transactions or business activities of Islamic financial institutions. At first glance, the approach laid down in those policies seems holistic. It appears capable of covering all SNC events and providing the best "cure" to all issues as it requires the practice, and similar practices, to cease immediately until the matters are rectified in the manner approved by the board of directors (BoD) of the concerned institution. The danger of applying a one-size-fits-all approach, however, is that there are instances where a different approach is more appropriate. Furthermore, requiring a financial institution to cease a practice or similar practices while waiting for the BoD's approval of a rectification plan—a step suggested in the BNM policies—is not warranted and may not be necessary for events of a certain nature.

* Hurriyah El Islamy, PhD, is IMF Expert in Islamic finance, Finance Accreditation Agency (FAA) Assessor and member of AAOIFI's working group on the Centralised Shariah Boards Standard. She can be contacted at hurriyah@gmail.com.

Hence, this paper aims to revisit the issues related to the reporting and treatment of SNC events by introducing a classification of the SNC events. Furthermore, it proposes that the reporting manner and treatment of SNC events be commensurate with and correspond to the events as classified.

Keywords: Sharī'ah Governance, SNC Classification, SNC Reporting, SNC Treatment.

I. INTRODUCTION

SNC, the acronym for Sharī'ah non-compliance (or non-compliant, as the case may be), is among the most common expressions used by the Islamic finance industry players in Malaysia. From the product development process to its launching, marketing and ongoing use in transactions, one primary concern of the relevant stakeholders is to ensure that there is no SNC element or event throughout the lifecycle of an Islamic finance product or service. In this regard, the Central Bank of Malaysia, which is called Bank Negara Malaysia (BNM), has issued several guidelines dealing with SNC events. In fact, the new statute regulating Islamic financial services in Malaysia, the Islamic Financial Services Act (IFSA) 2013, sternly deals with this matter. Section 28(1) of the new law specifically provides that “(a) n institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah.” The law further provides, in section 28(5), that contravention of such provision is an offence punishable with imprisonment for a term not exceeding eight (8) years and/or a fine not exceeding ringgit 25 million.

Many Islamic financial institutions (IFIs) adopt zero tolerance to Sharī'ah non-compliance in their business activities. However, the matter has become more serious in Malaysia in light of the abovementioned prison term or fine, or both, that non-compliance now entails. Hence, it is paramount that IFIs must not only instill the necessary mechanism to avoid occurrence of SNC events but also ensure that they have the proper mechanism to address them if they do occur.

In many countries, regulators leave the management and treatment of SNC events to the concerned institutions. In Malaysia it is regulated by BNM. This is indeed a laudable initiative. Having been part of the industry, however, the author found that there are instances where the approach as per the BNM policies is not the best option to adopt, given the circumstances of a particular event. Sometimes the approach is not commensurate with the issue at hand. For example, when the SNC event is of no serious consequence or can be rectified immediately without causing any disruption to the business, cessation of the business as required by the BNM policies is not warranted. Another example is when an SNC event is due to operational lapse or human error. When the standard operating procedure is compliant with the Sharī'ah and an SNC event occurs solely due to human error, cessation of business is not necessary. That is because such an event is an anomaly, and it is that event, not the business model or operation, which requires rectification.

The aim of this paper is to improve the existing process and introduce approaches that are more appropriate to the issues and to the corresponding SNC events. It is argued that a one-size-fits-all approach will not serve all purposes well because the nature of SNC events varies, as does the impact of non-compliance upon the transaction and the business. Thus, the treatment required should also vary, depending on the seriousness of the event. Accordingly, it is proposed that the SNC events should be classified into three different categories, and the reporting as well as the treatment of SNC events should correspond to each category.

The paper is thus outlined as follows: Section II defines SNC events; Section III provides the classification of SNC events; Section IV discusses the reporting of SNC events; Section V proposes the treatment for SNC events; and Section VI concludes the discussion.

II. DEFINITION OF SNC EVENTS

IFSA 2013 does not define the phrase Sharī'ah non-compliance (SNC). Nevertheless, it provides that compliance with any ruling of the BNM Shariah Advisory Council (SAC) in respect of any particular aim and operation, business, affair or activity shall be

deemed to be in compliance with Sharī'ah in respect of that aim and operation, business, affair or activity (IFSA 2013, Section 28(2)). The Shariah Governance Framework (SGF) for Islamic Financial Institutions (2011) requires IFIs to report any operations “found to be carrying out business(es) which is (are) not in compliance with Shariah, or against the advice of its Sharī'ah committee or the rulings of the SAC...” (Principle 2, paragraph 2.17). When these provisions are read together, it is safe to say that SNC refers to any failure to comply with Sharī'ah in respect of any particular aim and operation, business, affair or activity of IFIs or the conduct of these against the advice of the IFI's Sharī'ah committee or the rulings of the SAC.

III. CLASSIFICATION OF SNC EVENTS

Looking at the impact on contracts, SNC events could be classified into three categories as follows:

- a. Mere irregularities; i.e., SNC events that do not have any impact on any contract;
- b. *Fāsīd* (voidable) SNC events; i.e., SNC events that may turn a contract into a voidable contract;
- c. *Bāṭil* (void) SNC events; i.e., SNC events that invalidate the contract *ab initio*.

The definition of the above terms and classification of each category of SNC events are discussed below.

a. Mere Irregularities

There are certain SNC events that do not have any impact on the validity of an IFI's contracts. These are SNC events that may have occurred as part of an IFI's business activities and which usually happen due to an operational lapse or human error. Examples include the use of inappropriate images in promotional materials and mistaken use of SNC terms or phrases in documents.

Usage of inappropriate images in promotional documents is not consistent with the principles of Sharī'ah. However, it will not

affect the validity of any transaction that may be entered as a result. Similarly, the mistaken use of the word ‘interest’ as reference in an actual transaction that is interest-free will not affect the validity of the transaction either. An example is when an automated teller machine (ATM) mistakenly refers to the profit element or *hibah* of Sharī‘ah compliant accounts as interest. The mistaken usage of such term should be treated as a mere irregularity and should not have any impact on the validity of the transaction.

In all the instances above, each of the examples may be perceived as an SNC event. Nonetheless, the fact that the above examples do not pose any risk to the validity of the activities undertaken by the concerned IFI(s) means that these irregularities, although undesirable, shall not be treated as SNC events. This kind of event should be treated as a mere irregularity.

A party, however, needs to be cautious when ‘a mere irregularity’ occurs in a contract. In this case, the party has to ascertain whether or not such irregularity has any effect on the contract. The event will remain, and shall continue to be treated as, a mere irregularity if it does not factually affect the validity of the contract. For example, the mistaken inclusion of an SNC word in a transaction where both parties intended the transaction to be interest-free and the transaction remains free from interest-related income and/or charges should not affect the validity of the transaction.¹ That, however, will not be the case where the parties or one of the parties put reliance on the SNC provision in the contract. The mistaken use of such word or omission of such word from a contract or mistaken reference to such word (interest instead of *ta‘wīd*, for example) will not automatically transform a contract into an SNC contract. However, if either party (including its automated system) has effected any payment related to interest, or it is proven that the contract was executed based on the parties or one of the parties’ reliance on such term, then the contract should be classified as a *fāsid* contract.

1 On the authority of ‘Umar ibn al-Khaṭṭāb, who said: I heard the messenger of Allah (SAW) say: “Actions are but by intention and every man shall have but that which he intended. Thus he whose migration was for Allah and His messenger, his migration was for Allah and His messenger, and he whose migration was to achieve some worldly benefit or to take some woman in marriage, his migration was for that for which he migrated” (Related by Bukhārī and Muslim).

Based on the above, the events that will fall within this category are those which occur unintentionally or due to an oversight. It is proposed that in such events the IFI should determine whether or not there is SNC in substance. If it is determined that the SNC will not have any effect on the validity of the contract (including events occurring outside or independent of any contract), then such SNC event shall be classified as a mere irregularity and shall be reported and treated as such.

b. Fāsīd (Voidable) SNC Events

An SNC could be found as part of a business transaction. If the SNC is found in an accessory attribute (*wasf*) of a contract, such element is to be classified as a *fāsīd* SNC.²

Fāsīd is an Arabic word whose legal meaning is voidable, i.e., a contract that can be avoided or subsequently held to be void. A *fāsīd* SNC has an impact on the validity of a transaction as it makes a contract voidable.³ If the SNC element is not removed the contract will become void.

The existence of an invalid condition is an example that may turn a contract into a *fāsīd* contract. In a *muḍārabah* transaction, for instance, in the absence of negligence on the part of the *muḍārib* (manager), the capital provider must bear the risk of the transaction. If the parties, however, agree that the *muḍārib* will guarantee the return of the capital, such a condition amounts to a SNC event which, unless removed, will render the contract void.

2 “*Fāsīd*, according to the Hanafi School, is an intermediary class of contract between *ṣaḥīḥ* and *bāṭil*....a defect in an external factor (*wasf*) will only make the contract irregular (*fāsīd*). It does not necessarily render it void.” (Dusuki, Ali & Hussain, 2012: 8).

3 The notion of voidable in this context should be distinguished from a voidable contract under the Contract Act 1950. The point of reference is not the contract itself but rather the element within the contract. Thus, in this context we do not refer to “voidable” in the sense that it is merely enforceable by one of the parties exclusive of the other as provided in section 2(i) of the Contract Act. Rather, the contract has some element that can make the contract void. If this element is not removed, the contract ceases to be enforceable by law and becomes void, which is more akin to the provision of section 2(j) of the Contract Act, i.e., the contract is capable of being avoided.

Similarly, the concept of *mushārah* requires the parties to share the profit and bear the loss. A condition in a *mushārah* agreement that requires one of the partners to be the only party to bear the loss is a *fāsid* SNC which makes the contract voidable. If any of the parties refuses the removal of such a condition, the contract is void.

The existence of *ribā* (interest) in a transaction is another example of a *fāsid* SNC event. Intentional inclusion of interest in a transaction will result in the parties dealing with income that is prohibited in Islam; thus, such an element must be removed from the transaction. If the removal is possible, but one of the parties resists its being done, the contract is a *fāsid* contract that becomes void. If, however, the removal is not possible due to the nature of the transaction, then such element does not fall within the *fāsid* category. Instead, it should be classified and treated as a *bāṭil* contract.

c. *Bāṭil (Void) SNC Events*

Fulfilment of all of the contractual pillars is required for a contract to be *ṣaḥīḥ* (valid). When the SNC event is found in the essential elements (*arkān*) or conditions (*shurūṭ*) of a contract, such contract is void. The effect upon the parties is as if they did not enter into any contract in that respect. Examples include all transactions in prohibited items such as pork, alcohol, and gambling.⁴ Similarly, when an essential element is missing in an actual transaction, for example, where the parties intend to provide financing on the basis of *murābahah* but no asset was actually purchased by the financier and/or subsequently sold to the creditor. In this instance the transaction is void *ab initio*, and it could not be subsequently rectified as in the case of a *fāsid* transaction. In this case, the parties should be reinstated to the position before the *bāṭil* contract took place, and they should enter into a fresh agreement to give effect to their actual intention.

4 By the same token, section 25 of the Contract Act 1950 provides that agreements are void if they contain considerations and/or objects which are unlawful.

IV. REPORTING OF SNC EVENTS

IFSA (2013) Section 28(1) stipulates that an institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shari'ah. It requires that:

where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah or the advice of its Shariah committee or the advice or ruling of the Shariah Advisory Council, the institution shall—(a) immediately notify the Bank and its Shariah committee of the fact; (b) immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and (c) within thirty days of becoming aware of such non-compliance or such further period as may be specified by the Bank, submit to the Bank a plan on rectification of the non-compliance. (IFSA (2013), section 28(3))

The SGF (2011) Principle 2, Paragraph 2.17 provides a similar provision with further details as it stipulates that:

...in the event **the management** becomes aware **that certain operations** are found to be carrying out business(es) which is(are) not in compliance with Shariah, **or against the advice** of its Shariah Committee or the rulings of the SAC, the management shall: (i) immediately notify **the board** and Shariah Committee as well as the bank of the fact; (ii) immediately cease **to take on any new business** related to the Shariah non-compliant business; and (iii) within thirty (30) days of becoming aware of such non-compliance or such further period as may be permitted by the Bank, furnish a plan to rectify the state of non-compliance with the Shariah, **to be duly approved by the board** and endorsed by the Shariah Committee. [Emphasis added]

IFSA (2013) and the SGF (2011) do not differentiate between the impact of various SNC events on the IFI's business and activities; thus, it applies the same reporting requirement and a single manner to treat all SNC business and activities. This one-size-fits-all approach

is not the best way to deal with SNC reporting and treatment, and to a certain extent, it is not practical either.

The SGF (2011) requires all SNC events to be reported. The BNM circular on Shariah Non-Compliance Reporting (2013) at Paragraph 6.2 further stipulates:

In the event that the IFIs realized that they are engaging or have engaged in Shariah non-compliance activities, the IFIs are required to notify the non-compliance event to their respective Shariah Committee for confirmation as to whether the non-compliance event is either actual or potential Shariah non-compliance.

Paragraph 6.3 of the SNC Circular (2013) also states:

Upon the confirmation by the Shariah Committee that the reported event is actual Shariah non-compliance, the IFIs are required to immediately notify the board and subsequently to report to the [BNM] with sufficient information of the fact together with the rectification plan which has been approved by the board.

Paragraph 6.6.2 of the SNC Circular (2013) then states:

In the event that no board meeting will be held within thirty (30) days from the date of confirmation by the Shariah Committee that an actual Shariah non-compliance event has occurred, the IFI is required to exhaust other means to obtain the board's approval on the rectification plan prior to the submission to the [BNM].

While that could be the ideal way to deal with SNC events, the manner of reporting and dealing with any SNC event should be commensurate with the nature and degree of impact posed by each SNC event or a potential SNC event. It is proposed that the treatment of any SNC risk should take into consideration the nature (as per the above proposed classification) of the SNC, the effect of the risk, and the most reasonable way to manage it. In other words, not every single event that contains SNC risk warrants cessation of business, and not every event can only be rectified after the board's approval of the rectification plan and the Sharī'ah committee's endorsement of the same.

The sequence—first to get the Sharī'ah committee confirmation on whether or not a situation is an actual or potential SNC event and then to report to the board for approval of the rectification plan—is neither appropriate nor necessary in cases where it is obvious that the event poses SNC risk (including potential reputational risk) and the required rectification can be effected immediately.

The mistaken use of the word 'interest' or use of SNC images in advertisements are among the examples where IFIs should be allowed to take immediate steps to rectify the SNC events while or before reporting the same to their boards and Sharī'ah committees. It is proposed that SNC risks and/or events that would fall within the category of "mere irregularities" should not be subjected to the reporting requirement outlined above and the IFIs should not be required to cease the business or to cease taking new business until the rectification plan is approved in the manner provided in IFSA (2013) or SGF (2011).

In terms of mere irregularities, it is more proper that IFIs take immediate steps to rectify the SNC events even before or at the same time IFIs notify (as opposed to report) the SNC events to the board and Sharī'ah committee. Instead of reporting events on an each-case basis and completing the whole cycle within thirty days from each event as per the current framework, it is proposed that IFIs include these irregularities in their periodic reports (e.g., monthly or quarterly) to the board and Sharī'ah committee. They should also inform them of the rectification action that has been taken, whereupon the board and the Sharī'ah committee would endorse it or provide amendments or an alternative.

It may be argued that the Sharī'ah committee has the sole authority to determine if an event is a potential or actual SNC event. Nonetheless, it is also arguable that the SGF (2011) provides some room for the relevant function in an IFI to effect the rectification. SGF (2011) Principle 7, paragraph 7.4, stipulates that "the function [of Sharī'ah review] involves ... remedial rectification measures to resolve non-compliances and control mechanism to avoid recurrences". SGF (2011) Principle 7, paragraph 7.6, further provides that "the review process shall cover, but is not limited to, the following: ... (iv) rectifying any instances of non-compliance with the Shariah to prevent such event from recurring."

At the outset, these two provisions seem to conflict with Principle 2, paragraph 2.17, of the SGF (2011) and the reporting requirements under the SNC Circular (2013). To reconcile the possible conflict between these provisions, we can adopt this interpretation: in the instances that the Sharī'ah review can positively determine the occurrence of an actual SNC event and that such event can be easily and immediately rectified, to ensure immediate compliance with Sharī'ah and to prevent recurrence so as to protect the integrity and reputation of the IFI, the Sharī'ah review has the power to effect immediate rectification of the SNC event. This event, however, must be reported to the board and the Sharī'ah committee, and it is ultimately for the board to endorse the same. Thus, for example, Sharī'ah review has the power to remove all reference to interest on a website or other non-transactional documents of an IFI without having to wait for the board to approve the same. Similarly, when it is found that some images used in any advertisement are not Sharī'ah compliant, the Sharī'ah review should have the power to ask for such image to be removed immediately without having to wait for the board to approve such intent. To ensure proper governance, however, these must be included in the periodic report to the Sharī'ah committee and the board. The report should include, among others, the date of the occurrence of the SNC event, the rectification action taken, the date it was performed, and a column to note that the board and Sharī'ah committee have subsequently endorsed it.

Table 1 shows the proposed approach to reporting of SNC events.

Table 1: SNC Events Classification, Reporting and Format of Reporting

SNC category	Impact to Transaction	Rectification	Reporting	Format of Reporting
Mere Irregularities	No impact	Immediate	Periodic basis	To note, among others, (i) the date of SNC event; (ii) the rectification action; (iii) the date of the rectification action; and (iv) the status (rectified, ongoing, etc.).
<i>Fāsid</i> SNC	No impact (i.e., the voidable element is removed).	Immediate	Periodic basis	

SNC category	Impact to Transaction	Rectification	Reporting	Format of Reporting
	The contract becomes void (i.e., the voidable element is not removed).	Rectification plan is subject to the board's approval.	Immediate	To note, among others, (i) the date of SNC event; and (ii) the proposed rectification plan.
<i>Bāṭil</i> SNC	Void <i>ab initio</i>	Rectification plan is subject to the board's approval.	Immediate	

The above are without prejudice to the power of the Sharī'ah committee, among others, as outlined in paragraphs 3.6, 3.7 and 5.3 of the SGF (2011).⁵

V. TREATMENT OF SNC EVENTS

Just as with SNC reporting, the current regime applies a one-size-fits-all approach to treating SNC events. It does not differentiate between treatments based on different categories and/or by looking at the impact of the SNC event. The SGF (2011) states that all SNC events have to be reported, the concerned IFI is to cease dealing in such transaction, and the rectification plan must be approved by the board as sanctioned by the Sharī'ah committee of the concerned IFI. As we proposed earlier, to ensure immediate rectification of SNC events and to protect the integrity and reputation of IFIs, the Sharī'ah review should be allowed to exercise the power envisaged by the SGF (2011), including to rectify actual SNC events without having to wait for the Sharī'ah committee's confirmation of the same. Sharī'ah review should immediately rectify mere irregularities and rectifiable

5 Para. 3.6 Where the Shariah Committee has reason to believe that the IFI has been carrying on Shariah non-compliant activities, the Shariah Committee shall inform the board and to recommend suitable measures to rectify the situation.

Para. 3.7 In cases where Shariah non-compliant activities are not effectively or adequately addressed or no rectification measures are made by the IFI, the Shariah Committee shall inform the Bank of the fact.

Para. 5.3 ...the Shariah Committee will not be regarded as breaching the confidentiality and secrecy code if the sensitive information were disclosed to the Bank in good faith when reporting serious breaches of Shariah by the IFI.

fāsid SNC events. It is ultimately for the BOD to endorse the action and the Sharī'ah committee to confirm the treatment of SNC income, if any.

The proposed SNC events treatment for mere irregularities and rectifiable *fāsid* SNC is straightforward: the Sharī'ah review is to effect immediate rectification of the SNC element(s) or to lead such process if the rectification plan requires the involvement of other departments within the IFI such as the legal department and/or the business unit(s). In its periodic report, the Sharī'ah review shall include these SNC events and provide the status—whether or not the rectification process is completed. The report and the contents therein are for the board and Sharī'ah committee's information and subject to their endorsement.

Fāsid contracts, once rectified, do not warrant re-execution of the contract (Dusuki, Ali & Hussain, 2012: 17-18). If, however, the SNC element cannot be rectified, or either of the parties does not consent to the proposed method of rectification, the contract becomes void and the parties are at liberty to enter into another suitable nominate contract (Dusuki, Ali & Hussain, 2012: 19-20).

When any profit or income is derived from the *fāsid* contract, the Sharī'ah committee is to determine whether or not the SNC element in the contract has any effect on such income. If the Sharī'ah committee is of the opinion that the SNC element has impact and/or is instrumental in generating the income, then the sum should be purified by channeling it to charitable purposes if it is determined to be non-*ḥalāl* (non-permissible) income.⁶ If, however, it is determined to be unauthorised income, it should be returned to the rightful owner.⁷ This approach is applicable whether or not the contract is voidable due to the SNC element.

6 Non-*ḥalāl* income refers to the income or additional sum derived from non-*ḥalāl* activities or in a manner not sanctioned by the Sharī'ah. Due to the nature of its substance, neither party should be allowed to keep the non-*ḥalāl* income, in order to discourage the parties from participating in such an activity and/or benefiting from it.

7 Unauthorised income refers to the income or additional sum derived from a wrongful manner of conducting the transaction. Dusuki, Ali & Hussain (2012: 15-17) classify this as non-*ḥalāl* income derived from elements prohibited due to external reasons (*ḥarām li ghayrihi*).

If, however, the SNC element does not affect the generation of income out of the contract, the parties are entitled to keep their shares as per the contract or on a pro-rated basis up to the date of termination if the contract is voidable. Dusuki, Ali & Hussain (2012: 20) proposed that in case the contract is voidable due to the inability to remove the objectionable element, all income and asset are to be returned to the original owner. While this would be the position in case of a void contract (i.e., *bāṭil* SNC), it should not be the case where the contract is valid but the contract or any element(s) in the contract is (are) unenforceable due to it being an SNC contract. For example, in a *muḍārabah* agreement with a condition that the *muḍārib* must guarantee its performance, the *muḍārabah* arrangement itself is valid and enforceable; the condition, however, is not enforceable. When the parties fail to reach mutual agreement to remove such condition, the contract shall be avoided. Nonetheless, any profit earned and any fee payable prior to the termination of the contract shall be paid to the *rabb al māl* (capital owners) and the *muḍārib* (manager) respectively. Such 'income' is not derived from and is not related to the SNC element in such a contract. However, if there is any fee paid by the *muḍārib* pursuant to its performance guarantee, this will amount to 'unauthorised' income for the *rabb al māl* as it is derived from the SNC element in the contract. This sum must be returned to its rightful owner; in this case, the *muḍārib*.

Another instance is where parties to a *mushārah* agreement agreed that only one of the partners shall bear any loss out of the partnership. In this case, any profits that the partnership has generated shall be distributed among the partners as per the agreement. If the contract is subsequently avoided due to the partners' inability to agree to the removal of the condition, the partners are still entitled to their respective share in the profit up to the termination date as the SNC element does not have any effect on the partnership income. If, however, the undertaking partner has borne some financial loss due to his undertaking in the agreement, he shall be compensated by the partners before the profit is distributed. This is because the payment that he made was on the basis of a condition which is SNC and thus unenforceable by and between the parties.

The *bāṭil* SNC is more straightforward. The existence of *bāṭil* SNC makes the contract void *ab initio*. Thus, the law requires the

parties to be reinstated to the positions they had prior to the execution of the contract. If the parties agree that they must give effect to their original intent, they must enter into a new contract because a void contract cannot be rectified.

Furthermore, restitution will return the parties to their original status. That warrants the return of all assets and/or funds to their respective original owners. If any additional sum (excluding the parties' original assets and/or funds) has been generated from the contract, such income must be purified by channeling it to charitable purposes as neither of the parties should be allowed to benefit from a void contract. For example, in the case of commodity *murābahah* financing without any purchase and/or subsequent sale of the underlying asset, the respective parties are to be placed to their original positions. That is, the IFI is entitled to claim for the original sum of financing and the customer is entitled to the sum representing all payment he made under the facility including the sum representing the profit under the *murābahah* arrangement.

That is, the income generated in addition to the parties' original contribution in the contract has to be purified. The basis for this is that since the contract is void from the beginning, any activities in furtherance thereto shall not be of any effect either. An example is a *muḍārabah* arrangement for investing in non-*ḥalāl* activities or non-*ḥalāl* assets. The contract is void *ab initio*. The placement in furtherance thereto is also void. The *rabb al māl* cannot claim beyond its original contribution; the *muḍārib* is not entitled to claim for any fee either. If the investment has generated some income, neither of the parties shall have any claim upon the income derived from the investment; this sum has to be channeled to charitable purposes.

Applying the above to a bigger picture: when a contract becomes void, either from the beginning or when *fāsid* SNC is not rectified, the parties shall remain liable for all obligations arising from the contract prior to the termination in case of *fāsid* SNC and the obligations arising from the conduct in case of *bāṭil* SNC. The SNC element should not be seen as having any effect on other transaction documents. Thus, security documents, for example, are to be deemed enforceable against the said obligations as that was the intent of the parties.

Take, for instance, a case where the parties entered into a commodity *murābaḥah* agreement, pursuant to which the IFI disbursed the sum of RM 1 million and the customer made repayment (towards the capital and profit) totaling RM 100,000. Then it turned out that the transaction was entered without the existence of any underlying asset. In this case even though the contract itself is void *ab initio*, the parties had the intention to enter into a financing transaction for the above sum. The invalidity of the transaction does not release the customer from the obligation of repaying the IFI the sum of RM 1 million or the IFI from the obligation of accounting the sum of RM 100,000 to the customer.⁸ The IFI can exercise the right to set off by deducting the sum of RM 100,000 it owes to the customer from the total RM 1 million that the customer owes to the bank. Other legal documents should not be affected. The IFI should continue to have the full right to enforce its claim over the remaining sum including, without limitation, by enforcing any security or security documents.

In a nutshell, the existence of a *bāṭil* SNC makes a contract void *ab initio*. That warrants restitution, and any income derived therefrom is not valid. The invalidity, however, will not and shall not affect the validity of other transaction documents which are separable from the concerned contract. Nor shall it affect the validity and enforceability of security documents; the law must give effect to the original intention of the parties *mutatis mutandis*.

Table 2 shows the proposed approach to treatment of SNC events.

8 The obligation arises from conduct, i.e., *qard ḥasan* (interest-free loan) as and between the parties, that becomes due immediately. This is akin to resulting trust under the common law principle.

Table 2: SNC Events Rectification and Treatment

SNC category	Impact to Transaction	Rectification/ Treatment	SNC Income Treatment	Related Matters
Mere Irregularities	No impact	Immediate rectification by Sharī'ah review.	N/A	<ul style="list-style-type: none"> • Upon rectification, the business is to continue as usual. • Sharī'ah review to include the events in the periodic report as per the earlier table.
<i>Fāsid</i> SNC	Rectifiable; i.e., the voidable element could be removed.	Immediate rectification led by Sharī'ah review.	<p>(1) N/A if the SNC element does not have any effect on the income, and/ or no actual sum has been charged/ collected on the basis of the SNC element in the transaction.</p> <p>(2) When there is profit/ fee payment or income, the Sharī'ah committee is to determine whether or not the SNC element in the transaction has effect on the income:</p>	

SNC category	Impact to Transaction	Rectification/ Treatment	SNC Income Treatment	Related Matters
	Not rectifiable; i.e., when the voidable element cannot be removed (including when the parties cannot reach mutual agreement for its removal).	As per SGF (2011)	<ul style="list-style-type: none"> • If the SNC element has any effect on the income, the Sharī'ah committee is to determine whether it is non-<i>ḥalāl</i> income, which has to be purified, or unauthorised income, which has to be returned to the rightful owner. • If the SNC element does not have any effect on the income, the relevant party is entitled to the charges and/or keep the fees or income as per the contract, in case the SNC element is removed; or up to the termination of the contract in case the agreement is avoided (unless the agreement explicitly provides otherwise). 	<ul style="list-style-type: none"> • When the contract becomes void, its nullification shall not affect the validity of other transaction documents including, without limitation, charges, liens, and any other security documents. The IFI is entitled to rely and enforce its rights under and/or pursuant to these other transaction documents. • As for documents whose validity depends on the existence of the parties' obligation, such as guarantee, etc., they should be enforceable against the parties' obligation up to the effective termination of the contract to give full effect to the true intent of the parties.

SNC category	Impact to Transaction	Rectification/ Treatment	SNC Income Treatment	Related Matters
			For example, when the parties entered into a <i>muḍārabah</i> arrangement with a condition that the IFI has to guarantee its performance. When the client refuses removal of this condition, the contract becomes void, but the IFI should be allowed to keep the <i>muḍārib</i> fee as the SNC element does not have any effect on such income.	
<i>Bāṭil</i> SNC	Void <i>ab initio</i>	As per SGF (2011)	The contract is void <i>ab initio</i> ; the parties have to be reinstated to the position they were in before the contract was entered into.	<ul style="list-style-type: none"> • Restitution requires the parties to be reinstated to the positions they were in prior to the execution of the contract. • The sum advanced by the IFI to the customer will automatically convert to <i>qard ḥaṣan</i> and become due against the customer. The customer is entitled to all payment it

SNC category	Impact to Transaction	Rectification/ Treatment	SNC Income Treatment	Related Matters
				<p>has made under the contract including the capital and profit portion therefrom. This may be subject to set off.</p> <ul style="list-style-type: none"> • Other documents shall remain valid and be of effect up to the obligations arising as and between the parties following the restitution.

VI. CONCLUSION

There are many types of SNC events; they cannot be regarded to be of the same type and be treated in the same manner. Some SNC events do not have any effect on the contract, some are rectifiable, and others are not. Mere irregularities do not warrant the same treatment that is needed to address SNC elements that make a contract voidable. Similarly, it is not warranted to delay the rectification process by awaiting the board's approval and the Sharī'ah committee's endorsement when the SNC events are straightforward and easily rectifiable.

SNC events are to be treated and reported in the manner most suitable to each category of SNC event. This will not release the board and the Sharī'ah committee from their ultimate responsibility on the subject matter; nonetheless, applying the right approach, as proposed in this paper, to the issue at hand will provide better treatment in dealing with SNC events. This will ensure better protection of the

IFIs' integrity and reputation. It will also provide better protection and certainty to the IFIs and the customers and give the most effect to the original intent of the parties.

References

- Bank Negara Malaysia (2011). *Shariah Governance Framework for Islamic Financial Institutions*. Kuala Lumpur: Author.
- Dusuki, A. W., Ali, M. M., & Hussain, L. (2012). A Framework for Islamic Financial Institutions to Deal With Shari'ah Non-Compliant Transactions. *ISRA Research Paper 42/2012*. Kuala Lumpur: International Shari'ah Research Academy for Islamic Finance.
- Government of Malaysia (1950). Law of Malaysia Act 136 Islamic Financial Services Act 1950.
- Government of Malaysia (2013). Law of Malaysia Act 759 Islamic Financial Services Act 2013.