

# Managing and Reporting of Shari'ah Non-Compliant Income in Malaysian Islamic Banks: A Methodology Perspectives

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## Abstract

*Shari'ah Compliance and Governance Framework is essential to guide the banks on the regulatory requirement as it supports the growth and development of the Islamic finance industry. Section 28(1) and Section 28(3) of the Islamic Financial Services Act (IFSA) 2013, states that IFI needs to comply with the Shari'ah principles in all of their activities religiously. Managing and reporting Shari'ah Non-Compliance (SNC) for instance are crucial operational matters to the banks. In most cases, Islamic banks could be exposed to the SNC incidents due to Shari'ah non-compliance events (SNCE) or Shari'ah Non-Compliant Income (SNCI). This study will be focusing on SNCI, unblessed income that should be de-recognized from the bank's income. To investigate the end-to-end process of managing and reporting SNCI in Malaysian Islamic banks, the insight of the key functions, and the Shari'ah scholars were obtained. Besides in-depth interviews, documentation review of relevant policy documents and content analysis on the annual reports of ten Islamic banks were also performed to fulfill the delineated research objectives. Besides data source and methods triangulation, 'The Six Phases of Reflexive Thematic Analysis' was also applied to explore and develop understanding of patterned meaning across the datasets, eased by Atlas.ti. Finally, a guideline of best practices in managing and reporting the SNCI is proposed to the Malaysian Islamic banks.*

**Keywords:** *Non-complaint income; financial reporting; disclosure; Islamic banks; triangulation*

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## **A. INTRODUCTION**

### **1. Preamble**

Due to a dire study on the end-to-end process of managing and reporting Shari'ah Non-Compliant Income (SNCI) for Islamic banks, a basic study was conducted to generate more knowledge and understanding on the incidents. Although the term and incidents of SNCI are not new to the bank's key functions, the findings of this research are believed to be value-added knowledge to the interested stakeholders. It contributes further understanding on the multiple users and stakeholders especially for those who are concerned about the financial reporting in Islamic banking institutions (IBIs).

This study applies qualitative design of multiple-case study utilizing a data triangulation technique, essentially intends to enhance the accuracy of the findings using multiple sources of evidence. Triangulation is used in the research methodology both to address the research questions and for the hypotheses testing. This triangulation technique also helps to measure the observed phenomenon or issue precisely from multiple angles to ensure the consistency of measurement ([Evans et al., 2014](#)). From the works of Denzin (1978) and [Patton \(1999\)](#), there are four types of triangulation namely; methods triangulation, data sources triangulation, investigator triangulation, and theory triangulation ([Carter et al., 2014](#)).

This study applied the data sources and methods of triangulation so that a comprehensive understanding of a phenomenon can be developed ([Patton, 1999](#)). It is one of the strategies to increase the credibility of the research findings ([Denzin & Lincoln, 2008](#)). Data source triangulation involves the collection of data from different types of people, including individuals to gain multiple perspectives and validation of data.

In the context of this study, data triangulation was applied to ascertain the process of managing and reporting SNCI from the perspectives of the bank's key functions and the Shari'ah scholars. The bank's key functions and the Shari'ah scholars (the Shari'ah Committee and the Shari'ah Advisory Council) are the people who are directly involved with the subject under study. In line with the data triangulation technique, three methods were applied to address the research questions, including the face-to-face semi-structured in-depth interview, review of policy documents on Shari'ah governance policy ([BNM, 2019a](#)), ORION ([BNM, 2018b](#)) and, Financial Reporting for Islamic Banking Institutions ([BNM, 2018a; 2019b](#)) and finally, the content analysis of IB's annual reports of the ten IBs. However, this paper only focuses on a semi-structured in-depth interview with the stated informants as a proxy of the methodological perspective of this study.

### **2. Research Objectives**

This study investigates the current practices of managing and reporting the Shari'ah Non-Compliant Income by the bank's key functions and the Shari'ah Scholars in Malaysian Islamic Banks. To achieve the delineated objective, qualitative research was designed through in-depth interviews with the relevant bank's key functions represented by the Shariah Review (SR), Shariah Risk Management (SRM), and Shariah Research and Advisory (SRA), while the Shari'ah scholars represented by the Shariah Committee and the Shariah Advisory Council of Bank Negara Malaysia (BNM).

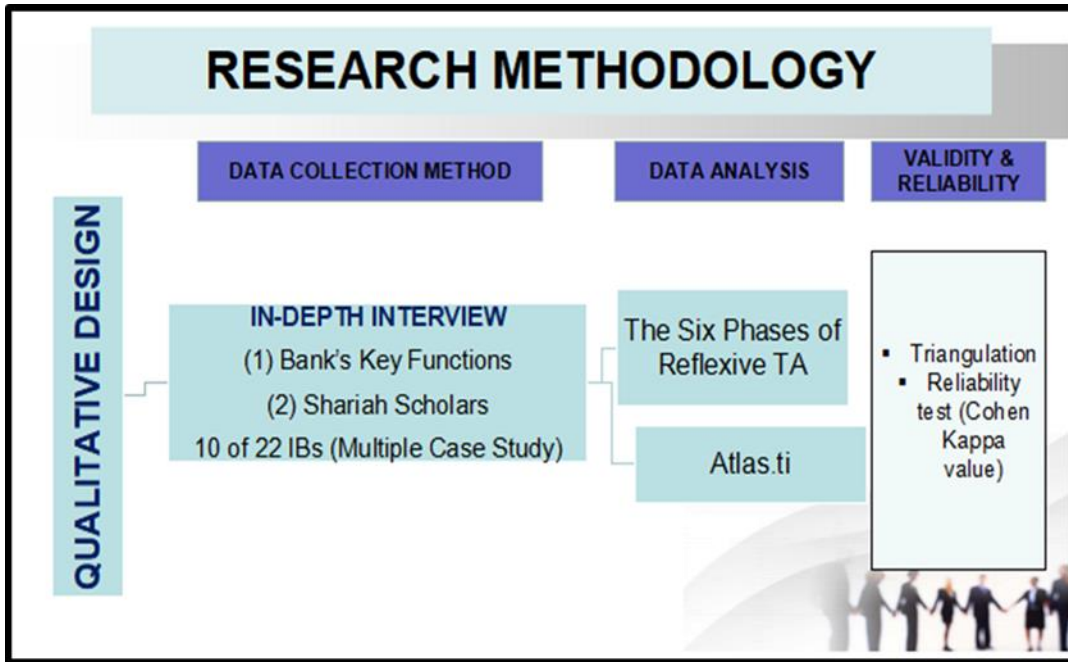
## **B. LITERATURE REVIEW**

### **1. Research Design**

This study incorporates a qualitative approach that focuses on managing and reporting SNCI obtained from in-depth interviews with the key functions of ten IBs in Malaysia. To achieve the objectives of the study, reviews of relevant literature on SNCI issues in managing and reporting SNCI were undertaken. A multiple-case study was applied as opposed to a single-case study design as a result of the latter proved that multiple-case studies were argued to be more convincing and lead to robust study ([Creswell, 2018; Yin 2014; 2018](#)). By having more than one category of IBs, comparison on the practice of managing and reporting SNCI by the bank's key functions from different aspects is visible. A multiple-case study design in this study retrieved data from the key functions of 10 IBs, that is represented by three categories of IBs; full-fledged Islamic banks (FFIB), Islamic banks subsidiary (IBS), and Development Financial Institutions (DFIs). This objective is impossible to achieve if a single case study

is applied in which it is evident that multiple-case studies are argued to be more compelling thus creating a robust study. (Stake 1995; Yin 2014).

The research samples for these multiple case studies were selected based on the purposive sampling strategy (Md Noor, 2009) whereby only the relevant key functions who were directly involved with managing and reporting of SNCI were chosen. The feedback from in-depth interviews with the relevant key functions was recorded, transcribed, and analyzed using the Computer Assisted Qualitative Data Analysis Software (CAQDAS) software, the Atlas.ti. 8.6 Software. Finally, the data was coded and themed using The Six Phases of Reflexive Thematic Analysis by Braun et al. (2018), a comprehensive method for capturing patterns (“themes”) across qualitative datasets. The summary of research methodology can be illustrated in Figure 1 overleaf:

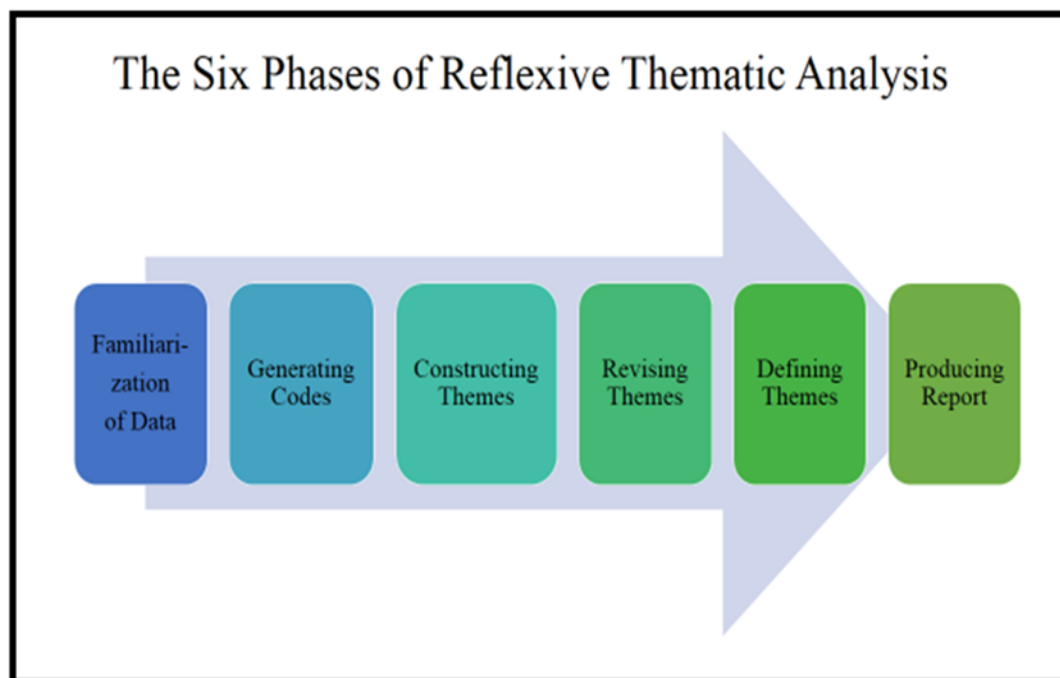


**Figure 1.** Summary of research methodology for the study

### **C. RESEARCH METHODS**

#### **1. Applying 'The Six Phases of Reflexive Thematic Analysis'**

'The Six Phases of Reflexive Thematic Analysis developed by Braun et al., (2018) was applied aiming to provide a coherent and compelling interpretation of the excerpt, grounded in the data. This method is first time applied for this kind of study with the following details as illustrated in Figure 2 below:



**Figure 2.** The Six Phases of Reflexive Thematic Analysis

Source: Braun et al., 2018

**Phase 1:** Familiarization of data - the phase where the researcher familiarized with the data by listening to the audiotape interviews besides reading and re-reading the transcribed data of the main input from (1) the bank's key functions (the control functions) and (2) the triangulated data of the Shari'ah scholars from the Shariah Committee (SC) and the Shariah Advisory Council (SAC).

**Phase 2:** Generating codes - at this level, 30 codes were generated from the bank's key functions, twenty-nine codes respectively from the Shari'ah scholars (the SC and SAC) that are within the acceptable code range suggested by [Creswell & Poth \(2018\)](#). Some redundant code with similar meaning and context were re-grouped and combined before developing categories or themes based on the framework from literature.

**Phase 3:** Constructing themes - the initial code might be "split" into two or more different codes, renamed, or combined with other codes to form categories or themes, then begin to integrate these categories or themes into theoretical frameworks. Later, the researcher would construct (candidate) themes to the codes generated in Phase 2 and it requires a few times reading. After that, matching of themes was conducted with the particular underpinning theory that is believed grounded in the data. In this study, the codes generated in Phase 2 were finally categorized into 6 themes, which is within the range of the number of themes suggested by [Creswell & Poth \(2018\)](#).

**Phase 4:** Revising themes - revising the themes were performed by comparing the themes assigned with the pattern regularities, the framework from the literature, research questions and objectives and the underpinning theory grounded in the data.

**Phase 5:** Defining themes - after finalizing the themes, the "agreement" (consensus coding) between the coders were obtained using Cohen's kappa value calculation to measure the accuracy or reliability of coding. The mean value was used to determine whether the data analysis process should be proceeded or otherwise.

**Phase 6:** Producing the report - a report is produced to indicate how well the themes work, individually concerning the data set, and in the overall setting of the research. Revisiting the research question and notes from the earlier phases of familiarization is important for coding, lists of codes, and

theme definitions. Theme mapping can be useful to ensure that the final themes remain close to the data thus, answering the research question well. It is believed that the themes developed and finalized are fit to answer the research questions and objectives outlined for this study.

**2. Developing Codes and Themes**

After ‘The Six Phases of Reflexive Thematic Analysis’ was applied, then the codes and themes were compared and matched with the proposed underpinning theory. The pattern was found to be consistent with the underpinning theory; the stewardship theory thus, strengthen the validity of the study. It is in line with the findings of [Denzin & Lincoln, 1994](#); Yin, 2002, that theoretical refutation and consistency strengthen the interval validity of the study.

From this study, it was discovered that an emerging theme from the analysed data of interviews with the bank’s key functions is a new contribution to the study, thus, adding value to the Stewardship Theory. An interpretation was then conducted based on the researcher’s discussion and reflection towards the findings and, it went beyond what was said from the interview. Personal reflections were also supported by the literature that provides an alternative view of the findings, which indirectly helped make sense of this study and supported the emerging themes identified in the current study ([Alatassi & Letza, 2018](#); [Abas, 2017](#); [Chiang et al., 2015](#); [Obid & Naysary, 2014](#)).

**3. Validity and Reliability Test**

Validity of data is realized through triangulation of data gathered from the banks’ key functions and the Shariah scholars gathered from three different types of IB as stated in the earlier section. The trustworthiness or reliability subsequently be validated using the Cohen Kappa inter-reliability test. The inter-rater reliability tests were conducted by colleagues who were familiar with the research area as proposed by Merriam (2009, p. 220). The rater or coder was requested to indicate with a tick in the “agree” or “disagree” column of codes developed by the researcher. For the disagreed codes, each rater was required to indicate their suggested code for the excerpts or quotations selected. In this study, three raters were selected based on their background of Islamic banking experience and research. The formula for Kappa value and the rate calculation in this study is as follows:

K=	$\frac{fa - fc}{N - fc}$
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**Equation 1.** Calculation of Cohen Kappa Value

Where,  
 K = Cohen Kappa value  
 fa = frequency of agreement  
 fc = frequency of chance (N/2)  
 N = number of units  
 Mean between raters =  $\frac{K1+K2+K3}{3}$

The calculation of Kappa value for each rater is as follows:

**Table 1.** Calculation of Kappa Coefficient (K) among the raters or coders.

Rater 1	Rater 2	Rater 3	Average value of Kappa coefficient (K)
fa = 77	fa = 75	fa = 78	$K = \frac{K1 + K2 + K3}{3}$
Fc = 78/2 = 39	Fc = 78/2 = 39	Fc = 78/2 = 39	
N = 78	N = 78	N = 78	
$K = \frac{77 - 39}{78 - 39}$ = 0.97	$K = \frac{75 - 39}{78 - 39}$ = 0.92	$K = \frac{78 - 39}{78 - 39}$ = 1.0	$K = \frac{0.97 + 0.92 + 1.0}{3}$ = 0.96

The mean value calculated in the current study is 0.96. The Kappa value is higher than 0.8, which indicates accurate or reliable coding agreement between the raters ([Braun et al., 2018](#)). Thus, the researcher proceeds with the proposed guideline as the coding scheme, categories and themes were considered valid.

## **D. DISCUSSION**

### **1. Managing the Shari'ah Non-Compliant Income**

The most crucial process in managing SNCI is the detection of Shari'ah issues after the approved products are launched by the Islamic banks. This process is considered a post-product launched where feedback was received from various stakeholders and the control functions itself after it is being operationalized. Prior detection process, the investigation process will be conducted before a decision is made by the SC and the SRM on the status of the SNC incident as approved to be actual SNCI or otherwise. These findings need to be reported internally by the SC and SRM through the Operational Risk Integrated Online Network (ORION) system before it is being reported in the annual report (external reporting).

Internal reporting requires better communication between the key functions at the bank level and the supervisory level (the SC). It is to fulfil the regulatory requirement of the regulator when the SNCI need to be reported through the Operational Risk Integrated Online Network (ORION). It also ensures the implementation of the bank's internally regulated policy. Hence, a comprehensive assurance of Shari'ah compliance at the regulatory level and the bank's level can be achieved.

### **2. Evidence from the Informants**

As said by one of the bank's key function:

*"In fact, we have our own guidelines other than what is required by BNM. We have self-regulated internal policy guidelines where we need to guide the bank on how to identify, report and rectify SNCI up to its disposal to charity."* (R1IB05).

Another bank's key function added:

*"Judgement by the SC will determine whether the issue is SNC or not, judgement and Ijtihad (carefulness) will determine whether SNC or Non-SNC."* (R1IB08).

On the other perspective, one of the SC added:

*"Compliance to SGF with regards to SNC means that an IFI is compliant if it treats SNC events as required by the regulator; potential SNC when it is found, has to be deliberated by the SC members. If it turns out to be actual compliant, report has to be escalated to BNM. Meanwhile IFI has dedicated time to mitigate the SNC. If it fails to adopt the processes, then it does not comply to the SGF."* (SCB01).

And, one of the Shariah Advisory Council (SAC) alleged that:

*"It's about the processes involved in providing assurance of all the activities to the fatwa, to the decisions and the solution of these particular committee...Shari'ah compliance is basically a process to provide assurance from Shari'ah requirement that the bank or Financial Institutions have been conducting themselves in accordance with the prescribes rules, regulations, processes, standards, either from the regulators or from the internal Shari'ah advisors to the institutions or any other bodies which has issue the standards and that should be put in practice to achieve the final assurance of Shari'ah compliance. ...Every IFI around the globe to be compliant and to be calling themselves IB and to be putting the assurance to the public at large they are actually compliant to the Shari'ah principles."* (SCR01).

The SAC further revealed that:

*"We need to start writing a very comprehensive SOP for Shari'ah compliance framework, which we don't have at the moment."* (SCR01).

It was learned from the relevant key functions feedback, that they need to manage the SNC incidents carefully. In this case, the authorized key functions need to exercise their stewardship role (accountability, transparency and disclosure, competency, independence and confidentiality) besides infusing prudence in managing the SNCI. Later, it has to be reported internally (through the ORION platform and internal reporting mechanism) and externally (in the annual report).

## **E. CONCLUSION AND RECOMMENDATIONS**

### **1. Summary**

A multiple-case study applies in this study as it is argued to be more convincing and robust compared to a single case study design ([Creswell, 2018](#); [Yin, 2014](#); [Yin 2018](#)). In this study, multiple case studies involved three categories of IBs: FFIB, IBS and DFI with triangulated methods of an in-depth interview with relevant key functions. The study believed that triangulation helps measure the observed phenomenon or issue precisely from multiple angles to ensure the consistency of codes or themes measured ([Evans et al., 2014](#)). To ensure the theoretical refutation and consistency achieved ([Denzin & Lincoln, 1994](#); [Yin, 2002](#)) thus, strengthening the interval validity of the current study is required. This study contributes to the methodology where 'The Six Phases of Reflexive Thematic Analysis' was applied to explore an understanding of patterned meaning across the datasets, eased by Atlas. ti software.

This study investigates the current practices in managing and reporting the Shari'ah Non-Compliant Income by relevant key functions in the Malaysian Islamic Bank. It is found that the key functions uphold the stewardship role to the banks and to the multiple stakeholders in discharging their responsibilities through efficient management and reporting mechanisms. Hence, it is of utmost importance to harmonize stewardship efforts with the prudence approach to promote financial stability in the Islamic banking industry ([BNM, 2019b](#)).

### **2. Suggestions**

It is suggested that other methods of validating themes or codes could be applied for future research other than 'The Six Phases of Reflexive Thematic Analysis'. A Quantitative research design is also suggested to investigate the process of managing and reporting the SNCI for Islamic banks for future research. Both recommendations may provide similar or different results from the current study.

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