

SHARIAH NON-COMPLIANCE RISKS IN SHARED AND OUTSOURCED SERVICES OF TAKAFUL OPERATORS

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Abstract: *Shared and outsourced services have been generally allowed by the regulator (Bank Negara Malaysia, BNM) for commercial expediency and enhanced competitiveness of takaful companies in Malaysia. While these objectives are acceptable, the requirement for takaful operators to be Shariah-compliant end to end is paramount. This study therefore aims to look at the processes involved to see whether there are any forms of Shariah non-compliance that needs to be mitigated. It uses qualitative approach through content analysis and interviews. In general, most of the processes are found to converge towards Shariah compliance. Findings from the study show that there are some Shariah non-compliance risks that could arise out of the shared or outsourced services. Firstly, there is a risk of non-compliance in the sharing of key persons who need to oversee both entities (takaful and insurance). Secondly, there could also be risks in the structure of promoting products through the same office or branches which could also lead to reputational risks. Several parameters are suggested to assist risk identification and mitigation processes in the shared or outsourced functions.*

Keywords: Shared/outsourced services, *Maqasid al-Shariah*, *takaful*

Introduction

Takaful in essence brings a group of people together in helping each other to face the occurrence of unexpected or unwanted events. Such will rarely happen to everyone in the group. Therefore, the fund having been pooled together will serve as a cushion for the minority who face any odd circumstances. Unlike conventional insurance, *takaful* is not a mere contract between the policyholder and the insurance company. In conventional insurance, policyholders will only pay premiums individually while not affecting other policyholders. *Takaful*, however, is somewhat a consensus of among policyholders to help one another when facing unwanted events such as accidents or injuries. This is much upheld by the *Shariah* and is among the reasons why *takaful* is not prohibited (*haram*).

In a clearer sense, the difference between *takaful* and conventional insurance lies in the existence of the elements of *al-riba*, *al-maysir*, and *al-gharar* (Syed Othman & Shaikh Hamzah, 2009). *Riba* is present in the form of returns from investments made by the insurance companies. *Maysir* or gambling occurs when a policyholder takes a chance in protecting himself and pays a premium depending on whether or not a risk materializes. If it does, the amount he pays may be much less than the compensation he receives. This is clearly prohibited by *Shariah*. The third element, which is *al-gharar* or ambiguity, also occurs with games of chance as it creates no certainty in the outcome of a contract and may cause injustice to either party. Since these elements make a contract void from the perspective of *Shariah*, *takaful* operators have to conduct their business by avoiding them.

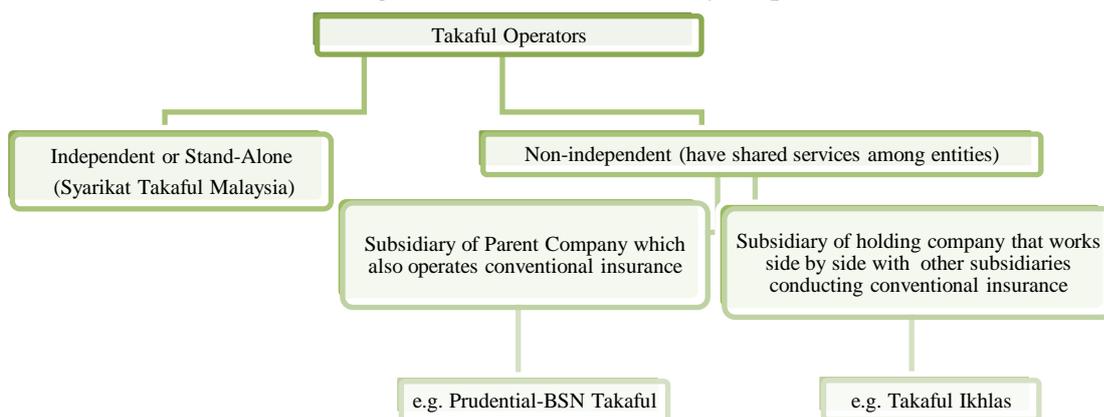
For these reasons, *takaful* has come up with the principle of *ta'awun* and *tabarru'*. From the Quranic injunction of Surah al-Maidah verse 5, *ta'awun*, which is to help one another in righteousness and piety, enables policyholders to come together as a group. Each of them contributes in the form of donation or *tabarru'* to the fund as a compensation to anyone from the group who faces an unfortunate event. Ultimately, these two important concepts have opened the way to *takaful* operators to avoid the prohibited elements and avoid the act of 'selling' the policy.

Organizational Structure of Takaful Companies

Malaysia, being an influential Islamic financial hub, was the first to implement a regulation specific to *Takaful* (*Takaful Act 1984*) and has since, required that a *takaful* company to operate as a dedicated subsidiary. Although BNM has a fairly strict approach in not allowing window operations for *takaful* (Frenz & Soualhi, 2010), operations of shared services are given less attention and are still allowed to cater for the competition the industry faces with its conventional counterpart. This needs further scrutinization in order to make sure that each activity of the operator is *Shariah* compliant but will need the application of *Maqasid al-Shariah* to be able to balance out the benefits and the risks.

Currently, eleven (11) *takaful* companies are in operation in Malaysia, of which only one (1) company, i.e. Syarikat Takaful Malaysia, is not part of any other company or parent company that operates under the conventional system. All the other ten companies either operate as (i) subsidiaries of a parent company which functions as a conventional entity; or (ii) side by side with a subsidiary that operates as a conventional insurance company. This is portrayed in Figure 1 below:

Figure 1: Classification of Takaful Operators



Conceptual Framework and Methodology

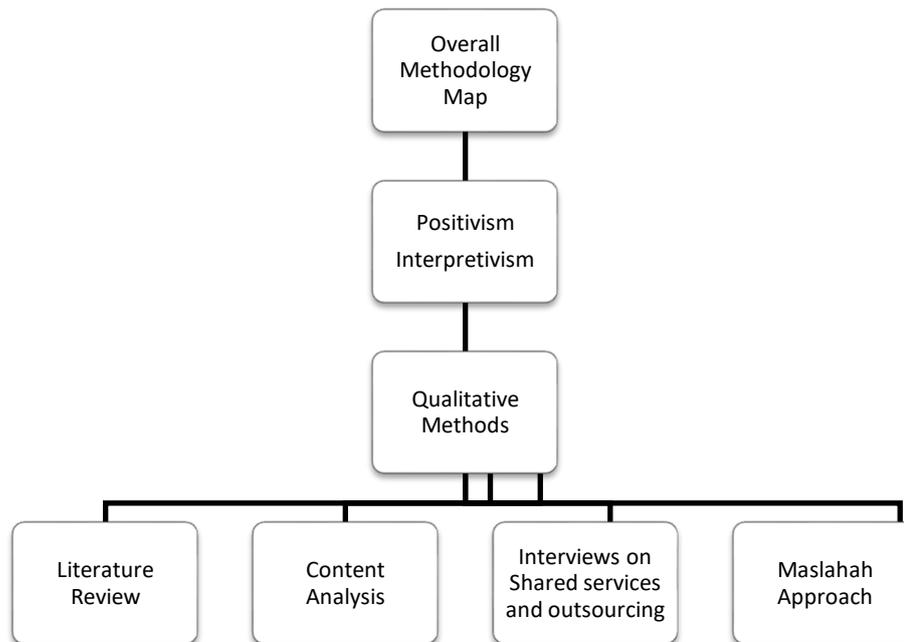


Figure 2: Conceptual Framework for Methodology

Referring to Figure 2 above, the current study adopts an analysis through a qualitative method. The qualitative approach is important in achieving the answers to part of the study which is attained from several interviews and content analysis of existing literature.

Sample

The sampling strategy adopted the judgment or purposive sampling. According to Saunders et al. (2009), purposive sampling allows researchers to use their judgment in selecting cases that best meet their research objectives. This is most applied in small samples such as case study research and where particularly informative and rich facts are required. Additionally, Marshal indicates that this method “actively selects the interviewees that could provide the most comprehensive or productive answers to the interview questions” (as quoted in Seng Kiong, 2014). Furthermore, the literature on Islamic financial industry specific on this area is considered very specialized in nature, leading to the need for beneficial information from experts in the field. It is generally viewed that such strategy does not allow for generalizations or is said to be not representative of the population; however, the overall objective of the research is not intended to do so. The sample for the study in general includes a total of eight (8) *takaful* operators.

Interviews

The interview questions are semi-structured and open-ended to allow room for a broader discussion on shared services and outsourcing, since there are a very limited number of studies in this topic. The interviewees consist of nine professionals either holding a CEO, *Shariah*, or other executive positions who have worked or currently working with *takaful* or insurance companies. The interviews lasted from 30 minutes to 60 minutes and were structured through

a set of themes following Strauss and Corbin (1990) and also include ideas from secondary data.

Maslahah Approach

The study also adopts the *maqasid* approach in arriving at the framework for decision-making. The specific method has been adapted from Hasan & Asutay (2010) where *maslahah* is used in stakeholder management for IFIs. The process from this approach involves the identification of *maslahah* (benefits) and *mafsadah* (risks). In general, the formula in applying such method is identified below:

Where M = *maslahah* and F = *mafsadah*.

Maslahah is considered the core element of *Maqasid al-Shariah* and is defined as the utmost righteousness and goodness; Its antonym, *mafsadah*, literally means something harmful or destructive (Shaharuddin, 2010).

Discussion of Findings

Shared/Outsourced Services in Takaful Operators

Based on the literature review, content analysis and interviews, information on *takaful* operators' organizational structures are summarized in table 1

Table 1: *Takaful* Operators involved in current study

Company / <i>Takaful</i> Operator	Ownership (Malaysian or Foreign)	With Interview
A	Malaysian (shared services)	Yes
B	Foreign (shared services)	Yes
C	Foreign (more to outsource)	Yes
D	Malaysian (shared services)	Yes
E	Malaysian (more to outsource)	Yes
F	Malaysian (shared services)	No
G	Malaysian (more to outsource)	Yes
H	Malaysian	No

From the general information obtained from the research only one company is considered as providing a truly full-fledged Islamic insurance service. The other ten operators are a form of subsidiary of a parent company offering conventional services including conventional reinsurance.

Some of the responses from the interviews highlighted below also provide insights into the areas which are shared or outsourced among the two entities (*takaful* and insurance):

“Most of them are still shared; ...human resources, training, new business, underwriting...”

“We still depend on the conventional for underwriting and actuarial functions”

“Yes, the IT functions too”

“We are not generally using shared services, we outsource most of the functions to the conventional side; for example, risk management and compliance”

“General policies are still centralized therefore HR rules and regulations follow the parent or HQ policies”

Table 2 summarizes the general functions of different departments in presenting the findings. They are basically divided into five categories and further expanded to the processes involved.

Table 2: Takaful Operators’ Shared or Outsourced Functions and Processes

Services/Dimensions	Subcategories
Finance	<ul style="list-style-type: none"> • Contribution Payment • Claims Settlement • Fund Management / Investments
Operations	<ul style="list-style-type: none"> • Product Development • New business and Underwriting • Agency Management • Customer Services • Policy Maintenance and Collections • Audit, Compliance and Risk Management • <i>Retakaful</i> and Reinsurance
Marketing	<ul style="list-style-type: none"> • Corporate Business and Communication • Business Development • <i>Bancatakaful</i> • Branding and Advertising
Human Resources	<ul style="list-style-type: none"> • Key Management Positions • Recruitment Process • Training of Employees • Payroll
Information Technology	<ul style="list-style-type: none"> • Collecting and Storing of information • Website and Online Information • Creating appropriate network for organizing mailing advertisements • Producing policies and other related documents

The list is a general perspective of the services shared or outsourced by one or more operators. Basically, the functions are shared or outsourced at two levels, which are (1) Group level and (2) Entity level.

At the group level, there are various functions carried out for the benefit of the whole group including subsidiaries. This is divided into certain categories like the Chief Executive Officer’s (CEO) office, corporate planning, risk and compliance and the shared services and outsourcing (SSO) function heads. The study finds that with regards to the CEOs, all operators have their own CEO to oversee the *takaful* side of activities. However, in terms of corporate planning, risk and compliance and the SSO function heads, there is a particular sharing of resources among the group. For example, the risk and compliance function involve risk management and governance activities which are held by the same persons under the Board of Directors (BoD) and committee. The BoD’s and the committee’s scope of functions covers both conventional and *takaful* activities.

Shariah Non-Compliance Risks

Shariah non-compliance risk is considered one of the unique risks in Islamic financial institutions due to the adherence to Islamic law compared to the conventional counterpart. This type of risk is considered part of the operational risks that Islamic financial institutions face, and is seemingly more complicated due to the different contractual features and legal documentation (Abdullah, Shahimi & Ismail, 2011). Sometimes it is not easily predicted when a non-compliance with Shariah principles occurs in such institutions therefore specific measures and methods need to be outlined in order to combat them. This is why Shariah governance framework is such an important method of defence as it determines the status of Shariah compliance risks. It is also crucial to link this framework to the board of directors and shariah committee of a company to ensure a smooth sail of identifying possible risks and undertaking them. Basiruddin and Ahmed (2017) investigates how the structure of the board of directors and shariah committee affects Shariah non-compliance risk in Malaysia and Indonesia over 5 years. The study recommends a more active Shariah committee in order to enhance the monitoring system, which could then result in lowering the Shariah non-compliant income. It has also been shown that poor governance in financial institutions is closely related to banks' behaviour in taking excessive risks and it turns out that they do more of risk taking during any crisis (Diaz & Huang, 2017). This is why governance framework becomes a major tool in Islamic financial institutions as to avoid such risks that seem going against the Shariah.

Another set of risks that could result from Shariah non-compliance risk is reputational risk. Reputation is considered the most critical asset that any financial institution could ask for as it plays a huge role to bring in more customers, shareholders and investors. It has been suggested that Islamic financial institutions, more specifically banks, to outperform in dealing with reputational risks in order to avoid customer retention or complaints that may damage reputation of Islamic banks and products. Azrak, Saiti & Engku Ali (2016) provides a review on local companies' (domestic vs foreign) annual reports and financial statements in trying to assess the transparency of disclosing their reputational risk management framework. The study found that local domestic banks are more transparent. Another study by Rosman, Che Azmi & Amin, (2017) also investigates on the disclosure of Shariah non-compliance income in Islamic banks in Malaysia and Bahrain and found no significant behaviors of the selected banks in these countries but further improvements still need to be done in order to enhance transparency. It is therefore fundamental that IFIs to adopt a different set of risk management process for the said reasons due to the unique features of its everyday transactions, as suggested by Hassan et. al (2017).

Shariah Non-Compliance in Shared/Outsourced Services

It is necessary to mention that the current research does not intend to put a definite rule or *hukm* on such processes involved in *takaful* operators. Nevertheless, it tries to promote thorough *Shariah* compliance through all processes including core and supporting functions to be in line with the recent requirements by IFSA 2013. From the findings in the previous section, the researcher uses the *Maqasid al-Shariah* approach in order to reach a conclusion on the ruling of such processes based on the understanding and experience in such shared or outsourced functions.

The findings have indicated that the SSO functions are seen at two levels; the group and entity levels. In either category, functions discussed are not free from potential *Shariah* non-compliance risks. In the corporate planning function, since officers have to work together in implementing projects and future developments, they are not able to avoid in discussing matters

related to the conventional counterpart. The potential risk is that they are hired by the *takaful* operator but may be assigned to perform specific conventional activities. This is similar to the SSO function heads as they become responsible towards both employees and undertakings of the two entities (*takaful* and insurance). The more prevalent *Shariah* non-compliance risk is potentially seen from the risk and compliance function. Possible poor communication between management and *Shariah* committee (SC) on issues arising may lead to non-compliance risks. The risk and compliance function discussed may only be general and refer to mitigation measures but it may fail to include issues related to *Shariah* on the group level. In addition, other potential risks include possibility of irregular *Shariah* review function and absence of *Shariah* research function to have an in depth analysis before submitting any issues to the SC. Furthermore, the lack of management on SC's interest and remuneration will possibly distant the management and *Shariah* function which finally may miss out on specific issues that fail to be addressed.

At the entity level, the various functions involved may also pose *Shariah* risks to the *takaful* operator. Risks at both entity levels are summarized in table 3.

Table 3: SSO functions and areas of *Shariah* non-compliance risks at two levels

Shared / Outsourced Arrangements (Group Level)	Identified sources of <i>Shariah</i> Non-Compliance Risks	
Corporate Planning	<ul style="list-style-type: none"> The officer hired by <i>takaful</i> operator may perform conventional insurance activities 	
Risk & Compliance	<ul style="list-style-type: none"> Poor communication between management and <i>Shariah</i> committee may lead to <i>Shariah</i> non-compliance risks Failure to escalate <i>Shariah</i> non-compliance issues to <i>Shariah</i> committee Irregular <i>Shariah</i> review functions of operations Absence of <i>Shariah</i> research functions to conduct in depth <i>Shariah</i> research before submission to the <i>Shariah</i> committee Lack of management of the <i>Shariah</i> committee's interest and welfare, including remuneration 	
Shared/Outsourced Service Function Heads (Key Management Person)	<ul style="list-style-type: none"> The officer hired by <i>takaful</i> operator may perform conventional insurance activities May raise public confusion and negative perception on <i>takaful</i> operator Lack of management of <i>Shariah</i> Committees' interest and welfare including remuneration which in turn may cause problems in attracting <i>Shariah</i> scholars 	
Shared / Outsourced Arrangements (Entity Level)	Processes	Identified sources of <i>Shariah</i> Non-Compliance Risks
Finance	Fund management / Investment	<ul style="list-style-type: none"> Poor controls may result in <i>Shariah</i> non-compliant investment funds Poor controls may result in commingling of <i>Shariah</i> and conventional income Investment staff failure to monitor investment subsequently identified as non-compliant

Operations	Agency Management	<ul style="list-style-type: none"> Agents under the <i>takaful</i> operator payroll system may be involved in conventional activities Failure to address specific underwriting measures to <i>Shariah</i> committee
	Actuarial / Underwriting	<ul style="list-style-type: none"> New product approval guidelines not approved by <i>Shariah</i> committee Failure to ensure pricing of product is in accordance with <i>Shariah</i>
Marketing	Branding/ Advertising	<ul style="list-style-type: none"> Bundling of conventional and Islamic products Improper or wrong usage of terminology and definition Failure to address <i>Shariah</i> non-compliant marketing issues to <i>Shariah</i> committee <i>Shariah</i> non-compliant marketing material may result in wrong perception to the public Same brand promoting both conventional and insurance may result in poor perception of public and raise confusion
	Bancatakaful	<ul style="list-style-type: none"> Bundling of conventional products with Islamic products Corporate image or public confusion with regards to availability of products through conventional branches
Human Resources	Recruitment/ Training	<ul style="list-style-type: none"> Payroll under <i>takaful</i> operator may be positioned under conventional activities Training provided under <i>takaful</i> operator expenses may end up providing conventional services Training events may include non-permissible entertainment
Information Technology (IT)		<ul style="list-style-type: none"> Inability of system to cater for specific <i>Shariah</i> features

Reputational Risks

Continuous emergence of these *Shariah* risks being unaddressed will eventually cause public confusion, and the credibility and integrity of *takaful* operators will be questioned. For example, the cross-selling of products through conventional insurance agents is initially not so much of a problem. However, if the same agent is seen to generate new business with clients over drinks or events which are clearly prohibited in Islam, then he goes over to Muslim customers to promote *takaful*, wouldn't this be contradictory in the eyes of the public?

With the technological features of social media nowadays, this act could be captured through mobile phones and immediately uploaded. The result is, within less than 5 minutes it could be widespread and known to the whole public. With such acts by one individual could result in detrimental effects to the operator. The basis of trust is an important element in the *takaful* business but when events such as these occur, people may lose their trust as the brand name is now affected. This could have serious implications for company revenue and sales. Similarly, promoting and entertaining customers through the same branch office could also trigger the same risk as people may question what difference does it actually make compared to window operated *takaful* services. The trust element of upholding *Shariah* and saying that everything is *Shariah* compliant could turn into a myth in the eyes of public who actually observe Islamic rulings.

Reputational risk has been defined by the IFSB as “the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, or regulators that can adversely affect an Islamic Institutions Offering Financial Services’ (IIFS) ability to maintain existing or establish new business relationships and continued access to sources of funding (Haron, Ramli, Injas & Injas, 2015).

Reputational risk is recently put as one of the priorities of company’s list and is considered as the most valuable asset. In the Western world, reputation has been one of the leading issues and its urgency has been described by Warren Buffet that “it takes 20 years to build a reputation and five minutes to ruin it. If you think about it, you’ll do things differently” (DeRose, 2007). However, being a complicated type of risk, reputational risk is difficult to quantify and takes meticulous strategies to protect and manage. Some previous studies as identified by DeRose (2007) have shown that both reputational and non-compliance risk could hugely impact and damage a company’s reputation which further results in companies losing their customers and profits. From such impacts on companies, it is urgent to make reputational risk a top priority in any risk management efforts. It should be effectively addressed before any matters arise.

In cases of Islamic finance, there is an urgent call to look at reputational risk especially since it strongly affects customer satisfaction levels (Hamzah, Ishak & Mohd Noor, 2015). The public seeking Islamic versions of banking and insurance in fact put their trust into the system and believe that the processes and services are done according to Islamic values. Therefore, if for some reason, they find out any circumstances that show the contrary, it will certainly cause them to look for alternatives. In extreme cases, the whole Islamic financial industry may be brought down by such perceptions as it fails to hold the trust and belief of customers.

In essence, reputational risk should be in line with the precepts of corporate governance as indicated by Zaman (2010). It has been quite a major concern for boards and directors, as any reputational risk that materializes will soon “affect income streams, endanger earnings growth, and affect investor confidence” (p.1). It has also been noted that despite the understanding of such concept being harmful to organizations, evidence suggests that the top management including the board are still not doing enough to curb such risks through specific policies and practices to manage exposure to these risks. On the other stand, stakeholders whose support is of critical value to an organizational sustainability including investors, regulators, customers, staff, and suppliers are increasingly becoming aware of such concerns and have started to demand evidence that companies are taking it as a serious matter.

In relation to the repercussions that may result from non-compliance risks, it is essential for the *takaful* industry to prepare for events that may occur at any time. When it suddenly hits and the operator does not have any measures to mitigate the risk to convince their customers, it could turn to be a more serious issue to be addressed. The shared and outsourced services can be either done through the following framework, with decreasing degree of *Shariah* non-compliance risk occurring.

1. Outsourced to conventional entity outside the group (Potential high risk)
2. Outsourced to conventional entity within group (Potential moderate risk)
3. Outsourced to *Shariah*-compliant entity outside group (Potential less risk)
4. Outsourced to *Shariah*-compliant entity within group (Potential minimum risk)

In terms of the risks, table 4 shows the level of risks with respect to their weights.

Table 4: Types of Outsourcing Level of Risk and Weightage

	Type of Outsourcing	Level of risk	Weightage of risk (out of 4)
1.	Outsourced to conventional entity outside the group	Potential high risk	4
2.	Outsourced to conventional entity within the group	Potential moderate risk	3
3.	Outsourced to <i>Shariah</i> -compliant entity outside the group	Potential less risk	2
4.	Outsourced to <i>Shariah</i> -compliant entity within the group	Potential minimum risk	1

Options 1 and 2 above are considered high and moderate risks, which not only increase potential *Shariah* non-compliant risks but also increase other risks of outsourcing in general. Since there are *takaful* operators with no general *takaful* products, option 3 is available for these companies. For companies that do have both family and general products, option 4 is much suitable.

Despite the above recommendation for option 3 and 4, the *takaful* operator should determine the best option in designing their respective outsourcing strategies depending on several factors which contribute to the selection of such options. These factors includes but not limited to:

- a. Talent, skills and expertise
- b. Governance, accountability and control of outcomes
- c. Productivity and efficiency
- d. Impact on *takaful* employed staff
- e. Transition and adoption of the new structure

The decision can be made through applying the *maslahah* approach from Hasan & Asutay (2010), in table 5.

Table 5: Application of *maslahah* approach on SSO

Formula	Illustration	Explanation
M> vs F> = F>	The management of the operator has four options to arrange the shared or outsourced functions	In this case the management shall make its decision on either option 3 or 4. The first two options, following the legal maxim “Severe harm is removed by a lesser harm” would be more detrimental as these options are more vulnerable to <i>Shariah</i> non-compliance risks and other sets of risks of outsourcing.
M< vs F< = F>	In choosing between options 3 and 4, the management has to look at the structure of the operator as option 4 may be better for companies with both family and general <i>takaful</i> , while option 3 is possibly better for companies without both products.	<i>Maslahah</i> in this exercise is that it may reduce the <i>Shariah</i> non-compliance risks for the company while at the same time it may cause <i>mafsadah</i> through higher costs. <i>Mafsadah</i> may then prevail over <i>maslahah</i> . In this case, the use of conventional services may be accepted if the restructuring will cause detrimental harm in not being able to service the participants of the operator. e.g. not being able to pay for claims and indemnification. This is based on the legal maxim “private harm is tolerated in order to ward off public harm”. Nevertheless, if this kind of <i>mafsadah</i> can be mitigated by having proper mechanism and restructuring done in stages, then the <i>maslahah</i> may prevail. This follows the legal maxim “Repelling an evil is preferable to securing benefit”.

Based on the discussion, the suggested options for enhancing *Shariah* compliance among the *takaful* operators are highlighted in options 3 and 4 which are the ones with second lowest and lowest risks respectively. This suggested framework for the said options are portrayed in figure 3 and 4

Figure 3: Suggested Framework for the Shared and Outsourcing of Services (Option 3)

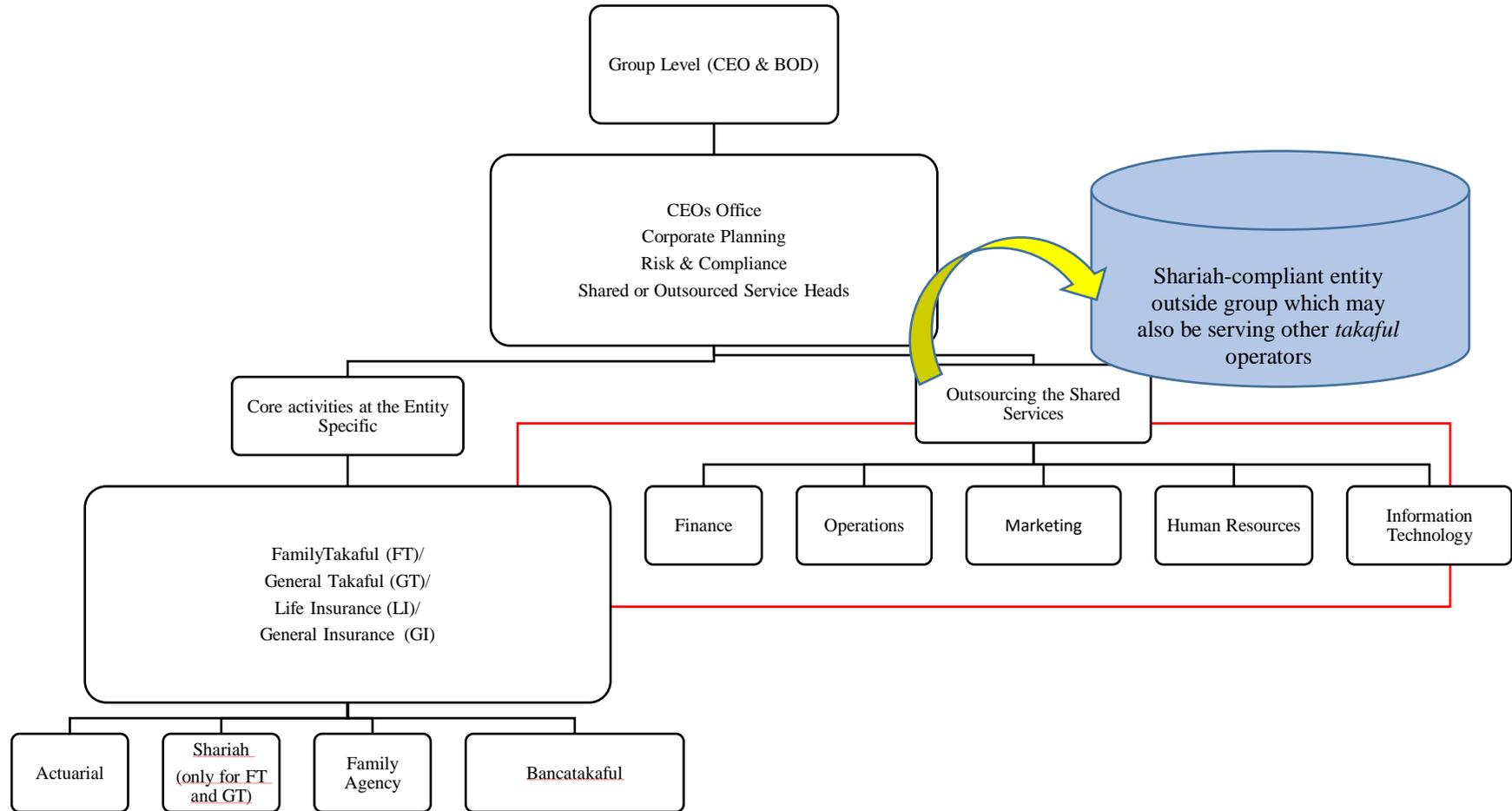
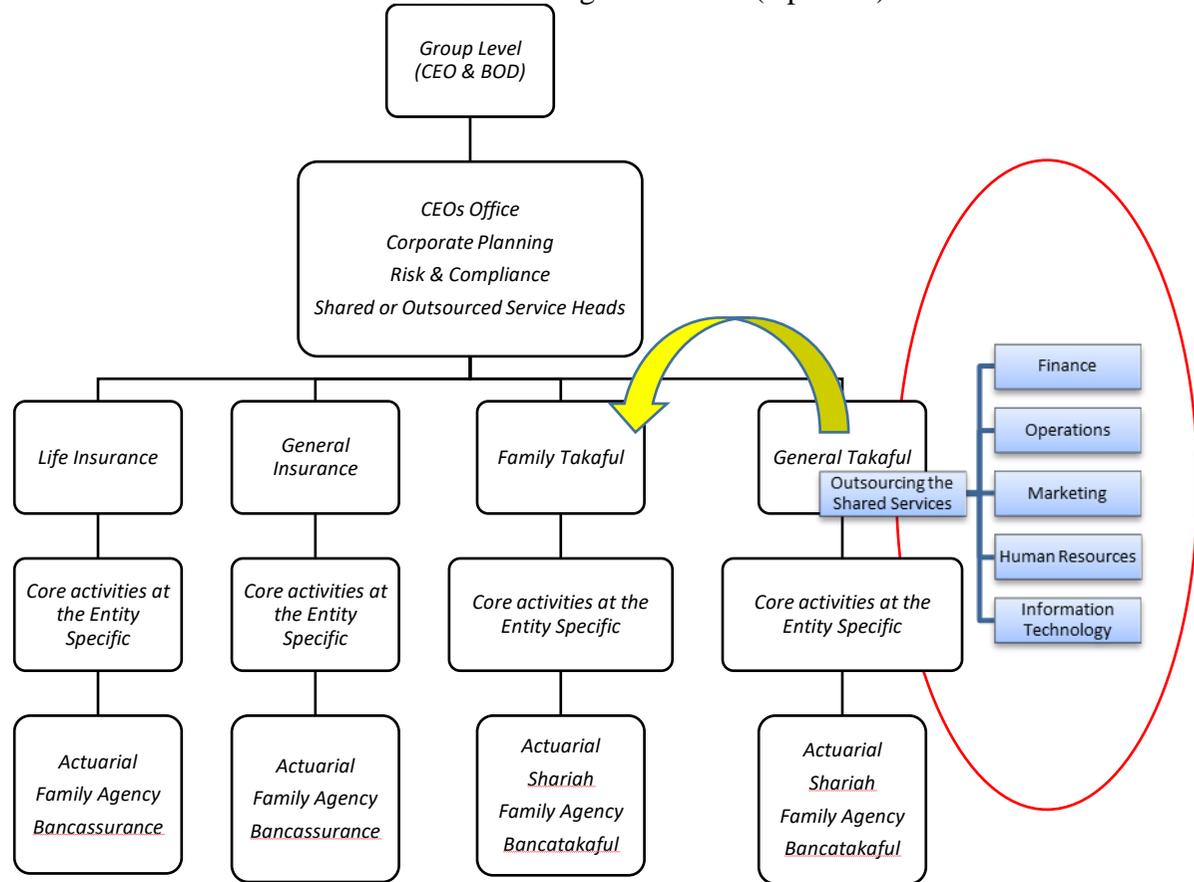


Figure 4: Suggested Framework for the Shared and Outsourcing of Services (Option 4)



Conclusion

The study has revealed that various processes being shared or outsourced among *takaful* and insurance companies are linked with *Shariah* non-compliance risks. Although not involved in all detailed aspects of the functions, the *Shariah* non-compliance risks may still arise with imprudent measures and may also lead to further issues like reputational risks as mentioned in the study. It is therefore suggested that companies have their own risk management measures specific to entail the aspects of *Shariah* non-compliance in the areas of shared and outsourced services as recommended in the study.

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