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Evaluating the effectiveness of shariah risk management in Malaysian Islamic financial institutions

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ABSTRACT

Effective Shariah risk management is crucial for Islamic Financial Institutions (IFIs) in ensuring robust identification and mitigation of risks associated with Shariah non-compliance. Incidents related to Shariah non-compliance in Islamic financial activities can lead to a loss of trust and credibility among stakeholders. Although IFIs have implemented Shariah risk management functions to address these risks, their effectiveness remains largely unassessed. This research explores the effectiveness of Shariah risk management in IFIs in Malaysia. A quantitative research methodology was adopted, utilizing a survey questionnaire to collect data from a representative sample of all 47 IFIs in the country. The measurement was based on the Shariah Governance Policy Document (SGPD) issued by Bank Negara Malaysia (BNM), which all IFIs in Malaysia are required to implement. The study found that most IFIs have implemented a moderately effective level of Shariah risk management functions and processes. This research provides valuable insights into the effectiveness of Shariah risk management in IFIs and emphasizes the importance of establishing robust control functions and fostering a culture of Shariah compliance to improve the management of Shariah non-compliance risks.

Contribution/ Originality: This study offers a novel contribution by conducting a comprehensive evaluation of the effectiveness of Shariah risk management across all 47 Islamic Financial Institutions in Malaysia. By quantitatively measuring the implementation level against SGPD, the moderate effectiveness highlights critical areas for enhancing Shariah control functions within the Islamic financial sector.

1. INTRODUCTION

Shariah risk management involves a systematic approach to identifying, measuring, monitoring, controlling, and reporting any risks associated with the violation of Shariah rules in Islamic financial institutions (IFIs) (Bank Negara Malaysia, 2019). In this context, IFIs are required to ensure that their products, services, operations, and transactions align with the ethical and legal principles of Islamic law. The primary goal regarding the Shariah risk management role is to maintain the IFI's compliance with Shariah principles, protect its reputation, and mitigate potential negative impacts arising from non-compliance with Shariah guidelines.

The IFIs in Malaysia are mandated to implement Shariah risk management as part of their Shariah governance framework, which is overseen by the Board of Directors and supervised by the Shariah Committee members (Bank Negara Malaysia, 2019). As per the Shariah Governance Policy Document (SGPD) established by Bank Negara Malaysia (2019), IFIs are advised to integrate the Shariah non-compliance risk management framework into their enterprise-wide risk management system (Bank Negara Malaysia, 2019). Any exposures to Shariah non-compliance risks, along with their possible influence on the IFI, must be reported to the Board, Shariah Committee members, and senior management concerning appropriate action. Developing a comprehensive Shariah risk management framework is critically important for IFIs due to the unique characteristics of their business operations compared to conventional counterparts (Ariffin, 2022). One of the significant reasons is to prevent IFIs from participating in activities considered impermissible in Islam. Failure to adhere to Shariah principles can adversely impact the reputation of IFIs among stakeholders and the community in broader contexts.

Despite extensive research on Shariah risk management, significant gaps remain in the literature. While scholars have identified issues of non-uniform interpretations across jurisdictions (Ariffin, 2022; Omar & Hassan, 2019; Rosman & Rahman, 2013) and challenges in aligning risk measurement strategies with Shariah objectives (Ariffin, Archer, & Karim, 2009; Bhatti, 2020) there has been limited empirical assessment of the effectiveness of implemented Shariah risk management in Malaysian IFIs. Previous studies have largely relied on qualitative approaches or focused on policy document analysis rather than on implementation effectiveness. Additionally, existing research has inadequately addressed the operational challenges faced by IFIs when integrating Shariah risk management into enterprise-wide risk management frameworks, particularly in measuring the effectiveness of these implementations. Without examining the effectiveness of Shariah risk management, the robustness of the integrated Shariah risk management function and process cannot be assessed, leaving stakeholders without a comprehensive understanding of whether the Shariah compliance function is adequately executed.

This paper addresses these limitations by examining the effectiveness of Shariah risk management in Malaysian Islamic Financial Institutions (IFIs) through a comprehensive empirical assessment. Unlike previous studies that focused primarily on theoretical frameworks or isolated aspects of Shariah compliance, this research provides evidence-based insights into how effectively current practices identify, measure, monitor, and control Shariah non-compliance risks in operational contexts. Evaluating the effectiveness of Shariah risk management is particularly crucial, given Malaysia's position as a global leader in Islamic finance. As Malaysian IFIs expand internationally, the robustness of their Shariah risk management practices not only affects domestic stakeholders but also influences global Islamic finance standards.

This research contributes to the ongoing discussion on how risk management theories can be effectively adapted to the unique ethical and legal requirements of Islamic finance. By examining the implementation effectiveness rather than just framework design, this study bridges the gap between theoretical Shariah governance models and practical operational challenges faced by Islamic Financial Institutions (IFIs) in an increasingly complex financial landscape. The study's findings offer valuable insights for regulators, Shariah Committee members, and the management of IFIs to enhance Shariah risk management frameworks and foster a stronger Shariah compliance culture, as emphasized in SGPD regarding the importance of cultivating a Shariah compliance risk culture across all IFIs in Malaysia (Bank Negara Malaysia, 2019).

The following sections concerning this paper are constructed as follows: The next section provides a review of the literature on Shariah risk management along with Shariah governance. The subsequent part includes a discussion of the research methodology and a comprehensive discussion of the findings in the following section. This paper's concluding section offers a comprehensive summary and highlights its significant contribution to this research.

2. LITERATURE REVIEW

This section provides an extensive review of the literature concerning empirical studies related to Shariah risk management and proposes measures for examining the effectiveness regarding Shariah risk management in Islamic Financial Institutions.

2.1. Shariah Risk Management

The conceptual and empirical literature in the area of Shariah risk management and risks management in IFIs have mainly argued on the perception of risks in IFIs (Ariffin et al., 2009) nature and concepts of Shariah non-compliance risks (Hassan, 2016; Hassan et al., 2022; Mohd Noor, Ismail, & Mohd. Shafiai, 2018) risk management practices in IFIs (Ariffin, 2022; Omar & Hassan, 2019; Rosman & Abdul Rahman, 2015) risk management techniques used to control Shariah non-compliance risks (Ariffin et al., 2009; Bhatti, 2020).

One of the earlier empirical studies examined the perceptions of Islamic bankers from 28 Islamic banks across 14 countries regarding various types of risks affecting Islamic banking operations (Ariffin et al., 2009). The risks encompass operational risks, liquidity risks, credit risks, foreign exchange risks, and Shariah non-compliance risks. According to Ariffin et al., (2009), Islamic bankers regard credit risk as the most significant risk to manage in Islamic banks compared to Shariah non-compliance risks. The findings are likely due to a higher understanding among Islamic bankers that increased credit risk can reduce profitability and diminish market perception among stakeholders, which could consequently affect the sustainability of Islamic banks in the future. The understanding of the significance of Shariah non-compliance risks remains limited in most countries (Ariffin et al., 2009).

Several years later, Rusni Hassan (2016) further defined Shariah non-compliance risks in IFIs. Note that the study emphasised that Shariah non-compliance risks evolve throughout the entire process of designing an Islamic financial product, beginning with its conception and design and extending to its implementation on the market (Rusni Hassan, 2016). Similarly, Mohd Noor et al. (2018) contended that Shariah non-compliance risks emerge from the implementation with regard to Shariah principles in executing Islamic financial contracts. In this respect, IFIs have a higher potential of facing Shariah non-compliance risks if there is any deviation from Shariah requirements in implementing Islamic financial contracts (Mohd Noor et al., 2018). The severity of the Shariah non-compliance risks depends on the contractual terms and conditions. Additionally, Shariah non-compliance risks are influenced by inadequate regulatory oversight, ambiguous legal frameworks, data falsification, fraudulent activities, misrepresentation, negligence, an insufficient internal Shariah governance structure, and discrepancies in accounting processes (Hassan et al., 2022).

In terms of practices, Rosman and Abdul Rahman (2015) evaluated the questionnaire responses from risk management practitioners in IBs from various countries. It is argued that IBs focus mainly on managing operational risks as well as Shariah non-compliance risks (Rosman & Abdul Rahman, 2015). Currently, IBs have established a clear identification of any Shariah non-compliance events and ensure that Islamic banking operations adhere to the Shariah rules and principles (Rosman & Abdul Rahman, 2015). Correspondingly, Omar and Hassan (2019) conducted an in-depth interview with Islamic banking practitioners from five IBs and found that IBs have complied with the requirements mandated by BNM in terms of establishing a Shariah risk management function. In this regard, the risk management process involves identifying Shariah non-compliance risk events, which are then validated with the qualified Shariah officer regarding the specific Shariah non-compliance issues. Once validated by the qualified Shariah officer, the issues will be decided by the Shariah Committee members before recommending the rectification plan (Omar & Hassan, 2019). Ariffin (2022) also argued that Islamic banks (IBs) have established reputable Shariah risk management practices. Although IBs currently follow an integrated risk management framework similar to that of conventional banks, they have clearly identified, measured, monitored, and controlled Shariah non-compliance risks related to Islamic banking operations (Ariffin, 2022).

Currently, IBs are using the same risk management techniques as conventional banks (Ariffin et al., 2009; Rosman & Rahman, 2013). Note that only a few IFIs implement Shariah non-compliant risk mitigation strategies to manage Shariah non-compliance risks (Rosman & Rahman, 2013). According to Ariffin et al. (2009), IBs in most countries employ less complex methods such as collateral arrangements, guarantees, loan loss reserves, and third-party enhancements to reduce the risks associated with non-compliance with Shariah. Likewise, Bhatti (2020) suggested the adoption of Shariah arbitration to manage Shariah non-compliance risks. Furthermore, the employment of Shariah arbitration and Islamic dispute resolution must be institutionalized within the Shariah governance structure to ensure effective Shariah risk management (Bhatti, 2020).

Referring to the literature review, this study discovered that most scholars argued about the urgent need for the Shariah risk management framework to be issued by regulators to ensure consistent practices of Shariah risk management and, consequently, to achieve effective Shariah risk management in IFIs.

2.2. The Proposed Measures

The SGPD is adapted to assess the effectiveness with regard to Shariah risk management in IFIs (Bank Negara Malaysia, 2019). Shariah risk management establishes a standardized framework to address risks associated with Shariah non-compliance. Its goal is to assess, examine, monitor, and mitigate such risks to prevent their recurrence. The evaluation consists of two main components: the role of Shariah risk management and the processes involved in it. The efficiency of Shariah risk management is assessed through five criteria derived from the SGPD (Bank Negara Malaysia, 2019). Shariah risk management must be integrated into the risk management framework of IFIs. Alongside examining various risk categories, it is crucial for IFIs to incorporate the evaluation of Shariah non-compliance risks within their framework. Therefore, the framework should support the examination, measurement, management, and continuous monitoring of Shariah non-compliance risks concerning Islamic financial activities. Moreover, the success of the Shariah risk management function depends on skilled Shariah risk officers with expertise in Shariah and Islamic finance. Therefore, IFIs should establish appropriate policies to manage Shariah non-compliance risks, ensuring an efficient Shariah risk management function. Additionally, the effectiveness of Shariah risk management is determined by evaluating the extent to which all levels of IFIs are made aware of Shariah non-compliance risks (Bank Negara Malaysia, 2019).

Conversely, the evaluation of an effective process for Shariah risk management utilises eight items as emphasised regarding the SGPD (Bank Negara Malaysia, 2019). The Shariah risk management process involves a series of comprehensive steps undertaken by the Shariah risk officer to identify, assess, and monitor Shariah non-compliance risks within Islamic Financial Institutions (IFIs). To ensure effective Shariah risk management, this process must involve assessing inherent Shariah non-compliance risks as well as developing strategies to mitigate them. The process continues with the evaluation of the potential impact of these risks within IFIs. Continuous monitoring of Shariah non-compliance risks is crucial for achieving effective Shariah risk management. Furthermore, the process includes the regular submission of reports to the Board, Shariah Committee members, and management concerning Shariah non-compliance risks (Bank Negara Malaysia, 2019). The study assesses the effectiveness of the Shariah risk management process based on its ability to implement preventive measures that prevent recurrence concerning Shariah non-compliance risks. Additionally, the Shariah risk officer is responsible for monitoring unrecognized earnings resulting from Shariah non-compliant activities. The process also includes assessing the potential for unreported profits by examining historical instances of Shariah non-compliance (Bank Negara Malaysia, 2019). Note that unacknowledged income generated from activities that do not comply with Shariah principles should be carefully monitored to detect potential future occurrences.

The above measurement aims to provide structured guidance for the effective implementation of Shariah risk management as outlined in the SGPD (Bank Negara Malaysia, 2019). The adoption with regard to a strong Shariah risk management framework is vital for obtaining Shariah compliance objectives in Islamic financial operations. Table

1 provides a brief summary concerning the components and items utilised to assess the effectiveness with regard to Shariah risk management regarding IFIs in Malaysia.

Table 1. Measurement of effective Shariah risk management.

Components	Items
Function	1. Creation of a function within the integrated risk management framework of the IFI. 2. Performed by risk officers possessing the required qualifications and/or experience in the field. 3. Assists in the identification, measurement, control, and monitoring of Shariah non-compliance risks inherent in the IFI's activities and operations. 4. Formulates and suggests Shariah-compliant risk management guidelines and policies. 5. Promotes Shariah non-compliance risk awareness within IFIs.
Process	1. Identifies the potential risks of Shariah non-compliance within IFIs and evaluates existing controls and measurements to mitigate risks. 2. Evaluates the potential influence of Shariah non-compliance risks on IFIs, drawing on historical examples and real cases of income loss resulting from activities that did not align with Shariah principles. 3. Tracks Shariah non-compliance risks to facilitate effective Shariah risk management. 4. Provides regular reports to the Board, Shariah Committee members, as well as management regarding Shariah non-compliance risks. 5. Evaluate the likelihood that similar Shariah non-compliance risks will occur in the future. 6. Evaluates potential unrecognised earnings using a historical analysis of Shariah non-compliance.

Source: Bank Negara Malaysia (2019).

3. RESEARCH METHODOLOGY

This study employs a rigorous methodological approach to assess the effectiveness of Shariah risk management at the institutional level, with individual Islamic Financial Institutions (IFIs) serving as the primary unit of analysis. The research design incorporates quantitative methods and expert validation to ensure robust and reliable findings. The study encompasses the total population of 47 IFIs operating in Malaysia, stratified across 6 distinct categories: 16 Islamic banks (IBs), Islamic windows in 7 commercial banks (IWCB), 3 investment banks (IWIB), 6 Islamic banking businesses in Development Financial Institutions (DFIs), 11 Takaful operators (TOs), and 4 Retakaful Operators (RTOs). This comprehensive approach allows for a thorough examination of effective Shariah risk management across Malaysia's entire Islamic financial ecosystem, enhancing the generalizability of findings.

For data collection purposes, one (1) key officer from each IFI was purposively selected based on their expertise and involvement in Shariah risk management functions. This purposive sampling technique ensures that respondents possess the requisite knowledge to provide accurate assessments of their institution's Shariah risk management effectiveness. The selection criteria for these key officers include: (1) direct involvement in the Shariah risk management function, (2) a minimum of three (3) years' experience in risk management or Shariah compliance, and (3) a managerial or supervisory position within the organization. This sampling strategy addresses the common limitation of survey-based research by targeting respondents with both the knowledge and authority to provide reliable information (Cochran, 1977).

The study adopts a survey questionnaire for data collection (Creswell & Guetterman, 2018). The survey instrument was developed based on the components and processes of Shariah risk management as outlined in the SGPD issued by Bank Negara Malaysia (2019). To ensure content validity and reliability, the draft survey questionnaire underwent preliminary validation testing with a panel of Islamic finance and Shariah experts. This validation process allows the experts to evaluate the relevance, clarity, and appropriateness of each measurement item (Anderson & Gerbing, 1991). Based on expert feedback, the survey questionnaire was refined before final distribution.

The final survey questionnaire employed a 5-point Likert scale (5 = Highly effective; 4 = Effective; 3 = Somewhat effective; 2 = Ineffective; 1 = Highly ineffective) to measure respondents' assessment of Shariah risk management in their respective institutions. The survey questionnaire includes the components and items outlined in Table 1 to evaluate the functions and processes of Shariah risk management in IFIs. Data collection occurred over a three-month period, utilizing both electronic and physical distribution channels to maximize response rates. Data were analyzed using IBM SPSS Statistics (Version 28), with preliminary checks conducted for data distribution characteristics, normality, and outliers (Pallant, 2016). The analytical approach included descriptive statistics for each measurement component and item, with mean and frequency distributions calculated to develop a comprehensive profile of current practices. Mean scores were categorized into effectiveness levels to facilitate interpretation: 5.00 (Highly effective), 4.00 – 4.99 (Effective), 3.00 – 3.99 (Somewhat effective), 2.00 – 2.99 (Ineffective), and 0.00 – 1.99 (Highly ineffective). Additionally, comparative analysis examined differences in effectiveness across different types of IFIs, providing insights into institutional variations in the effectiveness of Shariah risk management. This methodological approach enables a thorough assessment of Shariah risk management effectiveness across the Malaysian Islamic financial sector, producing findings that contribute to both the theoretical understanding and practical implementation of Shariah governance arrangements.

4. FINDINGS AND DISCUSSION

Based on the survey questionnaire, this study managed to collect 39 out of 47 responses (82.98%) from the IFIs. This response rate allows for a comprehensive and comparative evaluation of the effectiveness of Shariah risk management across various categories of IFIs in Malaysia.

As a preliminary evaluation, it is vital to note that six out of 14 IBs and 7 out of 9 TOs have obtained a mean score higher than 4.00, as portrayed in Table 2. The results strongly indicate that the processes and functions related to Shariah risk management in the majority of Islamic Banks (IBs) and Takaful Operators (TOs) are more well-established and effective compared to other types of Islamic Financial Institutions (IFIs), such as IWCB, Development Financial Institutions (DFIs), IWIB, and RTOs. Findings from TOs suggest that the higher-risk nature of Takaful operations may have prompted TOs to establish robust Shariah risk management practices. It is essential for TOs to ensure that the management of Takaful funds, underwriting of Takaful risks, claims management, and surplus distribution to participants are free from Shariah non-compliance issues. Previous studies have shown that most IBs in Malaysia have successfully implemented Shariah governance and Shariah audit practices as mandated by the SGPD (Ab Ghani & Abdul Rahman, 2015; Yahya, Mahzan, & Abu Hasan, 2018). Another study also revealed that the existing Islamic finance industry regulations are more focused on IBs compared to Takaful operations, as highlighted in SGPD (Mohamad Puad & Shafii, 2019). However, the findings in Table 2 highlight an improvement in the incorporation with regard to Shariah governance practices in TOs, in addition to IBs, as demanded by the SGPD (Bank Negara Malaysia, 2019).

In addition, the issues of the lack of current regulations pertaining to Islamic banking windows, Islamic banking business in RTOs, and DFIs need to be highlighted to facilitate further improvements in the execution of efficient Shariah risk management and Shariah governance in these types of IFIs (Ab Ghani, Ariffin, & Rahman, 2022). The lower capacity and insufficient resources in Islamic banking windows and RTOs should not discourage these types of IFIs from establishing a robust process as well as functions with regard to Shariah risk management, according to the size of Islamic banking and Takaful operations. Close monitoring by regulators of these types of IFIs might help assist their effective practices. This is essential to ensure that these diverse types of IFIs adhere to Shariah principles, gaining stakeholders' substantial trust and confidence similar to IBs and TOs.

Table 2. The effectiveness of Shariah risk management based on type of IFIs.

Type of IFIs	Highly effective (5.00)	Effective (4.00–4.99)	Somewhat effective (3.00–3.99)	Ineffective (2.00–2.99)	Total IFIs
IBs	3	3	6	1	14
TOs	1	6	1	2	9
IWCB	0	5	0	1	6
DFIs	0	2	3	1	6
IWIB	0	1	1	0	2
RTOs	0	0	1	1	2
Total IFIs	4	17	12	6	39

The research findings in Table 3 suggest a moderate level of effectiveness concerning Shariah risk management with regard to IFIs in Malaysia, as evidenced by the mean score of 3.874 presented in the table. It is imperative to underscore that this degree of effectiveness is achieved by incorporating the aforementioned functions and processes in managing Shariah non-compliance risks. Both function and process components exhibit a mean score of slightly less than 4.000, indicating only a moderate level of effective Shariah risk management.

The results shown in Table 3 highlight the function component as the primary factor influencing the effectiveness of Shariah risk management compared to the process component. This is supported by the computed average score of 3.903. The findings indicate that a significant number of IFIs have successfully integrated the function of Shariah risk management into the IFI's overall risk management framework in accordance with the requirements of the SGF and SGPD (Bank Negara Malaysia, 2019). Additionally, it highlights that IFIs have incorporated the Shariah element within enterprise risk management to examine, measure, control, as well as monitor Shariah non-compliance risks in the business operations and activities of IFIs (Ariffin, 2022). This measure contributes to ensuring a comprehensive level of adherence to Shariah regulations and principles.

When scrutinising the ranking of each IFI, it is evident from Table 3 that four IFIs attained exceptional performance with an overall mean score of 5.00. Three of these IFIs are Islamic banks (IB6, IB8, IB12), while the fourth is a Takaful operator (TO7). According to the research findings, these IFIs have achieved exceptionally high average scores in all aspects of Shariah risk management. This achievement can be attributed to the strong dedication of these IFIs in enhancing the effectiveness of their Shariah risk management, which has significantly improved their capacity to manage Shariah-related risks.

As mentioned in the annual report, IB6, a full-fledged IB, had already established its own Shariah governance framework to establish Shariah compliance before the initial issuance of SGF in 2010 (Bank Negara Malaysia, 2010). This highlights that the Board of Directors, as well as senior management of IB6, have continuously promoted a culture of Shariah compliance and created a clear pathway for implementing an effective Shariah risk management system that guarantees adherence to Shariah principles at all levels (Ab Ghani, 2025). By establishing a robust function and process, IB6 has built a solid foundation for promoting individual accountability, facilitating the evaluation of Shariah non-compliance risks, effective Shariah risk management, and continuous monitoring of Shariah-related issues. The commitment of IB6 towards developing a Shariah compliance culture and its distinguished function as a full-fledged IB could have contributed to the outstanding level of effective Shariah risk management (Chapra & Ahmad, 2002; Hassan & Christopher, 2005).

Furthermore, IB8 and IB12 rank among the largest Islamic banks in Malaysia, having been founded as Islamic subsidiaries of local conventional banks. Likewise, TO7 is one of the largest Takaful operators, established as a joint venture company with partial ownership by its parent company, which is headquartered in the United Kingdom. As prominent and sizeable Islamic banks and Takaful operators in the nation, they already have access to best practices and successful examples of a well-structured risk management framework within their conventional parent company. Hence, these Islamic banks and Takaful operators merely need to modify their existing risk management frameworks by incorporating the Shariah risk management component to conform to the particular characteristics of Islamic banking activities and Takaful operations. Additionally, they should establish a robust mechanism to ensure adherence to Shariah principles. The results also suggest that these Islamic banks and Takaful operators may possess adequate resources to develop an optimal organizational structure for Shariah control functions, implement a thorough Shariah risk management system to effectively address Shariah non-compliance risks, and leverage existing technology to establish initiatives that align with Shariah-compliant objectives (Wan Abdullah, Percy, & Stewart, 2015).

However, this study found that DFI2 is the only Islamic banking business in DFIs that obtained an ineffective score in Shariah risk management, as stated by the mean score of 2.85 in Table 3. It is crucial to emphasise that the process used in Shariah risk management significantly impacts the outcomes achieved. The inefficiency in Shariah risk management may stem from adopting risk mitigation techniques that resemble those of conventional financial institutions (Ariffin et al., 2009; Rosman & Rahman, 2013). Rosman and Rahman (2013) also argued that only a few Islamic Financial Institutions employ dedicated Shariah non-compliance risk mitigation techniques in managing Shariah non-compliance risks. This indicates that there is still a deficiency in the process of Shariah risk management within DFI2, despite the recognition that Shariah non-compliance risks are of utmost importance relative to other risk categories.

Similarly, this study also revealed that IB11 achieved the lowest score among the 39 IFIs, indicating ineffective Shariah risk management. According to the results presented in Table 3, the function and process of Shariah risk management in IB11 indicate a relatively low mean score of 2.20 and 2.25, respectively. IB11 is a full-fledged foreign Islamic bank established in Malaysia. The lower outcome in IB11 is probably because it must comply with additional regulatory requirements from its native country, in addition to the SGPD mandated by BNM in Malaysia (Abozaid & Khateeb, 2024). In this respect, IB11 might be focusing more on its compliance with the diverse Shariah governance regulations and jurisdictions in GCC countries as mandated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (Alkhamees, 2013; Hasan, 2011; Shafii, Zainal Abidin, & Salleh, 2015; Yussof, 2013). Furthermore, IB11 could have embraced a self-regulatory approach in its Shariah governance paradigm, which differs from the SGPD (Yussof, 2013). Specifically, the Shariah Supervisory Board (SSB) oversees voluntary management with regard to Shariah non-compliance risks for services as well as products in IBs (Alkhamees, 2013). Hence, IB11 may allocate fewer resources to establish effective Shariah risk management mandated by BNM through SGPD due to increased demands from the parent in their home country.

Table 3. Ranking profile of the effectiveness of Shariah risk management in IFIs in Malaysia.

Islamic financial institutions	Components of Shariah risk management		Total	Ranking	Range	Total
	Function	Process				
IB6	5.00	5.00	5.00	1	5.00 (Highly effective)	4
IB8	5.00	5.00	5.00	1		
IB12	5.00	5.00	5.00	1		
TO7	5.00	5.00	5.00	1		
IWCB3	4.80	5.00	4.92	2	4.00–4.99 (Effective)	17
IB14	4.80	5.00	4.92	2		
TO4	4.60	4.88	4.77	3		
IWIB3	4.80	4.50	4.62	4		
TO1	4.20	4.38	4.31	5		
TO9	4.20	4.13	4.31	5		
IWCB5	4.20	4.13	4.15	6		
IWCB6	4.20	4.00	4.08	7		
IB4	4.20	4.00	4.08	7		
TO5	4.00	4.13	4.08	7		
IWCB1	4.00	4.00	4.00	8		
IWCB4	4.00	4.00	4.00	8		
IB15	4.00	4.00	4.00	8		

Islamic financial institutions	Components of Shariah risk management		Total	Ranking	Range	Total
	Function	Process				
DFI1	4.00	4.00	4.00	8		
DFI6	4.00	4.00	4.00	8		
TO8	4.00	4.00	4.00	8		
TO10	4.00	4.00	4.00	8		
IB9	4.00	3.88	3.92	9	3.00–3.99 (Somewhat effective)	12
IB2	3.80	3.88	3.85	10		
IB13	3.60	3.88	3.77	11		
IB7	3.40	3.88	3.69	12		
DFI3	3.60	3.63	3.62	13		
TO3	3.60	3.63	3.62	13		
TO7	3.80	3.38	3.54	14		
DFI5	3.60	3.50	3.54	14		
IB16	3.00	3.75	3.46	15		
IB1	3.20	3.25	3.23	16		
IWIB1	3.00	3.38	3.23	16		
RTO1	3.40	2.88	3.08	17		
IWCB7	3.80	2.38	2.92	18	2.00–2.99 (Ineffective)	6
DFI2	3.40	2.50	2.85	19		
TO2	2.60	3.00	2.85	19		
TO11	3.40	2.50	2.85	19		
RTO3	2.80	2.50	2.62	20		
IB11	2.20	2.25	2.23	21		
Total means score	3.903	3.856	3.874			39

5. CONCLUSION

In conclusion, this study emphasizes the critical need for all Islamic Financial Institutions (IFIs) to implement effective Shariah risk management. The effectiveness of Shariah risk management depends on the extent to which IFIs can establish a standardized framework for addressing risks related to non-compliance with Shariah principles. The Shariah risk management framework must include examination, assessment, monitoring, and mitigation of Shariah non-compliance risks to prevent their occurrence. The research findings indicate that most IFIs, particularly Islamic Banks (IBs) and Takaful Operators (TOs), have effectively established a robust Shariah risk management function and process to address non-compliance risks related to Shariah principles. However, the implementation of effective Shariah risk management within Islamic banking windows, Islamic banking operations in Development Financial Institutions (DFIs), and Regulatory Takaful Operators (RTOs) still has room for improvement. Enhancing these practices is essential for mitigating potential risks and achieving Shariah compliance objectives.

The effectiveness of Shariah risk management in Islamic Banks (IBs) and Takaful Operators (TOs) is largely attributable to their strong adherence to Shariah principles within their corporate cultures and the presence of well-established Shariah risk management frameworks within their parent companies. Additionally, the inherently elevated nature of Takaful operations may have contributed to the superior level of Shariah risk management observed in Malaysian TOs. These Islamic Financial Institutions (IFIs) have been able to achieve their Shariah compliance objectives and reduce risks associated with Shariah non-compliance principles as a result of a supportive leadership culture that fosters a Shariah-compliant environment. These successful strategies could serve as models for other IFIs seeking to establish effective Shariah risk management and enhance their accountability in addressing Shariah non-compliance risks. In addition, the effectiveness of Shariah risk management in Malaysian Islamic Financial Institutions (IFIs) is largely influenced by the significant role of a two-tier Shariah governance oversight from the institutional and regulatory levels. IFIs in Malaysia are fully guided by the comprehensive structures and procedures outlined by the Shariah Governance Policy Document (SGPD) to determine the Shariah risk management function in managing Shariah non-compliance risks. Without this centralised Shariah governance structure, the IFIs in Malaysia could have established different Shariah governance practices. This study emphasizes the importance of a dedicated Shariah risk management framework or techniques for mitigating Shariah non-compliance risks as systematic guidance for managing such risks. The absence of specific measures to address Shariah non-compliance risks could be a significant factor contributing to the ineffectiveness of Shariah risk management in Malaysian Islamic Financial Institutions (IFIs). Although these institutions may have effective risk management systems for other risk types, managing Shariah non-compliance risks requires a proactive approach to prevent such non-compliance. These risks should be managed in relation to Islamic financial services, products, and across all levels of the IFI's business operations. These findings have several important policy implications for regulators, industry practitioners, and IFIs. First, BNM should consider developing more targeted regulatory frameworks that address the specific needs of Islamic banking windows, DFIs, and RTOs, which this study identified as lagging in establishing effective Shariah risk management. This could include implementing a phased approach to Shariah risk management adoption that accounts for the varying levels of institutional maturity and resources among different types of IFIs. Second, regulators should mandate periodic independent assessments of Shariah risk management effectiveness across all IFIs, with results benchmarked against industry standards. These assessments would promote transparency and accountability while identifying specific areas for improvement. The study also recommends establishing a centralized repository of best practices based on the successful models observed in IBs and TOs, which could serve as a resource for institutions seeking to enhance their effective implementation of Shariah risk management. Third, industry associations should develop standardized templates and toolkits for Shariah non-compliance risk identification and mitigation, particularly designed for smaller IFIs that may lack the resources to develop comprehensive frameworks independently.

In practical terms, the research findings contribute to strengthening the accountability and integrity of IFIs in establishing a clear path toward creating a strong corporate culture that prioritizes adherence to Shariah principles in product development, marketing strategies, business operations, risk management practices, and other aspects, aiming to maintain Shariah compliance throughout the entire process. Consequently, implementing these control functions will lead to a more seamless incorporation of Shariah principles into the daily operations of IFIs.

The findings from this study also offer significant contributions to international Islamic finance practices, particularly for countries developing or refining their Shariah governance frameworks. For emerging Islamic finance markets such as Africa, Central Asia, and Southeast Asia, Malaysia's two-tier Shariah governance model provides a proven framework that balances institutional flexibility with regulatory oversight. For countries with decentralized Shariah governance systems like Saudi Arabia, Kuwait, and Turkey, the findings from this study highlight the potential benefits of increased regulatory standardization. The effectiveness demonstrated by Malaysian IBs and TOs offers compelling evidence for a more structured approach to Shariah non-compliance risk management, even in markets that prioritize institutional flexibility. The identified best practices from Malaysian IFIs offer operational benchmarks that can be adapted to diverse regulatory environments while maintaining consistency in Shariah compliance standards. This is particularly valuable for IFIs expanding into new markets where Shariah governance frameworks may be less developed.

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Transparency: The authors state that the manuscript is honest, truthful, and transparent, that no key aspects of the investigation have been omitted, and that any differences from the study as planned have been clarified. This study followed all writing ethics.
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