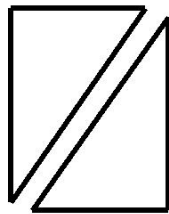




Technical Notes on Risk Management for Zakat Institution

November 2017



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This document does not represent the stance of BAZNAS or Bank Indonesia or IRTI – IDB. All opinions and any mistakes found are of the authors' responsibility.

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² The Glossary and Appendix will be added to this draft later on.

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Bismillāhirrahmānirrahīm.

Allāhumma ṣalli wasallim `alā Sayyidinā Muhammad wa`alā ālihi waṣahbihi

“And you see the mountains, thinking them rigid, while they will pass as the passing of clouds. (It is) the work of Allah, who perfected all things. Indeed, He is Acquainted with that which you do.” (Q.S. An-Naml 27:88)

The Messenger of Allah p.b.u.h. said: “Allah loves someone who when works, he performs it in perfect manner.” (Narrated by al-Bayhaqi 5312; Musnad Abu Ya’la 4386; aṭ-Ṭabrani in al-Mu’jam al-Awsaṭ 897)

“(He) who created death and life to test you (as to) which of you is best in deed – and He is the Exalted in Might, the Forgiving. (Q.S. al-Mulk 67:2)

The Messenger of Allah p.b.u.h. said: “Verily Allah has prescribed *ihsan* (proficiency, perfection) in all things.” (Narrated by Muslim 1955; Ibn Mājah 3170; Abu Dāwūd 2817; At-Tirmidhi 1409; An-Nasā’i 4479)

A. INTRODUCTION

Background

1. The International Working Group on Zakat Core Principles, in an effort to guide zakat towards an effective and efficient zakat operation, published a consultative document for Zakat Core Principles (ZCP) which was officially launched on May 23-24, 2016 during the UN Humanitarian Summit in Istanbul, Turkey. The document, Core Principles for Effective Zakat Supervision, provides a brief description about the foundation of zakat operations and system. Also, the ZCP covers all regulatory aspects relating to the zakat that promote effective zakat operations.
2. In the Core Principles for Effective Zakat Supervision, the major issues in zakat were identified and grouped into six main themes: (a) legal foundations; (b) zakat supervision; (c) zakat governance; (d) intermediary function; (e) risk management; and (f) *Sharī’ah* governance. These themes in zakat management require further research and guidance from the regulatory perspective.
3. This technical note is intended to establish standards and guidelines in the area of risk management⁴, for the direction and guidance of zakat institutions as well as zakat supervisors. This document discusses how management of risks inherent in zakat institutions should be implemented.

⁴ ZCP-11 to ZCP-14 elaborates the guidance for zakat supervisory authorities and zakat institutions with regard four types of risk exposures. [Risk Management, page 33 of Core Principles for Effective Zakat Supervision]

General Principle

4. Following the approach taken by the ZCP, this document sets out minimum standards to be applied in zakat institutions in order to bring the zakat instrument to the desired level of effective supervision and regulation.
5. This technical note has been designed to articulate principles that may be applied to a variety of circumstances, and does not prescribe specific quantitative standards. This is for practical reasons; differences in the various zakat institutions and their environments, as well as differences in their operational frameworks, mean that a detailed prescription that might be calibrated to suit one entity would not necessarily be suitable for others.

Main Objectives

6. The principles and recommendations set forth in this document are intended to achieve the following main objectives:
 - a. to help understand the risks to which a zakat institution is exposed;
 - b. to provide minimum standards for the development of a risk management framework for ease of management of the zakat institution and supervision by its governing bodies and supervisory authorities; and
 - c. to help create a safe and prudent environment for the growth, sustainability and development of the zakat instrument.

Scope of Application

7. This technical note is applicable to all zakat institutions. This technical note focuses on the risk management principles of zakat institutions. Similar considerations may apply where a zakat institution has branch operations in different jurisdictions. Due regard should be given to risk management considerations that are specific to a particular branch or subsidiary operation.

Specificities of Zakat Institutions Relevant to Risk Management

8. A zakat institution aims to uphold the principles of *Sharī'ah* in providing the risk management. The application of *Sharī'ah* principles is therefore fundamental to the operation of the zakat institution, and it should have a *Sharī'ah* Board/Committee to assist it in ensuring that these principles are upheld.
9. In similar vein to financial institutions, zakat institutions are also exposed towards various risks. Nevertheless, the type of risk exposures faced by zakat institutions is different from financial institutions due to the distinct operations between those two institutions. As risks are still arising in zakat institutions, risks identification, measurement, and mitigation are needed to have sound zakat institutions operating in Muslim countries and Muslim-minority countries.

B. RISKS ON ZAKAT INSTITUTION

International Standards on Risk Management for Zakat Institution

10. There are no international standards on risk management in zakat yet. However, significant contributions have been made regarding to this matter. One of the efforts is the consultative document of Zakat Core Principles (ZCP) prepared jointly by the National Board of Zakat of the Republic of Indonesia (BAZNAS) and the Central Bank of the Republic of Indonesia. It provides guidance on risk management, as part of core principles of effective zakat supervision. ZCP emphasizes types of risk and functions of risk management in general. A specific guidance related on risk management is covered on ZCP 11 – 14.
11. The supplementary requirements in respect of risk management requirements for zakat institutions establish a framework for that activity, including requirements for control, risk management, compliance, internal audit functions, operating within an enterprise risk framework that relates the zakat institution's risk management activities to the nature, scale and complexity of its operations, supported by policies and processes for identifying, assessing, monitoring, managing and reporting on risks. The standards set out in this technical note follow a similar approach, although with modifications to reflect the context of zakat.

Risks Specific to Zakat Institutions

12. Some of the risks to which a zakat institution is exposed are similar to other financial institutions, including operational risk and reputation risk. Certain risks, on the other hand, are specific to zakat operations. These include *Sharī'ah* compliant risk, allocation/ disbursement risk, and country and transfer risk.
13. The structure of this technical note applies the contemporary structure of the document of IFSB-1: *Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services* that has been internationally accepted with necessary adjustments in certain aspects representing zakat operations. The following paragraphs cover Zakat Core Principle 11 – Zakat Core Principle 14. These principles elaborate the guidance for zakat supervisor and zakat institutions with regard four types of risk exposures.

14. Country and Transfer Risk – (ZCP 11)

Definition

Country risk refers to all of the uncertainties arising from the economic, social and political conditions in a country. Transfer risk is one facet of country risk and refers more narrowly to the risk related to the impact of devaluation and other factors that affect the overall availability of foreign exchange.

- (i) As cross-country transactions become imminent in line with globalization, country and transfer risk is unhindered for zakat institutions as they may transfer the zakat funds into another country for charitable purposes. Generally, the wealthier countries transfer the zakat funds in good faith to the less wealthy country as zakat funds are still remaining in the wealthier countries after completion of zakat disbursement to *ashnāfs*. Due to that reason, zakat institutions are exposed to country and transfer risk.
- (ii) ZCP – 11 recommends 6 essential criteria and 1 additional criterion for managing country and transfer risk as presented in the Zakat Core Principles manuscript (Appendix 1).
- (iii) As stated in the **Exhibit 1** below, there are 8 types of country and transfer risk to be observed.

Exhibit 1 – Country and Transfer Constraint and Risk (The term risk is replaced by constraint)

| Type of Risk | Definition of Risk | Indicators |
|---|--|--|
| 1. Asymmetric information risk | The risk that arises due to inability of donor country to access confidential information from the recipient country (according to prevailing law in the respective country) and vice versa. | <ul style="list-style-type: none"> a) The existence of regulation on the confidentiality of information / data and official secrets Act; b) The existence of regulation on the citizen data confidentiality. c) The reluctance of national zakat authority to share data/ information; d) The absence of appropriate database system. |
| 2. Technical risk | The risk which is resulted from economic instability, monetary or financial crisis, the slowdown of the economy, and all changes due to macroeconomic changes. | <ul style="list-style-type: none"> a) The monetary or financial crisis that occur in the donor or recipient country; b) The global economic and/or financial crisis that influence the donor or recipient country; c) The economic slowdown of the donor or recipient country. |
| 3. Absence of <i>ashnāf</i> standard risk | The risk which is caused by the gap taking place between the donor and recipient countries with regard to different priority scale of the eight <i>ashnāf</i> due to an absence of international standards of <i>ashnāf</i> zakat. | <ul style="list-style-type: none"> a) The absence of zakat regulation or act to accommodate the <i>ashnāf</i> determination in the donor or recipient country; b) The different school of thought (<i>Madhhab</i>) in the donor or recipient country; c) The absence of international standard as the reference for ZIs in the donor and recipient country. |
| 4. Political conflict and diplomatic risk | The risk that is resulted from political disorder and high tension in diplomatic relationship between donor and recipient countries. | <ul style="list-style-type: none"> a) The existence of political instability in the donor or recipient country; b) The presence of domestic conflict in the donor or recipient country, such as war, terrorism, and riot; c) The absence of diplomatic relationship between the donor and recipient country. |
| 5. Legal system conflict risk | The risk that emerges as a result of inability to enforce different statutes, legislation, and regulations between countries that affect the fulfillment of agreements. | <ul style="list-style-type: none"> a) The absence of specific act regarding proper zakat management in the donor or recipient country; b) The conflict in the zakat implementation between the civil law and <i>Sharī'ah</i> law for zakat in the donor or recipient country; c) The different status of institution and/or authority in handling zakat management; d) The absence of international arbitration institution in the zakat system. |
| 6. Institutional risk | The risk which is caused by different types of zakat institution and their objectives in the implementation of zakat operation and system between the donor and recipient countries. | <ul style="list-style-type: none"> a) The absence of international arbitration institution in the zakat system; b) There is no regulatory framework or act that mandates the ZIs in the donor and/or recipient countries to execute zakat allocation programs; |

| | | |
|---|---|---|
| | | c) The existence of different institutional capacity and quality of the ZIs in the donor and/or recipient countries. |
| 7. Lack of co-operation risk | The risk that is resulted from minimum level of cooperation between the zakat donor and recipient countries and/or between the zakat institutions (ZIs) in the respective country. | a) The cooperation among ZIs has not been established yet in the donor and/or recipient countries; b) The communication gap among ZIs in the donor and/or recipient countries; c) The absence of ZIs in the recipient countries. |
| 8. Lack of international zakat management standard risk | The risk that is resulted from the absence of internationally accepted zakat management standard, including the zakat accounting reporting standard. | a) The absence of international standard in the donor and/or recipient countries; b) The absence of standardization of regulatory framework for zakat management; c) The absence of international accounting standard for the zakat institutions. |
| 9. Top management and authority risk | The risk that arises from different perception on terrorism, money laundering, and other global sensitive issues between government and zakat institutions and between donor countries and recipient countries. | a) The existence of legal standing and state policy on global sensitive issues between donor countries and recipient countries; b) The existence of different opinions and perceptions on global sensitive issues between government and zakat institutions in the same country. |
| 10. International criminal risk | The risk that is resulted from illegal, criminal and underground activities taking place at International level. | a) The lack of infrastructure and regulations on anti-money laundering, anti-terrorism financing, anti-human trafficking, and other illegal activities; b) The existence of unclear zakat beneficiaries and distribution programs in the recipient countries. |

15. Reputation Risk and Lack of Confidence – (ZCP 12)

Definition

Reputation risk is the risk arising from negative perception that can adversely affect a zakat institution's ability to maintain existing, or establish new, relationships with other parties.

- (i) Zakat institutions rely themselves to the public trust. The zakat payers, particularly in the countries that do not make zakat payment obligatory, have full freedom to determine zakat institution they want to pay their zakat to. Bad information about a particular zakat institution could potentially crush the public trust to that zakat institution.
- (ii) Reputation and lack of confidence risk may arise if zakat institutions fail to perform towards the expectations of stakeholders, manage zakat fund collected from *muzakkī*, and incompliant with domestic legal acts and zakat regulatory framework. This particular risk may cause zakat funds collections far below the optimal level if the risk is not well mitigated.
- (iii) ZCP – 12 recommends 6 essential criteria and 2 additional criteria for managing reputation risk and lack of confidence as presented in the Zakat Core Principles manuscript (Appendix 1).
- (iv) As presented in **Exhibit 2** below, there are 14 types of reputation risk and lack of confidence to be observed.

Exhibit 2 – Reputation Risk and Lack of Confidence

| Type of Risk | Definition of Risk | Indicators |
|---|---|--|
| 1. Vision, mission and objectives risks | The risks which emerge as the result of the lack of vision, mission and objectives. | <ul style="list-style-type: none"> a) The absence of vision, mission and objectives of ZIs; b) The unclarity of vision, mission and objectives of ZIs; c) The vision, mission and objectives are unmeasurable; d) The vision, mission and objectives are unrelated; e) The lack of infrastructures and facilities to achieve those vision, mission and objectives. |
| 2. Lack of education and awareness risk | The risk due to low level of zakat literacy which leads to deficiency of zakat education and awareness programs to public, government and internal ZIs. | <ul style="list-style-type: none"> a) The low understanding on zakat concept by the public, the government and the ZIs; b) Low levels of public awareness in paying zakat through <i>Āmil</i> institutions; c) Weak of education and socialization of <i>zakat</i> by the government and other stakeholders so that <i>zakat</i> is less than optimal; d) Minimum budget for zakat socialization and education; e) Low support from the government for the socialization and education on zakat program; f) The parties who are responsible for the socialization and education are still vague. |

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| 3. Reputation risk | The risk faced by ZIs that is resulted from the failure to meet stakeholders' expectation in performing zakat operations and management. | <ul style="list-style-type: none"> a) Inability of ZIs to collect, manage and allocate zakat fund properly and effectively; b) Inability of ZIs to report and comply with the prevailing regulation and <i>Sharī'ah</i> rules; c) The presence of conflict of interest between the ZIs and its stakeholders. |
| 4. Loss of trust risk | The risk of losing public confidence to the ZIs which leads to degradation of institutional credibility. | <ul style="list-style-type: none"> a) Inability of zakat institutions to handle reputation risk and stakeholders' dissatisfaction; b) The presence of violation of criminal law that leads to severe legal penalty. |
| 5. Reporting system failure risk | The risk that is resulted from the absence of periodic report to the <i>muzakkī</i> and public as part of transparency and accountability. | <ul style="list-style-type: none"> a) The lack of data collection and documentation; b) The weakness in information management system of ZIs; c) Lack of openness and transparency of information accessible to the public; d) The presence of unaudited financial reports of ZIs; e) Inefficient bureaucracy for financial reporting; f) The lack of accounting standard of reporting. |
| 6. Leadership risk | The risk which emerges as the result of ZIs leader's failure to fully understand and implement the vision and mission of the institution. | <ul style="list-style-type: none"> a) The weak leadership recruitment process in the ZIs; b) The incompetent leadership that leads to ineffective program of ZIs; c) The vagueness in leadership vision of ZIs; d) The presence of conflict between ZIs leader decision with ZIs mission. |
| 7. <i>Āmil</i> governance risk | The risk which is caused by improper <i>Āmil</i> governance conduct in the ZIs including ineffective <i>Āmil</i> governance structures and requirements, zakat management, and abuse of code of conduct. | <ul style="list-style-type: none"> a) The weak governance policies within the zakat institutions; b) The absence of instruments to be applied as the indicators of good <i>Āmil</i> governance; c) The excess operating expenses in ZIs which violates the standards set by the <i>Sharī'ah</i> rules and prevailing law; d) The incompetency and failure of the highest management body to control entire governance structure and system of zakat institutions. |
| 8. Lack of crisis mitigation risk | The vulnerability of ZI in the exposure of risk due to the failure of zakat system caused by the absence/lack of a sound mitigation system and crisis management protocol. | <ul style="list-style-type: none"> a) The absence of crisis management protocol in ZI; b) The lack of/ineffective crisis management protocol in ZI. |
| 9. <i>Muzakkī</i> loss risk | The risk which emerges as failure un ZM in maintain the <i>muzakkī</i> and inability of ZI in maintaining existing individual and group | <ul style="list-style-type: none"> a) The inability of ZI in managing decreasing reputation; b) The non-compliance of zakat collection scheme with the regulation and <i>Sharī'ah</i>; |

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|---|---|---|
| | <i>muzakkī</i> , which could exposed to risk of losing the <i>muzakkī</i> caused by decreasing reputation, mismanagement, etc., as well as risk of low satisfaction of <i>muzakkī</i> caused by low <i>muzakkī</i> service quality. | c) The inability of ZI in handling and managing <i>muzakkī</i> 's complain. |
| 10. Accessibility of collection channel risk | The vulnerability of ZI in the exposure of risk due to limited channels utilized for zakat collection system, especially in the remote area. | a) The absence/lack of synergy between ZIs and Islamic financial institutions (IFI) in providing zakat payment channels; b) The absence/lack of IT and others technical support in zakat collection; c) The absence/lack of zakat pick-up service by ZI. |
| 11. Lack of collection performance indicator risk | The ZI does not have (or lack of) established zakat collection performance indicator, which is adequate, simple, reliable, and measurable. | a) The absence/lack of indicators and measurements of effective zakat collection; b) The absence/lack of an institutional structure responsible for measuring the indicators of zakat collection. |
| 12. Mismanagement of zakat authority risk | The vulnerability of ZI in the exposure of risk due to the lack of zakat regulation system. | a) The unclear division of authority and function of regulator and operator on the zakat operational system; b) The absence/lack of effective and efficient zakat monitoring system; c) The absence/lack of ZI's zakat supervision by the zakat supervisor/authority. |
| 13. Criminal risk | The risk of vandalism, theft, fraud, corruption, security lacking, and other criminal actions. | a) The violation of criminal and civil law in ZI; b) The abuse of authority in the management of zakat; c) The violation of criminal and civil law committed by external parties to ZI. |
| 14. Corporatization of ZIs risk | The vulnerability of ZI in the exposure of risk due to the establishment of related social and/or commercial enterprise as its subsidiary outside the core activities of zakat management. | a) The expansion of ZI to establish social and/or commercial subsidiary to support ZI's activities; b) The misuse of ZIS (Zakat, <i>Infāq</i> and <i>Ṣadaqah</i>) funds to establish social and/or commercial subsidiary, which does not comply to Islamic principles; c) The existence of conflict of interest in the ZI is establishing social and/or commercial subsidiary. |
| 15. <i>Āmil</i> institution risk | The risk which is caused by improper zakat activities in the <i>Āmil</i> institution. | a) The lack of capability of <i>Āmil</i> institution due to limited number of qualified <i>Āmil</i> officers; b) The presence of corruption and other illegal activities beyond the core activities of zakat institution. |
| 16. Adverse government policy risk | The condition when there is a contradiction between the government policy and the zakat practices. Also when there is a political disturbance which creates a failure to the zakat activities. | a) The existence of contradicting regulations on zakat management; b) The existence of excessive political intervention and disturbance. |

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| 17. Social media risk | The risk which is caused by the negative or misconception of zakat institution through the social media. | a) The lack of social media management; b) Insufficient number of <i>Āmil</i> officers responsible for social media management. |
|-----------------------|--|--|

16. Allocation Risk – (ZCP 13)

Definition

Allocation or disbursement risk is the risk of failure to meet zakat institution's obligation to disburse the zakat fund to the *ashnāf* in accordance to *Sharī'ah*.

- (i) A sound allocation or disbursement risk management oversees the financial position sound and misallocation mitigation. First, zakat institutions are institutions that also have financial obligation to meet in time. The financial obligations arise from its operational activities to make sure that its functions can be done effectively. A failure to meet its financial obligation may initiate dispute or claim by other parties that will potentially cause significant disruption to its operational sustainability. Second, mismatch allocation of disbursement needs to be mitigated by a comprehensive *ashnāf* measurement and a proper financial planning, recording and management.
- (ii) Disbursement risk arising in zakat institutions is akin to liquidity risk in financial position. This risk is present due to misallocation of zakat funds collections to disburse them to 8 *ashnāf* which leads to shortage of zakat funds to meet all financial obligations.
- (iii) ZCP – 13 recommends 5 essential criteria and 2 additional criteria for managing allocation risk as presented in the Zakat Core Principles manuscript (Appendix 1).
- (v) As outlined in **Exhibit 3**, there are 9 types of allocation risk to be observed.

Exhibit 3 – Allocation Risk

| Type of Risk | Definition of Risk | Indicators |
|--|---|---|
| 1. <i>Mustahiq</i> risk | To maintain excellent service to <i>mustahiq</i> . The inability of ZI in maintaining existing <i>mustahiq</i> , which could exposed to risk of losing the <i>mustahiq</i> caused by misidentification by ZI, death, accident, etc., as well as risk of low satisfaction of <i>mustahiq</i> caused by the ineffective bureaucracy system especially on the disbursement of zakat fund. | <ul style="list-style-type: none"> a) Inability of zakat program in reducing poverty level of <i>mustahiq</i> (the amount of poverty, the depth, the severity of poverty); b) The lack of ZI in providing satisfactory service to <i>mustahiq</i>; c) The absence/lack of accuracy in the <i>mustahiq</i> database; d) Ineffectiveness of zakat allocation program to meet the typology of <i>mustahiq</i>; e) The absence/lack of standard in determining <i>ashnāf</i> of zakat. |
| 2. Zakat disbursement risk | The lack of ZI in the allocation of zakat fund disbursement for consumptive purposes. | <ul style="list-style-type: none"> a) The absence/lack of proper identification of <i>mustahiq</i> for zakat-based consumptive program; b) The absence/lack of proper selection of zakat-based consumptive program for targeted <i>mustahiq</i>; c) The absence/lack of ZI in applying <i>al-hājjah al-māssah</i> (emergency needs) to determine zakat-based consumptive program. |
| 3. Zakat utilization risk | The vulnerability of ZI to misutilized and/or over utilized zakat funds for zakat-based productive program. | <ul style="list-style-type: none"> a) The absence/lack of proper identification of <i>mustahiq</i> for zakat-based productive program; b) The absence/lack of proper selection of zakat-based productive program for targeted <i>mustahiq</i>; c) The ignorance of <i>al-hājjah al-māssah</i> (emergency needs) in determining zakat-based productive program for <i>mustahiq</i>; d) The improper management for zakat empowerment programs. |
| 4. Allocation to Collection Ratio (ACR) risk | The lack of ZI in achieving the targeted ACR ratio set by the zakat supervisor. | <ul style="list-style-type: none"> a) The absence/lack of planning and execution of zakat allocation program; b) Inefficiency in zakat operational cost; c) Delays in the use of zakat funds for zakat allocation program due to various reasons, such as placement of zakat fund as temporary investment. |
| 5. Allocation speed risk | The lack of ZI in achieving the targeted distribution period (which should be less than one year) set by the zakat supervisor. | <ul style="list-style-type: none"> a) The absence/lack of planning and execution of zakat allocation program; b) The lack of HR capability responsible for zakat allocation process; c) Failure of ZI in prioritizing zakat allocation program. |
| 6. Partnership risk | The vulnerability of ZI in selecting partner for zakat allocation, where the partner | <ul style="list-style-type: none"> a) The absence/lack of standard criteria in selecting qualified partner to implement zakat allocation program; |

| | | |
|--|---|--|
| | could misallocate or breaches the contracts/agreements made by both parties. | <ul style="list-style-type: none"> b) The existence of conflict of interest in the ZI in selecting qualified partner for zakat allocation; c) The absence/lack of supervision and evaluation of partner for zakat allocation; d) The high level of ZI dependence on certain partners for zakat allocation. |
| 7. <i>Ashnāf</i> priority risk | The vulnerability of ZI to misallocate zakat based on <i>ashnāf</i> priority, since every ZI has its own authority to allocate the zakat fund, while the formulation to determine the <i>ashnāf</i> is not based on the socio-economic and environment condition. | <ul style="list-style-type: none"> a) The absence/lack of standard in determining <i>ashnāf</i> priority; b) The absence/lack of proper <i>mustahiq</i> identification for zakat-based consumptive and productive programs; c) The absence/lack of coordination between ZIs in zakat allocation; d) The lack of creativity and innovation to create zakat allocation program, which in line with the criteria <i>ashnāf</i>. |
| 8. Geographical distribution risk | The ZI does not have (or lack of) the capability to assess its targeted region causing failure in prioritizing zakat distribution based on the territorial needs. | <ul style="list-style-type: none"> a) The absence/lack of regional mapping for prioritizing zakat allocation; b) The absence/lack of coordination between ZI as well as between ZI and local authorities; c) The existence of differences in the determination of <i>ashnāf</i> and programs in different areas. |
| 9. Lack of allocation performance indicator risk | The ZI does not have (or lack of) established zakat allocation performance indicator, which is adequate, simple, reliable, and measurable. | <ul style="list-style-type: none"> a) The absence/lack of indicators and measurements of effective zakat allocation; b) The absence/lack of an institutional structure that is responsible for measuring the indicators of zakat allocation. |
| 10. Accessibility of distribution channel risk | The ZI does not have (or lack of) access to distribute the zakat funds through various channel. | <ul style="list-style-type: none"> a) The lack of proper logistical infrastructure to reach remote areas and/or targeted areas for zakat distribution; b) Insufficient number of <i>Āmil</i> officers responsible for distributing zakat to targeted areas and/or targeted recipients; c) The lack of IT system support for zakat distribution. |

17. Operational and Sharī'ah Compliant Risk – (ZCP 14)

Definition

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For zakat institutions, this also includes risk of loss resulting from *Sharī'ah* compliant.

- (i) In general, operational risk in zakat institutions may cover potential fraud, technical failure of the computer system, and any other factors that may disturb the institutions from its daily operations including *Sharī'ah* non-compliant aspect. In order to minimize potential fraud and potential *Sharī'ah* violation, the zakat institutions should be equipped with good governance structure to assure that responsibility and accountability are in place.
- (ii) Human error, inadequate IT system, improper strategy and governance structure, and any other operational disturbances may cause operational and *Sharī'ah* compliant risk. This risk has to be well anticipated with appropriate policies and procedures set by top level management of zakat institutions.
- (iii) ZCP 14 outlines 5 essential criteria and 1 additional criteria as presented in Zakat Core Principles manuscript (Appendix 1).
- (iv) As described in **Exhibit 4**, there are 16 types of operational and *Sharī'ah* compliant risk to be observed.

Exhibit 4 – Operational and *Shari'ah* Compliant Risk

| Type of Risk | Definition of Risk | Indicators |
|-------------------------------|--|---|
| 1. Financial institution risk | The lack of ZI in mitigating risk from the failure zakat's financial institution partners. | <ul style="list-style-type: none"> a) The failure of ZI in selecting financial institution partners (i.e. banks, rural banks, etc.); b) Troubles in ZI's financial institution partners (i.e. liquidity problem, bankruptcy, etc.). |
| 2. ICT system risk | The ZI does not have (or lack of) adequate, efficient and reliable IT system. | <ul style="list-style-type: none"> a) The absence/lack of supporting standardized ICT system; b) The lack of ICT infrastructure and network; c) The lack of ICT technological development adaptation by ZI; d) The occurrence of disturbance and damage to ZI's ICT system; e) Inappropriate ICT platform to the need of ZI's ICT system. |
| 3. Code of ethics risk | The ZI does not have (or lack of) code of ethics standards between <i>Āmil</i> and <i>mustahiq</i> , <i>Āmil</i> and <i>muzakkī</i> or <i>Āmil</i> and <i>Āmil</i> . | <ul style="list-style-type: none"> a) Low supervisory action to human resources in the ZI; b) No standardization on code of ethics of <i>Āmil</i>; c) Lack of law enforcement on the breach of code of ethics; d) The absence/lack of code of ethics standards for <i>Āmil</i>; e) The lack of <i>Āmil</i> supervision; f) The lack of enforcement on code of ethics violation. |
| 4. Accounting risk | The lack of unified and standardized accounting method for ZI. | <ul style="list-style-type: none"> a) The absence/lack of accounting standard for ZI; b) The lack of financial recording system of ZI; c) The lack of financial auditing system of ZI; d) Inefficiency in financial reporting bureaucracy. |
| 5. Natural Disaster risk | The lack of ZI in mitigating risk from natural disaster, such as unforeseen ground conditions, weather, earthquake, fire or explosion, flooding and etc. | <ul style="list-style-type: none"> a) The absence/lack of early warning system against potential natural disasters; b) The absence/lack of a comprehensive mapping of natural disaster areas; c) The absence/lack of disaster response system. |
| 6. Human resource risk | The ZI vulnerability due to human error, incompetence, ignorance, tiredness, communication ability, culture, and natural causes (i.e. death, sickness, accident). | <ul style="list-style-type: none"> a) The lack of people's interest to become <i>Āmil</i>; b) The lack of <i>Āmil</i>'s quality and quantity; c) The lack of human resource management system; d) The lack of <i>Āmil</i>'s understanding on zakat concept and related regulations on zakat; e) The lack of <i>Āmil</i>'s reward and corrective actions system due to limited budget. |

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| 7. Lack of operational performance indicator risk | The ZI does not have (or lack of) established zakat operational performance indicator, which is adequate, simple, reliable, and measurable. | <ul style="list-style-type: none"> a) The absence/lack of indicators and measurements of effective zakat operation; b) The absence/lack of an institutional structure that is responsible for measuring the indicators of zakat operation. |
| 8. Property risk | The lack of ZI in mitigating risk of losing the asset and property due to mismanagement, ignorance, wrong calculation and others. | <ul style="list-style-type: none"> a) The lack of ZI's ability in estimating the depreciation of their assets and properties; b) The high cost of maintenance and replacement of assets; c) The lack of ZI's asset management; d) The lack of mitigating the risk of damage and loss of assets. |
| 9. Lack of SOP (Standard Operational Procedure) or SOM (Standard Operational Management) risk | The ZI does not have (or lack of) adequate SOP and/or SOM. | <ul style="list-style-type: none"> a) The absence/lack of SOP and/or SOM; b) The lack of SOP and/or SOM implementation in ZI; c) The lack of SOP and/or SOM supervision and evaluation in ZI; d) The absence/lack of internal structure to supervise and evaluate the implementation of SOP and/or SOM in ZI; e) The absence of quality standard certificate, such as ISO certificate. |
| 10. Lack of proper planning risk | The ZI does not have (or lack of) proper planning process in strategic and operational levels. | <ul style="list-style-type: none"> a) The absence/lack of proper and well-documented program planning in ZI; b) The lack of ability to design program planning in ZI; c) The absence/lack of standard on proper program planning in ZI. |
| 11. Lack of database risk | The ZI does not have (or lack of) proper and well-developed database management system of <i>muzakkī</i> , <i>mustahiq</i> , institutions, regions and other aspects, which might disturb the operations especially on collecting and allocating the zakat fund. | <ul style="list-style-type: none"> a) The absence/lack of valid and reliable database system; b) The lack of database management system; c) The lack of ZI's human resources in managing the database system; d) The lack of ZI's database infrastructure. |
| 12. Managing volunteer risk | The lack of ZI in managing volunteers, including the process from hiring to terminating. | <ul style="list-style-type: none"> a) The lack of people's interest to participate as volunteer; b) The lack of volunteer's quality; c) The lack of volunteer management system; d) The lack of volunteer's understanding on zakat concept and related regulations on zakat; e) The lack of volunteer's reward and corrective actions system. |
| 13. Competition risk | The ZI has not been sufficiently competitive compare to other similar organizations. | <ul style="list-style-type: none"> a) The existence of competition among ZIs or between ZI and other charitable organizations; |

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| | | <ul style="list-style-type: none"> b) The existence of competition on popular programs among ZIs; c) The existence of negative campaign among ZIs or between ZI and other charitable organizations; d) The absence/lack of regulations on the competition among ZIs or between ZI and other charitable organizations. |
| 14. Institutional access risk | The ZI has not been able to cover all areas within the country. | <ul style="list-style-type: none"> a) The lack of ZI to cover all areas within the country; b) The lack of ZI branch, network, and infrastructure to cover all areas within the country; c) The lack of utilization of infrastructure and other institutional infrastructure (i.e. banks, educational institutions, etc.). |
| 15. <i>Sharī'ah</i> compliant risk | The ZI and partners institution fail to comply with <i>Sharī'ah</i> principles on its operation. The absence/lack of <i>Sharī'ah</i> supervisory board to ensure the operational process in line with <i>Sharī'ah</i> rules. | <ul style="list-style-type: none"> a) The absence of fatwas related to zakat management; b) The absence of fatwa authority on zakat management; c) The absence of legislations and/or MoA (Memorandum of Association) that accommodate the implementation of fatwas on zakat management; d) The absence of <i>Sharī'ah</i> compliance guidelines and <i>Sharī'ah</i> compliance audit guidelines; e) The absence of authorized institution to carry out <i>Sharī'ah</i> audit; f) The lack of internal <i>Sharī'ah</i> supervision on ZIs and partners institution; g) The lack of enforcement by related zakat authority or government on <i>Sharī'ah</i> compliance aspect; h) The lack of certification of agencies/organization that collecting zakat in Muslim minority countries. |
| 16. Regulatory compliant risk | The ZI fails to comply with the law, acts, local regulation and other relevant rules set by the authorities or government. | <ul style="list-style-type: none"> a) The absence of related zakat authority established by the specific Act on zakat; b) The incompleteness of related regulations and rules on zakat management; c) The lack of power vested by related zakat authority; d) The lack of supervision by related zakat authority or government on regulatory compliance aspect; e) The lack of enforcement by related zakat authority or government on regulatory compliance aspect. |
| 17. Supply chain and market access risk | The risk caused by the lack of procurement facilities and the distribution of activities related to the distribution of productive <i>zakat</i> . | <ul style="list-style-type: none"> a) The absence of raw material supply of <i>mustahiq</i> production; b) The absence of a distribution channel for the marketing of the produce of a <i>mustahiq</i> business; |

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| | | c) The existence of destructive market barriers by business cartels that have similar products that produced by <i>mustahiq</i> . |
| 17. Educational Risk | The risk caused by the low levels of <i>zakat</i> literacy in public. | a) Low levels of <i>zakat</i> knowledge in public; b) Low levels of public awareness in paying <i>zakat</i> through <i>Āmil</i> institutions; c) Lack of education and socialization of <i>zakat</i> by <i>Āmil</i> institutions; d) Weak of education and socialization of <i>zakat</i> by the government and other stakeholders so that <i>zakat</i> is less than optimal. |
| 18. Disruptive economy risk | Risk arises from disruptive economic developments. | a) The emergence of financial technology which disrupts the economy; b) The lack of adaptability of <i>zakat</i> institutions towards technological changes. |

18. Differences in perception of *Sharī'ah* compliance may arise from varying interpretations of *Fiqh al-'Ibādah* and *Fiqh al-Mu'āmalāt* by *Sharī'ah* scholars. What may be deemed permissible by one scholar or in one jurisdiction may be considered otherwise by a different scholar or in another jurisdiction. Complications may arise when a parent organization has several *zakat* institution subsidiaries in various jurisdictions or a *zakat* institution operates cross-border, particularly if some jurisdictions provide for rulings and enforcement by a national *Sharī'ah* Board/Committee or similar body while in other jurisdictions the responsibility remains that of individual *zakat* institutions' *Sharī'ah* board/ Committee.
19. The list of risks above is not exhaustive. There are various practices on *zakat* operation in terms of technical program on each *zakat* institutions. The economic environment of *zakat* is also subject to evolution, and risk management necessarily involves regular reassessment of the universe of risks, the appetite to take on those risks and the mechanisms for mitigation.

C. RISK MANAGEMENT FRAMEWORK

The General Framework

20. Like any organization, a zakat institution is exposed to risks that may affect its ability to achieve its objectives or even its continuing existence.
21. A zakat institution, in its capacity as manager of the zakat funds, should accordingly establish and review regularly a framework for managing the different risks of the zakat process. This framework, which is commonly described as an "enterprise risk management (ERM) framework", should be comprehensive in nature, dealing with all risks in the organization, and should formalize through a set of policies, consistently applied its process for managing risks and its governance related to risk.
22. Committee of Sponsoring Organizations of the Tread way Commission (COSO) defined ERM as a systematic and integrated approach to manage all risks facing an organization. Also, ERM focuses on board supervision, aiming to identify, evaluate, and manage all related risks in an integrated framework (Olson and Wu, 2008).
23. For the purpose of this document, this technical note uses the term Risk Management for Zakat Institutions (RMZI) as modified and extended version of ERM framework utilized for zakat sector.
24. A zakat institution should then reflect these policies in operational processes across the zakat management through design and implementation of controls, effective risk reporting, and systematic assessment of control compliance and adherence to policy.
25. The zakat supervisor should consider whether a zakat institution has an adequate risk management framework, with appropriate scope and embedded within an appropriate governance structure.
26. This technical note describes a basic structure for an effective risk management framework for a zakat institution. It acknowledges the diversity of zakat practice worldwide. It cannot prescribe a single framework to be used. Modifications and adaptations may be made by respective zakat institutions, subject where necessary to the approval of the local zakat supervisor and *fatāwa* council, to suit the circumstances of the zakat institutions.

Risk Policies and Processes

27. A zakat institution should clearly document its risk policies and processes within a risk management framework that is appropriate to the nature and scale of its activities, including the specificities of zakat operation and its *Sharī'ah* obligations.
28. Risk management policies cover formal statement of zakat institution's overall intentions and direction regarding risk management. Risk management policies should be established by the board of zakat institution and operationalized by the management officer or equivalent. It should be communicated to the *Āmil* and zakat management
29. Where risk management processes describe the systematic application of management policies, procedures and practices to the activities of communicating, consulting, establishing the context, and identifying, analyzing, evaluating, treating,

monitoring and reviewing risk. The zakat supervisory authority determines that zakat institutions have a comprehensive risk management process (including effective Board and top management) to identify, measure, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capacity in managing zakat in relation to macroeconomic conditions.

30. Risk management policies and processes should be developed in a manner consistent with the risk management framework, to provide clear guidance to the personnel within the zakat institution as to the approach to be adopted towards risks. These policies and processes should be further reviewed on a regular basis by the zakat institution.

Risk Identification

31. Risk identification is the process whereby a zakat institution considers and records all potential risks whose occurrence could have an impact on the sustainability of a zakat institution. Once a risk has been identified, it is entered onto the risk register.
32. By its nature, risk identification is a qualitative process requiring a zakat institution to consider what can go wrong in or with respect to its service operations, and risks may be identified from a number of sources. The coordination of risk identification is normally the responsibility of a dedicated risk function. The process is likely to involve consulting those responsible for managing the various functions of zakat institution, obtaining their input as to the risks that relate to those functions based on their current and previous experience. The process should have a careful and professional approach, attempting to consider all foreseeable circumstances and their implications, indirect as well as direct.
33. A zakat institution should have processes in place to ensure that it considers the possibility of new risks emerging in the environment. The identification of new sources of uncertainty may result in a need for changes to the undertaking's processes and controls.
34. The risk management framework should include a risk register. This risk register serves as a master list of the risks identified by the zakat institution, quantification where relevant, and the extent to which the risks have been managed and mitigated. The risk register should be reviewed periodically and updated promptly for changes of which a zakat institution becomes aware.
35. The risk register should at a minimum contain the following information:
- (i) The date the risk is identified
 - (ii) Type, description and source of risks
 - (iii) Risk owner
 - (iv) Likelihood of occurrence
 - (v) The severity of occurrence
 - Qualitative impact
 - Quantitative impact
 - (vi) Mitigation steps
 - (vii) Status of the risks
 - (viii) Correlated risks
 - (ix) Level of concentration

Risk Assessment, Response and Control

36. Following the risk identification process, each identified risk will be assessed. A zakat institution should have a process for estimating, for each risk, the probability that it will occur, the likely consequences if it does so, when it could occur, and the possible means of avoiding, and mitigating. This process may commence at the same time as risk identification, as those who identify a risk frequently contribute to its assessment.
37. Assessment includes the process of risk categorization, by which risks are grouped into categories that are relevant to a zakat institution and to its services. Risks could, for example, be classified by their type (country and transfer risk, reputation risk and lack of confidence, allocation risk, operational and *Sharī'ah* compliant risk) and by whether they are quantifiable or not.
38. The measurement of risks, as to their probability, impact and timing, and the selection of potential mitigating actions, should be performed by top level management who are appropriately skilled and according to a process that is consistent with the risk appetite of a zakat institution and using parameters that are consistent as between risks. Advice should be obtained where relevant, including from external advisers where the necessary skills are not present within a zakat institution. The measurement and selection should be recorded and subject to review before approval. Risks that may be introduced by proposed mitigates (e.g. *Sharī'ah* non-compliance risk, operational risk, or any other risks that may disturb a zakat institution) should also be included for assessment.
39. A zakat institution should determine its response to each identified risk, commensurate with its risk appetite – that is, whether to avoid the risk, or to accept it but mitigate it by means of limitation, that is *Sharī'ah* compliant and should consult their *Sharī'ah* Board/Committee (if any) where a proposed response may involve questions of *Sharī'ah* compliance.
40. A zakat institution's decisions on responses to risks should be reflected in a set of risk policies, documented and approved by the Board of Executives. The risk policies provide the framework within which the services should be conducted and the controls should be designed. Risk policies should be recorded and implemented in a manner that facilitates their ready understanding and application in the operations of zakat institution. For example, a high-level policy on collection and allocation might be supplemented by detailed underwriting standards in the form of a manual.

Control Framework

41. A zakat institution should establish and maintain a control framework that reflects the risk policies adopted. The purpose of an internal control framework is to provide assurance at all levels of management that daily operations are being adhered to, and ultimately to enable the board to determine that the undertaking is following the approved strategy and risk appetite, agreed policies and processes, and applicable laws and regulations.
42. Controls should cover a zakat institution's key activities. Controls should be designed and implemented having regard to the expected incidence of the risk in question so as to provide reasonable assurance that breach of the approved policy in respect of that risk will be either prevented from occurring or detected in a sufficiently timely manner to permit its remediation without material or non-material impact on zakat institution.
43. Controls may be manual or automated. In a properly controlled IT environment, automated controls can be an efficient method of performing controls. However, a zakat institution should be aware of the risk of unwarranted reliance on automated controls or manual controls that are dependent on IT.

Risk Monitoring

44. A zakat institution should monitor the status of the risks that it has identified, through adequate management information systems. Relevant and measurable performance indicators should be identified for each risk, and should be monitored regularly. Performance indicators may be qualitative or quantitative. The information prepared for risk monitoring purposes should include information on all significant breaches of policy. Those responsible for monitoring the status of risks should receive risk information independently of operational management.
45. Where breaches of policy, or other evidence of risk occurrence, are identified, a zakat institution should examine the circumstances in order to determine whether such instances are symptomatic of weaknesses in its policies or procedures, and consider the need for revision of those policies or procedures.

Risk Reporting

46. A zakat institution should maintain a comprehensive reporting process for all the risks of the organization. The reporting process should cover all internal and external risk reporting requirements, including how relevant and reliable risk information is captured at the appropriate level of detail for each level of user, the Board of Executives, the *Shari'ah* Board/Committee (if any), and any required public or regulatory reporting.

D. THE SUPERVISORY REVIEW PROCESS OF RISK MANAGEMENT FOR ZAKAT INSTITUTIONS

46. As part of its activity in supervising zakat institutions, the zakat supervisor will normally review the risk management framework established by the zakat institution. Where necessary, the zakat supervisor may direct the zakat institution to strengthen its risk management framework.
47. It is not normally the responsibility of the zakat supervisor to give positive approval to a zakat institution's risk management framework. It is the responsibility of the Board of Executive in the zakat institution to ensure that an effective risk management system is established and operated, and to review its continuing effectiveness; however, the zakat supervisor should consider whether there is evidence that this responsibility is not being adequately discharged.
48. A zakat supervisor may pay particular attention to the following matters, among others.
- a. *Existence and Operation of a Framework.* Every zakat operator should have in place a risk management framework, established under the authority of the board of executive that provides clear upward and downward communication of risk issues and policies. The framework should be clearly documented and reflective of the processes that are actually carried out in the business. The zakat institution should be able to demonstrate that the framework is applicable in the zakat operation, and is not merely in existence to satisfy a regulatory requirement.
 - b. *Effectiveness of Risk Management Processes.* The existence of a framework does not guarantee its effectiveness. The zakat supervisor should consider the design of the framework, and such evidence as is available to demonstrate that the risk management processes are effective in operation. Methods available to the supervisor to assist in its assessment include on-site inspection and review of risk management report.
 - c. *Clarity of Shari'ah-Compliance Responsibilities.* The *Shari'ah* supervisory council or *fatāwa* council is responsible for the matters related to *Shari'ah* compliance risk. The zakat supervisor has no responsibility for *Shari'ah* supervision. However, the zakat supervisor might, for example, look for evidence of involvement in respect to help the *Shari'ah* supervisory council in the assessment of these risks, and of a process for testing controls over *Shari'ah* compliance.
 - d. *Supervisory Reporting.* The zakat supervisor should consider the implementation of formal requirements for zakat institutions to report to the zakat supervisor in respect of risk management. The frequency and scope of such reporting requirements may be responsive to the nature, scale and complexity of the zakat institution's operation. The zakat supervisor should consider whether reports should require independent external assessment.
49. If the zakat supervisor concludes that the risk management framework is deficient, the zakat supervisor should have the power to require the zakat institution to present a plan for remediation of such deficiencies, and to report to it on the implementation of that plan. Failure to present a plan that the zakat supervisor considers adequate to address the matters identified by it, or failure to implement such a plan to the satisfaction of the zakat supervisor, should be a reason for disciplinary action.

“We bind ourselves to the aforementioned statements in the service of humanity and for the pleasure of Allāh Subhānahu Wa Ta’āla. Allāh knows the best”

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