

Identifying the Determinants of the Shariah Non-Compliance Risk via Principal Axis Factoring

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Abstract : The objective of this study is to investigate the factors affecting the rise of Shariah non-compliance risk that can bring Islamic banks to succumb to monetary loss. Prior literatures have never analyzed such risk in details despite lots of it arguing on the validity of some Shariah compliance products. The Shariah non-compliance risk in this context is looking to the potentially failure of the facility to stand from the court test say that if the banks bring it to the court for compensation from the defaulted clients. The risk may also arise if the customers refuse to make the financing payments on the grounds of the validity of the contracts, for example, when relinquishing critical requirement of Islamic contract such as ownership, the risk that may lead the banks to suffer loss when the customer invalidate the contract through the court. The impact of Shariah non-compliance risk to Islamic banks is similar to that of legal risks faced by the conventional banks. Both resulted into monetary losses to the banks respectively. In conventional banking environment, losses can be in the forms of summons paid to the customers if they won the case. In banking environment, this normally can be in very huge amount. However, it is right to mention that for Islamic banks, the subsequent impact to them can be rigorously big because it will affect their reputation. If the customers do not perceive them to be Shariah compliant, they will take their money and bank it in other places. This paper provides new insights of risks faced by credit intensive Islamic banks by providing a new extension of knowledge with regards to the Shariah non-compliance risk by identifying its individual components that directly affecting the risk together with empirical evidences. Not limited to the Islamic banking fraternities, the regulators and policy makers should be able to use findings in this paper to evaluate the components of the Shariah non-compliance risk and make the necessary actions. The paper is written based on Malaysia's Islamic banking practices which may not directly related to other jurisdictions. Even though the focuses of this study is directly towards to the Bay Bithaman Ajil or popularly known as BBA (i.e. sale with deferred payments) financing modality, the result from this study may be applicable to other Islamic financing vehicles.

Keywords : Islamic banking, Islamic finance, Shariah Non-compliance risk, Bay Bithaman Ajil (BBA), principal axis factoring

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