

## APPLICATION OF TA'WIDH AND GHARAMAH IN ISLAMIC BANKING IN MALAYSIA

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### ABSTRACT

The objective of this paper is to explore the practical application of *ta'widh* and *gharamah* in Islamic banking in Malaysia with reference to the guidelines that are applicable to date; and find out the issues detected in the implementation of them. In the course of doing this, Shariah reasons for imposing *ta'widh* and *gharamah* in Islamic banking are discussed. Also, whether *ta'widh* and *gharamah* would be required for Islamic banking with reference to possible alternatives to them is also discussed. This qualitative study primarily focuses on library research and adopts case study approach for analyzing the application of *ta'widh* and *gharamah*. The jurisdiction of the study is Malaysia because the central bank of the country has made policies on the matter. The paper draws on observations made by Shariah scholars about the policies on the subject matter. This study gives an insight into the history and issues related to *ta'widh* and *gharamah* which are often kept tacit. It is recommended that future studies should look into the effectiveness of these two approaches to serve as a deterrent factor and contribute to the declining rate of non-performing financing in Islamic banks.

**Keywords:** *Gharamah*, Islamic banking, penalty, *Ta'widh*.

### INTRODUCTION

Prohibition of *riba* is unanimously regarded as the most fundamental factor that distinguishes Islamic finance from conventional finance. Preventing exploitation of interest-free financial transactions by delinquent debtors and upholding the prohibition of *riba* have presented a perennial challenge since the advent of modern Islamic finance industry. Even though there are significant operational changes in Islamic banking and these have given room for different sets of risks, the most common risk faced by Islamic banks is the default risk or credit risk (Ahmad, & Misman, 2012). However, to mitigate this risk, the challenges faced by Islamic banks are somewhat different from those of conventional banks in similar situation. Therefore, unlike the conventional banks, Islamic banks have an issue in charging a penalty for late payment of what is due as there are different views of shariah scholars on whether the charging of such penalty would amount to *riba* or not. As such, Islamic banks operating in different jurisdictions of the world act differently in this

regard according to their preferred juristic view. This research is an attempt to find out the position of late payment charges in Malaysian Islamic banking.

One of the criticisms against Islamic banks is that they “manipulate” and always find a way around Islamic tradition to “legalise” or make their business models and banking products approved by Islam. One of the issues under that sphere of criticism is regarding financial penalty or late payment charges which is said to be tantamount to *riba*. This late payment charge is one of the measures proposed by some Muslim jurists, other than imprisonment, to deal with the problem of delinquent debtors (Khan, 2013).

In today’s Islamic banking context, this financial penalty is recognised as late payment charges. The implementation of late payment charges in Islamic financial institutions in Malaysia, in the context of Bank Negara Malaysia (BNM) Guidelines on Late Payment Charges for Islamic Banking Institutions, comprises two elements, namely *ta’widh* and *gharamah*. *Ta’widh* is referred to as an amount that may be compensated to the Islamic Banking Institutions based on actual loss incurred due to default; while *gharamah* is defined as penalty charged on the defaulters over and above the *ta’widh* (Bank Negara Malaysia, 2011). On the other hand, BNM Shariah Resolutions in Islamic Finance, (Second Edition), defines *ta’widh* as a claim for compensation arising from actual loss suffered by the financier due to the delay in payment of financing/debt amount by the customer; while *gharamah* refers to penalty charges imposed for delay in financing/debt settlement, without the need to prove the actual loss suffered (Bank Negara Malaysia, 2010).

The Shariah Resolutions in Islamic Finance (Second Edition) explains the basis of the permissibility ruling for *ta’widh* and *gharamah* as delay in payment by the customer will produce harm to the Islamic financial institution as the financier as they suffer actual loss in term of incurring additional expenditure, such as cost for issuing notices and letters, legal fees and other related costs (Bank Negara Malaysia, 2010). Interestingly, it also explains that delayed payment by customer would cause difficulty to the financier to use the funds for other business purposes. This is actually an opportunity cost that results in *darar* to the financier.

The objective of this paper is to explore the practical application of *ta’widh* and *gharamah* in Islamic banking in Malaysia with reference to the applicable guidelines to date and find out the issues in the implementation of both including the kind of default by clients to warrant applying *ta’widh* and *gharamah* charges. In the course of doing this, Shariah reasons for imposing *ta’widh* and *gharamah* against defaulters in Islamic banking will be discussed. As to whether *ta’widh* and *gharamah* are required for Islamic banking, this issue will be examined with reference to the discussion on possible alternatives to both of them and in light of their practice in other jurisdiction.

This qualitative study primarily focuses on library research and adopts case study approach for analyzing the application of *ta’widh* and *gharamah*. The jurisdiction of the study is Malaysia because the central bank of the country has enacted policies on the matter. The paper draws on observations made by Shariah scholars and enacted policies on the subject matter.

This study gives an insight into the history and issues related to *ta’widh* and *gharamah* which is often kept tacit. It is recommended that future studies should look into the effectiveness of these two approaches to serve as a deterrent factor and contribute to the declining rate of non-performing financing in Islamic banks.

## **JURISTIC VIEWS ON CHARGING OF PENALTY FOR LATE PAYMENT**

In the early days of Islamic civilization, financial transactions used to be very limited, well-controlled and guided by Islamic principles. With little demand for new and innovative contracts, risk mitigations were then in small scales. As time went on, financial needs increased with growing innovations and challenges that require risk mitigations. Therefore, this leads to the practice of

inserting penalty conditions - “*syart jazaié*” - in contracts. A *syart jazaié* is a penalty clause in a contract that stipulates an agreed amount of money to be paid to a counterparty if the other counterparty is late in fulfilling a given contractual obligation. The very purpose and wisdom for that is that the parties should be held responsible upon entering into a contract and if found otherwise, they are to be penalized materially due to their negligence and irresponsibility (Muhammad, n.d).

In view of the foregoing, “*shart jazaié*” is considered to be one of the contemporary issues that cannot be directly related to a specific school of Islamic law. Accordingly, some classical jurists allow it (Uthmani, 2002) and this is the preferred view according to most contemporary jurists (Sheikh Abdur Rahman As-Sa’di, Sheikh Abdallah Ibn Bassam, Sheikh Abdallah Ibn Sulayman al-Mani, Abd al-Aziz Ibn Abdallah ibn Baz). Therefore, *shart jazaié* is a mechanism that is to be utilized based on the principles of each school of Islamic jurisprudence. This is due to the fact that jurists of the four classical schools of Islamic jurisprudence derive rulings based on their schools’ principles.

According to Shafie school of fiqh and a section of jurists from Hanafi school (Huraidi, 1986; Zuhayli, 2001), “*shart jazaié*” is not permissible because it is a condition and goes against a fundamental ruling that “condition” and “sale” cannot be put in one contract. In support of this view, they placed reliance upon a narration whereby the Prophet (pbuh) was reported to have prohibited a sale that is circumscribed with a condition (*bay ’wa shart*) (Kasani, n.d.). While majority of Hanafi jurists take an exception in allowing *bay ’wa shart* generally, the Shafies on the other hand do not allow it in any kind of circumstance as such. The Hanafi School therefore permits *Shart Jazaié* based on *istihsan* (juristic preference) in situations where it becomes a customary practice (Kamali, 2000).

Moreover, according to Maliki and Hanbali jurists, “*syart jazaié*” is permitted absolutely. This can be known by their outright and liberal stands on contractual condition (*shart*) generally (Samir, 2017). For instance, if a woman gives a condition in a marriage contract that the husband has to pay a certain amount of money, it becomes compulsory on the husband to follow and complete the condition. In commercial dealings, parties can stipulate as a condition for tailoring services to be undertaken that the tailor would be paid \$10 if he finishes the work in a week, but \$8 if more than a week. Therefore, in general, a condition is permissible in a contract as long as it does not permit the unlawful or prohibit what is lawful and it is willingly agreed upon by parties. (Al-Kasani, n.d.; Muhammad, n.d.; Huraidi, 1986).

On the basis of the foregoing discussions, some contemporary scholars (OIC Council of Fiqh Academy, 1992) agreed on the permissibility of stipulating late payment penalty or charges against defaulters in Islam. Among them are Syeikh Mustafa Al-Zarqa, Syeikh Muhammad Sadiq Ad-Dharir, Sheikh Abdullah Ibn Sulayman al-Mani’, Dr Zaharuddin Abd Rahman, Dr Abdul Sattar Abu Ghuddah as well as Abd al-Aziz Ibn Abdallah ibn Baz.

In furtherance of the permissibility viewpoint, Al-Zarqa’ as cited by Mahmood M. Sanusi, (Sanusi, n.d) mentioned that late payment penalty is allowed to compensate the creditor for his loss due to delinquency in repayment. Sanusi provides four justifications for his argument. Firstly, late payment of loan and financing without any excuse will cause harm to the creditors. The debtor is considered as an unjust person and is liable to pay all losses. Secondly, late payment without any excuse can also be reflected as devouring the benefit of property and can be categorized as *ghash*. Thirdly, the only way to compensate and remove any damage for delay in payment is through financial compensation. Finally, the punishment of a late payment penalty is focused on debtor with financial capability to compensate the loss. This penalty is essential to prevent any debtor from delaying repayment. At the same time, since no compensation fee is charged, it prevents injustice against an obedient debtor that fulfil his duty promptly.

Other jurists (Rahman, 2009) however, opined that the penalty fee must not form part of income of the creditor or financier, rather it should be channeled to charity. This opinion is similarly shared by Zaharuddin (2006) and Abdul Sattar Abu Ghuddah (2008). This is to avoid *riba* which can occur if the creditor or financier uses the penalty as his income. However, a third party can be involved on charitable basis as the beneficiary of the money (penalty fee) emanating from this transaction to address this issue. In practice, Islamic financial institutions maintain a charitable account into which the penalty fee is paid for this purpose. In this manner, then the problem of the money accruing as *riba* has been settled.

On the contrary, Sheikh Taqi Uthmani as cited in (Khan & Rahman, 2010) is of the view that late payment charges are impermissible based on the hadith,

"لي الواجد يحل عقوبته وعرضه"

"The delay in paying debt by the rich who has money makes dishonouring and punishing him permissible."  
(Sahih al-Bukhari, *hadith* no. 2400, vol.3, 185)

The learned mufti argues that this hadith does not contemplate financial punishment. Moreover, the punishment contemplated is to be decided by a judge (not by parties' pre-agreed arrangement) and where the fine or penalty that is imposed should be paid to the government. This view appears somewhat impracticable, given the modern system of government and the nature of the environment under which modern commerce and Islamic banks operate.

Based on the hadith above, the majority scholars (Abdallah Ibn Sulayman al-Mani', 2003) are of the view that it is permissible to charge compensation on a capable debtor that delays in repaying loan as the late payment brings injustice to the creditor.

However, Sheikh Taqi Uthmani (Uthmani, 2002) objects the opinion of majority of scholars under the justification that he believes that the Prophet did not mention financial charges or compensating creditor with money. In addition to that, Uthmani stressed further that there were no *muhaddithin* or *mufassirin* or Islamic scholars that clarify the punishment mentioned in the *hadith* as financial punishment. Even if any scholar clarifies the punishment, the fact that it is to be judged and meted out by a *hakim*, and not the creditor, needs not be overlooked. Another argument put forward by Sheikh Taqi Uthmani is based on the legal maxim usually cited by the other jurists to oppose monetary charges as late payment penalty,

"لا ضرر ولا ضرار"

Which means: No harm or reciprocation of harm.

He emphasises that while it is undeniable that one should not harm others, it is not necessary to eliminate the harm with financial punishment (Uthmani, 2002). Besides, the harm borne by the creditor is that he did not receive payment of debt within an agreed period. The only way to eliminate this harm is by giving him the exact amount of money owed without any addition to it, argues the learned sheikh, as any such addition is considered *riba*.

#### **REASON WHY TA'WIDH AND GHARAMAH ARE IMPOSED**

Tun Abdul Hamid (Mohamad, 2012), former Chief Justice of Malaysia, explained the history behind the implementation of *ta'widh* and *gharamah* in his remarkable writings. He mentioned that with the

development of Islamic banking since 1980s, customers began to default in payment obligations and civil suits were filed in courts. According to the erudite judge, in the initial years, Islamic banks did not ask the court to order for post-judgement monetary penalty and that made Islamic banks to be on the losing side. Such monetary penalty after judgment would have covered legal and related expenses in the process, including “loss incurred as a result of the delay in the settlement of the judgement debt”. His Lordship Tun Abdul Hamid equally drew attention to the fact that due to absence of post judgement penalty, Islamic bank clients delayed their settlement of judgement debts with the Islamic banks. Thus, the learned former Chief Justice then voiced concern about legalising penalty against default in paying judgement sum in Islamic financial services (Mohamad, Abdul Hamid, 2011). This is with view to creating a level playing field for Islamic banking institutions.

Subsequently, on 26<sup>th</sup> May 2005 and 24<sup>th</sup> August 2006, the Shariah Advisory Council (SAC) of Bank Negara Malaysia ruled out that “it is permissible for the Islamic banking institutions to get an order of compensation of up to 8 per cent of the judgement sum” but should only take an amount that is equal to their actual loss while the remaining is to be given to charity (Mohamad, 2012).

However, it is important to note that even before the Shariah Advisory Council ruling on judgement sum obtained in 2005/2006, there was already a Shariah Advisory Council ruling on the permissibility of *ta'widh* and *gharamah* issued at its meeting on 14<sup>th</sup> February 1998 (BNM Shariah Resolutions in Islamic Finance, 2010). At the same time; however, there were no uniformity in the implementation of late payment charges among the Islamic banks from that period. It was only after the issuance of the BNM guidelines in 2011 that the imposition of *ta'widh* and *gharamah* were streamlined (Salim & Abdullah, 2017). Late payment charge on judgement debts for cases involving Islamic banks is also sanctioned by order 42, rule 12 A, Rules of Court 2012 (Mohamad, 2012).

Apart from issues raised in disputes before courts (Kunhibava, 2016), the need to standardise and streamline the practice of late payment charges among Islamic banks was perhaps also due to the need to differentiate elements of *ta'widh* and *gharamah* from the calculation of *ibra'*. This was a prominent issue in default payment cases registered in courts during 2003-2009 (Dusuki, Khir & Muhammad, 2010; Yaacob, 2011).

## **CURRENT PRACTICE OF ISLAMIC BANKS TO DETER DEFAULT**

Risk management is one of the core component function of Islamic banks to deter default by customers and protect the institution from depleting its sources of deposits (Alamad, 2017). According to Muhammad Imran Ashraf Usmani (Usmani, 2012), in addition to other risks which conventional banks are typically exposed to such as credit risk, market risk, liquidity risk, operational risk, regulatory risk and reputation risk, an Islamic bank is exposed to additional risks such as Shariah non-compliance risk, process risk and counterparty risk, making “Islamic banking transactions riskier compared with the conventional banking transactions” (Usmani, 2012). Conventional banks “enjoy” leveraging on interest charges on late payment but Islamic banks do not and therefore is exposed to greater credit risk (Seho, Alaabed & Masih, 2016).

Credit risk mitigation of Islamic financial institutions in Malaysia is centred on Islamic Financial Services Board (IFSB) Guidelines based on international best practices. The IFSB in its December 2005 Guiding Principles of Risk Management (Islamic Financial Services Board, 2005) details out four principles in managing credit risk for IFIs. One of them is:

*Principle 2.4: IIFS shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.*

Under principle 2.4, the document states that IFIs shall detail out their risk mitigating techniques which shall include, among others, collateral and guarantees, and “a methodology for setting mark-up rates according to the risk rating of the counterparties, where expected risks should have been taken into account in the pricing decisions” (Islamic Financial Services Board, 2005)

Usmani (2012) outlines some of risk mitigation tools in Islamic banking as follows:

- a) Innovative collateral arrangements;
- b) Guarantees;
- c) Getting credit ratings of clients from credible institutions;
- d) Pricing that is able to cover all related risks; and
- e) Takaful coverage.

In practice, Islamic banks perform credit risk mitigation techniques during pre-approval process with “know your client policy”, “application scoring models” and application of records in Central Credit Reference Information System (CCRIS) similar to other similar financial institutions (Ashraf & Lahsasna, 2017).

Credit risk monitoring would then take place, among others, with credit and customer profiling and proactive monitoring (Bank Islam, 2013). Once an obligation payment due date lapsed, the collection and recovery department of the bank will send reminder either through a letter, short messaging system or an email before going into other collection approaches which may include legal proceeding, financial restructuring or external arrangement with Credit Counselling and Debt Management Agency Malaysia (Bank Islam, 2013).

It should be noted that another way in which Islamic banks mitigate risk is by way of applying Rule of 78, most popular under *ijarah*/lease financing (Alam & Rizvi, 2017). Under this rule, early repayments will involve more profit portion (or interest portion in conventional banking) than later monthly repayments. This is because should customers default in the early years, banks would still be able to recover some amount of profit apart from the principal amount. For house or land financing, although collaterals provided by virtue of the contracts allow Islamic banks to repossess and sell the underlying asset at current market price to cover losses, the market value of the fixed asset in the early years may not be sufficient to cover the outstanding amount as it would take years for the fixed asset to appreciate hence the principle of monthly repayment still follow the Rule of 78 (Comparehero, 2015).

Thus, based on risk premium/spread embedded in financing amount and also method of repayment, customers delay in repayment had actually been anticipated and priced into the financing facility.

## **PRACTICAL GUIDELINES ON TA'WIDH AND GHARAMAH**

Based on BNM Guidelines on Late Payment Charges for Islamic Banking Institutions (Bank Negara Malaysia, 2012) which came into effect on 1<sup>st</sup> January 2012, late payment charges are comprised of *ta'widh* and *gharamah*. Approval from Bank Negara Malaysia is required for an Islamic bank to impose maximum combined late payment charges (Bank Negara Malaysia, 2012). The guideline also states that the combined rate for late payment charges should not be more than “cost/interest borne by an equivalent customer under conventional finance” and that it should not be compounded (Bank Negara Malaysia, 2012). Refer **Figure 1**.

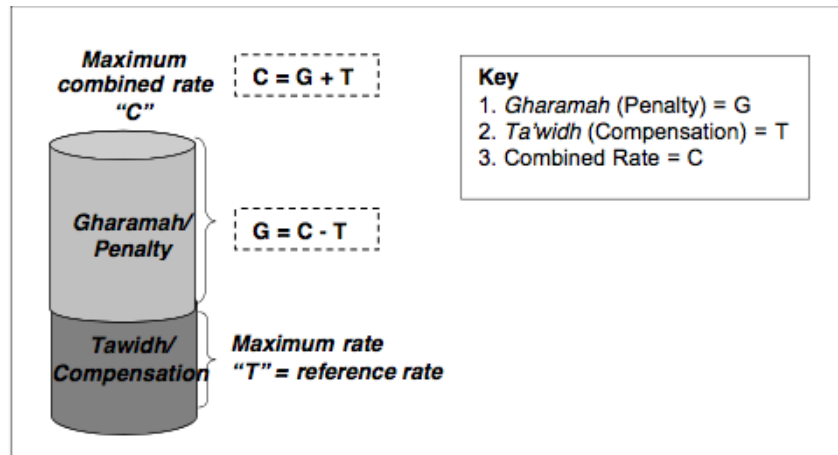


Figure 1: Late payment charge structure

Source: Bank Negara Malaysia guidelines on late payment charges for Islamic banking institutions

Few scenarios were drawn up for situations whereby *ta'widh* may apply as follows (BNM Guidelines on Late Payment Charges for Islamic Banking Institutions, 2012):

- (i) The actual loss to be compensated from any case of default payment (whether it is from overdue instalments or from outstanding balance that cause the entire facility to be recalled), from the date of payment until the maturity date shall not be more than 1% per annum;
- (ii) The actual loss to be charged from default payment that exceeded the maturity date shall not be more than the prevailing daily overnight Islamic Interbank rate (IIMM) on the outstanding balance of the Islamic financial product;
- (iii) The reference rate for the actual loss can be determined at the point of default, calculated on a monthly basis from the payment due date;
- (iv) The *ta'widh* shall be considered as income and can be included in the computation of profit distribution to depositors/investment income holders.

While *ta'widh* may be recognised as non-profit income to Islamic banks, *gharamah* is recognised as “other liabilities” and shall be utilised wholly for charitable purposes and not be invested by banks (Bank Negara Malaysia, 2012). In practice, it is found that most of the Islamic banks only implement *ta'widh* and not *gharamah* (Salim & Abdullah, 2017).

To compare the practical implementation of late payment charges between Malaysia and other countries, this paper will first look at fatwa issued by Dewan Syariah Nasional Indonesia, for example, regarding late payment charges. According to Dewan Syariah Nasional Indonesia (2004):

- a) *ta'widh* is imposed to delinquent debtor only;
- b) the creditor can be compensated based on the real loss that occurred and not with potential loss. Mode of repayment is by mutual consent of both parties;
- c) *ta'widh* can only be imposed on sale and lease-based transaction such as *salam*, *istisna'*, *murabahah* and *ijarah*. For profit sharing contract, *ta'widh* can only be imposed by a *rabbul mal* on the occasion that the investment made profit but the *rabbul mal* did not receive it;
- d) the penalty charge can be recognized as source of income to creditor.

Bank Indonesia (Central Bank of Indonesia), however, has not imposed any standard or guidelines regarding late payment charges yet. The practice of late payment charges therefore differs from one bank to another. Bank Negara Indonesia Syariah (BNI Syariah, 2016), for example, issued a policy that discontinues *gharamah* for both personal and corporate financing. Customers who delay in financing instalment payment is required to compensate the actual cost incurred by the bank in relation to the financing. Other banks such as Bank Muamalat Indonesia and Bank Mandiri have

different late payment charges with different percentage of payment, yet still using the same methodology whereby late payment charges will be calculated per day and can be negotiated with the debtor. This late payment charge is however treated under non-halal account (Dusuki, Khir, & Muhammad, 2010).

In Gulf countries such as Bahrain, Saudi Arabia and Jordan which follow the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards, they do not allow any stipulation of financial compensation by debtor as a penalty clause for his delay in settling debt (Mohammed, 2015). The debtor in default, however, shall bear all legal and other expenses incurred by the creditor in order to recover his debt. In addition to that, AAOIFI also provides for a non-financial punishment for debtor in default which is “name and shame” method, by blacklisting a defaulter and sharing the list of defaulters with other companies when required (AAOIFI, Shariah Standards No. 3, 2017). This is not applicable to a debtor who is insolvent or delay his payment for established Shariah reason.

The adoption of AAOIFI standard varies from bank to bank in the Gulf countries. For example, late payment charge in ADCB Islamic Banking is 2 per cent over agreed rate with minimum of AED 50 and maximum of AED 200 (ADCB Islamic Banking, 2017). This charge is applied for Murabahah Auto Finance facility. Meethaq Islamic Bank, (Meethaq Islamic Bank, 2016) on the other hand, imposes late payment penalty of 1 per cent per annum on the overdue amount for Meethaq Home Finance and Auto Finance facility. This whole amount will be given to charity as per approved by Meethaq Shariah Supervisory Board. At-Tijari Islamic Bank, Dubai (At-Tijari Islamic Bank, n.d.) applies late payment fee for home financing based on this calculation: due amount x 2.5 per cent x period divided to 365 days. Refer **Table 1**.

**Table 1:** Comparison of late payment charges between Gulf Countries, Malaysia and Indonesia

Issuer of ruling	Gulf countries AAOIFI	Malaysia Bank Negara Malaysia	Indonesia Dewan Shariah Nasional Indonesia
Permissibility of ta'widh	AAOIFI permits ta'widh as mentioned in the standard, “The debtor in default bears all legal and other expenses incurred by the creditor in order to recover his debt.”	The Council in its 4th meeting, held on 14th February 1998/16th Syawal 1418 resolved that ta`widh (compensation) may be imposed on the defaulting customer who fails to meet his obligation to pay the financing based on the following conditions: (i) The amount of ta`widh cannot exceed the actual loss suffered by the financier; (ii) The default or delay of payment is due to Negligence on the part of the	It is permissible to impose ta'widh provided with conditions below: 1. The creditor can be compensated based on the real loss occur from fixed cost and not by potential loss that happen due to opportunity loss. Mode of repayment is by mutual consent of both parties. 2. Ta'widh can only be imposed to sale and lease-based transaction such as salam, istisna', murabahah and ijarah. For profit sharing



		customer.	contract, <i>ta'widh</i> can only be imposed by <i>rabbul mal</i> or <i>mudharib</i> on the occasion of the investments make some profit but he did not receive it. 3. The penalty charge can be recognised as source of income to creditor.
Permissibility of <i>gharamah</i>	AAOIFI permits <i>gharamah</i> with condition that it cannot be recognised as income.	Gharamah is permitted by Shariah Advisory Council of Bank Negara with condition that <i>gharamah</i> cannot be recognized as income.	Not mentioned

### ISSUES DETECTED ON PRACTICING *TA'WIDH* AND *GHARAMAH*

#### ***Gharamah*: Controversy on Permissibility Persists**

Although SAC has ruled on the permissibility of both *ta'widh* and *gharamah* by Islamic banks in Malaysia and BNM has issued guidelines for implementation, it appears that only *ta'widh* is widely implemented. Most Islamic banks choose not to implement *gharamah* because of the “nature” of *riba* that is inherent in it, impediments in terms of setting up separate charity account, disclosure requirements and regulations associated with it (Laldin, Khir, & Parid, 2012). This might have contributed to the unanimous agreement on permissibility of *ta'widh* among Malaysian and Middle East scholars but persistence of differences of opinion on the permissibility of imposing *gharamah*.

#### ***Ta'widh*: Actual Compensation or Opportunity Cost?**

Taking *ta'widh* as an “amount that may be compensated to the Islamic Banking Institutions based on actual loss incurred due to default” under the BNM Guidelines on Late Payment Charges for Islamic Banking Institutions, this paper considers it anomalous if late payment charge is imposed in cases where there is no judgement involved. This is because, unless there is judgement, “actual” loss incurred has not yet been determined but rather only opportunity cost (Noor & Haron, 2016). This is because risk management department and mitigation measures adopted by banks are not established in the event of late payment but already exist as part of banking operations. The setup of risk mitigation department or recovery department and the actions made through either phone calls or letters to remind customer to make payment are part of the bank operational cost from day one; and it is usually priced in the financing facility given to customer among other price components (Usmani, 2012). This means it is the duty of the bank, normally through the staff of the risk department or the collection department, to remind customers when payment is due. Only a court can establish whether the customer is in fact negligent and whether there is actual direct or indirect cost incurred in the default case.

Therefore, the notion “...Islamic financial institutions will suffer actual loss in terms of incurring additional expenditure, such as cost for issuing notices and letters, legal fees and other

related costs” as stated in Shariah Advisory Council Resolution is not accurate because there is in fact no additional cost. This, in other words, is to opine that both *ta'widh* and *gharamah* do not cover any associated cost but rather serve more as “psychological deterrent” tactic to remind customers to pay on time.

### **Negligence and Non-Negligence Factor**

It is mentioned in the Bank Negara guidelines that Islamic banks are to ensure that the late payment charges are imposed only on negligent customers. A default, by definition from BNM, “arise from negligence when it occurs even though there are no reasonable mitigating circumstances (which includes cash flow problems, abandoned projects, unemployment, loss of property because of natural disaster as well as customers with good merit) that would forbid the customer from making payments”. (Bank Negara Malaysia, 2012).

Islamic banks are also expected to “act judiciously” and have clear procedures to ensure that defaulters with genuine financial difficulties are exempted from late payment charges (Bank Negara Malaysia, 2012). However, Kunhibava (2016) demonstrated in her article that negligence or financial difficulties of debtor is not taken into consideration when judgement is made in a few court cases.

### **Notice upon Default**

Operational requirements of the Bank Negara guideline on late payment charges specified that Islamic financial institutions must ensure that customers are duly informed of any revised fees at least 21 days before the effective date (Bank Negara Malaysia, 2012). However, in a reported case between *MK Associates Sdn Bhd vs Bank Islam Malaysia Bhd [2015] 6 CLJ 97* (“MK Associates”) Bank Islam was sued for wrongfully claiming *ta'widh*. The plaintiff claimed that the *ta'widh* should not have been imposed in the first place because it was not mentioned clearly under the BBA facility agreement, neither did the defendant give notice of the required *ta'widh* payment. Although the defendant claimed that *ta'widh* is compensation for losses and thus it is the right of defendant to claim for *ta'widh*, Judge Asmabi Mohamad held that the claim to *ta'widh* is not an absolute right and is subject to conditions whereby the defendant must act fairly. Another related case is between *Maybank Islamic Berhad vs M-10 Builders Sdn Bhd. & Anor [2015] 4 CLJ 526* (“M-10 Builders”) whereby the plaintiff (Maybank Islamic) did not send any notice on *ta'widh* nor penalty to the defendant upon default and thus the claim for *ta'widh* failed to be justified. These two cases were discussed in this manner by Kunhibava (2016) as well.

From the above cases, it appears that Islamic banks view *ta'widh* as their sole right whereas in fact imposing *ta'widh* is only a privilege and cannot be simply imposed on defaulters. It should be made known to the customer via a notice.

### **CAN ISLAMIC FINANCIAL INSTITUTIONS RELEASE DEFAULTERS & IS THERE ANY ALTERNATIVE FOR PENALTY IMPOSED ON LATE PAYMENT?**

In Islamic banking transactions, one may never find a loan transaction *per se*, as making money from money is prohibited in Islam. The only form of lawful loan that could be given by an Islamic bank is based on the principle of “*qard*”. *Qard* is a gratuitous form of loan in which nothing can be claimed more than what has been advanced by a creditor. This in essence is to uphold the prohibition of charging any excess over and above principal amount of loan given to a debtor. Otherwise it amounts to *riba* which is expressly forbidden in Islam.

In Islamic banking, the products used are different from that of conventional banking and hence the defaults happening in Islamic banking would be different. There are three categories of Islamic banking products; debt, equity and lease. It might be difficult for patrons of conventional banking who are not familiar with Islamic finance principles to understand how default occurs in

Islamic banking. **Table 2** below illustrates how the customer/client in different Islamic banking products may default:

**Table 2:** How default may occur in Islamic banking from client's perspective

No	Name	Nature	Explanation*	Default
1	Murabahah/ BBA	Debt	In Murabahah, client identifies the asset; bank acquires the ownership and then sells to the customer with a profit. The client pays in installment or deferred basis. In Malaysia and some other South East Asian countries, a form of Murabahah in which payment is made in installments sometime after delivery of goods is referred to as BBA.	If the client fails to pay the installments on time, then it could be said that the client has defaulted.
2	Salam	Debt	An exceptional contract of sale in Islam whereby the customer undertakes to supply some specific fungible goods to the bank at a future date in exchange for an advanced price fully paid on the spot.	If the client fails to deliver the goods of the quality and within the time specified, then the customer has defaulted.
3	<i>Istisna</i>	Debt	The bank as purchaser pays cash in advance and order a manufacturer to manufacture a specific commodity for it. If the manufacturer undertakes to manufacture the goods for the bank, the transaction of <i>Istisna</i> comes into existence.	If the customer fails to finish the construction of the specific commodity as per the specification given and within the time agreed, then it is a default by the customer.
4	Musharakah	Equity	Bank would become partner with the customer and shares profit in the pre- agreed ratio between them. Both parties also share loss per contribution to the partnership fund.	If the customer fails to keep his contribution with partnership fund for the agreed time specified in the agreement, then he is deemed to have defaulted.
5	Mudharabah	Equity	Customer advances the money and the bank manages the money. The profit would be shared between the parties according to the pre-agreed ratio. But any loss would be borne by the customer only.	If the customer fails to keep the money with the bank for the agreed time specified in the agreement, then it is a default.
6	Ijarah	Lease	Bank buys a certain property and allows the customer to have benefit of that product by leasing it. The customer in return would pay certain agreed amount of price (rental) to the bank. At the end of the tenure	If the customer fails to pay the rental agreed on time or if he fails to take good care of the leased instrument, then it is a default.

the bank may agree to transfer the ownership to the customer either by a sale contract or *hibah* (gift).

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Sources: (Alamad, 2017); (Alam & Rizvi, 2017); (Uthmani, 2002).

**Table 2** lists out certain Islamic financial products and services, with explanation on their nature and likely default by client patronising the products and services. The table provides a highlight of the instances when such a default can be said to have occurred on the part of the bank's client either by omission or commission towards a particular contractual responsibility or obligation in the product or service concerned. In this regard, some prominent Islamic financial products and services offered commonly by Islamic banks are chosen and illustrated to describe the default and events leading to them. Depending on the nature of the default committed, it would render the client liable to either *ta'widh* or *gharamah* and/or both. This is however up to a court of law, before which such a client is sued, to appropriately determine.

In Murabahah transaction, otherwise known as Bai Bithaman Ajil (BBA), client's failure to pay installments by or at the due date is an actionable issue as held by the High Court decision in *MK Associates Sdn Bhd v. Bank Islam Malaysia Berhad* [2015] MLJU 1954 30 October 2016. Specifically, the bank providing the service, the court declared, must have suffered and proved actual financial loss to become entitled *ta'widh* notwithstanding anything to the contrary in the parties' agreement. The bank can; however, on its own volition waive such delay and accept late payment. Moreover, in Istisna contract, if a customer fails to complete construction of a specific commodity (say a custom-built motor car) as per given specification and agreed timeline, this constitutes a default by the customer against which the bank can lay claim for *ta'widh*. For profit a sharing contract, i.e. Musharakah or partnership, *ta'widh* can be imposed on the partner-client when the parties make payment towards actualising a partnership agreement, but the partner-client fails to keep his contribution with the partnership fund for the agreed time. *Ta'widh* also can be claimed by the bank where it is the *rabbul mal* (one supplying capital to an entrepreneur), on the occasion that the musharakah investment made profit, but the bank did not receive the contribution from the partner-client.

The assessment and imposition of *ta'widh* and *gharamah* under relevant regulatory guidelines shall be ascertained from the agreement or documentation for the particular transaction. When it is a subject of dispute, it can be done by court of law, in accordance with the parties' agreement and the law (Bank Negara Malaysia Law Harmonisation Committee, 2013). In any event, before a court can order payment of *ta'widh* against a customer or client, an Islamic bank needs to adduce evidence to establish the actual loss it incurred as a result of the client's default. The *ta'widh* or compensation payment is to be charged on judgment debts. As decided by a Malaysian High Court in *Maybank Islamic Bhd v. M-IO Builders Sdn Bhd & Anor* [2017] 7 CLJ 127 that without incurring any loss that has actually been suffered, a bank has no right and no basis to charge *ta'widh*. Moreover, in the event it is established that the default resulting in incurring actual loss was wilful such that evidence can be adduced in proof of the client being a delinquent debtor, the court may impose *gharamah* to be charged against the client, in addition to *ta'widh* (Noor & Haron, 2016).

### **Shariah Perspective of Individual Obligation on Debt Repayment**

It is considered a religious duty in Islam to fulfil one's obligation under all contracts. Therefore, Islam defines specific rights and responsibilities of debtors and creditors. The duty of the debtor is to repay the loan (*qard*) in fulfilment of the contract made with the creditor and if found otherwise, God's punishment will be severe to the debtor whose intention is to usurp the loan (*qard*). The

creditor, on the other hand, should not impose interest or charges on the principal amount of the loan as it will be *riba* which is strictly prohibited in Islam.

Under the Shariah, debtors are divided into two categories: either a financially distressed debtor or a delinquent debtor. The Quran and Sunnah give an emphatic attitude towards distressed debtors by stating that a distressed debtor should be given respite till solvency (Al-Quran, 2:280). During this period of respite, such debtor is free to conduct his financial affairs without restrictions from the court (Muslim, n.d). Bankruptcy (*iflas*) only applies after the debtor is declared bankrupt by the court at his own request or the request of his creditors and thus the debtor cannot conduct his financial affairs without court supervision and permission (Hajjiri & Cohen, 2016). However, for the delinquent debtor, no such grace is granted. Once it is established that the debtor is a delinquent type, it is best understood that his property can be taken rightfully by force and that he can also be penalized (Al-Zuhayli, 2001).

Islamic banking institutions may release debtors without imposition of late payment charges in certain isolated cases (Salim & Abdullah, 2017). In most cases however, it is almost impossible for them to release debtors. This is so even when the debtors were not negligent and might have defaulted due to difficult financial circumstance like poverty. Accordingly, it can be seen from some court cases that the Islamic financial institutions simply impose *ta'widh* on customers without looking into negligence factor or giving any form of notification as prescribed by relevant Bank Negara guidelines. Nonetheless, this might not be unconnected to the fact that defaulters are not only made up of individuals, but also companies/corporations that involve huge amount of financing. As such it is imperative to formulate a yardstick to determine defaulters based on genuine reasons.

Instead of imposing penalty on late payment, Usmani, (2012) suggests innovative collateral (*rahn*) arrangements; guarantees (*Kafalah*); getting credit ratings of clients from credible institutions, pricing that is able to cover all related risks, and takaful coverage to be used. Unlike conventional banks that deal with money to make more money, Islamic banks deal with real underlying assets and deal with real economic activities to generate profit. As such, innovative ways need to be used to mitigate credit risk in Islamic banking (Ahmad, & Ahmad, 2004) rather than replicating the conventional banks in this regard.

## **CONCLUSION**

In conclusion, this paper suggests that the most significant reason behind the implementation of late payment charges in Malaysia was actually to mitigate the credit risk faced by the Islamic Financial Institutions. However, in the process of implementing this, a question arises as to whether there is accuracy in claiming that imposition of *ta'widh* is to recoup “additional” expenses incurred by the banks, should customers delay in payment when everything had already been priced in the financing earlier. Furthermore, it is imperative to formulate a yardstick to distinguish genuine defaulters from delinquent defaulters. Moving forward, this paper recommends future studies to look into whether late payment charges in Islamic banks really serve as deterrent factor and contribute to the decline in the rate of non-performing financing since the implementation of the guidelines on *ta'widh*. Accordingly, it is recommended that Islamic banks need to think out of the box and take another approach in dealing with the situation. In line with this, it is important for Islamic banks to formulate strategies and guidelines towards practical application of verse 280 of chapter two of the holy Quran.

This is to ensure that where customer's default in payment is due to poverty, such a customer must be given respite until he is in a position to pay. This should be done without compromising the Islamic bank's duty of care owed to the depositors to maximise profit as much as possible. So, in the view of the authors, there is a need to devise ways of departing from the current practise of taking *ta'widh* and *gharamah* which appears only to impose hardship on customer without

considering his circumstance as the holy Quran prescribes. Since the fundamental rule of Islamic banking is eliminating *riba* and the principal object of Shariah is to bring ease to people, then anything that is doubtful about or may contribute to *riba* and hardship must be eliminated and avoided, in any circumstance.

Without such proactive action, the objective of Islamic banking will be defeated and the prefix “Islamic” attached to banking will lose its essence. There is need for Islamic banks to unanimously take action and deviate from the current practise which is customer-insensitive and find alternative way that considers the Quranic prescription with respect to customer to handle the matter. This will preserve and enhance the unique Islamic identity of the Islamic banks. In Shariah, *rahn* (collateral) and *kafalah* (guarantee) can be used alternatively in order to recover money which a customer owes to an Islamic bank. These two contracts have much potential to deter default if properly applied in the transaction and understood by the parties thereto. These contracts serve as invisible safety nets to protect Islamic bank’s interest and with them, the likelihood that an Islamic bank would lose its money due to default at the end of the day is drastically eliminated.

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