



The Practice of Imposing Default Rate in Islamic Home Financing Product in Malaysia: Analysis from Regulatory and Shariah Perspective

Mohamad Syafiqe Abdul Rahim^{*1}, Ahmad Hidayat Buang¹

¹ Department of Shariah & Law, Academy of Islamic Studies, University of Malaya, 50603 Kuala Lumpur, Malaysia

ABSTRACT - In developing and structuring an Islamic banking product, one of the areas that should be addressed is to mitigate risk that includes default risk. Financial institutions will always be exposed to the risk of default by customers. This is faced by Islamic banks as well when granting financing facilities to customers irrespective of the underlying Shariah contracts that apply to the product structure. In order to mitigate such risk, bank normally will impose late payment charges if the instalment amount is not received by the payment due date. In addition to the normal late payment charges, banks may also impose default rate on customers who have defaulted within certain period. As such, this study analysed the practice of charging default rate in Islamic home financing product involving sale- and lease-based contracts. This qualitative study adopted the explanatory methodology as the main method of data collection from relevant documents, such as Shariah-related regulatory policies, Shariah resolution issued by Bank Negara Malaysia (BNM), decided court cases, and Islamic bank product documentation related to the practice of charging default rate. Next, secondary data from journal articles and other published sources, including Shariah literature relevant to this study, were deployed to analyse the said issue. Evidently, several Islamic banks in Malaysia seem to impose default rate in their product structure. Such practice may not be consistent with the spirit of Shariah and Islamic finance if the purpose is to gain more income while the customers face financial issues. This study prescribes Shariah scholars and regulator to re-evaluate the current regulatory policies and product structure to ensure that they embrace the spirit of Shariah, apart from protecting consumers from heightened financial burden.

ARTICLE HISTORY

Received: 22nd July 2021

Revised: 10th November 2021

Accepted: 29th November 2021

Published: 1st December 2021

KEYWORDS

Default rate, late payment charge, Islamic home financing, *ijarah*, *tawaruq*

INTRODUCTION

One of the greatest challenges that banks face is coping with increasing uncertainties and accompanying risks. The operation of Islamic banks shares common commercial risk in the banking industry, such as market risks and credit risks, as well as other risks involving operation, default, and liquidity (Silvira & Rani, 2021). Islamic banking is characterised by features that may reduce risk, whereby the religious beliefs held by customer may discourage default. Nonetheless,

risks stem from several factors, such as complexity of Shariah contract, restriction to impose default penalties, and moral hazard caused by profit-loss sharing contract (Abedifar et al., 2015).

Default risk has become particularly crucial in the context of the current financial environment, where banks will always be exposed to the risk of default by customers due to various unexpected turmoil, such as market disruption, financial crisis, and most recently, the Coronavirus Disease 2019 (COVID-19) pandemic. Islamic banks are also exposed to similar risk when granting financing facilities to their customers irrespective of the underlying Shariah contracts that apply to the product structure. In order to mitigate such risk, it is common for banks to impose late payment charges if the instalment amount is not received by the payment due date. In addition to the late payment penalty, banks may also impose additional default rate on customers who have defaulted within certain agreed period.

Compared to the extensive literature published on various risks on credit, default, market, and liquidity in conventional and Islamic banking spheres (Hassan et al., 2019; Makiyan, 2008; Abedifar et al., 2013; Al Rahahleh et al., 2019), only a handful of studies have assessed the practice of charging default rate but not specifically in Islamic banking sphere. Empirical studies on charging default rate in mitigating default risk are in scarcity and very few have addressed issues related to this specific risk. Researchers have addressed various risk management issues, including default risk without due regards being given to the practice of charging default rate by Islamic banks particularly in Malaysia. Therefore, this study bridges the gap in this particular area. It looked into the practice of charging default rate in Islamic home financing product in Malaysia based on regulatory standpoint and deliberation from Shariah perspective.

LITERATURE REVIEW

What Is Default Rate?

Default risk is a subset of credit risk which also includes portfolio risk and transaction risk (Spuchřáková et al., 2015). It refers to the risk of non-payment of financing due to the inability of customers to fulfil the obligations to the banks. Both Islamic and conventional banks have to face this risk in their daily banking operations (Noor et al., 2018; Al Rahahleh et al., 2019). For the purpose of this study, the discussion will also elaborate on credit risk in general.

Islamic banks are unique with regard to risk-related issues. For example, Islamic banks face two types of risks namely risks that are similar to those faced by conventional banks and risks that are unique because Islamic banks must comply with Shariah requirement (Ahmed & Khan, 2007). As Islamic banks operate as an entrepreneur or involve in trading depending on the underlying Shariah contract, they provide financing rather than just a normal conventional loan (Al Rahahleh et al., 2019).

Therefore, the risk on bank's portfolio depends on both external and internal factors. Islamic banks face credit risk from external factors such as potential change in the state of economy, market disruption and from internal factor due to weaknesses in the bank's operation (Spuchřáková et al., 2015; Al Rahahleh et al., 2019). Hence, one of the most adverse impact of risk faced by Islamic banks is the deterioration of financing quality that can cause significant potential loss of profit from the financing granted (Trad et al., 2017; Safiullah & Shamsuddin, 2019).

For that reason, Islamic banks must be aware and remain careful when evaluating financing application by looking at the future economic projections in addition to the interest/profit rate volatility which can cause impact on the cost of funds and profit (Al Rahahleh et al., 2019; Budiandru, 2021). Besides, Islamic banks should continuously monitor the business projections that are carried out by its customers before granting financing to ensure that potential customers have the ability to make prompt payment of their financing (Budiandru, 2021). Moreover, the aspect of Shariah governance is integral where the enhancement in the skills of the key organs such as the Board and the management by hiring qualified professionals and scrutinizing internal policy will mitigate the likelihood of default, and therefore mitigate provision for loss (Arshad et al., 2020; Misman & Bhatti, 2021).

In the Malaysian context, BNM has put in place a specific framework namely Credit Risk Policy Document (issued in 2019) that sets out the requirements to ensure credit risk management practices by banks are effective amid the size and complexity of product offerings. Generally, banks deal with default cases not from the point where customer defaults. In the banking practice, it involves implementing robust internal governance processes and policies, settling issues via dispute resolution channel, leveraging on technology to monitor delinquent and impaired financing and also involving of financial adviser agency such as Credit Counselling and Debt Management Agency, or commonly known as Agensi Kaunseling dan Pengurusan Kredit (Kabir Hassan et al., 2021).

In relation to internal bank's governance procedures, there are many mechanisms to mitigate the risk of default such as requiring collateral, third-party guarantor, and imposing stringent credit evaluation policies by ensuring that the financing is only granted to eligible customers (Kabir Hassan et al., 2021). In addition to that, the banks also impose additional interest rate on top of the existing interest rate charged to customers when payments on a financing facility are overdue as a result of default in payment. This higher rate is applied to outstanding balances in arrears in addition to the regular interest charges for the debt. The purpose of an enhanced interest rate is to motivate customers to pay promptly and avoid serious breach of other financial obligation (Whelan, 2019). The two typologies that describe this charging are default rate and default interest. These two terms are commonly used by practitioners to signify this practice. The only differences are on the percentage of the default rate, the period to trigger the default rate, and the period for customers to regularise the payment in order to be reinstated to the original interest rate. In this present study, the term 'default rate' is applied throughout the explanation.

When a default rate provision is incorporated in a financial document, typically it requires the customer to pay an increased interest rate should the customer has defaulted in making monthly debt-service payment. This default rate can substantially add to what the customer must account for (Neff, 2019). Such default rate provision is arranged to compensate the bank for unexpected cost and to manage credit risk, arising from individual defaulted loan and also from a specific pool of defaulted loan (Bender & Madison, 2008; Whelan, 2019).

Customers often challenge default rate claim. When a bank claims for default rate, the court typically looks as to whether the amount constitutes permissible liquidated damages or an unenforceable penalty under applicable law (Neff, 2019). A question that arises is whether default rate charging is considered as inequitable and become an unreasonable penalty (Murray, 2019). This is because; in order to maintain an "equality of arms" between the debtor and the creditor, the regulator may impose certain limits on how the normal interest rate should be set according to the monetary policy rate. This is to ensure that the bank does not abuse its contractual position (Sibneschi, 2016).

From a different stance, there is also an argument that default rate is a contractual rate that adjusts on default in the same way a variable interest rate in a loan contract changes as the risk of inflation fluctuates over time. Default rate provision also can be described as a variable-pricing provision, a term of the contract that provides for an interest-rate increase if the bank risk of future loss is increased by borrower default (Bender & Madison, 2008). This argument can be referred in one Appeal Court's decision in the U.S between Citibank, NA v. Nyland.¹ In this case, the Defendants (Appellants) argued that the charging of default rate is a penalty and not a reflection of increased risk, and as such is not enforceable. The Defendants contended that it was an error for the Judge to give effect to the provision of Plaintiff's (Appellee) loan that increased the interest rate on principal to a "default rate" (17.5% for most of the principal) in the event of default.

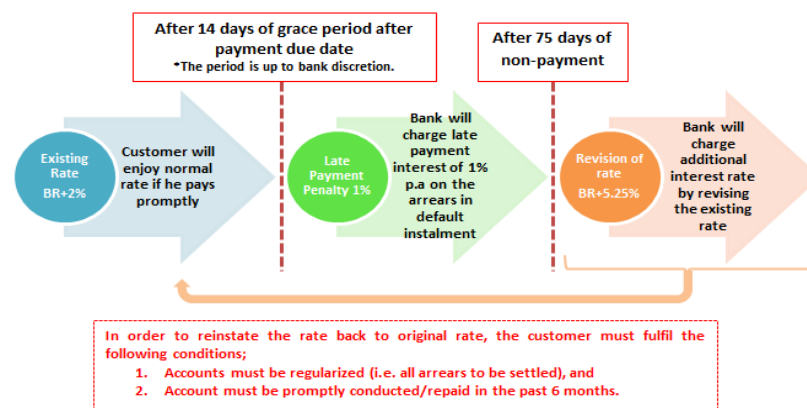
However, the court recognised that default rate represents a variable interest rate that reflects the heightened risk of repayment triggered by the borrower's default. Such a variable-pricing mechanism makes economic sense for banks. The court concluded that the default rate in

¹ 8 F.2d 620 (2d Cir. 1989)

question was "simply part of... (the) bargain" included to offset the "increased risk of non-collection". The Court further opined that when creditors are not allowed to impose such variable rates based on performance or default it would be worse for debtors overall who would likely see increased rates over the entire life of the loan in order to "reallocate the risk" of default.

In the context of Malaysia, the application of default rate has been discussed and recognised by the court. In one of the cases involving *Keypoint Computers Sdn Bhd & Others v OCBC Bank (Malaysia) Bhd*,² where the court stated that it is common for loan agreements to specify a default rate of interest, i.e., a higher rate that applies after the borrower's default. The intent of default rate clause is to empower the bank (Plaintiff) to impose additional interest rate upon default. In *RHB Bank Berhad v Sia Swee Hoe*,³ the court decided that by virtue of the default rate provision stated in the facility agreement, the fact that no notice of variation of the base lending rate (BLR) was extended to the defendant is immaterial as a failure to give notice shall not absolve the defendant from its obligation to pay interest at the prescribed rate determined by the Bank. However, the above court cases involved conventional banks and as of to date, there is no specific court case discussing on default rate involving Islamic banking product.

To better understand the default rate mechanism, Figure 1 illustrates bank charges default rate in conventional loan product:



BR refers to Based Rate in accordance with BNM Reference Rate Framework. The BR and profit margin (e.g.: BR+2%) used in the above is for illustration purpose only and vary among banks.

Figure 1: Default Rate Charging and Reinstatement of Rate in Conventional Loan

Figure 1 portrays an example of banking practice in imposing default rate. Referring to the diagram, a customer is required to make prompt instalment payment of the conventional banking loan facility where the rate is calculated based on the formula of Base Rate (BR) plus 2% per annum. In the event when the customer defaults in payment, the bank will impose late payment charge at the rate of 1% per annum on the arrears in default. This late payment charge will be imposed if payment has not been made after 14 days from the due date. If full payment of all the arrears with interest at the default rate is not received by the bank within 75 days from the due date of payment, the bank may at its absolute discretion revise the existing rate to higher interest rate of 5.25% i.e. default rate, resulting in higher instalment payment. However, once the debt is accelerated after default, the late payment penalty stops, but interest continues to accrue at the default rate on the outstanding balance.

The bank may only reinstate the interest rate back to the original rate if the customer has regularised all outstanding arrears and the account must be promptly paid for 6 months. This

² (2015) MLJU 1229

³ (2007) 8 MLJ 94

means; the process to revert to the original rate would take more than 6 months whereby during this period, the customer will have to pay higher instalment amount based on the default rate.

The Practice of Charging Default Rate in Malaysia: Regulatory Standpoint

All licensed financial institutions in Malaysia are governed and supervised by BNM. In this regard, banks are subject to several BNM policies, such as Risk-Informed Pricing and Reference Rate Framework, just to name a few.⁴ These two policies are mentioned here since both are inter-related to the discussion of this paper. However, these policies are only applicable to loan/financing to retail segment of customer. The policies provide guidance for banks in pricing their loan/financing. Risk-Informed Pricing policy sets out the requirements on the responsibilities of banks to adopt a risk-informed approach to price their retail loan/financing products. This is to ensure that the retail loan/financing pricing matches the approved risk appetite.

Generally, the policies adopt a risk-based pricing model where banks determine its financing rate based on the level of risk of the customer. Normally, a credit-scoring system is used to assess the creditworthiness of potential customers based on various type of information such as credit history, various financial ratios and current borrowing or financing. The credit score will be used to gauge the probability of default and the appropriate default risk premium when determining the rate of profit charged to customer. A good credit rating means a lower probability of default, which will translate into a competitive cost of financing, and vice versa (Isa & Lee, 2016).

It is necessary to measure the risk of default to quantify potential losses from credit operation. Nonetheless, the actual losses cannot be known therefore it is necessary to estimate it based on the expected rate of default on credit claims (Spuchřáková et al., 2015). One of the mostly used and generally accepted methods by banks in mitigating risk of default is the default prediction model using financial ratios which is proven in determining financial status of a firm. (Manab et al., 2015).

In the Malaysian context, while banks maintain ultimate discretion over pricing, banks should also determine the pricing component of each product to support risk-informed pricing decisions. The estimation of pricing component should weigh in expected loss, funding cost, and overhead cost (Item 8.2-8.10, BNM Risk-Informed Pricing). This approach is in line with the new BR pricing regime (previously BLR/Base Financing Rate (BFR)) under the Policy on Reference Rate Framework, item 8.2.⁵ The BR shall only consist of:

1. Cost of Funds (COF) – the equivalent to interbank borrowing rate or cost of capital; and
2. Statutory Reserve Requirement (SRR) – a regulatory reserve requirement for financial prudence.

According to item 8.7 of the policy, a bank shall exclude other components of pricing from the computation of BR, such as credit and liquidity risk premiums, operating costs, credit risk, and profit margins. The bank shall only reflect these components in the spread over the BR. This new pricing structure is more competitive and prudent when compared to the previous BLR/BFR structure⁶ in the sense that it considers the risk approach incorporated into the margin of spread. As such, the margin is now reflective of the customer's risk based on bank's assessment. A higher margin of the facility will reflect the customer's risk profile; the higher the margin, the higher is the customer's risk profile.

⁴ Refer to BNM Reference Rate Framework (18 August 2016) and BNM Risk-Informed Pricing (16 December 2013)

⁵ At the time this article was written, BNM has issued a revised Reference Rate Framework Policy. The new revision essentially includes an industry-wide, standardised reference rate based on a specified benchmark rate where it shall be set as the Overnight Policy Rate (OPR). This new benchmark shall be effective on 1 August 2022. This reference rate will be referred to as the Standardised Base Rate (SBR). Nevertheless, the requirements on other aspect of current policy remain the same including the issue discussed in this study.

⁶ Under previous BLR/BFR structure, its pricing components reflective of all risks, COF, SRR, premiums and margin.

Nevertheless, whilst this approach is more transparent and makes sense from the eyes of the bankers, the question is whether this may open to adjustment of margin of spread should the risk profile change throughout the loan/financing tenure. Typically, risk-based pricing means originally the pricing is determined upfront to cater all possible risk. However, the Reference Rate Policy allows the bank to revise the spread above the BR during the tenure of the retail loan/financing facility to reflect changes in the credit risk profile or creditworthiness of the borrower over the life of the loan/financing facility (item 8.1 BNM Reference Rate Framework).

Hence, if the credit risk profile of the customer varies during the tenure of the financing, the pricing i.e. the bank's spread may be revised to compensate for higher risk. The change in credit risk profile or creditworthiness refers to default situation. If a customer's creditworthiness is compromised and leads to default in payment, the bank will face additional risk for continuing to finance the customer, hence, the bank may revise the Bank's spread to mitigate higher default risk. Since financing is the major source of income, deterioration of financing quality will affect the banks' profitability. As the default risk increases, the bank has no choice but to increase its default risk premium charged to customer (Noor et al., 2018; Muneeza et al., 2019).

By allowing such an arrangement, it is consistent with the court cases explained in the previous section of this study where default rate is not considered as penalty but it represents a variable rate that reflects the heightened risk of repayment triggered by the customer's default. Such decision to revise the rate shall purely be based on bank's business decision to adjust the risk factor. While conventional banks may have no issue with this practice and is capable to embed this feature in their product, the question is still open as to whether it is possible and permissible from the Shariah perspective to be applied in Islamic banking product.

Although such practice has been regulated as explained in the foregoing, not all regulation has risk-reducing benefits for the bank. The impact of regulation on default risk is dissimilar for conventional and Islamic banks. For that reason, the regulator should consider the different nature of conventional and Islamic banks by issuing separate financial regulation to suit these operationally-distinct financial intermediaries (Rizwan et al., 2018).

METHODOLOGY

The exploratory method was employed in this study as the main method of data collection whereby relevant regulations, including Shariah-related regulatory policies and Shariah resolution issued by BNM, decided court cases, and Islamic bank product documentation related to the practice of charging default rate, were examined based on the qualitative approach. Secondary data from journal articles and other published sources relevant to this study were also deployed to assess the issue. This included texts in classical and contemporary *fiqh* literature, such as fatwas and Shariah standards.

This study only focused on Islamic financing product structured using sale-based or lease-based contract as both contracts are dominantly used in the Islamic banking industry in Malaysia. Besides, this study is limited to Islamic home financing product as reliable information of the product was retrieved from Islamic bank product disclosure sheet and information from website.

Product disclosure sheet is a requirement set by BNM to promote consumer's awareness and understanding of the financial products, as well as to facilitate consistency in disclosure of essential information on financial product (Item 14, Guidelines on Product Transparency and Disclosure). The requirement is applicable to products developed and offered by financial institutions, to individuals as well as small and medium-sized enterprises (SMEs), including deposit product, financing product, and investment product (Item 4.1, Guidelines on Product Transparency and Disclosure). In this study, information generated from product disclosure sheet from Islamic banks in Malaysia became the basis for inferring the situational attributes of default rate practice in Malaysia.

This study is limited to Islamic home financing product due to inadequate reliable sources that limit the scope of data in covering other types of financing product, including under business

and corporate segment. This is because; for such segment, product disclosure sheet is not required to be prepared by the bank. Hence, information on the practice of imposition of default rate may require application of other data collection methods, such as interview and survey.

ANALYSIS ON THE PRACTICE OF IMPOSITION OF DEFAULT RATE IN ISLAMIC HOME FINANCING PRODUCT

For the purpose of this study, the author retrieved the latest list of all Islamic banks in Malaysia from the BNM website.⁷ A total of 24 Islamic banks are established in Malaysia comprising of standalone full-fledge Islamic bank, full-fledge Islamic subsidiary bank, and development financial institution (DFI). Two banking institutions were also listed under the Islamic window structure, namely United Overseas Bank and Citibank that offer Islamic banking product.

Based on the exploratory research approach conducted on Islamic banks in Malaysia, several Islamic banks did incorporate the mechanism to charge default rate in their Islamic home financing product. The details of the observation are tabulated in Table 1:

Table 1: The Practice of Charging Default Rate by Islamic Banks in Malaysia

No	Islamic Banking Institutions	Shariah Contract	Charging Default Rate
1	Affin Islamic Bank Berhad	<i>Musharakah Mutanaqisab</i>	Yes
2	Agro Bank	<i>N/A</i>	N/A
3	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	<i>Tawarruq</i>	Yes
4	Alliance Islamic Bank Berhad	<i>Bay` Bithaman Ajil</i>	Yes
5	AmBank Islamic Berhad	<i>Tawarruq</i>	No
6	Bank Simpanan Nasional	<i>Tawarruq</i>	Yes
7	Bank Rakyat	<i>Tawarruq</i>	Yes
8	Bank Islam Malaysia Berhad	<i>Tawarruq</i>	No
9	Bank Muamalat Malaysia Berhad	<i>Tawarruq</i>	No
10	Bank Pembangunan	<i>N/A</i>	N/A
11	CIMB Islamic Bank Berhad	<i>Tawarruq</i>	No
12	EXIM Bank	<i>N/A</i>	N/A
13	Hong Leong Islamic Bank Berhad	<i>Tawarruq</i>	No
14	HSBC Amanah Malaysia Berhad	<i>Musharakah Mutanaqisab</i>	No
15	Kuwait Finance House (Malaysia) Berhad	<i>Ijarah Muntahiyah bi Tamlík</i>	No
16	Maybank Islamic Berhad	<i>Tawarruq</i>	Yes
17	MBSB Bank Berhad	<i>Tawarruq</i>	No
18	OCBC Al-Amin Bank Berhad	<i>Ijarah Muntahiyah bi Tamlík</i>	Yes
19	Public Islamic Bank Berhad	<i>Musharakah Mutanaqisab</i>	No
20	RHB Islamic Bank Berhad	<i>Tawarruq</i>	No
21	SME Bank	<i>N/A</i>	N/A
22	Standard Chartered Saadiq Berhad	<i>Tawarruq</i>	No
23	United Overseas Bank	<i>Tawarruq</i>	No
24	Citibank	<i>N/A</i>	N/A

Notably, 7 Islamic banks imposed default rate in their Islamic home financing product structure, while 4 Islamic banks (under DFIs) did not offer Islamic home financing product due

⁷ (4 November 2021). List of Islamic Banks. Retrieved from <https://www.bnm.gov.my/web/guest/islamic-banks>

to the nature of their banking business that only focused on business segment. Citibank had ceased offering Islamic home financing product, which was originally offered in 2007.⁸ The findings from the above are integrated with the existing literature to further concretise the study outcomes. The following discussion elaborates on what emerged from the integration of the data sources with the literature analysis.

The concept of default is broad in Islamic banking as the nature of Islamic banking products differs from that of conventional ones. Moreover, many products with underlying contracts put the parties in various types of relationships, thus affecting how default would be said to occur (Kabir Hassan et al., 2021). In view of the uniqueness of the structure of Islamic banking product, the analysis is divided according to the Shariah contract underlying the product (Ibrahim & Kamarudin, 2018).

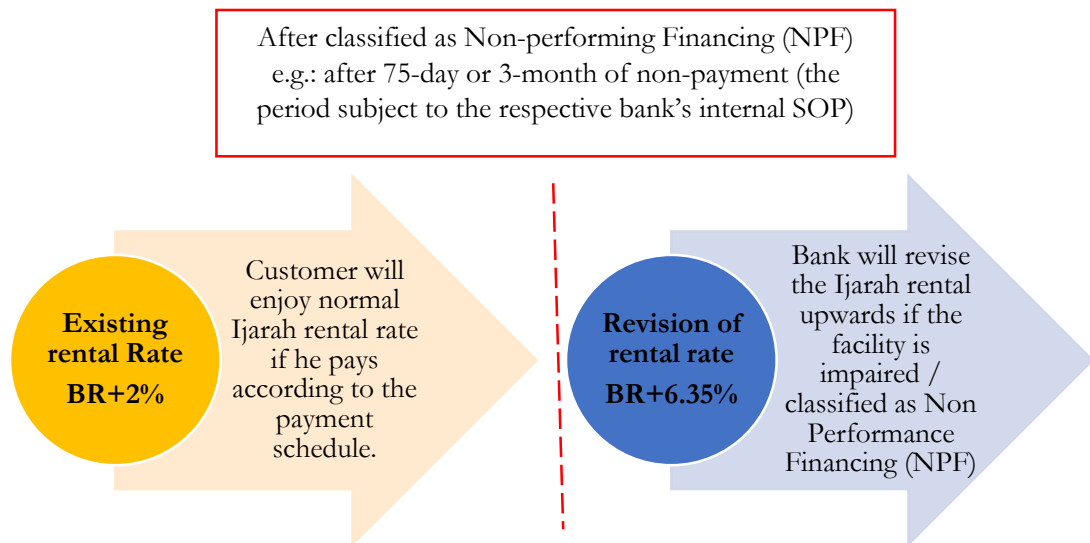
Product with *Ijarah* (lease) contract component such as *Ijarah Muntahiah bi Tamlik* or *Musharakah Mutanaqisah*

Ijarah muntahiah bi al-tamlik (IMBT) refers to a contract of lease with eventual transfer of ownership from the lessor to lessee at the end of the *ijarah* period. In banking product, the lessor is the bank and the customer is the lessee. As lessor, the bank will charge rental to customer (lessee) and it is payable based on the agreed rental formula. This can be translated as monthly instalment (Asni & Sulong, 2018).

Meanwhile, *musharakah mutanaqisah* is a form of partnership in which a partner promises to buy the share of the other partner gradually until the shares are completely transferred to him. In banking product, customer purchases bank shares. This also applies to *ijarah* contract where the bank will lease its shares to customers throughout the financing tenure. The gradual purchase of bank shares and lease of asset by customer denote the component of monthly instalment (Shubky et al., 2017).

From the above product structures, there is an *ijarah* component of which the *ijarah* rental is subject to certain formula and varies depending on certain pricing benchmark, such as bank COF and BLR/BFR. When a default rate mechanism is embedded in the product feature, the bank will revise the rental payment upwards when default condition is triggered. This scenario is illustrated in Figure 2:

⁸(1 November 2021). Citibank Malaysia Launches Citibank Home Partner-i. Retrieved from <https://www.citigroup.com/citi/news/2007/070306c.htm>



BR refers to Based Rate in accordance with BNM Reference Rate Framework. The BR and profit margin (e.g.: BR+2%) used in the above is for illustration purpose only and vary among banks.

Figure 2: Default Rate Charging in Ijarah-based Financing Product

Referring to Figure 2, the customer will enjoy the original *ijarah* rental rate as per the Letter of Offer if he makes prompt payment to the bank. In the event the facility is impaired or classified as non-performing financing (NPF), the Bank shall revise the existing *ijarah* rate to a higher rate (default rate), for instance at BR+6.35% p.a. As a result, this will increase the monthly instalment.⁹ The basis to vary the *ijarah* rate is due to the fact that under *ijarah* contract, the rental is flexible and to be revised from time to time subject to mutual agreement of the parties. Such varied *ijarah* rates shall continue to apply notwithstanding that customer may have at any time after such variation remedied such revised and/or regularised the account.

Sale-based product such as *Tawarruq* and *Bay' Bithaman Ajil*

One of the innovations in Islamic banking products is financing facility using sale-based contract with variable or floating rate feature. Sale-based contract is one of the categories of Shariah contract that involves buying and selling of a particular asset that can derive certain profit portion. The most popular Shariah contract used in Islamic banks is *tawarruq*.

Tawarruq refers to an arrangement that consists of two sale and purchase contracts. The first involves the sale of an asset by a seller to a purchaser on a deferred basis. Subsequently, the purchaser of the first sale will sell the same asset to a third party on cash and spot basis (Item 9.1 of BNM Policy Document on *Tawarruq*). In financing product, the bank is the seller and the customer is the purchaser. When bank sells an asset to customer, the bank will incorporate profit portion into the sale price. As far as the product is concerned, the sale price is equivalent to the combination of principal and profit portion. The sale price must be fixed and determined to avoid the issue of *gharar* (uncertainty), which is prohibited in Shariah.

⁹ (4 November 2021). Affin Home Assist Plus-i Product Disclosure Sheet. Retrieved from https://www.affinislamic.com.my/getattachment/Consumer-Banking/Consumer-Financing-i/Affin-Home-Assist-Plus-i/04-Affin_Home_Assist_Plus-i_ENG_v5-3.pdf.aspx. Refer also Maybank Islamic Property Financing Product Disclosure Sheet. Retrieved from <https://www.maybank2u.com.my/iwov-resources/maybank/document/my/en/loans/home/Islamic-Mortgage-PDS.pdf>

In the case of variable or floating rate structure, in order to vary the sale price and float throughout the financing tenure, *tawarruq* is transacted at a Ceiling Profit Rate (CPR) for computation of the sale price. However, the customer will only pay monthly instalment according to the Effective Profit Rate (EPR) based on customer's approved profit rate that varies depending on the prevailing pricing benchmark, such as BR or Bank COF, which reduces Bank's Sale Price gradually. The bank shall provide rebate (*ibra`*) on the remaining portion of Bank's Sale Price on monthly basis or upon termination of facility. Figure 3 presents the said arrangement:

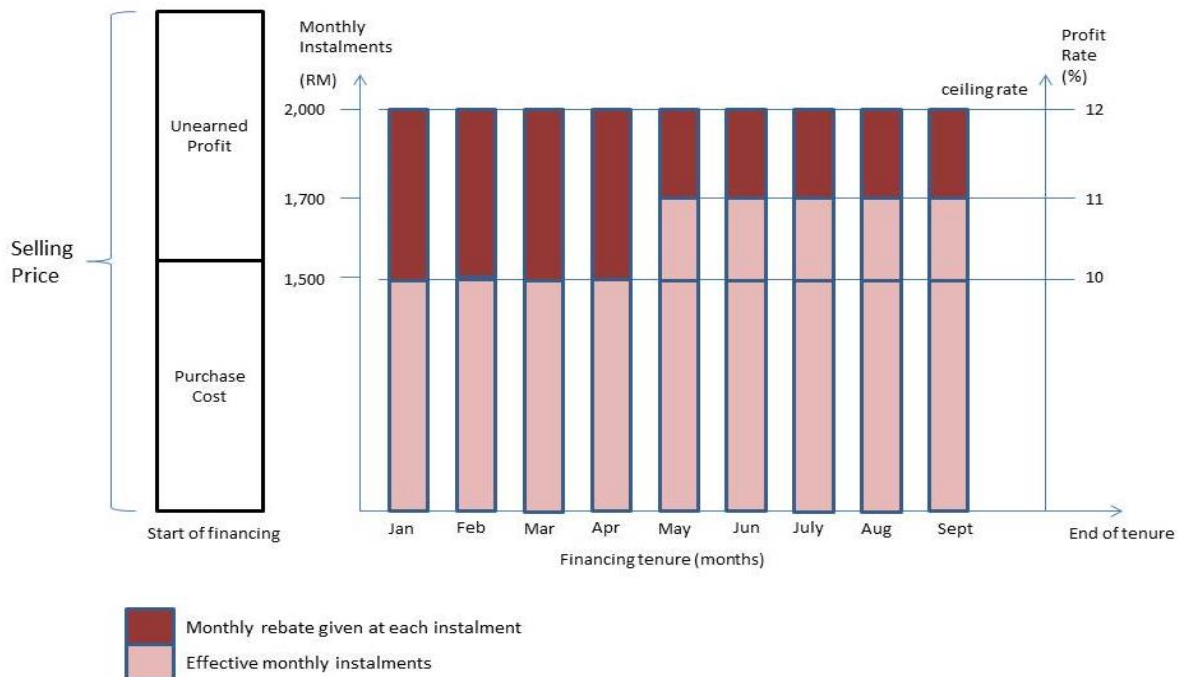
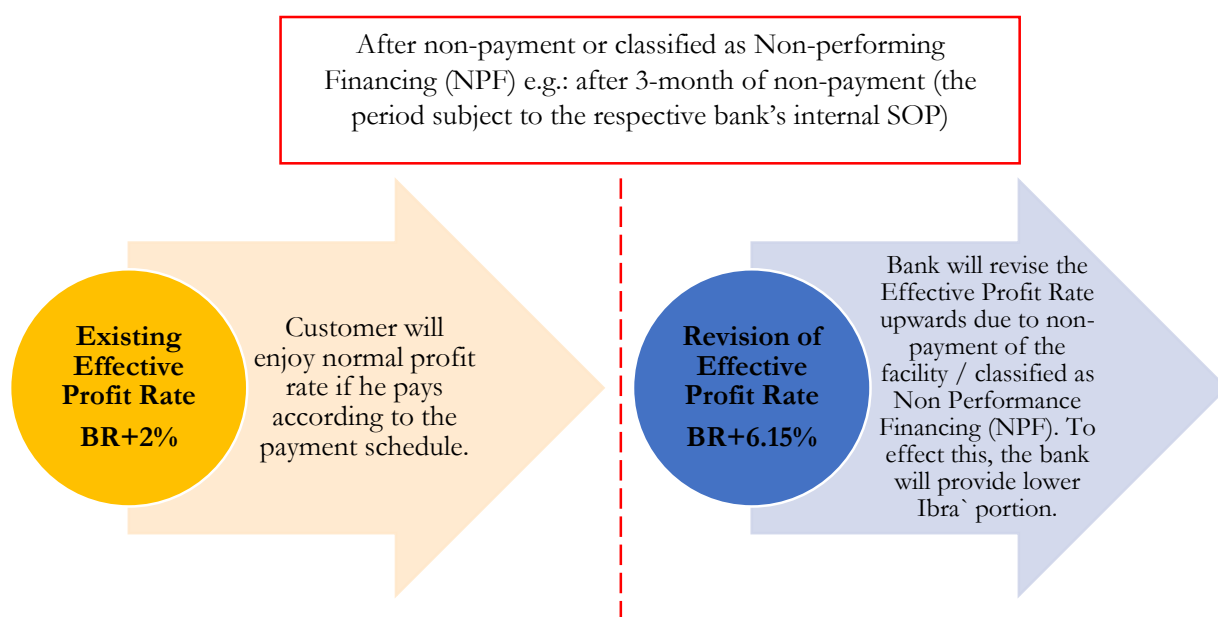


Figure 3: Variable Profit Rate or Floating Rate Financing Product (*Tawarruq*)

Referring to Figure 3, for instance, if the sale price is computed at CPR of 12% and the EPR (based on BR) is 10% from January to April, the bank shall grant *ibra`* (rebate) of 2%. Therefore, instead of paying monthly instalment of RM2000 (based on CPR rate), the customer is only required to pay RM1500 (based on EPR), in which the difference is rebated by the bank. However, if the EPR is changed to 11% due to change in the BR starting in September onwards, the monthly instalment will be revised to RM1700. This structure shows that the bank has full discretion in deciding the amount of *ibra`* to be granted to customer. In other words, the bigger is the *Ibra`* portion, the lower is the monthly instalment and vice versa.

In this structure, the default rate is imposed by adjusting the *ibra`* portion. As *ibra`* is up to bank's discretion, when the bank wants to charge default rate, the bank will adjust the *ibra`* by reducing the *ibra`* component to match the new revised EPR. Effectively, the customer will pay higher monthly instalment as a result of reduced *ibra`*. This scenario is illustrated in Figure 4:



BR refer to Based Rate in accordance with BNM Reference Rate Framework. The BR and profit margin (e.g.: BR+2%) used in the above is for illustration purpose only and vary among banks.

Figure 4: Default Rate Charging in Sale-Based Financing Product (*Tawarruq*)

Referring to Figure 4, in the event the facility is in default for three consecutive months or when the facility is classified as NPF, the bank shall revise the existing EPR upwards of which can be translated to lower *ibra`* portion. Effectively, the monthly payment will be higher than the original payment. Notwithstanding the above, the revision of EPR shall always be within the CPR or selling price and shall not exceed it.¹⁰

ANALYSIS FROM SHARIAH PERSPECTIVE

In Islamic banking, default occurs when customer fails to make payment obligation under a financing facility. However, conventional banking default always stems from a loan contract when the customer fails to repay the loan with compound interest (Kabir Hassan et al., 2021). Islamic banks have long tried to grapple with the issue of delayed payments or defaults, but thus far, there is no universal consensus across jurisdictions in this respect. This issue affects almost all types of products; ranging from consumer finance, home financing, leasing, hire purchase, credit and charge cards, to corporate finance, SMEs and Sukuk.

Managing default risk in Islamic banks is more complicated due to the nature of the underlying Shariah contracts and some additional factors, such as a restriction that prohibits Islamic bank from charging penalty due to default in payment. There is a possibility that this restriction can be abused by customers as they may intentionally default in payment knowing the fact that there will be no extra charge imposed on them unlike the conventional banks (Khan, 2003).

¹⁰ (4 November 2021). Maybank Islamic Home Financing Purchase Product Disclosure Sheet. Retrieved from https://www.maybank2u.com.my/iwov-resources/pdf/personal/loans/home/mortgage-islamic_PDS.pdf. Refer also Bank Simpanan Nasional MyHome-i (Product Disclosure Sheet. Retrieved from https://www.bsn.com.my/cms/upload/pdf/islamic/financing/residential_pds.pdf

From the Shariah perspective, the strictest view in this regard mentions that any increase in pricing due to default is considered as *riba jabiliyyah*, which is prohibited under Shariah. For instance, the Council of the Islamic Fiqh Academy under OIC, in its sixth session from 14 to 20 March 1990, had made a resolution that:

“If the buyer/ debtor delays the payment of instalments after the specified date, it is not permissible to charge any amount in addition to his principal liability, whether it is made a pre-condition in the contract or it is claimed without a previous agreement, because it is "Riba", hence prohibited in Shariah.”¹¹

However, in the context of the present Islamic banking environment, in case of delayed payment of financing amount, the financier is also unable to utilise the fund for other business purposes, of which should be settled within stipulated period. Technically, the two types of charges imposed by Islamic bank on customers who default in making payment are *ta'widh* (compensation) and *gharamah* (penalty) (Muneeza et al., 2019). There is also a practice that uses the term *ta`zir*, which shares the same meaning as *gharamah* (Syaifullah, 2021).

Whilst the main purpose of *ta'widh* is to compensate for actual losses suffered due to financial default, the imposition of *gharamah* requires careful deliberation to instil discipline on customers to pay promptly (Hamdan, 2020). The necessity of late payment is based on the concept of *maslahah mursalah* (considerations of public interest) to eliminate *mafsadah* (harm) to the bank, but it should not be used as mechanism to collect more revenue (Norazlina, 2019).

In determining the amount of *ta'widh*, it should only be restricted to actual cost but excluding indirect cost and any opportunity loss. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), for instance, has made the following resolution:

“It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of loss of income (opportunity loss) and in respect of a loss due to change in value of currency of the debt.” (Accounting and Auditing Organization for Islamic Financial Institutions, 2017)

In the context of Islamic banking in Malaysia, the Shariah Advisory Council (SAC) of BNM had resolved that *ta'widh* (compensation) and *gharamah* (penalty) may be charged on late payment of financial obligations resulting from exchange contracts (sale and lease) and *qard*. *Ta'widh* may only be imposed after the settlement date of the financing becomes due as agreed between both contracting parties. The bank may recognise *ta'widh* as income on the basis that it is charged as compensation for actual loss suffered by the bank (Resolution 81, SAC of BNM, 2010).

As for *gharamah* (penalty), it is charged for delay in debt settlement, without the need to prove the actual loss suffered (BNM, 2010). It can also be defined as what must be paid as a disciplinary measure or what needs to be paid as a burden, but not as compensation (ISRA, 2010). As such, it cannot be recognised as bank income and should be channelled to *baitulmal* or charitable organisation (BNM, 2012). The permissibility of imposing *ta'widh* and *gharamah* on a defaulted customer is considered based on the following evidence and arguments:

The following hadith of Rasulullah S.A.W. that considers intentional delay in debt payment by a person, who is able to pay, is a tyranny:

“From Abi Hurairah that Rasulullah S.A.W. had said: Delay by a rich person (in payment of debt) is a tyranny”

¹¹ (4 November 2021). Retrieved from <https://uaelaws.files.wordpress.com/2012/05/resolutions-and-ecommendations-of-the-council-of-the-islamic-fiqh-academy.pdf>

There is also a fiqh maxim extracted from a hadith relating to this matter:

“Neither harming nor reciprocating harm (in Islam)” (Ahmad al-Zarqa, 1989)

Totally prohibiting late payment charges by Islamic banks may significantly threaten its operation (Ishak & Nasir, 2021). Delay in payment by customers will create harm to the Islamic financial institution as the financier, whereby the Islamic financial institution will suffer actual loss in terms of incurring additional expenditure, such as cost for issuing notices and letters, legal fees, and other related costs. These issues should be avoided to ensure that business transactions are conducted according to the principle of market efficiency (Resolution 81, BNM, 2010; Norazlina, 2019; Ishak & Nasir, 2021). Nevertheless, it is worth noting that the permissible rate for *ta'widh* and *gharamah* is still lower than those charged by conventional banks. This dismisses any form of *riba* (interest) because it is computed based on actual loss. In fact, a study found that the rate of *ta'widh* charge of one per cent still could not cover the loss suffered by the bank (Norazlina, 2019).

In relation to the practice of charging default rate, technically, it may be considered as permissible since it is charged indirectly using various mechanisms, such as revising *ijarah* rental or *ibra'* adjustment, as elaborated earlier. In other words, such mechanisms are viable as a way out or *hilah* (legal stratagem) to impose default rate. According to Ibn Taymiyyah (1987), the application of *hilah* is acceptable if it is used for good means without breaching Shariah ruling.

In the context of default rate charging, the intention of the bank to impose default rate is to mitigate the risk of credit defaulter. Therefore, if the current mechanism of *Ibra'* reduction or adjustment of *Ijarah* rental is used as *hilah* to charge default rate, it should also weigh in several requirements to ensure that it disposes prohibited elements. The means employed for *hilah* shall not contravene the Shariah requirement and should always be based on the hierarchy of priority under *maqasid shariah* (objective of Shariah).

In analysing the issue in question, Shariah should also look from all angles, including the purpose as to whether it meets the objective of Shariah (*maqasid shariah*), as well as within the spirit of Shariah and Islamic finance to ease customer's burden when facing financial problem (Ishak, & Nasir, 2021). This is consistent with the verse 280 of Surah al-Baqarah, as given in the following:

“...And if the debtor is having a hard time, then grant him time till it is easy for him to repay; but if you remit it by way of charity, that is better for you if you did but know..”

Furthermore, the AAOIFI restricts adjusting the lease rental in the event of deferral of rental payment by the lessee since it is a form of *riba*. This is portrayed in the following:

“No increase in the rental due may be stipulated by the lessor in case of default in payment by the lessee” (Accounting and Auditing Organization for Islamic Financial Institutions Shariah Standard, 2017)

If the purpose of the bank to charge default rate is to prevent customers from taking advantage on the bank by paying late and also to instil discipline among customers to pay promptly, the best mechanism is by imposing *ta'widh* and *gharamah* on customers as permitted by the SAC of BNM. Nevertheless, if the imposition of *ta'widh* would still pose the bank to risk, the bank may introduce default rate but with certain adjustment of its process, such as funds collected from the default rate mechanism to be channelled to charity and the period for reinstatement of account to original profit rate to be shortened and simplified.

CONCLUSION

The role of financial institutions, including Islamic banks, is to act as financial intermediary to facilitate customers in providing financial instruments to meet their financial needs. Therefore, as a financial institution, be it conventional or Islamic bank, it cannot run away from the basic commercial and financial risk exposure and requirements. Default risk is the most important type of risk faced by a bank in its relationship with customers. In mitigating such risk, this study evidenced that several Islamic banks in Malaysia impose default rate in their product structure. This study sheds light on this issue and recommend Shariah scholars and regulator to re-evaluate the current regulatory policies and product structure to ensure that they embrace the spirit of Shariah, apart from protecting consumers from heightened financial burden.

While Islamic banking should have its own identity to offer ethical and Islamic values in its products and operations, it should also ensure that such proposition would not create moral hazard or open to abuse by customers that could be detrimental to the Islamic banking environment. For example, if a customer who is in financial difficulty and has both Islamic and conventional facilities, in view of conventional bank charges default rate and higher late payment interest when compared to Islamic bank, the customer may take advantage and prefer paying his conventional facility first instead of the Islamic facility. This would certainly contribute to higher NPF for Islamic bank, thus affecting its financial reporting and financing portfolio.

Apparently, several possible future research areas may be further explored to unravel firm outcome. One particular arising question is whether the current mechanism, as stipulated in BNM Policy Reference Rate Framework in determining the BR that allows bank (including Islamic bank) to adjust the spread depending on creditworthiness of customer, is acceptable from the ambit of Shariah. Furthermore, future study should also determine if the practice of charging default rate will give positive result in decreasing bank NPF cases, thus ensuring good discipline by customers to pay promptly. On the current practice of charging *ta'widh* and *gharamah* by Islamic banks, a study can be embarked to assess its adequacy as deterrent to avoid customers from deferring payment of Islamic facility, hence mitigating morale hazard that can adversely affect the Islamic banking industry.

REFERENCES

- Abedifar, P., Molyneux, P., & Tarazi, A. (2013). Risk in Islamic banking. *Review of Finance*, 17(6), 2035-2096. <https://doi.org/10.1093/rof/rfs041>
- Abedifar, P., Ebrahim, S. M., Molyneux, P., & Tarazi, A. (2015). Islamic banking and finance: Recent empirical literature and directions for future research. *Journal of Economic Surveys*, 29(4), 637-670. <http://dx.doi.org/10.1111/joes.12113>
- Accounting and Auditing Organization for Islamic Financial Institutions (2017). *Shariah Standard for Islamic Financial Institutions*. <http://aaoifi.com/shariaa-standards/?lang=en>
- Ahmad al-Zarqa' (1989). *Syarb al-qawa'id al-fiqhiyyah*. Dar al-Qalam.
- Ahmed, H., & Khan, T. (2007). Risk management in Islamic banking. *Handbook of Islamic banking*, 144.
- Al Rahahleh, N., Ishaq Bhatti, M., & Najuna Mismar, F. (2019). Developments in risk management in Islamic finance: A review. *Journal of Risk and Financial Management*, 12(1), 37. doi: 10.3390/jrfm12010037
- Arshad, Z., Hussain, T., & Khan, M. M. S. (2020). Does shariah governance eliminate default risk: A Shariah governance index for banking sector. *Paradigms*, 14(2), 180-188. DOI: 10.2412/20201402024
- Asni, F., & Sulong, J. (2018). Syariah analysis on hybrid contracts and its applications in Islamic housing financing in Malaysia. *The Turkish Online Journal of Design, Art and Communication*, 6(1), 57-62.

- Bender, S.W., & Madison, M. T. (2008). The enforceability of default interest in real estate mortgages. *Real Property, Trust and Estate Law Journal*, 43(2), 199-222.
- Bank Negara Malaysia. (2019). *Credit risk policy document*. https://www.bnm.gov.my/documents/20124/938039/Credit+Risk_27092019.pdf/5d643b56-de41-90de-dc9d-c9036f7ba256?t=1592250383370
- Bank Negara Malaysia. (2016). *Reference rate framework*. <https://www.bnm.gov.my/documents/20124/938039/Reference+Rate+Framework.pdf>
- Bank Negara Malaysia. (2013). *Risk-informed pricing*. https://www.bnm.gov.my/documents/20124/938039/20131216_B_PL_0043.pdf/c0dfc80a-a83f-da90-dae9-2317689c42b9?t=1592216160990
- Bank Negara Malaysia. (2013). *Guidelines on product transparency and disclosure*. <https://islamicbankers.files.wordpress.com/2013/12/20130401-guidelines-on-product-transparency-and-disclosure.pdf>
- Bank Negara Malaysia. (2018). *Tawarruq policy document*. https://www.bnm.gov.my/documents/20124/938039/pd_reissuancetawarruq_dec2018.pdf/bcc4b359-381c-5035-f9f0-3908faebb92a?t=1592249563244
- Bank Negara Malaysia. (2012). *Guidelines on late payment charges for Islamic banking institutions*. <https://islamicbankers.files.wordpress.com/2013/12/guidelines-on-late-payment-charges-for-islamic-banking-institutions.pdf>
- Bank Negara Malaysia (2010). *Shariah resolution in Islamic finance* (2nd ed.). Bank Negara Malaysia.
- Budiandru, B. (2021). Default risk on Islamic banking in Indonesia. *Journal of Economics, Business, & Accountancy Ventura*, 24(1), 49-62. DOI: 10.14414/jebav.v24i1.2474
- Ibn Taymiyyah (1987). *Al-Fatawa al-Kubra* (Vol. 6). Dar al-Kutub al-Ilmiyyah.
- Hassan, M. K., Khan, A., & Paltrinieri, A. (2019). Liquidity risk, credit risk and stability in Islamic and conventional banks. *Research in International Business and Finance*, 48, 17-31. <https://doi.org/10.1016/j.ribaf.2018.10.006>
- Hamdan, N. A. M., Sarkawi, A. A., Habib, S. N. H. A., & Othman, A. A. (2020). Assessment of ta'widh and gharamah in Islamic financing contract and its applicability potential for construction works contracts. *Environment-Behaviour Proceedings Journal*, 5(15), 255-262. <https://doi.org/10.21834/ebpj.v5i15.2504>
- Ibrahim, M. F., & Kamarudin, R. (2018). Islamic home financing base on debt: A review of practices of Islamic bank in Malaysia. *Labuan e-Journal of Muamalat and Society (LJMS)*, 43-50. <https://doi.org/10.51200/ljms.v12i.1349>
- Isa, M., & Lee, S. P. (2016). How Islamic bank set financing charges: A survey of people's perception in Malaysia. *The Journal of Muamalat and Islamic Finance Research*, 13(2), 1-18.
- Ishak, M. S. I., & Nasir, N. S. M. (2021). Maqasid al-shari'ah in Islamic finance: Harmonizing theory and reality. *The Journal of Muamalat and Islamic Finance Research*, 18(1), 108-119.
- ISRA. (2010). *ISRA Compendium for Islamic financial terms*. ISRA.
- Kabir Hassan, M., Muneeza, A., & Mustapha, Z. (2021). Mechanisms to handle default cases in Islamic banking: The Malaysian approach. *International Journal of Economics and Politics*, 2(1), 97-115. DOI: 10.29252/jep.2.1.97
- Khan, T. (2003). Credit risk management: A framework for Islamic banking. *Islamic Financial Architecture*, 399.
- Makiyan, S. N. (2008). Risk management and challenges in Islamic banks. *Journal of Islamic Economics, Banking and Finance*, 4(3), 45-54.
- Manab, N. A., Theng, N. Y., & Md-Rus, R. (2015). The determinants of credit risk in Malaysia. *Procedia-Social and Behavioral Sciences*, 172, 301-308. <https://doi.org/10.1016/j.sbspro.2015.01.368>

- Misman, F. N., & Bhatti, M. I. (2020). The determinants of credit risk: An evidence from ASEAN and GCC Islamic banks. *Journal of Risk and Financial Management*, 13(5), 89. <https://doi.org/10.3390/jrfm13050089>
- Muneeza, A., Zainudin, N. A., Ali, R., Ibrahim, S. N., & Mustapha, Z. (2019). Application of ta'widh and gharamah in Islamic banking in Malaysia. *The Journal of Muamalat and Islamic Finance Research*, 1-16. <https://doi.org/10.33102/jmifr.v16i1.205>
- Murray, M. W. (2019). Carrot or a stick: When is default interest not equitable? *American Bankruptcy Institute Journal*, 38(5), 26-61.
- Neff, D. M. (2019). Default interest claims make gains. *American Bankruptcy Institute Journal*, 38(6), 12-65.
- Norazlina, M., Alam, S., & Ridzwan, A. (2019) Masalah approach towards imposition of ta'widh in Islamic banking. *Global Journal Al-Thaqafah*, (Special Issue), 39-48.
- Noor, F. M., Shahrudin, A., Nawai, N., Marzuki, A., & Abdullah, W. Z. W. (2018). Intermediary role performance analysis of Malaysian Islamic and conventional banks. *Jurnal Pengurusan*, 53, 93-105. <https://doi.org/10.17576/pengurusan-2018-53-09>
- Rizwan, M. S., Moinuddin, M., L'Huillier, B., & Ashraf, D. (2018). Does a one-size-fits-all approach to financial regulations alleviate default risk? The case of dual banking systems. *Journal of Regulatory Economics*, 53(1), 37-74. <https://doi.org/10.1007/s11149-017-9340-z>
- Safiullah, M., & Shamsuddin, A. (2019). Risk-adjusted efficiency and corporate governance: Evidence from Islamic and conventional banks. *Journal of Corporate Finance*, 55, 105-140. <https://doi.org/10.1016/j.jcorpfin.2018.08.009>
- Shubky, K. H. M., Liu, J. Y., Abdullah, M. M., Mokhtar, Z. F., & Faizrahman, A. (2017). The implication of musharakah mutanaqisah in Malaysian Islamic banking arena: A perspective on legal documentation. *International Journal of Management and Applied Research*, 4(1), 17-30. <https://doi.org/10.18646/2056.41.17-003>
- Şibneschi, D. N. (2016). Default interest procedure. The particulars of the default interest rate. *European Journal of Law and Public Administration*, 3(2), 59-67.
- Silvira, O., & Rani, L. N. (2021). Probability of default measurement models of merton on Shariah banks and conventional banks in Indonesia for 2011-2017 Period. *Jurnal Syariah*, 29(1), 65-90. <https://doi.org/10.22452/js.vol29no1.4>
- Spuchřáková, E., Valášková, K., & Adamko, P. (2015). The credit risk and its measurement, hedging and monitoring. *Procedia Economics and Finance*, 24, 675-681. [https://doi.org/10.1016/S2212-5671\(15\)00671-1](https://doi.org/10.1016/S2212-5671(15)00671-1)
- Syaifulloh, H. (2021). Ta'widh dan ta'zir persepektif mufassir klasik dan implementasinya di Bank Syariah. *MALLA: Journal of Islamic Banking and Finance*, 5(1), 27-42. <https://doi.org/10.21043/malia.v5i1.10196>
- Trad, N., Trabelsi, M. A., & Goux, J. F. (2017). Risk and profitability of Islamic banks: A religious deception or an alternative solution? *European Research on Management and Business Economics*, 23(1), 40-45. <https://doi.org/10.1016/j.iedeen.2016.09.001>
- Whelan, S. T. (2019). Leasing law: In the penalty box: Default interest. *Com. L. World*, 33, 28.

