

A Revisit to the Practice of Late Payment Charges by Islamic Banks in Malaysia

(Penilaian Semula Amalan Caj Kelewatan Pembayaran oleh Perbankan Islam di Malaysia)

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ABSTRACT

Islamic banking in Malaysia have been experiencing late payment and default issues because customers are not allowed to be charged with interest (*riba*) as opposed to the practices in the conventional banking. To mitigate these issues, the Shariah Advisory Council of Bank Negara Malaysia has enforced *ta'widh* and *gharamah* as regulatory alternatives. Practically, *ta'widh* and *gharamah* were imposed on the defaulting customers who fail to meet their obligation to pay their financing based on several conditions. Given the significance of its imposition, this paper aims to analyse the current practice in Islamic banks and examine the views of contemporary Muslim scholars on *ta'widh* and *gharamah* and its suitability as alternatives for avoidance of *riba*.

Keywords: *Ta'widh* (compensation); *gharamah* (penalty charges); defaulting customers; actual loss; Muslim scholars' view; Islamic banking

ABSTRAK

Perbankan Islam di Malaysia berdepan dengan isu kelewatan bayaran balik dan kemungkiran pembayaran pinjaman kerana pelanggan tidak dibenarkan dikenakan bunga atau faedah, berbeza dengan praktis dalam perbankan konvensional. Untuk menangani isu ini, Majlis Penasihat Syariah Bank Negara Malaysia telah melaksanakan *ta'widh* dan *gharamah* sebagai alternatif perundangan. Secara praktisnya, *ta'widh* dan *gharamah* dikenakan ke atas pelanggan yang gagal memenuhi tanggungjawab mereka untuk membayar balik pinjaman berdasarkan beberapa syarat. Memandangkan signifikannya pelaksanaan tersebut, artikel ini bermatlamat menganalisis amalan semasa di perbankan Islam dan mengkaji pandangan cendekiawan Muslim kontemporari mengenai *ta'widh* dan *gharamah* serta kesesuaiannya sebagai alternatif untuk mengelakkan *riba*.

Kata kunci: *Ta'widh* (gantirugi); *gharamah* (caj penalti); kemungkiran pelanggan; kerugian sebenar; pandangan sarjana Islam; perbankan Islam

INTRODUCTION

Islamic banking in Malaysia was first introduced in 1983 based on the *Shariah* principles. The core principle of Islamic banking is the elimination of interest (*riba*) in the banking system. Evidently, the initial development of Islamic banking in Malaysia was structured on the conventional banking framework. The earlier Islamic banking products introduced was based on conventional products albeit with certain adjustments to ensure conformity with the *Shariah* principles. Nevertheless, Islamic banking has been facing various primary challenges in ensuring adherence to *Shariah* principles, maintenance of competitiveness with conventional banking and securing global banking market. This paper argues that at the current practice, the principal challenge faced by Islamic banks is that there is no interest chargeable on

late payment and default. On the contrary, if necessary policy measures are not taken, the Islamic banks may be adversely affected. The immediate need is to examine the current practice of *ta'widh* and *gharamah* imposed by the Bank Negara Malaysia to manage these late payment and default issues and to review the arguments on the possibility of *riba* in late payment charges. The future growth and development of Islamic banking financing products will depend largely on the nature of innovations introduced in the market.

The remainder of this paper is structured as follows. The next section provides a review of relevant literature on financial penalty in Islam and definition on *ta'widh* and *gharamah*. This is followed by the imposition of financial charges by Islamic banks in Malaysia. The results and discussions are presented in the subsequent section and finally, conclusions are drawn.

FINANCIAL PENALTY IN ISLAM

Fundamentally, Islam prohibits *riba* and these include any excessive amount in loan repayment. As per this principle, Islamic banks should not charge excessive repayment of loan to the customers. Moreover, the practice of excessive repayment charges may negatively impact Islamic banking and contribute to cases of late payment and defaults and consequently affect the flow of capital for Islamic banks. Undeniably, this situation may inadvertently constitute a loophole that can be manipulated by certain parties. The loophole is manipulated by deliberately withholding payments especially by those who are familiar with conventional banking (Bank Negara Malaysia 2012). As a consequence, some customers may legally prefer to take advantage of the situation by purposely withholding payment and in turn affecting the running capital of Islamic banking. This may consequently pose serious default risks to the Islamic banks (Muhammad Abdul Hakim 2013).

On the other hand, conventional banks in practice, charges cumulative interests on late payments and defaulting customers. With regard to these issues, Islamic banking seems to be relatively at a disadvantage compared to the conventional banking. Thus, an alternative mechanism must be brought into force to manage the repercussions of Islamic banking loan repayment issues.

One of the Islamic methods to mitigate or deter loan repayment default is through punishment. In one of the prophetic traditions (*hadith*), it is reported that the Prophet Muhammad SAW considered intentional delay in debt payment as an act of tyranny:-

From Abu Hurairah that Prophet Muhammad SAW had said: Delay by a rich person (in payment of debt) is tyranny.

(Al-Bukhari 1982: 175)

Thus, for a genuinely rich person a tyrannical deed like delaying the payment of debt justifies punishment. Punishment is further justifiable when the tyrannical deed affects the welfare of the larger Islamic community such as the sustainability of Islamic banking system. In addition, Muslim jurists justify penalty for default payment with usurpation (*ghasb*). Those whose property are withheld or those who are denied payment have unjustly suffered a grievance because they could not consume their property for their own benefit. Similarly are the lenders who have been denied their rights in utilizing their property or capital for other business purposes. According to Shafi'i and Hanbali schools of thought, *ghasb* is tyranny and deserves to be punished. This situation has to be avoided so that businesses are conducted according to the *istiqrar ta'amul* principle, that is the smooth running of the market. This view is based to the Islamic legal maxim (*qawaid al-fiqhiyyah*) principle of *al-dararu yuzal*, that is the "whatever harm should be removed" (al-Suyuthi). According to *Shariah* Resolution in Islamic Finance published by Bank Negara Malaysia, a punitive element could potentially be used to manage the harm

towards financiers as well as instilling discipline amongst customers to make timely payments.

In the event of a tyrannical deed, there are several other types of punishment. The punishment can be in the form of lashing, imprisonment, or financial penalty. The most commonly practiced punishment is financial penalty which includes destruction, augmentation, compensation and fines. However, during the International Islamic Fiqh Academy of the Organization of the Islamic Conference meeting held in Qatar on 2003, Abdullah ibn Sulayman al-Mani', a leading Saudi scholars argued that the most suitable method that meets the purpose of *Shariah* principles in regulating the harm caused by default payments is the use of fines. Citing the opinion of Ibn Qayyim, he said that there are no provisions with regard to the management of default payments because it is an *ijtihad* matter which can be decided by Muslim jurists based on their assessment as of the prevailing time, place and situation (al-Mani' 2003). Prophet Muhammad SAW had used several approaches in dealing with these issues. For instance, *zakat* evasion is punishable by confiscating a part of the offender's property and the act of theft at an orchard is punishable by paying double the amount of the produce stolen (Narrated in *Sunan Abu Dawud, Sunan al-Tirmidhi & Sunan Ibn Maja*). In addition, there is also a precedent in the Hanafi school of thought which allows penalty when a disadvantage happened to any party. Al-Mani' further argues that Ibn Taimiyyah is in favor of financial penalty for dealing with debtors who deliberately withhold payment and places them under the corporal punishment (*ta'zir*) category, which is in line with the prophetic traditions (*sunnah*) practiced during the times of Prophet Muhammad SAW. Some Muslim jurists also posit that the offender has to be liable for any losses and also be responsible for any legal costs incurred. These include the cost difference in terms of losses or profits, which most likely will vary from time to time. Thus, a financial penalty must take into consideration the period between the date of the loan is secured and the present time (al-Mani' 2003).

Many Muslim countries take their own approach in dealing with this matter based on their understanding and their respective national *fatwa*. In addition to imposing financial penalty on late payment, few other prevention methods have been used. The most common method is preemptive investigation to ensure that the customers who are to enter into the contract are the ones that have good credit ratings and have the ability to repay. Thus, early prevention can avoid subsequent occurrence of problems. If default occurs, the banks will use certain methods to make sure that the penalty charge is not oppressive, that is among others like extension of the contracts until the customers are able to repay, dissolution of the contract with the obligation of full repayment of the outstanding balance of the debt, or sells of assets which have been pledged as collateral in the contract and use the proceeds to pay the rest of the debt (Rifki 2009).

According to al-Tabtabae (2006), there are three main views regarding the ruling of financial penalty in Islam:

1. In the form of financial penalty.
This opinion was supported by Mustafa al-Zarqa and Muhammad Sadiq al-Dharir, leading contemporary scholars in Islamic Economics and Finance, *Shariah* Advisory Council of Jordan Islamic Bank and majority of *Shariah* Committees (SC) of Islamic banks in Malaysia. They opine that financial penalty is allowed and it could benefit the bank as an income. It is based on *masalih mursalah* which is preventing the public from taking advantage of the rules by delaying in payment.
2. In the form of financial penalty which must be channeled to the charity.
This opinion was supported by Abd Sattar Abu Ghuddah, a contemporary scholar from Saudi and the Shariah Board of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOFI). They are of the view that penalty is allowed in case of delayed payment but a portion of it should be channeled to charity based on *iltizam al-tabaru'* in the Maliki school of thought. This means that customers should agree to donate (*sadaqah*) and appoint an Islamic bank in their stead to distribute the *sadaqah* if he fails to commit to the debt payment. If the incurred penalty is surrendered to a third party or incurred for welfare purposes, it can no longer be considered as *riba*. Majority of Islamic banks adhering to this *fatwa* will appoint a Shariah Committee (SC) to oversee the whole process to avoid non-compliance or misappropriation.
3. No penalty should be charged at all.
This opinion was supported by Nazih Hammad, member of the International Islamic Fiqh Academy of the Organisation of the Islamic Conference and Mohammed Ali Elgari, Professor of Islamic Economics in Saudi. They are of the opinion that the assumed potential losses are merely speculative.

DEFINITION OF *TA'WIDH* AND *GHARAMAH*

In Malaysia, *ta'widh* and *gharamah* are two mechanisms used to avoid detriments to Islamic banks. They are different from interest in conventional banks. From the objectives of *Shariah's* (*Maqasid Shariah*) perspective, it is important to protect the religion of Islam by ensuring the sustainability of the Islamic banking system. The word *ta'widh* is derived from the word *al-'iwad* that means 'instead,' and the term *ta'widh* () or *syart jaza'i* is interpreted as "a fine as agreed by the parties to the contract as compensation that can be claimed by the creditor when the debtor failed to pay or make late payment of debts." *Syart jaza'i* means 'the agreement of the parties to do something if they failed to carry out their responsibilities.' *Ta'widh* also means the 'damages imposed on the actual loss suffered by the lenders, compensating for the impact of delayed payment by the

receiver.' The International Islamic Fiqh Academy of the Organisation of the Islamic Conference filed a definition of *ta'widh* as reward or financial compensation payment incurred as a result of causing harm to others. According to the Resolution of *Shari'ah* Advisory Council (SAC) of Bank Negara Malaysia (2010), *ta'widh* refers to the actual losses experienced which will be assessed and determined by a third party that is the Bank Negara Malaysia which acts as the regulator.

Gharamah is defined as penalty imposed for delayed pay off debt, without the need to prove actual loss (Engku Ahmad Fadzil 2013). Arabic Language Academy of Cairo (Majma' Lughah 'Arabiyyah 1969) defines *gharamah* as a monetary penalty which aim to instill discipline as well as to impose compensation among individual. *Gharamah* also is referred as a form of fine imposed to individual for doing something illegal and it is not prescribed in Shariah, or something that is contrary to the country law, or contrary to the public system and was inconsistent with local customaries, and the fine can be either in the form of money or goods (Azizi 2013). Technically, *gharamah* can be defined as a penalty/charge imposed to customers who delay in financing/debt settlement, over and above the amount of *Ta'widh* (Bank Negara Malaysia 2013).

IMPOSITION OF FINANCIAL CHARGES BY ISLAMIC BANKS IN MALAYSIA

In practice, the implementation of *ta'widh* and *gharamah* in the Islamic banking system will need some time to mature in its adaptation and adjustment. For instance, Bank Islam of Malaysia only managed to implement *ta'widh* in February 2010 even though the imposition on *ta'widh* in *Islamic finance* was issued in the 4th meeting of the SAC of Bank Negara Malaysia in 1998. Another issue also arises when some of the Islamic banks in Malaysia prefer to implement *gharamah* instead of *ta'widh*. This is usually practiced among the Middle-East Islamic banks operating in Malaysia. Their tendency and interest usually follow their parent banks which are based in the Middle-Eastern countries abiding by the AAOFI opinions (Muhamad Abdul Hakim 2013).

A major principle that must be adhered here is that the money from the penalty should go to charity and not for the benefit of the bank. In the 95th meeting of the SAC of Bank Negara Malaysia in 2010, it is decided that *ta'widh* is permissible and recognised as income on the basis that it is imposed based on the actual loss incurred by the Islamic banks. On the other hand, *gharamah* is not allowed to be recognised as income, such that it must be channeled to specified charitable bodies. But as a measure to protect customers, Islamic banks should consider the capability of customers to repay their financing. The maximum rate for both *ta'widh* and *gharamah* must be determined by Bank Negara Malaysia (Bank Negara Malaysia 2010).

The SAC of the Security Commission of Malaysia are in the view that *ta'widh* is allowed in cases where the customer purposely delays payment with conditions as below:

1. For default payments, the rate of *ta'widh* that can be charged is 1% per annum on outstanding profit payments. However, this total cannot be compounded.
2. For basic financing that fails to be amortised and exceeds the maturity date, *ta'widh* that may be imposed is at the current Islamic Interbank Money Market (IIMM) rate taking into consideration the Islamic money market.
3. The maximum number of *ta'widh* that may be imposed on the non-amortised financing should not exceed 100 percent of the financing balance sum.
4. *Ta'widh* obtained from the financing that is not amortised can be used by the financiers involved and can be divided among financiers according to the bank's current profit sharing ratio.

On the 101th meeting of the SAC of Bank Negara Malaysia on May 2010, the Council has ruled the permissibility of both concepts of *ta'widh* and *gharamah* subject to the following conditions:

1. *Ta'widh* can only be imposed for late payment of financial obligations arising from exchange contracts (such as buying, selling and leasing) and *qard* (lending).
2. *Ta'widh* can only be imposed after the end of the repayment period agreed by both contracting parties.
3. Islamic banks may recognise *ta'widh* as an income on the basis that it is imposed as a compensation for the actual loss suffered by the Islamic banking institutions.
4. *Gharamah* cannot be taken into account as an income; instead it must be channeled to certain charities.

The Resolutions of Shariah Advisory Council of Bank Negara Malaysia 2010-2011 was well conceived and duly observed by all the relevant institutions. Recently the practicality of the resolution becomes more established and increasingly abided by many more institutions (Bank Negara Malaysia 2010). In Malaysia, the role of Bank Negara Malaysia as a third party is highly significant. Bank Negara Malaysia as the central bank acts effectively as a regulator that oversees the activities of Islamic banking system in Malaysia to ensure their compliancy to *Shariah* principles from the point of production, processing and systems. Evidently, the existing laws in Malaysia are quite extensive and are fully enforced to control all institutions of Islamic finance and banking in Malaysia. The resolutions reserve Bank Negara Malaysia as an authoritative body to determine the actual rate of loss in *ta'widh* implementation. Rates that can be used to determine the actual loss is the daily overnight Islamic Interbank Rate as shown on the website of Islamic Interbank Money Market (<http://iimm.bnm.gov.my/index.php>). Further, the rate is determined on the date of verdict and calculated monthly based on the daily balance method (daily basis).

As a matter of fact, proceeds from *gharamah* cannot be used by Islamic banks and must be placed in a separate *gharamah* account from *ta'widh* to facilitate proper administration and governance of the accounts. Further, the SAC of Bank Negara Malaysia has taken a stand to give a mandate to the *Shariah* Committee of Islamic banks to determine the appropriate charitable bodies or institutions to receive *gharamah* including Islamic Treasury (*baitulmal*). The channel should be provided as remedies to the Islamic banks and it shall ensure that any proceeds from *gharamah* should not have any benefit to Islamic banks. Besides, all institutions that are subjected to the jurisdiction of Bank Negara Malaysia should produce *gharamah* distribution report from time to time (Bank Negara Malaysia 2013).

In the legal perspective, *gharamah* refers to the difference between the late payment charges and *ta'widh*, whereby the surplus of *ta'widh* is less than the amount of the late payment charges. The Islamic banks are entitled to the amount of *ta'widh* only; and if the amount of the late payment charges exceeds *ta'widh*, then it should be channeled to charity. Calculation of the amount of the late payment charges is on the basis of judgment and does not include late payment charges before judgment and other costs.

Latest development in Malaysia indicates that the practice of payment of late charges has experienced a process of improvisation and consolidation to enhance product transparency and disclosure requirements. However, there are variances in the methods applied by the Islamic and conventional banks, and both are becoming more competitive. One of the recent initiatives is the issuance of Guidelines on Late Payment Charges for Islamic Financial Institution (IFI) by Bank Negara Malaysia effective 1st January 2012. The primary aim of the guidelines is to provide guidance to the Islamic financial institutions including Islamic banks on the mechanism of late payment charges that applies the concept of *ta'widh* (compensation) and *gharamah* (penalty). These guidelines prescribe 3 major principles, (i) combined late payment charge, (ii) the Islamic banks shall be compensated up to the amount of actual loss incurred as a direct result of the delay in repayment or default by the customer, and (iii) the *gharamah* shall be channeled to charitable organisation(s) approved by the Islamic banks' *Shariah* Committee. It is clearly stated that Islamic banks may impose a combined late payment charges comprising of *ta'widh* and *gharamah*.

In line with the resolution issued by Bank Negara Malaysia, if Islamic banks want to implement new late payment charges, they are required to submit their applications to the Bank Negara Malaysia in writing, explaining the justification for the imposition of the revised late payment charges, conditions under which the new late payment charges may be imposed, and enclose a communication plan after it is endorsed by the respective Islamic banks' *Shariah* Committee.

SIMILARITIES AND DIFFERENCES

In conventional banking, penalty for late payment of a loan is about 2 to 5 percent of total loan outstanding. Rates charged by conventional banks are compounded and the penalty will be included in the loan amount. If there is further penalty, it will be pegged to the percentage of the original loan amount. For example, let's assume that A undertakes a housing loan of RM100,000 and the outstanding loan is RM90,000. A then fails to pay the debt for a month. A set of penalty of 5 percent is imposed. As a result, the amount scheduled to be paid by A is:

- Penalty = $RM90,000 \times 5\% = RM4,500$
- Penalty + outstanding balance = $RM90,000 + RM4,500 = RM94,500$
- Interest on the new balance = $RM94,500 \times 6.75\%$ (interest rate) = $RM6,378.75$
- New outstanding loan = $RM94,500 + RM6,378.75 = RM100,878.75$

Whereas in Islamic banks, *ta'widh* rate is charged at 1 percent and it is non-compounding. Hence, it is lower than the conventional banking charges. For example, B obtains a home financing from the Islamic banks of RM100,000. In the first year, B fails to pay installments of RM2,000 per month and also two months arrears. Therefore, the

amount of *ta'widh* to be paid is:

- $Ta'widh = 1\% \times (2 \times RM2000) = RM40$
- Total payment of 2 months due = $RM40 + (2 \times RM2,000) = RM4,040$

As illustrated, the amount of the fines imposed by Islamic banks for the two months in arrears is only RM40, which will be added to the 2-month overdue installments of RM4,000. Thus, the total amount to be paid by B is only RM4,040. Therefore, this computation illustrates how *ta'widh* is different from penalty (*riba*) charged in conventional banks. *Gharamah* also uses the same calculation but the earnings received will be channeled for charity. This is unlike *ta'widh* which is counted as an income for the bank. Even so, in an interview conducted with Ahmad Fadhlán Yahaya (2012) discover that in current practices, majority of Islamic banks impose *ta'widh* at 1% as opined by the Shariah Committee in each Islamic banks. Even though Islamic banks may conclude the proceeds as their income, but they prefer to channeled the proceeds for charitable purposes.

Although the practice of late payment charges by Islamic banks look similar to the practice of *riba*, the truth is, it is different and not oppressive. The above calculation evidently has confirmed this characteristic.

TABLE 1. Summary of characteristics of *ta'widh*, *gharamah* and penalty

Mechanism	<i>Ta'widh</i>	<i>Gharamah</i>	Penalty
Concept	<ul style="list-style-type: none"> • Losses due to late payment are borne by creditors 	<ul style="list-style-type: none"> • Penalty to avoid late payment 	<ul style="list-style-type: none"> • Charge for late payment
Rate of charge	<ul style="list-style-type: none"> • Based on real loss • Fixed at 1% • Based on outstanding principal balance 	<ul style="list-style-type: none"> • Based on rate by BNM • Non compounding • Based on outstanding principal balance 	<ul style="list-style-type: none"> • Based on rate by BNM • Compounding • Based on outstanding balance (principal + penalty)
Use of Proceeds	<ul style="list-style-type: none"> • Income to bank 	<ul style="list-style-type: none"> • Channel to charity 	<ul style="list-style-type: none"> • Income to bank
Liability	<ul style="list-style-type: none"> • Customer's liability is not exceeding 1% of outstanding principal balance 	<ul style="list-style-type: none"> • Shared liability; channel for charity 	<ul style="list-style-type: none"> • Customer's liability
Ruling (<i>hukum</i>)	<ul style="list-style-type: none"> • Recommended as Shariah compliant • No <i>riba</i> 	<ul style="list-style-type: none"> • Recommended as Sharia compliant • No <i>riba</i> 	<ul style="list-style-type: none"> • Shariah non-compliant or prohibited (<i>haram</i>) • <i>Riba</i>

* BNM = Bank Negara Malaysia

CONCLUSION

Islamic ruling does permits Islamic banks to impose penalty charges on customer payment defaults. However, the implementation of *ta'widh* mechanism is different from the *riba* penalty charged by conventional banks. The policy on the imposition of *ta'widh* and *gharamah* outlined by Bank Negara Malaysia may help Islamic banks to mitigate default payment risks, and enhance their competitiveness with conventional banks. This is regarded as legitimate methods to overcome the late payment problems faced by the Islamic banks in Malaysia. Shariah Committee of Islamic banks takes a cautious

approach to ensure compliance with the BNM's *Shariah* Resolution in Islamic Finance to prevent the possibilities of *riba* and at same time, Islamic banks need to vigilantly inspect the customer, whether they are liable to *ta'widh* or *gharamah*. This involves the management system and the use of resources and this will increase management costs over time. In addition, there is the need for innovation and development of Islamic banking financing products since it involves the management of penalty. The practice of late payment charges by Islamic banks in Malaysia should be explained properly to avoid confusion among customers. These efforts are regarded as the best move at this time to avoid the problems faced by the customers. In

conclusion this approach does not deviate from the policy and principle of Islam and with regards to avoidance of the principal issues of *riba*, there is need for consolidation of regulatory control by the Bank Negara Malaysia to instill transparency among Islamic banks in Malaysia.

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