

## LATE PAYMENT CHARGE IN ISLAMIC BANK

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### **ABSTRACT**

Islamic banking in Malaysia is facing problems due to default done by customers because no interest is charged as opposed to practices in conventional banks. Thus the *Shari'ah* Advisory Council of Bank Negara Malaysia has imposed *ta'widh* and *gharamah* in order to overcome this problem. The Council suggests that *ta'widh* and *gharamah* may be imposed on the defaulting customer who fails to meet his obligation to pay the financing based on several conditions. Therefore, this paper aims to examine the Islamic scholars' view on *ta'widh* and *gharamah*. It also analyses the concept of *ta'widh* and *gharamah* imposed by Bank Negara Malaysia and how it is difference from *riba*.

**Keyword:** *Ta'widh (delay of payment), gharamah, defaulting customer, actual loss, Muslim scholar's view and Bank Negara Malaysia.*

## INTRODUCTION

Islamic banking in Malaysia was developed in 1983 based on *Shariah* principles. The core practice of Islamic banking is the elimination of *riba* or interest in the banking system. However, through history, Islamic banking was structured based on conventional banking framework. Then Islamic product were introduced based on conventional product but with adjustment to ensure its in line with *Shariah* principles. However, Islamic banking faces challenges along the implementation process, in ensuring its adhering with *Shariah* principles as well as competitive to conventional banking and global banking market. One of the major challenges is no interest is charged in Islamic banking due to late payment by financee. As a result, customers prefer to take an advantage on the situation by purposely hold payment and this will affect the running capital of Islamic banking. Therefore, Islamic banking imposes *ta'widh* as a mechanism to solve late payment by finance.

## THE CONCEPT OF TA'WIDH

*Ta'widh* word derives from the word *al-'iwad* that means instead, and the term *ta'widh* (تعويض) or *syart jaza'i* selected is interpreted as 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 late payment of debts. *Syart jaza'i* means the agreement of the parties to do something if he failed to carry out its responsibilities. *Ta'widh* also means damages imposed on the actual loss suffered by the lenders financing the impact of delayed payment by the receiver. While, Majma' Fiqh Islami filed a definition of *ta'widh* as reward or financial compensation payment required for causing harm to others. In conventional systems, the application of a penalty or *gharamah* is used in the above situation. *Gharamah* defined as a penalty or fine imposed for late off the debt, without proof of the existence of the actual loss. Without doubt, interest is part and parcel with the penalty implemented in conventional banking system.

## VIEWS ON TA'WIDH

Basically, Islam prohibits *riba* and permit *halal* transaction. Any excessive payment in paying back loan is *riba*. Islamic bank should not charge any excessive payment to customer and this loop can be manipulated by them. This is a risk that must be avoided by Islamic bank. In *ta'widh* case, penalty is imposed because of deferred payment. Question asked, does it considered *riba*? three different opinions:

- a. It should be penalised in the form of money:

Sheikh Mustafa Zarqa', Sheikh Muhammad Sadiq al-Dharir, Shariah Advisory Council of Islamic Bank Jordan and most of *Shariah* Committee of Islamic banks in Malaysia, opined that penalty is allowed and it can be benefited by the bank as an income. It is based on *masalih mursalah* which is preventing public from advantage taking delaying in payment.

b. It should be penalised in the form of money but it should be channeled to charity:

Some of the scholars who agree with this opinion are Dr Abd Sattar Abu Ghuddah and Shariah Council of AAOFI viewed 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 Mazhab Malik.<sup>1</sup> It means that, customers should agree to donate (*sadaqah*) and appoint bank for his sake to distribute the donation if he fails to commit with debt payment.

c. No penalty should be charged at all:

Among scholars who voice out this opinion are Dr Nazih Hammad, Member of the Islamic Fiqh1 Academy, Jeddah, Saudi Arabia and Dr Md Ali El-Gari and Shariah Board Member of The Islamic Bank of Asia because they strongly believe that penalty is similar to *riba*.

### IMPOSITION OF *TA'WIDH*

In Malaysia, *ta'widh* is a mechanism used to avoid disadvantage to Islamic banks. *Ta'widh* is different from interest as charged in conventional banks. From the Maqasid Syariah's perspective, it is important to protect religion of Islam by ensuring sustainability of Islamic banking. The Prophet Muhammad SAW did refer those who deliberately refuse to pay back debt as tyranny. "*Delay by a rich person (inpayment of debt) is a tyranny*"<sup>2</sup>. Adding to that, there is also a precedent in Mazhab Hanafi which allowed penalty when disadvantage happened to any party. Majma' Fiqh al-Islami also strongly agree to allow the usage of *al-Syart al-Jazaie* or penalty clause in business. Therefore, based on those argument, its implementation must be in line with guideline resolved by Shariah Advisory Council of Bank Negara Malaysia its 4<sup>th</sup> meeting in 1998 which the amount of *ta'widh* cannot exceed the actual loss suffered by the financier. The determination of compensation is made by third party and the default or delay payment is due to negligence on the part of the customer<sup>1</sup>.

However, practically, to implement *ta'widh* in banking system need some time to change and adjust the banking system accordingly. For an instance, Bank Islam only managed to implement *ta'widh* starting from February 2010 even though resolution on *ta'widh* had been produced since 1998. Another issue also arises when some of Islamic banks in Malaysia prefer to implement gharamah instead of *Ta'widh*. This case usually practised among Middle-East Islamic banks which operate in Malaysia. Their tendency and interest usually follow their parental bank based in Middle-East country and abide by AAOFI opinions.

The biggest concern here is the money from penalty should go to charity and not benefits for the bank. In its 95<sup>th</sup> meeting in 2010, SAC decided that *Ta'widh* is permissible and recognized as

<sup>1</sup> Mohammad Abdul Razaq al-Tabtabae, *Al-Ta'widh `an al-Dharar wa al-Gharamah `ala al-Ta'khir fi al-Duyun*: Dirasah Tatbiqiyah `ala al-Mu`assasat al-Maliyyah al-Islamiyyah fi Daulati al-Kuwait, Al-Qadaya al-Mu`asarah fi al-Tamwil al-Islami: Munaqasyah fi al-Nadwah al-'Alamiyah li `Ulama' al-Syari`ah 2006, Bank Negara Malaysia, 2008, h. 91.

<sup>2</sup> Al-Bukhari, Sahih al-Bukhari, *al-Matba'ah al-Salafiyah*, 1982, v.2, p. 175

income on the basis that it is imposed based on actual loss incurred by Islamic banks. While, *gharamah* is not allowed to be recognized as income, must be channeled to specified charitable bodies. But as a measure to protect customer, Islamic banks should consider the capability of customer to pay back their finance. The maximum rate of both and *ta'widh* must be determined by Bank Negara Malaysia.<sup>3</sup>

According to the Shariah Committee of Security Commission of Malaysia, *ta'widh* is allowed in case where customer purposely delays payment with conditions as below:

- i. For default payments, the rate of *Ta'widh* that can be charged is 1% per annum on outstanding profit payments. However, this total can not be compounded.
- ii. For basic financing that fails to be amortized and exceeds the maturity date, *ta'widh* that may be imposed is at the current rate in the Islamic money market.
- iii. The maximum number of *ta'widh* that may be imposed on the non-amortized financing should not exceed 100 percent of the financing balance sum.
- iv. *Ta'widh* obtained from the financing that is not amortized, can be used by the financiers involved and divided according to the bank's current profit sharing ratio.

In its 101st meeting on 20 May 2010, the *Shariah* Supervisory Council of Bank Negara Malaysia has ruled that both the concept of *ta'widh* and *gharamah* permissible condition subject to the following:

- a. *Ta'widh* can only be imposed for late payment are of financial obligations arising from exchange contracts (such as buying, selling and leasing) and *qard*.
- b. *Ta'widh* can only be imposed after the end of the repayment period agreed by both contracting parties elapsed.
- c. Islamic banking institutions may recognize *ta'widh* as income on the basis that it is imposed as compensation for actual loss suffered by the Islamic banking institutions
- d. *Gharamah* cannot be taken into account as income, but must be channeled to certain charities.

## **METHOD OF COMPUTATION PENALTY AND TA'WIDH**

In conventional banking, a penalty for late payment of loan is about 2 to 5 percent of total loans outstanding. Rates charged by conventional banks are compounding and the penalty will be included in the loan amount. If there is it further penalty, it will be pegged to the percentage of the original loan amount. For example, A makes a housing loan of RM100, 000 and the outstanding is RM90,000. A

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<sup>3</sup> Resolution of Shariah Advisory Council of Bank Negara Malaysia, p.28-37

fails to pay the debt for a month. A set of penalty of 5 percent is imposed. As a result if the amount to be paid by A is:

- $RM90,000 \times 5\% = RM4500$
- $RM90,000 + RM4,500 = RM94500$
- $RM94500 \times 6.75\%$  (interest rate) =  $RM6378.75$
- $RM94500 + RM6378.75 = RM100,878.7$

Whereas in Islamic banks *ta'widh* rate charged is 1 per cent and non-compounding. Hence, it is lower than the conventional ones.

For example, B made a financing from the Islamic banks of RM100,000. In the first year B failed to pay as installments of RM2,000 per month. On top of that for 2 months arrears. There are, the amount of *ta'widh* to be paid is:

- $1\% \times 4,000 = 40$
- $40 + (2,000 \times 2) = 4,040$

As illustrated, the amount of the fine imposed by Islamic banks for 2 months in arrears is only RM40 plus 2 months overdue installments of RM4,000. Thus, the total to be paid by B is RM4,040. Therefore those computation illustrates how *ta'widh* is different from penalty (*riba'*) charged in conventional banks. In fact, revenue derived from *ta'widh* must be channeled to charitable purpose or used partly as accordance with the Shari'ah Supervisory Council bank advice respectively.<sup>4</sup>

## CONCLUSION AND SUGGESTION

It is no doubt that Islamic banks are allowed to charge penalty on default payment done by payees. However, the mechanism of *ta'widh* implementation is different from penalty charged in conventional banks which is *riba'*. The imposition of *ta'widh* and *gharamah* by Bank Negara may help Islamic banks in Malaysia to mitigate default payment risk as well as enable Islamic banks to compete with conventional banks.

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Resolution of Shariah Advisory Council of Bank Negara Malaysia, p.28-37

Resolution of Shariah Advisory Council of Bank Negara Malaysia, 29 Jun 2010

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