

Late Payment Treatment in Islamic Banking Institutions in Malaysia: A *Maqasid* Analysis

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Abstract

Contrary to the conventional banking institutions that impose compounding penalty, Islamic bank institutions in Malaysia will only impose compensation for actual loss suffered by the bank as a result of negligence of its customers. Yet charging more than the amount of principal debt is controversial in Islam because it is tantamount to the prohibited usury (*riba*). At the same time not charging anything at all for the failure of the customers to fulfill obligations will give rise to some problems such as bank losses and moral hazard. Hence, the legal position of the imposition of compensation (*ta'wid*) for the deferment or failure of the customer to fulfill obligation should be evaluated not only in terms of technicality in the contract, but also in terms of the objective of shariah (*maqasid al-shariah*). This paper aims to evaluate and analyze this issue based on the doctrine of *maqasid al-shariah* to get a comprehensive and fair view for both parties, customers and Islamic banking institutions. To achieve this goal a qualitative analysis based on the discipline of Islamic law (*fiqh*) and the doctrine of *maqasid al-shariah* will be carried out. The study confirmed that the imposition of *ta'wid* has its justification if it was done based on the actual losses incurred by the bank or at the nominal amount for the sake of avoiding morale hazard among customers. In the event banks need to impose a penalty which is not based on the actual losses, then the proceed should not be regarded as bank's income, instead, it should be channeled to charity organizations. In any case, banks need to evaluate the real position of the customer whether a genuine incapable debtor or just a negligence defaulter.

Keywords: Islamic Banking, Late Payment Treatment, Objective Of Shariah, *Maqasid Al-Shariah*, *Ta'wid*

Introduction

After almost four decades of operations, appraisal and criticism of Islamic banking institutions (IBI) are no longer revolves around *shari'ah* compliance concerning procedural and technicality but have surpassed the aspects of *maqasid shari'ah* (objectives of the *shari'ah*). It is generally acknowledged now that meeting legal requirements through systematic technical procedures is not sufficient any more. Hence the operation of IBI as a whole should be given a complete and holistic assessment of its technicalities and *maqasid*. One pertinent

issue in IBI is the issue of imposing ta'wid (compensation) and gharamah (penalty) on late payments and defaults. It is argued that there is no provision concerning the management of default payments because it is an ijtihad (reasoning) matter which can be decided by Muslim jurists based on their assessment as of the time, place and situation. This article will qualitatively analyse the imposition of ta'wid based on maqasid shari'ah doctrine. The qualitative analysis is chosen for this research because basically it is an analysis on the ideas and philosophy of one of the IBI products in order to refine and develop it further. In addition the doctrine of maqasid al-shariah is used here as it is very important to ensure the viability of the Islamic muamalat in contemporary banking system and fairness to both the IBI and customers.

Late payment Treatment in Islamic Law

Debt arrangement must adhere to specific rules and procedures in Islamic muamalat. The debtor must fulfil the obligation as promised and the sooner, the better. The creditor entitles the principal amount from the debt given, and any increase is considered as prohibited riba (interest). That is settled law in Islam. The issue, however, arises as to whether Islamic bank as the creditor can impose certain charge over and above the principal amount upon the debtor as a result of the latter failed to fulfil his obligation in time as agreed upon before. Amongst the Islamic law scholarship, this extra charge is elaborated under the theme of ta'wid or gharamah or al-shart al-jaza'iyy. Generally, there are three contentious points regarding the imposition of late payment charges. First the permissibility of the charge itself, second the method of determining the rate and third the treatment of the proceed from the charge.

Regarding the permissibility of the charge, the majority of contemporary Islamic law scholars opine that it is permissible. Based on several textual evidences especially the prophetic hadiths, some contemporary scholars like al-Tabtabae, al-Mani' and others in Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI) are in favour of financial penalty in dealing with debtors who deliberately withhold payment and places them under the category of ta'zir or corporal punishment (Yaakub, 2014; AAOIFI, 2015)

The second issue is the method to determine the amount of the charge that is fair to both the debtor and the creditor. It is maintained that the charge must be based on the actual loss incurred by the bank as the creditor. Loss in term of a financial transaction includes the cost that banks have to incur to secure the full payment of the debt that has been granted to the debtor. Cost is of two types, direct like the cost of documenting the debt and indirect like the employees' wages and the rent of the operating office. AAOIFI in its Shariah Standard No. (19) stipulates that Islamic financial institutions can only charge direct costs and expenses related to the disbursement of the debt. Therefore, the majority of Muslim jurists have agreed that all administrative costs and expenses related to the debt or financing must be borne by the debtor, as the purpose of the service and expenses is to facilitate the disbursement of such debt. In such a case, any costs that are charged over and above the amount of direct and actual incurred costs will be considered as riba.

However, in situations where debtors are required to pay compensation for deliberately delaying the payment while being capable of paying immediately, both direct and indirect costs may be permitted to be included in the compensation amount. This is because direct costs alone are not sufficient to cover the losses incurred. Financial institutions incur expenses in tracking down the debtor throughout the default period. Therefore, these indirect costs should be included in the compensation as well. Contemporary scholars such as those in

AAOIFI are of the opinion that the payment for compensation must be in accordance with the value of actual loss incurred (AAOIFI, 2015). In any case, the bottom line is the creditor does not make any profit out of the default committed by the debtor. The compensation imposed is just enough to cover the cost for the recovery process.

The third issue is regarding the treatment of the proceed from the late payment charge received by the bank. Can an Islamic bank treat the proceed as its income and take benefit from it, or it is not the bank income; thus no advantage can be gained from it. Although there are divergent rulings among the contemporary scholars of muamalat (Islamic law of finance) regarding the treatment of the proceed as bank revenue, the most popular and acceptable view is that the charge can be recorded in the bank's books as "revenue" to offset the actual expenses incurred in managing the delinquent account. For example, in its 95th meeting in 2010, SAC of BNM decided that ta'wid is permissible and recognised as income on the basis that it is imposed based on the actual loss incurred by Islamic banks.

Late Payment Charges in Islamic Banking in Malaysia

The practice of late payment treatment in Islamic banking system in Malaysia is sufficiently represented in the Guidelines for Late Payment Charges for Islamic Banking Institutions year 2013 issued by Malaysian central bank or Bank Negara Malaysia (BNM). Initially, the Shariah Advisory Council (SAC) of BNM in 1998 resolved that late payment charge may be imposed on the defaulting customers based on three conditions. There are the amount of ta'wid cannot exceed the actual loss suffered by the bank, the determination of compensation is made by a third party, that is BNM, and the default or delay of payment is due to negligence on the part of the customer. In 2010, to enhance product transparency and fulfilling disclosure requirements of the Islamic banking products, the SAC issued another resolution on late payment charge as an extension to the previous resolution to cover the combination of two elements in the charge namely ta'wid (compensation) and gharamah (penalty). This resolution was later on transformed into the form of Guidelines for Late Payment Charges for Islamic Banking Institutions that have been effective from January 2012. In the guidelines, ta'wid refers to the amount that may be compensated to the bank based on the actual loss incurred due to default, while gharamah refers to the penalty charged on the defaulters over and above the ta'wid. According to the guidelines, the banks are allowed to impose either ta'wid alone or a combination of ta'wid and gharamah.

To ensure that the ta'wid imposed is not exceeding the actual loss incurred, the guidelines stipulated that the rate of ta'wid is not more than 1% per annum on the overdue instalments in the case of default of scheduled payments or on outstanding balance in the case of default causing the entire facility to be recalled or brought to court of law. Although the amount of gharamah must not necessarily tie up to the actual loss incurred, the guidelines nevertheless stipulate that the imposition of the combined late payment charges consists of ta'wid and gharamah must be up to a certain prescribed limit. The accumulated combined late payment charges shall not exceed a hundred per cent of the outstanding principal amount. In general, the combined rate must not exceed the rate of the cost or interest on default borne by an equivalent customer under conventional financial institutions.

In term of the treatment of the proceed, since ta'wid is considered as the compensation for the actual loss incurred, it is treated as bank earning and shall be included as bank's profit distributable to depositors and shareholders. In the case when the combined rate is imposed,

the banks can only keep the ta'wid portion as the bank income whereas the gharamah portion cannot be regarded as bank earning. Instead, the gharamah portion shall be channelled to charitable organisations approved by the banks' Shariah Committee. The guidelines also require the banks to maintain a separate gharamah account from ta'wid to facilitate proper administration and governance. This is to allow better monitoring and identification of the source and utilisation of gharamah for distribution to charitable organisations. Since the nature and characteristics of gharamah are very close resemblance to the prohibited riba, the banks are expected to be very meticulous in the administration of the gharamah and should not be seen or implied at any point of time that it is benefiting from the management or distribution of the gharamah.

Although the latest guidelines are considered as the extension of the previous one, it is a pity though that this guideline is quiet about the different category of defaulters between musir (capable debtors) who are negligence in fulfilling the obligation and mu'sir, (uncapable debtors) and the difference treatments rendered unto them. While the shariah resolution of 1998 did mention about that, the shariah resolution of 2010 which form the basis for the guideline fell short of it.

Maqasid Shariah in Muamalat

Maqasid shariah or objective of shariah is an integral part of Islamic shariah itself. Every rule in Islam is destined toward achieving specific objective whether known to the human being or unknown to them. Many verses of the Qur'an and the hadiths of the prophet that prescribe certain commands and prohibitions are accompanied by maqasid for such commands and prohibitions. Therefore, after the demise of the prophet and expiration of the revelation, the companions and generations afterwards always looked at the wisdom and maqasid in setting forth new rules which are not explicitly available in the Qur'an and hadith of the prophet (Laldin, 2013)

In term of its scope, the maqasid shariah can be divided into two categories namely general maqasid and specific maqasid. General maqasid is the paramount objective of shariah in all its teachings (al-Yubiy, 1998), that is establishing wellbeing and repelling evil and harm (jalb al-masalih wa dar' al-mafasid) (al-Shatibi, 1997). All Islamic teachings at individual and societal levels are aimed at achieving this general maqasid. ('Abd al-Salam, 1994) The maslahah (wellbeing) that is promoted by the Islamic Shariah is divided into three categories in terms of its priority namely daruriyy, hajiyy and tahsiniyy (Al-Shatibiyy, 1997). The most important is the maslahah daruriyy which covers five items namely religion, life, intellect, lineage and wealth. This means that these five are the most crucial maslahah for human beings promoted and protected by Islamic law in various rules.

Specific maqasid refers to a certain maqasid promoted through the provision of rules in a particular domain of Islamic shariah. (Al-Yubiy, 1998, p.411) Maqasid in muamalat for example, are establishing wellbeing and preventing harm and evil related to the area of muamalat. The scholars have pointed out that among the critical wellbeing that is promoted in the field of muamalat are facilitating and preserving human life, growth, protection and distribution of wealth whereas the evils that are prevented are harmful element in wealth acquisition, oppression in transaction, quarrel in dealing, concentration of wealth in the hand of the few and circulation of it among them (Laldin, 2013; Dusuki and Bouheraoua, 2011). To achieve all of these specific maqasid, Islamic shariah stipulates various particular rules in muamalat such as the permissibility of multiple forms of exchanges and business transactions, the essentiality of justice and mutual consent, prohibition of riba, gharar (uncertainty),

gambling, fraud, hoarding and harm (Laldin, 2013). Duly and diligently observing these rules will lead to the achievement of the specific objective of shariah and furthermore reaching the general objective of shariah namely securing welfare and eliminating evil from the muamalat and economic life of human being. The diagram below (figure 1) simplifies the relationship between the general objective, specific objectives and rules in muamalat.

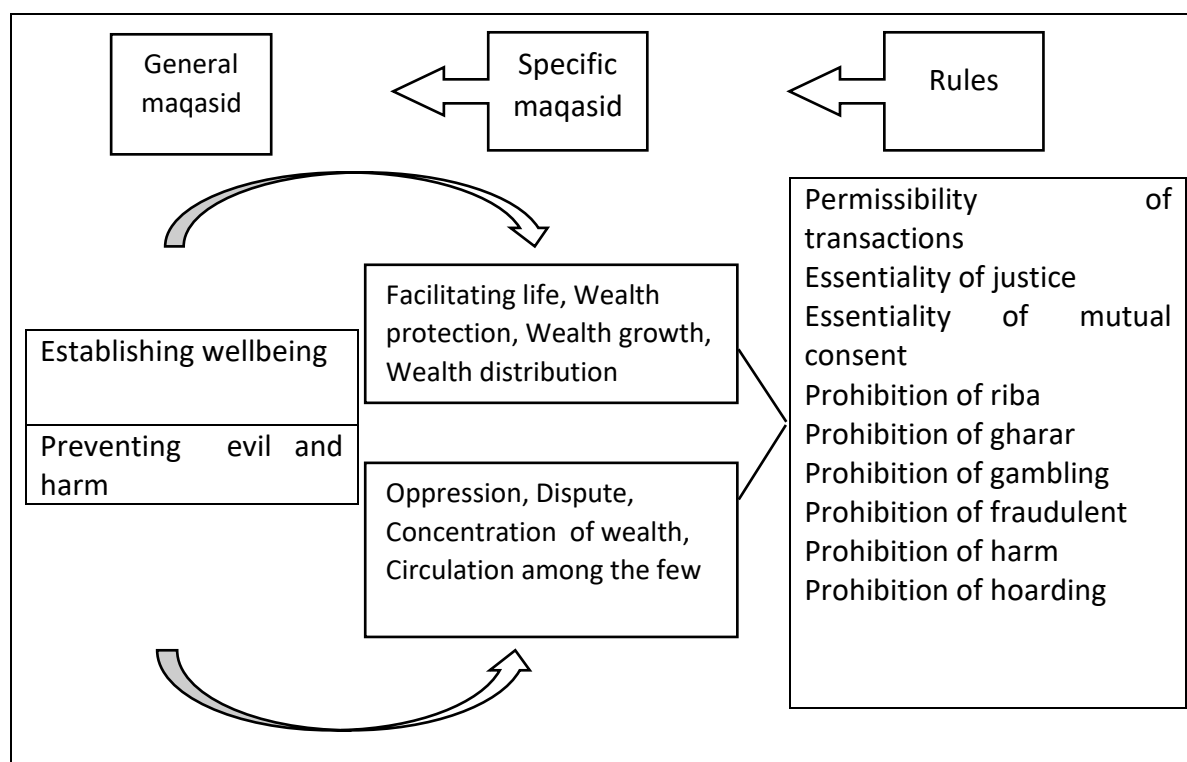


Figure 1. Illustration depicting the relationship between general maqasid, specific maqasid and rules in muamalat.

Analysis and Discussion

Permissibility of ta'wid and Gharamah

Regarding the general maqasid, the ta'wid imposed guarantees maslahah to both, the banks as well as the deficit sectors. From the banking sector's side, ta'wid safeguarding banks from unscrupulous clients who deliberately avoid their obligation. Such behaviour will affect the bank's sustainability in an economy. Many researchers have established the critical role of banking institutions as the engine for economic growth. Levine (1997), Arestis (2001) and Kendall (2012) empirically found that banks contribute positively towards economic growth whereas Kendall (2012) discovers that the under-developed local banking sector contributes to the delayed growth. Mohd Nor (2015) after doing a lengthy literature survey on the relationship between financial development and economic growth concludes that past literature has shown that financial development functions as a critical engine to economic growth. However, the stability of the banking sector itself depends on numerous determinants, including good loan quality and others. Arguably, ta'wid is a measure to maintain good loan quality. With ta'wid, banks do not need to inject additional capital to provide financing to its potential customers from the deficit sector. This means that in terms of attracting or promoting wellbeing, ta'wid plays a significant part by helping to ensure the

sustainability of bank's role as financial intermediary and thus continue providing loans and financing to the deficit sector that requires bank services.

From the aspect of rejecting mafsadah (harm or evil), ta'wid is supposed to ward off unnecessary hardship and harm to the deficit sectors and financial system instability. This is because the bank lending and financing activities are closely associated with the quality level of the loan and financing. An increase in the non-performing loan and financing (NPL) ratio rises riskier lending which potentially causing further deterioration of the loan and financing quality and financial system instability (Zhang 2016). The credit risk that arises from increases in NPL gives an impact on bank lending and financing behaviour (Cucinelli, 2015). The increases in NPL serve as an indicator of the high-risk levels, tighten credit standard and reduce the bank's lending and financing in future. Most of the studies find that NPL is negatively associated with banking sector development. The global financial crisis of 2007-2008 was a perfect example of the negative impact on the financial sector due to the default of mortgages and loans. (Cucinelli, 2015). Primarily, the philosophy behind the Islamic financial institution can be fully understood in the context of the overall objectives of the Islamic economic system as enshrined in the maqasid shariah. As aptly put by Dasuki (2008) Islamic banking is a subset of the overall Islamic economic system that strives for a just, fair and balanced society as envisioned and deeply inscribed in maqasid shariah. The importance of the banking sector to the economic well being underscore the importance of protecting the bank from unnecessary failure as a result of deliberate delay and default from errant customers. This is precisely in line with the requirement of maqasid shariah in an economy. In addition to the imposition of ta'wid, Islamic banking in Malaysia also imposes gharamah for late payment when the case has been tried in court. Gharamah is inflicted with the aim of preventing moral hazard so that people do not take for granted any credit or financing given to them. The assumption is that if the defaulters are only charged with ta'wid based on actual costs after being directed by the court, this will increase the likelihood of more and repeated negligence among Islamic banking customers. In other words, it may affect the conduct or behavior of Islamic banking customers when dealing with Islamic banking institutions. This behavior not only endangering the banking institutions and the overall economic condition as discussed above, it also a form of injustice to banking institutions, shareholders and depositors. Gharamah is also a lesson to the general public about the importance of carrying out the obligations. Islamic banking is even supposed to behave like da'wah and educational institutions (Mohamad, M.T., 2012) by playing roles in correcting the perceptions, attitudes, and behaviours of the society. People need to be taught good morals, rules and disciplines such as paying their debt as soon as they can without deliberate deferment.

Ta'wid is based on Actual Loss

The scholars of Islamic muamalat agreed that ta'wid to compensate for the loss of income (opportunities loss) is not allowed. (al-Zuhayliyy, 1998; Usmani, 2005; Noor, and Haron, 2016) The imposition of ta'wid on the basis of opportunity loss is tantamount to prohibited riba and will only cause wealth concentration in the hand of the wealthy capitalist and oppress the poor who continue to be poorer. Accumulation of wealth in the hand of the few without effort and contribution to the economy as a whole is a kind of mafsadah that must be avoided in the theory of maqasid shariah. In fact, the shariah objective in muamalat is to ensure the fair distribution of wealth through the expansion of the real economic activity which ultimately leads to sustainable economic growth. From the perspective of maqasid shariah, debt or loan is a form of tabarru'at (gratuitous) contracts, ie a contract for charity to ease the plight

suffered by people who are in need of money or goods. (Abu 'Arjah and Sabah, 2005). The philosophy of muamalat in Islam entails that one does not take debt or a loan except when one is in need of finances or goods and incapable of meeting such requirements except through a debt. So the creditor should help to prevent the hardships and anguishes without exploiting it to gain profit. Using debt or loan which is a kind of gratuitous contract to make a profit from people who are in need without taking any risk and not contributing to economic growth and fair distribution is a form of blatant oppression. Preventing oppression is an essential principle in maqasid shariah. Therefore ta'wid is only allowed to compensate for the actual loss suffered by the creditor.

In addition, the main feature of muamalat in Islam is that profit-making activities must also accept the risk of loss. In a joint venture business activities, for example, Islam asserts the concept of risk sharing rather than risk transfer as prevails in the conventional system. (Mirakhor, 2014; Mili and Abid, 2008) This feature enshrined in the legal maxims which say "al-kharaj bi al-daman" (the return on an asset relates to the risk of ownership) and "al-ghunum bi al-ghurum" (gain is justified with risk) (Manzur al-Haq, 2008). This means that a person involved in a business activity to gain profit is also willing to suffer losses. This principle does not exist in the activity of extending credit because the debtor is obliged to pay his debt regardless of what. Failure to pay off the debt causes him to be questioned not only in the world but the hereafter. If it is still alive, the court may force him to pay the debt and if he dies his property must be used to pay the debts first before dividing them to the heirs. This means that the creditor does not bear any risk of loss of the borrowed amount, thus nor profit is expected. The creditor is entitled only to receive the entire amount credited while the debtor is obliged to pay the entire amount deferred at the promised maturity date. In terms of fairness in muamalat transactions, the fact that the creditor may not charge any excess of the credited amount indicates that he should not be inflicted of any risk of actual loss as a result of his benevolent act. This means that if the debtor causes any actual loss to the creditor by deliberately delaying the payment after the promised date or the creditor has to pay the cost to claim the debt owed after the maturity period; the creditor may reclaim the actual loss or costs incurred due to the actions of the debtor. Islam considers the actual loss incurred by the creditor due to the negligence of the debtor as unnecessary harm that should be avoided in a financial system. Generally, it is included in the general fiqh method which reads "la darar wa la dirar," (neither harming nor reciprocating harm in Islam).

Difference between mu'sir (incapable debtor) and musir (capable debtor)

The actual ability of debtors to service obligations is always taken into account in determining their position in Islamic law thus deciding the appropriate actions from the creditor or bank. Ethic in Islamic muamalat dictates that when a person commits himself in a debt transaction, one must determine to fulfil the obligation. A person who commits a debt transaction with the knowledge that he cannot afford to pay the debt is considered as consuming others property wrongly and is likened to the person who stole the property of others. (Ibn Majah, 2009). The Prophet described the act of deliberate delay of payment of debt by a solvent debtor as an act of oppression (al-Bukhari, 1982). In terms of natural justice, the oppressor must be punished and forced to pay damages to the victim. The debtor who is capable of paying the debt but deliberately delaying the payment, penalties can be imposed as a lesson to him and the community. Hence, the stipulation of ta'wid and gharamah on errant debtors conforms to the maqasid shariah doctrine in preventing oppression and deprivation of the rights of others.

However, if the debtor is determined and work hard to repay his loan, yet, he is incapable of paying it on times, then he is regarded as a mu'sir. Mu'sir according to fiqh means genuine inability to fulfil financial or nonfinancial obligation (al- Mawsu'at al- Fiqhiyyah, 1986). Generally, the scholars are of the opinion that genuinely incapable debtor cannot be punished either in the form of physical imprisonment or financial penalty. The appropriate time frame must be given to him. In terms of banking, it can be done through the mechanism of rescheduling to enable the desperate debtor to repay the debts within the period suited to his capability. This is in line with the command of Allah (Qur'an, 2:280). The imposition of ta'wid upon customers who are genuinely not able to serve their payment is a kind of financial oppression, the very treat opposed by Islam.

While special treatment for the mu'sir customers is provided in the BNM guidelines, the categorisation of mu'sir and musir as there are at the moment need to be reviewed and improved. The categorisation of mu'sir which is eligible for special treatment from the bank covers only to those who are suffered from the catastrophe caused by the force of mother nature like the flood, drought, earthquake, storm etc. While natural disaster cause unbearable sufferings and difficulties, some human-made catastrophe in social and financial life need also be considered as mu'sir category. The lost of physical capability of the breadwinner in a family because of accident or illness or some non-negligence financial difficulties caused by a third party for example certainly warrants fair consideration from the part of the banks. However, the catastrophe caused by the negligence of the customer does not fall under the category of mu'sir which is eligible for special treatment. This measure can serve three objectives at once, first to avoid unnecessary damage to the banks, second, to avoid unfair hardship to the ill-fated customers, and third to avoid customer from deliberately cause themselves falling under the category of mu'sir.

Treatment of Proceed From Ta'wid And Gharamah

From the maqasid point of view, it is fair for the bank to treat ta'wid as bank income since the bank incurs unduly loss because of the default or delay from the customer. The only condition is that bank cannot gain any extra benefit from the ta'wid imposed other than the actual loss from the default or otherwise it is tantamount to riba al-jahiliyyah which is the prohibited riba at its core. (Mohammad Hatta and Abu Samah, 2015). In this situation, the principle of justice is fully operationalised. While on one hand the effective cause ('illah) for the prohibition of riba, which is increment does occur in this situation where the debtors has to pay more than the principal amount as a penalty for his own misdoing, but on the other hand, the creditor does not gain any increment as the amount of ta'wid imposed upon the defaulting debtors just enough to compensate the actual loss suffered by the creditor. To deny the right of Islamic bank to recognise ta'wid as bank income will cause unnecessary damage to the image of an Islamic banking institution. People might view some of the Islamic muamalat rules are not healthy enough for the survival of a modern banking institution as there are too soft, thus vulnerable to abuse and manipulation. As institutions established for the purpose of providing financing to the deficit sector, the prohibition of recognising ta'wid as income would most likely jeopardise its survival and sustainability. If this happens deficit sector will gradually be left hapless.

However, the same argument does not go for gharamah or penalty. As it is over and above the actual loss, bank, therefore, cannot take any benefit from it, be it in financial or non-financial forms. The proceed from gharamah must be channelled to the third party that has no relation to the bank in any way. In Malaysia, it is stipulated that the beneficiary from

gharamah proceed must go to charity organisations. This exercise not only manifesting the role of Islamic bank as financial intermediary institution but also its role to protect the interests and benefits of all parties involved in market transactions, promoting social harmony, ethical norms and social commitments which are certainly conform to the doctrine of maqasid shariah.

Conclusion

The direct and unambiguous proof of the permissibility of the imposition of ta'wid upon the unscrupulous debtor is not available in the two authoritative sources of the Qur'an and the hadith. Nevertheless, it is widely acknowledged that establishing wellbeing and warding off evil and harm in economic life is the paramount maqasid in Islamic muamalat. All principles and rules stipulated in the field of Islamic law of muamalat are geared towards the achievement of this objective. Therefore, the imposition of ta'wid by IBI in Malaysia must not be assessed only through the procedural and technical perspective. A due consideration must also be given in term of the importance of bringing about the achievement of the maqasid. From the analysis conducted, the implementation of ta'wid based on the actual loss or one per cent of the overdue instalment per annum and gharamah as an educational method channelled to charity organisations to prevent moral hazards, especially among the unscrupulous customers is satisfactorily fulfilling the desired elements of maqasid shariah. Bank must not gain any extra benefit from the imposed ta'wid and gharamah in any way what so ever or otherwise it will be tantamount to the prohibited riba. It must be ensured also that the combined rate of ta'wid and gharamah does not exceed the rate of the cost or interest on default borne by an equivalent customer under conventional financial institutions. Furthermore, the actual condition of the defaulters of either musir or mu'sir also plays important role in the decision. With these precautions, while on the one hand the sustainability of IBI as the vital agent for the economic development and growth is well protected, on the other, the devious and dishonest customers are fairly dealt with to prevent the same incident reoccur in the future. In summary, the implementation of the ta'wid and gharamah with conditions stipulated in the guidelines is arguably fulfilling some of the maqasid shariah doctrine.

This paper contributes significantly in its attempt to analyse the position of one of the most contentious issues in IBI industry namely the imposition of ta'wid on the late payment from the maqasid perspective. While this paper argues that ta'wid and gharamah are permissible based on the maqasid analysis, it does not mean that the IBI is given a full freedom to charge defaulting customers. This paper stipulates some of the guidelines that need to be complied by IBI in implementing ta'wid and gharamah so that the IBI can always maintain their adherence to the doctrine of maqasid al-shari'ah while at the same time ensuring its survivality.

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