


Exploring the Practice of Ta'widh (Compensation) and Gharamah (Penalty) Charges in Islamic Banks in Malaysia and Brunei

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ABSTRACT

Malaysia and Brunei differ in their treatment of ta'widh (compensation) and gharamah (penalty) for late payment charges in exchange contracts such as sale, lease, and qard (loan), where the Central Bank of Malaysia or Bank Negara Malaysia (BNM) permits them, while the Brunei Darussalam Central Bank (BDCB) has no ruling regarding the matter. This research reviews global Shariah scholars' views on imposing ta'widh and gharamah for defaulted Islamic financing, examines the suitability of BNM's 1% ta'widh rate, analyzes the impact on Brunei's Islamic banks for not charging ta'widh and gharamah, and offers recommendations to improve the implementation of ta'widh and gharamah in both countries. This research conducts face-to-face semi-structured interviews with representatives from the Association of Islamic Banking and Financial Institutions Malaysia and Bank Islam Brunei Darussalam who are directly involved with late payment charges. The findings indicate that Islamic banks in Malaysia practice ta'widh and gharamah in accordance with the guidelines by BNM on the late payment charges. Islamic banks in Malaysia believe that BNM is being considerate by permitting them to charge 1% ta'widh, despite some scholars contending that the 1% charge is considered as riba. As for Brunei, there is not yet any regulation on the practice of ta'widh and gharamah by BDCB but rather dependence on the Islamic banks themselves to decide on the practice. This study contributes to a new perspective related to the ta'widh and gharamah that would be very pertinent to the Islamic banks in Malaysia and Brunei.

Keywords: Ta'widh, Gharamah, Late payment charges, Islamic banks, Compensation, Penalty

INTRODUCTION

Islamic banking has now become one of the fastest-growing segments in the global financial industry, offering an alternative to the existing conventional banking system. Islamic banking operates according to the Islamic principles and has gained popularity not only in the Muslim countries but worldwide. The unique framework and characteristics of the Islamic banking system that adhere to the principles of risk-sharing, asset-backing, and the prohibition of riba (interest) have positioned Islamic banks to become a more ethical and socially responsible financial system. The modern practice of Islamic banking started in the early 1960s, with the establishment of the Mit Ghamr Savings Bank in Egypt in 1963. In 2024, the Islamic finance industry exceeded USD5 trillion in global assets, increasing by 12% from 2023 and 43% from 2020, with Islamic banking contributing more than 70% of total Islamic finance assets (Standard Chartered, 2025). These assets are projected to grow from USD4 trillion in 2024 to USD5.2 trillion by 2028.

Malaysia, being among the pioneers of Islamic banking in the Southeast Asia, introduced its first Islamic bank, Bank Islam Berhad, in 1983 and, to date, has 16 Islamic banks operating side by side with their conventional counterparts. The Islamic banks in Malaysia are governed by the Islamic Financial Services Act 2013 (IFSA) and regulated by its central bank, Bank Negara Malaysia, or the Central Bank of Malaysia. Its neighboring country, Brunei Darussalam, ranked 13th out of 136 countries globally in the latest Islamic Finance Development Report 2024 (Brunei Darussalam Central Bank, 2025), indicating tremendous growth of the Islamic banking sector in the country. The Central Bank of Brunei, or Brunei Darussalam Central Bank, which is the monetary authority of Brunei, promotes and establishes a robust regulatory framework for Islamic banks. Brunei Darussalam now has two main Islamic financial institutions, Bank Islam Brunei Darussalam (BIBD) and Perbadanan Tabung Amanah Islam Brunei (TAIB). Recently, the newly established Bank Usahawan, offering Islamic financial services, will contribute to the growth of the Islamic banking industry in Brunei Darussalam. Wawasan 2035 is a policy vision to place Brunei as an international financial center that greatly emphasizes Islamic finance. This policy plan intends to increase the financial sector's contribution to the country's GDP from 5% in 2015 to 8% by 2035.

As intermediaries, banks become the trustee of the depositors' money and must be prudent in giving out financing. However, banks are exposed to the risk of this financing becoming defaulted. The conventional banking system applies the concept of penalty, and the problems associated with default in loan repayments are controlled by charging *riba* (interest) to customers. Despite having the same risk, Islamic banks are not allowed to impose *riba* on customers' default on financing payment. Islamic banks all around the world have an issue in charging a penalty for late payment of what is due, as there are different views of Shariah scholars on whether the charging of such a penalty would amount to *riba* (interest) or not. In order to protect the depositor's money, the Islamic banks have the right to manage and mitigate the default risk up to a certain limit by incorporating a penalty clause in the contract, but the banks are not allowed to ask the lessee (in *ijarah* (leasing contract), for instance, to incur the risk of asset loss (Dusuki, 2009).

The Shariah Advisory Council of Bank Negara Malaysia has allowed the charging of *ta'widh* (compensation) and *gharamah* (penalty) on late payment of financial obligations that resulted from exchange contracts such as sale, lease, and *qard* (loan) (Shariah Advisory Council of Bank Negara Malaysia, 2010). 1% *ta'widh* is charged if there is financing for outstanding charges, but once the financing is due, the rate is then based on the Islamic Interbank Money Market rate (Badeeu & Muneeza, 2023; Bank Negara Malaysia, 2012). Thus, the term *ta'widh* refers to a sum that Islamic banking institutions may receive as compensation for actual losses resulting from default, whereas *gharamah* refers to a penalty imposed on defaulters beyond and above the *ta'widh* (Bank Negara Malaysia, 2012).

According to Bank Negara Malaysia, *ta'widh* can be considered an income to the Islamic banks, while *gharamah* must be channeled to charity if it is charged to the customers. The latest development in the industry of Islamic banking in Malaysia is that Bank Negara Malaysia has raised the concern whether the 1% *ta'widh*, which is allowed for the Islamic banks to charge, is genuinely the actual cost incurred to the banks, specifically when the customers defaulted on loan or financing repayment (Amir Alfatakh Yusof, personal communication, 19 March 2021). According to Amir Alfatakh Yusof from United Overseas Bank Malaysia Berhad (personal communication, 19 March 2021), even though Bank Negara Malaysia has allowed 1% charges under *ta'widh*, it is not certain whether the bank is gaining or experiencing losses from that 1% amount owing of *ta'widh*. Bank Negara Malaysia must ensure that the *maslahah* (benefit) of the Islamic banks is also protected in this case because Islamic banks are not charitable bodies, and they are actually managing the depositors' and shareholders' funds. The information of the actual cost incurred to Islamic banks in handling default on loan and financing cases must be clarified because only Bank Negara Malaysia can have a clear idea whether the fairness and equality to Islamic banks, as well as the customers, is upheld or not.

On the other hand, the Brunei Darussalam Central Bank treated *ta'widh* and *gharamah* differently. Brunei Darussalam Central Bank has not allowed *ta'widh* and *gharamah* to be charged to Islamic banking customers who defaulted on loan and financing repayments (Hanifah Jenan, personal communication 1, 22 May 2021). Brunei, being an Islamic country, has the political will towards promoting interest-free banking as their priority (Jibrail Bin Yusuf, Hassan Shakeel Shah, Mohammad Ayaz, and Jabal Muhammad Buaben, 2019). Hanifah Jenan, the Head of Shariah from Bank Islam Brunei Darussalam (personal communication 2, 15 July 2025), shared the information that the Islamic banks must bear the losses when the customer defaults on repayment the loan and financing. The customers are enjoying 'free money' from the Islamic banks because they are not being charged anything in the case they default, unlike the customers of the conventional banks, where *riba* is charged in the case of default payment. In this case, have Islamic banks in Brunei have not encountered any loss, and if there are some traces of losses, what would be the effect on the survival of Islamic banks in Brunei. Both *maslahah*, namely *maslahah* of the Islamic banks and the *maslahah* of the customers, should also be taken care of by the providers of Islamic banks because they are holding to fiduciary duty to utilize the depositors' and shareholders' money wisely and adhering to Shariah requirements (Mohd Zameri et al., 2024). Indeed, *ta'widh* and *gharamah* can be the best method to compensate for the loss suffered by Islamic banks due to default payment in loan or financing

repayment. However, the mechanism to charge ta'widh and gharamah must be explored exhaustively to avoid harm to the bankers as well as the customers from the profit and loss perspective, and through the Shariah compliance requirements.

Based on these grounds, this study is conducted to address the four main research objectives. The first objective is to discuss the view of Shariah scholars in the world on the imposition of ta'widh and gharamah on defaulted financing in Islamic banks. The second objective is to examine the actual percentage of late payment charges and the viability of 1 percent charges of ta'widh for the Islamic banking industry allowed by Bank Negara Malaysia. The third objective is to analyze the effect on Islamic banks in Brunei for not charging any penalty for defaulted financing. And finally, the research aims to highlight recommendations by the practitioners on the improvement of ta'widh and gharamah implementation in Brunei and Malaysia.

This paper is arranged as follows: beginning with the literature review, followed by methodology, findings and discussions, and finally the conclusion.

LITERATURE REVIEW

The definition of both ta'widh and gharamah had been discussed by previous researchers. According to Hidayat and Mumtazah (2025), ta'widh comes from the word 'iwadh', which means compensation. Kamaruddin and Mohd Hanefah (2023) stated that ta'widh is the compensation for the actual loss. Gharamah is the penalty imposed on the debtor to avoid late payment (Bank Negara Malaysia, 2012; Kamaruddin & Mohd Hanefah, 2023). In Islamic banks, ta'widh is imposed if a customer deliberately delays payments and causes real financial losses to banks, in which the amount charged must portray the actual loss incurred by the banks (Nurhayani Lubis et al., 2018). According to Muhajirin (2018), the concept of ta'widh follows the principle of dhaman al-aqd, or contractual responsibility. Dhaman al-aqd can be categorized into two, with the first one referring to the compensation due to contractual default, and the second one referring to the compensation due to unlawful acts which cause harm to others.

DISCUSSION ON TA'WIDH AND GHARAMAH

As intermediaries, banks take capital from their depositors to provide the financing. Banks are obliged to protect the interest of their depositors and must ensure the financing given is collected back. Delays in payments of these financing can expose banks to losing their depositors' money and increase their costs, such as legal fees, costs of sending letters and notices, and other associated charges. To avoid the circumstances, banks imposed late payment charges, in which, despite facing the same risks, Islamic banks are prohibited from imposing such charges. This can result in capital loss for the Islamic bank institutions, as the customers will take advantage of the prohibition of the late payment charges. Not only that, but Islamic banks are also known for offering ethical and Islamic values in their products and operations; thus, by implying late payment charges, Islamic banks are said to be similar to the conventional banks and do not portray their unique and distinct identity. According to Rahim and Buang (2021), as Islamic banks want to maintain its unique identity by offering ethical and Islamic values in its products and operations, it must also ensure that it will not create a moral hazard and be abused by its customers. This will not only affect the bank but also the Islamic banking environment.

Delay in payment can cause harm to the Islamic banks. By not imposing late payment charges, Islamic banks will face difficulties, lose their money, increase their expenditure, create moral hazard, be exposed to abuse by customers, threaten their operations and cause negative effect on the economic development (Ishak, 2021; Mohd Zameri et al., 2024; Zulkipli, 2020). And as the Islamic finance situation becomes more advanced and complex, Islamic banks need to motivate their customers to pay their debt for the banks to be able to compete with the conventional banks. Due to the potential harm to Islamic banks and the maslahah mursalah (considerations of public interest) to protect the funds of Islamic banks, many bodies agreed that Islamic banks can apply the late payment charge or penalty but with different approaches. The International Islamic Fiqh Academy (IIFA) allowed Islamic banks to enclose a penalty clause in the financial contract, stating that in the event of late payment, ta'widh will be imposed based on the actual loss and is not treated as profit. However, the Accounting and Auditing organization for Islamic Financial Institutions (AAOFI) does not allow ta'widh, but it allows the expenditures pertaining to the debt settlement process must be charged to the debtors. AAOFI also allows gharamah, or penalty, if there is delayed payment, where debtors need to pay some amount of money, which will then be donated to charitable bodies.

The Application of Ta'widh and Gharamah in Islamic Banks

In Islamic banks, all agreements between the bank and the customers must be honored by both parties. Any violation of the agreements or contracts that resulted in financial losses, compensation in accordance with the Shariah principles can be imposed. Islamic banks are allowed to charge two types of compensations to their customers who defaulted in payments, which are ta'widh and gharamah (Muneeza et al., 2019). Ta'widh is imposed to compensate for actual losses resulting from financial default, while gharamah intends to instill discipline in customers to pay promptly (Hamdan et al., 2020). Both charges are to treat late payment based on the concept of *maslahah mursalah* to eliminate harm to the banks but are not to be used as a mechanism to collect revenue (Mamat & Ahmad, 2019).

Bank Negara Malaysia allows the Islamic banks in Malaysia to impose both ta'widh and gharamah, as a mechanism used to avoid being manipulated by their customers, which leads to default or late payment. However, the Shariah Advisory Council (SAC) of Bank Negara Malaysia has listed the conditions that need to be followed in line with the practice of ta'widh and gharamah. According to the guidelines, ta'widh may be charged on late payment of financial obligations that comes from exchange of contracts such as sale and lease, and it can only be imposed after the settlement date of the financing becomes due. Islamic banks may recognize ta'widh as income on the basis that it is charged as compensation, only for the actual loss suffered by the institutions. On the other hand, Bank Negara Malaysia stated that, gharamah is charged for delay in debt settlement, without the need to prove the actual loss suffered, and cannot be recognized as income; therefore, it needs to be channeled to *baitulmal* or certain charitable bodies (Bank Negara Malaysia, 2010). The permissibility of ta'widh and gharamah is supported by the following *fiqh maxim*, which reads "*la darar wa la dirar*," or "neither harming nor reciprocating harm (in Islam)," and also the *hadith* of Rasulullah p.b.u.h.:

From Abi Hurairah that Rasulullah p.b.u.h. had said: "Delay by a rich person (in payment of debt) is a tyranny."

In Malaysia, only ta'widh is widely used by Islamic banks. Gharamah is not favored by most Islamic banks because of the "nature" of *riba* that is inherent in it, impediments in terms of setting up separate charity accounts, disclosure requirements, and regulations associated with it (Laldin et al., 2012).

However, the implementation of ta'widh and gharamah in Islamic banks in Malaysia has faced several issues. According to Muneeza et al. (2019), even though late payment charges are imposed to mitigate the credit risk faced by Islamic banks, there are issues pertaining to the implementation. One of the issues is to distinguish between the genuine defaulters and the delinquent defaulters. Islamic banks are suggested to formulate strategies and guidelines towards practical application to ensure that the customer's default in payment is due to poverty. Another issue is whether there is accuracy in claiming that imposition of ta'widh is to recoup "additional" expenses incurred by the banks. This is because in Malaysia, the pricing calculation depends on the bank itself. Some banks already include the loss incurred should customers delay in payment, while some banks only calculated the loss after it occurs. Zawawi and Hassan (2023) did a study on existing court cases involving ta'widh and gharamah. The study found several cases where there are wrong calculations of ta'widh, and the ta'widh charged was inconsistent with the financing agreement. Other cases on the implementation of ta'widh are such as whether ta'widh capped are at date of winding order. There are also cases on the admissibility of document consisting of ta'widh. The research also found cases where the ta'widh charge imposed was conflicted with Bank Negara Malaysia's Guideline and cases whether the Islamic banks can even charge ta'widh to their customers. The study found that the ta'widh charge must be carefully made to avoid any unwanted element of *riba*, and question of whether the implementation of ta'widh and gharamah by the Islamic banks in Malaysia is smooth sailing and effective. The study suggested that the Islamic banks and their customers need to come with a better alternative to dispute resolutions such as arbitration and mediation.

While the practice in Brunei, according to the Head of Shariah for Bank Islam Brunei Darussalam, Mrs. Hanifah Haji Jenan, Brunei Darussalam Central Bank, has not allowed ta'widh and gharamah to be charged to Islamic banking customers who defaulted on loan and financing repayments. However, ta'widh and gharamah can be imposed for overseas or third-party financing, such as which has been imposed with Maybank Malaysia.

Methodology

A qualitative research methodology, including a review of the currently available literature and qualitative thematic analysis, has been applied. The interview questions were developed based on research objectives.

Approach

Based on the objectives of the study, a qualitative research design was deemed the most suitable method for interpreting the array of views from Islamic bank practitioners and regulators on the imposition of ta'widh and gharamah on defaulted financing in Islamic banks in Malaysia and Brunei. Qualitative research is a methodology for scientific inquiry that intensifies the significance, depth, and richness of context and voice in understanding social phenomena. This depth of understanding is crucial for developing theories, informing policy, and

formulating interventions or solutions that are not only effective but also culturally sensitive and socially relevant (Lim, 2023). A qualitative approach was selected for this study because this approach is beneficial for studies seeking the reflection of individual reality and enables a researcher to see how people interpret their experiences. The approach also allows the generation of comprehensive insights, for the purpose of this study, from the Islamic bank practitioners and regulators on the imposition of ta'widh and gharamah on defaulted financing in Islamic banks in Malaysia and Brunei.

Sampling

This research conducted face-to-face semi-structured interviews with identified participants based on certain criteria, applying non-probabilistic, purposive, and judgment sampling methods. The study involved respondents who held key positions in the Islamic banking industry, including manager who is the practitioner in the Islamic banking industry as well as a representative from the Islamic banks' association in Malaysia. In Malaysia, the interview was conducted with a representative from the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) to represent the Islamic bank institutions in Malaysia. However, these participants wanted to remain anonymous. The interviewee is named "Informant 1" in this paper and helps to achieve research objectives number two and four. Meanwhile, for Brunei, an interview was conducted with a representative from Bank Islam Brunei Darussalam (BIBD) and is named as 'Informant 2' who helps to achieve research objectives number three and four. Since this study is exploratory in nature, the analysis of this study was solely dependent on the data collection of views, opinions, and facts given by the informants from the respective bank and the Islamic banks' association in Malaysia and Brunei.

Data Collections

The data were collected through semi-structured interviews to understand the perspectives of Islamic bank practitioners and Islamic banks' association on the imposition of ta'widh and gharamah on defaulted financing in Islamic banks in Malaysia and Brunei. The use of semi-structured interviews also gives flexibility to the authors to explore further areas of interest, as well as give the interviewees freedom to express ideas on the subject (Horton et al., 2004).

Interviewees were contacted via telephone to confirm their availability, and interview protocols and questions were subsequently shared with them via email. The researchers conducted the face-to-face interviews with a representative from AIBIM to represent Malaysia's Islamic banks, and for Brunei, the representative from BIBD. The interviews, conducted in English and Malay, took approximately 30 to 45 minutes each and were recorded. All interviews were transcribed to ensure data validation. The interview questions were divided into several subtopics. For Malaysia, the interview questions were done regarding the actual percentage of late payment charges by Islamic banks on defaulted financing in Malaysia, on the 1 percent charges of ta'widh allowed by Bank Negara Malaysia viable for the Islamic banking industry, and on the viable model of ta'widh and gharamah on defaulted financing that can be proposed as a guidance in Malaysia. While interview questions for Brunei were on the effect on Islamic banks for not charging any penalty for defaulted financing, as well as on the viable model of ta'widh and gharamah on defaulted financing that can be proposed as a guidance in Brunei.

The library research was conducted to get the view of Shariah scholars in the world on the imposition of ta'widh and gharamah on defaulted financing in Islamic banks to achieve research objective number one. further areas of interest, as well as giving the interviewees freedom to express ideas on the subject (Horton et al., 2004).

FINDINGS AND DISCUSSIONS

The View of Shariah Scholars in the World on the Imposition of Ta'widh and Gharamah on Defaulted Financing in Islamic Banks

There are different juristic views on charging penalties for late payments. There are permissible views and also impermissible views.

Permissible Views

Looking into the permissible views, several Islamic scholars and jurists allow the implementation of compensation, and the bank can utilize it as an income. The basis of their argument is *maslahah mursalat*, which is to prevent the public from taking advantage of and intentionally delaying their payments to Islamic banks. This includes Syeikh Mustafa Al-Zarqa, Syeikh Muhammad Sadiq AdDharir, Sheikh Abdullah Ibn Sulayman al-Mani', Dr. Zaharuddin Abd Rahman, Dr. Abdul Sattar Abu Ghuddah, Abd al-Aziz Ibn Abdallah Ibn Baz, the Religious Supervisory Board of the Islamic Bank of Jordan, and most of the Shariah Committees of Islamic banks in Malaysia (Hamdan et al., 2020; Mamat & Ahmad, 2019; Zulkipli, 2020).

According to these scholars, compensation for delayed payment in financing is not similar to *riba*. Another argument is based on the view of Imam Shafii and Hanbali on the seized property that should be compensated. This can be implied with the obstruction of the use of money given by the bank and exploiting it by not returning the money on time as agreed in the contract. Al-Zarqa believed that compensation imposed can secure economic interests, as delay in payment by customers is viewed as the disruption of the Islamic bank's business, as Islamic banks lost the opportunity to utilize the funds for their businesses. Zulkipli (2020) stated that, among the arguments that support the use of *ta'widh*, is that *riba* is stipulated earlier and determined based on future delay, agreed upon both the banks and the customers. But compensation is to prevent the capital owner from being deprived of their rightful due because of past delays that occurred without the bank's consent. Apart from that, the percentage of *riba* is determined in advance, whereas for compensation, the amount is determined based on the profit and loss during the period of default.

Impermissible Views

Whereas there are also several Islamic scholars and jurists, such as Dr. Zaki al-Din Sha'ban, Dr. Nazih Hammad, Dr. 'Abd Al-Nasir Al-Attar, Dr. Shabir, and economist Dr. Rafiq Al-Misri, that disagreed on the implementation of *ta'widh* and *gharamah*. According to these scholars, Prophet Muhammad p.b.u.h. was aware of the situations in which there would be default in payments, but there has been no evidence that the Prophet p.b.u.h. provided a *riba* exemption for it.

These scholars' arguments are also based on the hadith mentioned above, stating that procrastination on the part of a rich man will compromise his honor, which does not specifically indicate the permissibility of compensation (Zulkipli, 2020). They also argued that the *fiqh* maxim that reads "*la darar wa la dirar*," or "neither harming nor reciprocating harm (in Islam)," could not be referred to, as removing one harm does not include substituting it with another. According to the resolutions of the Islamic Fiqh Academy, imposing a penalty is considered as *riba jahiliyyah*, which is prohibited and mentioned in the Al-Quran. *Riba jahiliyyah* is a type of late payment charge. According to the resolution, "If a creditor stipulates to the debtor or imposes on him to pay an amount of money as a specific financial penalty or a certain percentage if he delays in settling the debt within the specified period between them, it is a condition or a loan that is invalid."

Dr. Rafiq Al-Misri argued on the view of Al-Zarqa, who believed that by delaying the payment, it would cause disruption to the banks' businesses. Dr. Rafiq Al Misri argued that the penalty imposed is *riba* being replaced with another term and feared that it would facilitate the practice of *riba* if this compensation and its compensation clause are allowed, which will lead to the possibility of transgressing limits. However, the Islamic Committee has given their assurance that the penalty collected will be channeled and spent on public welfare. Another argument to support the impermissibility of the practice is that the financial compensation for delayed payment today differs from the one during the era of Prophet Muhammad p.b.u.h. The teachings of Islam were adhered to strictly, and punishing rich procrastinating debtors took place by way of *ta'zir* (discretionary punishment), such as imprisonment (Zulkipli, 2020).

The Basic Concepts and Practices of Late Payment Charges and Penalty in Malaysia

The Actual Percentage of Late Payment Charges by Islamic Banks on Defaulted Financing in Malaysia.

The Shariah Advisor Committee (SAC) of Bank Negara Malaysia agreed to the imposition of *ta'widh* on the late repayment of Islamic financing at its 12th meeting on July 14th, 1999. On November 8th, 2000, during its 30th meeting, the SAC had resolved that *ta'widh* due to failure to pay after the due date or for arrears is allowed to be collected based on '*uqud mu'awadhat*' (exchange contracts), which includes Islamic debt securities. Among the guidelines for the imposition of *ta'widh* is that it can only be imposed after it is found that *mumathil* (deliberate delay in payment) is utilized on the part of the issuer to settle the payment of the principal or profit.

In the two situations where *ta'widh* is allowed, in the event of late payment of profit, the rate is 1% per annum of the arrears and should not be compounded. While for the case of failure to settle the payment of the principal, the rate is based on the current market rate in the Islamic interbank money market and should also not be compounded. The maximum amount of *ta'widh* imposed on unsettled payment of financing must not exceed the total amount of the remainder of the financing balance. Approval from Bank Negara Malaysia is required for an Islamic bank to impose maximum combined late payment charges. SAC also allows Islamic banks to consume the *ta'widh* collected from the financing that has not been settled and is being distributed according to the bank's prevailing profit distribution ratio. These are stated in the Bank Negara Malaysia's Guidelines on Late Payment Charges for Islamic Banking Institutions that came into effect on 1st January 2012. The guideline also states that the combined rate for late payment charges should not be more than "cost/interest borne by an equivalent customer under conventional finance" and that it should not be compounded (Bank Negara Malaysia, 2012). According to the guideline, the actual loss is to be compensated for by any case of default payment (whether it is from overdue installments or from an outstanding balance that causes the entire facility to be recalled); from the

date of payment until the maturity date, it shall not be more than 1% per annum. The actual lost parameter based on Bank Negara Malaysia includes personal cost for recovery, legal fees, third-party fees, administrative cost for recovery, liquidity cost, capital cost, and compliance cost.

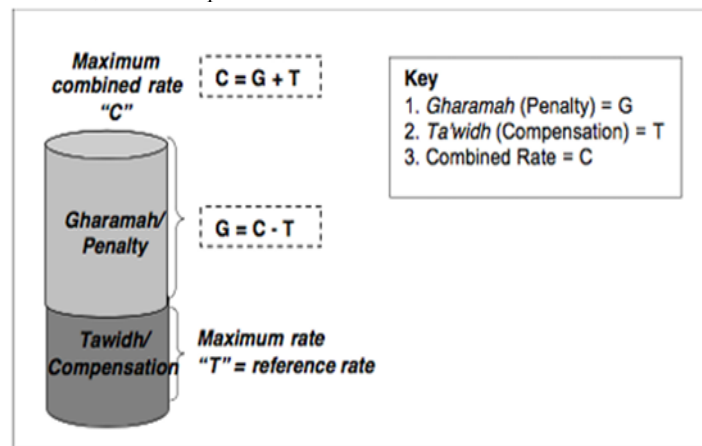


Figure 1: Late payment charge structure

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

Looking into an example of how ta'widh is calculated, vehicle financing from Bank Islam Malaysia Berhad (BIMB), as mentioned on its website, for the case of before the maturity of the facility, a sum equivalent to one per centum (1%) per annum on overdue installment(s) until date of full payment; while for the case of after the maturity of the facility, a sum equivalent to the prevailing daily overnight Islamic Interbank Money Market Rate on outstanding balance i.e., outstanding selling price less ibra' (if any). For post-judgment debt, a sum equivalent to the prevailing daily overnight Islamic Interbank Money Market Rate on the basic judgment date until the date of full payment (Bank Islam Malaysia Berhad, 2025).

Islamic banks in Malaysia follow the four Shariah parameters of actual loss proposed by the International Shariah Research Academy for Islamic Finance (ISRA). The first parameter stated that the loss must be financial in the sense that it has a realized financial impact on the Islamic bank's statement of profit or loss. The second parameter indicates that the loss is not related to a financial obligation towards a counterparty in a different contractual arrangement that has already been established. The third parameter mentions that the loss must be actual (darar muhaqqaq) and not an erroneous conjecture (darar mutawahham). And the final parameter is the loss that leads to negation of benefit (maslahah) must occur without any right (bi ghayr haqq).

The Viability of 1 percent Charges of Ta'widh for the Islamic Banking Industry allowed by Bank Negara Malaysia.

The study of Mamat and Ahmad (2019) found that the permissible rate for ta'widh and gharamah is still lower than those charged by conventional banks and found that the rate of ta'widh charge of one percent still could not cover the loss suffered by the bank. According to Informant 1 from AIBIM (personal communication, 2025), even though many Islamic banks highlighted that the 1% allowed by Bank Negara Malaysia is not sufficient to cover the loss from the late payment of financing, Islamic banks can already cover the loss through the pricing calculated earlier. Islamic banks in Malaysia tend to compare with conventional banks which charge up to 4 to 5 percent for default cases. Thus, when compared, Islamic banks think that they are at loss. Informant 1 also mentioned that the best way to tackle the issue is not on how much compensation needs to be charged but more on how to manage the risk. Informant 1 mentioned that if the pricing includes all the factors, then there will be no additional costs incurred, thus there will be no loss. The probability of default can be calculated earlier through mechanisms such as stress tests, where the financial position of the client can be assessed. Informant 1 also mentioned the need for Islamic banks to portray their ethical value and courtesy, as these defaulters may be due to genuine cases such as loss of income and health conditions. The best method, according to Informant 1, is to include all factors in the pricing. Although Informant 1 agreed on the 1% allocation by Bank Negara Malaysia in default and late payment, it is only for educational purposes to avoid people taking advantage of Islamic banks' principles. This is to prohibit the moral hazard that may occur due to not implying any late payment charges. Islamic banks must protect their unique value that differs them from conventional banks. If Islamic banks request a higher late payment charge, then there will be no differences between Islamic and conventional banks.

In summary, Informant 1 thinks that the amount allowed by Bank Negara Malaysia is enough, and Islamic banks need to stop comparing with their conventional counterparts but focus on other methods to avoid loss that comes from late payment.

The Basic Concepts and Practices of Late Payment Charges and Penalty in Brunei

According to Informant 2 from Bank Islam Brunei Darussalam (BIBD) (personal communication, 2025), Islamic banks in Brunei do not charge any penalty for defaulted financing. Even though ta'widh and gharamah are allowed for Islamic banks in Brunei, it is up to the banks whether to impose the practice in their operation. The practice of ta'widh and gharamah in Brunei needs to be controlled to ensure that it will not be the source of profit for these Islamic banks.

Informant 2 mentioned that, previously, the bank's Shariah Advisory Board (SAB) of BIBD had not decided on the ta'widh charges but allowed the bank to charge the maximum of 1% for education purposes if there was a need to do so. Since BIBD currently started to have cross-border transactions or deals with international counterparts, the late payment charges are already included in the contracts; therefore, BIBD will follow the late payment charges as agreed by their counterparty. As for retail transactions, BIBD has not yet charged late payment charges.

Informant 2 also shared that the recent SAB of BIBD has agreed to allow late payment charges for cross-border transactions or deals, treasury, and the global money market. The charges will be based on the negotiation with the parties involved. The BIBD will not take the ta'widh charge, and the ta'widh charge will be distributed or channeled to charity. According to Informant 2, this is because the implication of ta'widh is to educate and not for the benefit or profit of the bank. Ta'widh in BIBD is treated like gharamah, where the charges will not be considered as income for the bank.

Informant 2 also stated that there are disadvantages for BIBD for not charging ta'widh and gharamah. The main issue is moral hazard, where customers may neglect the repayment, and this will cause the bank to incur additional costs for restructuring and provisioning and affect the bank's profit. However, according to Informant 2, the percentage of defaults in financing for BIBD is still under control. This is because BIBD has taken several measures to minimize default in financing. BIBD has diligently conducted a very stringent credit evaluation of the customers before approving any financing. If considered necessary, BIBD customers are required to provide collateral as security when applying for financing.

When the researcher asked Informant 1 about the possibility of including the default cost in the pricing calculation of BIBD's financing, she responded by saying that the Brunei market is small as compared to Malaysia. If the default cost is included in the pricing calculation, it will increase the pricing, and customers will not favor getting any financing from BIBD. However, Informant 2 agreed with the ta'widh to be charged to the default customers mainly to prevent them from taking advantage of the Islamic banks which are not penalizing their customers in the case of default of their monthly installment.

RECOMMENDATIONS BY THE PRACTITIONERS ON THE IMPROVEMENT OF TA'WIDH AND GHARAMAH IMPLEMENTATION IN MALAYSIA AND BRUNEI

Islamic Banks in Malaysia

Informant 1 from AIBIM (personal communication, 2025) suggested that Islamic banks should ensure the reliability of their financing stress tests, which should be dynamic, as the test can project what may happen in the future. Islamic banks should investigate their pricing to ensure that everything is already included in the pricing. If everything is included in the calculation of the pricing from the beginning, no additional costs that may incur in the future will affect the bank's profit in the event of customers' default. Now, Islamic banks can only benefit from the 1% ta'widh charges allowed by Bank Negara Malaysia in the case of customers' defaults. However, Islamic banks still need to quantify the actual cost, which will be reflected in their pricing and profit calculation. The pricing for Islamic banks' financing differs among banks. Some banks already included default cost as part of the pricing calculation, while some did not.

Informant 1 suggested that Islamic banks should come out with a clear computation of the actual cost of financing, which includes default cost and personal cost. Some banks have already embedded default cost and personal cost in pricing, which will result in double counting if ta'widh is applied in the case of default. This is because it does not reflect the actual 'actual cost.' This is the practice in Islamic banks when determining the pricing; therefore, the best way, according to Informant 1, is to have a clear computation of actual cost, whether the pricing would include default cost from the beginning or only when default happens. If the pricing already includes the default costs, the 1% ta'widh is no longer required to cover the loss. Since the practice is unfair to the Islamic banks' customer.

Islamic Banks in Brunei

Although BIBD has not applied ta'widh charges, Informant 2 agreed that the charges can help mitigate the loss and the extra charges incurred due to late payments by customers. Despite not charging late payment charges,

BIDB has other mechanisms to counter the loss. BIDB requires walk-in customers to provide collaterals, while well-established customers are not required to do so. BIDB also collaborates with Brunei Islamic Religious Council (MUIB) to enable those genuine defaulters to use zakat under asnaf al-gharimin, or the debtors who are one of the categories of zakat (alms giving) in Islam, to help repay their default financing. Informant 2 also agreed on the practice of Islamic banks in Malaysia in calculating pricing and actual cost. She also agreed on the need to have a circular by the central bank on the matter to avoid injustice in the practice of price determination by all Islamic banks in Malaysia. Informant 2 suggested that Brunei Darussalam Central Bank should look into the practice of ta'widh and gharamah for Islamic banks in Brunei, as additional costs incurred are also important to the sustainability of the banks. Brunei Darussalam Central Bank should learn how Bank Negara Malaysia applies ta'widh and gharamah, as it not only a reflect compensation, but also a good tool to educate customers and prevent moral hazard.

CONCLUSION

Although there are differences in practices of ta'widh and gharamah in Islamic banks in Malaysia and Brunei, the application of ta'widh and gharamah is not only for compensation to cover the loss incurred by late or default payment, but it is more for the educational purpose of educating, motivating, and disciplining the customers to repay their financing on time. A 1% ta'widh charge to the financing defaulters by Islamic banks, which is allowed by Bank Negara Malaysia, is enough to cover the actual cost incurred based on the default payment despite arguments stating that the amount is not sufficient. On the other hand, Brunei Darussalam Central Bank has not come up with a specific ruling on ta'widh and gharamah for Islamic banks in Brunei. This study contributes to suggestions and alternatives to the application of ta'widh and gharamah that would be very pertinent to the Islamic banks in Malaysia and Brunei. This is crucial to mitigate the credit risk faced by the Islamic financial institutions. Islamic banks should focus on other mechanisms to cater to the issue of late payments, such as improving their risk management, which can be done by strengthening their stress tests and having a standard computation of actual cost to be included in their pricing. Islamic banks in Brunei also agreed that managing risks is the best way to handle late payment issues, which can be done through strict screening by the credit bureau and taking collateral. The mechanism of charging of ta'widh and gharamah can be explored to be applied in Islamic banks in Brunei with reference to the practice of Islamic banks in Malaysia, which at the same time still need some improvement where necessary.

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