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Late Payment Charges in Islamic Banking: A Critical Shariah and Legal Analysis with Reference to Malaysia and Comparative Jurisdictions

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ABSTRACT

Late payment charges in Islamic banking are a complex mix of Shariah rulings and modern financial operations especially regarding the prohibition of riba (interest). This study discusses the Shariah and legal basis for late payment mechanisms including, *ta'widh* (compensation) and *gharamah* (penalty) in Malaysia context and compares them with the jurisdictions of the Kingdom of Saudi Arabia, Pakistan, Indonesia and United Kingdom. This study uses a doctrinal and comparative approach by discussing the frameworks, judicial development and Shariah interpretations of such charges. As in Malaysia, the legal framework developed by Bank Negara Malaysia under Islamic Financial Services Act. This framework distinguishes between the compensatory and punitive parts in a systematic manner to comply with Shariah rulings and legal certainty. In contrast with the Kingdom of Saudi Arabia, where it generally follows the recommendations set by the Accounting and Auditing Organization for Islamic Financial Institutions. This shows the importance of the fines being paid for charity purposes. Pakistan is stricter as not allowing banks to gain money from penalty charges. However, Indonesia adopts hybrid types of regulations and its enforcement is not consistent. The United Kingdom is a non-Shariah jurisdiction but is focused on alternative dispute resolution and fairness in handling financial disputes. The findings highlight persistent concerns about the substantial similarities between late payment charges and conventional interest, as well as issues of consistency, transparency and Shariah compliance. The paper concludes that such mechanisms can be justified on the basis of *maslahah* (public interest), provided that it is subjected to strict regulatory control, ethical implementation and alignment with the aims of Shariah (*maqasid al-shariah*).

Keywords: Late Payment Charges, Islamic Banking, Ta'widh, Gharamah, Riba

INTRODUCTION

Islamic banking fundamentally differs from conventional banking as it prohibits *riba* (interest) affecting its contracts and operations. A common issue arises from this prohibition is how late payment and default are handled. Zulkifli, 2020 contended that late payment charges in conventional banking typically imposed as interest on overdue amounts and such are forbidden by Shariah due to the potential for *riba* as any increase in debt over the time is seen as problematic.

Islamic financial institutions developed an alternative to overcome this issue such as *ta'widh* (compensation for actual loss) and *gharamah* (penalty for deterrence). These alternatives are aimed to strike a balance between the need to prevent default and protect financial institutions with preservation of Shariah compliance (Yaakub et al., 2014). But there is still a scholarly debate with critics arguing that such charges may imitate conventional interest in substance, meanwhile advocates argue that they are justified by necessity and public interest *(maslaha)*.

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Malaysia is recognized as a leading country for its management of late payment charges through comprehensive legal and Shariah frameworks. Islamic banks may apply *ta'widh* and *gharamah* subject to strict guidelines as imposed by Islamic Financial Services Act 2013 with supervision of the Central Bank of Malaysia which is also known as Bank Negara Malaysia (BNM).

On the other hand, Saudi Arabia generally follow the rules of the Accounting and Auditing Organization for Islamic Financial Institutions where it allows imposition of late fines for late payment but requires such fines go to the charity rather than being retained as profit (AAOIFI, 2015). Pakistan also takes a similar stance by prohibiting financial institutions from making a profit on penalty fines and promotes their charitable nature (State Bank of Pakistan, 2015). In addition, a dual banking system in Indonesia allows certain late payment charges as long as in accordance with Shariah guidelines. However, there is still an issue in guaranteeing consistency and effective implementation (Otoritas Jasa Keuangan, 2019).

The United Kingdom instead adopts a unique approach for late payment charges in Islamic banking by combining Shariah compliant principles with conventional legal framework and particularly using mediation and negotiation methods rather than punitive charges. According to Wilson, 2009 this approach prioritizes transparency, consumer protection, and ethical consideration rather than financial penalties. It is a hybrid approach which prioritises fairness and institutional control as noted in Halsey v Milton Keynes General NHS Trust [2004] EWCA Civ 576.

This paper uses a doctrinal and comparative approach by critically analyzing the Shariah and legal framework of late payment charges in Islamic banking. This study also illustrates the complexity of regulatory methods and underlying contradiction between Shariah compliance and commercial necessity by contrasting Malaysia with the Kingdom of Saudi Arabia countries, Pakistan, Indonesia and the United Kingdom. The legitimacy of such systems does not just function as formal structure but also whether they comply with the aim of Shariah (*maqasid al-shariah)* which include fairness, justice and social welfare.

LITERATURE REVIEW

The basic principle of Islamic banking

The literature that specifically discusses the issue of the late payment charges in Islamic banking has been a great testament of a complex convergence and interrelation between the concept of Shariah principles and the current legal frameworks. This literature review will begin with a brief discussion on the nature of the Islamic banking. Abu Bakar and Ghazali (2013) emphasized that the Islamic banking system can be substantively differentiated from the conventional banking system by way of the prohibition of elements such as usury or *riba*, speculation or *gharar,* and gambling or *qimar.*

Similarly, Khan (2025) found that the significant element of the Islamic banking system is that it is a system that focuses on the involvement of real economic activities and it must be totally free from any impermissible activities such as gambling, tobacco, and alcohol. All these activities can be considered dangerous activities that are contrary to Islamic ethics. Supporting this view, Mohd-Zameri et al. (2025) noted that due to the nature of Islamic banking system in which it strictly prohibits the element of interests or *riba*, then coupled with the need for the Islamic banking system to embrace with the principle of risk sharing and asset-backing, it has become the main reason why the Islamic banking system to experience a significance growth in the financial system. Thus, we can make a deduction from the studies by Abu Bakar and Ghazali (2013), Khan (2025), and Mohd-Zameri et al. (2025), that they shared the same finding when identifying the main aspect of the Islamic banking in which is the prohibition of interest or *riba*.

The rationale behind the prohibition of interest (*riba*)

As we have seen how the previous studies highlighted the main element of the Islamic banking system is that it must be free from the element of interest or *riba*, the next part of this literature review will explore the reason or the rationale behind such a principle. In Abdulkabir (2021), the study highlighted that when a borrower needs to pay more than the principal amount that he owed, that can be a situation where *riba* is in existence. The study also clarifies how the element of interest or *riba* in a loan transaction has caused many people to be entangled with the danger of interest-based debt. The study also highlighted the rationale on why Islam prohibits *riba* is that *riba* could cause exploitation and injustice towards the livelihood of mankind.

The view in Abdulkabir (2021) is supported by another study by Hassan (2005) in which the study offers a much broader point of view in which it highlighted that the prohibition of interest or *riba* is not only prohibited in Islam, but other religions such as Judaism and Christianity also make interest as an impermissible act. The study also pointed out a different point of view of why Islam prohibits interest in which *riba* has caused a significant shift in the original use of money. The author noted that money is purely intended to be a medium of exchange in the transaction of buying and selling goods and not as a medium to gain profit from the money itself.

Next, in Borhan (2009), this paper asserts that the prohibition of *riba* not only would bring equality and justice to the society but also it diminishes would greatly bring good effects to the whole structure of the economy itself. The study shows that in a world whereby the whole economic business and activities are free from interest or *riba*, it would cause the economy to be more stable, avoiding inflation, secure employment opportunities and encouraging people to save more money. Thus, it can be derived from Abdulkabir (2021), Hassan (2005), and Borhan (2009) that the reasons behind the prohibition of interest or *riba* could be divided into two which firstly is to promote social justice and equality within the society, and secondly is to create an entire economic system that is more durable and trustworthy.

The concept of late payment charges within the Malaysian Islamic banking system

The concept of late payment charges in Islamic banking system is not a simplistic discussion. In Mohd-Zameri et al. (2025), the study indicated that there are two main concepts of the late payment charges under the Islamic banking system which are the concept of *ta'widh* and the concept of *gharamah*. In Yaakub et al. (2014), the paper noted the definition of the word *ta'widh* in which it can be defined as a form of damages to cover the loss that was suffered by the creditor in a situation where the borrower has defaulted in making the repayment for the financial agreement. Meanwhile, the Shariah Advisory Council (SAC) of BNM has given the definition to the word *ta'widh* as the compensation for the actual loss.

In a guideline provided by the Shariah Resolutions in Islamic Finance (Second Edition) that was issued by the BNM, *gharamah* can be defined as a kind of penalty or fine that can be imposed upon the person who failed to repay the debt. The difference between *gharamah* and *ta'widh* is that under *gharamah*, the need to prove the actual loss has been waived. That view is supported in Hamdan et al. (2020), whereby the study explained that *gharamah* is the most viable option for the Islamic financial institutions to adopt as it works as a form of fine towards the defaulted party. The paper noted that *gharamah* is very useful to handle cases on late payment within the industry of Islamic finance itself.

The permissibility of these charges is rooted in Islamic legal maxims and prophetic traditions. Firstly, a Hadith narrated by Abu Hurairah RA, the Prophet Muhammad PBUH said that, "Procrastination (delay) by a rich person (in payment of debt) is tyranny" (Al-Bukhari 1982: 175). Plus, we can also look at another maxim, in which it states that "neither harming nor reciprocating harm". Why is that this maxim is relatable with our discussion? The answer to that is because it works as a basis for financiers to claim compensation for the harm caused by delays. However, it is important to note that the views from the scholars in regard to this issue are varied. For example, Islamic scholars, such as Mustafa al-Zarqa and Muhammad Sadiq al-Dharir, gave their agreement with the permissibility for the financiers to have a redress mechanism in dealing with those who defaulted in making their repayment obligation. They believed it could work as a practical method in preventing public exploitation of the system. In contrast, other scholarly institutions such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Fiqh Academy are on the opposite view. According to them, whatever kind of financial penalty embedded in an agreement for debt delay, is actually *riba*. In the

Maliki school, the concept of *iltizam al-tabaru'* (commitment to donate) is used to justify penalties that are channeled to charity, thereby avoiding the classification of the charge as *riba*.

According to Sobol (2014), Malaysia can be considered as the leading country in implementing the Islamic banking system as so many Islamic financial institutions or Islamic banks have been established within the country. The paper also highlighted that these Islamic banks in Malaysia are indeed very successful in offering to their customers the financial services that are at the same level as those offered by conventional banks. The view of Sobol (2014) is later supported by World Bank (2020), in which it reported that among the reasons why Malaysia is deemed to be among the best country in the world that operationalized Islamic banking system are Malaysia has a very uniform and standardized framework for Islamic financial products, a very great and wholehearted support from the financial regulators, and a very active policy-making in relation to Islamic finance.

Now, Ishak and Nasir (2021) pointed out that if the Islamic financial institutions are not allowed or banned from imposing any kind of late payment penalty to those who had defaulted in making the repayment in any financial agreement, it could bring a negative effect to the financier itself in relation to its ability to stay in operation. The view in Ishak and Nasir (2021) is echoed in Zulkipli (2020) in which the study demonstrated that among the adverse consequences of the delayed payment towards Islamic banks are that the Islamic banks will be unable to compete with the conventional banks and the Islamic banks would not be able to generate incomes or profits. Thus, it can be deduced from both Ishak and Nasir (2021) and Zulkipli (2020) that banning the Islamic financial institutions from imposing late payment charges will only cause the downfall of the Islamic financial institutions themselves, and this could also affect the Islamic banks that are in operation in Malaysia.

The regulatory framework in Malaysia is primarily governed by the Guidelines on Late Payment Charges for Islamic Banking Institutions (2012/2013) issued by BNM. These guidelines prescribe three (3) major principles that Islamic financial institutions such as Islamic banks need to be in compliance with. Those principles are a combined late payment charge, compensation limited to actual loss, and the channeling of *gharamah* to charity. The actual loss (*ta'widh*) is generally capped at 1% per annum for defaults occurring before maturity. Post-maturity, the rate is determined by the Islamic Interbank Money Market (IIMM) rate.

Other than that, the SAC of BNM, in its 4th meeting dated 14th February 1998, 95th meeting dated 28th January 2010 and 101st meeting dated 20th May 2010, has given its ruling upon the usage of both *ta'widh* and *gharamah*. It was the SAC ruling that any Islamic financial institution in Malaysia is allowed to use either the concept of *ta'widh* or *gharamah* as a mechanism to tackle the issue of customers' default in clearing their financial obligations under Islamic contracts.

The SAC has gone further in setting out four (4) major conditions that must be adhered to by Islamic financial institutions when implementing the concept of *ta'widh* and *gharamah* to their customers. The first condition is that *ta'widh* may be charged on late payment of financial obligations resulted from exchange contracts (such as sale and lease) and *qard*. Secondly, *ta`widh* may only be imposed after the settlement date of the financing became due as agreed between both contracting parties. Third, Islamic financial institutions may recognise *ta`widh* as income on the basis that it is charged as compensation for actual loss suffered by the institution. The last condition is that *gharamah* shall not be recognised as income. Instead, it has to be channelled to certain charitable bodies.

Now, it is undeniable that Malaysia, through the SAC, permitted the usage of *ta'widh* and *gharamah* by any of its Islamic financial institutions. Nevertheless, there are a few critical areas of legal analysis involved in the conditions under which *ta'widh* can be claimed. One of the most significant conditions is that the default must be due to the negligence of the customer. However, this research identifies that, based on a decided case law, the need to establish the element of negligence are often disregarded. For example, in CIMB Islamic Bank Bhd v LCL Corp Bhd (2015) 8 MLJ 832, this case highlights that courts often grant *ta'widh* without taking into consideration whether there is, in fact, an element of negligence on the part of the debtor.

Moving on, there is also the need for the debtor to be given initial notice. It is crucial to note that this requirement is not mentioned in any resolutions that were issued by the BNM. Nonetheless, this study found that based on a decided case law of Maybank Islamic Bhd v M-10 Builders Sdn Bhd (2015) 1 SHR, the court ruled that the debtor shall be given an initial notice that *ta'widh* would be applicable upon them. Last but not least, apart from the need to establish the element of negligence and the requirement for the debtor to be given an initial notice, this research observes that in the case of Pan Northern Air Services Sdn Bhd v Maybank Islamic Bhd (2020) MLJU 2206, it is actually possible for the bank to make a wrong calculation when imposing *ta'widh*. In that case, the bank was ordered by the Court to make a refund of Ringgit Malaysia (RM) 5 million as the bank had adopted a wrong rate in making that calculation.

The model of late payment charges in other foreign jurisdictions.

Interestingly, it is worth noting that there are a few other countries around the world that also consider the permissibility or impermissibility of *ta'widh* and *gharamah*. The first country that this paper is going to observe is Saudi Arabia. As explained in Vogel and Hayes (1998), the study highlights that due to the influence of Hanbali tradition, and together with a much rigid judiciary approach, the concept of late payment charges is not allowed. Plus, a few Islamic scholars in Saudi Arabia shared a similar perspective in which the creditors, at all times, are prohibited from generating whatever kind of profits due to the delay of repayment on the part of the debtor.

Next, the second country this research is going to observe is Indonesia. There is little literature that explains the status of the concept of late payment charges within the ambit of Islamic banking in that country. For example, in Chair and Abdillah (2022), the study shows that Indonesia basically permits financial penalties to be imposed by the Islamic financial institutions against debtors who are basically in a condition of being financially stable to make the repayment, but chose to delay it. The study also emphasized the requirement for whatever profits gained from the financial penalties must be channeled towards charitable purposes. Last but not least, the research also suggests that Indonesia has successfully established a more institutionalised Islamic banking legal framework. These can be seen particularly through the scholarly opinion or *fatwas* of the National Sharia Council (DSN-MUI). Furthermore, in studies by Aminuddin and Devi (2024), and Mustika et al. (2025), these studies propose that the concept of late payment charges are indeed in line with the principles of *Maqasid al-Shariah* and commercial needs. Nonetheless, these studies also highlight a few apprehensions in the implementation of this concept. For instance, the lack of determining factors in assessing the debtor's capability in making the repayment and inharmonious application of compensation procedure.

The third country that this paper is going to observe is Pakistan. In Rao and Rafeeq (2018), this study shows that Pakistan accepts the implementation of late payment charges in its Islamic banking system. This study also highlights the reason for that permissibility in which it follows jurisprudence developed and introduced by the Shariat Appellate Bench. Plus, by virtue of the regulatory practices of the State Bank of Pakistan, it is crucial for the profits gained through the implementation of late payment charges to be directly channeled to any charitable funds. Additionally, Islamic financial institutions operating in the United Kingdom generally follow internationally accepted Shariah standards such as AAOIFI, under which late payment charges are allocated to charitable purposes rather than retained as profit by the institution. In Alkhalifa (2021), the Islamic banks in the United Kingdomare required to hire and set up their own Shariah Supervisory Boards or SSBs due to the fact that the United Kingdom regulator would like to minimize its interference when it comes to Islamic finance as they are aware they lack of expertise in that field.

Thus, it can be derived from the literature that has been discussed earlier that many Islamic Scholars are in view that the concept of *ta'widh* and *gharamah* are indeed permissible in Islam as long as it is not to be treated as interest or *riba*. Meanwhile in Malaysia, through its SAC of BNM, it gives the permission for all Islamic financial institutions to implement the concept of *ta'widh* and *gharamah*. Nevertheless, such permission is only applicable if Islamic financial institutions follow the guideline provided by the SAC. In comparison, countries like Indonesia, Pakistan and the United Kingdom also permit the concept of *ta'widh* and *gharamah*.

RESEARCH METHODOLOGY

This study employs a qualitative doctrinal legal research methodology to analyse the Shariah and legal issues of the imposition of late payment charges in Islamic banking with particular reference to Malaysia and selected comparative jurisdictions. The study mainly analyses the legal principles, statutory provision, regulatory guidelines, judicial decisions and the ruling of Shariah on the late payment charges in Islamic financial transactions, thus doctrinal legal research is appropriate.

The study is based on both primary and secondary sources. The main legal sources include Malaysian legislation such as the Islamic Financial Services Act 2013(IFSA 2013), guideline and policy documents issued by BNM, resolution of SAC of BNM, and relevant judicial decisions. Special focus is on the BNM Policy Document on Late Payment Charges for Islamic Banking Institution, which sets up a regulatory framework that governs the imposition of *ta'widh* (compensation) and *gharamah* (penalty) in Islamic financing facilities.

Secondary sources include academic journal articles, books, conference papers, theses and reports on Islamic banking, Shariah principles on debt obligation and comparative regulatory approaches adopted in other jurisdictions. The literature review is done to find out scholars' views on legality and practice of late penalties in Islamic finance.

The comparative legal analysis is also performed by considering selected jurisdictions with developed Islamic finance sectors such as Saudi Arabia, Pakistan, the United Kingdom and Indonesia. The comparative approach is useful to provide a broader view on the harmonisation of Shariah principles and the modern banking practices. It also helps to find similarities and differences in the treatment of late charges.

Content analysis was used to analyse the data collected. Legal texts, regulatory instruments and scholarly opinions are systematically reviewed to ascertain the degree of the Malaysia framework's consistency with Shariah principles while being commercially practicable. The research also explores the effectiveness of the Malaysian model in protecting the interests of Islamic financial institutions and customers, especially in preventing unjust enrichment, ensuring adherence to contracts and encouraging financial discipline.

Malaysia Legal Framework on Late Payment Charges in Islamic Banking

Introduction

Late payment charges have been a matter of discussion in Islamic banking for a long time. Unlike conventional financial institutions, Islamic banks cannot charge interest on overdue debts, as such charges would constitute *riba* which is not allowed under Islamic Law. However, Islamic financial institutions are also required to safeguard themselves against losses that may occur from customers who intentionally delay payment even though they are able to meet their obligations. Consequently, Malaysia has evolved a regulatory framework to try to strike a balance between Shariah principles and commercial realities. Malaysia is widely regarded as one of the premier jurisdictions of Islamic finance because of its comprehensive legal and regulatory framework. The framework for late payment charges is supported by legislation, regulatory policies issued by BNM, resolutions of the SAC and judicial recognition by the courts.

Islamic Financial Services Act 2013

The principle legislation governing Islamic banking finance in Malaysia is the Islamic Financial Services Act 2013 (IFSA). The Act places much importance on Shariah compliance and Islamic financial institutions are required to ensure that all aspects of their operations are in accordance with Shariah principles. Section 28 of IFSA 2013 specifically requires Islamic financial institutions to ensure that their business, affairs and activities are in compliance with Shariah at all times. This provision is particularly important in relation to the late payment charges as a charge imposed on a customer must be distinguishable from interest based penalties commonly found in conventional banking. Thus, an Islamic bank can only charge what has been approved by the relevant

Shariah authorities and regulatory bodies. The acts also strengthen the role of Shariah governance in Islamic financial institutions by mandating proper oversight and compliance mechanisms. This ensures that any practice of charging late payment fees is within the limits of Islamic law.

The Application of *Ta'widh* and *Gharamah*

Malaysia's method is unique as it recognises two different ideas in dealing with payment defaults, namely *ta'widh* and *gharamah*. These phrases are sometimes used together yet they are different in intent. *Ta'widh* is compensation provided to financial institutions for actual losses suffered on account of delay in payment. This is because a party incurs an actual loss of funds due to the default of another party. Thus, it ought to be entitled to reasonable remuneration. This ta'widh is regarded to be compensating, not punishing. *Gharamah*, however, is a penalty imposed for the purpose of deterring the consumers from purposefully delaying the payment. Unlike *ta'widh*, *gharamah* is not meant to reward the bank but to inculcate financial discipline in the clients. Income collected for *gharamah* cannot be regarded as bank income to avoid the element of unjust enrichment and is often directed to charitable cases approved by the Institution's Shariah Committee. This divergence is a reflection of Malaysia's attempt to adapt for practical banking needs while keeping the core *riba* prohibition.

Bank Negara Malaysia's Regulatory Framework

BNM has issued recommendations that further solidify the policy on late payment charges. These guidelines set out the rates and conditions under which *ta'widh* or *gharamah* may be imposed by Islamic financial organisations. Generally, Islamic banks are allowed to collect *ta'widh* on overdue installments within the existing structure at the rate set by BNM. The charge is designed to be a true reflection of the actual cost to the institution from late payment and is subject to stringent safeguards to avoid exploitation. BNM may impose additional costs on maturity or default within the authorised criteria providing the charges are Shariah compatible. The Malaysia approach is vital to bring stability and uniformity to the Islamic banking business. It is the regulatory framework that provides a uniform methodology that fosters fairness and transparency and not individual institutions deciding their own methods of calculating late payment charges.

Role of the Shariah Advisory Council

The SAC of BNM plays an important role in determining the Shariah validity of late payment charges. The SAC, which is the highest authority in Malaysia on matters pertaining to Islamic finance, has approved the use of *ta'widh* and *gharamah* as mechanisms to address late payment defaults. The SAC's position is supported by the principle that a debtor who has the means to pay but who wilfully delays payment commits an act of injustice. This principle comes from a Prophetic tradition which condemns the delay of debt settlement without a valid excuse. SAC therefore recognises the need for Islamic financial institutions to protect themselves against losses and strategic defaults, but not in a way that looks like interest-based transactions.

Judicial approach

The Malaysian judiciary has generally been supportive of the regulatory environment for Islamic banking. The courts have acknowledged the necessity of referring Shariah matters to the SAC in order to provide uniformity and predictability in the interpretation of the principles of Islamic finance. In Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor and JRI Resources Sdn Bhd v Kuwait Finance House (Malaysia) Berhad, the courts acknowledged the significance of Shariah governance and the role of the SAC in addressing matters related to Islamic financial products. Although these cases' trials did not focus only on late payment costs, they helped strengthen legal legitimacy of Shariah-based regulating mechanisms in the Malaysia banking industry.

Critical analysis

The Malaysia framework is a pragmatic response to the conflict between the prohibition of *riba* and the operational reality of contemporary banking. The method is meant to be fair to both financial institutions and their clients, distinguishing compensation for actual loss from fines that are intended to deter failure. That so, the framework has not been without its critics. There are some experts who believe that it is still hard to be accurate in the assessment of the actual losses and the standardized rate may not always be the same as the actual losses incurred by the financial institution. There are some who have asked if, even reconceptualized, some activities are substantively the same as old punishment mechanisms. Nevertheless, Malaysia's approach remains one of the most advanced in the Islamic banking market. Legislative regulation, Shariah monitoring and judicial oversight have significantly improved legal certainty and market confidence. The Malaysian experience provides useful insights for other countries wishing to efficiently manage late payment charges in a manner consistent with Shariah principles as the Islamic banking industry continues to expand.

Comparative Jurisdictions

This study compares how Saudi Arabia, Pakistan, Indonesia and the United Kingdom regulate Islamic finance, focusing on everything from Western market integration to full systemic Islamization.

Saudi Arabia

In September 2000, the International Islamic Fiqh Academy (IIFA) issued Resolution No. 109 (3/12) during its Riyadh session. This benchmark ruling serves as the definite Sharia standard for penalty clauses *(al-Shart al-Jaza'i)* in commercial contracts. By defining clear boundaries for liquidated damages, the resolution successfully protects business from exploitation while still allowing for reasonable risk management.

The IIFA draws a strict line between performance-based contracts and debt obligations. It approves penalty clauses only for operational agreements like manufacturing *(istisna'a)* or construction *(insha'a)*, where they encourage timely delivery and protect buyers from costly delays (Abizaid, 2021). This aligns with the Islamic legal maxim of "harm must be eliminated" (a*l-darar yuzal*), acknowledging that lost time equals to lost money. Conversely, scholars unanimously bans late fees or penalties on outstanding financial debts, regardless of whether they come from direct loans *(qard)* or deferred payment sales *(Bay al-Ajal).*

The evolution of Saudi Arabia's penalty clause demonstrates how Islamic law can adapt to modern commercial needs. By separating performance based liquidated damages from usurious debt accumulation, Resolution No. 109 (3/12) of IIFA spells out the groundwork for this legal framework. Decades later, the Saudi Civil Transactions Law formalised these gaps in Articles 178 and 179 (Chedrawe et al., 2023). Today, the Saudi system balances commercial predictability with ethical legal practice, ensuring these clauses offer fair compensation without turning into financial exploitation.

Pakistan

Countries such as Pakistan have diligently sought to completely transform their national financial sectors to achieve full Shariah compliance. The objective is to completely eliminate traditional *riba*-based banking from the whole economic system. In October 2024, Pakistan's Parliament enacted the 26th Constitutional Amendment, revising Article 38(f) to establish a strict, paramount legal requirement for the total elimination of *riba* by January 1, 2028. (Arab News Pakistan, 2024). A full-fledged Islamic bank does not operate on the basis of interest based conventional banking legislation. Instead, it is governed by a customised overlay of rules administered by the SBP's Islamic Banking Department. (State Bank of Pakistan, n.d.-d).

Although the International Islamic Fiqh Academy (IIFA) of the OIC and the Shariat Appellate Bench of the Supreme Court of Pakistan allow a penalty clause to deter wilful defaulters *(ta'zir),* they prohibit banks from keeping these fines as corporate income. (Editor & Ghafoor, 2022). The verdict in Dr. Mohammad Aslam Khaki, Shariat Appellate Bench in 1999 held that banks cannot keep late payment fees as profit but the contractual obligation to pay penalties to charity is a legal *ta'zir* mechanism to deter deliberate defaults. This ruling is against interest based commercial systems and gives a legal basis for punishing default in Islamic banking (*Dr. Mohammad Aslam Khaki v. Vice Chancellor, Islamic University, Islamabad*).

Late payment penalties are allowed in Pakistani Islamic banking primarily to discourage default and to prevent bad debt accumulation. To avoid the legal trap of usury, these penalty funds are isolated from bank profits and given directly to charity. The State Bank of Pakistan provides that the only exception to the above general rule is when the court verifies that the bank suffered genuine and quantifiable financial harms, then only the bank will be entitled to a determined portion as compensation.

Pakistan's shift toward Islamic finance is driven primarily by its courts rather than its legislature. For decades, the Federal Shariat Court (FSC) and the Shariat Appellate Bench of the Supreme Court have steered this legal evolution. A vital FSC ruling forced the issue by setting a strict legal deadline for the total elimination of *riba* based banking. Today, this transformation plays out as a mandatory, multi stage migration pushing public debt, treasury operations, and commercial banking assets entirely into a Shariah compliant system.

Indonesia

Indonesia operates a dual banking system where conventional and Islamic financial institutions run side by side. Under this model, Bank Indonesia and the Otoritas Jasa Keuangan (OJK) manage both sectors, allowing them to function either under shared rules or distinct regulatory tracks.

DSN-MUI Fatwa No. 17/DSN-MUI/IX/2000 establishes a strict three-tiered institutional framework to govern late payment penalties in Indonesian Islamic banking (Arief & Maula, 2023). This ensures that any financial sanctions applied to defaulting clients comply fully with national Shariah standards. First, only solvent clients (*nasabah mampu*) who wilfully or carelessly postpone their contractual responsibilities are subject to financial penalties. Secondly, debtors facing demonstrable financial hardship, bankruptcy, or force majeure are legally immune from punitive fees, necessitating banks to commence debt restructuring procedures instead. Finally, the structural framework and penalty rate must be transparently written in the original contract (*akad*) by mutual consent.

The DSN-MUI Fatwa No. 17/DSN-MUI/IX/2000 indicates that only financially competent debtors who wilfully default may suffer *ta'zir* sanctions (Nienhaus, 2011). According to the fatwa, Islamic banks like Bank Syariah Indonesia employ the *ta'zir* fine to settle defaults and offer financial assistance to consumers (Bariyah, 2024). Islamic banks can charge financially capable customers who purposely delay payments to develop financial discipline, however these funds are used for social benefit rather than bank profits, reflecting Islamic finance's ethics (Fiani, 2025; Hayati, 2022).

The DSN Fatwa above emphasises *ta'zir's* role in making customers more disciplined in performing their responsibilities, rather than replacing the bank's fixed costs or predicted losses (possible loss) due to lost opportunities *(al-furshah al-dha-i'ah).* The MUI National Sharia Board Fatwa sanctions capable clients who postpone or refuse to pay their debts (Harmoko, 2019; Sunur, 2018; Yufitasari, 2019).

The incorporation of national law and religious edicts (*fatwas*) into Indonesia's twin banking system demonstrates how modern statutory law can coexist with Islamic jurisprudence (*fiqh*). To penalise defaults ethically, Indonesian jurisprudence relies on a cross regulatory approach. Law No. 21 of 2008 and DSN-MUI Fatwa No. 17 work alongside Article 1243 of the Indonesian Civil Code (KUHPerdata) to manage late payments (Lina & Hosen, 2022). This synthesis ensures that while commercial defaults carry real financial consequences, the penalties never breach Shariah boundaries.

Ultimately, Indonesia's late penalty framework resolves the tension between secular civil law and Shariah principles. By strictly confining bank revenue to verified operational costs *(ta'widh)*, the system prevents unjust enrichment. Concurrently, routing punitive fines *(ta'zir)* to public charity strips these penalties of commercial profit motives, safeguarding the ethical foundations of Islamic finance.

The United Kingdom

United Kingdom financial legislation operates on a "substance over form" approach, treating Islamic finance identically to conventional banking. Rather than granting Shariah compliant firms a distinct legal status, English law subjects them to the exact same regulatory standards as traditional banks (Dewar and Hussain, 2018). Under the Financial Services and Markets Act 2000, the United Kingdom's Islamic banks fall under the sole regulatory and disciplinary oversight of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) (O'Sullivan, 2019). Beyond a purely descriptive Her Majesty's Treasury paper acknowledging the sector's existence, the United Kingdom lacks any formal, separate statutory rules for Islamic products.

Within the United Kingdom, penalty clauses in Islamic contracts navigate a distinct dual reality. While Shariah standards dictate internal structural compliance, English contract law retains exclusive authority over legal enforceability (Daouk, 2021). Because English courts interpret Islamic finance agreements strictly as commercial contracts rather than religious documents, they apply standard common law tests to any disputed late payment or default clauses.

The Supreme Court's ruling in the case of Makdessi unintentionally provides critical validation for the United Kingdom Islamic finance. By replacing the strict requirement for a precise loss calculation with a broader evaluation of "legitimate commercial interest", the Makdessi test accommodates Shariah-compliant default mechanisms. This legal compatibility underpins the United Kingdom's position as a dominant Western center for Islamic commercial contracts.

In conclusion, English law continues to be the default governing legislation for Islamic financing contracts in the United Kingdom. English courts often construe Islamic financial agreements as financing contracts, emphasising payment obligations over religious adherence, which encompasses the enforcement of profit returns and punishments for default.

FINDINGS AND DISCUSSION

Comparative analysis

It is evident that Islamic financial regulators permit the imposition of late payment charges by Islamic financial institutions as a mechanism to promote timely repayment and discourage payment defaults by debtors. In modern societies, the rulings of late payment charges are essential for the sustainability of Islamic financial institutions to compete with conventional banks. The regulators are keen to impose critical conditions such as the no-profit rule, actual losses and financial circumstances of the defaulted debtors in regulating late payment charges to ensure that it deviates from the concept of *riba* used by conventional banks. As such, the permissibility of *ta'widh* and *gharamah* by the regulators for the sake of *maslahah* is justified.

It is also evident that Islamic financial institutions are permitted to impose late payment charges on the condition that the charges are either to compensate the actual losses suffered by the Islamic financial institutions or as a penalty to the debtors provided that it is channeled to a charity. Additionally, the late payment charges imposed by Islamic financial institutions must not be subjected to compounding effects. The evidence indicates that, unlike conventional banks, Islamic financial institutions are not permitted to profit from late payment charges. The need for transparency in imposing late payment charges is also a fundamental principle in Islamic financial regulation. Thus, the late payment charges are permissible in Shariah due to its non-oppressive nature.

Legal framework of late payment charges

Malaysia adopts a combination of *taʿwidh* and *gharamah* in the imposition of late payment charges, with BNM prescribing the maximum rate that may be charged. Islamic financial institutions are permitted to retain compensation that corresponds to actual losses incurred due to late payment. The excess amount collected from late payment charges thereto is required to be distributed to charity. Saudi Arabia and Pakistan, on the other hand, permit judicial intervention in the assessment and adjustment of late payment charges. This shows that the courts play a significant role in determining the amount ultimately recoverable by Islamic financial institutions. In contrast, Islamic banks in Indonesia retain discretion in interpreting fatwas issued by the DSN-MUI of Indonesia; therefore, this contributes to variation in compensation practices among Islamic banks in Indonesia (Hidayat & Mumtazah, 2025). Conversely, the United Kingdom does not distinguish between Islamic financial institutions and conventional banks in its treatment of late-payment penalties.

Late payment charges as income

In Malaysia, only the portion of late payment charges equivalent to the actual losses suffered by Islamic financial institutions is permitted to be recognised as income. Any surplus must be channelled to charity. Indonesia adopts a broadly similar approach in permitting compensation for actual losses while imposing punitive sanctions on deliberate defaulters. It is impermissible for the punitive fees in question to be recognised as income; rather, they must be channelled towards charitable purposes for public benefit. Pakistan bans banks from recognising late payment penalty fees as income; instead, all such proceeds must be channelled to charity.

Table 1 below illustrates the approaches adopted by Islamic financial institutions across Malaysia, Saudi Arabia, Pakistan, Indonesia and the United Kingdom pertaining to late payment charges.

Table 1: Summary of Comparative Analysis

	Malaysia	**Saudi Arabia**	**Pakistan**	**Indonesia**	**United Kingdom**
Regulatory Body	Bank Negara Malaysia (BNM)	Saudi Central Bank	State Bank of Pakistan	Otoritas Jasa Keuangan (OJK)	Financial Services Authority (FSA), the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA)
Highest Shariah authority	Shariah Advisory Council (SAC) of Bank Negara Malaysia	No centralised national Shariah authority	Shariah Advisory Committee of the State Bank of Pakistan	Dewan Syariah Nasional – Majelis Ulama Indonesia (DSN-MUI)	No centralised national Shariah authority
Source of Law/ Regulatory Framework	Guidelines on Late Payment Charges for Islamic	Saudi Civil Transactions Law	None	DSN-MUI Fatwa No. 17/DSN-MUI/IX/2000	Law of contracts
Adopted shariah concept	Combination of ta'widh & gharamah	Not specific	Charity-based	Ta'widh & ta'zir	No
Late payment charges are recognised as income	Yes, for ta'widh only.	Not stated.	No, unless awarded by courts	Yes, for ta'widh only.	No information
Separation of Islamic and conventional financial systems	Yes	Yes	Yes	Yes	No

It is evident from the comparative analysis above that the legal framework pertaining to late payment charges in Malaysia is more comprehensive than those of the other jurisdictions discussed in this paper. In developing and overseeing a robust regulatory framework that addresses various aspects of late payment charges, BNM plays a pivotal role in ensuring a standardised approach that balances Shariah compliance, *maslahah* and sustainability across Islamic financial institutions. This mechanism ensures compliance with Shariah principles while preserving market efficiency.

CONCLUSION AND RECOMMENDATIONS

In conclusion, late payment charges are permissible under Shariah provided they are imposed to compensate for an actual loss suffered by Islamic financial institutions. The rationale for the permissibility and the practice of late payment charges under Shariah is not only to serve as a debt-recovery mechanism but also to ensure repayment discipline among debtors and, at the same time, to protect the interests of Islamic financial institutions.

It is apparent that Malaysia has established one of the most comprehensive legal and regulatory frameworks governing late payment charges by adopting a combination of the concepts of *ta'widh* (compensation) and *gharamah* (penalty). This allows Malaysia to develop a robust governance structure that balances the rights of Islamic financial institutions and consumer protection with the strict application of IFSA, BNM's guidelines, and SAC rulings.

Nevertheless, the question on how Islamic banks determine the actual losses raises concerns regarding consistency, transparency and standardisation of the amount of late payment charges. Similarly, the assessment of genuine financial hardship and reasonable mitigating circumstances requires clearer guidelines to ensure fairness and protection among customers facing temporary financial difficulties.

For future study, it is recommended to investigate the calculation of late payment charges and the assessment of genuine financial hardship and reasonable mitigating circumstances among Islamic banks. This will provide insights for SAC and BNM, as regulators of Islamic banking, into the need for a specific guideline that will furnish greater certainty regarding the calculation, application, governance and disclosure of *ta'widh* and *gharamah*.

Disclosure Of Ai Assistance

This paper was prepared with the support of artificial intelligence tools, which were used solely to assist with drafting and language refinement. All intellectual contents, scholarly analysis, interpretations and conclusions presented in this study are the original work of the authors. The use of AI tools was transparent and supervised, and it did not contribute to the generation of research data or substantive intellectual content.

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