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Innovations in Islamic Banking: Who Benefits More?

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ABSTRACT

Islamic banking has progressed tremendously since it was first introduced in Malaysia in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB). Bank Islam was given a monopoly to provide Islamic banking services for 10 years before Bank Negara Malaysia (BNM) allowed conventional banks to operate Islamic banking windows. Initially, Islamic banks provided financing based on a fixed-rate mechanism, which exposed them to interest rate movement risk, resulting in difficulty for Islamic banks to compete with conventional banks. To address this, Islamic banking has made several innovations in its products and services offered to its customers. Among the more notable innovations are the introduction of penalty charges on late payment in 1998, the inclusion of an undertaking to give a rebate in 2000, and the introduction of the variable rate Bai Bithaman Ajil (BBA) in 2003. This study aims to investigate who benefits from the innovations made to Islamic banking products and services. Research in this area of Islamic banking is still lacking, as evidenced by the lack of articles on this topic. . Using a qualitative research method, this study examines secondary data, primarily obtained from BNM regulations and guidelines, to determine who benefits more from improvements or innovations made to Islamic financing. The findings indicate that, financially, the banks do not gain much from the innovations. However, they have a significant negative financial impact on the customers, especially in the event of default. This study is confined to the financial impact of improvements or innovations made to the Islamic financing system in Malaysia on the banks and customers.

Keywords – 1. Islamic banking, 2. innovations, 3. Late payment charges, 4. Variable rate 5. Ibra' or rebate.

INTRODUCTION

Islamic banking is a banking system that adheres to the Islamic law known as Shariah law, which prohibits usury (Riba), uncertainties (Gharar) and gambling (Maisyir). Islamic banking was introduced in Malaysia in 1983 with the incorporation of Bank Islam Malaysia Berhad (BIMB) as an alternative to conventional banking, that has existed much earlier. The progress of Islamic banking in Malaysia has been phenomenal, from a humble beginning of 30 pioneering staff from their temporary headquarters on the first floor of Kompleks Jemaah Haji in Subang, Selangor (Bank Islam Malaysia Berhad, 2026). Islamic banking is currently offered by seventeen financial institutions, of which 11 are local Islamic banks and the remaining 6 are foreign-owned Islamic banks.

To compete with the already established conventional banks, Islamic bankers worked hard to design and offer products and services that are compatible with those offered by conventional banks. Thus, the introduction of products such as Overdraft-i, Trade financing-i, Sukuk and Ar-Rahnu, to name a few. This feat was done through creative innovation in Islamic banking products. This paper aims to explore three of the most significant innovations in Islamic financing and their impact on both the Islamic financial institutions and the consumers who patronise Islamic banks in Malaysia. It has to be pointed out that any improvement or innovation to the products and services of Islamic banking must be fair to both the banks and their customers. They should not be made on the pretext of Maslahah to benefit one party but to the detriment of the other party or parties.

LITERATURE REVIEW

The Islamic Banking Act 1983 defines "Islamic bank" as any company that carries on Islamic banking business, whose aims and operations do not involve any element that the Religion of Islam disapproves. (Malaysia

Legislation, 1983). The definition was refined in the Islamic Financial Services Act 2013, which defines "Islamic bank" as a person licensed to carry on Islamic banking business, including a licensed international Islamic bank, and Islamic banking business includes: -

(a) accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or

(b) accepting money under an investment account; and

(c) provision of finance; and

(d) such other business as prescribed under section 3 of the IFSA 2013.

Through creative innovations, Islamic banking can offer its customers products and services that match those offered by conventional banking. Among the notable improvements to Islamic banking in Malaysia are the introduction of a penalty for late payment in 1998, the incorporation of clauses in Islamic banks' legal documents promising to give a rebate (ibra) in 2000, and the introduction of variable-rate Bai Bithaman Ajil in 2003.

Imposition of Penalty on Late Payment (Ta'widh)

In the banking industry, a penalty is a fee imposed on customers who breach the terms of the loan or the financing agreements or failure to perform certain obligations. A penalty may be imposed for various reasons, such as late payments on a loan, exceeding the overdraft limit or early withdrawal of a fixed deposit. Imposing a penalty on late payment to customers who default on their payments has been a normal practice of conventional banks in Malaysia. However, Islamic banks were not allowed to impose any penalty on late payment as it was considered non-Shariah-compliant and thus prohibited.

Islamic banks were of the view that this situation might create a moral hazard as customers may prioritise their payments to conventional banks over payments to Islamic banks. Based on this assumption, they sought the Bank Negara Malaysia (BNM) Shariah Advisory Council (SAC) to look into this predicament. Accordingly, BNM's SAC at its fourth meeting on 14 February 1998 resolved that Islamic banks may impose late payment charges or ta'widh on customers who default in their payment obligation, subject to: -

1. The amount of ta'widh cannot exceed the actual loss suffered by the financier.
2. The determination of compensation is made by a third party, that is, Bank Negara Malaysia, and
3. The default or delay of payment is due to negligence on the part of the customer.

BNM revised the Guidelines on Late Payment Charges for Islamic Financial Institutions in January 2012, categorising late payment charges into Ta'widh (compensation) and Gharamah (penalty) and the total Ta'widh and Gharamah is called the combined late payment charge. The guideline stipulates that IFI may impose late payment charges comprising of Ta'widh and Gharamah, subject to the ceiling rate fixed by BNM and:-

1. The combined rate shall be capped at the IFI Average Financing Rate (AFR) at the point of default based on products and the type of customers, calculated monthly.
2. The combined rate shall not exceed the interest rate on default imposed on conventional finance on similar customers, and
3. The amount must not be compounded on the overdue instalment or outstanding principal.

Ta'widh refers to compensation for actual losses incurred by the Islamic Financial Institution resulting from the default by the customer. The maximum ta'widh that can be imposed is 1% per annum on: -

1. on the overdue instalments of the Islamic financial product in the case of default of scheduled payments; or on the outstanding balance (subject to ibra' if applicable) of the Islamic financial product in the case of default, causing the entire facility to be recalled or brought to court for judgment before maturity.

2. The actual loss to be compensated from default payment, which exceeded the maturity date, shall not be more than the prevailing daily overnight Islamic Interbank Money Market rate (IIMM) on the outstanding balance (subject to ibra' if applicable) of the Islamic financial product computed monthly from the payment due date.

Gharamah is a penalty charged to the defaulters of an Islamic financial institution over and above the ta'widh. For example, if the average financing rate of the IFI is 3.25%, then the maximum Gharamah or penalty that the IFI can charge is 2.5%, as the Ta'widh is capped at the maximum of 1%. It is charged at the rate of the difference between the Combined rate and ta'widh. Unlike Ta'widh, the Shariah doesn't allow Islamic Financial Institutions to be recognised as income to the institution; instead, it must be donated to charitable organisations.

Despite the permissibility of ta'widh and Gharamah by BNM and its Shariah advisory council, only ta'widh is widely implemented by Islamic banks in Malaysia, while the requirement of setting up separate charitable accounts, disclosure requirement copled with the regulation associated with it, resulted in their reluctance to impose Gharamah (Muneeza et al., 2019).

The claim for ta'widh and Gharamah by Islamic banks has been disputed by customers on several bases, which include wrong calculation of ta'widh by the financial institutions, the calculation of ta'widh is not in line with the financing agreements, and the ta'widh imposed is not consistent with the Central Bank guidelines. This could be the result of the lack of knowledge and understanding of the contracting parties (Mohd Zawawi & Hassan, 2023).

Undertaking To Grant Ibra' (Rebate) By Islamic Banking Institutions (Ibi)

Ibra' represents the 'waiver on right of claim' accorded by a person to another person that has an obligation (zimmah) which is due to him. Ibra' or 'rebate' refers to an act by a person relinquishing his rights to collect payment due from another person. In the context of Islamic finance, an Islamic financial institution (IFI) may grant ibra' to its customers of a sale-based financing (such as Murabaha and Bai' Bithaman Ajil) who settle their debt before the agreed settlement period as stipulated in the agreement concluded by both parties (Bank Negara Malaysia, 2013).

Ibra' is given at the discretion of the IBI. However, the practice of granting Ibra' differs among the Islamic banks. While some Islamic banks give Ibra' and incorporate the commitment to grant Ibra' into their legal documents, there were Islamic banks that were silent on the matter. The different practices of the IBIs have created confusion for the customers. The practice of granting Ibra's needs to be standardised among the IBIs to avoid confusion and create greater transparency and clarity. (BNM. 2012).

Thus, BNM sought its SAC's view on the matter, and BNM's SAC had at its 13th meeting on 10th April 2000 resolved that IBIs may incorporate a clause on the undertaking to provide Ibra' to customers who make early settlement in the financing agreement based on public interest (maslahah) and IBIs are expected to honour the undertaking or promise to grant Ibra' to its customers. To further safeguard public interest and ensure that the customers' protection is carried out consistently, BNM's SAC has at its 101 meeting on 20 May 2010, resolved that: -

1. BNM may require the IBIs to accord Ibra' to their customers who settled their debt obligation arising from a sale-based contract before the agreed settlement period.
2. BNM may also require the terms and conditions on ibra' to be incorporated in the financing agreement to eliminate any uncertainty with respect to the customer's entitlement to receive ibra' from the IBI; and
3. BNM to standardise the Ibra' formula.

BNM, in its guidelines dated 31 January 2013, categorised ibra' into two: ibra' on early settlement and ibra' on the difference between the ceiling rate or cap rate and the effective rate. Ibra' on early settlement is ibra' that must be given to customers who settle their financing before the end of the financing tenor of the facility, which may include, but is not limited to, the following situations: -

1. Customers who make an early settlement or early redemption, including those arising from prepayments.
2. Settlement of the original financing contract due to the restructuring of the said financing.
3. Settlement by customers in the case of default; and
4. Settlement by customers in the event of termination or cancellation of financing before the maturity date.

The second type of ibra', ibra' on the difference between the ceiling rate and the effective rate, is ibra' to be given to financing using the variable rate mechanism. The ibra' is the difference of profit calculated based on the cap rate and the profit calculated based on the effective rate and has to be given upon payment of the monthly instalment.

There are researchers, such as Sherin Kunhibava (2017), was of the view that with the issuance of the guidelines, the issue of Ibra' has been settled and that a rebate must be given when the facility is terminated, and recovery action is initiated against customers who defaulted in their payments.

Variable Rate Bai Bithaman Ajil (Vbba)

When BIMB first started operation in 1983, most of the financing products offered were using the fixed-rate BBA contract. However, Fixed-rate BBA exposes Islamic banks to funding mismatch risk as their short-term deposit are used to fund their long-term financing, making it difficult for Islamic banks to react to any movement in the market interest rate. For example, in the event of an upward interest rate movement, conventional banks would increase their deposit rates, giving higher returns to their depositors by increasing the interest rate on their loans. Islamic banks would not be able to do so as their income is tied to the fixed rate regime. This may result in depositors moving to conventional banks for better returns while maintaining their financing with Islamic banks, as Islamic banks would not be able to increase the profit rate on their financing.

Conversely, in the event of a downward move in the market rate, conventional banks would pass the rate reduction to their customers by reducing their interest rate on their loans. However, Islamic banks would not be able to do so as their financing is tied to the fixed-rate regime.

To mitigate the funding mismatch risk, BNM introduced the variable-rate BBA product in July 2003 to replace the fixed-rate BBA, which had been used since BIMB started its operations in 1983, to better compete with its conventional counterparts (Bank Negara Malaysia, 2004).

In a variable-rate BBA, the selling price is calculated at the rate called the ceiling rate or cap rate, which is the agreed contracted rate (CR) between the Islamic banks and their customers. However, the monthly instalment is calculated based on the current market rate, called the effective profit rate (EPR), which is much lower than the contracted rate. To illustrate the difference between the contracted rate and the effective rate, if a customer were to take a financing of RM500,000.00 for 30 years at an effective rate of 3.95% and a contracted rate of 10.25%. The difference in the selling price would be as shown in Table 1 below: -

Table 1: Simulation of selling price between fixed rate and floating rate.

	Fixed rate	Floating rate
	Ringgit Malaysia	
Financing Amount	500,000.00	500,000.00
Profit Margin (EPR/CR)	3.95%	10.25%

Duration (Years)	30	30
Instalment	2,372.69	4,480.51
Selling price	854,168.40	1,612,983.60
Profit	354,168.40	1,112,983.60

Source: Author's own.

If the EPR increases to 4.5% in tandem with the increase in the market rate, the Islamic banks would be able to increase the monthly instalment to RM2,533.43, just like their conventional counterparts. They would not be able to do so under the fixed rate regime. However, if the EPR increases to more than 10.25%, Islamic banks would not be able to charge more than 10.25%, as that is the agreed ceiling rate.

METHODOLOGY

This study adopted a qualitative research method using secondary data obtained mostly from Bank Negara Malaysia guidelines and the resolution of Bank Negara Malaysia's Shariah Advisory Council.

The data were analysed using the content analysis method, where the content of the guidelines and Shariah resolutions was scrutinised, and the findings were classified into several themes and discussed below.

FINDINGS AND DISCUSSION.

This section discusses the findings of this research, which are divided into three categories: the financial impact of the three innovations discussed, the advantages and disadvantages of the innovations, and who benefits more from the innovations, namely, the Imposition of penalty on late payment, the undertaking to grant ibra ', and the introduction of variable-rate financings.

Financial Impact Of The Innovations

The BNM's Shariah Advisory Council resolved that Islamic banks may impose a monetary penalty on late payment to Islamic banking customers in February 1998. However, due to system constraints, most banks that provide Islamic financing services were having some issues in implementing the penalty, as it can only be imposed on customers who were negligent in paying their instalments.

The guideline on late payment charges was subsequently revised in January 2012, dividing the late payment charges into Ta'widh (compensation) and Gharamah (penalty). At first glance, it appears that Islamic banks will benefit from this guideline. However, upon a closer look, Islamic banks do not benefit much as they are not allowed to recognise the penalty (Gharamah) charged as income. They have to channel the penalty collected to a charitable organisation. In addition, Islamic banks have to incur additional costs to upgrade their systems to cater for the implementation of the late payment charges.

As for ta'widh, it is compensation for actual losses incurred due to the default, which includes the cost of sending notices, legal costs and other recovery costs, subject to a maximum amount of 1.0% per annum of the defaulted amount. Taking the example above, if the customer were to default on the monthly instalment of RM2,533.43, the Islamic bank's penalty would be only RM2.11. If the Islamic bank terminated the facility and initiated recovery action after three months' default, the total ta'widh collected is only RM12.67. However, after termination of the facility, the penalty charged will be higher as the Islamic bank may charge penalty (Gharamah) at the average financing rate (AFR) on the principal balance outstanding.

Islamic banks will, however, reap benefits in kind as the ta'widh amount could be disguised as the Islamic bank's corporate service responsibility (CSR) when donating it to a charitable organisation, which will enhance their image.

However, the policy has a bigger impact on the customer as they will incur a total penalty at the average financing rate for the products. If the average financing rate for a house financing facility is 4.0%, the customer will incur a penalty of RM8.44 for every instalment defaulted. For three months, the customer will incur a total penalty of RM50.67 for the three months' arrears. The penalty amount imposed on the customer would be higher after the termination of the facility, as the whole outstanding balance became overdue after the termination of the facility.

Bank Negara Malaysia, through its guideline on Ibra' (Rebate) for Sale-Based Financing dated 1 November 2011, updated on 31 January 2013, has made it compulsory for Islamic financial institutions to grant ibra' to customers who settle their financing early, before the maturity period, which includes but is not limited to: -

1. Customers who make an early settlement or early redemption, including those arising from prepayments.
2. Settlement of the original financing contract due to the financing restructuring exercise;
3. Settlement by customers in the case of default; and
4. Settlement by customers in the event of termination or cancellation of financing before the maturity date.

This requirement addresses the inconsistent practice of Islamic financing institutions, where some Islamic banks incorporate the ibra' clause in their documents while others do not due to fear of Gharar (uncertainty) in the selling price.

There is no significant monetary impact to the Islamic banks or customers on the requirement to incorporate the Islamic financial institutions' undertaking to provide Ibra' on early settlement before the maturity date, as it has been the common practice of Islamic banks to give a rebate (Ibra') equivalent to the future profit or profit on the unexpired term of the facility to customers who fully settled their facility before the agreed period. However, the guideline does not elaborate on ibra' on the difference between the contracted rate and the effective rate. It only states that "the IFIs shall grant ibra' on the difference between the amount of profit calculated based on the ceiling/contracted profit rate (CPR) and the amount of profit based on the effective profit rate (EPR). Ibra' must be granted if the profit amount based on EPR is lower than the profit amount based on CPR". However, in practice, ibra' on the difference between the contracted rate and the effective rate is not reflected in the customer's statement of account. Although it does not have a significant impact on customers whose payments are regular, it has an impact on customers who default on their payments, which may lead to termination of the facility and initiation of legal action, as the amount claimed does not take into account the rebate for the payments already made which, if taken into consideration, the amount claimed would be lower.

To be more transparent, Bank Negara Malaysia should require the Islamic financing institution to give the rebate and reflect it in the customer's statement of account when payments are made or due. Realistically, Islamic Financing institutions would not be able to collect the full selling price even when the customers diligently pay the instalments for the duration of the facility, as they are required to accord rebates on the difference between the profit calculated at the ceiling or cap rate and the profit calculated at the effective rate.

This is one of the wisdom of the introduction of variable BBA in 2003. If they are not prepared to do so, they should not be allowed to use the variable rate mechanism but instead revert to the fixed rate products. The introduction of variable-rate Bay Bithaman Ajil in 2003 has significantly changed the landscape of Islamic finance. It was introduced to mitigate the interest rate movement risk faced by banks providing Islamic financing using the fixed rate mechanism. As the name suggests, it allows Islamic financial institutions to adjust the profit rate charged on financings granted to the customers within the ceiling rate/contracted rate, which in turn enables the Islamic financial institution to vary the monthly instalments accordingly.

The variable rate mechanism has significantly inflated the selling price of the merchandise being transacted between the banks and their customers. As an example, if a customer were to take a financing of RM500,000.00 to purchase a residential property for a financing duration of 35 years at an effective rate of 3.95% and a contracted or ceiling rate of 10.25%, the comparison of the selling price and instalments is as in Table 2 below:-

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Table 2 : Comparison of Selling Price Between Fixed Rate and Variable Rate

	Effective rate	Ceiling/ contracted
	Ringgit Malaysia	
Financing amount	500,000.00	500,000.00
Profit margin	3.95%	10.25%
Duration (Years)	35	35
Instalment	2,198.90	4,394.28
Selling price	923,538.00	1,845,597.60
Profit	423,538.00	1,345,597.60

Source: Author's own.

For the above example, the monthly instalment will be based on the effective rate, which is RM2,198.90, while the selling price will be based on the ceiling or contracted rate, which is RM1,845,597.60. In the event of an upward movement of the interest rate by 1.0%, the Islamic financial institution may revise the monthly instalment upward to RM2,507.52 based on the revised effective rate of 4.95%. However, the selling price remains unchanged.

The variable rate mechanism has doubled the customer's liability from RM923,538.00 to RM1,845,597.60, as that would be the amount stipulated in the security documents, such as the letter of offer, property purchase and property sale agreement and, in the case of house financing, where the property purchase is placed as collateral, the charge document.

In the event of default, the amount claimed by the Islamic bank under the variable rate mechanism becomes significantly higher than that of the fixed rate regime. Based on the above example. If the customer were to default after paying 116 instalments and the bank were to initiate recovery action on the 120th month, the difference in the amount claimed will be as follows: -

Table 3: Difference in Amount Claimed in the event of Default Between Fixed and Floating Rate

	Fixed rate (Effective rate)	Variable rate (Contracted rate)
	Ringgit Malaysia	
Financing Amount	500,000.00	500,000.00
Profit Rate	3.95%	10.25%
Duration (years)	35.00	35.00
Selling Price	923,538.00	1,845,597.60
Monthly instalment (Based on effective rate)	2,198.90	2,198.90
No of Instalments paid	116	116
Total instalment paid.	255,072.40	255,072.40
Instalment no defaulted	117	117
Instalment no recovery action initiated	120	120
Amount claimed.	668,465.60	1,590,525.20

Source: Author's own.

The table above shows that the amount claimed under the variable rate mechanism is almost three times the amount claimed under the fixed rate mechanism.

Islamic financial institutions do not significantly benefit from the variable rate mechanism, as the amount the IFI will receive would be based on the effective rate if customers were to diligently pay the financing until full settlement or make full settlement before the expiry of the financing, as the IFI would give a rebate on the difference in profit calculated between the contracted rate and the effective rate. Even if the customers were to settle after recovery action is initiated, the IFI is still required to grant a rebate to the customers.

However, the customers are adversely affected by the variable rate mechanism, as on paper, their liability would be inflated to almost three times compared to the fixed rate mechanism, and in the event of default, the amount claimed by the IFI is significantly higher than under the fixed rate mechanism.

CONCLUSION

Islamic banking has made several improvements to its products offered to the customers, with the intention of providing products that are compatible with those offered by conventional banking. Three of the more notable improvements are the imposition of a penalty on late payment charges to customers who defaulted in their payments, incorporation of an undertaking by Islamic financial institutions to grant ibra' or rebate to their customers who settle their financing facilities before the expiry period of the financing and the introduction of the variable rate Bai Bithaman Ajil which was applied to other financing products offered by Islamic financial institution.

However, upon closer examination, all the improvements made appear to favour the Islamic financial institution at the expense of its customers. The imposition of late payment charges, for example, was considered non-Shariah-compliant and haram prior to 1998. It was allowed based on maslahah to protect the interests of the depositors, and that it will only be imposed on customers who purposely defaulted on their payment while having the capacity to do so. Penalty for late payment should not be imposed on customers who are genuinely facing financial difficulties in line with verse 280 of Surah Al-Baqarah, which says: -

> "And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [from your right as] charity, then it is better for you, if you only knew"

(Quran: 2:280)

In practice, Islamic financial institutions impose a penalty on late payment to all customers who default in their payments, as the system would not be able to identify whether the default is due to financial difficulties or not.

On the face of it, the requirement for Islamic financial institutions to incorporate their undertaking to grant Ibra' or rebate in the legal documents appears to favour the customers. However, the guideline issued by Bank Negara Malaysia only compels the Islamic financial institution to grant ibra' or rebate to customers who settle their financing early before the expiry period of the facilities, which has been the practice of Islamic financial institutions even before the rule was issued.

There is no mention of when the Ibra'/rebate on the difference between the profit calculated at the cap or contracted rate and the effective rate to be given to the customers. Bank Negara Malaysia need to revisit and refine its guidelines on Ibra' /rebate for sale-based products to specifically indicate when the Ibra' /rebate on the difference between profit calculated at the cap rate and profit calculated at the effective rate is to be given and reflected in the customer's financing account.

Declaration

Credit Authorship Contribution Statement

This research article is solely written by Witrofoledy Saladin.

Declaration of Competing Interest

The author declares that he has no known competing financial interests or personal relationships that could have influenced the research work.

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Ethical Statement

The author declares that he understands the Publication Ethics and Malpractice Statement and has adhered to all the statements. They also confirm that this paper is original and has not been published in any other journal nor is under consideration by another publication.

Data Availability

Not Applicable

Disclaimer

The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of any affiliated agency of the author.

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