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Comparative Analysis on The Cost of Default Calculation Between Islamic and Conventional Home Financing

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Abstract

The sustainability of the Malaysian Islamic banking industry after a few decades of its inception can be seen via proactive initiatives taken by the players, along with a close monitoring system by the Malaysian financial authority. However, one aspect of Islamic banking that has been neglected and received less concern is the calculation of the amount to be claimed in the event of default or the cost of default. This paper aims to conduct a comparative analysis of default cost calculations between Islamic and conventional financing in Malaysia. To achieve the objective, this study employs a qualitative research method by analysing related court cases, policy documents issued by Bank Negara Malaysia, and resolutions from the Shariah Advisory Council (SAC) of Bank Negara Malaysia. Based on document analysis, the findings reveal that there is a difference in default cost calculation methods between Islamic and conventional home financing. The amount claimed by Islamic banks in the event of default is considerably higher than conventional banks due to the basis point of total financing calculation, which is based on the types of contracts adopted. This paper discussed the aspect of default cost calculation between the Islamic and conventional banking industry, which has been rarely touched or written about in the last 40 years.

Keywords: Comparative Analysis, Conventional Banking, Default Cost Calculation, Islamic Banking, Home Financing.

1. Introduction

The Malaysian financial industry is strictly regulated by the Central Bank of Malaysia (BNM) which was established in January 1959. BNM was established under the Central Bank of Malaysia Act 1958 which was later repealed by the Central Bank Act 2009. The principal objective of the BNM is to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy. Since the Malaysian population consists of various races and religions, its banking system is run under a dual system which is conventional and Islamic.

Conventional banking has been practised since the existence of British merchant communities in Penang and Singapore in the 19th century which was known as the Straits Settlement (Association Of Banks In Malaysia, n.d.). Due to the strategic location of Penang as a trading port, it has become a springboard for a bank. The first conventional universal bank was established by the British known as the Hong Kong and Shanghai Banking Corporation (HSBC) founded in Hong Kong in 1865 (headquartered in London), followed by Chartered Bank (now Standard Chartered) in 1875. The total assets of commercial banks in Malaysia have reached RM1.78 trillion in 2023 (Siddharta, 2024).

Compared to conventional banking, Malaysian Islamic banking is relatively new where it was started in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB). BIMB was given a 10-year monopoly on Islamic banking services as Bank Negara Malaysia (BNM) only allowed conventional banks to set up their Islamic banking windows in 1993. These Islamic banking windows were later converted to become Islamic subsidiaries of conventional banks. Currently, there are 16 Islamic banks in Malaysia of which 11 are local Islamic banks and the remainder 5 are Foreign Islamic banks (Bank Negara Malaysia, 2024). In 2023, Malaysia

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has acquired the largest Islamic banking assets in Asia and the third largest globally, after Iran and Saudi Arabia (Domat, 2024).

The Malaysian Islamic Banking industry has progressed tremendously until now where its assets have reached approximately RM1.22 trillion in the year 2024 (BNM, 2025). The growth of Islamic banking in Malaysia among others is supported by high financial inclusion among the Malaysians as well as clear direction and guidance from the regulator. Various initiatives and proactive actions are taken by the industry players to further boost this industry for future sustainability while at the same time ensuring *Shariah* compliancy. It includes avoiding from practising the contract that may attract *Shariah* issues and enhancing products and services that bring benefits to the society at large.

Hence, every aspect of the Islamic banking is underlined by the *Shariah* principles, and the aim of the business is towards achieving the objectives of the *Shariah (Maqasid al-Shariah)*. Compared to Islamic banking, the objective of conventional banking is to maximize profit for the company, and it is based on human-made law. Technically, both of these businesses are offering the same products and services to customers, but principally, they are operating under different tenets, spirits, and objectives. This research, therefore, is conducted to compare the practice of Islamic and conventional banking in terms of default cost calculation by referring to secondary data such as court cases, guidelines of BNM, as well as resolutions of the Shariah Advisory Council (SAC) of BNM. This research is structured as follows: The next section begins with literature review, followed by methodology and data analysis. This research is concluded with findings and conclusion.

2. Literature Review

Default In Islamic Banking

Default is a credit risk that banks are exposed to, be it Islamic or conventional. Default happens when the customers are unable or unwilling to meet their payment obligation when the payment is due (Kamaruzaman & Hassan, 2023); (Hassan et al., 2021). Generally, defaulters can be classified into three categories, solvent defaulters, insolvent defaulters, and habitual defaulters (Hassan et al., 2017).

Hassan et al., (2021) were of the view that default in Islamic banking differs from default in conventional banking as the nature of Islamic banking products differs from conventional banking products. While default in conventional banking arises out of the debtor and creditor relationship, the relationship between Islamic banking and the defaulters varies according to the contract they entered. The relationship could be that of seller and buyer if the contract entered was a sale contract such as *Bay' al-Bithaman Ajil* (BBA), *Salam, Inah, Istisna'* and *Tawarruq*, lessee and lessor if the contract is a lease-base contract such as *Ijarah*, as partners for equity-based contracts such as *Mudharabah* and *Musyarakah* and as agent and principal for service-based contracts such *Kafalah* and *wakalah*.

Bank Negara Malaysia's Guidelines on Classification and Impairment Provisions for Loans/Financing (2015) stipulate that accounts will be classified as impaired or non-performing financing or loans if the monthly instalments are unpaid for three months or more. When accounts are classified as impaired. The banks can either attempt to rehabilitate the accounts or proceed with legal action against the customers, guarantors (if any), and any security pledged to the banks (Kamaruzaman & Hassan, 2023). Rehabilitation by way of rescheduling the payments or restructuring the remaining balance of the facility can only be done if the customers are contactable and are willing to negotiate with the banks to either reschedule or restructure their accounts (Bank Negara Malaysia, 2015).

Rescheduling simply means that the monthly payments are varied from the original payment terms. It could be done by allowing the customers to make a lower payment for a certain period and the payments will be gradually increased as the payment capacity of the customers improves. The main terms of the financing, such as the selling price and duration remain unchanged. Restructuring, on the other hand, involved the creation of a new facility to replace the existing facility. A new aqad with a new buying and selling price will have to be entered between the customers and the Islamic banks and the proceeds of the new facility will be utilized to settle the existing facility. If attempts to rehabilitate the account fail, banks will terminate the facility and initiate legal action against the customer and the security that they have (Bank Negara Malaysia, 2015).

Kamaruzaman and Hassan (2023) were of the view that it is the duty and responsibility of the customers to approach the banks to discuss and find a proper solution, should they have financial difficulties in paying the monthly instalments, while the banks have the responsibility to mitigate the default and recover their money. This is in line with the findings of Abdul Muneem et al. (2020).

Should rescheduling or restructuring not be possible, banks will normally terminate or recall the facilities given to customers and initiate legal action against the customers who have defaulted in their payments to recover their money as provided by the legal documents executed by both banks and customers when entering the contract. In Malaysia, all civil suits on banking, Islamic or conventional will be adjudicated at the civil court (Markom et al., 2011). Thus, the decisions of the court are always based on the contract signed between the customers and the banks. The court does not apply *Shariah* consideration in making its decision.

The practice of Islamic banks in initiating recovery action against the customers who defaulted on their instalments has been criticised by customers and consumer associations as the amount claimed by Islamic banks is significantly higher than that of conventional banks (Md Dahlan et al., 2017).

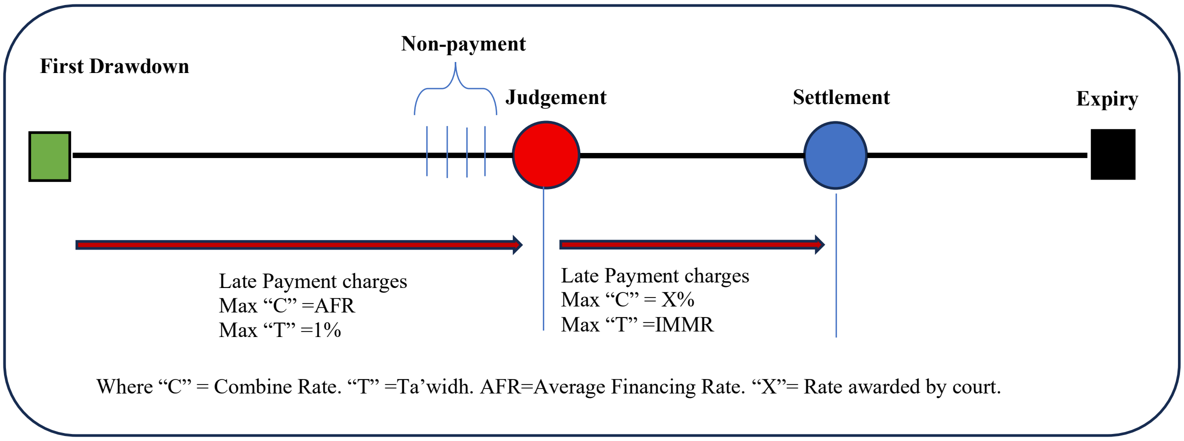
Late Payment Penalty

Unlike conventional banks which impose late payment interest on customers who default in their instalments, Islamic banks were not allowed to do so as it was considered *riba'* and non *shariah* compliance (Yaakub et al., 2014). This may create a moral hazard as customers may choose to delay the payment for Islamic financing for the preference of conventional loans (Bank Negara Malaysia, 2012). Islamic scholars have different views on incorporating the penalty clause known as *Syart Jazaie* in financing documents. To the Shafie school of thought and a section of jurists from the Hanafi school of thought "*Syart jazaie*" is not permissible because it is against the fundamental ruling that "condition" and "sale" cannot be put in one contract relying on a narration in which the Prophet (PBUH) was reported to have prohibited a sale that is circumscribed with a condition. However, jurists from the Hambali and Maliki schools of thought have permitted *Syart Jazaie* while the Majority of the jurists from the Hanafi school of thought allowed it based on juristic preference (*istihsan*) (Aishath Muneeza et al., 2019).

In Malaysia, the imposition of penalties by Islamic banks started in 1998 after the BNM Shariah Advisory Council at their 4th meeting on 4th February 1998 resolved that Islamic banks may impose compensation charges on defaulters. BNM further refined the guideline in December 2012 where the late payment charges may be imposed either as compensation (*ta'widh*) based on the actual cost incurred or penalty (*Gharamah*). BNM with the approval of the SAC has also allowed Islamic banks to impose penalties on the principal outstanding at Islamic interbank money market rate (IIMM) after judgment has been obtained until the judgment sum is fully settled (BNM, 2012). On top of the late payment charges, there are Islamic banks that impose a default rate on their customers (Abdul Rahim & Buang, 2021). The default rate is the higher profit rate that customers have to pay if they default on their payments.

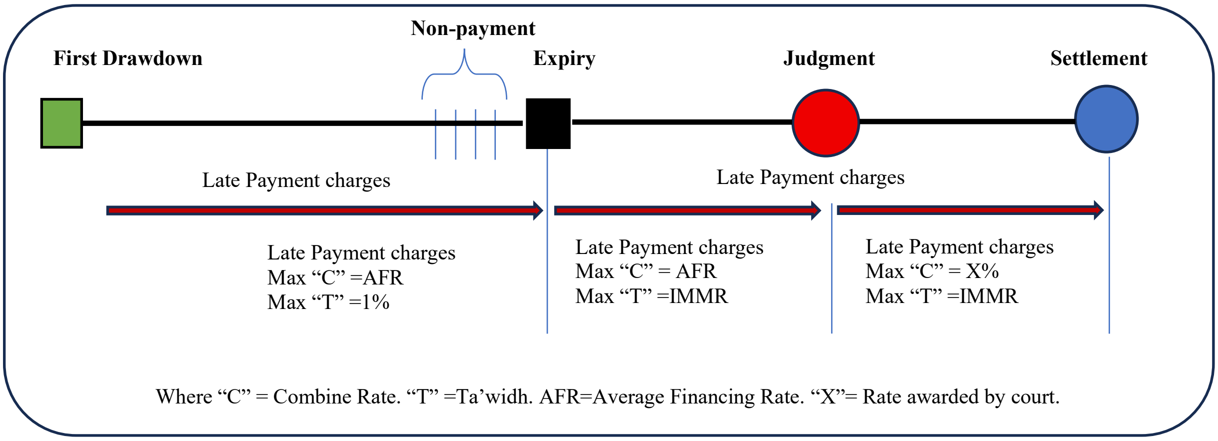
For legal action cases, the penalty on late payment charges can only be charged up until the date judgment is obtained as per the diagrams below. After the judgment has been obtained, a penalty at the rate prescribed by the court would apply to the judgment sum. Diagram 1 and 2 shows the calculation of late payment for judgment cases before and after maturity of financing. The penalty interest charged by conventional banks is in the range of between 2% to 5% of the outstanding balance and the penalty interest is compounded and added to the balance of the loan (Ezani Yaakub et al., 2014). However, with effect from 1 January 2012, conventional banks are only allowed to charge a penalty of not more than 1% of the amount in arrears (on a daily rest basis) which excludes credit card and hire purchase loans and they are not allowed to add the penalty charges to the outstanding amount in arrears for the calculation of interest due (Bank Negara Malaysia, 2012).

Diagram 1: Imposition of late payment penalty before maturity



Source: BNM guideline on late payment charges for Islamic Financial Institutions (2013)

Diagram 2: Imposition of late payment penalty after maturity



Source: BNM guideline on late payment charges for Islamic Financial Institutions (2013)

3. Methodology

This research adopts a qualitative approach to achieve its objective, and secondary data will be the main source for this research. It includes BNM policy papers and guidelines, related court cases of both Islamic and conventional home financing as well as the resolution of the SAC of BNM which were obtained from Bank Negara Malaysia's website, and other reliable internet sources.

Among the policy papers and guidelines of BNM referred to are guidelines on the imposition of fees on financial products (2012), guidelines on Ibra'/Rebate for Sale-Based Financing (2013), guidelines on Late Payment Charges for Islamic Financial Institutions (2013), guidelines on Classification and Impairment Provisions for Loans/Financing (2015), and Credit Risk Policy (2023). Reference is also made to the Bank Negara Shariah Advisory Council Resolution which was also issued by Bank Negara Malaysia. There are ten (10) court cases related to default cases of Islamic home financing and ten (10) conventional housing loans selected which will be discussed in the next section.

Findings: Comparative Analysis of Default Cases among Islamic and Conventional Home Financing

This section highlights findings from document analysis of court cases of default, both by Islamic and Conventional customers as reported by the Malaysian Law Journal. Table 1 lists default cases of financing granted by Islamic banks since 1994 and Table 2 reports lists of cases of loans by conventional banks in Malaysia from as early as 1990. It is observed that from 1994 up until 2010, most of the Islamic financing cases were based on the Bay Bithaman Ajil contract as it was the preferred concept used then. Cases involving Tawarruq came after 2012. This is parallel to the Malaysian Islamic banking industry practices for each substantive period. Even though these two contracts are different, yet the basis of these contracts are sale contract, and the method used to determine the claimed amount was similar that is the balance of the selling price. Among the earliest reported cases were Bank Islam Malaysia Berhad v Adnan bin Omar (1994) and Affin Bank Berhad v Zulkifli Bin Abdullah (2003). A similar method of default cost calculation was adopted for the rest of the cases which are based on Ijarah, Istisna', and Bay' Inah contracts. These practices continued until the recent case of MBSB Bank Bhd V Hiew Yee Sin & Anor (2025) where the contract of financing is Tawarruq.

As observed in Table 2, all the conventional housing loans were offered based on loan contracts. Among the cases reviewed are Citibank Na V Ibrahim Bin Othman (1990), Perwira Affin Bank Berhad V Tan Tien Ser (1994), Phileoallied Bank Berhad V Bhupinder Singh & Anor (1995), and RHB Bank Bhd V Zalifah Bte Juan & Anor (2006). Based on the reported cases, the amount claimed by the conventional banks consists of the principal balance outstanding and interest accrued at the point of termination. There is no selling price imposed in conventional housing loans compared to the Islamic home financing as they adopted loan contracts, and the banks only claimed the interest due to them at the point of default.

Based on a comparative analysis of the default cases under study, it is found that the Islamic banks claimed a higher cost of default compared to their conventional counterparts. This is due to the types of contracts as well as the rate imposed on the respective contracts (ceiling rate used by the Islamic banks and effective rate used by the conventional banks). It can be concluded that the method used by both banks to determine the cost of default is different and unfortunately, the financial effect is worse on the Islamic banks' customers where the banks charged the maximum rate (ceiling) to determine the default cost instead of using an effective rate. It is worrying that this practice remains the same until recent years even though the contract of home financing has evolved. Reported court cases such as Bank Islam Malaysia Berhad v Adnan Omar [1994] 3 CLJ 735; [1994] 3 AMR 44; [1994] 4 BLJ 372, Affin Bank Berhad v Zulkifli Abdullah [2006] 3 MLJ 67, Bank Islam Malaysia Bhd v Azhar Osman & Other Cases [2010] 5 CLJ 54 [2010] 1 LNS 251. and MBSB Bank Bhd V Hiew Yee Sin & Anor (2025) have indicated that the amount claimed by Islamic banks is significantly higher than that of conventional banks.

Last but not least, in the case of Bank Muamalat Malaysia Berhad and Others v Redha Resources Sdn Bhd and Others, Bank Muamalat Malaysia Berhad (Bank Muamalat), Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat) and Pembangunan Malaysia Berhad (Bank Pembangunan) granted a syndicated financing of RM125.8 million to Redha Resources Sdn Berhad (Redha) in August 2007 to undertake a concession known as *''Cadangan Membina, Mengendali Dan Memindahmilik Secara Perkongsian Sektor Awam Dan Swasta Untuk Pembangunan Kediaman Pelajar Dan Pusat Pelajar Kolej Universiti Islam Selangor bertarikh 07.03.2006'.* The concession involves the carrying out of, amongst others, the design, building, and completion of student accommodation and student centre of Kolej Universiti Islam Selangor (the Project) by Redha. The facilities granted were an Istisna' facility of RM87.4 million by Bank Muamalat and Bank Rakyat and a Bai Al-Inah facility of RM38.4 million by Bank Pembangunan. The selling prices of the two facilities were RM214.1 million and RM148.69 million respectively. Redha defaulted in the payment of the facilities and Bank Muamalat as the facility agent terminated the facility in January 2014, claiming a sum of RM326,669,571.59, which is the balance of the selling price of the two facilities.

Table 1: List of Islamic bank's legal action cases extracted from Malaysia's Law Journal

No.	Case Name	Year	Contract	Purchase price	Selling price	Default After	Amount Claimed
1.	Bank Islam Malaysia Berhad v Adnan bin Omar	1994	BBA	265,000	583,000	8 years	583,000
2.	Affin Bank Berhad v Zulkifli Bin Abdullah	2003	BBA	394,172	992,363	1.5 years	958,998
3.	Bank Muamalat Malysia Berhad V Kong Sun Enterprise Sdn Bhd.	2006	Ijarah	22,000,000	38,540,747		36,200,000
4.	Malayan Banking Bhd v Marilyn Ho Siok Lin	2006	BBA	500,000	995,205.64.	3 years	928,589.12
5.	Malayan Banking Berhad v Yakop Oje	2007	BBA	80,094	184,094	3 years	167,797
6.	Bank Muamalat Malaysia Berhad and others v Redha Resources Sdn Bhd and others	2015	Istisna'	87,400,000	214,100,000	7 years	326,667,000
			Inah	38,400,000	148,690,		
7.	AmBank Islamic Berhad v Seacera Group Berhad	2020	Tawarruq	1,260,000	1,269,360	3 years	1,877,526
			Tawarruq	5,000,000	6,800,000		6,141,410
			Tawarruq	4,820,300	4,889,252		4,889,842
8.	Bank Islam Malaysia Bhd v Azhar bin Osman	2009	BBA	177,960	451,895.04	NA	391,634.66
9.	Bank Islam Malaysia Berhad V Lim Kok Hoe and Koh Hsia Ping	2009	BBA	145,800.00	450,954.00.	7 years	370,425.05
10	Bank Islam Malaysia Berhad v Lim Soo Kok	2020	Tawarruq	6,039,030.42	NA	6 years	11,190,144.25
11	MBSB Bank Bhd V Hiew Yee Sin & Anor	2025	Tawarruq	816,941.70.	3,214,848.00	4 Years	2,967,659.23

Source: Authors' Findings

Table 2: List of conventional legal action cases taken from Malaysia Law Journal

No.	Conventional Housing Loan Default Cases	Year	Contract	Loan Amount	Default after	Amount Claimed
1.	Citibank Na v Ibrahim Bin Othman	1990	Loan	224,000	2 years	239,659
2.	Perwira Affin Bank Berhad v Tan Tien Ser	1994	Loan	205,000	NA	250,754
3.	Phileoallied Bank Berhad v Bhupinder Singh & Anor	1995	Loan	359,000	2 years	376,190
4.	RHB Bank Bhd v Zalifah Bte Juan & Anor	2006	Loan	90,000	3 years	90,477
5.	Alliance Bank Malaysia Berhad v Lim Vincent [2010] MLJU 1385	2010	Loan	357,700.00	7 years	444,298.72
6.	CIMB Bank Berhad V. Sivadevi Sivalingam	2019	Loan	185,320.00.	15 years	549,245.60
7.	Malayan Banking Berhad (3813-K) v Rosiah Binti Ahmad	2021	Loan	1,000,000.00	8 Years	383,290.08
8.	CIMB Bank Bhd V Yap Wee Leong	2021	Loan	2,040,000.00	1 year	2,023,571.41
9.	Bank Pertanian Malaysia Berhad V Abdul Razak Bin Ali	2020	Loan	600,000 00	13 years	795,189-89
10.	Standard Chartered Bank Malaysia Bhd V Joyce Hayati Tan	2024	Loan	2,205,000.00	6 years	2,131,558.15

Source: Authors' Findings

Findings: Simulation on Differences of Default Cost Calculation Method between Islamic and Conventional Home Financing

This research conducts a simulation analysis to dig into the calculation parts of the Islamic and conventional financing taking Affin Bank v Zulkifli bin Abdullah court case as an example. Table 3 below presents a table of simulations on the total amount of claims by an Islamic Bank. In Affin Bank Berhad v Zulkifli bin Abdullah, Zulkifli was granted a staff house financing of RM346,000 under the Islamic concept of Bai Bithaman Ajil for 18 years payable via 216 monthly instalments of RM2,161.33 with a selling price of RM466,847.25. When he resigned, the balance of RM394,172.06 was restructured with a new selling price of RM992,363.40 payable over 25 years via 60 monthly payments of RM2,500.00 and 240 monthly payments of RM3,509.84. When he defaulted in 2003 after making payments amounting to RM33,454.19 of the restructured facility, Affin sued him for RM958,997.21.

Table 3: Simulation on the amount of claimed by Affin Islamic Bank

No	Date	Details	Credit (RM)	Debit (RM)	Balance of Selling Price (RM)
0	01/12/1999	Disbursement		394,172.06	394,172.06
	01/12/1999	Profit @ 9.0%		598,191.94	992,364.00
1	31/01/2000	Payment	2,500.00		989,864.00
2	29/02/2000	Payment	2,500.00		987,364.00
3	31/03/2000	Payment	2,500.00		984,864.00
4	30/04/2000	Payment	2,500.00		982,364.00
5	31/05/2000	Payment	2,500.00		979,864.00
6	30/06/2000	Payment	2,500.00		977,364.00
7	31/07/2000	Payment	2,500.00		974,864.00
8	31/08/2000	Payment	2,500.00		972,364.00
9	30/09/2000	Payment	2,500.00		969,864.00
10	31/10/2000	Payment	2,500.00		967,364.00
11	30/11/2000	Payment	2,500.00		964,864.00
12	31/12/2000	Payment	2,500.00		962,364.00
13	31/01/2001	Payment	2,500.00		959,864.00
14	28/02/2001	Payment	954.19		958,909.81
			33,454.19		

Table 4 presents the simulation of the same case, and the total claimed amount by conventional bank in case of default. As we can see in the tables, in the case of Affin Bank Berhad v Zulkifli Bin Abdullah, if the facility were given under the conventional loan, the amount claimed would be approximately RM405,709.19 which is much less than the amount claimed by Affin Bank Berhad of RM958,997.94.

Table 4: Simulation On the Amount Claimed By Conventional Banks

No	**Date**		**Int @ 9.00%**	**Debit**	**Credit**	**Balance**
1	01/12/1999	Disbursement	394,172.06			394,172.06
2	01/12/1999	31/12/1999		2,956.29		397,128.35
3	01/01/2000	31/01/2000		2,978.46	2500	397,606.81
4	01/02/2000	29/02/2000		2,982.05	2500	398,088.86
5	01/03/2000	31/03/2000		2,985.67	2500	398,574.53
6	01/04/2000	30/04/2000		2,989.31	2500	399,063.84
7	01/05/2000	31/05/2000		2,992.98	2500	399,556.82

8	01/06/2000	30/06/2000		2,996.68	2500	400,053.49
9	01/07/2000	31/07/2000		3,000.40	2500	400,553.90
10	01/08/2000	31/08/2000		3,004.15	2500	401,058.05
11	01/09/2000	30/09/2000		3,007.94	2500	401,565.99
12	01/10/2000	31/10/2000		3,011.74	2500	402,077.73
13	01/11/2000	30/11/2000		3,015.58	2500	402,593.31
14	01/12/2000	31/12/2000		3,019.45	2500	403,112.76
15	01/01/2001	31/01/2001		3,023.35	2500	403,636.11
16	01/02/2001	28/02/2001		3,027.27	954.19	405,709.19
				44,991.32	33,454.19	

Source: Authors' Findings

From the comparative analyses done above, we can see that Islamic banks calculated the profit for the duration of the financing upfront to become the selling price of the facility and derived the cost of default by deducting the total amount paid by the customers, (Financing amount (RM394,172.06) + Profit for the duration of the facility (RM598,191.94) – total payment made by customers (RM33,454.19). Conventional banking takes the principal amount (RM394,172.06) and calculates the total interest monthly (RM44,991.32) into the customer's account less whatever payments that have been made by the customer (RM33,454.19).

Findings: Comparative Analysis of Default Cost Calculation for Tawarruq-based Home Financing and Conventional Housing Loan

The Malaysian Islamic Banking industry currently relies heavily on Tawarruq contract to structure almost all Islamic banking products. Tawarruq is a sale-based contract which involves four parties at the same time (bank, customer, commodity trader 1, commodity 2). It was introduced in the market to mitigate the issue of Bay Inah which happened in the BBA contract. As of today, Tawarruq is considered the best by Islamic banking practitioners given that there is no other alternative in place. A study conducted by Ibrahim and Sapian (2020) found that around 63 per cent of Islamic banks adopted Tawarruq for their home financing facility in 2020. Regulators, Islamic scholars, and practitioners are currently struggling to explore new contracts or the existing Islamic contract that may become the alternative to the Tawarruq that may bring benefits and fairness to all parties. The culture of Tawarruq-centred has attracted at least four possible risks which are reputation, credit, legal, and compliance risks (Kahf and Habbani, 2016). While all parties are trying to figure out the best alternative to the Tawarruq, the other side of the Islamic banking practices which is the treatment of default cost calculation is found to be neglected and deemed not comply to the Shariah which promotes fairness to all parties. One of the legal maxims has stated that 'The Fundamental Requirement in All Contract is Justice'. It is therefore the responsibility of the Islamic banking practitioners to ensure that the method to calculate the cost of default brings fairness to the customers who are in difficult situations.

In sales-based financing, a floating or variable rate of financing is adopted where the selling price is determined by the Ceiling Profit Rate and monthly instalment is calculated based on the effective profit rate (variable rate). In case of default, the treatment is similar to the other sale-based products as laid out in Bank Negara Credit policy guidelines which state that the Islamic banks may choose to rehabilitate the facility by either rescheduling the payments for the remaining balance or restructuring the outstanding balance to a new facility or initiate recovery action against the customer and any security pledged. The Islamic banks may also impose a Penalty (Ta'widh) and compensation (Gharamah) on the default account.

Table 5 illustrates the difference between the amount claimed by Islamic banks under the variable rate feature of Tawarruq-based home financing and conventional housing loan, if a customer was granted a house financing facility of RM644,704.00 and at an interest/profit rate at that point (variable rate) is 3.95% for 35 years. The monthly instalment would be RM2,835.28 regardless of whether the financing is conventional or Islamic. However, Islamic banks would have a selling price calculated at a rate higher than the prevailing rate and in this instance, the contracted ceiling profit rate is 10.25% per annum. The selling price for Islamic financing would be RM2,379,728.40. If the customer defaults the monthly instalment on the 117 months and the banks were to terminate the facility and initiate recovery action on the 120th month, the comparison of the cost of default between the Islamic and conventional banks would be as shown in Table 5 below: -

Table 5: Comparison of the cost of Default Cost Calculation between Islamic and Conventional Financing

		Islamic	Conventional
Loan/Financing Amount	:	RM644,704.00	RM644,704.00
Interest/Profit Rate (variable rate)	:	3.95%	3.95%
Cap/ contracted Rate		10.25%	NA
Duration	:	35 years	35 years
Selling Price	:	(Instalment at cap rate x no of months) (5,666.02 X 420) RM2,379,728.40	NA
Monthly instalment = P (r(1+r)^n)/((1+r)^n-1)	:	(644,704.00 x 0.0043978) 2,835.28	(644,704.00 x 0.0043978) 2,835.28
No Instalment paid Total instalment paid. 1st default	: : :	116 RM328,892.48 117th Instalment	116 RM328,892.48 117th Instalment
Facility terminated/ legal action initiated.	:	120th month	120th month
Amount claim.	:	(Balance of selling price). RM2,050,835.92	(Outstanding Principal + Accrued Interest) RM551,616.75

Source: Authors' Findings

The amount claimed by Islamic banks is more than triple than that of conventional banks and this will be the amount reflected in the Credit Tip-Off Service (CTOS) report.

The maximum amount that an Islamic bank may collect from its customers is the balance of the selling price. However, in the event of early settlement before the expiry of the facility, Islamic banks will grant a rebate *(ibra')* equivalent to the future profit, making the settlement amount at par with that of conventional banks. Rebate (*ibra*' will also be given if the customers were to settle the financing after legal action has been initiated (Alfatakh, 2020).

Ibra' is defined as a waiver that Islamic banks may give to their customers upon early settlement of their facility. It was given at the sole discretion of the Islamic banks as there was no provision in the contract for Islamic banks to give *Ibra'* to their customers (Bank Negara Malaysia, 2013). The practice of giving *Ibra'* among Islamic banks differs as there were banks that include the *Ibra'* clause in their letter of offer and legal documents while others don't. Some Islamic banks did not include the *Ibra'* clause in their financial agreement for fear that it would raise the issue of *gharar* (uncertainty) in the selling price. However, the absence of the provision also raises disputes between the Islamic banks and customers as evidenced by the case of Bank Islam Malaysia Berhad v Adnan bin Omar [1994] 3 CLJ 735 / [1994] 221 MLJU (Bank Negara Malaysia, 2010). To harmonize the practice of Islamic banks and provide greater transparency and clarity, BNM's SAC had at their 13th meeting on 10/4/2000, resolved that Islamic financial institutions may incorporate a clause undertaking to provide *Ibra*' to customers who make early settlements in their legal documents. Islamic financial institutions are expected to honour the said undertaking. However, the guidelines only illustrate that ibra' or rebate will be given upon settlement of the facility (Bank Negara Malaysia, 2013).

4. Discussions

The method of deriving the cost of default for Islamic banking has remained unchanged since Islamic banking was introduced in Malaysia over 40 years ago despite the development in other areas of Islamic banking. Imposing penalties on late payment charges and judgment sums was considered non-shariah compliance before Bank Negara Malaysia's Shariah Advisory Council allowed Islamic banks to impose penalties on late payment charges in 1998. Variable rate BBA was introduced in 2003 to mitigate interest rate movement risk faced by Islamic banks from fixed-rate BBA. These changes were made so that Islamic banks could compete with conventional banks.

The mechanisms introduced by Bank Negara Malaysia, such as the introduction of the variable rate and the imposition of penalty and Gharamah on late payment charges and judgment sum seem to be in favour of the Islamic banks as they resulted in the amount to be claimed in the event of default to be higher than before their introduction. Although the requirement to include the banks' undertaking to give *Ibra'* or a rebate in the legal documents was aimed at protecting the customers, it does not seem to have any impact on the method of deriving the amount to be claimed in the event of default. Apart from *ibra'* or rebate on the full settlement before the expiry date of the facility, there are no specific directions on when the *ibra'* on the difference between the contracted rate and effective rate is to be reflected in the customer's account. Instead, the guidelines mentioned that *ibra'* or rebate is still at the discretion of the Islamic banks.

The practice of claiming the balance of the selling price has been criticized by customers and the Malaysian Islamic Consumer Association (PPIM) which claimed that the Islamic banks are oppressive in treating their customers who defaulted on their payments and not in line with Islamic teaching (Persatuan Pengguna Islam Malaysia, 2020). PPIM highlighted two cases of an Islamic bank that claimed a sum of RM175,000.00 for financing which only RM36,000.00 has been disbursed and another case where RM36,000.00 was disbursed but a claim of RM240,000.00 was made on customers. In contrast, Conventional banks only claim the outstanding amount disbursed plus accrued interest, if any. This is evidenced by the amount claimed by a conventional bank for RM64,000.00 for the amount disbursed of RM46,000.00 for the same project which was abandoned and uncompleted (PPIM, 2014).

According to Md Dahlan et al., (2017), in a study conducted in 2015, purchasers Ahmad Bin Mat Husin and Ana Marliana Binti Sarian (purchasers), bought an apartment for RM98,000.00 from the developer, Simpulan Chemerlang Sdn Bhd. The purchaser was granted financing of RM88,000.00 by BIMB. The housing development project was abandoned after the completion of stage two (the commencement of the work below ground level including piling, pile caps, and footing) and BIMB disbursed a sum of RM26,700.00 for the said stage. The monthly payment has been started since the first disbursement. Realising the project had been abandoned, the purchasers stopped making payments to BIMB resulting in BIMB initiating legal action against the purchasers for the balance of the selling price of RM239,945.72.

The amount claimed by Islamic banking in the event of default is significantly higher than that of conventional banks. The higher cost of default is due to the different methods of deriving the amount to be claimed in the event of default by the two banking systems. While conventional banks simply take the balance of outstanding principal and accrued interest, Islamic banks add one more element to the formula, the future profit for the remaining unexpired period of the financing. Thus, the longer the unexpired period, the bigger the gap in the cost of default between Islamic banks and conventional banks.

Ironically, the practice of claiming the balance of the selling price by Islamic banks is in line with the Bank Negara Malaysia policy document, Guidelines on *Ibra'* (rebate) for sale-based financing issued on 1st November 2011 and updated on 31 January 2013 which says:

> *"In a sale-based financing contract, a customer is required to settle the* ***selling price (comprising the principal sum and profit margin)****, regardless as to whether the contract is on a deferred or spot basis. For deferred payment financing, principally an Islamic Banking Institution has the right to claim from the customer the outstanding selling price that will also include the deferred profit portion even in early settlement*" (BNM, 2013, p.1).

Although the method of calculating the cost of default as practised by Islamic banks does not contravene any resolution of Bank Negara SAC, it is prudent for all stakeholders such as Islamic bankers, Bank Negara Malaysia, and the Shariah committee to look into this issue to come out with an alternative method of calculating default cost to uphold the spirit of Maqasid Shariah (protection of property) and at the same time remain competitive in the banking industry.

Bank Negara Malaysia is highly encouraged to revisit its guidelines on the method of calculating the amount to be claimed in the event of default to at least include the rebate on the difference between the contracted rate to be given and reflected in the customer's account monthly when customers pay their instalment and that ibra' on the difference would be given and reflected in the customer's account when the facility is terminated. This will reduce the cost of default significantly as the longer the customer has been paying the higher the rebate given and the lower the default cost. Bank Negara should also require Islamic banks to state the method of calculating the amount to be claimed in the event of default in their security documents, so that the customers are aware of the consequences should they default on their monthly commitment. As it is, the practice of calculating the cost of default has remained unchanged even after Bank Negara Malaysia issued the guidelines for Ibra/rebate on sale-based products in 2013.

Limitations of this study.

This research deals only with the calculation of default for sale-based home financing products in Malaysia. Further research should be conducted on products and the calculation of the cost of default on products using other contracts, such as profit and loss sharing and leasing contracts. A study may also be conducted to compare the method of calculating the cost of default between Malaysia and other countries.

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