



AL-SHAJARAH

JOURNAL OF ISLAMIC THOUGHT AND CIVILIZATION
OF
THE INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA (IIUM)

SPECIAL ISSUE:
ISLAMIC BANKING AND FINANCE

2017

AL-SHAJARA

Special Issue

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WoS-Indexed under *Arts & Humanities Citation Index, Current Contents/Arts
and Humanities* and **Scopus**

ISSN 1394-6870



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CLASSIFICATION OF DEFAULTERS IN THE PAYMENT OF DEBT IN ISLAMIC BANKING PRACTICES

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Abstract

This paper discusses the issue of treatment of debt defaulters from Shari'ah perspective and its current practices in Islamic banking and finance. In doing so, the paper first explains the concept of debt and its payment obligation from Islamic point of view. The paper also critically reviews the current practice of treating defaulters by Islamic banks. A thorough analysis on various opinions and views of the classical and contemporary jurists in determining the types of defaulters is also provided. The paper concludes that besides the categorization of defaulters to solvent and insolvent in the modern Islamic banking practice, a new category namely, muta'atthir (a solvent debtor who is facing temporary shortage of liquidity) should also be considered. These debtors are not insolvent based on the ratio of their total assets to debts. However, they are in situation of default due to temporary shortage of liquidity that they are facing. Hence, this new category might have its own ruling from Shari'ah point of view in terms of debt settlement and restructuring where it does not carry the ruling of insolvent debtor.

Keywords: insolvent debtor, defaulter, solvent, Islamic banking, i'sār, iflās, ta'atthur.

1. Introduction

Credit risk is the risk of default arising from borrowers' failure to make required payment which could adversely affect the sustainability and viability of banking institutions. With the recent surge of demand on Islamic financial products, which operates within the ambit of *Sharī'ah* (although some scholars tend to argue that Islamic financial products are less risky due to the basic prohibitions in *mu'āmalāt* such as *ribā*, *gharār* and *maysir*), Islamic banks are not exceptional from being exposed to this type of risk. Despite, in certain cases where Islamic banks tend to adopt the conventional approach in securing payment from customers, a robust and idiosyncratic debt recovery system and its mechanisms, therefore, need to be established at Islamic bank level in the efforts of mitigating defaults in payment.

In the event of customers defaulted or are about to default, Islamic banks shall have two options. First is to call for default and take necessary actions to recover the due amount. The defaulted customer consequently will be declared bankrupt and hence a winding up process will take place immediately. Second, Islamic banks may opt for rescheduling or restructuring the credit facility instead to avoid calling for default which would affect, not only the customer's creditworthiness, but also the financial position of the bank. Whilst the former is also resorted to, the latter becomes the most preferable to Islamic banks.

The primary objective of this paper is to thoroughly discuss the issues revolving around default in payment of debt from *Sharī'ah* perspective and its application by Islamic banks. In doing so, a brief analysis on the characteristics of solvent and insolvent debtors from *Sharī'ah* point of view is provided. The present study argues that apart from the classical categories of defaulters such as *mūsir* (solvent) and *mu'sir* (insolvent), the modern practice of debt recovery by Islamic banks also needs to consider defaulters who fall under the category termed as *muta'assir* (financially constrained debtor). Meanwhile, in relation to insolvent debtors, this paper deliberately explains the concept of *i'sār*, *iflās* and *ta'athur* and their impacts on debt restructuring as practiced by Islamic banks.

2. Concept of Debt from *Sharī'ah* Perspective

2.1 Definition of Debt

In literal, the term 'debt' (*al-dayn*) denotes several meanings¹, among others are:

1. Loan (*dāna* or *adāna*), when someone borrows sum of money from other person.
2. Sale with deferred payment (*adāna*), when someone purchases something on credit basis.
3. Something which has a delayed maturity.
4. Something which is not present.
5. Death as it is a "debt (something that everyone must face)" on everybody.
6. Rewards or *dintuhu bi fi'lihi daynan* (e.g. I reward him for his work).

From a juristic point of view, there are two approaches in defining *dayn*. In general, *dayn* is defined to encompass any liability that must be performed by a person notwithstanding whether the subject matter relates to payment of debt or other liabilities including one's obligations to Allah, for instance, making up a missed prayer. In similar vein, Al-Babartī refers *dayn* as "a *Sharī'ah* description of a liability established upon a person that must be performed upon demand".² Similarly, Al-'Asqalānī remarks that "the word *dayn* covers everything that is established as a liability upon a person, including *hajj*, *kafārah*, *nazar*, *zakāt* etc."³ These definitions of *dayn* are meant to cover all types of debt, whether it is in monetary or non-monetary form and regardless it relates to God or human.

On the other hand, there are definitions of *dayn* offered by jurists to only cover debts related to property. Ibn Humām, for

¹ Al-Fayyūmī, Ahmad ibn Muhammad ibn 'Alī, *Al-Misbāh Al-Munīr*. (Beyrūt: Maktabah Lubnan, 1987), 144; Fairūzābādī, Majd al-dīn Muhammad ibn Yaakūb, *Qāmūs al-Muhīt*. (Beyrūt: Mu'assasāt al-Risālah, 2005), 254.

² Al-Babartī, Muhammad ibn Mahmūd, *Sharh Al-Ināyah 'Ala Al-Hidāyah*. (Beyrūt: Dar Al-Fikr, n.d) vol.6, 81.

³ Al-'Asqalānī, Ibn Hajar, *Fathu al-Bārī Sharh Sahīh al-Bukhārī*, (Beyrūt: Dar al-Rayyān lī al-Turāth, 1986) *Hadīth* no.2166, vol.6, 332.

instance, defines *dayn* as “a term used to denote any liability established upon a person to compensate for any property of others that he has destroyed, or loan that he has borrowed, or payment of sale price arising from a sale contract or rental payment arising from a usufruct that he has derived benefit from (for instance, a payment of dowry in marriage contract or rental in leasing contract)”.⁴ This practical definition of *dayn* seems to be more relevant to our discussion on the issues pertaining to the payment of debts arose from Islamic financial contracts such as sale price in contracts of *murābahah* or *bay‘ bithāman ājil*, rental price in *ijārah* contract, or earned but unpaid profit in *mushārahah*, *muḍārabah* or *wakālah* contracts.

2.2 Obligation to Pay Debt

There are many verses in the Holy Qur’ān, which command us to fulfil our obligations, promises as well as pledges and those who fail to do so are rebuked. Allah’s command to “*fulfil (all) obligations*” is general and applies to all obligations and covenants, regardless of whether those obligations are to Muslims or non-Muslims. The command to fulfil obligation also covers payment of debt as long as the obligation itself is not contrary to the provisions of Islamic Law. The Prophet (p.b.u.h) said:

*“There are four qualities that if a person possesses them all, he is a real hypocrite, and if he possesses some of them, then he has a share of hypocritical qualities until he abandons them. If he is entrusted, he deceives. If he speaks, he lies. If he makes a commitment, he breaks it, and if he argues, he goes out of bounds”*⁵

This *hadīth* gives a stern warning against breaking of promises. Like the abovementioned Qur’ānic verse, this *hadīth* has a general coverage on a person’s obligation to fulfil his promise. It applies to all kind of promises and pledges, regardless of whether the

⁴ Al-Humām, Muhammad Kamāl al-Dīn ibn Abd Al-Wāhid, *Sharh Fath al-Qadīr ‘ala al-Hidāyah*. (Beyrūt: Dar al-Fikr, 2003) vol. 6, 332.

⁵ Al-Bukhārī, Abdullah Muhammad ibn Ismāil, *Sahīh al-Bukhārī*, (Beyrūt: Dar al-Fikr, 1993), *Hadīth* no.59.

person to whom a promise is made is a Muslim or a non-Muslim.

One important personal obligation that deserves a serious attention is the obligation to pay debt. Those who fail to pay back their debts are given the sternest of warnings as the Prophet (p.b.u.h) said: “*The martyr is forgiven all of his sins...except for his debts*”.⁶ The Prophet (p.b.u.h) also said: “*The soul of a believer is held tied to its debt until it is paid on his behalf*”.⁷

Yūsuf al-Qarādwī has stressed that among the most crucial matters for Muslims to accomplish is to pay the debt promptly on its due date. If a person purposely delays paying his debts despite being able to do so, he is deemed to be unjust and deserves the punishment of an oppressor, both in worldly life as well as in the Hereafter.⁸

3. Classification of Debt Defaulters from *Shari'ah* Perspective

The treatment for defaulter of debt by Islamic banks are somehow different from its conventional counterparts as Islamic banks are bound to adhere with the principles and regulations that *Shari'ah* has prescribed for dealing with defaulters. In practice, Islamic banks transact with their customers by entering into exchange contracts such as *murābahah* contract (deferred sale), *istisnā'* (manufacturing contract) and many more in which the banks become creditors to their customers. Similarly, this also holds true when Islamic banks enter into *ijārah* contract with their customers where the customers are obliged to pay rental amount. This rental amount is deemed as debt to the customers which has to be settled on maturity date. This is due to the primary activity of an Islamic bank of generating profits through exchange contracts, in which the amount must be paid at agreed time and in periodic installments, either in the form of selling price or rental.⁹ The late or default in payment of installments by

⁶ Al-Nisābūrī, Muslim ibn Hajjāj, *Sahīh Muslim*. (Beyrūt: Dar Tayyibah, 2006), *Hadīth* no.1886.

⁷ Al-Tirmīzī, Muhammad ibn Isā, *Sunan al-Tirmīzī*, (Beyrūt: Dar al-Gharb al-Islāmī, 1996), *Hadīth* no.1078.

⁸ Al-Qarādwī, Yūsuf, *Daūr al-Qiyām wa al-Akhlaq fī al-Iqtisād al-Islāmī*. (Kaherah: Maktabah Wahbah, 2006), 120.

⁹ Al-Qurah Daghi, 'Alī Muhyiddīn, *The Problem of Delayed Debts and Their*

customers may cause Islamic banks to suffer reduction in profit margin or even loss.

In general, the classical jurists have classified debt defaulters into two categories as follows:

3.1 Solvent Defaulter (*al-mūsir, al-wājid*)

Solvent defaulters are those who choose to default on the debt with intention, despite being able to service it (make payments). From *Shari'ah* point of view, refusal to pay debt is a great sin and unjust act that deserves a punishment provided that the debt is unsettled.¹⁰ It is reported by Abū Hurayrah (May Allah be pleased with him) that:

“Procrastination in (settling) the debt by the rich is injustice. So if your debt is transferred from a rich debtor you should agree (to the transfer) (Al-‘Asqalānī, 1986). And his saying, “Procrastination by the solvent debtor deserves him punishment and his dignity been compromised”¹¹

From this *hadīth*, it is obvious that refusal to pay debt despite having the ability to pay it will subject the defaulter to penalties. Jurists have discussed in detail about possible penalties that can be imposed on the solvent defaulter, among others are:

1) Imprisonment.

In explaining the abovementioned *hadīth*, al-Khitābī remarks that “the *hadīth* suggests that the punishment by way of imprisonment shall not be applicable for a *mu’sir* (an insolvent debtor) because imprisonment shall only apply to a *wājid* (financially capable defaulter)”. Thus, there is no imprisonment for a *mu’sir* who is not a

Guarantees in Islamic Banks: A Shariah Study on Compensation for Deferred Loans, Chapter in Contemporary Issues in Islamic Finance. Deliberation at the International Shariah Scholars Dialogue (Kuala Lumpur: Bank Negara Malaysia, 2006), 161.

¹⁰ Al-‘Asqalānī, op.cit. vol.2, 542.

¹¹ Al-Sajistānī, Abū Dawūd Sulayman ibn al- Ash’ath al-Azdī., *Sunan Abī Dawūd*, (‘Ammān: Baitul Afkār Dawliyyah. n.d), *ḥadīth* no.3144.

wājīd.¹²

It is a consensus among the Islamic scholars that the solvent defaulters can be imprisoned for his refusal to pay debt. This is derived from the opinion of Imām Mālik and Imām Shāfi‘ī¹³, and the same goes to al-Qādhī Shurayh and the Hanafī School of Law who are of the view that the solvent defaulter should be arrested and detained until the debt is paid.¹⁴ According to al-Khitābī, the reason for arresting debt defaulters is to further investigate the actual financial position of the defaulter. If the debtor refuses to pay debt without valid reason, then he or she should be penalized.¹⁵

However, the scholars seem to have a disagreement as to whether the act of solvent defaulter in delaying his payment of the debt would make him a “*fāsiq*” (a wicked person and his testimony shall be rejected). The Mālikis and the Shāfi‘īs hold to the opinion that if the value of the debt is ten (10) dirhams and above, he is considered a *fāsiq* whereas other jurists hold to the contrary.¹⁶

2) Using Harsh Word.

Some scholars including Ibn Qudāmah have pointed out that if a solvent debtor refuses to pay his debt, the creditor may compel him to pay the debt. He is even allowed to speak up against the debtor to the extent that he may use hard words against the debtor.¹⁷ This is based on the previously mentioned *hadīth* which permits the creditor to disgrace the debtor’s honour by saying to him harsh words. Ibn Qudāmah in further clarifying the meaning of “*habsuhu wa ‘irduhu*” in the *hadīth* of “*Procrastination by the solvent debtor deserves his punishment and his dignity been compromised*”, opined that the dignity of a solvent debtor can be compromised by using hard words

¹² Alūsh, ‘Abdul Salām ibn Muhammad, *Ibānatul Ahkām Sharh Bulughul Marām*. (Beyrūt: Dar Al-Fikr, 2012), 120.

¹³ Mālik, Anas ibn Mālik al-Asbāhī, *Al-Mudawanah al-Kubrā* (Beyrūt: Dar al-Kutūb al-‘Ilmiyyah, 1994), vol.5, 205.

¹⁴ Alūsh, op.cit, 120.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibnu Qudāmah, Abī Muḥammad ‘Abdullah ibn ‘Aḥmad ibn Muḥammad, *Al-Mughni* (Beyrut: Dar al-Fikr, 1997), vol.4, 501.

as it is permitted according to a *hadīth* from the Prophet (p.b.u.h) which says: “*It is the right of the creditor to speak up against the defaulter*”.¹⁸

3.2 Insolvent Defaulter (*mu’sir*)

To begin with, having thorough discussion on the issue of insolvency from Shariah point of view is highly important as it provides a clear understanding on the juristic use of the terminologies in order to suit the current Islamic banking practices and arising customers’ needs. Therefore, this paper focuses on both the classical and contemporary jurists’ views with regard to insolvent debtors within the scope of two terminologies, which are highly relevant to the issue of default in debt payment, namely, *i’sār* (financial difficulty) and *iflās* (insolvency).

Literally, the term ‘*i’sār*’ means hardship, difficulty, distress and constraint.¹⁹ This definition extends to hardship in life, lacking of property and poverty faced by poor people as Allah mentioned in Qur’ān:²⁰ “*Allah has already forgiven the Prophet (p.b.u.h) and the Muhājirīn and the Ansār who followed him in the hour of difficulty*”; ‘*assāranī al-rajul* – “*the person asks from me something during the time of difficulty*”.²¹

Technically, there are several definitions which give similar meaning to financial difficulties. For instance, al-Qurtūbī defines ‘*al-’usrah*’ (المصعرة) as “*constrained situation due to having no assets*”.²² Likewise, the modern definition on *i’sār* also offer the same meaning. For instance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI’s) Shariah standards defines it as:²³

¹⁸ Ibid.

¹⁹ Al-Asfahani, Al-Raghib Husein ibn Muhammad Al-Mufadhal, *Al-Mufradat*, (Beyrut: Dar al-Kutub al-’ilmiyyah, 2009), 374.

²⁰ *Al-Qur’ān*, 9:117.

²¹ Al-Asfahānī. op.cit, 374.

²² Al-Qurtūbī, Abū ‘Abdullah Muhammad ibn Ahmad Al-Ansārī. *Al-Jāmi’ li Ahkām al-Qur’an* (Beyrūt: Dar al-Fikr, 2006), vol.3, 239.

²³ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari’ah Standards*. (Manama: AAOIFI, 2010), 1081.

“The present inability to discharge the financial obligations established in one’s liability”.

Originating from the word *i’sār*, a *mu’sir* can be defined as a person who is incapable of paying his debt, even after combining all of his assets. This definition of insolvent debtor can be derived the revelation in the Qura’nic verse on *i’sār* cited earlier.

The term *iflās* (derived from the verb “*falasa*”) is also closely related to the term “*i’sār*”. It refers to the event of when a person’s liabilities exceed his asset, or the person has reached to the extent where he has no more assets on hand.²⁴ More specifically, it is the state when a debtor fails to pay off his debts because he owes more than what he owns. From this point of view, the meaning of *iflās* is similar to *i’sār*.

Although the meaning of *iflās* can be understood from various definitions offered by Islamic jurists, the procedure to declaring someone a bankrupt is different from that of declaring someone a *mu’sir*.

Below are some of these definitions:

Al-Sarakhsī, a Hanafī jurist defines iflās as: “incapability of a person to earn a living (similar to people who are in terminal illness), and his asset will be used to settle his debt to the creditors”²⁵. It seems that the Hanafīs consider that the incapability of earning is the reason for a person to face iflās. On the other hand, the Mālikīs’ definition is more generic, without looking at the reason for iflās. To them, a muflis or bankrupt person (who is facing the situation of iflās) refers to a person who has put aside his asset for the purpose of paying the creditor although the amount is not enough to pay all his debts. So if the creditor brings him to trial, he shall be declared bankrupt as he is unable to pay the outstanding debt. According to the Mālikīs, iflās can be

²⁴ Ibn Manzūr, Muḥammad ibn Mukrīm, *Lisān al-‘Arab*. (Beyrūt: Dar Sadhīr, 2003), 165.

²⁵ Al-Sarakhsī, Abī Bakr Muhammad ibn Ahmad ibn Abī Sahl Syams, *al-Mabsūt*. (Beyrūt: Dar al-Ma’rifah, 1989), vol.20, 89.

categorized into two categories, namely, general bankruptcy (taflīs ‘ām) and specific bankruptcy (taflīs khās). General bankruptcy happens when the creditor declares that he will take action against the debtor. While, specific bankruptcy happens when the judge has ruled that the debtor is in the state of iflās hence his assets will be liquidated to pay off all his debts. It seems that categorizing bankruptcy into general and specific bankruptcy depends on the stages in which the bankruptcy procedure has taken place. General bankruptcy applies before the matter is brought to the court and prior to the court’s decision has been made against the debtor. Once the decision has been made on the debtor, he then falls under the category of specific bankruptcy.

The Shāfi‘is, on the other hand, define *iflās* by looking at the situation of the debtor after the judgement has been made, for instance, when the order has been made by the judge to restrict the debtor from dealing with his asset. For instance, al-Juwaīnī defined it as: “those whose debts are more than their assets; it is for the judge to restrict the debtors from any financial dealing, for the benefit of the creditor if they brought their case to the court.”²⁶

The Hanbalīs tend to define *iflās* by looking at the situation of the debtor, without giving any preference on the stages of *iflās*. One of the Hanbalī jurists, Ibn Qudāmah defines a *muflis* as a person who does not have any asset and unable to spend for his own needs. Another jurist, Ibn Rushd highlights that the term *muflis* commonly refers to two meanings: (i) first, when the debtor’s liabilities exceed his assets, and; (ii) second, when the debtor does not own any asset at all.²⁷

It is obvious from these definitions, the jurists tend to agree that *muflis* is the one who is unable to pay his debt because his assets are not sufficient to pay his existing debt. While some jurists opine

²⁶ Al-Juwaīnī, ‘Abdul Mālik ibn ‘Abdullah, *Nihāyatu al-Matlab fī Dirāyatu al-Mazhab*. (Qatar: Wizāratul Awqāf al-Qatariyyah: n.d), vol.6, 303.

²⁷ Ibn Rushd, Abī al-Wālid Muhammad ibn Ahmad, *Bidāyah al-Mujtahid Wa Nihāyat al-Muqtasid*. (Beyrūt : Dar Ibn Hazm, 1996), vol.3, 452.

that the situation of *iflās* can be determined without court's decision, others hold that the determination of *iflās* can only be made via court's decision. However, all agree that decision to impose *hajr* (legal impediment) over a *muflis* can only be made via court order.

From this explanation, it can be concluded that the term *i'sār* is interrelated to the term *iflās* despite the term *iflās* in its usage is more specific when compared to the term *i'sār*. Though both *iflās* and *i'sār* are used for a person who is unable to pay his debt (whether because his debt is more than his property, or due to the fact that he has no asset at all), the status of *iflās*, according to some jurists can only be obtained via court order. This is, however, not necessary for situation of *i'sār*.

A contemporary scholar, 'Issām al-Inzī has provided more essential differences between *iflās* and *i'sār*:²⁸

1. *I'sār* is associated with debt and matters other than debt, for example, *i'sār* may happen when someone is incapable of meeting his own needs as well as his family expenses (*nafaqah*). Whereas, *iflās* does not happen in this case except if the person is indebted.
2. The situation of *i'sār* is always be referred to customary practice (*'urf*), as mentioned by Ibn Hajar and Imam al-Ainī, while, *iflās* is always be associated with the court order.
3. The insolvent person (*mu'sir*) is the one who does not own any asset. Whereas, the bankrupt person (*muflis*) may sometimes be someone who owns a lot of assets, but due to certain reason his assets cannot be used to pay the debt.
4. It is possible for an order to be issued by court to restrict a *muflis* in dealing with his asset. Whereas, for a *mu'sir*, it does not come to the level of restriction or involves court order. From this perspective, a *mu'sir* is the one who is unable to pay his debt, but for him to be declared *muflis*, there must be certain order from the court that declares him to be a *muflis*.

²⁸ Al-'Inzī. op.cit, 12.

The classical jurists in dealing with *iflās* and *i'sār* have offered two solutions, depending on the scenario of the debtor. If the debtor has no asset to pay his debt (*mu'sir*), then the creditor should give him additional period of time for settling off his debt. This is clearly mentioned in Qur'anic verse as discussed before.

On the other hand, if the person has assets, he should liquidate his assets in order to pay his debt. If he refuses, he shall be declared *mufliṣ*, and all legal implications of *iflās* shall be applied on him, including liquidation of his assets to pay off his debt. However, there is no other arrangement offered by the jurists. As clearly mentioned by Ibn Taymiyyah that if the debt has matured and the debtor is found to be insolvent, then it is not permissible (according to the consensus of the scholars) to restructure his debt. The creditor should wait until the debtor is able to pay the debt. On the other hand, if he is solvent, then there is no need to restructure his debt, as the right thing to do in this scenario is to liquidate his assets and use the proceeds to pay off all his debts.²⁹

In a juristic discussion, it can be said that following the Qur'anic injunction, the jurists have agreed that the creditor should provide time indulgence to the debtor until he is able to pay back his debt. Nevertheless, the creditor should not increase the outstanding amount for extending the financing period as this will lead to *ribā al-nasī'ah* which is prohibited in Islam.

This can be seen clearly from *sabab nuzūl al-ayāt* (reason for the revelation) of the following Qur'anic verse:³⁰

وَإِنْ كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ

“And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease”

Al-Qurtubī narrated that the reason for the revelation of the following verse was that Banī Thāqif had asked for the payment of debt owed by Banī al-Mughīrah. Banī al-Mughīrah then told that they

²⁹ Ibn Taymiyyah, Taqī al-Dīn Abū al-'Abbās Hammād ibn 'Abd al-Halīm ibn Taymiyyah al-Haranī, *Majmū' al-Fatāwā*. (Beyrūt: Dar al-Kutub al-'Ilmiyyah, 1995), vol. 29, 419.

³⁰ *Al-Qur'ān*, 2:280.

were in the state of *al-'usr* (difficulties) by saying: “*we do not have anything to pay your debt*”. Hence, they asked for the postponement until the next harvest time and Allah revealed the verse, asking the creditor to give them the time”³¹.

From the above discussion it can be concluded that it is the responsibility of the debtors to pay their debt in any circumstances. However, if delay in payment of debt is caused by a valid reason, it is the duty of the creditor to give some time indulgence until the debtors are able to pay back. Nevertheless, the debt obligation shall remain in the liability of the debtor and will be carried over till the Day of Judgment unless the debt is forsaken by the creditors or someone else pays the debt on the behalf of the debtor.

4. Current Practice of Islamic Banks in Dealing with the Default

In today's banking practices, to grant customers of any financing facilities, creditworthiness is one the most important criteria assessed by the bank to determine the customer's ability to pay debt and the possibility of the customer may default on his debt obligation. This evaluation involves several aspects including their income, existing personal debts, business performance and operating cashflow (if the client is a business entity), credit history, source of payment and many more. Nevertheless, no matter how rigorous the bank's assessment is done, in certain circumstances, there will still be cases of default in payment of debt by the customers. Different from conventional banking, the method to recover debt and the action that will be taken against the defaulters by Islamic banks must be adherent to the principles of *Shari'ah*. As discussed earlier, the *Shari'ah* has differentiated the treatments for the two categories of defaulters, be it solvent or insolvent. As for the latter, *Shari'ah* encourages the creditor (i.e Islamic bank) to show leniency to the debtor by giving them ample time to settle their debt. However, when it comes to the actual banking practice, it is very difficult for Islamic banks to differentiate between the genuine defaulters and the non-genuine defaulters, due to the absence of guideline.

Since there is no clear legal framework or guidelines

³¹ Al-Qurtubī, op.cit, 729.

established to determine this, the banks usually use the general rule that once the customer has defaulted, he is then subject to the bank's recovery process, unless proven otherwise. Though this act is justified from the banking perspective, one may argue from *Shari'ah* point of view that only delinquent debtors should be punished. To do that, a comprehensive legal framework should be put in place to determine as to whether the debtor is delinquent or otherwise, which is beyond the scope of this paper.

Notwithstanding that, in many cases, scenarios of default are not always analogous with one another. For instance, there is possibility that the debtor is genuinely unable to settle his debt whereby his inability to serve the repayment is not enduring. In this case, the debtor could be temporarily insolvent and unable to pay the debt at that particular point of time, due to some financial constraints, but given additional time, he will be able to make the payment. In other circumstances, a debtor, be it individual or company, may not be able to pay his debt due to liquidity problem. This individual or company is not insolvent (*mu'sir*) because his asset which can be seen clearly from the financial position of the company³², if liquidated, can be used to pay his debt. However, liquidating assets may take some time and it is not feasible to be done instantaneously. Though the bank has the right to call for default and initiate recover process of the debt, this process of liquidation may not be a perfect solution, neither to the bank nor the customer. In certain market conditions, the defaulters may have his assets to be valued temporarily at discount. Hence, liquidating his assets would be detrimental to his financial position. In fact, the bank may not be able to recover the whole outstanding amount as the proceeds after liquidation will be shared with other creditors. However, to give him time indulgence, though benefiting the debtor, can be disadvantageous to the creditor, and what is more if the creditor were a bank which has a responsibility towards its shareholders and investors, and liability towards its depositors. On the other hand, to categorise him as a *mūsir* is also not possible, simply because in

³² Al-'Inzi, 'Issām, *Ta'athur al-Muassasāt al-Māliyyah al-Islāmiyyah (Naqs al-Suyūlah) wa al-Turuq al-Muqtarāhāt lī Mu'ālajatihi*, (Kuwait: 3rd Conference of Islamic Financial Institutions, 2009), 9.

actual fact, he has no liquid assets to pay his debt. Considering these factors, the classical classification of the debtor to *mūsir* (solvent debtors) whom are required to sell his asset to pay debt or *mu'sir* (insolvent debtors) whom are entitled to time indulgence, may not be possible. In both scenarios, it is either the position of the customer or the bank going to be jeopardised. The next section proposes another category of defaulters where the treatment of this types of defaulters is different from *mūsir* and *mu'sir* positions.

5. New Concept of *Ta'athur* and Its Relation to Debt Defaulters According Modern Jurists

As discussed earlier, the classical categorization of defaulters in debt payment into *mūsir* and *mu'sir* may not be able to cater the modern practice of Islamic banking and finance. Due to this fact, a new category of defaulters, namely *muta'athir* is introduced to solve this issue. This is a brand new term which had not been discussed by the classical jurists before³³. A modern concept of *ta'athur* can be defined as a scenario where a person does not completely have no asset, or his debt and liabilities have exceed his assets. However, due to certain temporary liquidity problem, he is not able to meet his debt obligations. Yet, he has a stream of cashflow or receivables that he is going to receive in the near future. Therefore, if he is given some time indulgence, he would be able to pay his debt³⁴. Paying the debt by liquidating his existing asset, in practice, is not feasible as the market price may not reflect the fair value of the assets. He may be forced to take big 'haircut' on the price of the asset to be liquidated. Instead, he is rather delay the payment of the debt until his temporary liquidity shortage is covered by receiving the expected payment. However, by not being able to meet his financial obligation, he may have to face the risk of being called for the default by the creditors.

³³ Al-Shā'ir, Saifuddīn Hussayn 'Alī, *Asbab al-Duyūn al-Muta'āthirah wa atharuhā 'ala al-istūhmār fi al-bunūk al-tijāriyyah fi al-Sudan fi al-Fatrah 2006-2010*, Partial Master Dissertation (Jāmi'ah al-Sudan li al-'Ulūm al-Teknolijiyah, 2012), p. 10, al-'Umarī, Muhammad al-Sharīf, *Ta'athur duyūn al-Uṣār wa kayfiyyat 'ilajihī, dirāsāt fiqhīyyah tahlīliyyah 'alā al-bunūk al-Islāmiyyah bi malīzia*, unpublished PhD Thesis, (Kuala Lumpur: International Islamic University Malaysia, 2016), 27.

³⁴ Al-'Inzī, op.cit, 12.

This sort of situation was not extensively discussed in the classical *fiqh* literature. To the classical jurists, the most suitable position to be taken by the creditor is either to give him time indulgence or to call for default hence liquidating his asset and use the proceeds to settle his debt obligation. Apart from that, the classical jurists did not allow for restructuring of his debt. As discussed earlier, both approaches may affect either the debtor or creditor. It is not fair for the creditor to simply give the debtor time indulgence as it jeopardizes the right of the creditor to receive the payment of debt on time. Though calling for default may benefit the creditor to a certain extent (despite the lengthiness of the entire debt recovery process that the creditor has to go through), it certainly affects the debtor to the extent of declaring insolvency for the indebted person and winding up of the company. Hence, an alternative approach must be taken to ensure that while the debtor is given time indulgence, the position of the creditor is not compromised at the same time.

Based on the above, it seems that, the best way in case of *ta'atthur* is to allow for the restructuring of the debt as it gives the debtor temporary indulgence which may assist him to breathe through the financial constraint and shortage of liquidity at present. This may also allow a financially constrained company to continue its business operations and recover its losses over times.

One may argue for giving time indulgence to the debtor as promoted by the Holy *Qur'ān*:³⁵

وَإِنْ كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ

*“And if the debtor is in straitened circumstances, then
(let there be) postponement to (the time of) ease”*

Though the abovementioned verse tells that there is an obligation of the creditor to give a respite to the debtor until he is able to pay his debt, this concept of time indulgence should also be considered from several aspects:

1. The situation mentioned in the verse is about the *mu'sir*, i.e the one who does not have asset at all, or his asset is not sufficient to pay off his debt, whilst *muta'assir* is a person

³⁵ *Al-Qur'ān*, 2:280.

who has adequate asset. If these assets were to be liquidated, he will definitely be able to settle the debt.

2. The creditor is obliged to wait until the debtor able to pay his debt only if this indulgence brings no harm on himself. This is the premise on which the jurists rely in obliging the creditor to wait. That is the reason why the jurists have resolved that no imprisonment should be imposed on the insolvent debtor (*mu'sir*) as it gives no benefits to the creditor because by detaining the insolvent debtor, the creditor would not get his debt paid, as the *mu'sir* has nothing to pay the debt.
3. Meanwhile, in banking regulation, by leaving the debt to go for default without restructuring it, Islamic banks may have to take the big loss. For instance, by leaving the debt position opens, the central bank or an accounting standard may require Islamic banks to provide a provision for the non-performance debt, which may impact the financial position of the bank, hence adversely affecting its capability to compete in the market. If this happen, the bank loses twice; first, is the defaulted debt and second is in the provision that it has to allocate for the non-performing debt.
4. In modern banking system in which the bank works as intermediary between the surplus and deficit units, any effect on the profitability of the bank will have a significant influence on the inclination of the customers towards depositing their surplus in the bank. Giving indulgence definitely benefits the defaulting client, but it deteriorates the overall performance of the bank, including also the return to the depositors and investors in a long run.
5. Whilst we want to protect the defaulting client, we have to also look at the rights of the bank, the shareholders and the depositors. As discussed earlier, the suggestion to allow for restructuring of the facility is only on the solvent client, but also the one facing certain liquidity constrain (*muta'athir*), who are in fact not insolvent. If their assets were to be liquidated, they will definitely be able to pay all their outstanding payment. However, liquidating their asset may

not benefit them. Hence, allowing for restructuring is going to definitely benefit them. It is unfair for us to look after the interest of the defaulting clients alone while ignoring the interest of the bank entirely. By allowing the restructuring, we will not only assist the client to recover, but at the same time the interest of the bank and its clients is also protected.

6. In actual fact, the default situations impact the bank more than the client, due to increasing of the amount of bad debt and its consequences will be prolonged for the consecutive years. As a result, this will restrict the bank in developing the products as well as increasing their financing portfolio. Subsequently, the same will impact the bank's income, even to certain extent, the risk of bankruptcy.
7. On the other side, the bank will face some liquidity management issues as they may not be able to distribute the dividend to its depositors upon maturity, or even worst, the bank may need to get financial assistance from other institutions for the purpose of fulfilling their liquidity requirement.

6. Conclusion

To conclude, it can be said that it is obligatory for solvent debtor is to pay his debt on time, thus, refusing to pay debt is be considered as one of the great sin and unjust act that requires a punishment. On contrary, it is the obligation of Islamic financial institutions to give time indulgence to the insolvent debtors till they are able to pay their debt. However, to be equal to all parties, we need to consider the case of solvent debtor who is facing temporary shortage of liquidity as earlier discuss as *muta'atthir*. These debtors are not insolvent because if their total asset and liabilities are considered, they will definitely able to pay their debt. However, they may be temporarily unable to pay their debt.

To simply request him to pay the debt may not be possible because he is temporarily facing shortage of liquidity; to call for his *iflās* and liquidate his properties may not be appropriate because if given times, and the movement of the market, he will be able to recover and satisfy all his liability. Nevertheless, to just ask the

creditor to wait is also not possible, as this may also harm their financial position. Therefore, in this scenario, the new category which is termed in this research as *al-ta'atthur* may be considered to be adopted and might has its own ruling from *Sharī'ah* point of view in dealing with default event in the contemporary banking practices.

