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THE CURRENT PRACTICE OF DEBT RECOVERY METHODS IN ISLAMIC BANKS IN MALAYSIA

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Abstract

Debt recovery is an essential activity either for Islamic banks or conventional banks in order to ensure the sustainability of the banks. The bad debt need to be managed properly or else the banks will experience problem with growing level of non-performing loan. One of the problems faced by the banks in collecting debt is defaulted debtor. Many have criticised and voice out their concern over non-ethical debt collection by Islamic banks. Therefore, the aim of this paper is to review the current practice of debt recovery methods in Islamic banks in Malaysia. This research employs the qualitative methodology utilizing content analysis technique. Primary data is collected from books and academic researches. The result shows that the authorities in Malaysia provided good methods and mechanisms for debt recovery in Islamic banks in Malaysia; in term of tools of recovery, procedures, laws and policy. However, still there is a lack in term of enforcement, due this situation, it has affected the debtor. Based on the findings of the study, the study recommended that the Islamic banks should enforce and improve the debt recovery practice according to the laws and policies prescribed.

Keywords: *Debt, banks, islamic, conventional, practice.*

INTRODUCTION

Over the past two decades, the global Islamic financial industry has grown to register overall total assets of US$1.88 trillion (RM8.08 trillion) as at end-2015, as per the Islamic Financial Services Industry Stability Report 2016 (Ng Min Shen, 2017). The World Bank and Islamic Development Bank Group's Global Report on Islamic Finance 2016 said Shariah-compliant financial products and services are now offered in 50 Muslim and non-Muslim jurisdictions worldwide (Ng Min Shen, 2017). The remarkable growth since the banks inception, is due to the fact that Islamic banks offfer Shariah compliant products to the customer which is *riba* free.

Islamic banking not only regarded as a banking service striving to fulfill the religious obligations of the Muslim community, but more significantly as an innovation in the banking industry, that ought to be, as competitive as conventional banking (Seethaletchumy, Hishamuddin and Uchenna, 2011). One of the important areas in Islamic banking that one might be overlooked is debt collection and recovery activities.

Many have critisied and voice their concern over non-ethical debt collection by Islamic banks. For instance, the Islamic Consumers Association of Malaysia or known as Persatuan Pengguna Islam Malaysia (PPIM) has criticized banks using the name 'Islam' in an effort to promote and sell their respective financial products while in fact they are still suppressing and using methods contrary to Shariah principles (Syahril A. Kadir, 2011).

The ethical issues here, whether Islamic banks adopted the same conventional banks practiced or they have different approach. The debtors entitled for fair treatment, including the protection of their privacy during the process and properties. These rights are protected under the principles of Shariah that is *hifdh al-mal* (the protection of one's property). Islamic banks should make their policy clear regarding on how to collect and recover the uncollected debt accordingly to Shariah principle and also concern about the protection of debtors' rights during the process. At the same time, the customer should be made aware of any consequence legally and financially.

There is also a concern raised by Md Ghani & Abdul Majed (2013) that bank is not actually conducting a good mediation. They argue that the mediation approach is very significant in terms of debt collection can be guaranteed in long term collection consistently. But in common practices, the bank mostly prefer to the lump sum payment. If the defaulters failed to make settlement within the certain period given, it seems hard for banks to give any discretion. They prefer to proceed with the legal process. Alternatively, they appoint the agencies to collect the maximum of payment as the targets are achieved (Yoong, Magendran and Hui, 2011).

The harassment of defaulting debtors by their creditors has caused recent concern in every many people, especially the Islamic banks users, because the unethical and harassment in debt totally in against with the Islamic teachings. At the same time, the lack of enforcement of the law or policy related to this issue will not guarantee the rights and the safety of the customers and their personal information can be well kept.

METHODOLOGY

According to Khanzone (2007), research design can help researcher to arrange and manage their ideas in specific ways. The researcher will use the qualitative research approach. Qualitative research concern with developing explanations of social phenomena. According to the research suitability, content analysis is the most appropriate to be used. Hsieh and Shannon (2005) defined qualitative content analysis as "a research method for the subjective interpretation of the content of text data through the systematic classification process of coding and identifying themes of patterns". Specifically, this research will explore the current practices by the Islamic banks in Malaysia.

The most suitable data colleting method for this study is document analysis. Since the main objective of this study is to review the current practice of debt recovery methods in Islamic banks in Malaysia, the researcher will refer classic and contemperory text related to debt in Islam. At the same time, the researcher also will analyse the current practices of debt collection in Malaysian Islamic banks. After the required data is collected, the next step is to analyse the data. Descriptive analysis will be used in this research. The data consist of classic and contemperory text relaed to debt in Islam. Besides, source of references related to current practice of debt recovery in Malaysian Islamic banks are also will be collected and analysed.

RESULTS AND DISCUSION

Instrument of Islamic Finance

These instruments are an alternative to conventional instruments which are known that in the conventional banks are interest-based activities (Joni, 2001). Basically in Islamic finance, there are two categories which are profit-and-loss sharing (PLS) and non-PLS contracts (Mumtaz, Asghar and Rima, 2015).

Profit-And-Loss Sharing (PLS)

There are two types under profit-and-lost sharing contracts: sharing the profit and loss with venture capital/partnership (*mudarabah*) and supporting joint ventures (*musharaka*). Compared with non-PLS financing, it is strong link to real economic activities, because it helps to promote a more equitable distribution of income (Faleel, 2012).

Non-PLS Contracts

Non-PLS contracts are generally used to finance consumer and corporate credit, as well as asset rental and manufacturing. There are six types of contract under this category which are: mark-up (*murabahah*), reverse murabaha (*tawarruq*), leasing or renting (*ijara*), sale by order (*istisna'*), forward sale (*salam*) and deferred payment sale (*bay' al mu'ajjil*) (Joni, 2001 and Faleel, 2012).

Debt Transactions For Personal Loan, Vehicle Financial and House Financial

In today's world, almost majority of household would inevitably be involved in some form of debt depending on the needs of the individual. The availability of various types of debt financing in the market enable households to acquire basic necessities such as house and vehicle as well as fulfill the education requirements (Sabri, 2014). It is the duty of Islamic banks to fulfill these needs.

In this point, the researcher will analyse the Islamic retail banking products in three selected Islamic banks in Malaysia named Hong Leong Islamic Bank, Public Islamic Bank, Al-Rajhi Bank. The researcher will only focus on debt transactions for personal financing, vehicle financing and house financing offered by banks mentioned earlier.

Hong Leong Islamic Bank
Personal Financing

Personal Loan

Hong Leong Personal Financing-i is an unsecured personal financing facility to assist the customer in meeting his/her personal consumption needs. It is calculated on a fixed rate basis resulting in a fixed instalment payment throughout financing tenure. The Shariah principle used is *murabahah* via *tawarruq* arrangement. This bank offers high financing margin of up to 5 times from the customer monthly salary/income, flexible payment tenure of up to 5 years, minimum income eligibility of only RM24,000 per annum and in this contract will not need any guarantor and no collateral (Hong Leong Islamic Bank (Personal Financing-i), 2018).

If a customer who fails to service his/her payment obligation in a timely manner, the following compensation charges (*ta'wid*) shall apply:

(a) During Facility Tenure

(i) For default of any payments during the tenure of the facility, at the compensation rate of one per centum (1%) per annum or such other rates approved by Bank Negara Malaysia on the overdue scheduled payment, calculated from the date immediately following the date of such default until the date of receipt of payment in full;
(ii) For default causing the facility to be terminated or brought to court for judgment prior to the expiry of the tenure of the Facility, at the compensation rate of one per centum (1%) per annum or such other rates approved by Bank Negara Malaysia on the outstanding balance (outstanding principal and accrued profit);

(b) Post Judgment

For default of payment of facility where judgment amount has been awarded by the court, at such rate which shall not be more than the Bank Negara Malaysia's prevailing daily overnight Islamic Interbank Money Market (IIMM) rate or such other rates approved by Bank Negara Malaysia on the basic judgment sum of the Facility subject to any rebate (*ibra'*) that may be applicable, calculated from the date the judgment is made until the judgment sum is fully settled. The compensation amount shall not be compounded and the reference rate for the actual loss shall be determined at the point of default, computed on a daily basis from the payment due date. The bank may set-off any credit balance in the customer account maintained with us against any outstanding balance in this financing account. Legal action against the customer may affect his/her credit rating leading to credit being more difficult or expensive to the customer.

Vehicle Financing

Auto Financing-i is an Islamic hire purchase facility, offered by the bank to part finance the purchase of a vehicle. This product is based on Shariah contract of *al-ijarah thumma al-bay'* (AITAB). If the customer fails to fulfill his/her obligation, the bank will impose a compensation charges of 1% per annum on overdue installment amount, causing the total outstanding to increase. The bank will repossess the vehicle if there had been two consecutive default of payments. In the event where Hirer is deceased, the bank will repossess the vehicle if there had been four consecutive default of payments.

All expenses incurred during the repossession will be charged to the customer *Auto Financing-i* account. The bank may set-off any credit balance in the customer deposit account(s) maintained with the bank against any outstanding balance in this financing account. The bank will provide a seven days prior notice to the customer before exercising this right. Legal action will be taken if the bank fail to respond to reminder notices. The vehicle may be repossessed and the customer will have to bear all the costs. He/she is responsible to settle any shortfall after the vehicle is sold. Legal action against the customer may affect the credit rating leading to credit being more difficult or expensive to the customer (Hong Leong Islamic Bank (Auto Financing-i), 2018).

House Financing

Hong Leong Bank My First Home Scheme is based on *murabahah* via *tawarruq* arrangement. Below is the standard house financing's indicative effective profit rate:

Financing amount	= RM350,00.00
Financing tenure	= 30 years
Lock-in-period	= NIL
Reference rate	= 4.03%
Indicative effective rate	= IBR+0.72% (4.03%+0.72%)
	= 4.75%
Monthly installment	= RM1,826.00

A customer who fails to service the payment obligation in a timely manner, the following shall apply (Hong Leong Islamic Bank (Property Financing-i), 2018):

Compensation Charges

a) For default payment during facility tenure = 1% p.a. on the overdue instalment amount;
b) For default causing the facility to be terminated or brought to court = 1% p.a. on the outstanding balance (outstanding principal plus accrued profit);
c) For default payment after expiry of facility tenure = BNM Islamic Interbank Money Market (IIMM) rate on the outstanding balance (outstanding principal plus accrued profit);
d) For default payment post judgment = IIMM rate on the basic judgment sum.
* Note:
(i) Compensation charges shall not be compounded and more than the outstanding principal
(ii) Compensation charges method and rate are subject to changes as may be prescribed by BNM
(iii) Compensation charges is computed on a daily basis from the payment due date/maturity date/judgement date.

Right To Set-off
The bank is entitled to set-off any credit balance in the customer deposit account maintained with the bank against any outstanding balance in this financing account.

Legal Action
Legal action will be taken if the customer fails to respond to reminder notices. The customer's property may be foreclosed and you will have to bear all costs.
The bank reserves a right to commence recovery activities, foreclosure and bankruptcy proceedings. The customer also responsible to settle any shortfall after his/her property is sold.

Credit Rating Deterioration
Legal action against the customer may affect his/her credit rating leading to credit being more difficult or expensive to the customer.

Public Islamic Bank
Personal Financing

Credit Cards

Basically Public Islamic bank offers two types of cards: Platinum cards and Goal card. The usage of *Credit Card-i* is limited to all the activities that comply with Shariah ruling. Most transactions are allowed except for transactions that are not allowed by Islam such as entertainment centers, gambling centers, massage parlours, escort services and drinking places are not allowed. If the customer fails to fulfill his/her obligation, the bank may (Public Islamic Bank (Credit Card-i), 2018):

Late Payment Charge
Failure to make the minimum payment by the due date, a further charge of a minimum of RM10 or 1% of total outstanding balance (retail transactions and cash advance only) as at statement date, whichever is higher, capped to a maximum of RM100, shall be debited to the card account.

Right to Set-Off
Public Islamic Bank Berhad has the right to set-off all or any accounts maintained with the bank, Public Bank and/ or Public Bank's subsidiaries against any outstanding balance in this credit card account with prior notice of seven calendar days.

Personal Loan

BAE Personal Financing-i is an unsecured personal financing product. It is computed based on fixed rate basis and is fixed until maturity of the facility. The facility available is for personal use and permissible by Shariah principle. The Shariah concept applicable is the *bay' 'inah* under which the customer will pay the Bank instalments for the asset sold.

In the event of default the Bank reserves the right to impose the following (Public Islamic Bank (BAE Personal Financing-i), 2018):

Compensation Charges
a) For failure to pay any instalments of the facility(ies) from date of the first disbursement until the date of the maturity of the facility(ies), the *ta'wid* (compensation) rate that shall be applied is one per cent (1%) per annum on any overdue amount, or any such rate as approved by Bank Negara Malaysia. Formula for *ta'widh* on overdue instalment(s) is as follows:

$$\frac{\text{Overdue Instalment(s) X } ta'widh \text{ Rate X No. of Overdue Day(s)}}{365}$$

b) Please take note that if the customer account remains in arrears and upon recall of the facility or brought to court for judgement before maturity date, late payment charge of 1% p.a. on the remaining outstanding balance will be imposed.

$$\frac{\text{Outstanding Balance X 1\% p.a X No. of Overdue Day(s)}}{365}$$

c) For failure to pay any instalments and which failure continues beyond the maturity date of the facility(ies), the compensation rate that shall be applied is the bank's Average Financing Rate* (AFR) on the outstanding balance or any such rate as approved by Bank Negara Malaysia. The formula for late payment charge after maturity is as follows:

$$\frac{\text{Outstanding Balance X AFR X No. of Overdue Day(s)}}{365}$$

*Also known as "combined rate" which consist of two elements namely *ta'wid* and *gharamah*. *Ta'wid* refers to the amount that may be compensated to the bank based on actual loss incurred due to default while *gharamah* refers to the penalty charged on the defaulters over and above the *ta'wid*.

d) The bank shall not compound the compensation payable to the principal amount/financing amount.

Right To Set-off

The bank has the right at any time without notice to the customer to debit the current/savings account with the bank towards payment of the monthly payment of the financing and any other charges and/or fees.

Vehicle Financing

AITAB Hire Purchase-i (AITAB HP-i) Facility is a leasing of goods facility ending with the sale of the goods by the bank to the hirer upon the expiry of the hiring period based on the Shariah concept *al-ijarah thumma al-bay'* (AITAB). If the customer fail to pay the bank have the right to impose (Public Islamic Bank (AITAB Hire Purchase-i), 2018):

Compensation Charges

Compensation (*ta'wid*) charges are calculated on a daily basis on the amount in arrears OR on the entire outstanding sum for deficit or matured accounts, where applicable: 1% per annum or at the prevailing Islamic money market rate for deficit or matured accounts. The bank has the right to set-off any credit balance in the customer account maintained with us against any outstanding balance in this financing account with a prior notice of seven calendar days.

Default Mechanism

The bank has the right to repossess the goods after the hirer had defaulted two successive instalments or the final instalment. A twenty one days notice of intention to repossess (Fourth Schedule) will be served on the hirer and guarantor (if any) by registered post to the last known address.

This will be followed by a second notice of the bank's intention to repossess, fourteen days after the Fourth Schedule notice. In the case of Scheduled Goods, a court order will be obtained before serving on the hirer and guarantor (if any) the Fourth Schedule notice if the hirer has paid total instalments of more than 75% of the total cash price of goods. Before the expiry of the twenty one days stated in the Fourth Schedule notice, the hirer must do the following to avoid repossession:

a) Pay the arrears amount stated in the Fourth Schedule notice, or

b) Return the goods to the Bank for disposal and pay the outstanding deficit sum, if any.

Legal action will be taken if the customer fails to respond to the reminder notices and you will have to bear all legal costs. The customer also responsible to settle any shortfall after his/her goods are sold. Legal action against the customer may affect his/her credit rating leading to credit being more difficult or expensive to the customer.

House Financing

ABBA House Financing-i is a variable rate financing based on the Shariah concept of *bay*' *bithaman ajil* which allows a customer to finance his/her properties with the bank on monthly instalments that put the customer mind at ease and protect the customer from any increase in the base rate/base financing rate beyond the ceiling rate. Here is an example of calculation for ABBA House Financing-I (Public Islamic Bank (ABBA House Financing-i), 2018):

Name of Customer	= Mr Wahab
Financing Amount	= RM100,000.00
Profit Rate	= 10.6%
Financing Tenure	= 20 years
Grace Period	= 2 years (24 months)
Grace Period Monthly Instalments (24 months)	
Grace Period Profit Formula	= Principal x Profit Rate x ½ x 2
	= RM100,000.00 x 10.6% x ½ x 2
	= RM10,600.00
Grace Period Monthly Instalment Formula	= Grace Period Profit/24 months
	= RM10,600.00/24 months
	= RM441.66

If a customer fails to fulfill the payment in a timely manner, the bank has the right to take an action to the customer. The actions are the same as prescribed earlier in personal loan and vehicle financing.

Al-Rajhi Bank

Personal Financing

Al Rajhi Bank Personal Financing-i is an unsecured financing facility offered to meet the customer personal financial needs which are Shariah compliant. The applicable Shariah contract is *bay*' *bithaman ajil* whereby the customer is allowed by the bank to pay the sale price via fixed monthly instalments over the financing tenure. Minimun financing amount for this financing is RM10,000 while the maximum amount is RM150,000.

However the final financing amount approved will depend on bank's credit evaluation. The range of profit rate starting from 6.99% - 8.25% p.a.. The tenure range starting from 2-8 years. The instalment equals to the Sale Price divided by the financing tenure in months. While the instalment due date is every first of month from the month succeeding the disbursement.

Below is an example of calculation (Al-Rajhi Bank (Personal Financing-i), 2018):

Financing Amount	: RM10,000.00
Profit Rate	: 5 % p.a.
Effective Profit Rate	: 9 % p.a.
Tenure	: 5 years
Sale Price	: RM12,500
Instalment	: RM208.33 (equals to RM12,500/60 months)
Disbursement date	: 13th December 2016
Instalment due date	: 1st January 2017 and onwards, every 1st of the month /

If a customer fails to fulfill his/her obligations, the bank may:

i. Right to set-off: the bank has the right to set-off any credit balance in the customer account maintained with us against any outstanding balance in this *Personal Financing-i* account.
ii. Legal action; Legal action will be taken against the customer for recovery of non-payment of outstanding amount. The bank may proceed with bankruptcy or any appropriate legal action against the customer to recover the outstanding amount. All legal costs related to the recovery action shall be borne by the customer.

Vehicle Financing

AUTO Financing-i is a financing facility to facilitate the purchase of a motor vehicle via the Islamic contract based on a fixed flat profit rate. The method of financing is based on the Islamic contract of *bay*' *bithaman ajil* or sale by deferred payment. The minimum amount of this financing is RM10, 000.00 while the maximum up to 90% of price of vehicle (the final financing amount approved will depend on bank's credit evaluation). Effective profit rate for cars from 4.40%pa while for motorcycles from 6.00% pa. The tenure for this financing is from 2 to 9 years. Below is an example of calculation (Al-Rajhi Bank (Automobile Financing-i), 2018):

Financing Amount	= RM10, 000.00
Profit Rate	= 5% p.a.
Effective Profit Rate	= 9% p.a.
Tenure	= 5 years
Sale Price	= RM12, 500
Instalment	= RM208.33 (equals to RM12, 500/60 months)
Disbursement date	= 13thDecember 2014
Instalment due date	= 1st January 2015 and onwards, every 1st of the month

If a customer fails to fulfill his/her obligations, the bank may:

i. Right to set-off: The bank has the right to set-off any credit balance in the customer current/saving CASA account maintained with us against any outstanding balance.
ii. Right to take possession: Right to take possession of the vehicle by virtue of deed of assignment of the vehicle to the bank.
iii. Legal action: Legal action will be taken against the customer for recovery of non-payment of outstanding amount. The bank may proceed with bankruptcy or any appropriate legal action against the customer to recover the outstanding amount.

House Financing

Structured Home Financing-i is a financing facility to facilitate the purchase of a house financing (completed property and property under construction) via trade line facility calculated based on variable rate basis. The applicable Shariah concept is commodity *murabahah.* This refers to the payment of bank sale price on a deferred basis. The bank sale price includes a profit margin agreed by the bank and the customer(s).

Minimum financing amount RM50,000 while maximum financing amount subject to meeting maximum coverage criteria. Tenure range minimum 5 years up to 35 years or age 65 years, whichever is earlier. Margin of financing up to 90% + 5% (MRTT only). The profit rate Base Rate (BR) BR ± spread p.a (Subject to current market rate). Below is an example of calculation (Al-Rajhi Bank (Home Financing-i), 2018):

Financing Amount	= RM 500,000
Profit Rate Rate	= BR+0.60% p.a

Effective Profit Rate	= 4.95% p.a
Tenure	= 30 Years
Bank Sale Price	= RM 1,579,629mil
Installment: based on effective profit rate	=RM 2,669.00 per month
Disbursement date	=13th February 2018
Installment due date	= 1st March 2018 and onwards,

every 1st of the month

If a customer fails to fulfill his/her obligation, the bank may:

i. Recovery of actual collection cost for overdue monthly installment based on 1% p.a. on the installment amount in arrears or total recovery of actual collection cost as approved by our Shariah Board, whichever is lower. However if the customer fails to pay instalments for 3 consecutive months, the bank may increase the financing rate.
ii. Right to set-off: The bank has the right to set-off any credit balance in the customer account maintained with the bank against any outstanding balance in this *Home Financing-i* account.
iii. Legal action will be taken against you for recovery of non-payment of outstanding amount. The bank may proceed with bankruptcy, foreclosure or any appropriate legal action against you to recover the outstanding amount.

Recovery Tools used in Islamic Financial Institutions in Malaysia

According to Yoong-Hon Lee, Magendran P. Palaniandy & Hui-Boon Tan (2011) there are three types of recovery tools used by Malaysian Islamic Banks which are:

In-house Recovery

Essentially, each bank has its own bad debt recovery department which is responsible for collecting on a monthly target basis. The collection and recovery of bad debts are divided into four stages; i) repayment proposal,[1] ii) settlement proposal (in full or part thereof),[2] iii) the auctioning and disposing of assets (of refinancing)[3], lastly the recovery process. Despite the various activities undertaken by banks, collection in most month is below target with the amount being recovered making up only a small fraction of the total portfolio. This tends to lead to tension among staff of the department and also pressure from the bank's management.

Besides that, centralized bad debt collection departments may employ specifically trained staff to handle the more difficult customers. Such specialization will ensure proper training which leads to a clear knowledge of the bank's strategy and facilitates better understanding of the debtors' status thus improving the performance of their daily collection activities. The centralization process will also assist the improvement of the performance management as well example employees at the centralized department are more focused to only job compared to the multi-taskers at the branch level.

Moreover, the centralized department will also allow banks to improve collection initiatives and ultimately, maximize recovery. Another added advantage of having a centralized department is that it can assist in as such, provide a boost for performance improvement as well.

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[1] The main objective of the negotiation is to get the debtor to agree on a full settlement of the account.

[2] Proposal to pay the total outstanding balance inclusive of legal cost, and other charges incurred for actions initiated to recover the account. Generally, the bank's aim is to get the debtor to settle in one payment instead of installment payments, which will take a longer period of recovery and result in additional administrative costs for the bank to monitor the account.

[3] In refinancing, the existing account will be closed and a new account is created under the new debtor's name and this contributes 100% recovery immediately.

Outsourcing Recovery

In this new era of banking business landscape, the trend for outsourcing the administrative functions and collection activities is growing rapidly since banks are focusing ever more on their core business activities. The initial stage in the process of outsourcing begins with assigning a list of account with the necessary details to the appointed collection agency for the purpose of monitoring and recovery of amount payable from the debtor. Accounts that can be outsourced include the accounts which have been written-down and those accounts with shortfalls ever after the collaterals have been disposed of.[4]

However, the act of debt collectors may go beyond the limitation that are given by the bank due to the insufficiency of provision of law in Malaysia that can control the collection agencies. Many have raised concern over the methods employed by the bank to recover the debt.

Sale of Bad Debt

The sale of bad debts is an outright sale of existing written-off accounts and non-performing financing which are classified as bad debts by the creditors to other companies, more often, the collection agency themselves. The bad debts buyers purchase the portfolio of bad debts from the creditors for an agreed price on a ratio or percentage basis of the total bad debts' face value. This option is attractive when the creditor's business is in need of immediate cash flow.

Essentially, the sale of bad debts can be classified as either a 'sale on recourse' or 'sale on non-recourse' basis. The former allows the bad debts purchaser to return the accounts to the creditor for a refund of the purchase price in the event that recovery fails while in the case of the latter, all related risk for collection and recovery are borne by the bad debts buyer at the time of the sale.[5]

BNM allows the banking institutions to sell outright the bad debts and non – performing loans to eligible third parties or purchase the same from other banking institutions provided they comply with certain conditions. Under the current ruling, banks are allowed to sell bad debts to any domestic banks or foreign banks incorporate locally in Malaysia, and domestic investors or any other foreign investors. However, the sale of bad debts to domestic or foreign investors must be conducted with an establishment of a special purpose vehicle (SPV). The establishment must be an entity locally incorporated in Malaysia, and a resident for tax purposes. Finally, banks may also establish their own SPVs to purchase and manage the bad debts.

There are also another recovery tool which is litigation proceeding or court judgment. Unfortunately, litigation proceedings very costly and time consuming. Sometimes the judgments from the court are not fair. At the same time, due to the inefficient law, legal and court systems that restrict the availability of options for bad debts recovery.

Body of Debt Recovery in Malaysia

Basically there are four types of bodies that related to debt recovery in Malaysia which are (Siti, 2013):

Central Bank of Malaysia (BNM)

Central Bank of Malaysia is a statutory body wholly owned by the government of Malaysia. The Bank reports to the Minister of Finance and keeps the Minister informed of matters

[4] The basic guiding principle is to exclude accounts with outstanding balances of less that RM1000 and those where the bank has received payment within the past three months. The other principles are to exclude the accounts that have been confirmed as fraudulent, accounts under insurance claims and finally accounts under the handling of police, custom or other authorities.

[5] In other word, creditors or banks can recognize the sale as an immediate recovery with obligation to 'buy back' from the bad debt purchaser.

pertaining to financing sector policies. It plays a greater engagement with the public to serve them a better understanding of their rights. To be specified on the debt recovery area BNM is emphasizing the financial advice and counseling to public.

Thus, regarding counseling approach, the Bank Negara has issued a complaint unit for public which is Credit Counselling and Debt Management Agency (AKPK). The main function of AKPK under Bank Negara is to help consumers manage their debts and become more self-reliant in their financial affairs and thereby preserve the resiliency of the household sector in the economic growth process.

Islamic Banks

All banks have their own recovery departments which function to minimize arrears and NPF (Yoong-Hon Lee, Magendran P. Palaniandy & Hui-Boon Tan, 2011). According to Islamic Financial Services Act (IFSA) 2013, Section 43 and 44 stated that the banks have the power to specify standards payment systems and the banks also have the power to propose a direction to the customers of designated payment system.[6] However, the power given must follow the instructions of operational arrangements under section 45 of the same law.[7]

As said earlier, the in-house recovery activity is conducted by the bank itself. However, at present, the approach used by the banks by appointing debt recovery agencies as their representatives; this is where the outsourcing activity is came up. The banks are depending on the agencies in assisting them in collecting debts to ensure the targets of collecting are achieved (Yoong-Hon Lee, Magendran P. Palaniandy & Hui-Boon Tan, 2011).

Many have criticied and voice their concern over non-ethical debt collection by Islamic banks. For instance, the Islamic Consumers Association of Malaysia or known as Persatuan Pengguna Islam Malaysia (PPIM) has criticized banks using the name 'Islam' in an effort to promote and sell their respective financial products while in fact they are still suppressing and using methods contrary to *Shariah* principles whenever the banks want to collected the debt from thee customers, not only that, they also received a lot of complaints from the Islamic banks' customers regarding to this issue. (Syahril A. Kadir, 2011).

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[6] 43.(1) The Bank may specify standards for payment systems—
(a) for promoting safety, integrity, efficiency or reliability of the designated payment system, the payment system set out in Part 1 of schedule 1 or the designated Islamic payment instrument including facilitating interoperability, technical specifications and security standards; or
(b) in the interest of current or prospective participants of the designated payment system or the payment system set out in Part 1 of schedule 1 or users.
(2) An operator of a designated payment system, approved operator of a payment system or approved issuer of a designated Islamic payment instrument shall at all times comply with the standards specified by the Bank under subsection (1) which are applicable to such operator or issuer.
44 The Bank may issue directions in writing to any participant of a designated payment system if the Bank is of the opinion that it is necessary for ensuring the integrity and proper management of the designated payment system or it is in the interest of the public to do so.

[7] 45.(1) An operator of a designated payment system, approved operator of a payment system or approved issuer of a designated Islamic payment instrument shall establish the following operational arrangements:
(a) rules, procedures and requirements setting out the rights, liabilities or any other obligations of—
(i) the operator and participants of the designated payment system;
(ii) the approved operator of a payment system and its participants; and
(iii) the approved issuer of a designated Islamic payment instrument and its users, including the risks that such participants or users may incur; and
(b) measures to ensure the safety, security and operational reliability of the designated payment system, payment system set out in Part 1 of schedule 1 or the designated Islamic payment instrument including contingency arrangements.

One of the crucial unethical approaches is regarding confidentiality of information. There is secrecy provision guided by legal provision of IFSA 2013, Section 145[8], and also in Bank and Financial Institution Act (BAFIA) 1989 Section 97(1) that basically set limitations governing access to the information and impose penalties to deter unauthorized access, abuse or misuse of the information.[9]

By virtue of Section 103(1)(a) of BAFIA 1989 stated could be fined a maximum of RM3 million and jailed up to three years if found guilty. Where else, in Section 145(4) of IFSA 2013 stated anyone who commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM10 million or to both. Even though by informing to the third parties is strictly prohibited, however the enforcement is not fully implemented.

Collection Agencies (Outsourcing Agencies)

A debt agency is a third party (sometimes a law firm) that is charge with the task of collecting debt. The out-sourcing activities by the collection agencies are ruled to follow Bank and Financial Institution Act (BAFIA) Act 1989 Section 97, it is clearly stated that the duty of secrecy only subject to four exceptions:

i. Disclosure under compulsion of Law.
ii. Duty to public to disclose.
iii. Disclosure in the Bank's Interest.
iv. Disclosure with the customer's consent.

According to the Act, the collection agencies cannot freely disclose the client identity to public and do any sort of harassment action towards the clients as to get them to pay the debts. Therefore, it is clearly understood the other conducts than these exceptions are totally cannot be considered.

However the reality is otherwise. For instance, the Islamic Consumers Association of Malaysia or known as Persatuan Pengguna Islam Malaysia (PPIM) stated that most of the collector agencies failed to show a valid copy of the appointment document issued by banks that they represented when claiming the debt. These unethical agents acted in unappropiate manners against the defaulted debtors and they are threatening in various ways. Not only that, they are also involving by using phone calls, threat, summons, seized

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[8] 145.(1) No person who has access to any document or information relating to the affairs or account of any customer of an Islamic financial institution, including—
(a) the Islamic financial institution; or
(b) any person who is or has been a director, officer or agent of the Islamic financial institution,
shall disclose to another person any document or information relating to the affairs or account of any customer of the Islamic financial institution.
(2) Subsection (1) shall not apply to any document or information relating to the affairs or account of any customer of an Islamic financial institution—
(a) that is disclosed to the Bank, any officer of the Bank or any person appointed under this Act or the Central Bank of Malaysia Act 2009 for the purposes of exercising any powers or functions of the Bank under this Act or the Central Bank of Malaysia Act 2009;
(b) that is in the form of a summary or collection of information set out in such manner as does not enable information relating to any particular customer of the Islamic financial institution to be ascertained from it; or
(c) that is at the time of disclosure is, or has already been made lawfully available to the public from any source other than the Islamic financial institution.
(3) No person who has any document or information which to his knowledge has been disclosed in contravention of subsection (1) shall disclose the same to any other person.

[9] 97.(1) No director or officer of any licensed institution or of any external bureau established, or any agent appointed, by the licensed institution to undertake any part of its business, whether during his tenure of office, or during his employment, or thereafter, and no person who for any reason, has by any means access to any record, book, register, correspondence, or other document whatsoever, or material, relating to the affairs or, in particular, the account, of any particular customer of the institution, shall give, produce, divulge, reveal, publish or otherwise disclose, to any person, or make a record for any person, of any information or document whatsoever relating to the affairs or account of such customer.

their house in order to get the uncollected debt from the defaulted debtor (Zuibaidah & Hafiz, 2017).

Credit Counselling and Debt Management Agency (AKPK)

Recently in 2012, AKPK has teamed up with seven smart partners to extend its reach in providing financial education to the public. It is collaborating with Malaysia Department Insolvency, Syarikat Perumahan Negara BHD, Yayasan Sosial Strategik, Financial Planning Association of Malaysia, Standard Financial Planner, National Association of Malaysia Life Insurance Field Force and Advisers and the Malaysia Financial Planning Council.

Since its inception in 2006, AKPK provides an avenue that is free of charge for adult consumers to seek guidance in managing their finances. Furthermore, financial literacy is an important skill as it is the foundation for growing, managing and protecting wealth in preparation for lift's uncertainty and comfortable retirement. AKPK's core business are actually provides financial education credit counseling and debt management services.

Procedure of Debt Recovery

The process of debt recovery that being practice by Islamic banks in Malaysia are just the same (Siti, 2013). This is because they have to follow the procedures and guidelines that being stated by BNM. The following steps are the steps of debt recovery that being used by Islamic banks in Malaysia (Amirullah and Razli, 2011):

1) Review Financing Portfolio
   Bank officers at the respective branches would review their respective financing portfolio from time to time in order to ensure that clients di not default in their financing payments.
2) Monitor the Progress of Client's Business
   Site visits must be conducted to monitor the progress of client's business as to ensure that payment can be serviced promptly.
3) Issuance of the first, second and final reminder letters
   First reminder letter is to be issued out to the client in respect of those financing accounts which are in arrears of one month after the payment due date. If payment is not received within seven days from the service date of the first reminder letter, a second reminder notice is to be served notifying the client to settle the overdue amount within any further delay
4) Legal action
   If the client failed to respond within fourteen days of the service date of the second reminder notice, a final reminder is to be issued by notifying the client of the outstanding financing amount owing as well as the bank's intention to proceed with legal action if the arrears in payment is not settled within twenty one days from the service date of the final reminder.

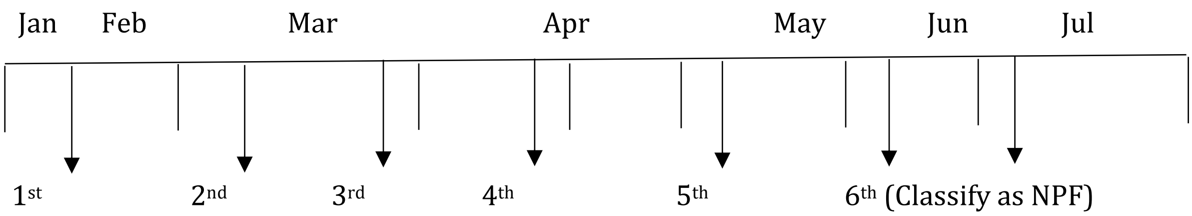
Debt Period

The Central Bank of Malaysia (BNM) defines a financing as impaired based on payment conduct where the principal or interest/profit or both is past due for more than 90 days or 3 months. In the case of revolving facilities, the facility should be classified as impaired where the outstanding amount has remained in excess of the approved limit for a period of more than 90 days or 3 month; or where the amount is past due or the outstanding amount has been in excess of the approved limit for 90 days or 3 months or less, the financing exhibits weaknesses that render a classification appropriate according to the bank institution's credit risk grading framework (BNM, 2015).

Financing can only be reclassified as non-impaired when payment based on the revised or restructured terms have been observed continuously for a period as determined by the banking institution's policy on rescheduled and restructured facilities. For rescheduling and restructuring of facilities where the amount is past due for 90 days or 3 months or less, these account shall be classified as impaired if they exhibit any weaknesses that render such classification as appropriate according to the banking institution's credit risk grading framework (BNM, 2015).

BNM defines a loan as a non-performing when the principal or interest is due and unpaid for six months or more from the first day of default (BNM, 2007). The same definition is also applicable to Islamic financing. Generally, financing facility is considered as non-performing when the principal sum or profit margin is due and unpaid for a consecutive period of 6 months or more from the first day of default (Amirullah and Razli, 2011). The following example, have been illustrated by BNM to show the actual operation of NPF by using of home financing account ad follows:

(1st repayment due but not paid)



(Month from the first day of default)

In the early January the customer has not made any payment until July and become inactive financing account holder. So in the end of July the customer financing account was reported to be a NPF to BNM.

Compensation (*Ta'wid*) and Fine or Penalty of Delayed Payment (*Gharamah*)

Basically, Islam prohibits *riba* and permit halal transaction. Any excessive payment in paying back loan is *riba*. Unlike In conventional banking, a penalty for late payment of loan is about 2 to 5 percent of total loans outstanding. Rates charged by conventional banks are compounding and the penalty will be included in the loan amount. If there is a further penalty, it will be pegged to the percentage of the original loan amount (Ezani, Mohamed, Asmak and others, 2014).

But, what happened if the debtor failed to pay or late payment of debts? Shall Islamic banking impose penalty or compensation to them? According to the precise of Islamic banking in Malaysia, they will give penalty or compensation to the default party (debtor) for the late payment of debt.

Not only that, Bank Negara Malaysia also made a Guidelines on Late Payment Charges for Islamic Financial Institution (IFI) that effective on 1st January 2012 which the primary aim of the guidelines is to provide guidance to the Islamic financial institutions including Islamic banks on the mechanism of late payment charges that applies the concept of *ta'wid* (compensation) and *gharamah* (penalty). In this point, we will discuss the *ta'wid* and *gharamah* concept and the differences between these two concepts with the concept that being used by the conventional bank.

Compensation (*Ta'wid*)

Ta'wid can be defined as a fine as agreed by the parties to the contract as compensation that can be claimed by the creditor when the debtor failed to pay or make late payment of debts. It also means the damages imposed on the actual loss suffered by the lenders, compensating for the impact of delayed payment by receiver (Ezani, Mohamed, Asmak and others. (2014). According to Central Bank of Malaysia (Bank Negara Malaysia – BNM) *ta'wid* refers to the amount that may be compensated to the Islamic banking institutions (IBI) based on the actual loss incurred due to default) (BNM, 2012).

The SAC of the Security Commission of Malaysia are in the view that *ta'wid* is allowed in cases where the customer purposely delays payment with conditions as below (BNM, 2012):

i. The actual loss to be compensated from any default payment, from the date of payment until the maturity date shall not be more than 1% per annum
ii. For basic financing that fails to be amortised and exceeds the maturity date, *ta'wid* that may be imposed is at the current Islamic Interbank Money Market (IIMM)[10] rate taking into consideration the Islamic money market but it shall not be more than the prevailing daily overnight Islamic Interbank rate (IIMM)
iii. *Ta'wid* obtained from the financing that is not amortised can be used by the financiers involved and can be divided among financiers according to the bank's current profit sharing ratio.

The way to calculate *ta'wid* according to Guidelines on Late Payment Charges for Islamic Financial Institution (IFI) is – example: For example, Ali obtains a home financing from the Islamic banks of RM200,000. In the first year, Ali fails to pay installments of RM2,000 per month and also two months arrears. Therefore, the amount of *ta'wid* to be paid is:

- *Ta'wid* = 1% × (2 × RM2000) = RM40
- Total payment of 2 months due = RM40 + (2 ×RM2,000) = **RM4,040**

As illustrated by Ezani, Mohamed, Asmak and others (2014), the amount of the fines imposed by Islamic banks for the two months in arrears is only RM40, which will be added to the 2-month overdue installments of RM4,000. Thus, the total amount to be paid by B is only RM4,040. *Gharamah* also uses the same calculation but the earnings received will be channeled for charity. Unlike penalty (*riba*) charged in conventional banks. A penalty for late payment of a loan is about 2 to 5 percent of total loan outstanding. Rates charged by conventional banks are compounded and the penalty will be included in the loan amount.

If there is further penalty, it will be pegged to the percentage of the original loan amount. For example, let's assume that Abu undertakes a housing loan of RM200,000 and the outstanding loan is RM90,000. Abu then fails to pay the debt for a month. A set of penalty of 5 percent is imposed. As a result, the amount scheduled to be paid by Abu is:

- Penalty; RM90,000 × 5% = RM4,500
- Penalty + outstanding balance; RM90,000 + RM4,500 = RM94,500
- Interest on the new balance; RM94,500 × 6.75% (interest rate) = RM6,378.75
- New outstanding loan; RM94, 500 + RM63,78.75 = **RM100, 878.7**

Penalty of Delayed Payment (*Gharamah*)

Gharamah according to Central Bank of Malaysia (Bank Negara Malaysia – BNM) refers as the penalty charged on the defaulters over and above the *ta'widh* (BNM 2012). *Gharamah* can not to be recognized as a source of income for IBIs, as opposed to *ta'wid*, and therefore, all *gharamah* amounts must be channeled to charitable organization(s). Therefore, it is crucial for IBIs to separate *gharamah* account from *ta'wid* in order to facilitate proper administration and governance of the accounts. This is to allow better monitoring and identification of the source and utilisation of *gharamah* for distribution to charitable organisation(s).

The Shariah Committee of Islamic banks are responsible to determine the appropriate charitable bodies or institutions to receive *gharamah* including Islamic Treasury (*baitulmal*). All institutions that are subjected to the jurisdiction of Bank Negara

[10] The IIMM rate; defined as the daily weighted average for overnight rate of the *murabahah* interbank investment at the Islamic Interbank Money Market , has been agreed by the Shariah Advisory Council to bethe reference rate for actual loss, post maturity. The IIMM rate can be sourced from the IIMM website http://iimm.bnm.gov.my/index.php.

Malaysia are required to disclose in its financial statements and IBIs also should produce *gharamah* distribution report from time to time (BNM, 2012). Based on what has been discussed above, the differences between *ta'wid*, *gharamah* and penalty impose by conventional banks are (Ezani, Mohamed, Asmak and others, 2014):

Mechanism	***Ta'wid***	***Gharamah***	**Penalty**
Concept	Losses due to late payment are borne by creditors	Penalty to avoid late payment	Charge for late payment
Rate of charge	Fixed 1% Based on outstanding principal balance	- Non compounding - Based on outstanding principal balance	- Compounding - Based on outstanding principal balance
Use of proceeds	Income to bank	Channel to charity	Income to bank
Liability	Customer's liability is not exceeding 1% of outstanding principal balance	Share liability; channel for charity	Customer's liability

CONCLUSION

In conclusion, the authorities in Malaysia provided good methods and mechanisms for debt recovery in Islamic banks in Malaysia; in term of tools of recovery, procedures, laws and policy. However, there is a lack in term of enforcement. Due to the high default rates, the banks will use any possible methods to recover arrears. Bad debt and non-performing loan will reduce the bank's profit.

Hence, due to this situation, it has affected the debtor. Based on the findings of the research, this research recommend that the Islamic banks should enforce and improve the debt recovery practice according to the laws and policies prescribed. Thus this will ensure that management and the operation of the Islamic banks parallel with Shariah principles and laws.

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