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Recent Court of Appeal Decision on *Ta'widh* Rate and Reference to Shariah Advisory Council of BNM

Pan Northern Air Services Sdn Bhd v Maybank Islamic Bhd
[2020] MLJU 2206 (CA)

Recently, the Court of Appeal discussed several issues concerning the *Ta'widh* (compensation) rate chargeable and reference to the Shariah Advisory Council of Bank Negara Malaysia in relation to disputes concerning an Islamic financing facility.

Background facts and HC decision

The appellant (**Customer**) obtained an Islamic financing facility (**Facility**) from the **Bank** by executing several Al-Bai' Bithaman Ajil Facility Agreements (**BBA Facility Agreements**). After resolving a wrongful termination of contract dispute, the Customer made an enquiry to the Bank about the settlement of the Facility. The Bank requested payment of a settlement sum of RM42 million, with a waiver of *Ta'widh* of RM1 million, if settlement was made before a stipulated date. The Customer, through its solicitor, made the payment without prejudice to its rights and remedies available in law. The Customer contended and disagreed with the Bank's charging of *Ta'widh*, both on the rate and calculation, and brought an action for recovery of the overpaid money. At the High Court, the Customer's claim was dismissed on the grounds that the Bank was entitled to charge *Ta'widh* at the rate imposed and that the calculation was correct.

Court of Appeal's decision

The Customer confined the legal issues for the appeal to the rate of *Ta'widh* charged and the refund of the excess money paid. In allowing the Customer's appeal, the Court of Appeal (**Court**), among others, considered the following issues:

1. What is the correct *Ta'widh* rate that is chargeable under an Islamic banking financing facility, which was paid after the default of the payment of instalments but before the maturity date of the financing facility; and
2. Whether when a Shariah question is raised, should the trial

court refer the matter to the Shariah Advisory Council (**SAC**) or is it entitled to look at available rulings of the SAC and decide accordingly.

Correctness of *Ta'widh* Rate Actually Charged by the Bank

In determining the applicable *Ta'widh* rate, the Court looked at the BBA Facility Agreements entered into between the Customer and the Bank in relation to the Facility and noted that the contractually agreed rate of *Ta'widh* provided for in the event of default of instalment payments was 1% per annum, and such rate may be varied by the Bank at its absolute discretion or via Bank Negara Malaysia's (**BNM**) advice upon written notification to the Customer. The clause governing *Ta'widh* is set out in the respective BBA Facility Agreements as follows:

> "*Section 9.32 — Ta'widh*
> *If the Customer defaults in any payment on its due date of any one or more of the instalments or any other moneys herein covenanted to be paid,* ***the Customer shall pay to the Bank ta'widh (compensation) at the compensation rate of 1% per annum on the overdue instalments calculated from the date of such default until the date of payment of the amount thereof*** *and shall not be limited to the period of the financing or any method approved by Bank Negara Malaysia or at the Bank's discretion. The Ta'widh (compensation) on late payment may be varied by the Bank at its absolute discretion or upon receipt of advise* [*sic*] *from Bank Negara Malaysia* ***upon written notification to the Customer***."

In determining the correctness of the *Ta'widh* rate charged by the Bank (whereby the rate actually charged was based on the Islamic Interbank Money Market rate, instead of the contracted *Ta'widh* rate of 1% per annum), the Court referred to the BNM letter issued in 1998 on *"Pengenaan Penalti Bagi Pembiayaan Perbankan Islam"* together with the attachments, and concluded that the BNM letter did not address the issue of *Ta'widh* but rather on the charging of "penalty" for default in instalment payments. Even if the BNM letter were to apply, it was silent on the need to provide notice for the *Ta'widh* rate, and the Court held the requirement relating to the notice of change in the contracted *Ta'widh* rate (as set out in the *Ta'widh* clause in the BBA Facility Agreements) must be complied with by the Bank, and in this case, it would appear that the Bank did not provide such notification to the Customer on the change in the *Ta'widh* rate applied by the Bank.

Further, the Court also referred to the Guidelines on Late Payment Charges for Islamic Banking Institutions 2012 (**LPC Guidelines**) issued by BNM on the concept of *Ta'widh*, which state that the rate of *Ta'widh* chargeable is 1% per annum on the actual loss incurred by the banks as a result of default in payments, calculated from the date of payment until the maturity date. After the maturity date, the LPC Guidelines provide that the rate on the actual loss to be compensated from the default in payment must not be more than the prevailing daily overnight Islamic interbank rate on the outstanding balance. The Court held that even though the LPC Guidelines were issued only after the BBA Facility Agreements

were executed in 2005, the LPC Guidelines nevertheless endorsed what had been the practice of the Bank in charging 1% per annum for *Ta'widh* as contractually provided for by the *Ta'widh* clause in the BBA Facility Agreements.

In view of the above, the Court then had to decide what was the correct *Ta'widh* chargeable for a default in payment, upon termination of the Facility before the maturity date. The Court held that that in this case there was an excess *Ta'widh* paid by the Customer to the Bank upon termination of the Facility before the maturity date, in that the *Ta'widh* rate of 1% per annum must be based on the balance sale price in accordance with the *Ta'widh* clause in the BBA Facility Agreements as if there had been no default and the full sale price would have been paid upon maturity date. Hence any failure to pay the instalment payments would require the Customer to compensate the Bank based on the balance sale price as at the date of termination of the BBA Facility Agreements upon default plus the compensation based on the *Ta'widh* rate for actual cost that the Bank has incurred due to the Customer's failure to pay the instalments on time.

Whether *Ta'widh* issue should be referred to SAC for determination

Civil courts have jurisdiction to hear claims on Islamic financial instruments, but are not in a position to decide on whether a matter under Islamic banking is in compliance with the laws of Shariah as this falls within the expertise of the SAC, whose opinion is binding on the civil courts. Although this issue relating to the need to refer to the SAC for determination was not pursued by the Customer in the course of the appeal, the Court decided to discuss this issue in detail in its judgment.

In deciding that it was not necessary to refer the issue to the SAC, the Court firstly looked at the relevant provisions dealing with reference to the SAC in ss 56 and 57 of the Central Bank of Malaysia Act 2009 (**CBMA 2009**), which state as follows:

> *"Section 56*
> *(1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall — (a) take into consideration any published rulings of the Shariah Advisory Council; or (b) refer such question to the Shariah Advisory Council for its ruling.*
>
> *"Section 57*
> *Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56."*

The Court also referred to the Federal Court decision of *JRI Resources*[1] which laid two options for civil courts to consider

[1] *JRI Resources Sdn Bhd v Kuwait Finance House (M) Berhad* [2019] 3 MLJ 561 (FC)

when confronted with a request to refer a question to the SAC (as follows):

(a) ascertain if there are already existing rulings of the SAC on the question raised before the civil courts;
(b) if there are none, then to refer to the SAC for its rulings.

Having discussed the above, the Court then set out the steps for civil courts to consider when faced with a Shariah issue:

1. whether the issue raised is a Shariah issue. If it is not a Shariah issue, then there is no need to refer to the SAC;
2. if it is a Shariah issue, whether there is existing guideline, ruling or resolution issued by BNM or the SAC (as the case may be) on that particular Shariah issue. If there is such existing guideline, ruling or resolution of BNM or the SAC, then there is no need to refer the matter to the SAC;
3. if there is more than one guideline, ruling or resolution of BNM or the SAC (as the case may be) on that Shariah issue, the civil courts should determine which of these is the applicable one, taking into account the facts of the case before the civil courts;
4. if there are no applicable guidelines, rulings or resolutions of BNM or the SAC (as the case may be), only then should the civil courts refer the Shariah issue to the SAC.

Observations

1. *Use of terms "borrower" and "loan" for Islamic financing*

   It is unfortunate that the Court had erred in using terms such as "borrower" and "loan" in the written judgment, which are not in line with the underlying Shariah structure for the BBA Facility Agreements in this case. Such terminology, while suitable for conventional banking, would be wholly inappropriate for Islamic financing, and as such it would have been better for the Court to use terms such as "customer" and "financing facility" that are consistent with Islamic financing in reference to the BBA Facility Agreements in this case.

2. *Importance of actual language used in drafting Ta'widh clause*

   The Court's interpretation of the clause relating to *Ta'widh* in the BBA Facility Agreements was laudable, as the decision placed primary importance on the language actually used in the drafting of the *Ta'widh* clause in the BBA Facility Agreements to determine whether any change in the contracted *Ta'widh* rate would be legally correct on the facts of the case. It would appear that the actual language used in the drafting of the *Ta'widh* clause in the BBA Facility Agreements had clearly specified the *Ta'widh* rate applicable, and that any change in the contracted *Ta'widh* rate can only be made if the Bank complies with the *Ta'widh* clause by giving written notification to the Customer. If the Bank had intended for a different *Ta'widh* rate to apply (such

as the Islamic Interbank Money Market rate) prior to and after the maturity date, then the Bank should have complied with the written notification requirement for such change in the contracted *Ta'widh* rate, in line with the *Ta'widh* clause in the BBA Facility Agreements.

3. *Whether BNM guidelines or policy documents can be considered in referring a Shariah issue to the SAC*

The Court's decision has certainly clarified the manner in which a reference to the SAC should be made by the civil courts, which clearly builds on the earlier Federal Court's decision in *JRI Resources*.[2] However, it may be noted that the procedure for reference as set out by the Court may not be entirely in line with s 56 of the CBMA 2009. This is because under s 56, the courts must determine whether there is any "published rulings Shariah Advisory Council" before referring a Shariah issue to the SAC. However, in this case the Court had actually gone further and included guidelines issued by BNM to determine whether there is any "published rulings of the Shariah Advisory Council" for the purpose of s 56. With respect, any guidelines (or policy documents) issued by BNM will not come within the meaning of "published rulings of the Shariah Advisory Council" for the purpose of s 56 of CBMA. In addition, the Federal Court's decision in *JRI Resources* (which was relied on by the Court in this case) also makes clear that only published rulings of the SAC may be considered for the purpose of s 56. Therefore, despite the Court's helpful suggestions on the procedure for reference, it would appear that civil courts can consider only the SAC's published rulings (and not any guidelines or policy documents issued by BNM) in determining whether a reference on a Shariah issue should be made to the SAC under s 56 of the CBMA 2009.

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[2] *Ibid*