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## AN EXAMINATION OF THE PENALTY FOR DELAYED PAYMENT IN FINANCIAL OBLIGATION IN NON-INTEREST FINANCIAL INSTITUTIONS IN NIGERIA

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### Abstract

Islamic Finance has distinguished itself from other financial systems by its compliance with *Shari'ah* principles and rulings. *Shari'ah* compliance is what distinguishes an Islamic financial institution from a conventional financial institution. The conventional financial system handles default in payment of financial obligation by charging interest on customers. Since charging interest is against the principles of *Shari'ah*, Islamic financial institutions are not allowed to emulate this mechanism to resolve the issue of delayed payment or default. Although, the recent guidelines issued by the Central Bank of Nigeria (CBN) generally empowers the Advisory Committee of Experts (ACE) to always monitor and supervise the disposal of Non-Permissible Income by the Non-Interest Financial Institution (NIFI) in its business operations. However, in cases where the institutions stipulate financial compensation for delayed payment, such decisions are sometimes considered arbitrary and not within the contemplation of Islamic law of commercial transaction. This paper, therefore, adopts a doctrinal method to examine the legality or otherwise of the payment of penalty for delayed payment in Islamic law. It found that there are justifications in Islamic law indicating that penalty can be imposed on a defaulting party especially in cases where the defaulter has the means to pay. The practice of delayed payment penalty in Islamic financial system in Nigeria is classified under the Non-Permissible Income (NPI) which is to be disposed of in charitable activities by Institutions Offering Non-Interest Financial Services.

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**Keywords:** Islamic finance, *Shari'ah* compliance, Delayed payment

## 1.1 Introduction

The conventional financial system handles default in payment of financial obligation by charging interest on customers. Since charging interest is against the principles of *Shari'ah*, Islamic financial institutions are not allowed to emulate this mechanism to resolve the issue of delayed payment or default. This requires a *Shari'ah* compliant mechanism to deal with the issue. This is necessary considering the fact that where there is delay in payment, it would inevitably affect the financial activity of the institution. Although, the recent guidelines issued by the Central Bank of Nigeria (CBN) generally empowers the Advisory Committee of Experts (ACE) to always monitor and supervise the disposal of Non-Permissible Income by the Non-Interest Financial Institution (NIFI) in its business operations. However, in cases where the institutions stipulate financial compensation for delayed payment, such decisions are sometimes not taken seriously and thus considered not within the contemplation of Islamic law of commercial transaction.

These are some of the *Shari'ah* Governance issues this paper aims to address. This paper, therefore, examines the meaning and nature of penalty for default in financial obligation in Islamic finance. It also discusses delay in payment of financial obligation in Islamic law. In this wise, the paper examines the permissibility or otherwise of the payment of penalty for delayed payment in Islamic law. The paper similarly discusses the practice of late payment penalty in Islamic finance in Nigeria.

## 1.2 Meaning and nature of penalty for delayed payment

Penalty for Delayed Payment is referred to in Arabic language as *Al-Ta'weedh or Gharaamah*. *Al-Ta'weedh* or *al-'iwad* literally means consideration, or counter-value.<sup>1</sup> The Fiqh Academy Journal defines it as: "Payment of financial

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<sup>1</sup>. Muhammad Ibn Akram Ibn Ali Ibn Ahmad Ibn Manzur, *Lisan al-Arab* (Dar al-Fikr, 1984) 474.

compensation or counter value, which is obligatory as a result of loss caused to others”. Thus, *ta’weedh* is more specific than *dhamaan* (surety for losses), which is based on the *Shariah* sources such as *diyat* (blood money), obligations (contracts), harmful act and *yad al-dhaman* (liability).<sup>2</sup> On the other hand, *al-gharaamah* can be defined as what ought to be paid. *Al-gharaamah* is a criminal punishment imposed by the state or the courts to protect the public interest.<sup>3</sup> In simple words, *ta’weedh* means compensation and *gharaamah* means penalty.<sup>4</sup>

### 1.3 Delay in payment of financial obligation in Islamic law

The general rule in Islamic law of commercial transactions (*Mu’amalat*) is that parties to all commercial dealings are to always honour their obligation without any delay. Honouring one’s obligation and fulfilling same is obligatory under Islamic law.<sup>5</sup> Allah, the Most High, says: “And fulfil (every) covenant. Verily! the covenant, will be questioned about”<sup>6</sup> Similarly, Ali ibn Abi Taalib (may Allah be pleased with him said: The Messenger of Allah (peace and blessings of Allah be upon him) said: “Whoever breaks the covenant of a Muslim, upon him be the curse of Allah, the angels and all the people, and Allah will not accept any obligatory or non-obligatory acts of worship from him.”<sup>7</sup>

In as much as honouring one’s obligation is emphasized under Islamic law, where there are genuine and verifiable reasons for the delay in payment, the law provides for granting respite to the defaulter. Allaah, the Most High, says: “And if the

<sup>2</sup>. Ahcene Lahsasna, *Introduction to Fatwa, Shariah Supervision and Governance in Islamic Finance* (Cert Publications Sdn, Bhd, Kuala Lumpur, Malaysia 2010) 288.

<sup>3</sup>. *Mausu’at al-Iqtisad Wa al-Tamweel al-Islami*, (nd) *Al-Gharamaat al-Maaliyyah*, p.1. Retrieved November 17, 2022 from <https://iefpedia.com>.

<sup>4</sup>. Zuhaira Nadiah Binti Zulkipli, Late Payment Penalty: Ta’widh and Gharamah Imposed to Debtor from the *Shariah* Perspective, *Yuridika*: (2022) (35) (1), 187 <<https://ejournal.unair.ac.id>> accessed 16 November 2022.

<sup>5</sup>. Wahbah Al- Zuhailiy, *Al-Fiqh Al-Islamiy Wa Adillatuhu* ( Dar al Fikr, Dimashk, 2008) 5.

<sup>6</sup>. Qur’an 17:34

<sup>7</sup>. Al-Bukhari, M.I. op. cit. Vol. 4, p. 3178.

debtor is in hard times, then grant him time till it is easy for him to repay...”<sup>8</sup> This is one of the distinguishing features of the Islamic financial system as compared to the conventional financial system where interest will continue to accumulate in as much as the debt has not been paid.

The issue that arises, however, is whether an Islamic financial institution such as an Islamic bank can impose penalty over and above the advanced principal amount upon the debtor as a result of the default in honouring his obligation under the agreement. This extra charge is referred to under Islamic law as *ta'wid* or *gharamah* or *al-shart al-jaza'iy*.<sup>9</sup> *Al-Shart al-Jaza'iy* is referred to as an agreement on the quantum of penalty to be paid in case of default.<sup>10</sup> There are always three issues to consider with regards to paying penalty for default payment. The first issue has to do with the permissibility or otherwise the penalty itself under Islamic law. The second issue has to do with the method of determining percentage to be paid as penalty. The third issue has to do with disposing the penalty.

#### 1.4 The legality of penalty for delayed payment in Islamic law

With regards to the permissibility or otherwise of the penalty for delayed payment, the majority of contemporary Muslim jurists are of the opinion that it is permissible to charge penalty for delay or default in repayment of financial obligation. They relied on quite a number of authorities as follows; Abu Hurairah narrated that the Prophet, peace and blessings of Allaah be upon said: “Delay by a rich person (in payment of debt) is a tyranny.”<sup>11</sup> This *hadith* considers an intentional delay in debt payment by a person, who, as tyranny. Similarly, they

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<sup>8</sup>. Qur'an 2:280.

<sup>9</sup>. Lahsana, A. op. cit. at p.288.

<sup>10</sup>. Muhammad Ali Al-Badawiy, *Al- Nazariyyatu Al-Ammah LI-Al'iltizam*, (Darul Kutubul Wazifah, Bengazi, 2005) 56.

<sup>11</sup>. Al-Bukhari, M.I. op. cit at p.2287.

relied on the legal maxim that says: “Neither harming nor reciprocating harm (in Islam).”<sup>12</sup>

In 2006, International *Shariah* Scholars Dialogue was held in Putrajaya. One of the issues discussed in the dialogue was the principle of compensation and penalty charges in dealing with loan default in Islamic finance. Muhammad ‘Abd al-Razzaq al-Sayyid Ibrahim al-Tabataba’i stated that there is a difference between compensation for damage and fine for late payment which in the former, the existence of damage is a requisite for compensation, whereas, in the latter, the fine is payable regardless whether damage exists or otherwise.<sup>13</sup>

The contemporary Muslim jurists hold two different opinions regarding the penalty for default in payment by a debtor who has the capability to repay. The first opinion has to do with the permissibility of payment of penalty by the defaulter who has the capability of repaying. Some of the jurists who hold this opinion include Mustafa Ibn Ahmad al-Zarqa, Shaykh Abdullah Ibn Sulayman al-Mani, Muhammad al-Zuhayli, Abd al-Hamid al-Bu’li, Muhammad Khatir, and Abd al-‘Aziz al-Qasar.<sup>14</sup> Proponents of this view argued that the following authorities from the *Qur’an*, *Sunnah* and Islamic legal maxims are in support of this view. Allah, the Most High, says “And fulfil (every) covenant. Verily ! the covenant, will be questioned about”<sup>15</sup> Allah, the Most High, also says: ““Verily! Allah commands you that you should render back the trusts to those to whom they are due”.<sup>16</sup> Allah, the Most High, also says: “Oh you who believe! Eat not up your

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<sup>12</sup>. Ibn Majah, M.Y. op. cit. at p. 228.

<sup>13</sup>. Muhammad Al-Tabataba’i, Compensation for Damage and Fine for Late Payment of Debts: An Applied Study on Islamic Financial Institutions in the State of Kuwait: *Deliberation at the International Shariah Scholars Dialogue* (2006) 84 <<https://pdfs.semanticsscholar.org>> accessed 7 January 2022.

<sup>14</sup>. Mohamad Akram Laldin, The Principles of Compensation and Penalty Charges in Dealing with Loan Default in Islamic Finance: *Deliberation at the International Shariah Scholars Dialogue* (2006). 135.

<sup>15</sup>. Qur’an 17:34

<sup>16</sup>. Qur’an 4:58

property among yourselves unjustly except it be trade amongst you by mutual consent”.<sup>17</sup>

The above texts had highlighted the necessity of fulfilling contract, rendering back trust, the prohibition of devouring property unjustly and delay in meeting with the deadline without the consent of the owner of the property because this is considered as eating up property or benefiting from it unjustly. Therefore, the defaulter becomes unjust for the loss incurred by the owner of the property, and he also responded for the loss incurred by the owner due to his default.

They also relied on the *Hadith* in which Abu Hurairah narrated that the Prophet, peace and blessings of Allaah be upon him said: “Delay by a rich person (in payment of debt) is a tyranny.”<sup>18</sup> This *hadith* considers an intentional delay in debt payment by a person, who can pay, is a tyranny. Similarly, they relied on the legal maxim that says: “Neither harming nor reciprocating harm (in Islam).”<sup>19</sup>

The second opinion does not allow for the payment of penalty by a defaulter who is capable of settling the debt if it is not stipulated in the contract. This is the opinion of the Islamic Fiqh Academy affiliated to the World Muslim League, the Islamic Fiqh Academy affiliated to the Organisation of Islamic Conference (OIC), and the *Shariah* Council of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).<sup>20</sup> This is also the opinion of other contemporary scholars which include Ahmad Fahmi Abu Sunna, Nazih Kamal Hammad, Ali al-Salus, Shaykh Taqi al-‘Uthmani, Muhammad Shabir, Muhammad al-Qari and many others.<sup>21</sup> They argued that financial compensation for delayed payment in this day and age is very different from the practice that existed during the era of Prophet Muhammad (PBUH), which was known as the era of the righteous caliphs. The teachings of Islam were adhered to strictly here, and punishing rich procrastinating debtors took

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<sup>17</sup>. Qur’an 4:29

<sup>18</sup>. Al-Bukhari, M.I. op. cit at p.1963

<sup>19</sup>. Ibn Majah, M.Y. op. cit. at p.228.

<sup>20</sup>. Ibid

<sup>21</sup>. Ibid

place by way of *Ta'zir*, such as imprisonment and lashes, not seizing of wealth.<sup>22</sup> The scholars who take this view argued that the *Hadith*, which mentions that procrastination on the part of a rich man will compromise his honor does not specifically indicate the permissibility of compensation. In fact, according to them, there is no *Hadith* or scholarly view that can be interpreted to allow for compensation. Even the legal maxim that says: “Neither harming nor reciprocating harm (in Islam)” could not be referred to as removing one harm does not include substituting it with another. The resolutions of the Islamic Fiqh Academy affiliated to the World Muslim League stipulate, “If a creditor stipulates to the debtor or imposes on him to pay an amount of money as a specific financial penalty or a certain percentage if he delays in settling the debt within the specified period between them, it is a condition or a loan that is invalid. It should not be fulfilled because this is essentially the *riba jahiliyyah* which the *Quran* was revealed to prohibit”. *Riba jahiliyyah* is a type of late payment charge that is generally acknowledged by scholars to be prohibited. This type of *riba* was practiced in pre-Islamic Arabia during the time of *jahiliyyah* or ignorance. *Riba jahiliyyah* occurs when Islamic banks ask debtors to settle their debts on time with the option for postponement as long as the debt is increased. The prohibition of *riba jahiliyyah* also has a moral basis in that a debtor in difficulty should be given respite instead of having further hardship imposed upon him.<sup>23</sup>

Considering the above two views, it is the considered opinion of this paper that the view of proponents of penalty imposition is more cogent. This is because where defaulters are allowed to get away with their defaults, especially in cases where the defaulter has the ability to honour his obligation, that would amount to consuming wealth in an unjust manner. Doing so will be at conflict with one of the objectives of the *Shari'ah* which the protection of wealth. However, extra care

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<sup>22</sup>. Zulkipli, Z.N. op. cit at p. 187.

<sup>23</sup>. Ibid

should be taken to avoid its stipulation ab-initio or its relaxation in the case of the person who is incapable of repaying.

### 1.5 Determining the amount to be paid as penalty

The second issue is the method of determining the amount to be charged that will be fair to both the debtor and the creditor. It is maintained that the charge must be based on the actual loss incurred by the bank as the creditor.<sup>24</sup> Loss in term of a financial transaction includes the cost that banks have to incur to secure the full payment of the debt that has been granted to the debtor. Cost is of two types, direct like the cost of documenting the debt and indirect like the employees' wages and the rent of the operating office. AAOIFI in its *Shariah* Standard No. (19) stipulates that Islamic financial institutions can only charge direct costs and expenses related to the disbursement of the debt. Therefore, the majority of Muslim jurists have agreed that all administrative costs and expenses related to the debt or financing must be borne by the debtor, as the purpose of the service and expenses is to facilitate the disbursement of such debt. In such a case, any costs that are charged over and above the amount of direct and actual incurred costs will be considered as *riba*.<sup>25</sup>

However, in situations where debtors are required to pay compensation for deliberately delaying the payment while being capable of paying immediately, both direct and indirect costs may be permitted to be included in the compensation amount. This is because direct costs alone are not sufficient to cover the losses incurred. Financial institutions incur expenses in tracking down the debtor throughout the default period. Therefore, these indirect costs should be included in the compensation as well. Contemporary scholars such as those in AAOIFI are of the opinion that the payment for compensation must be in accordance with the value of actual loss incurred (AAOIFI, 2015). In any case, the bottom line is the

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<sup>24</sup>. Lahsansa, A.op. cit. at p.285.

<sup>25</sup>. Ibid



creditor does not make any profit out of the default committed by the debtor. The compensation imposed is just enough to cover the cost for the recovery process.<sup>26</sup> However, where the delay is not deliberate on the part of the defaulter, such a defaulter will nonetheless bear the penalty.

### 1.6 Dealing with the proceeds from the default payment charge

Contemporary Muslim scholars have discussed the issue of proceeds from default payment extensively. They have argued that the proceeds from the default payment must be channeled to charitable organizations to avoid involvement in *riba*.<sup>27</sup> This is in line with the objective of the Shari'ah on the protection of wealth and morality. The idea is to not to have anything to do with such income since the source is questionable. Imam Ibn Qayyim also mentioned that the imposition of penalty in the form of property is allowable in certain situations in Maliki, Hanbali and one of the opinions of the Shafi'i school.<sup>28</sup>

The *Shari'ah* Supervisory Council of ABC Islamic Bank has also issued a *Fatwa* that late payment penalty can be imposed by stipulating it as a condition in *Murabahah* contracts (*al-shart al-jaza'i*) as a deterrent to delay in payment, provided that it is channeled to charity. Bank is not allowed to receive any profit out of this penalty (Fatwa No. 17/1). It further stated that any proceeds of late payment penalty either through stipulated condition in a contract (*al-shart al-jaza'i*) must be channeled to charity.<sup>29</sup>

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<sup>26</sup>. Abdullah, A. op. cit at p.32.

<sup>27</sup>. Lahsansa, A. op. cit. at p.294.

<sup>28</sup>. Ibn Qayyim Al-Jawziyyah, *I'lam al-Muwaqqi'in an Rabbil Alamin*, (Pustaka Azzam, 2000) 98.

<sup>29</sup>. Lahsansa, A. at p.295.

## **1.7 The practice of delayed payment penalty in Islamic financial institutions in Nigeria**

The practice of delayed payment penalty in Islamic financial system in Nigeria is classified under the Non-Permissible Income (NPI). Recently, the Central Bank of Nigeria (CBN) issued its guidelines on the disposal of Non-Permissible Income (NPI) for Non-Interest Financial Institutions (NIFI). The guidelines provide that it is part of the duties and responsibilities of the Advisory Committees of Experts (ACE) for Institutions Offering Non-Interest Financial Services to supervise and monitor the disposal of Non-Permissible Income by the institutions.

The guideline defines Non-Permissible Income as any income that accrues to the institution in any *Shari'ah* non-compliant manner, such as interest income, penalties for delayed payment of debt obligations, or any income declared by the ACE of the institution as impermissible according to the *Shari'ah*.<sup>30</sup>

The guidelines further provide that NPI is not an object of ownership of the Non-Interest Banks (NIB) and does not confer any ownership rights on it. It further provides that the NPI shall be put in a dedicated NPI account and shall not be commingled with the funds of the NIB. The NIB is under obligation to dispose of any NPI that accrues to it. Disposing the NPI to a charitable cause is regarded as proper disposal of the NPI on the following conditions:

- a. The NIB does not stand to benefit from the charitable cause in any way, even if by goodwill.
- b. The charitable cause does not give benefit to any shareholder, director, ACE member or management staff of the NIB.
- c. The disposal to the charity shall not be constituted nor included as part of the Corporate Social Responsibility of the NIB.

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<sup>30</sup>. Guidelines on Disposal of Non-Permissible Income, (2021). Central Bank of Nigeria, <[www.cbn.gov.ng](http://www.cbn.gov.ng)> accessed 3 January 2022.

The disposal of the NPI directly by the NIB or through a third party is acceptable, provided it fulfils the conditions mentioned above.

Whether the disposal is directly by the NIB or through a third party, the ACE shall review the disposal before and after the disposal to ascertain that the conditions mentioned under Paragraph (4) above are fulfilled. The ACE shall ensure that the NIB does not delay the disposal of the NPI without justifiable cause, as any unjustifiable delay shall be tantamount to the NIB deriving benefit from the prohibited NPI. Lastly, the ACE shall submit a quarterly report to the CBN on the disposal of the NPI by the respective NIB.<sup>31</sup>

The general provisions of the guidelines are novel in the sense that, for the first time, there is a guideline in that regard to monitor the disposal of the NPI. Similarly, the guideline has made explicit provisions on the need for NIB not to use the NPI as a means of attracting goodwill to the bank. In the same vein, the issue of delay in disbursing NPI has been addressed by the new guideline. Another vital issue that is addressed by the guideline is the supervisory role of the CBN wherein the ACE is requested to submit a report to the CBN on quarterly basis.

Despite the novel provisions of the guidelines, it is worthy of note that the guideline is silent on the quantum or amount to be paid as penalty for default in delay payment. Although, the ACE are to be guided by the general provisions of Islamic Law of Commercial Transaction (*Fiqh al-Mu'aamalaat*), the explicit provision of the quantum or amount to be charged as penalty would have gone a long way in determining the percentage to be charged as penalty in cases of delayed payment.

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<sup>31</sup>. Guidelines on Disposal of Non-Permissible Income, Op. Cit. at p.3.

## **1.8 Conclusion**

From the foregoing, it is found that there are justifications in Islamic law indicating that penalty can be imposed on a defaulting party especially in cases where the defaulter has the means to pay. The *Shari'ah* does not allow for unnecessary delay in payment of financial obligation. This is, more so, especially considering the fact that the issuing financial institution will be put into distress in cases where it gives facilities and those facilities are not forthcoming. Similarly, all administrative costs and expenses related to the debt or financing must be borne by the debtor, as the purpose of the service and expenses is to facilitate the disbursement of such debt. Also, the proceeds from the default payment must be channelled to charitable organization to avoid involvement in *riba*. It is also found that the practice of delayed payment penalty in Islamic financial system in Nigeria is classified under the Non-Permissible Income (NPI).

It is hereby recommended that Non-Interest Financial Institutions in Nigeria should always comply with the relevant provisions of the CBN guideline on the disposal of Non-Permissible Income (NPI) for Non-Interest Financial Institutions (NIFI). As to the proceeds from the default payment, Non-Interest Financial Institutions in Nigeria should dispose for charitable purposes without having to benefit indirectly or attract customers through such acts. The intention should be the avoidance of dealing with such proceeds and not benefitting from them in whatever form.