



Research Notes



COST OF FUNDS – IS IT A PART OF ACTUAL LOSS (*TA'WĪD*)?

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I. COST OF FUNDS

The understanding of the cost of funds from both the conventional and the Islamic perspective differs significantly. From the conventional perspective, the cost of funds is identified as the interest cost of borrowing money expressed as a percentage. It is simply understood as the interest rate paid on an outstanding loan. The parties involved in giving out loans to the banks include savings and current account depositors, lenders through the currency market, deposits and investment certificates holders, etc. The main point of departure in the definition of cost of funds from the conventional and the Islamic perspective is the presence of interest in the former. In the case of the latter, it has been identified that the cost of funds is derived from the sources which are based on specific types of Islamic contracts only. This has been set out in Table 1 below.

Table 1:

Type of Islamic Finance Contracts	Source of Funds	Cost of Funds
<i>Muḍārabah</i>	Depositors' savings and current account, investments	No. Both banks and depositors will face both profits and losses together.
<i>Qarḍ</i> and <i>wadī'ah</i>	Depositors' savings and current account	No. Banks do not have to provide any form of returns to the depositors.
Sale-based contracts (e.g. <i>murābaḥah</i> , <i>tawarruq</i> and <i>'inah</i>)	Islamic money market, depositors' investment account, etc.	Yes. The cost of funds is the difference between the cash inflows and the refunded amount retained by the bank.
<i>Wakālah bi al-istithmār</i>	Investments account	No. Both profits and losses are borne by the depositors.

(Source: Authors' own)

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As can be seen from Table 1 above, the sources of funds in the Islamic financial institutions (IFIs) are derived from the various types of Islamic contracts. However, not all the above-mentioned contracts are attached with cost of funds. The Islamic contracts with the existence of cost of funds are only the sale-based contracts (e.g. *murābahah*, *tawarruq* and *īnah*).

II. ACTUAL LOSS

Actual loss should be determined by the IFIs through the exercise of good faith where this actual loss will be recognised for the purpose of *ta'wīd*. In the Bank Negara Malaysia (BNM) guidelines, *ta'wīd* refers to the amount that may be compensated to the IFIs based on the actual loss incurred due to default, whilst *gharāmah* refers to the penalty charged on the defaulters over and above the *ta'wīd*. The IFIs may impose combined late payment charges comprising *ta'wīd* and *gharāmah* where the combined rate shall be capped at the respective IFIs' prevailing Average Financing Rate (AFR), to be computed on a monthly basis. This combined rate shall be determined at the point of entering into the contract. Therefore if the compensation fee imposed is more than the actual loss, IFIs need to place the excess in a *gharāmah* account. This is further illustrated in the formula below.

$$C = G + T$$

where:

C = Combined Rate [Capped at the respective IFIs' Average Financing Rate (AFR)]

G = *Gharāmah* (Penalty Charged over and above *Ta'wīd*)

T = *Ta'wīd* (Compensation /Actual Loss)

III. OBJECTIVE OF RESEARCH

The aim of this research is to investigate whether the cost of funds can be treated as an actual loss for the IFIs (as a form of *ta'wīd*) and

therefore be deemed as recognisable income for the IFIs. This is to compensate for the losses incurred by the IFIs.

In order to achieve this aim, the following steps will be taken:

- Further elaborate the importance of Shari‘ah parameters of *ta‘wīd* in Islamic finance.
- Further illustrate the justifications of the industry players on the need to have the cost of funds treated as actual loss.
- Provide further elaboration on the various Shari‘ah views on whether the cost of funds can be deemed as the IFIs’ actual loss.
- Propose other possible solutions for the IFIs under the context of *maṣlahah*.

IV. SHARI‘AH PARAMETERS OF TA‘WĪDH IN ISLAMIC FINANCE

In this section, the literature on the Shari‘ah parameters of *ta‘wīd* in Islamic finance from various Shari‘ah Standard Bodies and Shari‘ah Advisory Councils worldwide is reviewed. This is further summarised and illustrated in Table 2 below.

Table 2:

Islamic Institutions/ Bodies	Fatwās
Shari‘ah Advisory Council (SAC) of Bank Negara Malaysia (BNM)	Late payment charges comprising <i>gharāmah</i> (channelled to charitable organisations) and <i>ta‘wīd</i> (actual loss) is allowed. However, it is limited to the criteria listed below: <ul style="list-style-type: none"> • <i>Ta‘wīd</i> charges are only allowed on sale-based Islamic contracts and <i>qard</i>. • <i>Ta‘wīd</i> charges are only effective after the completion of the settlement of debt agreed by both contracting parties. • IFIs can recognise <i>ta‘wīd</i> as income on the grounds that it has been identified as the actual losses faced by the IFIs. • <i>Gharāmah</i> should not be taken as income, but must be channelled to charitable organisations.
Shari‘ah Advisory Council (SAC) of Securities Commission Malaysia	<i>Ta‘wīd</i> charges are allowed based on the criteria listed below: <ul style="list-style-type: none"> • <i>Ta‘wīd</i> charges of 1% are allowed to be imposed on the outstanding balances of the customers if there are any delays in making the payments of the profit. • <i>Ta‘wīd</i> can be charged based on the rate of the Islamic interbank money market if there are late payments on the principal amount by the customers. • The maximum amount imposed for <i>ta‘wīd</i> should not exceed the amount paid in arrears. • <i>Ta‘wīd</i> obtained from the customers can be used by the IFIs according to the rate and ratio of the profit distribution.

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<p>Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)</p>	<p>AAOIFI has made several decisions regarding the imposition of late payment charges. This is further explained below:</p> <ul style="list-style-type: none"> • <i>Ta'wīd</i> should not be imposed on the debtors in case of delays in payment whether by means of placing these conditions in the beginning of the contract or through court judgements. • The debtors shall bear all costs incurred by the creditors arising from the debt settlement process, such as prosecution costs, etc. • It is permissible to state in the terms and conditions of the debt contract (e.g. <i>murābahah</i>) that in the event of delays in payment, the debtors must allocate a certain amount of money to be distributed to charitable bodies (<i>gharāmah</i>). • The decision made by AAOIFI to allow <i>gharāmah</i> is however limited to debtors with financial capacity and not otherwise.
<p>Dallah Al-Barakah</p>	<p><i>Ta'wīd</i> charges are allowed based on the criteria listed below:</p> <ul style="list-style-type: none"> • <i>Ta'wīd</i> charges are allowed for debtors with financial capacity but who delay in making the payments. This <i>ta'wīd</i> is deemed as a compensation for the harm suffered by the creditors. • Some members of Dallah Al-Barakah agree that late payment charges should only be given out as <i>gharāmah</i> (given to charitable bodies) based on the principle of '<i>maṣāliḥ mursalah</i>'. • Dallah Al-Barakah further affirms that no pre-conditions on late payment charges should be permitted between the creditors and debtors.
<p>Kuwait Finance House (KFH)</p>	<ul style="list-style-type: none"> • In default cases or late payments, creditors may request the debtors to pay off the prosecution costs, etc. However this is only allowed for debtors with financial capacity. • When the debtors experience default or late payment and due to this, the IFI is not able to make investments and losses are incurred, these losses faced by the IFI cannot be replaced with <i>ta'wīd</i> charges. This is not permissible even though the debtors may fall under the category of 'financially independent' and delays in payment are made on purpose. However, the debtors are allowed to be charged with <i>gharāmah</i> and the proceeds will then be distributed to charitable bodies, and not to be taken as income to the IFI.
<p>Indonesia Council of Scholars</p>	<p>Indonesian Councils of Scholars' analysis of <i>ta'wīd</i> charges is further explained below:</p> <ul style="list-style-type: none"> • <i>Ta'wīd</i> charges can be imposed on debtors who cause intentional harm to the creditors and violate the terms and conditions of the financial contract. • <i>Ta'wīd</i> charges are limited to actual loss and not potential loss.
<p>Organization of the Islamic Conference (OIC)</p>	<ul style="list-style-type: none"> • In cases of delay in payments, <i>ta'wīd</i> charges are not permissible as this violates the rulings of Shari'ah. • Late payment charges should not be imposed on buyers who delay their payments from the stipulated time given to them. This is not permissible even if it is stated as part of the contract's clauses as this is similar to <i>riba</i>'.
<p>Muslim World League</p>	<ul style="list-style-type: none"> • Stating in the contract's clauses that <i>gharāmah</i> will be charged if there are occurrences of delay in payments or default scenarios is not permissible. This is because this violates the rulings of Shari'ah.

(Source: Authors' own)

From the illustration above, it can be concluded that the majority of the Shari'ah Standard Bodies and Shari'ah Advisory Councils agree that *ta'wīd* charges can be imposed on defaulting customers. Even though AAOIFI does not literally agree with the definition of *ta'wīd*, it does allow the actual loss to be borne by customers who default. Therefore it can be concluded that the main point of departure in opinions here arises only from the technical meaning of it. Also, *ta'wīd* charges are limited to actual loss, and not potential loss. Any amount in excess of actual loss is treated as *gharāmah* that cannot be recorded as income to the bank. Instead, the proceeds should be directed to various charitable bodies.

There is no clear parameter on the definition of actual loss. However, from the various examples given on actual loss (also categorised as out of pocket costs); it can be formulated as follows:

1. It is agreed that the defaulting customers will incur the necessary costs payable to the third party for the services provided by them in claiming the costs of debt from the defaulting customers, for e.g. lawyers' fees, auction fees, storage fees, assessment fees, etc.
2. Additional costs incurred due to the fact that the customers defaulted, for e.g. communication costs, etc.

V. JUSTIFICATIONS OF INDUSTRY PLAYERS FOR COST OF FUNDS TO BE TREATED AS ACTUAL LOSS

The various justifications by industry players in defining the cost of funds as the actual loss are as stipulated below:

1. Some of the banks believe that the cost of funds is not a profit to the bank. In fact, it is the actual loss paid by the banks to the depositors. The banks believe that they should be allowed to charge the actual loss from the customers who default. This is because the delay in making payments by the defaulting customers will incur further losses to the banks. Also, lawyers' fees, etc. are not sufficient to compensate for the losses incurred by the banks when the customers default.
2. Malaysian depositors are very sensitive to the changes in the rates of return. They prefer to invest in financial institutions that guarantee the best returns. However, on occasions where the customers default, the banks may not be able to achieve the rates of return as measured by indicators. This may cause the depositors to flee, as well as adversely affect the liquidity of the bank's financial position.
3. In reality, the IFIs in Malaysia still adopt the role of a financial intermediary. This leads to negative effects for the banks in fulfilling their responsibilities to the depositors when the customers default. It is important to take into account the welfare of both parties (customers and depositors) to ensure both financial and economic stability.

4. Some banks look into the concept of *maṣlahah* when taking into account the cost of funds as the actual loss. This is because if the cost of funds is not being taken care of properly, it may disrupt the normal activities of a financial institution – depositors will flee, banks' earnings will be affected, financing activities will come to a halt, and it will adversely affect both the reputation and image of the IFIs.

VI. VARIOUS SHARĪ'AH VIEWS ON WHETHER COST OF FUNDS CAN BE TREATED AS ACTUAL LOSS

Before any forms of establishment are accepted, including the cost of funds as the actual loss, it is only appropriate to study some of the Sharī'ah views provided by the various Sharī'ah Standard Bodies and Sharī'ah Advisory Councils. This is as stipulated below:

- The cost of funds present in an Islamic financial system and a conventional financial system greatly differs. From the conventional perspective, all sources of funding evoke costs. However, from the Islamic perspective, the source of funds is based on certain types of Islamic contracts, some of which come with costs while others do not. Thus, the above justifications from industry players do not have a solid foundation from a Sharī'ah perspective.

Based on the above facts, the cost of funds distributed to the IFIs' depositors is, in fact, not exempted from the two conditions below:

1. Distributions made to parties who should not be receiving any distributions if no profit is made – depositors and investors of contracts like *mudārabah*, *qard*, *wadī'ah*, and *wakālah bi al-istithmār*. In this case, there is no basis of Sharī'ah to impose the cost of funds on the defaulting borrowers as it is certainly not within the duty of the banks to also distribute the cost of funds to both the above-mentioned depositors and creditors.
2. The payment of cost of funds should be made to the sale-based financing contracts' depositors and investors. From the

perspective of Sharī'ah, there are two independent contracts – the first contract is between the bank and both the depositors and investors and the second contract is between the bank and the customers. Banks are entitled to pay cost of funds to both the depositors and investors due to the obligations arising from the contract. However, the customers should not be held responsible for this situation. This is because the bank and the customers are holding onto an independent contract—a contract by itself.

- To accept cost of funds as the actual loss of the bank from the context of *maṣlahah* can be taken into consideration if all the principles and conditions of *ḍarūrah* (necessity) are fulfilled. *Ḍarūrah* can be established based on strong evidence, in the absence of any authorised *wasīlah* (means), and affirmation that it will not inflict greater harm.
- Any *fatwā* decisions should take into consideration the principle of *ma'ālāt al-af'āl'*, that is, the consequences of an action. Additional charges incurred due to default funding may lead to *ribā al-nasī'ah*, which was prominently practised during the period of Jāhiliyyah.

VII. POSSIBLE SOLUTIONS FOR THE IFIS IN THE CONTEXT OF *MAṢLAḤAH*

After looking into various aspects of Sharī'ah, it has been concluded that the cost of funds cannot be treated as actual loss. However this does not mean that it cannot be addressed through other ways that are permissible in the context of Sharī'ah. Some of the proposed solutions which are based on the various Islamic finance contracts are found below.

1. For funding based on sale-based financing like the contracts of *murābahah*, *tawarruq* and *'inah*:

In the case where a customer defaults, the bank should claim full selling price. The *ibrā'* formula adopted should take into consideration the settlement date of the defaulting customer, and

not the default date. Banks should develop a new *ibrā'* formula to accommodate the cost of funds.

2. For funding based on partnership-based financing like the contracts of *muḍārabah* and *musharakah*:

Further emphasis should be given to the methods of managing the profit and loss. For example, more efficient ways of managing the profit equalisation reserve (PER) or a Sharī'ah-compliant method such as *tanāzul* (withdrawal methods), etc.

3. For funding based on lease-based financing like the contract of *ijārah*:

Ijārah for financing purposes will usually terminate with ownership (*muntahiya bi al-tamlīk*). In the case of default, the formula used to state the selling price of the leased asset, taking into consideration all the costs involved (inclusive of cost of funds), should be introduced. The *ibrā'* formula adopted should take into consideration the settlement date of the defaulting customer, and not the default date.

The above-mentioned proposals are not new innovative ideas in the Islamic finance industry. However, further serious consideration should be given to them in order to strengthen and facilitate the IFIs in managing their cost of funds.

VIII. CONCLUSION

Based on the reasons stated earlier, the research has taken the approach that cost of funds cannot be treated as actual loss that can be recognised as revenue of IFIs. However, the research affirms and agrees on the importance of cost of funds in bringing stability to IFIs, especially in handling the behaviour of IFIs depositors. This is because the IFIs' depositors are still not able to understand completely the functions of the various Islamic finance instruments. This understanding is further enhanced in Malaysia where the implementation of the Islamic financial system is in line with the conventional banking system. Even though the cost of funds cannot be identified through *ta'wīd*, this research proposes various ideas in reducing the burden of the IFIs in handling defaulting customers, like restructuring the *ibrā'* formula, strengthening the PER, etc.

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