

THE SHARĪ'AH BASIS FOR IMPOSITION OF FEES AND CHARGES IN ISLAMIC BANKING PRODUCTS AND SERVICES

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ABSTRACT

This research is essentially intended to explore relevant Shari'ah principles that may underlie imposition of fees and charges in various Islamic banking products and services (IBPS). It also aims at constructing a Shari'ah parameter for imposition of fees and charges in IBPS. This is a library research in which data has been collected from various materials such as classical *fiqh* books, regulators' policy guidelines and journal articles. In addition, deductive and inductive methods have also been employed to analyze the data critically in search for conclusive findings. The expected outcomes of this research may be in the form of a Shari'ah-compliant guide for practitioners and industry players in relation to the imposition of fees and charges in various products and services under different banking portfolios.

Keywords: Islamic Finance, Fees and Charges, Shari'ah Principles, Shari'ah Parameters

İSLAMİ BANKACILIK ÜRÜN VE HİZMETLERİNDEKİ ÜCRET VE HARÇ UYGULAMALARI İÇİN ŞERİAT TEMELİ

ÖZ

Bu araştırma, temelde, çeşitli İslami bankacılık ürünleri ve hizmetlerine uygulanan ücret ve harçların altında yatması muhtemel ilgili şeriat ilkelerini inceleme amacını taşımaktadır. İlaveten, İslami bankacılık ürünleri ve hizmetlerine uygulanan ücret ve harçlar için bir şeriat parametresi geliştirilmesinin amaçlamaktadır. Elinizdeki çalışma, verilerin fıkıh kitapları, düzenleyicilerin politika önerileri ve dergi makaleleri gibi kaynaklardan elde edildiği bir araştırmadır. İlaveten, nihai sonuçları arama maksadıyla veriler kritik bir şekilde analiz edilirken hem tımdengelsel hem de tümevarımsal yöntemler kullanılmıştır. Bu araştırmanın beklenen sonucu, farklı bankacılık portföyleri altında çeşitli ürün ve hizmetlere uygulanan ücret ve harçlarla ilişkili olarak uygulayıcılara ve endüstri aktörlerine şeriata uyumlu bir rehber sunma yönünde olabilir.

Anahtar Kavramlar: İslami finans, ücret ve harçlar, şeriat ilkeleri, şeriat parametreleri

As a financial intermediary, an Islamic financial institution (IFI) generates income from two essential types of products and services namely, fund-based and fee-based. Income generated from the former is called funded income while income generated from the latter is customarily termed as non-funded income. As for the former, an IFI has to pay for the cost of the fund which implies that it has to share any profits generated with parties from whom the fund has been sourced such as depositors and shareholders. Unlike its fund-based products, the bank may include all incomes generated from fee-based products under its income (Profit and Loss) statement. On this basis, the IFI would prefer to opt for fee-based products and services. There is no clear Sharī'ah basis for imposition of fees and charges in Islamic banking products and services (IBPS), however there are certain Sharī'ah principles that only allow imposition of fees and charges at actual cost or actual loss incurred by IFI. There are also Sharī'ah principles that justify charging more than actual cost on the basis of the principle of 'willing buyer, willing seller'. This is viewed as significantly beneficial to the IFI as the alternative is that the allowable charge is confined to actual costs incurred by the IFI. The research indicates that generally there are two Sharī'ah principles that require imposition of charges at actual amount namely *ta'wīd* (compensation) and *nafaqah* (cost/expenses). These principles specify that the charges have to be limited to the actual cost or actual loss incurred by IFI under certain situations such as default and breach of promise.

In general, an Islamic financial institution (IFI) may prefer fee-based products and services over fund-based products and services. It may want to charge various fees for specific services or transfer relevant operational costs to its customers under different portfolios of the IFI such as corporate banking, consumer banking and global markets. The issue at hand is the absence of clear Sharī'ah basis and parameters for the imposition of fees and charges that can justify the practice of charging certain fees and charges to customers. This is significant in view of the fact that IFIs offer many debt-based products that are subject to the Sharī'ah rulings on debt. Thus, this research seeks to identify relevant Sharī'ah principles that may constitute the basis for imposition of various fees and charges. For example, an IFI imposes a compensation charge for actual financial loss suffered on account of customers' late payment of its fund-based products such as financing facilities. In this case, it is obvious that the objective of imposing such a charge is to cover the actual loss suffered by the IFI. Thus, the relevant Sharī'ah principle that may justify this practice is *ta'wīd* (compensation). In fee-based products such as funds management service and money

remittance service, the IFI imposes a fund management fee and a SWIFT fee on its customers. In this case, the IFI may incur a marginal or variable cost that it needs to recover to break even. Any amount in excess of the marginal cost is marginal revenue for the IFI as a service provider. The ultimate objective of the IFI in imposing such fees is to generate profit from the customers who enjoys such services. It is clear that the ultimate objective of charging the customer differs markedly between the two cases. In consequence, the Sharī'ah principles that form the legal basis for imposition of the charge and the fee mentioned above are also very different. This causes a difference in the amount that the bank can charge; i.e., whether it is limited to the actual amount. This research will concentrate only on two Sharī'ah principles that form the basis for imposition of fees and charges namely *ta'wīḍ* and *nafaqah*. The scholars' views on the above Sharī'ah principles as well as the reason for which the IFI imposes certain fees and charges are examined to scrutinize their applicability in the imposition of certain fees and charges. Based on the above Sharī'ah basis, this research attempts to propose general Sharī'ah parameters for imposition of fees and charges in Islamic banking products and services. As both Sharī'ah principles only justify charging at actual cost, this research also embraces the issue of actual financial loss and actual costs incurred by IFI in certain situations.

This research is qualitative in nature and seeks to rely on both primary and secondary sources of data. Secondary sources of data include relevant documents such as guidelines on the imposition of fees and charges issued by the Bank Negara Malaysia (BNM). Library research was also employed in this study to examine relevant Sharī'ah principles that may form the Sharī'ah basis for imposition of fees and charges in Islamic banking products and services. The *fiqh* literature of various schools of thought was examined to explore the scholars' views on the inherent nature of the Sharī'ah principles that justify the imposition of fees and charges. Accordingly, the research is organized as follows: **Section 2** examines the overview of fees and charges in the context of actual loss and actual cost in Islamic banking products and services. **Section 3** delineates the two Sharī'ah principles that constitute the basis for imposition of fees and charges namely *ta'wīḍ* and *nafaqah*. **Section 4** proposes the Sharī'ah parameters for imposition of fees and charges in Islamic banking and **Section 5** concludes the discussion.

Overview of Fees and Charges in the Context of Actual Loss and Actual Cost in Islamic Banking Operation

This section explicates the concept of fees and charges as customarily construed by the fraternity of Islamic finance industry. In addition, it is also important to examine the overview of related concepts such as actual loss and actual cost as they are always considered in determining the amount and rate of certain fees and charges. Under certain contractual arrangements such as one that is based on a loan (*qard*) contract, the IFI may charge only actual costs that is incurred in providing such a loan to the customer.

The general meaning of 'fee' is "an amount charged for a service performed". For example, a stockbroker charges its clients a fee for buying and selling shares, and an accountant charges a fee for carrying out a company audit. (Clark, 2000, 148). The general meaning of 'charge' is "an obligation to meet a debt, a debit to an account, or the process of debiting" (Clerk, 2001, 44). This implies that a charge is imposed on a person when there is a fee payable to the provider of a specific product or service.

In the context of Islamic banking operations, it is customarily understood that the term 'charge' is typically related to products offered by an IFI that are tangible in nature such as current accounts, safe deposit boxes and credit cards. The term 'fee', as opposed to the term 'charge', is customarily related to services provided by an IFI that are intangible in nature such as a sukuk issuance arranged by the IFI. As a financial intermediary, an Islamic bank is an 'expert' in handling other people's money through its fund-based and fee-based products and services. This requires the bank to remain efficient and robust in its operation so as to avoid operational risk as well as other risks that may result in financial loss in the sense that such financial loss may impact the bank's profit and loss account and hit its balance sheet. It is important to understand that financial loss in the context of banking operation may be actual or non-actual or estimated or opportunity-loss particularly when the bank opts for accrual basis for its accounting treatment. There will be a case where the bank may face the so called 'paper loss' in the event that the profit has already been accrued but unearned due to various reasons like early settlement of debt facility by the customer on the asset side. This situation may seem like an estimated loss but in fact, it may also become a real loss. For example, such events may have a significant impact on the dividends that the bank will declare for its *muḍārabah* investment account holders. If the dividend declared is lower than expected, this may not be attractive to the *muḍārabah* account holders and will eventually impact upon deposit

mobilization. In such a case, the IFI may impose a charge on those customers who exercise early termination of an Islamic financing facility to cover such financial loss.

The Sharī'ah Basis For Imposition of Fees and Charges in Islamic Banking

In general, the imposition of fees and charges involves the transfer of property from one party to another as payment for a service or a cost incurred in rendering a service. This exercise is permissible via certain mechanisms approved by the Sharī'ah such as specific causes of ownership (*asbāb al-milk*) (al-Zuhaylī, n.d.: 4/5). This is significant to ensure that each fee and charge is not imposed out of nothing which would otherwise constitute taking another's property without right.

In general, there are at least four Sharī'ah principles that may form the legal basis for imposition of fees and charges in Islamic banking operation namely, (1) compensation (*ta'wīd*), (2) expenses (*nafaqah*), (3) penalty (*gharāmah*) and (4) *ujrah* (wage) for a service. However, this research will elaborate only on two Sharī'ah bases for imposition of fees and charges in Islamic banking products and services namely, (1) compensation (*ta'wīd*), and (2) expenses (*nafaqah*). These two Sharī'ah bases will be examined in the context of actual loss and actual cost in Islamic banking operation whereby the IFI discharges its role as a financial intermediary.

Ta'wīd as the Sharī'ah Basis for Imposition of Fees and Charges

Sharī'ah allows imposition of *ta'wīd* upon an individual when his action inflicts harm (*ḍarar*) on a transacting counterparty. In the context of Islamic finance, *ta'wīd* is imposed by IFIs in the following situations:

- i. Default (*mumāṭalah*) in payment of a debt: In the event of default, *ta'wīd* can only be imposed on a solvent defaulting customer (*mūsir*) and not on an insolvent defaulting customer (*mu'sir*). However, the chargeable rate or amount of *ta'wīd* shall be limited to the actual harm or loss suffered by the IFI due to its customer's default. This is because the actual harm or loss that can be compensated under the concept of *ta'wīd* shall be limited only to physical harm (*māddi*) or financial loss in the context of Islamic banking operations. However, scholars

have asserted that moral harm (*ḍarar ma'nawī* or *adabī*) should not be compensated under *ta'wīd*.

- ii. Breach of Promise (*ikhilāf al-wa'd*): In case of a breach of promise by the IFI's customer, it may seek compensation for actual loss that it suffered. For example, in a *murābahah* to the purchase orderer (MPO) transaction, the IFI is allowed to request security from the customer (*hāmish jiddiyah*) for the following purposes: (1) to demonstrate the customer's financial ability and (2) to demonstrate the customer's ability to pay *ta'wīd* for actual harm or loss suffered by the IFI in case of breach of promise by the customer. In this regard, the Shari'ah Standard on Murabahah Contract issued by the Central Bank of Malaysia on 23 December, 2013, pronounced (Bank Negara Malaysia, 2013:20):

"17.10 The seller may require the purchaser to place a security deposit (*hāmish jiddiyah*) to secure the undertaking to purchase the asset. "17.11 The security deposit may be used to compensate against actual loss incurred in the event the purchaser fails to purchase the asset from the seller."

The AAOIFI Shari'ah Standard No. 2/5/3 states:

It is permissible for the institution, in the case of a binding promise by the customer, to take a sum of money as *hāmish jiddiyah* (i.e. security deposit). This is to be paid by the customer at the request of an institution, both as an indication of the financial capacity of the customer and to ensure the compensation of any damage to the institution arising from a breach by the customer of his binding promise. Having taken this *hāmish jiddiyah*, the institution need not to demand compensation for damages as this may be charged against the *hāmish jiddiyah*.

- iii. *Sharṭ jazā'ī* (a punitive condition) in the context of delay in the completion of specific work and late delivery of an *istiṣnā'* asset to the purchaser (*mustashī'*). *Sharṭ jazā'ī* is a mutual agreement between the contracting parties on the amount of *ta'wīd* to be paid to the party who suffered loss or bore harm on account of the other party's failure to meet his contractual obligation or his delay in fulfilling the contractual obligation. However, it is not permissible to stipulate a punitive condition (*sharṭ jazā'ī*) in a debt-based contract like *salam* or a deferred sale. This is to avoid *ribā* in the form of an increment due to the extension of the time of the debt payment. A *salam* contract is considered a debt-based contract because the commodity to be delivered is a debt (*dayn*) liability on the part of the seller. Thus,

stipulation of a punitive condition in a *salam* contract may amount to *ribā* because the amount payable to the buyer under the precept of the punitive condition is an increment on account of a delay in delivery of the commodity being sold. Resolution No. 109 (12/3) issued by the International Islamic Fiqh Academy states:

Second: The Academy emphasizes its previous resolutions on the punitive condition (*sharṭ jazāʾī*) as stated in its resolutions on *salam* (Resolution No. 85 (9/2)): "It is not permissible to stipulate *sharṭ jazāʾī* for a delay in delivery of the subject matter of the *salam* contract (*musallam fih*) because it is a debt, and it is impermissible to stipulate any increment due to a delay in paying a debt", and its resolution on *istiṣnāʾ* (Resolution No. 65 (7/3)), which states: "The *istiṣnāʾ* agreement may comprise a punitive condition based on mutual agreement of the contracting parties provided that *force majeure* [is not the cause of the delay]" and its resolution on instalments sale (Resolution No. 51 (6/2)) which states: "If the debtor delays the payment of an instalment beyond the specified term, it is not permissible to impose on him any increment on the principal debt by an upfront stipulation of a condition or without a stipulated condition because it is deemed *ribā*."

Third: It is permissible to stipulate a punitive condition in association with the underlying contract as it is also permissible to stipulate it later (after the execution of the contract) prior to occurrence of harm.

Fourth: It is permissible to stipulate a punitive condition in all financial contracts except one based on a debt obligation. Indeed, the stipulated punitive condition in such contract is considered clear *ribā*.

Based on the above resolutions, the view of AAOIFI is adopted in this paper because *taʿwīḍ* in the context of a punitive condition is not related to payment of a debt (*ḍayn*); rather, it is related to delivery of a particular asset (*ʿayn*), which will not give rise to *ribā*. As it is established that the IFI can only compensate for actual loss under the principle of *taʿwīḍ*, it is important to explain the general overview of actual loss from the Sharīah viewpoint. This is because the industry users are facing the issue of how to determine actual loss so that they can regard it as an actual cost to be passed on to the defaulting customer.

Sharīah Perspective on Actual loss (AL) (الضرر الفعلي)

As a financial intermediary, the IFI's efficiency in liquidity management is determined based on its financing to deposit ratio whereby the amount of an IFI's financing is divided by the amount of its deposits at any given

time. A high ratio means greater efficiency on the part of the bank in utilizing deposits and managing the cost of its operation. In reality, most of the deposits will need to be paid back to the depositors over a certain period of time. In comparison, a bank will usually provide Islamic financing for a longer period to its customers. Hence, when a bank provides long-term financing from much shorter maturity funds, the situation is called asset liability mismatch. On account of this scenario, there are various charges imposed by the IFI on its customers due to the customers' breach of terms and conditions of the products and services. This is intended to compensate for financial losses suffered by the bank particularly in relation to asset liability mismatch.

However, the charges assume different names such as commitment fee, early withdrawal fee and early termination fee depending on the products. For instance, in the event of early withdrawal by the customers in a term deposit, the bank would have to borrow funds at a certain rate, such as the inter-bank money market rate, because the bank has already utilized the deposited money for investments and therefore thus cannot provide utilize the deposits to repay those depositors who exercise pre-mature withdrawal particularly in certain jurisdictions. Scholars argue that an IFI can impose a compensation charge on its customers to cover actual loss suffered due to the customers' default and breach of a binding unilateral promise. However, they do not spell out the concept of *ḍarar fi'lī* (actual damage) in the context of banking operations where the IFI acts as a financial intermediary. As a financial intermediary, an IFI mobilizes funds from various sources and utilizes it to generate assets as much as possible via different financial instruments.

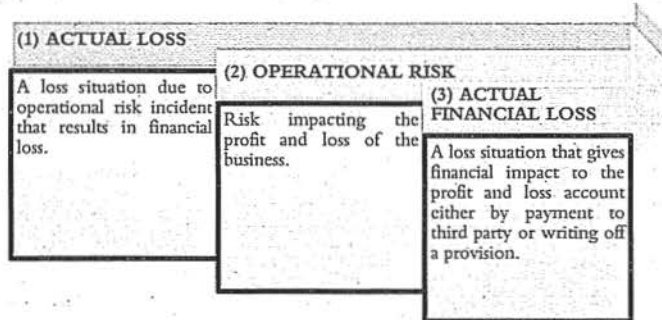
In fact, there are many situations where the IFI may be considered to have suffered a loss whilst financial loss as per the banking concept and banking operations is of many different types some of which may be actual and others may not be actual but rather they are estimated loss or opportunity loss. Thus, it is important to evaluate the concept of *ḍarar fi'lī* from Islamic jurisprudential perspective which includes specific parameter of *ḍarar fi'lī* acceptable to Sharī'ah. This parameter is primarily intended to guide industry practitioners in matters pertaining to identification of actual financial loss for which the bank can be compensated fairly and justly. This is because not all kinds of *ḍarar* can be taken into account when considering compensation payable to the bank particularly in respect of the actuality of the damage as certain financial losses claimed by the bank consist of opportunity loss which according to some jurists is not subject to financial compensation. For example, in the case of the prepayment of a debt facility, the bank may suffer a financial loss because the deposit money that the bank

sourced at a cost is also subject to liquidity cost in the form of payment for statutory reserves as required by the regulator but yet the deposit for the remaining months of the financing tenure is non-income generating. The question at hand is whether this situation is considered actual financial loss that the bank can charge to the customer who caused the damage.

Definition of Ḍarar (damage)

Literally, the word *ḍarar* is the opposite of benefit, and it is used to refer to a lousy situation (*sū' al-ḥāl*), poverty, distress of disease and body (Mu'jam Maqāyīs al-Lughah, p. 598, Lisān al-'Arab, p. 4/482). This is explained by Allah in the following verse: "Truly distress has seized me" (Sūrah al-Anbiyā', 83). Technically, the word *ḍarar* (damage or harm) refers to every injury/harm that inflicts to a person, whether in a permissible and protected property, or protected body, or protected honor (Muḥammad Būsāq, al-Ta'wīd 'an al-Ḍarar fī al-Fiqh al-Islāmī, p. 68). In respect of banking operations, actual financial loss can be construed as depicted on diagram (1).

Diagram 1: Definition of actual financial loss in banking operation



Conditions of Financial Compensation for Damage

The scholars stipulate that the Sharī'ah maxim: "Harm is to be eliminated" could be relied upon in the context of harm caused in Islamic finance transactions and that this harm could be removed by financial compensation. However, the term compensation is more specific than that of damage (*ḍarar*), as not every damage could be eliminated by way of financial compensation. Thus, jurists mention several conditions need to be satisfied for entitlement to financial compensation in the case of damage

(‘Alī al-Khaffī, al-Ḍamān fī al-Fiqh al-Islāmī, p. 48), which are as follows (Salmān al-Dakhīl, al-Ta’wīḍ ‘n al-Aḍrār al-Mutarattibah al-Mumāṭalah fī al-Duyūn):

The first condition: the damage should be related to property because there is no guarantee for things which are not of property type like a dog or a dead body or spilled blood.

The second condition: the property should be permissible and owned by the person who was affected by this damage. This includes what is owned through permissibility (al-mubāḥ). Thus, it is not obligatory for a Muslim to guarantee the destruction of alcoholic drinks or liquor and that of a pork as the element of permissibility of property (taqawwum) is absent in both examples with regard to the rights of a Muslim (‘Alī al-Khaffī, p. 169).

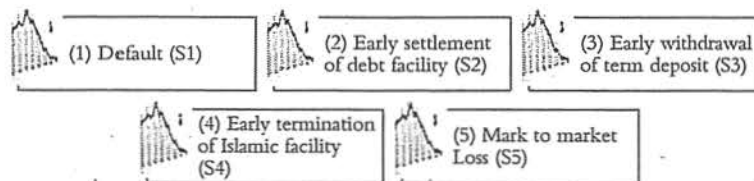
The third condition: the obligation of financial compensation must provide some benefit which means that the financial compensation shall possibly lead to securing the right and elimination of the damage so that the obligation of financial compensation is not in futility in the sense that it does not materialize the right of the affected person. Hence, a Muslim shall not guarantee the destruction of the property owned by a non-Muslim who wages war on Muslims (kāfir ḥarbī).

The fourth condition: the person who did the damage must be qualified to assume responsibility to guarantee which means that he has to possess the capacity to acquire rights (ahliyyah al-wujūb) and this capacity to acquire rights is established in every human without any restriction and condition.

The fifth condition: the damage has actually occurred and remained persistent. Thus, there is no guarantee in the case of an adverse act (an act that may cause damage) which does not cause actual damage or the damage caused does not persist for example someone digs a hole in the road, and another person falls in the hole but no harm is inflicted on him. Similarly, there should be no guarantee for damage which is expected to happen, damage of opportunity loss or moral damage.

Situations of actual financial loss in the context of banking operations

It is important to assess different situations of actual loss that an IFI may suffer in its day to day operations which may hit the bank’s balance sheet and result in the IFI incurring certain costs payable to a third party. The situations of actual loss can be summarized in the following diagram:

Diagram 2: Situations of Actual Financial Loss

It is also important to examine the impact of the above situations on the bank's operations particularly in terms of: (1) the bank's capital and (2) its liquidity requirements. This can be explained as follows:

S1: Default

In the event of default by the bank's customers, the bank will suffer financial loss due to the fact that it has to incur two (2) different costs namely, (i) operational cost and (ii) cost of capital.

The operational cost refers to the actual cost that the bank incurred for debt recovery processes which includes direct labour cost as well as direct material cost. In fact, this cost covers cost of operation in the remedial and business unit to recover the outstanding amount. Specifically, the operational cost includes the cost of incremental resources, notices of reminder, follow-up calls and regular reports generated to monitor customer's accounts. On the other hand, the bank incurs cost of capital in the event of non-prompt payment cases whereby the cost of capital may be based on the incremental expected loss (EL) and risk weighted assets (RWA) from the non-prompt payment of one month. The event of default may lead to capital deduction as the regulatory requirement is that the bank has to set a provision for bad accounts which is due to default case. In the case that the bank's capital is heavily deteriorating, the bank may have to top up the capital to enable its continuous operation as per the regulatory requirements. In-depth Shari'ah deliberation on this matter is significantly necessary to determine whether this cost is considered a real loss to the bank from a Shari'ah viewpoint that entitles financial compensation (*ta'wid'ah*).

S2: Early settlement of a debt facility

A financing facility such as a mortgage or term financing granted by the bank has a maturity date for example 1 year or 5 years in which case the bank has already calculated the profit that will be accrued throughout the

financing period. In this case, the bank will look for money for the required period which will be sourced at a certain cost to be borne by the bank. However, in the case of a 5 year financing facility the customer may want to settle the debt early in year 3 (instead of at maturity at year 5) which will cause loss to the bank for the remaining 2 years accrued, but as yet unearned profit. The situation may be worsened if the rebate is made mandatory by the regulator in the event of early settlement of debt arising from a sale-based financing facility. Another example is when a customer would like to apply for financing for the tenure of three months where the bank will source money for three months from its deposit funds. In this case, both the financing facility and deposit are based on *murābaḥah* whereby after the bank calculates all statutory reserve requirements for the liquidity cost, the bank's *murābaḥah* with its depositor is at 3% while the the bank's *murābaḥah* with its financing customer is at 3.5%.

In the above case, the 0.5% is in fact not the bank's profit because it is considered the bank's liquidity cost. Thus, the 3% and 3.5% are not viewed as profit as both are intended to cover liquidity cost. Now, when the financing customer prepays one month in advance, the accounting treatment on an accruals basis will have taken into consideration that the bank has lent at 3.5% whereby the bank has 'borrowed' at 3% and will have to pay the 3% *murābaḥah* charge to the depositor for the period of three months. In consequence, the bank has one month negative carry in the sense that it has to pay the depositor while the deposit money allocated by the bank for the third month is actually a non-generating deposit. Thus, this depositor's money becomes idle in the sense that it just resides on the liability side without generating any asset. It is important to note in this case that as long as the deposit sits in the bank's liability, the bank has to comply with its statutory reserve requirements as well as certain instruments that it has to purchase. This is in fact a cost to the bank which the bank has to pay even though the bank has no more income on the financing due to prepayment or early settlement of the financing amount.

S3: Early withdrawal of term deposit

Under a term "murābaḥah based term deposit", the depositor as seller and the bank as buyer would have been agreed to a certain maturity period say three months. This means that the bank is indebted to the depositor for the period of three months. In most cases, the bank should have used the deposit money by entering into a financing facility for a specific period of time for example one year. If the depositor wants to withdraw the money after a month, the bank cannot recall the financing facility to ensure availability of the deposit money. In fact, the bank has to source funds from

inter-bank money market at a cost. This cost is a loss to the bank if not paid for by the customer. In some jurisdictions, the regulator does not allow the bank to lock in the deposit of the depositor and the depositor is free to withdraw his deposit even though both parties have agreed to the maturity date of the deposit. To resolve this, the Sharī'ah committee of some banks adopted the principle of *da' wa ta'ajjal* (accelerate your debt settlement and I give you rebate) and some other banks apply the principle of *muṣālahah* which results in a settlement amount payable to the depositor.

S4: Mark to market loss

The bank may have an instrument that is marked against a price such as an Islamic profit rate swap, sukuk or any other investment instrument that is marked against the price. If there is a price loss such as in a situation in which the current market price is lower than the acquisition price of the instrument then this difference will be charged to the capital and the bank will suffer a capital loss.

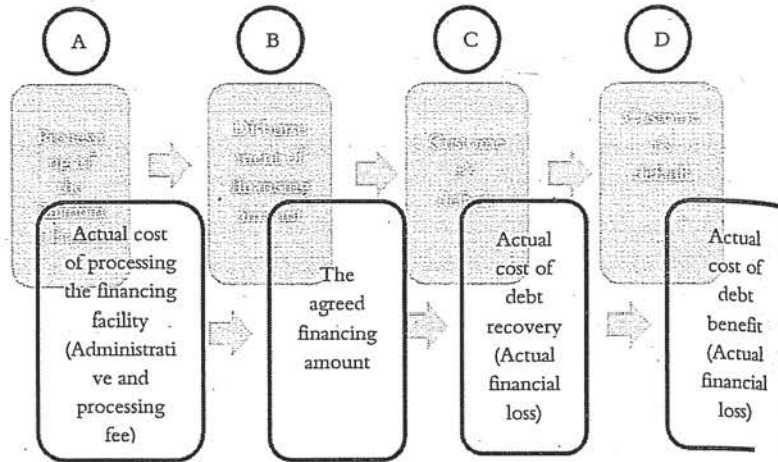
Sharī'ah Perspective on Actual Cost (AL) (التكلفة الفعلية)

Actual cost can be defined as follows: "Actual direct operating costs incurred by IFI in

- (1) providing financial services,
- (2) handling customers' default and
- (3) bearing consequences of breach of promise which may take the form of:
 - (i) direct material cost and / or
 - (ii) direct labour cost."

As established, the imposition of fees and charges on the basis of *nafaqah* and *ta'wīd* must be limited to actual costs/expenses incurred by the IFI particularly in a debt-based Islamic financing instrument in which the prohibitive elements such as *ribā* may be triggered if the charge exceeds the actual amount. It is therefore important to understand the possibility of actual loss in the life cycle of an Islamic financing facility. Diagram 2 shows the actual cost in a financing facility that can be compensated under the two bases for imposition of fees and charges namely *ta'wīd* and *nafaqah*.

Diagram 3 illustrates the position of actual cost in a particular financing facility that may lead to financial loss in the event that the IFI does not transfer it to the customer. In this context, most scholars agree that financial costs incurred by the IFI in situation (A) can be charged to the customer on the basis of *nafaqah*. Situations (C) and (D) represent financial losses to the IFI arising from the customer's default.

Diagram 3: Situations of Cost-Bearing in a Financing Facility

The financial loss in this case may include actual operational cost of debt recovery such as remedial cost, structuring cost and tracking costs as in situation (C). Scholars unanimously agree on the permissibility of passing these costs on to the defaulting customer. In conclusion, there are two situations in which the IFI can pass on the cost to the customer. They are as follows:

- i. Actual costs incurred in providing, preparing and processing a debt-based Islamic facility such as *qard*-based deposit and house financing facility based on deferred sale contract.

It is important to note that this situation is further divided into two categories.

First: the actual cost that is associated with any component (subject matter) of the underlying Sharī'ah contract such as maintenance cost and transportation cost in a murābahah contract that is related to delivery of the murābahah asset.

Second: the actual cost that is not associated with the components of the Sharī'ah contract but rather it is purely related to provision of the facility such as *qard*-based facility.

Usually, the processing fee as well as administrative fee would be charged to the customer under the **second** situation on account of preparing and processing the facility for the customer. Under the **first** situation, the actual direct costs that originally fall under the responsibility of the customer may

be included in the acquisition cost of the *murābahah* asset. However, the costs have to be direct and actual in the sense that they are not included under the general expenses of the IFI. Therefore, the costs related to the asset as a component of the *murābahah* contract like maintenance cost, delivery cost and transportation cost shall be originally borne by the customer. The research, however, suggests that the relevant Sharī'ah principle that may underlie the imposition of the above fees and charges would be the principle of '*maṣārif fi 'liyyah*' (actual expenses).

- ii. Actual financial loss incurred by IFI due to the customer's default and failure to meet his financial obligations arising from the contracts that he entered into with the IFI.

This situation can be further divided into two, namely;

- (i) actual financial losses incurred by IFI in the event of default by the customer and
- (ii) actual financial losses incurred by IFI due to breach of promise by the customer as a promisor.

Under **situation (i)**, the IFI may incur operational costs in the exercise of debt recovery which shall be originally borne by the defaulting customer. Therefore, the IFI may impose a compensation charge on the defaulting customer for the financial loss suffered due to the customer's default. Nevertheless, the Sharī'ah prescribes that the amount of compensation charge has to be actual.

Under **situation (ii)**, the IFI may incur financial loss when the customer breaks his promise in which the IFI may also stipulate a compensation charge on the promisor. For example, the customer promises to the IFI that upon approval of his application for a financing facility, he/she will sign the letter of offer to proceed with the facility. Due to his/her promise, the IFI conducts necessary actions relating to the facility in which the IFI incurs costs such as valuation costs and legal costs. Hence, in the event that the customer refuses to sign the letter of offer issued by the IFI, the customer has to compensate the IFI for the above actual costs.

Nafaqah as the Sharī'ah Basis for Imposition of Fees and Charges

From the *fiqh* perspective, the word *nafaqah* refers to "the expenses incurred by someone for the benefit of those under his responsibility. In *fiqh* literature, this is normally discussed under the subject of *nafaqāt*.

However, the intended meaning of *nafaqah* in this discussion is "the direct expenses incurred by an IFI in the execution of certain financial transactions with its customers under a particular Islamic banking instrument". For example, under an *ujrah*-based Islamic credit card, the IFI as card issuer may incur operational costs in providing the facility to its customer. They may take the form of direct material cost and direct labor

cost as per the definition of actual cost. In addition to expenses required in the provision of a facility, there are also expenses related directly to the subject matter of the financial contracts. For example, transportation cost, postal cost and storage cost (*nafaqat al-mabī'*) are associated with the delivery of the *murābahah* asset under a *murābahah*-banking instrument such as MPO. Another example is the expenses of the *muḍārib* related to utilization of the *muḍārabah* capital under a *muḍārabah*-based investment account. A third example is the maintenance cost of the pledged asset (*nafaqat al-marhūn*) in an instrument with a *rahn*-based security.

The above discussion indicates that there are certain charges in Islamic banking operations that an IFI may impose on its customers under the concept of *nafaqah*. For example, under a particular financing facility based on specific debt-based contracts such as *murābahah* and *qarḍ* the customer is required to bear the direct expenses incurred by the IFI in providing such facility to him/her. Thus, it is paramount to explicate direct expenses that shall be borne by the customer under the debt-based Sharī'ah contracts such as *qarḍ* and *murābahah*.

Sharī'ah Contracts That Entail Nafaqah

It is important to note that there are Sharī'ah contracts that require certain expenses (*nafaqah*) with regard to either:

- (i) fulfillment of the subject matter such as in *murābahah*, *rahn* and *muḍārabah* or
- (ii) preparation and provision of a debt-based facility in which *qarḍ* is the underlying contract.

In a *murābahah* contract, the seller normally incurs some expenses in providing the purchased asset to the buyer. This includes various costs related to the asset such as storage cost, maintenance cost, delivery cost and others. The seller may include such expenses in the acquisition costs before adding the profit margin and consequently fixing the selling price. Thus, *nafaqah* on the *murābahah* asset is originally borne by the buyer. The permissibility of including the abovementioned costs of preparing the asset in the cost price is based on the customary practice (*'urf*) of traders in any *murābahah* contract. They routinely include certain costs into the cost price before calculating the profit rate. This is explained by al-Kāsānī when he mentions an example of expenses that can be included in the acquisition cost of the asset:

“...because the tradition among traders is that they add those expenses to the capital [of the *murābahah* asset] and calculate them to

be part of it. And the Muslims' standard practice and culture comprise an absolute argument" (Al-Kāsānī, 1406H, 5:223).

Moreover, certain *āthār* from the *salaf* indicate the permissibility of including *nafaqah* in the cost of the *murābahah* asset before including the profit rate. In other words, *nafaqah* on an asset is borne by the customer.

The above discussion can be concluded as follows:

- 1- The expenses that can be included in the acquisition cost of the *murābahah* asset are limited to the actual expenses.
- 2- The actual expenses incurred by the seller in preparing the *murābahah* asset can be counted as acquisition cost provided that the expenses are regarded by the tradition and customary practice of the industry as costs to be included in the cost price.
- 3- The amount of *nafaqah* that can be counted as acquisition cost (capital) must be limited to actual expenses only. This is because the concept of *nafaqah* in a *murābahah* contract entails that the seller should not generate any profit out of the expenses.

Qarḍ Contract

Technically, *qarḍ* is defined as "transferring ownership of something on the condition that its equivalent will be returned" (al-Malībārī, n.d., 1:340). The actual cost in a *qarḍ* contract refers to actual direct expenses incurred by the creditor (*muqriḍ*) in the provision of a loan facility to the debtor (*muqtariḍ*), such as a service charge. It also includes other charges imposed to cover actual operational costs incurred in rendering ad-hoc services requested by the customer such as an additional statement request and audit confirmation. This implies that only actual cost/direct expenses can be passed on to the *muqtariḍ* as explained in AAOIFI Standard No. 19 (9/2) on the loan contract:

"Indirect expenses incurred in rendering services for a loan are not included in actual expenses; for example, employee salaries, space rental; furnishings and means of transport as well as other management and general expenses of the institution."

The above standard states that indirect costs cannot be counted as actual cost. Indirect costs refer to "the administrative costs that are generally borne by the IFI in its business operation". These costs include staff salary, rental fee for premises, furniture, transportation and the like. It could be understood that "employee salaries" in the AAOIFI Shari'ah Standard No. 19 above refer to salaries of those who are not solely dedicated to carrying out tasks specifically related to handling default cases or processing/servicing the loan (*qarḍ*) facility. In other words, their work is not discharged solely

for the benefit of the customer (borrower) as it is in the case of processing a loan for the customer; rather, it is for the benefit of the bank as a whole. Such cost is an indirect cost, which is not counted as actual cost; thus, it is impermissible to impose it on the borrower. In contrast, the salaries of employees who work for the sole benefit of the borrower, such as processing the customer's loan, are considered actual cost as they are direct costs. In classical jurisprudence, scholars mentioned that costs incurred on account of weighing or measuring the borrowed asset—if it is a kind of property that needs to be weighed or measured—must be borne by the *muqtarid*, and this is not considered *ribā*. In this case, scholars argue that the fee for any measurement and weight is payable by the debtor ('Izz al-Dīn 'Abd al-Salām, 1991, 1:191). The justification is that *iqrāḍ* is a *ma'rūf* action (*tabarru'*), and the one who does *ma'rūf* to others should not incur any expense for such a *ma'rūf* reason (al-Dasūqī, n.d.: 3/145).

The Sharī'ah Parameters for Imposition of Fees and Charges in Islamic Banking Products and Services

These parameters serve as a guideline for imposition of fees and charges in Islamic banking products and services particularly with regard to situations in which the IFI can charge only actual cost and actual financial loss suffered. This becomes far more important in respect to those that are structured on debt-based contracts such as *qarḍ*, *bay' bi thaman 'ājil* (BBA), *murābahah* and *rahn*. This is intended to ensure that the imposition of fees and charges in any Islamic banking products and services does not amount to any prohibited elements such as *ribā* and consuming property without legal justification. The parameter can be summarized as follows:

- (1) The imposition of fees and charges must be based on one of the following Sharī'ah principles; (i) *ujrah* (wage) for a service, (ii) *nafaqah* (actual expenses), (iii) *ta'wīḍ* (compensation) and (iv) penalty (*gharāmah*) or a combination of two or three or all of the above Sharī'ah principles.
- (2) The imposition of fees and charges must take into consideration the Sharī'ah contracts that underlie the contractual relationship between the IFI and its customer.

There are certain Sharī'ah contracts that accommodate the charging of actual cost to one of the contracting parties. Thus, if a certain product or service is structured according to such contracts, the IFI can only charge actual cost to its customer. In this case, the actual cost may arise from the following Sharī'ah principles:

- (i) *Nafaqah*; for example, in a *rahn* contract, the maintenance cost of the pledged asset incurred by the IFI (*nafaqat al-marhūn*); in a *qarḍ* contract, the direct expenses incurred by the IFI in providing a loan to its customer (*nafaqat al-iqrāḍ*); and in a *murābahah* contract, the delivery cost of the purchased asset incurred by the IFI (*nafaqat al-mabī'*).
 - (ii) *Ta'wīḍ*; for example, a customer's default in a *murābahah* contract or *qarḍ* contract, or breach of promise (*wa'd*) by the customer.
- (3) If a fee or a charge is imposed by the IFI based on the concept of *ta'wīḍ* or *nafaqah*, the chargeable amount must not exceed the actual cost or actual financial loss incurred by the IFI.
- (4) The imposition of fees and charges must be free from prohibited elements such as *ribā*, fraud or wrongfully devouring people's wealth.

CONCLUSION

There are various fees and charges that an IFI may impose on its products and services under different portfolios irrespective of whether they are fund-based or fee-based in nature. The Sharī'ah requires that the ownership transfer of an asset must be based on specific Sharī'ah principles that result in ownership transfer such as *ujrah*, *ta'wīḍ*, and *nafaqah*. These principles constitute the Sharī'ah basis for imposition of fees and charges, and their inherent natures and legal effects are applicable to the fees and charges based upon them. This entails that the imposition of such fees and charges must correspond to the above Sharī'ah principles, particularly in terms of the objective for which the fee is charged and the amount of a given fee that can be charged to the customers. In terms of the allowable amount of charge, it can be understood as follows:

- (i) The amount charged to compensate for actual cost as in the case of provision of a debt-based facility must be restricted to actual cost incurred by IFI as per the requirement of *nafaqah*.
- (ii) The amount charged to compensate for actual loss as in the case of default and breach of promise must be restricted to the actual financial loss suffered by the IFI as per the requirement of *ta'wīḍ*.

It is important to note that there is a crucial need for a thorough research on the detail of the Sharī'ah parameters for imposition of fees and charges. The parameter shall comprise distinctive criteria of actual cost and actual financial loss in various Islamic banking products and services. The parameter shall serve as the guidelines for the industry in so that no fee is charged without substantive legal basis.

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Appendix (i): Examples of Fees and Charges as per Their Shariah Bases (If charged separately)

	Shariah Bases				No Shariah Basis + Prohibited Elements
	1. Nafaqah	2. Ta'wīd	3. Ujrah	4. Gharāmah	5. Out of Nothing (If charged separately)
Fees and Charges	Processing fees		Sale charge	Late Payment Charge	Commitment Fee
	Disposal of asset cost and expenses.		Request for redemption statement fee		Opportunity Loss / Cost
	Legal fees and stamp duty		Custodian Fee		Lock in Penalty Charge
	Custody cost	Cancellation cost and expenses/ fee ¹	Trustee Fee		Redemption Fee
	Audit fees	Kash mua'kkad?	Management Fee		Break Funding Cost
	Administrative charges ²		Bank's Arrangement/ Structuring Fee		Early Settlement Charge
	Travelling cost	Abortion Fee	Facility Agent Fee		Cancellation Fee
	Legal fees	Consent Fee	Underwriting Fee		Rescheduling Fee
	Service Fee (current account-RM10-ABM)		Bank Guarantee Fee		Restructuring Fee
	Issuance of Cheque Book (stamp duty-RM0.15 per cheque leaf + 0.50 for)		Transaction Fee ³		Maintenance fee for all savings accounts
	Repossession Fee		Issuance of Cheque Book (RM0.50 per cheque leaf)		Unclaimed moneys transfer fee
	Dishonored Cheque (Inward returned-RM10-ABM)	Breakage Fee/Arrangement Fee ⁴	Coin Deposit (1 st 2000pcs free, next 100 pcs or part thereof RM1 max fee of RM500)		Dormant account reactivation fee
	Replacement of Lost Investment Deposit Receipt (ABM-not more than RM5)	Sales Charge ⁵	Sales Charge (8)		Service fee for account classified as dormant for no withdrawal
	Outstation Cheque Deposit (ABM-0.03% per item, min RM0.50 and max RM500)	Repurchase Charge	Hedging Cost		Referral Fee ⁶
					Search Fee
	Notice of Reminder	Cancellation fee (legal fees, valuation fees and stamp duty-(2.25%))	Inter branch Transfer (RM2)		Card Cancellation Fee
		Repurchase Chequer Order (RM2)		Change of coin fee	
		Cancellation and Replacement Cashier Order (RM4)		Early Closure A/C fee	

Appendix (i): Notes

- ¹ If a facility (or any part thereof) is cancelled after acceptance of the facility for any reason whatsoever or unutilized on the expiry of the availability period.
- ² This includes printing of annual/interim report, tax certificates, reinvestment statements, postage and other services properly incurred in the administration of the portfolios.
- ³ In the context of Islamic custody services, transaction fee is charged for each transaction processed on behalf of the portfolio. It is charged as a separate component.
- ⁴ There is actual cost incurred when financing rate is being fixed between ISB and global market / treasury to guarantee customer with 1) a fixed rate throughout the tenure 2) a ceiling rate for variable packages.
- ⁵ A commission paid by an investor on his or her investment in a mutual fund. The sales charge is paid to a financial intermediary (broker, financial planner, investment adviser, etc.) for selling the fund and is intended to provide compensation for the financial salesperson's efforts in assisting clients in selecting the mutual funds best suited to their needs.
- ⁶ A fee given to the third party who promoted the financing product and got the deal between the bank and the customer.