



A Framework for Determination of Actual Costs in Islamic Financing Products

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Abstract

Islamic banking commonly considered as an alternative to the conventional banking system, conducts its business based on certain financial contracts in order to attain profit, while doing away with the element of interest (*riba*). Among the services offered by Islamic financial institutions (IFI) are financing products and fee-based services to generate profits free from interests and other non-permissible incomes. The fee-based services conducted by Islamic banks may raise some *Shari'ah* issues such as the practice of charging a fee on services related to loan (*qard*) facility. Similarly, in financing activities, the IFI also imposes some amount of compensation or related charges in the case of late payment or default events for such financing. This paper aims to discuss the mechanism to determine the calculation of such actual charges and fees from *Shari'ah* perspective. Nevertheless, this paper does not intend to discuss the issue of “pricing” for Islamic financial products to determine its sales price and profit margin. This paper proposes *Shari'ah* compliance parameters on the computation of the actual costs for some related financing products offered by Islamic financial institutions.

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1. Introduction: Overview of Concept of Actual Cost

The definition of “*taklif*” or cost from an accounting perspective is the amount of expenses borne by the owner of a certain financial product for its production, which will provide an economical value now or in the future; regardless of it being a trading commodity or a service. (Khalil, 2005: 242) The meaning of cost in relation to loans or financing is defined by AAOIFI (2010: 271) as the direct costs, which do not bring any additional benefit that can be categorized as *riba*.

However, with regards to the discussion of actual cost, there is no specific definition for the term *taklif* *fi'iliyyah* or actual incurred cost. It is subjective and depends on the financing situation and features of the financing product utilised.

2. The Concept of Benefit (*Manfa'ah*) of Loan From *Shari'ah* Perspective

The concept of benefits (*manfa'ah*) derived from loan is a very substantive concern to be discussed because the determination of actual cost is a vital issue, which is related to the recent practices in the industry.

In this vein, the discussion for the benefits derived from loan can be categorised into the following circumstances (Al-Umrani, 2006: 374):

2.1 The benefits gained by the Lender

In this circumstance, the benefits derived from such loan specifically meant for the lender are prohibited by *Shari'ah*. The benefits can be as follows:

i) The benefit is the excess amount (*riba*) and not part of the loan amount.

According to Al-Shatibi (n.d: vol.4, 29-30), the effective cause (*'illah*) for the prohibition of *riba* is any excess without a justified compensation (*iwad*). For example, a loan associated with interest element or

any benefit. Prior to the advent of Islam, the Arabs regarded sale as similar and identical to *ribawi* transaction. In reality, in a sale contract there will be an equal countervalue exchange between the buyer and the seller which involves the goods or services being exchanged for a specific consideration. On the contrary, there will be no equal countervalue involved in *ribawi* transactions except for the exchange between deferred settlement and the excess amount in the capital repayment. Allah has stated with regards to the misconception of *riba* prevalent amongst the Jahilis:

“Trading is only like riba (usury), whereas Allah has permitted trading and forbidden riba (usury).” (Al-Baqarah: 275)

This misconception has been addressed by the Allah’s command to stop any *ribawi* transactions in order to avoid injustice and oppression.

“But if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).” (Al-Baqarah: 279)

The Prophet (PBUH) states that:

“Riba jahiliyyah is abolished and the first riba which is abolished is the riba of Al-Abbas ibn Abdul Mutallib and all of the riba are abolished altogether.” (Narrated by Muslim, Hadith no 1218)

The above *hadith* states that the prohibition of *riba* is closely related to additional payment which is not based on any equal countervalue. Any excess which is the essence of *riba* is abolished and this includes loans which give benefits to the creditor since it does not involve any exchange (Al-Shatibi, n.d: vol.4, 29-30).

Al-Imam al-Kasani (n.d: vol, 395) asserts that:

“Because of a pre-agreed condition for an excess resembles riba and it is a surplus which does not have any equal countervalue. Avoiding riba or anything that resembles it is mandatory.”

This statement clarifies that not every excess is considered *riba*. An excess is qualified as *riba*, only if it does not have any equal countervalue as above mentioned.

ii) The benefit is absolutely meant for the lender and not the borrower.

In this circumstance which is prohibited by *Shari’ah*, the benefit(s) derived from the loan is solely for the lender without any return or benefit for the borrower or debtor apart from the principal debt. This prohibition is based on the following *athar* and legal maxim:

“Every loan draws benefit (to the lender) is considered as riba.” (Ibn Abi Shaibah: athar no. 20691)

The Prophet (PBUH) also mentions:

“If anyone of you extends a loan and then he is given a gift or offered to ride the vehicle of the borrower, he must not ride it or accept it unless that act has been established as a custom and has been practiced even before extending the loan.” (Narrated by Ibn Majah Hadith no 2432)

Al-Qarafi (n.d: vol.5, 289) states in his book with regards to this issue:

“It is a condition for every loan that it must not produce or give any benefit to the lender.”

Among the clear examples for such a situation is when the borrower conducts a sale transaction with the lender. In this sale, a subject matter which has the initial value of RM 1,000 is sold to the lender at RM 500 due to the outstanding debt. This is the kind of prohibited loan which draws benefit to the lender. (Ibn Taymiyyah, n.d: vol.29, 533). In current banking practices, this can be illustrated when the depositor keeps an amount of money in the *Qard*-based account with the bank (for example: current account). The depositor is then entitled to get a discount in terms of a lower profit rate if he engages himself in a financing contract from the same bank. The depositor is not entitled for such a benefit if he doesn't have an account with the bank. Such a loan generates benefit to the lender i.e. the depositor and as such, the act is prohibited.

iii) The benefit is imposed by the lender upon the borrower; regardless of whether it is written in the the loan agreement or being practiced as a custom (*‘urf*).

The benefit which is imposed by the lender must either be in writing or based on business custom for that particular practice. Nevertheless, benefits which are not imposed upfront by the lender and are given out of willingness by the borrower upon repayment are permissible. They fall under the category of doing good in repaying outstanding debts. This is indicated in the *hadith* narrated by Abi Rafi' (RA):

“The Prophet (PBUH) borrowed a young camel from a man, and when the camel of zakat arrived, he told Abu Rafi' to repay the man his young camel. Then Abu Rafi' returned and replied to the Prophet (PBUH) that he could not find any camel similar to the one that the Prophet (PBUH) borrowed, except of a better quality. Thus, the Prophet (PBUH) answered him: “Give it to him, for the best among you is the one who, when he repays a debt, he repays it in a good way”. (Narrated by Muslim Hadith no 1600)

In another hadith narrated by Abu Hurayrah in Sahih Muslim:

“The Prophet (PBUH) borrowed an animal whose age was such and such and when he returned it to the owner, the animal was a bit older from the borrowed animal's age and the Prophet (PBUH) said: The best among you is the one who is generous when he pays back his debt.”(Sahih Muslim: *hadith* no. 1601).

In 'Umdah al-Qari, Al-Imam Al-'Aini (n.d: vol.10, 132) states that the above-mentioned *hadith* indicates that if the borrower repays back his debt with an excess in addition to the principal – the excess being in terms of type or weight - and this is known to the lender only upon repayment, then it is permissible for the lender to accept it. This is because the Prophet (PBUH) has praised those who when they repay their debts, they repay it in a good way.

Al-Nawawi (n.d: vol.11, 52) has explained in Sharh Sahih Muslim that this *hadith* encourages those who are in debt to repay their debts in a better manner, as it is considered a *sunnah* and a virtue. It is not considered a loan that gives benefit. The benefit is prohibited if it is imposed as a condition in a loan contract.

Thus, generally there is no *ijma'* (consensus of opinion among the scholars) on the prohibition of any benefit that is not stipulated upfront. The *ijma'* only applies to benefits which are stipulated upfront in loan contracts.(Al-Umrani, 2006: 380).

Nevertheless, Muslim jurists have unanimously agreed that if the lender imposes a condition on the borrower that the lender is entitled to receive a surplus or a gift because he has extended a loan to the borrower, in addition to the capital, then the excess will be considered as a *riba*.(Ibn Munzir: n.d, 120-121).

It is also mentioned in the book *Al-Istizkar* written by Ibn Abd Al- Barr (n.d: vol.21, 45) that:

*“And every excess from a subject matter or from an usufruct that stipulated by the lender upon the borrower is considered as *riba* and no doubt about it”*

He also mentioned that (Ibn Abd Al- Barr, n.d: 359):

“And every excess in a loan or usufruct extended, which will benefit the lender is considered as riba, even though it may only be a palmful of animal feed, and that is prohibited if it is imposed as a condition.”

It is also stated in the Al-Jami’ li Ahkam Al-Qur’an (Al-Qurtubi, n.d: vol.3, 157-158):

“The Muslims are in consensus – based on what was narrated by the Prophet (PBUH) - that imposing a condition of a surplus in a loan transaction is considered as riba even though the surplus may only be a palmful of animal feed.”

2.2 Benefits from a Loan Exclusively for the Borrower Only.

According to Muslim jurists, should the benefits derived from a loan specifically enjoyed by the borrower only, then it is permissible from *Shari’ah* standpoint..

Ibn Shash (n.d: vol.2,566) states in his book the following:

“When the benefit is exclusively for the borrower, it is allowable.”

Al-Kharshi (n.d: vol.5, 231) also states :

“According to the most popular opinion, the benefit from a loan must be exclusively reserved for the borrower.”

2.3 Benefits from a loan are Shared by Both Lender and Borrower.

In this category, if the benefit derived from a loan is shared by both lender and borrower, and the borrower attains more benefit, then it is deemed permissible from *Shari’ah* point of view. This opinion is based on the *athar* by ‘Ata’ where Abdullah bin Zubair (RA) had incurred debt in the form of some silver money from the Meccans and he then wrote to them, directing them to retrieve their loan from his brother Mus’ab in Iraq. Thus, the creditors retrieved their money from Mus’ab in Iraq. Ibn ‘Abbas was asked about this particular matter and he did not find anything wrong with it. He was also asked about the ruling if the creditors received silver money of better quality than those that were given as a loan earlier and he replied that it was not a problem if they took according to the weight of their silver money. This is also the opinion of Ali bin Abi Talib, Ibn Sirin and Al- Nakha’ie. (Ibn Qudamah, n.d: vol.4, 437).

Ibnu Taymiyah (n.d: vol.29, 531) mentions concerning this matter:

“The ruling for this issue is that it is permissible. This is because the creditor can attain benefit in terms of ensuring the security of the silver money from being exposed to dangers of it having travelled and transferred to that particular country. The debtor will also have the benefit of repaying the loan in that particular country and will not have to travel. Thus, both the creditor and the debtor benefit from the loan transaction. The Lawmaker does not prohibit something that will benefit and bring goodness to them, rather what is prohibited is anything that brings harm to them.”

Sheikh Abdullah ibn Al-Mani’ (n.d: 331) is of the opinion that the shared benefits between the creditor and debtor in which they both are helping each other falls under the category of “cooperation and sharing.”

Thus, it can be concluded that if the benefit is being shared by both the creditor and the debtor and it does not harm them, then it is permissible. In cases where the debtor will receive more benefit from the shared benefit, it is still permissible. However, if the creditor is the one who will receive more from the

shared benefit, then it will be prohibited as it is not justified with any equivalent countervalue. (Al-Umrani, 2006: 340).

3. Framework for Determination of “Actual Incurred Cost”

Generally, charging actual incurred cost on financing, deferred sale transactions, and combination of sale and loan contracts in one contract on the entrepreneur’s expenses in *Mudārabah* is permissible according to majority of the Muslim jurists. (Al-Suwaidan, 2011: 49).

One of the main reasons for the need to impose or charge actual incurred cost on customers is to prevent the creditor from attaining extra benefit apart from extending a loan to the debtor, in the form of charging fees, commission, compensation, administration costs etc., as a reward for disbursing the loan. This is one of types of *riba* that is prohibited in Islam.

The fact that banks should charge for costs incurred in the process of banking services they offer to the customers should not be ignored as well. Normally, the banks need to equip themselves with skilled workers, adequate information technology system, certifications, filings and many other facilities for the purpose of administrating the financing process, all of which incur costs.

In such a case, the incurred costs are not considered to be *riba*, rather it is regarded as *ijārah ‘ala al-‘amal* as it reflects the actual costs borne by the banks. However, there is a need to further refine and reexamine the fees imposed by banks on financing and loans to differentiate between what is allowed and what is not.

3.1 Shari’ah Ruling on Cost of Expenses on Loans/ Financings

Majority of Muslim jurists have agreed that the cost of documenting the financing/loan must be borne by the customer. This is based on the following Quranic verse:

“So let him write. Let him (the debtor) who incurs the liability dictate, and he must fear Allah, his Lord, and diminish not anything of what he owes.” (Al-Baqarah: 282)

They are also of the opinion that any expense for the purpose of repayment the debt and its payment falls under the liability of the debtor. (Al-Umrani, 2006: 362). It is mentioned in Al-Sharh Al-Kabir;

“Whoever borrows one irdib (a unit of measurement scale) – as an example - the commission for that scale must be borne by the borrower and when he repays it back, the cost of the scale process must also – without a doubt - be borne by him.” (Al-Umrani, 2006: 362).

It is also mentioned in Al-Sharh Al-Saghir (n.d, vol.2, 106):

“It is not compulsory for the creditor to take back what is due on him at places other than the original transacting place, as this will involve cost; except for gold and silver (currency) where he must receive the same repayment regardless of the place, as this does not involve any costs.”

It is also stated in Nihayah Al-Muhtaj (Al-Ramli, n.d: vol.4, 229):

“If the creditor receives the payment of the loan from the debtor in a place other than the transacting place and because of this costs are incurred which the creditor is unable to bear, he can ask the debtor to be liable for the costs of loan in the transacting country during maturity, as this act involves costs.”

It can be summarised here that all administrative costs and expenses related to the loans or financings must be borne by the debtor, as the purpose of the service and expenses is to facilitate the disbursement of such loans/financings. (Amulat al-Masrafiyyah, n.d: 106).

3.2 Can the Banks Charge Fees or Any Commission for Disbursing the Loans/Financings?

The situation in some financial institutions is such that customers do not receive the total financing amount that they have applied for. For example, if a customer applies for a personal financing amounting to RM100,000, he will only receive RM96,000, as the remaining RM4,000 is deducted from the applied amount and regarded as cost or other related fees for the financing. In such a case, the Shari'ah advisors of that particular financial institution should make an analysis and review of each charge which is imposed to determine whether it is justified or otherwise.

The majority of the contemporary scholars permit banks to charge costs related to the financing transaction, provided that it reflects actual incurred cost. This is the opinion held by the Fiqh Academy Council, OIC, Jeddah and this is also the essence of the fatwa issued by Standing Council of Scholarly Research and Ifta (*al-Lajnah daimah li al-buhuth al-'ilmiyyah wa al-ifta'*) Saudi and AAOIFI.

The resolution of OIC Fiqh Academy number 12: 1/3 states that:

“With regards to the issue of service charges imposed by the Islamic Development Bank: (i) it is permissible to charge such fees provided they reflect actual incurred costs; (ii) Every surplus on top of actual services rendered is prohibited as this is considered as riba.” (Majallah Majma' Al-Fiqh, n.d: 415).

Whereas in a fatwa issued by Standing Council of Scholarly Research and Ifta (*al-Lajnah daimah li al-buhuth al-'ilmiyyah wa al-ifta'*) (n.d: vol.13, 415) Saudi with regards to charging fees on a loan offered by the Industrial Development Fund, it is mentioned that:

“If the costs are estimated by those who are experienced and skilled in terms of operations and finances for the benefit of the project, then they have the right to take fees from the project. Nevertheless, it is more preferred if they considered it to be an assistance towards the project owner”

In the guideline for financing issued by the AAOIFI (2010) *Shari'ah Standards* (states the following;

“It is permitted for the institution which gives out financings to impose fees for the services rendered - a fee reflecting the amount of actual incurred cost, and it is prohibited for those institutions to charge more as every surplus up and above the cost of actual expenses is unlawful.”

This opinion is supported by following evidences:

First: Quranic verse

“There is not upon the doers of good any cause [for blame].” (Al-Tawbah: 91)

This verse serves as a legal maxim for contracts to be transacted on the basis of goodness and welfare. It also indicates that the one who does good in transactions should not be indulging in harmful activities in order to obtain a beneficial objective. In simpler terms, the end does not justify the means. Therefore, there is no doubt that the bank will suffer loss and injury if it does not count all the costs and expenses incurred in offering financing to customers.(Al-Dusuqi, n.d: vol.4, 235).

In other words, the prohibition is with regards to making profit and taking surplus from the act of offering loans or financing based on loans. Nevertheless, it is permissible to charge fees which reflect actual expenses.(Abdul Karim, 2009: 107).

Second: *Hadith*

“A (charged) camel is ridden and its milk can be consumed in commensurate to its maintenance expenses if it is charged, and chargor should bear the costs of maintenance.”
(Narrated by Al-Bukhari)

This *hadith* indicates that the creditor must not take any benefit from the debtor. Whereas, the Prophet (PBUH) allowed to take benefit from the goods which expenses are eligible to receive a fee as the chargor is entitled to take fee expenses on the pledge. (Abdul Karim, 2009: 108).

However, the majority of the scholars forbid the person who receives the mortgage to benefit from it if it arises from a loan and not from a sales transaction to prevent *riba*. (Ibnu Abidin, n.d: vol.6, 482), (Al-Kharshi, n.d: vol.5, 249-250), (*Fathul Wahhab*, n.d: vol.1, 192), (*Hashiyah Al-Rawdh Al-Murbi*’, n.d: vol. 5, 90).

Third: Islamic Legal maxim, *“Al-Ghunmu bi al-Ghurm”* and *“Al-Kharaj bi al-Dhaman”*. (Ibn Nujaym, n.d: 255).

These two maxims point out that the person because of whom an act or expense is incurred, will bear those expenses as compensation for the job. This is the content of similarities in fulfilling the duties which are specified therein, so that each party is obliged to bear an equal responsibility incurred by other parties without enriching one party over the other, or be eligible to reduce their effort and the desire to achieve. As the bank has right to request any security in form of (business or properties) to pay for the loan, then the bank has the right to claim a fee. (Abdul Karim, 2009: 109).

It can be concluded that banks may charge fees such as legal fees, registration fees, etc., related to the cost of financing. However, the banks should not impose any fees without justifiable reasons, as banks have already reaped profit from the profit margin.

3.3 The *Shari’ah* Ruling on Imposing Compensation (*Ta`widh*) Due To Late Payment

The First Opinion: Sheikh Ali Al-Khafif (1997: 19), Muhammad al-Buti (1981:148), Taqi Uthmani (2003: 40), Wahbah Al-Zuhayli (2002: 179), Nazih Hammad (1991: vol.1, 107), Ali Salus (n.d: no.6, 164), Muhammad Usman Shibir (1998: 55) are of the opinion that compensation should not be imposed on the debtor if the late payment arrangement is agreed by the contracting parties. The same opinion is held by the Majma’ Fiqh Islami (n.d: resolution no.8).

Their opinions are based on the following evidences:

(a) Qur’an verse:

“Allah has permitted trade and has forbidden interest.” (Al-Baqarah: 275)

They believe that compensation is a type of *riba* known as *riba jahiliyah*, which is prohibited.

“But if you repent, you may have your principal – [thus] you do no wrong, nor are you wronged.” (Al-Baqarah: 279)

Allah has forbidden His servants from taking *riba* and being involved in *ribawi* transactions. The above verse reveals that the creditor is only entitled to recover the principal amount. Thus, it can be implied that taking compensation from the debtor due to late payment is prohibited.

(b) Logical Reasoning

Islam forbids people who are capable of paying their debts from delaying in debt payment. In such a case, if the debtor delay for his debt payment, then the creditor may take this case to court either for settlement or to punish the debtor. The debtor may face imprisonment, warning or auctioning of his property to pay back the creditor’s capital and may be subject to additional penalty due to late payment of debt. That penalty falls under the category of *riba*. (Shibir, 1998: no.10, 55).

Second Opinion: According to the resolution of the Dallah Barakah's (n.d: 55) conference, Shari'ah Advisory Council of Islamic Bank of Jordan (n.d: 1003), Mustafa az-Zarqa (1998: no.2, 105), Muhammad Siddiq al-Darir (n.d; no.1, 118) and Sheikh Abdullah Mani` (n.d: no.2, 104), it is permissible to charge compensation from the debtor if he is late in his payment and the arrangement is pre-agreed. This argument is justified by the following evidence:

(a) Quran verse:

"O you who have believed, fulfill [all] contracts." (Al-Maidah:1)

The debtor must fulfil his obligation to repay the loan according to the agreed upon conditions between the contracting parties. It is not right for the debtor to delay in repaying the creditor without any valid reasons.

"And they who are to their trusts and their promises attentive" (Al-Mu`minun: 8)

The act of repaying a loan is a responsibility. It is mandatory for the debtor to fulfil his obligation by repaying the debt to the creditor.

"And do not consume one another's wealth unjustly" (Al-Baqarah:188)

The delay in the repayment of a loan without any valid reasons falls under the category of devouring other people's property unjustly. This opinion is held by the majority of the scholars.

(b) Hadith

"Harm should not be inflicted no reciprocated." (Musnad Ahmad: vol.1, 313)

According to Sheikh Mustafa al-Zarqa' (n.d: no.2, 107), this *hadith* indicates that it is permissible to charge compensation as a result of harm occurred and this is in line with the legal maxim "harm shall be removed" implies that the harm can be removed through imposing compensation.

"Delaying of the rich is ingratitude". (Sahih al-Bukhari, *hadith* no. 2400, vol.3, 118)

"The delay in paying debt by the rich who has money makes dishonouring and punishing him permissible." (Sahih al-Bukhari, *hadith* no. 2400, vol.3, 185)

The above *hadith* points out the permissibility of charging compensation on a debtor who is capable of repaying the loan but delays it. This is considered as an act of injustice towards the creditor, thus making the debtor chargeable for certain penalty such as paying compensation. The harm that is inflicted on the creditor through the late payment can be removed via the imposition of compensation. This reflects the essence of the legal maxim "harm shall be removed". (Al-Zarqa', 1998: no.2, 107) (Abdullah Mani`, n.d: no.2, 95).

(c) Qiyas

The delay in payment by the debtor when he had already promised to repay within a specific time can be regarded similar to the act of taking away (*al-ghasb*). This is based on the analogy that they share the same effective cause, which is taking other people's rights in an unlawful way, since the debtor is capable of repaying according to the agreement. It prevents the creditor from getting back his capital and thus, falls under the category of injustice. Another example of injustice is when the depositor is prevented from receiving back his deposit from the one who holds it. Thus, the depositor is entitled to compensation. According to Shafie and Hanbali scholars, the worth of a property is seen from its purpose. It can also be equated to the purpose of benefiting from a confiscated property. Hence, it is allowed to impose the

compensation when the repayment of a debt is being deferred by a capable payer. (Al-Mawardi, 1994: vol.7, 160) (Al-Zarkashi, n.d: vol.3, 171).

(d) Logical reasoning

In preserving the objectives of *Shari'ah*, Islam does not place a trustworthy person and one who is untrusted on the same level. Similarly, a just and an unjust person are not of the same level. Failing to adhere to a promise or conditions agreed between both contracting parties without any valid reasons falls under the category of injustice. There is evidence from the *Qur'an* and the *Sunnah* to prove this. Thus, delaying the payment of a loan in cases whereby the debtor is capable of paying is considered as an injustice to the creditor, as the creditor is prevented from retrieving his capital without any justified reasons. (Al-Zarqa, Mustafa, 1981: vol.2, no.2, 110).

3.4 Payment of Compensation Equivalent to the Actual Loss Incurred

Contemporary scholars such as Sheikh Zaki Sha'ban (n.d, vol.2, no.2, 217), Muhammad Zaki Abd Al Bar (1990: vol.2, no.1, 170), Muhammad al-Tabtabaie (2006: 8), are of the opinion that the payment for compensation must be in accordance to the value of actual loss incurred.

They base their argument on the *hadith* of the Prophet (PBUH) that if the debtor is capable of paying the creditor and purposely delays the payment, the action is considered as an act of injustice towards the creditor and he can be punished for this act. The word punishment is general and this includes imprisonment. The *hadith* also indirectly indicates that those who are not serious in repaying their debts should also be punished and charged compensation. The compensation is permitted provided it reflects the actual damage incurred. (Zaki Sha'ban, n.d: vol.2, no. 2, 217)

With regards to loans, the *Shari'ah* does not generally permit the creditor to impose any costs on the loan. This is due to the debtor being responsible for bearing all the service charges and costs related to the loan that he receives. This is based on the Qur'anic verse where Allah has said:

“So let him write and let the one who has the obligation [i.e., the debtor] dictate.” (Al-Baqarah:282)

This is the opinion of Fiqh Academy Council (Resolution no.13), AAOIFI (2010: 271) and other fatwa-issuing committee. An issue that arises in instances when banks impose charges is whether they can impose service charges based on direct or indirect costs?

AAOIFI (2010:271) and Fatwa of *Shari'ah* Committee of al-Rajhi Bank (2010, vol.2, 1027, resolution no. 669) are of the opinion that Islamic financial institutions can only charge direct costs and expenses related to the disbursement of the loans (*qard*). It is permissible to charge costs related to loans provided they reflect the actual costs borne by the institutions. In such a case, any costs that are charged above the amount of actual incurred costs will be considered as *riba* and means to *riba*. Costs that are above the actual incurred costs include indirect costs such as the employees' wages and the rent of the operating office. Thus, only direct costs related to the product are permitted to be charged to the customer.

However, the *Shari'ah* Board for Dubai Islamic Bank (fatwa no (343), vol.2, 836) has a different opinion. They deem it permissible for an Islamic financial institution to impose service charges on *qard* and this charge includes both direct and indirect cost. This is because the Islamic financial institution has to bear all the costs; regardless whether it is direct or indirect while providing *qard*. All these costs will affect the institution, thus justifying the argument permitting direct and indirect charges on loans.

In situations where debtors are required to pay compensation for purposely delaying the payment while being capable to pay 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.

However, apart from this circumstance, the authors are of the view that in cases where the financial institutions found that the cause of delay of debt payment by the debtor is genuine cases where he is unable to pay due to financial distress and any other valid reasons, thus the debtor should not be charged for such delays.

3.5 Compensation Based on Opportunity Loss

Opportunity loss means having to forgo future profit due to other reasons and available choices. This is not included in determining the actual expenses incurred, but rather the profit comparison between other possible financing products. (Mutawi`, 2009:8).

Sheikh Mustafa al-Zarqa (1998: vol.2, no.2, 111), Syeikh Sadiq Darir (n.d: vol.3, no.1, 117). Sheikh Abdullah ibn Mani` (n.d: no.2, 96) and Dr Abdul Aziz Qassar (2001: no.24, 76) are among the scholars who permit charging compensation based on opportunity cost on debtors capable of paying on time but intentionally delaying the payment. They support their opinion by arguing that delay in repayment of the loan according to the agreed time prevents the creditor from receiving back his capital and benefiting from it and this is injustice. Thus, incorporating opportunity cost in the compensation amount is valid and justified.

This is similar to Shafie and Hanbali schools of thought that recognize that the real benefit of property is contained in its physical substance (*zat*). It is in accordance with the main focus on the property. And if the benefit of a certain confiscated property is contained in its physical substance, then it's cost has to be borne by the hijackers. In case of delaying debt payment by a capable debtor, it shall be an obligation upon the creditors to receive compensation. (Al-Zarqa': 1998:vol.2, no.2, 108-109) (Al-Mawardi, 1994: vol.7, 160).

In such a situation, if the creditor receives the payment of debt according to the agreed time and he then invests the capital via legal modes such as *mudarabah*, *muzara'ah* and others to attain profit, the compensation liable for the debtor - who delays his payment intentionally without any valid excuse - includes the actual opportunity cost without any reference to the current interest rate in the banking sector.

This opinion can be refuted as it falls under the category of *qiyas ma'a al-fariq*, as the usufruct of a property and moveable asset is in its physical entity. Thus, it is appropriate to take compensation on any loss that occurs on it. However, in the case of monetary debt, the usufruct is not in the form of physical entity and the value will change according to changes in time and place. Therefore, there is no similar effective cause between the two and an analogy cannot be practiced in this case to derive a ruling. (Zaki Sha`ban, n.d: vol.2, no 2, 218) (Nazih Hammad, 1998: vo.3, no.1, 109).

The next argument is that banks will not use all the funds to provide financing. Investments will be diversified through various capital markets and money market products, which are *Shari'ah*-compliant. However, the returns on those investments aren't the same. Thus, how will the bank determine the amount of compensation based on different estimated profit rates?

Another argument in this case is with regards to the permissibility of charging compensation while referring to the estimated profit. This is similar to the act of charging interest due to late payment. This is proven through acts of certain banks charging the amount of opportunity cost in their financial products.

In this case, the thus paper is of the view that this charge of compensation which is based on opportunity loss is not allowable as it implies the concept of time value of money which is prohibited and does not construe any actual cost incurred.

4. Current Resolutions & Fatawa Related to Determination of "Actual Cost"

4.1 Guidelines in Imposing Late Payment Charges According To BNM (2014)

1st Option: Combination of Compensation and Penalty in Imposing Late Payment Charges

Islamic financial institutions can impose a charge, which combines compensation and penalty up to a fixed rate. The maximum rate can be imposed by the financial institutions with approval from BNM.

2nd Option: Ta'widh (Compensation)

The financial institution can charge compensation based on actual loss incurred which results from the delay in payment of debt by the debtor. Financial institutions are allowed to charge *ta'widh* according to rates similar to the actual loss borne by the institutions, which will be dependent on the combination of average rates. Banks can also impose a late penalty charge up to 1% during the financing tenure. However, if the tenure is due, they can impose a penalty according to the IIMM (Islamic Interbank Money Market) return.

The maximum rate of compensation that can be imposed is 1%. However, it needs to be stressed that the appropriate rate of compensation must reflect the actual cost incurred and should be approved by the bank's *Shari'ah* advisors.

3rd Option: Gharamah (Penalty)

The penalty received by the banks must be channeled to welfare organizations that are approved by the *Shari'ah* Board of respective financial institutions.

The penalty is intended to educate and punish those who are late in their payment or fail to repay. BNM's *Shari'ah* Advisory Council does not allow penalty to be recognised as a source of income for the financial institutions. The entire amount of money received from the penalty must be distributed to the welfare and charity organizations. However, if the penalty is recorded as an income, then it is considered as non-*Shari'ah* compliant.

4.2 The Following are Some *Fatwas* and Resolutions of Prominent *Shari'ah* *Fatwa* Bodies on the Related Issue of Charging Actual Cost:

Issue 1: Charging Actual Cost on Financing/Loan

a) Resolution of OIC *Fiqh* Academy Jeddah (1986:vol.1, 305).

1st: It is permissible to charge a fee for providing the loan and services with the condition that it must reflect the actual expenses incurred.

*2nd: Every excess or surplus over and above the actual services rendered is prohibited as it falls under the category of *riba*. Resolution no. (1: 13/3, 1407H/1986M)*

b) Resolution of AAOIFI (2010: 321) *Shari'ah* Standards

*9/1 : It is permitted for a lending institution to charge for services rendered in loans equivalent to the actual amount directly spent on such services. It is not permitted for the institution to charge an amount in excess of such a service charge. All charges in excess of the actual amount spent are prohibited. Therefore, it is necessary to ensure precision in the determination of the actual charges so that they don't lead to an excess that can be deemed a benefit. The fundamental rule is that each loan bears its own specific charges. The rule applies unless it becomes difficult e.g.; in the case of a group or common loan. In such cases, there is no restriction in the way of bearing direct collective charges for all the loans on the basis of entire sum. It is necessary that the method of charge determination be laid down by the *Shari'ah* Supervisory Board of the institution in detail. This has to be done by distributing the expenses incurred among all the loans and each loan has to bear its share proportionately. An explanation of such circumstances has to be presented before the Board along with suitable documents.*

9/2 Indirect expenses incurred in rendering services for loans are not included in actual expenses e.g.; salaries of the employees, rentals of space, assets, means of transport, other management and general expenses of the institution.

*10/ Among the most important modern applications of *qard* are the following:]*

10/3 Charges on credit cards for cash withdrawal from ATMs:

10/3/1 The charges imposed on cards for cash withdrawal from bank teller machines are a charge for services and are independent of the loan.

*10/3/2 It is necessary that the charges imposed on credit cards for cash withdrawals from bank teller machines be an amount that is certain. They should be within the limits of reasonable charges (*ujrah al-mithl*), excluding profit from *qard*. It is not permitted to link the charge to the amount withdrawn. It is not permitted for the institution to slice the withdrawals as a device for obtaining repeated charges. This is similar to the prohibition (for this purpose) to take into account the period of repayment of the amount withdrawn. Where there exists a difference in currencies, the application of the rate for the prevailing currency is stipulated. See also item 4/5 of *Shari'ah* Standard No. 2 pertaining to Credit and Charge Cards.*

Issue 2: Charging Actual Cost on Letters of Guarantee

a) Resolution of the OIC *Fiqh* Academy, Jeddah (1985:no.2, vol.2, 1035).

“The imposition of administrative charges for issuing the letter of guarantee and such similar charges are permitted in Islam; provided there is no additional charge or commission according to the market rate. It is also permitted to impose such charges regardless of the fact whether there is mortgage or otherwise for issuing the letter of guarantee.” 12: 12/2, 1406H/1985M.

Issue 3: Imposition of Actual Costs on Shari’ah-Compliant Credit Cards

a) Resolution of OIC Fiqh Academy, Jeddah (2000:no.12, vol.3, 459).

“(Secondly): It is permissible to issue credit cards which are not backed by any mortgage/guarantee, provided there is no condition of additional payment (*riba*) on top of the principal amount.

It is also permitted for the issuer to charge fees based on the actual cost of issuing and renewing the card, which reasonably reflects the type of services rendered.

(Thirdly): Cash withdrawal by the cardholder means that he is receiving a loan from the issuer and there is no prohibition by the Shari’ah to do so if there is no *riba* involved. Any excess on top of the service rendered is prohibited as it is considered *riba*. The same has been resolved by Majma, documented in its resolution numbered 102 (10/4) and 13 (1/3). Resolution, 108: 2/12, 1421H/2000M.

b) Resolution of AAOIFI (2010) Shari’ah Boards

4/5 Cash withdrawal using a card:

- i. It is permissible for the cardholder to withdraw an amount of cash within the limit of his available funds or more with the agreement of the institution issuing the card, provided no interest is charged.
- ii. It is permissible for the institution issuing the card to charge a flat service fee for cash withdrawal, proportionate to the service offered. However, the fee shouldn’t vary according to the amount withdrawn.

c) Resolution of Dallah al-Barakah

“According to the Shari’ah, there is no prohibition to use a debit card for withdrawals from the bank or any of its outlets, if there is an agreement to do so. This is regardless of the fact that if there is balance in the bank’s account or otherwise. It should also be agreed that the issuing bank will give an advance to the card holder without any interest charges. Also, there is no prohibition for a credit card holder to make a withdrawal from the ATM all over the world. It is also permitted to charge commission on the transaction whether it is for the benefit of the bank or other banks. The commission can be in the form of a fixed amount or a rate from the total amount - with the condition that it does not increase due to the overdraft. It is justified as the commission is based on the services rendered rather than on the amount of the loan.”(Abdul Sattar Abu Guddah, 1998: 206).

4.3 Analysis of the Fatwas Issued by the International Fatwa Bodies

From the resolutions and fatwas discussed before, it can be concluded that charging actual costs on services related to financings and loans must be equivalent to the actual costs incurred to avoid *riba*. The actual incurred costs only include direct costs related to those services. The reason behind the permissibility is not to accrue any profits or additional costs which are not related directly to the services, as this will be considered as *riba*.

With regards to the guidelines on accounting for actual incurred cost, they are as follows:

1. The measurement should not be binded or pegged to the amount of loan and its tenure.
2. It must not contain any one-sided benefit; for example, just for the creditor such as protection of his asset and others.
3. Most resolutions and fatwas only focus on determination of the actual cost incurred on a loan-based service where the cost is fixed. However, the fatwas and resolutions differ on determining the actual cost incurred on a fixed amount where it can be determined based on market commission (*ujrah al-mithl*).
4. The accounting for actual incurred cost is based on a special accounting method which needs to be supervised by the Shari’ah Advisory Committee.

5. Proposed Parameters and Guidelines for Determination of Actual Cost in Selected Islamic Financial Products

5.1 Proposed Parameters on the Determination of Actual Costs for Credit Cards or Charge Cards which Based on *Qard* Contract

1. The imposed charge must not be counted in the bank's revenue.
2. Costs that are being paid to a third party, such as legal fees and taxation fees, are among the costs that can be imposed on the customer.
3. The imposed charge should be the same amount that reflects the cost of debit cards, as its payment and withdrawal system are the same; serviced by Visa or Master Card.
4. Services that will only benefit the bank, should not be included in the costs imposed on customers. However, the costs incurred on services offered for the benefit of the customers can be included in the measurement of actual incurred costs such as *takaful* charges.
5. For services that bring benefits to both the bank and the customer, the extent of the benefit affecting both the parties should be taken into consideration. If the benefits are more for the customer, then the cost to offer that service can be included in the imposition of actual incurred cost. However, if the benefits are more for the bank, then the cost cannot be charged to the customer. In the event where the benefit for both parties are at the same magnitude and it cannot be determined which party will reap more of it, then the cost should be divided equally between both the parties, such as the cost for creditworthiness screening.
6. As regards the methods of determining actual cost of those employees' salaries who work for the control and supervision of credit cards compared to other products, it is determined by the estimated value of the work done for servicing credit cards compared to other products.
7. The credit card company's employee related expenses include his salary, electrical bill, water bill, rental of premise and the furniture used in the premise. However, the employee's bonus is not included, as the bank only gives it according to the performance of the employee generating sales from the issuance of credit cards.
8. Charges on all the services offered to card-holders (both credit and charge) can be included in the estimation for measuring actual incurred cost for the card. These charges must be borne by the card-holder even though he does not utilize those services.
9. In the event where the bank has to pay service providers such as Visa and Master Card a certain amount of money as the customer has utilised the credit card for purchases, the customer shall be liable to pay the fee. It can be included in the measurement for actual incurred costs imposed by the bank. However, it is incumbent upon the bank to mention clearly in the terms and conditions of the card that the customer is liable to pay any fees as a result of the utilization of their credit card for purchases.
10. Any notice for payment of outstanding debt must be based on the cost of the actual paper work process and the actual postage cost. It must not be based on estimations per se.
11. To account for the charge for cash withdrawals and its related fees is as follows:
 - a. Estimated cash production cost over total credit card cost (not specified cost for cash withdrawal) is based on ratio of operating cash withdrawal per operating cards which being added specific cost for cash withdrawal then it is divided from total cash withdrawal cost on credit cards on number of operating cash expenses which related to credit cards to withdraw operating cost whenever cash withdrawal is made.
 - b. The other costs should be calculated by dividing the number of cards in order to determine the issuance fee, the renewal fee, etc.

5.2 Proposed Parameter on Determining the Actual Cost for *Qard*-Based *Rahn*

Al-Rahn is very closely related to loans and, in essence, is a charge on the loan. It can never escape from the issue of receiving benefit from the loan disbursed. Due to this reason, any charges imposed must

be based on actual incurred cost in order to avoid indulgence in *riba*. Therefore, this article suggests parameters on credit cards as well as for other products:

1. It is not a *Shari'ah* issue to impose fees on safekeeping of gold provided the service comes from a third party.
2. If the creditor is the one who provides the safekeeping service, then the cost for safekeeping should reflect the actual cost and no amount of profit should be included in order to avoid dealing with *riba*.

As an alternative, the bank can offer financing based on commodity *murabahah* whereby the bank can earn profit from the sale of the commodity. Therefore, there will be no necessity to impose any charge for safekeeping the gold or jewelry.

5.3 Proposed Parameter on Determining the Actual Cost Charged for Letters of Guarantee

Besides suggesting guidelines for credit cards, this article also suggests the following guidelines regarding letters of guarantee:

1. It is important to differentiate between the cost imposed upon the issuance of a letter of guarantee by the bank and upon payment made by the bank as an obligation of it. When the bank makes a payment on behalf of the customer because of the guarantee that it provides, then the actual cost must be taken into account as a debt is involved.
2. There are differences in the permissibility of imposing charges based on the structure of the guarantee. There are some banks which only offer to guarantee the customer if the customer has sufficient balance in their account. In this case, service charge at any amount may be imposed as this is considered a commission for *wakalah* (agency).
3. Any determination of price must be supervised and approved by the *Shari'ah* board of the respective bank.

Some banks impose compensation at the amount of 1% for late payment and if the customer defaults, then the charge will be based on the Islamic Interbank Money Market rate after the tenor is due. This needs to be re-examined so that it reflects the concept of imposing charges based on actual incurred cost.

6. Conclusion and Recommendation

Based on the above discussion, the authors would highlight some conclusion and recommendation as the following:

1. Islamic banks earn profit from exchange-based and fee-based contracts, such as sale and lease. No profit should be earned from charging interest on loans and late payments.
2. The service charges imposed that are not related to the loan are permissible and can be accounted in the revenue for the bank.
3. The bank should not impose any vague or dubious charges which are labelled as “miscellaneous charge”. All charges, fees and incentives must be approved by the *Shari'ah* board.
4. Any fees imposed on loans and its management must only reflect the actual incurred cost and cannot be included in the revenue for the bank.
5. As imposition of actual costs on services related to loans is permitted, the determination of whether the benefit is for the bank or for the customer is essential. Nothing more than the actual cost should be imposed if the benefit is for the creditor or if the benefit is for both parties but the creditor will reap more of it as compared to the debtor.
6. For default cases, it is suggested that determining the cost based on Islamic Interbank Money Market should be reviewed. By determining the cost based on IIMM, there is a tendency to include opportunity cost in the amount charged. There is an element of *riba* as there is an imposition of an additional amount due to the extension of the repayment time.
7. For further research, it is suggested that all types of charges and fees imposed by the bank for its products be discussed and researched thoroughly so that their legal status is clear in light of the *Shari'ah*.

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