

# CONCEPTUAL UNDERSTANDING OF SERVICE CHARGES ON LOANS AND ITS APPLICATION IN ISLAMIC MICROFINANCE

(A Scholarly article by TASIS)

For an operation of advancing interest-free loans to be sustainable and self-reliant on an ongoing basis it has to be based on a system of service charges. For such an operation to be Shariah compliant it is important to fully comprehend what exactly is denoted by the concept of “Service Charges”. Hence in the following sections the concept of “Service Charges” is analyzed from Shariah and financial perspectives.

## 1. Shariah Perspective

In the present financial environment it has become an important issue for Shariah scholars to develop a system whereby a loan can be made available without interest. Even assuming that the capital for the loan can be made available without interest, there is still the issue of meeting the cost incurred on mobilizing the fund and disbursement of loan and its recovery. Hence the main challenge before us is how to develop a viable model of lending even when the fund provider is willing to provide his fund without any increment or benefit to him<sup>1</sup>.

Shariah scholars engaged in financial matters globally<sup>2</sup> are of the view that the lender is allowed to recover from the borrower the actual cost incurred in mobilizing the fund (other than its own funds involved, if any) and other actual expenses incurred during the operation. However they caution that the lender should not recover from the borrower any amount above the actual incurred cost and in case there is any payment over and above the actual incurred cost then the

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<sup>1</sup> "Every loan that brings some benefit (to the lender) is Riba" (Al-Matalib Al-'Aliyah 1/411, 1373 and Irwaul-Ghalil 5/235, 1398). This Hadith is considered weak; however, it alludes to same meaning as has been reported from a group of the Companions where any stipulated benefit on debt is understood to be Riba.

<sup>2</sup> In India, however most Shariah Scholars continue to be against recovering any additional charges from the borrower, recommending that the administrative cost of operations be met through charitable donations or through commercial deployment of part of the funds. It may be noted however that these options have repeatedly failed to prove economically/legally feasible.

borrower is entitled to get it back.<sup>3</sup> Since the cost in such a case is on account of providing a service, it is referred to as “Service Charges/ Service Fee”.

In the Fiqh literature many references can be found relating to loans (interest-free). In Hadith it is found that giving a loan is more rewarding than giving charity<sup>4</sup>, as this helps a really needy person.

A lender is not entitled to receive anything except the principal amount due to the borrower.<sup>5</sup>

Considering the prevalent difficult situation many scholars and Shariah Boards have permitted charging the borrower a fee to recover the cost of operations for providing that service. Some organizations like India’s Islamic Fiqh Academy, have however allowed this only as a last resort, whereas many others have allowed it to encourage an institutional mechanism of interest-free lending. In the following section we give more details on the subject.

When we come to the issue of payment made (over and above the loan) to a third party through whose assistance an interest-free loan has been procured, we find references in the literature which accept the validity of such a payment, without any reference or link to the cost incurred by the third party – indeed implicitly even recognizing the validity of a profit element in the payment.

According to Prof Nazih Hammad in a forthcoming book, “The interest-free loan procured with the assistance of a third party to whom a payment is made is considered to be permissible by the Shāfi’īs and the Ḥanbalīs, even though the borrower effectively pays more than the amount obtained, because the extra amount is not paid to the lender but to the party that arranged the loan. There is no shari’a prohibition of this.

In this regard, Burhan al-Din bin Muflih expatiates on this point through a practical example: "If he says, 'Obtain a loan for me of 100 dirhams and your fee is

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<sup>3</sup> With regard to the Janseva study we have had personal interactions with Dr Hussain Hamid Hassan, Chief of Dar Al Sharia, UAE. We also had several exchanges with Dr Ejaz Samdani (close associate of Mufti Taqui Usmani), Shariah Advisor of many institutions in Pakistan and Mr. Mohammad Ayub (Former Central Banker of Pakistan). Some clarifications were also obtained from Zubair Mughal of Al Huda Center of Islamic Finance

<sup>4</sup> It is narrated from Anas bin Malik that the Messenger of Allah (PBUH) said: “On the night on which I was taken on the Night Journey (Isra), I saw written at the gate of Paradise: 'Charity brings a tenfold reward and a loan brings an eighteen fold reward.' I said: 'O Jibril! Why is a loan better than charity?' He said: 'Because the beggar asks when he has something, but the one who asks for a loan does so only because he is in need.' ” (Vol. 3, Book 15, Hadith 2431)

<sup>5</sup> Quran (2:279) and the Prophet (pbuh) said “When one of you grants a qard and a gift is made to him by the borrower or he offers him a free ride on his animal, he is not to accept this from him, unless such a practice was prevalent between them prior to the Qard”.

<sup>6</sup> Al Mubdi'i, 4/213

10', this is legitimate and valid because it is a fee paid in consideration for an effort or influence."<sup>6</sup> In a similar vein, "If he says, 'Obtain a loan for me of 100 dirhams and your fee is 10,' this is a broker's fee.

This has been confirmed by al-Mawardi and al-Ruyani. In other words, the borrower has to pay a broker's fee to the arranger."<sup>7</sup> Al-Mawardi said "If a person says to another person: 'Obtain a loan of 100 dirhams for me, and I will pay you 10 dirhams', this is not considered desirable by Ishaq, but was permitted by Ahmad, and we consider it a fee with no harm in it. The person lending 100 dirhams is not entitled to the 10 dirham fee, because the fee can only be paid to a third party (the broker) as a reward for arranging the loan."<sup>8</sup>

Though prima facie this view (that a payment to a third party facilitating an interest-free loan can include a profit element) appears to negate the concept of service charges as a payment linked to costs, a careful analysis in fact leads to the conclusion that on the contrary it reinforces the same concept. We take it up for further discussion in section 3.4 below,

### **1.1 Rulings of Indian Fiqh Academy**

India's widely acknowledged Shariah research body, Islamic Fiqh Academy passed the following resolution in its third Fiqhi Seminar held during June 08-11, 1990 at Bangalore:<sup>6</sup>

**1.1.1.** To collect any amount, by whatever means, from the debtor over and above the actual loan amount is not permitted in Islam as all amounts so collected fall within the category of interest. Hence to collect any excess amount, be it for the benefit of one's own self, or the loaning institution or for the purpose of financing any other charitable or welfare institution, is Islamically not at all permissible. Similarly it is also haram (prohibited) to put the amounts belonging to such institutions as fixed deposits in banks and utilise the interest accruing thereupon.

**1.1.2.** The charity-minded well-off and affluent persons should bear all the operational expenses treating it as an act of service for their community and to seek the pleasure of Allah. If such institutions succeed in bringing it home to the people that they operate strictly within the bounds of Shariah under the guidance

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<sup>7</sup> Hashiyat Al Sharwani, 2/381.

<sup>8</sup> Al Hawi Al Kabeer, 6/440. See: Hashiyat Al Qayloobi, 2/258.

<sup>9</sup> It may be noted that this resolution is in the context of certain practices by some organisations where they mobilise interest-free deposits from the community and provide their members loans based on certain fees (service charge, cost of loan form, cost of security etc.) and a substantial portion of the fund in these organisations is kept with conventional banks for earning interest part of which earnings are also used for welfare activities: [http://www.ifa-india.org/english.php?do=home&pageid=Seminar\\_English3](http://www.ifa-india.org/english.php?do=home&pageid=Seminar_English3)

of Ulama and by offering financial assistance to their brethren to save them from the curse of interest, it is strongly hoped that the affluent Muslims will come forward to shoulder the burden of the operational costs of such institutions and even to provide finances for the expansion of their activities.

**1.1.3.** This Seminar was of the view that such institutions should try to invest a part of the capital in their hands in productive ventures to earn some jaiz (Islamically permissible) income, at least to the extent of being able to meet the operational costs of the institutions.

**1.1.4.** Many of the participants Ulama were of the view that service charges of operational costs, though indispensable and even if at the level of bare actual, cannot be charged to the creditors (sic)<sup>7</sup>. Some other Ulama hold that although in essence, this may be Islamically permissible, it should necessarily be held as impermissible as inherent in it is the danger of the door for interest getting opened.

Some other participating Ulama put forth the view that inasmuch as setting up of such welfare institutions fulfills a great need of the community and in case required cooperation from the well-to-do of the community is not forthcoming, nor is it possible to generate capital for the operational costs through Islamically lawful productive investments, in that case the actual cost necessary to meet the operational cost may be charged to the debtors because the amount thus collected goes neither to the persons collecting it nor forms a source of income for the institutions per se. However, even those holding this view are firmly of the opinion that as charging any amount to the debtor over and above the loan amount is quite against the Islamic spirit of loaning and since it is to be permitted only because of its unavailability, extreme care should be taken in computing the operational costs to be charged to the debtors. In case the operational costs, estimated with great caution and collected from the debtors, are found, at the end of the accounting period, to be in excess of the actual expenditure incurred, it would be incumbent on the institution, according to Shariah, to return the balance on pro rata basis to the debtors from whom it had been collected.

## **1.2 Rulings of the Fiqh Academy of OIC<sup>8</sup>**

Islamic Fiqh Academy of the OIC countries resolved the following:

**1.2.1.** Some Islamic banks give loans with service charges. The Council of the Islamic Fiqh Academy has resolved that it is permitted to charge a fee for

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<sup>10</sup> Actually it should be "borrowers", as the next sentence also confirms.

<sup>11</sup> Resolution number 13/3 Page 23. Also the Resolution number 50/1-6, P 101

loan-related services offered by an Islamic bank, provided that the fee relates to service-related expenses.

- 1.2.2. The service charge can only be calculated accurately after all administrative expenditure has been incurred (at the end of the year). However it is permissible to levy an approximate charge on the client, and then reimburse/claim the difference when the actual expenses are known.

### 1.3. Rulings of the Shariah Board of Islamic Development Bank

Islamic Development Bank (IDB) established in 1975 provides loans on the basis of Service charge in addition to its main business of providing financing to viable business proposals of private and government organisations in member nations. The following explanation of its Shariah Board is instructive:

- 1.3.1. Bank charges service fee on loan financing to cover actual administrative expenses related to the project. It differs from interest in that the service fee is the actual expense incurred by the Bank, while interest is payment for the use of the funds.

### 1.4 Fatwa of the AAOIFI Shariah Board

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1991 and representing more than 200 members from over 45 countries, is an Islamic international autonomous not-for-profit organization engaged in preparing Shariah, accounting, auditing, and governance standards for Islamic financial institutions and the industry. AAOIFI in its Shariah Standard No.19, Clause 4/1 states:<sup>9</sup>

- 1.4.1. The stipulation of an excess for the lenders in loan is prohibited, and it amounts to Riba, whether the excess is in terms of quality and quantity or whether the excess is a tangible thing or a benefit, and whether the excess is stipulated at the time of the contract or while determining the period of delay for satisfaction or during the period of delay and further, whether, the stipulation is in writing or is part of customary practice.
- 1.4.2. AAOIFI's Shariah Standard 19, Clause 9/1 further states; "It is permitted to a lending institution to charge for services rendered in loans equivalent to the actual amount directly spent on such services. It is not permitted to the institution to charge an amount in excess of such a service charge. All charges in excess of the actual amount spent are prohibited, and it is necessary to ensure precision in the determination of the actual charges so that they do not lead to an excess that can be deemed a benefit. **The fundamental rule is that each loan bears its own specific charges** (emphasis added), unless this becomes difficult as in the case of a group or

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<sup>12</sup> AAOIFI Shariah Standards 2008, Page 345-46.

common loan, in which case there is no restriction in the way of bearing direct collective charges for all the loans on the basis of the entire sum. It is necessary that the method of determining the charges be laid down by the Shariah supervisory board of the institution in detail, and this is to be done by distributing the expenses incurred among all the loans and each loan is to bear its share proportionately. An explanation of such circumstances is to be presented before the Board along with suitable documents.”

- 1.4.2.1.** And 9/2 reads, Indirect expenses incurred in rendering services for loans are not included in actual expenses, like the salaries of the employees, the rentals of space, assets and means of transport as well as other management and general expenses of the institution.

## **2. Service Charges Analyzed in Rational, Financial and Cost Accounting Perspectives**

In the above section we have put forth the views of various Shariah authorities on the concept of Service Charges. In the subsequent sections the same concept is analyzed from rational and financial perspectives.

### **2.1. The Rational Perspective**

It is evident that the purpose of offering the facility of loans by a financial institution without indulging in Riba is primarily to provide an important service to the borrowers. Also we need to keep in mind that an institutional mechanism to provide Riba-free loan cannot be developed unless the model itself is self-sustainable. In other words, the borrowers being the real beneficiaries of the facility – and no one else - it is only just and equitable that they pay for the services they are provided (in the event other options are not feasible – which normally is the case). It needs to be ensured however that none of the contributors of capital or the organization itself stands to gain from the service charges collected from the borrowers. Conceptually such service charges would be equivalent to a borrower paying the travel cost of a servant / well-wisher to enable him to fetch him a sum of money (as a loan) from a friend residing in another town.

Thus for the institution providing interest-free loans there are certain conditions that need to be met for it to be able to collect Service Charges from its borrowers.

- i.** The owners of capital (i.e. depositors and shareholders) must not gain anything over and above their original capital;<sup>10</sup>

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<sup>13</sup> Quran 2:278-79

- ii. Administrative costs of running the scheme must come out of the operation itself (i.e. they must be borne by the borrowers); and
- iii. Recovery from the borrowers of any amount over and above the principal amount lent must not be linked to the amount lent per se, (i.e. any charges recovered from the borrower must be linked to the principle of recovery of costs only).

## 2.2. In Financial Perspective

As we have seen above, according to some even recovering the cost of administration from the borrowers is objectionable. This needs some clarification. A comparison between service charges and interest would prove interesting. The income that banks receive (by way of interest) goes to three different sectors. These are:

- i. Depositors;
- ii. Employees and suppliers of goods and services;
- iii. Shareholders

These three sectors receive respectively;

- a) Interest on deposits;
- b) Salaries for their labour and prices of goods and services supplied; and
- c) Dividends on shares and increase in share values due to additions to reserves.

According to the Islamic view, the first payment is clearly wrong because the extra that depositors get is for lending their money (i.e. Riba). So is the third (as it amounts to profit-making by lending business either through own money or by borrowing from others). But the second does not fall in the same category, as the compensation they receive is either for the work they have done or the goods and services they have supplied. This second component is what constitutes Service Charges.

It may be noted here that the displeasure of Shariah scholars regarding working for a conventional bank is on account of “.....do not cooperate with each other in the work of sin and transgression”.<sup>11</sup> Since a conventional bank itself is created for conducting Riba-based business, therefore working for it is not approved. Otherwise there is no harm in working and receiving compensation/salary/payment from a financial institution that does not deal in Riba.

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<sup>14</sup> Quran: 5:2.

### 2.3. In Cost Accounting Perspective

As the stand on the issue of Service Charges in an Islamic financial institution is that they have to be based on actual costs of operation, hence the primary point to be clarified is regarding the nature and relative level of the costs.

The expenses of any lending institution can be divided into:

- a. Financing cost and
- b. Administrative cost

In case of an Islamic lending institution, unlike the conventional ones, the financing cost (cost of capital) is zero, though the administrative cost is relatively much higher, as all the funds have to be mobilized basically as demand deposits, which have high transaction intensity. Also it is observed that such deposits are usually in the form of doorstep mobilization, the same further adds to the administrative cost.

The total cost of such an organization is thus the cost of

- a. mobilizing and maintaining the deposits, and
- b. the administrative cost of advancing loans, their follow-ups for recovery and maintaining their ledgers till they are fully repaid.

There are also certain costs in the nature of overheads such as rent, electricity, repairs and office maintenance and salaries of senior and supervisory staff, which cannot be completely allocated to either of the above cost heads. These can be apportioned proportionately between the two major cost heads: cost of mobilization and cost of loan servicing. Hence the total expenses of the institution are finally gathered under these two cost centers.

#### 2.3.1. Cost of Mobilization

The cost of mobilization varies as a % per annum of the amount loaned; hence this part of the cost will apply to every loan as a definite percentage per annum. This is because for a loan of Rs. 1,000 the institution needs to mobilize a sum of Rs. 1,000, whereas for a loan of Rs. 10,000, it needs to mobilize Rs. 10,000.

Hence the cost of mobilization varies in proportion to the size of the loan.

Similarly, for a loan which is repaid after 3 months, the institution has **to keep the amount mobilized** for 3 months for that borrower (it needs to be noted here that the cost is not of just a one-time mobilization but of a continuing mobilization of the amount). Hence the expense borne by the institution on account of a borrower, who instead pays the same amount of loan after 6 months, is double. Hence the cost of mobilization varies directly with both time and amount. This

means that it is incurred as a % per annum (and therefore also needs to be recovered as a % per annum).

### **2.3.2. Cost of Loan Servicing**

The loan servicing cost however does not vary in this manner. In order to compare it with the cost of mobilization, it can be calculated in the form of an overall percentage on all the loans given out. However, it is not actually incurred as the same percentage on every loan. Basically, (unless the repayment involves just a one-time payment) it depends only on the time for which the loan is outstanding. Whether a loan is of Rs 100/= or Rs 1000/= or Rs 10,000/=, this cost (in Rs) will be the same for that loan as long as the period of repayment is the same, say ten months. However, if the period is doubled to say 20 months, this cost will also almost double. It will not be exactly double, however, as there are certain initial costs of loan servicing such as cost of forms, opening the borrowers folio in the loan ledger, etc., which are completely fixed and do not vary even with time.

Hence the cost of loan servicing if calculated as a percentage on specific loans will vary widely from a small percentage on large and/or long period loans to a relatively large percentage on small loans for a short period.

It may be noted that there is also another minor variable which affects the quantum of these costs, though marginally. It is the manner in which the loan is secured. Those loans secured by ornaments take up more time and resources (and therefore, cost) of the Society to process, than those secured against deposits of guarantors.

As a result, if the total cost of loan servicing is recovered as a uniform percentage over all the loans it will lead to injustice as it will effectively involve some borrowers subsidizing others (though the institution itself will not benefit in any way).

## **3. Recovery of Service Charges**

From the above it is clear that actually, service charges on loans really depend on several parameters: in the first instance on the cost of mobilization (which varies as a % per annum) and the cost of loan servicing; the latter again varies primarily on the basis of the pattern (number of installments) of repayment and secondarily on the security for the loan. The loan servicing cost thus has two components: one which is fixed, depending on the cost of initial processing and final closing of the loan account and another attracted by the period for which the loan is carried on the books of the institution and secondary aspects of the loan.

## 2.4. Components of Cost Recovery

*The recovery of the cost (i.e. the service charges), must accordingly also follow a pattern similar to the pattern in which the costs are incurred, namely:*

- a. an initial (fixed) loan processing cost,
- b. a quarterly (or monthly) two part charge comprising of
  - i. the cost of mobilization (calculated as a % per annum on the outstanding principal amount during the quarter (month), and
  - ii. a (fixed) loan accounting and follow-up charge payable for all the quarters (months) for which the loan is unpaid, and
- c. A final (fixed) loan closure charge at end of quarter (month) in which the loan is fully repaid and the security is released.

The timing of application of the various components has to be as indicated above. The quantum of the first and third components can be estimated on an annual basis based on the stationery and time required for the work involved and the salaries and benefits of the personnel involved (including apportionment of overheads). These fixed amounts will then be attracted by all loans at the relevant times (release and closure of the loans).

During the pendency of the loan the periodic charges (the second component) are to be applied. These need to be applied only on completion of the period (quarter or month) and finalization of calculation of costs for that period. Here again, the loan accounting and follow-up charge will be a fixed charge per repayment, on the basis of annual estimation of the costs involved in accounting for the repayment (similarly as for the other components of the loan servicing cost above).

As for the cost of mobilization, it will be calculated for each period on the basis of actual costs incurred for that quarter as a percentage per annum on the outstanding balance of principal in the loan account and applied to the borrower's account. In the event a specific loan is closed before a particular period (quarter or month) is completed and the cost calculations for that period are not yet available, a conservatively higher amount can be recovered for that period based on the trend of costs during the earlier periods. Any excess recovery can be reimbursed to the borrower when the actual costs are known, or retained with the Society as a donation (with prior permission of the borrower).

Hence recovery of the major portion of the cost, that is the cost of mobilization, will be on actual basis and the relatively minor portion of the loan servicing cost will be on the basis of costs reviewed and estimated on an annual basis.

As for apportionment of repayments, Whenever a payment is received against a loan, it needs to be first adjusted against the outstanding service charges attracted by the loan till that date and yet unpaid, and only the remaining amount credited against the balance loan amount.

### **3.2. A Simplification**

As we have discussed above, the service charges are actually comprised of two main components: cost of mobilization and cost of loan servicing. Empirically, it can be confirmed that about 85% or more of the total cost of running a normal Islamic lending operation in India is on account of cost of mobilization and the rest due to loan servicing.

This is evident logically too. Once a branch is out of the initial establishment phase and into the steady growth phase, the loan:deposit ratio is always less than one (generally of the order of 70% to 80%) and the average size of the loan outstanding amounts are on average several times the average size of demand deposit balances. The ratio of deposits to net owned funds (and long term deposits) too is a high figure, normally of the order of 5 to 8. As a result the number of demand deposit accounts is normally at least 10 times the number of loan accounts. Then, whereas there can be multiple entries in even a week in the deposit accounts, in the loan account there is normally not more than one entry in a month. This shows that the work (and therefore, cost) expended on account of deposits, is many times that on account of loans.

We have seen above that the cost of mobilization actually varies as a % per annum. Hence if the relatively minor loan servicing cost can be met from income earned by the institution from activities other than lending, then only the actual cost of mobilization needs to be recovered from the borrowers. In that event the calculation and application of service charges, every quarter, can also follow the pattern of a % per annum. This makes the exercise relatively very simple, particularly in the context of the present computational capabilities of even low-end computers.

### **3.3. An Important Clarification**

In the literature relating to Qard Hasan one often comes across two contradictory statements. On the one hand it is clearly acknowledged that an Islamic financial institution is entitled to recover the cost it incurs on providing Qard Hasan. This is unexceptionable.

At the same time it is asserted that the cost to be recovered should not be in the nature of a % of the amount lent or linked to time but it should be fixed. This is unwarranted; it involves a tacit assumption that the cost is being incurred on the account of the borrowers too in a uniform manner, which, as we have seen above, is actually not the case.

Perhaps this is because the focus of the literature is primarily on the Qard Hasan advanced by Islamic financial institutions or government institutions abroad. The focus of Islamic banks abroad is on commercial operations and Qard Hasan forms a negligible part of their operations. Under these circumstances, typically the institution/government sets aside a certain fund from their profits or budgetary allocations, respectively, to be used for providing Qard Hasan loans (which may be supplemented by charitable donations from affluent persons). Thus there is no cost to the institution itself of separately mobilizing the loanable funds. Under such circumstances the Cost of Mobilization is zero and the institution only needs to recover the Cost of Loan Servicing, which then may not vary greatly (though there will still be variation with the tenure of the loan).

Unlike the situation of Islamic financial institutions abroad, lending institutions in India have to raise their own funds on the basis of demand deposits which entail a high Cost of Mobilization (in comparison to the Loan Servicing Cost). Under such circumstances recovering the entire cost by means of a uniform fixed charge from all borrowers is likely to lead to gross injustice due to under-charging some borrowers at the cost of others, while also in effect discarding the basic principle of recovery of cost from individual borrowers.

A small example here will better drive home the point.

Assume that the funds deployed, as loans by an Islamic loaning institution were Rs 1.4 crores at the start of the accounting period and had risen to Rs 1.8 crores by the close of the financial year. Hence one can say that it had an average loaned fund of Rs 1.6 crores during the year.

Assume the total cost of running the institution is Rs 16 lakhs. Of this Rs 13.6 lakhs is spent on Cost of Mobilization and the balance Rs 2.4 lakhs on Loan Servicing.

Assume that during that period the institution had given out 4,000 loans. If we were to recover the total cost of running the institution by means of a fixed uniform charge, it would mean recovering from each borrower  $16,00,000 / 4,000$ , i.e. Rs 400.

Although we know that the Loan Servicing Cost itself too will vary depending on the tenure of the loan, let us for simplicity allow that it is fixed. Hence the Loan Servicing Cost to be charged to each loan will be 2,40,000 / 4,000, i.e. Rs 60

We know that the Cost of Mobilization varies as a % per annum So it works out to 13,60,000 / 1,60,00,000, i.e. 8.5%.

Among the loans made by the institution are 2 loans with the following parameters:

**A:** Loan of Rs 15,000 repayable in 12 months, and

**B:** Loan of Rs 3,000 repayable in 4 months.

If we were to calculate the actual cost to the institution of these loans, it is

**A:**  $60 + 8.5\% \times 15,000 \times 12/12 = 60 + 1275 = \text{Rs } 1335.$

**B:**  $60 + 8.5\% \times 3,000 \times 4/12 = 60 + 85 = \text{Rs } 145$

Hence recovering a uniform charge from all the borrowers leads to heavy cross-subsidization of the cost of A's loan by B.

Incidentally, the cost to A & B in % terms, as calculated below, also shows the glaring injustice inherent in the system of uniform recovery:

As per uniform charge:

**A:**  $400 / 15,000 \times 12/12 = 2.67\%$

**B:**  $400 / 3,000 \times 12/4 = 40\%$

As per actual costing:

**A:**  $1335 / 15,000 \times 12/12 = 8.9\%$

**B:**  $145 / 3,000 \times 12/4 = 14.5\%$

Persons running Islamic lending institutions experience the anomalies inherent in a system based on fixed service charges and generally move from a uniform charge to a graded charge based on the loan amount. But really speaking that is neither here nor there and a tacit admission of the necessity of moving to a scientific costing system from a system of charging a fixed amount to all borrowers.

### **3.4. Analysis of the Concept of a Profit Element for a Third Party Facilitator of an Interest-free Loan**

Apparently, the argument appears reasonable and one is initially inclined to accept it. But then does that not subtly open the door to charging of interest by institutions advancing interest-free loans. Or does it mean that such institutions can validly charge a profit element, as they are only effectively acting as go-betweens or agents, facilitating loans to borrowers using the funds of depositors?

The point to be clarified at the outset is that they are not acting as mere agents for the depositors but as principals in their own right - accepting deposits on the one hand and lending on the other. In the loan transaction the money lent is theirs and they alone have to bear the consequences.

The question that then arises is that if a third party can make a profit in facilitating an interest-free loan, can the same apply in case of a party who is using his own money. Let us analyze the entire issue a little more closely. Effectively we are faced with three options in the case of the loan:

1. Nothing extra to be charged on the loan
2. Charge only cost, and
3. Charge a fee (higher than cost).

Also let us understand clearly, what the charge is for. Here there can be two functions performed by the person who makes the loan possible:

- a.** (just practically) making the money of the loan available, without reference to who is the legal owner of that money, and
- b.** temporarily relinquishing the use of that money as its legal owner so that the borrower can legally use it instead.

In most situations of personal and even corporate loans, these two functions are intertwined and go together. In certain situations, where a financial adviser (essentially, a broker) is involved in a professional capacity, the first function may be split between the owner of the funds and the adviser; the second function is however that of the owner.

So we have three scenarios here.

1. A person who performs only function "a",
2. A person who performs only function "b", and
3. A person who performs functions "a" and "b"

It is reasonable to allow the person who performs only function "a" to charge a fee which could be higher than the costs he is incurring (recall the concept of a courier fetching the money for the borrower from the lender). In case of the person who is performing function "b", it is clear no charges can be collected, as it would be tantamount to riba. What about the person who is performing both functions, "a" and "b"?

Theoretically, it should be allowed to the person who performs both functions "a" and "b" to be able to charge for his services on account of performing function "a" higher than just the cost incurred by him in performing function "a", just as we allow a person who is performing only function "a" to do. Of course he cannot charge anything on account of function "b". However, how does one ensure that the (extra) margin he is avowedly charging only on account of function "a" is the justified margin for his performing just function "a" and does not also include some element on account of his performing function "b".

As it is, it is difficult to determine the cost incurred by him on account of his performing function "a". Secondly, his combining in himself the performer of function "b" (i.e. provider of money to the borrower for use at zero finance cost, thereby simultaneously denying himself the use of that money), in almost all cases gives him a kind of strong monopoly position for pricing his services on account of function "a". Hence to be able to generally determine his "fair" margin (over costs) for performing function "a" in such a situation, it is a well-nigh impossible task. As a result, the only practical solution in such cases, is not to allow such a person any margin for performing function "a" and restrict him to just recovery of costs.

Hence, even if we accept that a third party is entitled to charge a profit for the work of facilitating a loan, the lender himself, even if he is genuinely exerting himself in also facilitating the loan in some way, cannot charge anything other than actually incurred costs. Unfortunately very often our ulama tend to look at

issues in isolation and not in a comprehensive framework and therefore sometimes come up with rulings which may lead to anomalous situations or to their rulings being misapplied in practice.

#### **4. Institution of a Costing System for Determining Service Charges on an ongoing Basis**

For any ambitious Islamic Microfinance project, wanting to operate a system of interest-free loans and moreover, an institution which aims to provide both investment finance as well as loans, to be fully Shariah compliant, it is essential to install a full-fledged costing system in order to determine the costs of its various products on an ongoing basis. Such a move will not only ensure better compliance with Shariah but will also be extremely beneficial for the organization from a management control perspective. Given below is a gist of how the system could be designed.

##### **4.1. Gist of how a Scientific Costing System can be implemented**

The basic function of any system of costing is to provide a segregation of costs according to products and cost centers. Just as financial accounting involves classifying accounting entries and expenses according to their financial nature, cost accounting requires the same expenses to be classified according to the type of costs and according to the product to which they pertain. If a particular expense relates to more than one product, that total expense needs to be allocated among the different products or cost centers to which it pertains.

With this brief introduction, we can proceed to understand in brief how a costing system can be introduced in order to work out the cost on individual loans. As stated in the Report, for an operation which involves only loans, the expenses need to be allocated initially among three cost centers:

- Mobilization
- Loan Servicing and
- Overheads

Overheads are then to be apportioned between Mobilization and Loan Servicing. If the institution has in its portfolio, products other than loans too, it will accordingly also need to define at least one more cost centre "Others" ("Others" could be further sub-divided into further cost centers, such as "Other Service Products" and "Investment Products" – and the latter even further into

various separate investment products. Since our focus is on loans, let us club all non-loan products for this discussion under "Others". Thus we could have 4 cost centers: A, B, C and D, corresponding to the four cost centers mentioned above.

As for expenses other than manpower-related expenses, the vouchers or indents for the same need to be tagged as they are raised or issued. Take for instance, conveyance or stationery. When the conveyance voucher is raised, the person raising the voucher knows for what purpose the conveyance was used – whether in connection with loans, mobilization, investment or a general purpose (Overheads). Accordingly, the person will put the relevant letter A, B, C or D against the relevant amount on the voucher (the vouchers could be designed to have a 'Cost Code' column next to the 'Amount' column so that the expenses could be flagged as they are incurred.

In the case of items bought to stock such as stationery, the point of tagging could be the point of issue for high value items (such as printer cassettes and ribbons, expensive brochures or annual reports) and large volume items (such as Daily Deposit Receipt Books and Pass Books), with annual reconciliations, or point of purchase and tagging the items to "Overheads" in case of low annual turnover items.

Manpower related expenses would account for probably about 60% to 70% of total costs. Hence they need to be allocated in a more detailed fashion. The method of doing so involves each section or department in charge filling in weekly time sheets for the few subordinates reporting to him, indicating for each person working under him, the proportion of time in his estimation that subordinate has spent weekly on work related to each of the four cost centers based on the actual work allocations. The time sheets of all staff are tabulated, actual manpower benefits such as PF, etc. accrued are added on in the same proportion for each cost centre and the costs consolidated over all employees monthly for obtaining the allocation of the manpower related costs.

Adding up the manpower related and the non-manpower costs, cost centre-wise gives the allocation of all costs according to the four cost centers. Then the the Overheads are apportioned proportionately among the other three cost centers. We are not concerned with the allocation to the "Others" head. So we are left with the allocations to "Mobilization" and "Loan Servicing". Let these be Cm and Cl respectively.

The next step is determining the Mobilization Cost as a percentage per annum. For this we need to calculate the total Re-months deployed as (principal amount of) Loans outstanding during the period. Assume this figure is  $R_m$ . Let  $C_m / R_m = C'm$ . Then  $C'm \times 1200 = P_m$  is the mobilization cost in percentage per annum.

This is the common mobilization cost percentage to be applied to the outstanding Rupee-months of any specific loan during the period to obtain the mobilization cost to be recovered on account of that loan towards mobilization cost. The Loan Servicing cost on any loan is comprised of its elements as described in the Report and these elements need to be estimated on a periodic basis and reconciled with the actual consolidated Loan Servicing Cost calculated as above over all loans for that period; thereby the estimated elements of the Loan Servicing cost for the next period can be set, and so on.

The above is a broad overview of the system. If an institution offers multiple products, the scheme in its case will correspondingly be more complex. The detailed system will require maintaining detailed tables and spreadsheets for recording and totting up costs and calculating the required ratios. It will require regular and accurate feedback from the branches and a full-time team of one or two persons to follow-up and maintain the system. The pay-off will be full Shariah compliance, without having to resort to under-recovery and incur deficits.

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