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Original Research Article

Practical Operations of Islamic and Conventional Banking Systems: Cost of Financing (*Qard Al-Hassan)* Analysis

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Abstract

The major issue for current study is practical application of theoretical discussion on *riba*, what constituted *riba* (interest) itself in the practical operations of Islamic banks. For instance, Islamic bank is a business or commercial entity, how this entity is going to survive in business, if it cannot involve in receiving interest from or paying interest to its clients. This paper is both descriptive and exploratory with aims to contribute to the understanding of the operations of Islamic and conventional banking. Therefore, this study tries to make use of Cost of Borrowing (known as Cost of Financing in Islamic banking context: Qard Al-Hassan) to examine and critically analyses the operations of Islamic and conventional banks in practice. Some issues in estimating CoB/F under the two systems as well as illustration on (CoB/F) computation were analyzed. Reasons why CoB/F is allowed to be charged by the Islamic bank and to be paid by the customer is also examined and illustrated. The study will have policy implication to the policy makers and the practitioners in the area of Islamic and conventional banking system. It will also be a source of reference for the academicians, students, and other interested parties.

Keywords: Conventional banking, Cost of Borrowing/ Financing (*Qard Al-Hassan)*, Islamic banking, Practical operations, *Riba*

INTRODUCTION

The issue of *riba* (interest) has long being a central of concern and discussion in the area of transaction especially Islamic financial transaction for pious Muslims. Even what constitute *riba* itself has been a subject under serious discussion. The existence of *riba* has been argued to be a major factor for the low participation of the pious Muslims in the economic activities of the nations with Muslims majorities. For instance, and specifically before the establishment of Bank Islam Malaysia Berhad (BIMB) in 1983, *riba* was identified as the factor responsible for low participation of the Malays (who are Muslims) in the economic activities of Malaysia. The establishment of BIMB was a major step towards an interest-free financial system in Malaysia BIMB (1994). In addition, the bankable and economically active population that was outside the banking system in Nigeria was estimated at 65% by the Islamic Banking and Finance Committee, (2010). Furthermore, according to Sanusi (2011), there is high number of Nigerian Muslims who out of religious belief choose to keep the money outside the formal banking system and this has contributed to the high level of cash outside the banking system. Central Bank of Nigeria (2013) about 60 per cent of Nigerians is unbanked due to their religious beliefs.

The function of conventional modern bank is built on the interest system, which *Shariah* has condemned as evil. Although, the major objective of introducing Islamic financial and commercial system is to eliminate *riba*

(interest), but the Islamic principles of economic and social justice is paramount in the system and must also be achieved. Therefore, Interest – free financial activities is not equivalent to Islamic financial activities because the role of Islamic financial system is more than eliminating of interest (*riba*). Elimination of *riba* in financial activities, implementation of *Shariah* principles and achievement of the objectives of *shariah* are all the responsibilities of Islamic financial system in the society.

The heavily lopsided preponderance of Islamic banks to short-term financing results not from preference but from necessity. There are serious practical problems with long-term *mudarabah* and *musharakah* financing. Bacha (1995) pointed out that one of such problems is the agency problems of both conventional debt and equity financing. In order to avoid these problems, Islamic banks have chosen to concentrate on *Bay' Bithaman Ajil* (BBA) and other short-term financing modes. But the Islamic banks' current emphasis on short-term financing would not be congruent with social needs for enhanced real Gross National Product (GNP) growth. Unlike long-term loan financing, short-term financing cannot be used in financing of production facilities like factories, plants and infrastructure. But it is in the investment of such facilities that real economic growth rests. Unless a workable solution is found *mudarabah* and other long-term financing are likely to remain a minor financing technique and with that, Islamic banks will serve as peripheral players Bacha (1995). In view of the above, analysis of Cost of Borrowing (CoB) which is known as cost of financing in Islamic banking context (*Qard Al-Hassan*) will be of a great help in solving problem facing Islamic banks in providing long-term loan. Also, there is a misconception by the people that Islamic bank or financial institutions cannot borrow/lend money to an individual or corporation body. This misconception is due to the prohibition of interest *(riba*) in Islamic/*Shariah* principles.

What is the interest that shariah principles being referred to? Analysis of components of Cost of Borrowing/ Financing (CoB/F) under both Islamic and conventional banking systems will be the best way to provide answer to this question. Therefore, this study intends to shed light on practical operation of both Islamic and conventional banking systems making use of Cost of Borrowing/ Financing (CoB/F) analysis. With this analysis both the established and proposed Islamic banking and financial institutions and individual will be able to understand on how to finance individuals or corporate bodies without paying or receiving any interest and still be viable. This study will complement and contribute to the expansion of knowledge on opportunities identified for addressing the prevailing problem of failure of most of Islamic banks and financial institutions in providing both long and short terms specifically long term financing to individuals or corporate bodies under *Shariah* principles. Formerly established Islamic and financial institutions and proposed ones would be beneficial in terms of how to finance individuals or corporate bodies under Islamic principles making use of Cost of Borrowing/ Financing (CoB/F) analysis. Due to scanty previous research on the area, this study will also open door for incoming researchers as another area of interest. This paper is structured as follows: Discussion on objective and principles of *Shariah* is in section two after introduction and the rationale for the study. In section three is the brief discussion on *riba*. Section four describes and illustrates Cost of Borrowing/ Financing (CoB/F)/Qard Al-Hassan, Rationale for charging and paying CoB/F highlights in section five. The last section which is section six concludes.

Philosophy and objective of Islamic banking

An Islamic bank is a full-service intermediary financial institution that complies with the Islamic law (*Shariah* law). It is one of Islamic financial institutions in an Islamic economy, which mobilize funds from surplus units to deficit units. Islamic banking refers to system of banking that is consistent with the principles of *Shariah.* These principles are supported by Islamic banking's core value whereby activities that cultivated entrepreneurship, trade and commerce that bring societal development or benefit is encouraged. Activities that involves interest (*riba*), gambling *(maysir*) and speculative trading (*gharar*) are prohibited, BNM (2011). Islamic banks have similar functions and roles to any other ordinary commercial banks. But the objective and philosophy of the Islamic bank are the main functions that differentiate Islamic bank from conventional one. The basic objective of Islamic bank is to provide financial facilities by developing financial instruments that conform to the Islamic rules and norms of *Shariah.* Islamic bank needs also to participate actively in the process of the socio-economic development of Islamic systems (countries).

Both Islamic banking and conventional banking systems are performing similar functions but there is a fundamental factor as mentioned above in terms of approach that differentiates the two systems and this is 'Islamic Principles'. This was noted by many Islamic banking literatures such as Iqbal and Molyneux, 2005; Dusuki and Abdullah, 2006; Muhammad Ridhwan (2012); Hanefah *et. al*. (2012); Jalil *et. al.* (2011). All juristic scholars (Muslim Jurists) agreed that, the practice of the conventional banking system is not in line with Islamic principles and is not permitted in Islam. Therefore, the following major prohibition elements (Usury or *riba*, *Gharar* known as uncertainty/excessive risk/ambiguity /deceit, and *Maysir* known as gambling) that present in conventional system should be eliminated.

According to Dusuki and Abdullah, (2006); Dogarawa (2011c), Islamic banking system has the following distinctive salient features:

i. Justice, fairness and balanced society are what Islamic banking system is striving for,
ii. The principle of brotherhood and cooperation are what Islamic banking system is constructed upon,
iii. Ethical and moral framework of the Islamic law of *Shariah* is what Islamic banking system grounded upon.

Therefore "do good to others (benevolence) and equal rights for all person (egalitarianism) for the betterment of the Ummah**"** Rifaat Ahmed Abdel Karim (n.d., p.1) appears as the central philosophy of Islamic financial institutions (Islamic bank inclusive). According to Kamal *et. al.* (2008) and Marimuthu *et. al.* (2010), as a sacred duty, regarding the operations of Islamic bank or any other Islamic financial institution, Islam upholds contractual obligations and disclosure of information.

Riba/Usury (Interest)

Interest (*riba/usury*) can be defined as a contractual payment by the borrower to the lender for the use of money. In this case money is a commodity that commands a rental value. In *riba*/interest, money becomes a rented commodity in which the rental is interest. In general, *riba* is any unjustified increase in capital whether in loans or sales for which no equal compensation or return is given, Monzer Kahf (n. d.). Interest is strictly prohibited in Islam thus; Islamic finance relies on equitable risk-sharing and profit-sharing between the person who provides the capital and the entrepreneur. According to Iqbal, Askari and Mirakhor (2009), social justice demands that borrowers and lenders share equitably rewards as well as losses accruable from use of funds so that the process of wealth accumulation and distribution in the economy is fair and representative of true productivity. Thus, social justice, equality, and property rights will be achieved. Al-Jarhi and Iqbal (2001) defined *riba* with reference to *Shariah* scholars as "anything (big or small), pecuniary or non-pecuniary, in excess of the principal on a loan that must be paid by the borrower to the lender along with the principal as condition (stipulated or by the custom) of the loan or for an extension in its maturity.

The various Islamic financial institutions today carry out a variety of banking operations on a competitive basis. These operations include practically all the aspects of business, commerce and investment known to the conventional bank Monzer Khaf (n. d.). The explicit injunction against interest means that Islamic banks are not allowed to use some of the conventional application and sources of funds, such as lending operation on the basis of predetermined rates of return. Therefore, this study trying to make use of Cost of Borrowing/ Financing (CoB/F) to examine and critically analyse the operations of Islamic banks and that of conventional banks in practice.

Cost of Borrowing/ Financing (COB/F) and Riba/ Interest

Cost of Borrowing/ Financing (CoB/F) is the amount that will cost someone to borrow money or to secure financing especially from banks. According to Gafoor (1996, pp. 3 - 21) (CoB/F) has six components under conventional banking system, namely:

Cost of Borrowing (CoB) = ***Interest + Services cost + Overheads cost + Risk premium + Profit + Compensation for inflation***

The bank pays a certain percentage as interest to the depositors and recovers it from the borrowers when it lends. This is interest, pure and simple. Hence this component of the cost of borrowing falls into the prohibited category under Islamic financial system. In other word, under Islamic banking system (CoB/F) has five (5) components namely:

Cost of financing (CoF/ Qard Al-Hasan) = ***Services cost + Overheads cost + Risk premium + Profit + Compensation for inflation. This is what we called Qard Al-Hassan which refers to as benevolent loan.***

Riba/ Interest

The largest part of CoB is interest under conventional financial system. Bank promises the depositors some amount in percentage (fixed) to be paid to them if they deposit with the bank. The bank (which is not a lender none a borrower but a financial intermediary will over recover this amount from the borrowers. This is called interest, Riba or Usury, purely unIslamic, prohibited in the Holy Qur'an, Surat Al-Baqarah 2v275: "Those who devour Usury (Riba) will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say: Trade is like Usury but Allah hath permitted trade and forbidden Usury**……."**.

For instance, if someone goes to conventional bank to borrow, it is the interest (one of the six components) that the bank will tell the borrower that he/she will pay while actually the borrower will pay the total Cost of borrowing which has six components. In other world, the bank is deceiving from the beginning of the contract/transaction. In Islamic banking system if depositors did not collect or received interest the bank has no right to collect interest from the borrowers. As the interest is the largest size of the CoB, the CoB/F will be reduced dramatically under Islamic banking system.

Let us examine how conventional system calculates its interest, which is the largest size of CoB.

Simple Interest (SI)

SI = P x R x N

Where SI = total interest over the period of investment
P = original principal amount
R = rate of interest in %
N = number of years of investment

Illustration one

(a) What is the total interest of ₦500, 000 invested at 12% for 4yrs on simple interest basis?
(b) What is the total sum available to the investor (Sn)?

Solution

(a) SI = P x R x N = 500,000 x 12% x 4 = **₦240, 000**
(b) The ₦240, 000 sums is the interest earned plus the principal amount of
₦500, 000 for 4 years
Sn = ₦ (500,000 + 240,000) = **₦740, 000**

Compound Interest (CI)

A CI situation obtains or exists where interest is payable on the original capital sum invested plus cumulative interest to date.
Terminal value at the end of year 'n' is given by: Sn = $P(1 + r)^n$
Where Sn = the sum available to the investor after n yrs.

Illustration two

(a)What is the total interest of ₦500, 000 invested at 12% for 4yrs on compound interest basis?
(b) What is the total sum available to the investor (Sn)?

Solution

(a) First year: ₦500, 000 x 12% = ₦60, 000
Second year: *₦560, 000 x 12% = ₦67, 200
Third year: *₦627, 200 x 12% = 75,264
Fourth year: *₦702, 464 x 12% = 84,295
Total Interest = ₦ (60,000 +67,200 +75,264 +84, 2950) = **₦ 286,759**

(b) Total sum available to the investor = ₦ (60.000 +67,200+75,264 + 84,295.68 + 500,000) =
₦ 786,759.68 = **₦ 786,760**

*₦ 560,000 =₦ 500,000 + ₦ 60,000
*₦ 627, 2000 =₦ 560,000 + ₦ 67, 200
*₦ 702,464 = ₦ 627,200 + ₦ 75, 264

Frequency of Compounding

It sometimes happens that interest is paid at shorter intervals than a year e.g. a 12% annual interest rate may be implemented in such a way that 3% is paid at the end of every quarter. Where this is the case, the Effective Rate of Interest shall be calculated as follows:

Effective Interest Rate = $\left[(1+r)^{\frac{12}{m}} - 1\right] X 100$

Where m = number of months.

Illustration three

What is the effective annual rate of interest if quarterly interest is 3%?

EIR = $\left[(1+r)^{\frac{12}{m}} - 1\right] x 100$ m = 3 months; 4 times per year.

= $\left[(1+0.03)^{\frac{12}{3}} - 1\right] x 100$

= $\left[(1.03)^4 - 1\right] x 100$

= 12.6%

The total interest 12.6% at the end of the year is more than a single 12% interest for the year.
The effective rate of the interest per year for various periods of compounding would be:

1. Semi-annually $\left[\left(1+\frac{r}{2}\right)^2 - 1\right] x 100$
2. Quarterly $\left[\left(1+\frac{r}{4}\right)^4 - 1\right] x 100$
3. Weekly $\left[\left(1+\frac{r}{52}\right)^{52} - 1\right]\%$
4. Daily $\left[\left(1+\frac{r}{365}\right) - 1\right]\%$

Effects of Frequency Compounding

1. If compounding is done more frequently the effective interest rate would be higher than the normal interest rate.
2. The more times during a year that interest is paid, the greater the terminal value at the end of a given year.

From the different calculations above it is cleared that conventional banks and other financial institutions will use any one of these in order to achieve its purpose. For

example, if bank wants to calculate the interest that customer (borrower) will pay on the money borrowed, the bank usually preferred to use compound interest plus frequency compounding. This is done intentionally in order to maximize the amount of the interest the borrower will pay to the bank. It means if someone borrowed ₦ 500,000 this year he or she can end up paying more than ₦5 million in 10 years' time. In the other way round, if bank wants to calculate the amount of interest to pay to its depositor, the bank preferred to use simple interest only. This practice is not in line with *Shariah* principles and objectives. The general financial theory of Islam is concerned with eliminating of *riba* and justice, fairness balanced society are what Islamic banking system is striving for. Thus, the introductions of interest free banking.

Other Five Components of Cost of Borrowing/Financing (CoB/F)

Services Cost

This is the cost charged on the services provided by the bank on the amount borrowed. These could be legal and other charges which are charged on evaluating the collateral, the preparation of the loan documents, telephone calls, fax and postages etc. This is not proportioned to the size and time of the loan, except stamp duty charges. Rather it is a per transaction cost. It is directly estimated and linked to a particular transaction, loan obtained, or borrowed and it varies from transaction to transaction. This cost is allowed under both systems, Islamic and conventional banking Garoof (1996).

Overheads Cost

These are the direct, indirect and other general expenses incurred by the bank. They are:

i. Services to the borrowers: The bank renders services of the repayment of the loan to the borrowers. These services would depend on the size of the loan and how long it takes the borrower to repay the loan.

ii. Services to the depositors: These are the services rendered to the depositors for safe keeping of their money. We have two types of depositors: 1. Savings account depositor and 2. Current account depositor. Although current account depositor used more of the bank services compared to the savings account depositors, most of the funds come from savings account depositors. In essence both depositors are important because the savings account depositors provide the fund invested by the bank while the current account depositors create credit for the bank. Therefore, two of them have to be treated well.

iii. Advertisements and educating the public: In order for the bank to attract more funds or customers the bank needs to spend on advertisements, promotions, educating the public and so on.

iv. Overhead costs: These are general and indirect expenditures incurred by the bank such as salaries of staff, office rent and general administration costs, maintenance of the bank's equipment, buildings, materials and services Garoof (1996).

Under Islamic banking system, the problem is how we are going to estimate these costs and on what basis do we charge the borrower? This requires technicality on the average. In the first instance the larger the amount borrowed the more the services that need to be provided. Also the longer the time of repaying the loan the more services it uses up. Therefore, overheads cost need to be proportional to both the amount of the loan as well as its duration. Garoof (1996).

Estimate overheads cost

$$\frac{\text{Average (annual) total net expenditure of the bank}}{\text{Average (annual) assets of the bank}}$$

= Cost of procuring one naira of funds that can be advanced

Note: Net expenditure is used because the same infrastructure (staff, building, equipment etc) are used to provide free services and charged services. Like safe deposits, money transfers, bill collections etc. In order to calculate the actual cost incurred in securing funds for lending, income from charged services need to be deducted.

Risk Premium

These are preventive measures taken by the bank on the default of the customers or borrowers. The costs of these measures are borne by the users of the bank funds. They can take the measure inform of third party insurance or the bank's own risk insurance fund. Most of the time the bank sets aside an account for the purpose of this risk. When lending money, the bank charges the borrower, risk premiums and put that amount into risk account. Where a borrower default, money is taken from that account to cover the bank's loss. Under Islamic banking system after the borrower has fully repaid the loan, the bank pays the borrower all or part of the amount paid for risk premium. Of course this will bring cost of borrowing down/low in Islamic banking system because all or part of risk premium is being refundable Garoof (1996).

Profit

It is a well known fact that the aim of any business organ-

Table 1. Cost of Borrowing/Financing (COB/F)

S/N	Cost of Borrowing/Financing Components	Under conventional banking system	Under Islamic banking system *(Qard Al-Hassan)*
1.	Interest	15%	Zero
2.	Services Cost	2%	2%
3.	Overheads Cost	2%	2%
4.	Risk Premium	2%	Can be 1%, 2% zero
5.	Profit	2%	2%
6.	Inflation	2%	Can be zero, 1% or 2%
Total Cost of Borrowing		**25%**	**6%, 8%, 10%**

Source: Researcher

ization or financial system is to make profit. In Islamic banking system, the profit can be charged as a fixed percentage of the services cost and overheads cost.

Inflation

This is the general rise in the price level of goods and services of a particular country. It is normal that inflation affects: (1.) The value of the capital and (2) the services and overheads costs. Under pure Islamic economic system, if there would be inflation, it would be very minimum. For example, in Malaysia, in 1994 some of food items bought for (RMI) one Ringgit cost the same amount in 2001. And if there would be increased in price of some items with Islamic banking system under Islamic economic system the level of inflation will be very low. Meaning the Cost of Borrowing/Financing (CoB/F) will be lowered.

Now let us analysis with figures what we have been talking about in words. Under conventional banking system if the lenders/depositors are being paying 10% interest the bank will collect 15% or more interest from borrowers assuming, other 5 components of cost of borrowing are 2% each under the two systems. (Table 1)

Under conventional banking system, it would cost someone 25% to borrow money while under Islamic Banking System the highest it would cost is 10% and lowest is 6% this is referred to as a benevolent loan. The most important thing we must bear in mind is that if the interest rate of a country changed/increased after the conclusion of the contract/transaction the conventional banking system will also change/increase the interest the borrowers will pay. It means 25% apart from being too high is also not stable. Most important is that the interest will be compounded not simple and more frequencies.

If two business men, one of them finances his business at the rate of 10%, suppose the other one finances at the rate of 25%, can two of them charge the same price for their goods or services? Of course, no! Would it be easy for two of them at the same rate to repay their financings? There is no doubt it would not. As modern economists are generally in agreement that high interest rate had caused the development of low profit, high inflation and makes it difficult for governments in developing countries to achieve their economic goal.

So long as the depositors of an Islamic bank do not ask for (or are not paid) an amount over and above their deposits, the bank loans granted from such funds are free of interest. These should create no problem for Muslim depositors since they are prohibited by their religion from seeking such rewards, and the banks provide safekeeping for their savings without cost. The clients of the bank should also be happy for two reasons: one, they can access financing from the banks without dealing in interest; two, the cost of such financings will be reduced. The depositors of Islamic banks will be compensated through Sharing from the profit generated by the borrowers and this is what we are referring to as Profit-Loss-Sharing contract under Islamic banking system.

Rationale for Charging and Paying Cob/F

Why it is allowed to charge Cost of Borrowing/Financing to the client under Islamic banking system?

Bank is not the lender, but it is an intermediary between the lender and borrower. The bank collects money from the surplus side of the economy (lenders) and gives it to the deficits side of the economy (borrowers). For this service provided by the bank, the bank will incur expenses/costs. So it needs to recover these costs plus its own profit, the reason for the cost of financing (CoB/F).

Why is it the client that will pay?

For instance, if Mr. A. needs ₦ 500,000 loan, he turns to some of his friends and families to borrow him the amount. But these friends and families are not living in the same town. Two of his friends want to lend him ₦ 100,000 each and one of these friends is living in Ibadan

and the other one living in Akure while Mr. A himself is living in Abeokuta. Two of Mr. A's families are living in Abuja the other one is living in Abeokuta but far form Mr. A. The first thing Mr. A. needs to do is to contact all his families and friends to inform them about his need for ₦ 500,000 loan. Mr. A. needs to incur costs both inform of transportation money and telephone charges. It will also cost him his time and effort. All these served as cost of financing that need to be borne by Mr. A. Suppose Mr. A. finds no friends or families to borrow him the amount he needed. He will need to turn to the bank. If the bank (which is not a borrower none a lender but a financial intermediary) borrowed him the amount, then this justifies for him to pay the bank for the service rendered i.e. Cost of Borrowing/Financing without the interest component.

CONCLUSION

Cost of Borrowing/Financing (CoB/F) is the amount that will cost someone to borrow money especially from banks. CoB has six components under conventional banking system, namely: Cost of borrowing (CoB) = Interest + services cost + overheads cost + Risk premium + profit + compensation for inflation. Interest: The largest part of CoB is interest under conventional financial system. The bank pays a certain percentage as interest to the depositors and over recovers it from the borrowers when it lends. This is interest/riba/usury, pure and simple. Hence this component of the cost of borrowing falls into the prohibited category under Islamic financial system. In other word, under Islamic banking system (CoB/F) which is *Qard Al-Hassan* (benevolent loan) has five (5) components.

No doubt this study has provides clear understanding for the meaning of *riba* (interest) that has been prohibited in Islam. The study has addressing the prevailing problem of failure of most of Islamic banks and financial institutions in providing both long and short terms specifically long term financing to individuals or corporate bodies under *Shariah* principles. This study has provided suggestions on how these Islamic banks and institutions can provide long-term financing without paying or receiving interest and still be viable. As a result, social needs for enhanced real GNP growth will be achieved through provision of these long –term financing that can be used in financing production facilities like factories, plants and infrastructures etc upon which real economic growth rests. Therefore, the study will have policy implication to the policy makers and the practitioners in the area of Islamic and conventional banking system. It will also be a source of reference for the academicians, students, and other interested parties.

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