Indian Journal of Economics and Business
Vol. 23 No. 1 (January-June, 2024)
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Islamic financial intermediation

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Received: 10th September 2023
Revised: 02nd January 2024
Accepted: 15th March 2024

Abstract: The aim of this research project lies on the study of principles and activities that define the Islamic banking system, allowing the latter to be more efficient and more equitable. The performance evaluation is made on the basis of four models that govern the activities of the Islamic banks. The first model is based on the Mudharabah (deposit, investment funds); the second concerns the Mudharabah for the deposit only while for the investment we need the Musharakah; The third model is based on the Mudharabah for deposits but introduces the debt and quasi-debt instruments (Murabahah, Istisna, Salam, Ijara ...); The fourth model is based on Mudharabah for deposits and Mutajarah on the assets side. Results show that the first model is more efficient than the others, particularly the third which is paradoxically largely adopted. The fourth is not recommended for its negative impact on trade.

Keywords: Islamic banking, Islamic finance, Sharia compliance, mudharabah, musharakah, ijara, murabahah, riba.

Introduction

Islamic finance covers the whole of the financial and legal techniques allowing the financing with goods or services in accordance with *Shariah* requirements. Islamic finance is provision of financial services under *Islamic law* (or *Shariah*) principles. It was established as an alternative to conventional financial institutions mainly to provide *Shariah* compatible investment, financing, and trading opportunities. The Islamic financial industry is growing continuously ever since the first institutions started operating during the early Seventies. Today, it is received with significant interest and it has made great strides: the industry has experienced a dramatic growth and transformation.

Islamic finance has become a rapidly expanding phenomenon in the Muslim and non-Muslim world and a serious competitor to conventional financing. Although it remains still very concentrated in the Middle-East and South-east Asia, it has developed surprisingly quickly in the United States and in Europe.

Islamic finance, in agreement with Islamic law, is based on the principles of the prohibition of interest (*Riba*) also called usury, the prohibition of *Gharar*(risk, uncertainty), the prohibition of *Maysir* (speculation), the prohibition of unethical use of funds, and he profit-and-loss sharing.

Based on these principles, Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *Shariah*. Islamic bank is an institution which receives deposits and leads all banking activities except the collection and payment of interest. Islamic bank incites all the parts with a transaction to share risk and profit-and-loss. We can compare the Islamic banks depositors to investors or to shareholders, who receive dividends when the bank makes a profit or lose part of their economies if business makes a loss. Islamic finance stands for a system of equity-sharing and stake-taking. It operates on the principle of a variable return based on actual productivity, on the performance of the projects and on the quality of the projects, specific or general, individual or institutional, private or public, to devise an efficient and equitable system of profit-sharing. Prohibiting of*Riba* is not against earning money objective.Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.

The principal contracts used by an Islamic bank are: *mudharabah, musharakah, murabahah, will ijara, salam and istisna*… On the basis of these different Islamic financial modes, we finds four models which direct the Islamic banks activities. The first model is based on *Mudharabah*in both sides: on the assets side (*Mudharabah* contract with entrepreneur) and on the liability side (*Mudharabah* contract with depositors). The Second model is based on *Mudharabah*on the liability side and *Musharakah*on the assets side. The third model is based on *Mudharabah*on the liability side, but is introduced debt and quasi-debt instruments on the assets side (*Murabahah, Istisna, Salam, Ijhara…*). The fourth model is based on *Mudharabah*on the liability side and *Mutajara* on the assets side. The comparison of the four models enables us to highlight advantages and the disadvantages of each model.

This paper explores the importance of Islamic finance as an alternative system of financial intermediation (**section 1**) and derives the principles and the contributions of Islamic finance (**section 2**). In this paper, we analyze the principal financial models used by an Islamic bank (**section 3**)and we study and compare performance of the four models governing the activity of Islamic banks by highlighting the advantages and the disadvantages of each one (**section 4**).

1- Islamic finance as financial intermediation

Financial intermediation is defined as the process of channeling funds mobilized from the surplus sectors of the economy (savers), towards the deficit sectors (investors) by the intervention of a specific agent called financial intermediary. Financial intermediaries accept money from savers or investors and loans those funds to borrowers, thus providing a link between those seeking earnings on their funds and those seeking credit. Financial intermediaries include savings and loan associations, building and loan associations, savings banks, commercial banks, life insurance companies, credit unions and investment companies. The role of financial intermediaries is to *channel funds* from lenders to borrowers by intermediating between them.

The emergence of financial intermediaries is thus result from imperfections in the capital market (Leland and Pyle (1977), Diamond (1984), Diamond (1991)). Financial intermediaries exist to solve or reduce market imperfections (such as: differences in the preferences of lenders and borrowers (in terms of size, maturity, liquidity, risk), presence of transaction costs, shocks in consumers' consumption and asymmetric information (both adverse selection and moral hazard).

Several theories have been developed to explain how financial intermediaries reduce/solve these market imperfections. They are the theories of: theory of asset transformation, transaction costs reduction, liquidity insurance and informational economies of scale and delegated monitoring.

Asset transformation

Financial intermediaries playa major role in transforming particular types of assets into others. Borrowers' needs are a long-term capital and permanent capital and the desires of many lenders are a high degree of liquidity in their asset. Financial intermediaries simultaneously satisfy both borrowers' needs and desires' lenders by the process of asset transformation. They transform the primary securities issued by firms into the indirect securities required by lenders (Gurley and Shaw(1960); Fama(1980)). Specifically, they issue liabilities (deposit claims) with the characteristics of low risk, short-term, high liquidity, and use a proportion of these funds to acquire the larger size, high-risk and illiquid claims issued by firms. To reconcile the conflicting requirements of lenders and borrowers, financial intermediaries undertake four main transformations: maturity transformation (by making long-term loans and funding them by issuing short-term deposits), size transformation (by collecting the small amounts made available by lenders and parceling them into the larger amounts required by borrowers), liquidity transformation (by transforming deposits with high liquidity and low risk to loans with higher risk and illiquid)and risk transformation (by transforming risky loans (assets) into virtually riskless deposits (liabilities)). Banks transform risk by minimizing the risk of loss on each individual loan, diversifying risk and pooling risks.

Transaction costs

The existence of financial intermediaries is justified by the presence of transaction costs: financial intermediaries reduce transaction costs by developing branch networks and information systems, which enable lenders and borrowers to avoid the need to seek out a suitable counterpart on each occasion, by providing standardized products, by using tested procedures. Financial institutions are able to reduce transaction costs by taking advantage of economies of scale (The unit cost of the contract per loan is much smaller for the bank than for an individual who has a loan contract drawn up when undertaking direct lending), of economies of scope (Economies of scope are essentially concerned with deposit and payment services: deposits are the legal-financial claims by which banks both collect funds to sustain their lending activities, and satisfy the request of payment instruments) and of expertise (is essential to providing low-cost liquidity services).

Liquidity needs

A key role of financial intermediaries is to provide insurance against liquidity shocks that eliminates idiosyncratic liquidity risk and aggregate liquidity risk, as postulated in the liquidity insurance theory also known as consumption smoothing theory (Diamond and Dybvig(1983)).

This liquidity insurance will appear by the fact that financial intermediaries will propose to depositors checking accounts remunerated and the possibility of withdrawing their deposits on demand. Banks allow consumers to deposit funds that they can withdraw when they have liquidity needs. This liquidity provision allows banks to accumulate funds that they can use to lend to firms to fund long term investments. Banks must manage their liquidity so that they can meet the liquidity needs of their depositors.

Liquidity functions of banks affect investment and growth at different stages of economic development.

Asymmetric information: adverse selection and moralhazard

Second reason justifying the existence of the intermediaries financial is the reduction of information and asymmetries of information costs. The new theory of financial intermediation is concentrated on ex-ante problems of asymmetry of information(adverse selection) and ex-post problems of asymmetry of information(moral hazard).

- Adverse selection is the problem created by asymmetric information before the transaction occurs. It arises when the potential borrowers who are most likely to produce an undesirable (adverse)outcome are the ones who most actively seek out loans. Thus adverse selection increases the probability that bad credit risks will get loans. As a consequence, lenders may decide not to give any loans, even to good credit risks.

Adverse selection meets in all situations where information had by a type of agent is not observable by another agent on which it is dependent. Adverse selection is thus a form of ex-ante opportunism. Adverse selection appears in banking intermediation when borrowers has more information on the quality of his project that the lender. So lender cannot distinguish the "goods" and "bad" borrowers (Lemons problem by Akerl of (1970)).

Resolution of adverse selection implies that full information on the borrowers should be provided to the lenders(Leland and Pyle (1976)) and lenders selects good borrowers (screening).

Private production and sale of information, government regulation, and financial intermediaries reduce and solve the adverse selection problem. Especially financial intermediaries like banks produce more accurate valuations of firms and are able to select good credit risks thanks to their expertise in information production. Financial intermediary develops an expertise in order to be able to manage asymmetric information problems which continue to arise throughout financing relation.

One particular advantage of banks in information production is that they can have information about potential borrowers from the transactions on their bank accounts. By acquiring funds from depositor sand lending them to good firms, banks earn higher returns on their loans than the interest paid to their depositors. Asymmetric information theory offers a convincing explanation of the existence of financial intermediaries.

- Moral hazard is the problem that occurs after the transaction is made. Moral hazard thus appears in all situations where an individual seeks for example to maximize his utility function to the detriment of other individuals on which it is dependent. It is in that a form of ex-post opportunism.

Therefore, once agency relation is established, post-contractual risk appears in the form of Moral hazard. This last also finds its source in informational uncertainty but this one relates from now on to the behavior of the agent. Moral hazard occurs when principal cannot observe agent actions at least two reasons: control costs of agent actions are higher and/or principal is not able to measure perfectly agent actions by observing results because its actions do not determine completely the results.

In banking context, moral hazard is the risk (hazard) that the borrower will engage in activities that are undesirable (immoral) for the lender. These activities potentially reduce the probability that the loan will be repaid. Again, the consequence is that lenders may decide not to make any loans. Investors are more likely to behave differently when using borrowed funds rather than when using their own funds.

2- Islamic finance principles

A bank is considered a liquidity provider and a controller of capital utilization. Islamic bank also completed these two functions: it collects the financial resources for a better allocation in the various investment projects according to principles of *Sharia*. The latter is based on several sources including *Quran, Hadith* of the Prophet and also *Ijmaa* or *Fiqh* which represents Islamic jurisprudence based on a set of laws derived from Islamic scholars. The basic principles of *Sharia* are: the prohibition of interest, the prohibition of speculative behavior and gambling, prohibition of unethical use of funds (investment in illicit activities (*haram*)), equity (sharing of profit and loss between the parties to a transaction) and the obligation to lean all financial transactions in real economic activity…

2.1. Prohibition of interest (*Riba*)

Prohibition of interest is the main difference between Islamic finance and conventional finance. Islamic banking is based on the principle of prohibition of interest or also known as « usury ». This is explicitly stated in the *Quran* and *Hadith* explained the rules of legitimate trade. This hadith has detailed six products called "ribawi": gold, silver, wheat, corn, dates, and salt. Any exchange of identical product (cons gold golden wheat against wheat) with a benefit to a person constitutes a usurious transaction, except as regards the benefits resulting from the exchange of products of different nature (cons golden wheat). Also, any surplus from a transaction not based on real assets and previously owned by the seller is unlawful (haram). This category loan contracts. Specifically, bank credits whether consumer loans or business credits are considered illegal. Prohibition of interest is explained by the fact that interest is generated by the passage of time. For cons, indirect compensation through revenue from property or activity is not prohibited by *Sharia*.

2.2. Prohibition of speculative behavior and gambling

Prohibition of interest is not the only key point of difference between Islamic finance and conventional finance. Islamic banking differs from conventional finance in terms of speculation (*Maysir*) and uncertainty (*Gharar*). One of the principles of Islamic banking is the prohibition of speculative behavior and gambling. Therefore, any element of speculation or uncertainty is prohibited by *Sharia*. Islamic finance is to avoid conflicts with major speculative behavior or at least significantly reduce the risk of conflict. It also serves to support the criticisms of some conventional financial practices such as speculation, derivatives contracts and conventional insurance that have elements of *Ghararand* *Maysir* which are unethical to Islam.

2.3. Prohibition of unethical use of funds (illicit activities (*haram)*)

Sharia prohibits unethical use of funds (illegal and illicit activities). Islamic finance is a form of responsible finance excluding certain industries and involving filters ethical, social and environmental. Islamic finance portfolio excludes companies whose products or practices do not meet the criteria advocated by the fund. The ethical investment funds excludecompanies involved in tobacco, liquor, gambling, weapons, nuclear power andarmaments among others (Wilson, 1997).

Islamic finance also rejects all transactions that should not be marred by defects such as *riba* or *gharar*.

2.4. Equity (sharing of profit and loss between the parties to a transaction)

Third principle states that both sides of transaction are forced to share profits and losses. This principle based on equity dictated by *Sharia* shows that Islamic finance is participatory finance: Profits and losses must be shared between creditor and debtor, instead of being concentrated on one side. Islamic finance has a particular view on sharing risks and profits between different stakeholders in a financial transaction. *Sharia* calls for a fair sharing of profit and risk between the investor (lender) and the entrepreneur (borrower), whatever the form of financing used.

2.5. Obligation to lean all financial transactions in real economic activity

Islamic finance appears with this principle in the service of the real economy: financial transactions are systematically linked to real assets. This is an absolute necessity for lean asset to any financial transaction.

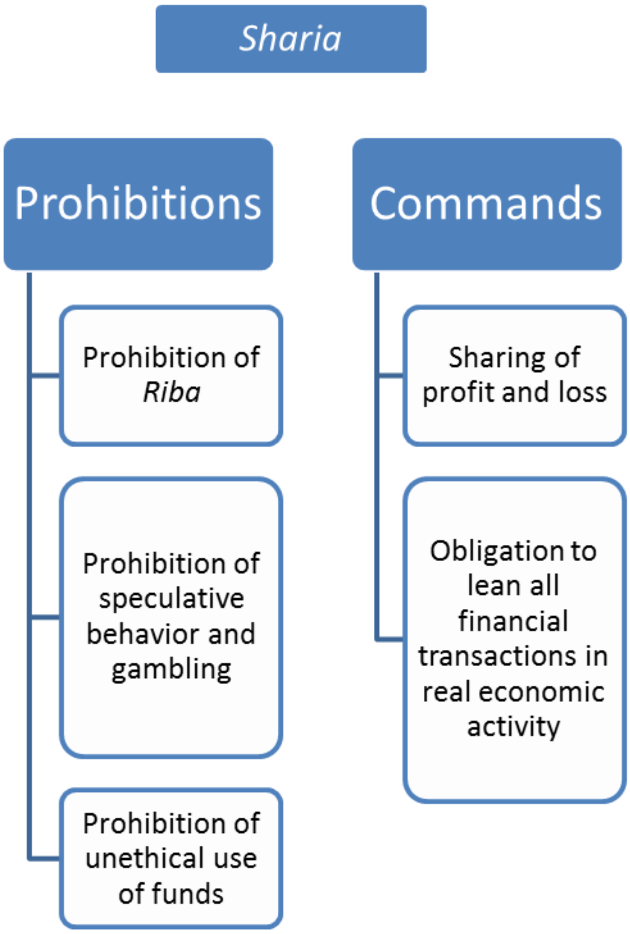


Figure 1: The five principles of Islamic finance

3- Basics techniques of Islamic finance

On the liability side, funds are raised primarily on the basis of a contract *Mudharaba*. On the assets side, Islamic banks provide the financing with the use of various contracts in accordance with the requirements of *Sharia*. Investments can be undertaken using profit sharing modes of financing (*Mudarabah* and *Musharakah*) and fixed-income modes of financing like *Murabahah* (cost-plus or mark-up sale), installment sale(medium/long term *Murabahah*), *Istisna/ Salam* (object deferred sale or prepaidsale) and *Ijarah* (leasing).

3.1. Islamic instruments on the liability side (deposits)

In Islamic banks, relationship between Islamic banks to their depositors is based on the principle of sharing profits or losses. This means that the bank gives no commitment to provide a fixed income and determined in advance. The relationship between Islamic banks and their depositors is not a conventional relationship between creditor and debtor. It is a relationship where both parties share risks and profits.

Islamic banksmakeall theservices(which are notcontrarytoIslamic jurisprudence) offered byconventional banks.ButIslamicbanking intermediationpresentsspecific aspectsaboutthefund-raising. TheliabilityofIslamic banksisformedbyshareholders andcurrent accountsandinvestment deposits.

Therefore, on theliabilitiesside, there are demand deposit accounts (Checking accounts) that are considered interest-free loans (Qardal-Hasan), andthereforetheyare guaranteed.Demand deposit accountsallowthe account holdertoreceiveacheck book, have asafe placefortheirmoney, theycan withdraweasily, at any time, with credit cardsordebit cards. Thesedemand depositsdonot takethe risksofbanking. Depositorspayadministrative costsandmanagementat thebankfor servicesprovidedbyit.

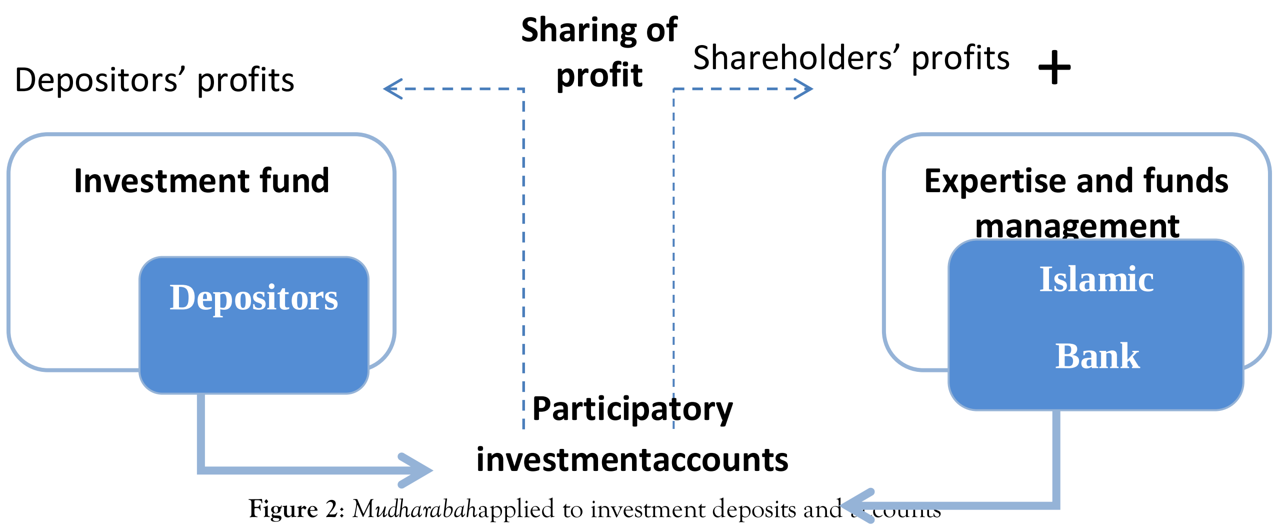


Figure 2: *Mudharabah*applied to investment deposits and accounts

Wealso findthatallfunds raisedarein the formof*mudharabah*. Inthislattercase, the Islamic bankacts asamanagerofinvestmentagainstdepositorswhosefundsfall under the categoryofinvestment deposits. Islamic banksharesitsnetearningswith itsdepositorsin proportion totheamountateach deposit. Depositorsare consideredinthiscase*Rabal-mal*(capital providers). Theymustbeinformedoncethe date of deposit of the distribution ofprofitswiththe bank. Islamic banksarecalled*mudharib*. Theymanage theinvestmentdepositaccountsalsocalledparticipatory investmentaccounts orProfit and LossSharingAccounts(PLSA). Thelossesincurredby depositors, except"operational risk".

3.2. Islamic instruments on the assets side

3.2.1. Mudharabah

In accordance with the principle of sharing of profits and losses, *mudharabah* is a form of passive participation treated as a limited partnership or a corporation. In a *mudharabah* financing, only the bank (Rab al mal or capital provider)provides capital while the client (Mudharib or entrepreneur) manages thebusiness.

Mudharibbrings its experience and expertise, manages the activity or business under and provide the labor needed to use these funds and does not guarantee the capital invested and the realization of profit.

The bank cannot interfere in the day-to-day running of the business. Any profit is shared. The client is not paid a salary, and if he or she does not make a profit, the client loses all the time and effort expended on the ventureand the bank absorbslosses. The distribution of profits and losses is fixed in the contract.

Returnoncapitalandprofitslessexpense
sofmanagement ofmudharib

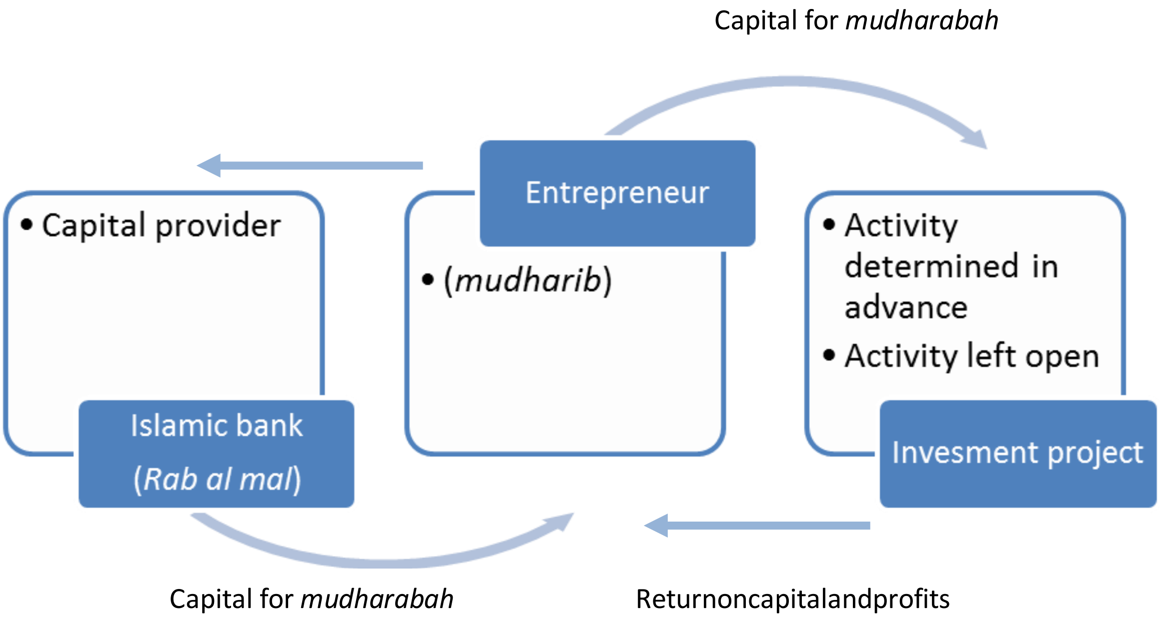


Figure 3: *Mudharabah*on the assets side

3.2.2. Musharakah

In*musharakah* (a form of active participation), both bank and client contribute capital and agree to a profit-sharing ratio (profit or loss). Specifically, Islamic banks have developed the permanent*musharakah* (The Bank participates in the equity of a project and receives a share of profit on a pro-rata basis. The period of contract is not specified) and diminishing*musharakah* (*mutanaquissa*: In this form of *musharakah*, equity participation and sharing of profit on a pro-rata basis is allowed. It also includes a method by which the bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset to the participants.).

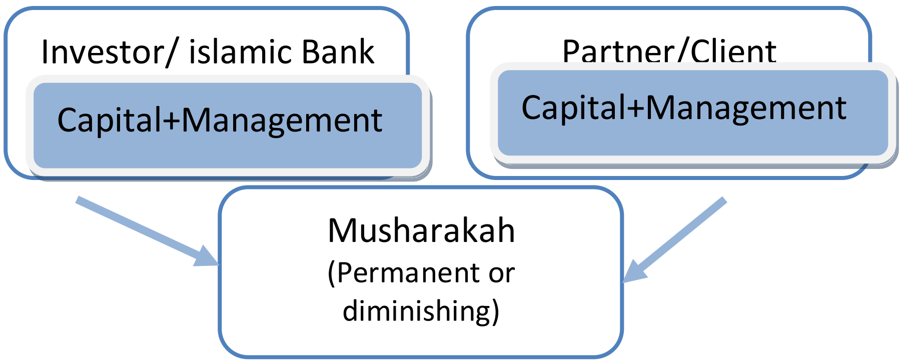


Figure 4: Musharakah

3.2.3. Murabahah

Withthe prohibitionofinterest, Islamallowsprofitsandfeesrelated tothesaleofan assetorproperty. This istheprincipleof*murabahah*(AL Bay'oubiribhinma'loum). *Murabahah*is a particular kind of sale where Seller expressly mentions the cost it has incurred on purchase of the Asset(s) to be sold and sells it to another person by adding some profit, which is known to Buyer.

With*murabahah*, thebank(lender) isthereforeavailable totheclient(borrower) (whoneedsimmediateliquidity) fundsfor theacquisitionofan assetorcommoditybecomesthesole propertyandfinal to theultimate buyer(customer

/borrower). Theclientthen paysthepurchase priceand commissionsrelatedtothiscontract(profit accruingtothe bank). Inthiscase, the bankacts asan executorofthepurchase order. Itoperatesby buyingfroma supplier(firstoffer)andsellingtheclient (purchase order).

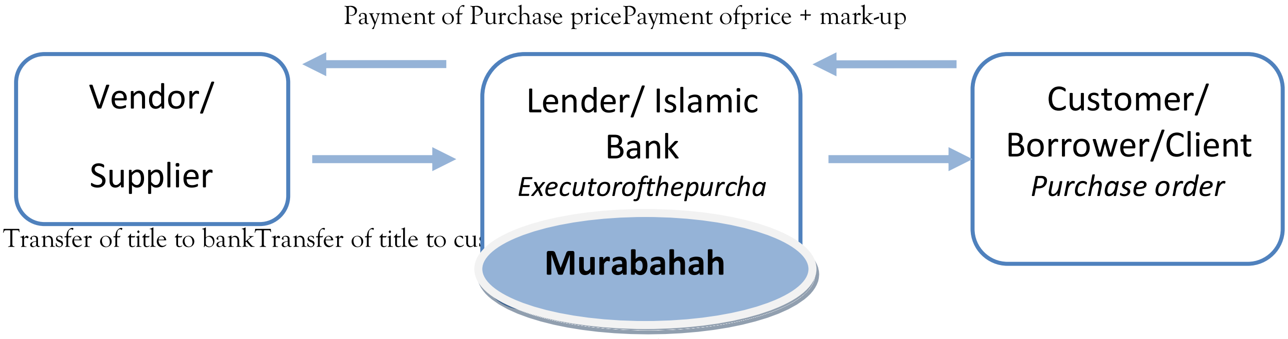


Figure 5: Murabahah

3.2.4. Ijara

*Ijara*isaleaseofequipment as well as property of an item by its owner to a customerwith a promiseofsale tothe customer.Credit institution likeabank(thecreditor/ financier) will purchase the property (machineryand/ orequipment) chosen by its customer for an agreed price and then will grant a lease to the customerfor period of lease (must be determined in clear terms at the time of contract). Thecustomerhas the optiontorepurchasethe property. Itreservestheoptiontoacquiredefinitelytheproperty.

Ijara involves a Leasor (the bank / financial institution) who purchase the property and lease to another party (the Lessee) for a specific period for a rental (must be determined at the time of contract for the whole period of lease).

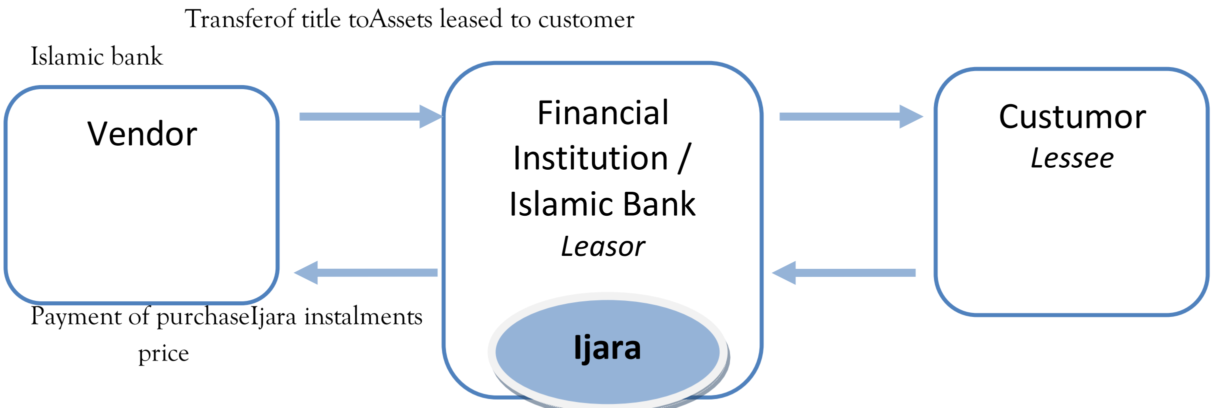


Figure 6: Ijara

There are two types of*Ijara*: operating and lease ending into ownership. The first (*Ijara Tachghilia*) being a contract of renting, hiring or leasing. The second is *Ijara Wa Iqtina*, which is also called *Ijara Muntahiya Bitamleek*, which is leasing with an undertaking from the Leasor to sell the equipment or the facility at the end of the rental term or to provide the leased property as a gift to the Lessee provided the Lessee pays the entire required rental within the specified period.

3.2.5. Salam

*Salam*canbedefinedas acontractof salewithdeferred deliveryof goods. *Salam* is an Islamic finance tool used to generate working capital and consists of a contractual sale in which advance payment is made by the buyer to the seller for the deferred supply of goods at a specified date pre-determined in the contract. Thus, it is a sale and purchase transaction whereby the payment is made in cash at the point of contract but the delivery of the asset purchased will be deferred to a pre-determined date. Islamic bankacts aspurchaser, withcash paymentofgoodsthatwill bedeliveredin time byher partner.

The price paid today represents a discount on the price, typically calculated by reference to a benchmark plus a margin that would have been paid if it were a cash sale at the time of the delivery. The implied cost of capital to the Salam seller is the difference between the present value of the future market price of the good and the price that one would receive today…The seller benefits in that she gains advance payment/liquidity and the buyer may benefit if the price of the commodity is more expensive in the future than she paid in the present.

Salam contractspecifiesthenature, quantities, prices ofgoods orderedandthetimeandmannerof deliver.Bothpartiessigneda parallelagreementof sale byproxythroughwhichthebankallowsthe sellertosellor delivergoodsto athird party. Thesellerundertakes, atitsfullresponsibilitytocollectandpay the proceedsof the sale tothebank. Atmaturity, the sellerdeliversthe goodsandinvoiceon behalfof thebank.Thesellerthen receivesacommissionorrebate orparticipation inthemargingeneratedbythesaleof goods. TheBankreleasedanet margin(after deductionofcommissionsandother costs) mustbe atleastequalto theminimum annualrate ofreturnasdeterminedinitsfunding policy.

The interventionof theIslamic bankmaybedirectorindirect. IncasetheIslamic bankinvolvesa seller(third party): itsays "*salam mouwazi*" (*Parallel Salam*).The financier may at the same time enter into a parallel but separate *bai salam* with a third party to resell the asset for an increased price or it may simply sell the asset on delivery.

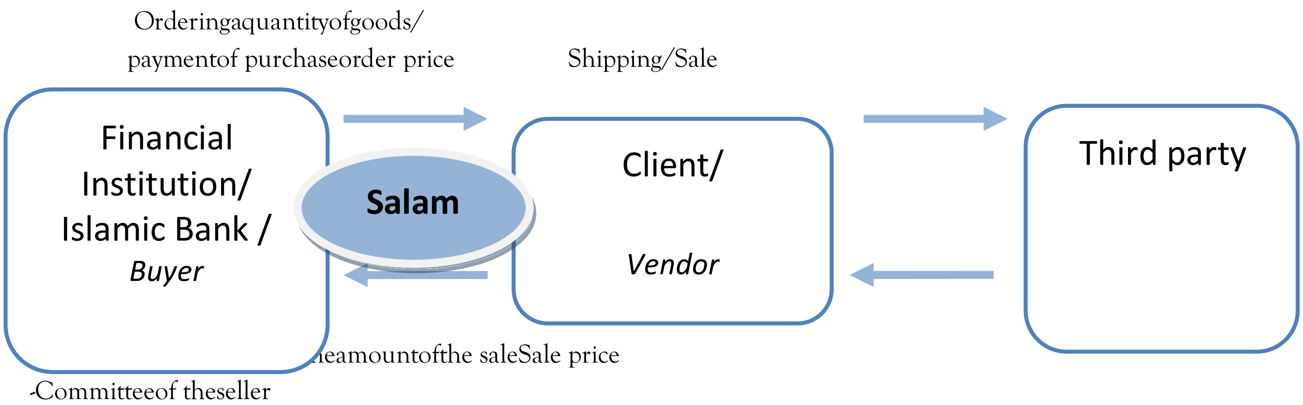


Figure 7: Parallel Salam

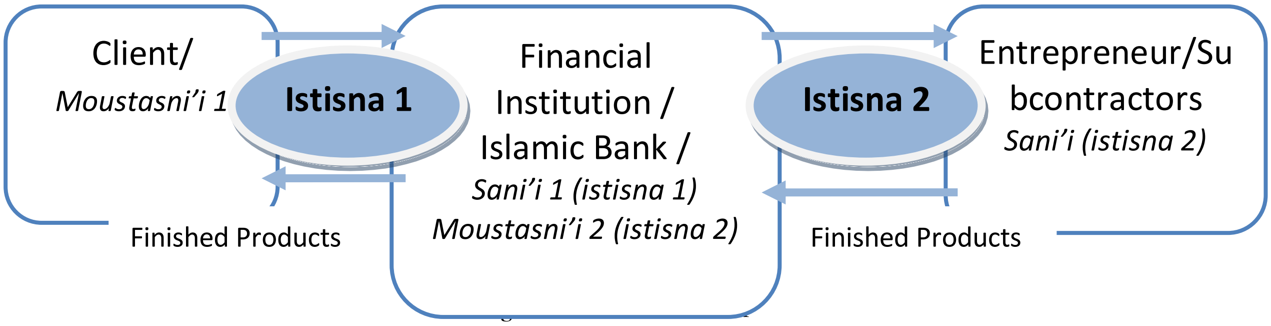
3.2.6. Istisna

The*istisna*akinto amodeoffinancingin the mediumterm. It is acontractmanufacturing(orconstructionorbusiness) under whichtheparticipant(seller) agrees to providetothebuyerwithin a certain timeandat an agreed price, goodsspecifiedaftermanufacturing(construction) in accordance with specifications. Inotherwords, the buyer(*moustasni'i*) requesttoanother party (*sani'i*) tomake himorconstructastructurefor anagreed price payable in lump sum or in installments in the matter mutually agreed by the parties.

Istisna is considered as a variation of Salam. despite the fact that *Istisna* and *Salam* have some points of similarity, such as the non-existence of the subject-matter or the future delivery, there are some points of differences as: The subject-matter in *Istisna* is always something that needs manufacturing while Salam is possible in anything whose descriptive conditions can be fulfilled; and it is necessary in a Salam contract that the price is paid in advance while in *Itisna* it can be prompt, deferred or paid in installments.

The bank (buyer in *Istisna*) can enter into a *Parallel Istisna* (*istisna mouwazi*) contract without any condition or linkage with the original *Istisna* contract. In one of them, the bank will be the buyer and in the second the seller. Each of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependent on the rights and obligations of the parallel contract. Further, *Parallel Istisna* is allowed with a third party only.

Price of the goods Price of the goods
to be manufactured to be manufactured
(Contrat istisna 1) (Contrat istisna 2)



4- Models defines the practice of Islamic banks

Islamic Bank conducts relations with lenders and borrowersand acts as financial intermediaries, channeling funds from savers toborrowers and in the process removing budget constraints that limit individuals andbusinesses.Financial systems also create incentives for an efficient distribution of resources within aneconomy, and the allocation of limited financial and real resources between competing ends.

An Islamic bank acts as the keeper and trustee of depositors' funds and guarantees to return the entire deposit, or any part of it, on the depositor's demand. At the same time,Islamic bank acts as principalwith borrowersthat she will advance the necessary funds.

Mark-upin Islamic bank is justified by its quality of owner in the case of a *mudharabah* or *musharakah*, either by providing marketing or lease of property previously acquired by it in the case of *murabahah, Ijara* (Leasing), *Salam or Istsina*. There are four models that define the practice of Islamic banks. We will detail these four models, and we identified the advantages and disadvantages of each. The comparison of these four models shows a clear superiority of the first model. Despite this, we note that the third model is the most replied.

4.1. Model1:*Mudharabah*on the liability side and on the assets side

Contract governing the relationship between Islamic banks and depositors and between Islamic banks and borrowers is known as *mudharabah*. In this model, Islamic bank is a pure financial intermediary: Islamic bank accept money from savers or investors and loans those funds to borrowers, thus providing a link between those seeking earnings on their funds and those seeking credit.In this case, the bank is on one side mudharib (with depositors) and on the other side rab al-mal (with entrepreneurs): the "mudharib yudharib". With this model, the primary function of the Islamic banking sector appears as financial intermediation.

Islamic bankplaystwo roles:

1-The role of general partner:depositors(rab al-mal) makeavailable tothebank(mudharib) theirdepositsandpaymanagement feesto thebank. Depositors agree that their funds be used by the bank to finance an open-ended list of profitable investments and expect to share with the bank the overall profits accruing to the bank's business.The bankdoesnot give themafixed incomeas wouldatraditional bank, butagreestopay themashareof theprofit orshare losses and depositors assume all risks. Also,depositors have no insurance against their deposits and have not right on controlling investment decisions made by the bank.

2- Theroleofsponsor: Islamicbankbecomes rab al-mal and provides the entire capital for financing a project, while the entrepreneur (mudharib) offers his labor and expertise. The profits or losses from the project are shared between the bank and entrepreneur at a certain fixed ratio. Financial losses are borne exclusively by bank. The liability of entrepreneur is limited only to his time and effort.

In *mudharabah* on the liability side and on the assets side, the profits from the project will be shared between the depositors, entrepreneurs and the bank. Depositors receive a share of profit as earnings from their capital and risk. Entrepreneurs, who are simultaneously agents and partners, receive a share of profits as a percentage as compensation for its efforts in the management of investment projects and the realization of benefits. The bank also benefits from a share of the profits since he played the role of financial intermediary. Financial losses are borne by bank and depositors. Entrepreneur loses only his time and effort.

4.1.1. Advantages of this model

- Withthismodel (*mudharabah* on the liability side and on the assets side),the bankis playitsrole as financial intermediariesin thecollectionandallocationofresources, itacts asafund manager. Shemanagesthe risksandasymmetric information associated with*mudharabah*. Consequently,itsoperationsgenerateahigh rate of return.

- *Mudharabah* is an instrument of sharing profits and losses. With this instrument mobilized on the side of liabilities and assets, Islamic bank assumes only the operational risk.

- *Mudharabah* allows Islamic bank to meet to a large extent the customer needs in financing cycles of creation, investment and operating companies.

- *Mudharabah*canconsolidateandacceleratethe paceofnew business growth, andalsoinnovative companiesbecause itcreates an ideal opportunityforinvestmentprojectsinvery little tangible, andhaving noguarantees. *Mudharabah*isareal instrumentforbusiness development.

- Thereturnofthe *mudharabah*islinkedtoproductivityandqualityof the project, thusthe yieldiscloseassociation withreturnintherealeconomy. The balancebetweentherealeconomyandthe financial economy inIslamic transactionsbased on*mudharabah*isassuredsincethisformissystematicallylinkedtoreal assetsas opposedto the"ribawi" system.

- Withthe contract*mudharabah*, contraryto conventional finance, it is notpossibleto usethe guarantees toensurea profitorguarantee results.Sincetheprincipleisthesharingof profitsandlosses, theexpected returnis thebasisof*mudharabah*and thereforesharesinthe profitof eachstakeholder(Islamic bank, entrepreneurs, and depositors). Also, withthecontract*mudharabah*, lack ofguaranteesappeasesentrepreneur's charges.

- Comparedto the systembasedon interest, the systembasedon*mudharabah*issuperior interms ofefficiencyand stability. Inaddition, investment decisionsdependgreatlyonfinancial factorswhichisin contradictionwithadvanced of Modigliani andMiller(1958) statingthatthereal decisionsof firms(eg investment), motivatedbymaximizingvaluesactionsareindependentof financial factorssuchasdomestic liquidity, debt levels, orpaymentof dividends.

- Thecreation of moneywithoutcounterpartin production, resultingon interestledtoan imbalanceinthe economy. Thepoint of view of Islamic finance is that moneyisan intermediaryandmeasuring instrumentin tradeingoods. At this pointthemoney can notgeneratemoneybuttobe usedinfinancial transactionsasa medium of exchangewhilehavinga store ofvalue. *Mudharabah*provideequilibriumtothe economy because itencouragesdirect investmentin production.Money creationwith*mudharabah*is correlatedwithreal investment.Moneycanproducesurplusonly to the extentwhere itistransformedpreviouslyintoreal good andnotvirtual good.

4.1.2. Inconveniencesof this model:

Mudharabah is a contract of passive partnership also considered a participatory contract based on sharing of profits and losses. In such contracts, moral hazard and adverse selection can be greatlyprejudicialfor the bank in an agency relationship. With this model, the bank appears as a principaland entrepreneurs as an agent. According to agency theory, there is a typical agency relationship between the bank and its entrepreneurs since there is a separation between ownership and control. The entrepreneur may act contrary to the interests of the bank that provides full funding of the investment project. The bank cannot control the actions of the entrepreneur, and faces problems of asymmetricinformation and moral hazard.

To facewiththisproblem, the bank's interest tocarefully selectits investment projectsand entrepreneurs who benefit from the funds collected from depositors.

Some analysts also argue that the regulatory framework of the Islamic bank should focus more on operational risk management and disclosure of information. This argument is based on the specific nature of the risk in the Islamic financial intermediation. Others argue that Islamic bank must intervene in the boards. This may exercise control over entrepreneurs and force them to an act which conformity with the interests of the bank.

4.2. Model2:*Mudharabah*on the liability side and *Musharakah* on the assets side

4.2.1. Advantages of thismodel:

- On the liabilities side, Islamic bankingemploys*mudharabah*. Butfromthe asset side, ituses*musharakah*(equity participation contract).Thismodelismostsuitable for theneedsof the cyclesof creationandbusiness developmentbothintermsof theconstitution (and/or increasing)thecapital and of the acquisition (and/orrenovation) of equipment.

- This model providesopportunitiesforlong-term and medium-term investmentof itsresources. With *musharakah* contract,the bank is not the sole provider of funds to finance a project. Entrepreneur contributes to the joint capital of an investment. Financial participation of the entrepreneur can subordinate its interests to those of the bank. Moral hazard problem cited previously in the first model is partly solved due to the convergence of interests of the bank (principal) and entrepreneurs (agent).

- Profits (and losses) are shared strictlyin relation to the respective capital contributions. Thisprincipleofsharing risk andreturnmakes*musharakah*anattractivesource of financing.

- Thismodelguaranteesdirect controland monitoringofthecontractor's actions.

4.2.2. Inconveniences of this model:

- The risk model is not entrepreneurial risks but the insolvency risk, the market risk and liquidity risk.

- Withthesharingofriskandreturn, theIslamic bankchoosesto finance therisklessproject. Islamic bank rejectsin theselection phaseprojectsthathaveahighlevelofrisk. FinancebyIslamic banksdoesnot favorprojectswitha highlevelof risk. This is theproblemofcredit rationingidentified byStiglitzandWeissin 1981.

-Withthismodel,the bankno longer playstheroleof financial intermediarybutratherthe roleofdirect investorintheprojectby sharingwith entrepreneursfundingand the riskand return.

4.3. Mode3:*Mudharabah*on the liability side and debt and quasi-debt instruments on the assets side (*Murabahah, Istisna, Salam, Ijhara…*)

Islamic bankuses*mudharabah*on the liability side, but on the assets side, shemakes use ofdebt andquasi-debt instrumentsforthe employment ofthosefundscollectedbydeposits. The bankwill beconductedtopractice*murabahah*, or*istisna*, or*ijara*andmaythusreducetherisks related to*mudharabah*and *musharakah*. Remunerationofthebank isdirectlyrelatedtothesedebtand quasi-debt instrumentsconcerningadirect use offundsfromthe bankwithout recourse to entrepreneurs or without investing in capital projects.

However, with this model, the bank does not fully play its role as financial intermediaries. According to the definition of a financial intermediary, the bank must raise funds from those who have excess money and make them available to those who have a need for money. This implies that the bank will support the risk associated with this activity as an intermediary and subsequently earn a return that she should share with other economic agents. Return derived from *murabahah*, *ijara* and *istisna* are for the benefit of the bank.

4.3.1. Advantages of this model:

- Thecapitalandincomeareguaranteedand do not supportrisk. Contrary to contracts based on the profit and loss sharing principal (PLS), this model has a predetermined and fixed rate of return and is associated with collateral. Ittherefore appearsthatthismodeloffersgreateropportunitiesandgreaterflexibilitytothe interventionofthebank,while keeping withinthecontext ofthe principlesof*Sharia*.

- Thismodel satisfiestoaneed for balancein the way of use of these fundsthatenablethe Islamic bank torespondtoa large extent of theneedsofitscustomersinfinancingcyclesofcreation, investment andoperatingcompanies.

4.3.2. Inconveniences of this model:

- Thismodeluses*mudharabah* on the liability side (deposits)whichmeansthat thebankassumes ahigh riskwithdepositors. The employment ofthesefundsusingdebt andquasi-debt instrumentsmeansthattheBank assumes alow riskon the assets side as a consequenceoflow profitability.Withthismodel,the banklosesthereturn linkedtobetterusesof funds.

- Withthismodel,the Islamic bankhas otherbusiness risksthatdo not existifIslamic bankchose*mudharabah*or*musharakah* on the assets side.

- Althoughthe*murabahah*, *ijara*, and*istina*areinstruments which conformto*Sharia*but the bankriskto fallinto haraamifconditionsrelated to the applicationofthesecontracts arenottakenintoaccount.

- These instruments employed on the assets side can be considered to be more closely associated with risk aversion and they do not substantially differ from those used in a conventional banking system.

4.4. Model4:*Mudharabah*on the liability sideand*Mutajarah*on the assets side

The principle of Islamic banking intermediation is collecting funds from depositors and make them available to people who have a critical need for funds for their investment projects or for their operational needs. M*utajarah* on the assets side makes the bank an economic agent who practices trade directly, but this is not in any case the principle of the bank.

This model does not present any advantages for the Islamic bank. It is considered by majority unsuitable for banking activity and not in conformity with the principles of financial intermediation. However, this model presents these disadvantages:

- If the Islamic bank collects money from depositors and practice direct trade, then Islamic bank will assumed a high level of risk that will be transmitted to depositors if we refers to the sharing profits and risks principle. If most depositors prove to be averse to risk, so they will not have the motivation to deposit their money in the bank. They then will look other less risky possibilities for their money.

- With the high level of risk assumed by the bank related to direct trade, the bank loses the confidence of partners.

- The principle of bank is financial intermediation, and with this model, Islamic bank no longer belongs to this category of financial intermediary, but rather to the category of direct investors and trading companies. Islamic bank will not be capable to face competition.

- The bankcanaccessinformationabout itscustomers, and this isnotconsistent with the principleofpure andperfectcompetitionifshepracticesthetrade.On the one hand,shehasinformationon these customers, andotherhand, shecompeteswithitscustomersinthetrade. Customersno longer haveconfidenceinthebanksince sheis consideredarival.

5- Conclusion

Thispaperhighlights therole ofIslamic banksasfinancial intermediaries.Itsupportstheimportanceof pure financial intermediation of Islamic banksaround themodel of *mudharabah* on the assets side and on the liabilitysideandshowsthat the entryofIslamic banksdirectlyintrade, industryandagriculture, through*mudharabah* on theliability sideand*murabahah*, or*musharakah*or*ijara*or*salam*or*istisna*onthe assets sidemeans that Islamic banksdeviate fromtheirrole as financial intermediaries.

Theseformspresentadvantagesand disadvantages fortheIslamic bankbutareconsiderednon-pure formsof financial intermediation. TheonlymodelsuitabletotheIslamic bankisthemodelof*mudharabah*on both sidesof thebalance sheetbecauseit isthemodelthat guaranteesequityand efficiencyforthe wholebanking system. However, the modelinvolving*mudharabah*on theliability sideanddebt andquasi-debt instruments(*murabahah, istisna, salam, ijara…*) on the assets sideisthe most appliedbyIslamic banks.

Thispapertherefore showsthatthebanks' interestisinpreservingtheirrole as financial intermediaries, and thatothermodels canbeappliedas reinforcementsto servethediverse needsofcustomers. M*urabahah, istisna, salam, ijara* on the assets sidemaybeusefulfortheIslamic bank on the condition that suchcontracts will besecondaryandthebankpreservesitsprimary role aspurefinancial intermediationwiththe contractof*mudharabah*on the bothsides of balance sheet.

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