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Islamic financial intermediation

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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 play a 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 moral hazard

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 Akerlof (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 depositors and 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 *Gharar* and *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 exclude companies involved in tobacco, liquor, gambling, weapons, nuclear power and armaments 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.

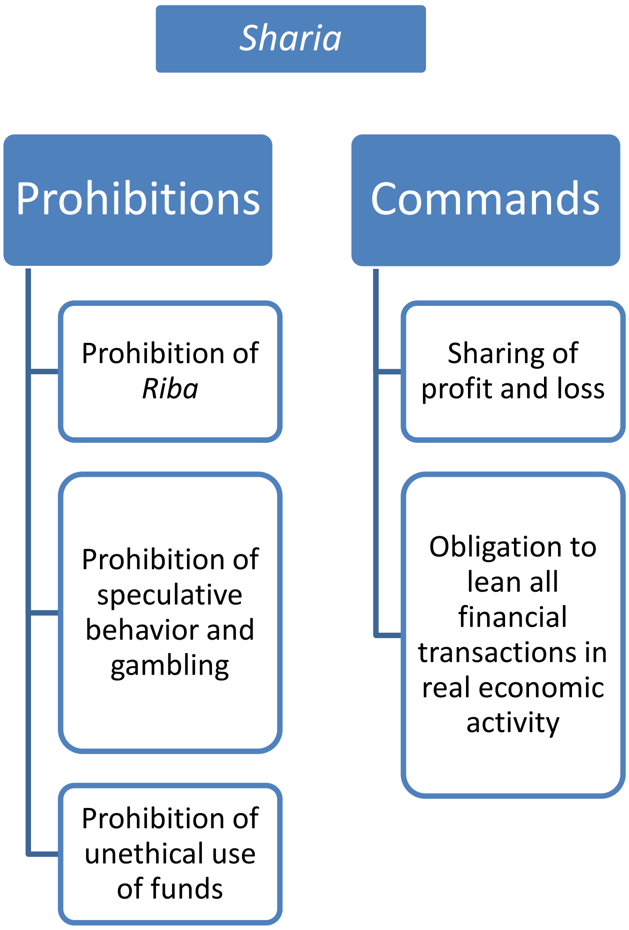


Figure 1: The five principles of Islamic finance

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 prepaid sale) 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 banks make all the services (which are not contrary to Islamic jurisprudence) offered by conventional banks. But Islamic banking intermediation presents specific aspects about the fund-raising. The liability of Islamic banks is formed by shareholders and current accounts and investment deposits.

Therefore, on the liabilities side, there are demand deposit accounts (Checking accounts) that are considered interest-free loans (Qard al-Hasan), and therefore they are guaranteed. Demand deposit accounts allow the account holder to receive a check book, have a safe place for their money, they can withdraw easily, at any time, with credit cards or debit cards. These demand deposits do not take the risks of banking. Depositors pay administrative costs and management at the bank for services provided by it.

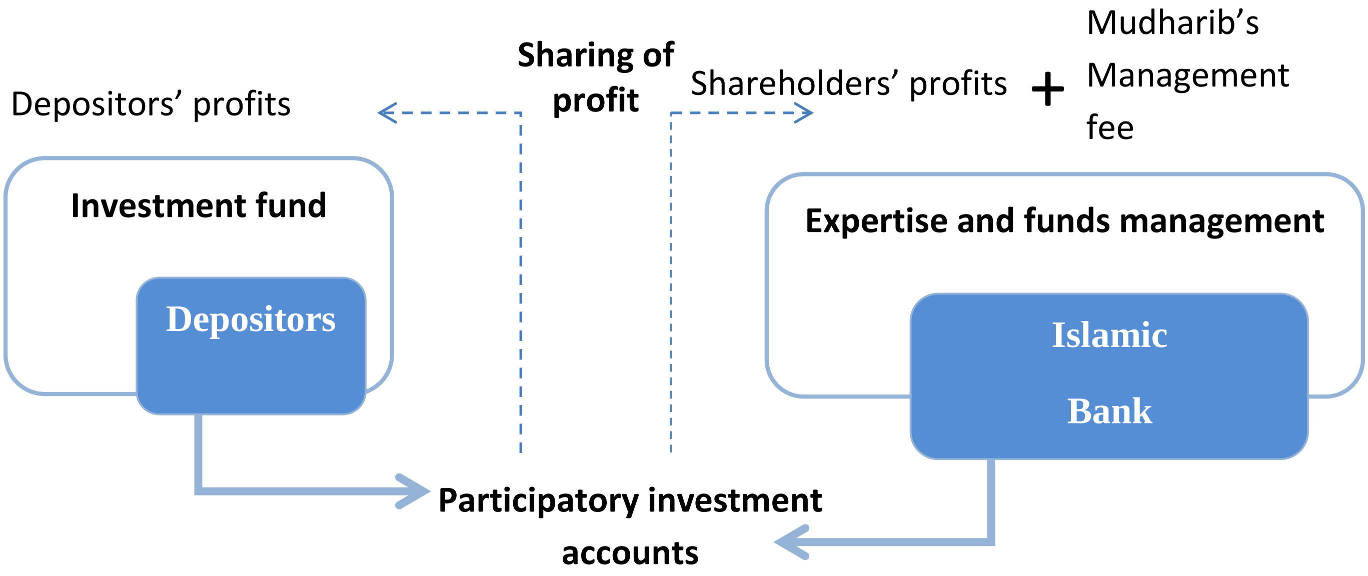


Figure 2: *Mudharabah* applied to investment deposits and accounts

We also find that all funds raised are in the form of *mudharabah*. In this latter case, the Islamic bank acts as a manager of investment against depositors whose funds fall under the category of investment deposits. Islamic bank shares its net earnings with its depositors in proportion to the amount at each deposit. Depositors are considered in this case *Rab al-mal* (capital providers). They must be informed once the date of deposit of the distribution of profits with the bank. Islamic banks are called *mudharib*. They manage the investment deposit accounts also called participatory investment accounts or Profit and Loss Sharing Accounts (PLSA). The losses incurred by 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 the business.

Mudharib brings 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 venture and the bank absorbs losses. The distribution of profits and losses is fixed in the contract.

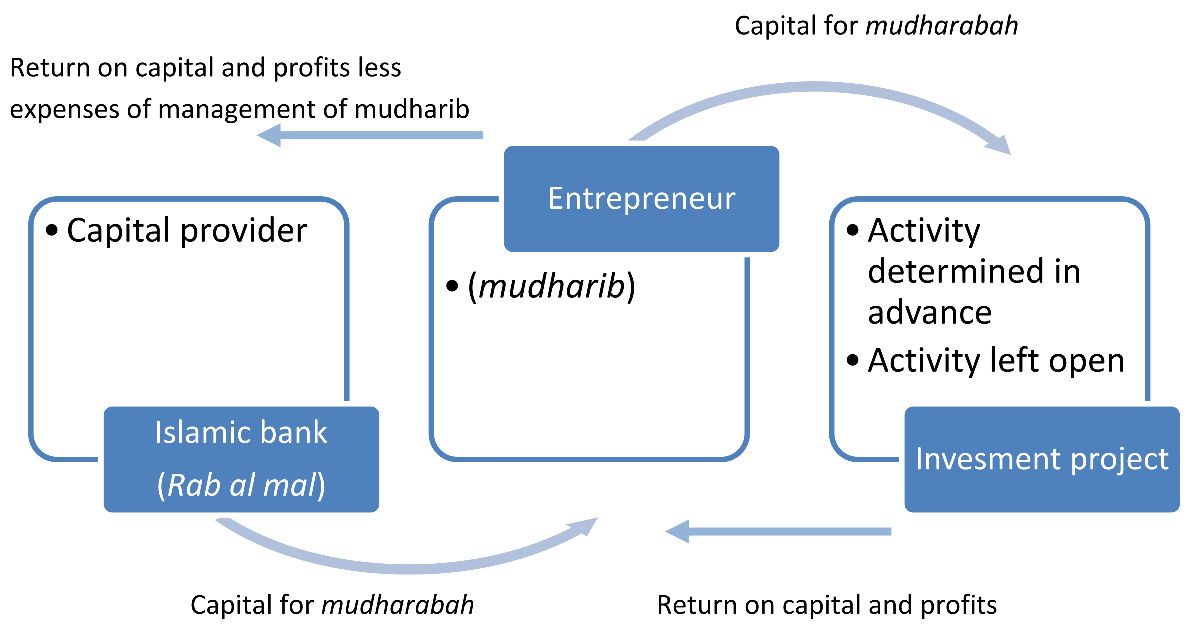


Figure 3: *Mudharabah* on the assets side

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.).

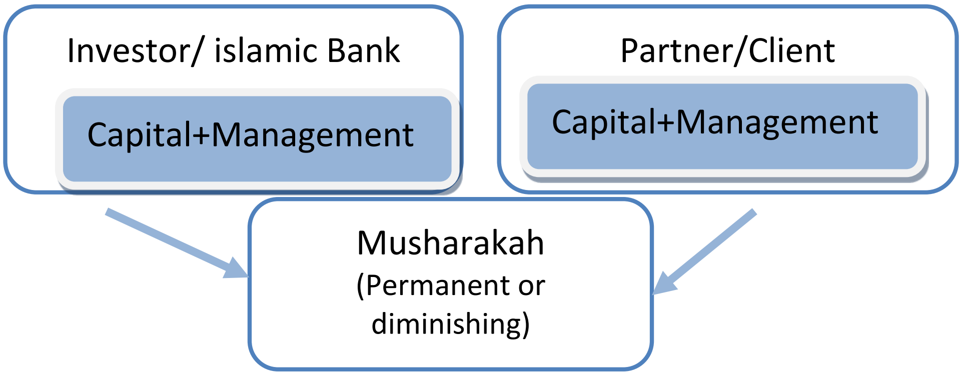


Figure 4: Musharakah

3.2.3. Murabahah

With the prohibition of interest, Islam allows profits and fees related to the sale of an asset or property. This is the principle of *murabahah* (AL Bay'ou bi ribhin ma'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*, the bank (lender) is therefore available to the client (borrower) (who needs immediate liquidity) funds for the acquisition of an asset or commodity becomes the sole property and final to the ultimate buyer (customer / borrower). The client then pays the purchase price and commissions related to this contract (profit accruing to the bank). In this case, the bank acts as an executor of the purchase order. It operates by buying from a supplier (first offer) and selling the client (purchase order).

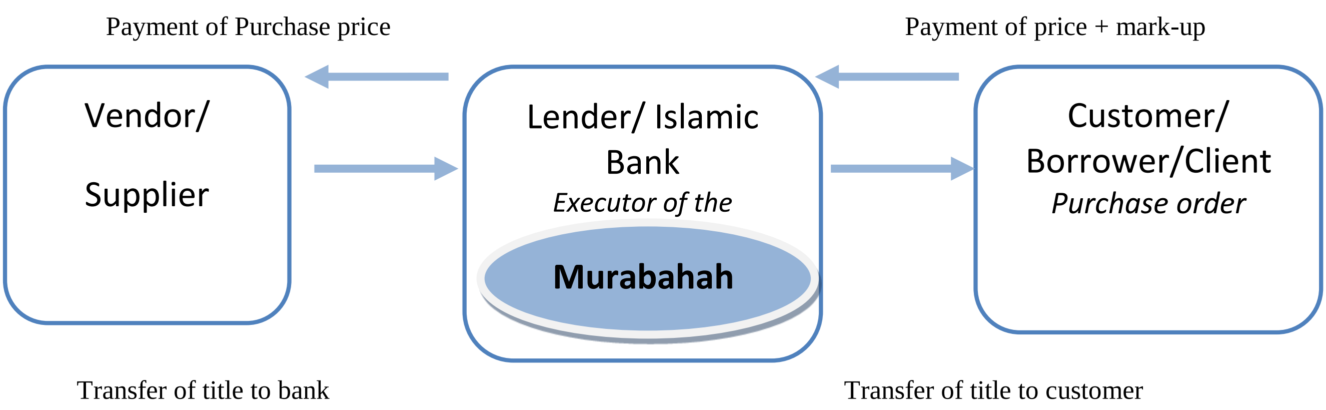


Figure 5: Murabahah

3.2.4. Ijara

Ijara is a lease of equipment as well as property of an item by its owner to a customer with a promise of sale to the customer. Credit institution like a bank (the creditor / financier) will purchase the property (machinery and / or equipment) chosen by its customer for an agreed price and then will grant a lease to the customer for period of lease (must be determined in clear terms at the time of contract). The customer has the option to repurchase the property. It reserves the option to acquire definitely the property.

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).

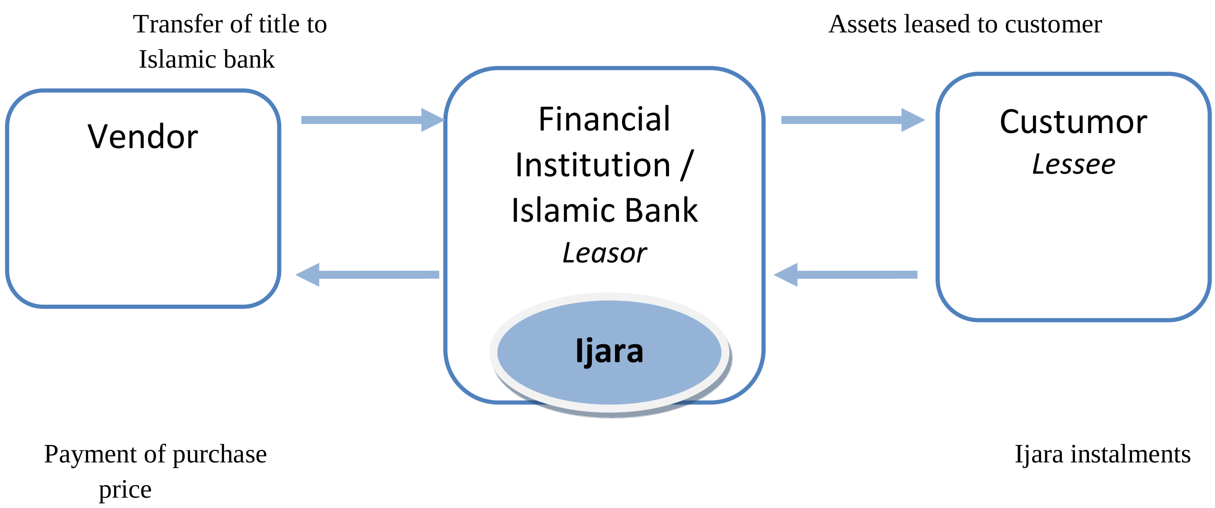


Figure 6: Ijara

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 can be defined as a contract of sale with deferred delivery of 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 bank acts as purchaser, with cash payment of goods that will be delivered in time by her 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 contract specifies the nature, quantities, prices of goods ordered and the time and manner of deliver. Both parties signed a parallel agreement of sale by proxy through which the bank allows the seller to sell or deliver goods to a third party. The seller undertakes, at its full responsibility to collect and pay the proceeds of the sale to the bank. At maturity, the seller delivers the goods and invoice on behalf of the bank. The seller then receives a commission or rebate or participation in the margin generated by the sale of goods. The Bank released a net margin (after deduction of commissions and other costs) must be at least equal to the minimum annual rate of return as determined in its funding policy.

The intervention of the Islamic bank may be direct or indirect. In case the Islamic bank involves a seller (third party): it says “*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.

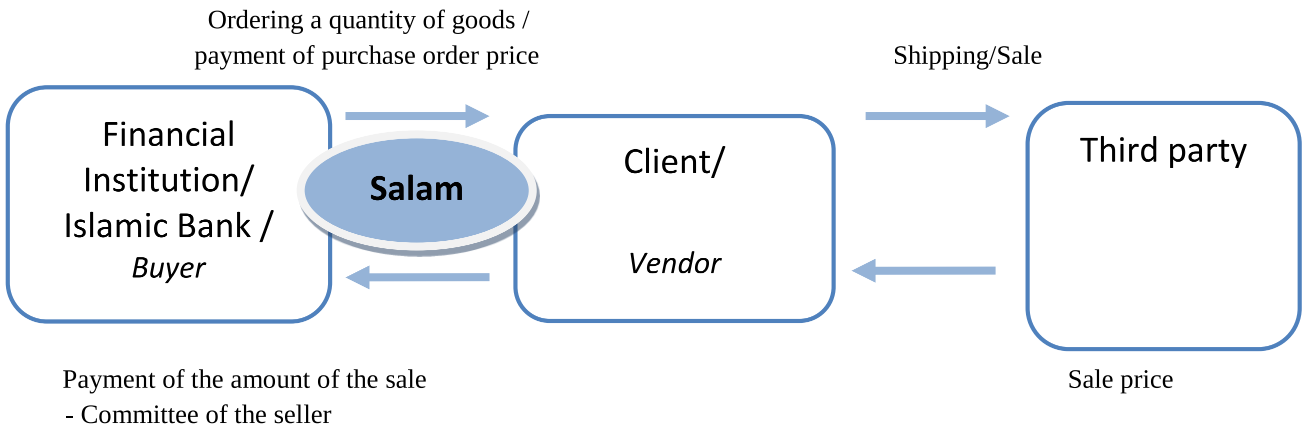


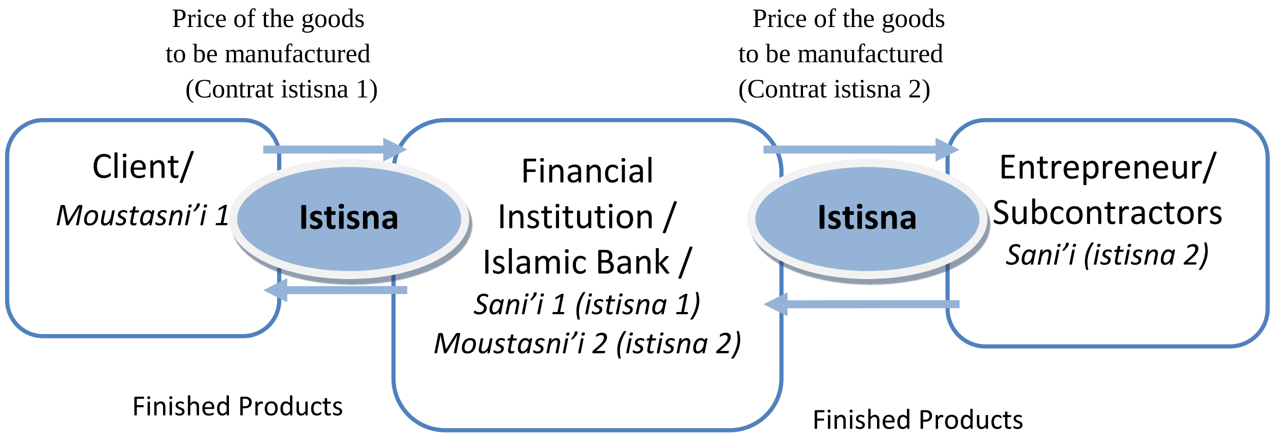
Figure 7: Parallel Salam

3.2.6. Istisna

The *istisna* akin to a mode of financing in the medium term. It is a contract manufacturing (or construction or business) under which the participant (seller) agrees to provide to the buyer within a certain time and at an agreed price, goods specified after manufacturing (construction) in accordance with specifications. In other words, the buyer (*moustasni'i*) request to another party (*sani'i*) to make him or construct a structure for an agreed 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.



4- Models defines the practice of Islamic banks

Islamic Bank conducts relations with lenders and borrowers and acts as financial intermediaries, channeling funds from savers to borrowers and in the process removing budget constraints that limit individuals and businesses. Financial systems also create incentives for an efficient distribution of resources within an economy, 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 principal with borrowers that she will advance the necessary funds.

Mark-up in 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. Model 1: *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 bank plays two roles:

1- The role of general partner: depositors (rab al-mal) make available to the bank (mudharib) their deposits and pay management fees to the bank. 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 bank does not give them a fixed income as would a traditional bank, but agrees to pay them a share of the profit or share 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- The role of sponsor: Islamic bank becomes 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

- With this model (*mudharabah* on the liability side and on the assets side), the bank is play its role as financial intermediaries in the collection and allocation of resources, it acts as a fund manager. She manages the risks and asymmetric information associated with *mudharabah*. Consequently, its operations generate a high 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* can consolidate and accelerate the pace of new business growth, and also innovative companies because it creates an ideal opportunity for investment projects in very little tangible, and having no guarantees. *Mudharabah* is a real instrument for business development.

- The return of the *mudharabah* is linked to productivity and quality of the project, thus the yield is close association with return in the real economy. The balance between the real economy and the financial economy in Islamic transactions based on *mudharabah* is assured since this form is systematically linked to real assets as opposed to the “ribawi” system.

- With the contract *mudharabah*, contrary to conventional finance, it is not possible to use the guarantees to ensure a profit or guarantee results. Since the principle is the sharing of profits and losses, the expected return is the basis of *mudharabah* and therefore shares in the profit of each stakeholder (Islamic bank, entrepreneurs, and depositors). Also, with the contract *mudharabah*, lack of guarantees appeases entrepreneur’s charges.

- Compared to the system based on interest, the system based on *mudharabah* is superior in terms of efficiency and stability. In addition, investment decisions depend greatly on financial factors which is in contradiction with advanced of Modigliani and Miller (1958) stating that the real decisions of firms (eg investment), motivated by maximizing values actions are independent of financial factors such as domestic liquidity, debt levels, or payment of dividends.

- The creation of money without counterpart in production, resulting on interest led to an imbalance in the economy. The point of view of Islamic finance is that money is an intermediary and measuring instrument in trade in goods. At this point the money can not generate money but to be used in financial transactions as a medium of exchange while having a store of value. *Mudharabah* provide equilibrium to the economy because it encourages direct investment in production. Money creation with *mudharabah* is correlated with real investment. Money can produce surplus only to the extent where it is transformed previously into real good and not virtual good.

4.1.2. Inconveniences of 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 greatly prejudicial for the bank in an agency relationship. With this model, the bank appears as a principal and 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 asymmetric information and moral hazard.

To face with this problem, the bank's interest to carefully select its investment projects and 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. Model 2: *Mudharabah* on the liability side and *Musharakah* on the assets side

4.2.1. Advantages of this model:

- On the liabilities side, Islamic banking employs *mudharabah*. But from the asset side, it uses *musharakah* (equity participation contract). This model is most suitable for the needs of the cycles of creation and business development both in terms of the constitution (and/or increasing) the capital and of the acquisition (and/or renovation) of equipment.

- This model provides opportunities for long-term and medium-term investment of its resources. 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 strictly in relation to the respective capital contributions. This principle of sharing risk and return makes *musharakah* an attractive source of financing.

- This model guarantees direct control and monitoring of the contractor'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.

- With the sharing of risk and return, the Islamic bank chooses to finance the riskless project. Islamic bank rejects in the selection phase projects that have a high level of risk. Finance by Islamic banks does not favor projects with a high level of risk. This is the problem of credit rationing identified by Stiglitz and Weiss in 1981.

- With this model, the bank no longer plays the role of financial intermediary but rather the role of direct investor in the project by sharing with entrepreneurs funding and the risk and return.

4.3. Mode 3: *Mudharabah* on the liability side and debt and quasi-debt instruments on the assets side (*Murabahah, Istisna, Salam, Ijhara*…)

Islamic bank uses *mudharabah* on the liability side, but on the assets side, she makes use of debt and quasi-debt instruments for the employment of those funds collected by deposits. The bank will be conducted to practice *murabahah*, or *istisna*, or *ijara* and may thus reduce the risks related to *mudharabah* and *musharakah*. Remuneration of the bank is directly related to these debt and quasi-debt instruments concerning a direct use of funds from the bank without 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:

- The capital and income are guaranteed and do not support risk. 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. It therefore appears that this model offers greater opportunities and greater flexibility to the intervention of the bank, while keeping within the context of the principles of *Sharia*.

- This model satisfies to a need for balance in the way of use of these funds that enable the Islamic bank to respond to a large extent of the needs of its customers in financing cycles of creation, investment and operating companies.

4.3.2. Inconveniences of this model:

- This model uses *mudharabah* on the liability side (deposits) which means that the bank assumes a high risk with depositors. The employment of these funds using debt and quasi-debt instruments means that the Bank assumes a low risk on the assets side as a consequence of low profitability. With this model, the bank loses the return linked to better uses of funds.

- With this model, the Islamic bank has other business risks that do not exist if Islamic bank chose *mudharabah* or *musharakah* on the assets side.

- Although the *murabahah*, *ijara*, and *istina* are instruments which conform to *Sharia* but the bank risk to fall into haraam if conditions related to the application of these contracts are not taken into account.

- 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. Model 4: *Mudharabah* on the liability side and *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. *Mutajarah* 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 bank can access information about its customers, and this is not consistent with the principle of pure and perfect competition if she practices the trade. On the one hand, she has information on these customers, and other hand, she competes with its customers in the trade. Customers no longer have confidence in the bank since she is considered a rival.

5- Conclusion

This paper highlights the role of Islamic banks as financial intermediaries. It supports the importance of pure financial intermediation of Islamic banks around the model of *mudharabah* on the assets side and on the liability side and shows that the entry of Islamic banks directly in trade, industry and agriculture, through *mudharabah* on the liability side and *murabahah*, or *musharakah* or *ijara* or *salam* or *istisna* on the assets side means that Islamic banks deviate from their role as financial intermediaries.

These forms present advantages and disadvantages for the Islamic bank but are considered non-pure forms of financial intermediation. The only model suitable to the Islamic bank is the model of *mudharabah* on both sides of the balance sheet because it is the model that guarantees equity and efficiency for the whole banking system. However, the model involving *mudharabah* on the liability side and debt and quasi-debt instruments (*murabahah, istisna, salam, ijara*...) on the assets side is the most applied by Islamic banks.

This paper therefore shows that the banks' interest is in preserving their role as financial intermediaries, and that other models can be applied as reinforcements to serve the diverse needs of customers. *Murabahah, istisna, salam, ijara* on the assets side may be useful for the Islamic bank on the condition that such contracts will be secondary and the bank preserves its primary role as pure financial intermediation with the contract of *mudharabah* on the both sides of balance sheet.

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