

Islamic banks (Profit Sharing Contracts and Agency Theory in the Islamic banks in Lebanon)

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Abstract

The central feature characterizing the financial Islamic system is the absolute prohibition of the payment and receipt of fixed interest in any transaction. Theoretically, Islamic Banking operates on the basis of Profit Loss Sharing (Mudaraba and Musharaka). In Lebanon the balance sheet of Islamic banks appear that, the percentage of PLS financing is very weak. The lack of profit and loss sharing (PLS) financing is an important problem affecting Islamic banks in Lebanon. The main objective of this research is to analyze problems faced by Islamic banks in Lebanon to use the PLS contract. The type of PLS contract raises a set of issues concerning the contractual relations between the Islamic bank and the clients.

These issues may be addressed from the perspectives of Agency Theory, as we will do in this paper.

Keywords: Islamic Banking, Profit-and-Loss Sharing, Agency Theory, Mudaraba, Musharaka, Lebanon.

المصارف الإسلامية

(عقود المشاركة في الأرباح والخسائر ونظرية الوكالة في المصارف الإسلامية في لبنان)

ملخص

ان الصفة الاساسية التي تميز النظام المالي الإسلامي هي التحريم المطلق للربا، اي عملية دفع او الحصول على اية فائدة، في أي معاملة. من الناحية النظرية، تعمل المصارف الإسلامية وفق لمبدأ تقاسم الأرباح والخسائر (المضاربة والمشاركة). في لبنان، تظهر الميزانية العمومية للمصارف الإسلامية أن نسبة التمويل عبر مبدأ المشاركة في الربح والخسارة ضعيفة للغاية. ان الافتقار إلى التمويل عبر مبدأ المشاركة في الأرباح والخسائر يشكل مشكلة مهمة تؤثر على البنوك الإسلامية في لبنان. الهدف الرئيسي من هذا البحث هو تحليل المشاكل التي تواجه البنوك الإسلامية في لبنان وتضعف من نسبة التمويل عبر مبدأ المشاركة في الربح والخسارة. يثير هذا النوع من العقود مجموعة من القضايا المتعلقة بالعلاقات التعاقدية بين البنك الإسلامي والعملاء. يمكن معالجة هذه القضايا من منظور نظرية الوكالة، كما هو الحال في هذا البحث.

الكلمات المفتاحية: البنوك الإسلامية، تقاسم الأرباح والخسائر، المضاربة، المشاركة، نظرية الوكالة، لبنان.

I. Introduction

The prohibition of interest in Islam is the aspiration of Muslims to convert this ban into reality in their economies. Over time, this led to the creation of a number of Islamic financial institutions worldwide. These institutions include Islamic commercial banks, Islamic investment companies, Takaful (Islamic insurance) companies, leasing and Mudaraba companies, and other non-banking financial institutions. In the absence of interest rates, the main substitute is the remuneration of financial capital by the principle of "Profit and Loss Sharing (PLS).

Financial intermediation in the Islamic system is conditioned by the application of the PLS principle whether on the part of the depositors or the borrowers. Islamic banking permitted to accept deposits based on Profit-and-Loss sharing (PLS).

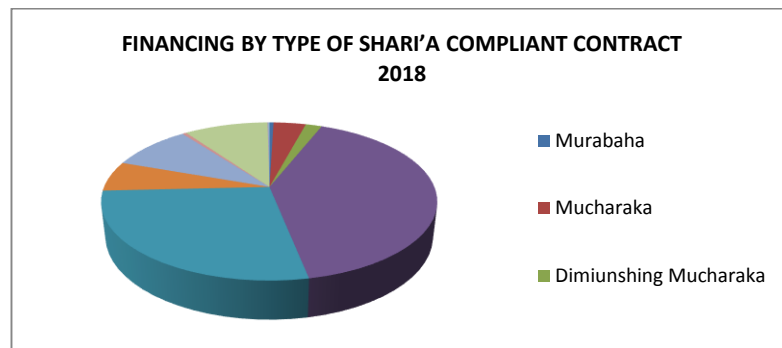
All the Islamic banks have three kinds of deposit accounts: current, savings and investment. Investment Account are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed, deposits for investment purposes are the main source of funds for the Islamic bank; they are more like shares of a company rather than term deposits.

The same principle of sharing of profit and loss refers to the use of funds. As such, there are two methods that fully meet the requirements of sharia law in this area, which are the "Mudaraba" and "Musharaka" contracts. Inside the importance of PLS Contract (Mudaraba and Mucharaka) we found that the Islamic banks don't use much these contract. Based on a study published by World Bank and the Islamic Development Bank in 2017 about Islamic banks transactions indicate that murabahah and deferred sales account for 78.5% and leasing and hire purchase accounts for 10.8% as oppose to the 1.7% and 4.2% for mudharaba and musharaka respectively. Also , at the end of 2018, for 18 countries members of IFSB, the percentage of Mucharaka is 4.80% (Mucharaka and Diminshing Muchraka) and the Mudaraba (0.4%) facing of 58% Murabaha contrat (Table1-Financing by type of contract).

Table 1 - FINANCING BY TYPE OF CONTRACT 2018

Mudarabah	0.4%
Mucharaka	3.20%
Dimunshing	1.60%
Mucharaka	
Salam	5.30%
Bai Bithaman	8%
Ajel	
Qard Hassan	0.10%
Istisnaa	0.4%
Murabaha	35.20%
Others	8.30%
Commodity	23.60%
Murabaha, Tawarop	
Wakala	0.10%

Figure 2 - FINANCING BY TYPE OF CONTRACT 2018



Estimated based on aggregated data from 18 countries

1.2 Objectives

The PLS contracts "Mudaraba" and "Mucharaka" used by the Islamic banks represent an agency relation, in the one hand, between the depositors and the Islamic bank and in the other hand, between the Islamic bank and the companies in the case of Mucharaka and Mudaraba contract. In this paper we try to see how the agency problem influence the PLS contract in Islamic banks?.

The main objective of this paper is to discuss the problem of Agency Theory in Islamic Banks which function in Lebanon. All theoretical models of Islamic banking are based on Mudaraba or Mucharaka or both.

Moreover, the concept of profit and loss sharing (PLS) is theoretically superior to conventional banking for different reasons (Khan and Mirakhor (1987)). However, in practice things seen to be different.

The question which arises in this case is, why the Islamic banks in Lebanon do not much use the contracts of "Mudaraba" and "Mucharaka" or don't contract with the principle of PLS?

1.3 Methodology

In the present research, the field of analysis relates to the Islamic commercial banks in Lebanon. Thus, the total population concerned with this work does not exceed 5 banks. With regard to present research, a sample, desired to diversify, population from the Islamic commercial banks studied in Lebanon. This sample comprises two principal cases, namely: Albaraka Islamic Bank, which is the pionnier in the Islamic banking field in Lebanon, and Lebanese Islamic bank.

In our case, the discussions with the persons in charge of the Islamic banks were particularly profitable for the question concerning the types of problems concerning the use of PLS contract in Islamic banks in Lebanon.

Miles and Hubermann(1991), propose three qualitative stages of data analysis : condensation of the data, presentation of the data and development /checking of the conclusions.

In our case, the categorization of the data was done according to about ten topics. To conclude research, it is up to the researcher to try hard of organization of the found results. Thus, a classification of the results in homogeneous categories will make it possible to the reader to have a total image of the contribution of research.

This effort of synthesis can lead the researcher to translate the new theory emerging of the “ground” in the form of a diagram or in the form of a paragraph or even in the form of only and single sentence.

The methodological approach presented by Eisenhardt was used to us as a basis to select, study and analyze two Islamic banks located in Lebanon.

2. Literature Review

Islamic banking has been around for more than 40 years. However, the Islamic Financial Services Board (IFSB) has announced that the total assets of the Islamic banking industry globally, from across 22 IFSB member jurisdictions increase of 70\$billion and have reached USD 1,754 billion in 2018 from USD 1,684 billion in 2017. Therefore, in this section we will introduce Islamic banking and the mobilization of funds by Islamic banks

The central feature characterizing the financial Islamic system is the absolute prohibition of the payment and receipt of fixed interest in any transaction. Islamic banking is based on the rule of Islam which prohibits the rate of interest. Islamic Banking operates on the basis of Profit Loss Sharing (PLS). This principle (PLS) is the main substitute for interest rate .

2.1 The mobilization of funds by Islamic banks

Once funds are collected, the Islamic bank has an important mission: the utilization of these funds into viable projects. Its financial intermediary position is that of a lender/provider of funds called on to finance the various sectors of the economy. In this section, we will discuss how in principle, in an Islamic banking system, funds are raised (mobilized) and allocated to different sectors of the economy, in the absence of interest rates.

For the philosophical concept of Islamic banking, the bank's activities should be based on investment operations. These operations are intended to provide the bank with the necessary revenues for the production of these "funds".

These transactions are essentially concluded by means of a financing contract by association (Mudaraba), by contract of association with participation "Musharaka" or purchase-resale contract "Mudaraba".

In addition, the intervention sectors of the Islamic bank finance all sectors of the economy, provided they conform to Sharia. Islamic laws do not allow investments in certain activities that are prohibited, such as insurance companies, typical commercial banks, gaming or "Maisir", distilleries, delicatessen traders, financial instruments such as "derivatives" and especially options, "futures" and other futures contracts because of their speculative nature (Sharia considers the uncertainty regarding the contract as illegal); hence, this will fundamentally condition the financial products to be developed as well as the corporate strategies and the business strategies of Islamic banks.

In the "Mudaraba" contract, the bank finances exclusively the entrepreneur who invests, in addition to bank funds, his effort and knowledge in a productive activity in exchange for sharing a percentage of profits. The losses are borne exclusively by the financier (lender). As for the entrepreneur (borrower), he only loses the time and effort invested in the company. This type of contract aims, in fact, to place on equal terms the human capital and the financial capital. The mode of financing "Musharaka" involves several funders. All parties (entrepreneur, bank and other associates) invest in variable proportions, and the profits and losses are shared among them according to their respective financial contributions.

2.2.1. The “Mudaraba”

From the perspective of linguistics, “Mudaraba” in Arabic language originated in the word "Al-Dharb" on earth which means moving on land because of travel or for business. Indeed, there are two meanings in Qur'anic verses (4, 101) and (73, 20). Also, it must be noted that “Mudaraba” is synonymous with the Arabic term "al-Kiradh" which means the divestiture of its capital in benefit of a third party so that it can work with.

1. Definition of “Mudaraba” in banking

The “Mudaraba” is a consent reached between two parties, one (the financier or owner of capital) providing capital, and the other “Mudarib”, providing the work. The profit is shared by a ratio determined at the time of signing the contract. Of course, consent bears a sharing ratio but neither on a specific amount nor on a percentage of capital. It is left to the discretion of the parties according to the complexity of the task by the “Mudarib”.

If, after use of funds, the transaction does not generate profits, the financier would have saved his capital, while the “Mudarib” would have lost his time and effort and may not try to draw gain by reducing the capital of his partner.

The “Mudaraba” is a partnership agreement between two parties: the first "owner of capital" provides all the capital and second "agent" provides the know-how. The Mudareb will manage and monetize the capital. The results will be distributed between the two parties on a predetermined percentage, whose base can only be the practical benefit of this operation. The principle is that loss is calculated on capital and profit is determined as customarily convened. This is true as long as there is no negligence from the “Mudareb” the agent, because if that is the case, the latter may be held responsible for part or all of the losses.

In authorizing the participation of the “Mudareb” in profits and forbidding him to participate in losses, the "Fouqaha's", Muslim Jurists outline the justice upon which is based the “Mudaraba” contract because the benefit of the owner of capital is the remuneration of his capital, while that of the “Mudareb” is the counterpart of his work. In other words, in case of loss, the “Mudareb” cannot withdraw anything in return for his effort. In this case, he would have lost time and effort invested in the company. Because, in the “Mudaraba” contract, the latter is considered a partner and therefore, he earns revenues only on the basis of achieved profits.

2. Conditions for Mudaraba

Like any other form of contract, the “Mudaraba” is lawful only if certain clauses are met. The contractors must be in good mental condition, otherwise the contract is declared null and void. It is not required that both sides are Muslim. For the “Mudaraba” contract to be valid, the invested capital must meet certain conditions including¹:

-The amount of capital must be known by both parties in advance, otherwise it will be difficult to calculate the profits if we ignore the costs incurred.

Also, knowledge of the invested capital helps protect the contracting parties against the risk of conflict or “Gharar”².

- The capital must be in monetary form. However, some “fouqaha”, Muslim Jurists, have relaxed this condition by accepting other forms of capital (physical inventory for example) if it does not complicate the calculation of results.

¹ Mondher Bellalah and Racha Ghayad, *Fundamentals of the Islamic Financial System and Financial Instruments* in "On Islamic Banking, Performance and Financial Innovations", Cambridge Scholars Publishing, 2014, UK.

² The prohibition of *gharar* because, as speculation, it introduces incertitude and risks.

- Payment of capital at the time of signing the contract so as to enable the “Mudareb” to initiate his activities. In the Mudaraba contract, profits represent earnings of the parties that are known only a posteriori. Thus, in order to eliminate any possibility of disagreement, the “foukaha”, Muslim Jurists, require that certain conditions relating to benefits are satisfied:

1) Determination of the benefit sharing rate upstream and not downstream.

2) The sharing rate on achieved profits, which should in no way refer directly or indirectly to the invested capital, because the Mudaraba amount bears primarily, if not exclusively, on profits.

3) The agreement shall be for a fixed amount, even if that amount is conditioned by the realization of profits.

4) The agreement of the two parties may be accompanied by additional conditions apart from the benefits accruing to each party. For example, neither party may require the provision of free services usually billable to others.

Based on Ghayad and Bellalah (2014), the “Mudaraba” is used by the Islamic bank in two ways: first in the sense of customer-Islamic bank, and then, in the sense Islamic bank-client. In the first sense, we consider that the client depositor, the contributor of funds, is the “Rabalmal”, and the Islamic bank with its market experience and the competence of its staff is the provider of the know-how, i.e. it becomes the Mudareb. In the sense *Islamic bank-client*, the bank seeks clients with the know-how and lacking capital in order to conclude with them a “Mudaraba” contract in which it becomes the “Rabalmal” and the client becomes the “Mudareb”. In reality, the Islamic bank - client relationship under the form of “Mudaraba” is very small in all Islamic banks. On a practical level, the “Mudaraba” is used primarily in the client-Islamic bank sense.

2.1.2. The “Musharaka”

The "Musharaka" is the association of a capital with another capital to share the profits and losses that may result to this effect. This is the concept of participation, taken in the very broad sense of the term, and namely applying the principle of Participation in Profits and Losses (P.L.S). In this type of contract, the client and the bank, for example, jointly participate in the financing of an operation and jointly assume the risk in proportion to their participation. This can be done either by a cash contribution by both parties or by a contribution in kind by either party. The losses are distributed between the client and the bank on the basis of each party's contribution. Regarding the sharing of profits, two theses have been developed: the benefit may be determined by agreement (thesis of the "Hanbalite" or "Hanafi" School); or benefit may be determined by the contribution of each party (thesis of the "Maliki" and "Chafite" School). The capital of the "Musharaka" can be: a cash contribution plus a cash contribution or a cash contribution plus a contribution in kind. The management of "Musharaka" can be made either by all the associates, by one or several associates or by one or several third parties. The loss must be apportioned in proportion to the capital.

Using the Musharaka by the Islamic bank

Based on Ghayad and Bellalah (2014), the "Musharaka" may be used in both directions: first in the Islamic bank /client direction, and next in the client/Islamic bank direction. The Islamic bank can finance its clients using the "Musharaka" (or P.L.S principle) in several forms: participation in the equity of existing businesses or to be created: all shareholders of a capital-intensive company are bound by a "Musharaka" contract; the funding of the operating cycle, and funding for the import.

The "Musharaka": client - Islamic bank

In this case, the client provider of funds becomes a semi-shareholder in the Islamic Bank by participating in the results (**Ghayad and Bellalah (2014)**). The client depositor is not paid by an ex-ante interest rate, but he participates in the bank's annual results based on the amount that he deposited and the time he left. He receives an ex-post interest rate. In fact, some Islamic banks use the method of "Musharaka" in the client- Islamic bank direction; most use the "Mudaraba" to pay depositors.

2.2 .Why Islamic banks don't use PLS contract ?

ORHAN Z.H. (2017) treats the problem of PLS in Islamic banks in Turkey" and he finds that PLS stays miniscule especially on the asset side of Turkish IBs. Some of the reasons identified by Turkish IB practitioners are : transparency, legal system/arrangements, less return vs. high cost and risk, and staff-related problems. Their empirical study discuss also problem solving approaches about PLS. Musharaka is preferred over Mudaraba in order solve the agency problem.

Al-Bahooth (2017) in his research treats the role of Islamic finance in supporting small businesses in Saudi Arabia conclude that the agency problem is one of the obstacles facing Islamic banks in the financing by PLS. This research also concluded that the lack of great uniformity in information, and the existence of more restrictions by Islamic banks on increasing financing on the basis of profit sharing, are added to the reasons for not using participation at a large percentage. In addition, there is a problem with the lack of ability to arrive at accurate forecasts of financing results based on PLS.

Imronudin (2016) in his work tries to answer why customers of Islamic banks in Indonesia prefer *murabahah* more than PLS. He found that one of the fundamental reasons of the preference of *murabahah* is its simplicity and that it does not need transparency and honesty.

Also we find that the research of **Abdul-Rahman and Nor (2016)** use qualitative methodology and find that the essential problems for the uses of PLS are the agency problems, specially the adverse selection, high risk, the demand for PLS financing is issued by a large percentage from companies that do not have high credibility, and capital security which is once more related with risk.

Bacha's (1995) in this research considered that the agency problem is the basic reason of the lack of PLS in Islamic banks. In practice, the Agency problem is the most important problems attributed to PLS.

2.3. Agency Theory and PLS Contract

Eisenhart defines agency theory as follows: "Agency theory is directed at the ubiquitous agency relationship, in which one party (the principal) delegates work to another (the agent), who performs that work. Agency theory attempts to describe this relationship using the metaphor of a contract." Agency theory has its roots in information economics.

The fundamental assumptions underlying agency theory are:

- (1) the principal and agent has each a different goal;
- (2) there exists hidden information either before or after contracting, i.e., it is difficult or expensive for the principal to supervise the agent's action,
- (3) and the principal and the agent have different risk preferences which may lead to different actions consequently taken.

The divergence of interests and asymmetry of information between principal and agent may cause output to depend upon the contingent nature of the compensation contract. Different theories of agency show that correlation between remuneration and productivity determines the growth of the enterprises and behavior of the agency. However,

the realization that 'Arrow- Debreu ideal' or 'more-less frictionless world of complete information, perfect foresight and castles transacting' is insufficient to accommodate a number of important economic phenomena has led the economists to focus on 'the process of contracting'- particularly its hazards and imperfections.

Principal-agent models analyse situations in which information is unevenly or 'asymmetrically' distributed between contracting parties with potentially divergent interests. The most commonly analysed relationships are those in which one party acts on the other's behalf, as is assumed to be the case in employment, agency or franchise agreements. Adverse selection, prior to the contract and moral hazard, during its performance, arise where the "principal" can not costlessly observe or monitor the agent's characteristics and/or actions. Therefore, the issue arises how the principal can induce the agent to act in such a way as to maximize the principal's utility.

2.3.1. Implications of Agency Problem in Islamic Contracts

Based on the perspective of the corporate finance literature, the main importance of PLS contract is his ability to allocate risk optimally through the sharing of project returns between entrepreneur and owner of capital. But the PLS have several principal-agent problems arising from asymmetric information and costly monitoring.

Based on the research of **Milles and Presley (1998)**, we can mention that Islamic bank would face difficulties in PLS contract with his client resulting from ex-ante information limitations concerning project quality. Borrowers have inside information about their personal activities and projects' likelihood of success that cannot be credibly signaled to the bank because every PLS applicant will claim to be of the highest quality.

The banks 'difficulty in determining the quality of loan applicants produces various adverse selection problems-especially when debt finance is available from competing sources'. Pryor (1985) indicate that borrowers choose PLS to finance their projects when they expect a low realized profits because they will enjoy high total returns at an artificially low cost of capital. In the same sense, Nienhaus, (1983) consider that Islamic bank will use PLS operations and they know that their project is highly risky because borrowers could inflate their declared profit expectations.

In PLS contracts, Islamic banks need to incur costly monitoring expenses to ascertain whether declared profit is true reflection of the activities or business enterprises/projects or not. Because borrowers have the interest to artificially reduce declared profit. They can decrease profit by resorting to accounting subterfuges. This ex-post information asymmetry leads Islamic banks to a moral hazard problem.

An Islamic bank's vulnerability to moral hazard and adverse selection would possibly make it uncompetitive with conventional rivals, because the Islamic bank will support an additional costs in information-gathering and project appraisal, reduced work incentives for entrepreneurs and higher production costs (e.g. Goodhart. 1987). The structure of **Mudaraba contract** mobilized by the Islamic banks may be seen as involving a complex agency problem (Archer and Karim).

3.Empirical study : Islamic banks in Lebanon

The empirical study was based on two Islamic Banks in Lebanon, namely (Al Baraka Islamic Bank and Lebanese Islamic bank).The case study with several interviews as its primary data source. The interview was done with the CEO of Albaraka Group, directors of Islamic banks and members of Shariah adviser.

The information was obtained from the professionals who were very experienced individuals with wide knowledge in the Islamic banking sector on Lebanon and directly involved in the activity and product development of their respective Islamic banks.

3.1 Analysis of results and discussion

In this part we will based on interviews and on an in-depth review of the texts to determine the reasons for not largely used Mudaraba and Musharaka contracts by Islamic banks in Lebanon. Knowing that, in theory, these contracts are ideal and suitable to help promote the development of the Islamic economy, as they are based on the sharing of profits and losses. So far, Islamic banks have not been able to maintain a large share of themselves on the Lebanese banking market. According to an interview with a senior official in Al Baraka Bank,

The percentage of financing through Mucharaka and Mudaraba is very small in Al Baraka Islamic Bank in Lebanon and other Lebanese Islamic bank.

According to Al Baraka Islamic Bank in Lebanon, participatory and speculative financing is not widely available to clients as both carry relatively high risks. The money that banks invest is owned by the depositors. Therefore, Islamic banks must be very careful in investing their funds as this involves high risk. Based on the results of the interviews, there are five challenges that can lead to obstacles in applying the concepts of Musharaka financing and Mudaraba in Islamic banks in Lebanon.

I- The high investment risks of the PLS contract

The profit loss sharing contract refers to a type of financing that has uncertain returns. Thus, mudharaba and musharaka financing are highly risky, causing Islamic banks' operating in Lebanon inclination to avoid them, or to adopt a risk-averse attitude towards the financing.

All the interviewers in this research expressed his views that factor concerning the risk and the risk aversion approach of top management is the most important factor on the lower level of application of PLS contract by Islamic banks in Lebanon.

The **Musharaka** process is, in its essence, a true investment activity that requires the search for suitable investment opportunities, studying their feasibility, evaluating and implementing them, or following up implementation in accordance with the principles and modern scientific and technical rules. It also needs to collect accurate data on financing applicants, data related to commercial efficiency, and others related to financial disclosure. Banks, by virtue of the nature of their work, are fully aware that they must accept risks in their business, provided that they are measurable and controllable risks. Note that the PLS contract carry high risks that our bank may be reluctant to expand.

The impact of **the high risk factor** on PLS contract by Islamic banks in Lebanon is explained, in table 1, by the following respondents:

Table 1- impact of **the high risk factor** on PLS contract

B/BIB /D2 : "The reasons for the decline in financing rates through the PLS contract in Islamic banks are due to several reasons, including that participation carry a loss on the owner of the capital, the bank, and that he bears the loss according to his share in the capital. Also, such formulas require the availability of high human skills and there is a lack of availability of these skills at the present time".

B/LIB/D1 : "One of the most important factors that contribute to limiting the expansion of the participation formula is the high risk of this type of financing formula, it is considered a direct deduction from the capital, in addition to being a long-term investment".

2- Banking legislation

Based on the interviews, we can consider that banking legislation is one of the reasons for the significant decline in Musharaka and Mudaraba in Islamic banks in Lebanon. The central bank of Lebanon has developed, in recent years, the legislation of Islamic banking to a large extent, especially permitting dealing in Islamic financing formulas, but these legislations still need to be further developed to suit the nature of Islamic banks' operations in Lebanon, especially with regard to the application of the principle of PLS.

We present, in Table No. 2, the most important things mentioned in the interviews about the impact of the legislative component on the low percentages of Musharaka and Mudaraba contracts in Islamic banks in Lebanon.

Table 2- Impact of legislative situation

B/BIB/D1 :

"The Islamic banking system faces legal obstacles when applying the partnership contract in many Islamic countries, including Lebanon, which is the absence of laws regulating commercial contracts from adopting the jurisprudential provisions of the partnership contract".

B/BIB/D3:

"Among the factors that contribute to limiting the expansion of the PLS contract, especially in light of the high risk of this type of financing form, and because it is considered a direct deduction from the capital, in addition to being a long-term investment, for all these reasons, central banks have placed some restrictions on participation financing. For example, the Central Bank of Lebanon prohibits Islamic banks from participating in establishing non-bank companies or owning companies, which puts restrictions on the expansion of these forms of financing".

B/LIB/1 :

"The central bank places restrictions on Musharaka financing contract, which prohibit Islamic banks to own assets for their account or establishing non-financial companies. But in general, these formulas are allowed to work, and it is left to the banks to estimate their willingness to accept this type of risk".

3-The non-participation of the Islamic bank in the management of project

Based on the case studies do in two Islamic banks in Lebanon, we find that the non-participation of the Islamic bank in managing projects financed through Mudaraba is an essential element in rejecting and avoiding financing through Mudaraba.

The relationship based on profit and loss sharing between Islamic bank and its customers makes the investor one of the most important prerequisites for success Mudaraba contract and its application. Due to the special nature of the Mudaraba contract represented by not allowing the owner of the money, the bank, to interfere in the affairs of management with the investor. Thus, working in the Mudaraba contract is surrounded by many risks and obstacles, as it depends on its foundation on the element of trust, which requires its application in an environment that has all the Islamic values.

Based on the case studies, we can mention that the "non participation in management of Mudaraba" by Islamic banks do the agency relationship between Islamic banks and his client very complicated and high risky. The impact of this factor on PLS contract is explained, in table 3, by the following respondents:

Table 3- Effect of non-participation in the management**B/BIB/ D4"**

" You know , if the **information available** to the bank is incorrect, in his case the bank will have taken the selection adverse, the result of which is a loss. Thus the effects of the problem of the inability to verify the level of transparency in the information offered by many dealers with the bank are reflected in the Islamic bank's reluctance to finance by Mudarabaha and Musharaka contract".

B/BIB/D1:

"As small and medium enterprises in Lebanon do not have regular accounting records that enable them to adequately disclose their financial positions with respect to banks, which according to their internal procedures must evaluate the risks of these institutions. The evaluation process hinders the availability of audited financial information approved by the accounting and auditing firms".

B/LIB/D2:

" The problem of non-compliance, dishonesty and infringement of the bank's rights arises from the lack of advanced devices and methods that provide Islamic banks with sufficient information about people, their fields of work and their previous transactions. The problem of moral hazard arises, represented by the behavior of customers against the benefit of the Islamic bank, such as keeping various account for the purpose of reducing profits and amplifying losses".

4-Lack of efficiency

Based on the interviews conducted, we can say that the human resources component represents one of the main obstacles to implementing the financing types through Mudaraba and Musharaka in Islamic banks in Lebanon. These contracts have a special nature, and therefore they require special specifications in the characteristics, skills and capabilities of workers in this field. The Mudaraba in Islamic banks has a special intellectual structure sourced from Islamic law and Islamic jurisprudence,

which means that there is a new set of rules and controls that govern the work of this system, and this requires the necessity of having a distinctive quality of human resources capable of managing these operations. The impact of **human factor** on PLS contract by Islamic banks in Lebanon is explained, in table 4, by the following respondents:

Table 4-Effects on Human factor

B/BIB/D2:

" The human factor is a major obstacle to enforcing contracts Mudaraba, because the nature of work in speculation is completely different from the nature of the traditional lending system. The size of this problem is compounded by the reliance of Islamic banks on Skills that have mastered traditional working methods. Which prefers to use formulas and methods that approach in its mechanisms and results from traditional financing methods such as murabahah and sales".

B/BIB/D1:

"**The musharakah** contract requires the bank to participate with a share in the capital, and therefore it must itself undertake participation in the management of projects financed through participation or assign a company specialized in that. This form of financing requires direct supervision by Islamic banks on the Mousharaka projects that finance their capital, but the lack of sufficient and expert skills for the supervision process makes the Islamic bank seeks not to assume responsibility for this aspect by signing bilateral contracts with the project manager or seeking the assistance of someone from abroad and others things".

5- Market size and economic situation

Through the interviews that were conducted, we can conclude that among the reasons behind the lack of use of Musharaka and Mudaraba in financing Islamic banking clients in Lebanon, including Al Baraka Bank,

it is not related only to the desire of Islamic banks to provide this type of financing, but rather is linked to the economic and financial situation and the state of political instability in The country with the highest risk of this type of financing contract. The impact of market size and economic situation on PLS contract is explained, in table 5, by the following respondents:

Table 5-impact of market size

B/BIB/D1:

The Islamic banks in Egypt, including Al Baraka Bank, deal in a large and active manner in all forms of Islamic financing, especially speculation, Murabaha, leasing and participation, because it is the reality of the Egyptian market, a wide market and rich in large projects and investment opportunities in almost all sectors. Mousharaka and Mudarabah has increased in Al Baraka Group in recent years. The main countries in which Islamic banks such as Egypt, Turkey and Jordan have witnessed great activity in establishing new companies in the fields of industry, services, trade, marketing and others. This motivated the founders of these companies to resort to Islamic banks." To take advantage of the flexible financing contracts it provides, as most of these companies see, for their part, that the bank's entry with them in the form of Musharaka will hold the bank responsible for the success of the company as well in order not to lose its share of the capital.

B/BIB/D2:

The main reason for the banks not adopting this type of financing is the current instability in the political, economic and financial conditions, which greatly raises the risks of this type of financing, because as you know, the success of new projects requires a developing and normal business environment.

4.1 Conclusions and Recommendations

This research treat the topic of PLS financing and the reason for not using it by Islamic banks in Lebanon. The research reached to present proposals and methods of solving problems that constitute an obstacle to financing through PLS.

Based on the case studies do in Islamic banking in Lebanon concerning the lack of PLS in banks presented in this research, we reached a number of important conclusions, which will be mentioned bellow :

1. There is a significant lack of PLS financing from Islamic banks in Lebanon, and the data show that the use of PLS financing in Lebanon is among the lowest rates compared to Islamic banks in other countries such as Egypt, Turkey, Arab Gulf, Indonesia and Malaysia.

However, it's so important actually to increase the percentage of PLS in Islamic banks in Lebanon due to the importance of PLS financing for the economic development, creation of employ, reducing inflation, as well as improving the benefit of society in general.

2. In Lebanon, there is currently a dual banking system, conventional banks in addition to five Islamic banks, and these banks face a severe shortage of PLS financing. Banking regulations in Lebanon need reforms and amendments. This is because the current laws represent a major obstacle to the adoption of Islamic banks the PLS financing. Hence, reforms in banking regulations are required to achieve a balance between management and control rights between Islamic banks and managers of the companies in which they invest.

3- Islamic banks in Lebanon need to ensure an actively participation by them in the management of the project being financed. So, this research propose an organizational structure based on Venture Capital (VC) that provides a equilibrium of authority among management and other owners who have a financial part in the

enterprise. The shareholders share decision-making with the management when the issue is related to the management of the organization. The value creation by a “VC” will be more important than other organizations. Managers, who also own equity in the “VC”, will be more productive as they have confidential information concerning the projects because possibly they already have been professionally associated with the ventures. In addition, joint ownership between managers and other shareholders will lead to in alignment of interests between them, decreasing the agency problem. Furthermore, in a VC financial controls will be replaced by strategic controls as all the shareholders (managers, Islamic banks, and institutional investors) are intimately involved in the management of the enterprise and making key decisions. These controls encourage long term investments in projects, which influence the firm's value.

The information sharing in VC will be less costly, this makes the decision-making process faster. Involvement of the institutional investors serves a positive monitoring function. Institutional investors in a VC will closely monitor managerial actions, thus reducing agency costs.

4-Finally, in order to increase the percentage of PLS financing in Islamic banks in Lebanon, a basic and important factor must be secured, which is the improvement of the economic and banking situation in Lebanon, and the recovery of the economy

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