ISLAMIC FINANCIAL INTERMEDIATION: THE EMERGENCE OF A NEW MODEL

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Abstract—**being the main function of any banking system, financial intermediation is defined in the Islamic economy based on certain parameters that confer on the organizations that operate it a particular financial activity and various objectives. Admittedly, the two theories of intermediation, whether conventional or Islamic, converge at the level of interposition between economic agents with a need for financing and agents with financing capacity to reach an optimal flow of funds; however, they differ as to the procedures put in place to ensure the function of intermediation. In other words, the Islamic financial intermediation has distinctive characteristics because, in addition to its economic vocation which shares it with its conventional counterparts, they support a social and ethical vocation constituting the specificity of Islamic banks in terms of intermediation.**

This paper focuses on the study of characteristics related to the financial intermediation of Islamic banks. It seeks to reconcile the theoretical approach of intermediation and the reality of Islamic intermediation while conducting a comparative analysis with that established by conventional banks. Alongside this analysis, we will present the inventory of financial risks specific to Islamic financial activity.

Keywords-component: financial intermediation, Islamic bank, conventional bank, Sharia, risk management.

I. INTRODUCTION

Having emerged in the seventh century AD and then reappeared in the twentieth century with a number of innovations, Islamic finance had as its main vocation met the needs of a Muslim community excluded from the so-called conventional financial system deemed inadequate to the principles of the Islam, before expanding, thriving and deepening to become an alternative financial system that would make up for the shortcomings of the conventional financial system. Indeed, the last financial crisis that the world experienced in 2008 from the euphoria of real estate loans in the United States and the massive use of securitization and derivatives have increased the attractiveness of Islamic finance in particular with regard to its potential for systemic stability, an essential condition for ensuring steady development and growth of economic activity.

In fact, the strong impact of the financial crisis on the economies of developed and emerging countries prompted several economists and analysts to examine the reasons for this crisis by highlighting the lack of prudential regulation appropriate to the risk [18], the fragile situation of the global economy and the loosening of the conditions for granting loans [2] , not to mention the conflicts of interest between the rating agencies and the unethical practices of risk management practiced by banks and the massive resort to speculation [15].

Thus, more than ever, to admit that an economic system is efficient is correlated to an efficient functioning of its financial system. In this context, Islamic finance distinguished primarily by its moral and religious dimensions in the definition of economic problems, can participate actively in the development of its economic environment or even spare the last financial crisis even if Islamic financial institutions had also suffered a slowdown in their global economic activity. It is then that several empirical works have flooded in order to establish a comparative analysis concerning the degree of resistance of the conventional banks and the Islamic banks to this crisis of which we quote someone to know: the comparative study on the effectiveness of banks conducted by Shafique, A., Faheem, MA, & Abdullah, I. in 2012, [25] , he analysis of Johnes, J., Izzeldin, M., & Pappas, V. (2014), whose goal is to compare the effectiveness of Islamic and conventional banks during the period 2004-2009. Other authors used Data Envelopment Analysis (DEA) and Meta Border Analysis (MFA) [16]. Other studies, such as that of Said, A. (2013), aimed at comparing the evolution of the efficiency of the various banks, particularly Islamic and conventional ones, which occurred during the economic slowdown from 2007 to 2009 [22].

To this end, for Toussi (2010), Islamic banks have a different understanding of financial intermediation based on a zero-rated banking intermediation model. It is therefore so-called free interest finance [27]. It also requires the backing of all transactions to a tangible asset while being based on the sharing of profits and losses. On the other hand, the precision of the specificity of the financial intermediation of Islamic banks compared to conventional banks remains an important challenge. The financial intermediation industry relies on a zero-rated banking intermediation model. It is in fact a so-called free interest finance which also requires the backing of

all transactions to a tangible asset while being based on the principle of sharing profits and losses.

Thus, we seek, through this work, to analyze the financial intermediation activity for the case of Islamic banks which obviously have distinctive characteristics compared to their conventional counterparts. This difference can be illustrated by the agency relationship model adopted by each bank. For Islamic banks, for example, it is not limited to the mere relationship between the lender and the borrower, but goes beyond this dimension to encompass the agency's dual agency relationship with the lender. On the one hand and with the applicant on the other hand. In this perspective, Islamic financial intermediation enhances the efficiency of the savings / investment process by eliminating incompatibilities between savers and investors in terms of maturity, funds and risk. This article is structured as follows: the second part is a general presentation of the Islamic banking profession as financial intermediaries. The third part specifies the distinguishing characteristics of so-called participative intermediation in an asymmetric information framework. As for the last part, we will focus on risk management and discuss the main challenges of participatory intermediation.

II. Islamic Banks: specificities and reasons for being

Admittedly, the combination of the two terms "bank" and "Islamic" may at first glance seem paradoxical. However, the notion of Islamic banking refers to a logic that fits into that of the Islamic economy in general and Islamic finance in particular. Thus, in presenting the central function of a banking system, financial intermediation is defined in the Islamic economy from a number of parameters that confer on the institutions that operate it a financial activity that is both specific and varied goals [19].

A. Presentation of Islamic banks

It is true Islamic banks present themselves as institutions whose main activity is financial intermediation in the developed sense. These operate with the aim of making profits in accordance with the principles of sharia, while recognizing the uncertain nature of the outcome of the operations financed. Although the majority of the works consider that the Islamic banks are a recent phenomenon appeared in the 70's. Historically, the role of financial intermediation in the Islamic economy is derived from the principle «*el moudharib youdharib*» which can be interpreted as such; "Whoever raises funds on the basis of profit sharing by offering them to users on the same basis". Indeed, this practice has existed in Muslim society since the early days of Islam, when most caravan goods were financed by the Mudarabah.

The existence of these banks is explained from an economic point of view, in the same way as that of the conventional banks, this financial system is based on principles inspired by the "*fiqh el mou'amalat"* which constitutes the branch of sharia which organizes the relationships between individuals. We present them below in four groups:

- **The prohibition of interest (Riba):** it is surely the main principle of this economic system. According to the Muslim religion, nobody should lend a sum of money to another for a given period, which he must then repay in full with a surplus that is called "interest" and which represents a method that generates profits without exposing himself to the risk of loss. You have to run a risk to make a profit; hence the principle of sharing profits and losses (PLS).
- **Asset-backing**: for the Islamic economy, money is a measure of value to facilitate trade, not a commodity in itself. In this perspective no eigenvalue should be attributed to money. It is a capital requiring the association with another source to generate a productive activity; hence the principle of backing up a tangible asset (asset-backing).
- **The illegality of the activity:** based on a moral dimension dictated by religion, Islamic banks cannot afford to finance illegal activities or those directly related to them, such as casinos, distilleries, alcohol, pork [3]…
- **Transparency and fairness:** transparency and fairness that must characterize financial transactions by prohibiting excessive uncertainty (gharar) whose modern meaning refers to risk or hazard. In conventional finance, the two areas deeply affected by gharar are insurance and derivatives such as futures, options and swaps.

B. The functioning of Islamic banks

The Islamic bank provides the same services as the conventional bank; it is an intermediary between capital redenters and borrowers.

1) The financial ressources of Islamic banks

In addition to capital and their own capital, which may be very high, Islamic banks find their main resources in the following operations:

- **Demand deposits**: used to finance exchange transactions and payments. Their nominal values are guaranteed by the bank. Holders of these deposits receive neither profits nor income, but they must pay fees for the administration of these accounts.
- **Savings accounts:** manage according to the principle of Wadia Deposit. The bank has the agreement of the depositors to exploit these funds against its own risks. However, the bank does not guarantee them a fixed remuneration in advance, but proportional to the investment result actually after deduction of the Zakat [7].
- **Investment Accounts**: This category of account traditionally constitutes the main resource of an Islamic bank. Indeed, in this type of account no guarantee of nominal value or rate of return is given. Depositors are treated as if they were shareholders [21]. In this case,

they are entitled to a share of the profits made or losses incurred by the bank. It is a participative investment account based on the principle of sharing profits and losses (3P).

- **The accounts of Zakat and the accounts of the social service:** where the amounts due to the obligation of Zakat are paid respectively and donations to fund social services. The bank administers the use of these funds.

Since the activity of Islamic banks is based on very different principles from two of their conventional counterparts, especially with regard to the question of the use of interest, it turns out that there are three types of relationship that undertake Islamic banks with their depositors [20]. First, we find debt relationships where the banks guarantee the entire deposit. Then, agent-principal relationships where the bank is likened to a shareholder who shares the profits and losses with his depositors. Finally, the relationship of administrative services, such is the case when the bank provides administrative services and information to its customers.

2) The use of funds by Islamic bank

The various resources collected by the Islamic bank are invested using the different types of funding recognized by the institution, of which we distinguish:

- ***Murabaha:*** Murabaha is a kind of purchase and resale agreement in which the bank buys a tangible good from a supplier at the request of its client, the resale price being based on the cost plus a profit margin [9].
- ***Ijara:*** It is a lease contract assimilated to a lease credit where a property is acquired by the bank from a supplier then the bank proceeds to lease it to the customer. For the cost of the lease plus the margin, they are spread over the entire lease period.
- ***Salam:*** It is a sales contract with deferred delivery of the goods. In this type of contract, the bank does not act as a seller on credit of the goods acquired on order, but as an acquirer, with cash payment of a commodity delivered to term.
- ***Istisnâa:*** It is a contract under which two parties, plaintiff and a manufacturer, the first undertakes to acquire from the second a particular product [9]. Payment can be made either in cash, installment or term.
- ***Financial investments:*** they are carried out on the real estate markets, the goods and services markets and the financial markets, in particular the Sukuks market either for the bank's own account or on behalf of its customers.
- ***La Moudaraba****:* It consists of the combination of a capital with an industrial contribution (work) in order to share the profits and the losses which can result from it. In this case, the customer brings his expertise and the bank provides the necessary financing for the realization of the operation. Management is the sole responsibility of Modareb (the customer who uses money in the workplace). In case of profit, the client is remunerated by his work and his expertise, while the bank is remunerated by his capital contribution. In case of loss, the client loses his job, if it is not proven that the loss is due to management negligence on his part, and the bank loses its funds. If there has been management negligence by the customer, the loss is borne by both parties.

In summary, Islamic banks offer several financing solutions that can be classified in Sharing Financing as the case of Mudaraba and Mucharaka and financing methods based on debt contracts, also known as deferred sales contracts such as the Murabaha, the bay Salam, the istisna.

III. The Financial Intermediation of Islamic Banks

Intermediation is essential in the financing of any economy since it consolidates the efficiency of the savings / investment process by eliminating incompatibilities between savers and investors in terms of maturity, funds and risk. In addition, this function allows economies of scale regarding transaction costs to be realized in the delivery of funds, and reduces the risks associated with asymmetric information. Regarding Islamic finance, the concept of intermediation is not prohibited by Sharia when it respects the Islamic precepts. Thus, we can say that there are points of convergence and divergences between Islamic banks and conventional banks in terms of financial intermediation [17].

A. Conventional financial intermediation

Exposing the peculiarities of financial intermediation among Islamic banks amounts to situating them first of all in the middle of the various financial intermediation institutions that exist in the banking landscape, namely the conventional banking system.

One of the main tasks of conventional banks is financial intermediation, which manifests itself in the collection of savings before redistributing them in the form of credits. In other words, it is the link between depositors and borrowers. However, it should be noted that, unlike Islamic banks, conventional banks have a bilateral relationship with the depositor and a bilateral relationship with the borrower, without any relationship between the depositor and the borrower [5].

From this perspective, conventional financial intermediation is based on two main characteristics: transaction costs related to information retrieval and transaction verification. In fact, for transaction costs, they are generally costs related to information asymmetry since the lender ignores the financial situation of the borrower in a direct and transparent manner. This is where the role played by banks is manifested in providing information about the borrower by assigning the conventional banks the role of information provider between the lender and the borrower which represents

a resolution to the problem of asymmetry information that the least informed party suffers [23].

The second characteristic concerns the function of transforming financial liabilities into financial assets [8]. In other words, conventional banks seek to transform deposits collected in the short or medium term into short- and medium-term loans. Thus, the main role of conventional banks can be reduced to transformation by prohibiting the use of any other activities such as commercial transactions or industrial activity with the exception of ancillary activities to cover debts [1].

B. The characteristics of Islamic financial intermediation

Before presenting the main characteristics of Islamic financial intermediation, it should be noted that the financial intermediation of either Islamic banks or their conventional counterparts overlap in terms of the principle of interposition between agents with financing capacity and agents needed for an optimal flow of funds to the problems of direct finance. Nevertheless, they differ in terms of the process adopted.

In other words, how funds are collected and channeled, and how they impact the savings-investment process [15]. For the foundations of Islamic financial intermediation, it is based on two theories: the theory of trust and the theory of the agency.

1) The Theory of the trust

The Trust arises when a person legally transfers to a third party (the trustee) a property that the latter must manage and return after an agreed time and according to certain conditions [8]. In other words, it is an operation by which one or more constituents transfer rights and security interests, or a set of property, rights and security interests, present or future, to one or more trustees , who keep them separate their own assets, act for a specific purpose for the benefit of one or more beneficiaries [4]. There is a distinction to be made between the notion of classic property and fiduciary property. Indeed, the latter is based on the appearance of a third quality namely that of the beneficiary who is none other than the person who, depending on the situation, represents the settlor, the trustee or a third party. On the other hand, in the case of classic property, we find two actors: the assignor and the assignee. In addition, the trust realizes a transfer limited in time contrary to the classic or ordinary property which remains perpetual.

2) The Theory of the agency

According to the theory of the agency, the owner holds three forms of rights: the usus which is the right to use a thing to discretion the property, the abuseus, the right to make a change or an alteration to the property and the fructus which is the usufruct of the property. In this perspective, the owner has the ability to allocate resources by keeping the fructus but delegating the usus to a manager. The owner keeps only synthetic decisions for himself. In this contractual relationship, the usus is leased to a third party with whom we contract. In this type of relationship, the corporate owner is the principal; the third party is the agent [26].

This agency relationship is illustrated in Islamic banks in two forms: the first is the private agency, according to which the bank will collect the savings of customers in the form of deposits to intervene in a project or activity determined and proposed by the bank [14]. By accepting this modality, the customer will mandate the bank to manage a project. In this case, it turns out that the role of the bank in this case should not exceed the scope of a mandate for a commission and without being obliged to assume the risks generated by this investment.

The second form is the relationship of the general agency, according to which the bank collects the client's deposits in order to invest them in a project which it sees fit in return for a commission. Depositors do not have any insurance against their deposits and they have no direct control over the investment choices made by the bank. However, depositors have the option of deciding the length of time after which they can recover their funds by bearing alone the risks engendered by the investment [14].

IV. THE DIFFERENCE BETWEEN ISLAMIC AND CONVENTIONAL FINANCIAL INTERMEDIATION

The difference between Islamic banks and conventional banks can lead to differences in financial intermediation. In fact, it does not boil down to simple loan-borrower relationships, but it develops a dual agency relationship between the bank and the depositor on the one hand and the bank and the entrepreneur on the other hand. In this spirit, we can identify some points of divergence between Islamic and conventional financial intermediation including the level of regulation of financial activities and the risks incurred by Islamic financial intermediation.

A. Level regulation of financial activity

To ensure the viability and stability of a financial system, the establishment of a regulatory body remains essential. However, the activities and risks run by the Islamic bank are quite contrary to those of the conventional system. Such a situation leaves us to ask the following question: can the regulation provided for the conventional banking system be adapted to Islamic banks?

Indeed, the various prudential measures all have the same objectives: to solidify the global financial system, in order to prevent banks from taking oversized risks. Thus, the bank is obliged to respect all these devices to be able to exercise its banking activity. At present, the acceptance of Islamic banks on the international interbank market obliges them to respect the rations established by these devices to be able to exercise their activities [6]. In addition, Islamic banks operate alongside conventional banks in many countries. Such a situation should make supervisors aware of the need to establish a regulatory framework that is both compatible with Islamic precepts and sufficiently flexible to meet internationally accepted prudential standards and control regulations [10]. A priori, compliance with these prudential rules does not prevent the Islamic bank from carrying out its activities, because it can exercise them while respecting these rules. These are not blocking points but an opening to the practice of Islamic finance activities.

On the other hand, even if these provisions do not constitute a point preventing Islamic financial activity, they can

hinder the smooth functioning of Islamic banks and make them less competitive compared to their conventional counterparts. As a result, in the long term, these can turn into troublesome factors because the accumulation of bad returns can lead the Islamic bank into bankruptcy.

B. The risks specific to Islamic intermediation

According to conventional theory, banks' risk behavior provides additional justification for financial intermediation. Risk and risk management have always conveyed the value created by banks [24]. For the Islamic banking activity, it may incur the same risks that are those of any banking activity such as credit risk, market risk, liquidity risk and operational risks which are moreover higher in conventional banks because of some of their speculative activities. Nevertheless, there are certain risks that are specific to the Islamic banking activity, so their coverage will not be the same.

For Galloux (1993), these risks, which are peculiar to the Islamic banking activity, are to the incorporation of participative financing in the portfolio of Islamic banks and which are also the riskiest for the simple reason that they are based on the confidence in the contractor. Thus, PLS financing makes the Islamic bank more vulnerable [11]. In particular, participatory financial intermediation entails the following risks that are specific to Islamic banking:

- ***The displaced commercial risk***: This is the risk that a lack of return on the assets of the Islamic bank will translate into a liquidity crisis, a consequence of the dissatisfaction of the depositors. This risk is defined by the Islamic Financial Services Board (IFSB) as the one referring to the losses that the Islamic bank absorbs to ensure that the holders of the investment accounts are remunerated at a rate of return equivalent to a rate of reference to ensure that depositors of the bank will not withdraw their funds if their income is lower than that paid by other banks.
- ***The managerial risk:*** This is the risk related to investors' doubts as to the conformity of banking behavior under the terms of the contract).
- ***The Liquidity risk:*** The liquidity risk arises mainly from the difficulty of acquiring liquidity at a reasonable cost either by borrowing or by selling the assets. The liquidity risk of these two channels is important for the Islamic bank. Indeed, since interest-bearing loans are prohibited by sharia law, on the one hand, Islamic banks will not be able to solve their liquidity needs by borrowing financial resources, and on the other hand, the Chariâa does not allow the sale of the debt only at face value. As a result, the Islamic bank will not be able to use these financing instruments to increase its financial capacity.
- ***The Risk of arbitration Sharia:*** The diversity, the difference and the standardization of the financial contracts used by the Islamic banks represent an obstacle to the correct functioning of this Islamic financial system, because each Islamic bank defines, independently of the others, its own instruments according to its own understanding of the Sharia. , its internal regulations, and its needs. Such a situation may give rise to a form of competition related to the application of religious principles. One bank can claim to be "more Islamic" than another.
- ***The legal risk:*** The legal risk comes from the lack of standardized contracts and the absence of a legal system to intervene in the case of a dispute related to Islamic contracts [12].

From this perspective, Islamic finance implies a specific risk taking that is completely different from the instruments used by conventional banks. In addition, Islamic financial intermediation is characterized by entanglement of risks given the tripartite transactions linking the three following actors: the depositor, the bank and the company. However, Islamic bank accounting does not allow easy identification and separation of risk classes [13]. It thus turns out that the efficient management of the aforementioned risks is of crucial importance for the Islamic banks as it allows them to enjoy a strategic positioning and the efficient use of their capital.

In summary, Islamic financial intermediation expresses a desire to promote social justice, equity and freedom of enterprise and an attitude of moderation not speculative while respecting the precepts of sharia to ensure their adequacy with the jurisprudential rules of Muslim ethics. Nevertheless, it appears that Shariah Compliant banking products expose Islamic banks to risks similar to their conventional counterparts such as credit risk, market risk, operational risk and liquidity risk. Islamic banking intermediation can expose banks to another category of risk called risk specific to Islamic financial intermediation namely, business risk shifted, fiduciary risk, reputational risk, risk of non-compliance with Shariah etc. As a result, the challenge facing Islamic banks is to know how to manage and control these risks in a legal and regulatory context often unsuitable for Islamic banks.

V. Conclusion

The rapid expansion of the Islamic finance industry as an alternative model of financial intermediation reflects its ability to become a true financial system. Indeed, based on a theory of financial intermediation quite different from that used by conventional banks, linked to the prohibition of the interest rate and its corollary the principle of sharing profits and losses, the Islamic financial intermediation offers distinctive features by offering a solution to ex ante and ex post information asymmetries, better risk sharing and more efficient use of capital.

In this perspective, it should be mentioned that despite the existence of a certain number of divergences which invaded the positioning of the Islamic bank on the same level as the conventional banks at the level of these three main aspects: the absence of rates of interest, lack of depositor protection, and lack of collateral on deposits, they guarantee the same functions as conventional banks. Indeed, they are payment

administrators, financial intermediaries; finance projects, and provide financial services [28].

In other words, the purpose of the intermediation of these banks can be explained, from an economic point of view, in the same way as those of their conventional counterparts, even if they have quite different characteristics. . Moreover, in addition to their economic vocation, linked to the financing of investments by mobilizing savings for viable economic sectors and helping businesses to access funds, they also hold an ethical and social vocation insofar as it proposes Sharia-compliant products, in addition to developing the spirit of partnership and sharing within society.

In this context, and in the face of its various challenges, risk management must be strengthened at the level of these institutions to further promote participatory intermediation. In addition, to being exposed to the same banking risks as conventional banks, they also face risks of a particular nature due to their particular modes of operation. Faced with this situation, Islamic banks are being asked to develop more rigorous risk identification and management systems to promote this growing industry.

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