The Legitimacy and the Success of the Islamic banks in Lebanon

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Abstract: Islamic bank has not known a significant growth in Lebanon. The assets of Islamic banks in Lebanon do not exceed 1% of the total banking assets, with only five Islamic banks in the country. Also, in Lebanon the balance sheet of Islamic banks appears 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 explain if the financial instrument adopted by Islamic banks affect the legitimacy of the Islamic banks in Lebanon and 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. This research find that the Islamic Bank cannot survive if it is not able to obtain its legitimacy and acceptability in the society that vis-à-vis its clients, especially those who invest in the bank for religious reasons.

Keywords: Islamic Banking, Profit-and-Loss Sharing, Agency Theory, Legitimacy, Ethic, Religious, Lebanon

1. INTRODUCTION

Islamic banks have their specificity in applying the rules of the Koran, the holy book of Muslims. All Islamic banks operating in different countries see clearly that their basic principle is the prohibition of interest based on the verses of the Koran, hence quoting as an example *The Sura Al-Baqarah (Cow Sura), verse 275*: *"... Those who live on usury will not rise up before Allah except like those who are driven to madness by the touch of Satan. That is because they claim: "Trading is no different than usury, but Allah has made trading lawful and usury unlawful."* In this prohibition of interest, it is also included the refusal of any purely financial speculation (Nisse-Jason, 1987). Money is considered by Islam as a mere means of exchange, without intrinsic value. If its circulation does not reflect a real economic activity, it would be immoral if it yields any premium whatsoever.

The difference between conventional and Islamic finance is characterized by Islamic principles, sometimes referred to as Islamic prohibitions. Scholars discuss Islamic principles with respect to five prohibitions. The first stipulates no charging or accepting interest and usury (Riba). This prohibition is the most controversial. The second forbids taking excessive risk (Gharar), which leads to the third restriction, which is on pure speculation or gambling. Fourth, Islamic-based transactions cannot involve trading commodities such as alcohol or being involved in activities.

Fifth and last, is the prohibition that no transaction shall be executed without the consent of both parties. Either party should not be forced against their will while conducting business (El-Gamal, 2006; Hussain et al., 2015; Obaidullah, 2005). Contemporary banking and finance practitioners designed financing products that fulfill funding needs and are compliant with Islamic principles.

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 on the basis of Profit-and-Loss sharing (PLS).

This principle lends itself to a very simple logic: the fact that nobody can reveal the future, why not agree, financier and entrepreneur, on the sharing of results. In the Islamic system, and to be fair, both parties are paid downstream. This principle of sharing the results of the company is at the root of establishing the Islamic financial system. 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. Depositors are considered as if they were shareholders of the bank and, therefore, neither are they assured of any par value guarantee, nor of any predetermined return of their deposits. If the bank makes a profit, the depositor receives an allocation under the "Mudaraba" contract; on the other hand, if the bank suffers a loss, the depositor is required to share such loss, also in accordance with the "Mudaraba" contract, and thus, he shall receive a negative return.

In terms of single deposits allocated or not for investment purposes, the bank guarantees the nominal value of the deposit, but does not pay these liabilities. Thus, they are considered equivalent to deposits on demand or at sight in a conventional banking system.

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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 only contractual agreement between the depositor and the bank is the extent to which losses and profits must be distributed. The ratio of sharing profits or losses should be discussed between the bank and depositors at the start of the operation and may be modified during the period, by mutual agreement. 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. In the “Mudaraba” contract, the bank finances only the entrepreneur who invests,in addition to bank funds, effort and knowledge in a productive activity, in exchange for sharing a percentage of the achieved profits. The losses are borne exclusively by the financier (lender); while the entrepreneur (borrower) only loses the time and effort invested in the company. This type of contract is, in fact, equally associated to human capital and financial capital. Inside the importance of PLS Contract (Mudaraba and Mucharaka) we found that the Islamic banks in Lebanon don't use much these contract.

Therefore, the question that arises is:

- Why Islamic banks in Lebanon don't use the financing through the principle of PLS?

Over the past three decades, Islamic finance has witnessed exceptional growth. According to Shoaib (2007), the field of Islamic finance is developing and rapidly expanding, with banking assets growing at 15 to 20 percent annually to reach about $750 bn (Shoaib, 2007). In Malaysia, Islamic banking assets have grown at an average annual rate of 18 percent since 2000 (Aziz, 2006). Even in non-Moslem countries, the growth of Islamic finance is on the rise, since Islamic banking is emerging as a rapidly growing industry, receiving wide recognition by both Muslims and non-Muslims alike (Iqbal and Molyneux, 2005). In June 2018, the Islamic finance industry recorded an 8.3% growth rate with total assets over USD 2 trillion. The banking sector is still dominating the industry with a 76% share. In spite of all signs of growth and development correlated to Islamic banking and finance about the world, the sector of Islamic bank has not known a significant growth in Lebanon. Lebanon has, so far, adopted the dual banking system with conventional and Islamic banks. The assets of Islamic banks in Lebanon, which do not exceed 1% of the total banking assets, with only five Islamic banks in the country, show twice the share of these banks in the local market.

Therefore, the question that arises is:

- What's the reason for the weakness of Islamic finance in Lebanon, unlike other countries?

The Islamic Bank cannot survive if it is not able to obtain its legitimacy and acceptability in the society that vis-à-vis its clients, especially those who invest in the bank for religious reasons. The Shari'ah legitimacy broadly means conformity to the Islamic Law. The legitimacy of Islamic banking refers to the compliance of operations and activities with the precepts of Shari'ah.

In this case, it will be important to answer these following questions:

- Do the financial instrument adopted by Islamic banks affect the legitimacy of the Islamic banks in Lebanon?

- Why Islamic banks in Lebanon don't use the financing through the principle of PLS?

2. LITERATURE REVIEW

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. Founding Principles of the Creation of Islamic Banks

We will deal with the founding principles that guide the establishment of the Islamic banking system as well as the factors underlying the establishment of Islamic banks and their operation. Thus, we will make a brief introduction on the characteristics of Islamic financial institutions.

The interest of this research lies in introducing the Islamic banking industry, whichis an emerging and still little known sector. The purpose of this section is to provide the basic elements of the Islamic banking system.

"No profits, no sacrifice," "Money cannot create money on its own without the action of physical capital and labor...etc.”. This is how some main players of Islamic finance summarize it - the philosophy of Islamic banking (Hawari, 1990).

A definition of key concepts addressed by Islamic financial institutions is newcessary, as well as traditionally used contracts. We also shall consider the implementation of these principles by Islamic banks. The major advantage of Islamic finance is the equal placement of human capital and financial capital. Thus, the banks themselves, whose role is limited to an outlet for savings and to develop investments, systematically associate with their clients in two forms: "Mudaraba" and "Musharaka".

The conventional banking model is based on the principle of interest rates upon which it borrows at a certain interest rate from individuals who make their deposits at the bank, and it lends money and capital at a more significant rate of interest to individuals as well as to production and trading corporations. This model is inconsistent with the fundamental principles of Islamic banks for two reasons: the first concerns the practice of interest and the second is related to the mode of distribution of profits within conventional banking which favors capital providers rather than workers.

In the case of Islamic banks, we observe two characterizing principles:

The first is respect for the prohibition of interest in all banking operations, which is the main constraint faced by Islamic banks. Operations must not include under any circumstances, directly or indirectly, a fixed or prior remuneration comparable to interest or "Riba" because Islam prohibits “Riba”, an Arabic word meaning both usury and interest. The prohibition of “Riba” figures in Islamic law. It is the foundation of Islamic finance. Certainly, the prohibition of interest in the context of the contemporary world reduces significantly the margin of maneuver of the Islamic bank and will affect the nature of its financial products and structures necessary for the launching of its products (Martens, 2001).

The second principle is the application of stake or risk-taking, i.e. the sharing of profits and losses between lender and contractor. That principle will involve the bank in non-banking activities (industrial, tourism, real estate, etc.). It is supposed to provide the bank a substitute for interest rates. According to the Islamic approach, the party that lends money for commercial and industrial purposes shall claim a share of the profit, because it becomes joint owner of the share capital and business risk. He is a partner in the company and not a creditor. The remuneration of the lender should be proportional to the share of wealth created by his money.

The respect of prohibitions of “Riba” in banking operations, according to Islamic principles, banking operations should not involve in any way, directly or indirectly, a previously determined remuneration comparable to the interest or "rias". The bank does not invest in activities that are considered immoral, such as commercial banks, insurance companies, distilleries, delicatessen traders, financial instruments such as "derivatives" and especially options, “futures” and other forward contracts because of their speculative nature. At the structural level, it will result in the creation of an entity whose mission is to ensure the compliance and integrity of banking transactions in terms of their Islamic character.

The Mission of the Islamic bank is considered in the context of an real service actually rendered to depositors - investors and developers, and remunerated in its fair value. The objective mission of the bank, besides the goal of building the economy through the operations of participation and partnership, aims to facilitate the fulfillment of every Muslim's duty to participate, as required by Islamic law.

Indeed, the bank under state supervision commits the funds deposited in its accounts in sectors of the public authority. The process of capital accumulation is characterized as such by a social aspect, since it now benefits all the dynamic forces of society.

Furthermore, the Islamic bank should be limited to its essential role of outlet for savings and investment designer. The Islamic bank will not lend its funds to its clients, but it systematically associates with them to undertake and carry out satisfactory economic projects. (Nienhaus, 1982).

The Islamic Bank: a Partner Bank

The principle of sharing profits and losses determines the behavior of the bank towards debtors. More than just a provider of capital, the bank becomes an active partner having the right of scrutiny in the management of the financed company, because its fate is directly linked to the performance of the latter. Thus, the bank does not transfer to the company only money but also expertise and advice. In other words, it provides funding and services: management consulting, information, new products, etc.. It is clear that this kind of service is currently offered by traditional banks, but it is motivated by competition for reasons of profitability *of the borrower*. In the Islamic system, the bank offers its services for a better performance of the partner company.

As such, the bank-corporate relationship is much more consolidated. The bank is no longer a passive funder interested only in the reimbursement of its loan, but a partner entitled to profits and eventually sharing losses. This scrutiny on behalf of the banks may be interpreted as a disadvantage for entrepreneurs who may see a dwindling in their chances to dispose freely of borrowed funds. This is not always true since the intervention of the bank does not aim to replace the company's management but to consolidate it. In many cases, young entrepreneurs need advice and technical assistance from the bank. The intervention of the bank positively affects the decision-making process at the corporate level, as long as the bank's objectives converge perfectly with those of the company (Karsten, 1982).

It is also worth mentioning that the Islamic modes of financing require a rigor of vital importance in keeping the accounting of operations carried out by corporations so as to minimize the risk of fraud. But in the long term, a corporationthat continues to produce bad results "artificially" will be denied new financing. The long experience of the capitalist banking system reveals that in no case whatsoever is the importance of moral factors relegated to second place. Instead, experienced funders frequently stress the moral factor as the most important criterion in evaluating credits.

2.2. Why Islamic banks in Lebanon don't Use PLS Contract ?

ORHAN Z.H. (2017) treats the problem of PLS in Islamic banks in Turkey" and he founds 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 reareach 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 behaviour of the agency. However, the realisation 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 maximise the principal's utility.

2.3. 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 signalled 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 realised 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).

2.3. Legitimacy and Continuity of Islamic Banks

Legitimacy represents a strategic resource for the leader (Pfeffer, 1981) as well as a social constraint that norm his decisions (DiMaggio and Powell, 1983). In any case, it imposes itself on the manager as a challenge for the sustainability and credibility of the company. The issues of legitimacy, the Islamic bank encounters them in relation to customers, depositors and competition. The multiple parties working with the Islamic bank may question the Islamic bank’s respect for the provisions of Islamic law, which is fundamental to the existence of the bank and affects its continuity.

Legitimacy is gaining attention in management sciences from the moment the company is no longer separate from its environment and has to demonstrate that it takes into account societal expectations. The issue of legitimacy is of utmost importance, especially in institutions and banks that declare that they apply certain ethical principles, as is the case in Islamic banks. This concern resurfaced strongly in recent years in the work of management sciences. For most authors, the company seeks to demonstrate its conformity to the environment. Thus the organization is part of the pursuit of legitimacy, which often includes symbols and speeches.

The interest in the question of legitimacy on the part of the management sciences testifies to a change in the perception of the relationship between the company and society, in a period when the company is "in society" (Martinet and Reynaud, 2001).

This research is based on the importance of legitimacy in the continuity of Islamic banks, because Islamic banking is of a religious nature, based on the values and principles of Islamic law. Islamic principles are not an option for Islamic banks, because they are linked to the nature of these banks themselves, and the principles of Islamic law represent at that time for Islamic banking the reason for its existence and its weapon in the face of competition.

The concept of legitimacy is essential for the continuity of Islamic banking. This key concept is indeed a resource to ensure the cohesion of the stakeholders around the Islamic banking project. Suchman's work is particularly enlightening in this respect for defining the concept of legitimacy. Legitimization then becomes a strategic objective.

The concept of legitimacy, stemming from political science, has nevertheless irrigated management science, particularly since the years 1990-2000 with the work of Suchman (1995) and Phillips et al., (2004) who recognize legitimacy as a central place in business strategy.

Legitimacy as a resource is an idea that had been put forward by authors like Pfeffer & Salancik; Fombrun & Astley; Ashford & Gibbs. According to them, legitimacy is a vital resource that allows the organization to achieve its objectives. This resource determines the survival of the organization. Legitimacy is what allows an organization to justify its existence and to maintain viable economic relations with its environment. legitimacy is therefore necessary to that the organization can continue to survive

Legitimacy and acceptability are two sides of the same coin. The acceptability of a organization depends on its legitimacy. Indeed an organization cannot survive after its creation only if its objectives and operations are perceived as acceptable by society.

There are many definitions of legitimacy in the social sciences. For Rawls (1971), the institution derives its legitimacy from the authority and validity of a public system of rules; these rules define the structures and positions, rights and duties, powers and immunities. Observance of legality and procedure would not be enough to define legitimacy. For Habermas (1978), it is also necessary to take into account the conscience and the values, the legitimacy can be located beyond the law, possibly in the contestation of authority.

Two complementary theoretical approaches explain the concept of organizational legitimacy in management science.

The sociological neo-institutional current insists on the institutional pressures to which the organization is subjected (Di Maggio and Powell, 1983). The company complies with the standards, rules and values of its environment. This pressure has the effect of homogenization, isomorphism, defined as "a constraining process that forces a unit in a population to resemble other units that face the same environmental conditions" (p. 149). Consequently, social legitimacy "must be considered as an 'input' in its own right in the process of organizational transformation (Hatch8, 2000); and the quest for legitimacy partly guides the evolution of companies" (Buisson, 2005: 152). Social pressures tend to generate ambivalent responses from companies, tempted to distinguish between their formal structures and their daily activities (Weick, 1976). While the former show signs of compliance with the environment, the latter are changing little.

With an openly instrumental aim, the resource-based approach presents legitimacy as a resource in its own right.

According to Pfeffer and Salancik **(**1978), the organization is necessarily in interaction with its social environment in order to acquire the resources it needs. It is therefore dependent on the environment for its resources. Therefore, the sustainability of the organization depends on its ability to manage the demands of its environment, in particular those formulated by the groups that hold the resources essential to its survival. Legitimacy will therefore guarantee the organization the approval of society and give it the possibility of obtaining the resources it needs to survive (Zimmerman and Zeitz, 2002), such as capital, technology, managers, skills, customers, networks. The same authors observe that in finance, legitimacy can represent a signal aimed at investors.

Legitimacy therefore becomes a strategic concept in management, on the same level or even more important than others: “the social acceptability that results from legitimacy can be more important than economic performance” (Pfeffer and Salancik, 1978: 194).

For the company as a socially integrated organization, legitimacy is therefore a way of social acceptance in general and of stakeholders in particular. M.C. Suchman's definition, accepted in management sciences, offers a synthesis between strategic and institutional approaches (Suchman, 1995: 577): « Consequently, in this article I take a middle course between the strategic and the institutional orientations. On the one hand, like the strategic literature, I address the dilemmas that focal organizations may face in managing their symbolic relationships with demanding constituents. In particular. Part III explicitly assumes that organizations can and do formulate strategies for fostering legitimating perceptions of desirability, propriety, and appropriateness. On the other hand, like the institutional literature, I consider cultural environments to be fundamentally constitutive of organizational life, and I adopt a somewhat skeptical attitude toward the autonomy, objectivity, and potency of managers. Managers do enunciate supportive myths and prescribe culturally congruent rituals; however, managers rarely convince others to believe much that the managers do not believe themselves. » (p.577). Thus Suchman presents legitimacy as a generalized perception that an entity's actions are desirable, appropriate to certain systems of constructed social norms, values, beliefs, and definitions (p. 574).

Three Dimensions are Identified**:**

Pragmatic legitimacy corresponds to the useful, the interest. It can be based on different sources: exchange, influence (e.g. integration of stakeholders in political decision-making places or their performance indicators) or finally the willingness to grant legitimacy to an organization that takes into account our interests.

Moral legitimacy corresponds to shared standards, to the values embodied by the company. It is based on an assessment of his good or better character socially.

We place our analysis in a so-called pragmatic or result-based approach. Two theoretical perspectives make it possible to understand the concept of legitimacy. An approach, called classic or formal, inspired by Weber, assesses the legitimacy of the organization by reference to a higher cause, to principles postulated a priori (Laufer, 2000), to an intention in a Kantian line (Husted and Allen, 2000). A second approach is considered pragmatic insofar as legitimacy is judged in relation to the consequences of the action, via an a posteriori evaluation based on common interests (Suchman, 1995). We can deplore an aspect that is too instrumental because legitimacy is defined as a judgment on the actions of the company; it is the purposes that are evaluated and not the causes, the origin of the existence of the organization. In an attempt at a synthesis, we can thus consider three forms of legitimacies (Gabriel and Cadiou, 2005): by the finality (pragmatic form), by the cause of the action (rational-legal form) and by the methods of power (procedural form).

Furthermore, the criticism addressed to Suchman also concerns the the very principle of a moral dimension: morality being reduced to a dimension of legitimacy, can we still speak of morality? The question is posed in the title of an article by B. Husted and D. Allen (2000): "Is it ethical to use ethics as strategy? ". Rousseau and Regnard respond to this from the economy of magnitudes (Boltanski and Thévenot, 1991) according to which the actors refer to conventions of justification: “the “legitimacy Morality “is not only a dimension of legitimacy, but legitimacy itself” (2007: 584).

Sharīʻah legitimacy refers to compliance of activities to the principles of Sharīʻah in letter and spirit. This compliance is pertinent to all areas, including the financial/business transactions (muʻāmalāt).

2.4. Legitimacy and Image

When the activity, role and goods and services of an organization are accepted and considered legitimate, it generates a certain reputation for the organization.

A favorable and lasting reputation generates a competitive advantage for the organization. Establish a lasting reputation requires the organization to develop strong relationships with all stakeholders.

Such relationships with stakeholders are only conceivable if the organization does not limit itself not to play a simple economic role but behaves as a social institution This is all the more true that attitudes towards the role of organizations in society have changed sensitive way, making reputation for social responsibility one more aspect more important.

According to Gray, a strong positive image allows a company to survive a great crisis. This is the case of Johnson & Johnson regarding Tylenol, or the serious financial crisis experienced by the Dubai Islamic Bank.

1.2. Objectives

This paper studies the effect of legitimacy and the lack of PLS on the progress of Islamic banks in Lebanon.

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. This paper explain also how the agency problem influence the PLS contract in Islamic banks and 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 main question of the research is : What are the effect of the absence of PLS contracts on the weakness of Islamic banks in Lebanon?

3. METHODOLOGY

The field of analysis in this research is related to Islamic commercial banks in Lebanon. Thus, the total population involved in this work is five banks. In the current research, the case of all Islamic commercial banks in Lebanon was studied. 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 study and analyze all Islamic banks located in Lebanon.

3. EMPIRICAL STUDY: ISLAMIC BANKS IN LEBANON

The empirical study was based on all Islamic Banks in Lebanon. 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. Based on to the interviews, 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 Mousharaka financing and Moudaraba 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 **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/D1: "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: **T**he 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.

II. Legitimacy and Success of Islamic Banks

The observation and analysis of the interviews carried out allows us to mention that the Islamic Banks of Lebanon cannot ensure its survival if it is not able to obtain its legitimacy and its acceptability within the society that it lives. vis-à-vis its clients, especially those who invest with the bank for religious reasons. The leaders of these banks have explained to us that they are aware of the obligation to take decisions that respect Sharia or, in other words, have an Islamic ethical character.

As the following box shows, compliance with "Sharia" (ethics) is essential for the success of Islamic banking. It is the external legitimacy of the bank that allows it to ensure its continuity and then good performance.

B/BIB/ADG/D12

« Ethic is a very important ingredient for the success of Islamic banking. Ethic is a Muslim cultural trait which relates to behaviour. All these cultural factors are very important for the success of Islamic banking vis à vis the bank's clients. That's why Bahrain Islamic Bank has set up a training school to instil these souloukiat to its employees. When we recrute people, at Bahrain Islamic bank, we worry very much about souloukiat, the prospective employee should have a good behaviour. In our school we teach them souloukiat as well as sharia principles and the technical side of banking. With souloukiat the bank achieves double results. Internally we achieve synergy, cooperation, efficiency and most of all internal legitimacy. Externally we strengthen the bank's image and hence its external legitimacy vis a vis the stakeholders, within the community and society at large. All this leads ultimately to organisational performance.

B/FH/DG/D1

"There are customers who work with the bank for religious reasons. These customers preferred the Islamic bank because it offers Islamic products regardless of the financial results achieved. Their religious conviction pushes them to work with the Islamic bank even if the risk borne is high".

External legitimacy + internal synergy = success of the Islamic bank.

PLS and Legitimacy of the Islamic banks.

It is found that the Musharakah and Mudaraba contract do not constitute a significant percentage in the asset structure of the bank. Islamic banks in Lebanon have not yet succeeded in adopting modes of financing based on the principle of P.P. P (Moudaraba and Moucharaka), the investments of the bank (2002) made according to this principle constitute less than 10% of its investments totals. Several explanations are able to shed light on the reasons why the bank does not use this principle much in its operations.

According to the interviewees, we can say that the low rate of Musharakah operations compared to the total operations of the bank poses a problem with regard to the legitimacy of these Islamic banks. The majority of customers are not convinced by Murabaha's compatibility with Sharia. The use of Murabaha by Islamic banks negatively affects their image and growth.

As we mentionned earlier, the principle of profit and loss sharing (PPP) dominates the theory of Islamic finance. This principle is a contractual transaction between two (or more) parties investing together in a project while sharing profits and losses. Most Muslim economists claim that the principle of PPP, based mainly on two types of contracts, namely Mudaraba and Musharakah, is desirable in an Islamic context where the sharing of reward is linked to the sharing of risk between the different parties. All theoretical models of Islamic banking are based on Mudaraba or Musharakah or both at the same time. For this, the legitimacy and the image of these banks depend on the use of these two contracts. But, the practice of Islamic banking in Lebanon is also far from these two models. Islamic banks finance commercial operations and projects according to the Murabaha contract. Indeed, the application of the principle of P.P. P is marginal in the practice of its banking operations

For the sake of compliance with Sharia and Islamic law, "the percentage of long-term investment" is the indicator for measuring the legitimacy and acceptability of Islamic banking.

4. CONCLUSIONS AND RECOMMENDATIONS

In all Islamic banks in Lebanon, religious legitimacy remains a determining variable for the success of the bank, it is also important in the choice of clients working with the Islamic banking sector. Without this determining factor, customers would have chosen to work with conventional banks offering a fairly diversified range of products. Indeed, religious legitimacy or in other words the context of a society compatible with Islamic principles is an essential element of the success of an Islamic bank.

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 organisation. The value creation by a “VC” will be more important than other organisations**.** 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 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-Finaly, 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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