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The role of financing withMusharaka in the growth of investment: An applied study on the Bank of the Al-Jumhouriain Libya

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Abstract: **Purpose** – This study aims to provide an interest-free valuation methodology for Musharakah contracts. Indeed, In Islamic finance, Murabaha contracts are widely negotiated. Their yield depends mainly on the contracted profit margin. In the current practices, this latter is based on a reference interest rate, which is highly criticized in Islamic literature, just likeMusharaka is a truly profit and loss sharing Islamic finance technique is fully in accordance with the principles and guidelines of Shari'ah. Being an equity-based and participatory mode of Islamic finance, Musharaka mechanism conforms to Shari'ah in letter and spirit. In this perspective, authors suggest a new valuation methodology with parameters related to the real economy.

Design/methodology/approach – The distributed questionnaires include (295) from Al-Jumhouria Bank customers in Tripoli. The data collected was analyzed using PLS SEM.

Findings – The results show that the pricing of Musharakah contracts could be based on several parameters linked to the real economy. Consequently, an implied value of the profit margin could be computed. Also, the interest rate is no longer implicated in the pricing of neither Musharaka contracts.

Research limitations/implications –In practical terms, the study involves many political effects on Libyan banks in terms of developing strategies, financing and marketing Islamic banking products, and it can help Libyan banks to integrate investment issues into strategic planning.

Practical implications – This work will restore the link between Islamic contracts and the real economy. For Islamic banks in particular, the suggested model would be equally useful in countries with a similar banking culture such as Libya. Socially speaking, the result will be beneficial for Libyan investors by helping them explore the advantage of investing in Islamic Musharaka tools as one of the Islamic financial products that are less risky and very profitable.

Originality/value – Several studies have analyzed the dependence between Islamic contracts and interest rates. In general, these studies confirm this dependence and few of them have suggested alternatives. Thus, the authors contribute to the literature by providing a practical and applicable model to detach the valuation of Musharakah from the interest rate.

Keywords: Musharaka; Islamic banking, Islamic finance, Libya.

INTRODUCTION

The global Islamic finance industry is estimated at $ 1.4 trillion, and has grown at a much faster rate than conventional financing over the past four decades. Although 80% of this industry is concentrated in the Middle East, North Africa, East Asia and the Pacific, it is active in 59 countries on all continents. Officially launched in the 1970s, this industry has deep roots in Islamic law and offers many implications for modern Islamic finance. In this survey, we explore the main aspects of Islamic finance with Musharaka through banks, capital markets and private contracting. Our goal is to attract the attention of academic researchers, regulatory bodies, standards-setting bodies, and Islamic finance providers / users to critical issues related to investment efficiency with Islamic Musharaka,Alzahrani, M., & Megginson, W. L. (2017).

Islamic financing instruments can be classified into two major categories: co-ownership-based and trade-based financial instruments. The co-ownership financing instrument calls for an equity stake in the financed asset/investment and earns a return based on risk sharing. As with any equity financing, the future outcomes of investments are uncertain and so are the future dollar returns from such investments. The co-ownership financing instruments are partnership (Musharaka) and trust partnership (Mudaraba). The partners in Musharaka contribute capital to the business and share the profit according to an agreed ratio, which may differ from the proportion of their initial contribution; however, any loss must be shared according to their initial contribution. Although the sharing ratio of profit should be specified in the partnership agreement, fixing a profit amount is not allowed as it then ceases to be equity financing. This implies that the conventional preferred equity investments are not allowed in Islamic finance because of the fixed-return feature,Ahern, K. R, & Cesare.F, (2015).

According to Ndungu (2010) Islamic Finance is so far the fastest growing segment in the global financial industry. Typically, one of the Musharaka partners can be hired as a manager of the co-owned business and may receive a specific fee for her service. Although debated among Islamic law schools, passive partners generally cannot share profit in a ratio higher than the proportion of their initial contribution. Moreover, subject to debate, a Musharaka agreement may have a specific expiration date. This particular feature can impact the type of investments financed by this agreement. Terminating a Musharaka at any time is an option available to all the partners.

However, Shari'ah conformity is not the only benefit of Musharaka, but it is the versatility and diverse nature of the concept that makes Musharaka, suitable for any kind of banking and finance transactions, from long-term financing to short-term funding, from project finance to working-capital finance, from corporate to consumer finance transactions, Ali, M. A. (2018, July). Musharaka offers solutions for almost all the contemporary finance dealings.Islamic system of finance emphasizes risk sharing by offering Islamic financial tools like Musharakah, Murabaha, Mudaraba, Ijarah, Salam, and Istisna—based on the Islamic guidelines derived from Holy Quran and the Sunnah (sayings and acts) of the Holy Prophet (SAW) to eventually facilitate trade and business in the society and to consequently bring economic well-being and prosperity (Aqib Ali, 2014).

RATIONALE OF THE STUDY

Islamic banking is an important financial service in Libya. This can be attributed to the increase and growth of investment in the country and the need to adhere to interest-free banking services as stipulated in Islam (Al-Garhi, 2007; Dosuke, 2008; Allam &Razfi, 2017; Rashid et al, 2018). To our knowledge, no study has been published using a theoretical model regarding the role of financing with Musharaka in the growth of investment, whether in Libya or any part of the world. Consequently, this study addresses this knowledge gap by the existence of Musharakah financing products in Islamic banking, the objective of maqasid shari'ah can be met, especially in terms of asset acquisition, which fulfils the shari'ah requirements. Moreover, risk-sharing will lessen the burden between parties and prevent potential abuse of the weaker party by the stronger one (Abdul-Rahman et al., 2014).Musharakah financing will also prevent businessmen or entrepreneurs from engaging in Riba', or usury, which is strictly prohibited by Islam. This mode of financing realizes the aspiration of Islamic economy that upholds socioeconomic development.

LITERATURE REVIEW

Islamic finance is money as an instrument of exchange, not a direct source of income. Therefore, any investment or project financing must be linked to the real economy through tangible assets. Interest ban supports this position(Ahroum, R., Touri, O., & Achchab, B, 2020).However, because Islamic finance has not yet developed in size, compared to conventional financing, it often faces the presence of an interest rate, especially in a mixed economy system. In this context, Islamic contracts are affected by the presence of interest in the economy system (Ghouri, 2015).The structure of the literature review is based on previous studies on participation and investment financing. Current studies have shown that participation financing can be potential and put in place because of many advantages, but implementation of participation financing, including investment risks, moral risks and asymmetric information(Abdul Rahman, S., & Salmat. 2020).

Participation in the banking industry (Aysan et al., 2013); the International Development Plan and an issue that needs excessive awareness (Aria and Seth, 2014); unvaccinated service (Coco, 2015); according to (WorldBank, 2016), companies and individuals who are They have access to appropriate financial products and services that meet the need for their payments, savings, transactions, credit and insurance distributed in an accountable course. Thus, investment becomes an urgent necessity for regulators, policymakers and development agencies around the world (WorldBank, 2016); and a public interest that promotes public policy (Bolino and Poti, 2016). Investment has become a competitive vehicle for the financial development of many developed and developing countries around the world. Investing in Islamic products such as sMusharakah aims to achieve some luxury and life goals (Shinkafi, A,& Sani, T. A. 2019).

The growth of investment

Any investment will only become a good investment if it achieves, or exceeds, the expectedreturns that were factored into the pricing of the investment at the time of purchase. If thecash flow turns out to be exactly as predicted, then assuming the asset was rationallypriced, the investor will have achieved exactly the target rate of return (required rate ofreturn) they had hoped. If the cash flow is higher than expected, the actual return will havebeen greater than the target rate; if the cash flows are less than expected, the actual returnwill be less than the target return French, N. (2019).The set of investment opportunities is “Potential investment opportunities and associated dividend yields” (Smith & Watts, 1992, p. 264). It can be determined according to the level of investments in Musharaka or through the rate of growth in growth options compared to the existing assets (Myers 1977). Assets in their place represent real (or physical) investments, while growth options represent the true value of the opportunity for future investments in assets (Orr, D., Emanuel, et al.& Wong, N. (2005).Given that previous studies have found the bank’s departments confident to be among the most conservative institutional investors, we expect prudence to play a more important role in the banking sector than other determinants of investment growth Lu, W., & Chiou, W. J. P. (2019).

Development of banking services

The development of technology in the financial sector led to the formation of a new financial and technological environmental system in the field of financial and banking services and to the interaction of each of the institutions among themselves and organizations with clients and investors. In the interaction between institutions, new companies appear to develop and offer technologies in the field of payment services at a lower price and more favorable terms, unlike traditional financial institutions (Karachun, I, & Marushka, D. 2019).However, the development of project financing may allow banks to expand the practice of financial investment and innovation projects, to attract new clients and expand the customer base, increase sales of products and banking services related to the project (Tinnilä, M. 2013).Evidence indicates that high quality works to improve and develop services by helping to create a competitive advantage, and thus increasing its market share, which in turn leads to increased profitability and investment growth. Therefore, the quality and differentiation of the bank provides opportunities to provide the customer with something, which is something special and necessary in Create a unique center for the bank in the minds of the target customers (Brige, A.2006).Although Islamic finance is currently observing rapid growth and development with an estimated 15-20 per cent annual increase globally. This means that Islamic finance is currently appropriate and widespread not only in Muslim countries but also in the west(Lone and Bhat, 2019).

Investment in Musharaka

Musharakah contract is a form of participatory financing. The primary partnership of the Musharakah contract is an innovation in the Islamic financial industry and a style that was not found in classical literature on literature (Hanif et al. 2011; Razak et al., 2015).The concept of Musharakah mode of financing, where Islamic bank and their customer jointly owned a property or a project with a subsequent transfer of ownership to the customer was first deliberated at the First International Conference on Islamic Banking held in Dubai in 1979 (Bendjalali & Khan, 1995). The formal acceptance of the concept was only announced by OIC's International Fiqh Academy at its 15th Session held in Muscat, Oman in 2004 (Resolution No. 136).Any loss in value of the asset underlying the contract will be shared in proportion to the partner's share in the asset, which is consistent with principles of Musharakah. Besides sharing profit or loss from (or renting) the asset, the customer gradually acquires partner's share in the asset by making additional payment over the bank's profit share (the rental payment) in every period (e.g. every month). At every subsequent payment, the profit (rental) part of the instalment decreases as the bank's share of ownership decreases in the shared asset. The partnership ends when the customer makes the last payment to the bank that covers both its profit (profit portion of the rental) and amount equal to remaining share of the bank in the asset.Though the concept is simple, there are many nuanced Shari'ah principles and country specific requirements of this agreement that makes it difficult to operate in full compliance in practice, Asadov, A., et al. (2018).

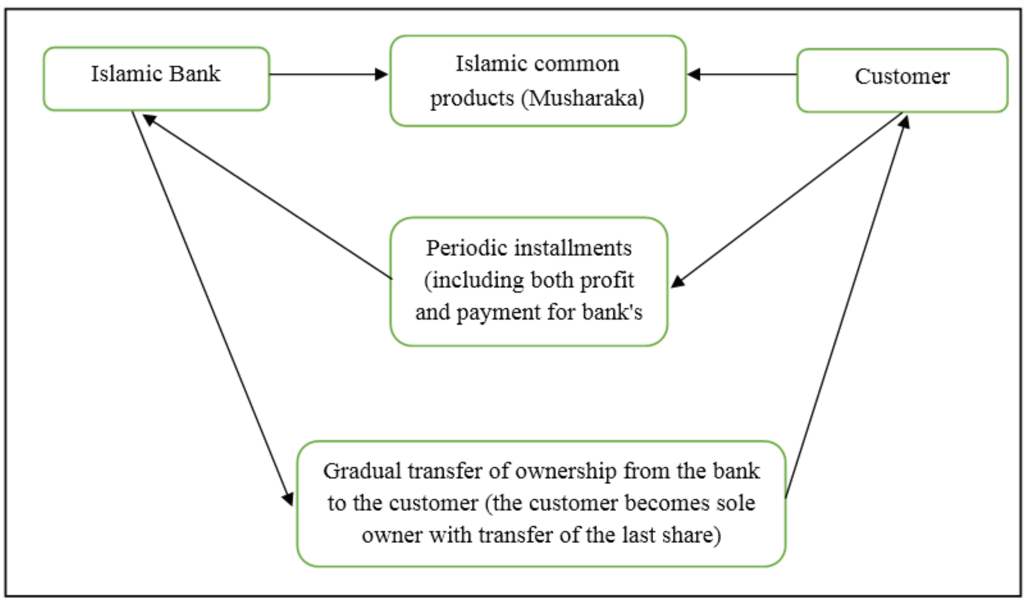

Figure 1: ***Working of Musharakah principle***

Currently, the value of the shares redeemed by the customer is determined in advance in the contract (Abdul Razzaq et al., 2011). Indeed, no revaluation of the underlying value has been made to reflect market fluctuations; this differs from the concept of participation, which provides for valuation of shares at market price in total or partial transfer (Bengali and Khan, 1995; Smallu and Kabir Hasan, 2011). In an Musharakah contract, lease is the fee for financial institutions. In practice, rent is based on the benchmark interest rate, regardless of the true properties behind it, which are criticized in the literature (Ghouri, 2015; Mira and Abdel-Razzaq, 2009).

A gap was observed between the theory and practice of Islamic finance, as the systems used in Islamic banks do not function optimally. Islamic banks prefer to invest in less risky short-term assets, such as debt-based financing (Dar and Presley, 2000; Askaria and Rakhima, 2008); thus, Musharaka is not the best way to finance Islamic banks at the present time. This is due to the lack of liquidity with banks when they are provided in the medium to long termInvestments. Consequently, Islamic banks cannot offer attractive investment opportunities to parties interested in medium or long-term investments. Musharaka is subject to operational risksGiven the risky nature of the partnership, the need for additional monitoring costs, the lack of transparency in the markets and the reluctance of depositors to take risks. Moreover, the funder may lack the appropriate technical expertise to monitor the project (Iqbal and Mulino, 2005; Mirakhor and Zaidi, 2007; Fabianto, 2012; Kayed, 2012). Additionally, the risks will be shared accordingly because the profit-sharing ratio is agreed by both parties (Mehri et al., 2017).

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

The theoretical framework in social and behavioral studies refers to a reasonable set of concepts and contexts; models, values, beliefs, assumptions, principles, assumptions, proposals, or a picture of a particular social and behavioral action. However, in the context of this study, our focus is mainly on theoretical concepts. Thus, the following picture deals with Islamic and banking financing in the field of investment. The theoretical framework presents some challenges, benefits and motives for achieving investment in Islamic finance. It is believed that this has an impact on Islamic countries in facing challenges and gaining the benefits of Islamic investment through Musharaka contracts and thus promoting financial and economic development and works as a key through which Islamic banks can realize the issue of economic development. Thus in this study, a theoretical framework on the role of finance was developed with participation in investment growth, as shown in Figure 2.

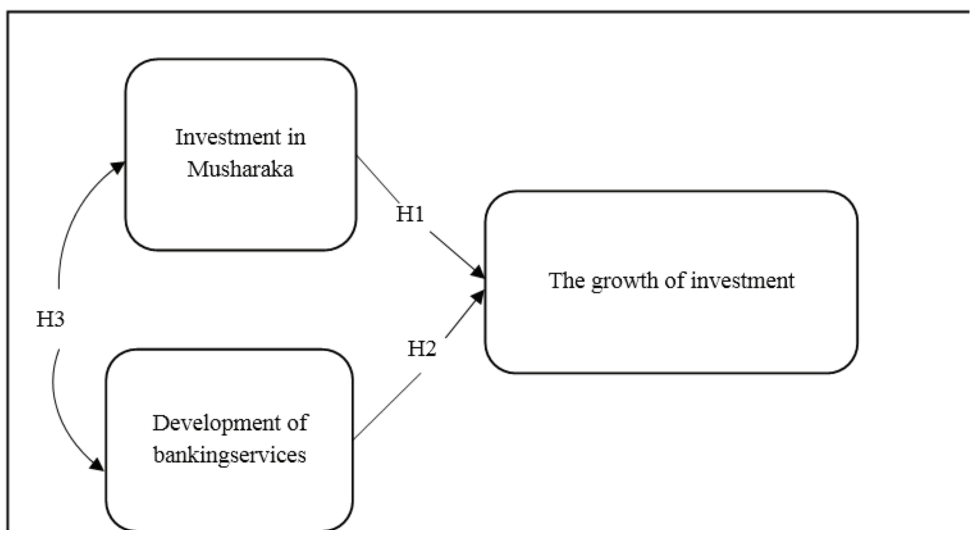

Figure 2:*Theoretical framework*

Investment in Musharaka and the growth of investment

Islamic finance has grown by leaps and bounds in the past decades around the world. This phenomenon has led to an increase and growth of investments that comply with Islamic LawThe growth of the real estate sector that is compatible with Islamic law depends on the extent of its Islamism. Banks can create products required by investment companies, especiallypartnership financing such as Musharaka and Mudaraba (Ibrahim, M. F, & Akinsomi, K. 2012).Musharaka is a truly profit and loss sharing Islamic finance technique and is fully in accordance with the principles and guidelines of Shari'ah(Ali, M. A., & Hussain, T. 2017). The Musharaka is one of the strongest products in Islamic finance because it represents a form of investment par excellence, to serve the individual but also society (Abdenbi, E., & Widiane, K. 2016). There is a need for Shari'ah compliant Musharaka banks which in addition to providing services for beneficiaries, would also effectively manage investment that contribute to overall national development and economic growth. This investment would be of high relevance to experts, financial managers, regulators and policy makers in the fields of investments, banking and finance(Tayachi, T, & Jamaldeen, F. (2020).Thus we hypothesize that**:**

H1: Aninvestment in Musharaka is positively related with growth of investment.

Development of banking services and the growth of investment

Access to financial services, primarily to credit, can enable agents to make longer-term consumption and investment plans, participate in productive economic activities and cope with adverse shocks(Corrado, G., & Corrado, L. (2017). Financial intermediaries and markets can mitigate market frictions by producing and developing information and exchanging risks in various ways. In practice, the structure of financial systems can be bank-based or market-based, and varies by country. The impact of the financial structure depends on investment economic growth and on the overall development of the real economy and institutions(Webb, I., & Martin, G. 2017). The results indicate that economic development and investment will initiate economic growth in all goods and services for the benefit of all people for inclusive growth. This discussion justifies the concept through logical reasons that technology works as a catalyst and positive factor in accelerating economic development and public investmentGhosh, N. (2020).

Thus we hypothesize that**:**

H2: Development of banking services is positively related with the growth of investment.

Development of banking services and Investment in Musharakah

The development of Islamic banking in Malaysia can be foreseen through several reasons. First its establishment has been successfully developed by the encouraging environment and support by the concern monetary policy maker (Billah, M. M. S. 2019). Moreover, Islamic banking provides a competitive alternative financing to conventional products. Muslims have realised that Islamic banking offers another form of financing with a viable investment method that is particularly inclined toward equity-basedfinancing and is consistent with the spirit ofshari'ah. However, equity-based financing contracts, such as Musharakah and Mudarabah are deemed less favorable in the Islamic banking industry (Abdul-Rahman et al., 2014; Hassan and Aliyu, 2018; Abdul-Rahman et al., 2019).The empirical results reveal that development of banking services has a positive relationship with ROI for both Mudarabah and Musharakah contracts (Zafar, S., & Nor, E. 2019).

Thus we hypothesis that:

H3: Development of banking services is positively related with Investment in Musharaka

METHODOLOGY

To achieve the goal of this study, a qualitative research design was adopted to obtain a comprehensive understanding of the specific situation (Maryam, 2009). Qualitative research is usually an exploratory study that answers a question. A separate data set for financing with Musharaka in investment growth. The independent strategy is appropriate because the distributed questionnaires include (295) clients of the Bank of the Republic in Tripoli, which were collected in order to build a larger topic to generalize the concept (Maryam, 2009). Since this study includes a specific industry (Islamic banking products and investment engagement contract), the case study approach is appropriate because it provides descriptive and comprehensive information that allows in-depth exploration of the topic (Bryman, 2016). This study collects primary data from the structured questionnaire process. The process begins with an interview with the owners of capital to obtain information about the partnership contract and fill out the questionnaire prepared to explore the understanding of clients of these banking institutions and their willingness to invest in the Musharaka product.

RESEARCH IMPLICATIONS

The research results presented in this paper contribute to knowing knowledge about the distinguished participation in general and specifically in Islamic finance practices and its role in the growth of investment and improving the performance of Islamic banks. In fact, the Al-Jumhouria of Libya's management should form a special committee to consider the issues highlighted in this paper and recommend strict guidelines for the bank's branches that practice selling Islamic products to improve their performance and practices.

CONCLUSIONS AND RECOMMENDATIONS

The rapid and steady growth of Islamic finance, as well as its international reach, requires careful analysis of its uniqueness, its impact on investors and markets, and its political implications. In this survey, we explore the constraining foundations of Musharaka and their impact on funding decisions and the performance of individuals and organizations. We critically study contracts, markets and financial institutions, and provide guidance for future research. Our questionnaire is a response to the scant hard work in Islamic finance and the limited scope of current analyzes despite many interesting research questions. To bridge this gap, we present the major aspects of Islamic finance in partnership to the broader base of scholars and doctoral students in the field of financial economics, as well as policy makers and executives of global companies.

This survey contributes to building an agenda for Islamic finance research with Musharaka by making Islamic financing by participation accessible to the main financial economists, and highlighting relevant research work in the prevailing financial economy that can guide future research in the area of Islamic finance with Musharaka and a cycle in increasing investment. These methods distinguish this survey from current Islamic finance surveys such as the (Zahir & Hassan 2001: Tahir, 2007: Abider et al. 2015).However, we should not ignore the fact that Islamic financing with Musharaka allows companies to take advantage of debt-like financing plans such as sukuk, Murabaha or leasing. More research is needed to assess whether these schemes play a debt-enhancing role in reducing agency problems, reducing information inconsistencies, or creating tax savings. Additionally, learning about the benefits and costs of these various schemes may help you understand their unique role within the future standard barter model.

Finally, Islamic banks, besides practicing the Musharaka contract in its true shari'ah spirit should extend the use of Musharaka contract in automobile and trade financing where rent or profit could be easily identified and value of the asset is more certain. The regulators and Islamic financial standard setting authorities need to oversight the shari'ah board decisions on Musharaka contracts a more viable and authentic Islamic finance industry.

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