


EXPLORING MORAL HAZARD AND ADVERSE SELECTION IN PROFIT SHARING CONTRACT

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ARTICLE INFO	ABSTRACT
<p>Article history:</p> <p>Received 13 January 2023</p> <p>Accepted 07 March 2023</p>	<p>Purpose: The aim of this study is to review relevant articles on the problem of adverse selection and moral hazard in profit-sharing contracts in Islamic Banks. Adverse selection and moral hazard problems are problems that occur in profit-sharing contracts, so they impact the low portion of this contract financing compared to margin-based and fee-based contracts.</p>
<p>Keywords:</p> <p>Moral Hazard; Adverse Selection; Islamic Bank; Profit Sharing Contract.</p>	<p>Theoretical framework: The profit sharing contract in an Islamic bank has two potential problems, namely adverse selection and moral hazard that arise due to asymmetric information. Asymmetric information can occur due to limited information owned by Islamic banks as owners of funds (<i>shahibul maal</i>) regarding the business to be run by customers (<i>mudharib</i>). This asymmetric information mainly causes the agency problem. If an agent is negligent in making decisions with negative consequences and does not want to take responsibility for his actions, this can be classified as a moral hazard. Moral hazard can be in the form of self-interest, side effects, fraud, opportunism, and the behaviour of agents who commit willful mistakes, negligence and breach of contract. Meanwhile, adverse selection arises when the principal cannot observe the agent's characteristics because of asymmetric information before the contract is signed.</p>
	<p>Design/methodology/approach: The study uses a qualitative approach by reviewing previous articles relevant to the discussion. The study is aligned with the practices that occur in profit-sharing contracts. Furthermore, discussions are deepened through forum group discussions with experts and practitioners in Islamic banks.</p> <p>Findings: The results show that the conflicts in profit-sharing contracts include principal-agent conflicts and principal-principal conflicts due to adverse selection and moral hazards. The study results reveal that signalling and screening measures can be applied to overcome adverse selection problems while monitoring actions and switching to debt contracts can overcome moral hazard problems.</p> <p>Research, Practical & Social implication: The study has implications for Islamic banks to draw up a clear and complete profit-sharing contract with the <i>mudharib</i> to reduce the moral hazard committed by the <i>mudharib</i>. In this case, Islamic banks can also ask the <i>mudharib</i> to submit comprehensive financial reports regarding their financial performance. Islamic banks must also pay attention to signalling and screening efforts to prevent adverse selection.</p> <p>Originality/value: The value of the study provides a new literacy regarding the potential for agency conflict in the form of moral hazard and adverse selection that will be faced by Islamic banks when applying profit-sharing contracts with other parties as managers (<i>mudharib</i>).</p> <p>Doi: https://doi.org/10.26668/businessreview/2023.v8i3.955</p>

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EXPLORANDO O RISCO MORAL E A SELEÇÃO ADVERSA NO CONTRATO DE PARTICIPAÇÃO NOS LUCROS

RESUMO

Objetivo: Este estudo tem como objetivo revisar artigos relevantes sobre o problema de seleção adversa e risco moral em contratos de participação nos lucros em Bancos Islâmicos. Problemas de seleção adversa e risco moral são problemas que ocorrem em contratos de participação nos lucros, portanto, impactam a parte baixa desse contrato de financiamento em comparação com contratos baseados em margem e baseados em taxas.

Referencial teórico: A informação assimétrica pode ocorrer devido à informação limitada detida pelos bancos islâmicos como detentores de fundos (*shahibul maal*) sobre o negócio a ser gerido pelos clientes (*mudharib*). Essa informação assimétrica causa principalmente o problema de agência. Se um agente é negligente na tomada de decisões com consequências negativas e não quer assumir a responsabilidade por seus atos, isso pode ser classificado como um risco moral. O risco moral pode assumir a forma de interesse próprio, efeitos colaterais, fraude, oportunismo e comportamento de agentes que cometem erros deliberados, negligência e quebra de contrato. Já a seleção adversa surge quando o principal não consegue observar as características do agente devido à assimetria de informação antes da assinatura do contrato.

Desenho/metodologia/abordagem: Este estudo utiliza uma abordagem qualitativa, revisando artigos anteriores relevantes para a discussão. O estudo está alinhado com as práticas que ocorrem nos contratos de participação nos lucros. Além disso, as discussões são aprofundadas por meio de discussões em grupo com especialistas e profissionais em bancos islâmicos.

Resultados: Os resultados mostram que os conflitos nos contratos de participação nos lucros incluem conflitos principal-agente e principal-principal devido à seleção adversa e riscos morais. Os resultados do estudo revelam que medidas de sinalização e triagem podem ser aplicadas para superar problemas de seleção adversa, enquanto ações de monitoramento e mudança para contratos de dívida podem superar problemas de risco moral.

Pesquisa, implicação prática e social: O estudo tem implicações para os bancos islâmicos elaborarem um contrato claro e completo de participação nos lucros com o *mudharib* para reduzir o risco moral cometido pelo *mudharib*. Nesse caso, os bancos islâmicos também podem solicitar ao *mudharib* que apresente relatórios financeiros abrangentes sobre seu desempenho financeiro. Os bancos islâmicos também devem prestar atenção aos esforços de sinalização e triagem para evitar a seleção adversa.

Originalidade/valor: A maioria das pesquisas anteriores discutiu as vantagens dos contratos de participação nos lucros e seu impacto no desempenho dos bancos islâmicos. Este estudo fornece uma nova alfabetização sobre o potencial de conflito de agência na forma de risco moral e seleção adversa que serão enfrentados pelos bancos islâmicos ao aplicar contratos de participação nos lucros com outras partes como gerentes (*mudharib*).

Palavras-chave: Risco Moral, Seleção Adversa, Banco Islâmico, Contrato de Participação nos Lucros.

EXPLORANDO EL RIESGO MORAL Y LA SELECCIÓN ADVERSA EN EL CONTRATO DE REPARTO DE UTILIDADES

RESUMEN

Propósito: Este estudio tiene como objetivo revisar artículos relevantes sobre el problema de la selección adversa y el riesgo moral en los contratos de participación en las ganancias en los bancos islámicos. Los problemas de selección adversa y riesgo moral son problemas que ocurren en los contratos de reparto de utilidades, por lo que impactan en la parte baja de la financiación de este contrato en comparación con los contratos basados en el margen y en los honorarios.

Marco teórico: la información asimétrica puede ocurrir debido a la información limitada que poseen los bancos islámicos como propietarios de fondos (*shahibul maal*) con respecto al negocio que administrarán los clientes (*mudharib*). Esta información asimétrica causa principalmente el problema de agencia. Si un agente es negligente al tomar decisiones con consecuencias negativas y no quiere asumir la responsabilidad de sus acciones, esto puede clasificarse como riesgo moral. El riesgo moral puede presentarse en forma de interés propio, efectos secundarios, fraude, oportunismo y el comportamiento de agentes que cometen errores intencionales, negligencia e incumplimiento de contrato. Por su parte, la selección adversa surge cuando el principal no puede observar las características del agente debido a información asimétrica antes de la firma del contrato.

Diseño: Este estudio utiliza un enfoque cualitativo mediante la revisión de artículos anteriores relevantes para la discusión. El estudio está alineado con las prácticas que se dan en los contratos de reparto de utilidades. Además, las discusiones se profundizan a través de discusiones grupales en foros con expertos y profesionales en bancos islámicos.

Hallazgos: Los resultados muestran que los conflictos en los contratos de reparto de utilidades incluyen conflictos principal-agente y principal-principal por selección adversa y riesgos morales. Los resultados del estudio revelan

que se pueden aplicar medidas de señalización y selección para superar los problemas de selección adversa, mientras que las acciones de seguimiento y el cambio a contratos de deuda pueden superar los problemas de riesgo moral.

Investigación, implicaciones prácticas y sociales: el estudio tiene implicaciones para que los bancos islámicos elaboren un contrato claro y completo de participación en las ganancias con el *mudharib* para reducir el riesgo moral cometido por el *mudharib*. En este caso, los bancos islámicos también pueden solicitar al *mudharib* que presente informes financieros completos sobre su desempeño financiero. Los bancos islámicos también deben prestar atención a los esfuerzos de señalización y selección para evitar la selección adversa.

Originalidad: la mayoría de las investigaciones anteriores han discutido las ventajas de los contratos de reparto de utilidades y su impacto en el desempeño de los bancos islámicos. Este estudio proporciona un nuevo conocimiento sobre el potencial de conflicto de agencia en forma de riesgo moral y selección adversa que enfrentarán los bancos islámicos cuando apliquen contratos de participación en las ganancias con otras partes como administradores (*mudharib*).

Palabras clave: Riesgo Moral, Selección Adversa, Banco Islámico, Contrato de Reparto de Utilidades.

INTRODUCTION

Islamic banking philosophy is very different from traditional banking. The Islamic banking philosophy states that money cannot create value or added value unless it is combined with other factors such as the work and expertise of other parties in actual economic transactions. The philosophy is to lend money to generate cash (Altameemi & Al-Slehat, 2022). In terms of contracts or contracts, traditional banking contracts are debt-based (*qard*) while Islamic banking contracts or contract types are more diverse and are not limited to debt-based contracts. In addition, the philosophy of Islamic banking contributes to the better performance of Islamic banks in times of crisis compared to conventional banking, including lower liquidity risk, higher solvency, higher financing and asset growth, as well as economic and financial stability (Zulpahmi et al., 2022).

Contracts in Islamic banking are broadly grouped into 3 (three) categories, namely asset-based contracts such as *murabahah*, *salam*, *istishna'*, and *ijarah*; profit and loss sharing based contracts such as *mudharabah* and *musharakah*; and fee-based contracts such as *wakalah*, *kafalah*, and *hawalah*. Compared to other contracts, profit-sharing-based contracts are the main principles in Islamic banking. In a *mudharabah* contract, the fund's owner may not interfere in the management of the company or project financed by the owner of the fund except to provide advice and conduct supervision and evaluation (Aljifri & Khandelwal, 2013). Although it is the main principle of Islamic banking, the facts show that profit-sharing-based contracts' contribution still needs to be in line with expectations. In some countries, such as Indonesia, Sudan and Bangladesh, the highest numbers are *mudharabah* financing. At the same time, Malaysia, Indonesia and Pakistan have the highest numbers regarding *musharakah* financing. Other results show that *murabahah* financing increases more in Malaysia,

Bangladesh, Indonesia, and Sudan than in *mudharabah* and *musharakah* financing (Abdul Razak & Abdul-Wahab, 2018).

In many economic, accounting and management literature, asymmetric information can occur if one party has an information advantage that exceeds the other party in a contract or agreement. This asymmetric information can also appear in various contracts in Islamic banks as in conventional banking. Asymmetric information can happen in the form of adverse selection and moral hazards. Both conditions of asymmetric information can occur in contracts or contracts in Islamic banking. A moral hazard arises when one party does something that another party does not observe.

Asymmetric information will cause agency problems between the contracting parties. Dar & Presley (2000) identified several causes or weaknesses of implementing the profit-sharing principle, including causing contract agency problems. When observed in actual practice in Islamic banks, it will appear that there are two agency problems: agency problems involving principals and agents and agency problems involving principals and principals. Principal-agent conflicts can occur in several contracts, including *murabahah*, *salam*, *istishna'*, *mudharabah*, and *ijarah* contracts. Meanwhile, principal-principal conflicts can arise in *musharakah* and *musharakah mutanaqishah* (MMq) contracts.

LITERATURE REVIEW

Profit-Sharing Contracts: *Mudharabah*

Investment with a *mudharabah* contract is a contract (transaction) between two parties in which one party hands over assets to the other to be traded with profit sharing between the two under the agreement. From this, it can be said that *mudharabah* is a form of cooperation between two or more parties in which the owner of capital (*shahibul maal*) entrusts some capital to the manager (*mudharib*) with a profit-sharing agreement. This form confirms cooperation with 100% capital contribution from *shahibul maal* and 100% expertise from *mudharib*. In this contract, Islamic banks act as *shahibul maal* (fund owners), while customers who receive financing act as *mudharib* (fund manager). All capital comes from Islamic banks as owners of funds (Salman, 2021).

The distribution of funds with this scheme consists of two types: *mudharabah muthlaqah* and *mudharabah muqayyadah*. In *mudharabah muthlaqah*, the Islamic bank acts as *shahibul maal*, which gives full authority to the *mudharib* to run the business without any restrictions on places, types of products, customers or suppliers. If the business managed by the *mudharib* has a profit, then the Islamic bank will obtain income from the profit-sharing ratio,

which is the bank's right. As for for *mudharabah muqayyadah*, Islamic banks only act as agents connecting *mudharabah muqayyadah* investment customers who have set certain limits on investment activities by customers who receive *mudharabah muqayyadah* investments. From the bank's efforts to facilitate the owner of the funds and the manager of the *mudharabah muqayyadah* fund, the bank receives a certain agreed amount of fee or *ujrah* (Salman, 2021).

Profit-Sharing Contracts: *Musharakah*

In the *musharakah* contract, partners jointly provide funds to finance a particular venture in *musharakah*, both existing and new businesses. Submitted investments by partners may be provided in cash, cash equivalents, or non-cash assets. Furthermore, one of the partners can return the funds and the agreed profit-sharing in stages or all at once to other partners. Because each partner cannot guarantee the other partner's funds, each partner can ask other partners to provide guarantees for negligence or intentional mistake. Negligence or intentional misconduct of any partner can be (1) a contract violation, including misuse of investment funds, manipulation of operational costs and income, and (2) Implementation that is not under sharia principles (Salman, 2021).

The efforts made by partners can provide benefits or losses. *Musharakah* business profits are shared proportionally among the partners under the funds deposited either in cash or non-cash assets or according to the partner's agreed-upon ratio. Conversely, a loss is charged proportionally according to the funds deposited (either in the form of cash or non-cash assets). Suppose one of the partners contributes or has more value than the other partners in a *musharakah* contract. In that case, the partners can get the same benefits more significantly than any other partner. The form more benefits can be in the form of giving a portion of profits more significant than the portion of the funds or in additional forms other advantages. The portion of the profit-sharing amount for the partners is determined based on the agreed ratio of the operating results obtained during the period contract, not the amount of investment distributed (Salman, 2017).

Agency Problems

Although agency problems can occur in many contracts in Islamic banks, this paper fo on *mudharabah* and *musharakah* contracts, the author refers to Ismail (2011). The latter explains that agency processes morels, both principal-agent conflicts and principal-principal conflicts, occur more or more frequently in these two contracts compared to other agreements. The many agency problems have resulted in many people choosing to finance with other

contracts because it offers fewer agency problems, such as *murabahah*. As Abdul Razak & Abdul-Wahab (2018), profit-sharing-based financing is still relatively small in portion compared to margin-based financing and fee-based financing. It is an exciting subject to be studied and studied in more depth. The basis for agency theory is explained by Jensen & Meckling (1976), which reveals that agency theory, otherwise known as the principal-agent relationship, is a theory in which a contract allows one or more principals to engage with others who act as agents to perform some services. The principal is the owner or manager of the organisation who delegates and transfers responsibility or capital to agents. An agent is a manager of an organisation that manages a company's business transactions for the owner's benefit. The party who decides to accept an agreement and then performs it under the terms of the agreement is called an agent. The party proposing the contract is called the principal. Agents are usually involved with asymmetric information problems (Nicholson & Snyder, 2012).

In the context of contracts in Islamic banking, the agency relationship involves the principal as the funder. The agent is always the representative or fund manager (principal-agent association) and can also involve the principal or fund owner (principal-principal relationship). Financial contracts strongly influence the agency relationship. Clear financial agreements are expected to reduce agency problems between principals and agents (Aljifri & Khandelwal, 2013).

The relationship between the principal and the agent can cause agency problems. Two central issues trigger agency problems. First, agency problems occur when the principal and agent have different goals or objectives. Second, agency problems arise when the principal faces difficulties accurately accessing the agent's information and behaviour. Agency theory assumes that the role and function of agency relations are asymmetrical because the principal only cares about profit or return due to work done by the agent. Meanwhile, the agent agrees on his interest in terms of compensation (Eisenhardt, 1989; Jensen & Meckling, 1976).

Asymmetric information relates to general information that is not imperfect use. The principal does not have access to information and agent behaviour. In its simplest form, information is asymmetrical, as the situation described by Akerlof (1970). The Lemons problem explains how buyers and sellers in the used car market cannot wipe out the market because sellers of low-quality cars are incentivised to falsely advertise their cars as good quality and demand higher prices. The existence of asymmetric information results in buyers not knowing whether the car they will buy is of good or bad quality.

In addition, asymmetric information also occurs between workers and employers and consumers and producers. A worker may know how much can be produced than his employer,

or a producer may understand the quality of his goods more than potential consumers. In this case, the employer can carefully observe workers' behaviour regarding the productivity of their workers. Similarly, consumers may infer something about the quality of a company's product based on how it is sold. Good workers may want to be known as good workers, depending on how they are paid. Manufacturers of high-quality products generally want to be known as such, but low-quality products also want to earn a reputation for high quality (Varian, 1992).

Adverse Selection and Moral Hazard

The contract, as described previously, can determine the rights and obligations of the parties, namely the principal and the agent. The principal-agent model analyses situations where information is asymmetrically distributed between contracting parties with potentially different interests. Relationships usually analysed are those in which one party acts on behalf of another, as is assumed in the case of employment, agency or franchise agreements. Adverse selection can occur before the contract, while moral hazard can occur during the agent's performance. Both of these problems arise when the principal cannot observe or monitor the characteristics or actions of the agent. Therefore, the problem that arises is how the principal can encourage the agent to act in such a way as to maximise the principal's utility (Sarker, 2001).

Self-interest, adverse effects, fraud, opportunistic and negligent agents' behaviour are moral hazards. If an agent is slack in a decision with negative consequences and does not want to be held responsible for his actions, this can be labelled as a moral hazard. The agency contract does not carry out activities and tasks correctly because the goals need to converge with the principal's goals (Eisenhardt, 1989). After the agreement is approved, a moral hazard results from the agent's self-interest and opportunistic behaviour. Adverse selection arises when the principal cannot observe the agent's characteristics due to asymmetric information before the agreement occurs. The principal has minimal information about the agent and does not know whether the agent has the potential characteristics to carry out the principal's burden.

The agency problem is primarily due to the existence of this asymmetric information. In the context of asymmetric information in sharia contracts, managers (*mudharib*) have more knowledge about internal details, problems and prospects of the company in the future compared to capital owners (*shahibul maal*). Asymmetric information can occur because of the limited information owned by the bank as *shahibul maal* regarding the business that the *mudharib* will run. Information that needs to be complete about the business level of the *mudharib* in the form of expected returns makes it difficult for Islamic banks to determine the profit-sharing ratio between fund owners and fund managers in the initial binding of profit-

sharing contracts. Asymmetric information can also be done by *mudharib* when reporting business in financial statements to the fund owner. *Mudharib* tries to underestimate income and overestimate expenses to lower the resulting profit. This practice is undoubtedly contrary to Islamic accounting standards regarding *mudharabah* accounting.

The profit-sharing contract states that the business manager must not violate Islamic Shari'ah law in his actions related to *mudharabah* and must comply with the customs that apply in that activity (DSN-MUI). However, the phenomenon proves that customers commit abuse as *mudharib* by allocating the funds they receive to investments or business sectors different from those stated in the contract. This abuse by the customer shows the abuse of authority committed by the customer because it is related to his non-compliance with sharia principles.

Likewise, in the contract, it is stated that in the event of a loss, the fund provider bears all the losses resulting from the *mudharabah* contract, and the business manager must not conduct any loss (Salman, 2017, 2020). This clause can cause abuse of the agreement from one of the parties because this clause benefits the manager and harms the fund provider. The management has the potential to abuse, as stated in the contract. It is due to the assumption of the business management that when a business loss occurs, they have no obligation to bear the loss so that they are not severe and optimal in carrying out their business activities.

However, suppose a business loss occurs due to an intentional error, negligence, or violation of an agreement made by the managing customer (*mudharib*). In that case, the business manager is responsible for bearing the entire loss. The owner of the funds (*shahibul maal*) does not take the slightest of these losses. This clause also can cause abuse of trust that the owner of the funds can do because they do not want to bear the loss. The fund owner tries to justify that a deliberate error causes any business loss from the manager on the part of the manager. This justification will free the owner of the funds from bearing the failure of the business run by the manager. Often the facts prove that for every business loss that occurs, the customer, as the *mudharib*, is required to bear the loss through the competent authority's decision. This situation is also one of the problems of the profit-sharing contract.

MATERIAL AND METHODOLOGY

This article uses a qualitative approach through a literature review. The data collected is secondary data on several journal articles from experts relevant to the topics discussed. Various articles were collected to understand the moral hazard and adverse selection in profit-sharing contracts in Islamic banks. The study is aligned with the practices that occur in profit-sharing contracts. A group discussion forum was held with several parties to deepen the

discussion regarding the practice of profit-sharing contracts. Parties are Islamic bank experts from the Department of Islamic Economics and Finance of Bank Indonesia, Islamic accounting experts from academics who work as Islamic accountants and Islamic bank practitioners who have long been involved in profit-sharing contracts. In the end, a solution to the problem of moral hazard and adverse selection will be presented.

RESULTS AND DISCUSSION

Principal-Agent Conflict and Principal-Principal Conflict in Sharia Contract

A profit-sharing contract can trigger agency problems, both principal-agent and principal-principal conflicts. The principal is the party who gives the mandate to the agent to carry it out by the principal's expectations. The agent is the party who receives the mandate from the principal to manage his funds. This agency problem can arise due to asymmetric information in the relationship between fund owners and fund managers as well as fund owners and fund owners.

There is a framework provided by Varian (1992) about the principal's conflict with the agent. The principal wants to encourage the agent to take some action that is costly to the agent. The principal may not directly observe the agent's actions but rather observe some output determined partly by the agent's actions. The principal problem is how to design an incentive payment from the principal to the agent that causes the agent to take the best course of action from the principal's point of view. Managers want workers to put forth as much effort as possible to produce as much output as possible. In contrast, rational workers wish to make utility-maximizing choices based on action and incentive pay schemes.

In principal-agent conflicts, often, the fund owner has different information than the fund manager. Fund managers take advantage of excess information to obtain individual preferences in maximum margins or profits. This condition is understandable because every human being is a rational being. Asymmetric information can occur due to limited information owned by the principal or *shahibul maal* regarding the business run by the agent or *mudharib*. Information that needs to be completed about the level of business of the agent in the form of expected return makes it quite difficult for the principal to determine the profit-sharing ratio between the principal and the agent in the initial binding of the profit-sharing-based contract. Asymmetric information can also be done by *mudharib* when reporting business in financial statements to the fund owner. *Mudharib* or agents underestimate income and overestimate expenses to lower the resulting profit. *Mudharib* or agents can be dishonest in reporting their

business activities (Yuliana, 2013). The *mudharib* can commit dishonesty by reporting the minor possible income or profit and the most significant burden or loss.

There may also be a principal-principal conflict in the contracts in Islamic banks. In this conflict, although both parties act as owners of funds, the roles are different regarding the level of knowledge and access to business and financial information. This condition can occur because one of the parties, in addition to playing a role in channelling funds, also acts as an agent or business manager. Meanwhile, Islamic banks are only the owners of funds, so they do not have knowledge of the businesses run by other parties and do not have access to company and financial information. This principal-principal conflict can occur in *musharakah* contracts where Islamic banks and customers include their capital so that both parties are *shahibul maal*.

The two agency conflicts have a significant influence on the performance of Islamic banking. Several studies (Alam et al., 2021; Banchit et al., 2013; Fayed & Ezzat, 2017) have investigated the relationship between principal-agent and principal-principal conflict and their impact on bank performance. Banchit et al. (2013) are motivated by companies in developing countries facing principal-principal conflicts and traditional agency conflicts between principal agents. Nevertheless, the two conflicts are very different and are rarely discussed in the case of Islamic banks. This study uses five-year panel data from 37 Islamic banks in ten countries. Banchit et al. (2013) showed that principal-agent conflict in Islamic banks remains a primary concern, while principal-principal conflict does not provide convincing results. However, this cross-country study helps establish agency conflicts in Islamic banking and increases knowledge about principal-principal conflicts.

Fayed & Ezzat (2017) found a different impact of the principal-agent relationship on risk-taking behaviour and performance of Islamic banks, compared to conventional banks, for a sample of 105 banks in 8 Arab countries during the period (2005 – 2009). This study distinguishes between two aspects of shareholder structure: the concentration of ownership and shareholder rights. Empirical evidence shows that principal-agent conflict is prominent in Islamic and conventional banks because of the influence of shareholder rights on risk-taking behaviour. In addition, it was found that principal-agent conflict is more inherent in conventional banks, taking into account their impact on bank performance. The result is robust to include different bank-specific and country-specific variables.

Alam et al. (2021) found that the quality of the Board of Directors (BOD), Shariah Supervisory Board (SSB), Shariah management and executives have positive and negative effects on Shariah compliance quality, image, goodwill, and performance of Islamic banks in Bangladesh. The composition, formation, and quality of SSB and Islamic Bank employees

positively affect Islamic bank fatwas, Sharia decisions, compliance quality, and company performance. This study also finds that the prevailing banking pressures, the current political situation, the will of BOD and management, and social restrictions impact the performance of Islamic banks, the quality of Shariah compliance, image, and goodwill.

Adverse Selection, Signaling, and Screening in Sharia Contracts

The agency conflict arises from asymmetric information and results in high monitoring costs. found three factors that constitute agency problems in contracts in Islamic banks: adverse selection, moral hazard, and relatively large agency costs. Adverse selection can arise due to the difficulties of Islamic banks due to limited ex-ante information regarding the quality of projects carried out by agents. Banks have difficulty determining the quality of loan applicants, resulting in various problems, especially the adverse selection problem (Mills & Presley, 1999). Borrowers have information about their business activities, and the bank cannot trust the success or failure of the project because each applicant for a profit-sharing contract will claim the highest quality. Borrowers who expect their projects to supply high non-monetary benefits but low realised profits will choose profit-sharing contract financing because they will earn high total returns at an artificially low cost of capital (Pryor, 1985).

The description of Sarker (2001) is very good at explaining the implications of agency problems in profit-sharing contracts. However, the use of the creditor and borrower of the terms made by Sarker (2001) needs to be criticised because the term is more appropriate to be applied to conventional banks that use borrowing contracts (*qardh*). *Mudharabah* and *musharakah* contracts, as previously explained, are business or project cooperation contracts, so it is more appropriate to use the terms *shahibul maal* (owner of funds) and *mudharib* (business manager). Based on Akerlof (1970), the buyer needs complete information as the seller about the used car to be purchased. Islamic banks are also faced with the problem of adverse selection in determining the quality of applicants from prospective agents (*mudharib*) because Islamic banks need to have information about business activities and the success or failure of the applicant's efforts. In contrast, the applicant claims to have the highest quality.

The adverse selection problem arises before the contract is concluded. In adverse selection, one of the transacting parties, the *mudharib*, has hidden information from the other party (*shahibul maal*). The adverse selection model is called the hidden-type model because the agent has private information about the state of his business before signing a contract with the principal (Nicholson & Snyder, 2012). In profit-sharing contracts, adverse selection may occur because entrepreneurs like *mudharib* know more about the project's yield structure than Islamic

banks. Suppose the Islamic bank cannot assess the quality of any sharia-compliant financing project. In that case, the Islamic bank will have a financial contract price which the Islamic bank offers at the average contract price. It will be unprofitable for entrepreneurs with good quality projects because they will subsidise poor projects in such a market. If there are other options for entrepreneurs with good project quality, such as debt contracts outside of *mudharabah* or *musharakah*, they will leave the sharia market. As a result, the quality of projects under contract at Islamic banks will gradually deteriorate, and Islamic banks must adjust the average project quality to a lower level.

This depiction refers to Akerlof (1970) showing off a market breakdown in the example of poor quality cars (Lemons) in the market for used cars. Entrepreneurs with good quality projects will exit the profit-sharing contract market and be tempted to seek financing in the form of other debts, both financing at conventional banks and other financings in Islamic banks other than profit-sharing contracts such as *murabahah*, *salam*, and *istishna'*. The provisions in the *mudharabah* agreement further exacerbate this. Islamic banks must provide full guarantees to entrepreneurs against losses, especially losses of a routine nature, not due to negligence or intentional negligence. Such conditions will, of course, attract entrepreneurs with poor-quality projects and thereby increase profit-sharing contracts. This condition is a severe problem faced in the *mudharabah* market in Islamic banks.

According to experts in group discussion forums, solutions related to adverse selection problems are signalling and screening. Signalling requires action from entrepreneurs with good-quality projects. This condition can occur because Islamic banks need to correctly assess project quality from entrepreneurs who apply for funding from Islamic banks. Entrepreneurs with good quality projects will bear some of the costs of disclosing the soundness of the project in order to receive high prices for contract financing. This solution can only be implemented if such an incentive structure prevents employers with poor-quality projects from imitating the signals. However, experts also reveal that in long-term projects, these signalling actions tend to be expensive and quickly adopted by entrepreneurs with low project quality.

The second solution, according to experts, is screening. The screening suggested that Islamic banks offering profit-sharing contracts to entrepreneurs be able to reveal the actual quality of their projects through reporting under applicable Islamic accounting standards. The arrangement regarding profit sharing still refers to the existing sharia provisions where if there is a profit, it is divided according to the profit sharing ratio. In contrast, if there is a loss, it is entirely borne by the investor. In designing the ratio in a profit-sharing project, according to experts, different incentives can be determined for entrepreneurs with good and bad quality

projects. Likewise, Islamic banks can ask for collateral from entrepreneurs with poor project quality or from third parties outside the entrepreneur.

Moral Hazard, Equity Contracts, and Debt Contracts in Sharia Contracts

In profit-sharing contracts, manager (*mudharib*) has an incentive to artificially reduce the disclosed profits so that Islamic banks have to incur expensive monitoring costs to ascertain whether the declared profits are a true reflection of the company's business activities or projects or not (Sarker, 2001). Moral hazard is related to asymmetric information, especially for entrepreneurs to reduce the profits or profits disclosed. The profits or profits are the basis for calculating the profit-sharing between the Islamic bank and the entrepreneur. Islamic banks can reduce asymmetric information but require costly monitoring costs. The moral hazard model is also called the hidden action model because the principal cannot observe the agent's actions during the contract period. The principal may observe the results associated with the agent's actions (Nicholson & Snyder, 2012).

In the case of profit-sharing contracts, the covert action could be diverting cash flows through the misstatement of figures or investing in unproductive activities. Another severe problem with *mudharabah* contracts is the entrepreneur's indifference to the magnitude of the loss. In a state of loss, entrepreneurs do not care how high or low the losses they suffer, bearing in mind that Islamic banks must bear any losses suffered by entrepreneurs. On the other hand, employers do not get compensation. In situations like this, moral hazard actions tend to affect the entrepreneur's willingness to run a business because there will be no compensation. Seeing these conditions, experts offer a solution by changing the profit-sharing contract into a debt contract in the form of buying and selling (*murabahah*, *salam*, or *istishna'*), leasing (*ijarah*) or lending and borrowing (*qardh*). This solution follows Aggarwal & Yousef (2000), which also offers debt-based instruments. Accounts payable contracts are a rational response from Islamic banks to their contractual environment where the agency problems of profit-sharing contracts are becoming more severe. Thus the debt contract becomes the dominant and better financial instrument. According to experts, one of the advantages is the guaranteed return of capital from entrepreneurs to Islamic banks, as well as offering benefits for Islamic banks in the form of margins in sales and purchase contracts or fees in *ijarah* contracts.

CONCLUSION

The more types of contracts designed and implemented by Islamic banks carry two opposite sides, like two sides of a coin. Islamic banks can generate more profits with the

increasing variety of contracts offered. The many agency problems in Islamic banks make it uncompetitive to compete with conventional banks. On the other hand, Islamic banks will face problems of adverse selection and more significant moral hazards. Therefore, it is necessary to have a clear and complete contract involving a sharia bank as the principal (*shahibul maal*) and the customer as an agent (*mudharib*). It is expected to reduce moral hazard problems committed by the customer as an entrepreneur because the contract confirms the entrepreneur's obligation to report his income and business expenses comprehensively.

The study results reveal that signalling and screening can be applied to solve the adverse selection problem. In addition, the study results also show that monitoring and switching to debt-based contracts is a solution offered by experts to reduce the problem of moral hazard. However, this study has limitations in the communication media used in group discussion forums. This condition occurred because the research period coincided with the Covid-19 pandemic, limiting the place and time for exploring more in-depth findings. Subsequent research can be directed at deepening contracts other than production sharing contracts, for example buying and selling (*murabahah, salam, istishna'*), lending and borrowing (*qardh*), and fee-based contracts (*ijarah, ijarah muntahiya bittamlik, wakalah bil ujah*).

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