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Effects of Islamic Modes of Financing on Profitability of Banking Institutions

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Abstract

This study intended to examine the effect of Islamic financing modes on profitability of banking institutions in Mogadishu Somalia. In detail, the study examined the effects of Murabaha (cost-plus) and of Mudarabah (profit sharing) on profitability of banking institutions in Mogadishu Somalia. The study used a correlational research design, and data were collected through self-administered questionnaire from 56 respondents. The results indicated that Murabaha and Mudarabah have a statistically significant positive effect on profitability of banking institutions. The findings reveal that a significant increase and adherence to these Islamic modes of financing is expected to significantly improve and increase the profitability of banking institutions. The study concludes that both Murabaha and Mudarabah are vital for Islamic bank performance and profitability. It is recommended to the management of Islamic banks to start putting into consideration clients' credit rating while determining the mark-up value and at the same time carry out regular and systematic visits to their partners to gain an insight into the operations of the joint venture businesses and also remind them to clear their obligations.

Keywords: Islamic finance, Islamic banking, Murabaha, Mudarabah, Profitability

1. Introduction

Islamic finance is one of the most fastest growing industry in global financial services (Gait & Worthington, 2008) in terms of capital, market growth and innovation. It is considered as one of the greatest progress and development in global financial system (Alaoui & El Marzouki, 2022; Al-Qudah & Jaradat, 2013; Mustafa and Mahmoud, 2013). This advancement is not only in the business industry, but also, in academics and research (Khan, 2017). Islamic finance is a type of finance system that adheres the principles of Islamic law i.e. Shari'ah (Rahmani & Avdukic, 2022; and Gheeraert, 2014). Islamic finance, in this context, is a financial system that complies with Islamic law. Shari'ah also known as Islamic law is derived from the Quran, and the Sunnah. Islamic banks are financial institutions that provide Shari'ah based financial services and products. These institutions are referred to Shari'ah complainant institutions which provide interest free banking services (Gait & Worthington, 2007). Additionally, Islamic banks are considered as interest free banking which adopt Shari'ah principles in their process, business and finance dealings. These dealings are based on cooperation and responsibility, where all parties involved could benefit based on their contributions and efforts. This distinctive feature of Islamic finance leads to the effective use of funds and the careful assessment of risks by both partners, i.e., the entrepreneur and the financier (Alasrag, 2010). As a result, it is abundantly clear that Islamic finance is distinct from conventional finance in terms of its goals, purposes, and responsibilities to society (Ramlan & Adnan, 2016). The Islamic banks play crucial role and consider all these responsibilities to a greater extent than conventional banks (Hassan & Adnan, 1998). According to Hagawe, et al., (2023); Ali (2022); Dusuki & and Abdullah (2007) and Ahmed (2000), Islamic banking is guided by the principles of mutual solidarity, partnership, resources sharing, and reciprocal social development.

Due to their uniqueness and ethical consideration, Islamic banking and finance have expanded significantly both in Muslim nations and non-muslim nation (Shah et al., 2023) and now is regarded as a serious competitor to "traditional finance". In particular, Islamic banking has developed and created an alternative model of financial intermediation, integrity, and credibility, as evidenced by the establishment of a significant number of Islamic financial institutions around the world (Karim et al. 2010). In service-providing economies, banks act as an essential financial intermediary and are crucial to the growth of the economy. Additionally, market conditions in financial industry have undergone extensive changes on the demand and supply sides (Sufian & Habibullah, 2009). Nabella, et al. (2023) and Usmani (2002) stated that Islamic banks generally use two modes of financing. The first one encompasses profit sharing and profit and loss sharing, which is considered to be the core or original Shari'ah compliant mode of financing. The second one is Non Profit and loss sharing (NPLS) in which the income is not shared between parties. For example, in the case of a murabahah contract, Islamic banks receive the profit in the form of a markup (or profit margin). So, Alrifai (2015) stated that financial sector might adopt modes of Islamic finance in order to create a better system, profitable business, and social justice (Alrifai, 2015).

In general view, Islamic modes of financing and other finance related practices allowed Islamic financial institutions have strong financial positions and survive from the financial crisis (Fitrah, 2022). The first empirical analysis of the factors that determine the profitability of Islamic banks showed that both internal and external factors, including capital invested, liquidity, the profit-sharing ratio, regulation, and competition, had an impact on a bank's profitability (Almazari, 2014; Haron, et al., 1997). Other studies presented that risk sharing structures i.e. mudarabah contribute to the performance of Islamic banks as compared to other product based approaches (Yanikkaya, et al., 2018). Some of the Islamic financing structures like cost plus (mudarabah) can also be used to decrease the risk of asymmetric information that reduce the profitability, create financial pressure to the bank institutions (Al Maddah, 2017). At macroeconomic level, mudarabah appear to be more effective tool for increasing welfare and reducing poverty (Cebeci, 2012). Similarly, banks can generate profits through financing murabahah (Azizah, & Mukaromah, 2020).

Islamic banking in Kenya has performed substantially during its brief existence, holding an aggregate share of the banking industry in terms of gross assets of 0.8% (Yarrow, 2014). Also, Ahmednoor (2012) made an assessment on the relationship between Islamic banking products and the financial performance, and discovered a strong positive correlation between the size of the product and the amount of the financial performance. Many studies show that the profitability of the Islamic bank will be affected by any changes to the product's availability, specifications and features. The most common notion that these studies share is that Islamic banks are more profitable, stable, efficient and cost effective, efficient (Hadriche, M. (2015; Srairi, 2010; Safiullah, 2010; and Hassan, 2006). From the above analysis, we found that a much studies relating to the concepts and methods of Islamic finance including banking institutions were conducted over years, and still the available literature indicates the needs of further studies and investigation towards this concept particularly Islamic modes of finance and its effects on the profitability of banking institutions. Thus, the purpose of this study is to determine whether such Islamic modes of financing have an impact on the profitability of banking institutions in Mogadishu, Somalia.

2. Objectives of the Study

The study was guided by both general and specific objectives.

2.1 General Objectives of the Study

The general objective of this study was to examine the effect of modes of Islamic banking on the profitability of banking institutions in Mogadishu, Somalia.

2.2 Specific Objectives of the Study

The study sought to specifically achieve the following objectives:

1. To examine the effect of Murabahah financing (cost-plus) on the profitability of Banking Institutions in Somalia

2. To examine the effect of Mudarabah (profit sharing) on the Profitability of Banking Institutions in Somalia.

3. Literature Review

3.1 Theory of Islamic banking

Islamic finance is built on special ideas that are very dissimilar from traditional financial ideas in terms of financing, risk sharing, reporting, asset quality and management (Uddin, 2015; Velayutham, 2014; Murat, 2014; Beck, et al., 2013). Vinnicombe, 2010; Haqqi, 2009; Chong and Liu, 2009). its fundamental principles include prohibition of riba (interest), Gharar (uncertainity), Maysir (gambling) (Uddin, 2015; Haqqi, 2009). Generally, it is referred as a 'interest-free' scheme. The majority of experts and scholars concur that all kinds of interest, excessive or not, are prohibited (Hanif and Johansen, 2012). According to Iqbal and Mirakhor (2011), interest is viewed as an unjust enrichment of one person at the expense of another, which is against Islamic values of justice and social fairness. The concept of the Islamic finance was developed on the foundation of Shari'a principles in the late of 1940s, (Ahangi, 2013). Mit Ghamr is the first Islamic bank that was established in Egypt, 1963 (Shibu & Chachi, 2021 and Chachi, 2005). Srairi (2009) asserted that the Islamic finance system was originally established to satisfy the financial needs of Muslim. However, The Islamic finance system has expanded dramatically since that time as well as captured the attention of researchers, practitioners and policymakers due to its distinctive features (Khattak & Khan, 2023). The estimated value of Islamic financial assets across all sectors is $2.18 trillion. (Abdulkareem, et al., (2022 and Khattak & Khan, 2023). According to the Asian Banker Research Group, Islamic banking has experienced extraordinary development. The 100 largest Islamic banks in worldwide have achieved an asset growth rate of 26.7% annually, and the Islamic finance sector as a whole is expanding by an average of 15-20% annually (Kunhibava, 2012).

In recent years, Islamic finance has expanded by about 20% yearly, which seems to speak to its persistence and universal appeal. The usage of Islamic finance has started to rise globally, with certain nations having a greater concentration than others (Hussain, et al., 2016). This is due, in part, to the fact that principles of equity, participation, and ownership are the three guiding principles of Islamic financial activities and transections. Additionally, Islamic finance principles promote risk-sharing, put restrictions on taking extreme risks, and close connection to actual activity. This is evident that adapting Shari'ah principles helped Islamic financial institutions become more apparent, more strong and shock-resistant in many ways. In terms of their investing and financing contracts, Kettel (2011) stated that in Islamic banks contracts are considered acceptable and financeable only when they are based on shari'a principles and values, any other activity beyond that could not be bankrolled and reflected as haram (prohibited in Islam). This means that the financial activities and transactions of Islamic Banks should be carried through asset backed. Precisely, earning money out of money is prohibited.

According to Alrifai (2015), Al-Janabi (2012), Khamis et al (2010), Batcha (2009), Khan and Bhatti (2008), and other scholars, money is seen in Islam as a means of exchange that represents a person's purchasing power and has no intrinsic value. Additionally, it can only generate income when invested in productive and profitable businesses. Therefore, in order to ensure that all financial transactions are conducted in line with Islamic law i.e. Sharia'a principles, it's referred to Sharia'a Supervisory Board (SSB). This supervisory board is a mandatory Board in all types of Islamic financial institutions who certifies and gives guarantee that transactions, dealings, contracts and all other activities under taken in the Islamic Banks are halal (permissible) and implemented in line with sharia'a law and principles (Lewis, 2005). Hassan and Lewis (2007) identified Murabaha (cost-plus financing) and mudarabah (finance by way of trust), are the two types of Islamic financing modes and they are widely accepted and exercised in Islamic Banking. Thus, in this study we examine the analysis on how such modes of Islamic financing affect the profitability of banking institutions in the context of Somalia.

3.2 Theory of Islamic Financial Contracts

Understanding the fundamental pillars of Islamic finance system has become more important as the sector has expanded rapidly over the past years (Uddin, 2015). One must be aware of the fundamental principles and how this Islamic financial system differs from others in terms vision, goal, values, ethics, relationships, transections etc. Briefly, this financial system is built on Islamic principles which promotes moral and ethical dealings at individual, business and state level. Alrifai (2015) and Chong and Liu (2009) argue that theoretically Islamic banking system is different in many ways from conventional or traditional banking system. One of the theories that guides Islamic dealings is the theory of Islamic financial contracts. Islam emphasizes the value of relationships from the outset, and the Quran mentions this (Shamsuddin, & Ismail, 2013). In this regard, there must be parties that establish contract and sometimes this relationship can be stated as principal-agent relationship.

In order for a transaction to be considered legal, the contract's creation is necessary. Additionally, the contract is made to guarantee the presence of a guideline to the parties involved, transaction, the condition, and all standing points involved. As a result, formal contracts that are in writing and have legal force are necessary when there are two or more parties involved (Shamsuddin, & Ismail, 2013). It gives each party a crucial tool to reflect the conditions, duties, and commitments that they must accomplish. However, due to the nature of the contractual relationship, it may create asymmetric information, where some parties may choose to hide their private information concerning the terms and transections of the contracts (Shamsuddin, & Ismail, 2013). Therefore, even though it is mutually agreed upon by the contracting parties, risk issues may still exist. This is when the parties involved may be significantly impacted by an information asymmetry. Adverse selection (hidden information) and moral hazard (hidden action) are two important circumstances, the first occurring before a transaction and the second occurring after (Arbi, 2021 and Bolton & Dewatripont, 2004).

In Islam, the theory of contract can be linked to the agency theory, which also explains the nature of the relationship between principal and agent. However, Islamic theory of contract provides fundamental steps or procedures required to flow in contracts. Many arguments support that this theory is based on the notion that is Islamic man's fundamental nature" differs from "economic man's human nature" (Sarker, (1999). This is in part the reason behind the differences between conventional and Islamic ones. In this regard, it is clear that those from conventional theorist lacks or have limited understanding of the idea that shapes the conduct, behavior and ethics of parties dealing in such matters., or forming contractual agreements (Shamsuddin, & Ismail, 2013). This theory of financial contract, mainly focuses on the concept of profit-loss and risk sharing. As a central element, moral hazard and asymmetric information difficulties were studied extensively in old and contemporary literature of conventional and Islamic finance (Arbi, 2021, Ahmed, 2002; Ahmad,1994; Gale & Hell-wing, 1985).

From the Islamic perspective, moral hazard and asymmetric information and adverse section were studies to some extent by Salman (2022), Saifurrahman & Kassim (2022), Zafar & Siddiqui (2019), Zafar & Nor (2019), Ajmi, et al., (2019) Laib & Abadli (2018), Yousfi (2013); Iqbal & Llewellyn (2002). Similarly, conventional finance literature also developed their viewpoints. For instance, Aljifri, & Khandelwal (2013) and Laib & Abadli (2018), compared and contrasted the stakeholder relationships between conventional and Islamic financial institutions. According to Salman (2022), agency conflicts that arise as a result of bad moral hazard are included in profit-sharing agreements. The most important contractual arrangements are those between managers and shareholders (employment contracts) and between shareholders and debt holders (loan contracts). Both of these contracts are typically regarded as having a financial foundation because they depend, among other things, on the company's reported earnings. Nevertheless, moral hazard issues can be solved by monitoring behavior and using debt contracts, while adverse selection issues can be solved by applying signaling and screening procedures (Salman, 2022). On this point, Islamic financial institutions have fewer agency issues than their conventional counterparts (Aljifri, & Khandelwal, 2013). This can be interpreted that agency cost and other related expenses are controlled by Islamic banks, hence it increases their performance and profitability.

3.3 Islamic Modes of Financing

In Islamic financial system, there are key concepts and financing methods that are unique to this system. First, the concept of loan is different from the one of conventional finance. Here, in Islamic finance, loan is only referred to a "benevolent loan" known as "qarad hassan" (Hussain, et al., 2016). It is not a gift but it is a free of charge method of providing financial assistance or support to those in need (Muneer & Khan (2019). Principally, the modes of Islamic financing can be classified into i) the profit-sharing structure (i.e. Mudharabah, Musharakah) ii) non-profit sharing mechanism (like Murabahah), and iii) fee-based products (Hadizada & Nippel, 2022 and Hussain, et al., 2016). The term "profit loss sharing contract" describes a form of finance with uncertain returns such as mudarabah and musharakah, while non-sharing contracts are applicable to a type with more predictable or certain returns such as murabaha and finally, Fee-based services offered by Islamic banks to their clients are classified as financial, agent, and non-financial services such as Wakalah (financial representative), Kafalah (guarantee), Sharf (foreign exchange), among others (Hardianto, & Wulandari, 2016). Both theoretical and practical perspective, these modes of financing are the principal source of income generating for Islamic banks (Alzoubi, 2018; Bukhari & Qudous, 2012).

The funding options offered by Islamic banks can be categorized into two main groups. The first consists of two different investment contract kinds, known as Musharakah and Mudarabah, and is founded on the principles of equity and profit-loss sharing., and the second group mostly consists of contracts like Ijarah, Murabahah, Istisna, Salam, and and is based on profit-margin participation, or cost plus basis. These arrangements are also regarded as debt-based financing. However, these contract should comply with the Islamic principles of contract. Alam, et al., (2017) and Sarker (1999) mentioned the forbidden elements in contract are Riba (interest), Gharar (uncertainity) and Maysir (Gambling). On the other hand, it's crucial to determine what factors influence Islamic banks' use of profit-loss sharing financing. Salman (2022), identified that these factors include capital adequacy ratios, third party funds, and profit-sharing ratio, etc. the concept of Islamic modes of financing were studies by many researchers such as Ryandono et al., (2021); Mas'ud (2020), Sitompul, & Nasution (2019), Hassan &

Sanusi, 2019, Pratama et al. (2017), Agza & Darwanto (2017), Fatmawati, et al. (2016) and Sodiq & Chalifah (2015), Thomi (2014). Based on the literature, the researchers developed the conceptual framework of the research.

3.4 Conceptual Framework

The conceptual framework presented below, describes the relationship between independent and dependent variables. The modes of Islamic financing are considered as the independent variable, while dependent variable is the profitability of banking institutions in Mogadishu, Somalia. The conceptual framework below illustrates and depicts diagrammatically, the effective modes of Islamic financing involving Mudarabah and Murabahah should be in position to enhance profitability of banking institutions which would be reflected in terms of return on investment, return on assets and liquidity. However, this ideal situation might be hampered by intervening variables such as regulatory environment, ethical considerations, client, and bank's customer. Such intervening variables must therefore be auspicious and held constant for the perceived relationship between modes of Islamic financing and profitability of bank institutions to prevail.

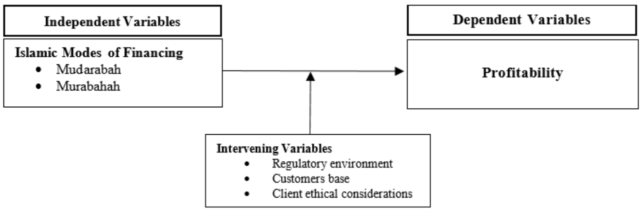

Figure 1. Conceptual Framework, developed by the researchers, 2023

4. Concepts of Murabaha, Mudarabah and Profitability

4.1 Murabaha Concept

Murabaha, which is known as (cost- plus) refers to a sales contract of particular items undertaken in Islamic Banks that are endorsed to a customer through predetermined profit added on the face value or the original cost. Murabahah is an Islamic term for selling an item at a price, which covers the cost of the item and the marginal benefit marked up additionally after mutual agreements between both sides the seller and buyer (Wahab, 2023 and Azzazi, 2012). In other words, Murabaha is the term for a legally binding sale and purchase transaction used to finance an asset, where by the cost and the additional profit of the item are known and agreed upon beforehand by all parties. The payment procedure may be on deferred lump sum or on installment basis as its stated in the contract agreement (Ahangi, 2013). In this case, the financial institution receives a security deposit from the customer or payment in full for any outstanding debt that is guaranteed or secured by collateral. Febyansyah, & Sihono (2023) and Iqbal and Molyneux (2005) stated that Murabahah occurs when there is a three party arrangement: the client who places an order with Islamic bank institution to purchase goods (products) from a supplier, the financial institution i.e. Islamic bank that is endeavoring to purchase the goods from the supplier and then sells them to the customer at pre-agreed price with a fixed credit period, and finally, the supplier who sells the commodity to the financial institutions. After making all of these agreements, the customer places an order with the bank for a certain commodity, which the bank then purchases from the supplier and sells to the client for a predetermined profit, allowing the client to pay the bank in full (lump sum) or over time (a deferred payment to the bank)

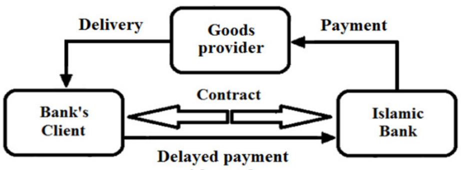

Figure 2. Murabaha Transction, Tatianaet al., (2015).

4.2 Mudarabah Concept

Islamic banking is founded on a profit-sharing arrangement between the financier (Rabul Mal) and the entrepreneur (Mudarib) through a Mudarabah (profit-sharing) contract, which is regarded as the cornerstone of Islamic Banking. Islam promotes business, entrepreneurship and socioeconomic development. An entrepreneur is someone focuses on profit and growth. Entrepreneurs are businesspeople who create (start), grow, and manage a business by putting their own time, effort, and money at risk for the purpose of making money or profit (Rusu, et al., 2012). Entrepreneurship is essential for business development, job creation, poverty reduction and small business growth (Nor, 2021). According to Alrifai (2015) and Hawary et al. (2004), Mudarabah is a financing contract where the financier provides the necessary funding, while the entrepreneur provides their skill and experience. Under this contract, the Islamic bank approves to finance the entrepreneur and share the profits of the project or venture being financed. Individuals make deposits to the Islamic bank under a Mudarabah, treating them as an investment in the bank. Then, the Islamic bank uses this investment (deposits) to make profits from its trading activities, such as financing entrepreneurs, individuals and businessmen. The bank agrees to give the depositor a share of its profits in return for their investment based on a pre-agreed ratio (Ryandono et al., 2021; Hassan & Sanusi, 2019; Otuyo & Abiodun, 2021; Iqbal & Mirakhor, 2011). The profits and losses are shared between the parties in a pre-agreed proportion, and the bank is solely liable for any losses because the entrepreneur sacrifices only their efforts and expected share in profits (Ikha et al., 2011).

In the mudarabah contract, the entrepreneur is known as the mudarib, while the investor is referred to as rab-al-mal, (Islam & Ahmad, 2022; Usmani, 2002). The investor (rab-al-mal) provides the capital and has no authority in the management or decision-making process of the project (Watkins, 2022). The entrepreneur (mudarib) is solely responsible for managing the project and the associated work (Ishak et al., 2022; Usmani, 2002). In islamic financial system, there are two types of mudarabah contracts. The first is one tier mudarabah and the second is two tier mudarabah. In a one-tier contract, the bank plays the role of a mudarib, manages depositors' money, and shares profits and losses with them. This is also known as an unrestricted mudarabah (Iqbal & Mirakhor, 2011 and Zaher & Hassan, 2001). In the two tier mudarabah contract, the bank acts as an agent and engages in an unrestricted mudarabah contract with the investment depositors while simultaneously engaging in a restricted mudarabah contract with an entrepreneur on the asset side. The restricted mudarabah contract is where the bank invests in a specific mudarabah contract with a specific entrepreneur (Rahman, 2018; Alasrag, 2010; Habibur, 2018; Hassan & Bello, 2014; Zaher & Hassan, 2001). In case of profit, the capital provider (rab-al-mal) receives the the invested principal and a pre-determined percentage of the profits, while the entrepreneur keeps the remaining share of income. In the scenario of underperformance, the losses are borne by the investor (capital provider), while the mudarib (entrepreneur) doesn't lose any money except for the time employed. However, in a special case, losses could also be borne by the entrepreneur if the reason for business or project failure is negligence or misconduct from their side (Sapuan, 2016). Typically, the mudarabah contract is used for short-term investment projects (Zafar & Nor, 2019; Zaher & Hassan, 2001).

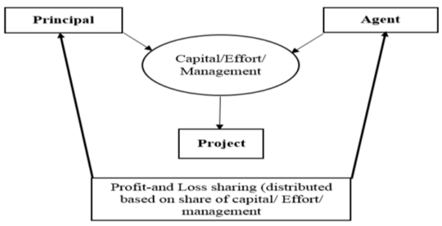

Figure 3. Partnership Contract’s Structure, Ajmi, et al., (2019)

4.3 Profitability Concept

The nature of the bank operations and services requires banks to design effective and efficient strategies so as to enhance profitability and liquidity as well as avoid risk and failure (Idowu, et al., 2017). Owolabi & Obida (2012) defined profitability as a business's capacity to generate revenue that is greater than costs related to producing that revenue across all of its activities. When banks are profitable, it shows that they are committed to operating profitably. As risk management strategy, diversification in terms of investing and financing is very beneficial to improve the profitability of banks, sine it reduces the effect of bad credits and increase the number of customers (Hardianto & Wulandari, 2016). However, profitability is an indicator used in measuring the performance as it shows the management’s effectiveness and efficiency to utilize resources in producing positive net return. In order to assess the bank’s ability to create earnings from its invested capital, the following two ratios are generally used ratios used in assessing the profitability of bans: return on assets (ROA), and return on equity (ROE) (Akinwumi, et al., 2017). Return on assets can be stated as “a comparison between net income and average assets.” While return on equity is defined as “the ratio between net income and the average equity or investment of bank owners” (Gustriani, et al., 2020).

Since the goal of Islamic firm i.e. Islamic banks is to maximize profit while also maximizing welfare, or falah, both mudarabah and murabahah financing serve to achieve this goal. However, in murabahah contract, profit can be calculated as a percentage of costs or as a fixed amount (Shah, & Niazi, 2019). According to Usmani (2007), and Guney (2015), the sale may be made with cash or with a deferred payment plan. According to Senouci (2022), mudaraba is a form of profit-sharing when one side contributes capital and the other (in this case, the manager) contributes labor. This type of agreement complies with Sharia law and controls the way that capital and labor cooperate in investing. The two parties split the profits made as a consequence of the mudaraba method according to the agreed-upon percentages and if the project loses money for a reason unrelated to the manager's misconduct or negligence, the bank, as the money's owner, loses money, and the manager loses his or her efforts and labor in accordance with the sharia rule, which states that sharing in profits also means sharing in losses (Nidaussalam, 2016).

The bank has the right to observe the partnership but not to get involved. However, in Mudarabah Financing Modal, the management’s result is measured with business income and business profit (Nidaussalam, 2016). The profitability of the bank is directly impacted by internal factors, such as bank capital, bank size, risk management, credit, liquidity, and management decisions (Petria et al., 2015; Almazari, 2014; Tan & Floros, 2012 and Staikouras & Wood, 2004). In his study, (Almazari, 2014) indicated the profitability of suadi banks are more profitable than Jordan banks as they are utilizing their resource efficiently. This study showed that profitability has positive and significant correlation with investment. Similarly, the profitability can be effected by external factors including market share, competition, ownership, inflation. However, the bank’s management should consider these factors when making, financing investments and partnership like murabahah and mudarabah respectively.

4.4 Effects of Islamic Modes of Financing (Murabahah &Mudarabah) on Profitability of Banking Institution

In the Islamic Banks, Murabhaha constitutes over 70% of their asset, and it becomes one of the main predominantly and essential instrument used as Islamic finance mode (Al-Tiby, 2012). According to Atthaariq & Adityawarman (2023) and Haron (1996), Murabaha is financing technique based on profit Margin (Make up in fund) that has a positive impact on organizational performance particularly financial performance which directly affect all aspects of the organization i.e. growth, sustainability, reputation. Similarly, it is a cost plus financing that is used to support and assist Muslim community in short term transactions (Cohen, 2005). Therefore, bank institutions consider, while determining, the cost of the sales price, several factors such as the price of the asset profit rate, the client’s credit rating and the matter of the contract subject (Aleraig & Asutay,2023; Warninda, et al., 2019 and Smolo, 2010). Other hand, when assessing the profit margin, they give attention to the bank’s money (fund), the income of the customer and the compensation for the time. However, the main necessity aspects of the Murabaha contract are disclosure of purchase price, the profit margin and other incurred costs in advance (Ibrahim & Salam, 2021). Katel (2011) also urged that the necessary condition in the contract of murabaha is the actual sale of a real asset to comply with shari’a principles. Marliyah et al. (2021) investigated the im of murabahah financing on the profitability of Islamic financial institutions measured by the return on assets (ROA), and found that murabaha has a simultaneous effect on return on assets. Similarly, Rahman and Rochmanika (2012) assessed how murabahah which is financing based on profit margin effects the earnings of Islamic banks, and realized that this method of financing will increase the ability to generate profits. In this regard, Islamic banks recognize the significance of Murabaha financing as they allocate enough financial resources to it, which makes Murabaha financing weight More than 40% of the total investments (Al-munshed, al-Saadi 2013).

Although, Murabaha financing contribute in the profitability of Islamic financial institutions i.e. Islamic banks, it involves some degree of risk i.e. default risk, that arises from defaulting in paying the full amount of debts in agreed time which may reduce the bank performance, (Hassan and Lewis, 2007 and Khan and Ahmad 2001). This risk is not limited to Islamic banks but also it exists in conventional banking system. Mainly, Islamic financial system prefers asset based financing (Suzuki & Uddin 2016). However, many studies revealed that Murabahah financing with acceptable level of risk has a vigorous effect on the level of profitability of Islamic bank (IB) (Afrizal & Shabri, 2023; Dari & Rahmawati, 2022 and Peter, 1999). According to Ratansari and Rayando (2012), Islamic banking institutions are expected to generate better levels of profitability from financing under the murabahah. Furthermore, Zaini and Rosly (2009), asserted that the the practices of Murabahah financing within the framework of Islamic bank investments results in favorable profit margins. Recently, after examining the impacts of murabahah (cust plus) financing on the profitability of Islamic

Commercial Banks (ICB), Atthaariq & Adityawarman (2023) came to the conclusion that murabahah financing had a favorable impact on the profitability of Islamic commercial banks in Indonesia in 2017–2020.

Hussain et al. (2016) and Cihak & Hesse (2010) indicated that profit sharing method enable Islamic banks to keep their value or net worth and avoid balance sheet deterioration during difficult economic situations, leading to greater stability during the early phases of a crisis. However, Majeed & Zainab (2017), Iqbal & Llewellyn (2002), and Uzair (1955) suggest that Islam emphasizes profit sharing rather than predetermined and fixed percentages. Idries et al., (2013) found that Mudarabah financing have an inverse relationship with several profitability indicators, which suggests that Islamic banks (IB) operating in countries with hybrid (different) banking systems face challenges with Mudarabah financing as entrepreneurs prefer conventional (traditional) banks when they expect high returns for their projects. Dar et al., (2011) argue that profit and loss sharing arrangements marginally in the practice of Islamic banking and finance, and even specialized firms such as Mudarabah Companies have a negligible proportion of their funds invested on a Mudarabah or Musharakah basis.

Due to the nature of banking operations, risk and profitability are related, Islamic banks increased their focus on the profitability through directing their financial resources to the most productive investment opportunities, therefore profitability of profit and loss (P&L) arrangements like mudarabah (Belkhaoui, et al., (2020). This is based on the notion that return on investment is directly dependent on the performance of the bank. According to Yanikkaya, et al. (2018) examined the patterns of profitability for both conventional and Islamic banks in the United Kingdom and Islamic Cooperation countries, during period between 2007 and 2013. According to their findings, using financing through profit-loss sharing technique encourages risk-sharing more than financing based on profit margin. So, this result can be explained that the adoption of this technique (profit-loss sharing) can assist for the banks to creating value for shareholders (Muda et al., 2013). Since the primary goal of the Islamic banks is to maximize the shareholders'(legal owner's) value in legitimate way, bank management should consider a wide range of factor that have connection with the financing methods and eventually effect of the profitability, including risk, efficiency and moral issues. When implementing a profit and loss sharing model, the bank management have to analyze the entrepreneur capacity to avoid risks which may reduce the level of profitability (Diamond & Rajan, 2001). In Sudan, Elgadi, (2016) analyzed reports of 27 Islamic banks from 2005 to 2013, and evidences showed that management of Islamic banks unable to forecast and avoid financial risk, as the results revealed that the profit and loss sharing model (Modarabah and Mosharakah) significantly boost profitability. This is a result of the Central Bank of Sudan's policy, allows each bank the authority to choose the Modarabah's percentage share of the earnings.

Despite these findings, the literature reviewed is largely focused on explaining the functionality of Islamic modes of financing without demonstrating how they affect profitability of banking institutions, particularly in developing countries like Somalia. Furthermore, most of the studies reviewed were conducted in previous years, and new developments have since emerged. Thus, there is a knowledge gap in the literature on the effect of modes of Islamic financing on the profitability of banking institutions in Somalia, which this study aims to address.

5. Methodology

The methodology used in this study was a correlational research design, which is a research approach that investigates the relationship between variables and estimates the effect of independent variables on the dependent variable (O'Connon, 2011 and (O'Connon, 2011). This design was chosen because it allows the researchers to measure research variables and examine the relationship among them (Asenahabi, 2019 and Creswell, 2014). The target population for the study was all employees at Salaam Somali Bank (SSB) in Mogadishu, and a sample of 65 people responded the questionnaire. The questionnaire consisted of closed-ended questions based on a Likert-type five-point scale. The questions were reviewed by experts to ensure their relevance, wording, and clarity and a pilot study was conducted to ensure the instrument's reliability. The Statistical Package for Social Scientists (SPSS) program was used to examine the data that had been obtained. SPSS is a statistical software package that is commonly used for data analysis in social science research (Bala, 2016 and It provides a range of statistical tools and techniques that can be used to analyze data and generate descriptive statistics (means, standard deviations, and correlations) (Okagbue, 2021).

6. Results and Findings

This section includes the presentation of the data and result interpretation. The presentation of the results is divided into two sections. Section one contains the background characteristics of the participants while section two presents the major findings related to the two specific objectives of the study. Pearson's correlation and coefficient were employed to analyze the relationship between study variables. The correlation coefficient measures the degree and direction of the linear relationship between two variables. The results of the data analysis were interpreted in light of the research objectives. The findings were used to draw conclusions about the relationship between the study variables and to provide recommendations for future research and practice.

6.1 Demographic Characteristics of Respondents

The first section of the data presentation presents the background characteristics of the research participants, which include their gender, age, and educational level. This information is important as it provides an understanding of the nature of the participants in the study area. The background characteristics of the participants were looked at using descriptive statistics like frequencies and percentages. These statistics were used to summarize the data and provide a clear picture of the respondents' demographic profile. The results of the descriptive analysis were interpreted and used to draw conclusions about the sample characteristics. This information was essential in providing context for the results of the study and in understanding the generalizability of the findings.

Table 1. Demographic characteristics of respondents

		Frequency	**Percentage**
Gender	Male	41	73.21
	Female	15	26.79
	Total	56	100
Age	20 – 24	7	7.14
	25 – 30	26	46.43
	31 – 36	18	32.14
	Above 36	8	14.29
	Total	56	100
Education level	Diploma	14	25.00
	bachelor’s degrees.	37	66.07
	Master’s degrees	5	8.93
	Total	56	100.

Based on the results presented in Table 1, it was found that females accounted for 26.79% while the majority of the respondents were male (73.21%). This gender gap is attributed to several factors, such as societal norms that favor boys for education and work, and cultural beliefs that encourage and motivate early marriage for girls, which hinders their education and career development. The above table also shows that the majority of respondents (46.43%) were in the 25–30 age range, followed by those in the 31–36 age range (32.14%). Respondents aged 20-24 years accounted for 7.14%, while those above 36 years accounted for 14.29%. This suggests that the majority of the respondents are energetic employees who can adjust to the market needs and maintain their service delivery to the clientele, thus improving the bank's performance. In terms of educational achievement, it was revealed that 25% of the percipients had diplomas, 66.07% had Bachelor's degrees and 8.93% possessed Master's degrees. This suggests that participants in the study had a sufficient level of literacy and were better able to understand and interpret the contents of the questionnaire (Blair, 2013; Martin, 2006 and Uma, 2000). This is important in social investigation research as it allows for more accurate and reliable data collection. Overall, the background characteristics of the respondents provided important insights into the nature of the sample and helped to contextualize the results of the study.

6.2 Effect of Mudarabah on Profitability of Banking Institutions

According to Table 2, the correlation (r) between Mudarabah and profitability of banking institutions was found to be 0.776, with a p-value of less than 0.05. As the value of r is positive, it specifies that Mudarabah has a statistically substantial positive effect on banking institutions' profitability. Therefore, increasing the use of Mudarabah is expected to boost profitability significantly. The researchers also utilized coefficients (beta values) to analyze the data and estimate the level of Mudarabah effect on profitability, as shown in Table 3.

Table 2. Correlations between Mudarabah and Profitability of Banking Institutions

		MUDARABAH	PROFITABILITY
MUDARABAH	Pearson Correlation	1	.776**
	Sig. (2-tailed)		.000
	N	56	56
PROFITABILITY	Pearson Correlation	.776**	1
	Sig. (2-tailed)	.000	
	N	56	56

Note. **. Correlation is significant at the 0.01 level (2-tailed).

According to the results in Table 3, Mudarabah has a beta value of 0.776. This shows that a 100% rise in Mudarabah is expected to result in a 77.6% increase in the profitability of financial institutions, based on the results of the study

Table 3. Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	.286	.345		.829	.411
	MUDARABAH	1.171	.130	.776	9.039	.000

Note. a: Dependent Variable: PROFITABILITY.

6.3 Effects of Murabaha on Profitability of Banking Intuitions

The study also investigated the impact of Murabahah (cost-plus) on the profitability of banking institutions in Somalia. To achieve this goal, the researchers gathered information from participants through a series of questions that explored the status and functionality of Murabahah in Somalia. In order to verify their findings, the researchers conducted a Pearson's Correlation analysis, which involved correlating the scores for Murabahah with those for profitability to assess if the two variables have a statistically significant relationship. Results in Table 4, indicate that there was a positive correlation ($r = 0.662$) between Murabahah and profitability, with a p-value of less than 0.05. This suggests that Murabahah has a statistically significant positive effect on the profitability of banking institutions in Somalia, and that increased adherence to this practice is likely to lead to a significant improvement in profitability. The researchers also employed beta values to further analyze the data and evaluate the extent to which Murabahah affects profitability, as shown in Table 5.

Table 4. Correlations between Murabahah and Profitability of Banking Intuitions

		MURABAHA	PROFITABILITY
MURABAHA	Pearson Correlation	1	.662**
	Sig. (2-tailed)		.000
	N	56	56
PROFITABILITY	Pearson Correlation	.662**	1
	Sig. (2-tailed)	.000	
	N	56	56

Note. **. Correlation is significant at the 0.01 level (2-tailed).

Table 5 of the study presents the results of the beta analysis, which found that Murabahah had a beta value of 0.662. Based on this finding, it can be inferred that a 100% increase in Murabahah is likely to result in a 66.2% improvement in the profitability of banking institutions. This suggests that Murabahah is an important factor to consider for banking institutions looking to improve their profitability in Somalia.

Table 5. Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.039	.527		-.075	.941
	MURABAHA	1.248	.192	.662	6.484	.000

Note. a. Dependent Variable: PROFITABILITY.

7. Discussion of the Findings

The first objective of this research aimed to determine whether Mudarabah has a statistically significant effect on the profitability of banking institutions in Somalia. The findings of this study suggest that there is a positive relationship between these two variables, as indicated by the respondents' agreement that profit-sharing arrangements based on Islamic finance principles can improve profitability. This conclusion is supported by the statistically significant positive correlation coefficient ($r = 0.776$, $p < 0.05$) between Mudarabah and profitability. These findings are consistent with those of previous studies, such as Mas'ud (2020), Sitompul & Nasution (2019), Thomi (2014), Rahman & Rochmanika (2012), and Izhar & Asutay (2007) all discovered a favorable correlation between profit sharing agreements and banks' ability to generate profits. Alzoubi, (2017) stated that Islamic banks are losing out a significant income by underinvesting some profit and loss sharing arrangements such as mudarabah. Additionally, Cihak and Hesse (2010), suggest that profit-sharing mechanisms can help Islamic banks maintain their net worth and avoid balance sheet deterioration during difficult economic situations. Overall, the results point to Mudarabah as a potential instrument for profitability of banking institutions in Somalia.

The study's second objective aimed to determine whether Murabahah has a statistically significant effect on the profitability of banking institutions in Somalia. The findings reveal that there is a positive relationship between these two variables, as indicated by the respondents' agreement that cost-plus (murabahah) arrangements can improve the bank's profitability. This conclusion is supported by the statistically significant positive correlation coefficient ($r = 0.662$, $p < 0.05$) between Murabahah and profitability. These findings align with those of previous studies, such as Ratansari and Rayando (2012), Zaini and Rosly (2009), Belkhaoui et al. (2020), and Peter (1999), which similarly found a positive relationship between Murabahah financing and the profitability of Islamic banks. Additionally, Alzoubi (2017) and Al-Tiby (2012) notes that murabahah is one of the most frequently utilized instruments by Islamic banks and accounts for more than 70% of their assets. The study's findings also align with those of Belkhaoui, et al. (2020), Alzoubi, (2017) and Sutrisno (2014), who found that Murabahah financing consistently influences the performance of Islamic banks, as measured by ROA and ROE. Furthermore, a study conducted in Kenya by Thomi (2014) found that Murabahah had the strong positive significant relationship with return on assets among the Islamic products offered by Islamic banks in Kenya. Overall, these findings suggest that Murabahah can be an effective tool for improving the profitability of banking institutions in Somalia.

8. Conclusions and Recommendations

The study's major conclusions are presented in this section. According to the results of the Pearson's correlation analysis, Mudarabah financing has a statistically significant positive impact on the profitability of banking institutions in Somalia ($r = 0.776$, p 0.05). Therefore, the researchers conclude that increasing the use of Mudarabah financing is expected to significantly improve and increase the profitability of banking institutions in Somalia. Similarly, the study's findings also indicate that Murabahah financing (cost-plus) has a statistically substantial positive effect on the profitability of banking institutions in Somalia ($r = 0.662$, $p < 0.05$). Hence, the researchers conclude that a significant increase and adherence to Murabahah can potentially improve the profitability of banking institutions in Somalia. Overall, these conclusions suggest that both Mudarabah and Murabahah can be effective tools for improving the profitability of banking institutions in Somalia. However, in regard to these findings and conclusions, the following recommendations are suggested:

1. To strengthen the contribution of Mudarabah towards the profitability of Islamic Bansk, the researchers recommend that the bank should contribute in the management of the business ventures it financed by getting

involved in matters such as strategies, policies budgeting, operating systems, and performance assessment. Additionally, in cases where the entrepreneur engages in misconduct or negligence, they are obligated to held accountable for the business's losses, rather than placing the burden fully on the bank. Adopting these suggestions could potentially lead to a significant improvement in the profitability of banking institutions in Somalia through the use of Mudarabah.

2. To strengthen the contribution of Murabahah towards profitability, the researchers recommend that bank management should start considering clients' credit ratings when deciding or determining the mark-up value as well as selling price. This would involve considering factors such as the clients' ability to repay the debt and record of meeting past obligations, and the financial strength of their business capital structure. By doing so, the bank can eliminate reduce the risk of default and get to know their customers better. Overall, adopting these recommendations could help to strengthen the contribution of Murabaha towards the profitability of banking institutions in Somalia.

3. Given that the scope of this study was limited to analyzing the impact of Islamic modes of financing banking on Bank's profitability in Mogadishu, Somalia, it is advised that a similar study be carried out in other banks in Somalia that provide Islamic banking services. This would enable comparisons to be made and increase the generalizability of the findings. Furthermore, it would be beneficial to include other factors or issues that could influence the performance and profitability of Islamic financial institutions, such as structure, budgeting, credit risk management, control systems, and others. This would make it possible to understand the factors that extensively affect the financial institutions of Somalia.

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Authors contributions

Dayah Abdi Kulmie was responsible for study design and data collection as well as drafted the manuscript. Mohamed Abdirahman Abdulle was contributed in drafting the manuscript. Mukhtar Sheikh Hussein and Hussein Abdi Mohamud revised it. All authors read and approved the final manuscript.

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