

TRANSFORMING SOMALIA'S BANKING SECTOR TO IGNITE ECONOMIC GROWTH: STATUS AND WAYS FORWARD



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1. Introduction

The outbreak of the civil war devastated Somalia's banking system, shutting down all state and domestic commercial banks for two decades. A community-driven informal financial system known as Hawala filled the void, providing financial services such as the transfer of remittances and facilitating trade transactions in domestic and international markets.



The development of a sound financial sector plays a significant role in driving economic progress. It fosters economic growth by promoting capital accumulation and technological advancement through various means

The development of a sound financial sector plays a significant role in driving economic progress. It fosters economic growth by promoting capital accumulation and technological advancement through various means. These include increasing the rate of savings, mobilizing and aggregating savings from different sources, providing information about investment opportunities, facilitating the inflow of foreign capital, and optimizing the allocation of resources. It is presumed that countries with well-developed banking systems with sufficient capital markets grow faster compared to those with underdeveloped systems.¹ So, when relative peace broke out, the federal government of Somalia (FGS) recognized the importance of financial sector development and the vital role played by commercial banks in boosting overall economic performance and investment.

In 2009, the FGS reestablished the Central Bank of Somalia (CBS) as the first step towards rebuilding credible financial institutions. In 2012, the CBS developed a financial institution law to provide for the licensing, regulation and supervision of commercial banks.² In 2016, the FGS enacted anti-money laundering and countering financing terrorism legislation which criminalized illicit financial activities.³ Thirteen commercial banks have since been successfully registered but they mainly provide remittance services. A few offer more varied services including providing credit cards, lending and giving credit to the private sector.



Somali commercial banks are not linked to the global financial system, although all banks have recently adopted International Bank Account Numbers (IBAN) to electronically validate bank accounts and enhance payment processes

Nevertheless, the financial sector in Somalia continues to operate under challenging conditions, including a poor regulatory and governance environment, political and security chaos, as well as dysfunctional market conditions. Somali commercial banks are not linked to the global financial system, although all banks have recently adopted International Bank Account Numbers (IBAN) to electronically validate bank accounts and enhance payment processes.⁴ The adoption of IBAN by Somali banks is also expected to restore the confidence of international correspondent banks, regulators, and investors, which in turn integrates the nation's financial system into global financial markets, according to CBS.

1. World Bank, 2008. Finance, Financial Sector Policies and Long-Run Growth. <https://documents1.worldbank.org/curated/en/635691468158710957/pdf/wps4469.pdf>

2. Central Bank of Somalia (CBS), 2012. Financial Institution Law. https://centralbank.gov.so/wp-content/uploads/2022/01/Financial-Institution-Law_2102.pdf

3. CBS, 2016. Anti-Money Laundering and Countering the Financing of Terrorism Act. <https://centralbank.gov.so/wp-content/uploads/2022/01/Anti-Money-Laundering-and-Countering-the-Financing-of-Terrorism-Act-English-Version1.pdf>

4. CBS, 2023. Central Bank of Somalia (CBS) Leads the Country's Commercial Banks to Adopt International Bank Account Numbers (IBAN). <https://centralbank.gov.so/wp-content/uploads/2023/03/Pressrelease-394-IBAN.pdf>

However, the state of the country's banking system, especially the commercial banks, is not fully understood. Unlocking the potential of inclusive economic growth in Somalia requires that a greater understanding be placed on current challenges and opportunities for strengthening the banking sector. This report examines the state of banking sector in Somalia with a focus on key bottlenecks to transforming the sector and offers various policy options to address them.

2. Methodology

A combination of desk review and qualitative interviews was adopted in order to achieve the objectives of this policy report. Twenty semi-structured, face-to-face and online interviews were held with a wide array of banking stakeholders including government officials, CBS senior management, stakeholders from commercial banks and the Somali Bankers Association. To ensure that the data was as comprehensive as possible, the HIPS researcher also consulted with financial sector experts. All data from the participants was transcribed and analyzed through interpretive methods. The researcher also reviewed relevant literature on the banking sector issues to help assess the current state of the sector and how it might develop.

3. Background

3.1 Historical overview

Somalia's banking sectors dates back to the colonial era (before 1960). In the early 1920s, Banca d'Italia opened a branch in Mogadishu⁵ offering agriculture-related financing such as the production and export of bananas and cotton for Italian traders. This was followed by the establishment of two Italian-owned banks in Mogadishu, Banco di Napoli⁶ and Banca di Roma in 1937 and 1958 respectively. They later expanded to other major cities such as Merca and Kismayu⁷ which were economic and trade hubs.

After Somalia was placed under Italian trusteeship in 1950, a joint stock company, the Cassa per la Circolazione Monetaria Della Somalia, was established to act as an autonomous monetary authority that issued Somali currency and facilitated exchange rate operations.⁸ During the same period, National and Grindlays Bank, formerly known as the National Bank of India, operated in British Somaliland, allowing the British administration to pay salaries for their staff.⁹ In 1960, this bank opened its first branch in Mogadishu following the unification of the former British protectorate of Somaliland and Italian Somaliland.¹⁰

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5. Strangio, D. (2012). Companies and Firms in Italian Somalia. The Reasons for Underdevelopment: The Case of Decolonisation in Somaliland, 75-100.

6. History of Banco di Napoli. Accessed at: <https://www.historypage.it/history-of-banco-di-napoli/>

7. <https://momentunion.wordpress.com/2011/12/18/central-bank-of-somalia/>

8. Strangio, D. (2012). Companies and Firms in Italian Somalia. The Reasons for Underdevelopment: The Case of Decolonisation in Somaliland, 75-100.

9. HIPS interview with former deputy governor of the CBS, 2022.

10. Ibid.

After independence in 1960, with the recommendations of the IMF and the World Bank, the National Bank of Somalia (NBS) was established under Decree-Law No. 3/1678. The bank was intended to take over issuing Somali currency from the Cassa per la Circolazione Monetaria Della Somalia, as well as to provide commercial banking activities.¹¹ In 1968, after merging with the Somali Credit Bank, the NBS was empowered with regulating Somalia's banking and credit systems and managing its external reserves.¹² The government also established the Somali Development Bank (SDB) under the Decree-Law No.2 of 28 February 1968.¹³ It provided financing facilities for strategic economic sectors such as agriculture-related industries and infrastructure development.



Following the military takeover by Siyad Barre, the government undertook a major economic policy shift by nationalizing all foreign banks. In 1971, Banco di Napoli, Banco di Roma, National and Gridlays Bank and Banque de Port were merged to form the Somali Commercial Bank

Following the military takeover by Siyad Barre, the government undertook a major economic policy shift by nationalizing all foreign banks. In 1971, Banco di Napoli, Banco di Roma, National and Gridlays Bank and Banque de Port were merged to form the Somali Commercial Bank.¹⁴ It was registered as public institution and all the assets and liabilities were taken over by the government.¹⁵ The new government also founded the Somali Saving and Credit Bank to take over the commercial portfolio of the Somali National Bank. The bank had branches in Kismayo, Hargeisa, Galkacyo, Beledweyne and Bosaso among other major cities. The Saving and Credit Bank was primarily catering to micro and small businesses and also provided lending facilities for agricultural and housing construction.

In 1975, The military government renamed the National Bank of Somalia to the Central Bank of Somalia, exclusively handling quantitative controls and allowable interest rate policy and, in a few instances, providing short-term credit to industrial businesses.¹⁶ Barre's revolutionary government also merged the Commercial Bank and the Credit and Saving Bank into the Somalia Commercial and Saving Bank.¹⁷ As a result, the banking sector failed to play a meaningful role in Somalia's economic development, such as attracting foreign and domestic private investments and providing sufficient liquidity facilities to businesses.

In the late 1980s, much like the rest of the country's economic institutions, the banking system was deteriorating due to the rapid increase in lending to people who were favored by the ruling regime and uncreditworthy public companies. This resulted in high inflation and financial crises.¹⁸

11. Naparst, N. (2018). Was the Cassa per la Circolazione Monetaria della Somalia an Orthodox Currency Board? (No. 125). The Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise. https://sites.krieger.jhu.edu/iae/files/2020/01/Was-the-Cassa-per-la-Circolazione-Monetaria-della-Somalia-an-Orthodox-Currency-Board_.pdf

12. Somali National Bank Law in 1968. http://www.somalilandlaw.com/Somali_National_Bank_Law_1968.pdf

13. Ibid.

14. International Development Research Centre, 1971. Country Profile Somalia. <https://idl-bnc-idrc.dspacedirect.org/bitstream/handle/10625/1445/9725.pdf?sequence=1>

15. HIPS interview with the former deputy governor of the Central Bank of Somalia, 29 Oct 2022.

16. HIPS interview with the former deputy governor of the CBS.

17. Ibid.

18. Maimbo, S. M, 2006. Remittances and economic development in Somalia. Social Development Papers, Conflict Prevention and Reconstruction, Paper, 38. <https://www.cbd.int/financial/charity/somalia-remittance.pdf>

After the civil war broke out in 1991, the entire banking sector collapsed. The assets and capital of the banks were looted and the infrastructure destroyed. In 1994, a few years after it declared its secession from Somalia, Somaliland established its own Central Bank that was responsible for monetary policy, supervising and regulating private banks and offering very limited commercial activities.¹⁹ Similarly, Puntland established its own regional bank, primarily accepting deposits and administering withdrawals of government revenues as well as licensing and supervising remittance companies.²⁰

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With the absence of a functioning state, the informal banking sector known as Hawala filled the financial services void, offering the transfer of remittances and trade-related transactions. Al-Barakaat, Dahabshiil, Dalsan, Amal Express and Towfiiq were first and largest established money operators in Somalia. They operated without regulations for more than two decades, relying on high levels of trust and good relationships with their clients. The majority of money transfer companies are owned by private shareholders and family groups.²¹ Somalia’s informal financial system, while experiencing significant growth in the last three decades, faced severe challenges in operating in an unregulated environment as well as multiple regulatory regimes in the global financial systems. This included failure to comply with anti-money laundering protocols, lack of customer due diligence, poor governance structures, as well as the absence of unified national payment systems.²²

3.2 Current state of the banking sector

3.2.1 Re-establishing the Central Bank of Somalia

Landmark legislation – the Financial Institutions Law (FIL) in 2012 – allowed the re-established CBS to oversee domestic financial institutions and licensing as well as regulating and supervising the commercial entities that accept deposits from the general public (primarily commercial banks and money transfer businesses), conduct administrative actions and enforce punishments.²³

The Anti-Money Laundering and Countering Financing for Terrorism (AML/CFT) law in 2016 allowed the CBS to combat money laundering and terrorist financing. This was aimed at aligning the financial system with international standards²⁴ as it required financial institutions to implement risk management procedures, conduct due diligence on high-risk customers and report suspicious transactions to the Financial Reporting Center (FRC).

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19. ILO, 2013. Financial Sector Diagnostic Study for Hargeisa, Somaliland. <http://slmof.org/wp-content/uploads/2019/02/Diagnostic-Study-for-Somaliland-Financial-Sector.pdf>

20. Omer, A. (2004). Feasibility study on financial services in Somalia. UNDP, United Nations Development Programme, Online, 132. <https://www.somali-jna.org/downloads/Final%20%20Feasibility%20Study%20%20April-2.pdf>

21. Oxfam International, 2013. Keeping the lifeline open: Remittances and markets in Somalia. Accessed at: <https://oxfamlibrary.openrepository.com/bitstream/handle/10546/297149/bp-keeping-lifeline-open-somalia-remittances-310713-en.pdf?sequence=1&isAllowed=y>

22. Ibid.

23. CBS, 2012. Financial Institutions Law. https://centralbank.gov.so/wp-content/uploads/2022/01/Financial-Institution-Law_2102.pdf

24. CBS, 2016. Anti-Money Laundering and Countering the Financing of Terrorism Act. <https://centralbank.gov.so/wp-content/uploads/2022/01/Anti-Money-Laundering-and-Countering-the-Financing-of-Terrorism-Act-English-Version1.pdf>

The CBS also established a national risk assessment committee and conducted training sessions for financial institutions. These efforts somewhat promoted financial stability and demonstrated Somalia's commitment to combating financial crime and promoting transparency in its financial system.

Other changes introduced by the CBS included:

- In 2014: licensing regulations for commercial banks were put in place.²⁵
- In 2015: regulations for capital adequacy and liquidity risk management were enacted.
- In 2016: regulations for internal audits and related persons transactions were introduced. Commercial banks were required to establish internal audit departments and to develop policies and procedures for managing transactions involving related parties.
- In 2017: regulations requiring commercial banks to submit audited financial statements to the CBS annually.
- Finally, in 2018, the CBS introduced asset classification and provisioning regulations, which required commercial banks to classify their assets and make provisions for potential losses.²⁶

The CBS also developed regulations for money transfer businesses (MTBs) intended to further strengthen oversight and monitoring over the country's nascent financial sector. The registration and licensing regulations introduced in 2014 require MTBs to be licensed by the CBS and meet certain minimum requirements, such as having adequate capital and risk management systems. Regulations introduced in 2015 were designed to prevent money laundering and terrorist financing through MTBs by requiring them to implement robust measures such as customer due diligence and transaction monitoring.²⁷ The MTB customer and operations regulations²⁸ introduced in 2016 were aimed at ensuring that MTBs implement adequate customer due diligence procedures and operational controls, such as security measures to protect customer information and funds.

Mobile money regulations developed in 2020 were critical to regulating the sector, which has become an increasingly popular way for Somalis to access financial services. The CBS also implemented institutional reforms to strengthen its workforce and core departments.



The registration and licensing regulations introduced in 2014 require MTBs to be licensed by the CBS and meet certain minimum requirements, such as having adequate capital and risk management systems

25. CBS, 2014. Regulations on Bank Licensing. <https://centralbank.gov.so/wp-content/uploads/2022/01/Regulation-on-Bank-Licensing.pdf>

26. CBS, 2018. Regulation on Asset Classification and Provisioning. https://centralbank.gov.so/wp-content/uploads/2020/06/Asset-Classification-and-Provisioning-Regulation-CBS_REG_09.pdf

27. CBS, 2015. Regulations for Money Transfer Businesses on Anti-Money Laundering. <https://centralbank.gov.so/wp-content/uploads/2018/07/AML-for-MTB-Regulation.pdf>

28. CBS, 2016. Regulations for Money Transfer Businesses on Customer Registration. <https://centralbank.gov.so/wp-content/uploads/2020/02/Customer-Identification-Regulation.pdf>

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The CBS has yet to restore its monetary policy role since the collapse of the state in 1991. The country's official currency is the Somali shilling, however, the majority of the banknotes in circulation are counterfeit, which has led to the economy being highly dollarized

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The main challenge is the significant budget gap required to finance the development and production of the new banknotes

The bank hired experts in key areas such as currency and banking operations and monetary, financial, and regulatory policy, as well as financial administrative and support services. The CBS provided capacity building programs for its staff, both in-house and overseas, to learn from best practices. Operationally, the CBS is limited to Mogadishu, however, there are plans to open branches in the capital cities of each federal member state, according to a CBS senior official.²⁹

The CBS has yet to restore its monetary policy role since the collapse of the state in 1991. The country's official currency is the Somali shilling, however, the majority of the banknotes in circulation are counterfeit, which has led to the economy being highly dollarized. Both formal and informal financial markets carry out daily transactions using the US dollar.³⁰ The volatility of the Somali shilling and its rapid fluctuations against the US dollar is a key challenge facing the country's financial sector. It is the currency traders in the Bakara market in Mogadishu who are currently setting the exchange rate, according to one expert interviewed for this report.³¹

According to a senior official interviewed for a report, the Federal Government of Somalia (FGS) has prioritized the development of new banknotes but faces financial and political obstacles hindering progress. The main challenge is the significant budget gap required to finance the development and production of the new banknotes, as Somalia's annual budget is largely funded by external donor grants, which are primarily allocated for the security and administration sectors of the country.³² Furthermore, the FGS and Federal Member States (FMS) must reach a consensus on the monetary policy of the country, particularly the development of the currency. While the FGS is responsible for developing the monetary policy, FMS must be consulted and agree on the development of new banknotes. Security issue is also another obstacle as some part of the country is controlled by the militant group Al-Shabaab, and the distribution of new banknotes must cover all regions. Therefore, it is imperative that the CBS prioritizes the allocation of resources towards the development of a new currency and establish policies and strategies to manage monetary policy. A stable and reliable currency would not only improve the financial sector but also boost Somalia's economic reconstruction.

29. HIPS interview, 2023.

30. World Bank, 2022. Collection of Policy Notes for the New Government: Unlocking Somalia's Potential to Stabilize, Grow and Prosper. <https://openknowledge.worldbank.org/server/api/core/bitstreams/4b07892d-d8a4-5a8e-9f35-bf67dd57d02f/content>

31. HIPS interview, 2023.

32. HIPS interview with a senior official at the CBS, 2023.

3.2.2 National payment system

In 2021, Somalia launched its first national payment system (NPS) to allow intra-bank transactions among 13 commercial banks.³³ This was a landmark step aimed at developing an effective financial industry. Information technology infrastructure was put in place including computer equipment, software required to operate and regulate that hardware, application software created to process payments, and qualified personnel to manage and run the system.³⁴ This groundwork step was successfully implemented by the CBS for transactions to become inter-operable among financial institutions.

Secondly the NPS implemented Somali Transaction Reporting System (STARS) project. This process consists real-time gross settlement system which enables movement of high-value payments within 60 minutes and involve money market transactions, securities' settlements and time-sensitive commercial transactions, as well as automated clearinghouse (ACH) for lower-value payment processes with obligations between commercial banks settled at the end of the day session to provide services such as payroll processing.



Three months after the launch of the NPS, the number of transactions had cumulatively reached 222,697 with a combined value of \$214.1 million

Three months after the launch of the NPS, the number of transactions had cumulatively reached 222,697 with a combined value of \$214.1 million.³⁵ The total value of the transactions facilitated by the NPS since its inception is more than \$1 billion.³⁶

Economic activity, aggregate monetary management, transaction costs, and the creation of new financial products—all of which could serve as significant sources of fee income for financial institutions—are anticipated to benefit from the establishment of the country's payment system. The NPS also moves Somalia one step closer to integrating into the global financial institutions.



The main obstacle to the full implementation of the NPS switch is the unwillingness of some of the players in the financial sector to complete in house bylaws required to comply with the system

However, the NPS has yet to operationalize Somali Payment Switch that can connect to any point of sale (POS) system, ATM, mobile payment system, and web-based commerce portals. It can then combine all electronic transactions and intelligently direct them to one or more payment processors for authorization and settlement.

The main obstacle to the full implementation of the NPS switch is the unwillingness of some of the players in the financial sector to complete in house bylaws required to comply with the system including providing approval signatures of their board of directors; and the lack of ICT personnel and technicians to develop the technical capacity that is required to be linked to the system.³⁷

33. CBS, 2021. Somalia Launches first National Payment System. <https://centralbank.gov.so/national-payment-system/>

34. HIPS interview with the executive director of currency and banking operations at the CBS.

35. CBS, 2021. Quarterly Economic Review (2021Q4). <https://centralbank.gov.so/wp-content/uploads/2022/08/Quarterly-Economic-Report-2021-Q4.pdf>

36. HIPS interview with the executive director of currency and banking operations at the CBS, January 2023.

37. HIPS interview with a financial sector expert.

3.2.3 Commercial banks

Following the re-establishment of the CBS, the FGS gradually began regulating and supervising the various financial institutions including commercial banks, money transfer businesses and mobile money operators. According to the CBS, there were seven commercial banks and 12 mobile money transfer businesses operating in Somalia in 2018. The seven licensed banks include: Dahabshiil Bank International, Amal Bank, International Bank of Somalia, Salam Somali Bank and Trust African Bank. These banks primarily provide Islamic banking products and none offer conventional banking services. At the end of March 2020, customers' deposits, predominantly in the form of current accounts based on Qard Hasan and Mudārabah investment accounts, constituted 80 percent of funding sources. Customer assets are essentially short-term financing, followed by cash on hand and investments in property and joint ventures. While Murābahah contracts, including commodity Murābahah, are predominantly used in the financing of transactions, other contracts such as Istisnā Mudārabah and Mushārahah are slowly being used by the banks.

Table 1: Somali commercial banks

Name	Year established
Agro Bank	2019
Amal Bank	1998
Amana Bank	2019
BB Bank	2020
Dahabshil Bank International	2014
Daryeel Bank	2006
Galaxy International Bank	--
Idman Community Bank	2020
International Bank of Somalia (IBS)	2014
MyBank	2018
Premier Bank	2013
Salam Somali Bank	2009
Sombank	2019

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The number of commercial banks increased to 13, as some of the money transfer businesses were awarded full banking licenses by the CBS

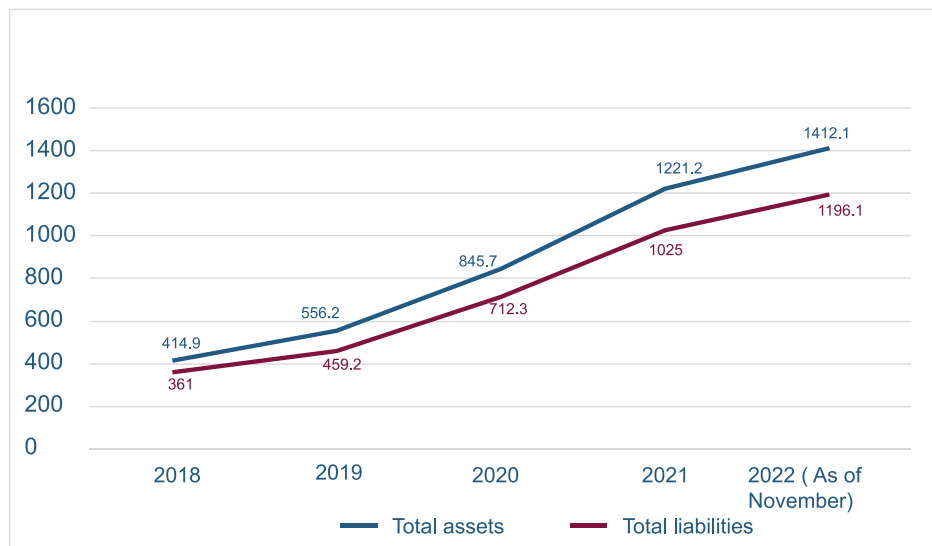
In 2021, the number of commercial banks increased to 13, as some of the money transfer businesses were awarded full banking licenses by the CBS. They include: Salaam Somali Bank, Dahabshil Bank International, IBS Bank, Premier Bank, Galaxy International Bank, MyBank, Sombank, Daryeel Bank, Amana Bank, Amal Bank, Agro Bank, BB Bank and Idman Community Bank. The majority have branches in the major towns and some have branches in neighboring countries.

It is important to note that, although commercial banks in Somalia primarily offer Islamic banking products, the country has not yet enacted specific Islamic finance legislation to regulate this sector. Implementing comprehensive Islamic finance laws would provide a clear legal framework and ensure the proper governance and oversight of Islamic banking practices in Somalia.

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Based on the third quarter of the 2022 financial reporting year, the total assets of the commercial banks in Somalia reached \$1.4 billion

The banking sector is experiencing a steady improvement despite facing challenging conditions. Figure 1 shows that the consolidated total assets of commercial banks surged to \$1.2 billion in 2021 from \$414 million in 2018. Total assets increased further in 2022 after new banks were registered and licensed by the CBS as commercial banks. Based on the third quarter of the 2022 financial reporting year, the total assets of the commercial banks in Somalia reached \$1.4 billion. Cash on hand is the largest asset (half of the total), followed by financing assets (\$253.8 million) and investment assets (\$222.1 million). Other assets accounted for \$74.2 million in 2022.

Figure 1: Consolidated total assets and liabilities for commercial banks in Somalia (millions)



Source: Central Bank of Somalia

The total liabilities of commercial banks increased to \$1.2 billion in 2018 from \$361 million in the third quarter of 2022 (see Figure 1). Customer deposits (demand deposits of commercial banks and individual deposits) represented a significant amount of total liabilities (\$1 billion) followed by other liabilities (\$75 million).³⁸ Microfinance loans constituted a small fraction of total liabilities (\$1.7 million as of March 2022).



There are significant risks associated with the commercial banks' exposure to real estate, which has been increasing in recent years. This has caused the real estate sector to experience significant overheating and there are signs of a bubble forming

There are significant risks associated with the commercial banks' exposure to real estate, which has been increasing in recent years. This has caused the real estate sector to experience significant overheating and there are signs of a bubble forming. In addition, the banking industry has a large, related party exposure (banks overwhelmingly lend to entities that are related to them). "There is a concentration risk with this" said a senior CBS official.³⁹

Most bankers and CBS officials interviewed for this study reiterated that commercial banks are adequately capitalized, despite the fact that their performance varies greatly, and asset quality is limited compared with regional peers. For instance, Liberia's banking sector's capital adequacy ratio stood at 31.8 percent in 2021⁴⁰ while Somalia's was 13.3 percent.⁴¹ While it is understandable that the nature of economic fragility impedes the performance of the banking sector, risk concentration, credit quality and growing liquidity constraints are said to be key bottlenecks to the efficiency and soundness of the sector. Operational risks such as using in-house systems remain a serious concern for Somali banks. There are also significant internal control weaknesses such as fraud, theft, system outages, data loss and cyber security breaches.⁴²

Contrary, the stability of Somalia's banking sector's asset quality, as reflected by the non-performing loans (NPLs) ratio, has been impressive over the years. Between 2019 and 2022, the sector maintained a low NPLs ratio of 3%, which can be attributed to the country's improved banking performance as well as the compliance measures of the CBS. However, in 2020, the total amount of NPLs increased to \$9.6 million, reflecting the negative impact of the COVID-19 pandemic on the sector.⁴³ Nevertheless, the amount NPLs declined to approximately \$6.1 million in 2021 as the economy rebounded.

38. Central Bank of Somalia (CBS) Quarterly Economic Review (2022Q2). https://centralbank.gov.so/wp-content/uploads/2023/02/Quarterly-Economic-Report_Q2_2022_12Feb23.pdf

39. HIPS interview 2023.

40. World Bank Report, 2022. Liberia Economic Update: Investing in Human Capital for Inclusive and Sustainable Growth. Accessed at <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099455109192219278/p177994009187f0f60ba8d0fe0eeb8b19ec>

41. World Bank report, 2022. Somalia Economic Update: Investing in Social Protection to Boost Resilience for Economic Growth. <https://openknowledge.worldbank.org/bitstream/handle/10986/38206/P17502402429f50e708a6408e3872dbb193.pdf?sequence=1&isAllowed=y>

42. HIPS interview, 2023.

43. CBS data on commercial banks of Somalia, 2023.



The industry's net financing assets grew from approximately USD 156 million in 2019 to USD 292 million in 2022, based on CBS data

Despite the challenges posed by the pandemic and other existential threats such as climate change, the industry's net financing assets grew from approximately USD 156 million in 2019 to USD 292 million in 2022, based on CBS data. The sector's exposure to liquidity risk remained low during this period, with the ratio of liquid assets rising from 35% in 2019 to 52% in 2022.⁴⁴ This increase ensured that the country's commercial banks had adequate liquidity to meet their financial obligations.

The credit availability scenario for businesses and individuals in Somalia is typically true for any war-ravaged economy where lack of financial infrastructure prohibits the development of effective credit financing tools. A study by Ernst & Young in 2018 indicated that the gap between the demand for credit from both businesses and individuals and supply is about \$2 billion.⁴⁵ The major means of raising of finance for both individuals and businesses is still informal sources such as family, friends and business acquaintances. According to the report, about two-thirds of businesses depend on friends or family to cover financial needs. Businesses use these informal sources due to the unfavorable terms and conditions offered by financial institutions and because they lack collateral.⁴⁶

In 2022, the World Bank released an economic update for Somalia showing credit to the private sector declined in 2021. According to the report, commercial banks' credit to the private sector as a share of total assets decreased to 25.5 percent in 2021, down from 26 percent in 2020.⁴⁷ In this regard, trade is the primary financing asset accounting for 32 percent, followed by construction loans and real estate loans. Somalia is at the bottom of the world's access to credit indicator, at 4.2 percent of GDP.⁴⁸



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There are six major microfinance organisations in Somalia, many linked to commercial banks. Additionally, numerous national and international NGOs offer microfinance products that are significantly subsidized.

However, microfinance remains very underdeveloped, and the CBS has yet to develop a specific microfinance regulation framework to help facilitate access to credit by the private sector, particularly for small businesses. Regulations were cited as crucial to improving access to credit for the private sector as well as facilitating loans to help small businesses to thrive. A CBS official said that the establishment of credit bureau and microfinance bills are underway and will soon be submitted to parliament.

44. Ibid.

45. Ernst & Young, 2018. Expanding the Circles of Trust: Unleashing the Power of Financial Intermediation and Global Connectedness for Somalia.

46. Ibid.

47. World Bank report, 2022. Somalia Economic Update: Investing in Social Protection to Boost Resilience for Economic Growth. <https://openknowledge.worldbank.org/bitstream/handle/10986/38206/P17502402429f50e708a6408e3872dbb193.pdf?sequence=1&isAllowed=y>

48. IMF, 2022. 2022 Article IV Consultation and Fourth Review under the Extended Credit Facility-Press Release; and Staff Report. <https://www.imf.org/en/Publications/CR/Issues/2022/12/16/Somalia-2022-Article-IV-Consultation-and-Fourth-Review-under-the-Extended-Credit-Facility-527022>

“deficiencies in the legal and judicial framework and weaknesses in contract enforcement, as well as lack of credit information impedes access to credit to small businesses and prevents loan recovery

“More than 80 percent of the population uses mobile money transactions, compared to 8.8% who have bank accounts for their financial transactions

Accessing credit is also difficult because Somalia’s economy is largely informal. According to a 2021 World Bank report, two-thirds of firms in major cities like Mogadishu and Bossaso are informal businesses. The majority of businesses, SMEs in particular, operate on a cash basis, which makes it challenging for banks to grant them credit. One bank manager said that “deficiencies in the legal and judicial framework and weaknesses in contract enforcement, as well as lack of credit information impedes access to credit to small businesses and prevents loan recovery”. He said dysfunctional courts which cannot be relied on to uphold agreements or collect loans are another obstacle to extending and diversifying lending.⁴⁹

3.2.4 Mobile money

Mobile money has been a significant source of financial services for the unbanked population, making Somalia one of the most active mobile money markets in the world. More than 80 percent of the population uses mobile money transactions, compared to 8.8% who have bank accounts for their financial transactions, according to the recent Integrated Household Budget Survey.⁵⁰ Services used include deposits of eMoney to mobile money accounts, cash withdrawals, merchant payment transactions and payment of salaries.

With the support of the World Bank’s Somalia Capacity Advancement, Livelihoods and Entrepreneurship, through Digital Uplift Project—SCALED-UP, the CBS developed mobile money regulations in 2020⁵¹ which stipulated that mobile network operators (MNOs) must obtain a license from the National Communications Authority (NCA). Mobile money was defined as a monetary value that is stored on any electronic device, not simply a mobile phone.⁵² Four MNOs were licensed: Hormuud Telecom, SOMTEL SOMALIA LTD, SOMLINK Telecom, and GOLIS Telecom.⁵³ Other MNOs still operate without a license, according to one official interviewed for this study.

Although mobile money offers opportunities, it also carries enormous risks. For instance, there are no explicit “Know Your Customer” requirements on customer identity under the current system being used, nor is there any parity between eMoney and physical cash in banks. Several participants claim that due to a lack of interoperability between various services and openness regarding finances, mobile money is unreliable and puts their money at risk.

49. HIPS interview with a bank manager.

50. SNBS, 2023. Somalia Integrated Household Budget Survey. <https://api.nbs.gov.so/wwwroot/Publications/188d169e4c294911a1e0c58ab00fd390.pdf>

51. CBS, 2020. Mobile Money Regulations. https://centralbank.gov.so/wp-content/uploads/2021/03/Mobile-Money-Regulation-2020_amended.pdf

52. Ibid.

53. CBS, supervision and licensing. <https://centralbank.gov.so/licensing-supervision-department/>

3.2.5 Money transfer businesses

Money transfer businesses (MTBs), also known as Hawala, represent a significant part of Somalia's informal financial sector. The MTBs facilitate domestic and international remittance inflows and trade transactions, as well as the transfer of humanitarian funds. The country has 12 licensed MTBs.⁵⁴ The best established are: Amal Express money transfer, Dahabshiil Money Transfer, TAAJ Money Transfer, Iftin Express LTD and Tawakal Money Transfer. Most operate across the globe using office agents and third-party financial entities to physically transport the money to Dubai – which serves as a financial clearing house for the MTBs.

Although the MTBs have been the backbone of Somalia's informal financial system for over three decades, many have now converted their businesses to banks which has contributed to the growth of the banking sector in the past two years. The remaining MTBs face considerable interrelated challenges that include poor compliance with anti-money laundering/countering the financing of terrorism (AML/CFT) regulations, lack of effective Know-Your-Customer mechanisms as well as lack of connections with the global financial system.⁵⁵ These challenges inhibit the operation and growth of MTBs which remain critical for the Somali people as they are key to the facilitation of remittances which are the lifeline of the Somali economy.

Complying with both domestic and international AML/CFT regulations requires concerted efforts such as improving the capacity of MTBs' personnel and developing proper identification systems to enhance KYC as well as sound government enforcement against those facilitating illicit financial activities. Financial experts believe that addressing poor compliance issues among MTBs, and the banking sector in general, is inextricably linked to the development of a national ID system to help identify customers and any criminal activities.

3.2.6 Foreign banks

In 2022, the CBS granted license for two foreign banks: the Turkish bank Ziraat and Egypt's Banque Misr. They became the first two international banks to get an operating license since Siyad Barre nationalized all foreign banks. Policymakers, scholars and domestic banks are deeply divided over the issue of granting licenses to foreign banks. Some view the move as timely and potentially beneficial, as it could increase access to capital and stimulate economic growth. Others believe it is detrimental to the growth of the domestic financial sector.



Policymakers, scholars and domestic banks are deeply divided over the issue of granting licenses to foreign banks

54. CBS, list of licensed money transfer businesses. <https://centralbank.gov.so/licensing-supervision-department/>

55. HIPS interview, 2023.

From a public policy perspective, foreign banks could help drive investment and development – easing international trade transactions, fostering increased efficiency and market discipline, and providing access to credit and more sophisticated products and services. According to Ross Levine, the entry of foreign banks into a country improves access to internal capital flows, facilitates the quality and availability of modern financial services with banking skills and technology, stimulates competition in domestic financial markets and improves domestic policy and financial infrastructure – which in turn promotes domestic financial development.⁵⁶ Government authorities hope that granting licenses to foreign banks could be a pathway for engaging with the global financial system and capital market flows, since domestic banks struggle to comply with international financial protocols and standards.⁵⁷

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Local banks believe they are vulnerable to outside competition, considering that foreign banks generally have higher capital adequacy

However, local banks have raised concerns about the government’s decision to grant licenses to Ziraat and Banque Misr. They say there are no regulations in place to govern how foreign banks will operate, or under what conditions they would be excluded from accessing the same financial products and services currently offered by domestic banks. Local banks believe they are vulnerable to outside competition, considering that foreign banks generally have higher capital adequacy.⁵⁸

CBS authorities interviewed for this report said that licenses granted to foreign banks are restricted to corporate banking activities.⁵⁹ Foreign banks are prohibited from offering retail banking and need minimum capital of \$20 million to set up compared with \$5 million for local banks which have a universal license allowing them to conduct retail and corporate banking.⁶⁰

Some experts interviewed for this report believe that foreign banks enhance the local banking industry by bringing in expertise and resources, as international airlines did for the local airline industry.⁶¹ Foreign banks could create healthy competition and improve financial services, leading to better customer service, increased access to credit and lower transaction fees. This can be observed through the examples of Ghana and Kenya. In Ghana, the presence of foreign banks has played a crucial role in boosting the return on assets of domestic banks. The competition introduced by foreign banks has forced domestic banks to enhance their performance and operational efficiency, thereby leading to improved financial results.⁶² The increased competition has also spurred innovation and the adoption of best practices by domestic banks to remain competitive in the market.

56. Levine, R. (1996). Foreign banks, financial development, and economic. *International financial markets: Harmonization versus competition*, 224.

57. HIPS interview with CBS senior official, 2022.

58. HIPS interview, 2023.

59. CBS regulation (Ban Licensing), revised version March 2022.

60. HIPS interview with CBS official.

61. HIPS interview, 2023.

62. Acheampong, 2013. The effects of foreign bank entry on financial performance of domestic-owned banks in Ghana. *The International Journal of Business and Finance Research*, 7(3), 93-104.



However, it is crucial for CBS to strike a balance between encouraging foreign bank entry and ensuring financial stability and oversight

Similarly, in Kenya, the entry of foreign banks has resulted in a more efficient domestic banking sector. As competition intensifies, domestic banks have been compelled to enhance their operations, reduce costs, and improve service quality. This has translated into a decrease in lending rates, making financing more affordable for businesses and individuals.⁶³ However, it is crucial for CBS to strike a balance between encouraging foreign bank entry and ensuring financial stability and oversight. Adequate regulatory frameworks and supervision mechanisms should be in place to manage potential risks and maintain the stability of the domestic banking system. This includes effective risk assessment, capital requirements, and monitoring of foreign bank operations to safeguard the interests of customers and the overall financial stability.

4. Developing Somalia's banking sector

Though Somalia's banking sector has been expanding, it continues to face numerous challenges. These constraints include a weak regulatory environment, global financial system de-risking, the absence of a national ID for AML/CFT compliance, poor capacity (including lack of skilled manpower), lack of cooperation among banks and regulatory bodies and insecurity which undermines expansion.

4.1 Weak regulatory environment

After the revival of the CBS in 2009, fundamental laws and regulations such as the Financial Institutions Law were put in place. This law allows the CBS to register, regulate and monitor commercial banks and other financial institutions. With the assistance of international partners, Somalia passed the AML/CFT law in 2016 to assess and manage risks associated with money laundering and financing for terrorism transactions. These laws were a landmark step towards reforming the country's informal financial system.



However, problems exist with enforcing the laws due to the country's dysfunctional judicial system.

However, problems exist with enforcing the laws due to the country's dysfunctional judicial system. There are concerns that several commercial banks and MTBs carry out money laundering and terrorism financing. According to a participant of this study, al-Shabaab uses local banks to save and transfer their money. The participant said, "I am not saying all of them but some of the banks facilitate embezzlement of funds by corrupt politicians and elites."

63. Oino & Ukaegbu, 2014. The impact of foreign bank entry on domestic banking in a developing country the Kenyan perspective. *Banks and Bank Systems*, 9(1), 28-35.

Though the CBS has made progress in improving the regulatory framework of banks, a number of essential laws are still not in place. For instance, the majority of Somali banks provide Islamic banking products such as Musharakah and Mudarabah, but there are no specific guidelines that safeguard the practice of Sharia-based transactions. Developing an Islamic banking act is one of the most important ways to foster credible Islamic banking in the country.

In 2021, an IMF report noted a lack of internal control procedures, particularly for ex-post internal Shariah reviews, may result in noncompliance with regulations in the way Somali banks operate.⁶⁴ According to the CEO of the Somali Bankers Association, Sharia-based banking will help minimize the risk associated with Islamic banking products and services, improving the soundness of the country's financial system.⁶⁵

4.2 Tightening of global financial system de-risking

Somali banks and MTBs have seen various levels of isolation from the international financial system since the attacks on the World Trade Center on 11 September 2001. This has made it more challenging for financial entities to interact with foreign banks, particularly in the US, the UK and other European nations where correspondent accounts and banking services were suspended.



Poor perception of the international financial system towards Somali banks is an obstacle to deepening the country's financial sector

Somalia's banks and their customers heavily relied on third-party international banks such as Merchants Bank for remittance-related transactions and banking services. However, the US-based bank took further de-risking, which resulted in the discontinuation of its money transfer services.⁶⁶ This has affected many households in Somalia, where remittances are a lifeline. Some participants of this study said, poor perception of the international financial system towards Somali banks is an obstacle to deepening the country's financial sector, which facilitates massive funding flows from and to domestic banks.



Global banks still lack trust in their Somali counterparts which impedes the growth of the sector

Despite the new laws and regulations, global banks still lack trust in their Somali counterparts which impedes the growth of the sector. A CBS official said that despite Somalia adopting AML legislation and a financial intelligence unit that is aimed at detecting and disrupting money laundering and terrorism financing, it is difficult to reengage with the international financial system.⁶⁷

64. See IMF Report, 2021. Technical Assistance Report-Bank Supervision and Regulation of Somalia. available at, <https://www.imf.org/en/Publications/CR/Issues/2021/03/31/Somalia-Technical-Assistance-Report-Bank-Supervision-and-Regulation-50315>

65. HIPS interview

66. Reuters, 2015. U.S. bank ending of Somalia money transfers to have a catastrophic impact. <https://www.reuters.com/article/uk-usa-somalia-remittances-idUKKBN0L726A20150203>

67. HIPS interview

4.3 Absence of national ID



A national ID is an accepted mechanism for accessing financial services around the world –where know your customer (KYC) and due diligence protocols are prerequisites for opening bank accounts

The lack of a national identification card is another major challenge confronting the banking sector. A national ID is an accepted mechanism for accessing financial services around the world –where know your customer (KYC) and due diligence protocols are prerequisites for opening bank accounts. Somalia has no comprehensive national identification system. Somali banks currently use various verification mechanisms including birth certificates, passports and driving licenses.

In 2020, the FGS president Mohamed Abdullahi Farmaajo signed the National ID Act to establish the National Population Identification and Registration Authority (DADSOM) which would issue identification cards to citizens and those who are legally residing in Somalia. However, this legislation was returned to the cabinet by the current president, Hassan Sheikh Mohamud, who called for amendments. In January 2023, the Ministry of Interior, Federal Affairs and Reconciliation tabled a new National Identification and Registration of Persons bill in parliament which passed in March 2023 and was signed into law by the president.

4.4 Lack of capacity



Lingering understaffing is among the critical constraints, with the CBS estimated to have less than half the staff it requires to meet demands. Staffing shortages are the result of the uncompetitive salaries being offered

Despite all the efforts of the CBS with the support of international partners including the IMF and the World Bank, the sector still faces significant challenges with institutional capacity. On the government side, the IMF has been providing technical assistance to strengthen the CBS’s capacity to supervise banking activities and operations. However, the effectiveness of onsite supervision has been hampered by the difficulty in finding highly skilled and knowledgeable employees who have sufficient knowledge of both Shariah and conventional aspects of banking operations. Lingering understaffing is among the critical constraints, with the CBS estimated to have less than half the staff it requires to meet demands. Staffing shortages are the result of the uncompetitive salaries being offered. It is important to note, however, that the CBS recently hired three executives and one manager, but their salaries are paid by the World Bank.

Managing day-to-day banking activities is also constrained by the lack of skilled manpower. The Bankers Association CEO said, “lack of skilled workforce in modern banking operations such as accounting standards, reporting and digitization of financial services provision hinder the growth potential of Somali banks.”⁶⁸

68. HIPS interview with the Somali Bankers Association CEO.

Though some banks provide capacity building training programs both in-house and overseas for corporate governance, digital services sales, customer care and risk management, the lack of technical-know-how is inhibiting the development of a sound banking sector. This suggests that transforming Somali banking requires skills development interventions.

4.5 Security and political chaos

“Conflicts and insecurity lower banks’ balance sheets, lead to inefficiencies in operational management and negatively affect asset and liability allocations

The security situation and instability poses obstacles to expanding banking services to rural areas, especially locations under al-Shabaab control. A 2016 study by Rother, Pierre, Lombardo, Herrala, Toffana, Roos and Manasseh found that conflicts weaken financial performance as banks cannot sustain financial intermediation and payment systems.⁶⁹ An IMF report in 2020 also found that conflicts and insecurity lower banks’ balance sheets, lead to inefficiencies in operational management and negatively affect asset and liability allocations.⁷⁰

The vast majority of the Somali population has no banking service. The 2022 National Bureau of Statistics’ Integrated Household Budget Survey (SIHRS) indicated that only 8.8 percent of the population over the age of 15 have a bank account, with the highest concentration in urban areas.⁷¹ However, the percentage decreases in rural areas and nomadic regions, with only 7.7% and 2.0% of people having bank accounts, respectively.⁷² The banks interviewed for this report were reluctant to open branches in insecure environments, where violent conflicts remain active. IBS and Premier Bank – two banks that provide modern banking services such as ATMs – recently opened branches in major cities but are cautious about moving into rural areas. “If not addressed, insecurity conditions could pose severe dangers to the viability and survival of individual banks as well as the sector’s performance as a whole,” said one bank manager.

5. Conclusion

Somalia’s financial sector breaks down into four distinct groups: commercial banks, micro finance institutions, mobile money and MTBs. Though the banking sector is gradually maturing, and the CBS has regained the authority to license, supervise and monitor banks, only 8.8 percent of the population have bank accounts. Less than 0.5 percent of those are active users. Challenges impeding further development of the banking sector include weak regulatory framework, the absence of a national ID, increasing conservativeness and tighter controls in the global financial system, poor access to credit, insecurity and political chaos.

69. Rother, M. B., Pierre, M. G., Lombardo, D., Herrala, R., Toffano, M. P., Roos, M. E., ... & Manasseh, M. K. (2016). The economic impact of conflicts and the refugee crisis in the Middle East and North Africa. International Monetary Fund. <https://www.elibrary.imf.org/view/journals/006/2016/008/article-A001-en.xml>

70. IMF, 2020. The Impacts of Conflict and Political Instability on Banking Crises in Developing Countries. <https://www.elibrary.imf.org/view/journals/001/2020/041/article-A001-en.xml>

71. SNBS, 2023. Somalia Integrated Household Budget Survey. <https://api.nbs.gov.so/wwwroot/Publications/188d169e4c294911a1e0c58ab00fd390.pdf>

72. Ibid

6. Policy recommendations

1. Improve regulatory measures to support a reputable and sound financial system by developing new legislation and implementing existing laws. Key laws such as the Financial Institutions Law, the Anti-Money Laundering and Countering the Financing of Terrorism Law, as well as the Financial Sanctions Law require implementation strategies with clear and measurable milestones. Given the limited financial and technical capacity of the FGS, international partners should provide assistance in operationalizing financial regulations and drafting the remaining bills in an inclusive manner. For implementation to succeed, it is critical that the views of bankers and other financial players are taken into account.
2. Government should enact a dedicated Islamic finance law that regulates Islamic banking activities, and enable transactions to be carried out in accordance with the Shari'ah principles, as well as the governance standards of Islamic banking operations.
3. Somalia should expedite the introduction of new banknotes to reduce the country's dependence on the U.S. dollar. As the country's high dollarized economy is associated with several risks, including loss of monetary policy, loss of seigniorage, and heightened liquidity risks, FGS must prioritize re-establishing new banknotes. This should be followed by putting regulations, strategies, and policies that can promote the use of Somali currency over the US dollar.
4. Enhance the capacity of economic institutions such as the CBS as well as the judicial agencies that support the implementation of supervisory and regulatory frameworks. This includes adopting merit-based recruitment and providing training and development programs. Passing legislations and policies will not be enough if there is no human capacity in the public sector institutions to implement them.
5. The FGS should expedite the process of developing a national ID to improve access to financial services for unbanked people as well as protect and mitigate the risks associated with theft, money-laundering and terrorist financing. Banking sector stakeholders suggested that the absence of a national ID is a key impediment to reintegrating Somalia into the global financial system. As debate about who is a Somali citizen could drag on for years and slow down the process, study participants proposed developing a temporary financial ID which could be merged with the national ID once it is developed.

6. The CBS should advance the national payment system by implementing payment switch and passing payment bill. The recent establishment of NPS was a big step towards efficient and reliable payment system. However, this report finds that current payment system is based on manual arrangements and associated with long cycle of clearing and payment settlement, thus resulting in increased systemic risks. Therefore, Firstly, FGS authorities should accelerate the enactment of specific National Payment Law for the efficient oversight of the payment system. Second, in parallel with strong legal framework, market players would need to have the technical and risk management capabilities to be able to understand their roles and responsibilities within the context of the national payment switch.
7. The FGS, with the support of international development partners, should tackle the barriers that limit access to financing for Somali entrepreneurs and those engaged in productive sectors. This requires microfinancing legislation to provide a sound legal basis, combined with the development of a credit information bureau and broadening access to credit to businesses such as agriculture. International development partners are encouraged to provide financial injections for credit development of the local banks.
8. Invest in the capacity of the banking workforce. This report reveals that lack of qualified manpower is an impediment to progress. A well-developed financial sector cannot operate without skilled human resources. Improving the technical skills of banking sector personnel is a rapidly growing need and one of the sector's top priorities. This can be achieved by fostering close collaboration between commercial banks, government and higher education institutions in providing a qualified cadre with modern financial and technical skills required by the banking industry. Such a partnership will enhance the employability of graduates and enable them to meet the changing demands of the banking sector.
9. This study found that Somali commercial banks concentrate on real estate financing. If the sector collapses, this will trigger a financial crisis. Commercial banks should decrease their investment in real estate and expand their financing of agriculture and entrepreneurship development.
10. Banks should minimize related party exposure and follow CBS regulations on exposure limits to avoid idiosyncratic and systematic risks. Failure to do so will lead to concentration risk. The CBS should also prioritize mechanisms that require greater disclosures by commercial banks.

11. Commercial banks should take operational risk seriously, otherwise people will lose confidence in the banking sector and impede the prospect of deepening financial sector development of Somalia. It is also imperative that banks to prioritize the establishment of comprehensive and enterprise risk management and risk governance strategies, such as implementing robust risk assessment frameworks and strengthening internal controls to successfully mitigate potential risks.
12. The CBS should place a moratorium on new bank licenses as the existing banks need time to converge to regional standards. Also, the sector may already be saturated given the fragility of the country, and the CBS needs more time to improve its regulatory regime and resources.
13. The CBS should adopt a risk-based approach to its supervision regime rather than compliance-based supervision. A risk-based approach would lead to the development of a more robust banking sector as it would focus on weaker and non-compliant banks.
14. Foreign banks should be allowed to access all banking activities to accelerate the development of alternative, and better, service delivery channels to benefit the Somali people. This will deepen the financial sector and contribute to inclusive growth prospects. Another option could be to locally incorporate foreign banks in Somalia. This will give a greater degree of protection against potential financial risks that could emanate from their origin countries. It would also ensure that domestic operations have a long-term capital commitment and a specialized board of directors with specific accountabilities and fiduciary duties for the local entity.

HERITAGE

I N S T I T U T E