



The Emergence of Islamic Banks in Somalia in the Post-Conflict Era: Prospects and Challenges

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Abstract: Since the fall of Somalia's central government in 1991, Somalia experienced an intractable civil war that not only undermined and devastated much of the nations' social life but also, led to a massive collapse of the country's financial sector. Nearly a quarter century, Somalia has no functioning financial system due to the conflict and political mayhem. Such circumstances prevented Somalia from developing an effective and coherent financial system. Following the collapse of the country's institutions, the only financial system that existed during these turbulent times were *Xawaalads* or money transfer operators mostly founded by Somali diasporas migrated to many countries around the world due to the country's instability. Another type of informal financial service emerged during the conflict was mobile money or mobile banking operated by giant telecommunication companies in the country. Following the formation of Somalia's federal government in 2012 and the return of relative normalcy, the major money transfer companies converted to full banking institutions and sought a license from the central bank as full-fledged Islamic financial banks. The purpose of this paper is to explore the emergence of the Islamic banking industry, opportunities and challenges ahead. The paper relied on secondary data obtained from textbooks, journals, newspapers and reports. The study found that Islamic banks in Somalia have potential opportunities but face unique challenges due to the effects of the civil war. The paper also postulates some recommendations for the policymakers to deal with the challenges facing the Islamic banks in Somalia.

Keywords: Somalia, civil war, Islamic banks, opportunities, challenges

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1. INTRODUCTION

Since 1991, Somalia has experienced instability and political unrest for over two and a half decades; it was evident that civil war and intractable economic stagnation have long plagued the country. This led to the country's economic, legal and social institutions cease its functions while the rule of law has no place to function. Just like any other industry in the country, the financial industry has no exception but a total collapse during the turmoil. When the Somali state collapsed, all national institutions, including economic and financial sectors that provided services and regulated the economic matters varnished. Since then, Somalia has no financial institutions except informal money transfer companies which were formed immediately after the collapse of the then central government and more recently, major telecommunication companies introduced mobile money services.

The role of money transfer operators was based on limited monetary services mostly used by Somali diasporas sending money to their loved ones and relatives back home, providing a lifeline to the large segment of the population (The World Bank, 2016). Mobile money services are often used for cash-in transactions, cash-out transactions, and cash withdrawals (Firestone, Kelly & Refon 2017). The service is also used for merchant payment transactions, bills, and salary receipts. As these mobile money operators were unregulated since their inception, they posed financial risks to their customers. Following the country's peace process initiatives that were failed many times due to political disagreements and the subsequent establishment of an internationally recognized federal government of Somalia in 2012, the situation was slowly returning to the normalcy. That gives the economic sectors hope to re-establish its collapsed institutions, including the financial sector. During the conflict era, Somalia's central bank entirely ceased functioning, which resulted in the absence of formal financial sector and the country's monetary authority (Mubarak, 2002).

Before the conflict and the collapse of the state government, the country only had one commercial bank namely Commercial and Savings bank of Somalia; this is the fact that the country was ruled under a socialist government that nationalized private financial institutions and merged in one bank (Mauri, 1988). Such condition made the country's financial system more worse after the only existed financial institutions (Commercial and Savings bank and Central Bank) ceased functioning. When the money transfer companies emerged soon after the collapse of the central government of Somalia, their role was initially limited to money transfers mostly engaged by Somalis living outside the country who channels money back to their relatives. However, after the establishment of the federal government of Somalia and the restoration of the central bank, new Islamic banks were formed, and the major money transfer operators also converted to full-fledged Islamic banks (Central Bank of Somalia, 2018). This was a restoration of hope for the country's financial sector and mainly the Islamic banking industry. Due to the importance of Islamic banking system in the country and need to assess its opportunities and challenges ahead, this paper will contribute to the little literature on this newly emerged industry in the country. The next section will discuss a brief evaluation of Islamic banking and finance in general and Somalia in particular.

2. AN EVALUATION OF ISLAMIC BANKING AND FINANCE

In Islam, the *Quran* and *Sunnah* set out its concepts of equity, morality, fairness justice and many other values that underpin the entire Islamic religion. As such, Islamic finance and banking is based on Islamic Shariah that prohibits *ribah* or interest payments, mandates profit and loss sharing concepts. Islamic banking and finance also emphasize

the ethical investments that can contribute to the greater good of society (Ogunbado, 2017). *Allah* says in the Holy *Quran*:

“Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: “Trading is only like Riba (usury),” whereas Allah has permitted trading and forbidden Riba (usury). So, whosoever receives an admonition from his Lord and stops eating Riba (usury) shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba (usury)], such are the dwellers of the Fire — they will abide therein”. (Surah Al-Baqarah, verse 275).

The *ayah* sheds light on how Islam rejects usury and encourages trade and business. Such principles laid the foundation of the Islamic financial industry’s establishment and its operations. Since its inception in the 1970s, Islamic finance was a new phenomenon in the global financial scenario, which attracted many customers and investors across the globe. Since then, Islamic finance made great strides in many Muslim majority countries and other parts of the world (Rahman & Riyad, 2008). The industry now manages nearly \$2 trillion in assets worldwide with annual growth of 15 to 20 per cent that seems to reflect its resilience and recent developments. Such vast improvements are partly owing to the foundations and principles that grown Islamic financial industry, including ownership and equity participation. Islamic finance also proved its relative resistance and robust to shocks because of guiding principles on risk sharing concepts, links to real sector activities as well as limits on excessive risk-taking (Husseini, Shahmarodi & Turk, 2015).

Nevertheless, such progress should not be taken into a grant as the industry has a century-long conventional counterpart that is more efficient and sophisticated. Islamic financial institutions should, therefore, sum up their utmost efforts to overcome their shortcomings to help their respective economies to progress and prove their self-sustained expansions and progresses. This will not only strengthen their capabilities but will also foster the economies they operate as that conforms to the very objectives of Islamic finance and banking (Warsame, 2016). As in the case of Somalia, the establishment of a financial institution in a volatile environment like Somalia with no prior financial sector in place requires more coherent and effective policies that can help the new Islamic banks to penetrate and fully engage the market to prosper and operate efficiently. Therefore, stakeholders of newly minted Islamic financial institutions in Somalia and relevant regulatory bodies should also learn from their counterparts in the other parts of the world who operated the industry for far too long. Malaysia is an excellent example of those jurisdictions that proved their extensive development in operating very competitive and well-sophisticated Islamic financial industry that runs beyond the border (Musse, 2015). Somalis should, therefore, cope with any imminent pitfalls that they may face during this early stage. The next section will discuss the opportunities for Islamic banks in Somalia.

3. OPPORTUNITIES FOR ISLAMIC BANKING AND FINANCE IN SOMALIA

Kammer et al. (2015) argued that Islamic banking and finance has more potentials in contributing but not limited to three magnitudes. The first contribution is that it encourages financial inclusion, particularly underserved Muslim communities. The second contribution that Islamic banking and finance can offer is the notion that asset-backed financing and risk sharing concepts could offer support for small and medium-sized enterprises or SMEs. Kammer et al. (2015) also postulated that the system could help investments and public

infrastructure. The third contribution suggested by Kammer et al. (2015) is the importance of risk sharing features as well as the prohibition of speculation which reflects the notion that Islamic finance poses less systematic risk than that of its counterpart or conventional finance. The suggestions made by these authors are also applicable to Somalia, a country that is just emerging from quarter-century-long conflicts that destroyed almost all economic sectors with no formal financial sector in place for the last two and half decades. Chapra (1985) emphasized that Islamic finance is convinced for supporting socio-economic goals such as poverty alleviation, the well-being of the ummah, equity, and justice.

These features are relevant and essential for today's Somalia. As a new entrant to the volatile environment, Somalia's Islamic banks will face more difficulties operating in a financial sector that was not functioning for nearly quarter-century but has more potential in capitalizing the country's hundred per cent Muslim population that is in need for strong financial institutions. This is the fact that the only formal financial institutions introduced in Somalia in the post-conflict era are the Islamic banking institutions that were primarily former money transfer operators. Though these institutions lack comprehensive experience, capital, strong governance and robust regulatory institution, their introduction to a fresh market will give a unique chance to fully operate and extend their capacities.

Thus, Islamic finance and banking have unique opportunities to help the financial sector by establishing a stronger financial system that will, in turn, contribute to more nurtured and inclusive Somali economic growth. It is evident that Somali people faced many challenges as they do not experience any formal financial system that can serve their businesses since the collapse of the state. Following the restoration of the country's central bank, the Islamic banking industry gains a foothold in the financial sector. The emergence of Islamic banking in Somalia could reflect that banks' operation as a catalyst of resources mobilization and pooling of funds. With the return of Somali diaspora, the growth of the private sector was increasing, which encouraged many Somali people in business to come back and invest their country back to recover from the ashes. Hammond (2012) argued that Somalis coming from abroad are injecting Somali economy as they are heavily involved in promoting and building private enterprises, public infrastructure, healthcare, and education. These signs are all indicating that the country is making a big comeback that would soon attract business in and outside the country. Hence, this is where Islamic banks can play their integral role in answering the private sectors' need for stronger and Islamic financial intermediaries that serve both surplus and deficit units.

Furthermore, opportunities for the growth of Islamic banking and finance in Somalia are expected to economically inject and better serve for the small and medium-sized enterprises. The country's growing population, combined with its increasing young adults and the return of the diasporas, are all opportunities for Islamic finance and banking system to expand its services. Somalia's extensive infrastructure and reconstruction needs would also offer an opportunity for Islamic banks to provide financing, investment and credit access for all sectors seeking more efficient financial sector. Nevertheless, Islamic banking presence in Somalia is still at a nascent stage of development that requires robust national masterplan and effective supervisory policies that would encourage the industry to grow. Also, Somalia can capitalize the nation's increasing Islamic financial markets to meet the country's rebuilding and reconstruction financial needs.

Similarly, newly emerged Islamic financial institutions can attract capital from Gulf Corporation Council member states and other Muslim countries as their saving rates are high. Mainly, Sukuk financing, which is growing in other Muslim countries, could also be a useful mechanism to finance Somalia's infrastructure investment projects. Islamic finance

can help strengthen SMEs and microfinance activities given that Somali households and firms had no credit access before the post-conflict era.

Table 1. Newly Emerged Islamic Banks in Somalia

No.	Name of the Islamic banks	License approval
1	Amal Bank	Approved
2	Premier Bank	Approved
3	International bank of Somalia	Approved
4	Dahabshil Bank International	Approved
5	Salam Somali Bank	Approved
6	Tawakal Bank	Approved
7	Daryeel Bank	Approved

Source: Central Bank of Somalia

The establishment of local *Sharia*-compliant banks will be a game changer and revival for the nations' varnished financial sector. This is in line with the argument made by Warsame (2016) who postulated that the new Islamic financial institutions emerging in Somalia's financial sector would be a cornerstone for future foundations of more robust and resilient financial sector. Another opportunity that Islamic banks in Somalia can reap and capitalize is the growing economy of the country. According to International Monetary Fund (IMF) (2017) report, the country's implementation of the fiscal policy has made significant improvement despite the challenges faced by the newly minted federal government. Somalia's domestic revenues grew 26.5 per cent in 2017 thanks to the booming private sector, GDP growth rate was also reasonable compared to previous years, where there was no economic progress during the conflict-era.

Progressing but with a slow pace, yet Somalia's future economic outlook gives Islamic financial industry hope to function their businesses. Apart from the country's economic progress and the return of law and order, the Somali federal government is making robust efforts to develop the financial sector with significant help from the IMF. The government made a more comprehensive financial sector masterplan that could highlight the critical elements for financial development and inclusion (Central Bank of Somalia, 2018). These efforts may significantly help the infant financial institutions that need more vigorous regulatory plans that will revitalize the financial sector. The other progressive add-ons that will offer opportunities for Islamic financial sector are the new development measures made by the central bank; rebuilding technical capacities, improving transparency, sound Islamic banking, and financial intermediation, Islamic banking licensing, supervision and proper regulation. The reflection of these simultaneous policies crafted by the central bank and other relevant stakeholders resulted in a substantial boost in the financial sector development. This is not only a game changer for the financial sector but a clear opportunity for the Islamic banking system. Also, there are no any conventional banks operating in Somalia as the central bank enacted a law that prohibits conventional banks from operating in the country unless they conform with the *Sharia* compliance banking system (Central Bank of Somalia, Act No. 130, 2012).

Moreover, Islamic banks in Somalia can leverage the large Somali diasporas mainly from Europe and North America flooding into their home country following the relative peace that shows many of them hope to return their country for good. It is evident that the diaspora contributed to the local economy through remittances reaching their families, relatives, and business they own in Somalia. According to Hammond, Ali & Hendrick (2012), millions of Somalis living in the diaspora channels the estimation of \$1.3 to \$2 billion annually through remittance transfer operators based both in the country and in the abroad. This includes remittances sent to families, relatives, individuals, private

investments and other funds for development. The World Bank (2016) also reported that remittances contribute to 23 per cent of Somalia's GDP. Most of the Somali diasporas are recently engaging investments and establishing a business in the country thanks to their innovative ideas learned from their second home countries. The resources they are coming with can generate more investments, support the economy and create jobs. Hence, these developments are encouraging and require better and more effective financial sector. As the saving rate of these Somalia diasporas is high compared to those living in the country, the Islamic banking system can play a vital role in leveraging their capacity to engage Somali diasporas through investments, financing and most importantly financial intermediation. The deficit units living in the country and surplus ones coming from the outside for investments would be better served.

Also, recent progresses made by Somalia's ICT sector open another unique financial service, the mobile banking system. A service that is known with the financial institutions, but emerged due complexity of operating financial services in Somalia, particularly during the peak of the civil war. Firestone, Kelly and Rifon (2017) suggested that 88 per cent of Somalis above the age of 16 possess 1 SIM card, whereas 83 per cent of these SIM card holders use mobile money. With this, there is no doubt that this young generation would have been banking account holders or do business with banks if there were a functioning banking system, now Islamic financial institutions are established in the country. Thus, Islamic banks can use these encouraging figures and engage more competitive policies that they are attracting this generation and offer more competitive advantages that mobile money operators could not provide.

4. CHALLENGES FACING ISLAMIC BANKING INDUSTRY IN SOMALIA

Despite the rare opportunities offered for the Islamic banking industry in Somalia, it is apparent that the industry met several challenges. Since Somalia was a war-torn nation for almost a quarter century, the country's economic sectors, including the financial sector, were destroyed. This becomes a severe challenge to a new financial system that requires participating institutions and a more business-friendly geopolitical environment. Following the outbreak of civil war, there were no permeant security and political stability. International Monetary Fund articulates that the country's financial sector suffered from structural problems such as the absence of centralized payment and inter-bank payment systems. The country's financial authority is also not strengthened yet as the body is still in a transition process which renders its supervisory activities. The central bank needs more years to stabilize monetary and regulatory policies. Such circumstances will also weaken the bank's mandates on tackling issues like anti-money laundering, combating the financing of terrorism, which can also hint the central bank's weak capacity to cope with these problems. As reported by International Monetary Fund, other imminent challenges face Islamic banks is the lack of more reliable national identification and business registrations systems that will limit the implementation of banks' Know Your Customer (KYC) systems. Also, Warsame (2016) highlighted that Islamic banks would face another challenge as they lack more experienced human capital and expertise. This means that banks are facing scarce availability of know-how professionals to manage the newly created Islamic banks.

Insufficient of human capital is a significant obstacle against Islamic finance and banking globally and Somalia in particular. Ogunbado (2017) stressed out that Islamic banks face inadequate human resource, and such obstacles will hinder the industry's core activities and needed to tackle such issues. (ISRA, 2011) Reported that human capital is significant for the operation and the functioning of Islamic banks as it will also ensure the flow of professional and more talented employees will stimulate, enable and sustain the

long-term development and growth of Islamic finance and banking. The combination of all these challenges will, therefore, threaten the emerging but an infant Islamic banking institutions in Somalia that are also operating very volatile geopolitics. Islamic banks in Somalia have just started their operations in a few years and still needs to catch up with the already-grown industry globally. Another serious challenge that Islamic banks in Somalia face today is robust competition posed by the mobile money operators that started their services years before Islamic banks gain a foothold in the country's financial industry.

Before the establishment of Somalia's central institutions and the central bank, in particular, money transfer operators were only penetrating the transfer and receiving of remittances. Islamic banks were not developed at the time, which introduced a breakthrough for Somalia's mobile money or mobile banking industry to establish informal money payment system in the country was giant telecommunication companies. They introduced mobile banking services that later become very well-known to Somalis. Thus, Islamic banks would actively need to enhance their competitive advantages so that they can fully penetrate the market and strengthen their market share. However, any proposed policies that Islamic banks seek to face these competitive challenges posed by mobile banking operators should be in line with the Shariah principles. Ogunbado (2013) suggested that Islam commended competitiveness, but it should not turn to negative one that threatens to anyone, in lieu, he suggested that competition should be confident and healthy that encourages better production and quality of living in this world and hereafter.

Furthermore, position in an infant stage with a low pace of capital resources is another challenge, particularly when Islamic banks in Somalia are facing liquidity risk. ISRA (2011) reported that liquidity risk is one of the significant risks that exposed to banks, mainly Islamic banks. In Somalia, where the financial industry recently gained a foothold and lacked proper liquidity management, there is no efficient inter-bank market in place. This makes it more difficult for doing business as most of the banks are new and not having sufficient capital to lend one another. This is another critical challenge that Islamic banks in Somalia need to overcome and frame proper liquidity risk management measures. Alzoubi (2017) postulated that the restrictions placed on Islamic banks create more difficulties in managing liquidity risks. He articulated that since Islamic banks cannot invest short-term financial instruments, treasury bills because of their interest involvement. Such challenges might force Islamic banks to depend more on their internal liquid sources by holding high levels of cash assets that will divert them from many profitable investments to tackle and manage their liquid risk. Somalia's new Islamic banks are not the exception but the most vulnerable ones. The other challenge that faces Islamic banks in Somalia is the lack of correspondent banking, which also shows how local banks are also isolated as most of them are not doing business with other international banks.

This is not surprising as the country's financial sector is in an early stage that requires to grow longer for the year to come. Also, due to the prolonged conflict, there is no proper and effective national identification system despite the government's efforts to address and fix the issue. The financial institution, including Islamic banks, therefore, face know-your-customer problems. This is the fact that banks cannot thoroughly verify the identity of their customers.

5. CONCLUSION AND CALL TO ACTION

After a brief introduction, the paper discusses the evaluation of Islamic banking and finance in general and in Somalia in particular. The paper also conferred opportunities of Islamic banking in Somalia under which we discussed the current and potential prospects that Islamic banks in Somalia need to capitalize. It also postulated the key challenges face

the newly emerged Islamic banking system in Somalia, to which Islamic banks need to address and find solutions for it. To demonstrate and tackle these challenges, the paper suggested the following solutions: the first suggestion that needs to be considered is to have stronger human capital capabilities equipped with in-depth knowledge and expertise in the field of Islamic finance and banking. In collaboration with the Islamic financial industry, the government should step up more endeavours to strengthen Islamic banking and finance through higher education institutions and further relevant research and development initiatives.

Authorities should also establish higher training and research institutes that will produce well-informed professionals and know-how that could revitalize the Islamic banking system. The second proposed recommendation of this study is to urge the government and other relevant authorities to help create more suitable environment and other avenues for Islamic banks to prosper and enhance their competences. The third solution that is important for stronger and well-established Islamic banking system in Somalia is to increase the banks' competitive advantage. To achieve this, Islamic banks should leverage their opportunities at hand through market penetration and customer engagement. Banks can also engage their customers through awareness and other marketing avenues that may help them to capture the large segment of working young middle-class Somalis, Somalia diasporas who are appealing to do business in the country and coming with resources and ideas that may need investment and finance projects.

The fourth solution to the challenges faced by the industry is to engage the full range of money mobile users who cannot have formal banking services from their service providers. The fifth recommendation that this paper articulates is to frame more comprehensive policies that will deal with the issue of liquidity risk exposures. Such policies should work alongside with country's monetary authorities, primarily central bank to come up with Shariah-compliant options that will support Islamic banks' liquidity flows. To cope with the issues that may arise from the clients, the government should steer up strategies and policies that will seek a solution for national identification, screening customers before doing business with the banks to reflect the process of know-your-customer. The last and sixth suggestion is to find a solution for the corresponding banking difficulties facing Islamic banks by increasing quality, efficiency and transparency measures and in Islamic banks business operations with the help of the central bank. International Islamic financial institutions will then work with these new banks.

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