BANKIGA DHEXE EE SOOMAALIYA
البنك المركزي الصومالي
CENTRAL BANK OF SOMALIA

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Somalia’s Financial Sector

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Central Bank of Somalia

Somalia's Financial Sector

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Central Bank of Somalia

May 2023

EXECUTIVE SUMMARY

The financial sector contributes significantly to the economy by providing services to the wider economy, including payment and transaction services to depositors and borrowers, and intermediation services by transforming deposits into funding for households, companies, or governments. A sound and efficient financial system encourages the accumulation of savings and enables their allocation to the most productive investments, hence fostering innovation and economic growth.

The Central Bank of Somalia has implemented major reforms to strengthen its regulatory capacity by introducing various regulations, manuals, guidelines, and directives to maintain a sound and stable financial sector to achieve its overriding objective of financial stability. CBS is currently revising the two key legislations, which govern the financial sector in Somalia – namely, the Central bank Act (2012) and the Financial Institutions Law (2012). In addition, CBS has finalized the National Payments System Bill and a Takaful Bill. The CBS has so far issued nine (9) prudential regulations, four (4) guidelines for commercial banks, six (6) regulations covering the non-banking (five (5) Money Transfer Businesses (MTBs) and one (1) regulation for Mobile Money Operators (MMOs)), and one (1) Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regulation for the financial sector. The Central Bank has also completed significant reforms to advance its capacity, organizational structure, and governance. It has also established a payment system to expedite the deepening and inclusiveness of the financial sector and to carry out wider financial sector reform by creating a safer and more effective payment infrastructure in the country.

CBS has issued licenses and regulated about three MMOs (Hormuud Telecom, Somtel, and Somlink), 12 (MTBs), and 13 commercial banks, in addition to two foreign branches. The Bank's comprehensive reforms are ultimately designed to boost public confidence in the country's financial system. This policy brief highlights some of the key challenges facing the financial sector in Somalia and provides appropriate policy options to make this important sector more resilient and efficient.

INTRODUCTION AND CONTEXT

The financial sector in Somalia is still nascent and, as such, faces a range of challenges. There are financial infrastructure-related barriers including high collateral requirements due to the absence of credit market infrastructure e.g., collateral registry, movable asset registry, and credit information systems. Arguably, the biggest obstacle facing the financial sector in Somalia is the absence of unified national identification, which hinders effective know-your-customer (KYC) processes and financial integrity.

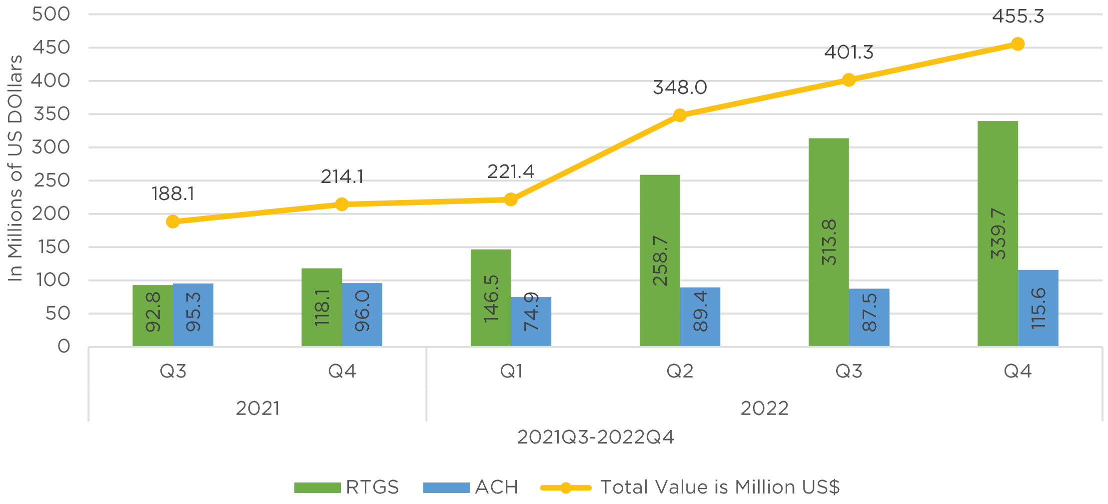
The coverage of the licensed commercial banks is relatively concentrated in urban areas as a result of the fragile security situation of the country. This constrains access to financial services and financial exclusion is significant with a sizable rural and nomadic population not having access to reliable banking services. Consequently, only around 15 percent of the population is banked. Instead of commercial banks, MTBs are widely used in rural areas, but these do not offer traditional financial services. Their focus is on facilitating domestic and cross-border payments, including remittances. Nonetheless, both Somali banks and MTBs face significant issues when it comes to correspondent banking relationships due to de-risking by international banks.

Credit to the private sector by commercial banks is one of the lowest in the world (around 4 percent of GDP). This is mainly due to the absence of credit market infrastructure and other significant risks relating to the fragility of the country, including lack of investor protection and effective enforcement. These issues have led to unfavorable credit terms and conditions, in addition to short maturities and significant costs. Also, the process of securing finance is riddled with risk aversion and imperfections including guarantors and physical collateral.

The absence of effective regulations and oversight for digital payment services is another challenge, which undermines the integrity and transparency of electronic transactions. The draft NPS Bill and associated regulations will support the effective regulation of this important sector. Moreover, there is weak interoperability of retail payment instruments though the National Switch, which is expected to be operational by the end of 2023, will galvanize the payment landscape.

In 2021, the Central Bank of Somalia established a national payment system (NPS) enabling commercial banks to electronically transact with each other. Payment systems are a crucial component of financial systems as they facilitate the settlement and clearance of interbank transactions. In 2022, The Somali NPS integrates Automated Clearing House (ACH), Real-Time Gross Settlement (RTGS), and Instant Funds Transfer (IFT) functionality into a single platform managed by the CBS. In 2022, the NPS facilitated 922,904 transactions in 2022 with a total value of US$1.4 billion.

Figure 1: National Payment System Report (2022)

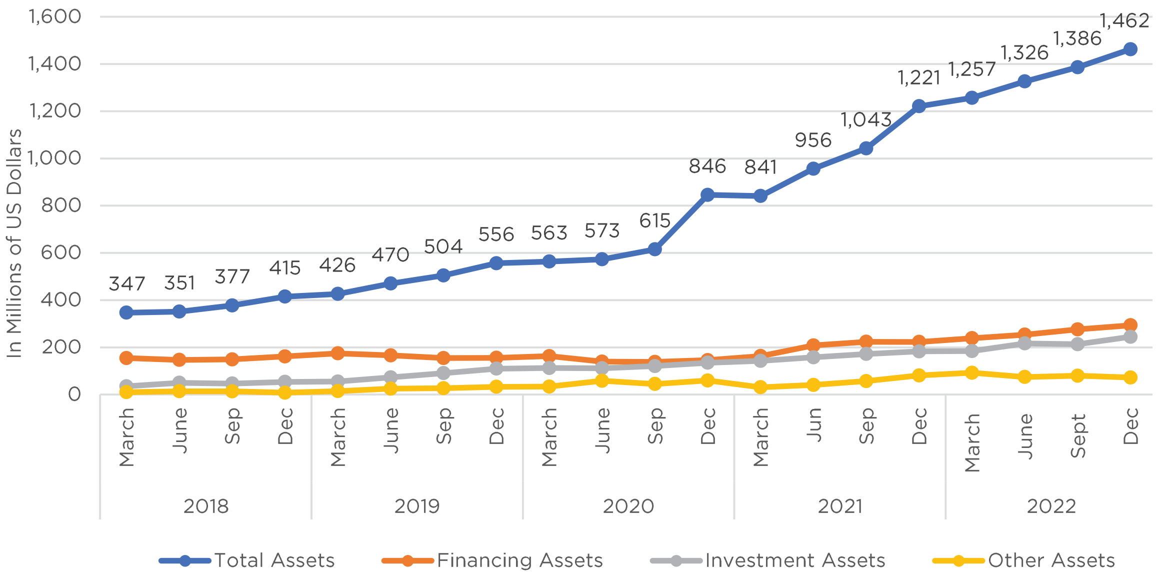


Source: CBS, 2022

Commercial Banking sector

Since 2015, the country's commercial banks have been recording remarkable asset growth. The total assets at the end of the fourth quarter of 2022 increased by 20 percent to US$1,462.5 million, up from US$1,221 million in the corresponding quarter of 2021 (see Figure 2). Credit to the private sector reached close to US$300 million, which represents 20 percent of the total assets. This figure is stubbornly too low given the substantial need for credit in the country. The salient story is that banks still face difficulties improving their lending due to the high collateral requirements due to weak credit assessment systems. In addition, assets that do not yield sufficient income grew much faster than banks' loan portfolios, which could have enhanced profitability.

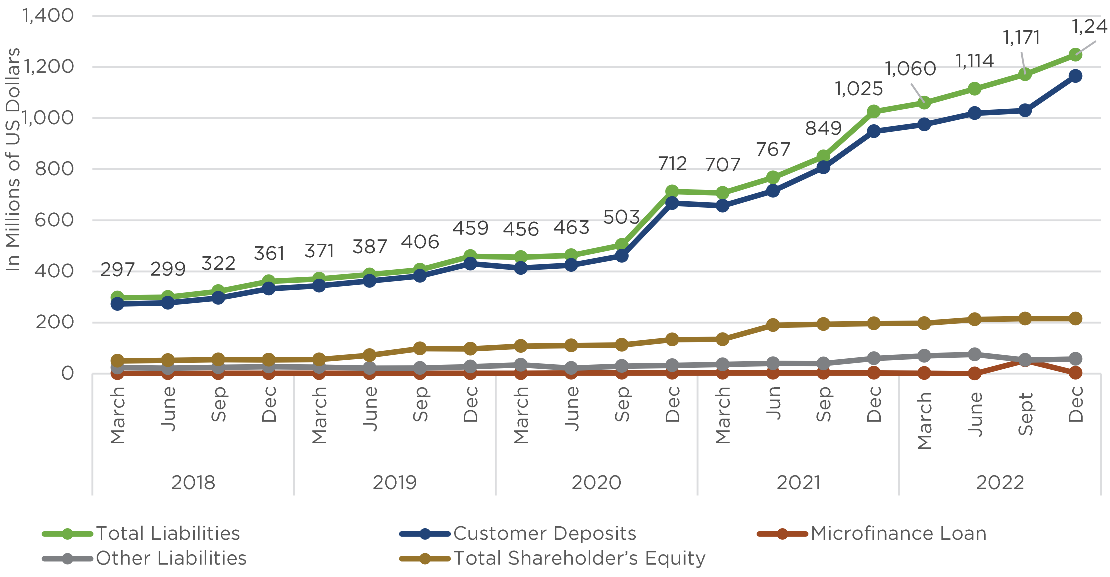
Figure 2: Consolidated Commercial Bank Data (Assets) (2018Q1 – 2022Q4)



Source: CBS, 2022

On the liability side, customer deposits reached US$1,247.4 million in the fourth quarter of 2022, up from US$1,025.1 million in the corresponding period of 2021, representing an increase of 22 percent (see Figure 3).

Figure 3: Consolidated Commercial bank Data (Liabilities) (2018Q1 – 2022Q4)

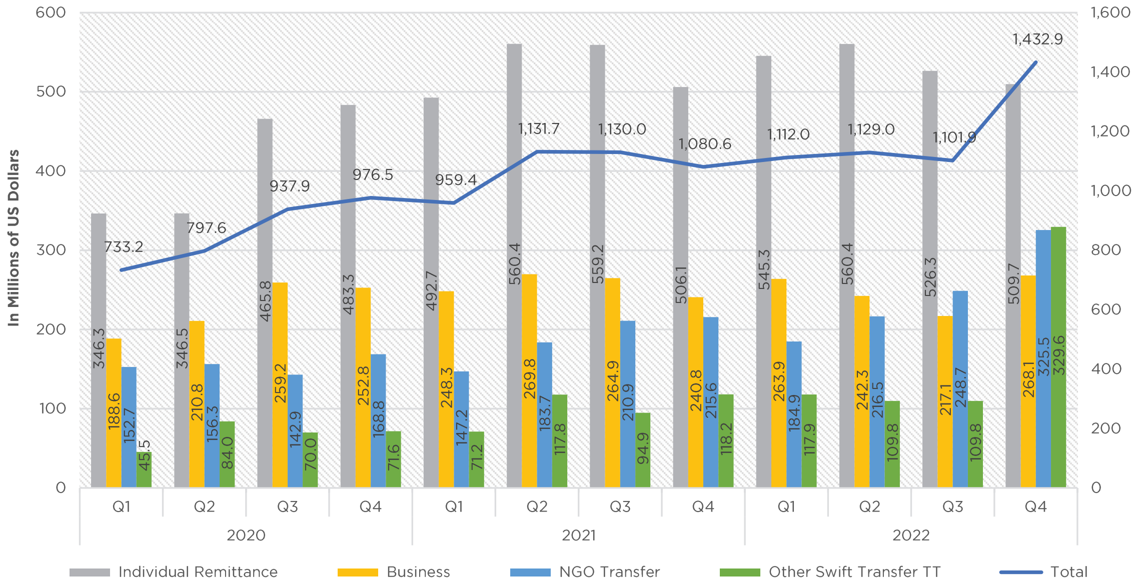


Source: CBS, 2022

Money Transfer Businesses (MTBS)

MTBs dominate the financial services industry in Somalia and significantly contribute to the country's economic viability. During 2022, MTBs brought about US$4.8 billion into the country. In the fourth quarter of 2022 alone, the total amount of inward transfers to Somalia reached US$1,432.9 million, up from US$1,080.6 million in the same period of 2020 – an increase of 33 percent (Figure 4). The total amount of individual remittances in the fourth quarter of 2022 amounted to US$509.7 million, which demonstrated a marginal increase of 1 percent compared to the same quarter of 2021.

Figure 4: Remittance Inflows



Source: CBS, 2022

MTBs registered in Somalia face a challenging operating environment. While Somali public institutions are re-emerging, many fundamentals required to support a strong financial sector are still in the initial stage of reforms. Due to the lack of a unified national ID, MTBs face some challenges relating to customer verification and KYC. MTBs are also affected by de-risking strategies taken by global financial institutions. Financial service providers find it difficult to robustly fulfill their customer due diligence (CDD) requirements. Failure to adequately comply with AML/CFT requirements due to the absence of robust KYC verification mechanisms have resulted in many Somali remittance providers and other financial institutions losing their correspondent banking relationships in recent years. This poses a threat to the livelihoods of millions of Somalis and has implications for food security and household consumption. It also impedes access to finance and entrepreneurship. Remittances also contribute significantly to the country's international reserves and, thus, help to finance imports, and improve the current account position of the country.

Mobile Money Sector

Despite its fragility and underdeveloped financial institutions, Somalia has one of the most active mobile money markets in the world, outpacing most of other developing nations. It has a vibrant mobile money sector where mobile wallets and digital payments dominate transactions. Approximately 650 million transactions worth $8 billion (equivalent to the country's GDP) are recorded yearly. Over 70 percent of adult Somalis use mobile money services regularly. This fosters financial inclusion as it is used for salary receipts, bill payments, merchant payment transactions, remittances and cash-in and cash-out transfers, and mobile wallet savings.

As of September 2022, CBS issued licenses to 3 mobile money service providers (Hormuud Telecom, Somtel and Somlink.). The Banks' decision to begin licensing and regulating mobile money operators is a significant step forward. There was a great need to supervise and regulate this sector as it offers a critical service used by more than two-thirds of the Somali population. According to a 2018 world bank report, 70 percent of the population above age of 16 use mobile money services and only 15 percent of the population (and just 7 percent of women) have bank accounts (World Bank Group, 2018). Mobile money penetration rate in urban areas is more than 83 percent and 55 percent in rural communities. Although the overall penetration rates of banking services remain very low, mobile money is a bank to the unbanked community since people in the rural who have no access to banking services receive their remittance through mobile money. This broadens access to financial services and enhances the speed and efficiency of transactions.

The current mobile money system in use lacks a formal effective KYC regime. In addition, there is also a lack of interoperability among mobile money operators though this is slowly changing. Nonetheless, as of today, there is no comprehensive system of interoperability, which efficiently links the existing mobile money service providers (EVC plus and E-Dahab, ZAAD, SAHAL, MyCash & E-BESA). Poor SIM card registration limits the efficiency of the verification system to monitor and detect suspicious customers.

POLICY RECOMMENDATIONS

To build a strong financial system, start with the foundation for monetary policy and price stability.

- Intensify the ongoing work with the World Bank and IMF to expedite the Currency Exchange Project to issue new and legitimate national currency.
- Establish monetary policy committee and related sub-committees.
- Draft an appropriate exchange rate regime, reserve and monetary policy including policy transmission mechanisms and operational strategies.
- Build the capacity of the existing monetary policy working group within CBS so that they can effectively undertake the preparatory work for monetary policy.
- Complete the revision of the CBS Act and the Financial Institutions Law to deepen the foundation of the financial industry governance structure.

Policies to improve the operations of MTBs and to mitigate the risks encountered by Somali remittance.

- Strengthen onsite and offsite examinations and implement strict adherence mechanism to correct outstanding violations.
- Introduce and enforce penalty regulations to incentivize the sector.
- CBS should ensure that the financial sector initiative enables institutions to register their customers' identities to improve both CDD and KYC.
- CBS should strengthen MTBs sector data integrity.
- Rollout a risk-based supervision framework and address risks arising from group relationships and operational risks.

Policies to improve the operations of Banks and to mitigate the risks encountered by the Banking Industry.

- CBS should strengthen banking sector data integrity.
- Rollout a risk-based supervision framework and address risks arising from group relationships and operational risks.
- Finalize the revised Financial Institutions Law to broaden the scope and effectiveness of regulatory landscape of the country's financial system.
- Support the establishment of credit market infrastructure to support private sector growth and financial deepening.
- Seek sustainable solution to address institutional barriers such as the high collateral requirements.
- In order for Somalia's financial institutions to receive global recognition, it is crucial for the Somali government to actively promote and deploy public relations agents who can showcase the positive aspects of our financial institutions to the world.

Policies to improve the operations of Mobile money service providers and to mitigate the risks encountered by Mobile money.

- Support the full interconnectedness and interoperability between different payment service providers, and digital platforms to reduce the vulnerability of the system.
- Complete specific guidelines covering AML/CFT measures for mobile money including tiered KYC system to protect vulnerable populations.
- Finalize the draft Bills (NPS and Takaful) plus associated regulations.
- Operationalize the National Switch to improve interoperability of banks

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