BANKIGA DHEXE EE SOOMAALIYA
البنك المركزي الصومالي
CENTRAL BANK OF SOMALIA

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Somalia's Financial Sector Development

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Central Bank of Somalia

Somalia's Financial Sector Development

Policy Research & Analysis Division
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Central Bank of Somalia

June 2024

SOMALIA'S FINANCIAL SECTOR DEVELOPMENT

EXECUTIVE SUMMARY

The stability and growth of Somalia's financial system hinge significantly on the strength of its emerging banking sector. Recently, the financial sector has seen remarkable growth, with substantial expansion in banking industry assets. The Central Bank of Somalia (CBS) has made notable strides in rebuilding the nation's financial infrastructure and enhancing the sector's robustness to combat money laundering and terrorism financing. Key initiatives include the introduction of the Targeted Financial Sanctions Law, the revision of the AML/CFT Law, and the endorsement of 13 crucial regulations and guidelines for commercial banks, 5 for money transfer businesses (MTBs), 4 related to AML/CFT, and 1 for Mobile Money Operators (MMOs). Updated regulations on Capital Adequacy and Liquidity Risk Management have also been introduced. In addition, CBS has issued guidelines on Know-Your-Customer protocols, customer due diligence, and reporting obligations for significant cash transactions and suspicious activities at commercial banks. Among the significant milestones achieved are the implementation of the national payments system, adoption of International Bank Account Numbers (IBAN), introduction of an AML/CFT compliance module, and launch of the SOMQR Code. The banking sector is proactively working to meet international standards necessary for correspondent banking relationships by developing and implementing new systems. Efforts have focused on broadening the scope of services, enhancing core banking tools, improving financial management systems, expanding credit to the private sector, and offering a variety of financial products. These reforms have resulted in increased transparency, public confidence, and improved access to credit for the private sector.

Despite these efforts, Somalia's financial sector is still considered high-risk by international banks and financial regulators due to ongoing concerns about money laundering, terrorism financing, and fragile security conditions. Consequently, the banking sector continues to face challenges in reintegrating into the international financial system and establishing correspondent banking relationships. This policy brief reviews the recent performance of Somalia's financial sector and provides policy recommendations to enhance and facilitate the reintegration of Somali banks into the global financial systems.

1. INTRODUCTION

The Central Bank of Somalia (CBS) has made significant strides in rebuilding the country's financial infrastructure, strengthening the financial sector, and promoting financial inclusion and economic stability. Reforms in the financial sector have resulted in increased transparency, public confidence, and improved access to credit for the private sector. Key measures include addressing money laundering and terrorism financing, such as the introduction of the Targeted Financial Sanctions Law in March 2023 and its regulations in July 2023, along with the submission of the revised AML/CFT Law to the Federal Parliament.

Somalia has reached notable milestones in its financial services sector, such as the implementation of a national payments system, the adoption of International Bank Account Numbers (IBAN), the introduction of an AML/CFT compliance module, and the launch of the SOMQR Code. These advancements reflect Somalia's progress in revitalizing its financial services infrastructure and moving towards a more inclusive and flourishing economy. The CBS Board of Directors has also endorsed 13 crucial regulations and guidelines for commercial banks, 5 regulations and guidelines for MTBs, 4 AML/CFT-related regulations and guidelines, and one regulation for Mobile Money Operators (MMOs). These include updated regulations on Capital Adequacy and Liquidity Risk Management to align with financial market development and Somalia's supervisory capacity. Additionally, CBS issued guidelines in July 2023 on Know-

Your-Customer (KYC) protocols, customer due diligence, and reporting obligations for significant cash transactions and suspicious activities at commercial banks and has been prompt in publishing its audited financial statements. Furthermore, the Audit Committee's independent oversight of the audit mechanisms and internal control system has been enhanced (IMF, 2023), alongside guidelines on mobile money transaction limits issued by the National Anti-Money Laundering Committee (NAMLC) in July 2023.

Efforts to elevate the country's financial sector profile have led to the establishment of the first international bank branch, Türkiye's Ziraat Katilim Bank, in over fifty years. Additionally, Somalia won the Central Banking's Payment and Market Infrastructure Development Award in 2023. Money Transfer Businesses (MTBs) and mobile money operators (MMOs) continue to play crucial roles in facilitating remittances and providing financial services in Somalia. As of 2023, the financial sector comprises 13 commercial banks, 1 foreign bank branch, 15 money transfer businesses, and 4 mobile money operators.

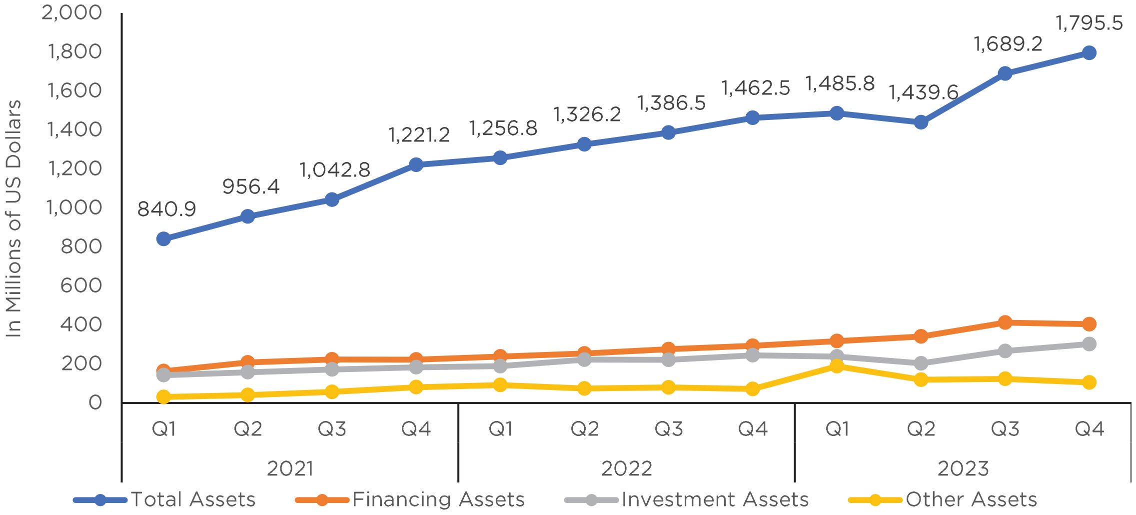
Despite these efforts, international banks and regulators continue to regard Somalia's financial sector as high risk due to concerns about money laundering, terrorism financing, and the fragile security conditions. Consequently, Somali banks have faced challenges in reintegrating into the international financial system and establishing correspondent banking relationships (Hardie, 2023). Moreover, the national identification card, introduced but not yet fully integrated into Somalia's financial system, affects the robust implementation of the KYC protocols, thereby impacting the financial integrity of institutions in the country (UNCDF, 2023). Additionally, Somalia lacks credit market infrastructure, a movable asset registry, and credit information systems, resulting in high collateral requirements (NEC, 2023).

1.1 Commercial Banking Sector

Somalia's banking sector plays a crucial role in ensuring the stability and growth of the economy, as well as expanding the financial sector. The total sector assets are equivalent to 17 percent of GDP, while credit to the private sector constitutes less than 4 percent of GDP. In the fourth quarter of 2023, commercial banks recorded total assets of US$1,795.5 million, reflecting a 6 percent increase from US$1,689.2 million in the third quarter of 2023 and a 23 percent increase from US$1,462.5 million in the fourth quarter of 2022. Credit to the private sector amounted to US$404 million in the fourth quarter of 2023, representing 23 percent of total assets. This figure was 2 percent lower than in the third quarter of 2023 but 38 percent higher than the US$293.4 million recorded in the fourth quarter of 2022. Investment assets in the fourth quarter of 2023 stood at US$301.8 million, accounting for 17 percent of the total banking sector assets. This marked a 23 percent increase from the fourth quarter of 2022 and a 13 percent increase from the third quarter of 2023.

The banking sector has been expanding and striving to meet international standards essential for establishing correspondent banking relationships (NEC, 2023). Efforts include broadening the scope of services, enhancing core banking tools, improving financial management systems, expanding credit to the private sector, and offering a diverse range of financial products. Despite these efforts, Somali banks remain isolated from the global financial system due to foreign de-risking, which has limited correspondent banking relationships (Hardie, 2023). Additionally, the incomplete integration of the National ID system has interfered with financial integrity and cross-border transactions (NEC, 2023). These challenges, along with a lack of credit market infrastructure, have undermined Somalia's financial sector, resulting in one of the lowest levels of credit to the private sector in the world. Furthermore, Somalia's heavy reliance on the US Dollar has limited the Central Bank of Somalia's (CBS) ability to conduct effective macroeconomic and monetary policies.

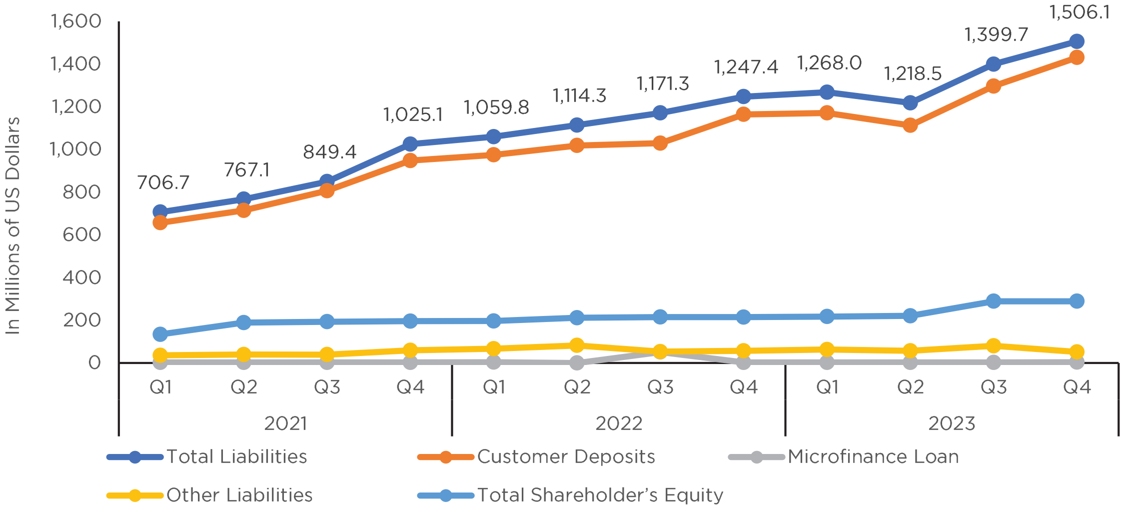
Figure 1: Consolidated Commercial Bank Data (Assets) (2021Q1-2023Q4)



Source: CBS, 2023

Over the past decade, Somalia has witnessed a steady increase in total liabilities and shareholders' equity. In the fourth quarter of 2023, commercial banks' liabilities reached US$1,506.1 million, reflecting an 8 percent rise from US$1,399.7 million in the third quarter of 2023 and a 21 percent increase from US$1,247.4 million in the fourth quarter of 2022. Customer deposits comprised the majority (95 percent) of commercial banks' liabilities, driven by demand deposits from both commercial entities and individuals, which accounted for 40 percent and 54 percent of customer deposits in the quarter, respectively. In the fourth quarter of 2023, customer deposits rose by 23 percent, from US$1,164.3 million in the fourth quarter of 2022 to US$1,430.9 million, with demand deposits from commercial entities and individuals increasing by 23 percent and 21 percent, respectively.

Figure 2: Consolidated Commercial Bank Data (Liabilities) (2021Q1-2023Q4)



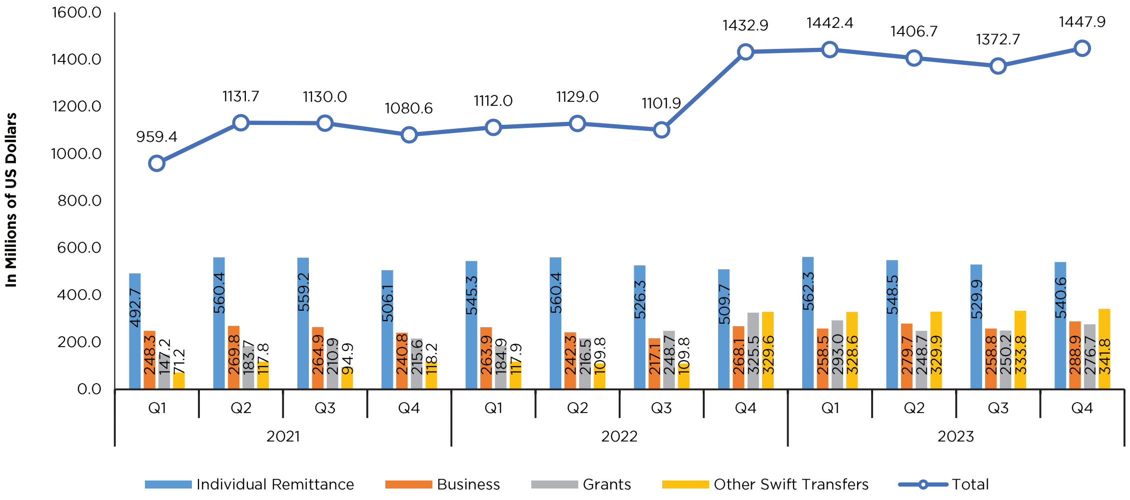
Source: CBS, 2023

1.2 Remittances

Remittances play a crucial role in sustaining Somalia's economy, supporting livelihoods and households. In 2023, the total inward transfers to Somalia reached US$5,669.75 million, with personal remittances amounting to US$2,181 million, business remittances at US$1,086 million, NGO transfers at US$1,069 million, and TT transfers at US$1,334 million. During the fourth quarter of 2023, total inward transfers increased marginally by 1 percent compared to the fourth quarter of 2022, amounting to US$1,448 million (Figure 3). Individual remittances and business transfers rose by 6 percent and 8 percent respectively, while NGO transfers declined by 15 percent, falling from US$326 million in the fourth quarter of 2022 to US$278 million in the same period of 2023 (Figure 3). Commercial bank TT transfers grew by 4 percent, reaching US$342 million in the last quarter of 2023.

Somalia's designation as a high-risk jurisdiction complicates the management of remittances for banks due to challenges with correspondent banking (UNCDF, 2023). This situation forces banks to rely on SWIFT transfers, which are often costly due to intermediary fees, subject to unfavorable exchange rates, and take several days to process. Conversely, MTBs offer a direct transfer avenue. However, bank de-risking has also impacted MTBs, making it increasingly difficult for them to open the bank accounts necessary for their operations (UNCDF, 2023). The high cost of sending remittances and the challenges in correspondent banking relationships continue to hinder the growth of Somalia's financial sector, impeding economic development and promoting informal trade. Furthermore, customer verification is difficult due to the lack of integration between existing payment systems and identity systems, increasing the cost for customers to open accounts and conduct financial transactions (UNCDF, 2023).

Figure 3: Total Inward Transfers (2021Q1-2023Q4)



Source: CBS, 2023

1.3 National Payment System (NPS)

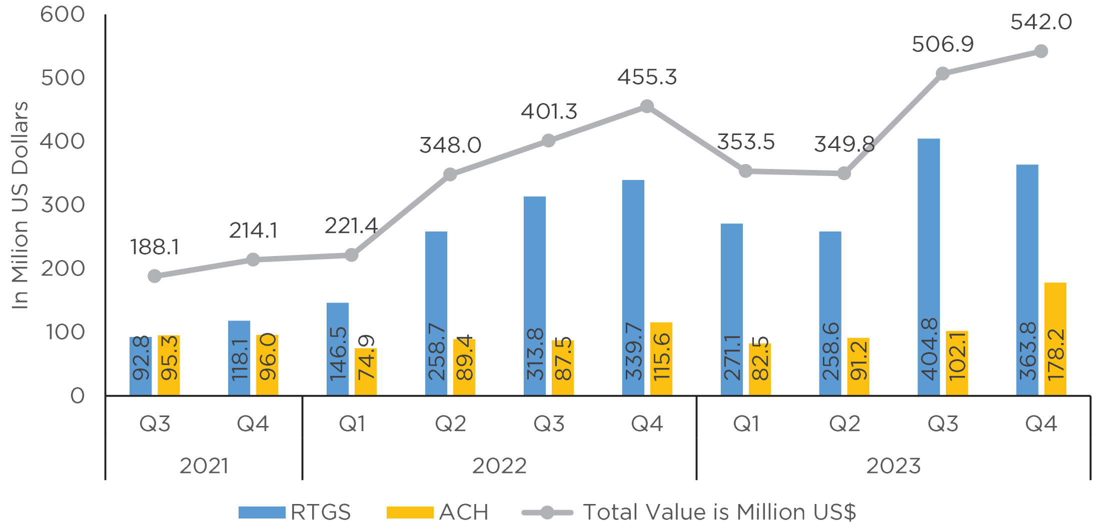
The efficient functioning of Somalia's National Payment System (NPS) is vital for achieving economic growth and financial stability. Given that most domestic payments are conducted in U.S. dollars, the introduction of the SOMQR code in June 2023 is expected to significantly boost domestic retail payments and enhance the efficiency of instant payments. In 2023, the NPS processed over one million transactions, totalling US$1,752 million. This represents a 28 percent increase in transaction volume and a 23 percent increase in transaction value compared to the previous year. The Real-Time Gross Settlement (RTGS) system handled transactions worth US$1,298 million, while the Automated Clearing House (ACH) transactions amounted to US$454 million.

The implementation of the SOMQR code is a major milestone for Somalia's payment infrastructure. It is designed to facilitate quick, secure, and convenient payments, fostering greater financial inclusion and encouraging more individuals and businesses to participate in the formal financial system.

As more users adopt the SOMQR code, the reliance on cash transactions is expected to diminish, reducing the risks associated with cash handling and enhancing transparency in financial transactions.

Furthermore, the growth in RTGS and ACH transactions indicates a positive trend towards a more robust and interconnected payment ecosystem. RTGS, being crucial for high-value transactions, ensures that large sums are transferred efficiently and securely, thus supporting business activities and investments. Meanwhile, the ACH system facilitates the processing of bulk transactions, such as payrolls and utility payments, contributing to the overall efficiency of the payment landscape. The advancements in Somalia's NPS, exemplified by the introduction of the SOMQR code and the increased usage of RTGS and ACH systems, are pivotal in driving the nation's economic growth and financial stability. These improvements are expected to reduce transaction costs, enhance payment speed, and provide a foundation for future innovations in the financial sector.

Figure 4: National Payment System (2021Q3-2023Q4)



Source: CBS, 2023

2. KEY NOTABLE ISSUES

1. Lack of Correspondent Banking Relationships due to Perceived Risks of Money Laundering and Terrorism Financing

- Somali banks struggle to reconnect with the international financial system and establish correspondent banking relationships. Despite reforms by the Central Bank of Somalia (CBS), the financial sector is still perceived as high-risk by international banks due to concerns over money laundering and terrorism financing.

2. Economic Instability and Fragile Security Conditions

- The country's economic growth is hampered by fragile security and political instability. This situation not only affects the financial sector but also deters foreign investment and hinders Somalia's reintegration into the global economy.

3. Regulatory and Supervisory Capacity

- Although the CBS has made significant improvements, international financial systems still find Somalia's regulatory and supervisory frameworks inadequate. Further development, including the use of artificial intelligence, is necessary to ensure comprehensive oversight.

4. Money Laundering and Terrorism Financing in Mobile Money and Remittance Systems

- Without the integration of national ID with the financial sector, Mobile Money Operators (MMOs) and Money Transfer Businesses (MTBs) face regulatory challenges and risks associated with money laundering and terrorism financing.

5. Adoption and Integration of Financial Technologies

- The introduction of the national payment system and technologies like the SOMQR code are positive steps. However, broader adoption and deeper integration are needed to enhance financial inclusion and transaction efficiency.

6. Lack of Credit Market Infrastructure

- The absence of credit market infrastructure, including asset registry, and credit information systems results in high collateral requirements, limiting access to credit and stifling economic growth.

7. Costly and Time-Consuming SWIFT Transfers

- Somali banks rely on SWIFT transfers for managing remittances due to Somalia's high-risk listing. These transfers are costly because of intermediary fees and unfavorable exchange rates, and they take several days to process.

The following policy recommendations are designed to provide a menu of options that are not exhaustive focusing on the law hanging fruits. In terms of prioritization, sequencing and the potential complementarities between these options, will need to be informed by a comprehensive financial sector strategy and its roadmap.

3. POLICY RECOMMENDATIONS

1. Strengthening Policies on Money Laundering and Terrorism Financing

- Enhance Anti-Money Laundering and Counter-Terrorism Financing (AML/CFT) measures by consistently monitoring, enforcing, and updating regulations to align with global standards.
- Develop a national strategy for combating money laundering and terrorism financing, with clearly defined objectives, responsibilities, and time frames. Regularly evaluate and update the strategy to address emerging risks and challenges.
- Provide financial institution personnel with comprehensive training and resources to ensure compliance.
- Train law enforcement and judiciary personnel on AML/CFT issues, including investigations and financial crime prosecutions. Establish dedicated AML/CFT units within law enforcement and the judiciary.

2. Promoting Economic Stability

- Enhance economic stability through forward-looking, robust policies focused on key economic drivers and structural bottlenecks.
- Create a conducive environment for economic growth and foreign investment.

3. Enhancing the Regulatory and Supervisory Capacities of The Central Bank of Somalia (CBS)

- Provide CBS staff with specialized training, modern tools, and resources for effective oversight of the financial sector.
- Establish knowledge-sharing partnerships with international financial watchdogs to improve CBS operations and align with best practices.
- Increase on-site inspections to evaluate financial institutions' operations and risk management practices and address weak compliance.
- Create a centralized database to store financial and supervisory information from all regulated institutions.
- Establish consultative committees with representatives from banks, FinTech companies, and other stakeholders to provide feedback on regulatory changes and industry trends.
- Implement modern oversight systems, including SupTech technology, to enable real-time monitoring and surveillance of regulated financial institutions.

4. Strengthening Oversight of Mobile Money and Remittance Systems

- Conduct regular audits to identify vulnerabilities, prevent fraud and money laundering, and enhance customer safeguarding and operational efficiency.
- Implement stringent compliance and technological safeguards to ensure system integrity and reliability.
- Utilize real-time data analytics to track transaction patterns, detect anomalies, and identify potential risks.
- Regularly update regulations to keep pace with technological advancements and emerging risks.

5. Increasing Transparency and Building Public Confidence

- Improve public trust in the financial system by publishing audited financial statements and enhancing transparency.
- Communicate frequently with the public about reforms, including milestones and anticipated next steps, to build trust.
- Implement a transparent complaints resolution system to increase trust in the financial sector.
- Build trust with international regulators and financial institutions by demonstrating tangible progress in reducing money laundering and terrorism financing risks.

6. Establishing Credit Market Infrastructure, Movable Asset Registry, and Credit Information Systems

- Enforce laws and regulations that promote a vibrant credit market, including lending guidelines, borrower rights, and mediation procedures.
- Enact legislation recognizing movable assets, such as inventory and equipment, as acceptable security for credit.
- Promote the expansion of microfinance institutions for marginalized populations, with lower collateral requirements.

7. Addressing the Transaction Costs Associated with SWIFT Transfers

- Negotiate with international banks and payment service providers to reduce SWIFT transfer fees.
- Encourage partnerships with microfinance institutions to make micro-remittances more affordable and accessible.

- Collaborate with regional partners to be part of regional payment systems which may offer a cost-effective and faster alternative to SWIFT.

- Leverage economic integration to adopt the Sustainable Development Goals target of lowering the cost of sending remittances to almost 3 percent.

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