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Somalia Banking: Transfers, Challenges And Opportunities

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Executive Summary

This paper is a primer that discusses the challenges and opportunities of Somali banking. A foreign investor interested in Somalia would need answers to the following questions:

- How do investors connect their money with projects?
- What type of banking institutions already exist?
- How are existing institutions used?
- Why aren't there any "traditional" investment banks in Somalia?

The paper presents three avenues used for transferring foreign currency into Somalia. These range from the ubiquitous Hawala system to "investment-in-kind" and cross-border currency movements. Recent examples of the documented uses of each channel are provided in the primer.

Methods for accessing funds already in the country are also highlighted. Under conventional financial protocols, these funds should be accessed from well-established banks, finance houses and foreign exchange (Forex) bureaus. However, the Somali jurisdiction does not, as currently constituted, lend itself to conventional finance. The primary movement of funds within the region is through innovative mobile telephone schemes. The Somali model is based on lessons learned from the more established mobile money transfer schemes in Kenya.

In addition, the primer discusses developments towards the eventual introduction of a two-tier banking system that includes an internationally acceptable Bill of Exchange Act which codifies the law in relation to bank transfers, automatic teller machines, check payments and other financial instruments. The primer surmises that these developments are still very much nascent and are tied to the fluid political situation in the country. Though the trajectory appears promising, major gaps still exist in the enforceability of contracts, provision of skilled manpower, protection of property rights, and the establishment of a national registry of citizens.

- A possible solution to the dearth of Somali-based brick-and-mortar banking outlets could follow Coasian bargaining theory, by mitigating political risk using the same principle that lies behind special economic zones (SEZ). In an SEZ, national laws may remain suspended, and an investor would then use a recognized third country's legal regime. This is an opportunity for private equity players with experience in the region or in similar situations where investor protection is weak or non-existent. Banks from neighboring countries (especially Equity Bank, Kenya Commercial Bank, Gulf African Bank and the First Islamic Community Bank) that have recently expressed an interest in establishing Sharia-compliant operations in Somalia are also building their plans on Coasian bargaining theory. All of these possibilities are further augmented by the vast remittances from the diaspora and by the Somali people's culture of saving.

Introduction

With its difficult history over the last quarter century, the country of Somalia has well-documented risk factors. Moving forward, any investor, whether foreign or local, needs information on banking facilities within the jurisdiction of Somalia/Somaliland. Operating in present day Somalia poses a set of challenges to the investing public. As a result, investors — especially foreign ones — require current information on the banking environment within the region. The questions posed include:

- How do investors connect their money with projects?
- What type of banking institutions already exist?
- How are existing institutions used?

Why aren't there any "traditional" investment banks in Somalia?

Access to Foreign Funds

According to Coasian bargaining theory, governments should create institutions that minimize transaction costs, to allow misallocations of resources to be corrected as cheaply as possible. In the absence of a strong government to build these institutions, the vacuum is occupied by other players. These players work on structures that mitigate risks to a bearable level. The implications of the Coasian theorem on the situation in Somalia, is that investors have become creative in how they allocate resources to their projects in Somalia.

There are three main ways investors get resources into the country. The first of these is the informal Hawala system which has a total of 17 participating organizations. The largest of these - and the main players in Somalia - are Dababshill, Amal Express, North American Money Transfers (Mustaqbal), and Kaah Express. Hawala is an alternative remittance system first developed in South-east Asia, before the introduction of Western banking services. The word Hawala comes from Arabic and is loosely translated to mean "change" and "transform." Hawala is based on trust, and makes extensive use of regional affiliations, and family relationships.

Unlike formal banking, Hawala rarely employs any negotiable instrument. Transfer of money takes place among members of a network of Hawala dealers. To the typical western investor, Hawala may seem cumbersome and risky. There are no checks to obtain, nor wire transfers to be made.

However the system is remarkably effective. It is cost effective, efficient, bureaucracy-free, and reliable yet it does not leave a paper trail. A customer deposits a specific sum at a Western outlet of the organization for further remittance to an individual in Somalia/Somaliland. The Western Hawala dealer charges a maximum of 5% commission for handling transactions of $ 2000 or less. Amounts beyond $ 2000 incur progressively higher commission fees. The recipient receives his or her money from a Somalia- based dealer in the form of Somali shilling or US dollars for a small fee. Costs of operations (especially overheads) are kept low. Operations are often conducted in buildings that could be any of shared premises, rented storefronts or even tea shops.

A second method used by project investors to get resources into the country is “investment-in-kind.” This method is mainly used by international non-governmental organizations and larger investors like those investing in the Coca-Cola plant in Hargeisa. This form of investment entails the actual delivery of materials or goods and even labor from other countries because the equivalent does not exist in sufficient quantity in Somalia.

The United Nations uses this system. Their Nairobi, Kenya offices undertake many Somalia projects. Consultants, logistics providers, and many others are paid in Nairobi for services rendered in Somalia. The same model is employed by organizations like the Danish International Development Agency, the United States Agency for International Development, Oxfam International, and the UK department of International Development, to mention just a few. The bulk of the US$ 1.7 billion donor funding received between 2009 and 2012, can be accounted for in this way. In the process all these organizations are lessening the risk and unpredictability in the local conditions.

A third method employed by investors, especially in the more unstable South Central regions (Banadir - Mogadishu included) is cross-border currency movement. Though this method is used infrequently, and is fraught with risk. Some daring investors move money from Kenya (often through the small airports such as Wilson Airport and the Garissa Airport). The system is under intense scrutiny by the United States and other world bodies including the Financial Action Task Force because of potential abuse by money laundering actors. In spite of this close monitoring, incidents of actual physical movement of money continue to be reported especially whenever cash-laden planes have a mishap while in Somali airspace.

Access to Funds Already in Somalia

Access to funds already within the country, also poses unique challenges. Under conventional financial protocols, local funds should be accessed from well-established banks, finance houses and foreign exchange (Forex) bureaus. The Somali jurisdiction does not, as presently constituted, lend itself to conventional finance. The primary movement of funds within the region is through innovative mobile telephony schemes.

Mobile telephone schemes have rapidly expanded among a few private sector players. The largest of these telecommunication operators is Golis Telecom Somalia. The others are Somtel, Nationlink, Telesom, Solteco, and Africa on Line. Data on actual subscriptions are scanty but reliable estimates by Dahabshill indicate that at least 70% of the Somali people have access to mobile services. The phones are used for voice data, web-based tracking (GPS), and short message service notifications for financial transactions.

The mobile telephone not only offers a cheap means of communication, but it also acts as a lifeline to many Somali people within Somalia/Somaliland. A significant use of phones is for making financial arrangements, many of which are linked to cash transfers from cities to rural areas. This is based on lessons learned from innovative schemes such as M-Pesa, a Safaricom service (Safaricom is a Vodafone subsidiary in partnership with the government of Kenya). In this service after registering with a mobile service provider, a customer does not need to have a bank account - he or she can use the phone to move money quickly, securely, and across distances, directly to another mobile user, who is not necessarily a subscriber to the same provider. The money is transferred in the form of airtime, which is then cashed out by designated agents of the mobile service provider. Airtime is also used to pay for everyday goods and services, essentially transforming the mobile phones into an airtime wallet. Replicas of this novel use of the mobile phone are also found in the Philippines in the form of the G-Cash service.

The mobile money channel is now the primary way in which local money moves around for the Somali people whether they are in South Central, Somaliland, or Puntland. The United Nations and other intergovernmental organizations such as CARE-Somalia, also make use of this avenue to make financial transactions while keeping deposit accounts with Dahabshill and other money receiving institutions. Individual mobile money transactions have an upper limit of $ 1,220 which is comparable to the rates of the newly introduced - Barclays Bank international mobile transfers services in the neighboring country of Kenya. The mobile telephone has indeed brought the previously un-banked segment of the population into the ranks of the banked.

The Banking Situation in Somalia

Somalia/Somaliland offers unique banking challenges for any investor coming from the Western world. Problems exist in the establishment of regular banking protocols along the lines of those that Western investors typically use. Beyond security concerns, a major factor in the dearth of brick-and-mortar banks is the lack of a fully functioning central bank. In the absence of a central bank, an international acceptable Bill of Exchange Act that codifies the law in relation to bank transfers, automatic teller machine, check payments and other financial instruments, cannot exist. A review of these protocols could shed further light on the Somalia/Somaliland scenario.

In general, how easily and at what costs firms operating in this jurisdiction receive access to finance depends on a wide range of factors both internal and external to the given firm. External factors are mainly connected to the institutional and regulatory environment. Regulations include those of the banking system. Other equally important aspects are the enforceability of contracts, the protection of property rights, and the availability of recognized banks.

In most countries, retail payment systems have been dominated by banks whose primary function in the basic sense is to gather deposits for deployment in loans and other permissible instruments. In order for this system to function effectively, a two-tier banking system must be in place. At the top of this tier is a central bank that focuses on regulating credit, bank licensing and supervision, and, setting monetary policies. While there is supposed to be close and continuous cooperation between the central bank and the government, as a rule, it is necessary to incorporate into the statutes provisions that guarantee the “independence” of the central bank so that it is not subordinate to the state. The central bank is therefore, designed to be autonomous and to serve as a core component of both the economic bureaucracy and the national security apparatus.

Central banks are tasked primarily with maintaining price stability. The authority of the central bank is derived partly from its technical expertise and policy efficiency which, in turn, are important functions of close public-private interactions with the broader banking community. In the process of formulating monetary policy, the central bank must maintain direct access to current banking operations and detailed information about financial markets.

The second tier of banking is populated by commercial banks, finance houses, deposit receiving institutions, and in the case of many developing countries, foreign exchange bureaus. It is these institutions which exercise decisions that are based on internal factors and which determine the availability of loans to the capital deficient. Commercial banks consist of retail, business, and investment banking components. The retail component is the set of operations that include issuing consumer loans, mortgages, and current/savings account operations. Business banking is not altogether different from retail banking because it entails deposit collection and loan making, albeit to businesses rather than to individual customers.

Investment banks on the other hand, specialize in underwriting securities, trading in securities and providing advisory services. Unlike retail and business banking, investment banking is generally a high-margin, but volatile, enterprise. Within all facets of banking, a primary principle is “know your customer.” This includes names and identification numbers in the case of individuals, registration certificates and articles of association for companies, and any other relevant information about the respective customer. The “know your customer” principle is used even in in Sharia compliant environments. The principle is part of the soft and hard information that banks refer to before any lending decision is made. Hard information in this situation is mainly availability of financial resources and other forms of collateral for potential borrowers.

The other organizations include finance houses such as mortgage houses, deposit receiving institutions of which the most common are savings cooperative societies and foreign exchange bureaus. These organizations do not meet the definition of a commercial bank. Commercial banks are in their most basic sense agents between the capital deficient and those with a capital surplus. To act as an honest agent, commercial banks must know their customers, be able to identify them in their event that there are duplicate entries, and enforce commercial contracts. A central bank must as a matter of necessity supervise commercial bank operations in order to maintain integrity in the system and to allow investor confidence to drive the process of capital surplus meeting the capital deficient.

Implications for Somalia/Somaliland

What are the implications of the two-tier banking system on Somalia/Somaliland? The country has not had an effective central bank ever since the 1991 fall of the last recognized government. This problem is further exacerbated by weak governance structures. Government agencies within the country, including those responsible for justice and the registration of persons, either do not exist or in the case of Somaliland, do not have the capacity to effectively carry out their mandate. There is no formal identification system for citizens of the jurisdiction. Entrants to this market would have to create their own unique identification system. Companies also cannot be incorporated nor can contracts be executed. Design of project contracts in the absence of a fully-functioning government, creates immense challenges. The degree of recourse that a capital surplus entity has in managing relationships with the capital deficient must take into consideration the huge political risk prevailing in the jurisdiction.

Project financing in this environment can still be undertaken in compliance with Coasian bargaining theory by mitigating political risk. The model to be used in such instances has close parallels to the principle behind special economic zones (SEZ). For all intent and purposes, Special Economic Zones overcome market and coordination failures, and act as catalysts for the reform of political-economic and market forces. Typically, a SEZ operates with laws that are either free-market oriented or more enforceable than those of the country in question. In the SEZ, national laws may remain suspended.

Investors would then have confidence in the proceedings within the SEZ because laws applicable to the zone have more international recognition than those of the particular jurisdiction. In the case of Somalia/Somaliland whatever laws exist, however weak, would be superseded by a recognized third country's legal regime. The projects could therefore, be structured as syndicated arrangements where the features of particular project (separate incorporation, high leverage, and extensive contractual agreements) are held by developmental banks with an appetite for high risk and which are located in other jurisdictions. This is an opportunity for private equity players with experience in the region or similar situations where investor protection is weak or non-existent. A detailed market analysis of this type of opportunity is discussed on the Shuraako website in the planned community living discourse.

Recent Developments

At a first glance the Somalia/Somaliland situation appears daunting to those who used to Western style banking. This should not be reason to shy away because those who operate in the environment (like the Dubai Ports, Tullow Petroleum and the Turkish investors), have adapted to the situation. The Somali people just like many of their East African neighbors have a collectivist culture that encourages group activity. Though much of the group activity is tied to clans, the ongoing efforts towards establishing peace and good governance structures in Somalia/Somaliland, can only help put in place banking laws and enforcement mechanisms that meet international standards.

There is already movement towards establishing a central bank in Somaliland. Restoration of the Bank of Somalia operations, headquartered in Mogadishu, is also ongoing. These efforts do not have a specific time-frame and are all tied to the fluid political situation. The recent developments in creating a legislative body with a Speaker of Parliament (in Mogadishu) and renewed efforts at stability in South Central Somalia coupled with other encouraging changes in Somaliland can only bode well for formal banking especially of the brick-and-mortar type. Among the many issues yet to be tackled is the introduction of parliamentary bills to legitimize the various institutions. Severe capacity constraints also have yet to be addressed.

Even in the relatively more stable Somaliland region, no recognized bank is in operation because of the mentioned structural deficiencies. There are however, a few deposit receiving institutions. Deposit receiving institutions do have the minimum capital requirements that a central bank would impose. For all intent and purposes these deposit receiving institutions purely function as a "post office" or courier for depositors. In Mogadishu, the largest city in Somalia, the Salaam Somali Bank (launched in 2009) is an example of these deposit receiving institutions. Other deposit taking bodies include the Mogadishu-based First Somali Bank, The Puntland institutions of which the Islamic Bank is the most prominent, and more importantly a few of the Hawala players such as Dahabshill and Mustaqbal.

Banks from the neighboring countries especially Equity Bank, Kenya Commercial Bank and the Islamic Community Bank have expressed interest in establishing Somalia branches that will offer all regular services including Sharia compliant instruments once the necessary structures are in place. There is also talk of Gulf African Bank moving into the jurisdiction. Gulf African Bank is a fully fledged Islamic institution that is focused on the expansion of Islamic finance. The bank is primarily owned by Gulf and Kenyan investors with the balance of shares (16%) taken up by the International Finance Corporation (IFC).

An even more recent development is the introduction of micro-loan products in Kenya by Safaricom, a Vodafone subsidiary. Telecommunication providers in Somalia could follow suit and create a variation of this system. Safaricom has launched a mobile banking service that allows users of its innovative M-Pesa platform to save and borrow money using their mobile handsets. The service, which targets micro-savers and borrowers, is Sharia compliant and is known as M-Shawri. M-Shawri customers can deposit as low as $ 0.012 and borrow as much as $ 1,200 payable with a one-off 7.5% fee. All borrowed money is to be paid within one month of disbursement. M-Shawri is packaged as a means to promote a culture of saving among ordinary Kenyans and allow those with no collateral to access loans through their mobile phones.

These developments are likely to build on the saving culture that, has to this point, been largely tied to family or close friends. The main form of these circles is Ayuuto or Hagbad. Loosely translated Ayuuto and Hagbad mean "help" and "sharing" respectively. Membership to the rotating savings groups of Ayuuto or Hagbad is restricted to those who arewell known to other group members. Each member contributes a specific amount to the circle every month. Part of the sums received is then loaned out to group members the basis of need or invested in a mutually agreeable upon venture. Some of the Ayuuto or Hagbad circles have accumulated significant resources which any operating bank would find quite attractive. These savings circles have permeated all levels among the Somali people and remain a corner stone to the Somali society.

Conclusions

Whether (and when) the vast resources of these savings circles are brought into formal banking will depend on the speed with which the proper institutions are set up in Somalia/Somaliland. Key lessons can be learned from the models developed by the Grameen Bank and the Bangladesh Rural Advancement Committee in tackling middlemen and moneylenders who have benefited greatly from the poverty, and vulnerability of women within the saving circles. Equity Bank, the largest Kenyan bank in terms of number of account holders, also grew from a micro-finance heritage and can give direction on how to mop up the funds that are held mainly by women within the savings circles.

How and when transactions are made, will be tied to Somali and Islamic culture. Any payment method will in the main depend on its ability to attract a sufficient user base. The user base will help drive change even as it too benefits from the same change. For this process to continue, several of the key participants such as consumers, government agencies, merchants, payment providers, or networks, need to benefit from the change. In any society, two major forces persistently shape the demand of these constituents.

First, demographics come into play. As each new generation is exposed to more advanced systems, younger consumers or returning members of the diaspora often favor payment mechanisms and other money management systems that provide superior or combined functionality when compared to the prevailing channels. Second, globalization of the payments market, facilitated by the internet, is creating demand for new payment products that support arbitrage opportunities. The use and continued development of mobile channels is a good illustration of the effect of globalization. Formal banking of the brick-and-mortar type will ultimately follow too. The trajectory for this development is clearly evident and the signs for Somalia being brought fully into international financial systems appear encouraging.

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