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Somalia Unit

Feasibility Study on Financial Services in Somalia



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Appendices

- Appendix 1 Regulatory imperatives in UAE for money exchange and remittance businesses
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- Appendix 3 List of consultations and meetings



Reproduction of material

Extensive use has been made of secondary research papers and reports in order to provide a perspective on global developments and policies for promoting informal remittance systems and stable banking sectors. Such research material has mainly been produced by the International Monetary Fund, the World Bank and the Bank for International Settlements.

With the kind permission of the International Monetary Fund, the World Bank and the Bank for International Settlements, Sections 3 and 4 and Appendix 1, which provide an overview of the global developments in and policies for promoting informal remittance systems and stable banking sectors, include significant material that has been reproduced from the following research papers:

- Boorman, J. and S. Ingves *Financial System Abuse Financial Crime and Money Laundering – Background Paper*, International Monetary Fund, 2001
- Demirguc-Kunt, A. *Designing a Bank Safety Net – A long-term Perspective*, World Bank, Development Research Group, Website Policy Note, 1999
- El-Qorchi, M. *Hawala*, International Monetary Fund, 2002
- Polizatto, V. *Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks*, World Bank Policy Research Working Paper 340, 1990
- Thony, J. *Money Laundering and Terrorism Financing: An Overview*, International Monetary Fund, 2002
- International Monetary Fund, *Annual Report on Exchange Arrangement and Exchange Restrictions*, Washington D.C., various issues
- The World Bank and the International Monetary Fund, *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, March 2003
- Bank for International Settlements/International Monetary Fund, *Financial Stability in Emerging Market Economies*, Report of the Working Party on Financial Stability in Emerging Market Economies, April 1997
- United Nations Development Programme/World Bank Somalia, *Country Re-engagement Note*, April 2003

We wish to thank the International Monetary Fund, the World Bank and the Bank for International Settlements for allowing the use and reproduction of their research material.



1 Introduction

1.1 Background

United Nations Development Programme Somalia (UNDP) has appointed KPMG East Africa Limited (KPMG) to conduct a **Feasibility Study on Financial Services** ('the study' or 'the project') in Somalia. UNDP and the European Commission Somalia Unit (EC) have jointly funded this study.

A contract was entered into by KPMG with UNDP on the 7th of May 2003 to provide the above services.

1.2 Original project objectives and terms of reference

In funding this study, UNDP and EC are seeking to strengthen the capacity of the financial sector in Somalia. The primary goals of the study were to:

1. Ensure the continued operation of Somali remittance companies by strengthening their transparency and compliance with regulations; and
2. Strengthen the capacity of Somali remittance companies in order for them to begin providing some commercial banking services.

The original objectives of the study were to:

1. Evaluate the capacity of the remittance companies to provide existing remittance services;
2. Recommend capacity strengthening initiatives to assist remittance companies to improve their ability to provide their current services;
3. Evaluate demand for expanded financial services in Somalia;
4. Recommend capacity strengthening initiatives to assist remittance companies to provide a wider range of financial services;
5. Evaluate compliance of existing remittance companies with host country regulations;
6. Evaluate the capacity of Somali governing and regulatory bodies and legislation; and
7. Make recommendations about the capacity of governing and regulatory bodies and how to strengthen legislation.

1.3 Emergent project objectives

Following completion of the initial stages of the project, it was apparent that remittance companies were not in a position to allow the project team to undertake detailed diagnostic evaluations of their operations. This effectively meant that the study team would not be able to comprehensively undertake the following activities:

- Evaluate the capacity of individual remittance companies to provide existing remittance services;
- Recommend capacity strengthening initiatives to assist individual remittance companies to improve their ability to provide their current services;
- Recommend capacity strengthening initiatives to assist individual remittance companies to provide a wider range of financial services; and
- Evaluate compliance of individual remittance companies with host country regulations.

Further, it was recognized that by focusing on ways to strengthen individual remittance companies, an unfair playing field would be created providing them with an unfair competitive advantage over other entrepreneurs who might be interested in establishing commercial banks.

Therefore, as detailed in the project inception report, two primary project objectives emerged on completion of the initial stages of the project. It was agreed that these objectives would supersede previous project objectives. These objectives were to:

- Assess progress of Somali remittance companies in the formalization process and develop options to strengthen their capacity. It was recognized that any recommendation were to apply to the entire Somali remittance sector as opposed to individual remittance companies; and
- Evaluate options to develop a formal banking sector in Somalia as part of the wider reconstruction of the country. Our area of focus was to develop options that would result in the creation of a conducive environment for entry of banks (formed out of either existing remittance companies or new private companies) into the market. It was recognized that the development of options for strengthening of the domestic regulatory environment would be a priority of international development agencies. It was also noted that “regardless of the formation of a strong central government and/or banking system in Somalia, the remittance system will remain an integral part of the Somali economy and monetary system for the foreseeable future” (Omer, 2002).

The primary focus of the project thus became:

- **An evaluation of progress made in the Somali remittance sector and determining ways of strengthening it in line with global developments in the area of informal money transfer systems; and**
- **The creation of a roadmap for the development of a banking sector in Somalia.**

1.4 Major deliverables and progress

At the commencement of the study, several deliverables on the part of the study team were agreed. The program for the delivery of these remained intact despite the changes in the focus of the project indicated above.

The following section sets out progress towards meeting the various deliverables.

1.4.1 Reports

The deliverables of the study were:

- An inception report to be completed after the completion of a desk study evaluating existing secondary information and studies about the Somali financial sector and other relevant information and a field visit to Somalia. A final version of this report was issued on 9th July 2003;
- A feasibility study report presenting the findings of this entire study, which will act as a base line against which all proposed project activities could be measured;
- A project document identifying possible implementing partners, including a specific overview of the strengths and weaknesses within the Somalia context and a clear identification of the roles and responsibilities of each stakeholder. A draft project document will be issued on finalization of the feasibility study report. The document will include:
 - Feasibility of proposed projects through the analysis of alternative technical solutions;
 - Relevance of these proposed project activities with the country's macroeconomic environment and well-being, ensuring that potential problems to the beneficiaries and organizations are adequately addressed;
 - Pre-conditions necessary for the start of project activities, including costs and specific conditionality during implementation; and
 - Sustainability of the project.

1.4.2 Workshops

In addition to the deliverables indicated above, KPMG held the following workshops/conferences:

- A Conference on Expanding Financial Services in Somalia held in Dubai, United Arab Emirates (UAE) on 21st and 22nd of June 2003. The primary objectives of the conference were:

- A shared understanding and recognition of the need for remittance businesses to regularize/formalize/legalize themselves and an understanding of how to proceed; and
 - A shared understanding of what will be required in establishing a commercial banking sector both on the part of remittance companies and government.
- A workshop in Nairobi, Kenya on the 31st of July 2003 during which the results of the feasibility study, specifically regarding the roadmap for establishing a banking sector in Somalia, were discussed.

1.5 Structure and objectives of this report

The structure and specific objectives of this report are set out below:

- Section 2: Provides a background to the overall project and sets out the context and rationale for engaging with the Somali remittance sector and for developing a banking sector in Somalia;
- Section 3: Provides an overview of the Somali remittance sector followed by the global developments in the informal money transfer sector. This section also assesses progress of the Somali remittance sector in this context and challenges going forward;
- Section 4: Sets out globally accepted standards and guidelines for the development of a banking system in a post-conflict setting and assesses the state of the formal financial sector in Somalia in this context; and
- Section 5: Finally, charts a road map for the strengthening of the Somali remittance sector and the development of a banking sector and identifies areas for technical assistance.

2 Background to the project

2.1 Introduction

Somalia has been engulfed in a civil war for over a decade. “The impact of state failure on human development in Somalia has been profound, resulting in the collapse of central state institutions, the destruction of social and economic infrastructure and massive internal and external migration” (UNDP/World Bank Somalia, 2003). As a result, Somalia is one of the poorest countries in the world. It is estimated that in 2003 over 43% of the country’s population lives in extreme poverty (defined as individuals living on less than one US dollar a day) whilst over 73% of the population live in general poverty (defined as individuals living on less than two US dollars a day).¹

Despite the absence of a central Somali state and its financial, economic and social institutions, combined with other challenges, the traditional Somali spirit of entrepreneurship remains strong and the private sector resilient and robust. Indeed, the private sector has managed to grow impressively in the decade since the onset of the civil war, particularly in the areas of trade, commerce, transport, remittance services and telecommunications, as well as in the primary sectors, notably in livestock, agriculture and fisheries.² The private sector now provides a host of services, including those traditionally provided by the state such as power, telecommunications, water and education. Various economic sectors are now, however, becoming either stagnant or their growth is hindered due to the lack of investment, insufficient human resources and the absence of a relevant legal and regulatory framework to enforce rules and regulations, common standards and quality control.³ A notable example is the various bans on livestock exports to Arabian Gulf that have hindered the sector in recent years.

The collapse of the central government in Somalia in 1991 gave way to the ultimate collapse of the country’s commercial banking sector. There are currently no formal financial institutions operating in Somalia nor any fully functioning formal financial sector regulatory bodies. The absence of a formal banking sector has significantly constrained Somalia’s private sector in terms of its ability to access credit and other financial services. Further, the scarcity of capital has made it impossible to encourage and harness domestic savings.⁴ “The long absence of a national government has further prevented access to international capital markets as well as the establishment of economic management institutions and regulatory bodies” (UNDP/World Bank Somalia, 2003).

¹ United Nations Development Programme/World Bank Somalia, *Socio-Economic Statistics, Somalia, Report No 1 Somalia Watching Brief 2003, draft*

² United Nations Development Programme/World Bank Somalia, *Country Re-engagement Note, April 2003*

³ Ibid

⁴ Ibid

Since the collapse of Somalia's central government, the disintegration of its banking system and the onset of internal and external migration have meant that Somali remittance companies, which have operated in Somalia for over four decades, have grown significantly. Remittance companies now provide a vital lifeline for a significant proportion of Somalia's population. It is estimated that remittances from Somalia's Diaspora for the purposes of household income amount to some US\$360 million annually, accounting for 22.5% of total household income.⁵ In addition to remitting funds from the Somali Diaspora to Somalia and the Horn of Africa, remittance companies effectively act as quasi-banking institutions, facilitating the transfer of funds within Somalia, ensuring the transfer of funds for domestic and foreign trade and offering deposit facilities. Overall, it is estimated that Somali remittance companies transfer between US\$750 million and US\$1 billion annually.⁶

In November 2001, Al-Barakat, formerly Somalia's biggest remittance company, had its assets frozen and its United States operations closed down based on allegations that it was susceptible to being used to fund terrorism. Since then several Somali remittance companies have been put under significant scrutiny and have been pressured to formalize their operations. Many have made significant efforts to do so since 11th September 2001.

Remittance companies are currently the only functioning financial institutions operating in Somalia. They have filled a major void that has emerged since the collapse of the country's central government, providing basic banking services and providing a vital channel for the transmission of remittances that a large proportion of the Somali people depend on. UNDP, with its mandate to ensure sustainable human development through poverty reduction, capacity building and institutional strengthening, recognizes the role of the Somali remittance sector and has designed the *Somali Remittance Initiative* (the 'Initiative') to assist Somali remittance companies in formalizing their operations to ensure their continued existence. Further, in accordance with UNDP's commitment to bridging the gap between relief to development in Somalia, the Initiative seeks to assist in developing a formal banking sector in Somalia.

2.2 Brief historical background to Somalia

"The Somali Republic was created in 1960 when the former Italian Trusteeship merged with British Somaliland" (EIU, 2002). Following a presidential assassination and a military coup by General Siad Barre in 1969, an unsuccessful war was waged with Ethiopia. This period was followed by an era of totalitarian rule by the General Siad Barre regime. The regime was subsequently ousted resulting in the collapse of the central government of Somalia in 1991 and the disruption of all facets of state apparatus.⁷ "With the continuation of civil war in the period since 1991 and the continued absence of a central authority, Somalia remains

⁵ United Nations Development Programme/World Bank Somalia, *Socio-Economic Statistics, Somalia, Report No 1 Somalia Watching Brief 2003, draft*

⁶ Omer, A. *A Report on Supporting Systems and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (Hawala)*, United Nations Development Programme Somalia, 2002

⁷ Ibid

highly fragmented with isolated and independent administrative entities emerging in regions throughout the country” (Omer, 2002). Numerous central state “institutions have collapsed and most economic and social infrastructure and assets have been destroyed resulting in a stateless Somalia with a highly militarized political environment, deep inter-clan hostility and societal mistrust of any central government” (UNDP/World Bank Somalia, 2003).

Northwest Somalia (other wise known as the Somaliland), covering former British Somaliland, declared itself independent in May 1991 after the collapse of the Barre regime in January 1991 and has since operated autonomously from the rest of the country. The territory is generally characterized by relative peace and stability. The territory has not, however, been internationally recognized. Despite the fragmented nature of the country “the United Nations continues to respect the principle of territorial integrity of Somalia as sanctioned by member countries and therefore considers Somalia a single nation” (UNDP/World Bank Somalia, 2003).

“More than a dozen peace agreements have been brokered between warring factions since 1991, but none of them have brought political stability or restored security” (EIU, 2002). In July 2000 a Transitional National Charter, which establish the institutional framework for an interim administration, was adopted.⁸ The Charter provided for a three year transitional government based on a federal system with a 245-seat Transitional National Assembly (TNA).⁹ In October 2000 a Transitional National Government (TNG) was established with a mandate running until 15th August 2003.¹⁰ However, “different administrations continue to exist and control various cities and regions of the country” (UNDP/World Bank Somalia, 2003). The current Somali National Peace and Reconciliation Process began on 15th October 2002 in Kenya and represents the fourteenth reconciliation effort on Somalia.¹¹

2.3 Economic context¹²

Somalia’s economic sectors vary significantly in terms of their level of development, size and growth. Somalia’s economy is heavily dependent on livestock and agriculture. According to World Food Programme estimates, stock rearing is practiced throughout the country and contributes to about 40% of GDP and 65% of export earnings (2000). Bananas comprise Somalia’s primary agricultural export, most of which are grown in farmland that lies between the Jubba and Shabelle rivers in the south of the country. Manufacturing in Somalia is extremely limited and is generally confined to agro-processing. Somalia’s service sector has grown with the emergence of the remittance and telecommunication sector.

⁸ Economist Intelligence Unit, *Country Profile, Eritrea, Somalia, Djibouti*, 2002

⁹ Ibid

¹⁰ United Nations Development Programme/World Bank Somalia, *Country Re-engagement Note*, April 2003

¹¹ Ibid

¹² This section is based on information drawn from the Economist Intelligence Unit, *Country Profile, Eritrea, Somalia, Djibouti*, 2002

Despite evident challenges placed on the economy arising out of a continuing civil war and absence of central government, Somalia's economy has performed relatively well in the last several years.¹³ Growth has been generated by the strong private sector that has spurred growth in livestock and agricultural sectors, and in the remittance and telecommunications sectors. However, a number of factors have served to significantly constrain economic growth and development over the last decade. In the early 1990s, large imports of food aid and the disruption of traditional rural-urban commercial networks grossly distorted Somalia's goods markets. In the first half of 2001, inflation rose dramatically throughout the country as a result of injections of foreign-printed currency.¹⁴

More recently, a number of factors continue to hamper Somali economic development and growth. In 2001, Somalia's economy contracted because of a series of bans on livestock imports imposed by Saudi Arabia and other Gulf states. A ban on the export of livestock to Saudi Arabia is still in place and continues to hamper the country's economic development.¹⁵ The Somali economy has also been adversely affected by a deficient financial sector that has been prone to instability. There is a general lack of credit and other financial services in the Somali economy. Further, the country's vibrant remittance sector, the only functioning component of the financial sector, has been put under intense pressure since the closure of Somalia's largest remittance company in November 2001, which resulted in the loss of significant amounts of funds on the part of businesses and individuals.

Concluding remarks

The collapse of the central government of Somalia in 1991 resulted in widespread disorder and the disruption of all central state institutions. With the continuation of civil war in the period since 1991 and the continued absence of a central authority, "Somalia remains highly fragmented with isolated and independent administrative entities emerging in regions throughout the country" (Omer, 2002).

In the absence of any central government, the importance of Somalia's private sector cannot be overplayed. Indeed, the entrepreneurial spirit of the Somali private sector has operated successfully within a central administrative vacuum for over ten years. Nonetheless, the country and the private sector continue to face major challenges. Adverse events in recent years, such as the livestock ban and closure of Al Barakat, have impacted drastically on the economy and society. Consequently, migrant remittances contribute significantly towards the economy and livelihoods of Somali families.

Against the brief background above, the need to strengthen the Somali remittance sector and develop financial services is now of great importance. Such services are a vital and necessary means for ensuring poverty reduction and sustainable economic growth.

¹³ United Nations Development Programme/World Bank Somalia, *Country Re-engagement Note*, April 2003

¹⁴ Economist Intelligence Unit, *Country Report Ethiopia, Eritrea, Somalia, Djibouti*, March 2003

¹⁵ *Ibid*

Political map of Somalia



Source: United Nations, Department of Public Information, Cartographic Section, August 1997

2.4 Background to Somalia financial sector

Somalia has been without a formal commercial banking and financial institutions sector since the overthrow of Siad Barre's government in 1991. Immediately prior to the civil war, Somalia's formal financial sector was composed of:¹⁶

- Central Bank of Somalia;
- Commercial and Savings Bank (in itself created through government's forced consolidation of a number of banks);
- Somali Development Bank; and
- State Insurance Company.

Very little information is available about the intermediation performance of banks prior to 1990. By 1991 these institutions had collapsed either as a result of bankruptcy or as a result of the collapse of state infrastructure. Historically, the Somali banking system is reported to have been plagued by excessive government involvement and mismanagement.

In the absence of a formal financial sector in Somalia, the informal financial sector has, to some extent, filled this void. The latter has traditionally been comprised of remittance companies. The remittance sector in Somalia dates back several decades. The scale and scope of remittances has been closely linked to Somalia's role as a source of labour for the Arabian Gulf and to the Somali Diaspora that has mushroomed in the West.¹⁷

Civil unrest, insecurity and absence of a formal banking sector have been the obstacles to economic development. Even though the remittance sector plays a vital role in the current Somali economy, the existing financial sector can be characterized by the following:

- Virtual lack of financial intermediation i.e. deposit-taking and lending through financial intermediaries, although some limited lending does take place through non-governmental organizations in form of micro-finance;
- The economy is predominantly cash-based;
- Lack of public confidence in a banking system especially where the government is a key player. This is not surprising given that the public has lost their monies in the past. Hence, the revival of the banking system will depend on regaining public confidence to a very large extent;
- The provision of very limited banking services, such as money transfers, foreign exchange and deposit facilities, provided by the remittance companies operating informally.

The banking sector in Somalia currently comprises of an active informal sector and virtually non-existent formal sector. The private sector remittance companies dominate the informal sector, whereas the formal banking sector includes central banks in Mogadishu (southern Somalia), Hargeisa (Somaliland) and Bosasso (Puntland). Although these central banks also

¹⁶ Somali Democratic Republic, Directorate of Planning, Ministry of National Planning, *The Five Year National Development Plan, 1986-1991*, September 1987

¹⁷ Remittance companies and money transfers in Somalia, Ken Menkhaus, October, 2001



provide commercial banking services, they are either dysfunctional (Bank of Somaliland and State Bank of Puntland) or defunct (the central bank in Southern Somalia).

Since the remittance companies dominate the rudimentary financial system that currently exists in Somalia, we commence with the review of this informal money remittance sector in the next section.

3 The Somali remittance sector

In this section, we firstly provide an overview of the Somali money remittance sector in terms of history, dynamics, operators, services, scope etc. We then describe the recent global events surrounding money remittance (transfer) businesses generally – often termed as ‘informal money transfer systems’ or ‘hawalas’. Finally, we describe progress made by the Somali remittance sector in light of the global pressures on such systems, as well as some of the challenges facing the sector going forward.

3.1 Overview of the Somali remittance sector

3.1.1 Brief history

A major contributing factor in the development of the Somali remittance sector has been migration of Somalis from Somalia to various parts of the world for a variety of reasons. “In the 1960s a significant number of Somalis migrated to central and eastern parts of Southern Africa, drawn by employment opportunities in the transportation industry. In particular, the construction of the Tanzania-Zambia railway line attracted many semi-skilled and unskilled labourers” (Omer, 2002).

Migration from Somalia to the North America, Western Europe and the Arabian Gulf increased significantly in the 1970s and 1980s as a result of political intolerance in Somalia and economic opportunity elsewhere. At this time the ‘*franco valuata*’¹⁸ remittance system was employed. It involved Somali laborers working in the Gulf States purchasing consumer goods and sending them to Somalia or simply remitting a portion of their income using Somali traders. In the first case traders took the proceeds of the sale of the goods and paid the laborers’ relatives in local currency. However, ‘*franco valuata*’ system proved to be both inefficient and time-consuming process.

“In the 1990s the collapse of the Somali state and the economy coupled with the ongoing civil war further increased migration to the western countries and many other parts of the world” (Omer, 2002). It is estimated that over 750,000 Somalis currently reside and work in North America, Europe, Australia, New Zealand and the Gulf States.¹⁹ During this period Somali migrants continued to remit portions of their income to relatives in Somalia using Somali remittance companies.

“What started as a way for an émigré to send cash back to their extended families has in many cases blossomed into full-blown financial operations. The remittance companies are the sole international financial institutions operating in Somalia. They are a lifeline for many Somali families both in Somalia and in the Horn of Africa, a conduit for hard currency

¹⁸ The description of this system included here is drawn from Omer, A. *A Report on Supporting Systems and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (Hawala)*, United Nations Development Programme Somalia, 2002

¹⁹ Ahmed, I. *Remittances and their Economic Impact in Post-War Somaliland*, *Disasters* 24, 4 (2000)

entering and leaving the country, as well as an instrument for trade and commerce in Somalia and abroad” (Omer, 2002).

3.1.2 The growth of the Somali remittance sector²⁰

During the early 1990s, the Somali remittance system was comparatively informal. Indeed the system depended on relationships based on trust with known brokers or agents who would insure that funds were delivered to Somalia or the Horn of Africa. As private high frequency (HF) radio communication service providers were often the only form of communication in Somalia, they were used to remit funds. These service providers would be promised reimbursement and a commission by a broker for providing funds locally. Recipients of funds would confirm receipt of the funds using the HF radio. “In this way, local HF radio operators became the first, small-scale remittance sector. Their lack of capital prevented them from expanding the service beyond very modest levels. Though some operators in small towns and villages continue to play a role in remitting money, since 1995 most HF radio operators were absorbed into larger remittance companies as local agents, operating on commission” (Menkhaus, 2001).

Fortunately, the growth in volume of Somali remittance sector in the 1990s coincided with advances in the telecommunications sector, significantly improving the reach and efficiency of the remittance sector.

In summary, three major factors that have influenced the growth of remittance companies in Somalia: migration, telecommunications, and the emerging trade sector. These factors hold true for the growth of numerous other remittance sectors in the world.

3.1.3 Current operators in the remittance sector

There are numerous remittance companies operating in Somalia who have operations worldwide. Whilst the owners and origins of these companies are Somali-based, most of them have operations in the United States, United Kingdom and Europe and East Africa. In most cases, the owners are heavily involved in the management of the operations, which are conducted through ‘agents’ – either as branches owned by the company or agencies franchised to independent agents. Typically, the international operators have put in place regional clearing centres or headquarters in key locations worldwide, thus decentralizing much of the operations at country level. The more significant operators are as follows:

²⁰ This section is based on a discussion about the growth of Somali remittance sector in Menkhaus, K. *Remittance companies and money transfers in Somalia*, 2001

Name	Headquarters
Amal Express	Dubai, United Arab Emirates
Al-Mustaqbal	Dubai, United Arab Emirates
Barwaqo Financial Services	Dubai, United Arab Emirates
Cidgal	Djibouti, Republic of Djibouti
Dalsan	Nairobi, Kenya
Dahabshiil	Hargeisa, Somalia
Global	Dubai, United Arab Emirates
Kaah Express	Nairobi, Kenya
Sahaan	Dubai, United Arab Emirates
Salama Money Express	London, United Kingdom
Towfiq	Dubai, United Arab Emirates

Source: Omer, A. A Report on Supporting Systems and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (Hawala), United Nations Development Programme Somalia, 2002

3.1.4 Services of remittance companies

Remittance companies rely mainly on the business of migrant remittances for family maintenance and supporting the daily needs of families. The bulk of this type of remittances relate to monies being remitted to Somalia from western economies. A recent survey conducted by UNDP estimates that more than 25% of families in Somalia receive remittances from abroad²¹. Although, a vast majority of such money transfers are cross-border, domestic remittances (i.e. within a country) are also widely applicable.

Aside from remittances for supporting the livelihoods of Somali families, remittances are also used for investment purposes (such as for the purchase of house or land), for facilitating domestic and international trade and to meet payroll and contract payments of aid and development agencies.²²

Individuals and businesses also deposit funds with remittance companies for short periods, using the companies as a crude savings bank.²³ However, the confidence of the business

²¹ United Nations Development Programme/World Bank Somalia, Socio-Economic Statistics, Somalia, Report No 1 Somalia Watching Brief 2003, draft

²² Menkhaus, K. Remittance companies and money transfers in Somalia, 2001

²³ Ibid

community was significantly dented as a result of losing such deposits due to the closure of Al-Barakat, the largest Somali remittance company prior to 2002. Nevertheless, it is this quasi-banking role that continues to generate the most interest amongst major remittance companies.

3.1.5 Scope of remittances in the Somali economy

Remittances into Somalia are by far the largest single source of hard currency entering the country.²⁴ One study estimates that remittances to the north-west area of Somalia, known as Somaliland, alone (which is home to about 1/5 of the total population in Somalia, estimated at about seven million people) reach as much as US\$500 million per year, some four times the value of livestock exports in a normal year (prior to any livestock ban).²⁵ Another study, that was also undertaken prior to any livestock ban, calculates that remittances constitute nearly 40% of the income of urban households in the northern towns of Hargeisa, Burao, and Bosasso.²⁶ “Data of remittances to southern Somalia are less well-documented. Mogadishu is unquestionably the largest recipient of remittances; it probably accrues a similar level of remittances as does Somaliland” (Menkhaus, 2001). A more recent survey by UNDP has estimated the amount of annual remittances for family maintenance to Somalia at approximately US\$360 million²⁷. Overall, best estimates indicate that total remittances nationally amount to somewhere between US\$750 million and US\$1 billion per year.²⁸ “Even the low end of this estimate dwarfs the amount of money the country earns from livestock exports or receives in foreign aid” (Menkhaus, 2001).

The role and impact of remittances in Somalia is vast. Indeed, “when one considers that most of the Somali population is living off less than one dollar per day, that the injection of hard currency from abroad is essential in enabling Somalia (which has a chronic balance of trade deficit and a local currency of little value) to purchase staple food imports like rice, sugar, and flour and that the remittances tend to have a “multiplier effect” in local communities, indirectly benefiting households that do not receive remittances themselves, the importance of remittances to Somali food security is hard to overestimate” (Menkhaus, 2001). Without access to remittances, Somalia would face a humanitarian crisis. Further, it is apparent that remittances “very much constitute a life support system for a comatose economy” (Menkhaus, 2001).

All estimates regarding the magnitude of remittances to Somalia must be treated cautiously. Such data is not freely available, neither is it possible to extract such information since remittance companies regard such information as a commercial secret.

²⁴ Menkhaus, K. Remittance companies and money transfers in Somalia, 2001

²⁵ Ahmed, I. *Remittances and their Economic Impact in Post-War Somaliland*, Disasters 24, 4 (2000)

²⁶ Medani, K. *Report on Migration and Remittance Inflows: Northwest and Northeast Somalia*, Nairobi UNCU and FSAU, 2000

²⁷ United Nations Development Programme/World Bank Somalia, *Socio-Economic Statistics, Somalia, Report No 1 Somalia Watching Brief 2003, draft*

²⁸ Omer, A. *A Report on Supporting Systems and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (Hawala)*, United Nations Development Programme Somalia

The role of Somali remittances in development

It is clear that Somali remittance companies play a vital role in Somalia. Remittances are used for:

- Daily subsistence (where typically amounts remitted range between US\$50 to US\$100);
- Investment in commercial projects (where, for example, remittances for capital investment in land or buildings would average around US\$100,000);
- Domestic and international trade (typically remittances for settlement of trade activities exceed US\$500,000); and
- Social development projects.

Source: Interviews with the management of Amal, Barwaqo, Dahabshiil, Dalsan, Global and Towfiq

3.1.6 Potential for becoming banks

The restoration of the financial sector, which is essential for progress and development of the economy, remains elusive, and while remittance companies have filled some of the void, there is an urgent need to revive the entire sector. That need aside, the remittance companies have proven to be a vibrant alternative, providing essential money transfer, foreign exchange services and, in some cases, deposit facilities, albeit without any deposit protection scheme in place. These companies are effectively a half-way house to banks, and function efficiently, providing quick and inexpensive services to all parts of Somalia. Their services are available to Somalis living worldwide with agents and franchises based abroad providing ease of local access.

There is no reason why the existing Somali remittance companies cannot expand their services to provide commercial banking services in Somalia, or anywhere else subject to meeting the rules and regulations applicable to the industry. However, for Somalia to revive its financial sector, one must look at the development of the sector in a holistic and sustainable manner. In the first place, the country currently lacks an environment conducive for the entry of banks; for instance, there are no regulations in place for financial institutions. While a holistic solution is needed to address this situation, the Somali remittance companies are faced with many other challenges in light of global events. The remittance sector has been critical to the economy, but following the tragedy of 11th September 2001 Somali companies have come under increasing international scrutiny. The closure of the largest company has created a crisis of confidence in remittance operations.

Following the tragic events of 11th September 2001 that took place in the United States, a number of governments have called for an urgent and co-ordinated effort to detect and prevent the misuse of financial systems by terrorists. World attention has also turned toward regulating the money transfer businesses given the informal manner of their operations, reported abuse for money-laundering in certain cases and the potential for abuse of funds. However, to ordinary Somalis living without formal banks, the informal remittance system is the only way to access money from relatives abroad. Given its critical importance to the

economy against the background of legitimate international concerns, the continuation of remittance operations is of paramount importance. In the following section, we consider the emerging global trend toward informal money transfer systems – the Somali remittance system being one of many such systems that fall under this category and operate throughout the world.

3.2 Global concerns and developments in Informal Money Transfer Systems

3.2.1 Introduction

A range of informal money transfer systems (IMTS) are in use in several parts of the world. The hawala system, one type of IMTS, is an informal channel for transferring funds between locations through the use of hawala service providers. While hawala transactions are most often initiated by migrant workers in developed countries, they also involve the transfer of funds from developing countries to developed countries, often for the purpose of trade.

Following the 11th September 2001 terrorist attacks in the United States, global interest in IMTS has increased, largely as a result of the alleged role of the hawala system in the financing of terrorism and other illegal activities. These allegations and suspicions prompted governments and international regulatory bodies to attempt to develop a better understanding of these IMTS, assess their economic and regulatory implications, and design and implement new approaches to work with this industry. As a result many companies in the hawala sector have come under intense scrutiny by regulatory and law enforcement authorities.²⁹

Importantly, almost all research unanimously agrees that the hawala system “provides a fast and cost effective method for the worldwide remittance of money, particularly for low income groups who may be out of the reach of the formal financial sector or who transfer relatively small sums that are often subject to prohibitively high charges at conventional financial institutions” (Buencamino & Gorbunov, 2002).

In the course of our discussion below, as far as possible, we distinguish Somali remittance companies from other hawala systems to reflect their progress wherever appropriate. The Somali remittance system does, however, have its roots in the traditional hawala system.

3.2.2 Main characteristics of informal money transfer systems (IMTS)

Various terms are used by scholars to denote IMTS. These terms can be misleading. IMTS, for example are often referred to as ‘underground banking systems’ when in fact they operate quite openly.³⁰ Further, it is also a misnomer to refer to these systems as ‘banking systems’

²⁹ Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

³⁰ Ibid

since they typically do not involve traditional banking functions.³¹ Broadly, “IMTS are remittance systems that exist and operate outside of (or parallel to) conventional regulated banking and financial channels, where these exist” (Buencamino & Gorbunov, 2002).

The reasons for the emergence and continued existence of IMTS are often misunderstood. Indeed, “it is widely believed that IMTS come into being when political instability impedes the efficient workings of conventional institutions or when people seek ways to evade trade and foreign exchange controls” (Buencamino & Gorbunov, 2002). However, “these reasons may help explain why IMTS continue to exist but they are not the reason they were established in the first place. Their beginnings were in fact benign and were the result of people of similar ethnic background seeking a workable, efficient, cheap and secure means of transferring money and settling accounts with each other” (Buencamino & Gorbunov, 2002).

“Although IMTS operate in various communities, the largest ones operating today evolved from two original types, namely the hawala (which developed in South Asia) and the fei ch’ien, which started in China” (Buencamino & Gorbunov, 2002). Various systems now exist amongst different communities, “they go under various names - Fei-Ch’ien (China), Padala (Philippines), Hundi (India), Hui Kuan (Hong Kong), and Phei Kwan (Thailand)” (El-Qorchi, 2002). “It is estimated that globally between US\$100 and US\$300 billion flow through IMTS every year” (Buencamino & Gorbunov, 2002).

A simple description of the hawala system

A remittance from a customer (CA) in developed country A to a beneficiary customer (CB) in developing country B would involve the following steps. CA would provide funds in a currency to a hawala operator (HA) in country A and in return would receive a personal transaction code for the purpose of authentication, which CA would communicate to a designated beneficiary (CB) in country B. HA would instruct a hawala operator (HB) in country B to deliver an equal amount in a local currency to CB, who would have to disclose the personal transaction code in order to obtain the funds. HA can be remunerated by charging a fee to CA or through an exchange rate spread. After the fund have been paid by HB to CB, HA has a liability to HB.

The settlement of their positions can be made by directly through financial means. Alternatively, settlement of the liability position of HA with HB can be done through a reverse transaction, often for the purpose of importing goods, making investments or for medical and education expenses.

The reverse transaction could involve a customer (XB) in developing country B sending funds to a supplier (XA) in developed country A for the purchase of a commodity. XB would not be aware that their transaction is a reverse transaction. In this way HA will settle its liability with HB. Note that a reverse transaction can involve different hawala operators and be tied to a different transaction. The system can therefore be simple or very complex.

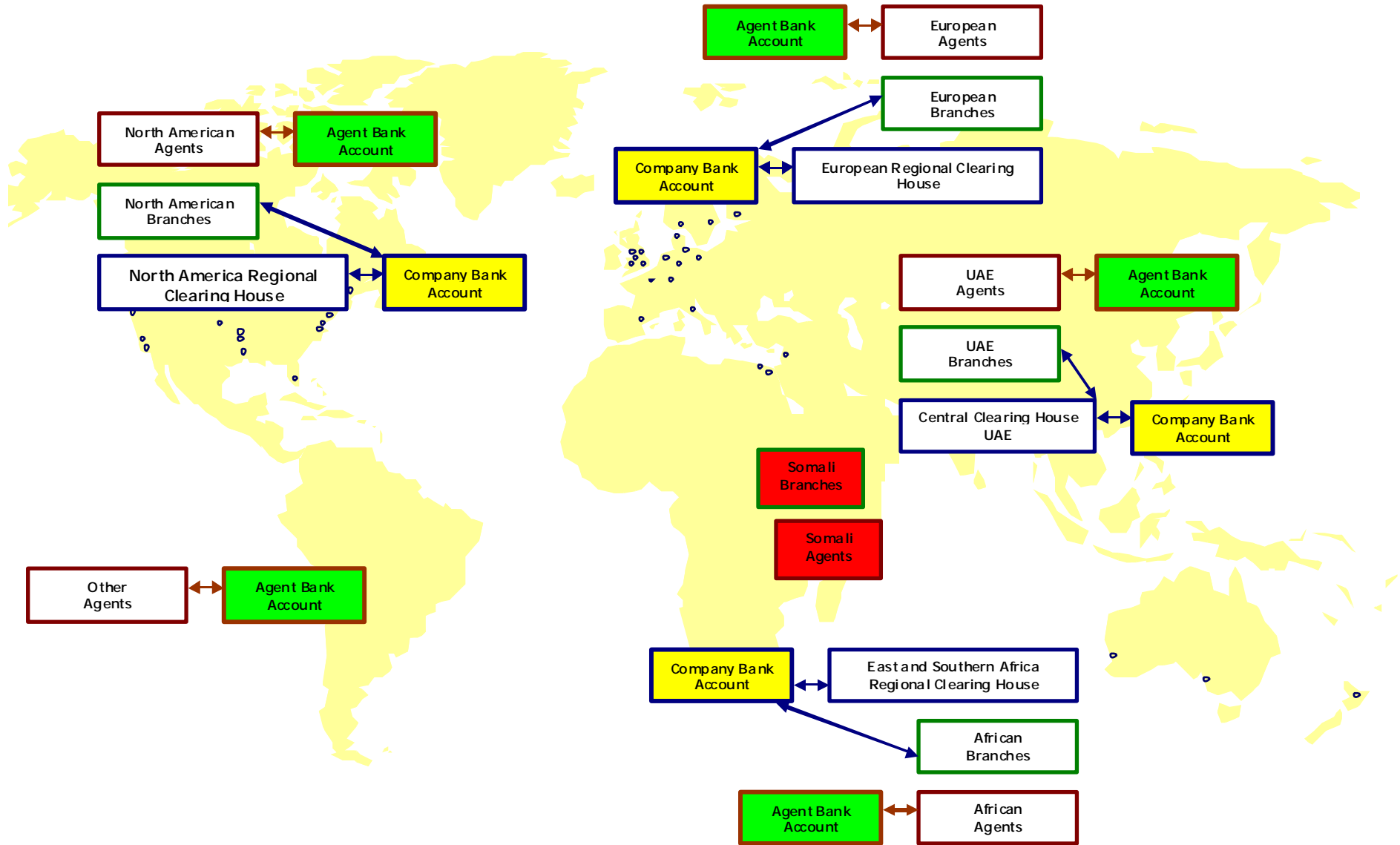
Source: El-Qorchi, M. *Hawala*, International Monetary Fund, 2002

³¹ Ibid

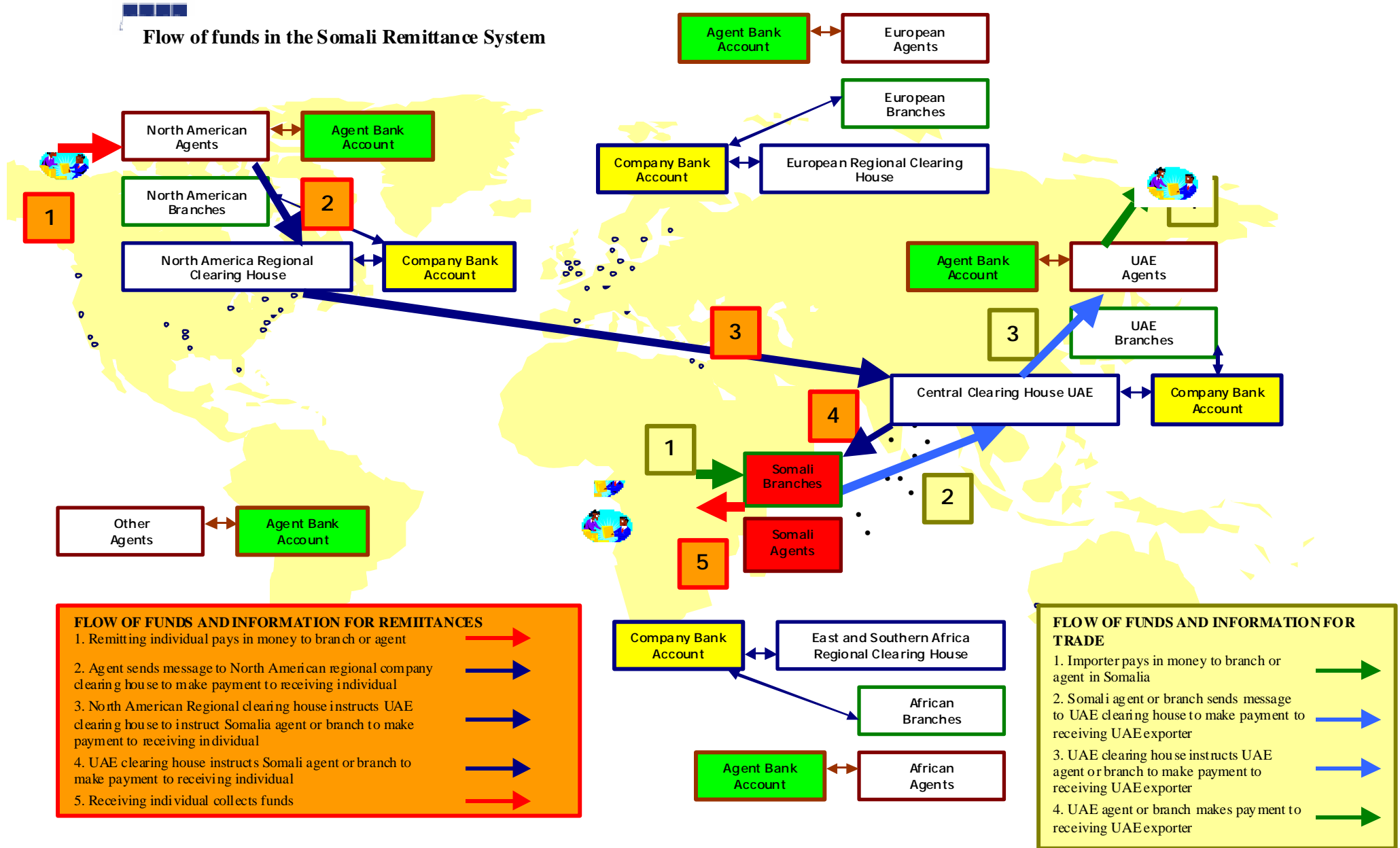


While the simplistic system described above was the root of the Somali remittance sector, the flow of transactions has undoubtedly changed with increasing size and coverage of operations. In the diagrams below, we demonstrate the flow of transactions broadly reflecting those of the present day Somali remittance systems.

Indicative Structure of the Somali Remittance System



Flow of funds in the Somali Remittance System



3.2.3 Why hawalas developed and continue to be used

Hawalas were originally used for trade financing - they were created because of the dangers of travelling with gold and other forms of payment on trade routes. The hawala system now enjoys widespread use but is historically associated with South Asia and the Middle East. At present, its primary users are members of expatriate communities who migrated to Europe, the Persian Gulf region and North America and send remittances to their relatives on the Indian subcontinent, East Asia, Africa, Eastern Europe and elsewhere. These systems continue to flourish and have not been replaced by conventional banking. However, whilst IMTS systems continue to be used for the legitimate transfer of funds, their relative anonymity and traditionally limited use of documentation in recording transactions have made them vulnerable to abuse related to the financing of illegal activity.

The reasons for the popularity of hawala are manifold. Economic and cultural factors explain the attractiveness of the hawala system. It is less expensive, swifter, more reliable, more convenient and less bureaucratic than the formal financial sector. Economic factors such as “host country macro-economic environments and government policies and regulations, such as currency controls and overvalued currencies, high tariffs and taxes, and slow and expensive licensing processes for financial institutions provide fertile ground for hawalas. In Jamaica, for example, the vibrant underground economy together with stringent government restrictions, slow licensing process and other prohibitions have resulted in a growth in IMTS” (Buencamino & Gorbunov, 2002).

The use of IMTS has also grown during times of political change and instability.³² Examples include the increased use of hawala in the Indian Subcontinent following the partition of India in 1947 and during the subsequent introduction of foreign exchange controls between India and Pakistan.³³

“There is a strong incentive to use IMTS if the official exchange rate is overvalued (thereby acting as an implicit tax on those who remit money through official channels)” (Buencamino & Gorbunov, 2002). Indeed, experts have contended that the difference between the official exchange rate and the black market rate is a determining factor affecting the choice of transfer channels.³⁴

Another major reason for the continued use of IMTS relates to weaknesses in conventional financial systems, including prohibitive costs, poor services and lack of access to the general population.³⁵ It is also evident that IMTS flourish where sections of society do not have complete faith in conventional banking systems. “In China, for example, IMTS thrive because the official currency exchange market cannot fully service the demand for foreign currency” (Buencamino & Gorbunov, 2002). The continued existence of these macroeconomic and institutional weaknesses has fostered the growth IMTS. Indeed, it is

³² Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

³³ Ibid

³⁴ Ibid

³⁵ Ibid

argued that “as long as these problems continue to exist it is likely that IMTS will continue to prosper. This effectively represents a market response by economic agents who are constrained by the level of financial development and government policies” (Buencamino & Gorbunov, 2002).

The wide reach of IMTS is another reason for its continued existence. IMTS are the only available means of transferring money in many cases. For example, the growth of IMTS in Australia is linked with the absence of banking services between Australia and several African countries.³⁶ In another example, several European Commission-funded aid organizations are known to use IMTS to transfer funds to several African and Asian countries.³⁷

Hawala companies generate income from by charging fees for transferring funds (either a flat rate or a percentage of funds transferred) and from exchange rate spreads. Hawala companies are generally able to charge lower fees for the transfer of funds than those charged by conventional banks as a result of their relatively lower cost base. Hawala companies have limited regulatory and operating costs, as they often have other small businesses operating from the same premises.

The hawala system can be significantly quicker than formal transfer systems such as conventional banks, largely due to the absence of bureaucratic structure and procedures. For example, the Somali hawala system is able to transfer funds to remote locations within a few minutes.

Many hawala systems serve specific cultural communities. Indeed, kinship and ethnic ties, as well as personal relations between hawala operators and expatriate workers make the system convenient and easy to use. Hawala operators are sensitive to particular cultural dispositions and preferences and develop relationships based on trust. Many expatriate communities for example, are exclusively male, because wives and other family members remain in the home country where family traditions prevail. These traditions may require family members, especially women, to maintain minimal contacts with the outside world. A trusted hawala operator, known in the village and aware of the social codes, would be an acceptable intermediary, protecting women from having direct dealings with banks and other agents. Thus, a system based on national, ethnic, and village solidarity depends more on absolute trust between the participants than on legal documents.

Indeed the element of trust plays a vital role in IMTS, as is the case for the Somali remittance sector. “It has been emphasized that in many respects the hawala system is self-regulating, as it is extremely rare for hawaladars to defraud one another or their clients. Cheating amongst hawaladars is punished by effective excommunication and a loss of honour, which is tantamount to an economic death sentence” (Buencamino & Gorbunov, 2002).

In net recipient regions, a number of factors contribute to the continued existence of IMTS. Restrictive economic and financial policies, inefficient banking institutions and unstable

³⁶ Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

³⁷ Ibid

political situations have offered fertile ground for the emergence of IMTS. However, even though IMTS generally thrive in regions marked by unsophisticated financial and economic systems civil instability, such systems still exist in financially developed and politically stable regions.

3.2.4 Is hawala legal?³⁸

The legality of hawala operations varies from country to country. Very few countries consider hawala operations to be completely illegal. “Even though hawala is illegal from a regulatory standpoint in some U.S. jurisdictions, hawaladars advertise their services widely in a variety of media (ethnic newspapers have been the traditional place to find them, now some are using the Internet). Enforcement of these regulations is difficult with respect to hawala. The advertisements are often printed in foreign languages, and wording like 'sweet rupee deals' does not necessarily suggest remittance services” (Jost & Sandhu, 2000).

In South Asia, legislation exists that “prohibits speculation in the local currency, prohibits foreign exchange transactions at anything other than the official rate of exchange, and imposes strict licensing requirements on money remitters and foreign exchange dealers. In addition, there are regulations governing inbound and outbound remittances” (Jost & Sandhu, 2000). Indeed, the regulatory regimes concerning IMTS in India and Pakistan are therefore amongst the most restrictive in the world. A key feature of such restrictive legislation is the fact that it contributes to the growth of IMTS in itself.

Another feature of the restrictive regulation and legislation relating to IMTS has been the emergence of Dubai, United Arab Emirates as a centre for IMTS transactions. Dubai’s status as a nucleus for South Asian migrants, its large gold market and its relatively unrestrictive legislation and regulation have given rise to its sizeable IMTS centre.

3.2.5 The potential for criminal use of hawala

The relative simplicity of IMTS and the ability to hide the origin and destination of funds or to break the audit trail have made such systems prone to abuse for the purposes of money laundering, gambling, smuggling or the financing of terrorism.³⁹ Indeed, it has been argued that “some characteristic features of unlicensed remittance centres of IMTS, such as inadequate customer background checks, customer identification records, transaction records and lack of compliance with laws requiring suspicious activities to be reported, lure criminal elements to use their services for illegal purposes” (Buencamino & Gorbunov, 2002).

It is unclear, however, as to whether IMTS are the preferred vehicle of criminals. “Whilst some argue that the small size of criminal transactions make them indistinguishable from those sent by its usual clients, it can be argued that conventional financial systems may be a more efficient vehicle to send funds to finance large operations as their capacity to process

³⁸ This section is largely drawn from Jost, P. and H.S. Sandhu, *The hawala alternative remittance system and its role in money laundering*, Interpol General Secretariat, Lyon, January 2000

³⁹ Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

large sums without arousing suspicion is greater than that of the typical IMTS” (Buencamino & Gorbunov, 2002). For example, it has been reported that the terrorists involved in the tragedy of 11th September 2001 received the majority of their funds through the conventional financial system.⁴⁰ Of equal importance is the fact that there does not appear to be conclusive evidence that criminal forces control or own IMTS, the European Commission going so far as to indicate that there is no evidence that the Taliban regime exercised control over the hawala system in Afghanistan.⁴¹

It is now widely acknowledged that there is some exaggeration to “argue that IMTS are heavily involved in criminal activity. IMTS seem to be no more of an impediment to laws aimed at eliminating money laundering or a risk of terrorism than conventional financial systems” (Buencamino & Gorbunov, 2002).

3.2.6 The potential use of hawala system for laundering money⁴²

“Money laundering consists of three phases: placement, layering and integration. Since hawala is a remittance system, it can be used at any phase” (Jost & Sandhu, 2000).

In the placement phase, fund derived from criminal activity is placed into the legitimate financial system. Typically, the greatest challenge for money laundering firms is introducing large amounts of funds into the conventional financial system, as this usually necessitates some form of regulatory reporting.⁴³ As hawala companies only make periodic bank deposits and are able to justify these as the proceeds of legitimate business, the hawala system offers an effective means of placement. The requirement by authorities worldwide on ‘know your customer’ programs is meant to address the placement stage and many of the Somali remittance companies have been working toward implementing such programs.

The layering phase involves the manipulation of illegitimate funds in order to make them appear that they are from a legitimate source. “Hawala transfers can leave a sparse or confusing paper trail and therefore there is no reason why hawala transfers could not be ‘layered” (Jost & Sandhu, 2000). The requirement for keeping adequate financial records by authorities worldwide has been adopted by many Somali remittance companies. Furthermore, all the major Somali remittance companies have automated or are in the process of automating their operations and records, although we have not been able to assess the accuracy and completeness of the available financial records.

The final integration phase involves the use the illegitimate assets or investment in alternative assets. “The same characteristics of hawala that make it a potential tool for the layering of money also make it ideal for the integration of money. Given hawala's close ties

⁴⁰ Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

⁴¹ Ibid

⁴² This section is largely drawn from Jost, P. and H.S. Sandhu, *The hawala alternative remittance system and its role in money laundering*, Interpol General Secretariat, Lyon, January 2000

⁴³ In the United States, for example, financial institutions are required to report cash transactions of over US\$10,000 (United States Federal Statutes, Internal Revenue Code (IRC) Section 6050 1)

to business activities, there is no reason why money cannot be 'reinvested' in a legitimate (or legitimate appearing) business” (Jost & Sandhu, 2000).

3.2.7 Economic implications of hawala

IMTS have direct and indirect macroeconomic implications for financial activity and for fiscal performance. For example, IMTS transactions have an impact on the monetary accounts of countries on both sides of transactions. As these transactions are not recorded in official statistics, neither as an increase in a recipient country's foreign assets or in the remitting country's liabilities, broad money is unaltered officially despite the fact that value changes hands and thus the composition of broad money in a recipient country can be affected. IMTS also have fiscal implications for countries involved because generally taxes are not paid on IMTS transactions.

IMTS transactions cannot be reliably quantified because records are often inaccessible, especially for statistical or balance of payments purposes. Some measure of volumes can be ascertained from hawala companies and from recipient and sending communities. Additionally, some countries sporadically make estimates based on their expatriate populations and balance of payments data. Global transaction volumes are estimated to run into billions of dollars.

3.3 Global policies to promote legitimate remittances⁴⁴

Recognizing that most IMTS transactions are legitimate remittance from migrant workers, regulators and policy makers have sought to develop effective means by which such workers can remit funds. A focus of such efforts has been on attempting to influence the medium with which migrants choose to remit funds.

3.3.1 Migrant specific policies

A typical government response to IMTS has been to encourage and, in cases, dictate that migrants remit funds through conventional financial institutions. For instance, “there have been several attempts to introduce mandatory remittance limits in the form of certain proportions of earnings transferred back to labour-exporting countries” (Buencamino & Gorbunov, 2002). Most of these initiatives have met with limited success.

However, there is broad consensus that using incentives rather than mandatory regulations is more likely to have a positive influence on migrants. That said, their incentive programs appear to have little lasting value if “macro-economic fundamentals remain distorted and institutional deficiencies persist” (Buencamino & Gorbunov, 2002).

⁴⁴ This section is drawn from Buencamino, L. and S. Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, United Nations DESA Discussion Paper, November 2002

3.3.2 Creating macroeconomic incentives to remit through institutional channels

“Social and economic stability, a low rate of inflation, positive interest rates, a stable and realistic foreign exchange rate and reliable financial institutions are the most important elements in deciding whether to remit through formal channels or use alternative systems” (Buencamino & Gorbunov, 2002). Currently, efforts have been focused on means on long-term structural policies aimed at reducing the demand that IMST meet.

“It has been argued that the best way to significantly reduce the volume of informal transactions is the orderly liberalization of the economy. A strong incentive to use IMTS exists where money is sent from the country that has a convertible currency and no capital controls to the country with inconvertible currency and/or ‘black market’ exchange rate. In this case informal transactions can be carried out at much better exchange rates than the official rates to the benefit of the remitter and the recipient” (Buencamino & Gorbunov, 2002).

Overall, however, it is apparent that most regulatory responses of net recipient countries have been unsuccessful in stemming the use of IMTS.

3.3.3 Improving conventional financial infrastructure

Buencamino & Gorbunov contend that the effectiveness of any incentives to switch into the formal financial system will ultimately depend on the ability of this formal system to compete with the informal sector. As migrants use IMTS for a number of reasons such as cost, efficiency and reach, policy makers have attempted to focus their efforts on encouraging these features in conventional financial institutions.

In tandem with this process, government initiatives in this area have included attempts to develop appropriate regulation in the money remittance sector. “These policies, it is argued, should be part of broader reforms aimed at modernizing the financial system. However, it should be noted that there are significant downsides to over-regulation” (Buencamino & Gorbunov, 2002).

3.3.4 Formalizing informal systems

Despite improvements in policies and conventional financial infrastructure, IMTS are likely to continue to play a major role in the money remittance sector. Not only are IMTS efficient and effective, they have also been proven to play an important stabilizing role for financial systems and economies in distress.

Conventional thinking is that banning or limiting access to IMTS would only serve to drive them underground as the conditions that have given rise to their need still exist. However, as there is a genuine inherent susceptibility of IMTS to criminal abuse, analysts thus generally recommend that the most appropriate way to contend with IMTS is to attempt to effectively regulate them.

A number of anti-money laundering and anti-terrorist measures pertaining to IMTS have thus been taken. “At an extraordinary meeting held in Washington D.C. on 29th and 30th October 2001, the Financial Action Task Force (FATF) agreed on a set of eight Special Recommendations on Terrorist Financing. Recommendation VI (Alternative Remittance) commits members to take measures to ensure that persons or legal entities that provide a service for the transmission of money, including transmission through an informal money transfer system or network, should be licensed or registered and subject to all the FATF anti-money laundering requirements that apply to banks and non-bank financial institutions. In June 2002, G7 Finance Ministers in their statement welcomed the work underway to combat the abuse of charities and hawalas” (Buencamino & Gorbunov, 2002).

The primary objectives of anti-money laundering and anti-terrorist measures are to increase the level of transparency of the money remittance business and to bring them within the scope of anti-money laundering legislation. Appendix 1 sets out the regulatory imperatives in the United Arab Emirates, a major global hawala centre.

“Unlike the option of prohibition, the introduction of regulatory measures strikes an important balance between protecting the financial and security interests and allowing informal operations to serve legitimate purposes for which they have been designed. Business owners thus acquire legal standing whilst customers are protected. There is a belief that most IMTS will want to comply with new legal requirements” (Buencamino & Gorbunov, 2002). Indeed, many Somali remittance companies have registered or in the process of registering their businesses in various countries. However, “there is also a recognition that it will take some time before affected businesses will come under the regulatory umbrella and that there may be some resistance to change” (Buencamino & Gorbunov, 2002). Indeed, there is a recognition that considerable efforts need to be made to explain the new regulations to those affected. Many of the Somali remittance companies are already aware of the new regulations in the countries they operate in. However, much more awareness from these companies is needed. It was with this background that a *Conference on the Somali Remittance Sector* was held in London, United Kingdom on the 3rd and 4th of December 2003. The conference was largely successful in increasing the awareness of participating Somali remittance companies of the regulatory regimes pertaining to the remittance sector in several European Union countries. Additional awareness programs are being planned by the recently established Somali Financial Services Association (SFSA), an industry association created by the Somali remittance sector.

There have been suggestions that more attention needs to be paid to the role and functions of conventional financial institutions that hold the bank accounts of IMTS. These organizations are now actively investigating account holders. Indeed, a major topic of discussion at the *Conference on the Somali Remittance Sector* focussed on the problems that Somali remittance companies face when attempting to maintain bank accounts with formal banking institutions. A key proposal that was made during the conference was the need to create dialogue with such institutions in order to ensure that such problems do not continue.

3.3.5 Difficulties for regulators

In the wake of heightened fears of global terrorism, international and regulatory bodies have attached significant importance to curbing the use of IMTS for money laundering and terrorist financing. It is widely perceived that IMTS are particularly vulnerable to abuse because of their perceived anonymity and limited record keeping. Yet selecting the appropriate regulatory and supervisory response requires a realistic and practical assessment and an understanding of the specific country environment in which the dealers operate.

There appears to be a widespread acceptance that the effective regulation of IMTS is likely to prove challenging, especially given the differing legal, economic and political contexts in which IMTS exist. Indeed, this was a particular problem identified by the Somali remittance companies at the Dubai workshop. As mentioned earlier, in a number of countries, the hawala system is prohibited. Any attempt to regulate this system in these countries would, therefore, be at odds with existing laws and regulations and would be seen as legitimizing parallel foreign exchange operations and capital flight.

Where it may be possible to regulate IMTS, there is a broad recognition that excessively stringent regulation and coercive measures are likely to push IMTS further underground. The purpose of any regulatory approach should, therefore, not attempt to eliminate them but to avoid their misuse. In this regard, policymakers tend to favour two options: *registration* or *licensing* of IMTS companies.

3.3.6 Experience of the hawala system in Afghanistan⁴⁵

In the context of Somalia, it is appropriate to share findings of the functioning of the hawala system in Afghanistan. The hawala system in Afghanistan is relevant to the Somali situation in a number of ways. The country has been through considerable civil strife and witnessed a breakdown of central institutions and law and order. As a result, the hawala system has flourished. The Afghan system operates throughout the world.

The significant findings of the World Bank were:

- The hawala is currently the most reliable, efficient, safe and inexpensive means of transferring funds into Afghanistan and between its provinces;
- There are estimated to be several hundred money exchange dealers but of these 300 are registered who have organized themselves into an impressive open market offering a wide range of services, including money exchange, funds transfer, micro-finance, trade finance and some deposit taking;
- The hawala system is extremely reliable and “there was 100% satisfaction rate with the delivery of funds” (Maimbo, 2003);
- The money exchange dealers provide an on-going mechanism for “the delivery of emergency, relief, humanitarian and developmental aid into Afghanistan for majority of international and domestic NGOs, donors, development aid agencies” (Maimbo, 2003).

⁴⁵ This section is based on Maimbo, S. A., *The Money Exchange Dealers of Kabul: A Study of the Hawala System in Afghanistan*, The World Bank, 2003

The majority of international and domestic organisations and NGOs use the system to move funds into and around the country. “NGOs alone are estimated to have channelled some \$200 million in emergency, relief and development funding through the hawala system” (Maimbo, 2003) (see box below);

- The ambiguities in the settlement process and general inaccessibility of records make the system vulnerable to abuse and the degree to which it is used for money laundering activities is difficult to document and quantify. The cultural and linguistic barriers also prove to be inhibiting factors;
- There are compelling reasons for not regulating or supervising the activities of money exchange dealers for such attempts can only result in the system changing its original characteristics and “push it further away from the formal sector, especially if the primary reason for its initial existence – foreign exchange arbitrage activities and poor banking services- have not been addressed” (Maimbo, 2003);
- Accordingly, any solution should be developed in the local context and given benefits, instead of focusing on the hawala regulatory and supervisory concerns, the financial sector reform efforts should concentrate on establishing a rudimentary commercial and central banking system in the country; and
- Meanwhile, there should be limited external regulatory and supervisory oversight so that the delivery of much needed aid funds remains unhindered through additional compliance.

Afghan Aid Flows through Dark Channels

Working feverishly to get Afghanistan back on its feet, the US administration has run into an unpleasant fact. To distribute aid there, it must rely on the same informal money-transfer networks that the US says terror and drug organizations use to move their funds.

Indeed, CARE, World Vision International and other aid agencies routinely use the networks, called *hawalas*, to move money from Pakistani banks to Kabul, the Afghan capital, and isolated rural areas. US administration officials have decided to let US funds pass through the system until the country develops a viable banking system.

The decision underscores the administration's fear that without a rapid inflow of aid, the government of interim President Hamid Karzai might not survive, and that a more violent Afghanistan might descend again into the kind of chaos that made it a haven for Al Qaeda terrorists. "The only alternative to using *hawalas* is to carry money on your person, and that has significant security risks," says Paul Barker, CARE's country director for Afghanistan.

Source: Wall Street Journal, June 2002

3.4 Progress in the Somali remittance sector

In light of the global concerns surrounding IMTS and international scrutiny of the Somali remittance companies, the Somali remittance sector appears to have made reasonable progress towards meeting the requirements on new and emerging regulation. Apart from the regulatory aspect, some have taken major strides toward improving efficiency of their operations through use of technology.

Somali remittance companies that were interviewed

A number of Somali remittance companies kindly allowed the study team to undertake an initial assessment of their operations. The study team met with management of these companies at various locations including Dubai (UAE), Nairobi (Kenya) and Bosasso, Hargeisa and Mogadishi (Somalia). Discussions with the management of these companies was extremely open and candid. Companies met included:

- Amal;
- Barwaqo;
- Dahabshiil;
- Dalsan;
- Global; and
- Towfiq.

3.4.1 Some general developments in the sector

At the recent conference in Dubai that was facilitated by the study team, participants indicated that the following progress has been made by some of the companies in the sector:

- Licensing and registration in host countries. For example, like many of the big remittance companies, Dahabshiil has registered their businesses in the United States;
- Formalizing ownership, capital and management structures. For example, Amal has separated the shareholders from the executive management, as well as put in place a decentralized structure of agents, branches, regional centres and head office for its worldwide operations;
- Ensuring accounts are produced in accordance with Internal Accounting Standards (IAS);
- Putting internal and external audits in place;
- Improving ‘know your customer’ processes including customer identification measures (technology enabled). Perhaps a strong control measure here applied by the Somali remittance companies is that transactions are normally carried out with known Somalis;



- Putting in place rules and conditions on agents/franchises, including vetting of agents; and
- Improving record keeping by the additional use of technology. At Towfiq, Microsoft Excel spreadsheets are used for downloading all remittance transactions across the world, and daily printouts are available listing the transactions and related details. Most of the other companies are similarly able to provide transaction listings.

3.4.2 Developments within individual companies

While the section above mentions general progress within the sector, it must be emphasized that this does not necessarily apply uniformly across the sector, and hence much more needs to be done. Nevertheless, the international pressures have brought out many positive developments within individual companies. Interestingly, some of the measures taken by the companies are more due to the increasing competitiveness in the sector as opposed to new regulation. Much of the progressive thinking of several individual Somali remittance companies is demonstrated in the tables below.

The regularization process at Dahabshiil, a Somali remittance company

The following is a list of initiatives by Dahabshiil in response to regulatory imperatives since 11th September 2001

- Embarked on a campaign to apply for and register its operations with concerned authorities in all countries where this has become a requirement;
- Hired money laundering reporting officers;
- Trained staff on rules and procedures;
- Incorporated appropriate checks in its new IT software to ensure regulatory compliance. Dahabshiil's new IT software is currently in its final stages of testing. The software allows for the reporting of suspicious activity and on transactions that exceed a certain amount by agents whilst ensuring several cost efficiencies. The software allows for the cross-checking of existing and potential clients with several international databases of suspicious individuals. Dahabshiil has dedicated a significant amount of human and financial resources to ensuring that its IT project is a success. A comprehensive training program has been put in place for agents and branches throughout the world;
- Converted branches and regional offices previously operating as sole trading businesses into limited companies; and
- Published guidelines for its agents on how to detect suspicious transactions and report them.

Source: Dahabshiil Company Profile, June 2003, and interviews with management in Hargeisa, North-West Somalia

Developments in organization structure – a perspective of Amal, a Somali remittance company

Since 11th September 2001, Amal has undertaken a series of initiatives to better define its organizational and operating structures in order to demonstrate transparency. Prior to this the organization had an operating structure comprising a loose federation of firms. Amal's structure now includes:

- Global head office and clearing house located in Dubai;
- Regional branches which act as regional clearing houses;
- Regional branches; and
- Agents.

Since 11th September 2001, Amal has registered in several parts of the world. Further registration and licensing is required and is currently underway.

Source: Discussion with the management of Amal in Bossaso, Somalia, Dubai, UAE and in Nairobi, Kenya

The use of information and communication technology– a perspective of Towfiq, a Somali remittance company

Towfiq is close to implementing its web-based software to facilitate money transfers. The company views its web-enabled software as crucial to meeting a number of objectives:

- Increase transaction speed significantly;
- Handle large of amounts of date accurately;
- Reduce operating costs;
- Manage agents more effectively;
- Control and monitor transactions from individuals centrally; and
- Allow for reporting of suspicious activity and on transactions that exceed a certain amount by agents, who are then able to pass these on to the company head office.

Source: Discussion with the management of Towfiq at meetings in Mogadishu, Somalia and in Dubai, UAE

The use of information and communication technology and gender-sensitivity – a perspective of Dalsan, a Somali remittance company

Through its website dalsanexchange.ayaah.com, Dalsan offers an e-business solution to providing remittance services. dalsanexchange.ayaah.com utilizes Dalsan's distribution network. It is the intention that the exchange will ultimately allow customers to use their credit card, check card, personal check and ATM cards to send money.

Dalsan has also embarked on a project to cater for women clients. The company recognizes that women comprise the majority of its clients and have therefore developed the concept of establishing designated women-only branches and agents in Bossaso. These branches would provide a comfortable and convenient environment for women to remit and collect funds.

Source: Discussion with the management of Dalsan in Nairobi, Kenya and information from <http://dalsanexchange.ayaah.com>

3.4.3 Assessment of progress against FATF best practices

In June 2003, the FATF released a paper on international best practices for combating the abuse of alternative remittance systems in order to provide guidance in implementing the Special Recommendation VI.

Although many of the best practices apply directly to countries/jurisdictions, one could easily interpret the best practices as applying to the remittance companies since inevitably there is an indirect impact on them. It is worth assessing the progress of the Somali

remittance companies against these best practices so that appropriate measures can be taken for meeting some of the gaps. This assessment is presented in Appendix 2.

3.5 Key challenges for the Somali remittance sector

Against the background of global concerns and developments in the remittance sector, and despite the positive developments made by some of the Somali remittance companies, the sector is faced with a number of challenges.

The ‘hidden’ challenges faced by Somali remittance companies since 11th September 2001 – a perspective from Barwaqo, a Somali remittance company

A very poignant and moving personal perspective on the challenges faced by Somali remittance companies since September 11th 2001 was shared by the management of Barwaqo during the plenary session of Conference on Expanding Financial Services.

It was stated that Somali remittance companies are subject to far more rigorous application of regulations in comparison to other companies providing remittance services between the United States and other parts of the world. In addition, it was argued that the stigma attached to Somali remittance companies since the closure of Al-Barakat, previously Somalia’s largest remittance company, has manifested itself in increased discrimination.

Finally, the constant threat of closure by regulators as a result of a new act of terrorism places tremendous fear in the shareholders, management and employees of Somali remittance companies. It is ironic that those who could stand accused of enabling terrorism are ultimately those who stand to lose their entire livelihoods as a result of it. Somali remittance companies thus live in constant fear of a new terrorist act as not only can they and their families become victims of it directly but that they can suffer in its aftermath.

Source: Views shared by the management of Barwaqo in plenary session at the Conference on Expanding Financial Services in Somalia, in Dubai UAE on 21st-22nd June 2003

An immediate challenge acknowledged by the Somali remittance sector is to carry out a damage limitation exercise against the backdrop of the closure of the largest Somali remittance company, post-11th September, because of the ensuing crisis of confidence and increased vigilance placed on the remittance sector as a whole.

Other challenges include: registration and licensing as legal entities according to host country financial rules and regulations, absolute transparency by ensuring proper corporate governance, account-keeping, and moving towards independent audit of books.

Several key challenges highlighted by participants at the Conference on Expanding Financial Services in Somalia include:

- Legal challenges:
 - High cost of registration and licensing – including bonds and fees

- Variations in registration and licensing requirements within and between countries and states
- Strict enforcement of regulations by various host authorities, without necessarily understanding the remittance businesses
- Cultural challenges:
 - Staff reluctance to adopt new ways of operating
 - Customers reluctance to adopt new ways of operating
- Lack of a 'level playing field' – no industry standards or a means to ensure all remittance companies comply with regulation, resulting in some companies having an unfair competitive advantage;
- Image problem – the closure of one of Somalia's largest remittance companies has resulted in stigma attached to the Somali remittance industry as a whole; and
- Absence of functioning internal central government.

3.5.1 The need for 'formalization' of the Somali remittance sector

The conference participants agreed and committed themselves to move towards licensing and registering their businesses as per rules of the host country of operation. This will assist in formalizing their operations and will provide a good basis for business growth as well as expansion of financial services.

The conference participants also established a preparatory committee to pave the way forward for the creation of an industry association.⁴⁶

The following is a summary of deliberations from the Conference on Expanding Financial Services in Somalia:

⁴⁶ The Somali Financial Services Association (SFSA) was subsequently established later in 2003. It was launched at the *Conference on the Somali Remittance Sector* in London, United Kingdom at a cocktail reception on the evening of 3rd December 2003.

What is the desired position of the Somali remittance sector within next two years?

- All Somali remittance companies registered as legal entities in all countries in which they operate
- The Somali remittance sector projects a clean, trustworthy and professional image to the international community

What do we need to do to achieve that position?

- Establish a professional trade association
- Recognize that the actions of one affect all
- Do not want to be victims and therefore the need for control of the situation

What needs to be done to establish an Association?

- Agree on the need/concept by participants
- Appoint and empower a preparatory committee

What are the objectives of the Association?

- Increase awareness of the Somali remittance sector
- Represent the sector to the outside world and domestic governments
- Function as an information databank, including information about licensing and registration requirements and update members about legal and regulatory developments
- Provide legal services
- Establish basic standards and code of conduct for members
- Ensure compliance with laid down standards
- Resolve conflicts amongst members
- Advocate for members in the international sphere
- Coordinate members' activities where beneficial for the sector as a whole
- Staffing should be independent and supervised by a Board of Directors
- Should be based in Dubai with regional offices in Nairobi, London and Minneapolis
- Develop common standards in auditing, accounting and IT
- Provide access to training

A preparatory committee was established at the conference with a mandate to establish an industry association. The Somali Financial Services Association (SFSA) was established and launched at the *Conference on the Somali Remittance Sector* in London, United Kingdom at a cocktail reception on the evening of 3rd December 2003.

Concluding remarks – global attitude towards IMTS

Overall there is broad agreement that hawala and other IMTS do respond to legitimate financial needs and offer a competitive and efficient channel for fund transfers. However, “the anonymity of the system makes it vulnerable to money laundering and terrorist financing” (World Bank/IMF, 2003).

“Attempts to tightly regulate the informal financial system may change the very positive characteristics of the business that have popularized it – speed, low cost and reach, in the process pushing it farther away from the formal sector, but also may place an additional administrative burden on financial sector regulators. Coercive measures to regulate these systems are unlikely to succeed in the absence of reforms in the formal financial sector. Financial sector modernization and reforms along with greater exchange liberalization are key in the longer term to reducing attractiveness of the formal sector in the remittance business. Therefore developing appropriate regulatory and supervisory frameworks requires a realistic and practical assessment and understanding of the specific country environment in which money exchange dealers operate” (World Bank/IMF, 2003).

Where hawala exists alongside the conventional financial system, hawala dealers are rightly being asked to register with regulatory authorities and keep adequate financial records, in line with FATF recommendations. A simultaneous need also exists for weaknesses in the formal sector to be addressed.

“In conflict-afflicted countries due to the lack of, or weak, supervisory capacity, even basic registration is not always possible. In these cases priority should be given to creating an environment conducive for the entry of new private domestic and international banks, and increasing the supervisory capacity. The authorities should also initially encourage a self-regulatory process through an existing local association of remittance dealers in these countries while the national financial system and supervisory capacity is established. Over time more formal registration and regulation should be introduced in accordance with money exchange dealer’s respective scale of operations, organization structure, asset size, number and volume of funds transfers and the scope of related financial activity in which the money exchange dealer is engaged” (World Bank/IMF, 2003).

Concluding remarks – Somali remittance sector

“Regardless of the formation of a strong central government and/or banking system in Somalia, the remittance system will remain an integral part of the Somali economy and monetary system for the foreseeable future” (Omer, 2002). Indeed,

- Remittance companies have the trust and confidence of their customers;
- Remittance companies have an extensive network of agents that service almost all the towns and villages in Somalia as well as in all major cities and towns in other countries populated by the Somali Diaspora;
- Remittance operations are far more efficient and cost effective than the formal financial institutions; and
- There are social and historical factors that reinforce a relationship of trust between individuals who are doing business; these are tied to the extended family, geographic and clan factors.

The remittance system in Somalia must not be viewed solely as a stopgap measure, but in the context of the long-term financial needs and preferences of the country. To this end, ensuring their future through compliance with international financial laws and regulations is necessary.

Consequently, a priority for the Somali remittance sector must be formalization or legalization as required by various host country regulations. “In the absence of domestic regulatory capacity in Somalia, an interim measure of self-regulation through an industry association is a viable means of ensuring sector-wide compliance and may level the playing field for all sector players. Strengthening of domestic regulatory institutions must be a priority of international development agencies in the medium-term” (World Bank/IMF, 2003).

There remains a challenge to try and find a way to take full advantage of the dynamics in this part of the financial sector for the benefit of Somali economy and Somali people. The challenge is to ensure money transfer businesses are effectively regulated as well as strengthened and integrated into the formal financial system.

In addition to the strengthening of the remittance sector, in Somalia’s current situation, priority also needs to be given to creating a conducive environment for entry of private domestic and international banks. The importance of developing a banking sector in Somalia, a conflict-affected area, is well summarized below:

“The need to establish a private commercial banking sector is critical to the advancement of the well being of the Somali population and the reconstruction of the Somali economy. Banks provide services that are not currently provided by the remittance companies such as retail banking, corporate banking, and loans for commercial and social development.”



Somalia does not have the legal framework, technical expertise, security, or strong central bank needed to regulate the establishment of any commercial banks. A careful, methodical process needs to be initiated in order to deal with some of these fundamental institutional, legal and human resource deficiencies” (Omer, 2002).

Accordingly, the next section describes the global standards for development of a stable banking sector. Comparing these globally accepted requirements of a strong banking system with an assessment of the existing rudimentary banking system in Somalia should allow an appropriate process to be designed for developing a fully-fledged commercial banking sector in the country.

4 Global standards for banking sector development⁴⁷

Banks play a large role in an economy. They hold unique a position in most economies as the creators of money, the principal depositories of public's financial savings, the primary allocators of credit and the managers of the country's payment systems. Banks enable resources to be allocated efficiently in the economy, support private-sector led growth and international trade and contribute to capital formation.

There is also a need to regulate the banking sector. The role of public policy in regard to a banking sector is well-recognized. Governments establish public policy for banks in public interest. In most market economies, the goals of these policies are to control the supply of money, prevent systemic financial instability and ameliorate concerns about the efficiency and equity of financial intermediation. Further, as banks perform the intermediary function as gatherers of deposits and allocators of credit, they are necessarily highly leveraged and thus vulnerable to depositor withdrawals and losses of public confidence. Finally, as most banking assets are usually held as loans and advances that cannot be easily valued there can be a lack of information as to the actual financial condition of any given bank, adding to vulnerability since depositors may be forced to act upon incomplete or inaccurate information.

Generally, governments aim to establish a banking sector that is market-based, efficient and robust. Failure of a large bank or multiple banks may lead to a sudden contraction of money supply, failure of the payments system, severe dislocation of the real economy, real or implicit obligations of government and a contagion effect and loss of confidence in system.

Therefore, of paramount importance in the establishment of a banking system is ensuring the *stability* of the system and *promoting public confidence* in the system. Policy toward banks is codified in the various laws, rules, and regulations.

There are currently no formal commercial banks in Somalia. Further, there is virtually a complete absence of a legal and regulatory regime in most parts of the country. Indeed, the rise of lawlessness and the collapse of central state institutions present acute risks to would-be banks, therefore tremendously constraining economic development in Somalia. These problems have led to the need for a comprehensive strategy to develop a banking system in Somalia based on a sustainable and comprehensive incentive structure. In the section below, we firstly explain the generic guiding principles and building blocks for development of a stable banking sector as recommended by various global authorities.

⁴⁷ Somalia does not currently have a functioning banking sector nor any banking sector infrastructure. For the purpose of this section, comparisons are made with Somalia only where it is felt that they add particular value. Sections of the following research papers and reports have been reproduced in writing this section: Demirguc-Kunt, A. *Designing a Bank Safety Net – A long-term Perspective*, World Bank, Development Research Group, Website Policy Note, 1999; Polizatto, V. *Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks*, World Bank Policy Research Working Paper 340, 1990; Bank for International Settlements/International Monetary Fund, *Financial Stability in Emerging Market Economies*, Report of the Working Party on Financial Stability in Emerging Market Economies, April 1997

4.1 A strategy for banking sector development

4.1.1 Banking sector stability – guiding principles

Banking stability in an economy depends on two fundamental sets of factors. The first comprises the macroeconomic and structural *conditions in the real economy* bearing on financial decisions and forming the environment within which the financial system operates. The second is the *robustness* of the financial system itself, comprising the financial markets, institutions, and arrangements through which financial transactions are performed. Major instabilities or distortions in the real economy almost inevitably pose risks to financial stability, however strong the financial system. Nevertheless, a sound financial system can lower the risk that problematic economic conditions will lead to financial crisis as well as reduce the damage from a crisis if it occurs. Financial stability depends not only on having the requisite institutions and other capabilities; there must also be sufficient political and social consensus supporting the measures needed to establish and maintain that stability.

A strong financial system is essentially one that meets the "test of markets", insofar as it remains stable and efficient under a wide range of market conditions and circumstances. Robust financial systems can take a number of specific forms, but all have three basic attributes.

- First, a sound system is *flexible* in that it continues to function efficiently in allocating finance according to underlying economic fundamentals under a full range of economic circumstances - in particular when those circumstances are changing rapidly;
- Second, the system is *resilient* in the sense that markets continue to function and payments are carried out reliably and expeditiously in the face of economic disturbances; and
- Third, a robust system is *internally stable* in the sense that it does not itself generate major financial shocks or magnify external shocks that can lead to financial crisis. An example of internal stability is when banks continue to lend for the purpose of real estate even when prices have gone beyond economically justifiable levels in the expectation that they will be bailed out if a contraction occurs.

The degree to which a financial system possesses the qualities needed for robustness depends largely on how well it performs three basic functions: maintaining appropriate *incentives* for financial actors; generating the available *information* bearing on financial decisions; and providing the necessary *capabilities* for institutions and individuals to respond effectively to market incentives and utilize information.

- *Appropriate incentives* are essential to ensure that investors, creditors, owners and managers, in the pursuit of their private interests, pay heed to the social consequences of their actions and take necessary precautions in the face of risk. For this scenario to exist, private actors need to reap the full gains and bear the full costs and risks of their financial decisions, and the gains, costs and risks to private actors need to be in line with those available to the economy as a whole. Markets must also be able to exercise adequate discipline, and stakeholders must be able to reward and penalize the managers of financial institutions for their successes and failures.

- **Timely access to relevant and reliable information** is essential for effective financial decisions, as well as for effective market discipline, corporate governance and supervisory oversight. Strong and efficient financial systems possess means for gathering and disseminating all material information needed by lenders and investors to assess the creditworthiness of their counterparts, by stakeholders to monitor the performance of delegated responsibilities and by supervisory authorities to exercise prudential oversight.
- To respond effectively to incentives and information, individuals and institutions also need to possess the **capabilities to implement their financial decisions**. There needs to be a sound infrastructure to ensure that transactions can be carried out reliably, in a timely manner and are enforceable; that information is disseminated adequately; and that there is a sufficient array of markets and financial vehicles to allow actors to allocate their resources effectively among alternative uses and over time and to diversify risks. In addition, financial actors need to be free from undue regulatory or other legal restrictions on their ability to carry out transactions.

The following should be emphasized:

- No single step or narrow group of steps can be sufficient to ensure a strong financial system. Robustness is a function not only of the individual factors themselves but of their interaction; thus improvements in one area typically require complementary measures in other areas if their benefits are to be fully realized; and
- The specific institutional arrangements needed to ensure robustness will change as markets and the economic environment evolve; thus the ability of the financial system, including regulatory and supervisory arrangements to adapt to economic change is essential to maintaining financial strength.

4.1.2 Strategic goals and objectives

Success in developing a viable banking sector requires some strategic goals and objectives to be formulated at the outset so that all stakeholders are aware of the long-term path being adopted. In turn, strategic goals and objectives for banking sector development depend on support for a wide range of structural reforms and the successfully developing a viable banking sector depends on a number of factors. They include a sound legal and institutional framework to ensure incentives are in place for adequate resource mobilization, proper risk management guidelines and practices and public confidence.

4.2 Building blocks

Building blocks for development of a *stable* banking sector in any economy normally include the following:

- Conditions in the macro-economy;
- Institutional and market infrastructure;
- Market functioning;
- Regulatory and prudential oversight;

- Operation of a safety net; and
- Market discipline/institutional level issues.

Each of the above conditions for a stable banking system is applicable to any country in the world. They have been explained below in more detail so as to guide Somalia's future strategy for development of a stable banking system. In the long-term, all these building blocks will be relevant to Somalia. However, attention will need to be given to the more urgent areas, focusing on building an enabling environment for entry of banks, in the near term. The more specific recommendations in priority areas for Somalia are described in Section 5.

4.2.1 Conditions in the real economy

Conditions in the real economy – macroeconomic and structural – provide the basic signals to which the financial system responds. Financial stability depends critically upon the degree to which these conditions promote the following objectives.

- The first is to provide as much predictability as possible in economic outcomes by minimizing fluctuations in real activity and avoiding unnecessary swings in asset prices and resource allocation. Such predictability reduces, although it cannot entirely eliminate, the risk of extensive financial "mistakes" that lead to financial problems. Predictability requires the avoidance of unsustainable debt loads or financial imbalances whose reversal can lead to sudden large shifts in asset prices and to instability in the real economy.
- The second objective is to generate appropriate incentives for the allocation of investment resources, across sectors and over time, in a socially efficient manner.
- And the third is to promote features of the financial system that strengthen its robustness.

Macroeconomic and structural conditions are important not only individually, but also because their effects are mutually reinforcing. Realization of the full benefits of stable macroeconomic conditions requires sound structural conditions; and certain structural imperfections can greatly magnify the financial risks arising from unstable macroeconomic conditions.

4.2.1.1 Macroeconomic requirements

The following macroeconomic requirements are crucial for the maintenance of financial stability:

- Policies that contain fluctuations in aggregate economic activity as far as possible are fundamental: macroeconomic policies should seek sustainable growth in line with the economy's potential, and avoid "go-stop" growth since it creates widespread uncertainty and risks of pervasive financial reverses;
- Achieving and maintaining price stability is of equal importance to sustain incentives to enter into long-term contracts and to minimize distortions and the uncertainty about relative prices fostered by inflationary environments;

- Sound public finances are essential: public deficit and debt levels should be sustainable and moderate;
- There must be an adequate level of national saving, private and public, to finance domestic investment needs without unsustainable reliance on foreign borrowing. External payments positions must be sustainable, which requires an adequate level of national saving, and an exchange rate that remains consistent over time with the underlying competitiveness of the economy. Capital flows financing the balance of payments and the associated external debt need to be sustainable and adequately diversified; and
- Macroeconomic policy instruments must be adequate and consistent with the exchange rate regime: monetary authorities need to be free to pursue price stability as their overriding objective; and fiscal authorities must have the capability to control public expenditures and collect adequate revenues.

4.2.1.2 *Structural requirements in the real economy*

Structural policies should seek to ensure that relative prices are in line with economic fundamentals so that they provide proper financial incentives; and that structural conditions promote the efficient and sustainable allocation of real and financial resources.

Structural policies affecting the financial sector need to ensure its efficient operation, stability and robustness.

4.2.2 Institutional and financial market infrastructure

The availability of information necessary for sound financial decisions, the ability to respond to incentives and the capacity to implement financial transactions efficiently all depend upon the quality of a number of infrastructure building blocks that support effective market functioning. These include the *legal and judicial framework* governing financial matters, the *accounting systems* used to gather and disseminate information, the *payment systems* for executing transactions, and the *infrastructure features of the markets themselves*.

4.2.2.1 *Legal and judicial framework*

The basic functions of the legal/judicial framework in supporting the financial system are to:

- Clearly establish the rights, responsibilities and liabilities of the parties to financial transactions;
- Establish codes to support market forces in maintaining appropriate incentives and adequate information; and
- Provide an enforcement mechanism for legal obligations and claims.

In order to accomplish these aims, the legal framework needs to include adequate contract, corporate, bankruptcy and private property laws. A basic requirement of any legal code is up-to-date contract law that clearly defines the contractual rights and responsibilities of all

agents involved in loans and in the purchase, sale and holding of the full range of available financial instruments. Among the legal provisions required are those governing obligations to meet contractual payments, the definition and consequences of non-payment, requirements entailed by covenants and other conditions placed on the borrower and custody of collateral. Fiduciary responsibilities and liabilities of financial agents, stakeholders and managers of financial institutions need to be clearly defined, so that they are held accountable for their conduct. As far as possible, legal provisions governing financial activity need to be "rule-based" and transparent. For example, conditions governing the exercise of contingent provisions, such as the taking of possession of collateral, need to be objective so that all parties can readily identify them. Legal provisions should also be formulated in a sufficiently flexible fashion to allow their extension to new instruments and activities as they emerge - while recognizing that changes in laws will be necessary when more fundamental market changes occur.

Since individual actors often have an incentive to withhold private information, legal codes need to mandate disclosure of facts directly material to counterparts, stakeholders and other interested parties if effective market discipline is to be maintained. Other activities that take undue advantage of information disparities or that abuse fiduciary responsibilities, such as self-dealing or insider trading, also need to be legally discouraged.

Of particular importance to preserving appropriate incentives are standards governing the entry of financial firms together with bankruptcy codes and other provisions relating to exit. Well-designed bankruptcy codes reduce uncertainty by specifying *ex ante* rules governing the distribution of unpaid obligations in the event of failure, and provide a necessary "breathing space" to make provision for an orderly disposition of the failing entity, or to allow the continued operation of an entity whose value as a going concern exceeds its break-up value. It is very important that such provisions maintain stakeholders' liability, up to the limit of their original commitment, for losses from failing institutions as well as management accountability so that moral hazard incentives are contained. Codes should be such that bankruptcy is seen as a last resort by institutions in financial difficulties to avoid undermining the fundamental principle that debts must be repaid on time and in full. To balance these considerations effectively, bankruptcy authorities need to have adequate legal and administrative authority to replace managements, to reorganize failing institutions, and to develop and, if necessary, impose formulas for distributing assets.

The effectiveness of the legal framework also depends critically upon the quality of enforcement of its provisions. Judicial remedies in the event of non-compliance with contracts need to be efficient and expeditious: judicial procedures should not be so costly that they discourage companies from acting to enforce their contracts. It is particularly important that remedies are obtainable in a time-frame that is relevant to the financial transaction involved: for example, unless creditors are able to gain possession of collateral rapidly in the event of non-payment, or to take action quickly when covenants are violated, the provisions are effectively voided in economic terms. Legal procedures for enforcement also need to be objective and honest so that outcomes of disputes are as predictable as possible on the basis of objective criteria. There should be laws against illicit financial activities, in particular money laundering, and they should be vigorously enforced since such activities, by undermining the reputation of individual financial entities, can impair confidence in the financial system as a whole.

Two other specific priorities are improvements in the *transparency and efficiency of the judicial mechanisms* to enforce financial agreements; and ensuring that *effective means exist to take possession of collateral*. Improvements in this area would help particularly in improving emerging market economies' access to external financial markets and in encouraging the transfer of skills and financial technology via direct investment.

All economies periodically face the task of *revising and updating legal codes to reflect new market realities*. Frameworks based on industrial country models have proved quite useful as a starting-point but must still be adapted to the particular financial systems of individual economies and altered as those systems evolve.

4.2.2.2 *Accounting and other information systems*

Accounting systems are central to the provision of the information needed by the creditors, borrowers, owners, managers and others with an actual or potential stake in an enterprise to make reasonable assessments of the effectiveness of the enterprise's operations and to assess its future prospects. High-quality accounting systems are essential to ensure the transparency of operations needed for effective internal governance and market discipline.

Effective accounting systems embody four basic quality standards. First, the information provided is numerically and factually *accurate*; second, it is *relevant and transparent* in that individual items correspond correctly to the underlying condition being reported; third, the information is *comprehensive* in covering all material activities and aspects of an enterprise's operations that bear on its present and future financial condition; and fourth, the information needs to be sufficiently *timely and regularly provided* to be of use when decisions are made.

A more general principle is that accounting measures should provide a realistic picture of the *true economic gains and losses*. Methods used to value assets need to take realistic account of their likely value when liquidated or redeemed, in the light of the portfolio strategies of the institution as well as unforeseen contingencies it may encounter. Valuation at historical cost of loans or other assets for which there is no satisfactory organized market, on the condition that adequate provisions are made for non-performance or losses, can provide a reasonable method of accounting for the true economic value of assets that are held to maturity. On the other hand, marking marketable assets to market value generally provides a more reliable indication of their true economic value, but only if the markets are sufficiently developed and efficient to provide reliable guides as to prospective asset-sale prices.

Essential elements of accounting procedures applying to banking and other financial institutions are standards governing.⁴⁸

- Classification and reporting of asset quality, including realistic valuation and strict criteria for recognizing bad loans;
- Timely and prudent procedures for provisioning and strict quality standards for the components of capital;

⁴⁸ International Accounting Standards Committee (1995)

- Accurate measurement and reporting of loan concentrations, including systems to detect excessive lending to related parties or over-concentrations in particular sectors or instruments;
- Relevant measures of profitability and other aggregate indicators of the overall financial position;
- Effective systems to assess individual risks as well as risks to the aggregate portfolio under various contingencies;
- Consolidated reporting including all relevant affiliated entities whose condition directly affects the financial position of the parent; and
- Adequate reporting of contingent and below-the-line liabilities, such as unfunded pension liabilities and guarantees for affiliates.

These procedures and rules are essential to avoid the concealing of serious asset quality or other financial problems in financial institutions from supervisors and stakeholders.

Auditing mechanisms are essential to ensure that accounting norms are effectively applied and maintained and to monitor the quality of internal control procedures. Both internal and external audits are vital complements to the assessment of financial institutions by supervisory authorities. Internal audits on an ongoing basis enable problems to be recognized before they can impair the financial soundness of an institution. External audits on the basis of internationally acceptable standards by independent qualified private entities are important in ensuring the objectivity and integrity of internal control procedures and the accuracy and comprehensiveness of information disclosed to external parties. To ensure their objectivity and credibility, external auditors need to be legally accountable for the competence and integrity of their examinations. There should be comprehensive laws setting out the responsibilities and obligations of external auditors, and independent auditing should be required at least for public companies and licensed financial institutions. However, internal management bears the first and primary responsibility for ensuring that internal audits are effectively conducted and that information disclosed to external auditors and the public is adequate.

The *development* of accounting standards so as to provide accurate, timely and internationally comparable information is a key priority for improving the robustness of financial systems in emerging market economies, particularly given the role that deficiencies in accounting systems have played in past banking crises. It is very important that national accounting standards be of high quality and be rigorously interpreted and applied. Harmonization of private accounting standards with those employed by supervisors is also important in reducing the costs to private institutions of complying with regulatory/supervisory requirements.

In many emerging economies, auditors, management and supervisory authorities face considerable difficulties in adequately measuring the value of individual instruments and therefore of an institution's portfolio as a whole. These difficulties have considerably hampered the ability of managements to assess adequately their institutions' financial status and to make changes in investment priorities when needed; also hampered are market discipline and the ability of regulators to recognize developing problems before they become

serious. While due partly to deficiencies in accounting standards, this difficulty is aggravated by underdeveloped markets, which make it hard to predict liquidation values; and where markets are better developed, by a lack of price data on which to base assessments of loan and other asset values.

This problem also raises a broader issue *about gaps and deficiencies in publicly available data*, particularly from national authorities, on aggregate financial indicators, conditions in the real economy and government policies. A lack of such basic data, for example, timely figures on the international reserves held by the government, has been an important factor limiting the ability of stakeholders and other interested parties, in particular foreign investors and official institutions, to effectively monitor the economic and financial condition of countries that are major international borrowers.

4.2.2.3 *Private market arrangements and conventions*

Apart from legal, judicial and accounting arrangements, robust financial systems generally possess a range of *private mechanisms and institutions* for the application of codes of conduct, conventions and "best practices" to limit price manipulation, fraudulent behaviour and other detrimental practices. They also possess mechanisms to facilitate transactions (for example, through documentation standards and valuation procedures) and facilities to organize relations among market players (for example, fair-dealing rules, dispute settlement, technical support). Such arrangements can be particularly important in markets with a high degree of diversity in participants or which involve heterogeneous instruments. However regulatory need to scrutinize such arrangements to ensure that they promote effective market functioning and are not used to restrict competition or otherwise used to promote the interests of a small group of insiders at the expense of the market as a whole. Competent, independent and objective *credit-rating agencies, credit bureaus and other similar entities*, such as central credit registers that specialize in the assessment of the financial condition of market players, can be of particular use in enhancing market information and market efficiency.⁴⁹ Credit-rating facilities can be essential to the development of certain markets, such as those for commercial paper, and can also improve access to markets by lesser-known borrowers by disseminating information about their creditworthiness.

4.2.2.4 *Payment and settlement systems*

Sound payment systems are essential to the smooth operation of market economies. They are necessary to enable the process of settling monetary transactions to be completed in a timely fashion, without imposing excessive costs on individual users or engendering excessive risks for the system as a whole. The potential interbank exposures in payment systems can be very large and thus the systems need to be highly reliable and to contain well designed and effective risk management mechanisms. Sound payment systems can be important for the maintenance and improvement of incentives for market discipline; their development also

⁴⁹ de Krivoy (1996)

enhances incentives for the adoption and observance of norms for prudent behaviour and for adequate disclosure.

4.2.2.5 *Market diversity and depth*

Financial systems need to have a broad array of instruments and markets and to provide a sufficient range of services if they are to be efficient and flexible and resilient enough to continue to function effectively in the face of disturbances or major economic changes. The most robust financial systems possess both well-functioning money markets and efficient capital markets, including primary and secondary markets for equities and markets for a full range of fixed income maturities. The markets are sufficiently deep, with an adequate breadth of participation, so that all but exceptionally large transactions can be executed throughout the trading day without triggering excessive price movements. Robust systems also need a variety of instruments that meet the differing needs of savers, borrowers and creditors for liquidity, marketability, length of commitment and credit and market risk. Provided that the markets for the underlying instruments are sufficiently well-developed, a reliable and efficient legal system is in place and financial institutions have the necessary internal controls, the availability of financial futures and derivatives enhances the potential for managing various risks.

Such an array of markets and instruments contributes importantly to financial robustness, and also helps to promote economic efficiency and development, in a number of ways, that is:

- Allowing adequate scope for diversifying risks and facilitating the bearing of risks by those in the best position to do so;
- Enhancing the liquidity and marketability of financial positions and the ability of financial actors to alter the structure of their portfolios when their circumstances change;
- Reducing fluctuations in financial asset prices in response to temporary shifts in the balance of market supply and demand, ensuring that market liquidity is maintained in the face of major shocks, and by reducing the likelihood that serious price misalignments will develop;
- Facilitating the management of public sector debt, including the avoidance of requirements on the central bank or commercial banks to absorb government debt to the detriment of monetary control and banking system financial soundness;
- Enhancing the effectiveness of market-based instruments of monetary control and by increasing the ability of monetary policy to prevent surges in capital inflows from interfering with domestic policy objectives; and
- Promoting the efficient allocation of funds provided by capital inflows and ensuring that private and public external debt positions are adequately diversified.

Historically, the development of a full array of financial markets has been an evolutionary process, with money markets often developing first and serving as a catalyst for the development of capital markets. *Regulatory policies that promote and do not unduly*

interfere with market functioning are essential to the development of diverse and efficient financial markets, for example:

- The freedom of interest rates to vary with market forces, and of financial institutions to sell and acquire securities freely, and the openness of the markets to all financially qualified participants are essential to the expeditious development of markets that are complete and efficient.
- The freedom of financial institutions, as well as non-financial entities, to issue a full range of liabilities, including bonds and equity; conversely, substantial segmentation of funding instruments and activities among different classes of financial institution tends to slow and limit market development; and
- Removal of officially directed lending and other limits on credit allocation (except those that are essential for prudential reasons) is indispensable to the development of robust and efficient financial intermediaries and markets.

The experiences of a number of industrial countries indicate that excessive constraints on domestic market functioning can effectively drive much domestic financial activity offshore. More generally, market development is promoted by infrastructure that supports efficient market functioning, such as mechanisms for disseminating information and settling transactions discussed earlier. In addition, supervisory norms and mechanisms need to be adapted and updated as financial innovations occur in order to ensure that incentives for prudent behaviour are maintained and that information disclosed to external parties continues to be sufficient and transparent.

The further development of existing markets and the expansion of the array of markets is an important priority for improving financial robustness in emerging market economies. In transition economies, the development of both short and long-term financial markets is closely linked to the development of financial intermediaries. The development of a sound and efficient banking system is essential in this regard, but other financial intermediaries such as pension funds, insurance companies and investment funds also need to be established. The improvement and expansion of securities markets, as well as the further development of equities markets, is particularly important in many other emerging economies, especially those that have had problems in the past with disruptions from large surges in capital inflows.

In the case of Somalia, given the complete lack of a financial sector, short-term priorities will need to be focused on establishing a traditional banking sector before taking any initiatives on diversifying the markets. Diversification should be part of the medium to long-term objectives.

4.2.3 Market functioning

Deficiencies in management and control have been common elements in banking and other financial crises. Thus the quality of the institutional governance - the oversight and control by directors, managers and responsible staff – of financial businesses is crucial to reducing the likelihood that crises will emerge, as well as to limiting the severity of crises when they do occur. The primary responsibility for ensuring sound institutional governance rests with

the owners and with the board of directors and senior management who act as their agents. However, institutional governance is likely to be strongest when there are strong external incentives for its exercise, in the form of *competitive markets and effective mechanisms and incentives for market discipline by stakeholders*.

4.2.3.1 Foundations of good institutional governance

The foundation of good institutional governance is a sound business strategy and a competent and responsible senior management. Managers and directors, acting with and on behalf of owners, need to inculcate and maintain a *sound credit culture* throughout the financial institution based on the principle that debts must be repaid on time and in full and that contracts must be strictly observed. Lenders must develop strong credit evaluation procedures, make credit decisions on an impartial basis and provide accurate reports to supervisory authorities. To this end, the highest priority must be placed on institutional arrangements to ensure that "due diligence" is exercised in assessing credit and other risks and in carrying out ongoing oversight of the payment status of loans and other investments. The legal provisions complementary to a sound credit culture are those relating to the responsibility implied by the act of borrowing.

Good institutional governance of banks and other financial institutions requires *comprehensive internal control procedures and policies* that are implemented by skilled personnel and carefully monitored by management. This good governance requires a clear delineation of responsibilities; policies governing lending standards and other financial decisions that are explicit, transparent and disseminated throughout the organization; comprehensive and internally consistent record-keeping systems; and internal audit and management control functions that are organizationally separated from the internal groups they are overseeing, along with other internal "checks and balances" for confirmation and cross-checking. Very important also are policies and enforcement means to ensure that staff act in the interest of the institution and do not engage in insider trading, disclosure of proprietary information, or provision of credit on grounds other than objective assessments of potential returns and risks.

Effective risk management of financial institutions is crucial and becomes even more critical as well as complex as markets develop. Financial institutions need to have effective means to measure, monitor and control the various risks they face. Banks in particular need to have high-quality systems to evaluate credit risk and monitor the financial soundness of major borrowers. Risk management systems need to include a means to gauge the overall risk exposure of the enterprise in its entirety, considering not only risks encountered in normal circumstances but also rarer contingencies, such as the possibility of unusually large adverse shifts in several major financial markets at the same time.

The maintenance of good institutional governance requires that owners, directors and senior management have adequate incentives and be subject to financial and, where appropriate, legal sanctions in the event that they behave improperly. Owners, in particular, need to have a sufficient financial stake in the enterprise, particularly if moral hazard incentives arising from the public safety net are to be contained. Partly for this reason, and also to provide a buffer to absorb losses, capital should be commensurate with the risks that a financial institution assumes. Directors also need to be accountable for gross negligence or other

failures to meet their obligations. Company law should set out clearly the duties of directors and the recourse that shareholders have in the event that these duties are not performed adequately. The structure of private ownership can also affect the quality of internal governance: for example, highly concentrated ownership by industrial and commercial enterprises increases the risks of connected lending.

Private ownership of financial institutions helps to foster good institutional governance by alleviating the conflicts of interest that can arise when institutions are owned by the government and by increasing incentives for strong managerial performance. In the case of Somaliland, this is particularly relevant since the present central bank is also a commercial bank.

To avoid such conflicts, the privatization of government financial institutions has been a key element of financial sector reform efforts in many countries in recent years. It is important to ensure that government-owned institutions, like privately owned ones, are managed according to sound principles of institutional governance. Directors and senior managers should be chosen on the basis of ability and integrity and be free of obligations to other government agencies that could conflict with their responsibility to ensure the efficient and profitable operation of the enterprise. Adherence to good commercial practices needs to be the ultimate criterion by which managements of government-owned institutions are judged and held accountable. Any privatization of financial institutions needs to be effectively implemented if it is to improve institutional governance. In particular, privatized institutions need to be established on a sound financial basis and with a sufficiently diverse ownership to prevent abuse of the institutions' franchise for the benefit of individual interests or commercial entities.

4.2.3.2 Information disclosure

Effective systems for providing information with the features described in the preceding section are essential to stakeholder monitoring. Accounting standards based on principles and rules that command wide international acceptance are crucial in this regard as they facilitate the comparison of performance across countries. Authorities need to ensure that institutions disclose sufficiently complete and accurate information to allow stakeholders to make intelligent assessments of their performance, and to make sure that adequate information is available on economic conditions affecting the institutions' performance. Admittedly, market reactions to the disclosure of information revealing performance problems is costly to the institution involved - but that is the essence of market discipline; moreover, the costs are greater when markets overreact and become excessively pessimistic in response to rumoured problems, as they tend to do when information is not adequately disclosed.

4.2.3.3 Competition

Competitive markets are essential if private gains and social returns from financial decisions are to be consistent. Uncompetitive markets encourage the inefficient use of resources to extract returns from other actors ('rents'), which do not represent gains to society as a whole. Lack of competition, since it limits the ability of stakeholders and customers to shun poorly

run institutions, seriously undermines incentives for good institutional governance and impairs market discipline.

A competitive financial market does not necessarily require a large number of institutions, nor exclude the presence of institutions with substantial market share; however, the market must be contestable in that market shares and prices are market-driven competitive outcomes and there is liberal entry and exit. In particular, entry should be open to entities that meet the necessary requirements regarding the competence of owners, capital and the adequacy of management and other systems. Entry from abroad, either on a de novo basis or via an interest in or affiliation with local firms, can be particularly useful in promoting competition, especially where local markets are small and/or underdeveloped, as well as in facilitating the transfer of financial technology and the development of the skills of local personnel.

Competition also requires that financial institutions be free to provide a full range of instruments, products and services and to develop and offer new vehicles, subject only to essential prudential requirements. Interest rates, prices of instruments and services and credit flows also need to vary with market forces if competition is to be maintained and efficiently pursued.

The social stake in financial stability beyond that which markets alone can be expected to provide can entail certain restrictions on competition. For example, authorities need to impose sufficiently stringent licensing requirements to prevent the entry of banks of questionable soundness or competence, since their proliferation could undermine public confidence in the overall integrity of the banking system. Prudential considerations have also been a factor in the past motivating authorities to impose restrictions on interest rates, branching or the types of instruments institutions can offer. However, the experience of industrial countries over the last several decades has led to general acceptance by their authorities that financial stability and efficiency are best secured by liberalized and well-developed financial markets. This approach, with a few possible exceptions, need not involve substantial "trade-offs" of prudential and competitive considerations and is consistent with the application of overall principles of competition policy to the financial sector.

4.2.4 Regulation and supervision

Official oversight of the financial system encompasses financial regulation, including the formulation and enforcement of rules and standards governing financial behaviour as well as the ongoing supervision of individual institutions. Financial regulation and supervision play an essential role in fostering financial robustness. They should seek to support and enhance market functioning, rather than to displace it, by establishing basic "rules of the game" and seeing that they are observed. Effective and adaptable regulatory/supervisory structures are critical in all economies. Special vigilance and skill are needed by the regulatory/supervisory authorities to contain the risks arising when the financial system is undergoing rapid and extensive change.

4.2.4.1 *General considerations for effective regulation and supervision*

A fundamental guiding principle in the design of all regulatory/supervisory arrangements is that they should seek to support and enhance market functioning, rather than to displace markets. Where financial systems are less developed, a key objective of policy is to reduce the need for regulation in the future by improving the quality of private market forces.

Apart from the specific responsibilities and objectives noted below, regulatory/supervisory authorities collectively need to pursue the following broader objectives:

- Define clearly the types of institutions subject to regulation and oversight along with the jurisdiction of each regulatory/supervisory agency for those institutions;
- Promote the reliability, effectiveness and integrity of the market infrastructure, in particular payments and transactions systems; and
- Foster efficient operation and competition in the financial system.

The specific forms taken by regulation and supervision in any particular country are necessarily shaped by individual circumstances, particularly the state of the key features described in earlier sections. Typically, there will be several regulatory/supervisory agencies, with authorities responsible for banks institutionally distinct from those responsible for other major classes of financial institution or for securities markets.

Banking and other authorities charged with overseeing financial institutions have three major areas of responsibility: licensing of new entrants and authorization for new or expanded activities by existing entities; ongoing supervision of the financial institutions; and remedial correction of problems arising in institutions that are failing or at risk of failing.

To carry out its mandate effectively, each official agency must have powers and responsibilities that are clearly defined and of sufficient scope to accomplish its mission, appropriate standards and enforcement mechanisms, and adequate human and other resources. There needs to be close coordination and exchange of necessary information among banking, securities market and other regulatory/supervisory authorities, with suitable protection of such information where appropriate.

A clear framework defining responsibilities, objectives and operational independence is an essential foundation for effective regulation and supervision. On the basis that a central bank is more suited to perform this regulatory oversight of the banking system, it is essential that a central bank does not engage in commercial banking at the same time, contrary to the case of the central banks in Somaliland and Puntland.

In order for supervisors and regulators to exercise their powers and responsibilities in a coherent fashion, *they need a comprehensive set of prudential norms and standards.* In the absence of such criteria, supervision is likely to be haphazard, idiosyncratic and more vulnerable to pressures for exceptions and exemptions, as is the case in Somalia today. The norms and standards need to be objective, internally consistent, transparent and well-understood by those to whom they are applied; such norms need to clearly define behaviour that is not permitted, as well as the nature and treatment of exceptional or "suspect" conditions, such as exposures that, while permissible, carry special risk or otherwise warrant attention.

Regulatory norms and standards must be relevant and consistent with prevailing conditions in the country in which they are applied. However *it is highly desirable that they be of high quality and shaped by certain core principles* for at least four reasons: first, to assure market participants, including foreign stakeholders, that sound financial practices are being applied, thereby increasing market confidence in the country's overall financial health; second, to help promote a level playing-field and fair competition among institutions of a similar type; third, to prevent countries adhering to rigorous financial practices from being unduly penalized by "regulatory" competition from jurisdictions with overly lax regulatory standards; and fourth, to make effective use of the experience and expertise of the international supervisory community (i.e. the Basle Committee) in formulating the principles.

Norms and standards can play this role only if effective means exist for their *enforcement*. All supervisory authorities need to have access to comprehensive, consistent, reliable and timely information on the activities of the financial institutions they oversee, including those of home or foreign affiliates. Supervisors should have sufficient independence and authority to be able to impose penalties if prudential regulations are not met. Depending on the institutions supervised, possible penalties include: fines; the removal of management in cases of unsafe or unsound banking practices; and constraints on the institution's permitted activities, including, in extreme cases, closure.

The formulation of policies and standards and their implementation and enforcement also require that regulatory/supervisory authorities *have adequate financial and human resources*. Financial crises have not been prevented in part because supervisors were either too understaffed or otherwise unable to detect problems arising from the changing strategies of the financial institutions. Supervisors need to understand the full range of activities undertaken by the institutions they oversee and their knowledge and skills need to be periodically updated to keep abreast of market developments, such as the use of novel instruments and complex portfolio strategies. Supervisors need to have the means to collect, review and analyze supervisory and financial reports from banks on a solo and consolidated basis. In the case of Somalia, if the remittance companies are subject to regulation, this could be a major challenge due to the fact that these companies operate in a number of countries around the world.

4.2.4.2 *Considerations applying to banking regulation and supervision*

The central role played by banks in the financial system imposes responsibilities on bank regulatory/supervisory authorities that, while generally similar to those of other financial oversight agencies, are also distinctive in some respects. In the licensing of new banks, authorities need to evaluate carefully the proposed ownership structure, operating plan, control systems and internal organization to ensure that they are adequate to support sound functioning; licensing authorities also need to verify in the case of a foreign bank applicant that it has the approval of its home supervisory authorities to establish operations in the host country. Authorities also need to ensure that directors and senior managers possess the requisite ("fit and proper") skills and integrity. At the same time, authorities should seek to facilitate and encourage entry by well-qualified institutions in order to improve the quality of the banking system and promote competition.

Both in the licensing process and in ongoing supervision, banking authorities need to pay particular attention to capital adequacy. The standards formulated by the Basle Committee on Banking Supervision constitute a minimum floor in this respect: standards applied in practice need to reflect the risks to which financial systems are exposed and may need to be higher than the Basle standards if the risks are higher because of vulnerabilities to external disturbances, a history of weak macroeconomic performance or undeveloped financial markets.

The Core Principles developed by the Basle Committee are important for effective bank supervision. Among them are:⁵⁰

- Evaluation of internal control mechanisms to ensure that they are commensurate with the nature and scale of the business undertaken, including systems for risk management and enforcement of measures needed to correct deficiencies in these mechanisms when they arise;
- Requirements that capital adequately reflects the risks that banks take and that asset concentrations and exposures are prudently determined and managed;
- Requirements for adequate disclosure of information concerning financial institutions' performance;
- Establishment and enforcement of rules and regulations governing activities requiring specific approval or prior notice, such as transfer of a bank's shares, major acquisitions or investments, and approval to establish foreign branches or subsidiaries;
- Establishment of realistic and effective policies, practices and procedures for loan classification and for provisioning against problem loans;
- Implementation of off-site monitoring and surveillance, on-site examinations and/or use of external auditors and consolidated supervision;
- Establishment and enforcement of standards for supervisory reporting, including accounting standards, provisions governing the scope and frequency of reporting, confirmation of the accuracy of the information provided, and disclosure;
- Determination that banks have adequate policies, practices and procedures to ensure that they are not used, intentionally or unintentionally, for criminal purposes; and
- Supervisors must require that the local operations of foreign banks be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed for consolidated supervision.

Three aspects of these responsibilities need to be emphasised. First, regular contact with a bank's management and a thorough understanding of the institution's operations are essential. There must be a means of independently validating information reported or disclosed, in particular the adequacy of asset valuations and loan loss provisions, and of monitoring banks' performance as market conditions change. On-site examinations are particularly important to allow supervisors to evaluate a management's effectiveness and compliance with supervisory standards in those markets where weaknesses in accounting or reporting systems impair the

⁵⁰ Basle Committee on Banking Supervision (1997)

effectiveness of off-site monitoring. Reliance should be placed on external auditors only when a well-developed independent auditing profession exists, when supervisors and auditors have a clear understanding of their roles and where auditors are fully accountable. More frequent examinations will typically be needed for institutions in difficulties or with relatively high risk profiles. Examiners also need to be equipped with realistic loan classification and provisioning criteria if they are to be able to identify asset quality problems and to ensure that managements take the necessary corrective action. Provided an independent and competent auditing profession exists and the respective roles of auditors and supervisors are clearly delineated, supervisors could use external auditors in lieu of their own on-site examinations in whole or in part.

In this context, consolidated supervision is essential if examinations, and general oversight, are to be effective. An important aspect of consolidated supervision is maintaining contact and sharing information with host-country supervisory authorities. In addition to facilitating consolidated supervision by other countries' authorities, bank supervisors need to have powers to share information with home-country supervisors of foreign banks operating in their country. Failure to account for related entities in reporting and examinations can lead to seriously inaccurate evaluations of a banking institution's true financial health and of the risks that it faces. This can be a serious concern in Somalia based on the worldwide informal operations of the remittance companies. Lack of consolidated supervision can also encourage the concealment of imprudent or illicit transactions booked with an affiliate not covered by the parent's reports or in its examination. It is especially important that supervision of domestic banking institutions extend to their offshore affiliates.

Second, the regulatory framework needs to pay special attention to banks procedures for assessing and managing all risks, including credit risks, particularly where stakeholder discipline mechanisms are poorly developed, competition is limited or historical circumstances have retarded the development of strong risk management as an institutional governance priority. In this context, care should be taken to limit two distinct credit risks that have frequently aggravated financial problems in emerging market economies. First is that of connected lending, and second is the undue risk concentrations vis-à-vis single borrowers, or several borrowers whose creditworthiness is closely related. In this context, authorities need to carefully monitor exposures to particular sectors, such as real estate, that are prone to periodic price cycles. Third, banking authorities also need to be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling market risks, including, in particular, exchange rate and interest rate risk. These mechanisms are particularly important when the currency has reached an unsustainable level or there are other distortions in domestic financial markets that provide incentives for banks or their creditors to engage in unsustainably large borrowing in foreign currency; regulatory restraint in such cases is clearly less preferable than fundamental economic policies to correct the misalignments or distortions, but is likely to be necessary in the event that such policies are not undertaken. For analogous reasons, authorities need to pay close attention to banks interest rate risk management procedures and exposures when the liquidity of domestic markets is limited. Effective monitoring of currency or interest rate exposures needs to take account of off-balance sheet as well as on-balance sheet exposures. Due attention also needs to be paid to potential indirect exposures, for example those that may arise when borrowers

with large open foreign currency positions become unable to service their debts to banks following a large and sudden change in exchange rates.

Finally, well-formulated policies for achieving corrective action and, in cases where an institution is not viable as a going concern, orderly exit policies are essential to the effective exercise of banking authorities' oversight responsibilities. Of particular importance to industrial as well as emerging market economies in this context are remedial procedures to deal with financial problems of individual banks. Since extensive delay can magnify the cost of resolving a crisis, it is useful to have concrete procedures available for prompt corrective action. In addition, corrective procedures that are at least in part rule-based can help to reduce political pressures for undue forbearance. At the same time, however, authorities need to retain sufficient discretion to be able to deal flexibly with problems that arise and to be able to adapt the means for dealing with problem banks to market circumstances. Moreover, the principal objective of prompt corrective action procedures is to prevent problems of individual institutions from becoming systemic, rather than to deal with systemic problems if they do arise.

4.2.4.3 *Framework for prudential regulation*

- Prudential regulations are designed to minimize risks that banks assume and ensure the safety and soundness of the banking institutions and the system as a whole through outside limits and constraints;
- A broad body of banking legislation is essential to ensure that bank supervisors can carry out and enforce their responsibilities;
- In most countries, the legal framework applicable to banks encompasses prudential laws and regulations, by as well as the laws governing commercial transactions and debt recovery and bankruptcy laws; and
- The absence or weakness of prudential regulation in critical areas could lead to banking failures and systemic instability.

Below, we consider some of the key prudential regulations that are normally designed in any well-developed banking system.

Criteria for entry

Newly licensed banks are particularly vulnerable to failure. To eliminate or reduce distortions and abuses, all decisions concerning licensing and other corporate activities (for example, mergers and acquisitions) should require the satisfaction of specific criteria prior to approval by the supervisory authority

Capital adequacy

Minimum capital is necessary to absorb unusual losses against risks that exist both on-and off-balance sheet.



Asset diversification

Lending limits, investment limits and other exposure limits, which prevent the concentration of risk in a single borrower or a related group of borrowers, are necessary for prudential purposes.

Loans to insiders and connected parties

A frequent cause of loan problems is credit granted to bank insiders and to individuals or firms connected through ownership or with the ability to exert control, whether direct or indirect. Such credit may not meet the same standards and the amount of credit often exceeds prudent levels.

Permissible or prohibited activities

Banks may engage in commercial activities or enter lines of business that are unsuitable for financial institutions because of the risks involved and the specialized expertise required, for example, speculating in real estate by purchasing office buildings that far exceed actual banking needs. Therefore, regulations detail permissible and prohibited activities for banks. Such regulations should address whether banks can engage in commercial activities, own equity stakes in firms or enterprises, and participate in non-banking financial activities.

Asset classification and provisioning

Banks systematically and realistically identify their problem assets and provide adequate reserves for possible losses by:

- Classifying the quality of their assets according to specific criteria;
- Defining non-performing assets;
- Requiring the suspension of interest and reversal of previously accrued but uncollected interest on non-performing assets;
- Precluding the refinancing or capitalization of interest; and
- Mandating minimum provisions to the reserve for possible losses based on the classification of assets.

Scope, frequency and content of the audit program

External audits independently verify and disclose the financial condition of the bank or enterprise audited. The following are required:

- Clear guidelines concerning the accounting standards to be used, the scope and content of the audit program, and the frequency of audit activities to be carried out; and
- Audit standards based on recognized international standards and practices.

Enforcement powers

Bank supervisors can usually impose fines and penalties for criminal acts and violations of specific statutes.

Treatment of failed banks

Legislation is necessary to permit supervisors to declare banks insolvent, close banks, and place them in receivership outside the normal corporate bankruptcy process.

4.2.5 Operation of the safety net

The high cost to society at large of a large banking system collapse, is a principal reason why authorities in virtually all countries provide a safety net involving the potential outlay of public funds in the event that the stability of the banking system is threatened. For instance, the lack of such a safety net in Somalia resulted in substantial losses for depositors in the early 1990s.

Such arrangements inevitably create moral hazard because they hold out the prospect that stakeholders will be at least partially indemnified for losses from failing institutions. In order to minimize this moral hazard it is essential to design and implement safety net arrangements so that incentives are not seriously distorted by the policies pursued. In general this will also reduce the likelihood of having to use public funds to support the banking system. In any case, any pre-commitment to a particular course of action in support of a financial institution should be avoided by the authorities, who should retain discretion as to whether, when and under what conditions support would be provided. In addition, when making such a decision, it is important to rigorously analyze whether there is a systemic threat and, if so, what options there may be for dealing with systemic contagion effects in ways that limit the adverse impact on market discipline. To this end, the arrangements should seek to implement the following principles:

- Deposit insurance coverage should be designed to mitigate moral hazard problems, for example, by confining it to smaller depositors who lack the ability or sufficient incentive to monitor banks; an element of co-insurance even for small depositors can augment market discipline;
- Private sector devices, such as "lifeboat" operations, mergers and takeovers should be encouraged and facilitated by the authorities whenever appropriate, not least because they are often in the collective interest of banks as a whole. Central banks or other neutral parties can foster such arrangements, without making any financial or other commitments, by providing their good offices and acting as an independent broker. The authorities should only encourage private sector support initiatives that will result in sufficient financial and managerial strength for the institution to be viable;
- Restructuring of failed institutions should maintain the hierarchy of liabilities mandated by law and by market arrangements; managers should be subject to strict accountability for their past performance; and shareholders and holders of unsecured debt should be given the lowest priority in recovering their investments;

- Official lending facilities, including "lender of last resort" support, need to be consistent with the central bank's overall approach to the implementation of monetary policy in pursuit of macroeconomic objectives while permitting it to deal with temporary liquidity shortfalls and systemic disturbances. Central bank lending should be adequately collateralized. In general loans should only be made to solvent institutions; and
- Public money should be provided only as a last resort, and if it must be provided, should be combined with stringent conditionality, clear performance criteria and reliable means of repayment, for example, through the use of warrants.

4.2.6 Market functioning/institutional level issues

It is important to note that the primary line of defense against banking insolvency and financial system distress is the quality and character of management within the banks themselves. Therefore, efforts to strengthen the financial system must also focus on strengthening management and management systems through a process of institutional development.

4.2.6.1 Directors

The role and responsibilities of directors of banks should be clearly defined. Directors' responsibilities typically include the following:

- Develop strategic direction and plan;
- Select competent executive officers;
- Effectively supervise the institution's affairs;
- Adopt and follow sound policies and objectives;
- Avoid self-serving practices;
- Be informed of the bank's condition and management policies;
- Maintain reasonable capitalization; and
- Observe laws, rules, and regulations.

Directors need to be accountable for the consequences of unsound or imprudent policies and practices. The majority of board should be independent of political interests, active management, and the interests of major corporate shareholders.

4.2.6.2 Management and management systems

A key responsibility of directors is to employ a competent chief executive officer. Senior management needs to assume the responsibility to manage the day-to-day affairs of the bank, to implement and follow the framework of policies and objectives established by the board of directors, and to employ, maintain, and educate a qualified staff. Further, senior management conduct the operation and administration of the institution through various



management systems, including written policies and procedures, internal controls, loan review, compliance, planning, budgeting, internal and external auditing, and management information systems.

4.2.6.3 *Sound documented banking policies and procedures*

Written policies should be formulated for each major business activity or function in which the bank is engaged. The policies and procedures should:

- Be comprehensive;
- Provide a clear framework within which management and staff can be expected to operate;
- Be reviewed annually, or more often as needed; and
- Provide an appropriate mechanism for exceptions when warranted.

4.2.6.4 *Internal controls and risk management systems*

A strong system of accounting and administrative controls is necessary to:

- Safeguard assets;
- Check the accuracy and reliability of accounting data;
- Promote operational efficiency; and
- Encourage adherence to established policies.

These need to include a plan of organization, procedures, and records that generate an accurate reporting system and accountability for assets and liabilities within the organization. A comprehensive risk management system that identifies, measures and monitors all risks that the institution is exposed to must be established.

4.2.6.5 *Loan review*

Since loans generally comprise the major component of bank assets, there should be an effective program of internal loan or asset quality review. Ideally, this analysis should be performed by an independent loan review department staffed by credit analysts who report directly to the board of directors, a board committee, or a senior officer not involved in lending. Responsibilities are to identify problem loans based not only on performance but on financial statement analysis, prepare summations to substantiate credit ratings, determine compliance with lending policies, and ensure that corrective action is forthcoming to strengthen or collect problem credits. The results of the internal loan review program are used as a basis for determining the adequacy of the loan loss reserve. Loan officers should be required to identify their own problem loans at early stages of deterioration to supplement the loan review process.



4.2.6.6 Compliance

It is necessary to ensure that the institution is operating within the constraints of law. This compliance function may operate parallel to or as part of an institution's internal control and auditing program, but its focus is on compliance with laws, rules and regulations.

4.2.6.7 Planning

Planning is essential for effective management. Changes in competitive conditions, volatility in the financial markets, technological advances, and deregulation increase the risks within the operating environment.

4.2.6.8 Budgeting

Budgeting is important both as a planning device and as a means of control. Budgets are usually prepared for a period of one year and involve translating operational activities into quantitative terms. Planning aspect of the budget involves the decision-making processes leading to the budget's preparation and/or subsequent revisions. Control aspect involves the comparison of budgeted expenditures and revenues versus actual results and the explanation of significant variations.

4.2.6.9 Internal and external auditing

The primary objectives of the internal audit function are the detection of irregularities and the determination of adherence to the bank's policies and procedures. In recent years, the responsibilities of internal auditors have expanded to include the appraisal of accounting, operating and administrative controls, with increased focus on risk-based auditing.

The primary objective of external audits is generally aimed at enabling the auditor to express an opinion on financial statements. External auditors can also assist management in:

- Establishing strong internal controls;
- Designing internal audit programs;
- Enhancing management information systems;
- Developing operating policies and methods of operations;
- Providing greater assurance that financial reports to shareholders and the public are accurate and include all necessary disclosures; and
- Aiding board members in fulfilling their fiduciary responsibilities.

4.2.6.10 Management information systems

To make informed decisions, management must have timely, accurate, and relevant information concerning the bank's loan portfolio, funding sources, foreign exchange risks,

profit and loss position, off-balance sheet contingencies, interest rates, among others. Balance sheets and profit and loss statements should be prepared at least monthly.

4.3 An assessment of the existing formal banking sector in Somalia

Prior to 1991, the Somali banking sector was underdeveloped. This was primarily the result of weak resource mobilization, lack of public trust in the system (since depositors were unable to access their funds just before and at the time of the collapse of the Barre regime) and a virtual absence of lending and formal transactions.

4.3.1 Historical structural weaknesses in the banking sector

It is reported that a number of weaknesses existed in the banking sector that operated during the time of the Barre regime. These included:

- An absence of financial analysis to assess risk;
- Political criteria became more important than commercial value in obtaining funds;
- Principal due was frequently rolled over without evidence of the debtor's ability to repay;
- Interest was frequently capitalized;
- Use of dubious collateral values;
- Inability of the judicial structure of the former system to enforce contracts or to resolve disputes in favour of creditors.

All of these factors contributed to a passive banking system, in which banks neither lent according to commercial criteria nor monitored for risk once loans were made.

Civil conflict resulted in the collapse of financial institutions, a curtailment of international lending flows to Somalia, a loss of liquidity in the banking system, and a virtual halt to banking operations. Moreover, the inability of depositors to access their funds in 1991 resulted in a collapse of public confidence in the formal banking sector. As a result a significant portion of the population in Somalia engaged in private sector activity in the "gray" and "black" economy. Thus, the incentive structure prevailing constrained formal savings mobilization and prompted full-scale financial dis-intermediation. This led to the virtual disappearance of the banking sector in Somalia after 1991.

4.3.2 Profile of the current banking sector

4.3.2.1 *Current financial intermediaries*

There is currently a complete absence of financial intermediation in Somalia. Whilst data is not available to estimate the level of financial deepening and penetration, the absence of any significant financial intermediaries in the country is proof of this.



The Bank of Somaliland (the central bank of the self-declared Republic of Somaliland) and the State Bank of Puntland (central bank of the state of Puntland) both currently provide limited commercial banking services such as deposit accounts and trade finance. The services of both these institutions are generally not used by the public, perhaps an indication of lack of trust in such national institutions given the experience of events in the past whereby the public lost significant amounts of money.

In the absence of a formal banking sector, most financial activities are conducted through the informal financial intermediaries.

A number of remittance companies currently provide certain banking services. Some of these have ambitions to become fully-fledged commercial banks as soon as there is a conducive environment in which to do so. Small-scale money traders also operate throughout the country. The services of remittance companies include:

- Remittance services;
- Current account type services with cheque books;
- Savings or fixed deposit services; and
- Foreign exchange services.

We are also aware of limited micro-finance lending through NGOs that are funded by donor agencies. We also understand that much of the lending in the economy is based on informal credit unions.

A survey conducted by KPMG revealed that there appears to be a lack of confidence on the part of businesses in the ability of remittance companies to safely provide a full range of banking services. It is also worth noting that there appears to have been an erosion of businesspersons' confidence in the ability of remittance companies to offer remittance services, let alone additional banking services, following the collapse of the largest Somali remittance company in 2001.

Selected quotes from respondents of the Somalia Financial Sector Survey regarding the ability of remittance companies to become commercial banks

“They are not safe and cannot act as banks for LC’s”

“Hawala companies do not have enough capital to transform into banks”

“They do not have appropriate relationships with international financial institutions”

“They will not be able to manage a commercial bank properly and it may involve misappropriation of funds”

“They have no experience, except money transfer”

“They lack capacity and banking ethics”

“They are unable to provide our requirements, and above all there is no security”

The above survey also provided an indication of use and the demand for banking services as described below.

4.3.2.2 Use and demand for banking services

The survey was carried out to assess demand for various banking services in Somalia. The survey was sent to about 100 businesses throughout Somalia. In total, 67 businesses from a wide spectrum of economic sectors responded to the survey. Key findings are highlighted below:

- Businesses generally use some of the following banking services at present – letters of credit (from foreign banks), money transfers (from remittance companies) and foreign exchange transactions (from remittance companies);
- Businesses frequently use banks that are based in the UAE. However, banks such as Citibank and Kenyan banks are also used by Somali businesses;
- Somali businesses are constrained in their activities as a result of not having a commercial bank present in Somalia. Such constraints include businesses:
 - Incurring increased operating costs. It was noted that businesses often have to establish offices in the UAE (at a cost of approximately \$20,000 annually) in order to access banking services;
 - Missing business opportunities abroad;
 - Being unable to make overseas payments;
 - Being forced to keep cash despite insecurity.
- The loss of funds as a result of the closure of the largest Somali remittance company in 2001 has resulted in a lack of business confidence in the remittance system.

Interestingly, this concern was also indicated in terms of the ability of remittance companies to become banks in the future;

- A number of specific comments about remittance companies made by the Somali businesses mentioned that they:
 - Only provide a limited number of services and thus they are unable to meet all their business needs;
 - Lack relationships with prime international banks;
 - Are subject to the threat of closure and are thus not perceived to be totally safe;
 - Need to improve accountability and must be regulated; and
 - Could merge to form a bank when a suitable environment is created.
- There was a general feeling that the remittance sector is used as a result of a lack of a viable alternative and that businesses would, if they had the option, prefer to deal with proper banks; and
- There was almost a universal agreement on the need to establish a domestic banking sector in Somalia. Businesses envisage using a variety of bank services including overdrafts, loans and trade finance.

4.3.2.3 *Regulatory infrastructure*

In all respects, the regulatory infrastructure in Somalia is largely ineffective. Apart from the lack of a legal framework necessary for a banking sector, the two operational central banks in Somalia (Bank of Somaliland and State Bank of Puntland) are highly dysfunctional.

The Central Bank of Somalia that operated prior to 1991 is now defunct. The total collapse of central state institutions in 1991 has resulted in the collapse of a functioning banking regulatory authority, banking legislation and a judicial system in Southern Somalia (i.e. Mogadishu).

The central banking institutions in Somaliland and Puntland are evaluated below.

Bank of Somaliland

The Somaliland financial system is essentially comprised of the Bank of Somaliland (BoS), the central bank of the territory. The BoS acts as both a central bank as well as a commercial bank. The dual functions of the BoS is in conflict with best practice which dictates that the role of a central bank should be limited to that of a regulator and policy setting body. Several weaknesses in the BoS arise from this conflicting role.

The BoS has 11 branches spread over the six regions of Somaliland: five in Hargeisa, two in Awdal region, one in Berbera, one in Togdheer, one in Sool and one in Sawal. It is also reported that the bank has five airport exchange offices.

The National Constitution provided for the establishment of a bank to carry out central banking functions. The BoS was thus established under Article 18 of the National Charter and the Constitutive law of the Bank of Somaliland, number 026. The Board of Directors ('Board') consists of seven members made up of the Governor who acts as the chairman of the Board, Director General as deputy chairman, and five members of which three are private businessmen.

The BoS has the responsibility for managing the monetary policy, the currency and for developing and regulating the banking sector, including the remittance companies, in Somaliland. In the absence of commercial banks it carries out limited commercial banking functions. Senior management indicated that a legal framework for establishing banks and a regulatory framework to regulate financial institutions, including the remittance companies, exists in Somaliland. The BoS has also reportedly developed regulations governing the establishment of operations of banks in the country.

Given the historic background of civil unrest and the collapse of the banking system, there is a general lack of public confidence in the BoS. It was indicated by senior BoS officials that the Board recognizes that such problems exist and that it is attempting to separate the BoS central and commercial banking functions by establishing separate management. Senior management stressed the need for immediate training at all levels, from senior management to junior staff, in all aspects of central and commercial banking work.

Based on the departments visited in the BoS, it is apparent that the BoS operates more as a commercial bank and government treasury than as a modern central bank. Most operations of the BoS are rudimentary and most significantly, it lacks regulatory capacity. Some of the departments/branches visited in the BoS included:

■ *Personnel Department:*

The primary function of this unit at the BoS is to keep records on salaries, attendances and transfers. All key decisions, however, are taken at the BoS headquarters. There are currently no job descriptions that define the roles and responsibilities for positions in this department as is best practice. Further, there does appear to be a specific training function at the BoS, normally the responsibility of a personnel department. Whilst there is appears to be a clear need for a personnel function at the BoS, the current personnel department appears to lack the capacity to undertake activities other than the most rudimentary, such as the payment of salaries.

■ *Audit/Inspection Department:*

This BoS department carries out bi-annual audits after which it produces an audit report. Best practice would dictate that internal audits, and the subsequent production of audit reports or comprehensive minutes, be undertaken far more frequently, particularly given the lack of computerization at the BoS. A double-entry book keeping system is employed and each branch's books clear every ten days. Given the scale of operations at the BoS, this practice appears to be satisfactory. This unit has 11 members of staff.

■ *Branch number One:*

The branch comprises 17 members of staff divided into three units: general accounts, all accounts and cash section. These units are typical of a branch of a commercial bank. The



department has about 1,500 current accounts and 50 accounts of government departments. All records are kept manually with a statement giving the running totals. Given the limited use of information technology at the BoS, this practise appears to be adequate. The branch maintains a signature card, with three specimen signatures, a practice that appears to be adequate. This branch does not engage in any lending business.

■ *Branch number Two (also known as foreign branch):*

The branch houses a fairly large banking hall and comprises four sections: accounts, airport office, current accounts and a cash section. As with branch number 1, aside from the airport office, these are typical units at a branch of a commercial bank. The branch has 12 members of staff and maintains about 70 foreign accounts. This branch does not engage in any lending business.

■ *General Accounts Department:*

This department prepares financial accounts manually. It is unclear as to whether the department prepares monthly management accounts, a general good practice. The BoS keeps US dollar accounts with two banks, one in Ethiopia and another in Djibouti. In addition, a Djibouti Francs account is also kept. It is unclear as to whether the department receives monthly bank statements for its accounts in Ethiopia and Djibouti and whether bank reconciliations are prepared to monitor any variance. Such activities would be in line with good practice.

■ *Foreign Relations and Foreign Business:*

The department has no permanent staff at present, aside from the manager and an assistant. Although the unit has been established for some time, there is neither a well-established correspondent network nor any substantial foreign business. It is thus evident that this department does not carry out any significant activity.

■ *Head Office Branch:*

The department has two sections: accounts and cash. Government offices maintain their accounts at this department (approximately 200). The treasury unit of the branch pays salaries to government employees. The department also acts as treasury to the government and exchanges foreign currency.

State Bank of Puntland

The study team was unable to undertake an assessment of the State Bank of Puntland. However, available documents prepared by other consultants⁵¹ indicate that the bank does not operate as a modern central bank since it conducts limited central banking functions and has no regulatory capacity. Additionally, the banking operations are highly manual. Excerpts from the report prepared by the consultant for the United Nations Development Programme illustrate the organization of the State Bank of Puntland:

⁵¹ United Nations Development Programme, *Modern Banking Operations, State Bank of Puntland*



■ *Cash Department:*

This department is headed by a chief cashier and comprises five cashiers and six money-counting clerks. A cashier collects money from the depositors and passes it on to the 'money counters' for verification before he finally receives it. The teller's work is not checked and no cash summary is made. Such controls would be in line with good practice. Further, tellers do not keep any record of the transactions they conduct as is normal practice. However, at close of business, tellers produce total balances, which they pass on to the chief cashier (who is also the officer in charge of the cash department).

■ *Treasury Cash:*

The bank makes no distinction between the treasury cash and the teller's operational balances, as is normal practice. The tellers operate as an extension of the treasury. The chief cashier monitors the daily cash movement computing the net daily balance. However, no control register is maintained between the cash leaving the vault and the chief cashier, as is best practice. The chief cashier records the daily net balances in a book.

The bank manager and the chief cashier act as custodians, and the strong room for holding currency/cash remains under the sole supervision of the chief cashier once opened.

■ *Back Office Security:*

There is no restriction of customers' access to the back office at the bank. The door leading to the back office remains open the whole day. It is difficult to differentiate between members of staff and the public.

■ *The Current Accounts Department:*

There were some 30 current accounts constituted as follows: one account for the Ministry of Finance, four accounts for government departments and 25 private individual accounts.

Accounts are opened on the strength of an application letter. No introductions or references are obtained, neither are identification documents nor any account opening forms completed. Only specimen signatures are taken.

Although cheque books are kept in the vault, their issuance and monitoring is not controlled, against best practice. The clerk has personal access to the vault, and has a stock register, which he does not update. Cheque books are thus not treated as accountable documents and no reconciliation is done in this regard. Although the customer ledger cards are marked with paid cheque numbers after every cheque transaction, cheques issued are not serialized. The identification of payees on third party cheques is done on the basis that all individuals in town are known to the members of staff. The entire process lacks sound internal controls and is therefore not in line with best practice.

■ *The Accounts Department:*

The bank does not produce comprehensive management reports. Further, there is no audit trail or even a list of transactions. There are a number of irregularities that are apparent:

- Posting is done directly from the vouchers to the general ledger on a 10-day basis. An intermediate set of subsidiary ledgers is not produced as is normal practice. Further, the posting is not centralized – cash entries are posted in the cash department; current



accounts department is responsible for posting customer withdrawals and so on. This process is thus highly irregular;

- Vouchers are not separated and posted on an account type basis. This is also a highly irregular process; and
- Although there is a double entry system, a single voucher is used to effect several accounts as opposed to the conventional system of every transaction being evidenced by an independent entry.

■ *Budgets:*

The bank neither prepares a capital budget nor an operating budget as is normal practice. Further, regular management reports are not prepared. These budgets and reports would be essential in planning and monitoring.

■ *Filing:*

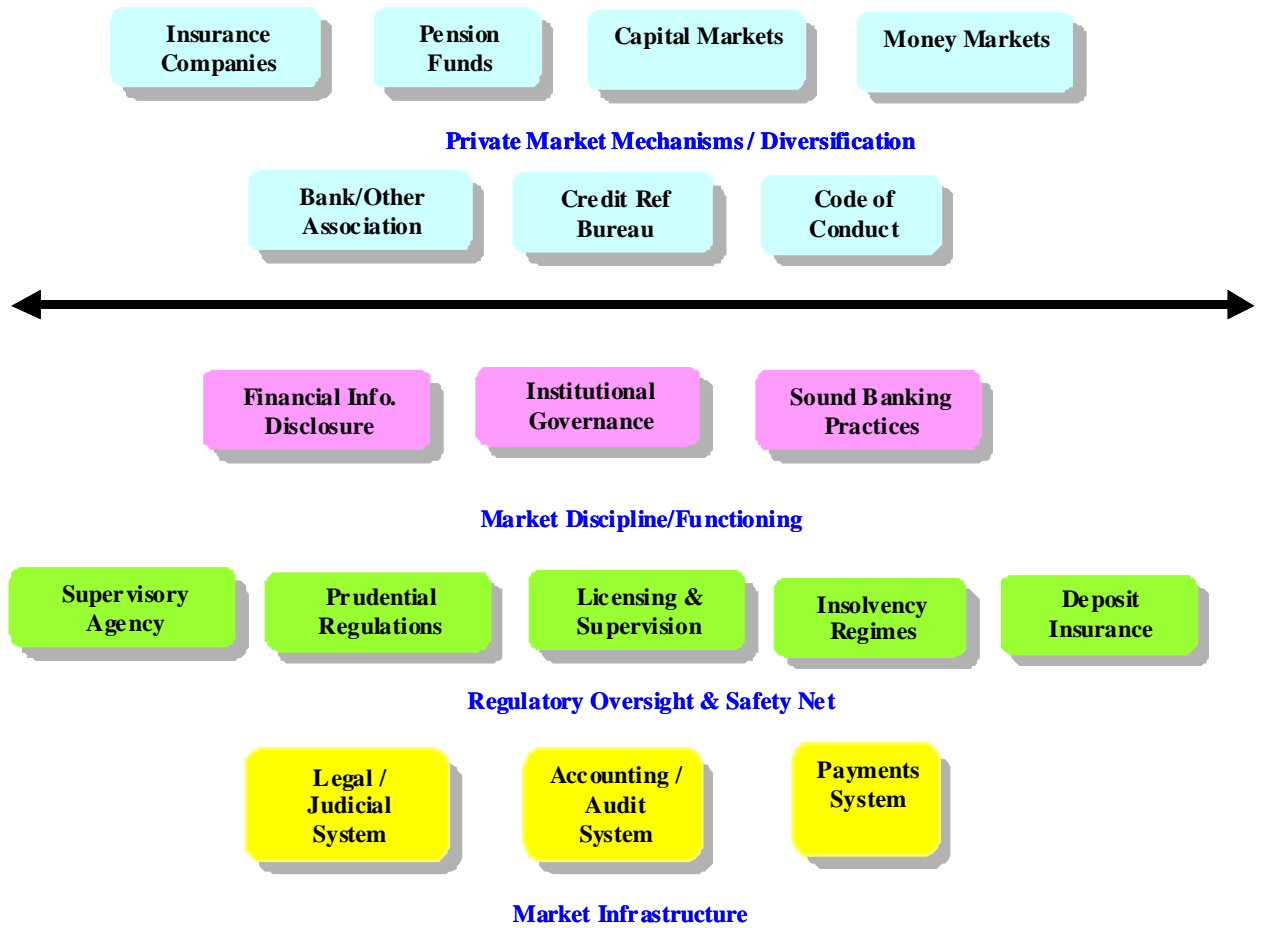
There is no system of filing at the bank except for the customer ledger cards, which have been systematically filed on an account number basis. Further, all customer correspondence is filed. While this would be standard practice, a comprehensive filing system is essential at a financial institution of this sort.

■ *Foreign Exchange Department:*

The bank runs an office at Bossaso airport, which acts as a bureau de change. The bank, however, does not have a formal foreign exchange department. Rates of exchange are determined by the informal foreign exchange markets. Whilst these rates have wide recognition and the confidence of the public, this process is highly informal.

4.4 A summary view of the building blocks relevant to Somalia

In the diagram below, we summarize the key elements explained in the previous section, insofar as they are more relevant to the medium to longer term development of a stable and sustainable financial sector in Somalia. However, it is perhaps fruitless to talk about the development of a financial sector in the longer term in light of the current urgent need of even the most basic banking system in Somalia as demonstrated by the assessment above. Therefore, in the next section, we have recommended the key elements that deal with some of the more near term priorities of establishing a banking sector as well as forming the building blocks for a stable and sustainable financial system.



5 Recommendations

This section seeks to make specific recommendations in respect of:

- First, strengthening the Somali remittance sector. This will involve building capacity to ensure that they become more regularized and transparent with the potential to become banks at some point in the future. The main thrust for UNDP/EC in this regard should be to maintain the current momentum of the remittance companies that emerged at the Dubai workshop and to provide technical support to remittance sector association;
- Second, creating a conducive environment for entry of banks as soon as possible – be it existing remittance companies or new private companies – especially since the private sector is extremely keen towards the re-establishment of the banking sector. Strengthening of domestic regulatory institutions must be a priority of international development agencies.

In both cases, donor assistance will be required. It is thus appropriate to align the recommendations to any donor assistance programs.

It must be emphasized once again that “regardless of the formation of a strong central government and/or banking system in Somalia, the remittance system will remain an integral part of the Somali economy and monetary system for the foreseeable future” (Omer, 2002). Therefore, it is not our intention to recommend ways of developing a banking sector at the subsequent expense of the demise of the remittance system that is working so effectively at present. Rather, we seek to recommend a roadmap for the strengthening of the formal banking sector and the informal remittance sector in ‘parallel’, with the longer-term aim of integrating the informal remittance sector into the formal financial sector. This roadmap will enable the achievement of a sustainable stable financial sector in the future.

5.1 Context for assistance – an integrated program for reconstruction

5.1.1 Toward a national reconstruction plan

Typically, the reconstruction plans of conflict affected countries aim to achieve a few key objectives. In the case of Somalia, no such plan is being considered at present, as the country is yet to emerge from a conflict situation. However, a most common objective of any reconstruction plan is poverty reduction. In the absence of any such plan for Somalia, poverty reduction is a priority of international humanitarian and development engagement in Somalia. In line with this goal is the development of the private sector, which in turn requires a sound and efficient banking system.

5.1.2 UNDP/World Bank principles of re-engagement⁵²

The joint UNDP/World Bank note on re-engagement in Somalia suggests that the overall “strategy aims at laying the initial framework for longer-term engagement in Somalia by facilitating institutional and policy change while improving basic social outcomes by focusing on four carefully selected areas of reform and by using key agents of change, particularly the private sector” (UNDP/World Bank, 2003).

The strategy for Somalia is articulated around three pivotal principles:

- *The strategy seeks to provide public goods in the absence of a fully functional national government in Somalia. In addition, the strategy embodies a strong regional public goods dimension, with potentially positive spill-over effects for neighbouring countries in all the proposed areas of intervention.*
- *The strategy recognizes the high degree of uncertainty in the country and therefore focuses on interventions which are not likely to be reversed in the event of instability. Such interventions include knowledge-intensive investments aimed at capacity and institution-building.*
- *The strategy has a strong income-generation emphasis through its support to the private sector in the livestock area, with the aim of fostering important economic payoffs.*

Further, the note suggests that “given the vibrant role that the private sector has played in Somalia since the fall of the Barre regime, and the limited capacity of administrations to raise resources, it can play an important role in promoting human development in Somalia. There is also a growing recognition by the Somalis themselves that the private sector has a vital role to play in strengthening governance in addition to generating economic prosperity and supporting social services in a more stable setting” (UNDP/World Bank, 2003).

UNDP and the World Bank have thus jointly identified four strategic entry points for engagement in Somalia based on country specific characteristics, the relative comparative advantages of each institution, and the shared goals of: (i) improved policies, institutions, and governance; (ii) provision of service delivery; and (iii) capacity building. The strategic entry points are:

- Support to Macro-economic Data Analysis & Dialogue;
- Creating an Enabling Environment for the Livestock and Meat Industry;
- Coordinated Action Plan to Address HIV/AIDS Issues; and
- Capacity Building for Skills Development/Centers of Training.

⁵² This section is based on United Nations Development Programme/World Bank Somalia, *Country Re-engagement Note*, April 2003

5.1.3 EC Country Support Strategy⁵³

The European Commission is Somalia's leading donor. Assistance provided by the EC is guided by the Country Support Strategy from 2002 - 2007. This strategy in many respects is similar to the United Nation's engagement with Somalia with the overall objective 'to contribute to the alleviation of poverty and the promotion of a more peaceful, equitable and democratic society'. Based on the analysis of this strategy and drawing upon the lessons from past experience, particularly regarding implementation and given the need for a short-term flexible rolling programme, the Commission advocates pursuing its multi-sectoral approach with a series of complementary and mutually reinforcing interventions in the following areas:

- Enhancement of good governance;
- Reduction of widespread vulnerability;
- Access to social services; and
- Economic growth and diversification.

5.1.4 Rational for strengthening the remittance sector

The study's recommendation to strengthen the Somali remittance sector recognizes the humanitarian role of the remittance sector and thus places value in regularizing the sector to ensure its continued existence.

5.1.5 Rational for developing a banking sector

The study's recommendation to develop a banking sector in Somalia addresses several needs. The development of banking sector would ultimately contribute to poverty alleviation by spurring private sector development through the creation of credit.

In the context of the principles of re-engagement, the recommendations meet the following needs:

- Focus on the aim of alleviating poverty;
- Recognition of the concepts of building capacity and strengthening institutions and of knowledge-intensive interventions; and
- Recognition of the role of the private sector in this process.

5.2 Scenarios for implementation of recommendations

In developing recommendations for the Somali banking and remittance sectors, it is imperative that the fluid political environment that currently exists in Somalia is considered. Whilst the strengthening of the Somali remittance sector can take place in the current

⁵³ Based on information provided by the EC Somalia Unit

political context, the development of a fully functioning banking sector in Somalia is, to a large extent, dependent on a more stable political environment. Two broad scenarios for the implementation of recommendations have been identified:

- Scenario 1: The current peace talks taking place in Kenya are successful and result in a stable political environment and the emergence of a central administration in Mogadishu; and
- Scenario 2: The current peace talks are not successful and the current political environment prevails.

The recommendations regarding the development of a banking sector that have been proposed in sections 5.3.1 to 5.3.8 are applicable in both Scenarios 1 and 2. However, additional recommendations have been made in section 5.3.9 should Scenario 2 prevail.

The recommendations proposed in section 5.4 regarding the strengthening of the remittance sector are applicable to both Scenarios 1 and 2.

5.3 Towards the development of a banking sector

5.3.1 Long-term objectives and guiding principles

We believe that the re-establishment of a banking sector in Somalia should have the following long-term objectives:

- Develop market-based banking sector with focus on improving financial intermediation in support of private sector development;
- Ensure the development of a stable and sustainable banking system; and
- Build the public confidence in the banking system so that sustainable financial intermediation can take place.

Accordingly, to rebuild the Somali banking system, the following would need to be achieved:

1. *Focus On Building Sustainable Financial Intermediation.* This will mean restoring confidence in a banking system so that public money is protected and financial intermediation can occur.
2. *Re-Establishing The Banking System Based On Globally Accepted Standards.* This will depend on largely applying the recommendations of the Basle Committee and establishing a well-regulated banking system for Somalia underpinned by a suitable regulatory and institutional framework for market-based competition and incentives for sound management and governance.

3. *Design Donor-Supported Projects That Focus On Interventions Which Are Not Likely To Be Reversed And Are Consistent With Market-Based Principles.* Donor assistance in form of technical assistance, capital investment and training will achieve better results if project design is harmonized and if commercial fundamentals are applied by enterprises and banks in concert with prudential regulations established by the regulatory authorities. Such an approach would also contribute to a meaningful and well-coordinated rejuvenation of the *formal* Somalia economy, which would support the long-term goal of developing a viable and competitive private sector in a well-managed and increasingly diversified economy.
4. *Include Explicit Exit Strategies In Donor-Supported Projects.* Donor assistance in helping to develop the banking system is likely to be significant in the short to medium-term. Such assistance should aim to build capacity and institutions necessary for a stable banking sector. Although there is no guarantee that private banks, domestic or foreign, will invest soon and play their proper role in restoring financial intermediation. Nevertheless, attracting legitimate private banks and professional management in this sector should be the main objective, with donor programs serving as a bridge. If adequate levels of investment and professionalization fail to materialize, prolonged donor-support may be required.
5. *Development of Human Capital.* The absence of a banking sector in Somalia over the last decade and high level of outward migration have caused a massive skills gap and shortage of human capital in this sector. Training in modern standards of efficient and sound banking is urgently required. This will need to be provided through intensive, hands-on technical assistance to bankers and bank supervisors over a period of years. Such knowledge-intensive investment in training will be valuable even if instability persists; indeed, however fine regulations, rules and manuals may be human skill, motivation and honesty is critical to the development of a stable banking sector. Encouraging entry of foreign banks that are regulated in their host countries would also enable skills-transfer and greatly contribute to human capital formation.

In achieving these long-term objectives and recommending a framework for the development of a banking sector, the following guiding principles have been adopted:

- Provide sufficient incentives to all market players;
- Deal with the urgent and near-term issues yet ensuring building blocks aligned to any potential reconstruction plan;
- Encourage private sector initiatives but apply a 'level playing field' for all market players; and
- Focus on recommendations that are unlikely to be reversed in the event of instability such as interventions aimed at human development and capacity and institution-building.

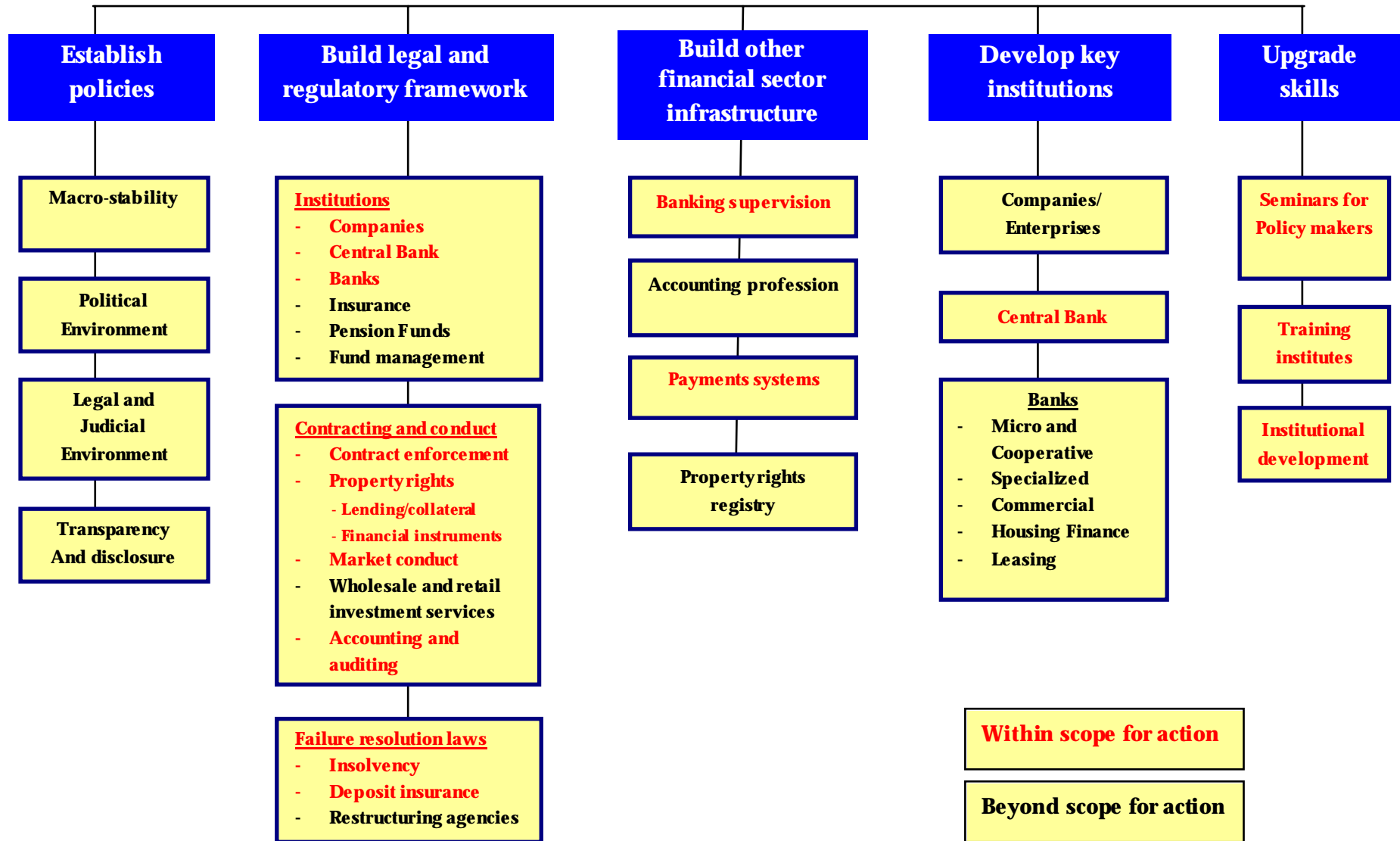
5.3.2 Framework

The diagram overleaf sets out a holistic framework for the development of a banking sector in Somalia. The framework comprises five pillars:

- Establishing policies;
- Building legal and regulatory framework;
- Building other financial sector infrastructure;
- Developing key institutions; and
- Upgrading skills.

5.3.3 Banking v/s financial sector development

It is worth noting that for the purposes of this study, we will limit our recommendations to the development of a banking sector. Thus the need for market diversification and depth are not being considered at this stage on the grounds that these are more medium to longer term requirements of a robust financial system. The development of the commercial banking sector is a key step in the development of a wider financial sector.



5.3.4 Establish policies

It is essential that policies be established to provide a suitable political and economic environment for the entry of banks. Key requirements are indicated in the diagram above. It is imperative that relevant national policies in these areas are agreed with relevant administrations from the outset. The implementation of further recommendations must fit within these policies.

5.3.5 Building legal and regulatory framework

The development of a sustainable banking sector must be underpinned by a legal and regulatory framework since this spells out the rules of the game for banks and markets. We believe the entire legal framework is currently being reviewed but in the absence of seeing actual documentation we are unable to comment on their contents, substance and relevance to the situation and what is needed. A qualified lawyer is currently working in Hargeisa under a programme funded by UNDP. He has begun the task of finding out which laws are available and where, including the *Sharia* laws, before embarking on their relevance and/or redrafting, as necessary.

In any case, the framework that is more relevant for the banking sector should comprise of the following laws and regulations:

5.3.5.1 *Laws relating to institutions*

- Central Banking Law which will describe the central bank's role, systemic and functional responsibilities, level of autonomy, enforcement powers etc.;
- Banking Law which defines the type of financial intermediaries, scope of banking business, conditions of entry and exit, minimum capital requirements etc;
- Prudential regulations to be issued by the central bank for ensuring the safety and stability of the banking system and depositor protection;
- Laws on other financial services including money transfer companies; and
- Currency Law.

5.3.5.2 *Laws relating to contracting and ethics*

- Contract Law for enforcing contractual rights;
- Property rights law and ability to pledge and seize collateral; and

- Bankruptcy law.

Development of expedient out-of-court measures may need to be introduced to compensate for weakness in judicial capacity and differences between the emerging business sector framework in Somali law. This approach would accelerate dispute resolution, in lieu of tying up claims in time-consuming court procedures. This approach might also alleviate some of the doubts creditors have regarding secured loans and collateral backing (along with contract enforcement measures). Clear guidelines would be needed to ensure rapid resolution. The guidelines would be developed as a precursor to creating the requisite judicial capacity to execute rules and regulations governing secured transactions.

5.3.5.3 *Accounting/auditing standards*

The introduction of accounting standards according to international norms will be essential. One way to accomplish this is to establish minimum standards as part of the regulatory framework (thus, for example, a prudential regulation on the need for preparing financial statements in accordance with international standards could be introduced). Another way is for the local professional accounting body to enact standards having the force of law. The latter would require the development of a new profession, which is one of the elements shown under the pillar of ‘Building other financial sector infrastructure’, which is likely to be a medium-term building block.

Therefore, the framework for introducing international accounting and auditing standards should be developed during the same time as the development of the prudential regulations. The introduction of international accounting standards (IAS) and IAS-based chart of accounts for the banking industry will need the provision of technical advice, assistance and training.

5.3.5.4 *Prudential regulations*

In order to promote safe and sound banking practice, the market conduct must be governed by prudential regulations. A prudential regulatory framework for Somalia must be designed and applicable regulations for the country will need to be developed together with the capacity building of the supervisory function within a central bank (see below).

5.3.5.5 *Failure resolution laws*

Laws relating to the following will need to be put in place:

- Insolvency regime for resolving insolvent banking institutions through control of management, liquidation, recapitalization etc.; and
- Deposit insurance scheme which provides cover for small depositors.

5.3.6 Building other financial sector infrastructure

5.3.6.1 Banking supervision

A supervision function within a central bank (a key institution to be developed as described below) will have to be established, housing the traditional functions of licensing, onsite examination, legal and offsite examination. Appropriate capacity building will be required for the function to carry out its role effectively. In this regard, a near to medium-term plan for building both staff and capacity will need to be prepared. Such a plan should entail on-the-job training that is conducted in a systematic fashion. In addition, a structured training program that combines formal instruction, case study and seminars should be included.

In the first place, the organization of the function, its role and responsibilities, policies and procedures will need to be defined and documented. The function should be responsible for:

- (i) Licensing new banks;
- (ii) Permitting banks to engage in new activities or offer new products;
- (iii) Permitting mergers and consolidations of banks;
- (iv) Providing guidance to banks on what the supervisor deems to be unsafe or unsound;
- (v) Assessing the condition of individual banks and of the banking system; and
- (vi) Initiating, pursuing and following up on corrective actions.

Policies and procedures related to direct supervisory activities will need to be disclosed to banks and to the general public. Disclosure enables the public to gain a better understanding of the supervisor's role. More importantly, informing banks of the supervisor's expectations and of the consequences for failure to meet them is an effective supervisory technique to encourage voluntary compliance. This aspect of public interaction is managed in a manner that suggests the government is promoting the stability and strength of the banking and financial sectors.

The supervision department would need to develop a basic policy framework utilizing a CAMEL-style (where CAMEL stands for Capital strength, Asset quality, Management quality, Earnings quality, Liquidity level) evaluation system to guide supervisory decisions, and then to extend the scope to include a broader array of assessment factors and techniques, such as risk management and risk profiling.

Further, a banking supervision department manual should be developed to delineate expectations regarding the standards of financial condition and management practices for financial institutions, as well as evaluation methodology. Specifically, this manual should focus on risk management principles and other non-financial areas, such as corporate governance, transactions with affiliates and insiders, internal controls, and issues related to regulatory compliance, etc. The manual itself should become a more comprehensive supervisory policy manual containing principles-based guidance for the assessment of risk in individual institutions and the sector. It will also facilitate consistent policy application throughout the range of supervisory activities, including licensing activities and procedures,

on-site examinations, and off-site surveillance. In addition, it will enhance the ability of the agency to design and initiate risk-appropriate corrective actions.

The framework of the manual would allow the application of the appropriate principles and concepts to any institution - regardless of structural or operational differences. The manual will detail on- and off-balance sheet activities, management practices, related policies and regulations. The manual will also describe a set of risk assessment principles and evaluation factors applicable to each area. Expectations for minimum risk management policies and practices are given.

The development of the policy manual also serves as the basis for continued development of the organizational structure, creation of supervision programs/cycles, on-site examinations, off-site surveillance and risk profiling activities. Additionally, the principles in the manual help to guide decision-making with respect to licensing and troubled bank management and resolution. It also provides the basis for periodic staff training as well as the foundation for a comprehensive training program. Lastly, the well-articulated policy structure, in conjunction with the legal and regulatory framework, provides a solid base on which the department can sustain sound financial sector management.

The central bank, as the licensing authority, will have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, will consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. In addition, the central bank should have the legal authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties. This review process is subject to policies that promote a competitive, market-based banking system.

With the legal and regulatory basis for licensing activities in place, the department will focus on the process of licensing, including the decisional framework, policies, tools and work products. The goal is to ensure that licensing activities are guided by the risk-based policies outlined in the policy manual, and decisions are consistent with market-based supervisory philosophies.

The supervision department should also develop an array of supervisory responses that allows it to respond to institutional and sector issues in a risk-appropriate manner. The policy framework should include an outline of possible actions or consequences that may be applied to an individual, an institution, or financial group, under specific conditions, practices or situations. This outline would include risk-appropriate measures for dealing with "problem banks" and procedures to liquidate insolvent institutions.

5.3.6.2 *Payments systems*

Assistance will be required with modernizing the payments system, moving toward increasing use of a non-cash payments method through use of improved technology (e.g. electronic transfers, credit cards). Budget execution requires an efficient payments system for public expenditure and revenue collection to be effected in a secure, timely and reliable manner. This need is immediate and the central bank must provide leadership in the development of national payments system despite the wide use of remittance companies.

Technical expertise and assistance is required to identify what is being done at present and what should be done in the immediate short-term to improve present payments systems.

Through a more detailed study on the payments area, short and long-term specific requirements need to be assessed. The study will need to determine the most suitable design for modernizing the payments system and long-term technical assistance will be needed with implementing a non-cash payments system in the country.

5.3.7 Developing key institutions

5.3.7.1 Central bank

As a key institution for regulatory oversight of the banking sector, a central bank will need to be established. All the organizational and operational aspects related to setting up a central bank afresh will need to be addressed. Some of the more general aspects have been discussed below:

Strategic Plan and Organizational Structure

- Adoption of a strategic plan for 3-5 years outlining the vision, objectives and key strategies;
- Design of new structure, work management, physical and human resources requirements;
- Appointment of key central bank personnel (for example, governor and vice-governors); and
- Establishment of a code of conduct, roles and responsibilities, decision-making processes, policies and procedures for each department in the bank.

Human Resources

- Development of personnel policies and creation of an HR function;
- Design of pay and grading structures;
- Design of job descriptions; and
- Design and implementation of a payroll system.

Accounting System and Financial Statements

- Design and implementation of a new accounting and management information system within the central bank;
- Preparation of financial statements in accordance with international standards; and
- Utilization of 'best practice' accounting procedures for preparing the first year's or current year's accounts as a stopgap can be considered, which should help to develop an



elementary level of credibility for official financial statements, until above recommendations are adopted.

Internal audit

- Development of an internal audit function for the central bank;
- Design of modern banking audit programs and procedures; and
- Design of a training program and delivery of training of new audit staff in risk-based auditing and international standards on auditing.

Training and development

- A detailed staff skills inventory and training needs analysis should be undertaken with the aim of assessing the best options available for building relevant skills (for example, banking operations, risk management, management skills, financial management, international banking); and
- Following from above, technical advice on developing an effective training function to serve the financial sector, taking into account evolving needs of bankers, money transfer companies and associated financing needs/activities throughout the country.

Policy issues and implementation

In addition to the supervisory role, the central bank will be tasked with monetary policy and currency issues. Specific areas for assistance here will include:

- Technical advice on design and issue of currency;
- Experts to assist with formulation of monetary policy (for example, based on controlling inflation rate), including introduction of monetary policy instruments and policy implementation, as the need for various options (for example, open market operations) becomes clear; and
- Development of a research function within the bank with capacity for statistical collection and analysis of data, particularly with reference to balance of payments.

Information technology and communications

- Expert assistance will be needed to assess the needs of technology and information systems, and thereafter develop an IT strategy for the bank; and
- Near-term needs for modest computer requirements should be assessed and given priority for implementation. At minimum, all key departments such as supervision, research, accounts should be provided with computers and training in basic tools (e.g. Microsoft Excel and Word).

5.3.8 Upgrading skills

Successful program implementation will require the training of potential bankers in a wide range of sound banking practices and operations, as well as corporate governance, accounting systems, anti-money laundering and countering of terrorist financing programs. More specifically, training will need to be provided to lenders to assess risk based on commercial terms and incentives. In the absence of a buoyant private banking market, technical assistance and training should play a key role in developing credit management skills. These would pertain to initial contact and assessment of firms through analysis of business plans, loan approvals, loan disbursements, monitoring the use of loan proceeds, maintenance of proper credit files and systems, and loan collection. When banks eventually become licensed, technical assistance and training would be needed to develop portfolio management capacity regarding prudential regulations, the avoidance of excess concentrations, asset-liability management, and other informational requirements for management and governance in a market-based system.

Some key activities for upgrading skills across the industry on an immediate basis are to:

- Assess training needs for the sector as a whole;
- Design a comprehensive training program;
- Conduct a feasibility of developing a training institute; and
- Conduct essential training (as described above) in sound banking practices and other relevant areas for players likely to be involved in the banking sector.

5.3.9 Specific recommendations regarding Scenario 2

5.3.9.1 *Feasibility of location for program implementation*

In Scenario 2, the lack of a central administration and political stability and security in Somalia would prohibit the implementation of proposed interventions in areas other than Somaliland. The only viable option would thus be to commence the modernization of the banking sector in Somaliland. A benefit of commencing the program in Somaliland is that certain relevant laws already exist and a central bank (albeit very rudimentary and more focused on commercial banking operations) is already in place. Depending on the success of the program in Somaliland, similar programs would be replicated in other regions once they have achieved relative political stability and security.

In this case, the timeframe could be shortened for entry of banks provided there is a willingness and commitment from the current administration. In this respect, it is also necessary to conduct workshops in the various regions in order to communicate the

objectives of the program and gain consensus. Furthermore, the actual implementation of any activities may also be tailored to the wishes of the local administration.

5.3.9.2 Restructuring of Bank of Somaliland

If the program were to be commenced in Somaliland, two additional activities will need to be carried out in respect of the existing central bank. These are as follows:

- First, separate the commercial banking operations from the central banking functions into two distinct legal entities. This would result in a central bank and a commercial bank in Somaliland. A restructuring study will be required to determine the options available for achieving this outcome. The options available are:
 - ‘Carving out’ a new commercial bank from the existing central bank, resulting in transfer of assets, liabilities and staff from the existing central bank to this new commercial bank;
 - Converting the central bank into a proper commercial bank since the operations of the Bank of Somaliland are predominantly of commercial banking nature. Under this option, a new central bank would be set up as recommended for Scenario 1; and
 - Shutting down all commercial banking operations within Bank of Somaliland.
- Subsequent to separation, conduct a study for possible privatization of the commercial bank.

The following steps should be undertaken:

- Conduct a wider study for restructuring of Bank of Somaliland, including an assessment of the options for separation of commercial banking operations and central banking functions and agree on the optimal route;
- Set up legal entities to house the different banking operations and effect transfer of assets and liabilities based on outcome above;
- Implement organizational and operational improvements in the central bank as per the recommendations of the restructuring study; and
- Conduct a study to assess the potential for privatization of the commercial banks with recommendations on the privatization options and implement the recommendations of this study.

5.4 Strengthening of the Somali remittance sector

We recommend that the donor community continue their support to Somali remittance companies given the importance of remittances to the livelihoods of many Somalis. In line with other informal money transfer systems, there is broad agreement that Somali remittance companies do respond to legitimate financial needs and offer a competitive and efficient channel for fund transfers. However, the “anonymity of the informal money transfer system does make it vulnerable to money laundering and terrorist financing” (World Bank/IMF, 2003). On this basis, financial authorities have agreed on the need for regulation of the system.

In line with emerging best practice towards informal money transfer systems, an appropriate regulatory and supervisory framework for Somali money remittance companies should be developed in Somalia. However, because of the lack of a regulatory and supervisory capacity in Somalia, even basic registration of Somali remittance businesses is not possible. Therefore, priority should be given to building up the basic supervisory capacity. This need was addressed in the previous section.

On an immediate basis, in the absence of a national financial system and supervisory capacity, a self-regulatory process is appropriate. Significant progress has already been made in this regard. The Somali Financial Services Association (SFSA) was established in 2003 and launched at the *Conference on the Somali Remittance Sector* on the 3rd and 4th of December 2003. It is intended that this institution will play a pivotal role in regulating the remittance sector.

We also recommend various measures for strengthening the Somali remittance sector, most of which should be undertaken under the auspices of the SFSA. Many of these recommendations are aimed at addressing the current weaknesses of and challenges facing remittance companies, with the overriding objective of protecting the flow of remittances to Somalia on the grounds of humanitarian needs and the lack of a formal banking sector in the near term. As far as possible, the recommendations are also aligned with the anticipated emergence of a banking sector so that the Somali remittance sector can eventually be integrated into the formal banking sector. Accordingly, our recommendations are focused, once again, on near-term priority areas under the following pillars:

- Regulation of the Somali remittance sector;
- Improving transparency and accountability of the Somali remittance companies;
- Upgrading of skills and awareness programs within the Somalia remittance companies; and
- Improving external awareness of Somali remittance business operations.

Following the successful conclusion of the *Conference on the Somali Remittance Sector*, held in 3rd and 4th December 2003 in the United Kingdom, a number of additional recommendations, aimed at meeting these broad objectives, were made. They have been included in the sections below.

5.4.1 Regulation of the Somali remittance sector

The medium to long-term aim could be to license and supervise the remittance companies through the central bank. For instance, the Banking Act mentioned earlier could include such companies as non-bank financial institutions with restricted activities. However, in the absence of such a supervisory and regulatory capacity, the immediate initiatives should be in line with a two-prong approach:

- Strengthening and supporting the SFSA as a self-regulatory measure. Any support from the donor community is likely to be for an interim period and could include technical advice on:
 - Supporting the SFSA in launching the association in key regions globally;
 - Appointing advisors and/or support SFSA in areas needed for its establishment and sustainability;
 - Assisting the SFSA in developing a high-level organization strategy;
 - Assisting the SFSA to design and document a procedure setting out the minimum requirements to become both associate members (not-certified) and members (certified). This would include the development of a SFSA certification system that is acceptable to commercial banks; and
 - Assisting the SFSA in strengthening the compliance standing committee comprising compliance officers from member companies. This committee would be responsible for compiling the SFSA AML Compliance Guidelines for members. As part of capacity building, this committee would initially require much guidance and assistance.
- Establishing an oversight mechanism, again for an interim period for two years, although this could be extended if necessary. Since there is currently a lack of political stability as well as a legal and regulatory framework in Somalia, this oversight mechanism is most pertinent to the Somali remittance sector. Acting as a substitute for the regulatory agency that Somalia currently does not have the benefit of, the oversight mechanism is essential for providing stability and confidence in the Somali remittance sector to international authorities and international banks as well as customers. The mechanism would also bring market discipline within the Somali remittance companies.

The mechanism would require an independent legal or auditing firm to conduct continuous on-site examination of Somali remittance companies assessing:

- Overall operations and conditions of the company;
- Competence of management;
- Internal governance and systems in place to comply with relevant international standards and regulations (e.g. 'Know Your Customer' programs, record-keeping, suspicious activity reporting);
- Adequacy of risk management and internal control procedures; and
- Adequacy of accounting and management information systems.

The results of the continuous assessment of the Somali remittance companies would be shared with international authorities and banks. Corrective measures for enhancing market functioning of the remittance companies can also be put in place based on the recommendations from the independent assessments.

Ultimately the SFSA should either become part of a larger association covering remittance companies from other countries in the region (Djibouti, Ethiopia, Eritrea for example) or develop strong ties with remittance associations in these countries. This would significantly enhance its ability to advocate for its members.

5.4.2 Improving transparency

The Somali remittance companies, in common with other informal money transfer systems, are criticized for their lack of transparency. In order to avoid such criticism and keep the remittance sector intact, it is of paramount importance that the following measures are taken:

- All Somali remittance companies need to formalize their operations in every jurisdiction they operate in based on the relevant legislation. For example, in the UK, they are required to register with the Her Majesty's Customs & Excise (HMCE) department, whereas in Dubai they need to obtain appropriate licences from the Central Bank of UAE. In the first place, it is likely that many of the companies will need to legally incorporate their operations so that the legal entities can easily be recognized by all stakeholders. The need for formalization was clearly agreed by all the Somali remittance companies participating at the Dubai workshop in June 2003.

To bring the discipline of formalization across the sector, the requirement for legal incorporation and registration could be enforced by assisting the SFSA in its efforts to establish its compliance and certification system. Indeed, the SFSA will be best placed for assisting its members in achieving this, and other, key milestones in a timely fashion. In this regard it is important that significant effort is attached to developing the capacity

of the SFSA to meet its objectives. Such technical assistance for the SFSA could include assistance in developing compiling compliance guidelines for the SFSA for both their headquarters and for the countries served by its regional offices. Additional assistance could be provided to the SFSA in training members of its compliance standing committee.

- Subsequent to or in tandem with the legal incorporation process, the remittance companies should address institutional governance/management issue. Such assistance should be channelled through the SFSA. In line with best practices, particularly those specifically in place for financial institutions, the whole area of corporate governance needs to be improved upon, including:
 - Establishment and disclosure of clear shareholder and capital structure;
 - Establishment and disclosure of clear management structure, involving appointment of Board of Directors, Management and officers with clear assignment of roles and responsibilities and decision-making authorities;
 - Establishment and disclosure of the organization structure;
 - Setting of corporate objectives and well-articulated strategic plans, corporate values, codes of conduct, etc;
 - Design and implementation of strong risk management and internal control systems; and
 - Establishment of internal audit function and appointment of external auditors.
- Preparation of financial statements subjected to external audits, and subsequent disclosure of financial and other information, particularly including related party transactions.

The above is by no means a comprehensive list of sound transparent corporate governance measures but it should go a long way to enhance the transparency and accountability of the remittance companies. It is most likely that the association will need to advocate for increased transparency very strongly, with some technical assistance and training to strengthen the ability of the boards and managers to exercise “fit and proper” standards for corporate governance and management that are in line with internationally recognized best practices. The oversight mechanism could perhaps also include an ongoing assessment of this whole area of institutional governance.

5.4.3 Upgrading of skills

For the immediate future, there is a strong need for bringing awareness of various regulatory legislation worldwide that affects the Somali remittance companies. To this end the

Conference on the Somali Remittance Sector, held in 3rd and 4th December 2003 in the United Kingdom set the tone of similar workshops that can be conducted by the association. The primary aim of such workshops should be to advise the Somali remittance companies of their licensing or registration and reporting obligations.

In addition to awareness programs, there is a need to train members of the SFSA's compliance standing committee in order that it can undertake its compliance and certification functions effectively. As it is intended that members of this committee be compliance officers from SFSA member companies, this training would serve to assist these individuals in developing and rolling out effective compliance programs at individual SFSA member companies. Additionally, it is intended that these officers then undertake training of the staff of their respective companies. Further, as indicated above, training on sound banking practices should be in line with the recommendations already made in section 5.2.

5.4.4 Awareness raising campaigns

It is widely accepted that money transfer businesses such as the Somali remittance companies are not well understood by regulatory authorities and formal financial institutions. The *Conference on the Somali Remittance Sector* on the 3rd and 4th of December 2003 was particularly successful in creating dialogue between the remittance sector and regulators. During the conference it became evident that there is indeed a need for further forums of this kind, and that in banking institutions, in addition to regulators, should be invited to participate. Such awareness campaigns could provide these parties an understanding of:

- How the Somali remittance companies are structured;
- The typical nature of the remittance business and how the Somali remittance companies conduct their operations;
- How the settlement process normally works;
- How the companies utilize bank accounts to conduct their operations, particularly in relation to the settlement process;
- The progress of the companies in registering their businesses; and
- Programs and processes in place for meeting anti-money laundering regulations; 'know your customer' programs (client identification and verification requirements, record keeping, reporting of suspicious activities).



5.5 Implementation and timeframe

5.5.1 Estimated timeframe

The charts below provide an overview of suggested timing and duration of the key activities recommended above under the two scenarios. It must be appreciated that the chart is based on indicative timing and duration of all activities that could be commenced or carried out in the near term (within two years). Some of these activities will need to continue beyond two years. It is also worth noting that many of these activities will require technical assistance as discussed below in section 5.5.2.

Our experience of Somalia during this project has proved that significantly more time is required to conduct studies and fieldwork in this country. Accordingly, we would caution against the estimated duration in this timeframe.



Indicative Timeframe for Scenario 1

Activity	Months											
	3	6	9	12	15	18	21	24	27	30	33	36
ESTABLISH POLICIES												
<i>Development of policies impacting upon financial sector</i>	█											
<i>Development of financial sector policies</i>	█											
BANKING SECTOR DEVELOPMENT												
Build legal and regulatory framework												
<i>Development of laws relating to institutions</i>			█	█	█	█						
<i>Development of laws relating to contracting and conduct</i>			█	█	█	█						
<i>Development of accounting and auditing standards</i>			█	█	█	█						
<i>Development of prudential regulations</i>			█	█	█	█						
<i>Development of failure resolution laws</i>			█	█	█	█						
Build other financial sector infrastructure												
<i>Bank supervisory capacity building</i>			█	█	█	█	█	█	█	█	█	█
<i>Development of payments system</i>			█	█	█	█	█	█	█	█	█	█
Develop institutions												
<i>Set-up of Central Bank</i>			█	█	█	█						
Upgrade skills												
<i>Training of bankers/central bank staff/remittance cos. staff</i>			█	█	█	█	█	█	█	█	█	█
REMITTANCE SECTOR STRENGTHENING												
Regulatory support												
<i>Support of Somali remittance companies' association</i>			█	█	█	█	█	█	█	█	█	█
<i>Interim oversight mechanism in place</i>			█	█	█	█	█	█	█	█	█	█
Improve transparency of remittance companies												
<i>Registration/licensing of remittance cos. in host countries</i>			█	█	█	█	█	█	█	█	█	█
<i>Institutional governance/management support</i>			█	█	█	█	█	█	█	█	█	█
<i>Accounting/auditing systems and external audit</i>			█	█	█	█	█	█	█	█	█	█



Indicative Timeframe for Scenario 2

Activity	Months											
	3	6	9	12	15	18	21	24	27	30	33	36
ESTABLISH POLICIES												
<i>Development of policies impacting upon financial sector</i>												
<i>Development of financial sector policies</i>												
BANKING SECTOR DEVELOPMENT												
Build legal and regulatory framework												
<i>Development of laws relating to institutions</i>												
<i>Development of laws relating to contracting and conduct</i>												
<i>Development of accounting and auditing standards</i>												
<i>Development of prudential regulations</i>												
<i>Development of failure resolution laws</i>												
Build other financial sector infrastructure												
<i>Bank supervisory capacity building</i>												
<i>Development of payments system</i>												
Develop institutions												
<i>Evaluation of Bank of Somaliland</i>												
<i>Restructuring of Bank of Somaliland</i>												
Upgrade skills												
<i>Training of bankers/central bank staff/remittance cos. staff</i>												
REMITTANCE SECTOR STRENGTHENING												
Regulatory support												
<i>Support of Somali remittance companies' association</i>												
<i>Interim oversight mechanism in place</i>												
Improve transparency of remittance companies												
<i>Registration/licensing of remittance cos. in host countries</i>												
<i>Institutional governance/management support</i>												
<i>Accounting/auditing systems and external audit</i>												

5.5.2 Areas for Technical Assistance

Clearly, a wide range of initiatives, involving capacity building and institutional strengthening, are necessary within the near term to enable the entry of a private bank at the earliest possible opportunity whilst strengthening the existing Somali remittance sector. Expert assistance in areas of specific relevance to our recommendations, some of which could be funded by donors such as UNDP and EC, include:

- General legal and judicial framework advisors: for designing the non-banking laws such as company law, property rights law, bankruptcy law and judicial system, amongst others;
- Legal advisors (with expertise in financial sector regulatory frameworks): for drafting the Central Bank law, Banking law and prudential guidelines relating to entry requirements to the banking sector including branches of foreign banks and the necessary supervision and regulatory oversight of banks, non-bank financial institutions, money transfer companies and microfinance entities, amongst others;
- Financial sector advisors: for assistance in setting up the central bank, designing and developing the bank strategy with particular reference to human resources and succession plan and a roadmap for the restructuring of the banking infrastructure in the areas of payments and clearing, adoption of, banking supervision and regulatory oversight, bank restructuring and licensing and institutional capacity building in areas such as management and corporate governance, lending and marketing, internal audit and control, credits function and collateral appraisal, amongst others;
- Financial sector accounting and auditing advisors: for assistance in adoption of international accounting standards and chart of accounts, design of accounting and auditing systems;
- Auditing firms: for carrying out external audits and oversight of the remittance companies;
- Financial advisors: for advice on the separation of central banking functions of Bank of Somaliland and Bank of Puntland from its commercial banking operations;
- Bank trainers: for training in banking practices, anti-money laundering regimes; and
- Legal advisors: for assisting with the formation of the Somali remittance companies' association.

5.6 Implementation options

5.6.1 Accelerating the timeframes

The above timeframes for creating an enabling environment for sustainable financial intermediation are based on totally re-establishing the necessary institutional and legal infrastructure. However, these timeframes can be shortened under following conditions:

- Allowing the entry of a major internationally recognized bank in Somalia on the basis that this bank is already licensed and regulated in other parts of the world. This was recently evidenced by proposed entry of Standard Chartered Bank in Afghanistan even though the country does not have the required capacity for regulating banks; or
- If the sole aim is to provide credit to support private sector development on an urgent basis, then an intermediation/credit agency can be put in place with donor assistance. However, it is imperative that any such initiative is in accordance with market-based principles and sound banking practices; or
- With very large donor financing, extensive 'hands on' technical assistance can be provided to accelerate the key reforms. For example, this could mean the outsourcing of the supervisory function to another central bank in the region or consultants. However, this may be at the expense of building sustainability whereby local involvement is balanced with outside technical assistance.

5.6.2 Program management options

The options for consideration and discussions are:

Option 1

The appointment of a senior advisor familiar with central and commercial banking functions in various environments, including Islamic and post-conflict background, to ensure effective co-ordination of entire modernization of banking sector, which must also include safeguarding and strengthening of money transfer companies' and improving their accountability and governance. This appointment would be initially for duration of two years with the senior advisor responsible for program management as well as implementation of certain key activities. The advisor would additionally co-opt or call upon various technical experts as outlined in the key areas above during the two-year period.

Option 2

This would be similar to Option 1 but without the senior advisor, in which case individual technical experts would be engaged to address specific areas recommended above. The program would be managed either by a key donor or by a Somali officer or unit within the central bank or Ministry of Finance. The duration for which the technical experts would be required will depend on the activity but in most cases they would not be required for more than one year.

In both these options, it is worth considering the possibility of short-term secondments of key experts from neighbouring central banks.

5.6.3 Momentum for safeguarding the Somali remittance sector

It is strongly recommended that the momentum built up to safeguard / strengthen money transfer companies must be maintained by continuing assistance, for example, in the areas of providing strategic guidance and technical advice to the SFSA, improved communications of the role of Somali remittance companies in the economy, and further workshops / seminars in key geographical locations. The opportunity must be taken to invite national regulatory authorities to these workshops so that their understanding of remittance business is improved, and there is transparency and communication of the progress being made by the Somali remittance companies. Selected assistance through the association to provide a lead and to strengthen the remittance operations should also receive priority.

UNDP must continue to play the leading role in driving the Somali remittance sector initiative to the point where the sector is stable.

5.6.4 Building local capacity through Somali skills

To accelerate progress, efforts should be made to identify qualified and suitably trained Somalis living abroad who would be willing to return to their homeland, bringing their expertise to the banking sector. The required skills are certainly available outside of Somalia, however adequate incentives are required for the return of qualified and skilled Somalis to Somalia. This initiative can be pursued by UNDP.

Of course, the presence of a stable environment in the region together with an acceptable international recognition should provide the much needed impetus to accelerate progress in this neglected part of the world, where we found significant private sector activity and people demanding the establishment of a proper and effective banking system that will contribute directly to poverty reduction by creating new business and employment opportunities, and to the economic growth of the country.

5.7 Implementation risks to restoring financial intermediation

There are numerous risks to establishing the kind of environment and framework required for stable banking and sufficient levels of financial intermediation in Somalia. Key among them are political risks, lack of public confidence and hence the ability of banks to mobilize funds for purposes of intermediation. Others relate to the amount of time required to build a new and comprehensive incentive structure for *competitive* market-based finance. These and other issues are highlighted below:

5.7.1 Political risk

Political risk represents one of the major impediments to financial intermediation. Internally, problems persist in reconciling the various groups. Until these problems are resolved and a

government is put in place, it is highly unlikely that the program for developing a banking sector can be commenced.

Meaningful levels of formal private investment are unlikely to materialize at least until some of these obstacles are removed. Political risk guarantees may facilitate larger investments, and a gradual restoration of confidence may lead to smaller investments. Prospects for financial intermediation may not be strong until the investment climate improves, which requires an improvement in the political landscape. Otherwise, it is doubtful that banks would expose themselves to risk for some time. Instead, they would probably rely on guarantees for balance sheet exposure, and focus on fee income-generating services in the form of transfers and remittances, trade finance, and foreign exchange trading. Consequently, deposit mobilization and lending activities will not be the banks' priority.

5.7.2 Market size

The size of the Somalia market remains relatively small. The population is less than ten million, and per capita income is amongst the lowest in Africa. While remittances, informal savings, and strong family ties translate into more financial protection than indicated by economic statistics alone, the market is still small. This may cause investment prospects to appear less attractive and weaken prospects for financial intermediation.

5.7.3 Public confidence

Restoring confidence in civil institutions is a slow process, particularly after a long period of living without any central form of national administration and institutions. Moreover, the loss of money by depositors and individuals after the total collapse of the banking system a decade ago and more recently in the aftermath of closure of Al Barakat, is most likely to translate into an enormous challenge in rebuilding public confidence in the banking system.

5.7.4 Ability of banks to mobilize funds

Funding for and from banks may be minimal for the foreseeable future. First, funding sources would be limited because of the unwillingness of depositors to place their funds in the banks. Second, there are no other financing markets. Third, in the case of Somaliland, there is understandable concern about licensing banks if they cannot meet regulatory requirements or if the supervisory capacity is not available. Fourth, prime-rated foreign banks to date have shown little interest in investing in the banking market in Somalia.

5.7.5 Willingness of banks to take risk

Banks in general are unlikely to lend in any great volume soon for several reasons. First, their funding base will be limited. Second, the regulatory regime will appear strict in terms of the management and quality of assets since private investors are not used to such rules in a lawless environment which has persisted for the last decade. Third, judicial weakness in the commercial framework undermines the use of collateral for secured lending. Competition probably will not materialize until political conditions have stabilized, risks have abated,

some measure of public confidence is restored, and at least two or three professionally managed banks are licensed and operating.

5.7.6 Time required to build new incentive structures

The restoration of financial intermediation to support sustainable long-term economic growth will require implementation of many incentives and building of key institutions. Even with the adoption of new regulations, it will take time for these changes to be implemented. Much training will be required, new principles and guidelines tested and adapted and new standards of information dissemination introduced. Also, an appeals process will need to be institutionalized throughout the judicial and political system. In the banking sector, personnel will need training in market-based commercial principles; regulations must be understandable, information systems should be used for strategic planning and monitoring; new standards of accountability and disclosure must be established; and management and governance practices need to be completely revamped to conform to emerging global standards.

5.7.7 Donor coordination

There are a number of potential issues that could weaken prospects for the development of a banking sector with sustainable financial intermediation. Justifiably, in an environment where human tragedy has occurred, there is a tendency to provide soft loans and grants for humanitarian purposes. However, in other cases, this has led to aid features that distort market development through subsidized pricing, free loans, and agency arrangements instead of risk-assuming principal positions for institutions. While immediate relief can be provided, such features ultimately can undermine the foundation for sustainable medium-term finance and institutional development. Second, there is the risk of donor as well as recipient fatigue: aid recipients become frustrated with slow progress or donors' reluctance to release funds without any accountability requirements on the part of the recipients. Donors may become frustrated with political division, corruption, or simply slow progress with the reform and implementation process. If this happens, there is a risk that donor coordination issues could undermine efforts to help Somalia build a viable banking sector with adequate intermediation capacity.



Appendix 1: Regulatory imperatives in UAE for money exchange and remittance businesses (reproduced from The World Bank and the International Monetary Fund, *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, March 2003)



Regulatory Framework for Money Exchange and Money Remittance Business in the United Arab Emirates

	Money Exchange Business and Money Remittance Business
Regulatory Authority	The Central Bank of the U.A.E
Legislation	<ol style="list-style-type: none"> 1. Federal Law No. 10 (1980) Concerning the Central Bank, monetary system, and organization of banking. 2. Resolution No. 31/2/1986 regarding the regulation of money changing business in the U.A.E. 3. Resolution No. 123/7/92 regarding the regulation of the money changing business in the U.A.E.
Licensing/Registration: Documentation	<ol style="list-style-type: none"> 1. <i>Business Plan</i>: nature and scale of money changing business, future development plans, including management plans [clause 3(a)]. 2. <i>Applicant</i>: name, address, brief statement about the applicant, copy of passport or of U.A.E. identity card [3(b)]. 3. <i>Guarantee</i>. An undertaking to provide a bank guarantee drawn in favor of the Central Bank equal to 50 percent of the capital of the applicant [3(c)]. 4. <i>Supervision</i>: An undertaking to comply with all Central Bank resolutions, instructions, directives, and subject the business records to the examination, audit, and supervision of the Central Bank [3 (d)]. 5. <i>Other Documents</i>: Any other information required by the Central Bank for purposes of processing the application [3(e)].
Licensing/Registration: Ownership	<ol style="list-style-type: none"> 1. <i>Paid up Capital</i>: Dh. 2 million [Article 4 (a)] Individuals: The applicant is a U.A.E. national above the age of 21 years [4.2(b)]. 2. <i>Ownership Structure</i>: The share of U.A.E. nationals in the company is not less than 60 percent of the total paid up capital [4.2(b)]. No commercial bank is allowed to manage the licensed person whether local or foreign [4.4 (c)].
Licensing/Registration: Fitness and Probity Test	<ol style="list-style-type: none"> 1. <i>Personal reliability</i>: be of good conduct and behavior; not convicted of any offense involving dishonor or dishonesty or violence, or have failed to honor his liabilities toward banks or other creditors; shall not have been declared bankrupt or reached a settlement; have had their assets put under judicial receivership [4.3 (a)]. 2. <i>Professional qualifications</i>: Must have the appropriate theoretical knowledge of money changing business and the necessary management experience [4.3 (b)].



	Money Exchange Business and Money Remittance Business
Permitted Activities	"Money Changing business" means <i>the purchase and sale of foreign currencies in the form of bank notes and coins, the purchase and sale of travelers checks</i> , the handling of remittance business in both the local and foreign currencies and other matters approved by the Central Bank.
Prudential Regulation	<ol style="list-style-type: none">1. <i>Capital:</i> Total assets must not exceed ten times the paid up capital and must not fall below the approved limit [8 1 (a)]. Any partner in the business may not withdraw any amount from the business in excess of his share of net annual profits [8.2(1)].2. <i>Management:</i> Managers must always receive prior approval from the Central Bank [8 2(b)].3. <i>Ownership.</i> The bank's ownership and capital structure should not be altered without Central Bank permission [8.2(c)].4. <i>Organizational Restructuring.</i> No mergers, amalgamations, or joint ventures without Central Bank permission [8.2(d)].5. <i>Location and Branches</i> The premises and change of premises for conducting the business requires central bank approval. NQ other activity of whatsoever nature can be undertaken in the same premises [8.2(e)]. No branches can be opened without Central Bank permission [8.2 (g)].6. <i>Business Name:</i> The business name shall not include the words "bank," "financial institution," "investment/commercial/real estate company," or any other than money changing business [8 2 (f)].7. <i>Auditors:</i> The business must appoint a Central Bank approved auditor [8 2(h)].8. <i>Accounting Records:</i> The business must maintain proper accounting records and submit these forms as required by the Central Bank [8.2 (h)]. The business is authorized to issue drafts in its own name and drafts must be signed by the duly authorized signatories [8 20)]. The business shall provide, upon request from the Central Bank, all data, information, or statistics, at any time, and for any specified period, and such information shall be identical to the records of the business and it shall be regarded and treated as confidential.

	Money Exchange Business and Money Remittance Business
	<p>9. <i>Customer Identification Records*</i>: Money changers that are involved in money funds transfers must record details of persons or institutions that transfer an amount of Dh. 2000 (two thousand) or equivalent in other currencies. To ensure the correct identity of the client, any of the following original documents are required:</p> <ol style="list-style-type: none"> (1) passport, or (2) U A.E. ID card for U.A.E. nationals, or (3) labor card for non-U A.E nationals, or (4) driver's license. <p>With the necessity to carefully check the person's photo in all cases (1) recording the phone number only (without the address). In the case of transfers in amounts less than Dh 2000, the transferor should be given a receipt without the said details.</p> <p>10. <i>Transaction receipts</i>: Dealings between the business and customers must be supported by official receipts [8.2(i)]</p> <p>11. <i>Disclosure</i> Customers must be informed by a public notice their right to a receipt and the rates at which the transactions are conducted [8.2(i)].</p> <p>12. <i>Asset Quality</i> The business shall not encumber any assets without the prior permission of the Central Bank [8.2(j)].</p> <p>13. <i>Insider Borrowings</i>: Shareholders, partners, directors, managers, or controllers of the business may not borrow from or lend to the licensed business and they may not have current accounts or any other accounts with the business [8.2(m)].</p> <p>14. <i>Prudential Reports</i>: The business is required to submit on a quarterly basis to the Central Bank a signed copy of the year end accounts and the auditors report [8.2(n)].</p>
Supervision	The Central Bank reserves the right to inspect the activities of the licensed person at any time it finds it appropriate to ensure adherence to the provisions of its resolutions [9].



	Money Exchange Business and Money Remittance Business
Revocation, Restriction or Variation of License	<p>The Central Bank may revoke a license if:</p> <ol style="list-style-type: none">(1) it appears there is a breach of the conditions of the license;(2) the business is in breach of any instructions or circulars issued by the Central Bank;(3) the Central Bank is issued with false, misleading, or inaccurate information from the business;(4) the interests of customers or potential customers of the business are in any other way threatened;(5) a competent judicial authority orders its liquidation;(6) a judicial receiver or manager has been appointed;(7) a bankruptcy order has been made against the business;(8) the business is unable to pay its debts as they fall due; and(9) the value of the assets are less than the amount of its liabilities, taking into account its contingent or prospective liabilities.

Source: Central Bank of the United Arab Emirates, Resolution No. 123/92 regarding the regulation of Money Changing Business in the U.A.E and Notice 1815/2001 to All Money Changers operating in the U.A.E on Outgoing Transfers, date 01/10/2001



Appendix 2: Assessment of progress by Somali remittance sector against FATF best practices



COMBATING THE ABUSE OF ALTERNATIVE REMITTANCE SYSTEMS

International Best Practices, FINANCIAL ACTION TASK FORCE (FATF), 20 JUNE 2003

Background

Special Recommendation VI: Alternative Remittance

“Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.”

The Best Practices Paper is intended to give additional details (including some examples), to offer jurisdictions suggestions in implementing Special Recommendation VI and to give them guidance on how to detect alternative remittance systems outside the conventional financial sector. It focuses on many practical issues, such as the identification of money/value transfer services, the procedures for licensing or registering such services and their customer due diligence procedures.

Definition

Money or value transfer service (MVT service) refers to a financial service that accepts cash, checks, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the MVT service belongs. Transactions performed by such services can involve one or more intermediaries and a third party final payment.

Principles

The following principles guide the establishment of the FATF best practices:

- In certain jurisdictions, informal MVT services provide a legitimate and efficient service. Their services are particularly relevant where access to the formal financial sector is difficult or prohibitively expensive. Informal MVT services are available outside the normal banking business hours. Furthermore, money can be sent to and from locations where the formal banking system does not operate.
- MVT services are more entrenched in some regions than others for cultural and other reasons. Underground banking is a long-standing tradition in many countries and pre-

dates the spread of Western banking systems in the 19th and 20th centuries. These services operate primarily to provide transfer facilities to neighbouring jurisdictions for expatriate workers repatriating funds.

- However, the staging posts of underground banking are no longer confined to those regions where they have their historical roots. Accordingly, informal MVT services are no longer used solely by persons from specific ethnic or cultural backgrounds.
- Informal MVT services can take on a variety of forms which, in addition to the adoption of a risk-based approach to the problem, points to the need to take a functional, rather than a legalistic definition. Accordingly, the FATF has developed suggested practices that would best aid authorities to reduce the likelihood that informal MVT services will be misused or exploited by money launderers and the financiers of terrorism.
- Government oversight should be flexible, effective, and proportional to the risk of abuse. Mechanisms that minimize the compliance burden, without creating loopholes for money launderers and terrorist financiers and without being so burdensome that it in effect causes informal MVT services to go “underground” making them even harder to detect should be given due consideration.
- It is acknowledged that in some jurisdictions informal MVT services have been banned. Special Recommendation VI does not seek legitimization of informal MVT services in those jurisdictions. The identification and awareness raising issues noted may however be of use for competent authorities involved in identifying informal MVT services and for sanctioning those who operate illegally.

Areas of Focus

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<p><i>(i) Licensing/Registration</i></p> <p>A core element of Special Recommendation VI is that jurisdictions should require licensing or registration of persons (natural or legal) that provide informal MVT services. The FATF defines these terms in its interpretative note to Special Recommendation VI. A key element of both registration and licensing is the requirement that the relevant regulatory body is aware of the existence of the business. The key difference between the two is that licensing implies that the regulatory body has inspected and sanctioned the particular operator to conduct such a business whereas registration means that the operator has been entered into the regulator's list of operators.</p>	<p><i>See below</i></p>	<p><i>See below</i></p>
<p><i>a. Requirement to Register or License</i></p> <ul style="list-style-type: none"> ■ At a minimum, jurisdictions should ensure that MVT services are required to register with a designated competent authority such as a Financial Intelligence Unit (FIU) or financial sector regulatory body. Registration of MVT services is likely to be a relatively cost effective approach when compared to the significant resources required for licensing. ■ The obligation of licensing or registration applies to agents. At a minimum, the principal business must maintain a current list of agents which must be made available to the designated competent authority. An agent is any person who provides MVT service under the direction of or by contract with a legally registered or licensed MVT service (for example, licensees, franchisees, concessionaires). 	<ul style="list-style-type: none"> ■ Jurisdictions following FATF best practice will require Somali remittance companies to either register (e.g. United Kingdom with HMCE) or license (e.g. United Arab Emirates with the Central Bank of the UAE). ■ Agents of Somali remittance companies (as defined herewith) will be required to register or license in certain jurisdictions. 	<ul style="list-style-type: none"> ■ Progress on this front varies throughout the sector. However, there has been a concerted effort to register and license where required to do so in the last two years. Larger companies in particular, continue to make progress on this front. Most large companies have registered in the UK and in several US states (e.g. Minnesota) and are in the process of being licensed in the UAE.

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
		<ul style="list-style-type: none"> ■ The registration and licensing process of agents of Somali remittance companies has been far slower than those of principal companies. Provision of lists of agents does appear to take place however, although not always in a structured manner.
<p><i>b. Applications for License</i></p> <ul style="list-style-type: none"> ■ In determining whether an application for licensing can be accepted by the regulatory authority, it is clear that some form of scrutiny of the application and the operator needs to be conducted. This is in line with FATF Recommendation 29, which states that regulators should introduce “<i>the necessary legal or regulatory measures to guard against control or acquisition of a significant participation in financial institutions by criminals or their confederates.</i>” ■ Authorities should conduct background checks on the operators, owners, directors and shareholders of MVT services. When considering the suitability of a potential operator, the authorities should conduct a criminal record check on the principal persons having control over the operations of the MVT service, as well as consult appropriate law enforcement databases, including suspicious or unusual reporting filings. Consideration should be given to defining the type of criminal record which would make the applicant ineligible to operate a licensed MVT service. 	<ul style="list-style-type: none"> ■ Authorities adopting FATF best practice on licensing will undertake some due diligence of Somali remittance companies seeking licenses. ■ Authorities adopting FATF best practice on licensing will conduct background checks on operators, owners, directors and shareholders of Somali remittance companies seeking licenses. 	<ul style="list-style-type: none"> ■ Several Somali remittance companies have been through such licensing procedures and have successfully been granted licenses. At least two larger companies have obtained licenses in the UAE whilst two other are currently engaged in the licensing process.

FATF Best Practice Recommendation	Implications for Somali remittance companies	Progress of Somali remittance companies
<p><i>c. Business Address</i></p> <p>MVT services should be required to submit details of the addresses from which they operate and to notify the authorities upon any change of address or cessation of business. Where possible, this information may be made available to both the public so they may check which MVT service is properly licensed or registered before using their services, and to investigative/regulatory authorities during the course of their work. This also has value for financial institutions with which the MVT services maintain accounts as they are able to identify which MVT services are licensed/registered and thus are more able to identify illegal operators and to report to the FIU or appropriate competent authority accordingly.</p>	<ul style="list-style-type: none"> ■ Authorities adopting FATF best practice will require Somali remittance companies to state the addresses from which they conduct business and notify authorities when they this changes. This information should be publicly available. 	<ul style="list-style-type: none"> ■ Somali remittance companies appear to comply with this requirement wherever it is made. Many of the larger companies have websites which list the addresses of their branches around the world. This requirement is typically met by companies for their agents, although it is difficult to tell if all agents' addresses are provided and updated.
<p><i>d. Accounts</i></p> <ul style="list-style-type: none"> ■ In processing cash and in the settlement of transactions, MVT services use bank accounts. Some operators run a number of businesses, of which MVT service is one, and use business accounts to conduct or conceal the remittances of funds on behalf of their clients thereby masking the true origin of the commingled funds and accounts. ■ MVT services should maintain the name and address of any depository institution with which the operator maintains a transaction account for the purpose of the MVT service business. These accounts must be capable of being identified and should be held in the name of the registered/licensed entity so that the accounts and the register or list of licensed entities can be easily cross-referenced. ■ Traditional financial institutions should be encouraged to develop more detailed 	<ul style="list-style-type: none"> ■ Somali remittance companies should maintain separate transaction accounts at banking institutions for the purpose of their remittance business. These accounts should be held in the name of the registered/licensed entity. ■ Traditional financial institutions should be encouraged to develop an understanding of how Somali remittance companies utilize their bank accounts to conduct their operations. 	<ul style="list-style-type: none"> ■ Somali remittance companies appear to have ensured that they hold separate bank accounts for their remittance business and that the names of their banks accounts are held in the same name as the registered/licensed entity. ■ There still appears to be a lack of understanding on the part of financial institutions as to the workings of Somali remittance companies. UNDP has assisted in this process with initiatives such as the



<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<p>understanding as to how MVT services utilise bank accounts to conduct their operations, particularly when accounts are used in the settlement process.</p>	<p>operations.</p>	<p>upcoming 'London Workshop'.</p>
<p><i>(ii) Identification and Awareness Raising</i></p> <p>Some informal MVT services are not known to regulatory and enforcement agencies, which makes them attractive to the financiers of terrorism. Identification of these MVT services will make it less attractive for criminal and terrorist groups to use them to facilitate and hide the financing of their activities.</p> <p>For the majority of jurisdictions, proactive identification of informal MVT services is an integral element of establishing and maintaining an effective registration/licensing regime. Once informal MVT services have been located, compliance programs can be instituted under which the agents are approached, their details are recorded and they are provided information as to their obligations. Once regulatory regimes are in place, ongoing compliance work will include strategies to identify those MVT services not yet known to regulatory authorities. Jurisdictions may apply a range of strategies to uncover MVT services, using a number of approaches concurrently. Jurisdictions are encouraged to foster close co-ordination within the relevant authorities for the purposes of developing inter-agency strategies and using available resources to identify MVT services that may be operating illegally. Below is a list of suggested best practices for identifying MVT services and raising public awareness about their activities. As best practices, it is recognized that some of these suggestions may not be appropriate for every jurisdiction and that each jurisdiction must develop strategies best suited to its individual system.</p>	<p><i>See below</i></p>	<p><i>See below</i></p>

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<p data-bbox="244 510 552 539"><i>a. Identification Strategies</i></p> <p data-bbox="244 577 791 640">Best practices in the area of identification strategies include:</p> <ul style="list-style-type: none"> <li data-bbox="244 680 791 1055">■ Examining the full range of media to detect advertising conducted by informal MVT services and informing operators of their registration/licensing obligations. This includes national, local and community newspapers, radio and the Internet; giving particular attention to the printed media in various communities; and monitoring activities in certain neighborhoods or areas where informal MVT services may be operating. <li data-bbox="244 1095 791 1608">■ During investigations, information about informal MVT services may be uncovered which should be passed on to the competent authorities. Best practices include encouraging investigators to pay particular attention to ledgers of business that may be associated with informal MVT services; encouraging enforcement agencies to look for patterns of activity that might indicate involvement of informal MVT services; and, where possible, encouraging enforcement agencies to consider using undercover techniques or other specific investigative techniques to detect MVT services that may be operating illegally. <li data-bbox="244 1648 791 1778">■ Consulting with the operators of registered/licensed MVT services for potential leads on MVT services that are unregistered or unlicensed. <li data-bbox="244 1818 791 1946">■ Being aware that informal MVT services are often utilized where there is bulk currency moved internationally, particularly when couriers are involved. Paying particular 	<p data-bbox="817 577 1125 741">The following strategies may be adopted by authorities of host countries in which Somali remittance companies operate:</p> <ul style="list-style-type: none"> <li data-bbox="817 781 1125 1016">■ Media searches to detect the existence of remittance companies and advise them on regulatory requirements and to monitor their activities; <li data-bbox="817 1057 1125 1187">■ Passing on information to other relevant authorities during investigations; <li data-bbox="817 1227 1125 1462">■ Obtaining information from registered/licensed remittance companies about unregistered/unlicensed companies; <li data-bbox="817 1503 1125 1738">■ Recognizing the role of remittance companies in moving large amounts of funds internationally and focusing the origin of these funds; <li data-bbox="817 1778 1125 1946">■ Paying attention to domestic suspicious transactions and unusual activity reporting as well as 	<p data-bbox="1152 577 1460 1122">Somali remittance companies appear to have been selectively subject to some of these strategies. However, it is clear that all major companies are well known to relevant authorities and have made efforts to do so. If anything it appears that not all authorities have fully embraced these strategies. Smaller Somali companies, however, may well be subject to such identification strategies.</p>

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<p>attention to the origin and owners of any such currency. Couriers could provide insights for the identification and potential prosecution of illegal operators with whom the couriers are associated, especially when potential violations by couriers are linked back to the source of the informal MVT service operation.</p> <ul style="list-style-type: none"> ■ Paying particular attention to domestic suspicious transaction or unusual activity reporting, as well as to domestic and international large value cash reporting, to identify possible links to informal MVT services. ■ Assisting banks and other financial institutions in developing an understanding of what activities/indicators are suggestive of informal MVT service operations and using this to identify them. Many informal MVT services maintain bank accounts and conduct transactions in the formal financial sector as part of other business operations. Giving banks the authority to crosscheck particular accounts against a register of these operators and notify the relevant regulatory authority as appropriate. ■ Once informal MVT services are identified international exchange of information and intelligence on these entities between the relevant bodies can be facilitated. Consideration could be given to sharing domestic registers with international counterparts. This strategy would also assist jurisdictions to identify local operators not previously known. 	<p>international large value cash reporting;</p> <ul style="list-style-type: none"> ■ Assisting banks and other financial institutions in developing an understanding of what activities/indicators are suggestive of remittance companies and using this to identify them; and ■ Once informal MVT services are identified international exchange of information and intelligence on these entities between the relevant bodies can be facilitated. 	
<p><i>b. Awareness Raising Campaigns</i></p> <p>Best practices in the area of awareness raising campaigns include:</p>	<p>The following awareness raising campaigns may be</p>	<p>Regulatory authorities that deal with Somali remittance</p>

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<ul style="list-style-type: none"> ■ Making informal MVT services aware of their obligations to license or register, as well as any other obligations with which they may have to comply. Ensuring that the competent authorities responsible for overseeing and/or registering or licensing informal MVT services know how to detect those services that have not registered or been licensed. Finally, ensuring that law enforcement is aware of the compliance requirements for MVT services in addition to the methods by which those services are used for illicit purposes. ■ Using education and compliance programs, including visits to businesses which may be operating informal MVT services to advise them of licensing or registration and reporting obligations, as opportunities to seek information about others in their industry. Using these outreach efforts by law enforcement and regulatory agencies to enhance their understanding about the operations, record-keeping functions and customer bases of informal MVT services. Extending outreach campaigns to businesses typically servicing informal MVT services (such as shipping services, courier services and trading companies). Placing in trade journals, newspapers or other publications of general distribution notices of the need for informal MVT services to register or license and file reports. ■ Ensuring that the full range of training, awareness opportunities and other forms of education are provided to investigators with information about MVT services, their obligations under the regulatory regime and ways in which their services can be used by money launderers and terrorist financiers. 	<p>adopted by authorities of host countries in which Somali remittance companies operate:</p> <ul style="list-style-type: none"> ■ Making remittance companies aware of their obligations, ensuring competent authorities know how to detect them and ensuring law enforcement authorities are aware of compliance requirements; ■ Using education and compliance programs to advise remittance companies and to educate themselves about the operation of these companies; ■ Ensuring that a full range of training, awareness opportunities and other forms of education are provided to investigators; ■ Issuing various financial sector publications of guidelines to encourage licensing or registration and reporting and also general material to ensure financial institutions currently 	<p>companies only appear to selectively adopt some of these campaigns.</p> <p>Large Somali remittance companies appear to have a strong and growing understanding of regulatory imperatives that are placed on them. At least one of the largest remittance companies has held comprehensive training sessions for staff and agents at a location in the US. The training material was prepared by the company's lawyers in the United States.</p> <p>Most companies actively display their license/registration documentation once they have been obtained. For example, a commonly displayed license at larger Somali remittance companies is that for the State of Minnesota in the US.</p>

<i>FATF Best Practice Recommendation</i>	<i>Implications for Somali remittance companies</i>	<i>Progress of Somali remittance companies</i>
<p>This information can be provided through training courses, presentations at seminars and conferences, articles in policing journals and other publications.</p> <ul style="list-style-type: none"> ■ Issuing various financial sector publications of guidelines to encourage licensing or registration and reporting and also general material to ensure financial institutions currently subject to suspicious transaction reporting requirements develop an understanding of MVT services. Informing potential customers about the risks of utilising illegal MVT services and their role in financing of terrorism and money laundering. ■ Requiring entities to display their registration/license to customers once they are registered/licensed. Legitimate clients will likely have a higher degree of confidence in using registered/licensed operators and may therefore seek out those operators displaying such documentation. ■ Making a list of all licensed or registered persons that provide MVT services publicly available. 	<p>subject to suspicious transaction reporting requirements develop an understanding of MVT services;</p> <ul style="list-style-type: none"> ■ Requiring entities to display their registration/license to customers once they are registered/licensed; ■ Making a list of all licensed or registered persons that provide MVT services publicly available. 	
<p><i>iii) Anti-Money Laundering Regulations</i></p> <p>The second element of Special Recommendation VI is that jurisdictions should ensure MVT services are subject to FATF Recommendations 10-21 and 26-29 and also to the Eight Special Recommendations.</p> <p>There is key information that both regulatory and enforcement bodies need access to if they are to conduct effective investigations of money laundering and terrorist financing involving MVT services. Essentially, agencies need the information about the customers, the transactions themselves, any suspicious</p>	<p><i>See below</i></p>	<p><i>See below</i></p>

FATF Best Practice Recommendation	Implications for Somali remittance companies	Progress of Somali remittance companies
<p>transactions, the MVT service’s location and the accounts used. The MVT service must also have further records on hand available to regulatory and enforcement bodies as needed.</p> <p>It is considered that to be effective in addressing the problem of MVT services, regulations should not be overly restrictive. Regulation must allow for those who abuse these systems to be found and stopped, but it should not be so burdensome that it in effect causes the systems to go “underground”, making it even harder to uncover money laundering and terrorist financing through alternative remittance.</p>		
<p><i>a. Customer Identification</i></p> <p>The principle of Know Your Customer (‘KYC’) has been the backbone of anti-money laundering and counter terrorist financing measures which have been introduced to financial service providers in recent years, and this should also be the case for the MVT service sector. Customer identification requirements in the formal financial sector have had a deterrent effect, causing a shift in money laundering activities to other sectors. FATF Recommendations 10-13 concern customer identification and record keeping.</p> <ul style="list-style-type: none"> ■ FATF’s Recommendation 10 is considered to be the minimum effective level which MVT services should be required to fulfill. The current recommendation sets out that for persons, the institution should “<i>identify, on the basis of an official or other reliable identifying document</i>” the client. The documents commonly acknowledged and accepted for identification purposes are identity card, passport, drivers’ license or social security card. It is important for the credibility of the system that failure to 	<p>Somali remittance companies are compelled to put in place sound KYC programs, as these are seen as the backbone of anti-money laundering and counter terrorist financing measures and which have been introduced to financial service providers.</p> <ul style="list-style-type: none"> ■ FATF 10 sets out that for persons, the remittance company should “<i>identify, on the basis of an official or other reliable identifying document</i>” the client; ■ Proof of identity should be required when establishing a business relationship with the MVT service whether 	<p>Several Somali remittance companies have embarked on KYC programs.</p> <p>Most remitters of funds typically hold acceptable forms of identification. In some of the bigger remittance companies, the details of a remitter are stored in a database, including a picture.</p> <p>Several companies are introducing alternative (non-official) forms of identification such as photograph or thumb print (and sometimes signature and thumb print) identification. This is certainly an advance on the previously used method of identifying individuals on the basis of societal</p>

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<p>produce an acceptable form of identification will mean that a client will be rejected, the transaction will not be conducted and, under specific circumstances a suspicious transaction report will be made.</p> <ul style="list-style-type: none"> ■ Proof of identity should be required when establishing a business relationship with the MVT service whether the relationship is a short-term i.e. a single transaction, or a long-term one. Transactions via phone, fax or Internet should only be conducted after customer identification complying with FATF Recommendation 10 has occurred (i.e., a business relationship has already been established). If the client's identification has not been previously established, then the transaction should not be processed. 	<p>the relationship is a short-term i.e. a single transaction, or a long-term one.</p>	<p>relationships. This practice relied on the premise that the remittance services were exclusively used by individuals of Somali origin.</p> <p>Several larger Somali remittance companies have introduced company identification cards for customers. These cards typically include customer names, photograph, signature and/or thumbprint, clan and a company-assigned personal identification number. This identification number can be used to track information (including transactions) of each customer from a company information system.</p>
<p><i>b. Record Keeping Requirement</i></p> <p>Investigative agencies need to be able to retrace transactions and identify persons effecting the transactions (i.e. the audit trail) if they are to successfully investigate money laundering and terrorist financing. The requirement for MVT services to maintain records is essential for effective regulation of the field, but it is this area in which the balance between the regulator's needs and the burden on the operator most clearly needs to be struck.</p> <ul style="list-style-type: none"> ■ Jurisdictions should consider FATF's Special Recommendation VII on Wire Transfers⁵ when developing guidance in this area. This recommendation specifically deals with funds transfers, including those made through MVT 	<p>As investigative agencies need to be able to retrace transactions and identify persons effecting the transactions, Somali remittance companies are obliged to maintain useful records. FATF 12 indicates that companies need to maintain, for at least five years, all necessary records on transactions both domestic and international. It is suggested that jurisdictions should consider setting some</p>	<p>Record-keeping by large Somali remittance companies appears to be undertaken and appears to be of a high standard. Most larger Somali remittance companies are known to maintain records for at least five years or for as long they have been in existence. However, the adequacy of these financial records for accounting purposes could not be assessed.</p> <p>Records are generally kept</p>

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<p>services. It should be noted that Special Recommendation VI covers the transmission of “value” as well as money.</p> <ul style="list-style-type: none"> ■ MVT services should comply with FATF Recommendation 12 to maintain, for at least five years, all necessary records on transactions both domestic and international. Jurisdictions should consider setting some minimum requirements for the form in which the records should be kept. Because records associated with MVT transfer services may often be coded and/or difficult to access, jurisdictions should also establish minimum standards for ensuring that they are intelligible and retrievable. 	<p>minimum requirements for the form in which the records should be kept.</p>	<p>in Somali, possibly giving rise to challenges for regulators.</p> <p>The study team was unable, however, to ascertain the completeness of records.</p> <p>It is evident, however, that standards do not appear to have been set in many jurisdictions.</p>
<p><i>c. Suspicious Transaction Reporting</i></p> <p>To maintain consistency with the obligations imposed on other financial institutions, jurisdictions should introduce transaction reporting in line with their current reporting requirements for financial institutions.</p> <ul style="list-style-type: none"> ■ Jurisdictions may consider issuing specific guidance as to what may constitute a suspicious transaction to the MVT service industry. Some currently used indicators of suspicious financial activity, such as those found in the FATF’s Guidance for Financial Institutions in Detecting Terrorist Financing, are likely to be relevant for money/value transfer service activity. However, particular activities and indicators that are unique to this sector should be further developed. ■ The second half of FATF’s Special Recommendation VII on Wire Transfers should also be taken into account when developing guidance in this area. For example, operators that receive funds/value should ensure that the necessary originator 	<p>To maintain consistency with the obligations imposed on other financial institutions, remittance companies are required to report suspicious transactions.</p> <p>Such reporting standards exist in certain jurisdiction in which Somali remittance companies operate.</p> <p>Notably, such standards indicate that remittance companies must ensure originator information is included when remittances are made.</p>	<p>Most large Somali remittance companies are aware of the need to report suspicious activity and have the means in place to do so. One of the largest Somali remittance companies has developed software that allows for the cross-checking of existing and potential clients against international suspicious person databases.</p> <p>It is, however, unclear as to the level with which companies have embraced this need and translated it into their operations.</p> <p>Although progress varies in the sector, it is clear that certain companies are attempting to advance this</p>

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<p>information is included. The lack of complete originator information may be considered as a factor in assessing whether a transaction is suspicious and, as appropriate, whether it is thus required to be reported to the Financial Intelligence Unit or other competent authorities. If this information is not included, the operator should report suspicious activity to the local FIU or other competent authority if appropriate.</p>		<p>process in their operations.</p>
<p><i>(iv) Compliance Monitoring</i></p> <p>Regulatory authorities need to monitor the sector with a view to identifying illegal operators and use of these facilities by criminal and terrorist groups. Jurisdictions are encouraged to consider the following options:</p> <ul style="list-style-type: none"> ■ Competent authorities should also be entitled to check on unregistered entities that are suspected to be involved in MVT services. There should be an effective process for using this authority. ■ Granting regulatory agencies or supervisory authorities the authority to check the operations of a MVT service and make unexpected visits to operators to allow for the checking of the register's details and the inspection of records. Record keeping practices should be given particular attention. ■ Establishing a process of identifying and classifying operators which are considered to be of high risk. In this context, "high risk" means those operators which are considered to be of high risk of being used to carry out money laundering or terrorist financing activities. Jurisdictions are encouraged to give such high risk entities extra attention from supervising authorities. 	<p>Regulators adopting FATF best practice are likely to monitor Somali remittance companies with a view to identifying illegal operators and use of these facilities by criminal and terrorist groups.</p>	<p><i>N/a</i></p>

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<p data-bbox="240 506 400 539"><i>(v) Sanctions</i></p> <p data-bbox="240 577 794 1160">In designing legislation to address this problem, one of the aspects to be considered concerns the sanctions which are available to redress non-compliance. If a MVT service operator is found to be non-compliant with the relevant requirements of the legislation the competent authorities would be expected to sanction the operator. Ideally, jurisdictions should set up a system to employ civil, criminal or administrative sanctions depending on the severity of the offence. For instance, in some cases a warning may initially suffice. However, if a MVT service continues to be in non-compliance, it should receive stronger measures. There should be particularly strong penalties for MVT services and their operators that knowingly act against the law, for example by not registering.</p> <p data-bbox="240 1216 794 1552">To monitor the continued suitability of an individual to conduct a MVT service, jurisdictions are encouraged to put systems into place which would bring any conviction of an operator, shareholder or director following licensing or registration, to the attention of the appropriate authorities. Consideration should be given to defining the type of criminal record which would make the applicant ineligible to be a MVT service provider.</p>	<p data-bbox="813 577 1128 880">In designing legislation, authorities adopting FATF best practice are likely to consider sanctions which are available to redress non-compliance. Somali remittance companies may well be subject to various sanctions.</p>	<p data-bbox="1147 577 1193 611"><i>N/a</i></p>



Appendix 3: List of Consultations and Meetings

1. Meetings during field visit to Bossaso between 8th-10th June 2003

United Nations Development Programme

Mr. Parakrama Siriwardana, Security Officer

European Commission

Mr. Alberto Fait, Liaison Officer

Amal Group of Companies

Mr. J. Kassim Ali, Director

Sandi Consulting

Mr. Mohamed Abshir 'Waldo', Director

Ministry of Finance

Mr. Hussein Farah Doodi, Minister of Finance

2. Meetings during field visit to Hargeisa between 10th-12th June 2003

United Nations Development Programme

Mr. Faisal Mohamed, Security Officer

Dahabshil Private Limited Company

Mr. Saeed M. Dualeh, Consultant

Ministry of Finance

Mr. Hussein Ali Dualeh, Minister of Finance

Bank of Somaliland

Mr. Abdourahman Dualeh Mohamad, Governor

3. Meetings during field visit to Mogadishu between 10th-12th June 2003

United Nations Development Programme

Mr. Rolf Helmrich, Security Officer

Meetings were conducted with representatives of:

Towfiq Nationlink

Global Money Transfer

The Somali Business Association



4. Meetings during field visit to Dubai between 23rd-25th June 2003

Amal Group of Companies

Mr. J. Kassim Ali, Director

Barwaqo

Mr. Ali Abdulle Sabriye

Towfiq

Mr. Dahir Jumale Addan

5. Meetings during field visit to Hargeisa between 13th-19th July 2003

United Nations Development Programme

Mr. Max Gaylard, Country Representative, UNDP Somalia

Mr. Ivanoe Fugali, Coordination Officer, Hargeisa

European Commission

Mr. Paul Simkin, TA, SME and Peace Building, EC Delegation Kenya, Somalia Unit

Mr. Paul Crook, Liaison Officer, Hargeisa Liaison Office

Bank of Somaliland

Mr. Abdourahman Dualeh Mohamad, Governor

Dr. Jama Ali Elmi, Vice President and Director General

Mr. Hasson Mohamed Ismail, Director General

Mr. Mohammad Dihood, Personnel Manager

Mr. Mohamad Bedde, Manager, Head Office Branch

Mr. Mahmoud Abdul Roble, Manager, General Accounts

Mr. Adem Mahmoud Bouni, Manager, Audit and Inspection

Mr. Hassan Abdale Hassan, Manager of Branch One

Mr. Abdullali Hassan, Manager, Foreign Branch (Branch Two)

Mr. Ahmad Hussain Aby, Manager, Foreign Relations

Ministry of Finance

Mr. Hussein Ali Dualeh, Minister of Finance

Mr. Ahmad, Director General

Mr. Ali, Director of Customs

Ministry of Commerce

Minister of Commerce



Somaliland Chamber of Commerce, Industry and Agriculture

Mr. Abdullahi Dirie Jama, Secretary General

Dahabshil Private Limited Company

Mr. Abdul Kader Hussein Saeed, Marketing Manager

Omaar International

Mr. Rajan and colleague (In the absence of chief who was away from office)

K-Rep Advisory Services (Africa) Limited

Mr. Francis Simba, Senior Consultant

6. List of remittance companies that were visited in Nairobi.

Amal Group of Companies

Mr. Ali Yassin Farah, Managing Director

Dalsan Systems Limited

Mr. Osman, Director

Mr. Abdullahi Sheikh Mohamed, Administration and Personnel Manager

Mr. Mohamuud Abdirahman Auke, General Manager



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