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# TECHNICAL REPORT

## SOMALIA

Technical Assistance on Bank Supervision  
and Regulation

**SEPTEMBER 2020**

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**GLOSSARY**

AML/CFT	Anti-Money Laundering and Counter-Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CBS	Central Bank of Somalia
CY	Calendar Year
FIL	Financial Institution Law
IAH	Investment Account Holders
IMF	International Monetary Fund
IT	Information Technology
LSD	Licensing and Supervision Department
MCM	Monetary and Capital Markets Department
MNO	Mobile Network Operator
MTB	Money Transfer Business
NCA	National Communications Authority
STF	Somalia Trust Fund
STX	Short-term Expert
TA	Technical Assistance
WB	World Bank

## PREFACE

The Monetary and Capital Markets (MCM) Department has provided a series of Technical Assistance (TA) under a multi-donor Trust Fund. The Trust Fund for Capacity Development in Macroeconomic Policies and Statistics for Somalia—the Somalia Trust Fund (STF)—was established in February 2015 to support the International Monetary Fund’s capacity development to Somalia in the key areas. The TA provided by the MCM under this STF has been instrumental in establishing a functional central bank, including developing a modern banking supervisory regime. Quarterly missions have been undertaken to build capacity in banking regulation and supervision.

The TA, provided under the STF Phase I, started in May 2015 and was completed with the final mission in April 2020.<sup>1</sup> Based on the Strategic Plan by the Central Bank of Somalia (CBS) and request from the Licensing and Supervision Department (LSD) of the CBS, in Phase I MCM provided peripatetic TA missions that focused on issues of banking regulation and supervision.

This report reviews and assesses progress achieved under the STF Phase I project on banking regulation and supervision and discusses future TA under the STF Phase II (FY2021–FY2024, October 1, 2020–October 30, 2024).

The mission would like to express thanks to officials of the CBS for the level of engagement and cooperation extended during the virtual mission, even though the CBS’s operation was interrupted by the COVID-19 pandemic. The insightful discussions helped the short-term experts (STXs) and MCM staff gain a deep understanding of the development and challenges in the financial sector in Somalia.

We also wish to thank the Arab Fund for Economic and Social Development, Canada, Italy, United Kingdom, United States, and European Commission for their funding of the project under which this TA was delivered.

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<sup>1</sup> Due to the precautionary measures related to the COVID-19, the mission originally scheduled to be delivered in Nairobi, Kenya (March 9–20, 2020) was postponed and an alternative virtual mission (April 8–17, 2020) was provided.

## EXECUTIVE SUMMARY

**The purpose of the missions of Phase I was to develop a functional central bank, including establishing a modern banking supervisory regime.** Especially, MCM provided TA missions under the Phase I that have focused on operationalizing banking license capacity, development of on and offsite supervisory capability, and other relevant areas.

**It is evident that there is a high-level of absorption of training and skill development.** The CBS has significantly improved its supervision and licensing exercises based on MCM's advice. Bank ownership has been restructured to bring the ownership levels into compliance with the law; banks have filed their external audit reports and have re-aligned their governance structure to promote the internal auditor's independence.

**The biggest challenge was inadequate human resources and technological support, and unforeseen tasks that interrupt the primary work of the LSD.** Sometime shortcuts on procedures are being taken, incomplete analysis is being conducted, and product quality and timeliness are suffering.

**Inadequate information technology (IT) resources continues to hamper the implementation of TA recommendations and good supervisory practices.** Of particular concern is how the data and information on financial institutions is managed and analyzed by LSD officials with a lack of a central data system. Though a newly introduced workaround may improve the existing data management that keeps the same-date data in different laptops of the LSD officials, it does not fully address the need for a document management system.

**Security concerns continue to hinder the LSD's ability to execute their mandate.** Some recent conditions obliged the LSD staff to postpone necessary meetings with external stakeholders and time allocated to the onsite examinations is very limited, which hampers the conduct of comprehensive reviews.

**The final mission in April reviewed and assessed progress achieved in the Phase I.** The comprehensive set of new recommendations in each section that should be implemented in the Phase II are summarized in the Table 1.

**Table 1. Key Recommendations**

Recommendations	Priority	Timeframe <sup>2</sup>
<b>Licensing Capacity Development</b>		
Update the Regulation on Bank Licensing	Medium	Medium-term

<sup>2</sup> Immediate: < 3 months; Short-term: 3 to 12 months; Medium-term: 12 to 24 months.

**Table 1. Key Recommendations (continued)**

<b>Recommendations</b>	<b>Priority</b>	<b>Timeframe<sup>2</sup></b>
Maintain the moratorium on new bank licenses until adequate resources in LSD are available to properly oversee the banking system	High	Immediate to Medium-term
Revisit the template used by LSD to guide the review of the licensing applications to ensure it is comprehensive and revised appropriately	Medium	Medium-term
Obtain a document management system that would facilitate the capture of licensing application information	High	Medium-term
Ensure more consistent enforcement of the regulation on bank licensing and more critical analysis of the licenses	High	Short-term
Reactivate an outreach to the foreign bank supervisors and to the management of the Puntland and Somaliland central banks	Medium	Medium-term
<b>On and Offsite Inspection</b>		
Develop an accounting standard that is consistent with Islamic banking	Medium	Medium-term
Develop and issue instructions to banks on compilation of prudential returns, and include guidance for consolidating financial information	High	Short-term
Provide guidance regarding the determination of financial data integrity and the dates from which data will be considered 'clean'	High	Immediate
Strengthen the financial analysis and narrative on banks' financial data (both per bank and industry summary)	High	Short-term
Establish and resource a comprehensive information technology and communication framework that would provide a records management system; a system to gather, store, validate, analyze and provide reports thereon; and provide adequate hardware and software to the LSD	High	Medium-term
Complete streamlining of onsite examination procedures	High	Short-term
Strengthen Anti-Money Laundering and Counter-Financing of Terrorism (AML/CFT) onsite and offsite procedures	High	Short-term
Develop procedures to conduct pre-opening visitation procedures	High	Immediate
Develop consolidated supervision framework—work with LSD staff to identify groups, risks arising from group relationships and to conduct assessments of risk	High	Short-term
Finalize the guidance on agent banking and develop supervisory review processes for agent banking (to be prepared in the event agent banking is authorized)	Medium	Medium-term
Review the template of the report of examination and workpapers, identify any needed changes to the templates and the procedures	Medium	Medium-term

**Table 1. Key Recommendations (continued)**

<b>Recommendations</b>	<b>Priority</b>	<b>Timeframe<sup>2</sup></b>
Review the Manual of Supervisory Intervention to determine if it needs upgrading and make the necessary changes	Medium	Medium-term
<b>Other Initiatives</b>		
Prioritize implementing measures to bridge the identified gaps in the Basel Core Principles for Effective Banking Supervision (BCP) self-assessment	High	Immediate
Formalize the internal approach of the policy making process	High	Medium-term
Revise the existing TA products (workpaper, template) to reflect the development of the industry	Medium	Medium-term
Formalize the CBS' code of conduct	High	Medium-term
<b>Islamic Banking</b>		
Include in the of the Financial Institution Law (FIL) revisions related to Islamic banking activities and Sharī'ah governance	Medium	Medium-term
Enhance the licensing framework to include fit and proper criteria for Sharī'ah Board at Islamic bank	Medium	Medium-term
Develop regulations and guidelines on Sharī'ah governance and internal control requirements	High	Short-term
Enhance financial reporting to include information specific to Islamic banking activities	High	Short-term
Upgrade the current risk rating system to include criteria related to Islamic banks	Medium	Medium-term
Incorporate in the assessment of Islamic banking issues, notably Sharī'ah governance systems	Medium	Medium-term
<b>Mobile Money</b>		
Review the relevant regulations including that for money transfer businesses (MTB) to ensure consistency in nonbank activities and relevant requirements	Medium	Medium-term
Communicate with other relevant authorities including the National Communications Authority (NCA) to ensure mobile money service providers are sufficiently regulated	High	Short-term
Continue to encourage all mobile money service providers to submit their transitional implementation plans and implement the regulation as agreed	High	Short-term

**Table 1. Key Recommendations (concluded)**

Recommendations	Priority	Timeframe <sup>2</sup>
Develop the risk-based methodology to calculate ongoing capital and publish the methodology (with support of the World Bank (WB))	Medium	Medium-term
Collaborate with the relevant authorities to develop a robust legal framework for trust to ensure customers' funds are legally separated from mobile network operators (MNOs)' assets	High	Medium-term
Complete the supervisory manual and operationalize data reporting template for MNOs (with support of the WB)	High	Short-term
Develop guidance for commercial banks on safeguarding MNOs customers' funds and investment mechanisms	High	Medium-term

## I. INTRODUCTION

1. **The CBS has achieved great progress in developing and strengthening banking regulation and supervision.** While financial sector supervision is strengthening and banks remain well capitalized, the quality of supervision needs to be strengthened further, including by supporting an enhanced organizational structure and governance. The LSD of the CBS has now been able to conduct supervision of banks and is set to continue to improve its capacity.

2. **To strengthen supervisory capacity and oversight, MCM has provided TA missions in Phase I focusing on the development of licensing and supervisory practices and relevant regulations.** Since 2014, the mission team has helped the LSD draft supervisory procedures, regulations and guidelines, begin streamlining and making more relevant existing procedures in the offsite and onsite manuals, and develop reporting templates where needed (Table 2).

**Table 2. Regulations and Guidelines Developed by Previous Technical Assistance**

No	Title of Regulation/Guidelines
1	Regulation on Bank Licensing, 2014
2	Regulation on Capital Adequacy, 2015
3	Regulation on Liquidity Risk Management, 2015
4	Regulation on Opening and Closing Branch Offices, 2016
5	Regulation on Audit Committee, 2016
6	Regulation on Transactions with Related Persons, 2016
7	Regulation on Internal Audit, 2016
8	Regulation on Audited Annual Financial Statements, 2016
9	Corporate governance guidelines 2018
10	Regulation on Asset Classification and Provisioning 2018
11	Guidelines on Operational Risk 2019

Source: The Central Bank of Somalia

3. **The development of the CBS’s governance framework is still work in progress and addressed by a separate workstream under the STF.** Absent a CBS-wide governance framework, the LSD documented its governance for examination, working papers and corrective actions. Included in the corrective action segment is a template for a letter to be issued regarding the corrective actions to be taken in order of priority.

4. **The LSD faces considerable challenges in building their capacity and in carrying out its responsibilities including implementation of MCM’s recommendations.** As a result of the restructuring of the LSD, its staff was re-assigned, and the number of staff actively engaged in supervision was reduced. With 13 banks soon to be operating in Somalia, there is a critical need for additional qualified staff in the LSD.

5. **This report is divided into seven sections.** After this introductory section, Section II provides an overview of the banking sector in Somalia. Section III reviews licensing practices of banks in the country. Section IV addresses on and offsite inspection. Section V discusses relevant initiatives taken by the LSD. Section VI reviews developments in Islamic Finance and Section VII summarizes the stock-taking on regulatory development of the mobile money sector in Somalia.

## II. BANKING SECTOR OVERVIEW

6. **Somalia’s financial sector has changed since the start of the technical assistance delivered by MCM in 2014.** The financial sector in Somalia was initially composed of six banks and 14 MTBs, all which were operating prior to the establishment of licensing requirements. Although all financial institutions claimed that they are operating based on Shari’ah (Islamic law), they are not explicitly recognized as such in the Somali’s legal and supervisory frameworks.

7. **The banking sector has grown considerably over the past few years, and MTBs have had to share the financial sector market with banks.** During 2015–2018, six commercial banks were operational. In mid-2018, a small commercial bank closed down voluntarily. By year-end 2019, eight banks were operational and held total deposits of \$417.3 million, and total assets of \$543.2 million. In 2019, assets grew by 31 percent compared to 2018 (from \$414.9 million). Capitalization ranged from 9.98 percent to 27 percent for the banks, not including the three banks which had just begun operations in 2019 (the average for the industry was 15 percent). Some of the established banks and all of the newly operational banks are recording losses. Nonperforming loan for the industry was 2 percent, and liquid assets to total assets was 40 percent in 2019.

## III. LICENSING CAPACITY DEVELOPMENT

### A. Main Findings

8. **Nine applications for bank licenses were reviewed during the December 2019 mission.** Ultimately, the CBS granted 13 licenses for banks to operate in calendar year

(CY)2020, and four applications were received and processed by the LSD subsequent to the established deadline. Prior to the mission, staff of the LSD reviewed and analyzed the applications, and during mission, presented their preliminary findings to the STXs. The STXs challenged the findings, and generally performed quality assurance checks. Due to insufficient information and extensive deficiencies in the licensing process, all applicants were required to submit additional documentation. Business plan was one of the significant areas where shortcomings were observed.

9. **Annual licensing of banks is conducted by the CBS at the end of each CY for operation in the succeeding year.** As the banking supervision program is still developing and the supervisory program is not robust, the CBS adopted annual licenses as a vehicle to comprehensively gather information on banks. Given the short duration of onsite examinations and questions on the integrity of data filed by banks on a periodic basis, the re-licensing exercise provides the LSD with considerable information to conduct deeper analysis.

10. **While the bank licensing regulation generally conforms to international best practices, it would benefit from an upgrade and expansion.** Changes include (i) license application fee that is nonrefundable and payable when the application is submitted; (ii) annual financial information of each significant shareholder; (iii) approval by the CBS of the Memorandum and Articles of Association (currently they are only part of the application); and (iv) prohibition against re-licensing if banks have not opened in two calendar years of the initial license being granted (one-year time out for the license).

11. **An annual license fee is required, but its collection is inconsistent.** This fee should be a separate payment for which those licensed banks are liable and payable before a license is issued. In two cases for CY2020, licenses were issued prior to the receipt of the annual license fee.

12. **During CY2019, a total of eight banks were licensed, five were operational the whole year, and three opened in the second half of CY2019.** For CY2020, a total of 13 domestically-controlled banks were granted licenses, of which 9 are operational and 4 are in formation. As of April 8, 2020, one license application filed by a foreign bank was pending and an exemption from the moratorium was granted by the CBS Board of Directors. If granted a license, the foreign bank would be subject to higher capital requirements and have limited authorized activities.

13. **A revised template to guide the review of the licensing applications was used by the LSD for the 2019 licensing exercise.** The new template provides for additional data points that were not on the original, but also omitted important items. Useful expansions include provision regarding the bank's governance, as well as oversight of AML/CFT risks. On the other hand, there is concern over the omission of information regarding related parties of the Board of Directors, senior management and significant shareholders and any information capturing foreign bank ownership. The STXs recommended that the LSD revise the template to ensure it

provides at a minimum all items required under the current licensing regulation.

14. **The quality of the submissions for licensing remains a concern, and LSD is advised not to consider incomplete applications.** The regulation clearly details the required documents and information to be included in an application, and the December 2019 mission highlighted such egregious deficiencies in the applications that they should have been rejected. Examples of missing information included management structure and names of individuals to hold the management positions; expertise, systems and policies to manage specific risks; expertise in a target market; business plan or feasibility study; and critical systems such as accounting and information technology and statements that they would be acquired after the license was granted.

15. **A more critical analysis by the LSD of the documents submitted in the application for a bank license is needed.** As the number of applications has increased, so has the volume of documents to be reviewed. The burden of a comprehensive analysis takes a heightened importance—especially regarding the business plans as the Somali banking sector is getting crowded and the economy remains fragile. The December 2019 mission noted that some of the newest applicants had included provisions in their Memorandum and Articles of Association<sup>3</sup> that were inconsistent with the CBS bank license. For example, an article limited the corporate life of a bank to 60 years, and another article addressed governance that was inconsistent with the FIL.

16. **The FIL and the Regulation on Bank Licensing permit conditions to be attached to the bank license issued by the CBS.** It can only be assumed that due to external pressure to grant licenses, the CBS has issued licenses with conditions that include the provision of documentation which is required as part of the application. The character, commitment, and capacity of applicants that are unwilling or unable to provide the required documentation while seeking a license should be questioned. Hence, the CBS should cease such a practice of granting of licenses with such conditions.

17. **Somali banks are suspected to have parallel banks in neighboring countries including Djibouti.** The LSD drafted a letter to establish a dialogue with foreign bank supervisors, but the reaching out to foreign supervisors was a ‘bridge too far’ for the CBS management. However, it is essential that the CBS establish some dialogue with the foreign supervisors

18. **Commercial banks have been established under the authority of central banks in two states (Puntland and Somaliland) in Somalia.** Some banks are operating in Somalia without a CBS-issued license, and the quality and scope of supervision over the state-licensed banks is unknown. An initial effort to establish a dialogue with these ‘state central banks’ was undertaken by the LSD while conducting onsite exams.

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<sup>3</sup> Memorandum and Articles of Association are required as part of the license application.

## B. Recommendations

### 19. It is recommended that CBS:

- Update the regulation on Bank Licensing;
- Maintain the moratorium on new bank licenses until adequate resources in LSD are available to properly oversee the banking system;
- Revisit the template used by LSD to guide the review of the licensing applications to ensure it is comprehensive and revised appropriately;
- Establish formal communication with other regulatory authorities;
- Obtain a document management system that would facilitate the capture of licensing application information;
- Ensure more consistent enforcement of the regulation on bank licensing and more critical analysis of the licenses;
- Reactivate an outreach to the foreign bank supervisors and to the management of the Puntland and Somaliland central banks;

## IV. ON AND OFFSITE INSPECTION

20. **Technical assistance to the CBS also includes developing a risk-based supervision program.** Much of the TA provided was to build the CBS's technical knowledge and skills; and flesh out the legal framework and provide methods to conduct on and offsite supervision. The structure of the supervision framework follows the Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) rating system and is used for on and offsite supervision.

### A. Main Findings

#### Offsite Supervision

21. **The CBS began collecting financial information from the banking sector as of Q1:2015, on a quarterly basis.** The initial set of data collected was limited to balance sheet, a statement of income and expenditure, and portfolio distributions of financing assets and deposit accounts. The scope of information has grown, but there are lingering questions regarding the integrity of some data due to the lack of guidance and other constraints. The LSD was working to correct errors identified during the onsite and offsite work. As part of this effort, the LSD compared the banks' audit report for years 2015–2018 to their submissions and is working with the banks to clear the differences. Post-mission, it was learned that the Governor had instructed the LSD to finalize their review and correction of data.

22. **Banks submit their financial information to the CBS in methods that range from paper submissions to emails.** Lacking sufficient IT support, banks' data was manually analyzed by the LSD staff and carried on their personal computers. In early 2019, the LSD established a drop box for the financial data, allowing the LSD access to the same data and promoting a single version of figures for the same date. Despite this initiative, the strain in the LSD's resources will grow as the number of operating banks has grown. A data management system that will gather, store, and validate the submissions as well as produce reports is needed.
23. **The Financial Reporting Instruments drafted in June 2016 would benefit from an upgrade and should be issued.** The scope of information was expanded to include capital adequacy calculation, liquidity calculations, report of related party transactions, nonperforming loans, and countries where bank balances are held abroad. The guidance indicates that the financial information is to be reported on a consolidated basis, however there is no guidance or criteria established for consolidated reporting.
24. **A template to guide the offsite analysis for each bank was developed by the LSD at the June 2018 mission.** Quarterly reviews are prepared and contain the financial analysis and the LSD's narrative. While the LSD is proficient in performing ratio analysis, their understanding of the linkages and ability to explain changes in the banks' condition are still lacking. Additional TA to strengthen the preparation of narrative and understanding of linkages between the banks' operations/risk taking and resulting financials is needed.
25. **A comprehensive quarterly summary of the banking sector, which is to be provided to the CBS executive, was prepared in June 2018.** However, the status of the report's preparation and its presentation to the CBS executive is not known. Future TA should review the quarterly summaries and determine if enhancements are needed.

### **Onsite supervision**

26. **A comprehensive set of tools is available to facilitate the conduct of onsite examinations.** There is an exam manual, standard workpapers, and a template for the report of examination. The structure of the manual and the report follows the CAMELS approach. A set of operating procedures guide the LSD's internal handling and provide quality assurance over the report of examination preparation/finalization and the development/retention of workpapers.
27. **The onsite exam manual contains a wide range of guidance.** For each area, it provides background information, legal and regulatory references, the objectives of the exam, processes and procedures to assess the management and control of the risks, as well as determine compliance with applicable laws. Inadequate time for onsite exams has resulted in the manual's disuse. Additionally, onsite assignments were made without regard to the supervisors' capacity, resulting in inconsistent and incomplete reviews. Under the guidance of the STXs, the LSD streamlined the onsite procedures for the review and assessment of capital to distill the extensive procedures to those essential to meet the exam's objectives. Between mission homework (August–December 2019) was to conduct a similar review and streamlining of the other exam

procedures. However, due to other assignments, this work was not completed.

28. **All onsite exams include an assessment of compliance with AML/CFT and the risk management in these areas.** Somalia has not had a Financial Action Task Force mutual evaluation, which would assess Somalia's level of compliance with the 40 recommendations. Although the CBS began issuing AML/CFT regulations in 2014, the Somali banking system has limited international access as banks have been de-risking especially more recently. A National Risk Assessment was begun in 1028, and the central government has committed to completing it by early 2021. Additional TA to strengthen the LSD's supervision of the AML/CFT is recommended.

29. **The first onsite exam was conducted in February 2017, and the first round of all onsite exams was completed in March 2018.** The LSD was able to identify violations of limits on capital ownership; inappropriate accounting of assets, and deficiencies in risk management, internal controls and in governance structures. Though risk-based approach is intended, the scopes of the exams have been broad but not sufficiently deep, largely due to the short duration of exams. Deeper dives are necessary for the LSD to have a better understanding of the various risks.

30. **By Q3:2019, all but one established bank had a second onsite exam.** There is evidence that the LSD's efforts have been effective. Ownership structures have changed—to comply with legal limits; stock certificates have been issued and a stock registry maintained; loss provisions have been established for problem loans; and governance structures and reporting lines—especially for the internal auditor—have improved.

31. **Closer engagement with the new banks is needed.** The December 2019 mission found that the LSD was not up-to-date on the developments in some of the new banks. These includes changes in management and advertising on the website the opening a branch in a foreign country—that would have needed previous the CBS's approval.

32. **Between missions (June–October 2018), the LSD developed guidance for the benefit of new banks.** The presentation highlighted the relationship between the banks and the LSD and was intended to be shared bilaterally with the new banks' management. As the number of new banks has grown considerably, and it was the STXs' opinion that the new banks were not sufficiently prepared to open, the December 2019 mission discussed the development of a pre-opening visit/exam to determine the readiness of the bank to open for operations. It is recommended that such pre-opening visits be conducted; and that TA be provided to complete the procedures.

33. **Consolidated supervision is needed.** As MTBs were the original financial service providers in Somalia, some MTB operators either organized banks or converted the MTBs to commercial banks. Some banks have affiliates or sister organizations or are part of a group which is not necessarily a financial group. Up until now, these affiliations presented limited concerns, however with the advent of mobile money service providers, this may present risks not

previously seen or considered. Additionally, the nonbank financial institutions, such as mobile money service providers, are required to cooperate with banks in safeguarding their customers' funds. (See Section VII) TA to guide development and/or enhancement of legal and supervisory frameworks that covers consolidated supervision across the financial sector is needed.

34. **Some banks established agent-banking relationships and were subsequently directed by the CBS to not engage in such relationships.** The LSD, under the guidance of the STXs, drafted a guideline to address the agent banking relationships at the April 2019 mission. While the CBS directive put a halt to agent banking activities, the possibility of such engagements is high, and the CBS is encouraged to finalize the guidance. It is recommended TA to support the development of appropriate supervisory review of agent-banking relationships.

35. **Standard workpapers have been developed in support of various exam procedures.** The workpapers include items such as the reconciliation of capital accounts; summaries of financing assets and associated loss reserves; and schedules that support details included in the report of examination. Over the course of TA missions, the workpapers have been revised to reflect changing needs, arising from regulatory changes, new activities undertaken by the banks, or awareness of risks. It is recommended that the workpapers be expanded and/or revised in conjunction with changes to the regulatory and supervisory frameworks.

36. **An LSD-internal operating procedure to address workpapers generated during onsite exams was developed in October 2018.** At that mission, it was agreed that the LSD should pilot the procedures and make appropriate changes. It is recommended that future TA reviews the LSD's practices vis-à-vis the operating procedure and make necessary revisions.

37. **The LSD uses a standard template for the report of examination.** The report is an exception report; all areas of the CAMELS, violations of law and AML/CFT are addressed. Risk assessments, governance, noncompliance with prudential requirements, bank financial information and various schedules detailing significant activities, and other relevant items are presented. Follow up on previously cited problems is also included. The report of examination may need to be revised to reflect changes in the regulatory and supervisory frameworks.

38. **An internal operating procedure was developed to promote the issuance of timely, consistent and high-quality reports of examination.** At the October 2018 mission, it was agreed that the LSD would pilot the procedures and make appropriate changes. It is recommended that future TA reviews the LSD's practices vis-à-vis the operating procedure and make necessary revisions.

### **Corrective Action**

39. **A Manual of Supervisory Intervention was provided to the LSD as of March 2017.** The manual is comprehensive with relevant legal references, the criteria, time frames, and a range of supervisory responses and specific actions. Although the LSD has had the manual for

about three years, the STXs are doubtful that the manual has been referenced. It has been recommended that in the future TA addressing dealing with problem banks; it may be useful to use the manual as the basis for training and a regulation on sanctions.

## **B. Recommendations**

### **40. It is recommended that CBS:**

- Develop an accounting standard that is consistent with Islamic banking and prepare criteria and guidance for consolidating financial information;
- Develop and issue instructions to banks on compilation of prudential returns;
- Provide guidance regarding the determination of financial data integrity and the dates from which data will be considered ‘clean’;
- Strengthen the financial analysis and narrative on banks’ financial data (both per bank and industry summary);
- Establish and resource a comprehensive information technology and communication framework that would provide a records management system; a system to gather, store, validate, analyze and provide reports thereon; and provide adequate hardware and software to the LSD;
- Complete streamlining of onsite examination procedures;
- Strengthen AML/CFT onsite and offsite procedures;
- Establish a closer engagement with new banks and develop procedures to conduct pre-opening visitation procedures;
- Develop consolidated supervision framework—work with LSD staff to identify groups, risks arising from group relationships and to conduct assessments of risk;
- Issue the guidance on agent banking;
- Review the template of the report of examination and workpapers prepared by LSD, identify any needed changes to the templates and the procedures to develop and maintain the workpapers; and

- Review with the LSD the Manual of Supervisory Intervention to determine if it needs upgrading and make the necessary changes.

## V. OTHER INITIATIVES UNDERTAKEN BY LSD

### A. Main Findings

41. **Since the December 2019 mission, the LSD staff started to undertake a self-assessment of the BCP.** This was done in part, to identify priorities for future TA. The STXs presented the BCBS methodology to conduct the self-assessment and provided the LSD with an Excel template to document their review, to be discussed in March 2020. In addition to providing findings, the template provides for documentation of weakness, recommended action, a priority rating and timeframes to address the priority. The template also provides for follow up on recommendations to track the LSD's implementation of reforms.

42. **The LSD is committed to gradually developing its internal approach in the policy-making process based on best practices.** At present, the consultation process is underdeveloped. It is carried out on an intermittent basis and then only with the banks. At the request of the LSD, the April 2020 mission discussed a guideline on the policy-development process for the LSD's consideration and is to be subsequently formalized by the CBS's board.

43. **The operational risk guideline was discussed during the March 2019 mission and updated in the December 2019 mission.** Subsequent review and revision pushed the start date of reporting to May 2020.

44. **Through the onsite examinations, the LSD recognized the need to revise a number of TA products that have been in use.** It was agreed that there is a need for a revision on the reporting template and guidance to be issued to reflect the unsophisticated banking activities in Somalia, including the definition of high-quality liquid assets, cash inflows and outflows, while bearing in mind best international practices. The revisions were to be drafted by the LSD with input from the STXs but is yet to be finalized. These changes will in turn be reflected in the Regulation on Liquidity Risk Management 2015<sup>4</sup> where liquidity coverage ratio is introduced, together with the reporting requirements.

45. **From mid-2017, there was an expressed need to engage with the external auditors, as there was a high level of noncompliance regarding the external audits.** During the course of a few missions, the LSD had prepared letters of invitation, presentations, talking points and a template to document meetings with the external auditors. Several meetings had been postponed mainly due to security issues while the LSD held tri-lateral meetings with the banks and the external auditors. Improvement in the submission of late audit reports was noted, and it is expected that the banks would engage with LSD on seeking approval before external auditors'

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<sup>4</sup> [https://centralbank.gov.so/wp-content/uploads/2020/02/Liquidity-Risk-Mgt-Regulation-CBS\\_REG\\_03.pdf](https://centralbank.gov.so/wp-content/uploads/2020/02/Liquidity-Risk-Mgt-Regulation-CBS_REG_03.pdf).

appointments are made, as per the FIL / best international practices.

46. **While the LSD met with bank representatives in October 2015 and October 2016, it was unsuccessful in holding several planned meetings since then.** The LSD consulted with the industry via letters and surveys via email. Input from the industry was obtained on new regulations and guidance.

47. **From 2017–2019, there have been a few changes in the LSD staff, and the new staff have attended the missions.** Recognizing that a considerable amount of reference material has been provided and generated, the LSD developed a program to promote its usefulness. An inventory of training resources (manuals, PowerPoint presentations, quizzes, and case studies) was made and a drop-box accessible to all staff was established.

48. **Recognizing the importance that staff have credibility based on their professionalism and integrity, at one mission, the team drafted a code of conduct for the LSD.** In the preparation stage, the STXs reviewed codes of conduct of other supervisory agencies and central banks. Candid discussions regarding pressure brought to bear on supervisors, questionable and unacceptable behavior, along with raising awareness of professional integrity, were held. The LSD prepared a comprehensive document and presented it to the senior management of the CBS. The view was that the CBS needed a code of conduct for the staff of the institution as a whole, and until that time, the LSD could not issue the code internally.

## **B. Recommendations**

49. **It is recommended that CBS:**

- Prioritize implementing measures to bridge the identified gaps in the BCP self-assessment;
- Formalize the internal approach of the policy making process;
- Finalize the issuance of operational risk guidelines;
- Revise the existing TA products (workpaper, template) to reflect the development of the industry;
- Reinforce the procedure for appointment of external auditors by commercial banks, which requires the approval of CBS;
- Formalize the CBS' code of conduct.

## **VI. ISLAMIC FINANCE**

50. **The structure of the banks' balance sheets reflects a limited diversification of**

**banking services.** As at end-March 2020, customers' deposits, predominantly in the form of current accounts (based on Qarḍ) and Muḍārabah investment accounts, constituted 80 percent of funding sources. Deposits and placements are primarily with foreign banks and other financial institutions. Customer assets are essentially short-term financing, followed by cash on hand and investments in property and joint ventures. While Murābahah contracts, including commodity Murābahah, are predominantly used in the financing transactions, other contracts such as Istiṣnā', Muḍārabah, and Mushārah are slowly being used by the banks.

## A. Main Findings

### Legal Framework

51. **Current laws in Somalia do not include any specific requirements for Islamic financial services activities.** The Central Bank of Somalia Act 2012 (CBS Act) and FIL do not provide any institutional framework and arrangements related to Sharī'ah governance framework. FIL mandates the CBS to oversee domestic financial institutions, have exclusively responsibility for licensing, regulation and supervision of the business entities taking deposits from the public (mainly banks and MTB), as well as taking administrative measures and applying sanctions. The WB is providing TA on the enhancement of the CBS Act and FIL and the mission commented on the proposed revised draft. In the case of insurance/takaful, despite lacking the legal framework, all insurance companies/takaful operators are required to register with the CBS.

### Prudential Framework

52. **Several elements of an appropriate licensing process require adjustments to accommodate the nature of banks offering Islamic banking services.** At present, there are no specific licensing requirements applicable to Sharī'ah compliant products and services, a corporate and Sharī'ah governance structure, and internal controls tailored to banks. There is a need to develop and implement fit and proper requirements to Sharī'ah board members, Sharī'ah firm or Sharī'ah advisor within banks.

53. **There are no regulatory frameworks on Sharī'ah governance.** At present, there is no legal basis supporting the regulations on Sharī'ah compliance in Somalia. The currently applied Sharī'ah governance is based on a self-regulated approach and with no guidance from the CBS. In other words, the notion of having the Sharī'ah governance system within institutions that offer Islamic banking services is rather a voluntary initiative to foster credibility in offering Islamic products. Banks have been adopting two types of Sharī'ah institutional arrangements in Somalia: permanent Sharī'ah board/committee and Sharī'ah advisor, with some banks only engaging a part-time Sharī'ah advisor for fatāwā (rulings). The mission prepared a draft survey questionnaire as part of the preparation to develop Sharī'ah governance framework, which is scheduled to be issued this year.

54. **The absence of appropriate internal control requirements specifically on ex-post internal Sharī‘ah reviews could potentially lead to noncompliance in banks’ operations.** At this stage, noncompliance risk may be minimal since banks in Somalia predominantly use Murābahah or Commodity Murābahah contracts on the asset side and Qarḍ contract to source the funds. However, the mission learned that other contracts such as Istiṣnā‘, Mushārakah are increasingly being used by banks. As the Islamic banking industry gets more competitive with product differentiations, potential reputational risk will emerge as banks may fail to comply with certain aspects of the Sharī‘ah requirements.

If investment account holders (IAH) were to face losses or forego profits, banks’ management could confront charges of misconduct and negligence.

55. **Current prudential reporting includes information on the types of Sharī‘ah contracts, but the CBS staff’s understanding of inherent risks and financial stability implications is limited.** The banks are exposed to specific risks not faced by conventional banks due to the various constraints enforced by Sharī‘ah. The complexities of profit and loss sharing contracts (Muḍārabah and Mushārakah) and their associated risks should be taken into account for banks to establish more effective risk management. Moral hazard issues may occur as a result of the relationship between the banks and the IAH. Withdrawal risk may persuade banks to deviate from traditional Sharī‘ah principles. This occurs if banks pay competitive market returns to the IAH regardless of the banks’ actual performance.

56. **Clarity on CBS’s usage of accounting standards for Islamic banking activities is critical in ensuring consistency and comparability of banks’ statements.** A review of banks’ audited financial statements showed one bank used Accounting and Auditing Organization for Islamic Financial Institutions standards, while others followed International Financial Reporting Standards. There is no specific requirement for reporting Sharī‘ah compliant products and services. It is important to develop and enforce a set of financial reporting templates that facilitates compliance with the law, official accounting standards and Sharī‘ah requirements. In turn, disclosures should facilitate the assessment of the banks’ financial position, risk exposures, and performance. Failure to disclose certain aspects of financing and investment activities and associated risk analyses could expose the banks to fiduciary risk vis-à-vis their IAH on the use of their funds, smoothing of the profits, and any potential tainted income in the future. A set of additional information related to Islamic banking activities is being developed, of which the revision of the financial reporting will be issued at the end of 2020.

### **Supervisory Structure and Process**

57. **CBS does not have adequate capacity to undertake risk assessments of Islamic banking activities.** Supervisors appear to have not conducted Sharī‘ah reviews. In addition, CBS onsite supervisors and banks did not discuss Sharī‘ah noncompliance issues. A key first step would be to enhance existing templates on banks’ balance sheet information for banks by utilizing templates as set out by the Islamic Financial Services Board. The information should

also be supplemented with information on income and losses from Islamic banking activities, the description of IAH and risk breakdowns by Islamic contract type, credit risk distribution for Islamic financing, and some key financial stability indicators.

58. **The CBS has adopted a bank risk rating system, but additional criteria pertaining to Islamic banking-related components needs to be developed.** Owing to the nature of Islamic banks that compliance with Sharī‘ah is mandatory, a critical examination of the resources available to Islamic banks for Sharī‘ah compliances and structured procedures need to be in place. Islamic banks do not have the same level of commitment to Sharī‘ah. In this respect, it is logical that Islamic banks will not have the same level of responses to the dynamic Sharī‘ah compliance process, so their level of compliance will also differ. Islamic banks that are not complying with Sharī‘ah will be exposed to the risk of their income cannot be considered as bank’s income, which has to be donated to charity.

59. **Onsite inspection proceedings are currently compliance-oriented but are transitioning towards risk-based.** An onsite inspection procedures manual exists, and some risks associated with specificities to Islamic banking products and services are highlighted. Additional risks related to Sharī‘ah noncompliance, rate of return risks, and treatment of the IAHs are yet to be included.

#### A. Recommendations

60. **It is recommended that CBS upgrades the legal, regulatory and supervisory framework to contain specificities of Islamic banking activities, including:**

- Revising the FIL related to Islamic banking activities and Sharī‘ah governance;
- Enhancing the licensing framework to include fit and proper criteria for Sharī‘ah board members at Islamic bank;
- Developing regulations and guidelines on Sharī‘ah governance framework and internal control requirements;
- Enhancing financial reporting and clarify on accounting standards to include information specific to Islamic banking activities;
- Upgrading the current risk rating system to include criteria related to Islamic banks; and
- Enhance the capacity to undertake risk assessments of Islamic banking activities.

## VII. MOBILE MONEY

### A. Main Findings

61. **The TA mission in April 2020 took stock of regulatory developments on mobile**

**money services, which are widely accepted in Somalia.** A large portion of the population is unbanked, and mobile money has a quite high penetration rate of 73 percent for a variety of purposes from daily payment transactions to saving money.<sup>5</sup> The stock-taking exercise undertaken by the mission summarizes progress in mobile money regulation and supervision to provide some insights for the CBS's plan of further development in financial regulation and supervision.

62. **Mobile money has been one of the key areas of the regulatory development in the CBS's recent strategic plans to help support financial stability.** Since September 2019, the IMF has provided the fourth Staff-Monitored Program (SMP IV) to support Somalia authorities and set some Structural Benchmarks on regulatory development for mobile money service. Based on the agreed division of labor between the WB and the IMF, the WB has actively provided practical support to the CBS on regulation and supervision of nonbanking sectors, including mobile money, under the Somalia Capacity Advancement, Livelihoods and Entrepreneurship, through Digital Uplift Project—SCALED-UP.<sup>6</sup>

63. **There are six operating mobile money service providers recognized by the CBS in Somalia.** In the regulatory framework of Somalia, mobile money regulation defines mobile money as a monetary value which is stored on any electronic device and it does not explicitly limit electronic devices to mobile phones. However, the regulation intends to regulate only MNOs by requiring MNOs to obtain a valid license issued by the NCA before being licensed as a mobile money service provider.

64. **The regulatory framework for mobile money service provider needs to be developed in better coordination with regulations on the other types of financial institutions to ensure consistency and precise cross-reference.** The definition of mobile money in the mobile money regulation is not consistent with that in the regulations for MTB. While the mobile money regulation broadly defines mobile money as a monetary value stored on any electronic device which is not limited to mobile phones, the regulations related to MTB define mobile money in a narrow way as one type of e-money products where the record of funds is stored only on a mobile phone or a related central computer system and can be drawn down through specific payment instructions issued from the bearers' mobile phone.

65. **This difference in the definitions while using the same term "mobile money" may create regulatory inconsistencies.** For example, in some cases, under different regulatory requirements for MNOs and MTBs, money transfer transactions performed by MNOs are unintendedly considered equal to the same activities delivered by MTBs. Considering that requirements under the MTB regulations are looser than those under the mobile money regulation, this discrepancy may enable regulatory arbitrage where a telecom company gets registered or licensed as MTB with fewer requirements in order to provide the same money

<sup>5</sup> Mobile Money Ecosystem in Somalia, 2017 (<https://www.alticonsulting.com/insights/mobile-money-ecosystem-somalia/>).

<sup>6</sup> <https://projects.worldbank.org/en/projects-operations/project-detail/P168115>.

transfer activities using the “narrow” mobile money definition.

66. **While the mobile money regulation stipulates that a mobile money service provider “may issue mobile money”, it is unclear if mobile money issuance is an integral nature of mobile money service providers.** The mobile money regulation can also be read as if a company can be regulated as a mobile money service provider as long as it performs some stipulated activities (e.g., money transfer) while it does not issue mobile money. To clarify the regulatory coverage of each regulation, both regulations need to be adjusted. In addition, the mobile money regulation should be revised to be more risk-based with some different levels of requirements based on the activities each MNO performs.

67. **Coordination with nonfinancial authority should be ensured.** Despite the requirement for MNOs to be licensed by the NCA before operating as a mobile money service provider, no mobile money service providers have been licensed by the NCA because of the lack of capacity of the newly established organization. As these MNOs are in operation already and licensing processes have started, the CBS should start communicating with the NCA to ensure that all MNOs are well regulated in the other functions they perform.

68. **The regulation and supervision for mobile money service providers is still at a nascent stage.** Although the CBS issued the new regulation on mobile money in 2019 with technical support by the WB, the regulation has not been completely implemented and no mobile money service provider is sufficiently covered by regulation and supervision. This is due to the lack of capacity of the CBS and difficulties to promptly secure full regulatory compliance by all the mobile money service providers. In addition, a phased-in implementation of the regulations was agreed in order to prioritize key elements to protect customers’ funds. The CBS has made efforts to encourage MNOs to steadily comply with the regulation. Currently, only two mobile money service providers have made applications for a license and the CBS is now processing these. The CBS also provided a comprehensive training on regulatory requirements and case studies for the MNOs, but it is not clear when the other mobile money service providers will apply to be licensed, especially under the COVID-19 pandemic.

69. **The current mobile money regulation in Somalia covers main regulatory factors that are common in the other jurisdictions.** Mobile money service providers in Somalia are required to have initial capital of \$2 million at the time of license application and all the time meet ongoing capital that is separately specified by official bulletin accordingly issued by the CBS. The CBS plans to develop a risk-based methodology to calculate ongoing capital approach.

70. **There are some measures in the regulations that intend to ensure that mobile money service providers safeguard customers’ funds against their failure.** The regulation requires mobile money service providers to take adequate measures to protect customers’ fund from loss, including separating consumers’ funds from MNO’s funds. The regulation requires MNOs to keep at least the amount of issued mobile money in a commercial bank account, and if the amount grows beyond a threshold, the funds need be kept in at least two commercial bank

accounts for diversification. This requirement to use commercial bank accounts is to ensure one-on-one relationship to maintain liquidity to meet obligations to all their customers.

71. **Due to the lack of trust law in Somalia, in case of failure of a mobile money service provider, it is unclear if customers' funds kept at commercial bank accounts are legally separated from assets of the failed MNOs.** The CBS should consider enhancing the safeguarding requirements including explicitly requiring mobile money service providers to keep consumers' funds in a trust account to legally segregate customers' funds as beneficiaries' assets.

72. **In addition to operationalizing the mobile money regulation, the CBS has some additional tasks to develop a better supervisory framework.** With technical support from the WB, the LSD has completed the first draft of a supervisory manual for mobile money service providers which will soon be finalized. The mobile money regulation also requires mobile money service providers to submit monthly reporting of specific data on mobile money. The CBS developed the data template with the WB experts' advice, but the required data has not been submitted by MNOs. The CBS has made efforts in capacity development for mobile money regulation with WB's guidance, which includes securing three employees responsible for mobile money regulations and supervisions by internal staff relocation in the CBS, and planning staff training by other country authorities (Turkey and Malawi) to acquire practical supervision on mobile money.

73. **Due to the small supervisory capacity of the LSD, the CBS and the WB plan to reinforce supervision on MNOs through supervision of commercial banks which safeguard MNO's customers' funds.** However, the current regulatory scheme is not clear on the division of responsibility in management of customers' funds between commercial banks and MNOs. The LSD needs to develop guidelines for banks on their risk management and investment mechanism to ensure the safeguards work.

## **B. Recommendations**

74. **Based on the main findings discussed above, it is recommended that the CBS should:**

- Review the relevant regulations including that for MTB to ensure consistency over regulated activities and their requirements;
- Communicate with other relevant authorities including the NCA to ensure mobile money service providers are sufficiently regulated;
- Continue to encourage all mobile money service providers to submit their transitional implementation plans and implement the regulation as agreed;
- Develop the risk-based methodology to calculate ongoing capital and publish the methodology (with support of the WB);

- Collaborate with the relevant authorities to develop a robust legal framework for trust to ensure customers' funds are legally separated from MNOs' assets;
- Complete the supervisory manual and operationalize data reporting template for MNOs (with support of the WB); and
- Develop guidance for commercial banks on safeguarding MNOs customers' funds and investment mechanisms.