

Can Islamic Banks Flourish in Somalia after 25 Years of the Collapse of the Country's Entire Financial System?

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Abstract

The purpose of this study was to establish if Islamic banking can flourish in Somalia and role it can play to tackle financial exclusion in the country. Similarly, determining the best way of enhancing the chances of Islamic banks succeeding in Somalia and identifying the most suitable marketing tools for achieving these objectives were investigated. Our findings reveal that the introduction of Islamic banking is long overdue in Somalia given the country's strong Islamic identity and the fact the only functioning institutions currently operating in the country are Hawala companies which only provide money remittance services. The results also reveal that the business community is in dire need for a well-functioning banking sector. However, majority of respondents were of the view there are severe institutional shortcomings including the absence of the rule of law that could severely impede the process unless properly addressed. Furthermore, results showed that Joint venture with International banks is the best banking model in this country due to lack of local expertise. Finally, the results revealed that online marketing tools and mobile systems can play a greater role in marketing Islamic banking products and services in Somalia.

Keywords: Central Bank of Somalia, Hawala, Islamic banks in Somalia, Sharia compliant finance

1.0 Introduction

Research confirmed that a financial system, especially a properly functioning banking system which provides credit to investors, plays an important role in financing economic development as empirical studies found statistically significant correlation between financial systems development and economic growth" (Beck, 2011).

One of the most important functions of financial intermediaries like banks is to transfer surplus money from savers and depositors (mobilization) and allocate it to producers and creators (Bashir & Kabir, 2003). Unfortunately, this may not be the case for most Muslims as majority of Muslims may not take part in conventional finance due to fear of violating the principles of their faith (Warsame, 2009). Theoretically, this would mean some form of banking compliant with their faith should be provided to these people to convince them to take part in the process which directs our attention to discuss the role Islamic banking can play in financial development.

1.1 Statement of the problem and research objectives.

Despite being one of the best enterprising nations in the world, Somalia is one of the poorest countries in the world and the population is heavily dependent on foreign aid. Violence and political unrest have prevented Somalia from developing a coherent and coordinated domestic marketplace (African Fixed Income Guidebook, 2006). The country has neither central monetary authority nor commercial banks, though the central banks in Bosasso and Hargeisa offer limited commercial banking services creating an undesirable conflict of interest with their role as treasurers of their respective regional governments

As Somalia strives to rebuild its shattered economy, a viable commercial banking sector will be indispensable. This paper seeks to establish the prospects of introducing a Sharia compliant financial system in Somalia as well as the biggest challenges that may hinder such efforts.

The main research objective of this study is to assess if Islamic banks can succeed in Somalia

and the biggest challenges that could derail such initiative. Hence, the specific research objectives of this paper are:

1. To establish if Islamic banks can flourish in Somalia and role they can play to tackle financial exclusion in the country.
2. To determine the best model of establishing a proper functioning Islamic banks in Somalia
3. To identify the most suitable marketing tools for Islamic banking products and services in Somalia

2.0 Literature review

Apparently, Somalia's banking system has been heavily impacted by the political chaos that has engulfed the country's recent history. Consequently, there are no proper functioning banks in Somalia, although certain money remittance companies claim to be banks and provide some basic financial services.

In 1970 all foreign commercial banks were nationalized and in 1971, two public commercial banks were established, namely, Somali Savings and Credit Bank and Somali Commercial Bank. The two banks were autonomous institutions with legal personalities and had capital of So.Shs. 2,500,000 each of which 50% was paid by the Somali Government and 50% was paid by the Central Bank of Somalia (Muradesh et al., 2001). According to the African Fixed Income Guidebook (2006), these two newly established institutions were fully owned by the Government with same objectives and activities as commercial banks and their operation were based on deposits and savings and short term loans. However, Somalia's financial system fell into deep crisis due to the complacency of corrupt officials which led most of the daily operations of the banking system

2.1 The role that banks can play in Economic development

While still far from being conclusive, the bulk of the empirical literature on finance and development suggests that well-developed financial systems play an independent and causal role in promoting long run economic growth. More recent evidence also points to the role of the sector in facilitating disproportionately rapid growth in the incomes of the poor, suggesting that financial development helps the poor catch up with the rest of the economy as it grows. These research findings have been instrumental in persuading developing countries to sharpen their policy focus on the financial sector. The finding that better developed banks and markets are associated with faster growth is also confirmed by panel and time-series estimation techniques (Beck et al., 2000). This research also indicates that financial sector development helps economic growth through more efficient resource allocation and productivity growth rather than through the scale of investment or savings mobilization (Beck et al., 2000). Similarly, cross-country time-series studies also show that financial liberalization boosts economic growth by improving allocation of resources and the investment rate (Bekaert et al., 2001).

Institutional shortcomings, including absence of the rule of law severely impede any meaningful and sustained economic activity. However, there is a general consensus among development economists that both transparent legal systems and well-functioning financial systems are indispensable ingredients for economic growth (Levine, 1998).

Currently, financial services are provided in Somalia through many informal institutions that existed under the collapsed national government. As the formal economic institutions and financial systems remained exceedingly fragile since the 1980s, their subsequent collapse in Somalia meant little for most of the population. Loans were traditionally secured through family members without the involvement of banks. Also, in the absence of a formal banking sector, the only way of transferring funds into Somalia is via remittance companies that use a system known as Hawala which relies entirely on trust and therefore circumvents formal transfer systems (African Fixed Income Guidebook,

2006).

2.2 Conventional versus Islamic banking in Somalia

Conventional commercial banks prefer to lend to low-risk activities and are reluctant to finance high risk projects, even if such projects present better investment opportunities and they are less willing to finance small firms that don't have adequate collateral.

In contrast, fostering serious economic development is an inherent key objective of Islamic banks as they seek to maximize social benefit. Islamic banks should therefore work hard to overcome shortages and difficulties to help the economy to progress to a higher stage of self-sustained development, resulting in a favourable effect on socio economic harmony due to equal income distribution. From above analysis, it is obvious that Islamic banking system is more suitable to the financial services needs of Somalia due to its dire need for a financial system with strong inclination to social justice and financial inclusion. In the coming section, we will briefly look at the underpinning principles of Islamic finance with the objective of evaluating its suitability to Somalia's financial services' needs.

Both conceptually and theoretically Islamic finance is rich in certain desirable socio-economic goals such as social justice, equity, the alleviation of poverty and human well-being (Chapra, 1985). The modern conventional banking system in Islamic countries is a product of colonizers using the support of financial institutions for mining, agriculture and manufacturing (Beck & Levine, 2003). The initial banks were predominantly used for the funds of foreigners and as a means to increase foreign-owned industries that spread through imperial rule.

We will now be looking at the available options for Somalia in this respect with the objective of evaluating the various possible models of establishing a practical, sustainable and feasible banking system in Somalia. However, it is worth noting in this context that Somalia had no central monetary authority for over fifteen years between the outbreak of the civil war in 1991 and the subsequent re-establishment of the central bank of Somalia in 2009. Paradoxically, the nation's payment system is fairly advanced primarily due to the wide spread existence of private money transfer operators that have acted as informal banking networks. Hence, one of the quickest and the most practical ways of establishing a functioning banking system in Somalia is the conversion of the existing Hawala companies into Islamic banks as we will discuss in the following section.

2.3 Upgrading the existing Hawala companies into Islamic banks

According to the KPMG report, there is no reason why the existing Somali remittance companies cannot expand to provide commercial banking services in Somalia, or anywhere else. Despite the lack of formal regulatory mechanisms in Somalia, all these companies exercise self-regulation of some kind. At a conference held in Dubai in June 2003, the remittance companies committed themselves to move towards licensing and to formalise their operations, preparing the ground for the expansion of financial services.

As the Central Bank of Somalia assumes its monetary policy responsibilities, some of the remittance companies (Hawala) are expected to apply for licenses so as to graduate into full-fledged commercial banks in the near future and thereby broaden the scope of payments system in the country to include cheques which will reinforce effectiveness of use of monetary policy in the macroeconomic management. Apparently, Hawala companies already possess much of the necessary infrastructure of providing financial services and would therefore be prepared to emerge as Somalia's new banking services providers. However, they would need to invest in human capital and establish proper banking systems, but there is no doubt that they stand a very good chance of exploiting this great opportunity of being the newly established Islamic banks for the entire nation. Upon the completion of the

empirical study, we will be in a position to understand the likelihood of this phenomenon.

2.4 International banks setting up Sharia compliant banks in Somalia

Although interrupted by the recent financial crisis, the past two decades have seen an unprecedented degree of globalization especially in financial services. Not only have cross-border bank (and other capital) flows increased dramatically, but also many banks from both advanced and developing countries, have ventured abroad and established presence in other countries. Although there are exceptions and regional differences, few countries have been left out from this trend of increasing financial integration.

Empirical research also found that both financial institutions and markets can improve management practices of firms and reduce agency problems within firms as well as between the management and firm's shareholders (Aghion et al., 1999).

Before the recent crisis, the general consensus among financial experts was that the benefits of foreign banks greatly outweigh costs in many dimensions. Particularly, it was generally considered that foreign banks add to domestic competition, increase access to financial services, enhance financial and economic performance of their borrowers and bring greater financial stability (Clarke et al., 2005; Claessens et al., 2008).

The crisis also highlighted that, while foreign banks play important roles in the global financial system and affect domestic financial systems, access to financial services, and consequent economic performance, many aspects are not yet well understood, in part due to lack of data. We have noted from the above literature that exporting financial services has considerable economic benefits for the host and the foreign investor, but also carries certain commercial and organisational costs which forces international banks to carry out a comprehensive and detailed analysis before embarking on such initiatives. However, Somalia is somehow unique in this respect as it has great potential for international banks as a financially unexploited and virgin territory with huge natural resources, but posts huge risks due to the poor financial infrastructure and the political instability that is not yet resolved.

2.5 Newly established local banks emerging in Somalia

Another suggestion by commentators on Somalia's future financial systems is the creation of locally owned private Islamic banks in Somalia. These banks would be financed by local Somali business men and managed by hired professionals mainly from Somali Diaspora. The proponents of this model argue that this is the best way of reviving the country's dead financial system and injecting life in to the currently idle funds to boost the economy which would lead to political stability. However, the most difficult task facing the supporters of this initiative is the scarce availability of expertise to manage these financial institutions in the country as well as the absence of strong financial regulation and political stability. Another important point that is worth noting is the unprecedented growth of mobile banking in the country driven by the highly developed telecommunication networks as Somalia is leading in technology since a large number of adult Somalis use mobile money .

The big question here is if local businessmen are willing to invest in establishing physical banks while it is easy to get basic services via the mobile! However, all the options discussed will be clearer when the findings of the empirical study become available and we will hopefully be in a better position to compare and contrast all these options.

3. Research Methodology

A purposive sampling was conducted on Somalis who met the research selection criterion such as financially literacy, current political awareness, business connection, strong Somali roots and were

resident in the United Kingdom or United Arab Emirates. Covariance based structural equation modelling was performed using Amos (IBM Corp, 2013). The sample size for the study was ($N=205$). In total we had 11 questions in our study. We performed the composite scores to come up with four observed variables that we used in the Confirmatory factor analysis (CFA) model. Univariate analysis of variance was performed on the significant categorical variables to determine their specific odds ratios in relation to revival of the banking sector in Somalia.

3.1 Composite scores

The composite scores for our Likert scale were; strongly disagree = (0-0.9), disagree = (1.0-1.9), neutral = (2.0-2.9), agree = (3.0-3.9), and strongly agree = (4.0-5.0). The descriptive statistics for the observed variables were; adoption of Islamic banking ($M=1.92$; $SD=0.51$), revival of the banking sector ($M=4.19$; $SD=0.49$), financial and economic development ($M=1.80$; $SD=0.69$), and suitable banking and financial systems ($M=4.21$; $SD=0.47$).

3.2 Confirmatory factor analysis (CFA)

Confirmatory factor analysis (CFA) was conducted using suitable banking systems for Somalia as the dependent latent variable. The independent variables, observed variables or indicators were literacy, education level, and age, mode of trading, business, gender, and adoption of Islamic banking, financial and economic development, and the revival of banking sector.

Suitable banking system was used as endogenous dependent latent variables. The Maximum Likelihood Estimations method was used to obtain the standardized estimations. CFA model fit metric was checked by dividing the chi square value with the degrees of freedom. Bentler, (1989) suggests that the fit metric should not exceed five for models with good fit and the value of 0.75 for this index displayed acceptable threshold ($\chi^2 = 10.50$; $df=14$); $p = 0.725$ of model fit. Thus the fit metric of our model was fit.

The Goodness of Fit Index ($GFI = .990$), Adjusted Goodness of Fit Index ($AGFI = .961$), Comparative Fit Index ($CFI=1.00$), Incremental Fit Index ($IFI=1.01$), and the Tucker Lewis Index ($TLI=1.02$), Normed Fit Index ($NFI = .985$), Relative Fit Index ($RFI=.952$) were all above their recommended levels of above 0.90 (Wheaton et al., 1977; Bentler & Bonett, 1980). The Root Mean Standard Error Approximation ($RMSEA=0.00$; $PCLOSE=.947$.) was well below the recommended limit of 0.05. Hence, the model showed an overall acceptable fit that we had an over identified model. Thus under the hypothesis of close fit, the $RMSEA$ wasn't greater than .05 in the population, and thus the probability of getting a sample $RMSEA$ as large as 0.00 was .947. The overall R squared value for the standardized estimate of the final model was 0.58 which was good, and thus the model was able to account for 58 percent of the variance in the measured items. The measurement model on suitable banking systems in Somalia and their standardized factor loadings of indicators are displayed in Figures 1.

Revival of the banking sector ($\lambda=0.77$) had maximum effect on suitable banking systems for Somalia. The values of the other indicators in the study can be seen on Table 1. The negative factor loading indicated low effect on suitable banking systems in Somalia, while positive loadings on indicators displayed higher effect on suitable banking systems in Somalia.

Therefore the choice on suitable banking systems in Somalia was increased more by revival than the other observed variables in the construct. The standardized coefficients revealed a stronger positive relationship between revival of the banking sector and suitable banking systems in Somalia.

The P values indicated whether the relations were statistically significant or not, and were interpreted as per their signage and β coefficients. Based on standardized estimates on Table 1, shows there were significant relation ($\lambda= .37$; $p = .005$) between education level and revival of the banking

sector in Somalia, ($\lambda = -.17$; $p = .024$) between the mode of trading and revival of the banking sector in Somalia, ($\lambda = .77$; $p < .001$) between revival of the banking sector in Somalia and suitable banking systems in Somalia. Therefore, the education level of Somalis significantly increased the perception on the revival of the banking sector in Somalia 1.43 times. Also the perception on the revival of the banking sector increased the perception on the choices on suitable banking systems in Somalia 2.17 times.

3.3 Univariate Analysis of Variance

The CFA were performed, only revealed significant relationships between education level and revival of the banking sector in Somalia, the mode of trading operation and revival of the banking sector in Somalia. However, the results could not specify the specific categories in education levels, and the mode of trading that were significant. Thus univariate analysis of variance on education and mode of trading were performed to determine their specific odds ratios in relation to revival of the banking sector in Somalia. The results were significant for respondents with a high school level of education, and the respondents involved in local business(es). In both scenarios, the t statistics were greater than 1.96, meaning that the p values obtained were real and not out of chance. The odds ratios for strongly agreeing on the necessity of the revival of the banking sector in Somalia was 1.19 times less for the respondents with a high school level of education compared with the respondents with a Graduate degree (Master's or PhD). See Table 2. The odds ratio for strongly agreeing on the necessity of the revival of the banking sector in Somalia was 1.22 times higher for the respondents involved in local business (es) compared with the respondents involved in International business (es). See Table 3.

Overall, with regards to the education level, the respondents with a graduate degree (masters or PhD) had the highest response on strongly agreeing on the perception on the revival of the banking sector in Somalia ($n = 74$; 36.1 percent), while respondents with a diploma/high diploma had the least response ($n = 11$; 5.4 percent). The respondents dealing with international businesses had the highest response score on agreeing with the perception on the revival of the banking sector in Somalia ($n = 81$; 39.5 percent), while respondents involved in local businesses had the least response ($n = 58$; 28.1 percent). See Table 4 for more results. Majority of local businesses were involved in whole or retail merchandising ($n = 26$; 44.8 percent). Education and health services had the highest percent ($n = 33$; 50 percent) in regional business, while financial services/ Hawala had the highest percent on International business ($n = 40$; 49.4 percent). The respondents with a college degree/bachelor level of education had the highest percent involvement in both local and regional businesses. However, those with a graduate degree (Masters or PhD) were mostly involved international businesses

3.4 Discussion of the research findings

The first objective of this study was to establish if Islamic banking can flourish in Somalia and role it can play to tackle financial exclusion in the country. All relevant variables were tested as mentioned earlier and the results revealed that establishing Islamic banks in Somalia is crucial as Hawala companies (money transfer) are the only financial institutions operating in the country and they cannot cater for the financial services needs of the majority of the Somali business people, especially those involved in international business ventures.

The second objective of this research was to determine the best model of establishing proper functioning Islamic banks in Somalia. All the relevant variables were tested to achieve this objective. Consequently, the results of the study reveal that the best banking model in Somalia is a joint venture model with international banks. The findings agree with Claessens et al., (2008) that foreign banks add to domestic competition, increase access to financial services, enhance financial and economic performance of their borrowers and bring greater financial stability.

The third objective of this study was to identify the most suitable marketing tools for Islamic banking products and services in Somalia. Similarly, all relevant variables were tested and the results revealed that online marketing tools such as personal contacts, twitter, Facebook, and other social media tools can be suitable marketing tools for Islamic banking products and services in Somalia. According to Patel, (2015), online marketing tools can be useful when there is limited budget to assemble a top tier marketing team. All that is required is Internet Communication and telecommunication skills (ICT) which is abundant in Somalia as we have noted in previous sections. This means that ICT and mobile systems can play a greater role in marketing Islamic banking products and services in Somalia.

4.0 Conclusion

This study had three research objectives and all of them were achieved by testing their respective relevant variables as previously discussed. Covariance based structural equation modelling using Amos was performed on the data.

Results revealed that there is a high demand for the revival of the country's banking system and the provision of banking services consistent with the belief of the local population who are 100% Muslims has a high chance of success which means that Islamic banking can indeed flourish in Somalia if the superiority of the rule of law can be assured. This suggests that the success on the revival of the banking sector in Somalia will greatly depend on ensuring the supremacy of law and order as well as the enactment of Pro-business laws. Also, the results revealed that the best banking model in Somalia is a joint venture model with international bank. Finally, the research found that online marketing tools and mobile systems can play a greater role in marketing Islamic banking products and services in Somalia.

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