

# **Financial Products Diversification in Somaliland: Challenges and Opportunities**

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October, 2023

Hargeisa, Somaliland

## 1. Introduction

The financial sector plays a crucial role in facilitating economic activities and promoting growth in any country or region. It encompasses various institutions, markets, and instruments that enable the mobilization and allocation of funds, risk management, and the provision of financial services to individuals, businesses, and governments (Kammer et.al, 2015). Financial products refer to the range of instruments and services offered by financial institutions to meet the diverse needs of customers (Salman, 2014). These products can take various forms, including loans, deposits, insurance services, investment funds, stocks, bonds, and derivatives. Financial products are diverse and each serves a specific purpose and provides different benefits and risks to individuals and organizations (Aliyu, 2012). In the context of the financial sector, diversification refers to creating a portfolio of different financial products to spread risk and enhance potential returns. It involves investing in a mix of assets with varying characteristics. Diversification aims to reduce the impact of potential losses from any single investment and increase the likelihood of achieving more stable and consistent returns over time (Haron, 2017).

According to IMF (2022), globally the financial sector is witnessing rapid evolution with the advent of technology, changing consumer preferences, and regulatory shifts. The rise of Fintech, Blockchain technology, and innovative financial instruments are reshaping the landscape, necessitating adaptability and innovation within individual financial systems. As per the IFDI (2022), the global Islamic finance industry has expanded beyond traditional Muslim-majority countries and now operates in various regions. In 2021, Islamic finance demonstrated significant growth, with total assets reaching 4 trillion USD, representing a 17% year-on-year increase, alongside a total of 1,679 Islamic Financial Institutions (IFDI, 2022). In particular, Islamic banking recorded an estimated total asset value of US\$ 2.8 trillion, supported by a network of 566 Islamic banks. Furthermore, the Islamic finance sector has achieved global success by demonstrating sound governance practices, fostering stability, and enhancing awareness and knowledge among users worldwide.

Somaliland's financial sector historically operated on an informal basis, with limited involvement of traditional banking systems (Ahmed, 2021). Over time, recognizing the need for a formalized financial sector, Somaliland initiated steps to develop a more structured financial system. Somaliland's financial system has evolved, incorporating elements of Islamic finance. According to the Central Bank of Somaliland (2023), Islamic banking and finance, based on Shariah principles, have gained prominence in the region due to its predominantly Muslim population. The first commercial banking license was granted in 2013, and subsequent licenses have been issued to additional banks. Notably, all commercial banks in the country are under local ownership. Alongside the commercial banking sector under the central bank's purview, commercial banks maintain operations through 50 branches nationwide in 2023. Moreover, all six banks extend their services across borders, reaching into Djibouti and, for certain institutions, into Somalia. Preceding the establishment of the banking industry, non-bank financial entities, primarily remittance

institutions, offered structured financial services encompassing modest loan and savings provisions (CBS, 2023).

The financial sector in Somaliland is in a state of transition, moving towards a more formalized structure to better serve the economic needs of the populace. However, this transition is accompanied by challenges. These challenges may include regulatory constraints, limited market infrastructure, information asymmetry, and lack of investor awareness or understanding. Particularly concerning the limited range of financial products available to the public. The traditional financial offerings are constrained in scope and do not adequately cater to the varying financial requirements of the diverse segments of society. Moreover, the introduction of innovative financial products is hindered by regulatory, infrastructural, and economic challenges. These limitations have resulted in a financial sector that is yet to reach its full potential in terms of product diversity and inclusivity.

The need for financial product diversification is critical, considering the diverse economic activities and financial preferences within Somaliland. The absence of a comprehensive and diversified portfolio of financial products constrains the population's ability to manage risks, plan for the future, and access suitable financial services tailored to their requirements. Understanding the challenges and opportunities in financial product diversification is pivotal for policymakers, regulatory bodies, and financial institutions to strategize and take necessary steps to bridge these gaps and realize the true potential of the financial sector in Somaliland. The study aims to comprehensively analyze these challenges and shed light on potential opportunities. By doing so, it seeks to provide actionable insights to policymakers, regulatory bodies, and financial institutions to develop effective strategies for overcoming hurdles and advancing financial product diversification in Somaliland. Addressing these issues is critical to realizing the true potential of the financial sector, enhancing financial inclusion, and fostering economic growth and stability within the region.

### **1.1.Objectives of the study**

The objectives of this study are:

1. To conduct a comprehensive analysis of the present state of the financial sector in Somaliland
2. To identify key challenges hindering product diversification in Somaliland's financial sector
3. To investigate the policy and legal gaps in creating more risk-sharing products
4. To explore financial product diversification opportunities to effectively meet the diverse needs of society in particular the lower-income segments

This paper follows a structured format organized into four distinct sections. Following the initial introduction, the methodology section will be presented, outlining the research approach and techniques employed. Subsequently, the third section delves into detailed analysis, evaluating the pertinent aspects under discussion, leading to the final section which encapsulates conclusions drawn from the analysis and offers recommendations based on the findings.

## 2. Methodology

The study adopts a mixed-method approach, utilizing both primary and secondary data sources to comprehensively investigate the financial sector in Somaliland. The primary data was gathered through 68 questionnaires distributed among businesses and individuals. Additionally, in-depth interviews and discussions were conducted with key stakeholders in the financial sector, encompassing representatives from the Central Bank of Somaliland, the Somaliland Insurance Authority, the Somaliland Banking Association, the 5 operational banks in Somaliland, insurance companies, and microfinance institutions.

The data collected underwent a rigorous analysis involving both qualitative and quantitative techniques. For the quantitative aspect, descriptive analysis was employed, mainly central tendency, and analyzed trend data. In the qualitative analysis, the interviews and discussions were transcribed, providing valuable insights and significant findings. The transcripts were carefully examined to identify patterns, themes, and recurring concepts, contributing to a deeper understanding of the financial sector dynamics in Somaliland. This mixed-method approach ensures a comprehensive and holistic understanding of the financial sector, integrating quantitative precision with qualitative depth, enriching the study's findings and conclusions.

## 3. Results and Discussion

### 3.1. Demographic profile

In this section, the study presents the demographic profile of the 68 respondents who participated in the study, as outlined in the subsequent table. The data provided here offers insights into the diverse demographic characteristics of the individuals and businesses that contributed to the research.

**Table 1: Demographic characteristics (n = 68)**

<b>Gender</b>	<b>Percentage</b>
Male	<b>91%</b>
Female	<b>9%</b>
Total	<b>100%</b>
<b>Educational level</b>	
Primary level	<b>14.7%</b>
Intermediate or secondary education	<b>29.4%</b>
1 <sup>st</sup> degree	<b>32.4%</b>
2 <sup>nd</sup> degree	<b>23.5%</b>
Total	<b>100%</b>
<b>Employment sector</b>	

Business sector	<b>67.6%</b>
Public sector	<b>11.8%</b>
Academics	<b>20.6%</b>
Total	<b>100%</b>

*Source: own survey (2023)*

As Table 1 shows the majority of the respondents were male (91%), and 9% only female. This reflects that the business sectors randomly selected were male-dominated like electronics, stores, general traders, and academicians are mostly men. In level of education, more than half of the respondents (55.9 percent) were university level (bachelor’s or master’s degree), and this shows that the level of education of the respondents is high. Finally, the respondents are dominated by the business sector which accounts for 67.6 percent of the respondents, whereas the public sector and academicians account for 11.8 percent, and 20.6 percent of the respondents respectively.

**3.2. Current status of the financial sector in Somaliland**

The financial sector of Somaliland contains banking and non-banking institutions. The banking sector contains five operationally working Islamic commercial banks, and one that is licensed but is yet to start banking activities. The non-banking institutions comprise seven insurance firms, four mobile money service operators, 16 money transfer businesses, and four microfinance institutions.

The banking sector of Somaliland made tremendous growth since its establishment when the first bank was licensed in 2013. The total value of assets of banks reached 463 million dollars in 2022, and the total assets of commercial banks to Somaliland's GDP was 19%. The commercial banks have 50 branches across the country, and the total number of active accounts is approximately 237,691 accounts in 2023.

In 2022, the Islamic commercial banks have adequate capital as the capital adequacy ratio was 11% which is above the 8% capital adequacy ratio requirement under the Basel III international regulatory framework for banks (Bank of Somaliland, 2023).

In terms of finance products, the banks offer products like house financing, trade financing, working capital financing, business financing, automobile financing, and project financing. Working capital financing is the most common product that banks finance due to the economic nature of Somaliland; most economic activities in the country are trade activities as imports accounted for approximately 56% of the GDP in 2022. Secondly, automobile finance and house financing are the second and third largest financing activities made by commercial banks in Somaliland according to research interviews held with the managers of the commercial banks.

In the second quarter of 2023, the commercial banks’ total loans and deposits were 107 million dollars and 890.7 million dollars respectively.

Most Islamic modes of financing are used by commercial banks in Somaliland like Murabaha, Mudarabah, Musharakah, Ijarah, and Istisna, but the most common mode of financing is Murabaha

financing. According to interviews from the managers of the banks Murabaha mode of financing accounts for 80 to 90 percent of the total financing conducted by the banks.

Some of the reasons that Murabaha is the most common mode of financing according to the interviews include that Murabaha is the most convenient mode and closest to conventional banking in terms of simplicity of use. Other modes of financing are equity-based, and it is costly for the banks to share business with thousands of different customers, as every business requires supervision and accountability. Thirdly, other modes of finance are very risky. Fourthly, Murabaha responds to the needs of the customers as the customers apply for the purchase of business goods, house financing, or automobile financing. Finally, banks use one product for different modes of financing, for example house financing they invest using the Murabaha rate of financing, Musharaka mutanaqisah, Istisna, or Ijarah. According to the data collected from the banks, the mode of financing highly depends on the product and the needs of the customers.

The net profit of the banks decreased from 6.7 million dollars in 2021 to 5.95 million dollars in 2022. The decrease in profits of the banks reflects that the economic performance of the country dropped in 2022 (according to GDP).

In microfinance institutions, the total finance was 16.3 million dollars in 2022 and made 11.7 percent growth compared to the previous year. The institutions made investments of up to 15 thousand.

### ***3.3. Profit rate of Islamic financing in Somaliland***

#### ***3.3.1. Financial institutions argument***

While examining the profitability aspect of Islamic finance in Somaliland, this paper addressed pertinent factors such as the rationale and mechanisms behind the rates charged by banks, the public's perception of these rates, and the assessment of their fairness. Furthermore, a comparative analysis is conducted by juxtaposing these rates with those observed in neighboring countries within the region. Through this comprehensive approach, researchers aim to delve into the multifaceted dimensions surrounding the rate of profit in Islamic financing.

At the outset, financial institutions clarified that the term 'tariff' encompasses the various fees banks impose for their services, among which the profit rate stands as a significant component. This rate, similar to other charges, is determined by the bank's board, with managerial input serving in an advisory capacity during the rate-setting process.

The banking institutions provided a comprehensive rationale for their determined profit rate, elucidating multiple key factors that influence this setting. Firstly, they underscored the elevated cost of funding and conducting business as a primary driver. The intricacies and expenses associated with acquiring funds and maintaining operational functions substantiate the necessity for a certain profit margin. Furthermore, the prevalent unbanked behavior within the public significantly impacts the volume of deposits garnered by banks, thus necessitating a commensurate profit rate to sustain financial operations effectively.

Another pivotal aspect highlighted was the challenging economic conditions prevalent in the country. The adverse economic landscape poses constraints on offering lower rates, aligning with the need to maintain financial stability and solvency. In addition, the time value of money emerged as a significant determinant, justifying the profit rate in light of the principle that money available today holds a higher value than the same amount in the future. Thus arguing this fundamental economic concept drives the establishment of a reasonable profit rate.

Moreover, the presence of bad debtors or defaulters within the system presents a real concern for financial institutions. To mitigate the risks associated with non-repayment or delayed repayment, a justifiable profit rate is essential. Additionally, the occurrence of late repayments without an accompanying increase in the rate of profit further influences the profit rate determination. All these articulated factors collectively contribute to the rationale behind the establishment of the rate of profit in the banking sector.

### ***3.3.2. Public perception***

Examining the perspective of the public, it becomes apparent that this profit rate is widely perceived as exceedingly high. Drawing from an extensive data collection process involving diverse segments of the public, the study offers a comprehensive insight into the sentiments of the populace. Among the 68 respondents, an overwhelming majority of 60 individuals (88%) expressed the viewpoint that the bank profit rate is high. This significant response sheds light on the perceived assessment of profit rates within the banking sector by the sampled participants. A unanimous response emerged from all the respondents, unequivocally stating that the profit rate is indeed exorbitant. Their argument pivots on the belief that while this rate is undoubtedly lucrative for banks, it simultaneously poses a substantial obstacle for both the general public and businesses.

The public's viewpoint reflects a critical concern regarding the balance between profitability for financial institutions and the equitable treatment of the public. The data underscores a shared sentiment that the existing profit rate disproportionately favors the banking sector, potentially leading to financial constraints for individuals and hindrances for businesses. The perception of an imbalanced benefit structure highlights the need for a reassessment of the profit rate, emphasizing a more equitable distribution of gains that takes into account the interests and welfare of both banks and the broader society.

### ***3.3.3. Scholars and finance experts***

Opinions from scholars and finance experts on the issue of the profit rate in the financial sector are varied and offer a multifaceted perspective on the matter. Diverse scholars present differing views, advocating for distinct approaches to address this prevalent concern. A notable stance is the belief that reducing the profit rate is feasible by bolstering other critical factors, such as reinforcing the security of financing. They argue that a secure financial environment can allow for a reduction in the profit rate, promoting a fair balance between profitability and affordability for the public.

Conversely, there is a significant cohort of experts who concur with the public's perspective, emphasizing that the existing profit rate is indeed high and acts as a deterrent to the demand for

financing from the public. They contend that a more reasonable profit rate could potentially spur increased participation in financial services, ultimately benefitting both the public and the overall economy.

However, certain scholars adopt a different approach, contextualizing the profit rate within the realities of the country's economic situation and the associated risks in financing various sectors and needs. They emphasize that this rate is a reflection of the intricate challenges faced by banks, including substantial obstacles and high operational costs. To address this, they propose enhancing the legal framework to streamline the financing process and alleviate burdens on banks, ultimately enabling them to lower the profit rate and create a more conducive financial environment.

The collective suggestion from these scholars underscores the importance of a holistic evaluation of the profit rate issue, considering economic, regulatory, and societal dimensions. Striking an optimal balance between profitability, public accessibility, and economic sustainability remains a critical goal, urging further dialogue and concerted efforts to enhance the financial system's efficiency and inclusivity.

### ***3.3.4. Comparative analysis of the profit rate in Somaliland's financial sector with the countries in the region***

After meticulously gathering extensive information and data pertaining to the profit rate within the country, the study embarked on a strategic comparative analysis. Recognizing the importance of situating the country's financial dynamics within a broader regional context, this analytical endeavor sought to shed light on the relative positioning of our financing profit rate when compared to neighboring nations within the region.

Among the five banks operating in Somaliland, three stipulate a 12% rate of profit in their initial contract documents. However, following negotiations or upon reaching a maturity date exceeding a year, the average rate of profit typically adjusts to 10%.

To contextualize and compare this profit rate with neighboring countries in the region, the table below illustrates the financing rates in four neighboring countries:

<b><i>Country</i></b>	<b><i>Rate</i></b>	<b><i>Year</i></b>	<b><i>Source</i></b>
<b><i>Ethiopia</i></b>	7%	2023	<i>National Bank of Ethiopia</i>
<b><i>Djibouti</i></b>	11.2%	2022	<i>Trading Economics</i>
<b><i>Kenya</i></b>	13.5%	2023	<i>Central Bank of Kenya</i>
<b><i>Sudan</i></b>	9%	2023	<i>Institute of Developing Economies</i>

*Sources: available in the table*

The provided table exhibits varying financing rates across four countries: Ethiopia, Djibouti, Kenya, and Sudan, presenting rates of 7%, 11.2%, 13.5%, and 9%, respectively. When juxtaposed with the prevalent financing rate in Somaliland banks, primarily set at 12% but averaging at 10%, intriguing observations emerge from a comparative analysis.

Compared to these regional counterparts, Somaliland's banking sector adopts a primary rate of 12%, implying a somewhat competitive lending landscape. However, when considering the average rate of 10%, a nuanced perspective emerges. The average rate, lower than the primary rate, could signify a subtle flexibility in the market to accommodate varied financial circumstances. This may stem from efforts to promote borrowing and stimulate economic activities while ensuring a balanced risk-return profile for the lenders.

The comparative analysis sheds light on the financial dynamics of these countries, showcasing variations in lending rates and potential strategic considerations. Somaliland, aligning closely with its neighboring nations, navigates a delicate balance to optimize lending rates and encourage economic growth within its unique financial landscape.

### ***3.4.Challenges Hindering Product Diversification in the Banking Sector in Somaliland***

#### ***3.4.1. Challenges in the Serviceability and Security***

Serviceability and security are critical considerations in the context of financing, whether for assets or debts. Serviceability represents a fundamental aspect determining the borrower's ability to meet the repayment obligations based on their income, financial stability, and existing liabilities. It is a crucial factor that is assessed by both the bank (lender) and the borrower during the loan approval process. On the other hand, security pertains to the measures and collateral put in place to mitigate risks and ensure the repayment of loans. These factors play a crucial role in determining the terms, conditions, and approval of a financing arrangement, safeguarding both the borrower's and the lender's interests.

The results indicate that one of the fundamental hurdles confronting borrowers to get a diverse range of financial products stems from their frequently encountered difficulty in furnishing adequate collateral. Numerous loans, particularly those of substantial amounts, necessitate assets to be pledged as security. For borrowers who do not possess valuable assets or property, meeting the bank's security prerequisites becomes an arduous task. This predicament imposes limitations on their access to loans, and in cases where loans are extended, it often results in higher rates as a compensatory measure for the heightened risk perceived by the lending institution. This limitation significantly impedes the ability to offer more profitable yet inherently riskier financial products. Without ample collateral, financial institutions hesitate to extend such products, as the risk associated with potential defaults is perceived as substantially higher.

The study discerned that the financial products holding the potential for significant benefits and high returns are primarily intertwined with a host of challenges. For instance, in financing contracts utilizing the Mudaraba mode, a prevalent issue is information asymmetry. Entrepreneurs possess in-depth knowledge of the business and pertinent market insights, while the same level of understanding is lacking within banks. Another pressing concern is the absence of an impartial third party capable of elucidating precise details about the prospective business venture mutually to be undertaken by the banks and the entrepreneur.

*"Asymmetric information is a significant challenge we face. Entrepreneurs often withhold potentially profitable business ideas, investing their own funds in these ventures. They tend to present us with riskier business proposals and, later, provide various reasons for project failures. To mitigate this risk, we've shifted towards short-term Murabaha for working capital financing, aiming to transfer the risk. Additionally, we've transitioned a substantial portion of inventory financing to Murabaha to address this issue effectively." A bank manager.*

In addition, the potential collaboration between banks and businesspersons through the Musharaka mode in business financing and contracts presents its own set of hurdles. One major obstacle is the apprehension among businesspeople regarding sharing critical business information with banks. This apprehension stems from the fear that banks might independently pursue and invest in their ideas without their involvement. Additionally, a prevailing culture of reluctance exists, where both parties avoid sharing business ventures with external entities. The findings underscore that a principal factor contributing to these challenges is the absence of well-defined and formalized guidelines and regulations that could facilitate and govern such collaborative financing endeavors.

A significant hurdle lies in the underutilization of Sukuk (financial certificates often termed 'sharia-compliant' bonds), which have the potential to facilitate the circulation of money in the financial system and drive additional investments for the economy. In our context, however, these Sukuk instruments are frequently supplanted by investments in land, presenting a distinct challenge in the adoption and integration of Sukuk within the country's financial system. The study's results further emphasized that devising comprehensive strategies and policies to introduce and promote the utilization of Sukuk can concurrently assist in effectively managing land ownership and related issues within our country.

Another critical challenge emerges in the context of financing businesses and large-scale investments. Lenders and investors typically rely on past financial performance as a predictor of future success and risk assessment. Local businesses often rely on traditional documentation methods, and their financial records are either inappropriate or absent altogether. However, assessing the creditworthiness and potential returns becomes challenging when such data is absent or limited for a large-scale or nascent venture. This absence of a documented financial history becomes a formidable barrier, hindering the potential financing of ventures that could yield substantial profits and drive significant economic growth.

The study identified a notable challenge in the financing of international trade—the absence of the Letter of Credit (LC). This absence adds a layer of risk to international trade financing, prompting caution from banks regarding potential risks. Banks often resort to utilizing correspondent banks as intermediaries or agents on behalf of others to navigate financial transactions and services. However, the responses indicate that this approach comes with inherent difficulties and additional costs. Moreover, this issue has emerged as a significant obstacle in financing various financial products associated with international trade.

All the challenges mentioned above can be categorized as ' challenges in the serviceability and security' directly or indirectly impeding the financing of numerous profitable products and hindering their introduction and seamless integration into the financial system.

### ***3.4.2. Legal framework and policies gaps***

According to the interviews with the top managers of commercial banks, the legal framework is one of the main challenges faced by banks in terms of financing product diversification. Recently published legislation that governs the financial sector is the Central Bank Act, Islamic Commercial Bank Act, Remittances Act, and Money Laundering and Terrorist Financing Act.

There are several acts that are important for financing that are not in place, like the foreclosure act. The absence of this act means that if a bank customer does not repay a loan, the banks should sue him in court, but the banks can't sell the collateral they held against the borrower as there is no legislation for doing so. Furthermore, it is expensive and requires a lot of bargaining and administration for the bank to collect the non-performing loans. Recently the act has been in a draft stage and the Bank of Somaliland expects to submit to the parliament.

Another legal challenge is when the bank holds the land as collateral, there is no GIS in other cities, and yet the customer can sell the land which qualifies as the collateral, which means there is no collateral for the bank to seize if the borrower does not repay their loan. The legal challenge is that this process will be a civil case in court, as there are no courts specific to financial issues.

Without the full legal framework in place, lending by banks becomes a riskier activity, and as such they hold excess capital and liquidity to compensate for this. To better adequately identify and mitigate risks, there also needs to be banking risk management guidelines, which are yet to be produced.

Consumer protection regulation is another regulation that is not in place and promotes fair and equitable financial services practices, which has a range of important benefits to both consumers and the financial sector. This includes setting minimum standards for financial services providers in dealing with consumers, increasing transparency in order to inform and empower consumers of financial services, fostering confidence in the financial services sector, and providing efficient and effective mechanisms for handling consumer complaints relating to the provision of financial products and services.

Finally, microfinance institutions lack a legal framework, as microfinance regulation is in a draft stage as mentioned by the officers of the Bank of Somaliland.

### ***3.4.3. Lack of awareness and low financial literacy***

The results revealed that the lack of awareness and low financial literacy significantly pose formidable challenges to financing and product diversification within Somaliland's financial sector. The lack of awareness and low financial literacy significantly pose formidable challenges to financing and product diversification within Somaliland's financial sector. A major challenge arises from the populace's limited comprehension of financial products. Many potential customers

may not fully grasp the array of financial products available, their respective benefits, risks, or how to choose the most suitable ones for their needs.

*“The impact of inadequate financial literacy, a significant challenge—is the population's lack of knowledge in making informed financial decisions. For example, many individuals frequently opt for Murabaha without realizing that a more fitting mode tailored to their specific business activity could be more beneficial if they were better informed about their options.” A bank officer emphasized*

The study found that the low level of financial literacy results in underutilization of basic banking services. Most people are not aware of the advantages of savings accounts, investments, or even how to access credit. This underutilization restrains the growth of the financial sector as it limits the inflow of deposits and reduces the market for financial products.

In addition, the lack of financial literacy leads to excessive risk aversion. People avoid potentially beneficial financial products due to a lack of understanding or fear of the associated risks. Informed decision-making is critical for diversifying financial products and services, but without adequate financial education, individuals might stick to traditional, low-risk options, impeding innovation and diversification. Another bank officer highlighted:

*“The financial sector's performance is notably challenged by a pervasive lack of awareness. A considerable portion of our society remains unbanked, preferring traditional methods to deposit and save money due to a lack of trust in banks. Additionally, a significant portion of the population, lacking financial literacy, tends to be risk-averse, refraining from seeking financial products for financing needs.”*

Moreover, the findings show a notable majority of defaulters and individuals with bad debt records lack adequate financial literacy. Without an understanding of basic financial concepts, individuals mismanage their resources, leading to inefficient use of finances. This inefficiency directly affects the overall economic growth and development within the region. In addition, effective risk management within the financial sector requires a knowledgeable customer base that understands the risks associated with various financial products. Without this awareness, risk management becomes challenging for both financial institutions and individuals.

Through this situation, the study found that financial institutions, reluctant to introduce new products without a certain level of consumer awareness, may resist diversifying their offerings. This lack of innovation could stagnate the financial sector, preventing the introduction of innovative and tailored products that could better serve the needs of the population.

#### **3.4.4. Economic condition challenges**

A substantial segment of Somaliland's population grapples with a low income level. The limited disposable income hinders their capacity to engage with and benefit from various financial products. This economic constraint often translates to a reduced demand for financial services, inhibiting the development of diverse financial products that could cater to a broader range of

needs and preferences. Interviewees lamented their low income status, expressing frustration over the struggle to obtain financing. Limited income makes banks reluctant to offer loans or credit, hindering aspirations such as starting a small business.

*“I have aspirations, especially in starting a small business to improve my financial standing. However, without the initial capital or access to financing, my dreams remain just that - dreams. It's frustrating to feel trapped in this cycle of financial limitation. To improve my financial situation, I need resources and financial support. Yet, to access that support, financial institutions require a level of financial stability that seems out of reach for me. It's a cycle that's difficult to break, and it's disheartening.” An interviewee mourned.*

On the other hand, the results show due to the existence of a large number of businesses in Somaliland operating in the informal sector. These informal businesses often lack proper documentation and financial records, making it challenging for financial institutions to assess their solvency. Consequently, banks hesitate to extend financial products or credit, hindering the potential for product diversification and effectively reaching this significant sector of the economy.

Moreover, the study found another challenge arises from the case of Somaliland operating within a predominantly dollarized economy, where the U.S. dollar is widely used for transactions and savings. This poses a challenge in terms of financial stability and control. The reliance on a foreign currency limits the resources to be used as financing, factors crucial for an effective and diverse financial product portfolio.

Ultimately, the findings indicate that the absence of a lender of last resort, a key institution in a stable financial system, presents a notable challenge. In times of financial distress or liquidity crises, having an entity that can provide emergency liquidity assistance is essential. The absence of such an institution amplifies risks and creates an environment of caution among financial institutions, potentially impeding their willingness to diversify products and services.

#### **3.4.5. Financial infrastructure**

One of the main challenges mentioned by top managers of banks is a lack of credit information and credit rationing. A customer can apply for a loan from all commercial banks at the same time, or a customer who is already in debt in one bank can take a loan from another bank. The lack of a source for the list of debtors, and the lack of credit reference bureau is a challenge for the banks and contributes to the non-performing loans of the banks.

Clearance house and settlement regulation was launched in 2022, and a regulatory office would be under the powers of the Bank of Somaliland, but the office is yet not functional and is in an establishment stage.

A national payment system is not yet available, which is challenges faced by the financial sector to operate efficiently.

### ***3.4.6. Financial Inclusion***

Financial inclusion means planning to provide adequate, affordable, and quality financial products or services at all levels of society. A country can only grow if people have unlimited access to financial services. If significant areas of a country remain underbanked, then the financial resources of those areas are wasted.

The data collected from the respondents states that 73.5 percent of the respondents have bank accounts, but in terms of financing only 16.7 percent of the respondents applied for loans from the banks for the last three years. The financial inclusion in Somaliland depends on the sectors, the academicians, and macro-businesses are closer to the banking sector compared to small and medium enterprises.

A survey conducted by OXFAM in 2021 stated that 90% of women surveyed never applied for a loan from the banks and 74 percent of women businesses interviewed do not have a bank account. Another survey conducted by the Bank of Somaliland in 2022 mentioned that 57% of businesses collected from the data do not have bank accounts (Bank of Somaliland, 2022).

The lack of bank accounts and low bank saving habits of the population mean wasted financial resources and a reduction in the lending ability of financial institutions. Although deposit levels are low, financial institutions also do not fully utilize the resources they have. This is demonstrated by the loan-to-deposit ratio of the banks in the second quarter of 2023 which is approximately 12 percent, and the ideal loan-to-deposit ratio for banks is around 80 to 90 percent.

One of the reasons that managers of the banks mentioned is that few people are in the business sector, and only those in the business sector apply for bank loans and investments.

### ***3.4.7. Financial market***

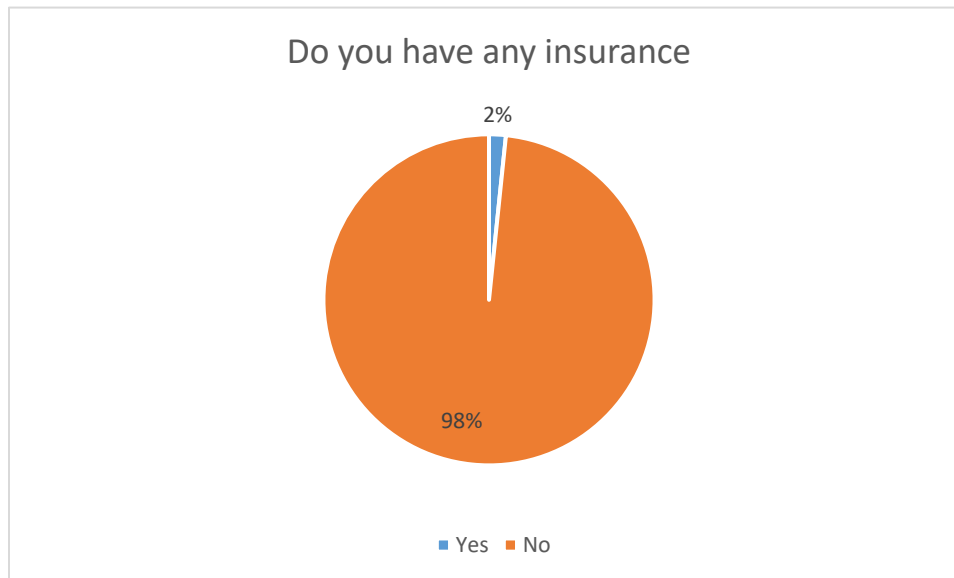
Capital markets are markets that bring buyers and sellers together to trade stocks, bonds, currencies, and other financial assets. Capital markets include the stock market and the bond market. They help people with ideas to become entrepreneurs and help small businesses grow into big companies. In Islamic banking, Sukuk are Islamic-compliant bonds used in Islamic finance.

In Somaliland, lack of capital markets subjugates the financial sector development, and product diversification of the sector. If there is a capital market the commercial banks this would aid the banks in investing their financial resources, which will boost the economic growth of the country.

## ***3.5. Insurance***

In Somaliland, the first insurance firm was established in 2016, which has grown to seven insurance firms operating in the country to date. The firms offer products like health insurance, automobile insurance, marines insurance, and travel insurance. Work Injured Benefit Act (WIBA) which is an insurance cover that protects employers, should their employees incur injuries or die in the course of their work, is another product that insurance companies offer to their customers.

Finally, the type of insurance depends on the needs of the customer and the firms offer any insurance compliant with the Sharia.



According to chart 1, only 2% of the respondents have any insurance, while the majority of them do not have any insurance. That shows how insurance use in Somaliland is very uncommon.

According to interviews with top managers of insurance companies, 90 percent of the products they offer are medical, 7 percent for motor insurance, and 3 percent for others.

The insurance sector is underdeveloped and the products are not diversified. The challenges and obstacles in the firms according to the primary data collected and secondary data from the Somaliland Insurance Authority (SIA) are classified as follows:

### ***3.6.Challenges Hindering Product Diversification in the Insurance Sector in Somaliland***

#### ***3.6.1. Sociocultural and religious factors***

This study found that socioeconomic factors, particularly the prevalent traditional support systems based on clan or community structures, significantly challenge the uptake and growth of the insurance sector. In Somaliland's clan-based or tight-knit communities, individuals often rely on collective financial contributions within the community to manage risks. This could involve regular contributions or contributions in times of need, creating an informal insurance-like system. Such practices limit the perceived need for formal insurance products as the community serves as a safety net. In addition, trust and solidarity within the community are pivotal factors. People trust that in times of crisis, their clan or community will support them financially, ensuring their needs are met. This strong sense of trust can diminish the perceived necessity of external financial instruments like insurance.

The results indicate that cost-effectiveness and customization to needs play crucial roles and create an obstacle. Responses show that community-based support systems are often seen as cost-effective alternatives, as they may not involve monetary premiums or administrative fees. Members contribute resources based on need or a pre-established understanding, providing a low-cost solution for risk management compared to formal insurance premiums. Moreover, the study discerned that community systems are highly adaptable to the specific needs and circumstances of the locality, allowing for tailored solutions. This customization enhances their perceived effectiveness and relevance to the community, further overshadowing formal insurance.

Most importantly, the results show that due to a long history of existence and successful functioning, community-based support systems are often perceived as highly reliable. This perceived reliability reinforces the belief that these systems will adequately cater to the needs of individuals, diminishing the incentive to explore insurance alternatives.

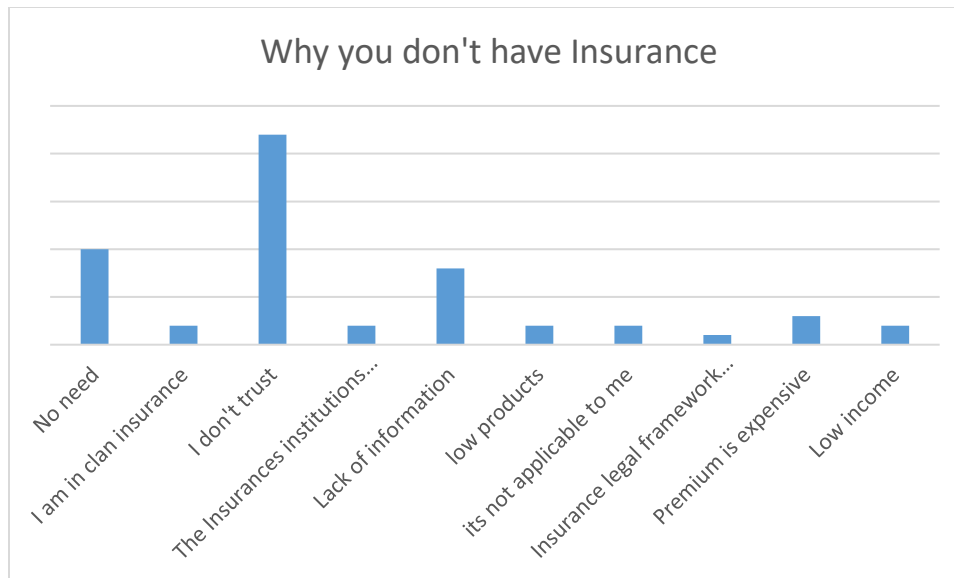
On the other hand, religious issues are a determining factor. The findings demonstrate that among the community there is a prevailing belief that life events are predetermined or controlled by a higher power. This belief system diminishes the perceived need for insurance, as individuals might feel that outcomes are preordained, making risk management through insurance seem unnecessary.

The study found that within Somaliland, there exists a discord of opinions among religious scholars regarding the permissibility of insurance within the context of Islamic teachings. This diversity of perspectives has led to confusion among the populace, particularly concerning whether the prevalent insurance practices align with religious doctrines. Some scholars assert that insurance, as it stands, is haram, or forbidden, based on their interpretation of religious principles. Conversely, other scholars hold the view that certain forms of insurance are permissible within the bounds of religious guidelines. An insurance officer responded to this issue:

*“This theological divide contributes to a lack of clarity and understanding among the general population. Many individuals are unaware that the insurance practices prevalent in Somaliland can be categorized under the umbrella of what some scholars deem haram. This lack of awareness further fuels the confusion and inhibits individuals from making informed decisions regarding insurance, potentially deterring them from exploring insurance as a risk management tool.”*

### **3.6.2. Education and Awareness**

The first insurance company was established in Somaliland in 2016, the insurance concept is new in the population. The issue caused discussions and public arguments during the time when the parliament of Somaliland was discussing the Insurance Companies Act. Those public discussions shed light on how the insurance industry, or education about it, is not popular in society.



The above figure 2 states that 14.8 percent of the respondents responded that one of the reasons that they did not have insurance is that they do not have information about the insurance and how it works.

There are no empirical studies showing the level of education of society in insurance, but recent interviews from top managers of insurance institutions mentioned low education and awareness of society regarding insurance.

Finally, there is no training center in the country for developing and teaching knowledge about the insurance sector. This shows how the sector lacks experts who can contribute to insurance innovation and development.

### ***3.7. Opportunities for product diversification in the banking sector***

This section encapsulates the expansive opportunities within the financial sector, encompassing both banking and insurance. The insights delineated herein have been derived from comprehensive responses obtained from banks, microfinance institutions, public stakeholders, the insurance authority, and insurance companies. The subsequent findings have been categorized into several pivotal domains: opportunities stemming from technological advancements, the burgeoning potential of fintech, prospective areas for financing, specialized financial products catering to underprivileged segments, strategies enabling product diversification, ongoing or pending regulatory measures poised to enhance the financing landscape, and the untapped potential in international relations concerning the realm of finance. Each of these vital domains is expounded upon in a comprehensive manner within this section. The subsequent discussions offer an in-depth analysis and exploration of the multifaceted opportunities present within the financial sector, providing valuable insights and perspectives.

#### ***3.7.1. Product diversification***

The results indicate that opportunities for product diversification in the financial sector of Somaliland are abundant, presenting a promising landscape for innovative and tailored financial instruments that can meet the diverse needs of the population.

The findings show that most financing activities are based on debt financing relative to asset financing which is a critical aspect of the financial sector, allowing individuals and businesses to acquire essential assets. In the context of Somaliland, structuring asset financing products in compliance with Islamic principles is pivotal.

One significant opportunity identified in the study in the diversification of financial products and modes of financing is introducing a neutral third party to address the issue of asymmetric information, validate commitments from both parties, and serve as a liaison with the judicial system could mitigate uncertainties related to projects requiring financing. Such an intermediary could play a crucial role in enforcing regulations, ultimately fostering increased confidence in financed projects and incentivizing larger-scale investments by banks.

Another opportunity revealed by this study is the potential for advantageous trade relations with neighboring countries, particularly Ethiopia. Establishing free trade zones and implementing conducive regulations could unlock significant financing opportunities for trade. Banks could identify potential areas for collaboration with businesses and individuals, fostering mutually beneficial financial partnerships and further stimulating trade and economic growth. Within the realm of trade financing, banks could explore collateral-based financing mechanisms. This could involve purchasing goods on behalf of borrowers and using these goods as collateral until the borrower sells them. Such an approach aligns with Islamic finance principles, allowing for asset-based transactions and expanding the avenues for financing in trade-related activities.

Moreover, a notable opportunity lies in the government's proactive role in identifying safe and viable zones for investment. By collaborating with banks to strategize productive modes for these areas, a conducive environment can be established for entrepreneurs to secure financing with bank assistance. This approach encourages partnership between the public sector and financial institutions, promoting economic growth through productive investments.

The study also highlights the issue of high housing costs and expensive rents, emphasizing the potential for real estate development through low-cost housing projects. Collaborative investments by banks and the government in this sector could be pivotal. By providing land and partnering with construction firms, the government can facilitate the construction of affordable housing units benefiting both households and businesses, particularly aimed at supporting low-income civil servants and fostering economic growth.

### ***3.7.2. Assets Financing in Primary Production***

The responses stressed the opportunities for financing production, particularly agricultural and fishery assets such as tractors, fishing boats, irrigation systems, and fishing and farming equipment. Supporting the primary sector by providing Sharia-compliant asset financing helps

primary producers acquire modern equipment, enhancing productivity and contributing to food security and economic growth.

*“Mudaraba mode can be used to finance agricultural projects, where the financier provides the funds, and the farmer manages the project. Profits are shared based on the agreed terms, fostering a cooperative and profit-sharing partnership.” A finance scholar responded.*

*“Fishermen can use Salam to finance fishery production by receiving upfront funds for their produce, allowing them to cover expenses and invest in necessary assets for their fishing activities.” A bank officer emphasized.*

*“Agricultural cooperatives or partnerships can utilize Musharaka to jointly finance and own assets like agricultural land, equipment, or irrigation systems, distributing the financial burden and risk. Hence enhance country’s output.” An interviewee*

### **3.7.3. Asset Financing in Manufacturing, Technology and Service**

One significant opportunity identified in the study relates to financing the manufacturing sector through Istisna in a country that lacks manufacturing factories. In a scenario where the country primarily imports its products and grapples with a high unemployment rate, leveraging Istisna financing for setting up manufacturing units can be transformative. Banks could collaborate with aspiring entrepreneurs to fund the establishment of local manufacturing facilities, boosting domestic production, reducing unemployment, and promoting self-sufficiency in various industries, ultimately aiding economic development.

An additional compelling opportunity identified by this study pertains to financing the burgeoning technology sector. In a landscape where people demonstrate openness and adaptability to technology, and the world is progressively shifting towards technology-based systems, leveraging finance through modes like Mudaraba and Musharaka could be pivotal. With the potential for numerous projects and activities to be seamlessly integrated with advanced technology, banks can collaborate with tech entrepreneurs to fund innovative ventures. This not only aligns with the global shift towards tech-driven solutions but also positions the country at the forefront of technological advancements, fostering economic growth and global competitiveness.

Furthermore, the study uncovers a promising opportunity in financing the service sector. In a landscape where services constitute a significant portion of the economy, and there's a growing trend of embracing diverse service-oriented businesses, by adopting appropriate financial modes can be highly beneficial. Considering the increasing demand for varied services and the potential for innovation in this sector, banks could partner with service providers to fund new ventures and initiatives. This collaborative approach not only supports the burgeoning service sector but also enhances job creation, fosters entrepreneurship, and amplifies the country's economic resilience in the face of evolving global markets.

### ***3.8. Specialized Financial Products for Lower-Income Segments of Society***

The study found that Introducing specialized financial products tailored for lower-income segments of society presents a wealth of opportunities, aligning with the goal of promoting financial inclusion and addressing the unique needs and challenges faced by this demographic.

The results addressed that microfinance facilitates the development of specific products for poor women and youth by providing them with small loans, fostering entrepreneurship, and enabling savings. These loans offer crucial financial support to start or grow small businesses, enhancing economic opportunities for women and youth. Additionally, microfinance institutions often offer financial literacy training, empowering these demographics to manage their finances effectively. The flexibility in repayment terms ensures that loans are manageable, encouraging financial responsibility and sustainability.

In addition, findings underline the significance of microcredit, as a subset of microfinance, directly supports the development of products for poor women and youth by offering them small loans for entrepreneurial ventures. This empowers them to initiate income-generating activities, fostering financial independence and self-sustainability. Microcredit addresses the specific credit needs of these demographics, allowing them to invest in their enterprises, thus promoting economic growth within their communities.

More importantly, results indicate that specialized saving and investment accounts, designed for poor women and youth, encourage them to save and invest their funds wisely. These accounts often offer competitive interest rates and favorable terms, motivating them to build their savings and secure their financial future. By promoting a culture of saving and investment, these accounts contribute to financial stability and resilience among these demographics.

#### **Micro-insurance**

Microinsurance products offer coverage to low-income households or to individuals who have little savings. It is tailored specifically for lower-valued assets and compensation for illness, injury, or death. Microinsurance looks to aid low-income families by offering insurance plans tailored to their needs. Microinsurance is often found in developing countries, where the current insurance markets are inefficient or non-existent. Because the coverage value is lower than the usual insurance plan, the insured people pay considerably smaller premiums.

Somaliland is one of the lowest-income countries in the world, and The per capita income of Somaliland is estimated at 804 dollars in 2022 (Ministry of National Planning, 2022). The majority of society can't afford insurance, so there is an opportunity for micro-insurance programs can be tailored for the lower-income portion of the society. This opportunity will enhance the knowledge and awareness of society and expand the insurance industry of Somaliland.

#### **Urbanization**

The recurrent and long-lasting droughts increased rural-urban immigration, and this contributed to the increase of population people living in cities and created new villages. Urbanization creates and lowers the people to depend on their tribes. This self-dependence of the individual will contribute the person to transferring risks to other parties and applying for insurances.

In addition to that, the increase in urbanization and transportation caused car accidents to increase, and this put a lot of a burden on clan elders to collect clan contributions to compensate for damages created by automobiles. The clan elders understood how these automobile-related risks can be transferred to another party (insurance firm), and this opportunity can increase automobile insurance.

### **Third-party car insurance**

Third-party insurance is a policy purchased by the insured (first party) from the insurance company (second party) for protection against the claims of another (third party). A common example of third-party insurance is car insurance, which is designed to protect the first party against the claims of third parties in case of an accident.

The Insurance Companies Act recently (July 2023) passed by the parliament of Somaliland makes mandatory third-party car insurance and will be implemented in 2024. This mandatory policy will expand the insurance industry of Somaliland.

#### **4. Conclusion**

This study has shed light on the multifaceted challenges faced by the financial sector in Somaliland. Among these challenges, serviceability and security emerge as paramount concerns. The availability of reliable collateral and guarantee mechanisms remains a significant hurdle in enabling the financing of potentially profitable yet risky ventures. Additionally, the lack of a robust financial documentation system poses challenges, hindering the financing of high-return projects crucial for economic growth.

Furthermore, a critical challenge to financial sector development lies in the lack of awareness and low financial literacy. This hinders the demand for financial products and services, restricting the overall reach and impact of the banking sector. Efforts towards enhancing financial literacy are essential to overcoming this obstacle and empowering individuals to make informed financial decisions, hence promoting a more inclusive and vigorous financial landscape.

The economic conditions, characterized by a majority of informal businesses and a dollarized economy, present another tough challenge. The low-income levels and lack of a formalized economic structure hinder the growth and stability of the financial sector. Addressing these challenges requires innovative strategies that encourage formalization, generate employment, and foster economic diversification.

On the other hand, the insurance sector in Somaliland faces challenges that hamper its growth and effectiveness. Among these challenges, religious and cultural factors hold significant influence. Conflicting opinions among religious scholars regarding the permissibility of insurance present a substantial obstacle. The lack of consensus has led to confusion among the population, constraining their understanding and acceptance of insurance as a viable risk management tool. Additionally, deeply ingrained cultural beliefs, caution, and hesitancy towards modern financial instruments like insurance further hinder its adoption and success within society.

However, amidst these challenges lie abundant opportunities for the banking sector and product diversification. The potential for leveraging technology to enhance accessibility and create tailored financial solutions stands out prominently. The advent of fintech, coupled with strategic collaborations and regulatory enhancements, provides an encouraging outlook for the financial sector's future in Somaliland. Moreover, the untapped potential in trade, manufacturing, real estate, and the service sector offers promising prospects for specialized financial products, aiding economic growth and stability.

#### **5. Recommendations**

To mitigate the challenge of society's perceived high profit rates in the financial sector, regulatory bodies must play a proactive role. Implementing financing profit rate caps can prevent excessive profit margins that burden businesses and individuals. Additionally, fostering transparency in profit rate structures and promoting competition within the financial sector can create a healthier market environment and encourage fair pricing.

Fostering innovation and human capital development is fundamental for financial sector growth. The government and financial institutions should collaborate to establish innovation hubs, providing a favorable environment for new ideas and technologies. Furthermore, investing in training and education programs focused on financial innovation will equip professionals with the skills needed to drive sectoral advancements.

The government should strategically intervene in the banking sector, ensuring alignment with national development goals. This intervention can manifest through establishing financial institutions with a mandate to facilitate economic growth, especially in underserved sectors. Such entities should operate with transparency and efficiency, actively participating in socioeconomic development.

To overcome regulatory challenges, a robust legal and regulatory framework must be established. This should encompass clear guidelines for profit rate determination, risk management, and ethical practices. Regular reviews and updates of these frameworks are essential to ensure they remain relevant and effective in a dynamic financial landscape.

Enhancing financial literacy and awareness among the public is imperative to tackle the lack of understanding within the population. Government-led initiatives, in collaboration with financial institutions, should conduct widespread awareness campaigns, educational workshops, and informational sessions. Additionally, integrating financial literacy into school curricula can instill financial responsibility from an early age.

Microfinance institutions can play a significant role in addressing the challenges of financial inclusivity. Encouraging and supporting microfinance institutions to expand their reach and services to underserved communities can provide access to essential financial products and services for those excluded from the formal banking sector.

To bridge the infrastructure gap and overcome economic challenges, fostering public-private partnerships (PPPs) is crucial. The government should create an enabling environment for PPPs, offering incentives and ensuring regulatory clarity. Collaborations between the government and private entities can help develop critical infrastructure and spur economic growth.

Embracing technological advancements, such as fintech solutions and mobile banking, is vital to overcome challenges related to financial access. The government and financial institutions should actively invest in and promote the adoption of these technologies to reach a broader spectrum of the population, especially in remote or underdeveloped regions. This digital transformation can enhance the accessibility, affordability, and efficiency of financial services.

