

## ISLAMIC BANKING IN SOMALILAND

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### ABSTRACT

*Islamic banking refers to the banking or financing activities that comply with Shari'ah (Islamic law). This study aims to examine the development of Islamic banking in Somaliland, evaluate the challenges faced by the industry, and identify potential avenues for growth. The Islamic banking system in Somaliland officially started with the enactment of the "Islamic Banking Act No. 55/2012" in 2012. The rise of Islamic banking in Somaliland primarily reflects the local demand for Shari'ah-compliant financial products and services. Islamic banking in Somaliland is still in its early stages, and despite the challenges, the sector has the potential to expand. Although Islamic banking presents significant opportunities in the country, it also comes with various challenges. Among the challenges highlighted in this paper are gaps in the legal and regulatory framework, limited awareness, human capital challenges, and limitations on the implementation of Shari'ah governance. Addressing the challenges facing Islamic banking in the country is crucial to unlocking its full potential.*

Keywords: Islamic banking, Islamic finance, Islamic financial institutions, Somaliland

### INTRODUCTION

Islamic banking refers to the banking or financing activities that comply with *Shari'ah* (Islamic law). *Shari'ah* prohibits charging or receipt of *riba* (interest) in transactions, projects bearing excessive uncertainty (*gharar*), and gambling (*maysir*). Islamic banking/finance encourages profit and loss (risk) sharing financing modes and emphasizes transactions based on tangible assets, ensuring that physical assets back financial dealings. It avoids engaging in activities deemed harmful, such as alcohol. The key Islamic financial industry sectors include Islamic banking, the Islamic capital market, and *Takaful* (Islamic insurance). These sectors have been growing rapidly over the past years. The global value of the Islamic financial industry exceeded USD 3 trillion as of the end of 2022 (IFSB, 2023a). According to IFSB, the Islamic banking sector accounted for the highest share of global Islamic financial industry assets at 69.3%, followed by the Islamic capital market segment (namely, *Sukuk*/Islamic bonds, Islamic funds, and Islamic equities) at 29.8%, and *Takaful* at 0.9%. With countries in the Gulf Cooperation Council and Southeast Asia being the biggest hubs of Islamic finance, Islamic financial institutions are also emerging in the Western world (Sulub and Salleh, 2019).

Theoretically, the Islamic banking business model includes *Musharaka* (profit-and-loss-sharing contract), *Mudaraba* (profit-sharing contract), *Murabaha* (cost-plus or mark-up contract), *Salam* (advance payment, deferred delivery contract), *Istisna* (manufacturing or construction contract with deferred delivery and price being advanced, delayed, paid in installments, or paid upon delivery), *Bai' Bithaman Ajil* (deferred payment contract), *Ijarah* and *Ijarah thumma al-bai'* (Islamic leasing and hire-purchase contracts), *Ijarah Muntahia Bittamlik* (lease to own contract), among others. Islamic Banks (IBs) also offer deposit accounts, usually savings, current, and investment accounts. Besides these financing instruments and deposit accounts mentioned above, IBs also provide services to facilitate international trade transactions, such as Islamic letters of credit and Islamic bank guarantees (Sobol, 2015). It is worth noting that interest-bearing loans are not permissible under *Shari'ah*; hence, any loan should be extended on a goodwill basis (i.e., *Qard hasan*). Moreover, IBs are also expected to undertake an essential social and community role by distributing *Zakat* (almsgiving) to the poor and those in need. *Zakat* is the third pillar of Islam, and eligible individuals and businesses must pay it when their wealth reaches *Nisab* (i.e., a minimum amount of wealth so that *Zakat* can be imposed) (Sulub, 2022). Therefore, IBs are expected to abide by *Shari'ah* principles and should set up a *Shari'ah* board/committee to ensure that the bank's activities are *Shari'ah*-compliant.

In the context of this study, the potential of Islamic banking in Somaliland can be immense, given the high demand for Islamic financial services in the country. However, many challenges face the growth of Islamic banking in the country. Thus, this study aims to explore the development and current state of Islamic banking in Somaliland and scrutinize some of the challenges facing IBs in the country. In addition, opportunities for Islamic banking in the country are presented. To the researcher's knowledge, no previous research has examined the challenges, opportunities, and current state of Islamic banking in Somaliland.

The present study is desk-based research, collecting relevant data from secondary sources such as research articles, reports, bank websites, government web portals, newspapers, and magazines. The researcher then assesses the challenges facing IBs in the country and proposes opportunities.

The remainder of this paper is organized as follows. The next section provides an overview of Somaliland's banking system. The third section presents the development of Islamic banking in Somaliland, and section four examines the country's current state of Islamic banking. Section five discusses the challenges facing Islamic banking in the country and explores the opportunities it offers. Finally, the last section sets forth the conclusion and recommendations.

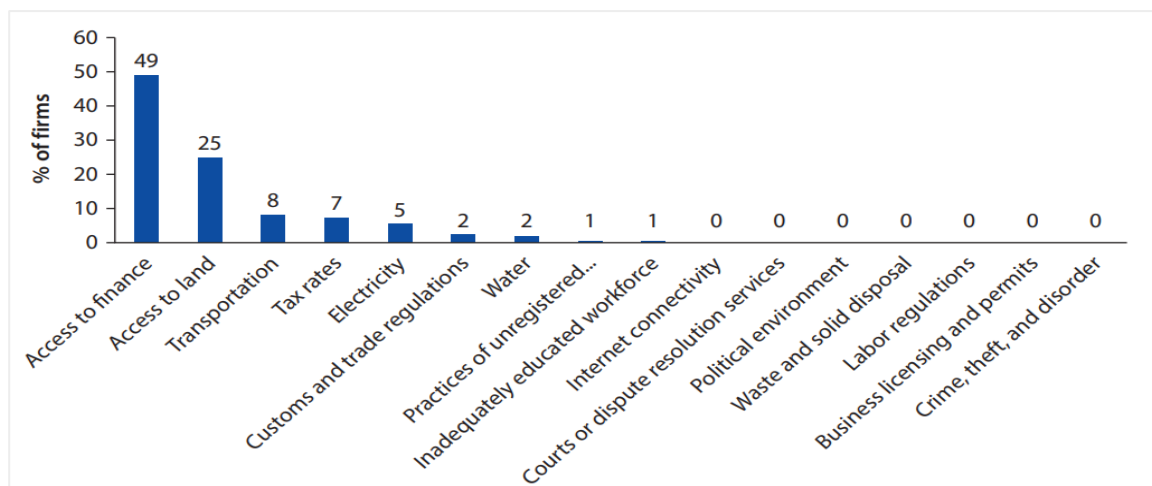
## OVERVIEW OF THE BANKING SYSTEM IN SOMALILAND

Somaliland is in the Horn of Africa and is a *de facto* independent state that declared independence in 1991 (Ahmed, 2016). According to the World Bank, Somaliland is a low-income country with a GDP per capita of USD 348, ranking it the 4th lowest globally, only ahead of Burundi, DR Congo, and Malawi (World Bank, 2015). However, a recent report shows that the GDP per capita increased to USD 853 in 2022 (CSD, 2023). As of 2024, the population of Somaliland is estimated to be approximately 6.2 million (Egge, 2024). The country's inhabitants are 100% Muslim (Yonis, 2012; Ahmed, 2016).

The Bank of Somaliland (i.e., the central bank) was established in 1994 to function as both the monetary authority and the treasury of the government (Mal, 2017) and serve as the primary regulatory authority overseeing the banking sector in Somaliland. Commercial banking in Somaliland started in the 2010s when several banks were granted licenses to operate in the country. Before this, Somaliland traditionally had no formal banking sector, and its residents mainly relied on remittances from diaspora communities in Europe, North America, and the United Arab Emirates, as there were no ATMs or loan facilities (Reuters, 2014). With the limited capacity of the Somaliland government, the private sector provides most of the essential services, leading the informal sector to dominate different sectors, such as commercial and industrial economic activities, utilities, education, and health (Mal, 2017). Similar to other sectors that operate informally, the financial sector remains largely informal and unregulated. Because formal financial services such as loans and lines of credit were unavailable, businesses and individuals had to rely on their savings or borrowings from family and friends (Mousley et al., 2015). Indeed, access to finance has always been one of Somaliland's most significant issues faced by individuals and businesses. Figure 1 shows the percentage of 500 Somaliland firms that reported the biggest business obstacles. The survey, based on 500 private-sector enterprises in seven of the largest cities in Somaliland (Hargeisa, Lasanood, Wajaale, Berbera, Burao, Borama, and Erigavo), included micro-enterprises with fewer than five employees, as well as larger firms, formal manufacturing firms, gums and resins, telecoms, remittance companies, retail, construction, hotels, and other enterprises. As shown in the figure, almost 50% of the surveyed businesses reported access to finance as the biggest obstacle. This demonstrates the dire need for formal and regulated banking institutions and other financial service providers in Somaliland.

The underdevelopment of the financial sector prompted money transfer operators to take on the role of banks (Bekkin, 2007). According to Mousley et al. (2015), remittance companies offered a limited range of financial products, including savings and current accounts, trade finance, mobile payment services, and Islamic financing products, mainly *murabaha* and *musharaka*. However, several remittance companies, such as the prominent Dahabshil money transfer service provider, officially launched commercial banking in 2014 (Ahmed, 2016).

Currently, the Somaliland financial sector comprises banking and non-banking institutions. As of 2023, there were five commercial IBs, seven insurance operators, six microfinance institutions, 18 remittance service providers, and four mobile banking providers (BOS and MOF, 2023).



**Figure 1: percentage of firms in Somaliland reporting the biggest obstacles to their business**  
Source: (Mousley et al., 2015)

## DEVELOPMENT OF ISLAMIC BANKING IN SOMALILAND

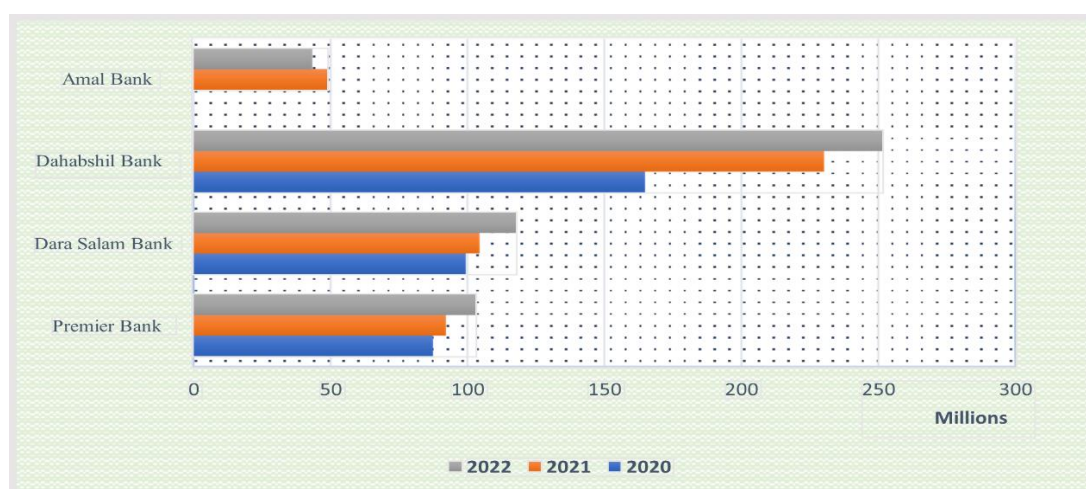
Somaliland's history of Islamic finance is rooted in the region's Islamic identity. Informal forms of Islamic financial service providers, such as the Hawala system (money transfer system), have long been prevalent, serving as a means of financial intermediation and facilitating trade and commerce across the horns of Africa. With the entire population being Muslim, the principles of *Shari'ah* hold significant importance in everyday life, including financial dealing and business activities. Concepts such as interest-free lending (which aligns with the teachings of *Shari'ah*) have been prevalent among the people of Somaliland (Waris, 2018). Hence, Islamic banking, grounded in the principles of *Shari'ah*, aligns deeply with people's beliefs in the region.

The history of Islamic finance in Somaliland commenced with remittance service providers, chiefly by Dahabshil, the largest provider of money transfer services in the country, providing limited Islamic financing services and products on an informal basis (Bekkin, 2007). Besides their core business of money transfers, remittance companies also offered other facilities usually provided by banks, including the provision of savings and current accounts to individuals, private companies, and international organizations (Mousley et al., 2015). According to these authors, many also offered trade finance and international payment services for imports by issuing letters of credit, while other financial services, such as *murabaha* and *musharaka* Islamic financing products, were made increasingly available to the private sector, the main modes used for financing export/import/domestic products and longer-term investment financing, respectively. Moreover, Mousley et al. (2015) state that the growth of these vehicles, especially *murabaha*, was strong, whereas, in the case of one of the leading remittance companies in Somaliland, *murabaha* financing grew from approximately USD 500,000 in 2011 to USD 6 million in 2013. They further add that the availability of *musharaka* financing (i.e., equity-based financing) was more constrained where, in 2013, in the case of one of the remittance companies, *musharaka* amounted to only 5 percent of *murabaha* financing (i.e., around USD 300,000). The increase in these *Shari'ah*-compliant financing instruments indicates a high demand for Islamic financial services across the country.

Recognizing the demand for financial services that align with Islamic principles, the government of Somaliland enacted the "Islamic Banking Act No. 55/2012" into law in 2012. The Act laid the legal foundation by providing provisions for controlling, guiding, and supervising IBs in Somaliland and established the conditions that IBs must meet before operating in the country. The "Central Bank Act No. 54/2012" gives the Bank of Somaliland (i.e., the central bank) the authority to regulate IBs by issuing licenses, registering, monitoring, and guiding the activities of IBs. In 2019, another important piece of legislation was introduced: the "Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act No. 87/2019", the first law to criminalize such activities in Somaliland.

The "Islamic Banking Act No. 55/2012" paved the way for the establishment of banking institutions that conduct banking activities in conformity with *Shari'ah* requirements, allowing them to operate in an environment without conventional banking institutions. Nonetheless, it is worth mentioning that before the introduction of the Islamic Banking Act in 2012, there was a debate by policymakers to allow Islamic and conventional banking to coexist in a dual banking environment; however, there were two concerns: religious and constitutional (Mousley et al., 2015). First, because Somaliland is an Islamic nation, there have been objections from religious leaders and public disapproval concerning the passing of a conventional banking bill. Second, Article 5(2) of the Constitution of Somaliland states: "The laws of the nation shall be grounded on and shall not be contrary to Islamic *Sharia*" (Mousley et al., 2015). Hence, only the provisions of Islamic banking law have been introduced, and therefore, the licensing of banks is limited to IBs.

Indeed, enacting the Islamic Banking Act of 2012 was a key milestone in Islamic banking in Somaliland. This legislation marked the beginning of the establishment of the first fully-fledged Islamic bank, Dahabshil Bank International, in 2014. Currently, there are five commercial IBs in Somaliland: Dahabshil Bank International, Dara Salam Bank, Amal Bank, Premier Bank, and the newly established IBS Bank (BOS and MOF, 2023). Figure 2 shows the sizes of IBs in terms of their total assets as of 2022. As depicted in the figure, Dahabshil Bank International is the largest, followed by Dara Salam Bank and Premier Bank, whereas Amal Bank is the smallest.



**Figure 2: the sizes of IBs in Somaliland in terms of their total assets**  
Source: (Ministry of Finance Development, 2023)

## CURRENT STATE OF ISLAMIC BANKING IN SOMALILAND

Islamic banking in Somaliland is still in its infancy, and despite the various challenges, the industry has the potential to grow. According to the Annual Economic Performance Bulletin report by BOS and MOF, the total assets of the Islamic banking industry in Somaliland grew from USD 290 million in 2020 to USD 463 million in 2022 (BOS and MOF, 2023). The bank deposits and financing of IBs in Somaliland over the last two years and their quarters are shown in Table 1. The average deposits amounted to approximately USD 310 million in 2023 (2022: 324.49), representing a roughly 5% decline compared with the average deposits in 2022. The decrease in total deposits was due to economic crises caused by the burning of the *Waaheen* market in Hargeisa, Somaliland, and the war in Ukraine (BOS and MOF, 2023). Furthermore, the total value of financing by IBs amounted to USD 441.24 million (2022: 455.16), a 3% decrease compared to the previous year.

Regarding the performance of the industry, financial performance indicators of IBs in the country remain unclear, as they are not obliged to disclose financial information publicly. Similarly, other indicators crucial for assessing the resilience of the Islamic banking industry, such as liquidity, asset quality, financing exposures across different sectors, capital adequacy, and leverage, are also unavailable.

**Table 1: deposits and financing of IBs in Somaliland (in millions of USD)**

| Quarter | Average bank deposits |          | % Change | Quarter | Total bank financing |          | % Change |
|---------|-----------------------|----------|----------|---------|----------------------|----------|----------|
|         | 2022                  | 2023     |          |         | 2022                 | 2023     |          |
| Q1      | \$396.58              | \$280.31 | -29%     | Q1      | \$113.28             | \$103.22 | -9%      |
| Q2      | \$349.23              | \$296.88 | -15%     | Q2      | \$95.19              | \$107.52 | 13%      |
| Q3      | \$255.38              | \$318.96 | 25%      | Q3      | \$148.19             | \$115.91 | -22%     |
| Q4      | \$296.77              | \$343.38 | 16%      | Q4      | \$98.50              | \$114.59 | 16%      |
| Average | \$324.49              | \$309.88 | -5%      | Total   | \$455.16             | \$441.24 | -3%      |

Source: adapted from (BOS and MOF, 2023)

In terms of Islamic banking services, all IBs in the country, as indicated on their websites, cater to personal and business banking needs. Moreover, all IBs offer typical savings and current deposit accounts, while Dara Salam Bank and Amal Bank also provide investment accounts based on *mudaraba*. Common items and activities available for financing by IBs include vehicles, homes, trading, construction, and SMEs. *Murabaha* is the most prevalent mode of Islamic financing in the industry, with almost all IBs offering this product. It is worth mentioning that Dara Salam Bank provides the most diversified financing mix comprising both equity financing (i.e., *mudaraba* and *musharaka*) and debt-like financing (e.g., *murabaha*, *salam*, *ijarah*, and *qard-hasan*). Moreover, IBs in the country largely facilitate international trade by providing letters of credit and bank guarantees. Regarding *qard-hasan*, Dara Salam Bank and Amal Bank offer such interest-free loans. Additionally, IBs provide a range of other services, including debit cards, ATMs, and mobile and online banking. Table 2 summarizes the services offered by IBs in Somaliland.

## CHALLENGES AND OPPORTUNITIES

### CHALLENGES

Islamic banking in Somaliland faces many challenges, including gaps in the legal and regulatory framework, limited awareness, human capital challenges, limitations in the implementation of *Shari'ah* governance, and unique risks to Islamic banking. The challenges faced by the industry are discussed as follows.

#### 1. Gaps in the Legal and Regulatory Framework

Laws and regulations are essential to maintain the integrity, stability, and trustworthiness of the banking industry. In Somaliland, legal infrastructure is substantially underdeveloped. As highlighted earlier, the financial sector remains largely unregulated, with gaps existing within the country's legal and regulatory framework. The Islamic banking industry is mainly regulated by the "Islamic Banking Act No. 55/2012", "Central Bank Act No. 54/2012", and "Somaliland Companies Act No. 80/2018". Although the Islamic Banking Act, passed in 2012, provides the legal structure for the establishment, regulation, and operation of IBs within the country, it contains several unclear legal provisions, which pose a challenge for regulators in enforcing certain aspects of the law. This situation can lead to inconsistencies in the application of the law, potentially weakening the regulatory regime and causing difficulties in ensuring full compliance by IBs. Furthermore, many critical legislation and regulations for financial institutions have not yet been implemented, including but not limited to consumer protection laws, contract laws, sales of goods laws, bills of exchange laws, clearing house regulations, and prudential regulations and supervisory framework. Therefore, it is consequential that policymakers and regulators develop the legal and regulatory infrastructure to help maintain the integrity, stability, and efficiency of the Islamic banking sector, ensure legal certainty, and protect the financial system as well as consumers.

#### 2. Limited Awareness

Being relatively new, awareness of Islamic banking may be one of the most significant challenges facing its development in Somaliland. Many potential customers may not fully grasp how Islamic banking works, particularly concerning the products and services offered. This lack of awareness may affect the adoption rate of Islamic banking in Somaliland. Therefore, increasing awareness of Islamic banking and its potential benefits could boost its penetration in Somaliland. As such, IBs, the government, academic institutions, and other stakeholders should collaborate to enhance Islamic banking awareness by developing educational programs, seminars, and workshops.

**Table 2: summary of services provided by IBs in Somaliland**

| Islamic banks                | Banking services              | Deposit accounts                          | Offered financing items/activities                                             | Modes of financing                                                                                                                                                       | Other services provided                                                                             |
|------------------------------|-------------------------------|-------------------------------------------|--------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------|
| Dahabshil Bank International | Personal and business banking | Savings and current accounts              | Vehicle, home, real estate, business, trade, micro, and agribusiness financing | <i>Murabaha</i> , letter of credit, bank guarantee, and documentary collections.                                                                                         | Debit cards, ATMs, online banking, mobile banking, among others.                                    |
| Dara Salam Bank              | Personal and business banking | Savings, current, and investment accounts | Vehicle, home, construction, trade, micro, and property financing              | <i>Murabaha</i> , <i>mudaraba</i> , <i>musharaka</i> , <i>salam</i> , <i>ijarah</i> , <i>qard-hasan</i> , letter of credit, bank guarantee, and documentary collections. | Debit cards, ATMs, online banking, mobile banking, money exchange, among others.                    |
| Premier Bank                 | Personal and business banking | Savings and current accounts              | Vehicle, construction, business, and trade financing                           | Letter of credit, shipping guarantees, bank guarantee, and invoice financing.                                                                                            | Debit cards, ATMs, online banking, mobile banking, payroll processing, SWIFT service, among others. |
| Amal Bank                    | Personal and business banking | Savings, current, and investment accounts | Vehicle, home, appliances, student, micro, and business financing              | <i>Mudaraba</i> , <i>qard-hasan</i> , and micro-grants.                                                                                                                  | Debit cards, ATMs, online banking, mobile banking, among others.                                    |
| IBS Bank                     | Personal and business banking | Savings and current accounts              | Vehicle, home, construction materials, real estate, micro, and trade financing | <i>Murabaha</i> , commodity <i>murabaha</i> ( <i>tawarruq</i> ), and <i>murabaha</i> letter of credit.                                                                   | Debit cards, ATMs, online banking, mobile banking, insurance, among others.                         |

**Note:** The Islamic banking products and services listed in this table are limited to those mentioned on the respective IBs' websites.

Source: compiled by the author from IBs' websites.

### 3. The Human Capital Challenge

There is a need for skilled professionals who are well-versed in the operational aspects of modern banking practices and the religious principles that underpin Islamic banking and finance. This shortage could slow the development of the sector. Hence, educational programs and training specific to Islamic banking and finance are required to build a knowledgeable workforce. Collaboration among Islamic financial and academic institutions is vital for overcoming this challenge and ensuring the industry has the talent and expertise necessary to thrive. A significant emphasis should be placed on educational courses that focus on Islamic banking and finance. Academic institutions offering Islamic banking and finance programs, such as the University of Hargeisa and Beder International University in Somaliland, should play a leading role in this effort. In addition, the Institute of Certified Public Accountants of Somaliland (ICPAS) should train accountants and auditors in financial reporting and standards for IBs. Therefore, educational and training programs are essential for developing skilled personnel and addressing the human capital challenge.

#### 4. Limitations on the Implementation of Shari'ah Governance

*Shari'ah* governance is a unique characteristic of Islamic financial institutions and is vital for ensuring effective compliance with *Shari'ah* principles. According to IFSB (2009), *Shari'ah* governance refers to “the set of institutional and organizational arrangements through which an IIFS (institutions offering Islamic Financial Services) ensures that there is effective independent oversight of *Shari'ah* compliance.” *Shari'ah* governance is a mechanism led by *Shari'ah* principles and controlled by an effective *Shari'ah* board to validate that the activities of Islamic financial institutions are *Shari'ah*-compliant (Grassa, 2013). Safeguarding *Shari'ah* compliance in Islamic financial institutions is essential as the risks that arise from non-compliance can have serious consequences on the stability and even the existence of such institutions. *Shari'ah* non-compliance is a subset of operational risks and may, in certain circumstances, lead to legal, financial, or reputational risks (AAOIFI, 2018). This can undermine the confidence of customers, depositors, investors, and other stakeholders. For this reason, in addition to the regular board, an additional governance layer (i.e., a *Shari'ah* Board) is required in Islamic financial institutions to ascertain *Shari'ah* compliance.

Implementing an effective *Shari'ah* governance framework is a challenge facing not only IBs in Somaliland but also the entire Islamic financial industry worldwide. In Somaliland, IBs must have a *Shari'ah* board before commencing their operations. Article 31(1) of the Islamic Banking Act 2012 states, “Every Islamic bank is obliged to have a *Sharia* Council”. Although requiring IBs to have an in-house *Shari'ah* council/board represents a positive step towards fostering sound *Shari'ah* governance practices and is recommended by major standard-setting organizations for Islamic financial institutions, such as AAOIFI and IFSB, several challenges concerning *Shari'ah* governance face the Islamic banking sector in Somaliland, including the lack of a comprehensive *Shari'ah* governance framework. A comprehensive *Shari'ah* governance framework encompasses a structured system designed to ensure the adherence of IBs to the *Shari'ah* principles. This typically includes, among others, having guidelines and procedures in place to design, structure, and market products while ensuring *Shari'ah* compliance at all times (IFSB, 2023b). Furthermore, it is vital to have highly independent and competent *Shari'ah* boards/councils in place and internal *Shari'ah* compliance controls, such as *Shari'ah* review/compliance and *Shari'ah* audit functions. In addition, formulating an effective *Shari'ah* governance framework is also reflected by responsible boards and management, as they are also obligated to safeguard *Shari'ah* compliance. The board, being responsible for the strategic direction of IBs, should ensure that all strategies and policies of IBs do not contradict *Shari'ah* principles. At the same time, the management is accountable for ensuring that the day-to-day operations of the bank comply with *Shari'ah* and implementing the guidelines provided by the *Shari'ah* board.

Therefore, implementing a comprehensive *Shari'ah* governance framework for IBs in Somaliland is of utmost importance. Doing so requires concerted efforts from public and private stakeholders. This may involve putting in place principles and procedures guiding *Shari'ah* compliance assurance, securing the complete independence of *Shari'ah* boards/councils, establishing robust internal *Shari'ah* compliance controls, and clarifying the roles and responsibilities of the SSB, board, management, and other organs towards upholding *Shari'ah* compliance. It is also vital to improve the transparency and disclosure practices of *Shari'ah* compliance mechanisms, such as the *Shari'ah* board/council composition, their roles and responsibilities, and the annual *Shari'ah* compliance report presented to stakeholders. By addressing these challenges, IBs can strengthen their *Shari'ah* governance and maintain stakeholder confidence. At last, this study recommends that regulators and IBs adopt AAOIFI or IFSB *Shari'ah* and corporate governance standards to improve the governance practices of IBs.

#### 5. Unique Risks to Islamic Banking

While IBs face risks similar to conventional banks, such as credit, liquidity, operational, and market risks, they also face unique risks, such as equity investment risk, rate of return risk, displaced commercial risk, and *Shari'ah* non-compliance risk. Equity investment risk arises when IBs enter equity partnerships such as *mudaraba* and *musharaka* contracts. This risk may occur for various reasons, including information asymmetries that lead to moral hazards and adverse selection. *Mudaraba* and *musharaka* are considered high-risk investments and may explain why debt-like financing instruments (e.g., *murabaha*) are more popular. Another unique risk IBs face is the rate of return risk that occurs when investment depositors withdraw their funds because expected returns are lower than market benchmark rates. This introduces withdrawal risk to banks and potential liquidity issues. A consequence of the rate of return risk is displaced commercial risk. This risk arises when IBs have to forgo part of their share in profit to meet depositors' expectations, especially in a competitive environment. To prevent withdrawal, banks allocate part of their profit share to investment depositors (Ahmed and Khan, 2007), which impacts their profitability. Notably, IBs can mitigate the rate of return risk and displaced commercial risk by implementing reserves. Finally, the *Shari'ah* non-compliance risk arises when the products or activities of IBs do not comply with *Shari'ah* principles. *Shari'ah* non-compliance risk is a subset of operational risks that may lead to legal, financial, or reputational risks (AAOIFI, 2018). Therefore, IBs in Somaliland must establish an effective risk-management framework that caters to these unique and other traditional banking risks.

### OPPORTUNITIES

Islamic banking in Somaliland presents several opportunities and prospects for growth and development, including meeting the demand for Islamic finance, public acceptance, and driving financial inclusion. These opportunities are discussed as follows.

#### 1. Meeting the Demand for Islamic Finance

As discussed earlier, there has been increasing demand for *Shari'ah*-compliant financial services in Somaliland. For instance, Mousley et al. (2015) report a robust growth in Islamic financing instruments, where in the case of one of the leading remittance companies in Somaliland, *murabaha* financing grew from approximately USD 500,000 in 2011 to USD 6 million in 2013. This suggests a high and increasing demand for *Shari'ah*-compliant financing. Hence, IBs in Somaliland can capitalize on the rising demand for Islamic financial services by offering a wide range of financial products and services to meet the diverse needs of customers. The growing economy of Somaliland also presents significant opportunities for IBs. That said, IBs in the country are well-positioned to meet the rising demand by providing accessible financial products and services.

## 2. Public Acceptance

Religious motivation is perhaps one of the most significant factors in the adoption of Islamic banking in Somaliland. As Somaliland is an Islamic nation, *Shari'ah* principles are crucial in daily life, including financial dealings and business activities. Accordingly, the local population is more likely to trust financial institutions that align with their religious beliefs and, therefore, are more likely to patronize Islamic banking.

## 3. Driving Financial Inclusion

As illustrated in Figure 1, access to finance is the biggest obstacle faced by companies in Somaliland. IBs in the region can address the unmet financial needs of businesses and individuals who largely do not have access to formal banking services or have limited access to them. Thus, IBs can contribute to broader financial inclusion in Somaliland.

## CONCLUSION AND RECOMMENDATIONS

Islamic banking in Somaliland officially began in 2012 with the enactment of the “Islamic Banking Act No. 55/2012”. While Islamic banking in the country presents significant opportunities, it also faces various challenges, including gaps in the legal and regulatory framework, limited awareness, human capital challenges, and limitations in the Implementation of *Shari'ah* governance. Addressing these challenges requires concerted efforts from public and private stakeholders to unlock the full potential of Islamic banking in Somaliland. This study has important implications for policymakers and regulators as they should build a robust legal and regulatory infrastructure that supports the growth and stability of the Islamic banking sector in Somaliland. They should ensure that all legal provisions within the Islamic Banking Law are clearly defined and unambiguous. Moreover, creating a detailed and comprehensive regulatory framework that covers all aspects of Islamic banking, including corporate and *Shari'ah* governance, risk management, and compliance, is critical. Furthermore, promoting awareness of Islamic banking and finance, improving human capital, and implementing comprehensive corporate and *Shari'ah* governance are among the key steps toward ensuring the growth of Islamic banking in the country.

The conclusions of this study may also benefit researchers by informing them of the development, current state, and challenges facing Islamic banking in Somaliland. Therefore, future studies should further examine this topic. Subsequent studies should utilize primary data collection techniques, such as interviews with the practitioners and industry experts, to obtain a deeper understanding of the challenges and issues facing Islamic banking in Somaliland. Upcoming research should investigate the factors influencing the adoption and non-adoption of Islamic banking in the country to comprehend customers' behavioral intentions. Finally, future studies should examine other challenges, including the affordability of Islamic banking products and Somaliland's lack of international recognition.

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