CHALLENGES FACED BY THE SOMALI REMITTANCE INDUSTRY

Report

Challenges faced by the Somali Remittance Industry

2018

About SIPAM Institute

SIPAM is a non-partisan, independent, not-for-profit organisation based in Mogadishu, Somalia. It was established as a leading advisory, research and training centre aimed at developing the capacities of public and private sector players to competently deal with major challenges in administration and management. SIPAM conducts research to inform strategic interventions and evidence-based practices for sustainable development.

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Executive Summary

Over a million Somalis, currently living abroad, remit back home an estimated 1.5 billion US Dollars annually. About fourteen Somali companies are offering money transfer services at present. There are a few international money transfer companies venturing in Somali money transfer industry. Somali operators rely exclusively on Somali agents and sub-agents they have appointed in some 40 countries worldwide. This report examines the challenges Somali remittance industry faces including the complex and different Anti-Money Laundering and Terrorist Financing regulations in all these countries.

The report focuses on remittance industry challenges from both global and Somali perspectives. It probes the dynamism in the industry in relation to the varying sizes of companies and cross-border differentials in regulatory frameworks. Money Laundering (ML) and Terrorism Financing (TF) risk are the greatest challenges posed by the booming remittance business. The weak financial regime and systems have further exposed the already fragile industry to manipulation and money laundering. The report acknowledges thatkey deficiencies in the industry revolve around regulation and identification issues.

The second issue relates to the services provided by the Somali remittance companies. In addition to money transfer, remittance companies also offer savings and transactional accounts for business and private clients. Another important service offered by these companies is the transfer of large amounts of cash from one location to another. Over the past years, these remittance companies have ventured into strategic investment in different industries.

Following the above-stated challenges and gaps, the discussion moves on to different regimes that have regulated the remittance industry. UN Security Council resolutions (2001) imposed a series of obligations on UN member states to suppress terrorism by regulating money transfer. The Financial Action Task Force (FATF) has also developed recommendations on Money Laundering and Terrorist Financing; all these geared towards safeguarding remittances from being misused for terrorism financing. Risk-based approach and ML/TF risk assessments have also been implemented effectively to strengthen banks and other financial institutions. Internal governance processes continue to participate nationally and internationally in global banking network facilitating international funds transfer for its wider customer base. With this arises the need to identify customer segments that may potentially lead to adverse risks and vulnerabilities.

The report further explores the issues, challenges and policy implications surrounding the Somali remittance process. Some of the issues highlighted in this report include the illegality context within which the remittance business operates dishonesty among some overseas agents, trust management, and the lack of regulation among the Somali remittance companies. It also looks at the operational implications of various policies in the sector and the need for the field to be regulated fully, thus realising its potential in a manner that conforms to the global regulations of money transfer.

Finally, the report makes actionable policy recommendations including the establishment of government-industry working group tasked with the responsibility of developing options for strengthening regulatory oversight of remitters. The report further recommends various strategic roles Somalia Financial Reporting Centre should be allowed to perform for regularizing the industry.

1.0 Introduction

Remittance or money transfer businesses (remitters) are non-bank financial entities that transfer money on behalf of others. Remitters provide a relatively quick, low-cost service, giving customers access to foreign regions and countries with limited or no financial infrastructure. Migrants and workers commonly use remitters to send money home. Somalia is enlisted among those African countries which have remittance beneficiaries from their diaspora population.

The existence of remittance economy in Somalia got strengthened by two main factors: the rapid growth of a migrant workforce from the early 1970s, and an unrealistic fiscal and monetary policy, especially the maintenance of a totally artificial exchange rate that quickly led to the emergence of a vibrant parallel or black market. These were often managed by state officials and their associated middlemen.

Remittances play a major role in developing countries.[i] Before the collapse of the state in 1991, the Somali territories developed a far-flung diaspora through labour, student and business migration and refugee movements. With the collapse of the state and banking sector in the early 1990s, the demand for alternative financial mechanisms grew. In 2016, remittances amounted to a minimum of $1.4 billion, as compared to the typical levels of Official Development Assistance (ODA) of $1.3 billion, and foreign direct investment of $339 million.

From the very beginning, the major importers were the people through whom money was channelled into Somalia. These traders/importers would collect money in hard currency from migrants for buying their commodities. Meanwhile, their relatives would be paid in Somali shillings at the parallel/black market rate. Later, it altered into a separate business and certain companies specialised in it. Today, traders and frequent travellers, carrying money for relatives or close friends, are considered participants in remittance.

However, remittances to Somalia carry the risk of being caught in the backlash of a global tendency towards tighter regulation of financial flows. This new tightening aims to prevent money laundering and block flows to groups involved in terrorist activities. Recognizing the economic importance of remittances in many poor countries, development policymakers have embarked on a range of initiatives on improving remittance management. The focus is especially on improving data, curbing costs and encouraging transfers through formal institutions by streamlining regulatory frameworks for the industry.

1.1 Services Provided by the Somali Remittance Companies

What exactly do these companies do? They provide a range of services that make them quasi-banking institutions in Somalia, without any expertise or institutional capabilities to provide all the banking services. Currently, they play several important roles by conducting the following operations:

Traditional Remittance Business: Migrants send small amounts of money to their families for upkeep, or specific events like weddings, funerals, etc. The remittances can be regular or intermittent, depending on many factors. Either way, the sent amount ranges between US$50 and US$200. In the case of greater amounts, it is likely to be funded in projects or partnership investment ventures.

A Platform for Saving and Money Transfer: Remittance companies also run saving and transactional accounts for their clients. These clients range from businessmen to private parties as they may deposit cash for safe-keeping and saving.

Besides major and minor traders, there are people keeping a fair amount of cash as they either plan to buy a piece of land or build a house. Undoubtedly, it is a positive development after years of distrust for the business community.

Another important service provided by Somali remittance companies entails moving (transporting) cash from one location to another. Structurally, the money transfer companies require local currency to pay their customers. So, from time to time, close relatives of senior management travel from Dubai or Nairobi only to transport large amounts of US Dollars (ranging from a few hundred thousand to one or two million).

It is therefore not surprising that when traders bring fresh cash into Somalia for transfer to Dubai, the commission is very low. The cash stays in Somalia while the payments due in Dubai are made from the money that reaches Dubai headquarters.

Remittance companies make strategic investments in different industries among which telecommunication industry is most prominent. These investments are made with an aim to eventually seize the mobile payment market. As mentioned earlier, remittance is not unique in Somalia; therefore, it is befitting to look at the remittance industry challenges from a wider perspective.

2.0 Methodology

This report adopted a qualitative research methods approach where key informant interviews (KIIs) were conducted on a wide range of stakeholders in the industry including remittance operators, researchers, government officials, financial analysts, beneficiaries (locals) and industry experts. Key informants that were selected to take part in the study have a wealth of experience from their prior participation in various capacities in the industry. An in-depth desk review was also conducted to further enhance the understanding of the remittance industry and the challenges it faces. Data collected was transcribed, coded, and synthesized based on key thematic areas.

3.0 Challenges to the Remittance Industry

3.1 The Global Perspective

The remittance sector enjoys a global diversity ranging from large organisations overseeing international remittance networks to smaller, informal money transfer systems that often operate outside the regulated financial systems.

The services provided by remitters are believed to pose a higher Money

Laundering/Terrorism Financing risk than any other sector as they operate outside the conventional banking system. This is because they are usually involved in sending money to various places without any modern banking network.

3.1.1 Licensed Remittance Providers

Over the past few years, banks in the Western countries have been closing accounts held by remitters. This is partly in response to the concerns on the perceived reputation risks associated with serving the remittance industry. These include Money Laundering/Terrorism Financing risk and the risk of breaching legal sanctions. In some cases, this 'de-banking' is also a response to the requirements imposed by international correspondent banks.

Various stakeholders express concerns that de-banking may render migrants and workers unable to access remittance services thus resulting in financial hardships for their families overseas. This adds to the need for 'financial inclusion in the domain of banking services. Concerns are also raised on denying access to bank accounts as this may lead remitters and their customers to opt for the unregulated, 'underground' financial systems.

3.1.2 Weak Financial Regime

An established view upheld by Western law enforcement (which has also been expressed in their respective national risk assessments) tells that the remittance sector poses a high Money Laundering/Terrorism Financing risk. The informal nature of remittance businesses and their ability to send money worldwide, with limited or no financial infrastructure and potentially weak Anti-Money Laundering/ Counter Terrorism Financing controls, makes them vulnerable to terrorists and other criminals.

The recent closure of remitters' accounts by banks reflects the banking sector's concerns on varying levels of professionalism within the sector and its limited capacity in mitigating its vulnerability towards Money Laundering/Terrorism Financing abuse. A significant number of remitters admit that changes are indispensable to improve the sector's professionalism and compliance with Anti-Money Laundering/Counter Terrorism Financing obligations if they want to operate in, and benefit from, a well-regulated financial system.

Limits to the total value of the funds, a remitter can remit within a certain period (for example, a month) have been imposed. This however barely mitigates the risks as small operators, who have exhausted their monthly limit, can simply outsource transfers to other remitters. Imposing a transaction threshold, that is, allowing a remitter to process transactions up to a prescribed maximum value, in addition to a volume limit, will help mitigate some of these risks. However, transfers to high-risk countries for Terrorism Financing tend to involve small amounts of funds below any prescribed threshold. In any case, either option requires close supervision to ensure that remitters are complying with similar transaction threshold requirements.

3.1.3 International Obligations

The underlying deficiencies of the remittance sector revolve around regulation and identification issues. International organisations, governments, and industries have introduced different regimes to regulate the remittance industry.

3.1.4 United Nations Security Council Resolutions

On 28th September 2001, in response to the September 11 terrorist attacks in the United States, the United Nations Security Council adopted Resolution 1373 (2001) imposing a series of obligations on the UN member states to suppress terrorism. Sub-paragraph 1(c) of Resolution 1373 obliges member states to

"Freeze without delay funds and other financial assets or economic resources of persons who commit, or attempt to commit, terrorist acts or participate in or facilitate the commission of terrorist acts; of entities owned or controlled directly or indirectly by such persons; and of persons and entities acting on behalf of, or at the direction of such persons and entities, including funds derived or generated from property owned or controlled directly or indirectly by such persons and associated persons and entities."

3.1.5 Financial Action Task Force

The Financial Action Task Force (FATF) has developed forty recommendations on Money Laundering and nine special recommendations, which include combating standards too, on Terrorism Financing. Special Recommendation VIII (SR VIII) sets up measures FATF member countries shall take to ensure that remittances cannot be misused for the purpose of terrorism financing. This has added to the levels of the bureaucratic process, something never before experienced in the industry.

3.2 The Somali Perspective

The first difficulty faced by the remittance industry is the fact that the business can be run illegally. Low commissions are possible as no license fees or taxes are involved.

In addition, a dishonest agent overseas can escape with the money and nothing can be done against him. There have been several cases in which agents of prestigious Somali money transfer companies got into trouble, as they lent the collected money (that was supposed to be transferred to their headquarters) and that money was not refunded. In certain cases, there is a possibility that the agent invests the money with a hope to refund it after some profitable commercial operation which does not materialize. In some cases, however, since the agents are often considered trust-worthy in the community they serve, they get involved in the trafficking of fake visas and are arrested afterward.

To overcome the above-mentioned difficulties, Somali remittance companies now demand the agents to keep a deposit at the headquarters of the company and/or hold shares in it. The bottom line is that the company must pay the customer for maintaining its reputation in the market. Just like any other business, profits can be high, but so are the risks.

Another problem faced by remittance companies is that of trust. For instance, it is very likely that migrants from a clan do not trust money transfer companies and use some kinsmen (who are trusted traders) to remit money to their relatives in Somalia. This practice is less common nowadays than it used to be in the early 1990s, though it has not diminished altogether. It is linked with the migrants' experience and their connection with other communities of the Somali diaspora.

The US decision to close Al-Barakat created a new situation since migrants suddenly feared to be associated with disreputable operations or companies.

Although such an impact is difficult to measure, its reality is beyond the scope of this discussion. Both the remittance companies and the people in Somalia have been vocal about it.

Another interesting dimension to the discussion is the honesty and quality of service on the end of remittance companies. At the beginning of the 1990s, the strategic tool was the HF radio which was one of the ways to communicate with people from the outside world. After 1994, things improved dramatically when Olympic (AST/ TELCOM) and Al-Barakat's telecommunication company, BETELCO, started operating.

In 1997, joined by Nation-link and two other companies, NetXchange and Amana entered the market. One can understand that the telecommunication business very much relies on these activities. Many customers in Somalia rent a telephone line, less to call than to be called. The Somali operators, therefore, obtain a significant part of their revenues and profits from incoming calls, rather than outgoing ones.

The scale and nature of remittances give rise to several public policy issues at both national and international levels. Remittances make a massive contribution in alleviating poverty and funding economic development. Higher the remittances, greater are the beneficial effects.

Remittance companies are financial institutions whose development can lead into the broadening of financial markets. They can also provide the much-needed competition for commercial banks which are often reluctant to deal with low-income people.

As Somali remittance companies are largely unregulated and certainly subject to much less onerous regulation than banks, there is a risk that they can be used to circumvent controls in the banking system dealing with money laundering and crime generally. The US decision to close Al-Barakat on 7th November 2001 affected this sector dramatically. The disappearance of the main remittance company in Somalia had tremendous impacts on other remittance companies too. As for its economic dimensions, it seems that Al-Barakat was able to impose a rather low rate of commission and most of its competitors had to align their rates accordingly.

Since Al-Barakat's exit from the market, the level of commissions has risen by 20-30%. At first, commissions (which vary with the size of the sum remitted) were 5%; Al-Barakat pulled these down to 3%. Since December 2001, they have again risen to 7%. The justification provided by the other companies is that their service has become more formal and so their costs have increased. They argue that their operations are now documented (the sender must show an official identification that is now recorded) and in some places, license fees are also involved. At the same time, there is a concern that any significant operation can attract the attention of the US authorities causing unnecessary suspicions.

The vacuum left since the exit of Al-Barakat is significant. The issues discussed above have attracted official interest at both national and international levels. However, different bodies have different agendas. Development agencies wish to see an increased flow of remittances, while financing agencies wish to see formalization of remittance flow through banks taking an increasing share of the market, or the remittance companies becoming banks. Law enforcement agencies wish to reduce the scope for the remittance business to be used for curbing money laundering and financing crime generally.

4.0 Risk Factors in the Remittance Sector

Much has been written about the risk-based approach in connection to the perceived de-risking. It is wrong to think that banks have arbitrarily decided to exit a segment of business without appropriate consideration. Several banks have literally undertaken hundreds of enhanced due diligence reviews on remitters including onsite visits/systems reviews to assess the effectiveness of remitter process/systems and controls in connection with Anti-Money Laundering/Combating Terrorism Financing (AML/CTF).

4.1 Risk Assessment Approaches (ML/TF Risk Assessments)

The AML/CTF regulatory environment is dynamic and constantly evolving. This is due to the nature of risks it seeks to mitigate. Criminals or organisations involved in ML/TF are continually adapting to and changing their behaviour in an effort to circumvent AML/CTF regulations and controls.

Accordingly, the financial services that used to facilitate unlawful payments, including banks and remitters who are subject to AML/CTF regulation in the countries they operate in, need to be alert to their ML/TF vulnerabilities and the emerging trends and themes.

To maintain currency in AML/CTF vulnerabilities, banks maintain a "watching brief" on all developments in vulnerability areas. This takes considerable Subject Matter Expert (SME) resources. Regulators in their capacity, as the country's Financial Intelligence Unit (FIU), issue an annual typologies and case studies report. It is common for FIUs around the world to issue reports of this kind.[ii]

The Regulator's report describes case studies based on real cases from a particular year to provide guidance about the kinds of developments in crimes related to finance in the finance industry. These case studies are used by the banks to stay informed of the risks involved in the business and to update their standards, procedures, systems, and controls.

The case studies are important but cannot be relied upon as the only source of information for two reasons:

1. The typologies are used not only by the banks, but by the criminals attempting to manipulate the banks' protective systems, and
2. Only a limited number of those who attempt to manipulate the system are apprehended or included as a case study in the annual report.

The banking and remittance sectors are used more frequently than any other channel to send funds to individuals engaged in foreign insurgencies and conflicts, some of whom are also suspected of being accomplices with terrorist groups. This largely reflects the central role of the banking sector and the utility of the remittance sector for transferring smaller amounts of money to jurisdictions where formal financial channels are less accessible.

4.2 Correspondent Banks

Correspondent banks in other countries are subject to their home jurisdiction legislation and AML/CTF requirements. Banks must consider the relevant foreign legislation and AML/ CTF requirements for any transaction that they route through their correspondent banks. Some banks hold the US banking licence and are subject to the US legislative requirements, including the Bank Secrecy Act.

If a bank is a US banking licence holder, international transactions undertaken by it in the US Dollars shall fall within the scope of certain US legislative requirements. This potentially attracts penalties if these requirements are not met (also in the sanctions area). The burden and obligations on banks to comply with international Anti-Money Laundering/ Counter Terrorism Financing laws continues growing invariably. Typically, before entering a relationship with a foreign correspondent bank, a bank undertakes due diligence on the correspondent bank.

Correspondent banks are required typically under the legislation in their home jurisdiction to undertake such due diligence in relation to that bank. As part of the ongoing due diligence undertaken by US correspondent banks, banks receive inquiries, "cease and desist notices" and information about the US Banks' risk appetites and requirements for accepting international funds transfers from time to time.

A "cease and desist" notice is a notice from a correspondent bank that it will no longer accept settlement or transfer of a kind from a bank customer or class of customers. As a matter of operational practice, it is essential for the bank to comply with "cease and desist'' notices and other requests from correspondent banks. If it does not, that bank may cease to be a bank that the correspondent bank considers dealing with under its own AML/CTF regulatory obligations.

In this case, the increased levels of perceived risk in the bank's client base in turn influence the correspondent bank's ML/TF risk assessment. It is likely that the banking of remitters will place a bank as a high-risk entity as far as US correspondent banks are concerned. Their being a high-risk entity results in an increased number of queries raised and increased resources are required to deal with such queries. Recently, majority "cease and desist'' notices from the correspondent banks are delivered to the banks that deal with remitters. In addition, most of the correspondent bank inquiries received also relate to remitters.[iii]

4.3 Bundling/Aggregation and High-Risk Destinations

In general, the practice of bundling/aggregation is fundamental to a remitters' business model. Remitters engage in the bundling of multiple transfers within a single transfer order placed with a bank for reducing the remitter's transactional costs.

This bundling process gives rise to an increased level of ML/TF risk for the bank. It is exceptionally challenging to identify the true economic/business purpose, the true originator, and the true beneficiary of the individual underlying transactions. The bank must rely on the process, procedures and effectiveness of the remitter business as customers of a customer.

Another risk related to remitters is that many of them transfer a large percentage of their funds to the countries classified as high-risk countries. Accordingly, transfers to high-risk countries require greater levels of AML/CTF scrutiny. In many cases, recognition of the need for special attention to high-risk countries does not form part of the remittance.

The following are some other risk factors present in the remittance sector:

Remittance businesses carry an additional risk, especially when it comes to banks. This is primarily due to the separation of the 'customer' from the bank. Banks are reliant on remittance businesses implementing adequate Know Your Customer (KYC) policies and procedures to mitigate AML/CTF and sanctions risk. Regulatory requirements still place the obligation on banks to ensure the management of AML/CTF and risk attached to remittance business.

Remittance business operations are often part of a secondary business. To illustrate, there have been places where a grocer also offers remittance services. Banks are often reliant on various things (transaction monitoring, remittance register, media, etc.) to identify their customers as remitters. Remittance businesses do not reveal their actual business activity to the bank at account opening stage. A regulatory requirement has been placed on remittance businesses to disclose their business type to their banks at the time of account opening.

Remittance business transactions are often aggregated while the underlying remitter information is not captured by the bank. Regulatory expectations internationally are 'understand the customers of your customer'. Transactions flowing from remittance business activity are not easily identified by the banks from their primary business funds. Conducting transaction monitoring is difficult due to the mingling of primary business revenue with remittance funds. A regulatory requirement can nevertheless be implemented requiring remittance businesses to maintain separate accounts for funds from their remittance operations. Multiple bank relationships further remove the banks' ability to understand and monitor the transaction flows. Thus, remittance businesses can be made incumbent to disclose their account in different banks. This will limit the multiple relationships a remitter is having with several banks.[iv]

Increased scrutiny on the sector has resulted in a greater regulatory burden, especially in terms of maintaining the customer relationship with the remitters. Banks are required to conduct significant due diligence on these customers and their transactions. The remittance businesses offering their services as a secondary business often lack adequate AML/CTF policies and procedures, and may thus not maintain proper registration with the regulator.

There are risks and issues, both at the national and international levels, which cannot be mitigated in the short run. These include:

- Requests by the US banks not to send remittance business funds through correspondent banking accounts. Banks are now often instructed to avoid funds being sent through certain correspondent banks due to the increased requirements imposed by the US banks.

- Banks are continually asked to provide their internal remittance business policy and control procedures for their peers and correspondents. This requires the banks to provide details of transactions initiated by the remittance business in the context of ‘know your customer’s customer’.
- It is widely recognised that the global appetite for remittance businesses has significantly reduced. This is mainly due to law enforcement action and cancellation/enforcement by regulators. Remittance businesses are continually linked with Money Laundering and Terrorism Financing which increases the risks for banks.
- Globally, the banks have to pay increased costs for conducting due diligence on remittance businesses as customers have made the remittance industry commercially unviable.

5.0 Case-by-Case Overview, Resources, and Segregation of Duties

The barrier to entry for remitters in any source country market is exceptionally low and there are currently no capital requirements, competency assessments or segregation of duty requirements for the remitters. Many of these are small family enterprises expected to have the equivalent control regime in place of a small business. Most remitters have been reviewed by banks recently, especially those that are sole traders, since the former lacks the financial capacity to implement a robust AML/CTF compliance program.

As reviewed by a certain bank in the year 2013/14, it was observed that many remitters lack a general awareness and understanding of the AML/CT compliance requirements that are needed to be addressed. Some banks have expressed concern on a large number of remitters that neither have specific AML/CTF compliance training or qualifications, nor keep any AML/CTF compliance officer with appropriate training and qualifications. This appears to be consistent with the fact that many remitters run small businesses sometime as sole proprietors, for whom employing someone with AML/CTF expertise is pretty expensive and thus prohibitive. Banks recognise that a businessman of this kind simply does not have the resources to conduct regular monitoring of business operation and development. Similarly, he/she cannot look after the consequential regular review and update his/her AML/CTF programs, though the obligations under the law remain as they are.

In the reviews, many remittance businesses are found lacking in the segregation of duties. Often, it has been found that only one person acts in various capacities: the owner, the sole director, and the AML/CTF compliance officer. This presents a significant risk from several perspectives. Good practice demands that an international remitter (or any financial service provider) should have an AML/CTF control infrastructure that is separate and independent from the operational part of the business. For example, at least a qualified compliance officer should be employed to work independently from the part of the business that carries out day-to-day funds transfers or uses or outsources compliance service. This is separate from the independent review function (recommended by the regulators) which is conducted periodically. The segregation of duties imposes a significant cost on any entity and may not be practical for many small remitters. Contrary to this, banks need a model to ensure segregation of duties.

The fact that remitters present a significantly higher level of AML/CTF risk (for the reasons described in the foregoing paragraphs) implies that the AML/CTF and Sanctions Teams at the banks spend a great deal of effort in mitigating these risks. One bank indicates that its retail AML/CTF and Sanctions Team devotes a disproportionately great amount of time on remitters as compared to the overall retail customers.

Remitters form 0.00001% (or 1/100,000) of the retail customers of that bank. According to the bank, its retail team has devoted over 50% of its time dealing with remitters over a 12-month period. While recognising the services provided by the remitters, the cost of compliance is disproportionate not only to the number of customers but also to the revenue generated for the bank against its services to the remitters.

Remitters require the bank to incur a high level of day-to-day operational costs in managing AML/CTF compliance. Given the high-risk nature of the industry, they also signify a very high potential cost. The potential costs include fines that banks may incur should an ML/TF transaction not be detected, though these are not limited to fines only. They may include the possibility of reputation damage and additional compliance costs resulting from the undertakings given to a regulator because of a breach. All this can have flow-on effects.

As mentioned above, the correspondent banks have their own AML/CTF requirements. If they learn, through their own due diligence process or through the media that regulatory action has been taken against a bank or regulatory action has been taken against its customers, it will be entirely the correspondent bank's discretion to continue or discontinue its services to the host bank. This naturally has an adverse effect on the relationship between the two banks.

All banks rely heavily on their internal operating and governance processes (in relation to AML/ CTF and Sanctions Risk Management and compliance) in the national and international market. These processes enable them to participate in the network of global banks that facilitate international funds transfers for its wider customer base. There is a need for the identification of customer segments that may impact these processes adversely.

6.0 The Special Position of Somalia's Remittance Industry

The Somali money remittance business has its own special characteristics. The country is one of the poorest in the world and has for many years survived internal conflicts. There is no stable and competent government in Somalia and no formal banking system.

These factors have led to large-scale immigration. It is estimated that out of an approximate population of twelve million Somalis, two million live abroad. The historical migration of Somalis out of Africa is significantly related to the development of money transfer arrangements. These started from Franco Valuta system, went through High Frequency Radio Services, and culminated in the current branded Somali remittance companies.

Today, there are no effective banking and regulatory financial institutions to provide services required individually and commercially in Somalia. Furthermore, internal and external investment has reduced exceptionally due to multiple risk factors. However, all is not lost and the expansion of the traditional 'Hawala' services offered by remittance companies for over four decades has enabled them to act not only as money-transfer agents but also as conduits for trade and as quasi-banks.

During transfers, the agent faxes, e-mails or uploads the information which comprises the amount, the sender, the recipient, and the instructions as to where to deliver and the details of the clearinghouse. The clearinghouse contacts the agent closest to where the recipient lives and delivers the cash in U.S. Dollars completing the transaction.

The maintenance of the money transfer process by the Somali Remittance Companies (SRCs) is pretty cumbersome.[v] To outsiders, it may appear as a simple process of transferring value from A to B, while to others it may look like a murky system where the money goes through several hands under the table and the messages are relayed orally without leaving any trace. In fact, it is a very sophisticated business which overcomes day-in day-out technical, regulatory, security, cultural, institutional, logistic and managerial challenges in an environment which is anything but hospitable.

6.1 The Somali Remittance Process and Technicalities

Each remittance company has agents in various countries throughout the world. The process of remitting funds is like this; a sender contacts an agent of the remittance company

in the country where he/she resides, presents the cash they want to remit, pays the fees, and supplies information of the recipient. The agent deposits the cash in a local bank account to transfer to the company bank account in Dubai. At the same time the agent collects the details of the transaction including the amount, the sender, the recipient and instructions as to where to deliver. The company contacts the agent closest to where the recipient lives and delivers the cash in U.S. dollars and the transaction is complete.

6.1.1 Information Flow Stages

The information flow consists of seven stages

i. Receiving information from the sender including personal details, identity, amount, and destination
ii. Transmitting information electronically
iii. Organising, sorting, and filtering information at a central processing unit
iv. Notifying the paying agent and the beneficiary of value
v. Taking personal details and the identity of the beneficiary
vi. Informing the sender and/or the sending agent of the payment made, and
vii. Keeping and updating the records.


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6.1.2 Value Flow Stages

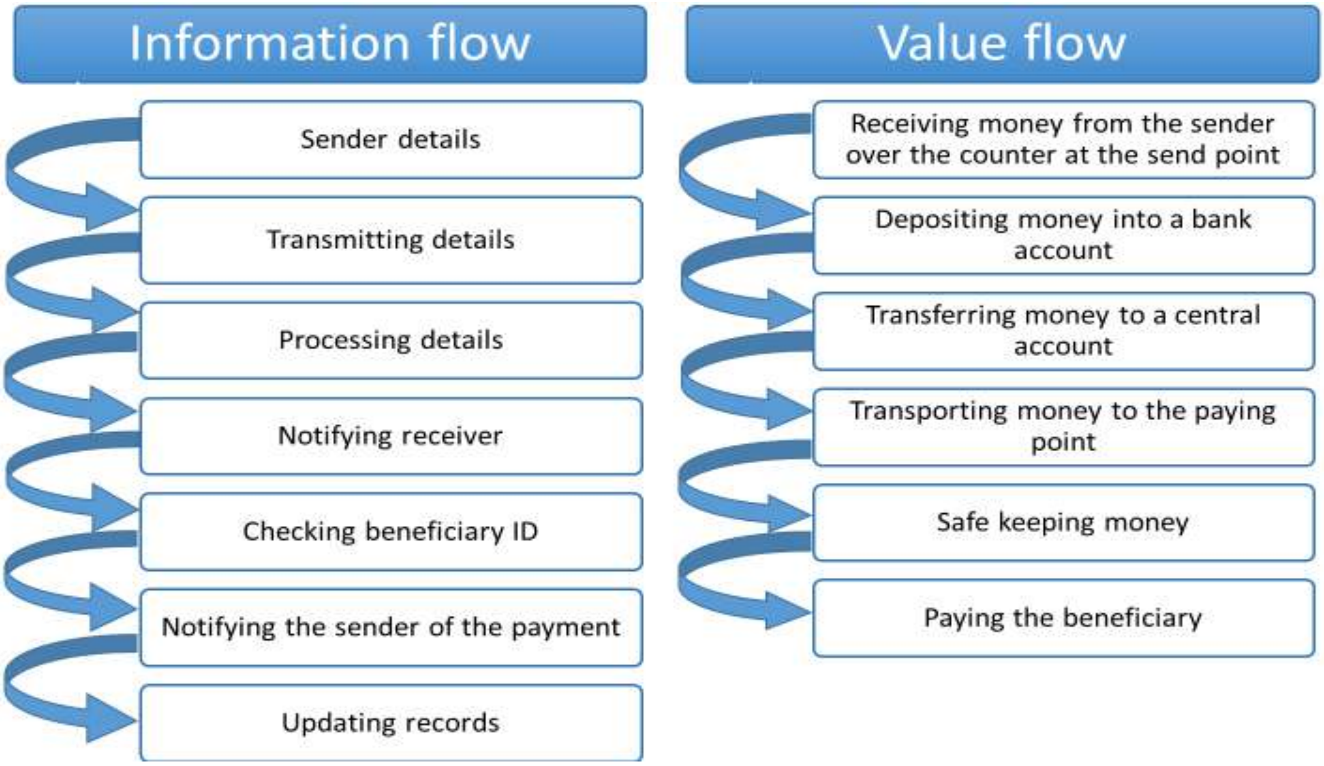
This process consists of six stages

i. Receiving money from the sender over the counter at the sending point
ii. Depositing money into a bank account
iii. Transferring money to a central account
iv. Transporting money to the payment point
v. Safe-keeping of money, and
vi. Making payment to the beneficiary

6.1.3 Technicalities

The process involves several technicalities including:

Cultural –There are three elements prominent in the Somali culture that feature the information flow process. These include trust, privacy and tribal or clan identity. Somalis are generally trustworthy people who believe in the sanctity of private life. Asking for personal information beyond what they consider to be necessary in any transaction or relationship is interpreted as questioning one's integrity – an act of offense in the Somali cultural milieu. Hence, SRC agents have to do something convincing to persuade a customer to provide his or her personal details or identity. They must deal with the question like, do you know me?



The remittance process consists basically of two flows: an information flow and a value flow, each having its own challenges.

Why do you need my address or ID?

On the other hand, tribal or clan identity is a very useful aspect of Somali culture in this process. Every individual has a unique set of lineal names. Each name in the line is like a chromosome in a DNA helix. Thus, one's tribal identity is like a biological tag, which people are willing to reveal. This makes it easy to identify and pay beneficiaries in places where there are neither addresses nor IDs.

Regulatory – Regulations require Know Your Customer (KYC) at both sending and payment points. Other rules govern the flow of information across borders and the revelation of personal information to the third party. The law has also prescribed a period for which the data is kept and stored before it can be destroyed. Compliance with these regulations is neither easy nor cheap.

Nevertheless, this is a process to which SRCs are by and large committed to. Apart from the legal requirement, KYC and record keeping are essential in the remittance business for customer service, accounting, settlement and protection against fraud.

Managerial – The management of hundreds of thousands of transactions and the maintenance of advanced software and hardware systems are challenges which all SRCs have to contend with. All of them engage IT engineers in one form or another. Some of them have their own IT departments.

Managing to pay $100 sent from Minnesota today to someone in a small village in the middle of nowhere in Somalia tomorrow is quite challenging. Getting money from where it is collected or in surplus to where it is needed on time worldwide is not an easy task.

It requires a sophisticated logistic operation, especially in a country like Somalia, where there are no banks and the infrastructure is extremely poor.

Managing Accounts **–** Exchange rates and foreign currency, working towards minimising losses and maximising returns, are some of the challenges SRCs face on daily basis. This is quite similar to the situation in the money markets in New York.

Security **–** Like all financial businesses, security is the major concern for SRCs. It is a challenge they have to face from the receiving stage to that of making the payment. This is a serious problem particularly in Somalia where government authority is either weak or non-existent in large areas.

The SRCs have been very resourceful in minimising this risk by limiting the physical transportation of cash around. This is achieved by operating as banks, whereby local beneficiaries are paid through the money received from local traders. The latter want to be paid in a major commercial centre or in another country, where they can import or buy their stock.

There are of course occasions when one location has more cash than it needs, while another location needs more to fulfil its obligation to pay customers. For situations like these, cash has to be transported and so the remittance companies resort to armed escorts.

Traditions also play a major role in providing protection. That is because the tribe provides a sort of insurance cover to its members in need, who are in turn expected to pay their dues by helping other members in need.

Institutional **–** Access to banking services is essential to the transfer of value. Before 9/11 terror attacks, this was not a problem. Today, however, it has become the greatest challenge which SRCs face. The closure of Barakat and the allegation by the media and in political circles, that the so-called Hawalas assist or are vulnerable to terrorists moving money around, has given an unwarranted bad image to the industry.

This had the unfortunate effect of scaring off banks which, perhaps, do not want to earn a bad name by association. It has now become extremely difficult for the SRC to open a new account and, while it is even more difficult to survive as one.

Technology – The remittance business, like other finance businesses, is highly indebted to technology. In the beginning, the information is mainly handled manually. However, as the transactions grow, the application of modern information and telecommunication technology become imperative.

This has evolved over time from reliance on radio communication, fax, telephone, internet, use of simple spread sheets and databases to sophisticated platforms. In a way, the SRCs have been the driving force in ushering the information age into Somalia.

Maintaining up to date accounts, keeping track of transfers, monitoring foreign exchange and money markets, and affecting transfers securely and conveniently are all essentials to the flow of value and require the adoption of modern technology. This has been embraced to a lesser or greater extent by SRCs which are usually keen on adopting new technology.

The SRCs do not operate in isolation. They work in an environment in which there are many actors and elements that have a bearing on all aspects of their activities directly or indirectly. These include:

- Regulators
- Financial institutions
- Lawmakers
- Academics
- The public
- Technology
- National and local authorities
- Law enforcement agencies
- International and regional organisations
- Local markets and competitors
- Global markets and competitors
- The media
- Terrorism

These environmental factors present opportunities as well as threats which SRCs must deal with, guard against or take advantage of. The following paragraphs highlight some of the threats and opportunities posed by the environmental factors:

7.0 Threats and Opportunities

7.1 Threats

Financial Institutions **–** The most immediate threat is posed by the reluctance of the banks to provide banking facilities to SRCs, not because of anything wrong they have done, but because of poor perception. Unfortunately, SRCs cannot operate without banks.

Regulations **–** In some of the countries where there are Somali communities, regulations allow only banks to carry out money transfer. Others require significant capital investment or deposits, which are beyond the means of SRCs, or which cannot be justified economically given the size of the market. Communities in these countries or states face the risk of being excluded from SRC services. The diversity and fragmentation of the regulations within the United States and in the European Union, where every state and every country has its own regulations, present constant difficulties to SRCs. Another challenge comes from the published list of blacklisted individuals.

The only information provided is their names. By and large, these are Muslim names and databases, which incorporate such lists sometimes holding up 20-30% of the transactions because of names matching. [vi] The net result of these regulatory hurdles is the exclusion of some Somali communities who desperately need SRC services.

Law Enforcement – The closure of any SRC operation like Barakat, have a devastating effect on the industry. It is, therefore, important to ensure that any legal action taken is based on established facts and is proportionate to the committed crime.

Real or perceived, terrorism presents a threat to SRCs. First, the Somali community which they serve is just as likely to fall victim of terrorist atrocities as any of the other communities in the countries in which they reside. Second, every terrorist action tends to result in tighter regulations for the industry. Third, many politicians and opinion makers, instead of focusing on the causes of terrorism to deal with, find it easier to talk about the funding of terrorism in a way that implicates remittance services.

Global Competitors – Ironically, the SRCs had a safe haven in an unsafe Somalia where international money transfer operators used to consider a no-go area due to perceived risk, weak government, and poor infrastructure. Things have changed now, and the substitute to Western Union has created a presence in Somalia having a share of 1-2 billion US Dollar market. With their worldwide network, financial muscle, technology and great experience in the development of new markets, they pose a real threat to SRCs. International banks are also likely to set up branches and will be competing with SRCs at least for the international trade business.

7.2 Opportunities

Global Markets – The vibrant global and regional markets, especially the Eastern Africa region, present a great opportunity for SRCs. So far, SRCs have targeted just the Somali market. With a little more focus on the strategically located neighbouring countries such as Kenya, Ethiopia, Djibouti, Eritrea, and northern Africa with large Somali population, there is great potential in expanding the market base.

Exclusive focus on Somali market is characterised by the developments which are likely to render it unsustainable. The Somali market is limited and is probably heading towards its peak in the next few years. With a high cost of compliance, new regulations and the required formalization of operations maintaining profit margins (which must be spread out over a greater number of transactions), it is imperative that transactions be spread across the borders of Somalia in the new regional markets. In addition, the entrance of international money transfer operators and banks compounded by a steady rise in the costs and commission rates have further heightened competition in the industry. This is likely to reduce SRCs' share of the Somali market, which further calls for the need to expand the market sources across Somalia. ***Banking –*** In the absence of traditional banking, Somalia presents a great opportunity for SRCs to convert into proper banks, taking deposits and giving loans. It is true that the necessary banking regulations are not the same everywhere, which is why SRCs must lobby hard to ensure their enactment.

Technology – This is the future, which will either make or break the SRCs. The adoption of new transfer technologies is crucial for SRCs to:

- Improve services
- Reduce operating cost, and
- Go global and compete effectively with international operators

One of the main comparative advantages of international money transfer companies is technology which allows them to:

- Establish a global network of agents
- Pay in real time
- Accept credit and debit card payments
- Process online payments
- Pay into customers' mobiles or bank accounts
- Issue and pay by debit cards which can be cashed at ATMs
- Text-message customers
- Carry out instant analysis and reporting
- Comply with regulations.

8.0 Recommendations

A government industry working group should be established to develop options for strengthening regulatory oversight of remitters, including a registration/licensing power and the penalty regimes.

The Somalia Financial Reporting Centre should then be allowed to:

- De-register remitters that are not conducting remittance activities (as evidenced by a lack of reporting or other relevant activity).
- Ban individuals from involvement in the management or business of a remitter based on a demonstrated lack of suitability or fitness.
- Publish refusals and notices detailing the circumstances of cancellation of a remitter's registration.
- Adopt the FATF 40 Recommendations on money laundering and the FATF 8 Special Recommendations against terrorist financing.
- Create awareness on emerging trends, anticipated challenges and opportunities for the remittance industry.

The preferred approach to address the ML/TF risks posed by remitters is to enhance regulation and give the Somalia Financial Reporting Centre more powers to control the registration/licensing of remitters.

In addition, the Somalia Financial Reporting Centre and the regulatory authorities shall consider the introduction of:

- Tiered licensing, with categories of registration/licenses based on the nature and scale of a remitter's business activities and the introduction of caps in the amounts that can be transferred under each category of registration/license.

- Fit and proper person tests and examines the probity and suitability of all key personnel, such as directors, managers, beneficial owners, and any other persons who direct or control the business.
- A technical capacity or competency requirement
- Where applicants must demonstrate, understand and meet the regulatory and compliance obligations to operate a remittance business.
- Mandatory AML Financing awareness sessions should be conducted once a year bringing together both enforcement government officers/departments and business actors in the remittance industry. This will help provide platforms for policy changes and briefs, emerging local/regional/global market trends, and related lessons and information.
- Issuing regulatory rules and compliance requirements must be made mandatory upon registration of businesses to ensure that they are operating within stipulated and gazetted regulatory frameworks. This will help inform both running and potential businesses and reduce misinformation.
- Through the institutionalization of an operational Credit Reference Bureau, the regulating body shall be able to provide updated blacklists of clients and businesses. This will protect the industry from multiple defaulters.

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