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Somalia Regulatory Digest

***Too Catastrophic to Fail:* *Part Two* of this Issue looks at the sort of regulatory framework that should strike a careful balance between consumer protection and risk mitigation.**

A New Regulatory Approach

Any new regulatory requirement must be proportionate to the scale of the E-MMT business models without restricting innovation or disrupting consumer choice. Businesses in Somalia are at the forefront of service innovation and best placed to exploit how their services are delivered. It is important for regulations not to get in the way of entrepreneurial risk-taking.

Industry Consultation

Industry consultation is critical to the successful implementation of any new regulations. There should be a formal mechanism of consultation which gives opportunities to businesses to provide feedback. As risks change and the payment innovations mature, the regulatory expectation will also evolve, making a close and continuous engagement with the industry vital for on-going success.

A consultation process also ensures policy coherence, builds confidence and leads to the right regulatory outcome. Regulations that fail to take account of industry concerns, are arbitrary or inappropriately framed against particular businesses, are unlikely to have the right regulatory outcomes.

Waxyaabaha Muhiimka Ah Inta aan Sharci La soo Saarin

Inta aan la soo saarin sharciyo cusub, waxaa aad muhiim u ah in shirakaddaha ganacsiga si wanaagsan loola tashado. Shirkadaha wadanka waa in ay helaan fursad ay jawaab-celin kaga bixin karaan qodobadda sharciga inta aanan sharciga soo bixin. Sidoo kale, waa lagama maarmaan in maamuladda dowlada (sida Bangiga Dhexe iyo wasaaraddaha shaqada ku leh arimaha ganacsiga) ay fahamsan yihiin ujeedada sharciga loo keenaayo inta aan sharciga lagu deg degin.

Waa muhiim in sharciyadda xoogga saaraan sidii loo maamuli lahaa dhiibaatooyinka imaan kara (sida lacagaha oo lumaan ama shirkadaha oo si lama filaan ah dhibaato ugu timaado, kaasoo halis gelin karta macaamiisha iyo dhaqaalaha wadanka).

Ugu dambeyntii, waxaa muhiim ah in sharciyada ay faraha la gelin, ama xayiraad gaar ah ku soo rogin, geedi socodka ganacsiga ee shirkadaha.

Regulatory Digest

The Regulatory Digest focuses on financial services innovation and regulation in Somalia. It is intended to help regulators and businesses understand and identify financial/non-financial risks and implement good practices.

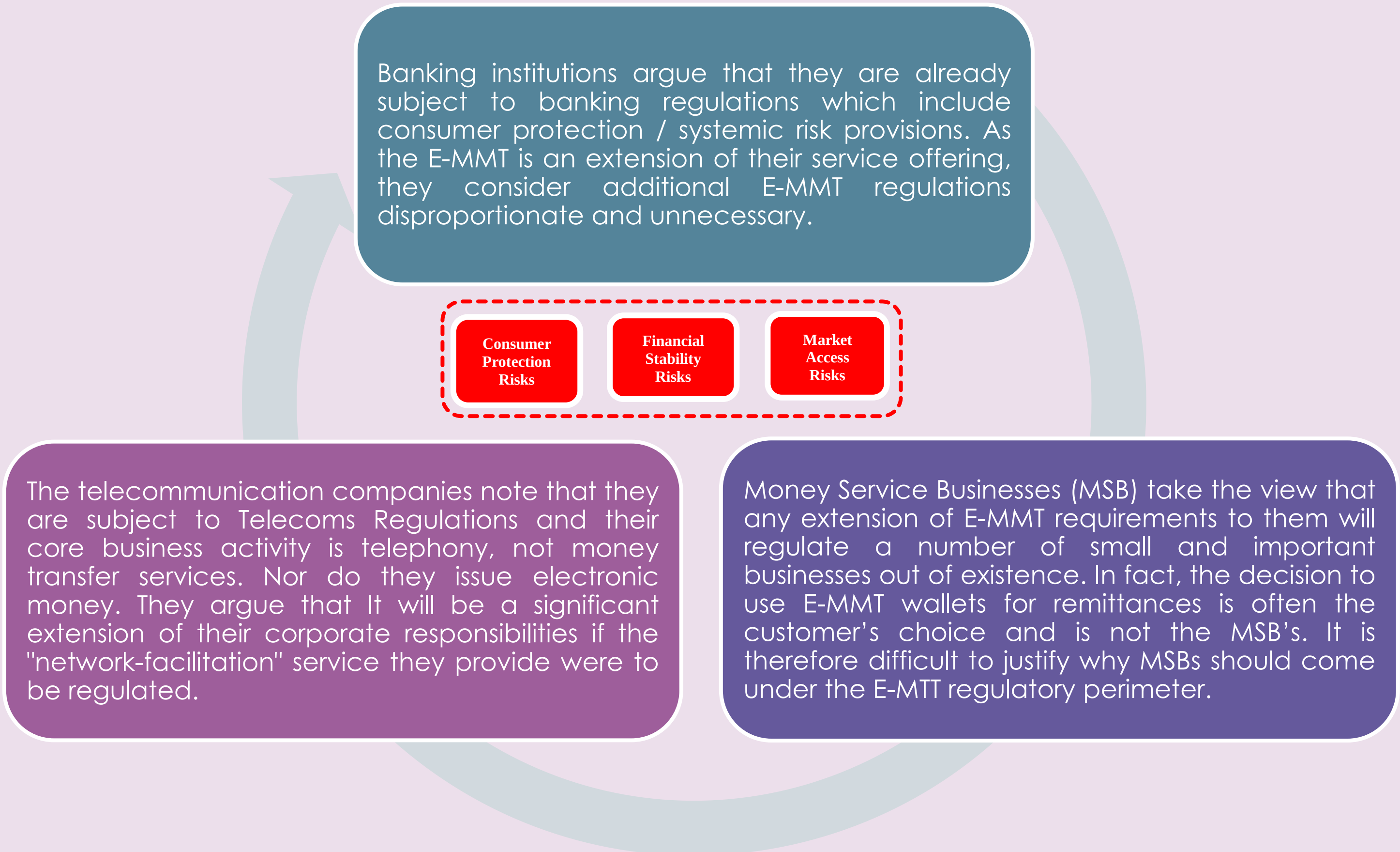
A CIRCULAR ARGUMENT

Whilst the consumer protection and financial stability risks are fairly obvious, the accountability for those risks is not clear-cut. E-MMT operators generally argue that the facilities they provide are optional service extras, and not a core business product.

All E-MMT operators also claim that they merely provide electronic facilitation (i.e. ensuring the funds get from one customer to another within the same network) and comply with all of the regulations that are relevant to their underlying business model.

Doodaha Warwareega ah

Shirkadaha – ama ha ahaadaan Bangiyada, Shirkadaha lacagaha ama shirkadaha teleefoonadda – waxay badankood aaminsanyihiin in ay kasoo baxaan sharciyadda ayaga quseeya. Hadaba, hadii ay sidaas tahay, su’aashu waa: yaa ka mas’uul ah dhibaatooyinka ka imaan kara lacagaha moobiladda?



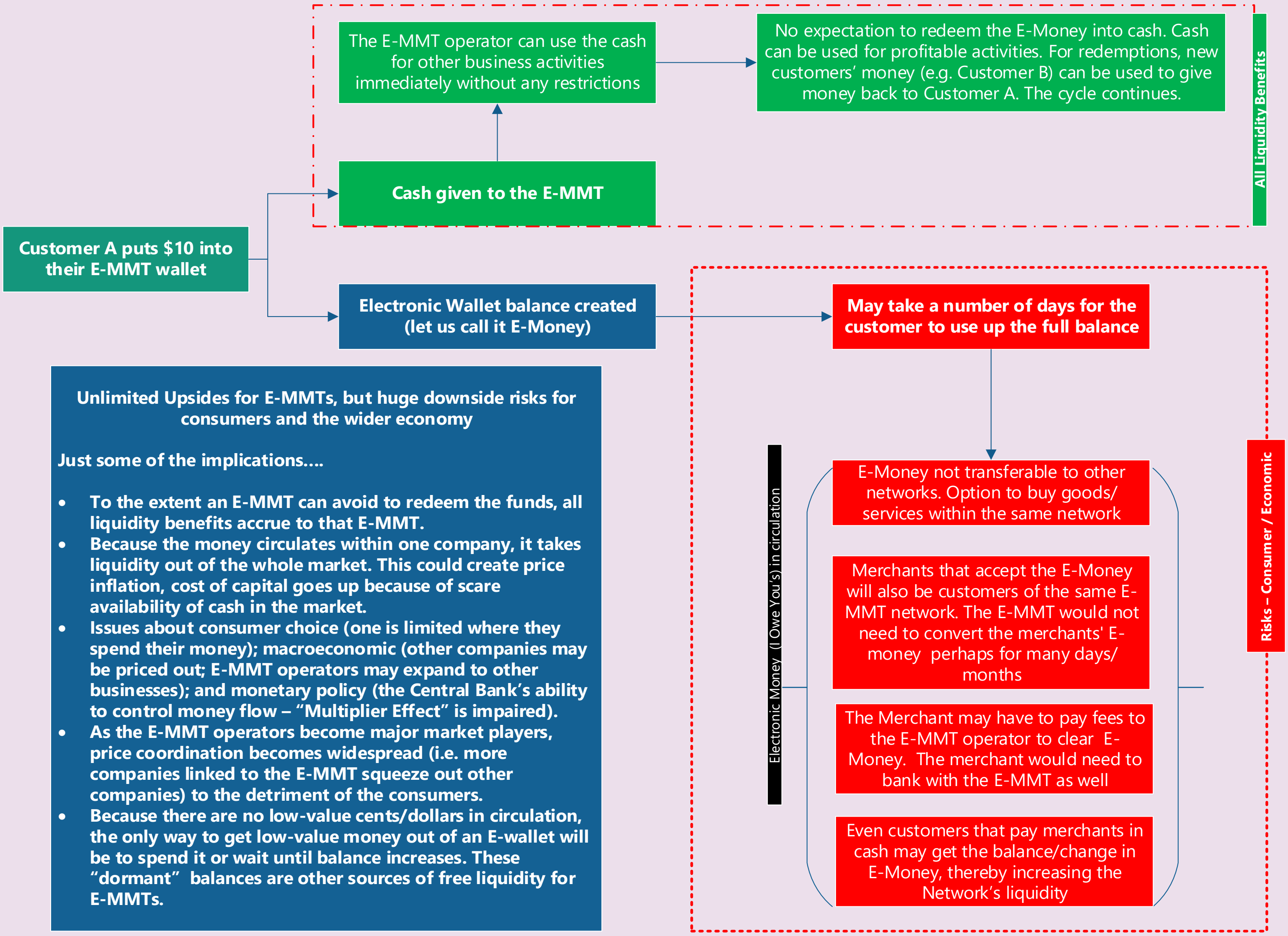
Box 2: A Very Profitable Model

E-MMTs vs. Consumers /Economy: How the Risks are stacked

There is a general assumption that E-MMT operators absorb significant costs in order to be able to facilitate money transfer services (mainly to ensure their network reaches remote communities and disadvantaged consumers). However, when one looks carefully at the economics of the model, it becomes fairly obvious that all of the financial/economic upside accrues to the E-MMT operators, while all downside risks are borne by consumers/economy. In fact, this model has all the financial transformation benefits of a bank, but without the risks and regulations.

Consider this example: Liquidity = Free Cashflow

The Free Liquidity… Aaway Doolarkii..



The Dollar Pull and Customer Push

Somalia's Shilin is almost worthless, so the United States Dollar (USD) is used everywhere. As there are no small value USDs in circulation (the one dollar and cents), using E-MMT becomes a particularly convenient way to settle transactions. Rarely are customers able or want to redeem their small value e-money into hard cash.

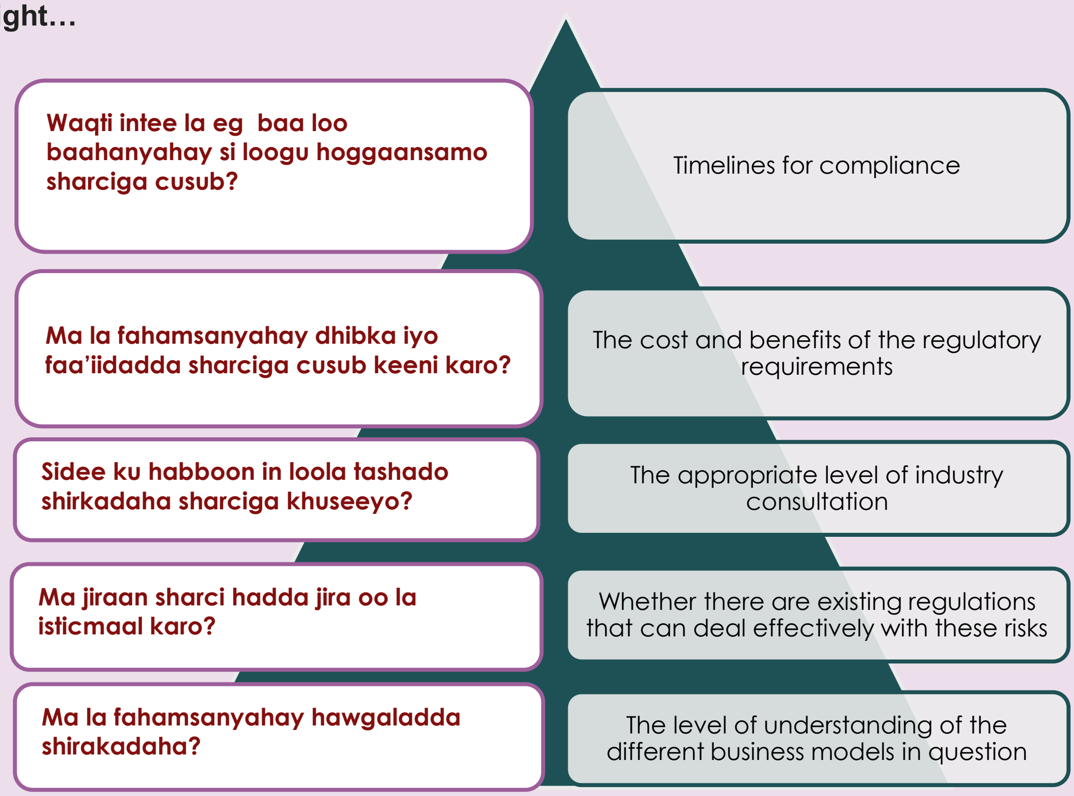
The result: An E-MMT operator is unlikely to be faced with a significant cash redemption problem. Because, no one has a reason to redeem the E-wallet into cash, the free liquidity is almost guaranteed, hence the customer push. This does not of course mean the business model is unethical, but the potential for misusing market dominance is real.

Small unusable (dormant) balances are a significant source of free liquidity for the E-MMT operators and a cost to consumers: The cash cannot be redeemed, nor transferred out to another network's E-MMT wallet.

REGULATORY DEVELOPMENT: A BOTTOM-UP APPROACH

One of the major problems in Somalia is that the regulations put in place by the Central Bank and/or relevant government ministries are done in complete isolation. Moreover, a significant number of the regulations are often copied from elsewhere, with hardly any thought given as to their relevance and/or applicability to Somalia's idiosyncratic commercial landscape. Nor, is there any consultation with the industry before new rules are implemented. A careful approach of industry consultation not only ensures better regulation but also increases the chance of successful implementation.

Getting it right…



Su'aalaha loo baahan yahay in ay sharciyada ka jawaabaan:

1: Maxaa la sameenayaa haddii ay dhibaato ku timaado lacagaha lagu haayo moobiladda? Halkee lacagta laga soo celin karaa haddii ay lunto?

2: Sidee baa loo xalin karaa haddii mid ka mid ah shirkadaha mas'uulka ka ah lacagaha moobiladda lagu isticmaalo dhibaato ku timaado, dhibaatadaasoo qal qal gelin karta dhaqaalaha iyo isku socodka ganacsiga wadanka?

3: Sidee loo furfuri karaa isku socodka lacagaha moobiladda iyo ganacsiga guud ahaan si ay macaamiisha ugu faa'ideeystaan, wadanka dhaqaalahiisana u kobco?

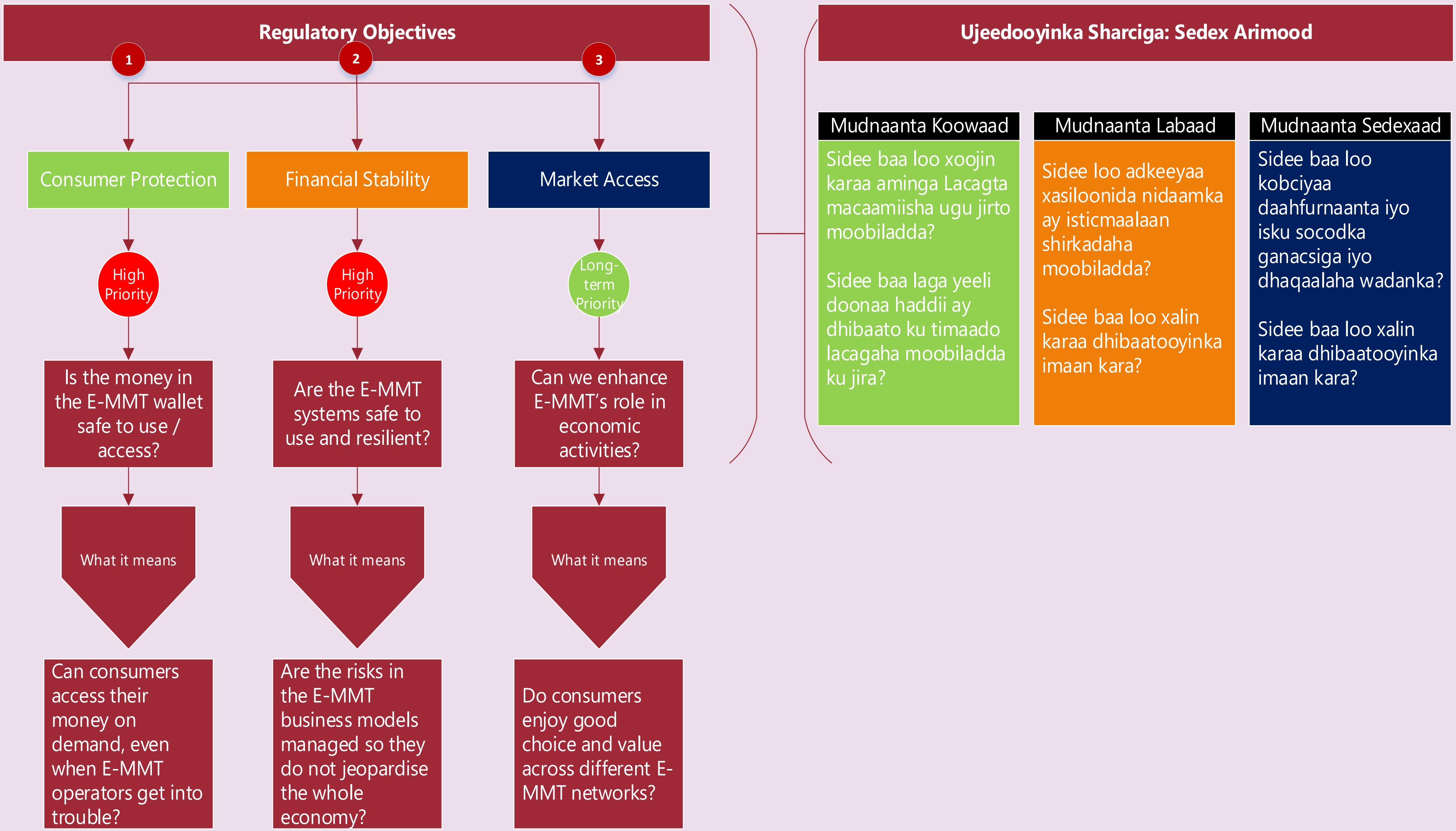
La tasho oo haku deg degin sharciyada cusub

Dhibaatda ugu weeyn wadanka waa sida sharciyadda bangiyadda iyo shirkadaha lacagaha loogu soo koobiyeeyo wadamada kale, iyadoo la tixraaceeynin in ay haboon tahay iyo in kale. Shirkadaha sharciga la rabo in ay meel mariyaan waa in ay fahamsanyhihiin marka hore waxa laga rabo. Sidoo kale, waa in ay dowlada fahamsantahay sida nimdaamka lacagaha uu u shaqeeyo, iyo meelaha loo baahanyahay in uu sharciga wax ka qabto. Dabacan, latashiga ma'ahan in qof walba wixii la rabo loo sameeyo. Waa wada shaqeyn si loo helo waddo loo wada dhan yahay.

THREE REGULATORY PILLARS

The key pillars to an effective E-MMT regulatory approach should be focused on Consumer Protection, Financial Stability and Market Access:

The E-MMT Risk Areas:



Options for Reform

E-MMT systems present unique regulatory challenges. They are vital to supporting some economic activities but the risks they pose is material. The principal purpose of regulating E-MMT operators should therefore focus on making their activities less risky, without curtailing the beneficial element of their service.

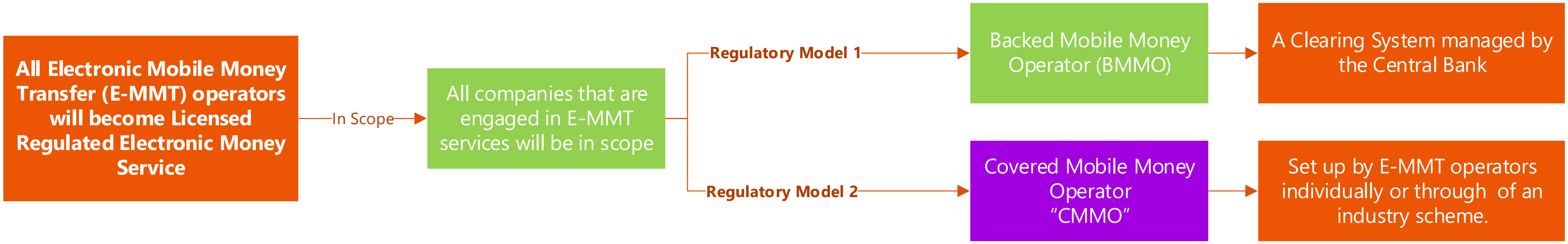
There are two possible options on how this can be:

(1) Through a clearing scheme backed up by the Central Bank: ***Backed Mobile Money Operator (BMMO) model***.
(2) Through a self-insurance scheme which requires all E-MMT operators to become covered operators: ***Covered Mobile Money Operators (CMMO) model.***

Both of the models above would need to be supplemented by the designation of the activity of mobile money transfer as a "Regulated Electronic Money Service" – (REMS). Such a designation is necessary to ensure that all operators, irrespective of whether they are Telecommunication Companies, Financial / Non-Financial Institutions or Money Service Business, are deemed to be engaged in regulated electronic money service as long as they facilitate any kind of mobile money transfer. This addresses the circular debate that was explained in Box 1 (page 2).

The Detail

Once a company is designed as a REMS because of the activities it provides, it can be subject to two regulatory compliance models: A Covered Mobile Money Operator (CMMO) or Backed Mobile Money Operator (BMMO) as shown in the diagram below:



There would need to qualifying criteria for both regulatory models. For example, Companies that choose to be licensed under RM1 will generally be those that can provide inter-network transfer facilities. RM2 could be the choice of operators that may not be ready to open up their network services to others, are small companies or choose the option for other strategic reasons. In both models, the oversight role of the Central Bank will be quite important in continuously assessing compliance as the nature of the operators' risks evolve.

A key principle in both models is liquidity requirement. Under both models, E-MMTs must set aside sufficient liquidity to cover the customers' E-MMT wallet deposits. The liquidity requirements will be proportionate to each E-MTT's risks and reflect whether the E-MMT is /is not a member of a clearing system.

Contingency Planning and Incident Management (CPIM) Requirements

All operators that are licensed as Regulated Electronic Money Service providers would also be subject to the CPIM requirements. The focus here will be on effectiveness of the systems and controls and the contingency planning in place for business continuity.

How the Supervisory Strategy Will Work in Practice

There are five intended outcomes from the regulatory requirements:

- Making sure consumers' money is safe and repayable on demand in hard cash as required;
- Ensuring operators have effective systems in place to deal with problems when things go wrong;
- Opening up the country's financial system so that competition flourishes, enhancing consumers value;
- Making sure owners of the E-MMTs have the incentive to manage risks prudently. If an E-MMT fails, their liquidity money will be at stake; and
- Distribution of E-MMT risks across a wider number of market participants to reduce overall systemic risks.

The High Level Technical Details:

Regulatory Model 1	Regulatory Model 2
Operator becomes a member of a Central Bank-administered Clearing System	Operator becomes a covered entity which self-insures against default / failure
Subject to Contingency Planning and Incident Management Framework	Subject to Contingency Planning and Incident Management Framework
No overall cap on the number of customers that an operator can have	Overall cap on the number of customers that an operator can have
Overall (but higher) cap on how much customers can deposit in an BMMO network wallet	Overall (but lower) cap on how much customers can deposit in a CMMO network wallet
Simplified / Enhanced requirements on customer due diligence (eg. know your customer, on-boarding, etc), depending on customer	Simplified requirements on customer due diligence (eg. know your customer, on-boarding, etc)
Intraday and Overnight Liquidity Requirements	Full Guarantee of Customers' Funds
Requirement for an external audit of the coverage scheme. Audit scope requirements mandated in the regulatory requirements	Requirement for an external audit of the coverage scheme. Audit scope requirements mandated in the regulatory requirements
Central Bank regulatory reporting requirements on payments (customers / volume) and major incident reporting	Central Bank regulatory reporting requirements on payments (customers / volume) and major incident reporting

Consumer | Financial Stability | Market Access

How the Regulatory Models 1 & 2 will address the Consumer, Economic and Financial Stability Risks

The first point is that E-MMTs are not financial intermediaries that are involved in the transformation of customer deposits into customer loans. Their role is purely to facilitate transactions. The liquidity requirements reflect that.

A Central Bank clearing system (RM 1) would open up inter-network payment facilitation which will ultimately benefit consumers and businesses and reduces systemic risks (eg. Customers on Network A will be able to send payments directly to Network B).

A cap on the customer numbers is intended to encourage E-MMTs to clear through the Central Bank as their business scale becomes larger. RM 2 is for small operators and the policy objective is to ensure they do not become far too big outside of the clearing system.

A customer deposit cap ensures that E-MMTs should be used primarily for settling small value transactions. A higher cap (eg. say $400 or Shilin equivalent) under RM 1 and a lower cap (eg. say $150 or Shilin equivalent for RM 2). This also means consumers that need to use much more significant amounts would need to be migrated to other financial products (eg. bank accounts).

Given RM1 operators are already subject to intraday and overnight liquidity (which must be maintained at the Central Bank), the customer deposit guarantee will be a proportion of their overall deposits (eg. 70% guarantee, with the rest covered by the overnight deposits at the Central Bank). However, RM 2 will need to fully guarantee all customer deposits (i.e 100%) liquidity must be held against all customer balances in E-MMT wallets.

Audit requirements (both models) will outsource some of the regulatory heavy lifting to reliable outside parties that will have relevant skills. This will complement, not replace, the Central Bank's oversight role.

The requirement for regulatory reporting will help the Central Bank assess the risks and make the appropriate supervisory interventions / take actions as risks/issues emerge.

LIQUIDITY FACILITIES: HOW THE COVERAGE WILL WORK

The coverage requirement will be in the form of liquidity facilities (e.g. cash, highly liquid securities, backstop liquidity guarantee) that will either be cash or cash equivalents with an active market, and redeemable with no significant loss of value. The liquidity facilities will back up the deposits in the E-MMT wallets.

The coverage requirement will have a stabalising impact, including:

- Management will have the incentive to manage risks prudently. If an E-MMT fails, its customers will not be worse off.
- The Central Bank can use the liquidity requirement as a policy tool to encourage/discourage E-MMT market access and to control systemic risks.
- Distribution of EMMT risks across a wider number of market participants which will reduce the overall systemic risks.
- The coverage requirement will support competition by making it costly for large operators to capture the market (the bigger an E-MMT becomes, the more liquidity it will need to hold against customer deposits which will be very expensive).
- Overall caps on customers and deposit balances will ensure E-MMTs do not become quasi-banks outside of the appropriate regulatory perimeter.

CUSTOMER INFORMATION DATABASE

To enhance transparency, the Central Bank should set up a database which gives details of the status of the licensed BMMO/CMMO operators. The database should also provide consumer advice and the facility to check whether a mobile number's E-MMT wallet is covered (i.e. coverage status facility). This will help educate users of the risks of using larger funds than officially authorised (e.g. a user will know only a certain amount is covered by the deposit guarantee).

CHALLENGES FOR REGULATORS : *The case in Somalia – Key Challenges*

1. ***Expertise**:* Whether the Central Bank of Somalia (CBS) has the necessary experts that can design and operate such important, but complex, regulatory reforms. These reforms need to be in parallel with the currency reforms currently planned in Somalia.
2. ***Trust and Leadership:*** The sort of regulatory oversight envisioned here requires a considerable degree of trust between the CBS and the companies that operate the E-MMT system. An example of this is whether the CBS itself has the right governance, systems and controls in place before it can be entrusted with sensitive commercial information (i.e. information management and confidentiality, safety of assets, right governance framework and effective leadership).
3. ***Effective Engagement:*** The reforms are unlikely to have the intended regulatory outcomes if there is no effective and continuous engagement with the industry and all relevant stakeholders. The reforms will not work if they do not provide a level playing field for all market participants.

Arimaha is hor istaagi kara in la dheqan geliyo soo jeedinta sharciyada kor lagu soo sheegay waxaa ka mid ah:

1. Bangiga dhexe ma heestaa qibradii loo baahnaa ee lagu sameeyn lahaa isbedelkaan muhiimka ah?
2. Sidaa baa loo heli karaa is aamin u dhaxeeya bangiga dhexe iyo shirkadaha wadanka? Sidoo kale, bangiga dhexe ma leeyahay maamul iyo nidaam lagu kalsoonaan karo (sida lacagaha la dhigo, sidii loo hayn lahaa macluumaadka sirta ah ee leeyahiin shirkadaha, hogaan wanaagsan, nidaam daahfuran oo cid walba u siman, iwm)
3. Ma jiraa is faham wax ku ool ah (sida latashiga, aqoonta nidaamka ay u shaqeeyaan shirkadaha, iwm) oo u dhaxeeya bangiga dhexe iyo shirkadaha wadanka?

Hadaan le helin sedexdaan arimood, ma laga yaabo in ay wax hagaagaan.

Looking Ahead...

In Somalia, most of those that use E-MMTs do so out of convenience and necessity: the dollar pull and customer push effect. However, as the use of E-MMTs becomes more business-as-usual, their systemic importance will take on another dimension. It is possible that, in a matter of few years, E-MMTs may become the only electronic means of transferring funds between parties, and that will have huge implications for Somalia's economy and the Shilin reform.

This is also where the opportunities for businesses are most promising. As more disrupters move into the market, the key market participants of today are unlikely to have a lasting monopoly over the E-MMTs, given the indications of the new innovations emerging. Equally, as consumers begin to understand the risks they take with their E-MMT wallets, the free liquidity that is plentiful at the moment could become scarce.

That is why an E-MMT venture on its own is unlikely to be a profitable business model for the long term. It is profitable in Somalia, and of course elsewhere in East Africa, because of either accommodative regulatory policies or, in the case of Somalia, no regulations at all. Properly regulated, E-MMTs may become a costly venture to operate, unless they include other value-adding facilities for which consumers may have to pay a premium.

The fact that no systemic E-MMT operator has failed so far does not mean they are fail-safe. What is certain is that an E-MMT operator failure will not be a costless one. The regulatory approach detailed in this analysis paper, if properly implemented, could mitigate some of the key consumer and financial stability risks (and help E-MMT businesses operate safely) in four main ways:

- Provide a regulatory safety net for millions of (mostly financially unsophisticated and vulnerable) consumers whose livelihoods are in their E-MMT wallets;
- Re-assure consumers that their money is safe which could lead to more business activities transacted across the E-MMT networks, opening up the wider economy;
- Open up the market so that the barriers to entry for new operators are lowered and competition amongst operators is encouraged; and
- Enhance brand recognition: companies that are seen to be regulated and provide good service will reap significant financial benefits.

In the meantime, in Somalia and many other African countries, the E-MMT systemic risk clock continues to tick.