

**ISSUES AND CHALLENGES OF ISLAMIC
MICROFINANCE IN POST-CONFLICT SOMALIA**

BY

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ABSTRACT

The institution of microfinance has been touted as a viable mechanism for poverty reduction in many parts of the developing world for several decades. Moreover, in post-conflict countries, microfinance is expected to play a larger role as an intervention tool for peace building, economic development, rebuilding institutional trust, reconciliation and restoring the lives and dignities of the poor and war-affected people. Somalia is in the wake of a conflict that has lasted for three decades, and the country urgently needs to institutionally rebuild the damaged economic and social infrastructures. A decade ago, the country witnessed the establishment of the first commercial banks that provide Shariah compliant services. The growing financial services, which are still considered a new phenomenon in the country, include microfinancing offered to the poor and low-income people. This research uses the Institutional Economic Theory (IE) and sets out to investigate the current situation of the emerging Islamic microfinance sector in post-conflict Somalia. the aim of the current study is to discover the issues and challenges facing Islamic microfinance and to chart the path forward to enhance and institutionalize the sector. The study designated to use the phenomenological methodology to form descriptive themes regarding the investigated phenomenon. The researcher conducted interviews with 15 respondents from the supply side who considered the key informants in the field of Islamic microfinance in Somalia. The in-depth face-to-face interviews provided rich data that was generated and refined using the NVIVO software. The study found that, although, the security situation in Somalia is still moving towards gaining full stability, the business environment in the country is thriving. The financial system of the country is found to be at the rebuilding stage, and all the 5 commercial banks are offering Islamic microfinance services based on *qard-hasan* and *murabahah* contracts to the low-income people, however, the capacity of the sector and coverage remains very small. Islamic microfinance programs and similar grants are confirmed to be the best intervention to support these war-affected people along with the utilization of zakah and waqf institutions. Moreover, the Islamic microfinance industry in Somalia faces many issues and challenges. The main challenge is the lack of microfinance regulations, lack of supportive environment, poor infrastructures, inadequate funding, low level of education and awareness and several issues related to engagement with the microfinance clients. Moreover, the study discovered several factors that can develop successful Islamic microfinance in Somalia. These factors include providing comprehensive such as savings, insurance and trainings to the low-income population in the country, increasing outreach and affordability and accessibility of Islamic microfinance services and these services should be at the heart of the Somali national policy agenda.

خلاصة البحث

تعتبر مؤسسة التمويل الأصغر لعدة عقود آلية مثلى للحد من الفقر في العديد من دول العالم النامي. بل يلعب التمويل الأصغر المزيد من الأدوار في البلدان الخارجة من الصراع خاصة بجانب الحد من الفقر؛ ومن أمثلة ذلك أنه يعتبر أداة لتفعيل وبناء السلام و مد جسور المصالحة بين أطراف الشعوب المتناحرة ، وآلية للتنمية الاقتصادية والإعمار وإعادة بناء المؤسسات والمساعدة في تحسين حياة الفقراء وخاصة الذين تأثروا بشدة جراء الحرب. يخرج الصومال من صراع أهلي استمر لثلاثة عقود ، والحاجة ماسة لإعادة بناء الهياكل الاقتصادية والجسور الاجتماعية المدمرة. يشهد البلد حاليًا إنشاء بنوك تجارية جديدة تقدم خدمات كالتصويل الأصغر الذي بدأ مؤخرًا لمساعدة الفقراء وذوي الدخل المحدود ، ولكن هذه الخدمات ما تزال تعتبر ظاهرة جديدة في البلاد. تستهدف هذا الأطروحة دراسة الوضع الحالي لقطاع التمويل الأصغر الإسلامي الناشئ في الصومال بناء على نظرية الإقتصاد المؤسسي ، و هدف الباحث هو استكشاف العقبات والتحديات التي تواجه التمويل الأصغر الإسلامي وتحديد الطرق المثلى لتقوية القطاع حتى يكون مؤسسة ناجحة تلعب دورا حيويًا في إعادة بناء الصومال الجديد. استخدمت الدراسة المنهجية الظاهرية لتوفير موضوعات وصفية تتعلق بالتمويل الإسلامي المصغر. أجرى الباحث مقابلات مع 15 شخص في مجال التمويل الأصغر الإسلامي في الصومال، شملت المقابلات مدراء البنوك التجارية و المؤسسات المالية ومسؤولين في الجهاز التنظيمي للبنك المركزي الصومالي وكذلك عدد من المسؤولين الحكوميين بمن فيهم نائب وزير المالية الحالي في الصومال. نتج عن المقابلات وجهًا لوجه والدراسة الميدانية المتعمقة بيانات غنية استحصلت من خلال استعمال برنامج NVIVO. توصلت الدراسة الى أن عدم وجود لوائح لتنظيم عمل التمويل الأصغر يعتبر من التحديات الرئيسية التي تواجه القطاع، وكذلك افتقار العاملين فيه إلى بيئة داعمة ، مع ضعف البنية التحتية ، وعدم كفاية التمويل ، وانخفاض مستوى التعليم. إلى جانب ذلك ، اكتشفت الدراسة العديد من العوامل التي يمكن أن تحقق الطريق إلى الأمام لتعزيز وتطوير التمويل الإسلامي الناجح في الصومال. تشمل هذه العوامل أولاً ، توفير خدمات التمويل الأصغر الشاملة إلى جانب القروض الصغيرة الأساسية مثل توفير حسابات جارية لزيادة مدخرات ذوي الدخل المحدود وتوفير خدمات التأمين وتقديم الدورات التدريبية لهم ، وثانيًا زيادة إيصال هذه الخدمات إلى أقصى عدد ممكن من المستفيدين للقضاء على الفقر ، وتحقيق التنمية الاقتصادية وبناء التكامل الاجتماعي.

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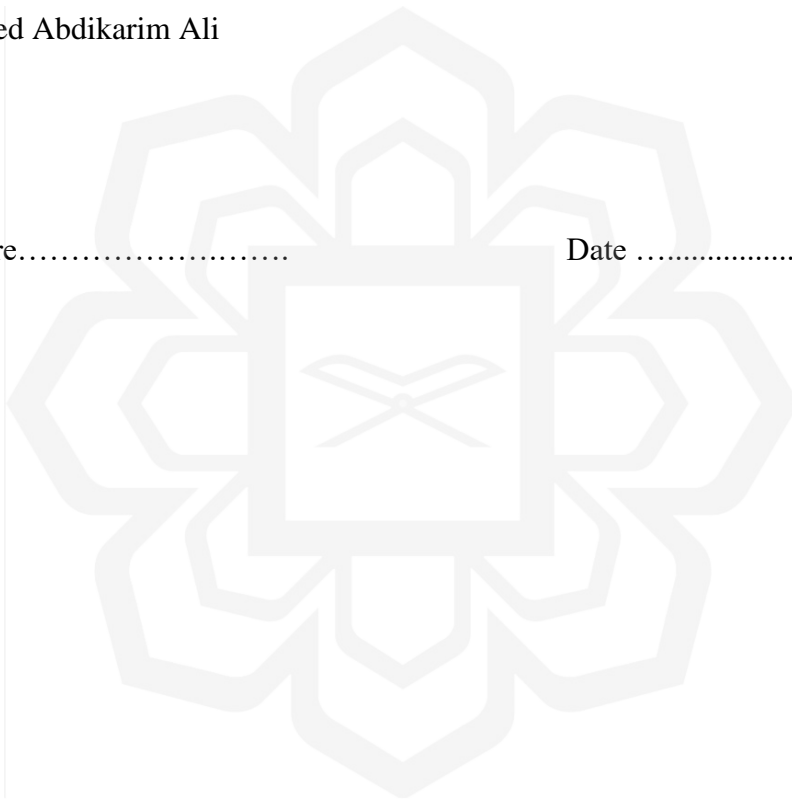
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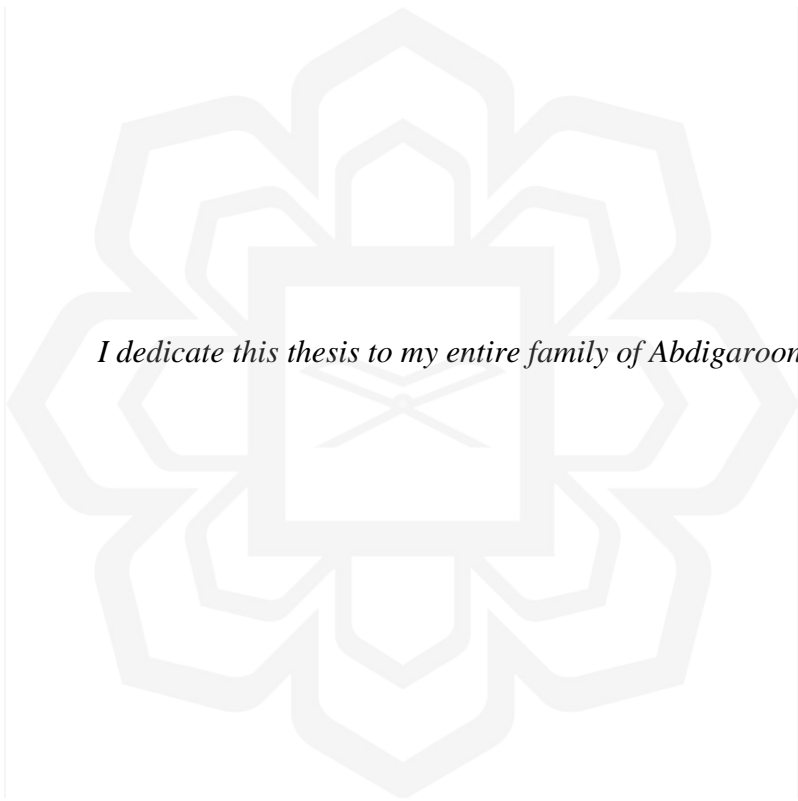
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I dedicate this thesis to my entire family of Abdigaroon

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TABLE OF CONTENTS

Abstract	II
Abstract in Arabic	III
Approval Page.....	IV
Declaration.....	V
Copyright Page.....	VI
Dedication	VII
Acknowledgements.....	VIII
List of Tables	XII
List of Figures	XIII
CHAPTER ONE: INTRODUCTION	1
1.1 Background of the Study	1
1.1.1 Poverty in Somalia	2
1.2 Motivation for the Study	4
1.3 Theoretical & Conceptual Frameworks of the Study	6
1.4 Problem Statement	17
1.5 Research Objectives	20
1.6 Research Questions	21
1.7 Significance of the study	21
1.8 Scope of the study	22
1.9 Structure of the study	23
CHAPTER TWO: OVERVIEW OF ISLAMIC MICROFINANCE.....	24
2.1 Introduction.....	24
2.2 History of Microfinance	24
2.2.1 Grameen Bank	25
2.2.2 Kalanjiam Program.....	26
2.2.3 Village Bank Model	26
2.3 Islamic Microfinance	27
2.4 Salient Features of Islamic Microfinance	28
2.5 Islamic Microfinance Services.....	29
2.5.1 Micro-Lending.....	29
2.5.2 Micro-Savings	29
2.5.3 Micro-Takaful	30
2.6 Islamic Microfinance contracts.....	31
2.6.1 Charity-Based Products	31
2.6.2 Profit-Based Products.....	36
2.7 Islamic Microfinance and Alleviation of Poverty.....	38
2.7.1 Effectiveness of Islamic Microfinance in Alleviating Poverty	40
2.8 Issues in the Islamic Microfinance	43
2.8.1 Market Penetration	43
2.8.2 Lack of Regulation	44
2.8.3 High Transaction Costs	46
2.8.4 Sustainability and Growth of Islamic MFI.....	48
2.8.5 Islamic Microfinance for Muslim Minorities.....	49

2.9	Chapter Summary	50
CHAPTER THREE: MICROFINANCE IN POST-CONFLICT COUNTRIES		52
3.1	Introduction	52
3.2	Understanding Post-Conflict Situation	52
3.3	Microfinance in Post-Conflict Countries	54
3.3.1	Challenges Facing MFIs Operating in Post-Conflict Countries....	56
3.3.2	What is the Suitable Microfinance Intervention Approach?	58
3.3.3	The Institutional Approach of Microfinance.....	61
3.4	Post-Conflict Countries Experiences with Microfinance.....	66
3.4.1	Kosovo.....	67
3.4.2	Bosnia.....	68
3.4.3	Liberia	73
3.4.4	Sierra Leone	76
3.5	Chapter Summary	79
CHAPTER FOUR: MICROFINANCE IN SOMALIA		80
4.1	Introduction	80
4.2	Institutional Settings of Somalia	80
4.2.1	Public Expenditure and International Aid	82
4.2.2	Remittance in Somalia.....	83
4.3	Microfinance in Somalia	83
4.3.1	Microfinance Advantages for Somalia’s Refugees and IDPs	85
4.4	Types of Institutions Offering Microfinance Services in Somalia	88
4.5	The Current Situation of Microfinance in Somalia and Its Issues	89
4.5.1	The Issue of Limited Microfinance Services.....	91
4.5.2	The Issue of Outreach.....	94
4.5.3	The Issue of Inadequate Funding	97
4.5.4	Lack of Supporting Policies and Relevant Guidelines	98
4.6	Research Gap	100
4.7	Chapter Summary	101
CHAPTER FIVE: METHODOLOGY		103
5.1	Introduction	103
5.2	Defining the Research Methodology and Strategy	104
5.2.1	Qualitative Research.....	105
5.2.2	Phenomenology	106
5.3	Data collection	108
5.3.1	Library Research	108
5.3.2	Field Research	109
5.3.3	Sampling, Access, and Setting	110
5.4	Data Analysis Methods	114
5.5	Chapter Summary	115
CHAPTER SIX: DATA ANALYSIS AND FINDINGS		117
6.1	Introduction	117
6.2	The Current State of Islamic microfinance in Somalia.....	117
6.2.1	Improvement of the Security	118
6.2.2	Reopening of Markets	124

6.2.3	Situation of War-affected People	128
6.2.4	Financial Institutions	136
6.3	Challenges.....	146
6.3.1	Lack of Regulations.....	148
6.3.2	Poor Infrastructure.....	155
6.3.3	Inadequate Funding	156
6.3.4	Engagement with Microfinance Clients	161
6.3.5	Education.....	166
6.4	The Way Forward	170
6.4.1	Comprehensive Services	171
6.4.2	Outreach	181
6.4.3	Contribution to Economic Development.....	188
6.4.4	Contribution to Social Interaction	191
6.4.5	Achieving to Poverty Eradication	193
6.5	Findings of the Study	195
6.5.1	The Current State of Islamic Microfinance Activities in Post-Conflict Somalia	197
6.5.2	Islamic Microfinance Challenges in Post-Conflict Somalia	203
6.5.3	The Way Forward for Islamic Microfinance in Somalia.....	208
6.6	Chapter Summary	214
CHAPTER SEVEN: RECOMMENDATIONS AND CONCLUSION.....		215
7.1	Introduction.....	215
7.2	Summary of the Study	215
7.3	Implications and contributions of the study.....	218
7.4	limitations and Suggestions for Future Studies	223
REFERENCES.....		225
APPENDIX A: THE INTERVIEW QUESTIONS		239
APPENDIX B: REQUEST FOR INTERVIEW SESSION.....		241

LIST OF TABLES

Table 2.1: Types of Islamic Microfinance Services	30
Table 5.1: List of the Respondents and Their Positions and Brief Profiles	113
Table 6.2: CBS Working Report	141
Table 7.1: List of the Study Themes	196
Table 7.2: Developed for the Study	222



LIST OF FIGURES

Figure 1.1: Self-constructed Conceptual Framework	17
Figure 6.1: Main Themes and Sub-themes of the Islamic Microfinance in Post-conflict Somalia	118
Figure 6.2: Model for Current State of microfinance in Post-conflict Somalia with its Sub-themes	118
Figure 6.3: Model for Security Situation in Somalia	120
Figure 6.4: Reopening of Market in Post-conflict Somalia	125
Figure 6.5: Situation of War-affected People in Post-conflict Somalia	129
Figure 6.6: The state of Financial Institutions and Islamic Microfinance in Post-conflict Somalia	137
Figure 6.7: Geographical Distribution of Phase one CBS Microfinance Project	141
Figure 6.8: Issues & Challenges Facing Islamic Microfinance Sector in Post-conflict Somalia	147
Figure 6.9: The issue of Lack of Regulation and Its Dimensions	149
Figure 6.10: Issues of Poor Infrastructure to the success of Islamic microfinance in Somalia	155
Figure 6.11: The Issue of Inadequate Funding	158
Figure 6.12: Issues Related to Engagement with Islamic Microfinance Clients in Somalia	161
Figure 6.13: The Issues Related with Lack of Proper Education among Low-Income People in Somalia	167
Figure 6.14: The Way Forward for Islamic Microfinance Sector in Somalia	171
Figure 6.15: The Need for Comprehensive Islamic Microfinance Services in Somalia	172
Figure 6.16: The Need for Islamic Microfinance in Somalia to Ensure Outreach	181
Figure 6.17: Contribution of Islamic microfinance in the Economic Development of Somalia	189
Figure 6.18: The Role of Islamic Microfinance to Enhance Social Interaction	192

Figure 6.19: The Role of Islamic microfinance to Eradicate Poverty in Somalia 193

Figure 6.20: Self-constructed summary of the important findings 214



CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

With the increasing concern regarding the wide spread reach of poverty, many countries have put emphasis on microfinance. Broadly defined, microfinance is a comprehensive financial service that distributes small loans to individual entrepreneurs or groups to stimulate business activities that generate profits for the low-income people (Ledgerwood, Earne, & Nelson, 2013). In fact, microfinance is regarded as a well-established poverty alleviation instrument, where poor households can borrow, save, invest and protect their wealth and families. It is considered a viable tool to enhance the living standard and economic wellbeing of the poor in general (Abbas & Shirazi, 2015). Microfinance now is almost fifty-year-old industry that started in the mid-1970s with a series of a few lending groups in the villages of Bangladesh, associated with Grameen bank and other microfinance institutions (MFIs). Not much later, microfinance was globally embraced (Haldar & Stiglitz, 2016).

Even though, Grameen bank was introduced in an overwhelming Muslim majority country (i.e., Bangladesh), its model being non-compliant with the *Shari'ah* has led many Muslims to refrain from subscribing to its services. This resistance was prominent even in the birthplace of Grameen bank itself in Bangladesh and in other Muslim countries. Although MFIs can offer products that are in line with Islamic principles to serve poor Muslims, due to their high administration fees, high costs, and lack of regulation, they tend to compete with and emulate the conventional MFIs (Abdul Rahman, Muhammad, Ahmed, & Amin, 2016).

Islamic microfinance (IMF) makes up a small proportion of the Islamic financial market, (about 1 percent), although it was forecasted that the industry will grow at a double-digit annual growth of almost 20 percent between 2014 and 2018 (Center for Financial Inclusion, 2016; IFSB, 2017; Reuters, 2017). However, less than 14 percent of the Global Muslim population uses banks, and more than 42% of the total Muslims in the world live on less than \$2 per day (Haneef, Pramanik, Mohammed, Bin Amin, & Muhammad, 2015). To ensure financial inclusion and sizable outreach for Islamic microfinance institutions (Islamic MFIs) the policy makers in the Muslim countries must provide and enhance the microfinance regulations that will suit the needs of the poor citizens.

Although Islamic microfinance is regarded as a viable solution for poverty alleviation in the Muslim world, however, the industry still needs a lot of efforts to significantly improve the lives of Muslims. Moreover, it has been suggested that there is a need for increased access to ensure the sustainability of MFIs. However, these institutions face several challenges such as low market penetration, lack of funds, high administrative costs (Abdul-Razak & Amin, 2013; Shaikh, 2017), and loan repayment issues among others (Kazemian et al., 2016).

This study will explore Islamic microfinance services in post-conflict Somalia along with its issues and challenges. The next section discusses the socio-economic background of Somalia and briefly highlights key features of the chosen institutional setting.

1.1.1 Poverty in Somalia

Somalia is a Muslim country located in East Africa and regarded as the post-conflict nation coming out of more than two decades of civil war and absence of a centralized

government. Besides the conflict, the country suffers from severe drought that puts the lives of millions in danger, increasing the number of refugees and Internally Displaced People (IDPs) causing a devastating poverty. Between the years 2015-2017 the country was hit by the latest drought which caused a famine, affected more than 6.2 million people, and increased the number of IDPs to more than 2.1 million people (UNOCHA, 2017).

Prior to this, the country experienced the worst famine of the 21st century in 2011-12, the absence of an urgent response from the government and delay of international aid resulted in the loss of more than 258,000 lives (Maxwell et al., 2016). Additionally, more than 900,000 refugees are reportedly migrants in neighbouring countries such as Yemen and Kenya (UNHCR, 2017).

Because of the civil war and unrest, poverty in Somalia is alarming. According to the World Bank report, almost half of the country's population of about 12 million live on less than \$1.90 per day, which is below the international poverty line. However, about one third of the people 35.4 percent receive remittances are from this category. As a result of this extreme poverty, there is a high level of inequality, and it is driven by the different causes of poverty in different locations. For example, the capital city of Mogadishu, the inequality is close to 60 percent, while in other urban and rural areas the percentage is slight lower at 40 percent or 50 percent. However, the highest percentage of inequality is witnessed among the IDP settlements of about 70 percent (World Bank, 2017). These unfortunate people strive to restore their livelihood and economic self-reliance in absence of financial services that can contribute into their socio-economic growth and a better well-being.

1.2 MOTIVATION FOR THE STUDY

Microfinance has proven to be an effective mechanism for poverty alleviation and an effective reconstructive tool in many developing countries, especially post-conflict countries such as Bosnia and Herzegovina, Kosovo, Cambodia, Lebanon, Liberia, Angola, Mozambique, and Rwanda (Djankov, McLiesh, & Ramalho, 2006; King, 2008; Manalo, 2003; Samuels, 2006; Wijesiri & Meoli, 2015). Some of the areas that can be tackled using microfinance are: microenterprise development, household reconstruction, social capital enhancement, ethnic conflict resolution, housing development, refugee resettlement, and financial services reconstruction (Jacobson, 1999; King, 2008; Wilson, 2002).

Having previously discussed the situation of Somalia, a country surrounded by poverty and political instability, there is a need to intensify efforts to eradicate poverty and restore the living standards of the populace. However, even with the unfavourable environment, entrepreneurs have been able to adapt and cope with the unpleasant situation by venturing into different business sectors, such as international trade, remittances or money transfer services (*hawalah*), telecommunications, and transport. Moreover, the Small and Medium Enterprises (SMEs) in the country constitute the largest part of the private sector. Most of these enterprises are indigenously owned and run by families. Most of the SMEs are less than five years old and rarely grow beyond medium scale due to lack of efficient markets and financing. According to Siyad, (2013), the accessibility to microfinance services is considered difficult for small businesses due to the heavy requirements imposed by most of the existing financial institutions in the county.

According to Isak Sagal, (2015), although the Somali youth make up the majority of the society, the rate of unemployment among them is more than 67 percent.

She believes that this is due to the absence of basic economic infrastructure, lack of any clear and promising policies and lack of social services. Moreover, based on the Hall, (2016) report, Somali women are active in the local economy and they run almost 60 percent of the businesses in the informal sector of the country. However, the major challenge they face is the lack of access to financial services. The report suggests the microfinance providers to focus direct their services to those active women in order to help them achieve financial independence. Another report from the World Bank recommends the governments to focus on expanding non-banking financial institutions including microfinance to provide small scale and microcredit to boost savings mobilization and enhance the lives of the poor in the country (World Bank 2015).

The president of Somalia Mr. Mohamed Abdullah Farmajo while speaking at the Special Summit held on the 25th of March 2017 in Nairobi to devising lasting solutions for Somali refugees said:

“We have to launch an investment scheme for resettlement refugees and Internally Displaced Persons (IDPs) so that they can restart and sustain their livelihood. Many are farmers and pastoralists, but most have the inherent entrepreneurial spirit of Somalis and they would excel in small business. All they would need is small investment and faith in their God given talent. This required investment could be in the form of **microfinancing** and other incentives. Together with the private sector and development partners we are confident that such schemes could become a catalyst of a durable solution for refugees and IDPs”.

Indeed, microfinance is currently a new phenomenon in Somalia and this research will explore the phenomenon to gain a complete understanding of the issues and challenges facing microfinance practices in post-conflict Somalia. The study aims to propose profound suggestions and recommendations for the way forward based on the best practices of Shari’ah compliant microfinance that can be implemented to help establishing successful Islamic MFIs in Somalia.

1.3 THEORETICAL & CONCEPTUAL FRAMEWORKS OF THE STUDY

The current study employs the theory of Institutional Economics (IE). IE places the role and evolution of institutions at the center of its analysis and observation (Hodgson, 2004). The theory addresses all levels of institutions from firms to states. According to Hodgson, 2004, at the core of its analysis, IE focuses on the interrelation between actors that shape the addressed institution, while at the same time being shaped by other institutions or environments. This refers to relations to relations such as between economy and the legal system or between culture, values and the institutional design of businesses. While basic elements and terms of institutionalism were defined in the beginning of the twentieth century by Hamilton in (1919), as stated by Hodgson, (2004), even earlier advocates of different economic trends can be considered to already have integrated institutional perspective into their work, ranging from Karl Marx to Adam Smith (Hodgson, 2004).

Towards the last quarter of the last century, specifically in the 1970s New Institutional Economics (NEI) emerged as a different of Institutional Economics, which took into consideration different components of neoclassical theory and integrating more interdisciplinary approach to traditional Institutional Economics (Klein, 1998). interdisciplinary enterprise of NIE combines economics, law, organization theory, political science, sociology and anthropology to understand the institutions of social, commercial and political infrastructures. The aim of NIE is to describe what institutions are, how they grow, what purpose they serve, how they change and how they should be reformed if the reform is possible (Klein, 1998).

The wider field of NIE can be distinguished into two main categories. The first category is institutional environment which discusses the external factors, and institutional arrangements which focuses on the external factors shaping institutions.

The institutional environment includes all aspects that design the framework within which human action takes place, and vice versa. While the assessment of the institutional environment like at the interrelation between institution and external factor. The analysis of institutional arrangements focuses on processes that are internal to the formation and evolution of institutions (Klein, 1998).

Moreover, NIE mechanisms are used to define and explain the issues pertaining to development, because to comprehensively understand the institutional economic change, we have to first examine the changing initial conditions confronting diverse groups of individuals or institutions (North, 1993). For example, in post-conflict contexts, the theory requires a deeper understanding of different environmental challenges that influence the characteristics of institutions and their evolution.

Furthermore, lately the relevance of NIE and development policy and research is prominent through the emerging understanding that two categories of institutions are a prerequisite for development based on a market economy: institutions that lead private sector development and boost economic growth and public institutions that protect private property and persons rather than expropriate and subjugate them (Ménard & Shirley, 2005).

Recently this approach has gathered even high attention far beyond the academic community, when Acemoglu and Robinson concluded in their popular book *Why Nations Fail* that development is about “institutions, institutions, institutions” (Acemoglu & Robinson, 2012). They conclude that ‘Nations fail today because their extractive economic institutions do not create the incentives needed for people to save, invest, and innovate. The authors have defined extractive economic as the institutions that allow the elite to rule over and exploit others, extracting wealth from those who are not in the elite or have no access to political influence (Acemoglu & Robinson, 2012).

In the field of microfinance, a large body of evidence is based on New Institutional Economics. Research on the institutional environment focuses on regulation and policy, such as by Staschen who assesses the impact of regulation on MFIs in Uganda (Staschen, 2010), and other researchers who investigated the role of microfinance in post-conflict situations in terms of economic environment and political stability (Jacobson, 1999).

A large body of publications on institutional arrangements is available in regards to studies on the transformation of institutions from NGOs to formalized and regulated institutions which are mostly based on the Theory of the Firm (Ledgerwood & White, 2006). The concept of transaction cost is the foundation for research on alternative delivery channels that utilize faster and convenient payment system such as mobile banking or mobile money (Jack & Suri, 2011). Property Rights Theory is applied to the issues of collateral and alternative lending mechanisms (Morduch & Armendariz, 2005). As well as the ownership of microfinance institutions, often in connection with the Principal-Agent Theory (Mersland & Strøm, 2009).

Comprehensive work on institutional environment and arrangements can be found in the Microfinance Handbook which describes a basic methodology rather than applying it to concrete data sets (Ledgerwood, 1999). The handbook assesses the microfinance sector based on the country context which is similar to the chosen approach for this research.

Thus, this research focuses on both institutional environment and arrangements in the emergence of microfinance institutions in post-conflict Somalia to draw lessons on the issues and challenges facing the sector that are particular to Somalia since in microfinance details of microfinance in each context matter and there is no one-size-

fits-all product to provide financing the poor (Obaidullah, 2015) especially in post-conflict setting such as Somalia.

Conceptual Framework of the Study

In the process of conducting qualitative research, a conceptual framework must be developed in order to outline the research objectives and research questions. Jabareen, (2009) defined the conceptual framework as a network of related or interlinked ideas, theories and concepts that when formed together will provide a better outlook and comprehensive understanding of the phenomenon being studied. The author further argues that while quantitative models offer a theoretical explanation, conceptual frameworks provide understanding and can be developed and constructed through qualitative assessment. Moreover, besides being a collection of concepts, a conceptual framework also involves the construction in which each concept plays an essential role.

As this research focuses on the institution of Islamic microfinance in post-conflict and specifically aims to develop a well-articulated understanding about the phenomenon of the emerging Islamic microfinance sector in Somalia, the following conceptual framework was developed based on the theory of institution combined with other components derived from previous literature on the microfinance institutions in other post-conflict countries. Researchers have identified essential conditions and several requirements that must be in place to facilitate the establishment of successful microfinance institutions as a viable intervention in a post-conflict country. Similarly, the study considered investigating different issues and challenges that are evident in most post-conflict situation as well as the unique obstacles facing the Islamic microfinance in Somalia.

Finally, the research further aims to recommend the way forward, focusing on key components that can enhance the institutional experience of Islamic microfinance in post-conflict Somalia and contribute towards its success. The following are the summary of the important factors for establishing successful Islamic microfinance in post-conflict countries which stands as the conceptual framework of the current research:

Listed below are the mentioned essential conditions or necessary requirements, both internal and external factors that allow the establishment of successful Islamic MFIs in post-conflict situations. The following is a brief explanation on each of the concepts in the first column: low intensity of conflict “security or absence of active war”, the re-opening of markets, resettlement of refugees and IDPs, and the existence of financial institutions offering core microfinance services (Doyle, 1998; G Nagarajan & McNulty, 2004; Geetha Nagarajan, 1999):

1. Security Improvement.

The first condition is security or low intensity of conflict and absence of chaos, which requires at least a low degree of political stability which can allow the clients of microfinancing to engage in profitable business activities with confidence and a certain level of security. In fact, any institution such as microfinance will not fulfil its function if the level of uncertainty is high, there must be an acceptable amount of safety and stability to social relations and financial transactions (Alonso & Garcimart, 2013). In Somalia, despite the rare bombing attacks in the capital city nowadays, there is no active clashes or heavy fighting. Doyle, (1998) strongly argues that the complete absence of conflict is not a necessary requirement to establish a microfinance business.