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Regulatory Compliance and Supervisory System of Islamic Banks in Mogadishu Somalia

Hamdi Jama Warsame[1]* and Fatima Abdullahi Suleiman[2]

[1]Department of Management Science, SIMAD University Mogadishu, Somalia
[2]Department of Accountancy, SIMAD University Mogadishu, Somalia

Abstract

This research concentrates on the current regulatory and supervisory environment for Islamic banks in Somalia, including their compliance with and ability to effectively oversee that framework. The transition to conventional banking in Somalia is fraught with difficulties. Existing banking regulations are inadequate. The goal of this study was to investigate the regulatory and supervisory background of Islamic banking in Somalia in order to provide recommendations for how to best accommodate this banking system. There is an emphasis on depth of experience and personal insight in this study. We also used interviews to gather data from customers of the Premier, Dahabshil, Amal, and Salama banks. What's more, the research uncovered that Islamic banking presents its own unique set of dangers. Credit risks, which impact P&L transactions, and market risks, which have an impact on sales-based deals, are the two most prominent examples. The research also showed that Islamic banking presents numerous difficulties for the country's banking regulation and supervision systems. Ultimately, regulating banks helps to calm the economy by keeping depositors' money secure and preventing banking systemic failures. This means its significance to Islamic banking cannot be overstated. Since Islamic banking functions on different rational foundations than traditional banking, the study concludes that new regulatory and supervisory laws are needed.

Keywords*:* Regulatory compliance & supervisory system • Growth and evaluation • Risk management and Islamic banks

Introduction

In recent decades, Islamic Finance (IF) has emerged as a viable financial system, attracting attention from around the globe thanks to its socially responsible principles. Islamic banking and finance (IBF) was founded in the middle of the 1960s and has since expanded to countries all over the world. However, despite its phenomenal growth, IBF still faces a number of challenges as it tries to conform to the legal, economic, and regulatory systems of both Islamic and non-Islamic nations. There is a wide variety in the regulatory and supervisory frameworks for Islamic banking across the many countries that practice it because Islamic law varies greatly from country to country. There is an effect of this adaptability on the system's dependability, growth, and global applicability as a replacement for the traditional system [1]. There has been a growing movement over the past three decades to examine the Islamic financial system from new perspectives. According to Wilson, since the time of the Prophet Mohammed (SAW), Muslims all over the world have been using a profit-sharing alternative to interest-based finance between merchants and moneychangers. As an intermediary between surplus and deficit units, this system is poised to play a significant role in the real economy as it stands today by easing the burden of saving and financing projects [2].

However, preserving the effectiveness, integrity, and security of the financial system through the implementation of prudential regulation and supervision requirements is the primary focus of regulatory and supervisory agencies. By evaluating and observing institutions' financial health and hazards, these supervisory and regulatory requirements aim to safeguard depositors and prevent repetitive risk in the banking system. The efficacy of bank supervision regimes can be evaluated against international criteria or benchmarks provided by the Basel Committee on Banking Supervision of International Banks for Settlements (Basel Committee, Core Principles Methodology, 1999). The first country in East and Central Africa to permit the function of Islamic banking was Kenya, which opened the doors in 2007. On May 29, 2007, the Central Bank of Kenya authorized First Community Bank (FCB) to start operating as a fully-fledged Shariah-compliant commercial bank; making it the first nation in East and Central Africa to permits the procedure of Islamic banking. Later, the Commercial Bank of Kenya gave license to another bank, Gulf African Bank (GAB), allowing it to become the second fully-fledged Shariah compliant bank in Kenya.

A regulation is a formal directive issued by the government or another authority. It is a set of specific guidelines or accepted behavior that limits the activities and business processes of the world's organizations in order to achieve a specific goal. These guidelines may be imposed by a government body or other external agency or may be self-imposed by explicit industry agreements. When it pertains to financial institutions, regulation is viewed as a set of particular standards of accepted behavior that are either explicitly agreed upon by the industry or imposed by the government.

Financial regulation, as can be seen, is in place to ensure that laws are upheld, behavior is disciplined, and operations among stakeholders are directed toward an effective and efficient financial system. To the best of my knowledge, the Islamic banks' regulatory compliance and supervisory systems in the commercial banks of Somalia have not yet been put to the test. So, the main goal of this study is to find out if Somali commercial banks follow the rules for regulating Islamic banks. Researchers agree on the significance of supervision and regulation guidelines for both conventional and Islamic banks. An active regulatory framework ensures market discipline, governance, and operational policies. Each of these factors is crucial for a stable financial system, which is a requirement for macroeconomic stability. The fact that Islamic banking cannot be avoided and that it is a recent, significant development that is unfamiliar with the current legal system raises important questions that mandate the need for in-depth research in the field. In this study (Abdel, 2004), the effects of Islamic banking on regulation and oversight in the Somali financial sector will be looked at.

***Address for Correspondence:** Hamdi Jama Warsame, Department of Management Science, SIMAD University Mogadishu, Somalia, Tel: +252618825555; E-mail: hamdijwarsame@simad.edu.so*

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Literature Review

A regulation is a formal directive issued by the government or another authority. It is a collection of particular guidelines or accepted behaviors that are either imposed by a government body or other external agency or are voluntarily adopted by institutions operating in the industry in order to achieve a specific goal. The financial system is made up of a number of institutions, markets, tools, and operators that interact to offer financial services inside an economy. Similar to that, it is an organization made up of several institutions that work together to provide financial services to the right clientele.

These services, among many others, make it easier to swap currencies and allocate resources to enhance global trade. After considering the aforementioned, it can be said that a financial system is fundamentally a systematic arrangement inside the financial framework of an economy that creates the conditions for interaction between various institutions, markets, tools, and operators to provide financial services. Of course, this is consistent with the opinions of Uffot and Olorunshola.

Islamic banking regulation

In this section the previously available literature on Islamic banking regulation, and different problems delayed in the way to develop globally excepted regulatory and supervisory is reviewed.

The fundamentals of Islamic finance

As opposed to conventional financial systems, which place more emphasis on return maximization, Islamic financial systems' primary goal is to adhere to the tenets of the Holy Quran. Asserts that the Islamic common law is drawn from the Holy Quran, the Sunnah and Hadith of Prophet Mohammad (P.B.U.H.) and the Ijma and Qiyas, among other sources of Shariah. There is total agreement among all schools of Islam that Shariah prohibits financial transactions including interest (Riba), risk/uncertainty (Gharar), and games of chance [3].

Prohibition of Riba

The prohibition of Riba has been clearly mentioned at several places in Quran. In Surah al- Rum, verse (30:39), “That which you give as Riba to increase the people’s wealth increases not with God; but that which your give in charity, seeking the goodwill of God, multiplies manifold”. Similarly the prohibition of Riba is also mentioned in Surah al-Nisa’ (verse 4:161). Further in Surah al-Baqarah (verses 275-281), the glorious Quran clarify the difference between trade and interest in great details.

Avoidance of Gharar

Gharar is the excessive uncertainty in contracts, where details regarding the sale item are unknown or uncertain, or there is lack of information or control in a contract. In Hadith of Holy prophet, the prohibition/avoidance of Gharar is clearly mentioned in several places. Ahmad and 'IbnMajah narrated on the authority of Abu Said Al Khudriy that “The Prophet (pbuh) has prohibited the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of rewards of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.”

Supervisory Islamic financial system

Islamic financial institutions are required to follow the finest corporate governance procedures, but they also have an additional layer of oversight in the shape of religious boards. The religious boards serve in both a consultative and a supervisory capacity. It is crucial that only scholars of the highest caliber be selected to their religious boards because the Shari'ah scholars serving on those boards have significant responsibilities. An Islamic financial institution must set up operational guidelines to make sure that no type of investment or business activity is carried out without the religious board's prior approval. The management must also periodically report to the religious board and certify that the institution's actual investments and business activities follow the procedures previously approved by the religious board. (www.islamic-banking.com) Therefore, religious boards that serve as independent Shari'a Supervisory Boards and are made up of at least three Shari'a scholars with specific understanding of the Islamic laws for dealing, fiqh al mu'amalat, as well as knowledge of contemporary business, finance, and economics, must be in charge of Islamic financial institutions that provide goods and services in accordance with Islamic principles (www.islamic-banking.com). They are primarily in charge of approving that the banking and other financial products and services offered comply with Sharia and then verifying that the activities and operations of the financial institutions have adhered with Sharia's principles (a type of post-audit). Sharia a certificate of conformance with Sharia must be independently issued by the Sharia's Supervisory Board.

Research Methodology

In order to understand how the expansion of Islamic banking has affected the existing regulatory and supervisory environment, this study concentrated on the factual recounting of a situation. The study employed an interview-based research methodology. The term "in-depth interview" refers to a qualitative research technique that involves "in-depth interviews with a small sample of respondents to explore their viewpoint or ideas, program, or issue" [4]. Structured, semi-structured, and unstructured interviewing techniques are all acceptable. So that all respondents could reply uniformly to a set of preset questions, structured interviews were used in this study. Because researchers may compare and evaluate many responses to a particular question, data analysis in structured interviews is frequently simpler than in other types of interviews. A sample of 28 respondents was selected from the target market. Four bankers who possess the necessary Islamic banking knowledge, seven employees of commercial banks that practice Islamic banking, and three members of the Banks Supervision Directorate were among the 14 respondents who submitted information. A minimum sample size of 30 is generally required for statistical investigations, but I was able to change that for my study [5].

Results and Discussion

In the section we discussed the result of our research, make an analysis of the data in relation to the research questions, and objectives behind the study that motivated the doing of this research as stated in previous study, therefore, the study mirror and asked the responses three research questions that this study dealt with. The researcher presents data collected from the Premier Bank, Dahabshil Bank & Amal Bank. Data are also, presented from secondary data mainly from an analysis done on various pieces Shari’a principles relating to banking and subsidiary legislations which include regulations and circulars that are used in banking regulation and supervision.

What are the inherent risks in Islamic banking practices?

All fourteen respondents were interviewed as per the interview guide herein annexed as regards this question. Most of them they were knowledgeable of presence of risks in banking generally, they had the idea what would be the risks in Islamic banking. Out of fourteen respondents in the sample only four responded to this question positively, one is a bank expertise from Central Bank of Somalia, who supplied documents, which contained answers, and three Bank directors who were much aware of presence of risks in banking generally but not particularly in Islamic banking and four members of bank staffs. These constitute 60% of all respondents who responded to this question. Thus, what is presented here is a mix of information from their best of knowledge and information obtained from the documents they supplied.

The researcher discovered that Islamic banking carries a significant number of inherent dangers after analyzing the data they had collected. A first risk was described as a doubt or a potential for a poor result from an undertaking. Islamic banking is not risk-free because it functions in the same context as conventional banking does and has the same purpose of supplying money to the local economy. Islamic banking is a dangerous endeavor by definition, just like conventional banking. Although risk is a crucial component that both systems equally share, the reality remains that each system is unique and has its own defining characteristics that change the type and level of risk to each of them.

In consideration of Islamic banking functions on risk sharing arrangements, which is the very basis of all Islamic financial transactions, risk itself cannot be divorced from it: these financing transactions are risky in themselves. There are generally the following types of risks in Islamic banking namely *credit risks,* which mostly militate against the PLS contracts, *market risks* and *liquidity risks*. These are discussed hereunder:

Islamic banking credit risks

The primary impacted funding methods for PLS are credit concerns. Risks are important, for example, in Murabaha transactions, particularly when the client does not pay the bank on time despite the bank promptly delivering the assets. The bank is unable to take quick action to pay its debts, and it is also unable to apply interest or penalties to the outstanding total. Both the bank's own money and the money of its depositors are at risk of loss. So, the possibility of loss exists for both the bank and the customer. The Islamic bank plays no active role in the Mudarabah transaction. As a result, it lacks the tools necessary to keep an eye on its money or take part in managing the project it funded. If the business owner manages the company poorly, the bank is in risk of losing all of its investment.

In conclusion, the Profit and Loss Sharing (PLS) modes are somewhat riskier because the rate of return on them can either be positive or negative, depending on how the firm financed ultimately performs. Failure of the business has an impact on both the bank and the clients who deposit money with the bank. In the event of a loss, this is when the principal amount of investment deposits erodes. As a means of maintaining capital, the bank will deduct from consumer deposits. Therefore, the bank's loss could indirectly affect its clients. The traditional banking system, on the other hand, guarantees all demand as well as time and term deposits.

Islamic banking market risks

Market risks mostly result from contracts covered by sales-based modes. These hazards resemble mark-up risks in murabaha (cost plus sale). The mark-up rate for Murabaha and other trade-financing instruments must be set at the time of contracting, according to Islamic Shari'ah. This means that, for the duration of the contract, the rate agreed upon-say, 30% of the asset's cost-is pre-fixed at the moment the contract is made. Without being able to gain from a growth in the markup rate, the Islamic bank is subject to the danger of it. Somali banks will ideally face significant market risk because all Somali banks concentrated on just a few Islamic investment products such as Murabaha, Musharkah, and Mudarabah after providing services such as current accounts and savings accounts. This can make them lose a lot of money because they miss out on a lot of opportunities with Islamic bank products, including ones that could make them money, like Bai salam, Istisna, Ijara, and others.

Islamic operational risks

Operational risk is described as the possibility of suffering a loss as a result of external occurrences or insufficient or ineffective internal processes, people, or systems [6]. Operational risks can thus occur in a variety of circumstances. Due to the unique contractual characteristics of the mode of finance as well as the asset-based nature of the contractual relationship between the bank and its customers, Islamic banking is more operationally risky. Due to the absence of infrastructure and education in the developing nation of Somalia, operational risk is significantly higher. This was seen during the CEO of the Somalian Amal bank's interview. It will be more challenging to draw clients given the increased demand for personnel training and the fact that the nation has gone over 25 years without a banking system.

All bank officials agreed that because the vast majority of their assets are kept in the form of illiquid assets, Islamic banks are most impacted by liquidity issues that result from a general shortage of liquidity. Liquid assets, such as cash and financial securities, are separated from illiquid assets. Islamic banks do not deal with money; instead, assets are the main aspect of their dealings. One participant remarked that the scarcity of Shari'ah-compliant money markets is the primary factor contributing to liquidity risk in Islamic banks. The money these banks hold in current accounts is primarily in the form of idle cash, which cannot be used to invest in a wide range of activities as conventional banks do because there are no illiquid short-term devices (as liquid instruments are forbidden under Islamic shariah law). The second, third, and fourth reasons are that there is no true inter-bank money market; there are no secondary markets; and finally, the money in these banks' current accounts is largely maintained in the form of idle cash.

Conclusively risk in Islamic banking is said to be the distinctive feature of Islamic finance. Risk is chiefly considered to be a dividing line between Shari'ah acceptable profit and interest (riba). Risk is present in all Islamic financial transactions including saving and deposit accounts. Of significant is that risk as it is applicable in Islamic banking has unparalleled attributes and distinctive characteristics.

What is the challenges Islamic banking practices engendering to the regulatory and supervisory regime?

The majority of respondents from three banks were the ones the researcher targeted for this inquiry. But the 14 people who were chosen for the sample were all asked questions that were in line with the interview guide. However, only 8 gave their approval. The remaining three respondents, or 40% of the sample, were not sufficiently explicit about any issues. This accounts for 60% of all respondents. The largest issue, according to many who responded, is that Islamic education is not covered by the existing regulatory and oversight documents. However, the researcher was able to gather sufficient data regarding the CB's oversight of banks and other financial firms. The researcher also conducted a thorough examination of the existing primary and ancillary laws that pertain to the regulation and supervision of banks. When the researcher looked at the information, he or she found that Islamic banking has many problems, including leg al, regulatory, and oversight problems.

Regulatory and supervisory challenges

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Islamic banking is centered on Islamic Shari'ah rules and is based on the Islamic religion, as the term implies. It is already integrated into and is steadily integrating into the Somalian financial system. As a component of this system, it is likely to have an impact on the economy of the nation if its operations and administration are not overseen by the CBS. This could lead to inconsistent practices across Islamic banks. To address these issues, CBS must include the Islamic Bank Act into their constitutions in addition to maintaining trained personnel who can oversee and manage these institutions. Only then will we be able to distinguish between banks that are truly Islamic and those that are not [7].

The banking and financial institutions act, 1989 and 2012 of CBS

The researcher found out that this Act whose objectives among others are to provide for comprehensive regulation of banks and financial institutions with the view to maintaining the stability, safety and soundness of the financial system aimed at reduction of risk of loss to depositors. Convincing, as this objective would appear, it does not by necessary implication apply to Islamic banks. These were found to be in the following aspects: eligibility to acquire licence, maintenance of liquid assets ratios, restriction to trade by banks and minimum capital requirements.

Deposit protection fund

In Somalia, the Central Bank will establish a deposit protection fund in conjunction with the Minister of Finance with the dual goals of enhancing the stability of the country's financial system and safeguarding bank depositors. All contributions and other payments required by this part to be made to the Fund should be made payable to all banks from which the Fund's required payments must also be made. To protect their customers in the event that those banks fail, banks pay money into the Deposit Protection Fund. When this occurs, the fund reimburses the bank with a sum that is more than what the bank had previously contributed (www.IADA.org). Additionally, S. 100 (2) stipulates that the funds that make up the Fund must be deposited in a bank account to be invested in Federal Government obligations or obligations that are guaranteed by the Federal Government, as well as other obligations that the CBS deems to be suitable investments in light of the Fund's objectives. It follows from these sections that since deposit insurance entails an exchange of money for money, different values are used in the trade, and a contributing bank receives more than it contributes. Scholars of Shari'ah would consider this to be an unlawful, interest-based transaction. When the deposit insurance fund is invested in interest-based transactions or projects that are not permitted by Islamic Shari'ah, the interest component may also be present in deposit insurance. It would be doubtful to use the profit to compensate an Islamic bank in the event of its failure because it would be seen as being against the law.

Trading restrictions & prohibitions

The researcher found out that this Act (130, 2012) whose objectives among others are to provide for comprehensive regulation of banks and financial institutions with the view to maintaining the stability, safety and soundness of the financial system but there is omitted principle of Islamic finance (Prohibition of Riba, Gharar and Maysir) and it is the most importance issue that Islam care about it; we can found almost all prohibitions e.g.(Prohibition on lending against security of own shares, gratuities and similar payments, insider transaction, against issuing of stored value cards transactions, financial exposures) the is missed the most dangerous as Islamic prospective and that is (Riba). Trade is central to Islamic banking. The current regulatory and supervisory framework is not clear restricts trading for banks that prevent banks to engage directly in business enterprises using depositors' funds. There is a need for further auxiliary legislation in order to fully realise the goals of Islamic banking by either enacting new law or modifying the existing statutes and the CBS regulations.

Do the existing commercial banks in Somalia work according to the principle of Islamic banking and how we can differentiate them from conventional banks?

In relation to this question all respondents-including bank customers-were interviewed. Respondents who responded to questions relating to this research question as per interview guide did not have any doubt about commercial banks are Islamic banking, but they have issue about how would these banks be regulated and supervised because there is no act relate for Islamic banks stated in financial institution Law No. 130 of 22 April, 2012

From the analysis of the obtained information, the researcher found out that the current financial institution law requires fine-tuning to supervise and regulate the Islamic banks so people can be in confidence condition. Because, they know there is rule that will guide these banks and control them. Therefor Islamic banks focus on investment, emphasis on soundness of the project, coordination with partners in source mobilization, and apply moral criteria in investment. While, conventional banks focus on lending, emphasize the ability to repay, dependence in borrowing in recourse mobilization, and lastly apply only financial criteria [8-9].

Summary

Our study was performed in order to investigate the regulatory and supervisory consequences of Islamic banking adoption in the banking sector of Somalia. Researchers agree on the current state of supervision and control standards for both conventional and Islamic banks. An active regulatory framework ensures market discipline, governance, and operational policies. For a full financial system, which is also necessary for macroeconomic stability, all of these components are important. The fact that Islamic banking cannot be avoided and that it is a recent and significant development untested in the current legal system raises important questions that necessitate the necessity for in-depth research into the subject. The main component of the Shari'a governance framework is the Shari'a Board (SB), which Islamic banks find strange. The study's goal was to investigate the relationship between Shari'a compliance, Shari'a supervision in practice, and the significance of Shari'a governance. These objectives allowed the study to be completed, after which the respondents were asked to reply to a variety of items by making choices based on their impressions. For these goals, data was gathered through interviews in which open-ended questions were asked to get people's thoughts and critiques of their ideas [10-12].

According to the study, bank regulation is carried out to protect depositors from the risk of loss posed by these institutions. Like any other banking system, Islamic banking contains risks that are categorized as credit risks in the profit and loss statement. According to the results of the sharing schemes, the majority of respondents, whether they were bankers or customers, are generally aware of Islamic banks but not in-depth. Also, there is a difference between commercial banks that are aligned with Islamic banks and the Central Bank of Somalia's Financial Institution Law, which is a traditional law. This means that CBS needs to pass new Islamic laws in order to regulate and supervise these types of banks properly.

Conclusion and Recommendation

The initial goal was to evaluate Somalia's current financial supervision and regulation framework in relation to Islamic banking. The study comes to the conclusion that the current regulatory framework, which is made up of various banking statutes like the Banking and Financial Institutions Act, Law No. 130 of April 22, 2012, and Financial Institution Decree Law No. 37 of November 23, 1989, as well as circulars issued by the governor of CBS, is not designed to accommodate the smooth operation of Islamic banking. Accordingly, the study demonstrated that bank regulation is carried out to protect depositors from the risk of loss by these banks. Islamic banking, like all other banking systems, is subject to risks, such as those associated with credit, markets, inflation, liquidity, and other factors. The study also comes to the conclusion that Islamic banking cannot be conducted under the current regulatory and supervisory framework without modifications. A customized regulatory and supervisory system is required in order to fully integrate Islamic banking, according to the study, which also finds that Islamic banking in Tanzania presents a number of regulatory and supervisory problems due to its nature. In connection with this, the study found that some of the laws that the CBS uses to watch over banks do not apply to Islamic banking because Islamic banking has different rules than traditional banks.

The study found out that the nature of Islamic Banking requires a reinforcement of prudential regulation and effective supervision, with special stress on capital adequacy, proper risk assessment and management and greater transparency, however, the researcher came up with the following recommendations:

- **Adjustment of the regulatory and supervisory systems:** The Central Bank of Somalia (CBS) as the body assigned with regulation and supervision of banks needs to have in place a regulatory device, which takes on board both the traditional prudential supervision aspect and a developmental role that is equally important to Islamic banking.
- **Preparations of regulatory and supervisory rules to international best practices**: This stems from the imperative of ensuring the viability, strength, and continued expansion of these institutions, and enhancing their contribution to financial stability and economic development. The regulatory and supervisory instruments of the CBS need something with regard to Islamic banking in view of the relatively different risk perspective of these institutions.

- **Concentrated training to employees:** Practitioners within the CBS especially those in the Directorate of Bank Supervision must be well trained to enhance the supervision exercise. They need to know how Islamic banks work in order to effect a worthwhile supervision to the benefits of Islamic banking and the general financial system. It is dangerous in a central bank to have staff engaged in supervision of Islamic banks, while they have not had enough exposure to Islamic banking activities. There is a need to put in place requisite Islamic banking professionalism in the CBS supervision practice.

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