POLICY BRIEF

RETHINKING YEMEN'S ECONOMY

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Enhancing the Role of Microfinance Banks for Sustainable Impact in Yemen

By The Sana'a Center Economic Unit

Executive Summary

- Yemen's microfinance sector is undergoing a radical transformation. Despite initial success in empowering small businesses, the ongoing conflict has exposed deep vulnerabilities. Competition between the fractured central banks has driven a surge in microfinance bank (MFB) licenses. While this promises to expand financial inclusion, it raises serious concerns about long-term sustainability and financial stability.
- Several other factors are driving the transformation of existing money exchange companies into MFBs. These include the erosion of trust in the traditional banking system, the growth of the informal financial sector, and maneuvering by the exchange companies themselves. Additionally, lower entry requirements compared to conventional banks make becoming an MFB an attractive option.
- However, the surge in MFBs presents its own challenges. The divide in the Central Bank of Yemen (CBY) creates an uneven playing field, hindering financial inclusion efforts. The rapid issuance of licenses devoid of proper planning could threaten financial stability. Geographic dispersion and limited infrastructure make reaching rural populations difficult and expensive. Lack of financial literacy and a cultural aversion to debt in some regions further complicates client acquisition.
- Inexperienced staff at new MFBs also raise concerns about microfinance expertise and responsible lending practices. "Mission drift" looms large as a systemic risk, as MFBs prioritize easily reachable clients in major cities over underserved rural populations. Fierce competition could lead to unsustainable practices like excessive lending, jeopardizing the very clients these institutions aim to serve.
- Despite these challenges, MFBs hold immense potential. They can bridge the financial inclusion gap and empower underserved rural entrepreneurs. Unlike traditional donor-dependent microfinance institutions (MFIs), MFBs benefit from a sustainable financing model through customer savings. Yemen's regulatory framework also allows MFBs to offer a broader range of financial services compared to most other Arab nations.
- To ensure a sustainable future for the sector, a collaborative effort is needed from the CBY, MFBs, and international donors. The rival CBYs should institute a temporary pause on new MFB licenses and conduct a thorough assessment of the existing landscape. The regulatory framework for MFBs should be strengthened, focusing on fair competition, risk management, and client protection.
- Consolidation of MFBs' activities and increasing focus on offerings to lower-income clientele can create stronger institutions and a more efficient financial sector. MFBs themselves must develop sustainable business models and build capacity through training and technology adoption. Collaboration is crucial to developing client outreach strategies for rural areas, potentially leveraging financial technology (FinTech) solutions. Effective risk management frameworks and a national credit information system are essential to prevent over-indebtedness. Finally, knowledge sharing and impact monitoring are necessary for continuous improvement and to guide data-driven decision-making.
- MFBs present both opportunities and challenges for Yemen's financial sector. By addressing the challenges and implementing a comprehensive strategy, MFBs can become a powerful engine for financial inclusion, economic growth, and poverty reduction in Yemen.

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Introduction

Yemen's microfinance sector is a story of both remarkable progress and persistent challenges. Introduced in 1997 with the backing of international donors, microfinancing emerged as a vital tool in the fight against poverty and unemployment. The Social Fund for Development (SFD) acted as a driving force, establishing the Small and Microenterprise Development Unit (SMED) to head this initiative and strengthen the national economy by expanding financial services to micro and small-scale entrepreneurs (MSEs).

Yemen's MSE sector struggles with a complex web of challenges. Internal weaknesses include poor management and a lack of skilled staff. External challenges include negative perceptions of lending to the poor, underdeveloped infrastructure, and a low savings rate, which hinders growth. Hardline religious attitudes that ban interest rates and limit female businesses further complicate matters. Finally, inflation and currency instability make it difficult for MSEs to secure funding and increase borrower defaults.[1]

The SMED focuses on empowering microfinance institutions to be productive, competitive, resilient, and able to provide microfinance services to MSEs, especially in rural areas. It provides capacity-building programs and concessional financing to microfinance institutions (MFIs) and fosters the entry of the private sector into the microfinance business. This includes encouraging the transformation of microfinance programs into foundations with formal structures, commercial banks downscaling services to meet the needs of MSEs, and, most notably, the metamorphosis of money exchange companies into microfinance banks (MFBs). This strategy has seen impressive results.[2]

Unlike most of the Arab world, Yemen and Sudan (through microfinance banks) and Syria (via non-bank financial institutions) allow microfinance institutions to offer a broad range of financial services, including deposit mobilization. This empowers MFIs to move beyond providing credit and cater to the holistic needs of a wider client base. In contrast, countries like Tunisia, Jordan, and Palestine restrict MFIs to credit provision, hindering their potential for growth.[3] The Al-Kuraimi Islamic Microfinance Bank exemplifies the success of Yemen's approach, having transformed from a money exchange company into a full-fledged financial institution. Similarly, Syria's First Microfinance Bank serves as a powerful testament. By leveraging its nation's enabling regulations, it shed its NGO shackles and emerged as a deposit-mobilizing non-bank financial institution (NBFI).[4]

[1] Adel Mansour, "Small and Micro Enterprises Development in Yemen and Future Prospects," The Social Fund for Development, 2011, https://smed.sfd-yemen.org/images/2022/10/23/Official_English_SMED_Book_pdf-20120714.pdf. Accessed September 1, 2024.

[2] Ibid.

[3] Alex Silva, Mohammed Khaled, and Karen Beshay, "Transforming Microfinance Institutions in the Arab World: Opportunities, Challenges, and Alignment of interest," World Bank Group, May 2018, https://documents1.worldbank.org/curated/en/174101532542008689/pdf/128854-WP-MNA-Transforming-Microfinance-22-5-2018-PUBLIC.pdf. Accessed September 1, 2024.

[4] Ibid.

Yemeni microfinance reported active borrowers' growth of 17 percent annually, from around 66,400 in 2010 to 121,000 in 2014, with the SFD managing 13 microfinance institutions (MFIs) that provided 53 percent of this growth, and the rest accounted for by other MFBs.[5] However, the 2015 conflict severely disrupted this progress. In that year alone, active borrowers declined by 23 percent to 93,118. By the end of 2023, the number of active borrowers had dwindled to 78,686, reflecting a cumulative client base decline of 15.5 percent since 2015. Throughout this period, banks and MFIs exhibited a remarkable parity in total borrowers, capturing nearly equal market shares of 53 percent and 47 percent, respectively.[6] The loan portfolio in Yemen's microfinance sector fell from about YR12.2 billion (US$57 million) in 2014 to less than YR7 billion (nearly US$30.4 million) in 2015.[7] However, it exhibited steady growth in subsequent years, reaching YR44 billion by the end of 2023, with MFBs holding a dominant share of this portfolio, roughly 69 percent.[8]

While the conflict has negatively impacted microfinance lending, depositors have increasingly chosen microfinance banks like Al-Kuraimi Islamic Microfinance Bank to hold their deposits in light of the growing distrust of the traditional banking sector. Microfinance banks, though the smallest category in the banking sector (8 percent of total assets in 2020), witnessed a surge in depositors post-2015. Yemen's MFBs saw their active savers grow by an impressive 28 percent annually, reaching 3.3 million in 2023. This translates to a dominant 96 percent market share in the deposits market, compared to a negligible 4 percent share held by traditional MFIs between 2016 and 2023. Al-Kuraimi Islamic Microfinance Bank captured the majority of this growth (91 percent), capitalizing on perceived instability in commercial banks.[9]

Yemen's microfinance industry operates in two distinct spheres: the formal sector (MFBs), regulated by the CBY under the 2009 microfinance law, and the informal sector (MFIs), governed by the Law on Associations and Foundations (Law No. 1 of 2001). MFIs are non-banking entities, including some programs that do not have legal status as financial institutions. They resemble financial networks, such as money exchange companies and money exchangers (hawala agents), which are registered with the government and pay taxes but are considered informal in the Yemeni context. Unlike MFBs, which can access public savings for loans, MFIs rely heavily on aid from the SFD, which also supervises their operations.[10] The watershed in microfinancing came with

[5] "Loan Portfolio Monthly Reports," Social Fund for Development, 2009-2023, https://smed.sfd-yemen.org/index.php/en/blog-4/aaflp1. Accessed September 1, 2024.

[6] Ibid.

[7] "Republic of Yemen National Report: Third United Nations Conference on Housing and Sustainable Urban Development - HABITAT III," Republic of Yemen, 2016, https://habitat3.org/wp-content/uploads/Yemen-National-Report-September-2016.pdf. Accessed September 1, 2024.

[8] "Loan Portfolio Monthly Reports," Social Fund for Development, 2009-2023, https://smed.sfd-yemen.org/index.php/en/blog-4/aaflp1. Accessed September 1, 2024.

[9] In 2020, conventional banks dominated Yemen's banking sector with 31 percent of total assets, followed by government banks (29 percent), Islamic banks (23 percent), and foreign banks (10 percent). Microfinance banks, though the smallest category, held a respectable 8 percent of total assets. See: "Connecting the Yemeni Private Sector to the World," The International Bank for Reconstruction and Development/The World Bank, 2023, https://documents1.worldbank.org/curated/en/099032024141038420/pdf/P17763112a6d5d0a518fdc1db18e0368bfd.pdf. Accessed September 1, 2024; "Loan Portfolio Monthly Reports," Social Fund for Development, 2009-2023, https://smed.sfd-yemen.org/index.php/en/blog-4/aaflp1. Accessed September 1, 2024.

[10] Moneef al-Shaibani,"Microfinance in Yemen: An Overview of Challenges and Opportunities," RYE Policy Brief 6, Sana'a Center for Strategic Studies, DeepRoot Consulting, and CARPO, April 30, 2020, https://devchampions.org/publications/white_papers/microfinance_in_yemen/. Accessed September 1, 2024.

the introduction of MFB licensing under the CBY in 2007 and the microfinance banking law (Law No. 15) of 2009. This law, coupled with a YR500 million minimum capital requirement for MFBs, aimed to bolster financial inclusion, poverty reduction, and social stability through micro-loans and banking services for small businesses. By late 2020, three MFBs were operational, including the pioneering Al-Amal Microfinance Bank, established in 2008. The SFD's successful support for Al-Kuraimi Exchange Company's transformation into an MFB in 2010 served as a model for other exchange companies, fostering a more robust MFB landscape.

The 2015 conflict severely impacted both MFIs and MFBs. The war led to a large-scale displacement of people, making it difficult for many borrowers to repay their loans. Displaced clients defaulted on loans more frequently and withdrew deposits due to the conflict's economic hardships. Increased defaults and deposit withdrawals put the financial sustainability of MFIs and MFBs at risk, while unregulated lenders, like retailers and money exchangers, emerged with more relaxed loan terms. This forced MFIs and MFBs to adapt their strategies to remain competitive. This adaptation included offering more flexible loan products, adjusting interest rates, and expanding outreach to maintain or attract clients. Measures included increased loan write-offs, loan rescheduling, cost-cutting initiatives (branch closures, staff reductions), and suspension of loan disbursements and expansion plans.[11]

Since 2021, a dozen new MFBs have emerged across the divided zones of control. While the entrance of private sector players with resources into microfinance offers opportunities for financial expansion and inclusion, significant challenges remain. Yemen's banking sector suffers from weak infrastructure, a lack of credit history, and financial illiteracy among the target population, complicating outreach. The war has added another layer of challenges represented by the division of the CBY, with conflicting regulations and dual exchange rates hindering MFB operations. Many new MFBs lack microfinance expertise and may prioritize profit over serving the underbanked. The surge in MFBs could lead to unsustainable practices and an eventual bubble. Collaboration between MFBs, the CBYs, regulators, and international organizations is needed to address these challenges. By outlining recommendations for a sound and formally regulated MFB sector, this brief aims to contribute to a future where microfinance becomes a powerful tool for financial inclusion and economic development in Yemen.

[11] "Microfinance in Yemen: Hopes vs. Reality," Yemen Microfinance Network, July 2015, https://www.findevgateway.org/sites/default/files/publications/files/microfinance_in_yemen_-_impact_of_war_ymn_july_2015.pdf. Accessed September 1, 2024.

Recent Trends in MFB Licensing

A remarkable trend has emerged in Yemen's war-torn financial landscape: a surge in MFB licenses. This surge, however, is not driven by a strategic plan for financial inclusion but rather by fierce competition between the fractured CBY in Sana'a and Aden. This licensing spree targets money exchange companies seeking to circumvent regulations and expand their financial service offerings. The Yemeni money exchange law limits money exchange houses to currency exchange and financial transfer transactions, prohibiting them from holding deposits or granting loans. However, acquiring an MFB license unlocks a treasure trove of benefits. It grants access to public savings and deposits, enabling these companies to offer a wider range of financial services, including microloans and SWIFT international transfers.

This regulatory competition and a perceived need for wider financial inclusion have fueled the exponential growth of MFBs. The government-affiliated CBY-Aden has already licensed over ten new MFBs,[12] with several more in the pipeline. The CBY-Sana'a, affiliated with the Houthi (*Ansar Allah*) authorities since September 2016, isn't far behind, granting licenses to two new institutions and processing a dozen more applications. This aggressive licensing has the potential to push the number of MFBs well beyond the total number of all Yemeni banks operating in pre-conflict Yemen.[13] The geographical distribution of these new MFBs reveals a troubling trend. Rather than strategically targeting underserved populations for financial inclusion, these institutions replicate the footprints of the money exchange companies from which they originated. For instance, Al-Busairi Bank for Microfinance and Bin Dowal Islamic Microfinance Bank are both concentrated in Hadramawt, reflecting the pre-existing locations of their parent exchange companies.[14] Al-Qasimi Islamic Microfinance Bank, an extension of the Al-Qasimi Exchange Company headquartered in Sana'a, has secured licenses from both CBYs, highlighting the complexities of the divided financial system.

The motivations behind MFB licensing differ between the rival CBYs. For the CBY-Sana'a, it aligns with their vision[15] of supporting small and medium enterprises (SMEs) for economic recovery. On the other hand, the CBY-Aden, in collaboration with international stakeholders such as the International Monetary Fund (IMF) and the United States Agency for International Development (USAID), launched a

[12] During 2021-2022, the CBY-Aden awarded several prominent market exchanges licenses to operate as MFBs. These included Al-Qutaibi Islamic Bank for Microfinance and the Aden Islamic Bank for Microfinance, which are headquartered in the interim capital of Aden; Al-Busairi Bank for Microfinance and the Bin Dowal Islamic Microfinance Bank, headquartered in Mukalla, Hadramawt; and the Sharq Yemeni Bank for Islamic Microfinance, headquartered in Marib.

[13] Given the number of currently pending licenses, microfinance banks would outnumber all banks operating in the country. Prior to the conflict, there were only 18 banks operating in Yemen: 11 commercial banks, four Islamic banks, and three microfinance banks. The three MFBs were Al-Amal Microfinance Bank, Al-Kuraimi Islamic Microfinance Bank, and Tadhamon Microfinance, all regulated by the CBY.

[14] For instance, Al-Busairi Bank for Microfinance is a development of Al-Busairi Exchange Company, which was established in 1992 and has its main headquarters in Mukalla, Hadramawt. Bin Dowal Islamic Microfinance Bank is a development of the Bin Dowal Exchange Company, a subsidiary of the Bin Dowal Trading Group established in Mukalla in 2015. Al-Qasimi Islamic Microfinance Bank, granted licenses by both central banks, was founded as an extension of the 22-year-old Al-Qasimi Exchange Company headquartered in Sana'a.

[15] "National Vision for the Modern Yemeni State," Supreme Political Council, Republic of Yemen (Sana'a), March 26, 2019, https://nwm.unescwa.org/sites/default/files/2023-06/National%20Vision%20For%20The%20Modern%20Yemeni%20State%20%28EN%29.pdf. Accessed September 1, 2024.

comprehensive package to strengthen existing banks, promote transparency, and encourage the establishment of sound new institutions. Resolution No. (2/11/2022), issued in March 2022, mandates a clear separation between microfinance activities and currency exchanges, aiming to prevent conflicts of interest and safeguard financial stability.[16] Minimum capital requirements were raised significantly for both conventional banks (YR45 billion) and MFBs (YR5 billion), with an additional 300 percent increase for MFBs under a new resolution, No. (3/11/2023), issued in December 2023.[17] The CBY-Aden encourages MFBs to either specialize in microfinance or convert into fully-fledged commercial banks, a more rigorous process requiring conversion to a Public Limited Company. It is already supporting such transformations, with Al-Qutaibi Microfinance Bank seeking to become a full Islamic bank and Al-Kuraimi considering such a conversion.[18]

Despite these positive steps, several challenges threaten the future of the MFB sector. Some MFB owners blatantly disregard regulations by continuing to combine microfinance services with exchange activities. The divided CBY creates an uneven playing field, and the sheer number of new institutions raises concerns about their long-term viability.

[16] According to this resolution, banks have a five-year grace period to comply with the increased capital requirements, with the option of utilizing reserves upon central bank approval. The resolution prohibits the establishment of microfinance banks with shareholders who own exchange companies, except in conversions from existing exchange companies. Furthermore, founders with pre-approved licenses for microfinance banks, who also own exchange companies, are required to divest completely from their exchange businesses within one year. Non-compliant institutions risk license revocation. The reforms emphasize compliance with international anti-money laundering and countering the financing of terrorism (AML/CFT) standards, and fostering trust and confidence in the Yemeni banking system. See: "Resolution (2022/11/2) on Microfinance Banks Law [AR]," Central Bank of Yemen (Aden), 2022, https://cby-ye.com/files/623ad771a78d7.pdf. Accessed September 1, 2024.

[17] "Resolution (2023/11/3) on Raising Microfinance Banks' Capital Requirements [AR]," Central Bank of Yemen (Aden), 2023, https://cby-ye.com/files/659aa2ee5852b.pdf. Accessed September 1, 2024.

[18] Interview with a senior Yemeni banker based in Aden, April 2024.

Drivers of Microfinance Bank Transformation

The surge of MFBs has been driven by a confluence of factors, including the erosion of trust in traditional and Islamic banks, the growth of the informal financial sector, and strategic maneuvering by money exchange companies. The 2015 escalation of the conflict severely weakened Yemen's formal banking system. Commercial and Islamic banks lost customers and a significant portion of their cash flows, which was particularly damaging in a heavily cash-dependent economy. The subsequent split of the CBY into rival branches in Sana'a and Aden in late 2016 further exacerbated the crisis. This turmoil eroded public trust in formal banking, triggering a mass exodus of funds towards unregulated money exchange networks.[19] These networks, active on both sides of the conflict, readily exploited existing vulnerabilities to expand their operations. Hundreds of new exchange shops emerged, offering a haven for those wary of the formal banking system. Their profitability enticed many, particularly family-owned money exchange companies, to seek formalization through MFB transformation. This path offered a gateway to the regulated sector while preserving family control of these lucrative businesses.

The 2016 liquidity crisis crippled formal banks. With assets frozen and public debt payments suspended, they struggled to meet customer demand. Money exchange companies brazenly exploited this vacuum, morphing into shadow banks. They began offering services beyond currency exchange and money transfers, such as opening accounts, accepting deposits, and extending credit to individuals and businesses, replicating bank functions. The fragmented CBY, struggling to retain control over the monetary cycle, witnessed a surge in currency circulating outside the banking system – from YR811 billion (nearly US$3.8 billion) in 2014 to YR2.453 trillion (nearly US$4.65 billion) by 2018.[20] While filling the financial inclusion gap, the explosion of the informal sector also carries risks, such as money laundering and currency manipulation.[21] The CBYs' attempts to regulate exchange companies by enforcing limitations on their operations have backfired. Faced with losing their massive cash holdings, many companies opted for MFB transformation. The perceived deficiencies in existing financing schemes for small and medium businesses further fueled this trend.

The ease of entry into the MFB sector exacerbated the rapid issuance of licenses. In contrast to the rigorous standards for obtaining a traditional banking license, establishing an MFB was a significantly less complex process. MFBs only require three family members as owners and boast a minimum capital requirement a mere third of

[19] Farea al-Muslimi, "Revitalizing Yemen's Banking Sector: Necessary Steps for Restarting Formal Financial Cycles and Basic Economic Stabilization," Sana'a Center for Strategic Studies, February 15, 2019, https://sanaacenter.org/publications/analysis/7049 Accessed September 1, 2024.

[20] "Yemen Economic Monitoring Brief," The World Bank, March 19, 2019, https://documents1.worldbank.org/curated/en/161721552490437049/pdf/135266-YemEconDevBrief-Winter-2019-English-12-Mar-19.pdf Accessed September 1, 2024.

[21] "Bridging the Divide: Mitigating the Impacts of the CBY Schism on Yemen's Banking Sector," Sana'a Center for Strategic Studies, March 2, 2023, https://sanaacenter.org/publications/analysis/19617 Accessed September 1, 2024.

that of conventional banks.[22] While traditional justifications for MFB transformation – like offering a broader product range and accessing capital – remain valid, Yemen's context raises concerns. The rapid MFB expansion, driven by crisis opportunism rather than long-term strategic planning, could threaten financial stability in a deeply divided country. Thus, the rise of MFBs in Yemen presents a complex picture. While they offer a lifeline to the unbanked and underbanked, their motivations and potential consequences require scrutiny. As the conflict continues, navigating this new financial landscape will be a critical challenge for Yemen's future.

[22] Interview with a senior Yemeni banker based in Aden, April 2024.

Threats to MFB Growth

While Yemen's financial landscape is undergoing a dramatic shift with the rise of MFBs, this surge could create many challenges that threaten to derail the sector's potential for financial inclusion and economic growth. The fragmented CBY, with rival branches in Sana'a and Aden, poses a critical challenge. Conflicting regulations on everything from monetary circulation to liquidity management create a disjointed operating environment for MFBs. The issuance of licenses based on geographic control further splinters the financial system. MFBs licensed by one CBY branch face restrictions in areas controlled by the other, hindering outreach and undermining financial inclusion efforts. Even when both branches grant a license, the prevailing conflicting financial policies create operational complexities. The ongoing "currency war"[23] further complicates matters. The bifurcation of the currency has thrown a wrench into the establishment of a unified financial system while hindering the development of the modern payment system and credit infrastructure essential for financial inclusion. It has also driven up the cost of financial transactions, especially between divided zones of control. This "war" translates into massive fees (over 200 percent)[24] for transfers from government-controlled areas to Houthi-held areas stifling economic activity and hindering the potential reach of MFBs.

The recent dangerous escalation in the economic warfare between the rival central banks further complicates the already precarious situation for MFBs. Early 2024 saw a dramatic rise in tensions, with each CBY competing for control over remittances and money exchange networks. These tit-for-tat actions, including the Houthi coin minting and the CBY-Aden's demand for bank relocation,[25] have created a chaotic environment. Recurring disputes among fragmented branches of the CBY could further isolate financial systems, making it difficult for MFBs to operate effectively in both regions. Meanwhile, escalation over the prevailing dual-rial currency scheme adds another layer of complexity, potentially limiting MFBs' clientele and hindering financial transactions.

Reunification of the CBY may offer long-term relief, but current hostilities and the escalating battle for control of Yemen's financial institutions pose immediate challenges. Even before the 2015 conflict, providing financial services to SMEs in Yemen was a complex task, as "almost 74 percent of the Yemeni population lives in scattered rural, often mountainous, settlements, making it extremely difficult to provide basic social services, including microfinance."[26] This geographic dispersion, coupled with a near

[23] This intensified in early 2020, when Houthi authorities banned the circulation of new rial banknotes printed by the CBY-Aden after 2016 in areas under their control. In March 2024, the CBY-Sana'a's introduction of new currency further deepened the monetary division and escalated the battle between the respective central banks for control of the financial system.

[24] Due to the prevailing dual-rial currency system, banknotes issued by the CBY-Aden post-2016 are currently worth less than one-third of the pre-2016 banknotes circulating in Houthi-controlled areas. This disparity stems from the wartime split of the central bank. As a result, for an individual to receive YR100,000 in Sana'a in old currency, the sender in Aden has to send over YR300,000 of new currency, with the difference accounting for over 200 percent of the amount to be received.

[25] Sana'a Center Economic Unit "The Economy – The Yemen Review Quarterly, January-March 2024," Sana'a Center for Strategic Studies, April 9, 2024, https://sanaacenter.org/the-yemen-review/jan-mar-2024/22281 Accessed September 1, 2024.

[26] Deena Burjorjee and Mary Jennings, "Microfinance Gender Study: A Market Study of Women Entrepreneurs in Yemen," Social Fund for Development, June 2008, p.6, https://smed.sfd-yemen.org/media/attachments/2019/08/06/microfinance-gender-study-en.pdf. Accessed September 1, 2024.

absence of basic infrastructure in these areas, significantly increases operational costs for MFBs. High transaction costs coupled with poor transportation networks limit MFBs' geographic reach and ability to serve the underbanked. This creates a vast financial exclusion zone. Further complicating the matter is the absence of credit history among the poor, which creates an information gap, making it challenging for banks to assess their creditworthiness and financial behavior. To top it off, the minuscule loan sizes typically required by these populations are dwarfed by the high costs associated with serving them. Challenges gathering accurate information, operating in areas with limited infrastructure, and dealing with impermanent addresses all contribute to this burden.[27] Additionally, a lack of financial literacy among the rural poor and a cultural aversion to interest-based loans in some regions create obstacles to client acquisition and financial inclusion efforts.[28]

Many newly established MFBs struggle with inexperienced staff, questionable practices, and inadequate internal controls. These weaknesses, often stemming from their origins as money exchange businesses, translate into a lack of microfinance expertise. While money exchange companies offer valuable experience in cash flow management and customer service, they often lack the specialized knowledge of microfinance institutional structure, loan management, and regulatory compliance. The emergence of new MFBs has triggered other unintended consequences, as experienced staff from existing traditional banks have been lured away, sometimes weakening the capacity of these established players. These transitioned staff may also struggle to adapt from commercial banking practices, which prioritize collateral and long-standing client relationships but are generally unsuitable for microfinance clients. This knowledge gap could hinder MFBs' ability to effectively assess creditworthiness, design appropriate microfinance products and services, and promote financial literacy among their target clientele, ultimately jeopardizing their long-term viability. Building essential knowledge of microfinance tools, principles, and product development requires a stable environment, which is currently absent in war-torn Yemen.

Furthermore, concerns exist about the long-term commitment of exchange company owners to microfinance. The influx of new MFBs has intensified competition, raising questions about potential "mission drift." These institutions may prioritize easily reachable, low-risk clientele in urban areas, neglecting the underserved rural populations that microfinance traditionally aims to support. The fierce competition could incentivize unsustainable practices, such as excessive lending, with exorbitant interest rates and misleading marketing tactics. Unregulated credit information sharing could exacerbate this issue, pushing clients towards over-indebtedness by borrowing from multiple MFBs.

[27] Ali Saleh Alshebami and V. Rengarajan, "Microfinance Institutions in Yemen: 'Hurdles and Remedies,'" International Journal of Social Work, 2017, Vol. 4, No. 1, https://www.findevgateway.org/sites/default/files/publications/files/5th_paper_published.pdf Accessed September 1, 2024.

[28] Ibid.

The exceptional benefits currently offered by the CBY-Aden to entice MFB formalization may be temporary, raising questions about their ability to achieve long-term financial stability. Furthermore, the shifting priorities of the money exchange company owners who establish MFBs pose another risk. They might find microfinance less profitable than anticipated and abandon the sector to seek regular banking licenses. The CBY-Aden's concern about a "follow-the-leader" mentality among money exchange companies leading to an unsustainable surge in MFBs is well-founded. The ease of setting up MFBs, combined with potentially lower capital requirements compared to commercial banks, could create a race to the bottom.[29] The CBY-Aden's proposed solution – allowing MFBs to specialize or transform into fully-fledged banks – offers some mitigation but also reflects concern about a potential bubble and highlights the lack of a long-term strategic plan for Yemen's banking sector. A surge in MFBs driven by short-term trends during the conflict could lead to unnecessary competition followed by a brutal restructuring and consolidation phase – mirroring the Iraqi banking sector's experience following the 2003 US-led invasion.[30] Blind transformation comes with higher risks and associated costs, highlighting the need for a more strategic long-term vision and a precautionary approach from the CBY-Aden on how Yemeni banks should be institutionalized to achieve financial stability and serve development goals.

These challenges are not unique to Yemen. Developing countries around the world grapple with similar issues, including limited outreach, high operating costs, and the need for specialized expertise. Despite the challenges, MFBs hold immense potential to transform Yemen's financial landscape. By learning from global experiences and addressing the issues outlined above – fostering a unified CBY framework, mitigating the impact of the dual currency system, investing in infrastructure development, and building strong institutional capacity – MFBs can become a powerful engine for financial inclusion, economic growth, and poverty reduction in Yemen. This requires a collaborative effort from MFBs, the CBY, regulatory bodies, and international organizations to navigate the complexities of the current landscape and ensure a sustainable future for Yemen's microfinance sector.

[29] Interview with a senior Yemeni banker based in Aden, April 2024.

[30] Ibid.

Prospects and Benefits of MFB Transformation

Microfinance has emerged as an important component of sustainable development in developing economies, particularly in Islamic countries like Yemen, where conventional banking may be limited. However, Yemen's microfinance sector suffers from significant underdevelopment, leaving millions without access to crucial financial services. This is particularly detrimental considering the dominance of micro, small, and medium-sized enterprises (MSMEs), which account for over 97 percent of businesses and are generally considered an engine of economic growth while employing a significant portion of the workforce.[31]

Conventional banking has largely failed these segments, prioritizing risk-averse investments in government debt instruments such as treasury bills. Conventional banks view the poor as undesirable clients due to factors like limited income, unstable employment, and the lack of collateral – a requirement banks cling to despite its limitations.[32] This neglect resulted in a dismal financial inclusion rate of less than 10 percent by 2014,[33] a staggering exclusion of 90 percent of the population, especially those in rural areas. Despite Yemen's predominantly rural population, all ten MFBs/MFIs favor urban areas, where 93 percent of their clients are based.[34] This massive gap indicates that there is a significant opportunity for microfinance institutions to expand their reach and financial services to underserved areas.

MFBs, with their broader outreach compared to traditional banks, are ideally positioned to bridge this gap. Their existing infrastructure and expertise can be readily adapted to offer microloans and other financial services to the unbanked and underbanked. Financial inclusion has the potential to unlock economic opportunities, empower entrepreneurs, and foster the proliferation of MSMEs, the backbone of the Yemeni economy. Unlike traditional MFIs, which are heavily reliant on donor funding,[35] newly-formed MFBs benefit from a sustainable financing model. They can leverage customer savings for strategic product development and enjoy greater flexibility in participating in donor programs based on strategic alignment.

The recent trend of both CBYs issuing new MFB licenses to money exchange agents comes with a crucial shift: agents must transition from currency exchanges to full-fledged microfinance operations, offering a broader suite of financial products and services, including deposit-taking and potentially even access to international

[31] Nabila Assaf, "Stimulating Business and Employment in Yemen," MNA Knowledge and Learning Quick Notes Series, No. 91, World Bank, April 2013, https://documents1.worldbank.org/curated/en/990001468339586248/text/768120BRI0QN910B0x374389B00PUBLIC0.txt. Accessed September 1, 2024.

[32] Ali Saleh Alshebami and V. Rengarajan, "Microfinance Institutions in Yemen: 'Hurdles and Remedies,'" International Journal of Social Work, 2017, Vol. 4, No. 1, https://www.findevgateway.org/sites/default/files/publications/files/5th_paper_published.pdf. Accessed September 1, 2024.

[33] Moneef al-Shaibani, "Microfinance in Yemen: An Overview of Challenges and Opportunities," RYE Policy Brief No. 6, Sana'a Center for Strategic Studies, DeepRoot Consulting, and CARPO, April 30, 2020, https://devchampions.org/publications/white_papers/microfinance_in_yemen/. Accessed September 1, 2024.

[34] Ibid.

[35] Ibid.

financial networks like SWIFT. This empowers them to offer more effective and consistent financial services compared to their informal counterparts.

Yemen stands out as a vibrant anomaly in the Arab world's microfinance landscape, offering a fertile ground brimming with lucrative incentives and unparalleled opportunities for MFIs and money exchange companies to shed their limitations and evolve into full-fledged MFBs. This advantage stems directly from Yemen's progressive regulatory framework, a stark contrast to the stifling legal environments plaguing many Arab nations. Microfinance, effectively delivered through transformed exchange companies, can play a vital role in empowering Yemeni entrepreneurs and fostering economic development.

Recommendations

The proliferation of MFBs in Yemen presents a unique opportunity to reinforce financial inclusion. However, their sustainability and potential impact hinge on navigating a landscape riddled with challenges and demands a comprehensive strategy. This strategy requires a collaborative effort from the CBY, MFBs themselves, and international donors. These recommendations target the existing phase of conflict where the CBY is still divided and a future phase where the CBY will be reunified (or, at the very least, a coordination mechanism is established) and legislative institutions are again active.

I. Fostering a Healthy and Sustainable Ecosystem

- **Phase 1 (During Conflict)**
    - Strategically pause new MFB licenses and review existing frameworks.
    - Conduct a microfinance ecosystem assessment to identify gaps and assess the exchange company transformation experience.
    - Review regulatory frameworks on how best to streamline licensing, risk management, client protection, and rural outreach. To enhance the regulatory and legal frameworks governing microfinance banks, collaboration between the central banks in Aden and Sana'a is imperative. This coordination should encompass the establishment of clear restrictions to prevent conflicts of interest between banking and exchange activities.
    - Strengthen oversight and supervision over the operations of MFBs to ensure their strict adherence to established laws and standards and prevent harmful practices like money laundering and currency manipulation.
    - Review how to improve lenders' access to creditworthiness data.
- **Phase 2 (Unified CBY)**
    - Consolidate and finalize the microfinance ecosystem assessment.
    - Implement updated MFB regulatory frameworks and leverage active credit bureaus.
    - Consolidate MFBs through encouraging mergers and acquisitions.
    - Expand consolidation to MFIs with the goal of creating a new generation of sound microfinance institutions.
    - Engage with exchange companies to encourage strategic investments in established banks.
    - Explore strategic downscaling aimed at lessening reliance on traditional banks in favor of strengthening the financial role of MFB agent networks.

II. Building MFB Capacity

- **Sustainable Business Models and Technical Expertise**
  - Develop long-term business models (5+ years) with international donor support.
  - Provide training for MFB staff on microfinance principles, responsible lending, FinTech, and risk management.
  - Offer technical expertise in product development and client outreach for rural populations.
- **Client Outreach and Financial Inclusion**
  - Develop strategies for reaching unbanked/underbanked populations, particularly in rural areas.
  - Leverage FinTech, including mobile banking and digital financial services, for efficient service delivery.
  - Partner with established MFIs to share best practices in rural outreach.
- **Risk Management and Client Protection**
  - Develop risk management frameworks for rural lending.
  - Train MFB staff on risk assessment, credit scoring, and portfolio management.
  - Support the development of a national over-indebtedness alert service as part of the credit bureau system.
- **Knowledge Sharing and Impact Monitoring**
  - Facilitate knowledge sharing between Yemeni MFBs and international practitioners.
  - Implement social performance management systems to track MFB impact beyond profitability.
  - Develop a system to monitor MFBs’ impact on financial inclusion, poverty reduction, and rural development.

RETHINKING YEMEN'S ECONOMY

The Rethinking Yemen's Economy (RYE) Initiative and its associated Development Champions Forum aim to contribute to and support the advancement towards inclusive and sustainable development and peace by seeking to achieve the following: a) the enabled inclusive engagement of Yemenis in economic peacebuilding; b) an improved understanding of crucial policy areas related to economic peacebuilding and development in Yemen. The RYE initiative is implemented by DeepRoot Consulting, the Sana'a Center for Strategic Studies, and CARPO – Center for Applied Research in Partnership with the Orient. It is funded by the European Union.

For more information and previous publications: www.devchampions.org

Implementing Partners

The project is implemented by a consortium of the following three partners:

The Sana'a Center for Strategic Studies is an independent think-tank that seeks to foster change through knowledge production with a focus on Yemen and the surrounding region. The Center's publications and programs, offered in both Arabic and English, cover political, social, economic and security related developments, aiming to impact policy locally, regionally, and internationally.
www.sanaacenter.org

DeepRoot Consulting is a dynamic social enterprise passionate about Yemen's development. DeepRoot aims to help international development actors, the private sector, local civil society organizations and the Yemeni Government anchor their interventions in a deep understanding of Yemen's national and local contexts, and international best practices. Our leadership team and advisory board has decades of combined experience working in Yemen and internationally in the public, private and nonprofit sectors.
www.deeproot.consulting

The Center for Applied Research in Partnership with the Orient (CARPO) is a Germany-based organization whose work is situated at the nexus of research, consultancy and exchange with a focus on implementing projects in close cooperation and partnership with stakeholders in the Middle East. The CARPO team has long-standing experience in the implementation of projects in cooperation with partners from the region and a deep understanding of the Yemeni context.
www.carpo-bonn.org

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