

**Republic of Yemen**  
**Comprehensive Development Review**  
**Financial Sector Building Block**

**Phase I:**

**Basic Data and Trends**  
**International Comparisons**  
**Development Goals and Prospects [to be completed]**

**DRAFT: Not for Distribution or Quotation**

**Republic of Yemen**  
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**Phase I**

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**Republic of Yemen**  
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**Phase I:**

**I. INTRODUCTION**

This paper has been prepared as part of Phase I of the Comprehensive Development Review (CDR) for the Republic of Yemen. It reviews the current state and recent developments of the financial sector in Yemen, focusing on the principle component of the system – the banking sector – while providing more limited information with respect to other components of the system – the pension system, rural finance, housing finance, foreign exchange services, leasing activities, micro-finance, and the payments system. Components of more developed financial systems but which have not yet emerged in Yemen – such as the capital and bond markets (with the exception of Treasury bills) and insurance – are mentioned only briefly

**II. OVERVIEW OF THE FINANCIAL SYSTEM**

The financial system is composed almost entirely of private and public commercial banks, although pension funds for public-sector and for private-sector employees also exist, as well as a postal deposits system and foreign exchange traders. This description and analysis will therefore largely contain information on the banking system. Information on availability and extent of other aspects of financial intermediation will be included as available.

**Key Financial System Indicators**  
**YR billion**

	1995	1996	1997	1998
Nominal GDP	447.8	665.2	740.6	701.3
Nominal Non-oil GDP	378.6	463.9	532.2	579.2
Inflation	62.5%	27.3%	6.3%	11.1%
% change in real GDP	6.7%	4.3%	7.1%	2.9%
% change in real non-oil GDP		2.2%	6.9%	3.0%
Broad Money (M2)	248.3	269.6	298.4	333.3
Currency + Demand Deposits (M1)	164.1	156.7	166.4	179.9
Quasi Money (Time and Savings deposits)	28.5	49.0	55.6	57.4
FX deposits	55.6	63.9	76.4	96.0
FX deposits as % of M2 (Dollarization)	22.4%	23.7%	25.6%	28.8%
% change (yearly) in M2	20.4%	8.6%	10.7%	11.7%
% change (yearly) in YR broad money	20.0%	6.8%	7.9%	6.9%
Monetization/Financial Depth				
M2 as a % of GDP	55.4	41.1	40.3	47.5

M2 as a % of non-oil GDP	65.6	58.0	56.1	57.5
Velocity of M2 (GDP/M2)	2.0	2.6	2.7	2.5
Non-oil velocity of M2 (non-oil GDP/M2)	1.7	1.9	2.0	2.0
Exchange Rate YR/\$	40	110	129	135
Benchmark deposit rates	20.0	20.0	11.0	10.0
Real YR deposit rate (Benchmark – CPI)	-42.5	-7.3	4.7	1.3
Average lending rate	28.3	28.3	18.0	17.0
Stock of treasury bills/GDP	0.4	1.7	6.8	10.8

**Aggregate Monetary Indicators:** Although the economy of Yemen has largely stabilized, it has not yet achieved strong or consistent growth in GDP. The inflation rate, as measured by the Consumer Price Index (CPI), dropped from about 71 percent in 1994 to around 27 percent in 1996, and then to only 6.3 percent in 1997. 1998 inflation rose to 12.2 percent, but 1999 inflation is expected to decrease to approximately 9 percent.

The Government no longer borrows directly from the banking system – it now largely issues treasury bills – and has prohibited public-enterprise borrowing from the banking system.

The ratio of outstanding treasury bills to GDP have increased from 1.7% in 1996 (the first full year in which treasury bills were issued) to 6.8% in 1997 and 10.8% in 1998, reflecting the Government's increasing use of this tool. These reforms have limited the increase in broad money and has helped to minimize inflation. The exchange rate, which in 1990 was 18 YR to the US dollar, averaged during 1998 approximately 135 YR/US\$. Economic difficulties related to the drop in oil prices in 1999 resulted in further depreciation of the currency (the exchange rate peaked at 170 YR/US\$), however, the exchange rate has recently stabilized at approximately 160 YR/US\$.

The country is not highly monetized, with a ratio of broad money (M2) to non-oil GDP of approximately 57 percent. Non-oil monetary velocity is approximately 2.0.

### III. THE BANKING SYSTEM

#### Commercial Banks

Financial system assets total approximately YR 532.5 billion and are concentrated in the Central Bank – with total assets at end-1998 of YR 326.0 billion – and the banking system – with total assets of YR 206.5 billion (US\$ 3.9 billion; 2.41 billion; and 1.53 billion, respectively). With a ratio of Central Bank assets to total assets of 61 percent, the financial system is heavily dominated by the Central Bank. Of Central Bank assets, loans and advances to the Government (including approximately YR 75.7 billion in outstanding treasury bills) are 60 percent, or YR 196.7 billion, at end-1998.

Of the 13 commercial banks in Yemen, five are wholly or partly foreign owned, and two are majority owned by the government but planned to be privatized. In addition, there are two government-majority owned specialized banks (the Housing Credit Bank and the Cooperative and Agricultural Bank (CACB)). A third public specialized bank – the Industrial Bank of Yemen – is in the process of liquidation, having been burdened for many years by non-performing foreign-

currency loans made while the exchange rate was fixed at YR12/US\$.<sup>1</sup> A summary of the ownership structure of the banking system is provided on the following page.

### Bank Ownership Structure

	Date of Establishment	Head Office Location	Capital (YR Million)	Shareholders	Shareholding (Percent)	Total Branches <sup>1</sup>
<b>Commercial Banks</b>						
Yemen Bank for Reconstruction and Development	1962	Sana'a	619.0	Government Yemeni private	51 49	37
National Bank of Yemen	1969	Aden	1023.0	Government	100	34
United Bank Ltd.	1972	Sana'a	595.0	United Bank (Pakistan)	100	2
Arab Bank PLC	1972	Sana'a	1286.0	Arab Bank (Jordan)	100	7
Banque Indosuez	1975	Sana'a	1704.0	Banque Indosuez (France)	100	5
Yemen Commercial Bank	1993	Sana'a	890.0	Yemeni private	100	8
Yemen-Kuwait Bank for Trade and Investment	1979	Sana'a	821.0	Yemeni private	100	3
International Bank of Yemen	1980	Sana'a	708.0	Yemeni private Saudi Arabian banks	75 25	5
Rafidain Bank	1982	Sana'a	82.0	Rafidain Bank (Iraq)	100	1
<b>Islamic Banks</b>						
Islamic Bank for Finance and Investment	1995	Sana'a	443.0	Yemeni private <sup>2</sup>	100	1
Al-Tadamon Islamic Bank	1996	Sana'a	1440.0	Yemeni private <sup>2</sup>	100	5
Saba Islamic Bank	1997	Sana'a	1181.0	Yemeni private <sup>2</sup>	100	1
Al Watani	1998	Sana'a	500.0	Yemeni private	100	1
<b>Specialized Banks</b>						
Industrial Bank of Yemen (under liquidation)	1976	Sana'a	130.0	Government Yemeni private	70 30	1
Housing Credit Bank	1977	Sana'a	222.0	Government Yemeni private	70 30	2
Cooperative and Agricultural Credit Bank	1982	Sana'a	389.0	Government Yemeni cooperatives	87 13	29

<sup>1</sup> Including head office.

<sup>2</sup> With some foreign minority shareholders.

**Financial Intermediation:** Financial intermediation remains limited, particularly outside of the urban areas. Although two-thirds of the population live in rural areas, only the two government-controlled commercial banks (the Yemen Bank for Reconstruction and Development (YBRD) and the National Bank of Yemen (NBY)) have branches outside of the main cities. CACB, as the state agricultural bank, has branches throughout the country, but until recently did not take individual deposits (see Rural Finance, below).

<sup>1</sup> Ninety-five percent of the Industrial Bank's loans were non-performing at the time of liquidation.

**Deposits:** Bank demand deposits, time deposits, and foreign exchange deposits account for only 25 percent of GDP in Yemen, compared to more than 60 percent of GDP in OECD countries. The tables below provide deposit/GDP ratios for Yemen from 1995-1998 and comparator ratios for other countries in the Middle East.

**Yemen: Deposits/GDP, 1995 - 1998**

	1995	1996	1997	1998
Deposits/GDP	26.6	22.8	23.2	25.0

**Bank Deposits (Demand, Time, and Foreign Exchange Deposits)  
as a percentage of GDP (1998)**

Country	Deposits/GDP
Egypt	68%
Jordan	86%
Morocco	55%
Tunisia	40%
Algeria	28%
Yemen	25%

Despite the low deposit-to-GDP ratio, deposits form the largest source of funds for banks – 80 percent of total liabilities and equity in 1998 (an increase from 72 percent in 1997). Although a very high figure, this is logical in the context of an undercapitalized financial system with almost no other sources of funds.

**Lending:** The loan-to-deposit ratio for the commercial bank system is very low, at 27 percent in 1998. This figure has not fluctuated much over the past four years, with a significant exception in 1996, when it dipped to 17 percent. This dip corresponds to the introduction of a flexible exchange rate in Yemen, and uncertainty surrounding this change undoubtedly contributed to significantly decreased lending. These low figures, as well as the low deposit/M2 and deposit/GDP ratios, indicate an extremely low level of financial intermediation, conservative lending, and overall lack of confidence by the banking sector in the capacity and willingness of the private sector to repay debt.

Low lending levels reflect conservative lending practices dating back decades. Given difficulties in loan repayment and recovery, commercial banks have long been reluctant to lend resources outside of a small group of select customers, which has contributed to credit concentration<sup>2</sup> and a large liquidity overhang (bank reserves were almost 150 percent of required reserves in June, 1998 [see table below]). The late-1995 introduction of treasury bills has only partially helped to reduce liquidity. Commercial bank loans to the private sector accounts for

<sup>2</sup> Compliance with CBY-regulated lending limits (no more than 15% of a bank's paid-in capital and retained reserves to a single borrower or group of related borrowers) is weak. Estimates made for the end of 1998 indicate that 11 of the country's 16 banks were not in compliance with these limits.

only 6.5 percent of GDP (compared to around 70 percent of GDP in OECD countries) and for only 12 percent of total credit to the economy.<sup>3</sup>

### Bank Reserves/Required Reserves, 1995 - 1998

	1995	1996	1997	1998
Reserves/required reserves	137.0	200.3	103.1	147.0

### Credit to the Economy (Loans/GDP) and to the Private Sector (PSLoans/GDP) 1998

	Loans/GDP	Private Sector Loans/GDP
Jordan	80%	73%
Egypt	62%	48%
Morocco	57%	48%
Tunisia	51%	51%
Algeria	24%	4% (1997)
Yemen	11.7%	6.5%

The distribution of commercial bank loans by recipient type (Government, public sector, and private sector) to the economy between 1995 and 1998 is provided in the table below. The clearest trend is the replacement of loans to public enterprises – i.e., direct banking system funding of public enterprises – to lending to the Government through the purchase of treasury bills. Total commercial bank credit to the economy as a percentage of GDP has been increasing, but the largest part of that increase is coming from increases in credit to the Government (in the form of purchases of treasury bills). In addition, the near disappearance of commercial bank loans to public enterprises over 1997 and 1998 reflects the prohibition in December 1995 of new lending to public enterprises, and a significant repurchase by the Central Bank and the Ministry of Finance of non-performing public enterprise loans in the two public commercial banks.<sup>4</sup>

<sup>3</sup> The latter figure includes “loans to Government” of YR 36,267, which should probably be accounted for in commercial bank balance sheets as holdings of treasury bills.

<sup>4</sup> Cabinet Resolution #152 of 1997 announced the resolution of YR 2,063 million in non-performing public enterprise (PE) loans to the National Bank of Yemen and YR 1,784 million in non-performing PE loans to the Yemen Bank for Reconstruction and Development. The loans to NBY were settled in cash, which was to be held in an escrow account pending NBY’s privatization (i.e., not allowing an increase in lending capacity); those to YBRD were settled by the transfer of Government treasury bills. These amounts are more than the total loans to PEs in 1996 and 1997; the difference may be explained by misclassification of PE loans to the private sector.

**Table: Distribution of Commercial Bank Credit**

	1995		1996		1997		1998	
	YR million	% of GDP	YR million	% of GDP	YR million	% of GDP	YR million	% of GDP
Loans to Public Enterprises	10,826	2.42%	2,056	0.31%	1,453	0.10%	12	0.00%
Loans to Government	1,295	0.29%	6,963	1.06%	34,873	4.70%	36,267	5.17%
Loans to the Private Sector	23,865	5.33%	22,358	3.41%	34,384	4.64%	45,957	6.55%
<b>Total Loans</b>	<b>35,986</b>	<b>8.04%</b>	<b>31,377</b>	<b>4.79%</b>	<b>70,709</b>	<b>9.55%</b>	<b>82,235</b>	<b>11.73%</b>

**Loan Maturities and Sector Concentrations:** The tables below show the distribution of commercial bank lending by loan maturities and sectoral concentration. Approximately 90 percent of loans from commercial banks have maturities of less than one year. This highlights two primary factors: first, that banks are generally unwilling to lend for investment purposes, which would require longer-term maturities, due to loan collection risks and lack of effective collateral; second, the importance of imports to the economy and the relative safety of loans and advances for imports. In 1995, 72 percent of all commercial bank lending was for imports. This has declined to 50 percent in 1998, likely reflecting the depreciation of the Rial. In contrast, almost no lending is provided for exports; 1998 lending for exports represented only 2 percent of total lending to private and public enterprises.

**Distribution of Commercial Bank Loans and Advances  
to Private and Public Enterprises  
YR million**

	1995	1996	1997	1998
<b>Short-term Lending</b> (under 1 year)				
Agriculture	370.6	351.5	129.6	100.3
Exports	71.5	--	43.0	952.5
Imports	24,953.7	16,780.4	21,935.4	23,103.1
Industry	3,602.3	3,101.8	8,758.0	6,175.7
Other	2,244.1	2,442.1	2,192.4	10,792.6
<b>Total Short-Term Lending</b>	<b>31,242.2</b>	<b>22,675.8</b>	<b>33,058.6</b>	<b>41,124.2</b>
<b>Medium and long-term lending</b> (1 - 5 years)				
Agriculture	--	--	--	--
Industry	78.0	96.3	95.0	--
Housing	544.4	452.3	241.2	186.4
Other	2,825.5	1,189.7	2,437.7	4,657.7
<b>Total Med. and LT Lending</b>	<b>3,447.9</b>	<b>1,738.3</b>	<b>2,774.0</b>	<b>4,844.1</b>
<b>Total Commercial Bank Lending to Private and Public Enterprises</b>	<b>34,690.1</b>	<b>24,414.1</b>	<b>35,832.5</b>	<b>45,968.3</b>
<b>as a percentage of GDP</b>	<b>7.75%</b>	<b>3.73%</b>	<b>4.84%</b>	<b>6.55%</b>

**Distribution of Commercial Bank Loans and Advance  
to Private and Public Enterprises  
Percentage of Total Loans**

	1995	1996	1997	1998
<b>Short-term Loans</b>	90.1%	92.9%	92.3%	89.5%
Imports	71.9%	68.7%	61.2%	50.3%
<b>Medium- and Long-Term Loans</b>	9.9%	7.1%	7.7%	10.5%

**Banking Concentration:** The bulk of the banking system is concentrated in four banks – the two public commercial banks (YBRD and NBY) and two foreign commercial banks (Arab Bank and Banque Indosuez). As of end-1998, these banks held approximately 70 percent of total loans and total deposits. Classified loans, however, are concentrated in YBRD and NBY and in the public-sector specialized Industrial Bank of Yemen, and in two private Yemeni-owned commercial banks. The table below summarizes the concentration of total loans, deposits, and capital among the largest four banks.

**Banking Sector Indicators**

	1993	1994	1995	1996	1997	06/1998
Top 4 banks' share in:						
Total loans	83.0	77.0	77.0	60.0	71.0	69.0
Total deposits	85.0	83.0	76.0	77.0	72.0	70.0
Total capital	63.0	57.0	71.0	51.0	54.0	41.0

**Distribution of Assets, Capital, Deposits, etc. by Bank Ownership:** In terms of capital, assets, lending, and deposits, the private commercial banks have been steadily gaining ground over the two public commercial banks. As of June 1998, private commercial banks account for more than half of the banking system in terms of capital, assets, net loans, and deposits. The table below summarizes the distribution of key balance sheet items by ownership structure of banks.

	% System Capital	% System Assets	% System Net Loans*	% System Deposits
Public Commercial Banks	14%	30%	22%	29%
Public Specialized Banks	6%	3%	12%*	1%
Private Commercial Banks	55%	59%	54%	65%
Private Islamic Banks	25%	8%	13%	5%

\* Net Loans = Gross Loans less actual provisions. Net loans of public specialized banks are relatively high due to significant underprovisioning. With adequate provisioning, net loans of public specialized banks would be more on the order of 5 percent of net loans in the system.

## Interbank Lending

Interbank market activities are very limited. To some extent, this is due to the high liquidity in the system, as detailed above.

## Risk and Vulnerability Analysis

The banking sector as a whole is weak, with a large volume of problem loans, low capitalization, and significant provision shortfalls. The following table summarizes key areas of vulnerability.

### Banking Sector Vulnerability Indicators (%)

Indicator	1994	1995	1996	1997	June 1998
Problem Loans* to Total Loans	10.3	10.5	58.5	49.9	59.0
Total Capital to Total Assets	1.8	2.6	3.7	5.6	5.9
Net Foreign Currency Position to Total Bank Capital	8.1	4.0	0.8	0.9	0.7

Source: Central Bank of Yemen, IFS, OP #169, and IMF staff estimates.

\*Defined as NPL over 90 days past due. The large increase in 1996 reflects the use of CBY's classification system instead of banks' reporting.

**Credit Risk:** The large proportion of NPL to total loans shows the vulnerability of the banking sector to credit risk. Almost half of the NPL are concentrated in the two public commercial banks; with the exception of one specialized bank, all public banks are technically insolvent after accounting for inadequate loan loss provisions.

In order to determine the vulnerability of the private banks (i.e., the banks with relatively healthier loan portfolios, the private commercial banks and the Islamic banks) to additional credit risk, a sensitivity analysis was conducted. In Scenario 1, it was assumed that classified loans increased by 20%, with provisioning at 15% (the rate required by CBY for substandard loans). In Scenario 2, it was assumed that classified loans increased by 40%, with provisioning at 40% (a blend of the rates for various classification levels). In both scenarios, it was assumed that total loans and total assets were unchanged.

### Credit Risk Sensitivity Analysis (Private Banks)

	Actual		Scenario 1		Scenario 2	
	NPL to Total Loans	Adjusted Capital* to Total Assets	NPL to Total Loans	Adjusted Capital* to Total Assets	NPL to Total Loans	Adjusted Capital* to Total Assets
<b>Commercial Banks</b>	32%	2.37%	38%	2.15%	44%	1.17%
<b>Islamic Banks</b>	11%	18.97%	13%	18.87%	15%	18.40%

\*Adjusted Capital is Total Capital less the estimated loan loss provision shortfall.

NOTE: The total assets of private commercial banks and Islamic banks represent about 66% of the total assets of the banking sector.

**Interest Rate Risk:** Another significant potential risk to the banking sector is interest rate risk, which can not be calculated with the information available. In order to estimate interest rate risk, the maturity distributions of loans, investments, deposits, and borrowed funds must be obtained.

### Foreign Currency Loans and Deposits [to be developed further]

#### Foreign Currency Share of Banking System Loans and Deposits

	1995	1996	1997	1998
Foreign currency share of total loans	21.1	23.0	28.4	29.1
Foreign currency share of total deposits	46.7	42.8	44.6	46.7

**Worker Remittances:** Estimates of the total level of worker remittances are not readily available, however, net remittances within the banking system are estimated as follows:

#### Net Worker Remittances 1992 - 1997, US\$ million

	1995	1996	1997
Remittances (US\$)	1,067.0	1,123.0	1,157.0
(YR million)	42,680	123,530	149,253
As a percentage of commercial bank liabilities	23.9%	64.5%	72.2%

Source: Arab Monetary Fund and Yemen estimates, as cited in Qasiour, *Status and Requirements for Establishing Yemen Securities Market*, 1999.

### Constraints to Financial Sector Development

**Lack of Real Sector Investments and High Returns on Treasury Bills:** The low loan-to-GDP ratio, low loan-to-deposit ratio, and low ratio of loans to the private sector to total lending, and the high concentration of lending for trade activities all point to lack of effective demand for term lending. Although businesspeople may be in need of financing, and although real spreads between lending and deposit rates are significant, banks clearly do not have adequate incentives to lend to the private sector. Spreads are not high enough to compensate for the high credit risks of lending in Yemen -- in particular, lack of collateral and inadequate legal protections for creditors -- and banks receive sufficient return on risk free assets (treasury bills, offering returns of nearly 23 percent in the latter half of 1999) to enable them to ignore commercial lending.

The introduction of Treasury bills have successfully shifted public-sector deficits from being funded by commercial (public and private) bank loans, to being funded indirectly through the purchase of treasury bills. Combined with the lack of viable lending opportunities, banks' income depends on returns from treasury bills.

Given the above, it is clear that, for the time being, Yemen is "overbanked". Until there are indications that existing banks are finding viable lending opportunities and that there is a demonstrated need for additional banks, the Central Bank should not approve new applications

for banking licenses. In addition, the current capital requirements for banks -- YR one billion -- should help to encourage the merger of existing, undercapitalized banks.

**Legal Constraints:** The state of the legal system in Yemen seriously constrains financial sector development. Legal problems which affect the banking system significantly contribute to the low level of credit extended to the private sector. First, the absence of a land registration system results in multiple claims, which reduces the value of real property as collateral against loans. Second, loan contracts are rarely enforced, due to, among other problems, lengthy delays before a hearing, decisions against payment of interest, and the absence of a system to enforce the implementation of decisions. Finally, pervasive rent-seeking activity frequently directly influences the outcome of court decisions on bank cases.

### **Demand for and Accessibility of Services**

Although the evidence is clear that the banking system has a very small presence in the economy, no detailed studies have yet been done to determine the scale of demand for financial services – either savings or loan facilities – or the degree to which demand is not met. Early successes in the Social Fund for Development micro-finance programs indicate that there is widespread unmet demand, and that households are willing to pay for such services.

A detailed household survey will be undertaken in early 2000 by the Social Fund for Development which will analyze use of and demand for financial sector services in both the formal and informal sectors.

## **IV. OTHER FINANCIAL SERVICES**

### **Postal Deposit System**

Yemen has a relatively extensive postal deposit system (Post and Postal Savings Corporation – P&PS) which appears to operate well, but which is not supervised as a bank and whose assets and liabilities are not included in the country's financial sector statistics. The P&PS is organized in 5 regions and 150 branches. The branches are used for mail services and financial services, and postal branch staff work on both type of services.

**Savings Services:** The P&PS has 63,000 accounts, which correspond to an equal number of customers (each customer has a single identification number and hence can only have one account). The minimum savings amount is YR 200 (US \$ 1.25), which makes establishing savings accounts significantly easier than at commercial banks (which may require initial deposits of US\$ 200 or even \$500). The total savings balance at end-1999 is YR 769 million (US\$ 4.8 million). To provide a comparison, time, and savings deposits in the commercial banking system at end-1999 were estimated to be approximately YR 51 billion. The average savings account balance is YR 13,000 (US\$ 81.25).

The P&PS can legally use the savings to make loans, however, they have not yet done so. The savings are held in an interest-bearing account with CBY or in T-bills. Interest rate paid to account holders for 1999 was 11.31%.

**Other Services:** The P&PS pays monthly the pensions of over 100,000 pensioners (civilian and military). Pensioners living in those areas with on-line branches can get their pension in cash each

month. Pensioners living in areas without on-line branches or without any branches may travel every 6 months to the nearest branch in order to receive 6 post-dated checks (for each of the coming 6 months). The pensioner may cash the checks any time within six months of its date.

The P&PS also offers money orders, a service that has grown from YR 40 million two years ago to YR 2 billion last year. Daily, 3000 transactions (issuance and payment) are processed. The service appears to cover its costs: a flat YR 50 fee is charged, plus 2 percent for the first YR 20,000 followed by 1 percent for any amount above YR 20,000. The system is efficient and is even used by the United States embassy and USAID to pay people in remote areas. For now money orders are transacted only in YR, but the P&PS intends to offer the service in FX in the near future.

The P&PS does provide transfer of funds in US dollars, but not in other foreign currencies. For example, if remittances are sent from abroad in foreign exchange, the P&PS converts non-US dollar amounts to dollars for payment.

Forty-six of the 150 branches are connected on-line (in real time) with the HQ in Sana'a using dedicated lines. The main computer is an AS/400 and each branch that is on-line has a PC and printer. The cost of this technology is relatively low. The initial set-up of the system to 20 branches was funded by a grant and assisted by the Universal Postal Union in Bern; the set-up of the other 26 branches were financed by the P&PS itself. The P&PS is seeking funding and assistance to get the whole network on-line.

## **Rural Finance**

There are little or no semi-formal or formal savings and loan services available in rural areas. Farmers in particular have little or no access to medium and long-term credit. Pilot projects in rural savings and loan approaches have been initiated under the World Bank's Social Fund for Development project in Dhaman, but these will take a long time to mature.

The state agricultural bank, CACB, does not function as a rural finance institution. As detailed in the 1998 Rural Finance report, CACB provides only thin coverage of rural financial needs; its operations have not always been directed to the highest potential agricultural activities; and the real value of its financing has been declining. Its lending is limited to agricultural production, whereas the rural economy is quite diverse, and the share of agricultural income in the rural economy is declining. CACB has recently begun to take deposits from individuals,<sup>5</sup> but does not provide other financial services. The bank could conceivably become a vehicle for real rural finance, but significant restructuring is required – a large-scale capital increase, paying market rates for deposits, discontinuing trading activities, and, in particular, completely overhauling its lending activities, credit procedures, and information systems – before the bank can become an effective rural finance institution. While such restructuring would be necessary, experience around the world with such institutions has yielded mixed results.

Additional information on CACB is available as Appendix 1 to this report.

## **Housing Finance**

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<sup>5</sup> CACB has until recently only taken deposits from agricultural cooperatives, which were required to deposit into the bank.

Housing finance – like most forms of credit in Yemen – is quite limited. While in many countries housing finance is considered among the safest lending vehicles, in Yemen *de facto* (and possibly *de jure*) prohibitions against property guarantees have led banks to limit housing loans to only well known and trusted wealthy clients.<sup>6</sup> Central Bank figures on lending indicate that only 0.23 percent of total commercial bank loans in 1998 were for housing. The table below provides the total amount lent by commercial banks for housing purposes for 1995 through 1998, and the percentage of commercial banks' housing lending to total lending.

**Commercial Bank Housing Lending in Yemen, 1995 - 1998**  
(YR million)

1995		1996		1997		1998	
Housing Loans	% of total loans	Housing Loans	% of total loans	Housing Loans	% of total loans	Housing Loans	% of total loans
544.4	1.5%	452.3	1.4%	241.2	0.34%	186.4	0.23%

Source: Central Bank of Yemen. Although CBY reporting indicates that these figures are only from commercial banks, it needs to be confirmed that they do not include the housing portfolio of the Housing Credit Bank.

Although extensive comparator data is not available, housing finance in Jordan does provide one point of comparison. There, the portfolio of commercial bank housing loans to *GDP* (not as a percentage of total loans, as above) for 1999 is estimated to be 4.8%. Including public loan programs and estimating for 2000, the total portfolio could be as high as 11 percent of GDP. Stable middle-income countries tend to have housing portfolios in the area of 15 to 25 percent of GDP. For Yemen, the figure is for all intents and purposes zero.

While it has generally been considered that the Government's Housing Credit Bank (HCB) is the main vehicle for housing lending in Yemen, analysis of HCB's balance sheet (see Appendix 2) indicates that HCB's total portfolio of individual housing loans is only YR 102 million, or just more than half the housing portfolio of the commercial banks.

In addition to the limited amount of commercial bank and HCB lending for housing, it is reported that, for public sector employees, the public-sector pension fund can sometimes be used in a limited way for construction activities. It is also reported that there are Government-sponsored housing schemes, for which loan repayments for housing are directly deducted from the employee's salary, and which are not intermediated by HCB. Unfortunately, it is not known the extent, structure, or financing of such schemes, how many employees and/or households benefit from them, eligibility requirements, or the size of the benefit. Additional research in this area may be useful. The table below summarizes the terms and conditions of the three primary sources of housing finance. As the table shows, housing finance in Yemen is characterized by relatively short repayment periods and reliance on income rather than property guarantees.

<sup>6</sup> One report stated that a presidential decree in the 1980s ruled that property guarantees (residences, cars, furniture, or other articles) against loans were invalid, resulting in the legal and practical impossibility of using housing as collateral. Banks report that a significant number of bad debts have resulted from this decree, and that some banks have abandoned providing any loans for housing finance. The apparent exception to the residence-as-collateral restriction is that non-primary residences (properties in which borrowers are not permanently residing) can be offered as guarantees. Such borrowers would in general qualify for loans from banks on other grounds as well. However, it is not known if such guarantees have ever been upheld in court in the event of non-payment by the borrowers.

	<b>HCB</b>	<b>Commercial Banks</b>	<b>Pension Fund Loans</b>
<b>Maximum loan limits</b>	YR 30,000 – 40,000	no limit	YR 100,000
<b>Interest rate</b>	20-22% fixed	20-22% variable	20-22% fixed
<b>Basis of loan size</b>	salary and/or income	salary and/or income	accumulated pension contributions
<b>Repayment period</b>	5 years	1 year (renewable at new interest rates)	10 years or retirement, whichever is earlier
<b>Guarantees</b>	Employer/commercial guarantees, ownership documents	employer/commercial guarantees, ownership documents	employer guarantee and pension entitlement

**Constraints to the development of housing finance:** The single most significant constraint to the development of housing finance in Yemen is the prohibition against using personal property as collateral for loans. It has been reported that CACB has certain privileges – unavailable to other lenders – that allow it to seize property, and it may be that HCB has similar privileges. This needs to be confirmed. HCB has reported that it has developed a number of ways of strengthening property covenants both within the law and Islamic traditions, however, these have not been specified. Instead, it is widely understood that HCB has reduced loan losses by requiring the automatic deduction of repayments from borrowers, something that has also limited loans largely to civil servants.

Additional information on HCB is provided as Appendix 2 to this report.

### **Foreign Exchange Services<sup>7</sup>**

The foreign exchange market mainly consists of money changers and commercial banks, with CBY involvement limited to intervention aimed at smoothing volatility. There is also a black market involving unlicensed money changers, which becomes active at times of exchange rate pressure. However, in recent years no meaningful spread over the free market rate has been observed.

No firm data on the average daily volume of the free foreign exchange market are available, but the underlying transactions for private current and capital account activities are estimated in the range of US\$ 1 - 15 billion a year on both the buy and sell wide. The CBY estimates that money changers account for about 60-70 percent of total transactions, and the commercial banks for the balance. There are currently 170 licensed money changers in Yemen, of which 71 are located in Sana'a, some with offices also in Saudi Arabia and the UAE. About 5 to 6 money changers account for up to 90 percent of the money changers' market.

The CBY publishes its daily rate by calculating an average from a sampling of rates from a group of the larger money changers and banks. This rate is then used by the CBY for official transactions. If the CBY directly intervenes in the market, so far virtually always as a seller, it

<sup>7</sup> The information in this section is taken from the IMF's Staff Report for the 1998 Article IV Consultation, Review Under the Extended Arrangement, and Request for Second Annual Arrangement Under the Enhanced Structural Adjustment Facility, prepared by Paul Chabrier and Jesus Seade, dated March 3, 1999.

typically invites open bids from a number of large money changers and most commercial banks, and awards foreign exchange to the highest bidder.

Official transactions go through the CBY directly. On the inflows side, these include mainly crude oil export proceeds and foreign loans and grants; on the outflows side it is mainly wheat and wheat flour imports, public sector debt service, and foreign exchange requirements of most public enterprises. CBY annual foreign exchange receipts and expenditures have been in the range of about US\$ 1 billion each. Available information indicates that neither the CBY nor other market players are involved in forward or derivative operations.

Yemen maintains no exchange restrictions on current account or capital account transactions. Foreign banks are allowed to freely conduct all foreign and domestic currency business, as are domestic banks. Since January 1996, commercial and specialized banks are required to observe prudential regulations regarding currency exposure and to report their positions. The open positions (both oversold and overbought) are limited to 25 percent of all foreign currencies, and 15 percent of any one currency, as of November 1998.

### **Leasing Activities<sup>8</sup>**

Data is not available on the extent of leasing activities in Yemen. Previous interviews with banks indicated that several devices for providing security for loans or credit are at least considered by banks, including title-retention sales contracts, sales and lease-back arrangements, and forms of financial leasing transactions. The relatively new Islamic banks use leasing (*ijara*) as a secured financing technique, since it is sanctioned by Shari'a. However, banks are engaged in very little true asset-based financing. The one exception to this general pattern is the Cooperative and Agricultural Credit Bank, which frequently uses title retention sales contracts as a method of financing the purchase of agricultural equipment. When a farmer wishes to acquire an item of equipment, he makes arrangements with CACB to purchase the equipment from the supplier. CACB then enters into an agreement to sell the equipment to the farmer. The agreement provides that the farmer will pay the purchase price by installments over a period of time. However, until the amount owed to the Bank is paid, the ownership of the equipment remains with CACB. If a customer defaults in making agreed payments and a grace period has expired, CACB seizes and sells the equipment. *However, a legal expert advised that CACB's right was only exercisable because of its status as a state organization, and that such a right was thought not to be generally available to other financiers.*

The basic form of leasing contract is recognized in Yemeni law. The lessor is treated as the owner of the leased property, with the lessee having the right to possession and use of the property in accordance with the terms of the lease contract. No specialized body of law dealing with modern equipment leasing exists, and therefore considerable uncertainty exists as to how the law would address many of the issues that arise in the context of the various types of modern leasing transactions.

During interviews, most bankers noted that their reluctance to engage in leasing or other forms of asset-based financing was due to the fear that, in the event of default in payment by borrowers or lessees, they would not be able to enforce their security rights or would be able to do so only after such delay and expense that the rights would be commercially useless. In the context of leasing, this means that, as lessors, they would face long delays in getting a court order

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<sup>8</sup> Information in this section is from IFC's report, *Equipment Leasing in the Republic of Yemen*, prepared by Bassel Hamwi in July, 1997.

to permit repossession. If and when such repossession order were obtained, they would face additional difficulty in getting the assistance of the police in repossessing the leased property in cases where lessees resist surrender of the leased property to the lessors.

There is a difference of opinion as to whether or not “self-help” repossession (i.e., repossession allowed without a court order) by lessors is permitted under existing Yemeni law. Most thought that it was not, even though the lessor is the legal owner of the leased property and has a contractual right to its return upon default by the lessee. As noted above, CACB uses self-help repossession when buyers under title retention sales contracts default, however, legal experts felt that this right was exercisable due to CACB’s status as a state organization, and that other companies or individuals would not have this right.

### **Supplier Credit**

Information is not readily available on the amount of credit made available by suppliers of machinery, equipment, retails goods, etc.. Given the formal banking system’s concentration on the larger companies and families of companies, there is significant scope for the use of supplier credit by small and medium-sized businesses.

The household survey to be undertaken by the Social Fund for Development will collect data on the use of and availability of supplier credit to small and medium-sized businesses.

### **Micro-finance Services**

The provision of credit to small and micro entrepreneurs is a new phenomenon in Yemen. Except for the limited experience of the Small Enterprise Development Unit (a unit established within the Industrial Bank of Yemen to support small businesses and funded by international donors<sup>9</sup>), the Social Development Fund’s Small and Micro Enterprise Development (SMED) program is the only provider. The program supports the development of small and microenterprises through technical assistance, training, and access to credit.

SMED has developed nine income-generating programs (IGPs)<sup>10</sup> in Yemen, five of which involve livestock raising. This concentration in a single activity is thought to reflect a lack of innovation by requesting parties, rather than the demand of the poor. Some of the IGPs are very close to achieving operational self-sufficiency. However, limited markets and limited economic opportunities reduce the chances of schemes becoming sustainable. Institutional instability is another challenge to the continuity of these programs.

The SMED program has developed four micro-finance programs (MFPs), which provide financial services for a variety of economic activities and may also provide savings vehicles. The Hodeidah Microcredit program has been particularly successful – the first of its kind in Yemen to provide credit to micro-entrepreneurs, the program is based on an Islamic financing mechanism called *murabaha*, in which a lender purchases items needed by the borrower and resells to the borrower at an agreed mark-up. The full price is repaid by the borrower according to an agreed-

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<sup>9</sup> SEDU is now independent of the IBY; its assets and liabilities and operations were always accounted for separate from the larger IBY portfolio.

<sup>10</sup> IGPs are projects that provide credit to a single economic activity, like livestock raising or bee-keeping. Some non-financial services like training and veterinary services are also provided.

up schedule. The program has been active for nearly two years, has 1405 clients, an outstanding loan portfolio of YR 38 million, and portfolio-at-risk of 3 percent.

The following table summarizes the activities of the IGPs and MFPs under the SMED program. As mentioned above, these programs are effectively the only organized programs in Yemen providing credit and/or financial services to micro-enterprises.

#### **Active Clients, IGPs and MFPs (Yemeni Rials)**

Project	Borrowers		Savers		Outstanding Loan Portfolio	Total Savings Amounts
	Total	% female	Total	% female		
Income-Generating Projects (9)	1,083	25%	n/a	n/a	43,958,220	n/a
Micro-Finance Projects (4)	2,003	39%	1,988	100%	47,600,015	2,769,090
<b>Total</b>	<b>3,086</b>		<b>1,988</b>		<b>91,558,235</b>	<b>2,769,090</b>

#### **Cumulative Figures, IGPs and MFPs (Yemeni Rials)**

Project	Borrowers	Savers	Total Loan Amounts	Total Savings Amounts
Income-Generating Projects (9)	2,347	n/a	89,792,921	n/a
Micro-Finance Projects (4)	4,648	1,988	118,978,471	2,769,090
<b>Total</b>	<b>6,995</b>	<b>1,988</b>	<b>208,771,392</b>	<b>2,769,090</b>

### **Informal Financial Services**

The informal means used by people to save small sums of money or to borrow funds for various purposes are not well-studied, and the form and reach of such services are not known. However, as part of research into demand for micro-finance services, the Yemen Social Development Fund will be conducting a baseline survey of households in Yemen, which will include questions on current financial services – formal and informal – used by households.

### **Insurance**

Insurance sector activities are not developed in Yemen, although there are approximately 10 insurance and re-insurance companies operating in Yemen. There activities revolve largely around trade-related insurance. The sector operates within the legal framework of Law No. 37 of 1992. The only real supervision of the sector is the transfer of 30 percent of income to the supervisory ministry (Ministry of Supply and Trade).

### **The Pension System**

The pension system as a social security mechanism is covered under the Social Protection Building Block, however, the pension system can also be considered a means of building and

storing wealth and of allocating savings and investment in the economy, i.e., a financial sector vehicle.

The contribution and benefit structures of the main public and private-sector pension systems as well as their actuarial, financial and operational issues are well documented in the Social Protection Building Block. As one of the primary operational issues of the systems is lack of accurate financial information, there is little data that can be relied on. However, current system assets are estimated as follows:

#### Pension System Assets (YR billion)<sup>1</sup>

	1995	1996	1997	1998
Public -Sector Pension Plan Assets	4.3	8.3	14.6	20.5
Private-Sector Pension Plan Assets	2.0	2.9	4.1	5.3
<b>Total</b>	<b>6.3</b>	<b>11.2</b>	<b>18.7</b>	<b>25.8</b>
As a percentage of GDP	1.41%	1.71%	2.52%	3.68%
As a percentage of commercial bank assets	3.54%	6.25%	9.77%	12.49%

<sup>1</sup> Not including pension systems of the Military and of the police. Information on the assets of these plans are not available.

Arab Monetary Fund research indicates the following distribution of assets:

#### General Authority for Social Security and Pensions Distribution of Assets: 1993 - 1997, YR billion

	1993	1994	1995	1996	1997
<b>Liquid Assets</b>					
Deposits in banking system	5.71	7.30	8.88	12.55	18.23
Treasury bills	--	--	0.20	0.77	4.05
<b>Sub-total</b>	<b>5.71</b>	<b>7.30</b>	<b>10.08</b>	<b>13.32</b>	<b>22.28</b>
<b>Other Assets</b>					
Real property	0.15	0.17	0.17	0.17	0.12
Participation in companies	0.03	0.02	0.20	0.20	0.41
<b>Sub-total</b>	<b>0.18</b>	<b>0.19</b>	<b>0.37</b>	<b>0.37</b>	<b>0.53</b>
<b>Fixed Assets</b>	0.07	0.09	0.11	0.15	0.27
<b>TOTAL</b>	<b>5.96</b>	<b>7.58</b>	<b>10.56</b>	<b>13.84</b>	<b>23.08</b>

Source: Dr. Adi Qasiour, *Status and Requirements for Establishing a Yemen Securities Market*, 1999.

**Investment Returns:** According to studies funded by the World Bank, the investment portfolios of both the private and public sector funds have yielded low returns for most of this decade. The studies indicate that the real rate of return on assets in both funds has, at best, averaged a little over six percent since the early 1990s. The high inflation levels experienced between 1992 and 1996 led to negative growth in the funds' returns up to 1997. Various reports have indicated that fund investments have shifted toward Treasury bills, and that their higher rates of return have resulted in improvements in the overall rate of return. The Arab Monetary Fund estimates nominal returns as follows (not disaggregated by asset type):

**General Authority for Social Security and Pensions**  
**Nominal Rates of Return**  
**1993 - 1997, YR million**

	1993	1994	1995	1996	1997
Total Assets	5,960	7,580	10,560	13,840	23,080
Return on Investments	459	600	807	2,287	3,734
Nominal Rate of Return*		8.86%	8.90%	18.7%	20.23%

\* calculated as return/average assets for end of year and end of preceding year.

Source: Dr. Adi Qasiour, *Status and Requirements for Establishing a Yemen Securities Market*, 1999.

**V. CAPITAL MARKET DEVELOPMENT**

Capital or financial markets in Yemen are not well developed. The market consists nearly entirely of the Government treasury bill market, which was first created in 1995 when the Central Bank of Yemen began issuing one-month treasury bills. By 1996, two and three-month bills were issued, and by 1997, one-year bills were issued. Demand for treasury bills is attributed mostly to commercial banks, the government agency for pensions and social welfare, insurance companies, and non-financial public sector institutions. There is no secondary trading of treasury bills – maturities remain relatively short – mostly one- and three-month bills; bills are purchased in part due to a lack of alternative investments; and, although bills could be used as liquidity instruments, high liquidity in the banking system eliminates any need to hold them as such.

**Supply of Securities:** A limited legal base does exist for development of a stock exchange. Foremost, companies may take the form of corporations, however, few do so. The Ministry of Supply and Trade lists approximately 64 publicly incorporated companies – primarily firm involved in commercial activities, although also in financial and industrial activities. Only 10 of those corporations have capital above US\$ 5 million. Corporations that wish to offer shares for public subscription require licensing by Prime Ministerial decree (while corporations that do not offer shares for public subscription require licensing by decree of the relevant minister). For those few companies whose shares are relatively widely held, the law holds that existing shareholders all hold pre-emptive rights, thereby limiting the liquidity of those shares.<sup>11</sup> In addition, the close-knit nature of the Yemeni formal economy also limits trading of existing shares. That being said, there are a few private-sector companies large enough to list shares publicly. In addition, several public enterprises slated for privatization could offer shares. In general, however, almost no companies – public or private – have management, accounting, and disclosure systems adequate to meet prudential requirements for public listing of shares.

**Securities Trading:** There are no figures on the extent of trading or transfer of ownership of shares in Yemen. The trading process is entirely manual and is based on physical, paper share certificates. Trading of shares requires the physical transfer of ownership certificates at every sale transaction and the issuance of new certificates. Buyers and sellers negotiate a sale price among themselves, and then inform the relevant company, which provides a transfer/assignment form. Both buyer and seller fill in the forms, which are considered legal contracts, and appear in

<sup>11</sup> Pre-emptive rights are contractual restrictions on the rights of transmission of a company's securities. These rights give insiders a right of first refusal, i.e., they can pre-empt a sale by exercising their rights. Apparently, Islamic-based law holds in many places that property owners have pre-emptive rights with respect to related property owners, however, such rights are usually only applicable to real estate (and movable property). These rights are not usually applied to ownership of stocks and bonds.

court to certify the transaction. The relevant company registers the transaction in the name of the future and a new ownership certificate is issued. The process takes approximately two weeks, including one week for the completion of court procedures. There is no formal system of financial brokers or intermediaries; transactions are made directly between a buyer and seller, through a member of the board of directors of the company, or through the shares management division of the company.

**Development of a Securities Market:** The constraints to the development of the banking sector and to greater financial intermediation discussed earlier apply equally to the development of the capital market. The development of the legal system to protect the rights of lenders, the strengthening of and adherence to accounting standards, and the improvement of corporate governance in general are just three important foundations of financial systems, without which it will be impossible to develop a working capital market. That being said, a specific legal framework would also need to be developed in order to establish a stock exchange or securities market. This would involve possible revisions to the Companies Law and/or the Banking Law, the preparation and passage of a securities law, development of a settlement system, etc.

## VI. PAYMENTS SYSTEM

The payments system in Yemen is quite basic: banks consolidate and exchange claims against one another in clearing rooms in the four largest cities – Sana’a, Aden, Taiz, and Hodaidah. The number and value of checks cleared between 1995 and 1998 are as follows:

<b>Clearing Room (Value in YR million)</b>				
	1995	1996	1997	1998
<b>Sana'a</b>				
Number of checks	75,170	75,952	95,152	108,275
Value	61,446	77,419	110,292	115,518
<b>Aden</b>				
Number of checks	35,219	30,660	41,196	24,109
Value	7,709	17,931	32,292	14,456
<b>Taiz</b>				
Number of checks	24,826	21,827	26,794	12,092
Value	2,538	32,402	42,062	15,604
<b>Hodaidah</b>				
Number of checks	53,156	47,815	48,860	33,333
Value	29,109	37,378	37,283	33,189
<b>Total</b>				
Number of checks	<b>188,371</b>	<b>176,254</b>	<b>212,002</b>	<b>177,809</b>
Value	<b>100,802</b>	<b>165,130</b>	<b>221,929</b>	<b>178,767</b>

It is not known at this time how often the exchange takes place, or the exact mechanisms for settlement. Processing of a check takes about two weeks, and it is likely that this only applies to checks written and cashed in Sana’a. There is no system for settlement of checks written in foreign currencies, which probably reduces the flow of worker remittances into the banking system.

## **VII. BANKING SUPERVISION**

An assessment of Yemen’s banking supervision has been conducted using the *Core Principles Methodology* of the Basle Committee on Banking Supervision. The Basle methodology specifies that supervisory agencies should be rated not only on the authority they have “on paper”, but also in how they apply that authority in actual practice. CBY is the banking regulator and supervisor for the country, having the legal authorization to license and liquidate banks, to issue prudential banking instructions and regulations, and to monitor banks’ compliance with these instructions and regulations. CBY is rated “materially non-compliant” or “non-compliant” on the majority of the core principles; most of these low ratings are due to non-application of laws and regulations. With the support of the Bank and the IMF, Yemen has developed a solid legal framework for banking supervision. The next step is to help CBY take authority and begin enforcing the banking laws and regulations.

A summary of the ratings of each of the Basle Core Principles is provided as Appendix 3 to this reports. The last step of the process – the discussion of the ratings with the supervisory authority – has not yet taken place, and therefore the ratings shown in Appendix 3 should be considered preliminary and subject to change.

## Appendix 1

### The Cooperative and Agricultural Credit Bank (CACB)

As a bank, CACB has not turned a profit for several years; in fact, profits until 1996 for the institution were dependent on trading activities. Although the law which regulates CACB's activity defines its objective as that of providing banking services to the agricultural, fisheries, and cooperative sectors, its by-laws provide for trading in agricultural and fisheries equipment. The bank has undertaken this activity successfully, initially thanks to its access to favorable (official) exchange rates which put it at a competitive advantage with respect to private traders. In addition, the bank has financed the purchase of such equipment for farmers and others at below-market interest rates.<sup>12</sup> As a result, this activity has historically enabled the bank to earn a profit; however, the change in the interest rate structure of the specialized banks in July 1998 and the elimination of the multiple exchange rate structure has placed the bank on an equal footing with private traders and has reduced demand from farmers. This has resulted in a lower level of profitability for this activity (YR 30 million in 1998, vs. YR 45 million in 1997, vs. YR 152 million in 1996). The lower profit on these activities now fail to cover the losses on banking activity, and total annual losses will eliminate CACB's capital base in the near term.

CACB's paid-in equity totals only YR 293 million, far short of the YR 1 billion now required by the CBY. The Government, which holds 90 percent of the shareholding of the bank, is in theory responsible for increasing the paid-in capital of CACB. Operating losses and low loan recovery rates (see below), if realized, would effectively wipe out CACB's capital.

#### CACB Expenses and Revenues

CACB's banking (i.e., non-trading) business is insufficient to cover operating expenses, as can be seen in its annual profit and loss statements, below. It has excessive administrative costs, and although its on-lending rates have been historically positive (due mostly to the non-payment of interest on deposits [which has been changed in 1998]), its net interest and operating margin has been insufficient to cover operating expenses. CACB has excessive staff numbers; its administrative costs were 13 percent of its portfolio in 1998; and the bank had a ratio of only 5 loans disbursed per employee in 1998. Despite operating losses, the bank nevertheless has consistently increased its staff numbers over the last 3 years (up to 1,044 at end-1998, up from 969 at end-1997 and 945 at end-1996).

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<sup>12</sup> CACB depends passively on quasi-captive deposits from cooperatives and donor loans. It has only just started to mobilize domestic savings (about YR 500 million in mid-1999). It could be in a position to attract additional funding, but before being allowed to solicit deposits, it needs to comply with the minimum capital requirement (YR 1 billion) as required by the CBY.

### CACB: Annual Profit and Loss Statements (YR million)

	FY 1996 <sup>1</sup>	FY 1997 <sup>2</sup>	FY1998 <sup>2</sup>
Net interest and operating income	279.9	380.6	318.3
Operating expenses	343.9	422.0	428.7
Operating Profit (Loss)	(64.1)	(41.4)	(110.4)
Trading Profit	152.0	45.3	30.2
Profit (Loss) after Trading	88.0	4.0	(80.2)
Loan loss and other provisions	(212.9)	(11.6)	(12.1)
Suspended Interest	(85.9)	(61.0)	(50.0)
Net Profit (Loss)	(210.9)	(68.6)	(142.3)

<sup>1</sup> As per recommended adjustments of independent auditor, but not including FX gains.

<sup>2</sup> From internal management figures; provisions as per independent auditor estimates.

### CACB Lending Performance

The bank has poor collection or debt recovery rates, with an yearly rate in 1998 of just 64 percent of current principle and interest due (only 59 percent if the “problematic” regions of Marib and Al-Jawf are included), although it has generally recovered a further 25 percent of amounts past due. This poor collection performance exacerbates the problem of low interest margins and is unsustainable in the medium term. Problems in collection mirror those in the rest of the financial system: “big shots” do not repay; courts will not adjudicate in favor of CACB when land title is used as collateral and refuse to adjudicate interest, as it is “un-islamic”; and management of the portfolio is poor.

### Government Support of CACB

The cost of CACB’s ongoing operations to the government, not including the annual coverage of foreign exchange risk (which in 1996 amounted to as much as YR 425 million) has increased every year over the last three years, as can be observed from the following table:

**CACB: Total Government Exposure and Annual Costs  
(YR million)**

	FY 1996	FY1997	FY1998
<b>1. Gross Outstanding Loans</b>	2,202.4	2,900.6	3,308.3
1.1 Minus Int. on non-performing loans	86.9	61.0	50.0
1.2 Minus provisions on classified loans	433.2	444.8	456.9
<b>1.3 Net Value of Loans</b>	<b>1,682.3</b>	<b>2,394.8</b>	<b>2,801.4</b>
<b>2 Government funding</b>			
2.1 Government Equity	293.1	293.1	293.1
2.2 Other Government domestic loans	161.9	147.0	150.0
<b>2.3 Total government domestic financing</b>	<b>455.0</b>	<b>440.1</b>	<b>443.1</b>
<b>2.4 Borrowing from foreign sources (Gov't guaranteed)</b>	<b>981.3</b>	<b>873.3</b>	<b>2,025.7</b>
<b>2.5 Total Government commitment (2.3 + 2.4)</b>	<b>1,436.3</b>	<b>1,313.4</b>	<b>2,468.8</b>
<b>3.3 Opportunity costs of classified loans (1.2) and accrued interest (1.1) at 12% ('96), 15% ('97, '98)</b>	<b>62.4</b>	<b>75.9</b>	<b>76.0</b>
<b>4. Operating costs</b>	<b>343.9</b>	<b>422.0</b>	<b>428.6</b>
<b>Annual cost of Government domestic finance (2.3) at 12 and 15%</b>	<b>54.6</b>	<b>66.0</b>	<b>66.5</b>
<b>Total annual cost to Government (3+4+5)</b>	<b>460.9</b>	<b>563.9</b>	<b>571.1</b>

**CACB Balance Sheet, 1993-1997 (YR Million)**

	1993	1994	1995	1996	1997
<b>Assets</b>					
Cash and deposits with banks	369	320	271	948	696
Loans	1084	1077	1573	2031	3223
Investments	52	53	57	53	162
Inventories	20	52	52	0	0
Fixed assets (less depreciation)	78	195	204	252	269
Other assets	644	1050	1067	623	513
<b>Total Assets</b>	<b>2247</b>	<b>2746</b>	<b>3223</b>	<b>3907</b>	<b>4863</b>
<b>Liabilities</b>					
Deposits of development associations and cooperatives	719	249	272	1381	2217
Credit from CBY	0	0	0	0	0
Credit from GOY	179	179	189	172	147
Credit from international donors	232	428	447	711	847
Other liabilities	800	1547	1972	1255	1212
<b>Equity and Reserves</b>					
Government equity	251	263	263	263	263
Development associations and cooperatives equity	30	30	30	30	30
Retained earnings and reserves	37	51	51	95	146
<b>Total Liabilities and Equity</b>	<b>2247</b>	<b>2746</b>	<b>3223</b>	<b>3907</b>	<b>4863</b>

## Appendix 2

### Housing Credit Bank (HCB)

HCB was established in 1977 to provide loans for housing finance. The bank currently has paid-in capital of YR 200 million (CBY currently requires paid-in capital of YR 1 billion), and is 93 percent owned by the Government. There are a number of factors that significantly limit HCB lending. The bullet points below summarize the most important facts of HCB:

- HCB is highly undercapitalized, with capital only ¼ that required by the CBY;
- HCB is an extremely small institution, with a very small asset base (net loans and advances are approximately YR 262 million, and only YR 102 million of that figure are individual housing loans);
- HCB is heavily dependent on borrowings, including borrowings from the Ministry of Finance and the Ministry of Housing and Construction at heavily subsidized rates;
- At the most recent assessment, average loan size was around YR 135,000 (less than \$1,000 at current exchange rates), indicating that the bank may be reaching a relatively low-income population; however
- The absolute number of loans to borrowers may be as low as 2,000 (and limited to borrowers in Sana'a and Hodeida), indicating that HCB's reach is quite limited; and
- Borrowers are required to pledge collateral of at least 70 percent of the loan amount, indicating that it may be difficult to meet HCB's objective of reaching lower-income borrowers;
- Despite concessionary interest rates on borrowings, CBY forbearance on many regulatory matters, and low staff salaries, HCB is currently operating at a loss;
- Management information systems appear to be extremely weak, with management unable to track basic questions such as interest arrears on loans or non-performing loans; and
- In all likelihood, HCB is unable to collect on collateral pledged against loans in the event of non-payment due to legal and cultural constraints.

### HCB: Summary Balance Sheet (1996, YR million)

	YR Million		YR Million
<b>Assets</b>		<b>Liabilities</b>	
Cash and due from CBY	145.9	Current Accounts	0.3
Treasury bills	2.5	Long-term borrowings from the Government <sup>3</sup>	119.4
<b>Loans and Advances</b>		<b>Deposits</b>	
Housing Societies	1.4	Savings deposits	42.3
Real Estate Commercial Loans	164.8	Time deposits	1.7
Individual Housing Loans	102.0	Deposits against projects	49.9
Less Provisions	-5.5	Borrowers' and other deposits	4.6
		Total deposits	<b>98.5</b>
Investments <sup>1</sup> (share portfolio)	7.1	<b>Shareholders' equity</b>	
Fixed Assets	5.6	Paid-up capital	200.0
		Reserves	25.7
		FX losses	-7.2
		Total equity	<b>218.5</b>
On-lent government loans <sup>2</sup>	105.9	On-lent funds	95.4
Accrued income and other assets	17.4	Interest and dividends payable	6.9
		Accruals	8.1
<b>Total Assets</b>	<b>547.1</b>	<b>Total Liabilities</b>	<b>547.1</b>

<sup>1</sup> Equity participation in three companies: Yemeni Kuwaiti Real Estate Company, National Company for Construction Materials, and Yemeni Company for Hotels.

<sup>2</sup> This refers to investments/loans in Urban Development Projects. The UDP is funded by a loan provided by the Ministry of Housing; Repayments related to the UDP is channeled directly back to the Ministry of Housing.

<sup>3</sup> Government loans include a YR 64 million loan from the Ministry of Housing for the Social Development Project (Urban Development Project?)

The majority of the Housing Credit Bank's sources of funds are long-term borrowings from the government and the Ministry of Housing (approximately 22 percent), its paid-in capital (approximately 30 percent, also largely Government), and deposits (18 percent). However, an additional 18 percent of the bank's funds are on-lent directly to urban development projects, for which the Housing Credit Bank acts merely as a conduit rather than as a bank. Over half of deposits appear to be deposits of the Ministry of Housing that are to be directed to social housing projects. Only YR 44 million, or 8 percent of total resources in 1996, came from client deposits. Constraints on funding (inability to attract client deposits, budgetary limits on Government and Ministry of Housing deposits and lending) result in limiting the HCB's contribution to satisfying housing finance demands – over the past 12 years, HCB has provided financing for perhaps 10,000 housing units. Declining profitability (HCB reported a negative return on total assets of 1.32 percent in 1996) will only worsen HCB's ability to meet the demand for housing finance.

Operating cost ratios – 12 percent of total assets in 1996 – are unsustainably high, largely because of the low volume of operations in terms of both average transaction and aggregate volume. This is despite low salary levels. The spread between lending rates – 22-23 percent – and deposit rates – 17-18 percent – is inadequate to cover costs, provisions, and a profit margin to support growth. Even marginal profitability in past years has only been possible because of below-market costs of Government and Ministry of Housing funds.

### Appendix 3

#### Assessment of the Basle Core Principles for Effective Banking Supervision Central Bank of Yemen

Core Principle	Compliant	<u>Largely Compliant</u>	<u>Materially Non-Compliant</u>	<u>Non-Compliant</u>	N/A
1.1 Clear responsibilities for supervisory agencies	X				
1.2 Operational independence & resources for supervisory agencies			X		
1.3 Legal framework for authorization of banking establishments & supervision		X			
1.4 Legal framework for compliance, safety & soundness	X				
1.5 Legal framework protecting supervisors				X	
1.6 Information sharing between supervisors & confidentiality			X		
2 Definition & control of word “bank”, activities subject to bank supervision		X			
3 Licensing criteria		X			
4 Transfer of significant ownership or controlling interest			X		
5 Criteria for major acquisitions, investments, corporate affiliations			X		
6 Capital adequacy			X		
7 Loan & investment policies			X		
8 Internal practices & procedures for asset classification & provisioning			X		
9 MIS & limits for concentrations			X		
10 Insider lending			X		
11 Country & transfer risk				X	
12 Market risk		X			
13 Risk management (liquidity, IRR, operational)			X		
14 Internal routine & controls			X		
15 “Know-your-customer” rules & anti-crime procedures				X	
16 On-site & off-site supervision		X			
17 Regular contact with bank management & understanding of bank operations			X		
18 Prudential & statistical reports, solo & consolidated			X		
19 Independent validation of supervisory information (on-site/external audit)		X			
20 Consolidated supervision			X		
21 Accounting standards & accuracy of financial statements			X		
22 Corrective actions			X		
23 Globally consolidated supervision					X
24 Contact with foreign supervisory authorities				X	
25 Operating standards for foreign banks & information sharing				X	
<b>TOTAL</b>	<b>2</b>	<b>6</b>	<b>16</b>	<b>5</b>	<b>1</b>

Note: The last step of the Core Principles Methodology, the discussion of the ratings with the supervisory authority, has not yet taken place. As such, the ratings shown in the table below should be considered preliminary and subject to change.

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