Development Needs Assessment of the MSME and Agricultural Finance Sector in Yemen

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Submitted by:
LFS Advisory GmbH
c/o Dr. Mattias Grammling
Schönhauser Allee 10/11, 10119 Berlin, Germany
Mattias.Grammling@lfs-advisory.com
+49 30 4075 4347

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List of Abbreviations

Abbreviation	Meaning
CBY	Central Bank of Yemen
DFS	Digital Financial Services
FAO	Food and Agriculture Organization
FI	Financial Institution
HDI	Human Development Index
ICSB	International Council for Small Business
ICT	Information and Communication Technology
KII	Key Informant Interview
KYC	Know Your Customer
MFB	Micro Finance Bank
MFI	Microfinance Institution
MNO	Mobile Network Operator
MSME	Micro, Small, and Medium Enterprises
NGO	Non-governmental Organization
PAR30	Portfolio at Risk / loans in arrears for over 30 days
SFD	Social Fund for Development
SME	Small and Medium Enterprises
SMED	Small and Micro Enterprise Development
SMEPS	Small and Micro Enterprise Promotion Service
UNDP	United Nations Development Programme
WB	World Bank
YLGP	Yemen Loan Guarantee Program
YMN	Yemen Microfinance Network

Executive Summary

Introduction

As one of the poorest countries in the world, Yemen has faced a multitude of problems including food insecurity, malnutrition, and poor sanitary and health conditions. Since 2015, the country has been undergoing a war that has just deteriorated the situation, displacing millions, causing casualties, and resulting in a catastrophic loss of economic wealth. In 2019, the UN estimated that about 75% of the population needed humanitarian assistance and protection. The Yemen Microfinance Network (YMN) war impact assessment has identified several risks affecting the economic and financial environment in Yemen (such as climate change, import and export restrictions, airstrikes, population displacement, and more) while the World Bank has listed seven main constraints to the development of the private sector in the country (SME closures and shrinkages, access to finance, lack of investment, decreased sales, decline of financial intermediation, banking sector instability, and overreliance on cash payments and money exchange companies).

This study builds on the previous project "Promotion of the MSME-related Finance Sector in Yemen" for the Social Fund for Development of Yemen (SFD) and financed by KfW Development Bank and created by LFS Advisory, that focused on strengthening the supply of financial services to MSMEs in Yemen by building the institutional capacity of different players in the sector. Despite the significant progresses achieved by the project at different levels, the financial sector in Yemen requires further strengthening to be able to address the financing needs of MSMEs and small agricultural enterprises in an adequate and sustainable manner. The study has three main objectives:

- Assess to what extent the financial needs of beneficiaries (MSMEs and small agro-enterprises) are met by the currently available financial products and services;
- Examine the scope and impact of recent development interventions and promotional activities by donors for strengthening financial institutions and improving the offer of financial products and services;
- Provide conclusion on success factors and formulate recommendation for future project priority areas and measures to further strengthen the MSME and agriculture financial sector.

Overview of Yemen financial sector

In Yemen, the banking sector plays a relatively modest role with 19 banks in total (including six Islamic banks, four conventional banks, five branches of foreign banks and four Government-owned banks). The sector is faced with many inefficiencies and has been significantly affected by the war. Commercial banking lending is primarily focused on corporate clients and their principal shareholders and the majority of loans are short term and are for trade financing. Commercial banks offer customers current accounts, savings accounts, and time deposits. The regulations of the Central Bank of Yemen prevent conventional banks from offering Islamic banking products.

Microfinance Banks and MFIs trying to fill the gap left by commercial banks and have shown remarkable resilience even though the sector facing an abundance of challenges (disruption and destruction of business due to the war causing high default rates, lack of regulation and monetary war between the de-facto two Central Banks, liquidity crunch and others). This is partly due to the past and ongoing donor support.

There is still a huge unmet demand for MSME finance in the market, this is especially true for the agricultural sector. Commercial Banks have started to invest in the sector and unregulated financial service providers have started to fill the existing gap (causing challenges to consumer protection, etc.).

The microfinance sector has a strong interest and sees a great potential in digitalizing internal operations as well as products and services. While the current level of digitalisation is low, MFIs and microfinance banks are expecting efficiency gains and are hoping to reach new unserved segments of the population by adopting digital technologies.

Demand for financial services of MSMEs

Because of the conflicts in Yemen, the UNDP and SMEPS Rapid Business Survey from 2015 has estimated that 24% of micro businesses, 27% of small businesses, and 35% of medium-sized businesses have been forced to shut down, causing a decrease in the total number of MSMEs in the country in recent years. An IFC report from 2017 on the MSME Finance Gap in emerging markets estimates the number of the formally registered Yemeni MSMEs to have dropped to 400,235 and employ more than 1.5 million people. However, the informal unregistered businesses remain a very large part of the MSME economy and are not included in those statistics. The informal sector comprises approximately 80% of the total employment in the country, meaning it can be projected that the unregistered businesses employ more than 6 million people. Based on that, we assume that there are 2-3 million formal and informal MSME in Yemen at present. The study further concludes that the total finance need of MSME would amount to roughly USD 1.5-3 billion, whereas, from a lender's perspective, somewhat more than half of that amount would be needed as the average outstanding loan size is about half the finance need. Although the lack of even just somewhat reliable data makes those figures extremely rough estimates, we believe that the main message of our estimate is robust: There is no lack of demand for finance among MSME in Yemen. FIs that support MSME are (in the rather favorable) situation to be limited by their own capacities to grow and by their own capacities to deploy suitable financial products to MSMEs.

The International Council for Small Business (ICSB) estimates that MSMEs make up over 90% of all firms and are responsible for 70% of employment and 50% of GDP in Yemen. Nevertheless, MSME characteristics vary greatly depending on the level of economic development as well as specifically defined thresholds, reliant on national accounting principles and legal documents.

LFS has conducted a quantitative survey among 260 MSMEs and has deepened the findings using 20 Focus Group Discussions with a total of 147 participants and 9 in-depth interviews with medium-size enterprises to uncover the perspective of MSMEs on the finance market.

The survey revealed that MSMEs in Yemen still face many challenges and constraints. Access to finance remains as one of the main constraints; however more than half of the respondents reported that the situation has improved since 2015. The perception of loan accessibility had an impact on the reasons for not using formal financial services. The biggest challenge for not obtaining a loan not surprisingly was the high interest rates. Another often mentioned challenge was collateral. Covid-19 presented a new challenge to MSMEs, although, more than 80% of the respondents in the survey did not feel the effect of the disease. Nevertheless, a decline in loan availability and longer process lengths were mentioned as results from the pandemic.

There is a high demand for loans in general and specifically from the agricultural sector. Overall, more than half of the LFS survey respondents plan to take a loan in the next 12 months. Those who did not want to take a future loan pointed out no need for one, fear of not being able to pay back, high interest rates, and religious considerations as the reasons for that decision. All respondents wanted to have loans greater than YER 100,000 and most above YER 300,000. Loans with maturities below 6 months were not sought after and there was a strong preference for monthly repayments and individual loans. MSMEs mostly offer guarantors as security and are willing to provide a wider range of collateral for future loans, including land/real estate, fixed assets, current assets, or agricultural produces. Although respondents had numerous sources for loan repayment, generally most preferred to use earnings from business for both the repayment of their last loan or any future loans. In all business sectors, there was also a tendency to choose gold or salaries as the alternative repayment option. Additionally, with the cash surplus from loans, many chose to reinvest it in business activities or utilize it for loan reimbursement.

The vast majority of respondents reported positive impacts on their socio-economic lives, especially on production/profit, business sustainability, and household income. During the LFS survey, respondents were asked to rate several loan conditions by importance. Overall, the most important conditions came out to be adequate loan size, adequate costs, and easy collateral while the least important was quick disbursement. Somewhat more than half of all MSMEs were able to create jobs thanks to a loan. The mean number of jobs created was 3.7, whereas larger firms and male owners create more jobs, and women entrepreneurs create considerably more jobs for women than men do.

The participants in the LFS survey were questioned on their current and desired use of financial services. Different types of financial services have a different degree of utilization among business sectors and regions in Yemen. The most preferred type of loan overall is for fixed assets / equipment, followed by loans for working capital. The largest gap between product usage and desire to use (and, thus, large market potential), exists in saving accounts. Large gaps occur in the current account category as well as mobile services and insurance. The main reasons for not using financial services were fear of not being able to pay back, intransparent or complicated procedures, no need for further investments, religious considerations, and lack of access.

Overall, the LFS primary data collections uncovered a surprisingly high level of customer satisfaction with MFIs. When being asked, 92% of the respondents agreed to the statement that “MFIs have a simple, helpful, and respectful attitude towards customers”. With 85% of the respondents, the vast majority was of the opinion that MFIs are “very” (66%) or “usually” (19%) responsive to their questions and concerns. All of the surveyed MSMEs reported that microfinance institutions at least somewhat helped them to achieve their goals.

Development needs assessment and interventions

With a total number of approximately 2-3 million, MSMEs present the microfinance sector with a great opportunity for further growth to be tapped into. Access to finance remains one of the main constraints that MSMEs have to face, supported by findings from the survey. Therefore, if access can be improved, the microfinance sector could further not only improve its overall performance, but also grow tremendously with more clients. On the supply side, MFIs pointed out that the main factor preventing them from providing finance to more MSMEs is the lack of financing in the industry.

Capacity building, adoption of new technologies and financing for long-term sustainability emerged as needs.

Food insecurity and a shift of economic activities towards agriculture, a sector with one of the highest potentials when it comes to financial services, are being seen within Yemen. However, in order to be able to take advantage of such opportunities, the difference in factors of importance when looking at financial institutions have to be considered. Therefore, support for MFIs and Microfinance banks in developing tailored agricultural lending products is necessary to improve financial services.

Collateral remains a large challenge in Yemen as most customers cannot provide it. Making things worse, the destructions, internal displacements, and loss of life during the war means that many (potential) borrowers no longer have guarantors or that their former guarantors are no longer eligible to secure a loan. Well-designed credit guarantees can serve as a substitute for collateral and encourage FIs to provide finance to otherwise ineligible borrower by covering a share of the default risk. Therefore, a refinancing of the Yemen Guarantee Program can not only increase its current reach but also build capacity.

Mobile money and further financial sector innovations can provide many benefits to FIs and end users but the uptake is still limited. Awareness, financial education, and training are needed to improve the reach of those services. In addition, coordination between banks and MNOs to maximize uptake can contribute to expanded accessibility.

Most FIs view limited financial and business management skills of MSMEs as a key challenge in their work. Imbedded basic financial literacy and entrepreneurship trainings as part of the MSME lending process as well as utilizing public financial education can improve the levels of financial capability throughout the country and address many of the current challenges.

Recommendations

Some of the most quick-win vital recommendations resulting from the study include digitalizing processes and introducing new digital products to enhance financial inclusion, providing targeted support to commercial banks, and strengthening MFIs risk management and operations. Mid-term recommendations are investing in ICT infrastructures for increased flexibility and transparency as well as development of agricultural loan products and provision of technical advice to the Central Bank to enable regulations. For the long-term, financial education, refinancing of the Yemen Loan Guarantee Program, and support of insurance companies when it comes to MSMEs are possible interventions.

1 Introduction

1.1 Country background

Even before the armed conflict escalated in 2015, Yemen has been one of the poorest countries in the world with a Human Development Index (HDI) ranging between 0.4 and 0.5 between 1990 and 2014. Food insecurity and malnutrition as well as poor sanitary and health conditions have been major poverty symptoms in Yemen for decades. In 2019 the UN estimated that about 75% of the population needed humanitarian assistance and protection.

Prior to the conflict, the private sector represented about 50% of Yemen GDP and 69.4% of the employed population.[1] Since the start of the war in March 2015, the overall situation in Yemen has been deteriorating massively. Bombardments have caused casualties, massive displacements (affecting more than 3 million people) and a catastrophic loss of economic wealth. The World Bank estimates a cumulative GDP drop of 39% since 2014. The conflict has not only caused vast destructions of the physical infrastructure as well as private houses and business premises, but also severely decimated the country's major economic sectors (oil, gas, and agriculture).

A 2019 World Bank report observes that 25% firms closed because of the conflict, 80% observed a drastic drop in sales, and 30% relocated their activities domestically or internationally. Over 20% of firms lost employees (part time and full time) and a significant number of firms experienced shrinkage from large and medium to small enterprise or small to micro enterprise.[2] Operating hours have been reduced and about 32% of firms experience non-operational days. Combined with reduced sales and increasing operating costs due to insecurity and lack of supplies and inputs, private sector stakeholders and especially MSMEs are struggling to prevent their business from bankruptcy.

The World Bank identifies seven main constraints to the development of the private sector in Yemen: SME closures and shrinkages, access to finance, lack of investment, decreased sales, decline of financial intermediation, banking sector instability, and overreliance on cash payments and money exchange companies. With the escalation of the conflict, firms have diminished access to the banking system and rely on cash payments and money exchange companies for their business transactions and financial transfers. The World Bank observes that over 97% of firms surveyed pay their employees in cash, and about 68% also pay suppliers in cash. This may indicate a lack of trust in the financial sector and/or the lack of capacity of the financial system.[3] The World Bank also notes that access to finance has been restricted since 2015. Over 60% of surveyed firms reported increased restrictions in accessing credit.[4] Private sector credit contracted by 14% in 2017 started to show gradual recovery in 2018, according to the World Bank.[5] Financial inclusion is low as only 6% of adults have an account in a bank.

The YMN war impact assessment identifies several risks affecting the economic and financial environment in Yemen:

- Environmental risks: climate change, scarcity of water, etc.
- Legal environment instability: different fiscal and monetary policies between territories within Yemen.

[1] 2019 World Bank, Impact of conflict on private enterprises.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] 2019 World Bank, Economic Monitoring Brief Winter 2019

- Economic environment risks: decreased remittances, import and export restrictions, destruction of infrastructure
- Security and safety: airstrikes, ground fighting, terrorism
- Infrastructure and services: electricity, communication infrastructures and decrease in the quality of state services
- Socio-economic conditions of the population: displacement, large part of the population in need of humanitarian assistance, large part of the population living under the poverty line.

The agriculture in Yemen faces numerous challenges that are aggravated by the conflict (e.g. resource constraints). According to FAO, the agriculture sector has been severely affected by a shortage of agricultural inputs, particularly vaccines, drugs, feeds and other essential commodities for the livestock and poultry sector. The price of poultry feed concentrates increased by 70% since the beginning of the crisis. The doubling of fuel price has increased irrigation costs and water prices, forcing more farmers to abandon their farms. Prior to the war, 73% of the population relied on agriculture for their livelihoods and the agriculture and fishery sectors employed more than 50% of the country's workforce. Consequently, the livelihoods of 1.7 million rural households engaged in crop and livestock production have been seriously compromised. Existing value chains and contractual relationships have been weakened or destroyed, and the access of small farmers to markets and storage solutions has been further diminished.[6]

1.2 Rationale of the study

This study builds on the previous project "Promotion of the MSME-related Finance Sector in Yemen" for the Social Fund for Development of Yemen (SFD) which was financed by KfW Development Bank and created by LFS Advisory. That study focused on strengthening the supply of financial services to MSMEs in Yemen by building the institutional capacity of different players in the sector. This included the apex institution SMED, several microfinance institutions (MFIs) and the loan guarantee facility LGP. Despite remarkable progresses achieved by the project at different levels, the financial sector in Yemen requires further strengthening to be able to address the financing needs of MSMEs and small agricultural enterprises in an adequate and sustainable manner.

However, the ability of SFD and other stakeholders to contribute to the further strengthening of the sector requires an updated analysis and critical review of the current situation, which reflects the requirements and characteristics of the target group as well as a thorough examination of the market landscape and operating environment. The analysis of the operating environment shall highlight to what extent the MFI sector is affected by the current political and economic situation in Yemen.

This study has three objectives:

- Assess to what extent the financial needs of beneficiaries (MSMEs and small agro-enterprises) are met by the currently available financial products and services;
- Examine the scope and impact of recent development interventions and promotional activities by donors for strengthening financial institutions and improving the offer of financial products and services;
- Provide conclusion on success factors and formulate recommendation for future project priority areas and measures to further strengthen the MSME and agriculture financial sector.

[6] 2018. FAO, Yemen, Plan of Action –Strengthening resilient agricultural livelihoods (2018–2020)

2 The financial sector in Yemen

2.1 Regulatory Environment

Yemen's financial sector continues to suffer from the fragmentation of national institutions between the two conflicting parties. The existence of two different Central Banks, one in Aden and one in Sana'a, presents a multitude of challenges to the financial sector at large. The Central Bank in Aden is internationally recognized, has access to global financial systems and international support and has the right to print currency. The Sana'a based Central Bank kept the vast majority of the Central Bank's staff and institutional memory.

The financial sector has emerged as one of the battlegrounds of the two warring factions, a development which is most prominently highlighted by the ongoing currency war between Aden and Sana'a and the existence of different bank notes. The Central Bank in Aden has been printing new currency notes since 2017, initially only to replace damaged old banknotes but subsequently to drastically increase the money supply in the county. The massive issuance of the new bank notes combined with limited availability of foreign currency let to strong depreciation of the Yemeni Rial. The depreciation of the currency played a big factor in eroding the purchasing power of Yemeni households due to the country's heavy reliance on imports.

This development was taken as the official reason for the de facto authorities in Sana'a to ban the use of the new banknotes issued by the Central Bank in Aden in early 2020. A move which in turn lead to flourishing black-market currency trading, currency smuggling, more economic imbalances and additional obstacles for businesses operating in the areas controlled by the de facto authoritiesand Government controlled areas. A further result of this ban is the huge USD exchange rate disparity (up to 33% in August 2020) between Sana'a and Aden and the related business challenges.

2.2 Banking Sector[7]

In Yemen, the banking sector plays a relatively modest role compared to other countries in the region. There are 19 banks in Yemen, including six Islamic banks, four conventional banks, five branches of foreign banks and four Government-owned banks. Branch coverage is mostly limited to urban areas, while above 70% of the population is estimated to live in rural areas. Competition is generally weak due to dominance of a few, mainly public sector banks. The sector is faced with systematic and institutional inefficiencies, ineffective functioning of the banking system, weak regulatory supervision, weak coordination among banks and a high volume of non-performing loans. This is partly due to the war and related uncertainties, which, amongst others, lead to a fall in banking balance sheet as large deposit withdrawals in both local and foreign currencies were made and high default rates due to the loss of life, productive assets and collateral.

Table 1: List of Banks in Yemen

State owned-banks	Foreign Banks	Domestic Banks (Conventional)	Domestic Banks (Islamic)
- National Bank of Yemen - Credit and Agricultural Cooperative Bank	- Arab Bank Limited - Calyon Credit Agricole (CIB)	- Yemen Kuwait Bank for Trade & Investment - Yemen Commercial Bank - Yemen Gulf Bank	- Tadhamon International Islamic Bank - Saba Islamic Bank

[7] Based on KIIs conducted by LFS with different Stakeholders

- The Yemen Bank for Reconstruction and Development - Housing Bank	- Qatar National Bank (QNB) - United Bank Limited (UBL) - Rafidain Bank Yemen	- Al-Amal Microfinance Bank	- Alkuraimi Islamic Microfinance Bank - Shamil Bank of Yemen & Bahrain - CAC Islamic Bank - Islamic Bank of Yemen for Finance and Investment

Commercial Banks and Islamic Banks operate mostly in urban and semi-urban areas with a focus on segments with strong economic and monetary potential. They focus their lending activities on corporate clients, their principal shareholders, and related parties.

The products and services offered by commercial banks include savings, loans, domestic and international money transfers, and remote payment systems using mobile telephony, the Internet, ATMs, card payment systems at different points of sale. Improvement and diversification of products, including their distribution channels, are made possible and stimulated by the use of these new

Box 1: Commercial Banks and MSME Lending

> Commercial Banks have recently developed a stronger interest in MSME lending. YKB now has a dedicated MSME lending department and also Saba Islamic Bank has become more active in MSME lending under the BRAVE Project with the Islamic Corporation for the Development of the Private Sector and Al-Kuraimi Bank. Still, the overall exposure of commercial banks is very limited. As of September 2020, YKB has only 142 borrowers with an outstanding portfolio of YR 1,409

technologies. The provision of mobile banking services will undoubtedly help to reach a "non-bankable" segment of the population that the formal financial sector would otherwise not have entered. Most loans are short term and usually do not exceed 12 months. Medium-term loans are difficult to obtain, as lending criteria are rigid.

Consumer lending is a more recent development and is mainly payroll based. The retail segment includes car loans and housing loans which are assessed on the basis of a client's salary and his or her resulting repayment capacity. Islamic Banks offer financial products based on Islamic principles, the most common of which are Morabaha, Mudaraba and Musharaka.

- Morabaha (cost-plus financing) is a partnership between a business and a FI whereby the business petitions the FI to purchase an asset on their behalf. The FI adds profit and resells the asset to the business, in order to cover their operations (for sustainability). It is mostly used for the purchase of productive assets such as machinery.
- Mudaraba (Profit and Loss Sharing/ participatory banking) is often used in the agricultural sector, with the FI paying for input such as seeds, fertilizer, machinery and the farmer provides the land and labour. The FI only shares in the profits.
- Musharaka is a joint partnership arrangement in which the business and the Islamic finance provider both provide capital, with the business also providing management and labour. Profits shares are pre-agreed. This product is used for long-term financing needs.

Commercial banks also offer customers current accounts, savings accounts, and time deposits. Several kinds of cards are available: ATM cards and cards for point-of-sale transactions, debit cards, credit cards, and cards for specific purposes. Several mobile wallets have been introduced. Currently, Al-Kuraimi Islamic Bank offers the mobile money service M-Floos, Amal Microfinance Bank offers the service PYES, Tadhamon International Islamic Bank offers a mobile money service called Mahfathati and CAC bank offers CAC Mobility. Yemen and Kuwait Bank partnered with the technology company QualityConnect to offer Floosak and is in the process of launching additional mobile money services with Saba Phone and MTN. Before mentioned mobile money services allow users to transfer funds from one mobile wallet to another and to and from bank accounts, cash in and cash out through agents as well as pay bills. The dominating service is M-Floos from Al-Kuraimi. Main billers include electricity, internet, water and telephone providers. The regulation is bank-led which means that only financial institutions licensed by the Central Bank are allowed to offer mobile money services.

Conventional commercial banks are not allowed to offer Islamic finance products.[8]

2.2.1 Microfinance Banks and Microfinance Institutions

Financial Institutions dedicated to MSME finance activities can be categorized into two groups in Yemen:

1. Microfinance banks which are regulated by the Central Bank (operating under the 2009 Microfinance Banks Law) and
2. Microfinance Institutions (MFIs) which are regulated by the SFD.

As opposed to MFIs, Microfinance Banks can collect savings and deposits from the public to finance their activities. MFIs are operating under the Non-governmental Associations and Corps. Law No. 1 of 2001 and lack the regulatory framework to collect public deposits and are therefore almost completely dependent on external funds channel through the SFD. These funds are often tied to specific progammes and interventions in pre-defined areas.

The microfinance industry in Yemen was underdeveloped even before the conflict. The deterioration of the socio-economic and regulatory situation after 2015 and the impact of the conflict on Micro, Small and Medium Enterprises (MSMEs) have significantly impacted the financial sector. The main development in this area has been the extremely rapid decline in the portfolio quality of all MFIs from 2015 to 2017. The portfolios were reduced (in terms of number and volume) and the proportion of portfolio in arrears >180 days increased.[9] In the second half of 2017, the MFI sector stabilized, and the quality of portfolios started to increase again. From 2017 to 2019, the PAR30 decreased significantly from over 50% in 2017 to 14% by the end of 2019. This is still higher than before 2015 and the Arab spring but it shows a sharp increase in the portfolio quality. To decrease the portfolio at risk, MFIs took a number of measures after 2015. The key factor affecting the portfolio's quality is the capacity of clients to repay their loans. Mitigation measures included extending the instalment payment period, restructuring the loans, and renewing loans for clients with a good credit track record.[10] The average outstanding loan size increased from YER 75,320 to 225,281 over the same period of time. In the meantime, the total number of borrowers decreased from 35,084 to 31,667. There was also a decrease in the average rate of internal operational efficiency until the end of 2017. The average rate was 128%

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[8] This section largely builds on LFS interviews with key stakeholders in Yemen and desk research (particularly reviewing the

- 2019 YMN War Impact Assessment
- 2019 WB impact of conflict on private enterprises
- 2019 SFD Market Study of Women Entrepreneurs in Yemen
- SEEP reports of MFIs
- SMED strategic plan 2018-2022

[9] SEEP reports and SMED strategic plan 2018-2022.

[10] 2019 YMN War Impact Assessment

at the end of 2014 and fell sharply to come up again.[11] This rate stands as of February 2020 at 96%.[12] The same pattern also goes for Financial Self-Sustainability (FSS).

The instable situation in 2015 pushed MFIs to ask for stricter collateral requirements and The study Yemen War Impact Assessment observed a decrease in the loan renewal rate.[13]

Numerous initiatives started in the years after 2015 to increase the resilience of MSMEs, including the Yemen Loan Guarantee Program created in July 2017 by the SFD. Its objective is to increase the facilitation of credit to entrepreneurs and it provides guarantees on loans made by banks and MFIs to MSME borrowers. As of February 2020, 109 loans are guaranteed by the YLGP. As of February 2020, the active number of borrowers for MFIs is 89,536, and the active number of savers 1,348,042. The outstanding loan portfolio equals YR 27,754 million and the average outstanding loan size is YR 313,551 (USD 523).[14][15]

The war impact assessment conducted by YMN in August 2019 finds that 85% of MFI managers and credit officers report a decrease in the number of active clients and 96% of them observed a drop in number of new clients. Besides, that assessment notes that 13.8% of microfinance clients became internally displaced and left their microenterprises behind. 19.7% of the clients closed their business and only 5.1% relocated their business to other areas of the country. Almost 79% of microfinance clients reported that their enterprise suffered from a large decrease of income. Problems identified by respondents (MFI clients) are, among others, the fear of losing collateral, loans ceilings and the difficulty in choosing a suitable enterprise or loan in the current situation. The war impact assessment of YMN also notes a decline in the number of female borrowers. The proportion stood at 42% in December 2018 while it was around 60% before 2014. Initially, MFIs were reluctant to resume loan activities immediately after 2015 and the demand was also weak. It seems that MFI picked up the pace again and started to offer new products and larger loan sizes to carefully selected clients. The YMN war impact assessment observes that group lending is a popular financial product, targeted mainly at female borrowers.

The war impact assessment of 2019 observed the following problems faced by MFIs:

- Non-repayment of instalment (increasing the portfolio at risk)
- Decreased lending rate
- Active client leaving because of the complicated guarantees newly needed
- Limits on loans
- Security situation
- Decreasing interest rates because of devaluation
- Lack of liquidity
- Increase of operational expenditures and administrative spending
- Disruption of complete stop of operations in some branches. Due to physical damage to their branches (air strikes or ground fighting)

The YMN war impact assessment identifies new possibilities and opportunities that arose due to the conflict. Opportunities are, for example, the installation and maintenance of solar power

[11] 2019 YMN War Impact Assessment
[12] SMED monthly indicators, accessed March 2020.
[13] Ibid
[14] SMED monthly indicators, accessed September 2020.
[15] Using an exchange of 1 USD = 600 YR as of February 2021

infrastructures and alternative energy sources. Cooling industries, agricultural inputs such as greenhouses, irrigation methods, and other farming activities, and communication businesses. Some MFIs have started to provide mobile banking services to boost their outreach and decrease operational expenses. Some MFIs have started to partner with International Non-Government Organisations (INGOs) in Yemen and donors to provide cash disbursement services.

A further challenge to the financial sector poses the fact that some people are associating specific MFIs with political affiliations which makes it difficult for MFIs operating in the South to open operations in the North or the other way around. This does not only apply on the institutional, but also on the individual level (e.g. difficulties for MFI staff originating from one area to work in the other).

Table 2: Microfinance Banks and Institutions in Yemen

Name	Established in	Classification	Established by	Number of Branches	Number of Governorates present
Al-Amal Microfinance Bank	2007	Bank	Joint cooperation among the Yemeni government, the Arab Gulf Program for Development and the private sector, as the culmination of Saudi prince Talal Bin Abdulaziz's initiative to establish banks for the poor in the Arab region.	16	9
Al-Kuraimi Islamic Microfinance Bank	2007	Bank	Al-Kuraimi Exchange	65	22
Tadhamon Microfinance	2006	Bank	Tadhamon International Islamic Bank	22	9
National Microfinance Foundation	2002	Foundation/ NGO	Collaboration among government officials, including former Yemeni prime minister Dr. Abdul Karim Ali Al-Eryani, academics, prominent businessmen and bankers.	20	10
Nama'a Microfinance Foundation	2000	Foundation	Agreement between the United Nations Development Programme (UNDP) and the Charitable Society for Social Welfare (CSSW) within the micro-star program in Yemen.	12	5
Azal Islamic Microfinance Program	2001	Program	Collaboration between Yemeni non-governmental organization SOUL For Development and the SFD	8	4
Hadramawt Microfinance Program	2000	Program	Social Fund for Development (SFD) and Alnahda Social Foundation	8	1
Union Microfinance Program - Abyan	2003	Program	Under the platform of the Yemen's Women Union.	6	3
Aden Microfinance Foundation	2005	NGO	Social Fund for Development (SFD)	5	3

2.2.2 Key figures of the microfinance industry

Value of outstanding portfolio volume[16]

Figure 1: Value of outstanding portfolio volume

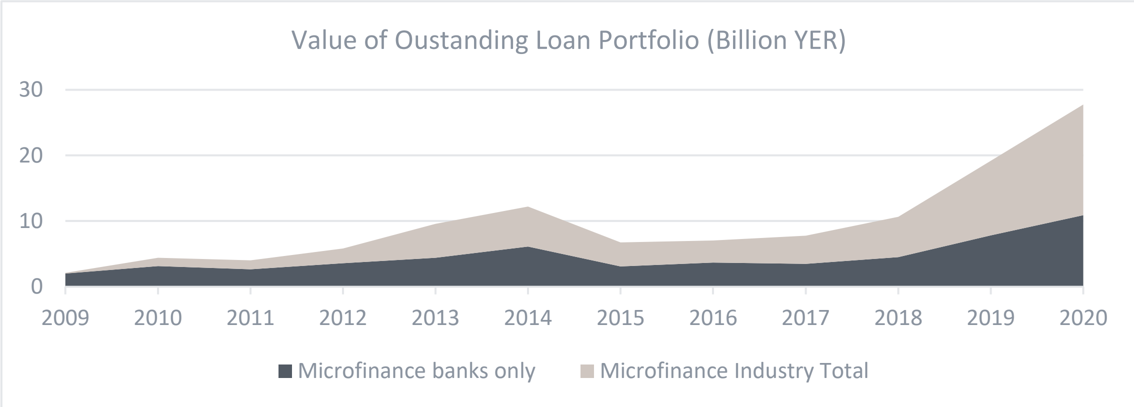

Table 3: Value of outstanding portfolio

Value of Outstanding Loan Portfolio (Million YR)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	**2020**[17]
Microfinance industry total	2,104	4,413	4,030	5,846	9,590	12,226	6,741	7,045	7,800	10,667	19,192	27,754
Microfinance banks only	99	1,243	1,357	2,247	5,191	6,084	3,624	3,381	4,311	6,156	11,354	16,853
Al-Amal	99	556	534	956	1,904	2,765	2,414	2,324	2,285	2,601	3,402	3,428
Al-Tadhamon	-	607	750	732	1,433	1,272	430	245	616	1,167	1,795	2,690
Al-Kuraimi	-	80	73	559	1,854	2,047	780	812	1,410	2,388	6,157	10,735
Percentage of MF banks from industry total	5%	28%	34%	38%	54%	50%	54%	48%	55%	58%	59%	61%
Portfolio Value: MFIs	2,005	3,170	2,673	3,599	4,399	6,142	3,117	3,664	3,489	4,511	7,838	10,901

[16] data obtained from SFD
[17] as of end of September 2020

Number of Active Microfinance Borrowers[18]

Figure 2: Number of Active Microfinance Borrowers

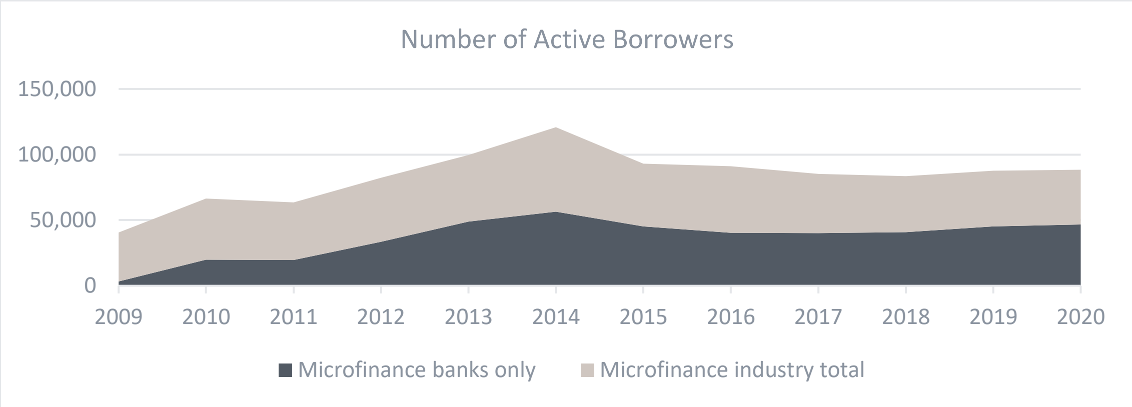

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Table 4: Number of Active Microfinance Borrowers

Number of Active Borrowers	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	**2020**[19]
Microfinance industry total	40,630	66,419	63,618	82,206	99,726	*120,839*	93,118	91,017	85,259	83,490	87,791	88,515
Microfinance banks only	3,298	19,774	19,650	33,420	49,008	56,455	45,230	40,438	40,172	40,875	45,175	46,738
Al-Amal	2,691	14,730	15,939	26,154	34,374	40,819	37,671	35,152	34,098	33,502	34,958	34,377
Al-Tadhamon	607	4,810	3,381	5,437	8,787	7,886	3,873	2,119	2,696	3,618	4,817	5,152
Al-Kuraimi		234	330	1,829	5,847	7,750	3,686	3,167	3,378	3,755	5,400	7,209
Percentage of industry total	8%	30%	31%	41%	49%	47%	49%	44%	47%	49%	51%	53%
No. of active borrowers excluding banks	37,332	46,645	43,968	48,786	50,718	64,384	47,888	50,579	45,087	42,615	42,616	41,777

[18] data obtained from SFD
[19] as of end of September 2020

Number of Microfinance Savers[20]

Figure 3 Number of Microfinance Savers

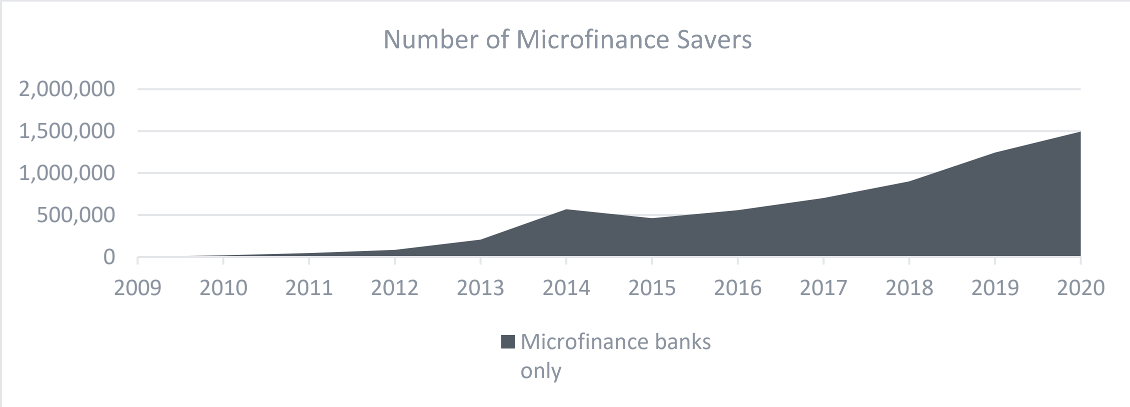


Figure 4: Number of Microfinance Savers

Number of Savers	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	**2020[21]**
Microfinance banks only	2,678	19,601	45,106	84,130	206,513	571,069	463,452	557,052	702,314	900,248	1,244,914	1,494,293
Al-Amal	2,678	18,513	32,720	44,336	57,894	93,053	122,377	125,296	127,940	129,801	181,952	190,102
Al-Tadhamon												
Al-Kuraimi		1,088	12,386	39,794	148,619	478,016	341,075	431,756	574,374	770,447	1,062,962	1,304,191

[20] data obtained from SFD
[21] as of end of September 2020

An analysis of the data provided by the SFD reveals that formal microfinance banks are outperforming MFI in terms of overall portfolio value and number of borrowers. Microfinance banks have maintained a market share between 48 and 59 percent since the outbreak of the conflict. In 2018, microfinance banks reached pre-war portfolio level and showed overall resilience. MFIs reached the pre-war portfolio level a year later.

A very interesting development is the significant increase in active savers at microfinance banks over the past years. The overall number of active savers (individuals with a savings account at a microfinance bank) rose from only 2,678 in 2009 to over 1.2 million in 2019. Taking a closer look at the number of savers by institution reveals that the bank that has been able to mobilise most savers is Al-Kuraimi Islamic Microfinance: Bank. This can partly be explained by the fact that Al-Kuraimi's extensive network of branches and agents covers a wide area of the country, including in rural regions. In addition, the bank offers complimentary financial services, most importantly money transfers, to customers.

2.3 Key Informant Interviews Scorecard

In order to consolidate our discussions with the Key Informants and for the purpose of obtaining a global rating of financial sector development needs in Yemen, Key Informants completed a scorecard using a scale of 1 - 5 with 5 being the highest score. 14 KII respondents scored 10 statements. The scorecard below shows the average scores and a summary of the most relevant comments.

Table 5: Scorecard Analysis from KIIs in 2020

#	Statement	Average Score	Comments
1	There are suitable financial products and services for MSMEs and agro businesses in the market	2.5	▪ The available financing is not enough, the banking system is on the verge of collapse since 2015 ▪ There is really important groundwork to do in terms of product variety (i.e. housing), customization (products are often not based on customer needs) and coverage ▪ On the positive side: ▪ Recent positive developments in agricultural finance (especially solar pumps and solar panels) but still a huge unmet demand ▪ Total of 9 MF providers means there is competition in the market ▪ Different Commercial Banks such as Alkuraimi Islamic Bank and YKB have recently started to downscale their operations and introduced SME lending
2	MSMEs and agro businesses are aware of financial products and services available in the market and have a good understanding of the features and benefits	3	▪ Especially the smaller MFIs are less known ▪ In rural areas financial literacy is very low ▪ Many MSMEs were created after the war, the older ones (pre-war) are regarded as more professional and have a good management (including financial management) while newly established ones often have weaker management structures in place

3	Suitable marketing channels are used to make customers aware and inform them of the benefits of existing financial services	2	▪ Most MFIs and some FIs do not have a dedicated marketing department and marketing budget is limited ▪ some MFIs use Radio and TV ▪ larger MFIs and commercial banks increasingly use social media (mostly Facebook and Twitter) but internet coverage is limited to the urban centres ▪ word of mouth is important especially in rural area ▪ service providers (distributers of solar panels and pumps) are used to market financial products in rural areas
4	There is the appropriate amount of publicly available research	1.5	▪ not much financial sector research, SFD tries to involve universities but so far limited success ▪ most of the existing sector research is provided by YMN and available on their website ▪ some FIs conduct their own small-scale demand studies but the results not in the public domain → much more research needs to be done
5	Consumer protection regulation is appropriate	2	▪ from Government side not much regulation, regulation from side of SFD, posters are available at MFIs that is showing interest rates, SFD is working on a grievance system (basic system exists but expansion is expected), together with MFIs, SMED audit conducts regular audits of MFIs, question about satisfaction ▪ There is a need to support key players to make this happen
6	Know Your Customer (KYC) regulation is appropriate	3	▪ different IDs exist: Old ID, new (computerised) ID, Passport, Workplace ID, some are easily manipulated; SFD has communicated with MFIs to disburse loans to borrowers with the new computerized ID ▪ borrowers need to provide the new ID when applying for a loan which is not widely available (due to lack of plastic cards) but the issuing authority grants temporary IDs (on a DIN A4 paper) ▪ Credit Bureau is housed at the Central Bank for Commercial Banks ▪ Credit Bureau for MFIs housed at SFD ▪ SFD has been enforcing KYC compliance in the MFI sector
7	Government policies and central bank regulation enables increased financial inclusion	2	▪ MFIs are regulated by SFD and the Social Affairs Ministry (the entity that issues licenses to MFIs and NGOs, Central Bank regulates MFBs, which creates its own challenges, MFBs have to report to both Central Banks ▪ Existence of two Central Banks, one in Sana'a (which is in a very bad shape), and one in Aden which is internationally recognised but also in a bad shape, ▪ Central Banks in Aden has no institutional memory, all information/ institutional memory in Sana'a, right now it is not possible to do any reform ▪ The Central Bank are generally supportive in driving financial inclusion; this includes (digital) financial

			innovation such as the introduction of electronic wallets but lack the capacity to regulate the sectors ▪ huge differences in USD exchange rates (30%) between Sana'a and Aden ▪ Problems of SWIFT transfers between Sana'a and Aden,
8	The economic, business and political environment is conducive for increasing financial inclusion	1.5	▪ Strong negative impact due to the war, many businesses were destroyed/ had to stop operating and cannot pay back loans (over indebted) ▪ deterioration of the currency, boycotts and sanctions hurt the economy (frequent fuel shortages) ▪ people are associating some MFIs with affiliations, difficult for MFIs operating in the South to open operations in the North, on institutional but also individual level ▪ brain drain means FIs are losing qualified staff
9	Investments are being made across the sector and which will help to catalyse it	2	▪ Surprisingly, in spite of the war, investments are happening ▪ Mainly local investments, international investments remain very low and mostly of philanthropic nature ▪ Commercial Banks have a lot of liquidity (banks are no longer holding government bonds), invest access liquidity in different sectors, including SME finance sector ▪ Gaining back stability is the main crucial factor for international investments
10	Recent development interventions and promotional activities by donors have a positive impact on financial inclusion	2.5	▪ Development partners have started to come back to Yemen, WB is developing a strategy (working through UN Framework of Cooperation; majority of operation is on emergency and humanitarian and emergency assistance (80 – 85%), on financial development (10 – 15%) ▪ lot of interventions from different donors, ▪ cash for work, nutrition ▪ infrastructure improvement in rural areas had a positive impact ▪ SFD has limited funds ▪ financial inclusion does not necessarily have to be grants, should build on Digital Transformation

The findings of the scorecard confirm that Yemen is a difficult market for financial services. However, the MSME finance sector remains resilient and even Commercial Banks started to “downscale” their operations and developed loan products for Small and Medium Enterprises (SMEs). There is still a huge unmet demand, especially in the agricultural finance sector, and opportunities for innovative and disruptive digital financial services. As such, a focus should be put on the strengthening of the existing institutions, increased efficiency and transparency of current operations and the development of new customer-centric products and services while ensuring client protection.

3 Demand for financial services of MSMEs

3.1 Estimated market size

Before the war, four main studies have been conducted to not only give Yemeni MSMEs a definition, but also gain a comprehension of their number in the country. The first study is from 2000[22], estimating the number of MSMEs at approximately 310,000. Four years later, the Central Bureau of Statistics conducted the Yemen Establishment Census, approximating the number of registered enterprises as well as other government and non-government institutions in the country to roughly 407,000[23]. However, of those, the private enterprises represented only around 307,000. In 2014, the Yemen Ministry of Trade and Industry estimated the number of MSMEs in the country to be about 27,796 enterprises only in manufacturing. According to a paper from 2012[24], the manufacturing sector comprises 4% of the total market, making the estimation for the total number of registered MSMEs 694,900. The same study estimates that the agricultural industry takes up around 50%, making the registered agricultural MSMEs number stand at approximately 347,000.

The informal unregistered businesses remain a very large part of the MSME economy and are not included in those statistics. As in many other developing countries, Yemen's economy includes a thriving informal sector. Many entrepreneurs conduct commercial activity without an official structure or permits and do not use organized accounting. Many businesses neglect to register their companies which makes the actual size of the informal sector hard to measure. Different studies do however suggest that a large part of Yemen's economic activity is conducted by informal businesses. LFS Financial Systems (now LFS Advisory) has conducted a study with funds from KfW for the SFD/SMED in 2014 and estimated that there are 1.78 million micro enterprises and 85,000 Small Enterprises, including unregistered businesses. This figure is currently being used by SMED as the most reliable one and we attempt to update it with this report. All the studies mentioned above show that micro enterprises comprise the highest percentage of MSMEs in Yemen for both the registered and unregistered sectors, followed by the small businesses. Very roughly, 90% of all MSME have 4 or less employees, while 10% have more staff.

[22] 2000. Van Elk, Koos, and Paul Wijmenga, "MSE Baseline Survey: Final report of a nation-wide baseline survey among micro and small business enterprises (MSEs) in Yemen." Sana'a, Yemen: Social Fund for Development and the World Bank.
[23] Establishment Census 2004 Report Table No 7
[24] 2012. Aliriani, Kais, Role of Small and Medium Enterprises in the Economy: The Case of Yemen.

Because of the conflicts in Yemen, the UNDP and SMEPS Rapid Business Survey from 2015 has estimated that 24% of micro businesses, 27% of small businesses, and 35% of medium-sized businesses have been forced to shut down, causing a decrease in the total number of MSMEs in the country in recent years.[25] An IFC report from 2017 on the MSME Finance Gap in emerging markets estimates the number of the formally registered Yemeni MSMEs to have dropped to 400,235 and employ more than 1.5 million people.[26] On the informal market side, the same study elaborates that many Yemeni MSMEs, especially those that have less than 5 workers, are unregistered. The informal sector comprises approximately 80% of the total employment in the country, meaning it can be projected that the unregistered businesses employ more than 6 million people.[27] Assuming that informal businesses have the same size as formal businesses, this would lead to an estimate of 1.6 million informal MSMEs and a total of 2 million MSMEs. However, since informal businesses are considerably smaller than formal businesses (in fact, it can be assumed that most informal businesses are family-run businesses), the true number of informal businesses can be significantly larger, ranging from 2-3 million or even more.

The MSME finance gap is estimated as the difference between current supply and potential demand which can potentially be addressed by financial institutions.

Results of the LFS survey suggest that one third of the MSMEs plan to take a loan during the next 12 months and another fourth plan to take a loan but are not sure if they qualified. Only 35% are not interested in taking a loan in the next 12 months (see Figure 14). Using those indications, we estimate that about 30%-40% of all MSMEs are interested and eligible for financing. In view of an average loan size of YER 627,102[28] or USD 1045 among MSMEs, the total finance need of MSME would amount to roughly USD 627

Box 2: LFS Estimates on Market Size

LFS Estimates on the market size

Number of MSME (registered and unregistered):	2-3 million
Proportion of microenterprises among MSME	>90%
Proportion of unregistered MSME	>80%
Number of people working in the MSME sector:	7.5 million
Finance need of the sector:	USD 627 million – 1.25 billion
Number of MSME with loans (2020):	88,515
Value of Outstanding loan portfolio (2020)	USD 110 million
Estimated MSME finance gap:	1.4-2.9 billion

Conclusion: There is no lack of demand for finance by MSME

[25] 2018. Alcar for Consultancy, Small and Medium Sized Enterprises Damage Assessment: Yemen (Sana'a City and Suburbs)
[26] 2017. IFC, MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets
[27] 2018. ESCWA, Fostering Innovation in Small and Medium Enterprises in the Arab Region
[28] Section 0 suggests that the average outstanding loan amount is YR 313,551. The disbursed loan amount is roughly twice as high, i.e. YER 627,102

million – 1.25 billion[29], whereas, from a lender's perspective, somewhat more than half of that amount would be needed as the average outstanding loan size is about half the finance need.

In Box 2, LFS attempts to summarize those studies to provide a rough overview of the MSME finance situation in Yemen. We would like to emphasize that the reliability of those figures is rather low and that the real figures could easily vary to as much as 50%. Nevertheless, the main message for that study does not change even if figures needed to be corrected considerably: There is no lack of demand for finance in the MSME sector. FIs that support MSME are (in the rather favorable) situation to be limited by their own capacities to grow and by their own capacities to deploy suitable financial products to MSME.

There is no lack of demand for finance in the MSME sector.

FIs that support MSME are (in the rather favorable situation) to be limited by their own capacities to grow and by their own capacities to deploy suitable financial products to MSMEs.

3.2 Socio-economic characteristics of MSMEs

3.2.1 Geographic zones

Geographically, Yemen has four main zones – coastal plains and highlands in the west, and highlands and desert in the east. While certain regions such as the highlands receive an adequate amount of rainfall to keep crops alive, the desert areas suffer from water scarcity and are, thus, very scarcely populated. The most heavily developed regions, especially when it comes to agriculture, remain the coastal plains.

Since 2015, Yemen has been suffering through a political conflict.

Our demand side study is largely based on primary data collected in Aden, Sana'a and Hadhramaut (see below). Additionally, the focus group discussions will take place in Aden, Sana'a, Hadhramaut, Lahj, and Al-Hudaydah.

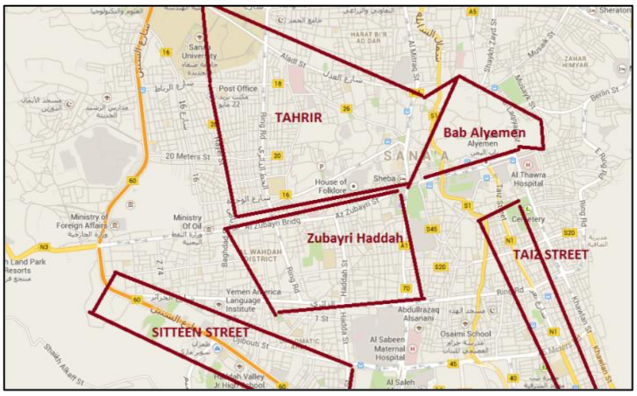
The choice of those regions was based on their geographical locations and the importance of the MSMEs and the agricultural sector within the region. The survey results show that within Sana'a, Aden, and Hadhramaut, the trade, services, agriculture, industry, and production sectors were covered sufficiently. However, each region has a different distribution between those business sectors. For instance, in Sana'a, most of the respondents were in the services industry.Hadhramaut had the most responses in the trade sector and very little in the services industry. The sample in Aden included a large share of agricultural firms in Lahj. Therefore, all three regions provide a unique perspective on the MSME market. The selection of those geographical areas ensures that the survey covers micro, small, and medium enterprises in all three regions in urban, semi-rural, and rural settings, within its scope.

Sana'a

[29] We estimate the minimum market size as follows: 2 million MSME x 30% that are interested and eligible x USD 1,045 average loan size = USD 627 million. Analogously, we calculate late maximum market size: 3 million MSME x 40% that are interested and eligible x USD 1,045 average loan size = USD 1250 million.

Sana'a is Yemen's capital city (according to the country's constitution and is located within the central highlands region. With a population of almost 4 million people, the city is the largest in the country. As the capital city, 21% of jobs remain in the public sector[30]. Other primary sources of formal employment in Sana'a are in trade and services. The city has the highest rate of informal employment as well as prevalent poverty and unemployment. Estimations show that more than a quarter of Sana'a's population is currently unemployed.

Figure 5: Map of Sana'a Business Centres



Many businesses of different sizes have chosen Sana'a as their location, especially in the trade and service sectors. The famous business centres in Sana'a are Tahrir, Hadda Street, Zubairi Street, and the region around Sitteen Street. The busiest areas are Tahrir centre, the old city (Sana'a Al Madina), Hadda Street, and Zubairi Street. The largest shopping centre in the city is in the Tahrir district where different sizes of trading and service businesses selling a variety of goods, ranging from clothes, to food, jewellery, and medicines, are located. The same also hosts several banks, foreign exchange bureaus, restaurants, and street vendors. The Old City Al Madina has also developed rapidly in recent years and now hosts three large hotels as well as a variety of stores and restaurant. The area is also known for its parks and the President's palace.

Aden

Aden is an important port city and transportation hub and, since 2015, temporary capital. Aden is the second largest city in Yemen after Sana'a in terms of population, business, and trade, with more than 800,000 residents. Located in the easter part of the country, Aden has been in the centre of the Yemeni war.

Figure 6: Map of Aden Business Centres

Aden has numerous distinct sub-centres such as Crater (the original port city), Ma'alla (the modern port), Tawahi, and Khormaksar, which is located on the isthmus that connects Aden proper with the mainland. The biggest centers in Aden are Sheik Othman, Crater, and Tawahi. Sheik Othman hosts the biggest and busiest marketplace in Aden which is also among the biggest in Yemen. Micro, small, and medium enterprises in trade, manufacturing and services operate in Sheik Othman as well. The market offers the opportunity to those enterprises to sell a large variety of goods from clothes and fabrics to food spices and construction materials. In addition, smaller industries are hosted in the market such as furniture workshops. Several commercial banks and foreign exchange bureaus operate branches in the market. The market hosts a considerable number of

[30] 2018, Ministry of Planning & International Cooperation: Yemen Socio-economic Update

road transport companies that operate bus trips to all Yemen and to Saudi Arabia and Oman Sultanate. Crater is the second to Sheik Othman in terms of geographic area and business activity but is mainly dominated by retail shops, restaurants, street vendors, and fresh food dealers.

Hadhramaut

Figure 7: Map of Hadhramaut Region and Most Important Cities

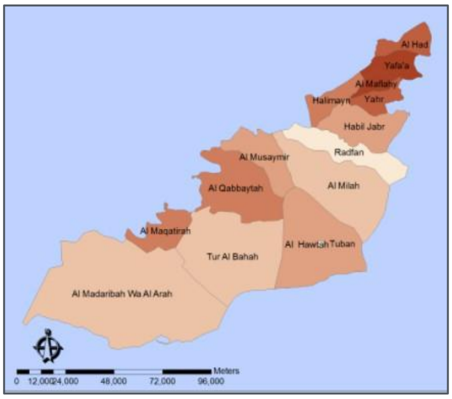
Hadhramaut is a region in South-Eastern Yemen that consists of a narrow coastal plain, surrounded by a broad plateau. The Hadhramaut Governorate is the largest in the country, consisting of 28 distinct districts and a population of approximately 2.3 million. Majority of cities in Hadhramaut have been based near the coastal plain which contributed to some becoming traditional centres of learning. The capital and largest city in the region is Mukalla. Thanks to its port, the city has gained importance in the region as a transportation hub. Other significant cities in Hadhramaut include Ash Shahar, Say'un, and Tarim (an acknowledged theological, juridical, and academic centre).

The region is very well known for its agricultural focus with widely spread crops including wheat and millet, tend date palm, coconut groves, tobacco, and honey . The mountainous regions of Hadhramaut allow for sheep and goat keeping, especially by the Bedouins. Hadhramaut produces more than 250,000 barrels of oil per day, contributing to the further development of the region. Other developed industries include services, transportation, fishing, and tourism. Although the official unemployment rate for Hadhramaut is 12%, estimates show a number closer to 40%. 36% of the Governorate's population live below the poverty line.

Lahj

Lahj is a city in the South-Western parts of Yemen, about 45 km north of Aden. The city has a population of about 30,000 people and is known as a doorway between the Southern and Northern parts of Yemen. Lahj is one of the most fertile parts in the entire country, making it an important agricultural centre. Known for its semi-tropical climate, the city and areas surrounding it have an abundant production of vegetables, fruits, various types of grain and cotton.

Figure 8: Map of Lahj Region



Lahj has become a well-known industrial hub where many important MSMEs have established their activities., thanks to the city's availability of labor, land, and infrastructure. Lahj's location is close to a seaport which further has helped businesses to ship their goods to international markets. Having mineral rich areas within the region has also boosted industrial production.

Figure 9: Map of Al-Hudaydah

Al-Hudaydah

Al-Hudaydah is the fourth largest city in Yemen with a population over 400,000. Located on the coastal plains bordering the Red Sea, Al-Hudaydah has become an increasingly important port for the country, especially for exporting coffee, cotton, dates, hides, and skins. Most importantly, approximately 75% of all humanitarian aid to Yemen enters the country through that port and more than 65% of all commercial imports do so as well. Additionally, many raw and processed foodstuffs (vital for war-torn regions especially), machinery, and metal goods also enter through the port. Another factor that makes Al-Hudaydah very crucial are road connections that serve as a direct link between Al-Hudaydah and Sana'a and Al-Hudaydah and Ta'izz as well as an airfield with service to Sana'a, Ta'izz and Aden. This makes the city an important trade centre.

Al-Hudaydah has also a lot of agricultural activity, with numerous crops being cultivates such as vegetables (like tomatoes, okra, and squash) and other crops such as sesame, cotton, tobacco, and maize. The rich soils in certain areas are even capable of producing several crops per year. In addition, livestock from Al-Hudaydah is also sold at several local markets including in Sana'a.

3.2.2 General profile of MSMEs

Micro, small, and medium-sized enterprises (MSMEs) are businesses, usually in low barrier markets, with personnel numbers below a specific threshold (see Table 6). The International Council for Small Business (ICSB) estimates that MSMEs make up over 90% of all firms and are responsible for 70% of employment and 50% of GDP in Yemen.[31] Micro enterprises are usually managed by a single person (sometimes including family members) and are typically in traditional and/or informal markets where wages are lower and labour is largely unskilled. Even though these businesses have gained importance in recent decades, especially when it comes to job creation and economic development, estimates still show that their financing needs are largely unmet. Just as micro enterprises, small and medium ones have continued being an important source of economic growth. They tend to have a larger degree of job creation and, as a result, have a larger capital need for their expenses related to the recruitment.

MSME characteristics vary greatly depending on the level of economic development as well as specifically defined thresholds, reliant on national accounting principles and legal documents. In 2014, the Yemen Ministry of Trade and Industry defined MSMEs based on the number of their employees (micro have 1-3, small have 4-9 while medium have 10-50 employees). An USAID report[32] provides a generalized definition for SMEs as enterprises whose personnel is between 10 and 99 employees (employees of small enterprises range from 10 to 49 while those of medium enterprises are between 50 and 99). Micro enterprises remain those with less than 10 employees. The same report establishes thresholds for an SME's finances – an SME has to either comply with a USD 1.4 million threshold of annual sales or USD 1.4 million threshold for assets.

The focus of this report is on assessing the development needs of Yemeni FIs in general and MFIs specifically considering their products and services to Micro, Small and, to a lesser extent, Medium size Enterprises. From that background, this study defines MSME according to the number of employees as indicated in Table 6 below, largely following the definition of the Yemen Ministry of Trade and Industry.

[31] UN: Micro-, Small and Medium-sized Enterprises Day, 27 June

[32] 2017. USAID, Booklet of Standardized Small and Medium Enterprises Definition

Table 6: Definition of MSMEs

Size	Number of employees (including business owner)
Micro Enterprise	1-4
Small Enterprise	5-9
Medium Enterprise	10+

LFS has conducted a quantitative survey among 260 MSMEs and has deepened the findings using 20 Focus Group Discussions with a total of 147 participants. In addition, LFS has conducted 9 in-depth interviews with medium-size enterprises. Most (75%) of the surveys were conducted face-by-face, while the outbreak of COVID-19 and/or the security situation required conducting the remaining quarter of surveys by phone. All focus group discussions were conducted by WhatsApp group chats or face to face discussion. Table 7 includes the number of respondents by their sample categories; the participants of the focus group discussions were chosen from among the survey respondents, and the number of focus groups are included in that table as well.

Table 7: Number of survey respondents and focus groups by their sample categories

Sector / Region	Trade		Services		Production		Agriculture		Total	
	Survey	*FGD*	*Survey*	*FGD*	*Survey*	*FGD*	*Survey*	*FGD*	*Survey*	*FGD*
Aden	25	2	26	2	17	2	28	2	96	8
Sana'a	20	1	27	1	21	1	25	2	93	5
Hadhramaut	24	1	10	1	17	1	20	0	71	3
Lahj	-	0	-	0	-	0	-	3	-	3
Al=Hudaydah	-	0	-	0	-	0	-	1	-	1
Total	69	4	63	4	55	4	73	8	260	20

The survey was undertaken in Aden (37% of the respondents), Sana'a (36%), and Hadhramaut (27%). The survey respondents are roughly distributed equally across the trade (27% of the respondents), services (24%) and agricultural (28%) sectors, while there are somewhat fewer respondents in the production sector (21%).

Figure 10 below includes the main characteristics of the respondents to the survey.

Figure 10: Main characteristics of respondents

Out of 260 interviewees, 220 were micro (85%), 28 were small (11%), and 12 medium (5%) enterprises. 168 (65%) of the respondents were male and 92 female (35%) and 162 (62%) were in urban areas while 61 (23%) were in semi-rural and 37 (14%) were in rural areas. One quarter of the respondents were below 30 years of age. 30% of the respondents had completed university and another 30% had completed secondary education. Only 10% of the surveyed were illiterate.

SMEs are significantly longer in existence than micro enterprises: 30% of micro businesses had existed for 1 to 3 years, followed by 28% that had existed for 4 to 10 years and 16% that had existed for less than one year. Only 14% of micro businesses had more than 10 years in operation. When it comes to the small businesses, 50% of the interviewed had been in operation for more than 10 years. 50% of the medium-sized businesses had also been active for more than 10 years and no medium-sized businesses had been operating for less than 1 year. Business data, such as assets, profit, and turnover, was not thoroughly analyzed due to lack of a significant amount of responses.

3.2.3 Challenges and business constraints in Yemen

In 2019, the World Bank published an assessment of constraints and the impact of conflict on private enterprises.[33] About 25% of the enterprises surveyed as part of that paper by the World Bank closed because of the conflict. Security threats pushed close to 20% of surveyed enterprises to relocate their activities either domestically or abroad. 30% of the rest of the respondents identified the interruptions

[33] 2019 WB impact of conflict on private enterprises

of key service provisions, such as electricity, and 26% loss of customer base as the main constraints to their business. Disruption of domestic and imported supplies, high supply costs, loan restrictions and substantial spending on taxes and regulatory fees were also identified as challenges by the private sector. Access to finance was identified as another challenge and over 60% of firms surveyed reported difficulties in accessing credit and foreign exchange. Half of the respondents reported increased costs of financing and most firms (about 71%) did not have credit.

To sum up, the World Bank study lists some of the main constraints to the private sector: SME closure and shrinking access to finance, lack of investment, decreased sales, decline of financial intermediation, banking sector instability, overreliance on cash payments and money exchange companies, lack of service provision political and security risks. Generally, the business environment is substantially degraded by the combination of all the above-mentioned factors.

As aforementioned, access to finance remains one of the main constraints. The results of the LFS survey show that this constraint has not alleviated since 2015. In fact, 19% of respondents believe the access to finance stayed the same since 2015 and 27% think that the accessibility got more difficult than before (especially present in medium-sized businesses where 42% chose that option). Only 18% of the interviewed believe that accessing a loan is easier now than it was in 2015. These findings were supported by the focus group discussions where many still mentioned the difficulties of accessing loans, especially in the current situation. Others believed that associations who used to give loans in the past have stopped doing so currently. Access, according to focus group discussion participants, is being affected by the ongoing war conflict, electricity shortages as well as the Covid-19 pandemic. A focus group respondent from Aden cited the electricity shortages as reasons for not being able to work. Banks have little liquidity due to lack of confidence in them, meaning less loans. At the same time, demand for loans is very high as businesses have faced many challenges recently. The instability of the exchange rate against the U.S. dollar was mentioned as a constrain. Some cited complicated processes as obstacles to access during the discussions. Some businesses have stopped importing because of customs and double taxes while transportation of goods has become increasingly difficult. Others are battling high rents and lack of proper working space. Earlier closing times due to the ongoing conflict have also affected businesses negatively. Focus group participants stated that especially for long-term business needs, access has become more and more difficult.

Box 4: Fear of Not Being Able to Pay Back

> *"[Access is difficult], because of the volatility of the situation, the instability of prices of goods and the fear that installments will not be met in the specified time due to the lack of payment of salaries to employees or their delay"*
>
> *~ Male participant of a Focus Group Discussion from the production sector in Sana'a*

Box 3: Currency and Prices

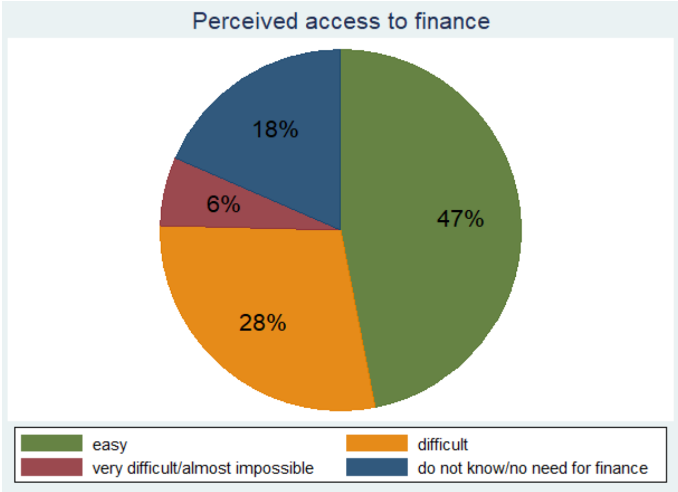
> *"I am divorced and I have two sons, and the current situation is difficult due to the high currency and high prices, and non-delivery of salaries, so the demand has decreased, but we are continuing and trying to equalize the purchase price and the offer price with a reasonable increase."*
>
> *~ Female participant of a Focus Group Discussion from the trade sector in Aden*

As Figure 11 demonstrates, 47% of all respondents were of the opinion that the overall accessibility to loans is “easy” while 28% viewed it as “difficult” and 6% viewed it as “very difficult or almost impossible”. The remaining 18% had no opinion or no need for finance, respectively.

The perception of loan accessibility had an impact on the reasons for not using formal financial services. Many of the respondents who viewed access as easy were not using financial services due to reasons - mainly no need for further investments (24%) and fear not to be able to pay back (24%).

Those who viewed access as difficult had fear of not being able to pay back (37%) while 17% chose no sufficient collateral as reasoning. Not very surprisingly, this shows that those with lower capacities to repay and/or guarantee perceive access to finance more difficult.

Figure 11: Perceived access to finance



When being asked to name the 3 main difficulties in getting a loan, most (57%) of the LFS survey respondents reported that there were no difficulties.

Figure 12: Main difficulties while trying to get a loan

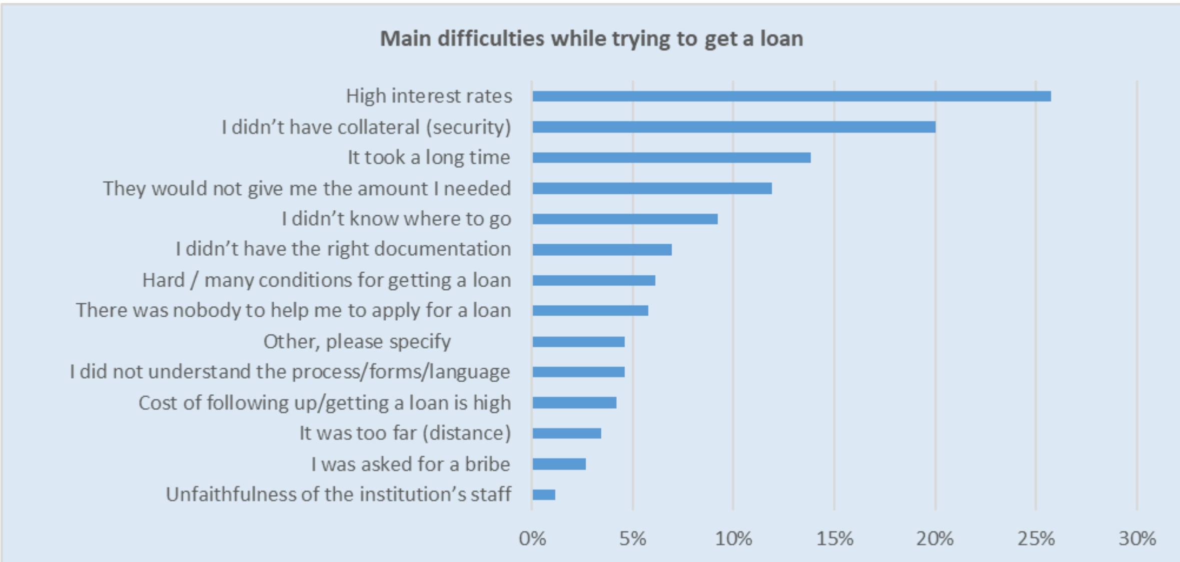


Figure 12 summarizes the responses of the remaining respondents.

A deeper analysis of those results reveals that:

- Interest Rates and Costs: Not surprisingly, the biggest challenge for businesses when obtaining a loan are the high interest rates (26% of the surveyed agreed). 4% found the cost of following up and getting a loan high while 12% were not given the amount they had applied for by the institution, a finding supported by the focus group discussions. Participants stated that even if one is granted the amount needed, they often receive it in installments due to the currently challenging circumstances within the country. High interest was also one of the main constraints mentioned during the focus group discussions. A respondent from Sana'a mentioned that small business support loans can reach an interest of up to 25%.

Box 5: Loan Difficulties

> *"We cannot obtain a loan from any bank because we do not have the guarantees required by the bank."*
>
> *~ Male fisheries participant from Aden*

- Process and Collateral: 20% of respondents agreed that one of the main challenges when obtaining a loan remains the often-observed lack of collateral – a conclusion, supported by the focus group discussions. Participants from the agricultural sector (fisheries) focus group mentioned that lack of guarantees was the breaking point in the loan acquiring process, and since their business is risky, no one wants to be a guarantor. Land, gold, real estate, and various commercial securities as collateral were also cited as challenges when applying for a loan. 7% of the respondents to the quantitative survey mentioned the lack of correct documentation as a challenge while 6% agreed that the amount of the conditions or difficulty of the conditions for getting a loan is also an issue. Participants in the focus groups re-iterated this finding, saying that some conditions included, such as high amounts in advance or age groups they could not provide. Additionally, the length of the process as well as the overall complexity of the process, forms, and language presented a challenge for 14% and 6% of the respondents, respectively. Difficult conditions and the length of loan procedures were named as some of the main challenges within the focus group discussions. Finally, 6% of the enterprises struggled with the lack of personnel to help them apply for the loan.
- Institutional issues: 9% of respondents mentioned that lack of knowledge regarding the location of the institution was a challenge that they had to face when trying to get a loan. For another 3% of the surveyed, the location was simply too far distance-wise. Very few respondents (2.7%, all of which had not taken any loan in the past) perceived that providing bribes was a requirement and/or reported the unfaithfulness of the institution's staff (1.2%) as an issue when obtaining a loan.
- Sectoral differences: In the trade sector, similarly to all other sectors, some of the top difficulties pointed out by respondents were collateral (23%), high interest rates (30%). In the service sector, 21% found that they were not given the amount they needed by the institution. In agriculture, the time that it took to obtain the loan (19%) was mentioned in addition to the other difficulties. Finally, 16% of the industry sector respondents did not know where to go to obtain the loan and 11% did not have the right documentation.
- Regional differences: The difficulties chosen also varied according to the location of the respondent. In Aden and Sana'a, the biggest challenge was the interest rate, followed by the high collateral. However, in Sana'a, many also pointed out that they did not receive the amount they needed (16%), compared to less than 10% for the other two cities. Hadhramaut had the highest percentage of respondents that did not face any problems when acquiring a loan (73%).

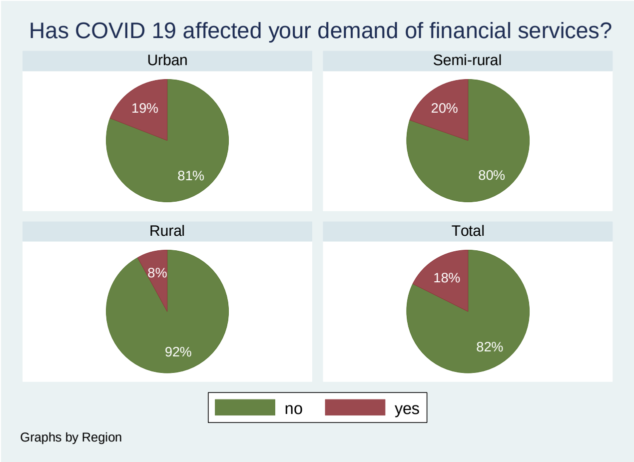
- Differences for business types: Urban, semi-rural, and rural businesses all pointed out similar challenges: collateral, process length, and high interest rates.
- Gender differences: There were no differences in the responses of male and female entrepreneurs.

Depending on the loan accessibility perceptions, the above-mentioned difficulties also varied. From those who perceived loan access to be easy, 68% faced no problems when getting a loan. However, 22% cited the high interest rate and 17% mentioned collateral requirements as difficulties. As a contrast, from those who found access to be difficult or very difficult, only about one third had no problems getting a loan and the main difficulties mentioned included high interest rates or collateral requirements. One fourth of respondents who perceived access as difficult or very difficult also found the amount of conditions and difficulty of conditions for getting a loan to be a barrier.

Limited impact of COVID-19 on the use of financial services

Another worldwide constraint during 2020 became the Covid-19 pandemic. The overwhelming majority of respondents (82%) from all sizes of enterprises, however, did not feel the effect of the disease when it comes to the use of financial services (see Figure 13).

Figure 13: Impact of COVID-19 on the use of financial services



Micro businesses were impacted the least (15%) while small and medium businesses suffered the most (32% and, respectively, 25%).

The agriculture and trade sectors were impacted the least where approximately 13% of respondents' usage of financial services was affected by the pandemic. From the focus group discussion in the agro-fisheries sector, one finds that Covid-19 actually decreased the prices of oil derivatives, having a positive impact on the sector. At the same time, however, many in the fisheries sector use a lot of diesel (but quantities in the country have decreased during the pandemic) and do not own their own means of production, meaning daily risk of becoming unemployed. In comparison 37% of the industry sector said their usage of financial services was impacted.

When it comes to geographical location, the usage of financial services was impacted the most in Sana'a with 27%, followed by Hadhramaut with 25%and Aden with 13%. The impact of Covid-19 was considerably smaller in rural areas (8%) than in semi-rural and urban areas (19% in each category).

Those who perceived the access to loans as "difficult" or "very difficult/ almost impossible" were more often impacted by Covid-19 (24% and 25% respectively) than compared to those who perceived access to loans as "easy" (16%). There were not significant differences between male and female respondents.

Covid-19's greatest effect was on income and business operations which decreased drastically and, therefore, affected the financing needs of businesses. From the focus group discussions, it becomes evident that the pandemic has caused a halt in cash transfers, imports and exports, and market activities as well as a rise in prices. On the positive side, it caused tax authority and municipalities to stop demand payments. Nevertheless, a participant from Sana'a stated that all government operations and businesses in the large markets have been affected. An Aden participant concurred, saying that because of the rising prices, they cannot afford to buy materials for manufacturing purposes. Demand has sharply fallen, because people no longer go outside, making businesses struggle further. Losses of 80% of business operations were emphasized during the discussions.

Box 6: Covid-19 and Prices

> *"Corona raised prices in Yemen, and is a major reason for raising food prices"*
>
> *~ Male respondent from the fishery*

In the survey, some enterprises in the services, agriculture, and industry sectors and especially in Sana'a and Aden, pointed out that there is a decline in loan access and the acquisition of a loan takes longer than prior to the pandemic. Nonetheless, even among those who were affected by the pandemic, the majority of respondents (63%) still planned to take a loan in the 12 months. The affected group had a different opinion on the importance of certain loan conditions. Respondents who were affected by Covid-19 believed flexible repayment and quick disbursement were the most important conditions while putting less emphasis on the knowledge of the institution, reputation of the credit institution, and good customer service. This can be due to the fact that the pandemic – if one was affected, then the need for flexible repayment and quick loan disbursement becomes greater. The group that was not affected by the pandemic believed quick disbursement, knowledge of the institution, and adequate duration were the most important loan conditions.

Box 7: Medium Enterprise views on the effects of Covid-19 on their finance needs

> From interviews with 9 medium-size entrepreneurs in Aden, Sana'a and Hadhramaut, mixed results regarding the Covid-19 pandemic constraints emerged. Some respondents agree that business closure, decrease in income, and increasing financial burdens presented further difficulties. However, others believed that Covid-19 did not exacerbate the already-existing constraints. Notably, aside from sterilization changes, coping mechanisms were not altered for

> Many challenges still remain when it comes to accessing financial services and especially loans. Nevertheless, more than half of the respondents reported that the situation has improved since 2015. The perception when it comes to accessibility also has an influence on the reasons behind a lack of financial services usage. Some of the main difficulties include high interest rates and collateral. The Covid-19 pandemic has presented an additional challenge to about one-fifth of the surveyed.

3.3 Use of and demand for credit

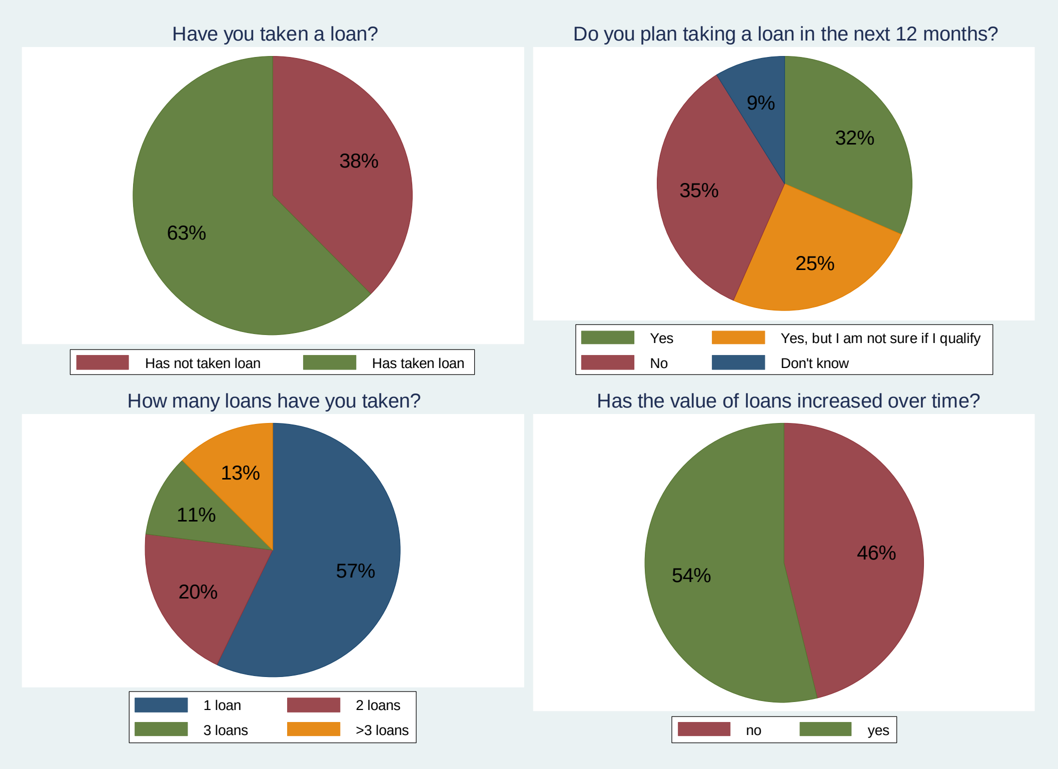
3.3.1 High demand for credit

The LFS survey was rather designed to collect development needs for MFIs than to assess the market potential and, thus, the SMED databased was used to create most of the sample. It can strongly be assumed that MSMEs in that database are more likely to have experience with loans and are at least somewhat more likely to plan taking loans in the near future, than MSMEs that are not in that database. The following figures should be seen under that light.

<u>MSMEs take loans</u>

From the LFS survey, 63% of respondents had a loan, whereas 53% took a business loan and 10% a consumer loan (see Figure 14). The latter group was not further considered in the survey. While somewhat more than half (57%) of the MSMEs with loans reported to have taken one loan only, one third (31%) has experience with 2 or 3 loans, and 13% with more than 3 loans.

Figure 14: MSMEs' experiences with loans



From among the LFS survey respondents, 56% of the micro businesses, 71% of the small ones, 67% of medium-sized enterprises had taken a loan in the past. More micro rural businesses had taken a loan than those from other regions. The industry sector and agriculture sector had the most respondents that had taken more than one loan – 58% and 52% respectively. As a contrast, in the service sector, only 21% of respondents had taken more than one loan.

There were no differences between male and female respondents. Nonetheless, a higher percentage of female respondents had more than one loan (56% compared to 36% for males). This may be linked to the somewhat higher portfolio quality that women tend to have globally. Interestingly, more than 70% of the illiterate respondents had more than one loan as compared to less than 45% for the rest of the educational levels.

Repeat borrowers were twice as often found in Hadhramaut, where 59% of the respondents had more than one loan than in Sana'a (with 32% having had more than one loan) and Aden (30%). Half (50%) of the rural respondents had more than one loan, compared to 42% of urban and 40% of semi-rural areas.

Only a small majority (54%) of those with more than one loan reported that their loan size has increased. This is especially surprising when considering the high inflation rate in Yemen.

Loans are highly demanded by MSMEs, especially agricultural firms

More than half (57%) of the respondents to the LFS survey plan on taking a loan in the next 12 months. This includes one fourth of respondents who are not sure if they qualify for a loan. Somewhat more than a third (35%) of the MSMEs were not interested in taking a loan, and 9% were not sure, yet. Although those figures need to be seen with some care, they suggest that more than half of all MSMEs are interested in taking a loan, including more than two thirds of all agricultural MSMEs.

The agricultural sector had the most respondents who plan on taking a loan (70%) while the trade sector had the least (45%). From those, the agricultural sector had the most people who were not sure if they qualify for a loan (44%) as compared to only 15% in the trade, 16% in the service, and 24% in the industry sectors. The Development Needs Assessment in Section 4 proposes ways to tailor loan products specifically to be able to tap into the opportunities presented by the large demand in the agricultural sector. Rural regions had the highest percentage of people who plan on taking a loan in the next 12 months - 76% - out of which 68% are not sure if they qualify for a loan. The semi-rural regions followed closely after with 71% planning to take out a loan. However, in semi-rural regions, only 28% were not sure if they qualify for a loan.

Sana'a saw the highest proportion of respondents who plan on taking a loan – 80% including 31% that were not sure if they qualify. Hadhramaut had the lowest demand for future loans. Aden had the highest percentage of people who are not sure if they qualify for a loan – 33%. In general, more males (59%) planned on taking a loan than females (52%). From those who perceived loan access as easy,

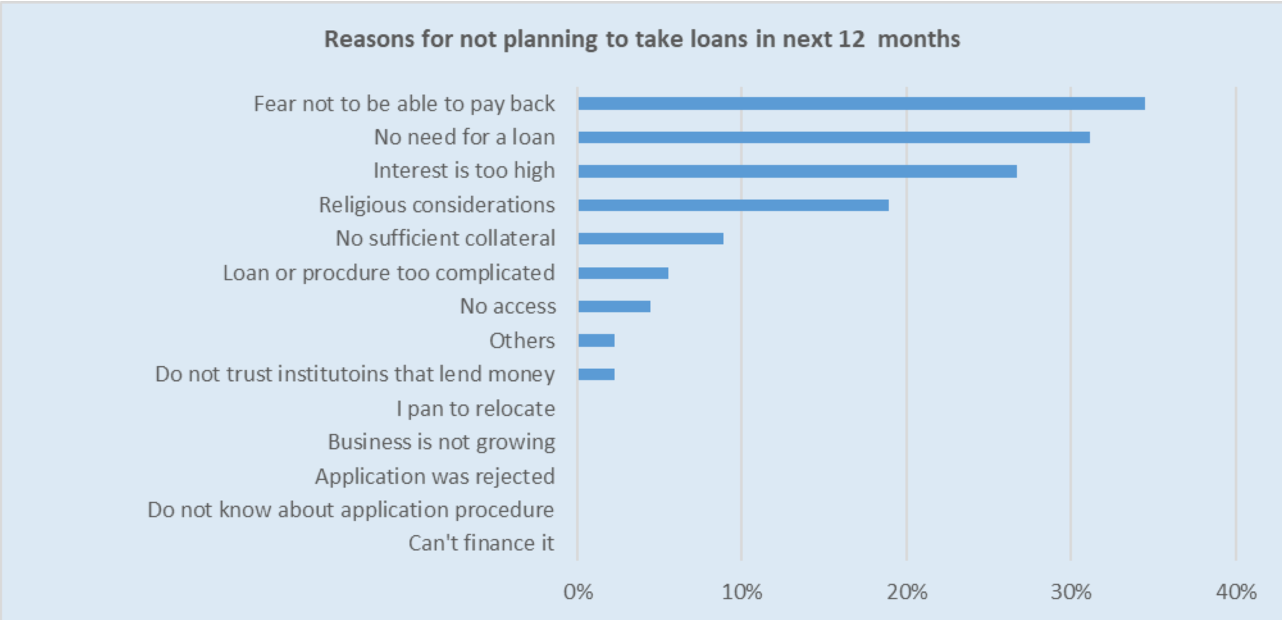
> There is high demand for loans in general and specifically in the agricultural sector: More than half (57%) of the survey respondents plan to take a loan in the next 12 months. In the agricultural sector, even more than two thirds (70%) are interested in taking a loan. However, more than half of those agricultural firms were not sure if they qualified for a loan.

65% planned on taking a loan in the next 12 months. From the respondents who believed that loan access is difficult or very difficult / almost impossible, about half planned to do so.

3.3.2 Why do some MSME not plan to work with loans?

The respondents who do not plan on taking out a loan in the next 12 months gave a wide range of reasons for their decision (see Figure 15). The most prominent ones include “no need for a loan”, “fear of not being able to pay back”, “high interest rates”, and “religious considerations” (the latter especially the older groups). Religious considerations were cited as a constraint to loans within the focus group discussions. A possible reason for that was the presence of non-Islamic banking loans, meaning respondents referred to those loans as usury. Less prominent reasons include “lack of sufficient collateral”, “too complicated loan procedures”, and “others”. Those reasons were re-iterated in the focus group discussions. “Difficulties with the business”, “rejected applications in the past” or “plans to relocate” were not mentioned as reasons for not taking loans.

Figure 15: Reasons for not taking loans



The findings proved similar for all business sectors. Only the “fear of not being able to pay back” was higher in the agricultural sector (42%) than in other sectors. However, participants in the focus group discussion from a variety of sectors mentioned salaries being cut, preventing loans to employees, especially as part of the pandemic. In both urban and rural settings, the “fear of not being able to pay back” was the biggest reason for not wanting to acquire a loan. In semi-rural settings, the most important reason was “lack of need for a loan” or “high interest”. In Sana’a and Hadhramaut, “no need for a loan” was the strongest reason (35% and 47% respectively) as compared to only 15% in Aden. In Aden, the fear of not being able to pay back was the most chosen reason. Notably, in Sana’a, nearly one quarter of the respondents chose the “lack of access” while in the other two regions, no respondents pointed “access” as a reason for not taking a loan. All focus groups from Lahj mentioned religious considerations as a reason for not getting a loan.

Box 8: Interview Findings Credit Use and Demand

> Medium-sized enterprises had mixed opinions on the usage and demand of credit products. Some of the respondents found the application process, collateral, and disbursement process easy while others shared certain difficulties. When it comes to challenges, in Sana’a and Hadhramaut, respondents mentioned collateral as one of the main difficulties for obtaining a loan - something that one-fifth of the survey also agreed with. Other challenges mentioned included the credibility of the financial institution, loan acquisition process, high interest rate, delays, and the ongoing pandemic, some of which were also consistently seen in the survey. Additionally, some of the respondents mentioned that the loan that they obtained did not correspond to their financial needs.
>
> When choosing a loan, the respondents agreed on some of the criteria such as interest rates, ease of collateral,

Overall, males had a tendency to point out “lack of need for a loan” as the biggest reason while half of females chose the “fear of not being able to pay back”.

When it comes to education, the interest rate was pointed out as a challenge for those who were illiterate (43%) a bit more than for the rest of the education levels.

From the respondents who viewed access to loans as easy, 54% decided that the lack of need for a loan is the main reason for not acquiring one in the next 12 months. However, from those who perceived loan access as difficult, 42% pointed out the high interest as the main reason and 39% chose fear of not being able to pay back. The findings were similar for the group that believed loans are very difficult / almost impossible to acquire.

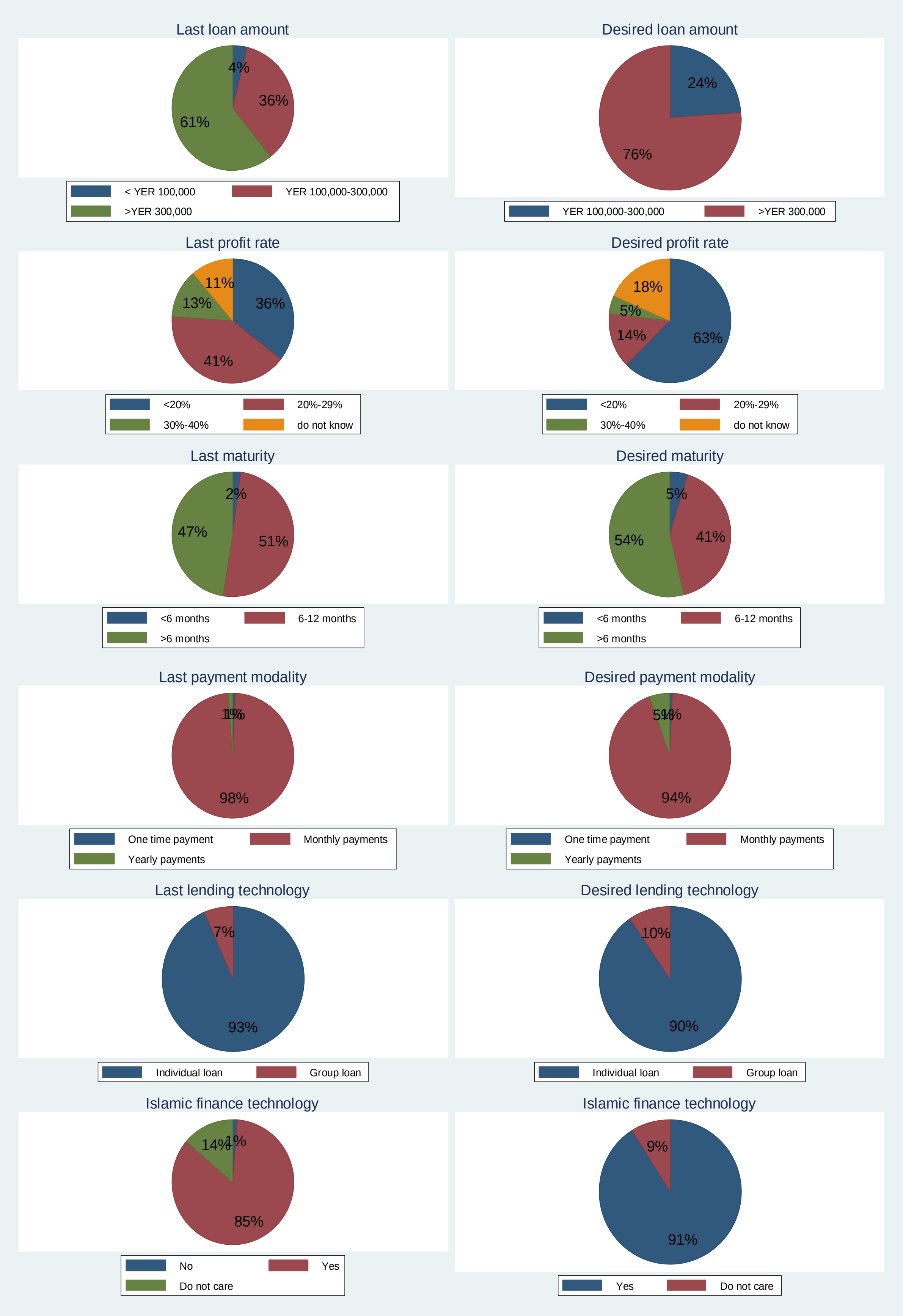
> The main reasons for not taking loans include the fear of not being able to pay it back, no need for loans or the perception that interest rates are too high, followed by religious considerations.

3.3.3 Characteristics of existing and desired loans

<u>Main loan characteristics</u>

The LFS survey has asked MSME owners for the characteristics of their existing loans as well as for the

Figure 16: Characteristics of loans and desired loans



desired characteristics for future loans. Figure 16 illustrates the results.

Analyzing Figure 16, we observe that:

- Loan amount: All respondents wanted to have loans greater than YER 100,000 (approximately USD 167) and three fourth of all participants preferred loans above YER 300,000 (approximately USD 500). Compared to their existing loan sizes, this is an increase as only 61% of the responding borrowers reported having loans above YER 300,000. However, in the focus groups, some respondents mentioned a need for much larger amounts.
- Maturity: Loans with maturities below 6 months are not sought by MSMEs. About half of the respondents work with maturities between 6 and 12 months, and half (47%) of the respondents with maturities above 12 months. There is a light tendency towards longer desired maturities as 54% of the MSME reported to prefer such for future financings.
- Repayment: There is a strong preference for monthly repayments (94% would like that option and 98% currently have it), even among agricultural MSME.
- Loan type: Group loans are barely demanded, and 94% of the respondents prefer working with individual loans.
- Islamic Finance: With about 91%, almost all respondents want to work with Sharia compliant credit, while the remaining MSMEs do not consider the Sharia compliance of credit products in their decision making.

Box 9: Loan Amount

> *"Most of the authorities give you loan with a little capital, which only allows you to open a small project, for example I have a project idea and it needs an amount of at least 6 million, I don't think that I will find an agency that will give me a loan to support me."*
>
> *~ Male respondent from the trade sector in Aden*

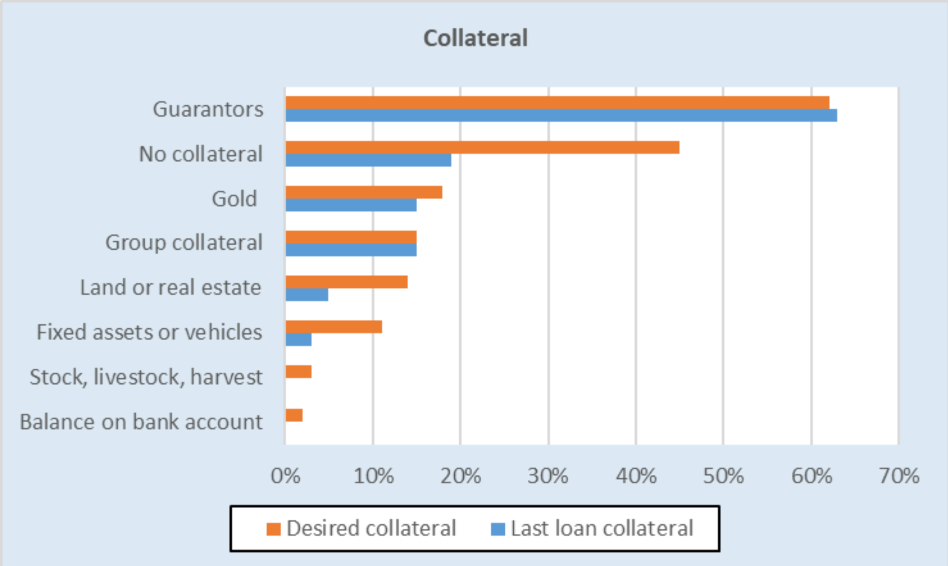
Box 10: Interview Findings Islamic Finance

> Although most medium-sized businesses that were interviewed mentioned only advantages for Islamic finance (including opportunities for young people, ease of procedures, and lack of usury), some of them also cited disadvantages such as high profit rate (interest rate), lack of client consideration, and delays. Nevertheless, religious consideration presented an important condition – a finding consistent with that of

<u>Collateral</u>

Figure 17 includes the type of collateral that respondents provide with their existing loans and are willing to provide for future loans. About two-thirds of the borrowers provide guarantors, and about 15% provide gold. One fifth of the respondents reported to have uncollateralized loans.

Figure 17: Provision of collateral



In all business sectors, the most used collateral for both the last loan and desired loan was guarantors. This is not very surprising. Although guarantors are typically difficult to convince to pay for their customers, they are helpful to keep the contact to customers who are not willing to pay alive. In the focus group discussions, guarantors, as well as gold, real estate and commercial securities were cited as types of collateral wanted from the financial institutions. Previously, salaries were also accepted as guarantees, but that has recently stopped as a practice.

Compared to the status quo, respondents in the LFS survey offered a wider range of collateral, including vehicles or fixed assets (11% for future loans as opposed to 3%) and land or real estate (14% as opposed to 5%). It can be assumed that the accepted range of collateral is largely driven by the supply side. In current financings, 19% of the MSME reported that they have not needed to provide any collateral and – not very surprisingly – even more (45%) preferred such uncollateralized lending for the future. The fact that most respondents offered collateral reveals that uncollateralized loans are largely and rightly perceived as barely realistic for Yemeni MSMEs at present, although the gathering and use of extensive data may facilitate that in future. Nevertheless, we believe that guarantors can greatly improve the portfolio quality both, by directly or indirectly supporting the assessment of the creditworthiness, and by supporting following up on delinquent customers later. The development needs assessment in Section 4 expands on collateral and explores ways in which it can become less of a challenge for MSMEs in Yemen.

Notably, no respondent chose stock, livestock, harvest as an option for collateral for their last loan. The same finding applies for balance on bank account. The older age groups had a larger demand for the usage of land or real estate as collateral for future loans, but the ">49 years of age" group also had less demand than the younger groups for no collateral future loans.

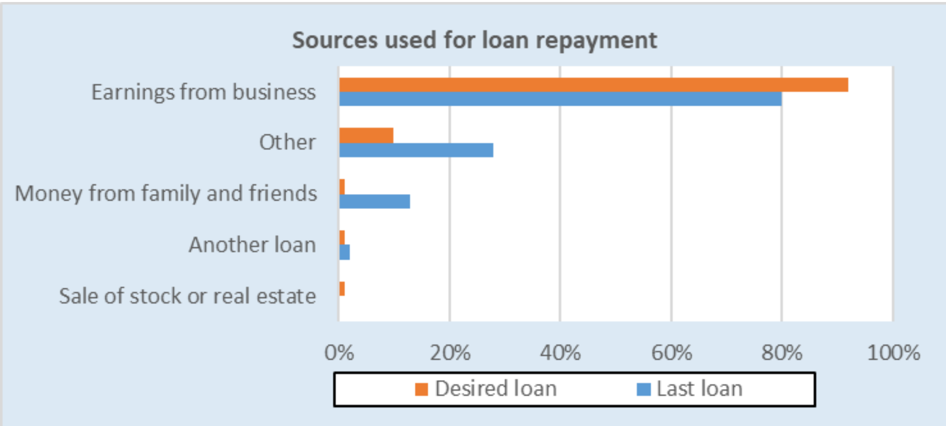
Although in urban, semi-rural, and rural regions, guarantors were the most used collateral, more than one-quarter of respondents from rural areas also chose group collateral for their last loan. 45% of the illiterate respondents chose group collateral for their last loan – an option chosen much less by the higher educational levels. In semi-rural areas, land or real estate was a popular desired collateral choice with 35% of respondents. In urban and semi-rural regions, 21% and 19% of respondents respectively also chose gold as a desired collateral. Gold was the second most popular option among respondents in Hadhramaut (41%) for last loan collateral. Generally, males preferred guarantors more than females (more than 70% as opposed to less than 50% for females) while females had a much higher preference for group collateral (more than 30% as opposed to less than 8% for males). Those who believed access to loans is easy, tended to choose guarantors for both the last loan and desired loans a bit less than those who believed loan acquisition is difficult or very difficult / almost impossible.

There is a strong demand for Sharia-compliant individual loans above YER 300,000 with 6-12 months or longer maturities and monthly repayments. MSMEs mostly offer guarantors as security and are willing to provide a wider range of collateral for future loans, including land/real estate, fixed assets, current assets, or agricultural produces.

How are loans repaid?

Respondents had numerous sources from which they could repay the loan, including business earnings, family money, and real estate (shown by Figure 18). Not very surprisingly, most of the LFS survey respondents preferred to use earnings from business for the repayment of their last loan (80%)

Figure 18: Sources used for loan repayment



and for any future loan repayments (92%). This held true for all education levels. However, the >49 age group used business earnings as a way of repayment less than the younger age groups, although desire to use it for any future loan repayments remained high. 13% of respondents repaid their last loan through money from friends and family. Those may have run into trouble with their business. This option was used more for last loan repayment for the 18-39 age groups than desired for future loan repayment in the same age groups. 28% of respondents chose to provide an answer different than those available including the usage of gold and salary for repayment.

- Sector: The service and industry sectors had the heaviest tendency to prefer earnings from business as the method of repayment for any future loans, standing at 97% for both. However, the trade sector followed closely with the majority of enterprises preferring the option. The agricultural sector differed in that only 66% of the surveyed chose earnings from business as the repayment method for the last loan. This may hint at poorly designed agricultural loan products, i.e. products where repayments are not aligned to agricultural cash flows. This was also shown within the focus group discussions where farmers complained that the repayment periods are not linked to the farming season. In all four sectors, there was a tendency to choose gold (most likely if the business has problems) or salaries (most likely if the business is not the single or main source of income) as the alternative repayment option. Those alternatives were more selected when it comes to the last loan rather than future loans. Notably, almost no one reported to have taken another loan or the sale of stocks / real estate as a method of repayment.

- Region: The pattern among regions is similar to that within the different sectors of activity. In Aden, 94% of the respondents chose to use earnings from business to repay their last loan. 83% chose this option for future loans as well. In Sana'a, although results differed, earnings from business remained the most chosen answer for last loan repayment (68%) and future loans (97%). However, money from friends and family was also chosen more in Sana'a than in the other regions regarding last loan repayment (20%) hinting at higher repayment problems there. In Hadhramaut, remarkable 59% of respondents used gold and salaries to repay their loans. As a whole, urban, semi-rural, and rural MSMEs had a preference for the usage of earnings from business for repayment purposes. 31% of semi-rural businesses also chose gold or salaries – a higher percentage than in the other two regions.
- Gender: Males chose to rely more on earnings from business. Female respondents differed in that, 25% chose to rely on money from friends and family for the repayment of their last loan. Only 7% of males chose to also do so.

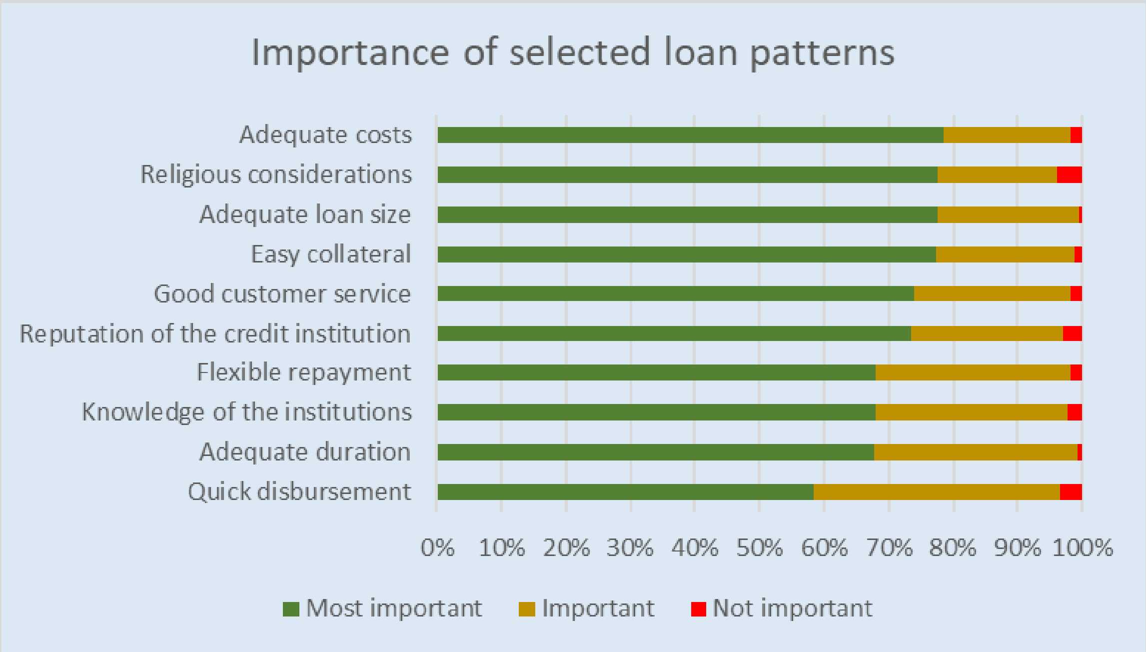
Although respondents had numerous sources for loan repayment, generally most preferred to use earnings from business for both the repayment of their last loan or any future loans.

In all business sectors, there was a tendency to choose gold or salaries as alternative repayment option. In Sana'a, some respondents reported to use money from friends and family as a method of repayment. Asking family and friends or using gold or salaries to repay business loans is likely to be a reflection of difficulties with the business and/or credit products that are not aligned to business cash-flows.

3.3.4 Importance of specific loan conditions for customers

In the LFS survey, respondents were asked to rate several loan conditions by importance. Overall, the most important conditions came out to be adequate loan size, adequate costs, and easy collateral, while the least important was quick disbursement. However, there was little variation in the responses and most selected loan conditions were rated roughly equally high.

Figure 19: Importance of selected loan patterns



3.4 Positive socio-economic impacts of loans

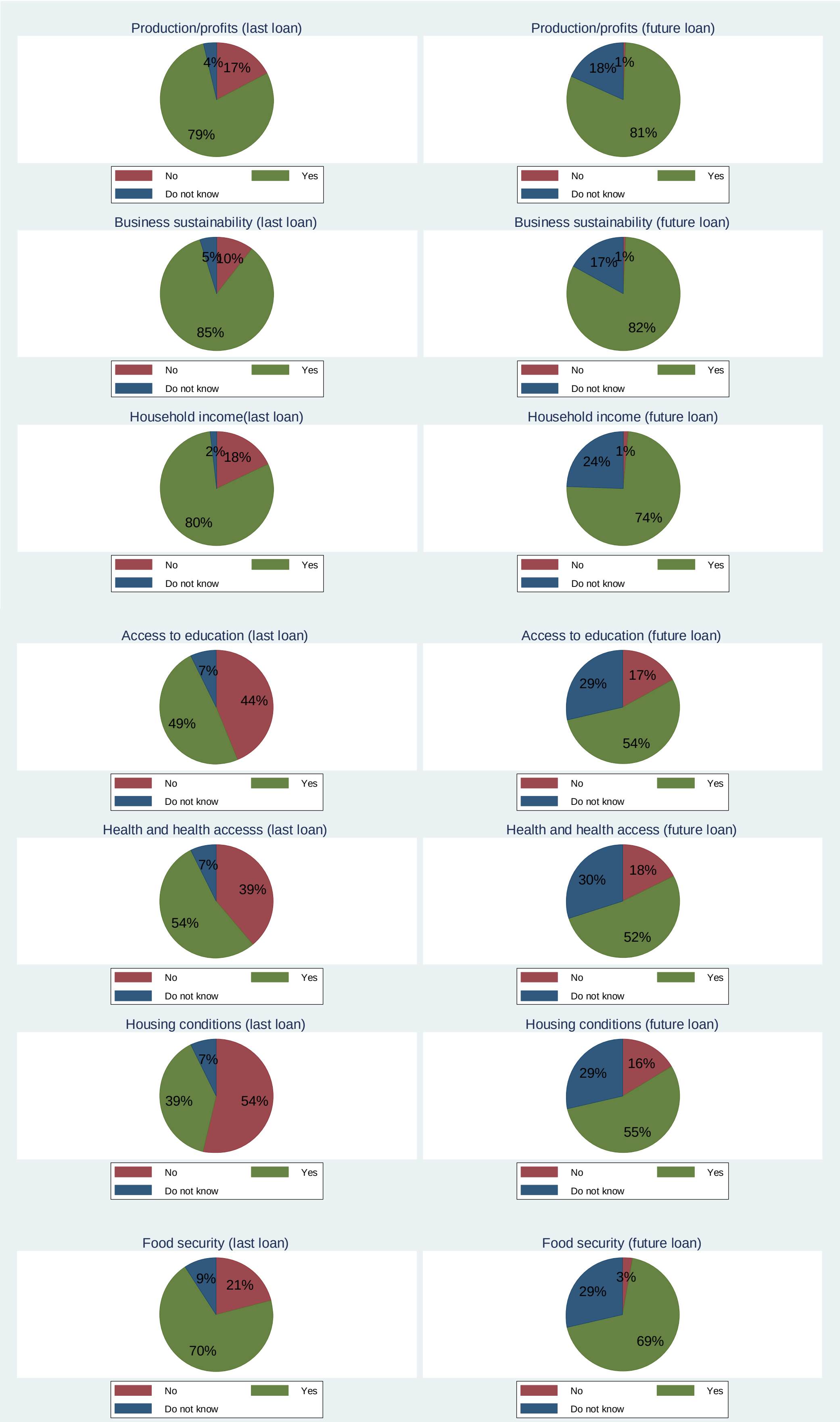
Respondents that had a loan were asked about the impact of that loan on their socio-economic conditions in the present and in the future. As can be seen from Figure 20, the respondents were generally very positive about the impacts of their loans, and expected even more positive outcomes for future loans.

More than three quarters of the respondents reported positive effects of loans on productions/profit, business sustainability, and household income, whereas less than one fifth could not agree on positive effects for those economic parameters.

Positive effects of loans on social living conditions were largely rated positively, but not as strongly as the direct economic effects. About half of the MSME owners reported positive effects of their loans (and, respectively, possible future loans) on access to education, health/access to health, and housing conditions.

About 70% reported positive impacts of loans on food security, i.e. a parameter that is more directly linked to economic well-being than the social parameters above).

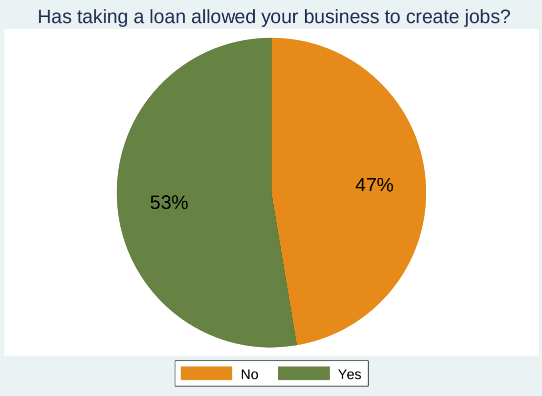
Figure 20: Loans have/will improve the following areas:



Loans create jobs

As Figure 21 shows, slightly more than half of the respondents in the LFS survey agreed that having taken a loan has allowed their business to create jobs. This is a surprisingly positive result.

Figure 21: Loans create jobs



From those who had created jobs thanks to a loan, the median number of created jobs was 2. The mean number of jobs created was 3.7, which included a mean of 0.95 jobs for women, 0.8 jobs for internally displaced people , and 0.05 jobs for persons with disabilities or special needs[34].

Male business owners had created almost twice as many jobs as their female peers. When creating jobs, female business owners hire 46% women, while that ratio is more than twice as low (21% females recruited) for male entrepreneurs. Younger entrepreneurs had created 57% more jobs than older MSME owners and, not very surprisingly, micro enterprises create less jobs than SMEs. The most respondents who believed that a loan has helped in job creation were in the industry and service sectors (64% and 62% respectively) and the least in the agriculture sector (37%). More businesses in the semi-rural region had created jobs because of loans (66%) than in urban (53%) or in rural (35%) settings. More than 59% of respondent businesses in Sana'a and Hadhramaut indicated that the loan helped creating jobs, compared to only 38% in Aden. There is no indication that the created jobs would just be temporary jobs. Many jobes were created in grocery, sewing, carpentry and farming businesses.

> The vast majority of respondents reported positive impacts on their socio-economic lives, especially on production/profit, business sustainability, and household income.
>
> Somewhat more than half of all MSMEs were able to create jobs thanks to a loan. The mean number of jobs created was 3.7, whereas larger firms and male owners create more jobs, and women entrepreneurs create considerably more jobs for women than men do.

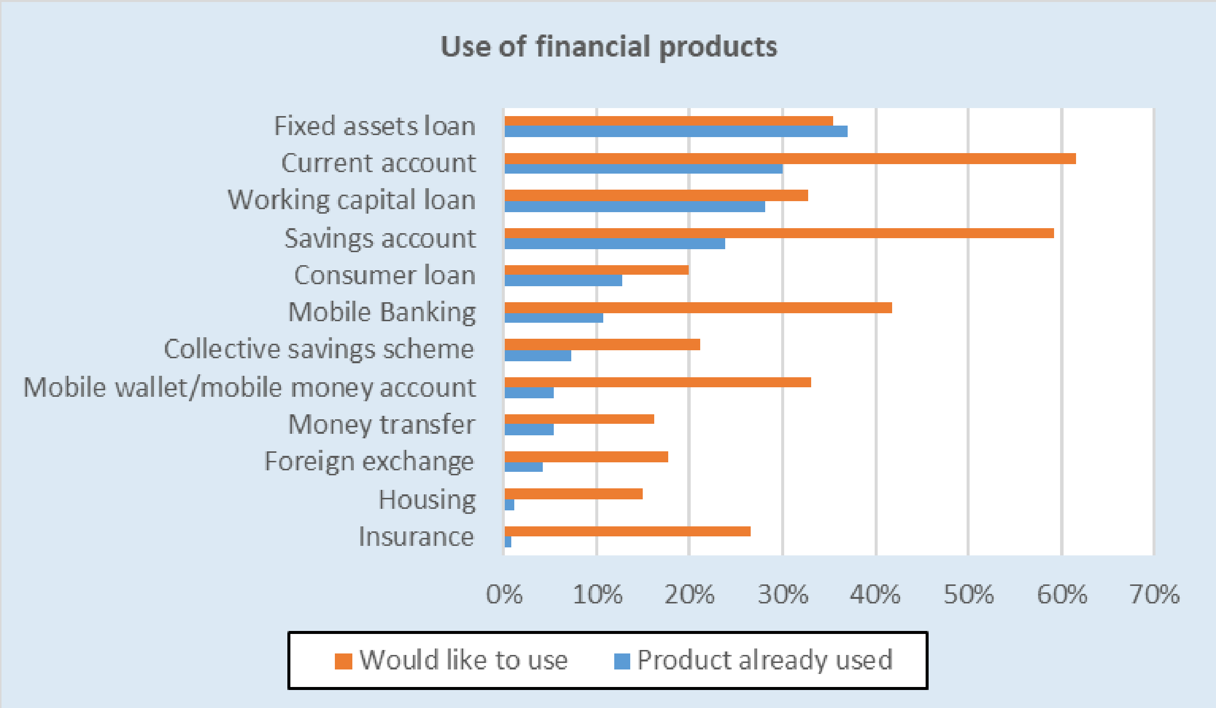
[34] Considering that the war has resulted in a large number of disabled persons, a proportionally small number of jobs for disabled persons was created.

3.5 Use of and demand for financial services

3.5.1 Overview of used and desired financial services

The participants in the LFS survey were questioned on their current and desired use of financial services. Figure 22 demonstrates their responses.

Figure 22: Use of Financial Products



3.5.2 Loans

The most preferred loan that respondents had was for fixed assets / equipment, followed by loans for working capital. The loans for fixed assets were also the most desired (35%) when compared to loans for working capital, personal use, or construction / purchase of business premises. However, loans for working capital and fixed assets / equipment especially had almost matching current and desired usage, making them the least demanded services. In fact, for loans for fixed assets / equipment, the current usage was slightly greater than the desired, meaning the market is quite saturated for the product. Nonetheless, this was the only financial service that was not demanded more than the current usage, showing that there still exists quite a large market to be served by financial institutions. Overall, the findings demonstrate that in many areas of financial services there is room for growth, explored further in the development needs assessment chapter.

- Sector: The agricultural sector had the highest usage of loans for working capital as well as for loans for fixed assets / equipment. Additionally, 26% of MSMEs in the agricultural sector were using or had used loans for personal purpose while in the other sectors less than 11% had done so.
- Region: Rural regions were the ones with the highest usage of loans – 73% used loans for working capital, 70% used loans for fixed assets / equipment, and 41% used loans for personal

purpose[35]. These percentages can be either a consequence of the current war in Yemen as rural regions are less impacted and thus, remain the more secure customers for financial institutions or due to the survey sampling. Loans for working capital and loans for personal purpose were found the most in Aden and Hadhramaut; however in Aden the demand for future loan usage for both loans as well as loans for fixed assets / equipment was much lower than the current usage, showing a saturation in the region. When it comes to future use, loans for working capital were wanted the most in Hadhramaut (59%) while loans for fixed assets / equipment were most demanded in Sana'a (53%). Although barely used currently, loans for construction or purchase of business premises were desired in Sana'a (20%) and Hadhramaut (25%) as compared to Aden (2%). Loans for personal purpose were wanted in Sana'a (28%) and Hadhramaut (27%), but not desired in Aden (7%).

- Those who found access to loans easy had the most usage and desire for loans for working capital and fixed assets / equipment. For loans for personal purpose, the MSMEs who found loan access to be very difficult / almost impossible had the highest need for future use.

3.5.3 Savings

What do MSME owners do with cash surplus?

When being asked what they do with cash surplus, 37% of respondents in the LFS survey use it to reinvest in business activities or in other businesses while 31% choose to utilize it for loan repayments. Another third (37%) reported not to have cash surplus available. Many of the focus group participants mentioned a complete lack of cash surplus, especially after covering the essential expenses of their households. Those who had some mainly chose to reinvest it or repay their loans. A participant from Sana'a wanted to use cash surplus to start a business eventually. Others mentioned that the fluctuating prices and exchange rate are the reasons for lack of savings. No cash surplus was also a reason mentioned for the lack of desire to use other financial services. The older age groups tend to reinvest cash surpluses a bit more than the "younger than 30 years" group, but generally the survey shows quite similar results for all age categories.

Box 11: Interview Findings on Cash

> Similar to the survey findings, medium-sized businesses that were interviewed mentioned that if any cash surplus is available it is either reinvested in businesses or used for loan reimbursement.

Notably, no respondent chose to voluntary deposit their cash surplus in a financial institution and very small percentages invest in real estate or lend it to friends or family. 49% of respondents in rural regions choose to reinvest their cash surplus in business or in other business as opposed to approximately 35% in urban and semi-rural regions. In those two regions, respondents are more likely to use surpluses for loan reimbursement as well as keep cash at home.

Enterprises from Hadhramaut were more willing to reinvest in businesses while those in Sana'a and Aden preferred to use cash surpluses for loan repayments.

[35] These percentages do not add up to 100% because some split the loan amount to finance various purposes and/or they had taken more than one loan for different purposes in the past.

Gender-wise, 42% of male respondents chose to reinvest in business as opposed to only 27% of females. Additionally, 35% of males preferred loan repayment as compared to 24% for females. More female respondents (47%) than male ones (32%) experienced no cash surplus.

When it comes to cash surplus as related to loan acquisition perceptions, those respondents who believed loan access is difficult experienced more lack of cash surplus than those who perceived loan acquisition to be easy.

Box 12: Cash Surplus

> *"[With cash surplus], I try to expand my business and get involved in selling expensive things."*
>
> *~ Female respondent from the trade sector in Hadhramaut*

Use of savings services

Usage of saving financial services: 24% of LFS survey respondents currently use financial services pertaining to savings. However, 59% desire to do so in the future. During the focus group discussions, some of the respondents showed desire for saving financial services. Others, however, still chose to save at home. One of the reasons for maintaining such savings mentioned by a participant from the production sector was the lack of trust in financial institutions due to gaps between banks and depositors. Additionally, participants from Hadhramaut and Sana'a complained that after trying to withdraw deposited savings, the financial institution did not pay back the interest acquired. The savings account data was where one saw the largest gap between current and desired usage, making it the highest demanded financial service. Sector: In the trade and service business sectors, the findings were very similar with approximately one-quarter of respondents currently using a saving account and around between 57% and 59% wanting to do so in the future. Although the findings for the desired use of a saving account in the agricultural sector were consistent, only 15% of respondents in that sector were currently using such an account. The industry sector had the highest usage (36%) and highest desire to use (69%) saving accounts.

- Region: Although usage of saving accounts in Aden, Sana'a, and Hadhramaut remained quite similar (19%, 26%, and 28% respectively), the desire to have such accounts in Sana'a and Hadhramaut was much larger at 67% and 80% when compared to only 33% in Aden. When it comes to rural regions, the usage of saving accounts was much lower (5%) than the usage in urban (29%) and semi-rural (21%) areas. At the same time, the desire to use such services was also the lowest in rural areas with about one-quarter of respondents wanting a saving account in the future. In contrast, 84% of respondents in semi-rural areas and 57% in urban areas would like to use such financial services in the future.

Usage of collective saving schemes: Only 7% of the LFS surveyed enterprises were currently participating in a collective saving scheme and less than one-quarter (21%) of the respondents desired to do so in the future. During the focus group discussions, collective saving schemes were sometimes referred to as limited, unreliable, and unstable, but also religiously considerate, easy, and excellent for people with steady incomes. According to the discussions, those schemes were for smaller amounts, to use in times of emergency. Most of the participants who had used such schemes had beneficial experiences with them in hard times or in times of larger purchases e.g. a car. Lack of trust between the savers, even when presented with flexibility and

Box 13: Collective Saving

> *"[Collective saving], has many positives and it is better than loans that help achieve economic growth on the personal level."*
>
> *~ Male respondent from the production sector in Sana'a*

freedom, in such schemes was mentioned as one of the reasons for the lack of usage of collective savings.

- Sector: The usage of a collective saving scheme among respondents was the highest in the industry sector, standing at 15%. For the other three sectors, the usage was lower than 9%. The desire for collective saving schemes for future usage was also the highest in the industry sector (29%), followed by the service sector (25%). The trade sector had the lowest desire for such services (14%).
- Region: Although current usage of collective saving schemes remained at no more than 10% in Aden, Sana'a, and Hadhramaut, the three cities differed when it comes to future utilization of such services. Sana'a had the highest percentage of respondents who would like to use collective saving schemes in the future (38%), followed by Hadhramaut (15%), and Aden (9%). In rural regions, collective saving schemes were much more spread among respondents (22%) than in urban (6%) and semi-rural (3%) areas. However, the desire for such schemes was much higher in semi-rural regions (38%) than in urban and rural which had less than 17% of respondents choose the option.
- Gender: Although usage of collective saving schemes was quite similar in both males and females, the desire to use such schemes in the future was higher in males (24%) than in females (15%). Some focus group participants from Aden mentioned that collective saving schemes are usually arranged by the women, to be used in case of illness or holidays.

Box 14: Interview Findings Regarding

> Medium-sized enterprises, similar to answers from the survey, rarely use collective saving schemes. Rather, they would like to maintain future savings in order to maintain financial security, pay off loans, or increase working capital. Re-iterating the findings from the survey, some of the interviewees desire to utilize saving financial products in the future in the form of personal savings or saving accounts.

3.5.4 Current accounts

With 30%, about one third of respondents use a current account, but more than 61% want to utilize one in future. In the 18-29 age group, the demand gap was almost 40%. Unlike the other business sectors, the agricultural sector had much less usage of current accounts. However, the desire to use such accounts in the future stayed above 55% in all sectors. Not very surprisingly, urban regions had the highest usage of current accounts (39%) The desire for such accounts was also much higher in urban and semi-rural regions than in rural ones. In Sana'a current accounts had the highest percentage of MSMEs that have or are currently using them (38%) but also the highest percentage of enterprises who would like to use them in the future (88%). When related to the perceptions regarding loan access, those who found such access very difficult / almost impossible, had the highest percentage of current account users (50%).

3.5.5 Mobile services wallets and mobile banking

The LFS survey revealed that mobile wallets and mobile money accounts are less common and less desired than mobile banking where 11% were current users and 42% wanted to become users. Nevertheless, mobile services were among the ones who had the highest gap between current and desired usage. Several focus group participants supported the idea for access to digital services. Several participants mentioned to have used them with their salaries and emphasized their ease of use. Those services had some of the highest demand for future use in the survey, showcasing a need for such digital services in the market and their more widespread adoption (covered in the development needs assessment chapter of this report). However, the focus group discussions revealed a lack of education and means regarding digital services. Some participants were of the opinion that fees with mobile transfers are much higher, transaction approvals are needed more often for large sums, and that this type of financial services provides no privileges for the account holders. Others were afraid of using the technology, categorizing it as misleading, and emphasized a lack of reliable internet connection in the country.

Box 16: Mobile Services Usage

> *"It was easy for us, for example, to pay phone bills and transfer money while you were at home and at any time you like."*
>
> *~ Male respondent from the trade*

Box 15: Mobile Services Means

> *"Some people do not use mobile phone money, because they do not have an electronic ID card, or because they do not have the money to buy a smart phone, or because they do not save money."*
>
> *~ Male respondent from the trade sector in Aden*

MSMEs in agriculture had the lowest desire to utilize mobile banking. The demand for mobile services was larger in groups younger than 49. The demand for mobile wallet, mobile money account, and mobile banking services as a percentage of the sample was the highest in semi-rural regions. Sana'a was the leader in usage and desire for future usage when it came to mobile wallet, mobile money account, and mobile banking. Males had a higher tendency of preferring mobile services for the future than females.

3.5.6 Other banking services

Only 5% of respondents had currently used money transfers while 16% wanted to in future. Approximately the same values hold true for foreign exchange services with 4% current users and 18% who desire for future. MSMEs in agriculture had the lowest desire to use both services. Still, participants from the agricultural industry in the focus group discussions mentioned using such services for sending and receiving remittances. No respondent from rural areas used or wanted to use money transfer and foreign exchange services. Money transfer were wanted for the future the least in Aden (3%) when compared to the other two regions – Hadhramaut (18%) and Sana'a (28%).

Foreign exchange services were neither currently used nor desired for future use in Aden, while 20% wanted such services in Hadhramaut and 30% in Sana'a. However, during the focus groups, it was mentioned that currency exchange shops close before cash transfers can be received, which presented an obstacle to those who wanted to use the service.

3.5.7 Insurance

The usage of insurance among the enterprises in the LFS survey was quite low, standing at less than 1%. Nevertheless, 27% of the respondents wanted to use such services in the future. The younger age groups had a higher desire for insurance services than the >49 group. Insurance was among the least currently used financial services, but demand remained quite much higher, showing a need for insurance services in the market.

Box 17: Interview Findings Regarding

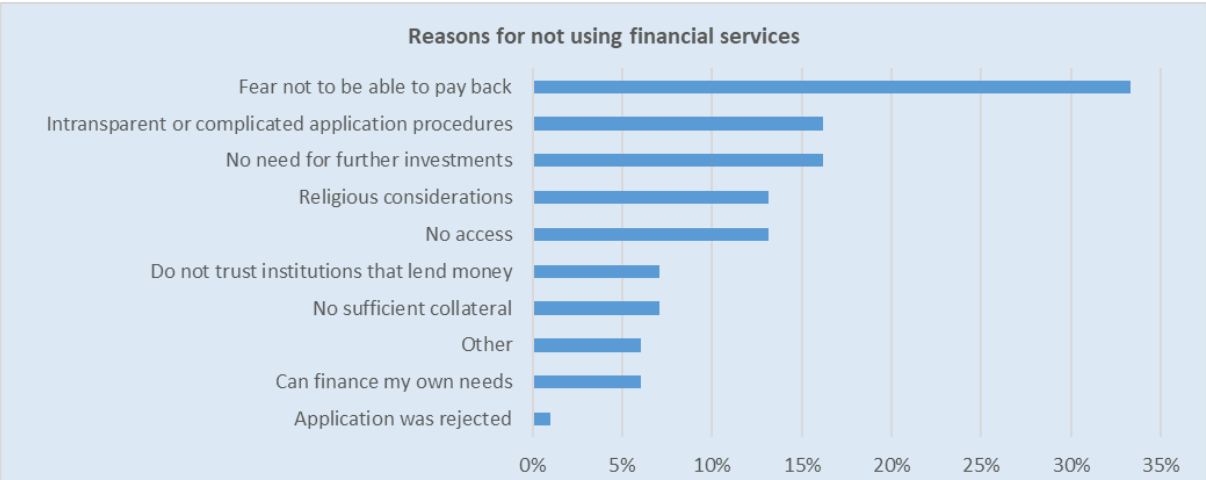
> During the interviews with medium-sized enterprises, the findings from the survey regarding insurance were confirmed. Eight out of nine of the interviewees did not currently use insurances. Several expressed desire to use such services in the future. Some of the types of desired insurance include disaster, asset, theft, personal and

- Sector: The industry and trade sectors had 32% of respondents' desire insurance in the future. However, when considering the sample, the most respondents that wanted to use insurance financial services in the future were in the service sector. Nonetheless, overall, there were only little differences across the sectors when it comes to demand for insurance. The trade sector was the only one who had current users of such services.
- Region: Rural regions had neither current users of insurance financial services nor users who wanted to use such services in future. In the semi-rural regions, 43% of MSMEs would like to use insurance in future while in urban that figure stood considerably lower, at 27%. Aden had almost no respondents who use or want to use insurance. In contrast, although Sana'a and Hadhramaut showed very low figures for current use, they had 41% and 35% of respondents who want to use insurance.
- Gender: Males had more desire to use insurances in future (31%) as compared to females (18%).

3.5.8 Reasons for not using financial products and services

Survey respondents that reported not to use financial services were asked for the reasons. Their responses are presented in Figure 23.

Figure 23: Reasons for not using financial services



The main reasons include:

- Fear of not being able to pay back: In all business sectors, the most prevalent challenge is the fear of not being able to pay back. That fear can well reflect the situation of the businesses and their difficult operating environment. For many enterprises, it may not be the best time to expand and to take risks. While the SFD and SMED could definitely support those MSME with capacity building and eventually grants, Financial Institutions should obviously not attempt to target customers who are reluctant in taking risks.
- Untransparent or complicated application procedures: Too complicated and/or unclear application procedures ranked second among the reasons for not using financial services – a finding supported by the focus group discussions. That reason was mentioned by 16% of the survey respondents and could and should be addressed by FIs both, by reducing complexity and by communicating processes better. 32% of the industry sector respondents chose the procedures as a challenge compared to 17% for agriculture, 15% for service, and only 6% for trade. Sana'a had more respondents that also chose that option as opposed to Aden and Hadhramaut.
- No need for further investments: Of similar importance and linked to the single most important reason is the lack of need of finance. This was mentioned by 16%. FIs may be able to identify some MSMEs that could benefit from finance and market their products with respective care, but in the current situation, there might be "quicker wins", i.e. easier to get MSMEs with lower risks. Only 8% of Aden respondents chose no need for further investments as compared to 24% in Hadhramaut and 18% in Sana'a.
- Religious considerations: Religious considerations were mentioned by 13% and were especially prevalent in the older groups. We have not gathered further information. All FIs supported by SMED are fully Sharia compliant and follow Islamic Finance principles and respectively active communication and marketing of FIs might potentially be an opportunity. When compared to the other two regions, Sana'a respondents were the least concerned about religions considerations. Nonetheless, respondents from all business sectors as well as both males and females cited religious consideration as a challenge.

Box 18: Findings from interviews with 9 Medium

> Medium Enterprises mentioned that they currently use a current account or wish to use one in the future – findings that are consistent with those within the survey. Fear due to current and future circumstances as well as preference in dealing with a single bank prevented some of the interviewees from using certain non-credit services, which was also one of the main difficulties mentioned by respondents in the survey. When it comes to mobile money, a lack of wide-spread availability, lack of need, and lack of knowledge were the key cited barriers. Similar to the survey, mobile services were not commonly used among the respondents

- No Access: Another 13% of the respondents reported not to have any access to products and services, and there is, thus, unmet market potential. No respondents in the agricultural industry pointed out the lack of access as a difficulty. Sana'a had the largest number of respondents that cited access as a challenge. Approximately 13% of both males and females cited the lack of access as a challenge.
- Do not trust institutions that lend money: 7% of the respondents as well as several participants in the focus groups reported not to trust lenders. FIs could attempt accessing those MSMEs

with marketing activities. No respondents in the agricultural industry pointed trust as a challenge. More respondents in Sana'a chose to cite trust in institutions as a difficulty than in the other two regions. Around the same percentage of male and female respondents also mentioned it as a challenge.

- No sufficient collateral: Another 7% mentioned not to possess sufficient collateral to access the desired financing. Where repayment capacity is insured, SMED could look into credit insurances to support FIs financing those businesses. Although such credit insurances are typically linked to high costs and wrong incentives, a market as Yemen may benefit from them – at least as long as the conflict continues and as long as there are many MSMEs that lost collateral and fixed assets in the war. 21% of respondents in the agricultural sector chose collateral as a challenge as compared to less than 6% in the other three sectors. No respondents cited it as a difficulty in the trade sector. Collateral was also a larger challenge among Sana'a respondents (13%) when compared to Hadhramaut (4%) and Aden (3%).

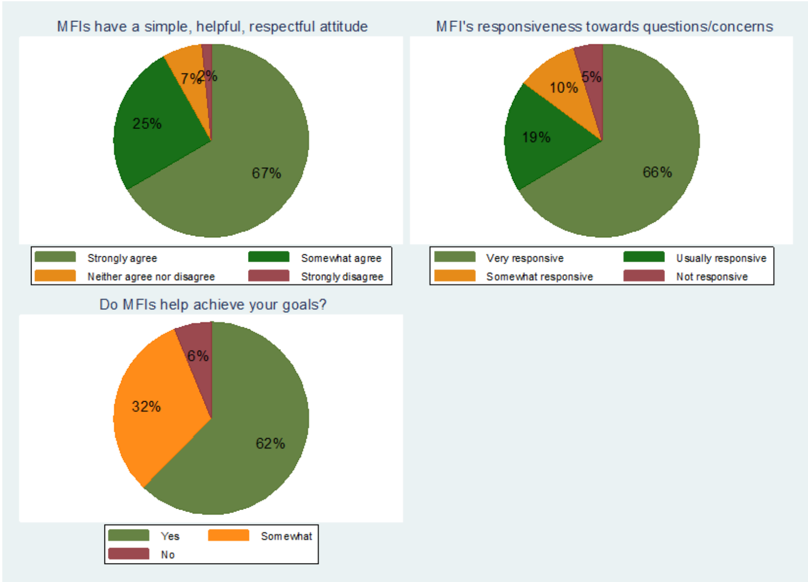
Different types of financial services have a different degree of utilization among business sectors and regions in Yemen. The most preferred type of loan overall is for fixed assets / equipment, followed by loans for working capital. The usage of financial services varies based on the perception regarding the ease of loan acquisition. Nonetheless, barriers such as the fear of not being able to pay back, collateral, and religious believes exist and influence people's decisions on whether to use financial services.

MSMEs are not used to save cash surplus voluntarily with financial institutions. This is an observation that should be further observed and addressed.

The largest gap between product usage and desire to use (and, thus, large market potential), exists in saving accounts. Large gaps also occur in the current account category as well as mobile services and insurance.

3.6 High levels of customer satisfaction

Figure 24: High customer satisfaction



Overall, the LFS primary data collections uncovered a surprisingly high level of customer satisfaction (see Figure 24 and Box 19 for the MSME survey and, respectively, small enterprise interview results).

When being asked, 92% of the respondents agreed to the statement that "MFIs have a simple, helpful, and respectful attitude towards customers" (including three fourths that agreed even "strongly" to this statement. That level of satisfaction was a bit lower for agricultural firms (82%), for MSMEs in rural areas (78%) and older MSME owners. There were no significant differences across the different geographic locations or gender. From those who agreed, 51% had the perception that access to loans is easy while 30% said it was difficult. The only MSMEs that disagreed with the statement were located in Sana'a and were male respondents.

With 85% of the respondents, the vast majority was of the opinion that MFIs are "very" (66%) or "usually" (19%) responsive to their questions and concerns. Only 5% perceived MFIs as "not responsive", and 10% assessed MFIs as "somewhat responsive". MSMEs from rural and semi-rural regions had a more positive view on the MFI's responsiveness than MSMEs from urban areas. MSMEs of Hadhramaut appear to have somewhat more critical views on the responsiveness of MFIs to their needs: in Hadhramaut only 44% agreed that MFIs are "very responsive" (as opposed to Sanna'a, where 84% agree to that statement), and with 13%, about three times as many MSMEs of Hadhramaut than of other regions reported that MFIs are "not responsive". There were no significant differences when results were evaluated by business sector, age or gender, although older owners and women tended to be slightly less satisfied. Still few, but with 10% twice as many illiterate MSME owners found MFIs "not responsive". Additionally, those who believed that MFIs are "not responsive" tended to also be in the group which does not plan to take a loan in the next 12 months.

Box 19: Small Enterprises' Perceptions

> When interviewed, the 9 medium-sized enterprises had a generally good experience with financial institutions and the majority was satisfied with the service. Re-iterating the survey findings, some enterprises mentioned religious considerations, interest rates, and the ease of collateral as criteria for choosing to use financial services

The majority (94%) of the surveyed MSMEs reported that microfinance institutions at least somewhat helped them to achieve their goals. This is a remarkably positive result.

When it comes to the trust in and criteria for choosing a financial institution and utilizing certain financial services, more LFS survey respondents cared about the procedure for loan application and the ability to pay back the loan rather than whether they trust the institutions that lend the money. Especially in the trade and industry sectors, more than 15% of the respondents put an emphasis on religious considerations when it comes to usage of formal financial services and products. Additionally, 19% of respondents pointed out religious considerations as reasons for not taking a loan in the next year from a financial institution. Unfaithfulness of the institution's staff as well as lack of staff to support with loan application were only mentioned as challenges by 1% and 5% of respondents, respectively.

Almost all survey respondents believe that MFIs have a simple, helpful, and respectful attitude and approximately two-thirds of respondents found them very responsive to their questions and concerns. Almost all of the respondents found MFIs to have at least somewhat helped them with achieving their goals.

4 Development needs assessment and interventions

4.1 Needed MFI/FI developments to meet demand

Throughout the course of our research five overarching themes emerged that exert a major influence on the state of financial inclusion in Yemen and impact the development needs of the financial sector:

1. *Strong performance and growth rates of the Microfinance sector*
2. *Financial sector innovations*
3. *Shift of economic activities towards agriculture*
4. *Lack of collateral is a major impediment for SMEs to access finance*
5. *Challenges due to low financial literacy and consumer behavior*

These themes, which are discussed in greater detail in the following paragraphs, developed against the backdrop of a country in an ongoing civil war and were strongly influenced by the war situation and political unrest and instability in the country. The lack of security was one of the main constraints to doing business mentioned during the focus group discussions. Over the past years, many MSMEs had to close their businesses, were forced to relocate, lost their property, collateral and/or guarantors and find it therefore difficult to access loans or repay existing loans on time. At the same time, many former employees of larger businesses lost their jobs due to the war and were driven into self-employment as the only means to survive which lead to a high number of new micro and small enterprises opening in the recent past. The operations of most businesses are limited to a specific region with difficult access to other regions due to the political instability.

4.1.1 Strong performance and growth rates of the Microfinance sector & great potential for future growth

With a total number of approximately 2 million, MSMEs present the microfinance sector with a great opportunity for further growth to be tapped into. In fact, only 23% of the enterprises questioned in the survey had not taken and did not wish to take a loan in the future, meaning 77% either had a loan at one point or wished to be serviced by the microfinance sector. More importantly, 67% of respondents planned on taking a loan in the next 12 months, showing a large demand for such services, especially in Sana'a where the demand for future loans was 80%.

Access to finance remains one of the main constraints that MSMEs have to face, supported by findings from the survey. Therefore, if access can be improved, the microfinance sector could further not only improve its overall performance, but also grow tremendously with more clients. With more growth, microfinance institutions could secure a higher volume of loans – a feature that according to more than 65% of respondents has yet to change. The microfinance sector has gathered positive perceptions as shown by the respondents in the survey. More than 90% agreed that the microfinance institutions have a simple, helpful, and respectful attitude towards customers. Additionally, MFIs were deemed responsive by 85% of the surveyed and supported customers in achieving their goals. Trust in microfinance institution was also not one of the main criterial that the surveyed enterprises pointed out when choosing a financial institution. Therefore, it can be assumed that MFIs have earned the trust already, so other characteristics such as religious consideration have become more important.

If the microfinance sector can tackle issues such as religious consideration (one of the most important conditions for loans according to the survey) by becoming more compliant, a further market of clients could be opened up as well. With more loans, socio-economic conditions will be improved further, allowing in return even more loans to be taken by MSMEs.

When shifting the focus to the supply side, the main findings from the demand side survey are substantiated: Data obtained from the SFD show that after an initial drop in microfinance loans in 2014 due to conflict-inflicted closure of MFI branches, cessations of loan disbursements and unprecedented defaults due to business disruptions, forced relocations and loss of life and assets, the microfinance sector started to recover and continuously grow since 2016: The value of the outstanding loan portfolio of all MFIs and microfinance banks nearly doubled from 2016 to 2019 even though the number of active borrowers increased only slightly. In 2019, SFD reported a total of 87,791 active microfinance borrowers compared to 120,839 active borrowers before the war. This study estimates that the current MSME finance gap is anywhere between USD 1 billion and 2 billion. These findings were mirrored in our discussions with Key Informants from the supply side, with all of them pointing out that there is a huge unmet demand for financial services in the MSME sector. Commercial Banks such as Yemen Kuwait Bank (YKB) have identified this as opportunity and established SME lending departments (YKB in 2017) or express interest in the sector.

Moreover, different Key Informants pointed out that, especially in rural areas, informal and unregulated lenders, such as retailers and foreign exchange businesses have started offering credit to MSMEs. This is another finding pointing towards a considerable MSME finance gap.

When asking MFIs about the main factor preventing them from providing finance to more MSMEs, the most common answer is the lack of financing in the industry. While Microfinance Banks are permitted to accept savings as part of a decree passed by the Central Bank, MFIs lack the regulatory framework that would allow them to mobilize savings from the public and therefore rely on donor funds. Such funds are channeled to FIs via the SFD and are mostly tied to programs that target specific recipients and/or economic sector and leave the MFIs with little room to implement/ follow their own lending strategies. These interventions are moreover unsustainable as the programs are of limited duration.

Resulting development needs:

To build on this positive momentum in the microfinance sector and close the MSME finance gap, this study identifies three main development needs:

a) *Capacity Building*: Building strong organizations is paramount for the success of the MFI sector at large. The sector has a great potential which is exemplified by the growing interest of different formal and informal players in MSME lending. In the meantime, MFIs are still suffering from “brain-drain” and must be equipped to cope with the growing portfolio, increasing demand and evolving technologies. This includes capacity building in the areas of risk management and corporate governance to increase the trust of partner organizations and donors. This also includes supporting Commercial Banks in their downscaling efforts. Different from MFIs, Commercial Banks do not experience a liquidity crunch but are often looking for sectors to invest their excess liquidity. Different Commercial Banks have recently identified the MSME sector as potentially profitable target for investments but lack the experience and capacity to setup an MSME loan department and develop MSME lending methodology.

b) *Adoption of new technologies*: Digital technologies can be used to change a business model and provide new revenue and value-producing opportunities. Digital products and services tailored to the specific needs of the currently underserved population can help MFIs to reach new customer segments in a cost-effective manner. At the same time, the digitalization of internal processes can help MFIs to operate more effectively and transparently, i.e. by reducing time for loan disbursements, reducing mistakes and loss when using physical files, free up admin staff who can be given other tasks and improve overall coordination and monitor operations through easier communication.

c) *Financing:* To ensure long-term sustainability, MFI need access to diversified founding sources for their activities. Access to donor funds should be uncoupled from specific programs so that MFIs can pursue their own strategic plans. The sector furthermore requires a regulatory framework that allows MFIs to accept savings from the public while protecting (e.g. through the definition of qualifying criteria for MFIs such as capital adequacy, stress testing, etc.). The results of our demand side study reveal that there is a high demand for savings accounts. While only 24% survey respondents currently use a savings account. 59% want to do so in the future.

4.1.2 Food insecurity and the shift of economic activities towards agriculture

The ongoing war in the country has resulted in a humanitarian crisis with 20 million people struggling to find food for survival. The agricultural sector has suffered from forced displacements and loss and destruction of farming machines, pumps and generators. According to World Bank data, the conflict resulted in a productivity decline on two-thirds of the total cropland.[36]

At the same time, the war has resulted in a high number of unemployment forcing people to move from different economic sectors into agriculture as it is seen by many as only option to earn a living and improve their family’s food security. While a lot of the newly started agricultural ventures are small in scale and often limited to subsistence farming, other internally displaced persons were successful in starting micro, small and medium sized agricultural businesses. This demonstrates that a strong agricultural sector could rapidly absorb large amounts of labor and rebuild household economies while improving the overall food security situation in the country.

[36] http://documents1.worldbank.org/curated/en/181081539873944469/pdf/Summary-slides-on-food-availability-and-access-for-rural-households-in-Yemen-and-Djibouti.pdf

Still, the sector is suffering from a shortage of agricultural inputs, particularly seeds and fertilizers but also vaccines and feeds for the livestock and poultry sector. A water deficit and difficult access to water moreover means that farmers are highly dependent on water pumps. To purchase the necessary farm equipment and input, farmers are in dire need of finance, a need that has not remained unnoticed by FIs. Many MFIs and microfinance banks have developed new agricultural loan products and increased their agricultural loan portfolio in recent years. Asset finance products such as solar pumps and solar panels have proven particularly successful and the majority of FIs interviewed for this study indicated their plans and/or interest to increase their agricultural lending exposure due to the high demand in the sector.

Findings from the demand side survey however indicate that agricultural finance products currently offered by MFIs and microfinance banks need to become more targeted towards the specific needs of the sector. This is particularly evident in loan procedures – respondents from the agricultural sector in the survey mentioned that the time that it took to obtain a loan was a difficulty, in addition to collateral requirements and high interest rates. The fear of not being able to pay back was the highest in the agricultural sector. Some enterprises pointed out that there is a decline in loan access and that the acquisition of loans now takes longer than prior to the pandemic, even though the agricultural sector was the one least impacted by Covid-19.

Nonetheless, the agricultural sector has one of the highest potentials when it comes to financial services. More than 50% from the sector had taken more than one loan and 70% planned on taking one. The agricultural sector has a very high usage of working capital, fixed assets / equipment, and personal purpose loans. Additionally, current and saving accounts are least utilized in the agricultural sector, but equally as desired for future use as in other sectors, opening up an additional opportunity to be tapped into. However, in order to be able to take advantage of such opportunities, the difference in factors of importance when looking at financial institutions have to be considered. For example, the agricultural sector puts a high level of importance on the knowledge of the institution through previous loans or personal contacts than other business sectors. Agricultural customers are wider spread geographically, often less educated, with more irregular cash-flows and they have to deal with a number of agriculture-specific risks (such as weather). Those factors are important to consider for MFIs who intent to set up products and operations in the field of agricultural finance.

Resulting development need:

a) *Support MFIs/Microfinance banks in developing tailored agricultural lending products*: MFIs require support in market definition, market research, product prototyping, costing and pricing, pilot testing, rollout, marketing, lifecycle management and so forth and clarify the impact of introducing new products on the organization (human resources, corporate culture, operations and systems, financial results, and operating results)

4.1.3 Most customers cannot provide collateral

In the survey, 20% of the total respondents agreed that one of the main challenges remains the lack of collateral. This held especially true for the agricultural sector, where sufficient collateral is one of the main difficulties for MSMEs which want to obtain a loan. The most used collateral for loans remains guarantors. In rural areas, around one-quarter of respondents provided group collateral. Therefore, there is a need for loans that either lower the need for collateral (e.g. by deploying more solid assessment techniques) or are non-collateralized by customers (e.g. by deploying a credit insurance), particularly in the agricultural regions of the country.

Indeed, FIs in Yemen are usually reluctant to extend uncollateralised credit to MSMEs, even at high interest rates as it is very costly for the FI to obtain adequate information on the true credit quality of small and young companies. Also, FIs report that the lack of collateral is one of the key obstacles to providing finance to more people. Even before the war poor people often had difficulties providing the necessary collateral to secure a loan. This situation has only worsened as many Yemenis lost their property due to damage in the war or as they were forced to flee and leave their belongings behind. Making things worse, the destructions, internal displacements and loss of life during the war means that many (potential) borrowers no longer have guarantors or that their former guarantors are no longer eligible to secure a loan.

Well-designed credit guarantees can serve as a substitute for collateral and encourage FIs to provide finance to otherwise ineligible borrower by covering a share of the default risk. In 2017 the Social Fund for Development (SFD) established the Yemen Guarantee Program (YLGP) to facilitate access to credit to micro and small enterprises with insufficient collateral. Commercial banks, microfinance banks and MFIs can apply for partial credit guarantees under the program which specifically targets women and youth entrepreneurs. Our key informant interviews revealed that FIs generally view the introduction of YLGP as a positive development in the financial sector and that it has the potential to change the credit culture in the country. However, key informants also highlighted the limitations of the program, namely the limited geographical outreach and the focus on micro and small enterprises but not medium enterprises.

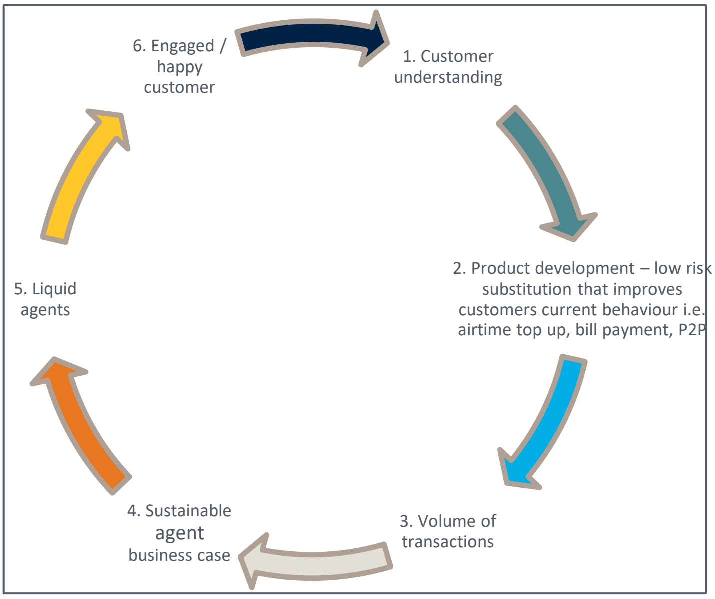
That said, we would like to highlight that the topics of credit insurances that replace collateral or lowering collateral requirements is deputable. While it has the potential to increase access to finance in environments where borrowers cannot provide sufficient collateral to finance their businesses, it opens up a complete set of risks linked to adverse selection and moral hazard.

Resulting development need:

a) *Refinance of YLGP*: The loan guarantee scheme supports borrowers who cannot provide sufficient collateral for the loans but has a limited outreach (in terms of geographical area and loan amount covered). In order to increase its current reach, the YLGP requires more funds, ideally combined with capacity building measures.

4.1.4 The (potential) role of mobile money and further financial sector innovations.

The security situation, bad road infrastructure and electricity problems make it impossible for banks to transport cash and open branches in all parts of the country. Mobile money services provided through agents are the logical response to these challenges, noting that there need to be a minimum infrastructure to facilitate agent liquidity management. Even though most KIIs agreed that the Yemeni financial sector lags in innovation comparing to other regions, there have been number of positive developments, the introduction of mobile money being the most recognizable and most promising one. The Central Bank of Yemen (CBY) with support from SFD and CGAP first introduced Mobile E-Money Service Circulation in 2014. The regulation is bank-led and only allows licensed financial institutions to introduce mobile money services.



Agents are the physical backbone of the Yemeni mobile money ecosystem as they play a key role in registering customers, educating them and facilitating cash-in and cash-out transactions (CICO). For most mobile money users, agents are the first and only point of interaction with the service, and thus a well-managed agent network is one of the basic prerequisites to achieve a "virtuous mobile money circle" which puts the customer at the heart of the mobile money ecosystem.

Currently, mobile money accounts and mobile wallets are quite uncommon when compared to traditional financial services such as current accounts. Nevertheless, in certain geographic regions, many MSMEs would like to use such mobile services. The demand side survey shows that while only 11% respondents are currently using mobile wallets, 42% want to use a mobile wallet in the future, hence pointing at a high unmet demand for the service in the market.

In order to tap into such innovations, certain barriers, mentioned in the interviews with medium-sized enterprises, have to be faced: lack of wide-spread availability, (perceived) lack of need, and particularly lack of knowledge. Additionally, the lack of Internet infrastructure, supporting digital financial services, also presents a challenge for those who need such services and would like to use them – a fact re-iterated during the focus group discussions.

Insurance services are another example of possible financial sector expansion of services. From the survey, usage of insurance services was extremely low, standing at below 1%. However, more than one-quarter of enterprises who participated in the survey, expressed desire to use such services in the future, meaning an expansion is possible and demanded. This demand comes mainly from semi-rural and urban regions. Among the types of insurance mentioned in the interviews with medium-sized businesses were disaster, asset, and personal and workplace insurance. Consequently, there is a need for an adoption of insurance services for customers to have a way to cope with the multitude of risks present in Yemen.

<u>Resulting development needs:</u>

a) *Awareness creation and financial education*: Even though, mobile money services are available and provide many benefits to FIs and end users, the uptake is still limited. This study reveals that one of the main impediments for the largescale adoption of mobile wallets is the limited awareness and understanding of the services. This can be addressed through targeted awareness creation campaigns on the use and benefit of mobile money among end users, merchants and agents are important. An awareness creation campaign should ideally be combined with basic financial literacy trainings.

b) *Training of agents*: Agents are the backbone and face of any mobile money ecosystem and can build or destroy the trust in the service Agents are the backbone and face of any mobile money ecosystem and can build or destroy the trust in the service. Therefore, improving overall agent management means investing in all steps of the interaction: 1) Identify (strategic locations / businesses), 2) recruit, 3) train, 4) brand 5) manage agents.

c) *Coordination between Banks and* MNOs: Increased coordination between banks and MNOs to target currently unserved user segments and maximize uptake. Banks and MNOs have different competitive advantages when it comes to mobile money services. The huge advantage of MNOs is their vast customer base. Strategic cooperation and coordination between banks and MNOs would provide banks with access to millions of more customers.
d) *Development of insurance products for MSMEs*

4.1.5 Challenges due to low financial literacy and consumer behavior

Our supply side study reveals that most FIs view limited financial and business management skills of MSMEs as a key challenge in their work. Limited financial literacy renders the business of MSMEs inefficient, non-transparent and susceptible to failures. It increases the information asymmetry between MSMEs and FIs as many MSMEs do not keep proper records. The low level of financial literacy means that it is difficult for many Yemenis to make informed judgments and effective decisions regarding the uptake, use and management of financial services, leaving them vulnerable to exploitation from unregulated financial services providers such as retailers and foreign exchange, more especially so in the absence of an effective consumer protection regime.

FIs noted a low repayment culture among some MSMEs, partly due to a “grant culture” resulting from the ongoing humanitarian and emergency support by international donors and NGOs, which requires the strengthening of systems to enforce loan repayments.

One of the main challenges for respondents remains the fear of not being able to pay back the borrowed amount. Both, respondents who viewed access to loans as easy and those who viewed it as difficult faced this challenge.

When it comes to financial literacy, mobile and digital financial services are widely unutilized because of a general lack of knowledge regarding those services. As shown by the LFS survey, especially the older groups and those less educated do not have sufficient knowledge to utilize such services. Additionally, lack of knowledge and understanding of mobile financial services became evident in the focus discussion groups.

Resulting development needs:

a) *Imbed basic financial literacy and entrepreneurship training as part of the MSME lending process*. Currently only few MFIs (such as Azal and Nama) provide financial literacy training services to MSMEs. They reported positive results. Building on existing initiatives such as the SFD business center, integrating financial literacy and business training in the lending process has the potential to address many of the before mentioned challenges.
b) *Public financial education* Simple but crucial information on the use of financial products and services can be spread to a wide audience using billboards, TV, radio, social media advertisement, TV shows, cooperation with musicians, roadshows and on digital platforms. Another way to address the financial literacy challenge is to include the basics of budgeting, managing risk, public money, insurance, savings and pensions, income and expenditure, credit and debt and financial products in the national curriculum. The Tanzanian National Financial Education Framework 2016 - 2020 championed by the Tanzania National Council for Financial Inclusion and the Financial Sector Deepening Trust, Tanzania (FSDT) provides a good reference

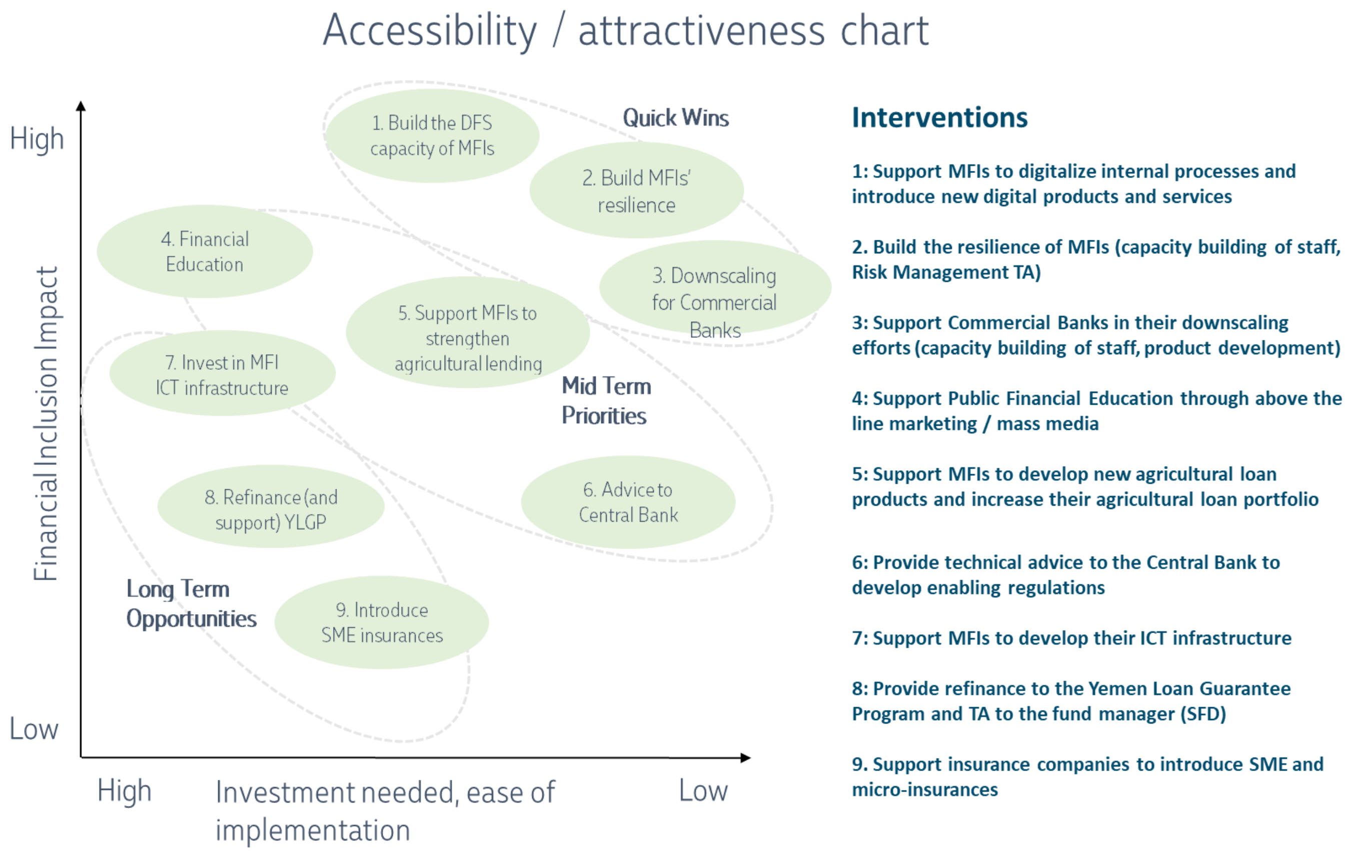
framework to improve the levels of financial capability in a country through changes of the formal curriculum and extra-curricular activities.

5 Recommendations

Based on the Development Needs Assessment, LFS Advisory has identified 9 areas of intervention that could strengthen the MSME finance sector. Figure 25 provides an overview of those proposed interventions and categorizes them according to their potential financial inclusion impact and investment needs, whereby:

- Financial inclusion impact means the potential of the investment or advisory opportunity to improve access to appropriate financial products and services for a maximum number of people.
- Investment needed considers the ease of implementation of monetary investment requirements, time required and the current readiness gap (how big is the gap between current and desired state).
- Quick wins are those opportunities which require a low level of investment and have a high potential to enhance financial inclusion in the country, making the opportunity highly accessible and highly attractive. These opportunities are depicted in the top right corner of the chart. Opportunities that require a high level of investment and have a moderate impact on financial inclusion are depicted in the bottom left corner.

Figure 25: Accessibility / attractiveness chart



Recommendations include:

1. The accessibility/ attractiveness chart shows that providing assistance to MFIs to digitalize their internal processes and introduce new digital products and services requires a relatively low level of investment but has the potential to greatly enhance financial inclusion in Yemen. Hence, the opportunity is classified as “quick win”. Starting with the definition of a digital strategy, the digital transformation of MFIs can create new revenue streams for MFIs and an increase in customer base whilst at the same time drastically driving down costs through the optimization and automation of processes (leading to greater efficiencies). Some Yemeni MFIs have successfully started to digitalize their agricultural lending activities but still have a great demand for further improvements, understanding that digital transformation is more than pointed interventions but a wholistic strategy to make an organization more customer centric. It must be noted that any digital transformation interventions must be in line with the overall capacity and existing information systems of the MFIs (see point 4).

2. Another quick win is an investment in the resilience of existing MFIs. Institutional strengthening, particularly risk management is still one of the major needs of MFIs in the country and a prerequisite to continued and responsible lending to MSMEs in Yemen in spite of the ongoing political unrest. This includes the further strengthening of MFIs risk

management and operations based on international best practices that need to be tailored to the reality on the ground. It also includes further training and coaching of senior staff and loan officers.

3. The third quick win is targeted support to commercial banks who are currently in the process of downscaling their lending operations or planning to do so. Specifically, this should include technical assistance to develop SME lending business case models, organization of SME loan departments, implementation of an appropriate lending technology for SMEs, definition of processes, product development, implementation of an appropriate MIS, training of management and loan officers, etc.

4. Investments in the ICT infrastructure of MFIs have the potential to significantly improve financial inclusion but can require significant funds. An ICT strategy and ICT investments should complement the digital transformation of the MFIs and, indeed are often a prerequisite for DFS interventions. Based on the MFIs' transformation strategy a "fit for purpose" ICT infrastructure needs to be identified which can include but is not limited to the Core Banking System (especially for larger MFIs) and the Information Management System of MFI. Focus should be on the flexible integration of new products and services, better data handling and increased transparency.

5. Supporting MFI to further strengthen agricultural lending and develop new agricultural lending and green finance products requires limited investments but has the potential to improve financial inclusion, making it a mid-term priority which should ideally complement the identified "quick wins". MFIs as well as Commercial Banks have increasingly invested in agricultural lending products in the past years often combined with green and asset finance (solar panels and pumps) but there is still a large unmet demand in the market.

6. The accessibility/ attractiveness chart shows that providing advice to the Central Bank is another mid-term priority. This intervention has a relatively high potential to enhance financial inclusion in Yemen, but the ease of implementation is rather low. Different KIIs highlighted that Yemen used to be a regional pioneer in introducing enabling regulations for the financial sector before the war. This changed with the war and the Central Banks currently lack the capacity to effectively regulate the financial sector. Targeted technical advice especially in the areas of digital finance and consumer protection could lead to a much more conducive environment for financial inclusion. The advisory services can be combined with study tours to other countries. However, the existence of two Central Banks means that interventions will be difficult to implement, take time to realize results and will be limited to certain governorates.

7. Making financial education a prominent part of the national curriculum and a large scale above the line media campaign with billboards, radio and TV adverts to increase awareness of financial services and consumer protection issues has the potential to greatly improve the financial literacy in the country and ultimately enhance financial inclusion. However, the causal link is not a direct one, the investment for this intervention is rather high and will take time to materialize, especially in the current political environment in the country resulting in a classification as a long-term opportunity.

8. The establishment of the Yemen Loan Guarantee Programme has been supported by various donors, including KfW. While achieving promising first results in facilitating access to finance to MSME with insufficient collateral, the reach of the programme is still limited. Scaling up the credit guarantee scheme requires significant investments but has the potential to provide access to finance to more MSME without collateral and is therefore categorized as long-term opportunity.

9. The Yemeni financial sector currently lacks insurance products for MSMEs. The availability of MSME insurances would not only mitigate the risk of MSMEs but also the risk of lenders and thereby encourage FIs to extend more credit to previously underserved segments. Hence an intervention in this area has the potential to increase financial inclusion in the country. However, the ongoing conflict and political instability make Yemen an extremely risky market to insurances and reinsurances to operate which makes any outside intervention difficult and costly. Furthermore, any intervention would need to be combined with financial education and/ or awareness creation as the current level of understanding of insurance services among the Yemeni population is very low.

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