YEMEN ECONOMIC BULLETIN:

BATTLE TO REGULATE BANKS THREATENS TO RUPTURE THE FINANCIAL SECTOR

By

THE SANA'A CENTER ECONOMIC UNIT

SANA'A CENTER FOR STRATEGIC STUDIES
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COVER PHOTO: A man exchanges money at Al-Hamdi Exchange Shop on Haddah Street in Sana'a on August 14, 2020. // Photo by Asem Alposi

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INTRODUCTION

The rival branches of the fragmented Central Bank of Yemen (CBY) have recently escalated their battle for control over access to data held by the country's commercial and Islamic banks and money exchange firms, threatening the viability of the financial sector overall and risking a broad spectrum of economic and humanitarian fallout. This struggle comes as the latest salvo in the years-long economic war between the Aden-based CBY, affiliated with the internationally recognized Yemeni government, and the Sana'a-based CBY, controlled by the armed Houthi movement, *Ansar Allah*, with the former holding international recognition and controlling Yemen's connections to global financial networks, while the latter controls the country's largest markets and financial center.

This year has seen the warring sides issue conflicting mandates to Yemeni banks and money exchange firms regarding data provision while escalating real and threatened punitive measures against them for non-compliance. A particularly intense escalation has occurred since September, with the increasingly hostile environment undermining financial sector actors' ability to remain operational.

THE ESCALATING BATTLE OVER BANK DATA

By law, Yemeni banks are required to regularly submit statements to the central bank, detailing such things as their assets and liabilities, local and foreign currency holdings, foreign currency trades, internal and external financial transfers, account openings and closings, import financing, and loans.[1] This data is meant to allow the central bank to ensure the banking sector is abiding by local laws and circulars, and also adhering to international regulations concerning anti-money laundering and combatting terrorism financing. Subsequent to Houthi forces taking over the capital, Sana'a, in 2014, the Yemeni government officially transferred the CBY headquarters to its interim capital, Aden, in 2016, meaning the CBY-Aden has since been legally entitled to collect the bank data and carry out the other primary functions of a monetary institution.

In January 2020, the Houthi authorities banned the country's financial institutions from continuing to transfer their monetary data to Aden. The Houthi leverage to enforce this action comes from the fact that Sana'a remains Yemen's economic hub, where 17 of the 18 banks currently operating in the country are headquartered, in addition to the country's largest money exchange companies – with the banking information system in Yemen being highly centralized in bank headquarters, which enjoy exclusive access to data and information of all affiliated branches. The majority of trade and financial activity is concentrated in Houthi-controlled territories (where the majority of the population resides), along with some of the country's biggest traders, who are major clients and shareholders in the banks headquartered in Sana'a.

At the same time, the CBY-Aden has seen its ability to fulfill its monetary mandates erode. It lost its regular access to bank data, which would enable CBY-Aden to maintain a constant tracking of different financing sources available to banks, to whom they are channeled, and how they are utilized. The US$2 billion

1) According to Article (28) of the Law No. 38 in 1998, every bank must send to the central bank, no later than the fifteenth day of the following month, a statement according to a form approved by the central bank, showing its assets and liabilities including its branches and offices in Yemen, in addition to analyzing advances, discounted bills and other assets as it is at the end of the last day of the previous month and the analysis of foreign exchange operations during the same month. Moreover, this Article gives the central bank the right to occasionally ask for any data and information from Yemeni banks when it deems necessary.

that Riyadh supplied the Yemeni government for financial support in 2018 has been nearly exhausted this year, hindering the CBY-Aden's ability to finance essential imports, while the Houthi ban on newly printed banknotes issued from Aden, implemented in January 2020, has seen these bills flood into Yemeni government-controlled areas. Both factors have undermined the CBY-Aden's ability to contain the pace of rial depreciation in Yemeni government-controlled areas. A compounding factor has been the increasing challenges to the authority of the Yemeni government and CBY-Aden in southern Yemen from rivals within the anti-Houthi coalition, namely the Southern Transitional Council (STC).

In March 2020, the International Monetary Fund (IMF), as it periodically does, requested data on Yemen's formal banking sector, which the CBY-Aden was able to provide through the end of 2019. In an unsuccessful attempt to force financial institutions to resume providing data for 2020, in June the CBY-Aden began leveling fines against banks and money exchange outlets, according to the Yemen Banks Association (YBA).

In September the CBY-Aden postponed a scheduled meeting with the IMF,[2] following which it redoubled efforts to impose its purview over the country's financial sector by renewing calls for Yemeni commercial, Islamic, and microfinance banks and money exchange outlets to share their data, or face reprisals. Banking officials close to the proceedings, who were not authorized to speak publicly, told the Sana'a Center Economic Unit that CBY-Aden followed up on this threat in October by referring the boards of directors and executive managers of three banks – International Bank of Yemen (IBY), Yemen Kuwait Bank (YKB), and the Yemen Bank for Reconstruction and Development (YBRD) – to the public prosecution office in Aden for failing to provide their transaction and operations data. As of the third week of November, conflicting reports have emerged over whether a travel ban had been imposed on the executives and board members.[3]

Simultaneously, the Houthi authorities sought to buttress their own clout over the financial sector and further weaken the Yemeni government's claim to authority. At the end of September, the CBY-Sana'a ordered Al Kuraimi Islamic Microfinance Bank to close its headquarters in Sana'a and all branches operating in Houthi-controlled areas. Al Kuraimi branches reopened on October 1 after the bank committed to refrain from disclosing data to the CBY-Aden and paid a 1

2) Interviews with staff at CBY-Aden and CBY-Sana'a, November 16, 2020, and officials with the IMF, November 19, 2020.

3) Interviews with senior banking officials closely monitoring the case being brought against IBY, YKB, and YBRD on November 24, 2020; per a joint letter that the YBA and YEA submitted to the IMF during the third week of November 2020.

billion Yemeni rial fine to Houthi authorities.[4]

With their member institutions seemingly under siege from both sides, the YBA and Yemeni Exchangers Association (YEA) held discussions with the central bank administrations in Sana'a and Aden in an attempt to create a neutral space for financial sector actors to operate. These efforts failed. Speaking to the Sana'a Center, YBA officials said they had also appealed to the United Nations to intervene with the two rival parties, but to no avail. In a statement on November 3, the YBA then laid out a series of escalatory steps it would take to try and bring the warring parties to compromise, starting with a partial bank strike in Aden for three hours per day for three days and, in the event this failed, a comprehensive strike for all banks in all governorates that would last until their demands were met.

In a follow-up November 7 statement, the YBA proposed steps to deescalate the central bank standoff and avoid a bank strike. These entailed banks and exchange companies committing to provide the CBY-Aden with detailed data regarding customers and operations only in areas of Yemen outside of Houthi control, in return for which the CBY-Aden would cease all punitive measures against them, including fines for noncompliance. The statement said that the bank strike would begin the next day if there was no compromise to end the standoff, though the YBA subsequently backed down on this threat.

During the second week of November, the Houthi-run Security and Intelligence Bureau (SIB), upon orders from the CBY-Sana'a, forced the headquarters of Tadhamon Bank in Sana'a to close in retaliation for the bank sharing its data with CBY-Aden. After entering the Tadhamon headquarters, SIB officials ordered bank employees to vacate the building, turned off the servers and security cameras, and subsequently occupied the premises for several days as the bank suspended operations.[5] CBY-Sana'a then ordered Yemeni banks to cease their respective banking operations in Aden, prompting the CBY-Aden to send Yemeni government security forces to detain eight Yemeni bank branch managers in Aden for 24 hours.[6]

4) "The first statement from Al Kuraimi bank after the Houthi closed all the bank's branches," Al Mashad Al Yemeni, Oct 1, 2020, https://www.almashhad-alyemeni.com/180488

5) Saeed al-Batati, "Yemeni bank reopened after Houthi raid in Sanaa," Arab News, November 15, 2020, https://www.arabnews.com/node/1763551/middle-east

6) Interviews with senior Yemeni banking officials based in Aden, November 13 and 16, 2020.

A CONTEST FOR CONTROL OVER FOREIGN AID FUNDS

The banks most directly targeted with actions by both rivaling central bank branches suggests that control over foreign currency entering Yemen, and in particular foreign aid funds, is a significant motivating factor in the rapidly escalating standoff over the country's banking sector. IBY – the country's largest bank controlling roughly 20 percent of total banking sector assets[7] – Al Kuraimi, YKB and Tadhamon Bank are the Yemeni banks most actively involved in exchanging foreign currency on behalf of UN agencies and INGOs and paying out humanitarian cash transfers, via intermediary financial agents, to intended beneficiaries in Yemen. Meanwhile, YBRD, which is 51 percent government owned, historically attracts a large share of foreign currency deposits accumulated abroad by migrant Yemeni workers.

Since late 2016, when Yemen's central bank headquarters was officially moved from Sana'a to Aden and the Yemeni government instructed central and commercial banks around the world to cease interacting with the CBY-Sana'a, direct wire transfers from western banks to Yemen have not been possible. Instead, foreign donors seeking to finance operations in Yemen have had to access the country's financial system through intermediary banks abroad where Yemeni commercial banks hold accounts. A donor would deposit hard currency into one of these accounts and in return a branch of the respective commercial bank in Yemen would disperse Yemeni rials, exchanged at an agreed exchange rate, to the appropriate recipient.

Yemen has suffered from a shortage of foreign currency for most of the ongoing conflict, heavily impacting the country's ability to finance imports, putting downward pressure on the domestic currency, and making the accumulated stocks of foreign currency from donors and how they have been used a contentious question. The answer has been elusive, however, given the lack of a joint transparent mechanism to track all donor funds and the inability of the bifurcated CBY to effectively regulate Yemen's financial institutions. ACAPS, the

7) Total banking sector assets amount to roughly YR3.618 trillion, of which IBY holds YR713 billion. The second largest bank in terms of assets is Tadhamon Islamic Bank with YR557 billion in assets.

humanitarian analysis project, estimated that 80 percent of humanitarian aid funds directly flowing into and disbursed across Yemen in 2018 were managed through financial institutions located in areas under Houthi control, home to the majority of the population and most of those in need of humanitarian assistance.[8]

Since 2018, the CBY in Aden has been calling for the establishment of a new foreign exchange mechanism through which INGOs and foreign donors would transfer aid funds under the CBY-Aden's supervision. In 2019, the Yemeni government-affiliated Economic Committee accused the Houthi authorities in Sana'a of embezzling funds from foreign exchange transactions and financial aid transfers to fund their war efforts.[9]

In 2020, Yemen's foreign currency shortage has become rapidly more acute, with regional economic contraction leading to a dramatic decline in remittances from Yemenis abroad, international donor funding for the relief effort similarly plummeting, while the US$2 billion in Saudi support supplied in 2018 is effectively exhausted. The internationally recognized Yemeni government is also contending with a drop in revenue and foreign currency inflows from crude oil exports, owing to the drop in global oil prices in March and April 2020. The challenges for the Yemeni government and the CBY-Aden were compounded in April 2020, when the STC's declaration of self-rule across southern Yemen triggered widespread security instability and further weakened the Yemeni government's authority to rule. The insecurity in the interim capital temporarily forced some qualified government employees hailing from northern regions to leave Aden, including from the central bank. The CBY-Aden has thus experienced a drastic deficiency in its overall capacity to exercise basic monetary functions, such as maintaining price stability and supervising banking operations. This weakness has made it difficult for the CBY-Aden to bring the commercial banks back under its authority.

8) "Volatility of the Yemeni Riyal," ACAPS Yemen Analysis Hub, January 2020, https://www.acaps.org/sites/acaps/files/products/files/20200129_acaps_yemen_analysis_hub_drivers_and_impact_of_yer_volatility_0.pdf

9) "Humanitarian Economics - Yemen", Economic Committee Yemen, 2019, https://ecyemen.com/uploads/2019/07/The-impacts-of-economy-on-yemen-lastv-converted.pdf

IMPLICATIONS AND FUTURE SCENARIOS

Possible future action and responses from CBY-Aden and CBY-Sana'a

In the immediate term, CBY-Aden and CBY-Sana'a need to evaluate the proposal the Yemen Banking Association (YBA) submitted in early November. The central component of the proposal looks to secure a compromise in which Yemeni banks would limit the amount of monetary data they share with CBY-Aden to information that concerns banking activity in areas nominally under the government's control. Doubts remain over whether CBY-Aden or CBY-Sana'a will agree to this arrangement. The YBA and Sana'a-based YEA recently submitted a joint letter to the IMF, raising their concerns over the actions being taken by CBY-Aden and their potential impact on the formal banking sector.[10] This proposed solution to the banking crisis, formulated under pressure from Houthi authorities, ignores any issues of legitimacy and instead would instill a de facto division of authority and economic and financial capacities between Houthi- and government-held areas.

For CBY-Aden, acceding to the proposal would represent an acceptance of its currently limited capacity to access monetary data and implement its monetary policies nationwide. For CBY-Sana'a, the temptation may well be to continue insisting that Yemeni commercial and Islamic banks and money exchangers do not share any monetary data with CBY-Aden, viewing that this would not only undermine CBY-Aden from a domestic banking supervision perspective, but could also prompt a shift in the contrasting international status for both central banks. International actors may seek to increase engagement with CBY-Sana'a in view of obtaining monetary data that CBY-Aden is less equipped to provide.

Another outstanding issue that YBA sought to address when consulting with CBY-Aden concerned the potential imposition of daily fines accumulated by the three banks currently on trial in Aden. In accordance with Commercial Bank Law No. 38 of 1998, YKB, IBY, and YBRD are liable to pay the daily fines (between 51,000-100,000 Yemeni rials) that CBY-Aden have been calculating since June

10) Per a copy of the letter shared with the Sana'a Center on November 23, 2020.

2020 for the banks' failure to provide monthly monetary data. The YBA would like CBY-Aden to suspend the imposition of these fines. Meanwhile, according to the law, if no agreement to correct the violations is reached, the central bank retains the right to reorganize the banks and even liquidate their assets in a worst-case scenario.

While CBY-Aden is likely to insist on the payment of fines, it is unlikely to suspend the licenses for the three banks in question or make any moves toward liquidating assets. Such a move would put the banks in a very difficult position and could prompt further retaliation from security authorities in Sana'a akin to the measures taken against Tadhamon Bank. CBY-Aden finds itself in a difficult position, constrained not least because of the internal capacity issues that the bank has struggled to address since President Abdo Rabbu Mansour Hadi ordered the relocation of CBY headquarters from Sana'a to Aden in September 2016. Moreover, CBY-Aden is operating in an unstable political environment amid the entrenchment of the STC's hold over the government's interim capital Aden since August 2019 and the lack of progress over the implementation of the Riyadh Agreement, the unimplemented deal intended to halt the conflict in southern Yemen. Furthermore, CBY-Aden is under financial constraints due a lack of foreign currency resources and the depreciation of the Yemeni rial in government-controlled areas. CBY-Aden will thus need to be cautious about how it proceeds to prevent further weakening of the economy in areas nominally under government control.

The Houthis and CBY-Sana'a may continue warning financial sector actors against sharing monetary data with CBY-Aden, seeking to undermine the position of CBY-Aden in front of international actors. In this scenario, CBY-Aden would presumably look to respond with a confrontation approach, as is true to form within the embroiled and embittered economic warfare between the government and the Houthis. CBY-Aden may consider suspending the SWIFT for the three banks currently on trial, possessing the legal tools to take such action inlight of the failure of three banks to provide any data to CBY-Aden. Per the Commercial Bank Law no.b 38 of 1998, CBY-Aden can escalate its response from the imposition of fines against the banks after 30 days of having notified the banks in question of future escalatory measures. In addition to the suspension of the three banks' access to SWIFT, CBY-Aden could theoretically take over the management of these banks.

Based on past precedence with the Cooperative Credit and Agricultural Bank (CAC Bank), the government and CBY-Aden may look to transfer the headquarters of the YBRD from Sana'a to Aden and appoint a new executive management team (both banks are majority government-owned).[11] Further drawing on what occurred with CAC Bank in February 2019, the next plausible step for the government would be to reallocate the SWIFT currently used for YBRD in Sana'a to the new headquarters in Aden.

The outlook for the banking sector as a whole

The latest chapter in competing attempts to exert authority over the formal banking system is symptomatic of the broader economic warfare that is occurring between the government and the Houthi movement. Both sides look to use their respective CBY headquarters to draft and implement competing monetary, fiscal and economic policies as well as conflicting banking and trade regulations. As a result of this schism over the past four years, Yemen and its economy became increasingly fragmented as well as increasingly politicized.

The constrained and heavily politicized domestic operating environment compounds macroeconomic challenges that Yemeni commercial, Islamic, and microfinance banks already face during the conflict. Such challenges include: difficulty accessing foreign currency and formal regional and international financial networks, owing to the categorization of Yemeni banks as "high-risk" in 2015; a severe liquidity crisis, with assets, principals, and interest rates written out on public debt instruments (treasury bills, government bonds, Islamic sukuks) remaining largely frozen and non-paid, resulting in a shrinking customer base; senior staff regularly detained by de facto authorities for banking compliance-related issues; and increased vulnerability to money laundering and terrorism-financing risks.

The further politicization of the banking sector over the sharing of monetary data will arouse additional concern among external actors. First, it may reduce the chances of Yemeni banks being able to challenge their "high-risk" classification.

11) Farea al-Muslimi, "Revitalizing Yemen's Banking Sector: Necessary Steps for Restarting Formal Financial Cycles and Economic Stabilization," The Sana'a Center for Strategic Studies, February 15, 2019, https://sanaacenter.org/publications/analysis/7049

Lack of transparency over monetary data and the level of political interference is unlikely to help the case of Yemeni banks when it comes to trying to demonstrate their commitment to addressing any concerns over money laundering. Incidentally, it is plausible that both the Houthis and the government may look to defend any questionable past or future actions taken against certain banks on the grounds that they are demonstrating their commitment to anti-money laundering measures. The Houthis adopted this narrative when they released a statement in response to the actions taken against Tadhamon Bank.[12] Second, there may be a drop in the level of confidence and trust among exporters and other external service providers (e.g. shipping companies, correspondent banks etc.) toward Yemeni banks, which could negatively impact trade – specifically imports to Yemen).

The conflict over financial data also has wide-ranging and fundamentally destabilizing implications for Yemen's ongoing economic and humanitarian crises. Without a resolution to deescalate the standoff and allow financial sector actors to, as much as possible, resume normal operations, the country is likely to see further distortion of the monetary cycle, increased black market economic activities, an accelerated rial depreciation (particularly in government-held areas), and a dual financial system arising at the bank level, all of which will have further cascading effects that will impede humanitarian agency operations and deepen the economic crisis at large.

12) "Sana'a Central Bank reveals the reasons for closing Al-Tadhamon Islamic Bank," Yemen al-Ghad, November 16, 2020, https://yemenalghad.net/90425/

URGENT INTERVENTION REQUIRED FROM INTERNATIONAL ACTORS

As the Sana'a Center has argued before, the international community must elevate the importance of the economy in its Yemen policy immediately, starting with increasing political pressure on the Houthis and the government to halt the current escalation and battle for control over Yemeni banks and money exchange outlets. Neither side has shown a willingness in the past, or can be expected in the future, to act responsibly and in the best interest of the overall economy and the broader population. If the warring parties are left to their own devices, the economic warfare will only continue to escalate and the economy will continue to fragment. The longer this goes on, the more difficult the damage will be to undo. While the military conflict has claimed many lives and caused significant destruction to the country, it is the economic warfare that has a wider, and arguably more devastating, impact on the population and the country as a whole.

Until now, it would appear that more concerted and coordinated action on the economy is on hold until there is a comprehensive political settlement to the conflict. However, there needs to be a greater acceptance among external actors that war looks set to continue, and therefore, action must be taken to find temporary yet critical solutions to the multiple problems that Yemen faces while the wait for a peace agreement goes on.

A new framework must be established to address Yemen's economic woes. For the different external actors that are actively engaged on Yemen's economy, and in direct communication with different Yemeni economic stakeholders, there needs to be more coordinated action, rather than the piecemeal approach adopted until now. The UN Special Envoy, the Office of the Special Envoy of the Secretary-General for Yemen, the Yemen Quad (US, UK, Saudi Arabia, and the UAE), the European Union, the World Bank, and the International Monetary Fund, among others, need to ramp-up efforts and coordination to address the burgeoning economic issues in Yemen. A division of labor and acknowledgment of what different external actors can and are willing to do is essential. It is also critical that international actors continue to engage with and seek input from local economic actors, institutions, and groups. Where possible, local mediation efforts and the continuation of open lines of communication between public and private sector actors that straddle the gulf between the two competing sides should be supported and utilized.

Editor's Note: *A previous version of this bulletin stated that meetings between the IMF and representatives of the CBY-Aden and CBY-Sana'a were held in September 2020. These meetings did not take place. The Sana'a Center regrets the error.*

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

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